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Performance Audit

Preparation of the Tax Expenditures Statement

Department of the Treasury
Australian Taxation Office

Australian National Audit Office

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Canberra ACT
9 May 2013

Dear Mr President
Dear Madam Speaker

The Australian National Audit Office has undertaken an independent performance audit in the Department of the Treasury and the Australian Taxation Office in accordance with the authority contained in the *Auditor-General Act 1997*. Pursuant to Senate Standing Order 166 relating to the presentation of documents when the Senate is not sitting, I present the report of this audit to the Parliament. The report is titled *Preparation of the Tax Expenditures Statement*.

Following its presentation and receipt, the report will be placed on the Australian National Audit Office's Homepage—http://www.anao.gov.au.

Yours sincerely

Ian McPhee
Auditor-General

The Honourable the President of the Senate
The Honourable the Speaker of the House of Representatives
Parliament House
Canberra ACT

AUDITING FOR AUSTRALIA

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Abbreviations

ABS	Australian Bureau of Statistics
AFTS	*Australia's Future Tax System*, Report to the Treasurer (also known as the Henry review), December 2009
ANAO	Australian National Audit Office
ATO	Australian Taxation Office
BPORs	Budget Process Operational Rules
CGT	Capital Gains Tax
Charter of Budget Honesty	*Charter of Budget Honesty Act 1998*
COAG	Council of Australian Governments
ERC	Expenditure Review Committee
Finance	Department of Finance and Deregulation
GDP	Gross Domestic Product
GFS	Government Finance Statistics
GST	Goods and Services Tax
IMF	International Monetary Fund
JCPAA	Joint Committee of Public Accounts and Audit
Murray Review	Senator Andrew Murray, *Review of Operation Sunlight: Overhauling Budgetary Transparency*, June 2008
MYEFO	Mid-year economic and fiscal outlook
OECD	Organisation for Economic Co-operation and Development

TES	Tax Expenditures Statement
The Treasury	Department of the Treasury
2008 ANAO audit	ANAO Audit Report No.32 2007–08, *Preparation of the Tax Expenditures Statement*

Glossary

Budget Process Operational Rules	Standing rules endorsed annually by Cabinet that set out the major administrative and operational arrangements that underlie the management of the Australian Government Budget process.
Operation Sunlight	The Government's reform agenda to improve the openness and transparency of public sector budgetary and financial management, and to promote good governance practices.
PRISMOD	The 'Price, Revenue, Incidence Simulation Model' is a large scale, disaggregated model of the Australian economy using national accounts data from the Australian Bureau of Statistics, that is used by the Department of the Treasury.
Tax benchmark	The 'standard' tax treatment applied. It includes the rate structure, accounting conventions, deductibility of compulsory payments, provisions to facilitate tax administration, and international fiscal obligations.
Tax expenditure	A provision of the tax law that provides a benefit to a specified activity or class of taxpayer that is concessional when compared to the 'standard' tax treatment that would apply.

Summary and Recommendation

Summary

Introduction

1. Tax expenditures are, broadly, tax concessions that fall outside a tax norm or benchmark.[1] They can include tax: exemptions (amounts excluded from the tax base); deferrals (delays in paying tax); deductions (which reduce total assessable income); or offsets (which directly reduce the amount of tax payable). Tax expenditures are used by governments to promote particular policy objectives and provide an alternative mechanism to direct expenditures.[2] As such, they have an effect on the Budget position like that of direct expenditures. Alternatively, they may be viewed as opportunity costs, which impact revenues that if collected would be available to fund other government policies and/or improve the Government's Budget position.

2. Reporting of tax expenditures is required under the *Charter of Budget Honesty Act 1998* (Charter of Budget Honesty). The Department of the Treasury (the Treasury) commenced the annual publication of a separate Tax Expenditures Statement (TES) in 1987, and has prepared a statement for each year (except for 1999–2000) up to and including 2012. The TES contains details of each of the tax expenditure items, and where possible reports the estimated value or order of magnitude of the benefit to taxpayers over an eight-year period, as well as the reliability of the estimate.

3. The TES includes both new and modified tax expenditures. New tax expenditures arise from measures that were announced since the previous TES up to the date of the most recent *Mid-Year Economic and Fiscal Outlook*, and items recently identified as tax expenditures. Modified tax expenditures refer to existing tax expenditures that have changed materially, for example because of a change to the benchmark, a decision to remove a tax expenditure in a certain year, an amalgamation or split of tax expenditures, or the inclusion of a new element to an existing tax expenditure. The annual TES gives Parliament and the general public the opportunity to examine existing tax expenditures.

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1 ZL Swift, H Polackova Brixi, and C Valenduc, 'Tax Expenditures: General Concept, Measurement, and Overview of Country Practices', in H Polackova Brixi, C.M.A Valenduc, ZL Swift (eds.): *Tax Expenditures-Shedding Light on Government Spending through the Tax System: Lessons from Developed and Transition Economies*, The World Bank, Washington D.C., 2004, p. 3.

2 Direct expenditures include for example, grants, or the purchase of goods and services by the government.

4. In 2011–12, Commonwealth tax expenditures were estimated at $111 billion, or around 7.6 per cent of GDP.[3] Taxation revenue reported by the Australian Government in 2012 amounted to $316.5 billion.[4] The number of tax expenditure items has increased in recent years, from 272 in TES 2006, to 364 in TES 2011 and to 363 in TES 2012. The largest measured tax expenditure items in TES 2012 related to the: concessional taxation of superannuation (two items together estimated at $30.3 billion); concessional capital gains tax treatment of owner-occupied housing (two items together estimated to provide a benefit to taxpayers of $30.0 billion); and the Goods and Services Tax exemption on food items prepared and/or consumed at home (estimated at $6.2 billion).[5]

5. The Treasury stated in TES 2012 that the statement is an integral component of the Australian Government's Budget reporting, and serves three key functions:

> to allow tax expenditures to receive a similar degree of scrutiny as direct expenditures; to allow for a more comprehensive assessment of government activity; and to contribute to the design of the tax system, by promoting and informing public debate on all elements of the tax system.[6]

Previous reviews of Commonwealth tax expenditures

6. In May 2008, ANAO tabled an audit of the *Preparation of the Tax Expenditures Statement*.[7] The objective of this audit was to assess the completeness and reliability of the estimates reported in TES 2006. Consistent with a suggestion of the Senate Standing Committee on Finance and Public Administration's March 2007 report (*Transparency and accountability of Commonwealth public funding and expenditure*)[8], the ANAO audit also examined opportunities for greater transparency in the reporting of tax expenditures.

7. The 2008 audit report concluded that: the Treasury had not yet found a way to integrate the reporting of outlays and tax expenditures; tax expenditures had not been treated consistently with outlays within Budget

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3 Department of the Treasury, *Tax Expenditures Statement 2012*, p. vii.

4 *Consolidated Financial Statements for the year ended 30 June 2012*, p. 35.

5 In TES 2012, tax expenditures are ranked in size using 2012–13 estimates.

6 Department of the Treasury, *Tax Expenditures Statement 2012*, p. 14.

7 ANAO Audit Report No.32 2007–08, *Preparation of the Tax Expenditures Statement*.

8 Senate Standing Committee on Finance and Public Administration, *Transparency and accountability of Commonwealth public funding and expenditure,* March 2007, p. 33.

processes; and the measurement, monitoring and reporting of tax expenditures through the TES could be improved. Against this background, the audit commented that the ongoing review of tax expenditures would be beneficial.[9] The audit made six recommendations (outlined in Appendix 2) directed at improving the quality of information relating to tax expenditures over time through regular review and evaluation of tax expenditure items, and improvements to the data and reliability of the models used to quantify tax expenditures. The recommendations were agreed, or agreed with qualification—by the Treasury for each recommendation, and by the ATO in response to two recommendations.[10]

8. The Joint Committee of Public Accounts and Audit (JCPAA) conducted an inquiry into the above-mentioned audit in September 2008, and released its report in June 2009.[11] The JCPAA report made three recommendations (outlined in Appendix 3), aimed at enhancing the Treasury's reporting of tax expenditures in the annual TES, including through: the publication of revenue gain estimates; investigating other models of reporting; and including information in the Budget Papers on the extent to which tax expenditure reporting had improved through the receipt of reliable data from other agencies. The Treasury's response to the Chair of the Committee in December 2009 indicated it had implemented two of these recommendations and had taken steps towards implementing the third.

9. Other Australian Government inquiries have also commented on the tax expenditure reporting and management framework. Specifically, the review by the then Senator Andrew Murray in June 2008[12], as part of *Operation Sunlight* reforms[13], encouraged the Government to adopt and implement the recommendations of the 2008 ANAO audit of tax expenditures. In addition, the review of *Australia's Future Tax System*[14] in December 2009, which considered how Australia can best structure its tax and transfer system into the future, made four recommendations relating to the tax expenditures

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9 ANAO Audit Report No.32 2007–08, *Preparation of the Tax Expenditures Statement*, pp. 12–13.

10 The ATO responded to Recommendation No's 4(b) and 6(a), (b), (c) and (d).

11 Joint Committee of Public Accounts and Audit, Report 414, *Review of Auditor-General's Reports tabled between August 2007 and August 2008*, June 2009.

12 Senator Andrew Murray, *Review of Operation Sunlight: Overhauling Budgetary Transparency*, June 2008.

13 *Operation Sunlight* is the Government's reform agenda to improve the openness and transparency of public sector budgetary and financial management and to promote good governance practices.

14 *Australia's Future Tax System, Report to the Treasurer*, December 2009.

framework. These covered the treatment of tax expenditures in the Budget, the need for amendment of the Charter of Budget Honesty, the development of reporting standards for tax expenditures and state government reporting of tax expenditures.

Audit objective and scope

10. The objective of this audit was to assess the extent to which the Treasury and the ATO have improved the management of tax expenditure estimates by implementing the six recommendations in the 2008 ANAO audit and the three recommendations made by the JCPAA following its inquiry.[15]

11. The audit examines developments from May 2008, when the original audit tabled, to the release of TES 2011, in January 2012.[16] The audit mainly focuses on the Treasury, which has primary responsibility for preparing Budget documentation on tax expenditure estimates and coordinating the publication of the TES. The ATO was also included in the audit because of its role in developing the tax expenditure models, and a number of the 2008 audit recommendations involved the ATO.

Overall conclusion

12. Tax expenditures are revenues a government forgoes in pursuit of its policy objectives, including its medium-term fiscal strategy. Tax expenditures have been an important part of the Australian income tax system since the early 1900's, when tax exempt invalid and old age pensions were introduced.[17] In some areas, such as the retirement income system, they are heavily integrated into the Government's policy framework.[18] The number and aggregate value of tax expenditures have increased substantially over time and were estimated in 2011–12 to be around $111 billion. This represents a significant level when viewed in the context of the Australian Government Budget.

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15 Joint Committee of Public Accounts and Audit, Report 414, *Review of Auditor-General's Reports tabled between August 2007 and August 2008,* June 2009.

16 TES 2011 is the focus of this audit report. However, TES 2012 was released in January 2013, after ANAO had completed its fieldwork and analysis, and the report includes some high-level information from TES 2012.

17 K Sadiq, 'Tax Expenditures as Part of Australia's Retirement Income System: The Elevation from "Disguised" Expenditures to Architectural Pillars of the 21st Century', in L Phillips, N Brooks and J Li. *Tax Expenditures: State of the Art*, Selected Proceedings of the Osgoode 2009 Conference, Canadian Tax Foundation, 2011, p. 13:3.

18 ibid., p. 13:10.

13. The ANAO's 2008 audit and subsequent JCPAA review[19] encouraged improvements to the administration of tax expenditures through better integration of tax expenditures into the Budget process, systematic review to ensure that tax expenditure items continue to meet their intended objectives and improved reporting in the annual TES.[20] Progress by the Treasury and the ATO in implementing the recommendations in the 2008 audit and JCPAA review has been slow. Treasury advised that, facing reduced resourcing, it has focussed on providing advice on the Government's key revenue priorities, as well as servicing the review of Australia's future tax system and other key reviews.

14. Of the recommendations in the 2008 audit and JCPAA review, only two ANAO recommendations have been fully implemented.[21] The remaining recommendations, which continue to be relevant, have only been partially addressed. The status of the recommendations that have not been fully implemented is as follows:

- processes have been put in place to better integrate tax expenditures into the Budget process, although there is the potential to increase the quantification of tax expenditures resulting from new policy proposals in the relevant Budget Papers (relating to ANAO Recommendation No. 2);
- the systematic review and evaluation of tax expenditures on an ongoing basis commenced in 2008 but ceased in 2011, without publicly reporting the results (relating to ANAO Recommendation No. 1);
- the Treasury has not advanced the development of standards or pursued international methods of reporting (relating to ANAO Recommendation No. 3 and JCPAA Recommendation No. 8); and

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19 ANAO Audit Report No.32 2007–08, *Preparation of the Tax Expenditures Statement* and Joint Committee of Public Accounts and Audit, Report 414, *Review of Auditor-General's Reports tabled between August 2007 and August 2008*, June 2009.

20 ANAO's findings were supported in Senator Andrew Murray's June 2008 report *Review of Operation Sunlight: Overhauling Budgetary Transparency.* The review of *Australia's Future Tax System* was also supportive of selected ANAO recommendations.

21 These recommendations were ANAO Recommendations Nos 4 and 5. ANAO Recommendation No. 4 relates to promoting more comprehensive reporting of tax expenditures by liaising with Commonwealth entities to identify all entities that potentially administer tax expenditures, and developing arrangements to obtain relevant data from entities outside the Treasury portfolio. ANAO Recommendation No. 5 relates to reporting selected tax expenditures using the revenue gain method. This method measures how much revenue could increase if a particular tax concession was removed, seeking to account for the behavioural changes of taxpayers. The Treasury has partially met related JCPAA Recommendation No. 7, to include in the TES the 20 largest tax expenditures using both the revenue gain and revenue forgone methods. ANAO Recommendation No. 6(b), relating to the disclosure of reliability of tax expenditure estimates has also been implemented.

- there has been no measurable improvement to the reliability and quantification of the Treasury's tax expenditure estimates over time (relating to ANAO Recommendation No. 6(a) and 6(c), and JCPAA Recommendation No. 9).

15. Changes to Budget operating rules have been made to assist the integration of tax expenditures into the Budget process.[22] Since September 2009, the Expenditure Review Committee of Cabinet (ERC) is the only committee that can formally recommend any new spending or tax expenditure proposals to Cabinet[23], unless the Prime Minister agrees otherwise. This change promotes greater scrutiny of tax expenditures, by assisting in integrating the consideration of revenue measures, outlays and tax expenditures in the annual Budget process. However, in practice, there are a number of arrangements in place for considering and approving tax expenditures relating to new policy proposals in the Budget process.

16. For TES 2011, 24 of the 45 tax expenditure items associated with new policy proposals were considered by the ERC. The other items were considered through: correspondence (such as between the Prime Minister and Treasurer), or by the Cabinet (and not the ERC); and are often associated with a broader package of Government revenue measures, or revenue and expense measures. These arrangements reflect the nature of government, where there will be times when matters are considered outside the normal committee processes of Cabinet. However, extensive use of such arrangements can detract from the goal of achieving better integration of tax expenditures in the Budget process. Further, the capacity for meaningful scrutiny in the Budget process is diminished when estimates of the value of tax expenditures are not provided. Of the 45 tax expenditure items resulting from new policy proposals in TES 2011, only 23 were explicitly quantified in the relevant Budget Papers.

17. Unlike government outlays, once introduced, tax expenditures are not subject to ongoing Parliamentary scrutiny through appropriation bills. Therefore, it is important that other government processes are in place to assess whether tax expenditure items have been achieving their policy objectives, and to compare the estimated and actual uptake of the measure. The Treasury commenced systematically reviewing tax expenditures in

22 These rules are endorsed by the Cabinet.

23 The Budget operating rules for September 2009 also included the Strategic Priorities and Budget Committee but the rules for later Budgets did not reference the Strategic Priorities and Budget Committee.

September 2008. However, these reviews ceased in early 2011, with only 31 per cent of the tax expenditure items in TES 2011 being reviewed. No further separate tax expenditure reviews have been undertaken, although some analysis has been conducted of tax expenditures as part of various Budget savings measures.[24] Re-establishing a priority-based program of tax expenditure reviews would enable the Treasury to more fully inform the Government of the costs associated with individual tax expenditures and whether they are meeting their intended policy aims.

18. In the absence of the ongoing review of tax expenditures, the annual reporting of tax expenditure items through the TES is the primary means by which the existence and level of tax expenditures is monitored. However, the reliability of tax expenditure estimates remains an ongoing issue. Since TES 2008, the Treasury has disclosed information on the reliability of individual tax expenditure estimates in the annual TES. Successive statements have demonstrated that the arrangements introduced to improve the reliability of published tax expenditure estimates have not resulted in any significant improvements to the reported reliability ratings over time.[25] More importantly, the Treasury has not developed a formal approach to improve the overall reliability of tax expenditure estimates, as recommended by the 2008 audit. A significant portion of tax expenditures also remain unquantified (32 per cent in both TES 2006 and TES 2011).

19. The 2008 audit noted that there had been a number of Government and Parliamentary reviews of tax expenditures over the last 35 years, each identifying similar shortcomings and making similar recommendations, yet few of these recommendations have been adopted.[26] Similarly, this audit has found that the majority of the ANAO's 2008 audit recommendations, and the recommendations from the associated JCPAA review, have not been implemented. These recommendations continue to be relevant, particularly if there is to be confidence in the public reporting of tax expenditures. In addition, the ANAO has made a further recommendation to improve the consistency of the published reliability ratings by standardising the methodology for allocating ratings.

24 Savings measures are attempts by the Government to reduce a Budget deficit or increase a surplus by identifying areas where it can reduce expenditure or increase revenue.

25 Of those estimates with a reliability rating in TES 2011, four per cent were rated high, and for TES 2012, three per cent were rated high.

26 ANAO Audit Report No.32 2007–08, *Preparation of the Tax Expenditures Statement*, p. 14.

Key findings by chapter

Budget integration and reporting (Chapter 2)

20. New revenue and expense measures generally affect the Budget deficit or surplus in the Budget year and/or the forward estimates. New revenue measures may also directly affect the level of tax expenditures by increasing or decreasing tax concessions. Because of the potential impact on the Budget of new policy measures involving tax expenditures, it is desirable that such measures are evaluated early on, in a similar manner to outlay measures, and are reported against objective standards to maximise transparency about their fiscal impacts.

21. In recent years, changes to Budget processes have encouraged the better integration of the consideration of outlays and tax expenditures in the annual Budget process.[27] Specifically, the Budget operating rules envisage that ERC is the only Cabinet Committee that can recommend any new spending or tax expenditures proposals to the Cabinet, unless the Prime Minister agrees otherwise. ANAO found that 21 of the 45 tax expenditure items resulting from new policy proposals reported in TES 2011 did not involve ERC consideration. Many of these new and modified tax expenditure items were associated with a broader package of Government revenue measures, or revenue and expense measures. While this approach potentially allows tax expenditures to be considered with related policy measures, extensive use of such arrangements (that do not involve the ERC) can detract from the goal of achieving better integration of tax expenditures in the Budget process. Integration would be further improved by including, wherever possible, the quantification of tax expenditure items resulting from new policy proposals in the relevant Budget Papers.[28]

22. The Murray review as part of *Operation Sunlight* and the review of *Australia's Future Tax System* both supported the ANAO's recommendation[29] relating to the development of standards to govern the reporting of tax expenditures. However, this has not occurred, with the Treasury advising the ANAO in August 2012 (in line with its response to the 2008 audit) that the

27 This relates to Recommendation No. 2 of the 2008 audit.

28 Of the 45 tax expenditure items resulting from new policy proposals in TES 2011, only 23 were explicitly quantified in the relevant Budget Papers.

29 This relates to Recommendation No. 3 of the 2008 audit.

standards governing the calculation and publication of tax expenditures are the benchmarks published each year in the TES. However, benchmarks are arbitrary, and are therefore not a desirable standard to govern reporting. The Treasury also advised the JCPAA in December 2009, in relation to its recommendation that the Treasury further investigate the merits of the Canadian model of taxation expenditure reporting[30], that the department had investigated the Canadian model, but, at that time, did not intend to move further in that direction.[31]

23. Unlike other areas of financial reporting, there are no external reporting standards to guide the reporting of tax expenditures. The development of standards that establish the basis for the identification and measurement of tax expenditures would provide a stronger conceptual underpinning to the TES, enhance the transparency and reliability of the statements and promote comparability between years. The development of standards would best be pursued by the Treasury with other jurisdictions in the interests of sharing both experience and resources.

Review of existing tax expenditures (Chapter 3)

24. The systematic review of tax expenditures highlights opportunities for improvements in modelling the impacts of tax expenditures as well as ensuring they are periodically evaluated and continue to align with Government policy objectives.

25. The Treasury agreed to the ANAO's recommendation to develop an approach for the conduct of an ongoing prioritised review of tax expenditures, and commenced the formalised review process in September 2008, with the aim of completing all reviews by 2013. However, the reviews ceased in 2011. Treasury advised ANAO in April 2013 that it discontinued the formal review process due to the utility of the reviews relative to other priorities, particularly providing advice to the Government on its tax priorities.

26. In total, the Treasury conducted 123 tax expenditure reviews between November 2007 and early 2011.[32] Of the 364 tax expenditures listed in TES

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[30] The 2008 audit noted that Canada takes a broader approach to the reporting of tax expenditures, reporting measures that are unarguably tax expenditures along with a range of others that may or may not be so categorised.

[31] The Treasury advised ANAO in January 2013 that it is unable to provide any documentary evidence of its review of the Canadian model of tax expenditure reporting.

[32] These reviews include five tax expenditures that were reviewed twice.

2011, only 113 (31 per cent) were reviewed as part of this process, representing $32 billion (or 29 per cent of estimated quantified total tax expenditures) in 2010–11. While a comprehensive methodology was devised for the reviews undertaken, it was not always applied. In light of these factors which have impaired progress, Recommendation No. 1(a) from the 2008 audit has not been fully addressed. The ANAO considers that there is still a strong case for conducting a priority-based program of reviews—to assess tax expenditures that are most significant or where other information suggests a review would be beneficial.

27. In addition, the timing and outcomes of the reviews of individual tax expenditures have not been made publicly available. As such, Recommendation No. 1(b) from the 2008 audit has also not been fully implemented. The release of this information would improve the transparency of the tax expenditure review process, although ANAO recognises that this would be a decision for government.

Quality of tax expenditure estimates (Chapter 4)

28. Tax expenditure estimates are based on often complex economic models. To run these models, the Treasury and the ATO need to draw on a variety of data sources and the accuracy and timeliness of data can vary.[33] Consequently, tax expenditure estimates have differing degrees of reliability. In order to make reporting on tax expenditures as useful to readers as possible, a focus on improving the reliability of estimates over time is important. As well, consideration of behavioural impacts on estimates is desirable.

29. Since 2008, the Treasury has corresponded with a range of Australian Government agencies to obtain information on possible unidentified tax expenditures.[34] However, only four additional items were identified through correspondence with relevant agencies. In contrast, the Treasury identified 38 items[35] within its own portfolio from 2008 to 2011 that were not previously recognised as tax expenditures. These different results suggest there are potential benefits in the Treasury adopting a more active approach towards

33 In this context, the Treasury has advised that in many cases a complete absence of data may make it almost impossible to estimate some tax expenditures, particularly where tax expenditures arise due to the exemption from tax of certain income or activities.

34 These correspondence activities have been in line with Recommendation No. 4(a) of the 2008 ANAO audit. Further, in its report on the audit, the JCPAA recommended that the Treasury include information in the Budget Papers on the extent to which tax expenditure reporting has improved through the receipt of reliable data from other agencies.

35 Twenty-two of these 38 tax expenditures related to GST items in TES 2008.

identifying new tax expenditures in other portfolios, including assisting in those instances where there may be some question as to whether the item was a tax.[36]

30. Similarly, there is little evidence that additional data collected from agencies by the ATO and the Treasury has significantly improved the reliability of the estimates.[37] A more systematic approach to obtaining data, including reviewing non-Treasury portfolio data to identify possible tax expenditures, and identifying where a lack of data is reducing the reliability rating of an estimate, is required if the reliability of individual estimates within the TES is to be improved. The approach would potentially be aligned with a program of prioritised reviews of tax expenditure items.

31. The 2008 audit suggested that tax expenditure reporting could be improved through the introduction of significant revenue gain estimates. Revenue gain estimates seek to take into account behavioural changes among taxpayers, unlike the revenue forgone approach which is the standard methodology used to prepare estimates in the TES.[38] The Treasury has included revenue gain estimates in their TES from 2008 onwards (meeting Recommendation No. 5 of the 2008 ANAO audit). However, the Treasury is some way from meeting the JCPAA's recommendation that it publish information on the 20 largest tax expenditures using both the revenue forgone and revenue gain methods. Only 10 revenue gain estimates were published in TES 2011, all of which were among the 20 largest expenditure items. To satisfy the intent of the JCPAA recommendation[39], the Treasury could include, in future TES publications, revenue gain estimates for the 20 largest items or the reasons why this approach was not adopted.

32. Since TES 2008, the Treasury has disclosed information on the reliability of individual tax expenditure estimates in the annual TES, addressing Recommendation No. 6(b) of the 2008 audit. However, there remain a number of areas for improvement in relation to the reliability of

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36 The 2008 audit noted (p. 60) that in some cases, there may be competing views as to whether a revenue measure is a tax.

37 This relates to Recommendation No. 4(b) of the 2008 audit.

38 The different methodologies used to prepare tax expenditure estimates, including the revenue gain methodology, are discussed further at paragraphs 4.16 to 4.20.

39 The Treasury advised the JCPAA in December 2009 that: 'Estimates of six tax expenditures using the revenue gain approach were published in the 2008 TES…It should be noted that there remain practical difficulties in making revenue gain estimates including the information or assumptions needed for the behavioural responses of taxpayers to policy changes and the assumptions must be made regarding the policy specifications for removing each tax expenditures.'

estimates, notably that the Treasury has not developed a formal, documented approach to prioritise improvements to reliability.[40] Inconsistencies were also identified in the approach taken by analysts within the Treasury and the ATO to assigning reliability ratings to estimates. The rating categories originally developed as part of the 2008 ANAO audit, and subsequently adopted by the Treasury, have not been further developed into a standardised process for analysts to effectively rate the reliability of individual estimates.

Summary of agency responses

33. The Treasury provided the following summary response, with the formal response in Appendix 1:

> The annual publication of the Tax Expenditures Statement (TES) continues to be regarded by the Treasury as an integral part of the Australian Government's Budget reporting. It allows tax expenditures to receive a similar degree of public scrutiny as direct expenditures and contributes to public debate on the elements of the tax system. The Treasury welcomes scrutiny of the TES itself, including from the ANAO in this follow-up audit. The Treasury agrees with the report's recommendation to take steps to standardise the allocation of reliability ratings of estimates published in the TES.
>
> Improvements have been made in a number of areas of the TES since the 2007-08 audit and subsequent recommendations by the Joint Committee of Public Accounts and Audit (JCPAA). The Treasury is also committed to the ongoing improvement of the TES, including through the quantification of new and existing tax expenditures and improvement in the reliability of estimates, where this is cost effective. The Treasury will continue to pursue improvements in the TES through progressing recommendations made by the ANAO and JCPAA, with regard to the available resources and in the context of Government priorities.

[40] As set out at Recommendation No. 6(a) of the 2008 audit. In addition, the number of unquantified estimates as a percentage of total tax expenditure estimates has remained fairly stable since 2006 and there are a number of large estimates which featured in TES 2006 that have not yet been quantified. As such, Recommendation No. 6(c) of the 2008 audit has only been partially addressed.

Australian Taxation Office

34. The ATO provided the following summary response, with the formal response at Appendix 1:

> The ATO agrees with the recommendation in the report, acknowledging as it does the inherent difficulties in the calculation of tax expenditures.
>
> Despite these inherent difficulties, and the resourcing concerns mentioned by Treasury, the ATO and Treasury have made improvements in Tax Expenditures Statements since 2008. From the ATO's point of view these improvements have included improvements to models used and the gathering of more data from other agencies.
>
> There are other matters canvassed in this audit which is more appropriate for Treasury to comment on.

Recommendation

Recommendation No. 1

Paragraph 4.64

To improve the consistency of the reliability ratings disclosed in the Tax Expenditures Statement, ANAO recommends that the Department of the Treasury and the Australian Taxation Office review and standardise their internal methodology for allocating reliability ratings to tax expenditure items.

ATO response: *Agreed* **Treasury response:** *Agreed*

Audit Findings

1. Introduction

This chapter examines the nature of a tax expenditure, and the reporting of tax expenditures by the Australian Government. It also provides an overview of the 2008 ANAO audit on tax expenditures and the subsequent Joint Committee of Public Accounts and Audit review. The audit objective is also outlined.

Background

1.1 Tax expenditures are, broadly, tax concessions that fall outside a tax norm or benchmark.[41] In Australia, the *Tax Expenditures Statement 2011* (TES 2011) defines a tax expenditure as:

> A provision of the tax law that provides a benefit to a specified activity or class of taxpayer that is concessional when compared to the 'standard' tax treatment that would apply.[42]

1.2 The benchmark includes the rate structure, accounting conventions, deductibility of compulsory payments, provisions to facilitate tax administration, and international fiscal obligations.[43] However, in practice, a benchmark, or 'standard' tax treatment differs from country to country. In Australia, the tax benchmark is based on two principles: it should represent the standard taxation treatment that applies to similar taxpayers or types of activities; and may incorporate certain elements of the tax system that depart from a uniform treatment of taxpayers, where these are fundamental structural elements of the tax system.[44]

1.3 Tax expenditures can include tax: exemptions (amounts excluded from the tax base); deferrals (delays in paying tax); deductions (which reduce total assessable income); or offsets (which directly reduce the amount of tax payable).

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41 ZL Swift, H Polackova Brixi, and C Valenduc, 'Tax Expenditures: General Concept, Measurement, and Overview of Country Practices', in H Polackova Brixi, C.M.A Valenduc, ZL Swift (eds.): *Tax Expenditures-Shedding Light on Government Spending through the Tax System: Lessons from Developed and Transition Economies*, The World Bank, Washington D.C., 2004, p. 3.

42 This definition focuses upon legislated tax concessions, although favourable treatment of some taxpayers might arise by other means such as when a law is not administered as legislated. This report proceeds upon the basis of the Department of the Treasury's definition of 'tax expenditure', while noting that there is no statutory reason to restrict the concept to legislated tax concessions.

43 ZL Swift, H Polackova Brixi, and C Valenduc, op. cit., p. 3.

44 Department of the Treasury, *Tax Expenditures Statement 2011*, p. 213.

1.4 Tax expenditures are used by governments to promote particular policy objectives. They provide an alternative mechanism to direct expenditures[45] and as such, have an effect on the Budget position like that of direct expenditures. Tax expenditures offer certain potential advantages over other policy tools, including administrative efficiencies where recipients are taxpayers (in that government spending agencies do not need to manage programs and deliver payments). However, there can be issues associated with the use of tax expenditures as a policy tool. A 2010 Organisation for Economic Co-operation and Development (OECD) report on tax expenditures in selected OECD countries noted:

> Tax expenditures can be inferior policy instruments, degrading the efficiency and effectiveness, fairness, and simplicity of the tax system and of government operations generally, threatening fiscal sufficiency as well. Tax expenditures may under important circumstances be easier to enact than spending programs, and not always because of underlying policy merit. Tax expenditures are also generally less transparent, and less subject to review and remedial action despite any policy deficiency.[46]

Reporting of tax expenditures

1.5 Reporting of tax expenditures is required under the *Charter of Budget Honesty Act 1998* (Charter of Budget Honesty). The purpose of the Charter of Budget Honesty is to improve fiscal policy outcomes through two means: requiring fiscal strategy to be based on principles of sound fiscal management; and facilitating public scrutiny of fiscal policy and performance. Clause 16 of Schedule 1 of the Charter of Budget Honesty requires that the mid-year economic and fiscal outlook report is to contain a detailed statement of tax expenditures. In practice, the Tax Expenditures Statement (TES) is published annually in a separate publication. The Department of the Treasury (the Treasury) commenced the publication of a separate TES in 1987, and has prepared a statement for each year (except for 1999–2000) up to and including 2012. The Treasury states in TES 2012 that the statement is an integral component of the Australian Government's Budget reporting, and serves three key functions:

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45 Direct expenditures include for example, grants, or the purchase of goods and services by the government.

46 Organisation for Economic Co-operation and Development, *Tax Expenditures in OECD Countries*, 2010, p. 34.

to allow tax expenditures to receive a similar degree of scrutiny as direct expenditures; to allow for a more comprehensive assessment of government activity; and to contribute to the design of the tax system, by promoting and informing public debate on all elements of the tax system.[47]

1.6 The annual TES lists each of the identified tax expenditures and contains, where possible, the estimated amounts of the tax expenditures over an eight-year period. The TES includes both new and modified tax expenditures. New tax expenditures arise from measures that were announced since the previous TES up to the date of the most recent *Mid-Year Economic and Fiscal Outlook,* and items recently identified as tax expenditures. Modified tax expenditures refer to existing tax expenditures that have changed materially, for example because of a change to the benchmark, a decision to remove a tax expenditure in a certain year, an amalgamation or split of tax expenditures, or the inclusion of a new element to an existing tax expenditure.

1.7 The TES also contains a brief description of the tax expenditure. In 2011–12 Commonwealth tax expenditures were estimated at $111 billion, or around 7.6 per cent of GDP.[48] Taxation revenue reported by the Australian Government in 2012 amounted to $316.5 billion.[49] The number of tax expenditure items has increased in recent years, from 272 in TES 2006, to 364 in TES 2011 and to 363 in TES 2012.[50] Table 1.1 outlines the ten largest tax expenditure items in 2012–13.

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47 Department of the Treasury, *Tax Expenditures Statement 2012*, p. 14.

48 ibid., p. vii.

49 *Consolidated Financial Statements for the year ended 30 June 2012*, p. 35.

50 Different approaches to measuring the cost of tax expenditures are outlined at paragraph 4.16.

Table 1.1

Ten largest tax expenditures in 2012-13

Tax expenditure	Estimate ($m)
Superannuation—concessional taxation of superannuation entity earnings	17 100
Capital gains tax main residence exemption— discount component	16 500
Capital gains tax main residence exemption	13 500
Superannuation—concessional taxation of employer contributions	13 150
GST—Food; uncooked, not prepared, not for consumption on premises of sale and some beverages	6 200
Capital gains tax discount for individuals and trusts	4 180
GST—Education	3 550
GST—Health; medical and health services	3 000
Customs duty[1]	-2 960
GST—Financial supplies input taxed treatment	2 850

Note 1: Negative tax expenditures are measures that raise more revenue than implied by the relevant benchmark.

Source: Department of the Treasury, *Tax Expenditures Statement 2012*, p. 7.

1.8 The Australian Taxation Office (ATO) is responsible for developing and maintaining the mathematical models and data for the majority of tax expenditures. The Treasury has primary responsibility for preparing Budget documentation on tax expenditure estimates and coordinating the publication of the TES.[51]

Reviews pertaining to tax expenditures

1.9 The ANAO tabled Audit Report No. 32 *Preparation of the Tax Expenditures Statement* in May 2008. The objective of this audit was to assess the completeness and reliability of the estimates reported in *Tax Expenditures Statement 2006* (TES 2006). Consistent with a suggestion of the Senate Standing Committee on Finance and Public Administration's March 2007 report[52], the ANAO audit also examined opportunities for greater transparency in the reporting of tax expenditures.[53]

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[51] Department of the Treasury, *Annual Report 2010–11*, pp. 37 and 47.

[52] Senate Standing Committee on Finance and Public Administration, *Transparency and accountability of Commonwealth public funding and expenditure,* March 2007, p. 33.

[53] ANAO Audit Report No.32 2007–08, *Preparation of the Tax Expenditures Statement*, p. 30.

1.10 The 2008 audit also reviewed the:

- systems the Treasury employed (and the records supporting them) for the production and publication of TES 2006;
- methods, models and data sources used by the ATO to produce the estimates of tax expenditures reported in TES 2006; and
- reporting of tax concessions by some other agencies responsible for administering Commonwealth taxing and charging laws so as to assess the completeness of the TES.

1.11 The 2008 audit report concluded that: the Treasury had not yet found a way to integrate the reporting of outlays and tax expenditures; tax expenditures had not been treated consistently with outlays within Budget processes; and the measurement, monitoring and reporting of tax expenditures through the TES could be improved. Against this background, the audit commented that ongoing review of tax expenditures would be beneficial.[54] The audit made six recommendations (outlined in Appendix 2) directed at improving the quality of information relating to tax expenditures over time through regular review and evaluation of tax expenditure items, and improvements to the data and reliability of the models used to quantify tax expenditures. The recommendations were agreed, or agreed with qualification—by the Treasury for each recommendation, and by the ATO in response to two recommendations.[55] The recommendations are discussed in each of the relevant chapters.

Joint Committee of Public Accounts and Audit inquiry

1.12 The Joint Committee of Public Accounts and Audit (JCPAA) conducted an inquiry into this audit in September 2008, and released its report in June 2009.[56] The JCPAA report made three recommendations (outlined in Appendix 3), aimed at enhancing the Treasury's reporting of tax expenditures in the annual TES, including through: the publication of revenue gain estimates; investigating other models of reporting; and including information in the Budget Papers on the extent to which tax expenditure reporting had

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54 ibid., pp. 12–13.

55 The Treasury and the ATO's response to each of the recommendations is outlined in Appendix 1.

56 Joint Committee of Public Accounts and Audit report 414, *Review of Auditor-General's Reports tabled between August 2007 and August 2008*, June 2009, Canberra.

improved through the receipt of reliable data from other agencies. The Treasury's response to the Chair of the Committee in December 2009 indicated it had implemented two of these recommendations and had taken steps towards implementing the third.[57]

Operation Sunlight

1.13 'Operation Sunlight' is the Government's reform agenda to improve the openness and transparency of public sector budgetary and financial management and to promote good governance practices.[58] On 24 March 2008, the then Minister for Finance and Deregulation announced that Senator Andrew Murray had commenced a review of Budget transparency issues as part of the Operation Sunlight reforms.[59] Senator Murray completed his review in June 2008.[60] The report made one direct recommendation pertaining to tax expenditures:

> That the recommendations of the Australian National Audit Office May 2008 *Preparation of the Tax Expenditures Statement* Performance Audit be adopted and implemented by Government, then applied nationally through COAG agreement.

1.14 In its response to the report in June 2008, the Government stated it agreed with qualification to the recommendation. The qualification was on the basis that the Commonwealth is not able to require states and territories to adopt this recommendation, and positions would need to be negotiated through the Council of Australian Governments or a similar forum.[61]

1.15 In addition, in its reform agenda to improve the transparency and accountability of the Budget[62], the Government indicated its policy was to:

- require an independent up-front audit and assessment of existing concessions; and

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57 The Treasury's response to the JCPAA's recommendations is outlined in Appendix 2.

58 Details of Operation Sunlight are reported at<http://www.finance.gov.au/financial-framework/financial-management-policy-guidance/operation-sunlight/index.html> [Accessed 12 July 2012].

59 Minister for Finance and Deregulation, Media Release 09–2008, *Appointment of Senator Murray to Advise on Improving Budget Transparency*, 24 March 2008.

60 Senator Andrew Murray, *Review of Operation Sunlight: Overhauling Budgetary Transparency*, June 2008.

61 *Government Response to Review of Budget Transparency*, June 2008, p. 10.

62 *Operation Sunlight-Enhancing Budget Transparency*, December 2008. This version incorporated the Government's response to the recommendations of the Murray Review.

- require more detailed specification of what is to be achieved from tax expenditures, set in place processes for their periodic review and notionally allocate such expenditures to functions and sub-functions to facilitate comparisons with other expenditure.[63]

1.16 This paper also noted that the Government, through the Treasury and relevant agencies, was progressively reviewing all tax expenditures.[64]

Australia's Future Tax System

1.17 The recent review into Australia's tax system, chaired by then Secretary to the Treasury, Dr Ken Henry AC and published in December 2009 (*Australia's Future Tax System*) made four recommendations relating to the tax expenditures framework:

- The Australian Government should ensure that the rules governing the development of the Budget encourage trade-offs between tax expenditures and spending programs. Budget decision-making processes should measure and treat tax expenditures and spending programs symmetrically, to ensure that there is no artificial incentive to deliver programs through one mechanism rather than another (Recommendation No. 135).
- The Government should introduce legislation to amend the *Charter of Budget Honesty Act 1998* to recognise the publication of detailed information about tax expenditures in a Tax Expenditures Statement separate from the Mid-Year Economic and Fiscal Outlook (MYEFO). However, the Tax Expenditures Statement should continue to be released by the end of January in each year, or within six months of the last Budget, whichever is later (Recommendation No. 136).
- The Government should ensure that reporting standards are independently developed for the identification and measurement of tax expenditures in the Tax Expenditures Statement. In addition, the standards should establish a basis for reporting the broader economic and distributional effects of tax expenditures in the periodic Tax and Transfer Analysis Statement (see Recommendation No. 132) (Recommendation No. 137).

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63 ibid., p. 13.

64 ibid. See paragraph 3.5 on the Government's efforts to review all tax expenditures as part of a broader review of all government expenditures in 2008 and 2009.

- The Council of Australian Governments should examine the ways in which the States could uniformly report tax expenditures annually according to the independent standards developed under Recommendation No. 137 (Recommendation No. 138).[65]

1.18 The Government's response to the AFTS Review was outlined in a joint press release from the then Prime Minister and Treasurer. The recommendations relating to tax expenditures were not explicitly addressed in the media release.

Audit objective, scope, criteria and methodology

1.19 The objective of this audit was to assess the extent to which the Treasury and the ATO have improved the management of tax expenditure estimates by implementing the six recommendations in the 2008 ANAO audit and the three recommendations made by the JCPAA following its inquiry.[66]

Audit scope

1.20 The audit examines developments from May 2008, when the original audit tabled, to the release of TES 2011, in January 2012.[67] The audit mainly focuses on the Treasury, which has primary responsibility for preparing Budget documentation on tax expenditure estimates and coordinating the publication of the TES. The ATO was also included in the audit because of its role in developing the tax expenditure models, and a number of the 2008 audit recommendations involved the ATO.

1.21 The audit does not address the development and publication of aggregated information on tax expenditures included in the Budget Papers pursuant to Division 1 of Part 5 of the *Charter of Budget Honesty Act 1998*, and conceptual issues around: the definition of a tax expenditure; the selection of a benchmark tax system; and the selection of various benchmarks.

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65 *Australia's Future Tax System, Report to the Treasurer*, Part Two Detailed Analysis, Volume 2 of 2. December 2009.

66 Joint Committee of Public Accounts and Audit, Report 414, *Review of Auditor-General's Reports tabled between August 2007 and August 2008,* June 2009.

67 TES 2011 is the focus of this audit report. However, TES 2012 was released in January 2013, after ANAO had completed its fieldwork and analysis, and the report includes some high-level information from TES 2012.

Audit criteria

1.22 When following up the recommendations from the 2008 audit and JCPAA inquiry, particular consideration was given to whether:

- steps have been taken to better integrate the consideration of outlays and tax expenditures in the annual Budget process, and Ministers advised accordingly;
- standards to govern the reporting of tax expenditures have been developed;
- a rigorous approach for conducting an ongoing prioritised review of tax expenditures has been developed and implemented[68];
- arrangements are in place to identify all potential Commonwealth tax expenditures, including from outside of the Treasury portfolio;
- arrangements are in place to obtain relevant data from entities outside the Treasury portfolio;
- selected tax expenditure estimates prepared on a revenue gain basis have been quantified and published;
- an approach to prioritise improvements to the reliability of published tax expenditure estimates has been developed; and
- a reliability assessment of tax expenditure estimates has been undertaken and published in the annual TES.

1.23 The audit team interviewed relevant staff in the Treasury and the ATO and examined files and documentation in both agencies relating to the preparation of the TES. This included examining all tax expenditure reviews undertaken by the Treasury in the relevant timeframe, and tax expenditure models on a sample basis. The audit did not assess the accuracy of individual tax expenditures.

1.24 The audit was conducted under Section 18 of the *Auditor-General Act 1997* at a cost of $297 500.

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[68] The audit does not explicitly consider the ex ante evaluation of proposed tax expenditures.

Structure of the audit report

1.25 The audit findings are reported in three chapters, which examine key elements of the preparation of tax expenditure estimates by the Treasury and the ATO, as outlined in Table 1.2.

Table 1.2

Report structure

Chapter	Chapter overview
2. Budget Integration and Reporting	Examines the Treasury's response to recommendations of the 2008 audit relating to the integration of tax expenditures into the Budget process (Recommendation No. 2) and the reporting framework for tax expenditures (Recommendation No. 3).
3. Review of Existing Tax Expenditures	Examines the Treasury's response to the recommendation of the 2008 audit regarding the ongoing review of existing individual tax expenditure estimates (Recommendation No. 1).
4. Quality of Tax Expenditure Estimates	Examines the Treasury's and the ATO's responses to recommendations of the 2008 audit regarding the quality of the tax expenditure estimates (Recommendation Nos. 4, 5 and 6).

2. Budget Integration and Reporting

This chapter examines the Treasury's response to recommendations of the 2008 audit relating to the integration of tax expenditures into the Budget process (Recommendation No. 2) and the reporting framework for tax expenditures (Recommendation No. 3).

Integration of outlays and tax expenditures

Charter of Budget Honesty Act 1998

2.1 Requirements relating to the reporting of tax expenditures are contained in the Charter of Budget Honesty. It was intended that the Charter of Budget Honesty would 'establish an integrated fiscal framework that provides for greater discipline, transparency and accountability in fiscal policy.'[69] The Charter of Budget Honesty provided for the publication of three regular fiscal reports: a Budget economic and fiscal outlook report with each Budget; a mid-year economic and fiscal outlook report by the end of January each year or within six months after the last Budget (whichever is later); and a final Budget outcome report within three months of the end of each financial year.[70]

2.2 The mid-year economic and fiscal outlook report was to be the major source of publicly available information on tax expenditures.[71] Clause 16 of the Charter of Budget Honesty states that a mid-year economic and fiscal outlook report is to:

> update key information contained in the most recent Budget economic and fiscal outlook report; and contain a detailed statement of tax expenditures, presenting disaggregated information on tax expenditures.

Findings from original audit

2.3 The 2008 ANAO audit noted that, since the Charter of Budget Honesty took effect, no mid-year economic and fiscal outlook report (MYEFO)

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69 *Charter of Budget Honesty*, Statement by the Honourable Peter Costello MP, Treasurer of the Commonwealth of Australia, 20 August 1996.

70 *Charter of Budget Honesty Act 1998*, Schedule 1, Part 1, Clause 2(3).

71 The overarching purpose of the mid-year economic and fiscal outlook report is to provide updated information to allow the assessment of the Government's fiscal performance against the fiscal strategy set out in its current fiscal strategy statement. (*Charter of Budget Honesty Act 1998*, Schedule 1, Part 5, Clause 15).

has contained disaggregated tax expenditures as provided for by the legislation. Rather, a separate TES has been published each year except 1999-00. The audit report suggested that the integration of both outlays and tax expenditure estimates would help to ensure that tax expenditure measures received Parliamentary scrutiny, alongside spending programs, as an aspect of total government spending. The Treasury advised ANAO at the time[72] that it was not possible to include the full detailed tax expenditure estimates in the MYEFO release without significant changes to the focus of the MYEFO document and without delaying the release of MYEFO itself.[73]

2.4 The audit also highlighted that there is a potential for apparently conflicting fiscal outcomes to arise where the Budget management and reporting of outlays and tax expenditures are not integrated. In this context, the 2008 ANAO audit identified that certain Budget processes serve to separate the consideration of revenue and outlay measures by Government. Specifically, under the then Cabinet arrangements, outlay and revenue measures were considered by separate committees of Cabinet, with outlay measures considered by the Expenditure Review Committee, and revenue measures (including most tax expenditures) considered by the Ad Hoc Revenue Committee, which could result in competing outlay and revenue measures.[74] The audit also noted the discrepancy between the treatment of proposals for new tax concessions (where Ministers were required to offset the expenditure from savings within their portfolio) and proposals to remove an existing tax expenditure (where Ministers cannot usually claim the 'savings' as an increase in portfolio revenue).[75]

2.5 Consequently, the audit made the following recommendation:

ANAO Recommendation No. 2
ANAO recommends that the Department of the Treasury examine and advise Ministers on options to better integrate the consideration of outlays and tax expenditures in the annual Budget process.
The Treasury agreed to the recommendation.

[72] ANAO Audit Report No.32 2007–08, *Preparation of the Tax Expenditures Statement,* p. 41.

[73] This issue is considered further at paragraphs 2.20 and 2.21.

[74] ibid., p. 43.

[75] ibid., p. 43.

Review of Australia's Future Tax System

2.6 The review of *Australia's Future Tax System* (AFTS) in 2009, reinforced many of ANAO's findings in relation to the consideration of tax expenditures by Cabinet. Specifically, the review of AFTS commented that:

- the Budget is the Government's key decision-making process for revenue policy, and it is therefore the most important process by which new tax expenditures are created and existing ones can be reviewed;
- under the Budget process, tax expenditures are not usually examined with spending measures, and there are no other formal processes to ensure tax expenditures are prioritised against other spending, increasing the risk that tax expenditures are not properly coordinated with spending programs in the same policy area; and
- Ministers are not usually able to claim as savings any increases in revenue that might flow from the removal of an existing tax expenditure, which, in the past, has discouraged the replacement of tax concessions with equivalent spending programs.[76]

2.7 In this context, the review of AFTS recommended that:

> The Australian Government should ensure that the rules governing the development of the Budget encourage trade-offs between tax expenditures and spending programs. Budget decision–making processes should measure and treat tax expenditures and spending programs symmetrically, to ensure that there is no artificial incentive to deliver programs through one mechanism rather than another.[77]

2.8 The Government also indicated in the December 2008 Operation Sunlight report that its policy was to notionally allocate tax expenditures to functions and sub-functions to facilitate comparisons with other expenditure.[78]

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76 *Australia's Future Tax System, Report to the Treasurer*, Part Two Detailed Analysis, Volume 2 of 2. December 2009, pp. 729–730.

77 ibid, p. 729, Recommendation No. 135

78 *Operation Sunlight-Enhancing Budget Transparency*, December 2008, p. 13.

The Budget Process Operational Rules

2.9 In relation to the issue of whether Treasury had addressed ANAO's recommendation and provided advice to Ministers on options to better integrate the consideration of outlays and tax expenditures in the annual Budget process, the Treasury informed ANAO in August 2012 that:

> There is already significant integration provided for in the Budget Process Operational Rules, which are revised annually on advice from the Budget Coordination Committee, a committee of Treasury, Department of Finance and Deregulation and Department of the Prime Minister and Cabinet. The Budget Process Operational Rules are provided in advice to Cabinet and confirmed by a Cabinet decision each year.
>
> The Budget Process Operational Rules specify that new tax expenditures are to be considered in the same way as any other new policy proposal (see Finance Estimates Memorandum 2011/31). The references at paragraphs 11, 15, 20, 22, 23 and 24 are all aimed at ensuring tax expenditures are considered alongside outlays in the same manner. The Appendix 2 '*Expenditure Review Principles*' also require consideration of why tax expenditure proposals are preferred to direct outlays.

2.10 The Budget Process Operational Rules are standing rules endorsed annually by Cabinet and set out the major administrative and operational arrangements that underlie the management of the Australian Government Budget process. With respect to tax expenditures, the current Budget Process Operational Rules (for the 2013–14 Budget) indicate that there are many similarities in the treatment of new tax expenditures and new outlay measures in the Budget process. Specifically:

- new tax expenditures are explicitly considered as a new policy proposal;
- new tax expenditures, as for other new policy proposals, submitted within or outside the Budget process, must be offset by 'genuine savings';
- the Expenditure Review Committee (ERC) is the only Cabinet Committee that can recommend new spending or tax expenditure proposals to Cabinet;
- all new policy proposals must be considered by ERC (including a joint meeting of ERC and the National Security Committee where necessary) prior to consideration by Cabinet, unless the Prime Minister agrees otherwise; and

- all new policy proposals involving expenditure, including those that propose tax expenditures or regulations as alternatives to spending programs, must include an evidence based assessment of the proposal against the 'Expenditure Review Principles'.

2.11 The major difference in the current Budget Process Operational Rules between the treatment of tax expenditures and other expenditures relates to the different roles played by the Treasury and the Department of Finance and Deregulation (Finance) in the Budget process. Specifically:

- for taxation revenue related issues, the Treasury will determine what constitutes a new policy proposal (with Finance performing this role in relation to expenditure and non-tax revenue related issues);
- all new policy proposals involving tax revenue must have had costs agreed by the Treasury (with Finance performing this task for all expense, capital and non tax revenue new policy proposals); and
- all tax revenue new policy proposals must have the Treasurer's agreement that the proposal can be brought forward for consideration, and the proposal must be brought forward by the Treasurer or jointly with the Treasurer, unless the Treasurer agrees otherwise.

2.12 The previous audit reported that, at that time, revenue measures were considered by the Ad-Hoc Revenue Committee, usually after the ERC had finalised the Budget outlay measures.[79] The Ad-Hoc Revenue Committee was last convened on 19 April 2007 and was replaced by the Strategic Budget Committee, which was abolished in September 2010. Consideration of both revenue and outlay measures now occurs through the ERC. In this context, the role of the ERC was clarified through the 2010–11 Budget Process Operational Rules[80], which stated that all new policy proposals[81] must be considered by the ERC prior to consideration by the Cabinet unless the Prime Minister agrees otherwise, and the ERC is the only Cabinet Committee that can recommend any new spending or tax expenditures proposals to the Strategic Priorities and Budget Committee or Cabinet.[82] The emphasis on ensuring all tax expenditures

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79 ANAO Audit Report No.32 2007–08, *Preparation of the Tax Expenditures Statement*, p. 43.

80 Issued on 29 September 2009 in Estimates Memorandum 2009/49.

81 Not just major policy proposals as had occurred in the past.

82 The Budget operating rules for September 2009 included the Strategic Priorities and Budget Committee but the rules for later Budgets did not reference the Strategic Priorities and Budget Committee.

are considered in the same way as outlay measures is designed to improve the integration of tax expenditures into the annual Budget process.

Tax Expenditures Statement 2011

2.13 Many of the new policy proposals, or policy principles, outlining the creation of new and modified tax expenditure items in TES 2011 did not involve ERC consideration. Specifically, of the 45 new and modified tax expenditure items resulting from new policy proposals, 21 were not considered by ERC.[83] Consistent with the Budget Process Operational Rules, these 21 items included:

- eight that were considered through correspondence involving the Prime Minister, Treasurer, Assistant Treasurer, the then Parliamentary Secretary to the Prime Minister or the then Parliamentary Secretary for Climate Change and Energy Efficiency. Four items related to environmental and specific taxation measures. The other four items related to the revised resource tax regime. Key aspects of the revised resource tax package were announced by the Prime Minister and then Minister for Resources and Energy[84], and were approved through correspondence between the Prime Minister and the Treasurer; and
- thirteen that were considered by the Cabinet. Eleven of these items related to the Clean Energy Future Package. The Treasury advised ANAO in April 2013 that the Climate Change Committee of Cabinet worked closely with the Multi-Party Climate Change Committee to develop the Clean Energy Future package. The two other items covered levies and environmental deductions.

2.14 There is the potential that items considered outside of ERC are not always viewed in the context of related revenue and/or expense measures, which could detract from the goal of achieving better integration of tax expenditures in the Budget process. In this context, many of those new and modified tax expenditure items that were not considered by ERC were associated with a broader package of Government revenue measures, or revenue and expense measures.

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[83] Two of these 21 items had two components, one of which was considered by ERC.

[84] Joint Media Release with the Hon Julia Gillard MP, Prime Minister and the Hon Martin Ferguson AM, MP, then Minister for Resources and Energy, *Breakthrough Agreement with Industry on Improvements to Resources Taxation*, 2 July 2010.

2.15 At the time of the 2008 ANAO audit, the Treasury advised ANAO that the best focus for controlling tax expenditures is at the policy development stage. The Budget rules help ensure that the cost of any new tax concession proposal is counted against the relevant portfolio budget and that savings offsets are required in the same way as for outlays. In this context, ANAO notes that a number of tax expenditures resulting from new policy measures in TES 2011 were not quantified in the relevant Budget Papers. Specifically:

- only five of the 24 new tax expenditure items in TES 2011 were quantified in the relevant Budget Papers; and
- eighteen of the 21 modified tax expenditure items in TES 2011 were quantified in the relevant Budget Papers.

2.16 There were some instances where the tax expenditure was explicitly identified in the Budget Papers, but was considered unquantifiable by the Treasury. For example, 'Relief for taxpayers affected by natural disasters' was identified in the *Mid-Year Economic and Fiscal Outlook 2011–12* but was not quantified.[85] In other instances, the actual tax expenditure was not separately identified or quantified within the Budget Papers, although the overarching revenue or revenue and expense measure may have been quantified. For example, the exclusion from the carbon pricing mechanism for entities producing below 25 000 tonnes of emissions (which resulted in the 'CPM thresholds for obligations' tax expenditure in TES 2011) was not separately identified as a tax expenditure or quantified in MYEFO 2011–12, although the overall revenue from the sale of carbon units was provided.[86] In this regard, Treasury advised ANAO in April 2013 that it:

> advises government on the revenue consequences of its tax policies, including the revenue impact from any tax expenditures associated with the policy. Sometimes the revenue loss (or forgone) by not adopting a tax benchmark has not been quantified at the point of decision for a variety of reasons, including that the amount is unquantifiable, it is infeasible to adopt the benchmark or it is uncertain what the appropriate benchmark should be at the time a decision is taken.

85 *Mid-Year Economic and Fiscal Outlook 2011–12*, p. 158. This indicated that the measure ('Capital gains tax-relief for taxpayers affected by natural disasters') would have an unquantifiable but small revenue impact over the forward estimates period.

86 *Mid-Year Economic and Fiscal Outlook 2011-12*, pp. 150-151. This indicated that the Government would raise an estimated $25.5 billion over the forward estimates period from the sale of carbon units.

2.17 Nonetheless, wherever feasible, identification of, and quantification within, the Budget Papers is desirable to maximise the integration of tax expenditures into the Budget process.

2.18 Under the current Budget Process Operational Rules, all new policy proposals (including new tax expenditures) within or outside the Budget process must be offset by genuine savings. The distinction between genuine and non-genuine savings is outlined in the Budget Process Operational Rules.[87] Tax expenditures are not explicitly included in either of the examples of genuine or non-genuine savings measures. The Treasury advised ANAO in August 2012 that:

> Nothing in the Budget Process Operational Rules precludes using the reduction of tax expenditures as an offset for outlays programs. Accordingly, reductions in tax expenditures can and are used as offsets. Revenue, including reductions in tax expenditures, is taken into account as a component of 'saves' in Table 2 of the 2012–13 Budget Statement 3.

2.19 The framework for integrating tax expenditures into the Budget process has been strengthened in recent years, including through ERC considering both outlay and revenue measures, and the requirements of the Budget Process Operational Rules. In practice, however, there is scope to improve integration, by quantifying wherever possible these items in the Budget Papers.

Reporting of tax expenditures

2.20 As outlined at paragraph 2.3, no MYEFO report has contained disaggregated tax expenditures envisaged for by the legislation. The AFTS review examined the reporting of tax expenditures, and more specifically, the requirement under the Charter of Budget Honesty that MYEFO include detailed estimates of tax expenditures. The review noted that the purpose of MYEFO is to update key information in the recent Budget, and provides an update on the Government's fiscal and revenue strategy, rather than a comprehensive account of all measures, so even if detailed estimates of tax expenditures could be produced, it would be difficult to compare them against spending programs in any detailed way. The review of AFTS also noted that including fully detailed tax expenditure estimates in MYEFO would

87 The Budget Process Operational Rules list a number of non-genuine savings including general revenue increases, fortuitous underspends, deferral of existing expenses and second round effects.

significantly change its focus as an update to the Government's fiscal and revenue strategy and could delay its release, and that a better means for managing tax expenditures is by ensuring they are examined in the same way as spending programs in the Budget process.[88] Accordingly, the review recommended that:

> The government should introduce legislation to amend the *Charter of Budget Honesty Act 1998* to recognise the publication of detailed information about tax expenditures in a Tax Expenditures Statement separate from the Mid-Year Economic and Fiscal Outlook (MYEFO).[89] However, the Tax Expenditures Statement should continue to be released by the end of January in each year, or within six months of the last Budget, whichever is later.[90]

2.21 In relation to Recommendation No. 2 of the 2008 audit, the Treasury advised ANAO that there has not been explicit advice put to Government on including tax expenditures within MYEFO, or making legislative changes to the Charter of Budget Honesty to remove the requirement that tax expenditures be included within MYEFO. Specifically, the Treasury advised ANAO in August 2012 that:

> The production of the TES is extremely resource intensive and there are not the resources to produce both MYEFO and TES to be published simultaneously, as the same resources are required for the production of both.
>
> AFTS Recommendation No. 136 [see paragraph 1.17] was to change the Charter of Budget Honesty to explicitly change the timing of the release of the TES. This recommendation has not yet been acted on.
>
> The MYEFO and Budget both report aggregate tax expenditure estimates from the preceding TES updated for revised GDP estimates. The detailed TES is published within the timelines laid down for the preparation of the MYEFO update (within six months of the Budget or by 31 January, whichever is later).

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88 *Australia's Future Tax System, Report to the Treasurer*, Part Two Detailed Analysis, Volume 2 of 2. December 2009, pp. 730–731.

89 The Joint Committee of Public Accounts commented that 'it is the Committee's opinion that Treasury should not be operating at odds with the *Charter of Budget Honesty Act 1998*. The Committee will pursue this matter with Treasury and the ANAO.' Joint Committee of Public Accounts and Audit Report 414, *Review of Auditor-General's Reports tabled between August 2007 and August 2008*, June 2009, Canberra, p. 54.

90 *Australia's Future Tax System, Report to the Treasurer*, Part Two Detailed Analysis, Volume 2 of 2. December 2009, p. 729, Recommendation No. 136.

Development of standards to govern the integrated reporting of outlays and tax expenditures

2.22 MYEFO, including the reporting of tax expenditures, is governed by external reporting standards.[91] The 2008 audit noted that neither the *Australian System of Government Finance Statistics* (GFS) or *Australian Accounting Standard No.31 Financial Reporting by Government* (AAS31) are designed to capture all the notional transactions involved in the majority of tax expenditures.[92] The Treasury advised ANAO in this context that tax expenditures can only be measured by reference to a 'benchmark' tax system. The 2008 audit also noted that Canada takes a broader approach to the reporting of tax expenditures, reporting measures that are unarguably tax expenditures along with a range of others that may or may not be so categorised.[93] Accordingly, the ANAO made the following recommendation:

ANAO Recommendation No. 3
ANAO recommends that the Department of the Treasury develop standards to govern the integrated reporting of outlays and tax expenditures under the Charter of Budget Honesty, drawing on international developments in this area.
The Treasury agreed with qualification to the recommendation. The Treasury commented that it already monitors international developments in the reporting of tax expenditures and looks for ways to better integrate the reporting of tax expenditures with outlays, but noted the difficulty with integrated reporting because of inconsistency with definitions of 'tax expenditures' and 'outlays'.

2.23 The JCPAA report on the 2008 audit commented that the system employed by the Treasury prevents reporting of tax expenditures that can be viewed as preferential but are included as part of the benchmark[94], and recommended that the Treasury further investigate the merits of the Canadian model of taxation expenditure reporting, publishing its findings in the TES.[95]

[91] See Schedule 1, Clause 16 of the Charter of Budget Honesty. External reporting standards are defined in Schedule 1, Clause 3 of the Charter of Budget Honesty as: the concepts and classifications set out in GFS Australia; and public sector accounting standards developed by the Public Sector Accounting Standards Board.

[92] ANAO Audit Report No.32 2007–08, *Preparation of the Tax Expenditures Statement,* p. 44.

[93] ibid., p. 45.

[94] TES 2011 (p. 13) states that not all concessional elements of the tax system are classified as tax expenditures. It provides the example of the personal income tax system, which includes a progressive marginal tax rate structure, which results in individuals on lower incomes paying a lower marginal rate of income tax than those on higher incomes. TES 2011 states that this arrangement is a structural design feature of the Australian tax system and is therefore not identified as a tax expenditure.

[95] Joint Committee of Public Accounts and Audit Report 414, *Review of Auditor-General's Reports tabled between August 2007 and August 2008*, June 2009, Canberra, Recommendation No. 8, p. 55.

In response to this recommendation, the Treasury advised the Chair of the JPCAA in December 2009 that:

> Treasury has conducted further investigation of the Canadian model of tax expenditure reporting.[96] In particular, it has noted the use of 'memorandum items' alongside tax expenditures in order to provide information on Canada's tax system. Treasury does not intend to move further in that direction at this time. However, Treasury will continue to monitor international developments in the reporting of tax expenditures and will incorporate developments, as appropriate, that will improve the content and usefulness of Australia's TES.

2.24 The Murray review as part of Operation Sunlight[97] and the review of AFTS supported the development of specific standards to govern the reporting of tax expenditures, with Recommendation No. 137 of the AFTS review stating that:

> The Government should ensure that reporting standards are independently developed for the identification and measurement of tax expenditures in the Tax Expenditures Statement.[98]

2.25 In response to questions regarding whether any standards had been developed, the Treasury advised (in line with its response to the 2008 audit) in August 2012:

> Outlays and revenue are reported in the Budget according to standards set out under the Government Finance Statistics (GFS) guidelines published by the ABS (which are based on the IMF GFS guidelines) and modified as set out in the Budget papers.
>
> The standards governing the calculation and publication of tax expenditures are the benchmarks published each year in the Tax Expenditures Statement. Appendix A of the 2011 TES sets out in detail the conceptual basis for the tax expenditure benchmarks, what the benchmarks are, what is included in the benchmarks and the basis for the variations. Each benchmark in the TES is

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96 The Treasury advised ANAO in January 2013 that it is unable to provide any documentary evidence of its investigation of the Canadian model of tax expenditure reporting.

97 The Murray Report stated: 'Indirect outlays (tax expenditures) have a long way to go before they catch up to the accounting and reporting standards that apply to direct outlays. This is particularly so with respect to the need for a settled nationally applicable and comprehensive reporting framework for tax expenditures, a set of benchmarks, and accounting standards.' (Senator Andrew Murray, *Review of Operation Sunlight: Overhauling Budgetary Transparency*, June 2008, p. 46).

98 *Australia's Future Tax System, Report to the Treasurer*, Part Two Detailed Analysis, Volume 2 of 2. December 2009, p. 729. The review of AFTS also recommended that the COAG should examine the ways in which the states would uniformly report tax expenditures annually according to the independent standards developed under Recommendation No. 137 (see p. 729).

described in a consistent manner, outlining the various elements including the tax base, tax rate, tax unit and tax period for each.

2.26 As noted in Chapter 1, the benchmark includes the rate structure, accounting conventions, deductibility of compulsory payments, provisions to facilitate tax administration, and international fiscal obligations.[99] Tax expenditures are defined and measured as deviations from the benchmark. The tax expenditure benchmark concept is, as outlined at paragraph 1.2, based on two principles: it should represent the standard taxation treatment that applies to similar taxpayers or types of activity; and may incorporate certain elements of the tax system which depart from a uniform treatment of taxpayers where these are fundamental structural elements of the tax system.[100] This entails judgements regarding what should or should not be included in the benchmark. However, as noted by the Treasury in TES 2011, benchmarks are arbitrary[101], and are therefore not a desirable standard to govern reporting.

2.27 Unlike other areas of financial reporting, there are no external reporting standards to guide the reporting of tax expenditures. The development of standards that establish the basis for the identification and measurement of tax expenditures would provide a stronger conceptual underpinning to the TES, enhance the transparency and reliability of the statements and promote comparability between years. The development of standards would best be pursued by the Treasury with other jurisdictions in the interests of sharing both experience and resources.

2.28 The Treasury advised ANAO in January 2013 in relation to further investigation of different models and approaches of tax expenditure reporting that:

> In relation to the broader issue, while there is potentially some value in exploring alternative models and approaches for reporting tax expenditures, this must be balanced against the resources required to conduct such investigations. The production of the existing tax expenditures statement each year already places significant demand on Treasury and ATO resources. In this context it is unclear that a detailed and thorough examination of

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[99] ZL Swift, H Polackova Brixi, and C Valenduc, 'Tax Expenditures: General Concept, Measurement, and Overview of Country Practices', in H Polackova Brixi, CMA Valenduc, ZL Swift (eds.): *Tax Expenditures-Shedding Light on Government Spending through the Tax System: Lessons from Developed and Transition Economies*, The World Bank; Washington D.C., 2004, p. 3.

[100] Department of the Treasury, *Tax Expenditures Statement 2011*, p. 213.

[101] ibid, p. 21.

alternative models of tax expenditure reporting would represent the best use of Treasury and ATO resources.

Conclusion

2.29 New revenue and expense measures generally affect the Budget deficit or surplus in the Budget year and/or the forward estimates. New revenue measures may also directly affect the level of tax expenditures by increasing or decreasing tax concessions. Because of the potential impact on the Budget of new policy measures involving tax expenditures, it is desirable that such measures are evaluated early on, in a similar manner to outlay measures, and are reported against objective standards to maximise transparency about their fiscal impacts.

2.30 In recent years, changes to Budget processes have encouraged the better integration of the consideration of outlays and tax expenditures in the annual Budget process.[102] Specifically, the Budget operating rules envisage that ERC is the only Cabinet Committee that can recommend any new spending or tax expenditures proposals to the Cabinet, unless the Prime Minister agrees otherwise. ANAO found that 21 of the 45 tax expenditure items resulting from new policy proposals reported in TES 2011 did not involve ERC consideration. Many of these new and modified tax expenditure items were associated with a broader package of Government revenue measures, or revenue and expense measures. While this approach potentially allows tax expenditures to be considered with related policy measures, extensive use of such arrangements (that do not involve the ERC) can detract from the goal of achieving better integration of tax expenditures in the Budget process. Integration would be further improved by including, wherever possible, the quantification of tax expenditure items resulting from new policy proposals in the relevant Budget Papers.[103]

2.31 The Murray review as part of *Operation Sunlight* and the review of *Australia's Future Tax System* both supported the ANAO's recommendation[104] relating to the development of standards to govern the reporting of tax expenditures. However, this has not occurred, with the Treasury advising the

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102 This relates to Recommendation No. 2 of the 2008 audit.

103 Of the 45 tax expenditure items resulting from new policy proposals in TES 2011, only 23 were explicitly quantified in the relevant Budget Papers.

104 This relates to Recommendation No. 3 of the 2008 audit.

ANAO in August 2012 (in line with its response to the 2008 audit) that the standards governing the calculation and publication of tax expenditures are the benchmarks published each year in the TES. However, benchmarks are arbitrary, and are therefore not a desirable standard to govern reporting. The Treasury also advised the JCPAA in December 2009, in relation to its recommendation that the Treasury further investigate the merits of the Canadian model of taxation expenditure reporting[105], that the department had investigated the Canadian model, but, at that time, did not intend to move further in that direction.[106]

2.32 Unlike other areas of financial reporting, there are no external reporting standards to guide the reporting of tax expenditures. The development of standards that establish the basis for the identification and measurement of tax expenditures would provide a stronger conceptual underpinning to the TES, enhance the transparency and reliability of the statements and promote comparability between years. The development of standards would best be pursued by the Treasury with other jurisdictions in the interests of sharing both experience and resources.

[105] The 2008 audit noted that Canada takes a broader approach to the reporting of tax expenditures, reporting measures that are unarguably tax expenditures along with a range of others that may or may not be so categorised.

[106] The Treasury advised ANAO in January 2013 that it is unable to provide any documentary evidence of its review of the Canadian model of tax expenditure reporting.

3. Review of Existing Tax Expenditures

This chapter examines Treasury's response to the recommendation of the 2008 audit regarding the ongoing review of existing individual tax expenditure estimates (Recommendation No. 1).

Introduction

3.1 The 2008 ANAO audit noted that monitoring existing tax expenditures is important because they provide many billions of dollars of relief from taxes and charges, with significant effects on the Budget and the economy.[107] However, they are subject to a less comprehensive management and reporting framework than are outlays.[108] As of September 2007, processes were not in place for the regular review of tax expenditures and the audit noted that regular and systematic reviews of tax expenditures would help to identify the benefits and shortcomings of particular tax expenditures and assess their attendant risks.[109] The Treasury advised ANAO at the time of this audit that it intended to regularly review tax expenditures and that a review of tax expenditures was already being implemented in response to the priorities of the new Government.[110] Consequently, ANAO made the following recommendation:

Recommendation No. 1
ANAO recommends that the Department of the Treasury: a. develop an approach for the conduct of an ongoing prioritised review of the existing program of tax expenditures; and b. publish for each tax expenditure information on the timing and outcome of the review.
The Treasury agreed to part (a) and agreed with qualification to part (b). The qualification was on the basis that the Treasury considers that it is a matter for the Government to determine whether it will publish information about the outcome of tax expenditure reviews.

107 ANAO Audit Report No.32 2007–08, *Preparation of the Tax Expenditures Statement*, p. 31.

108 ibid., p. 31. Government outlays are government direct spending that should be authorised by parliamentary appropriation. Such direct spending includes grants and also the purchase of goods and services by the Government. There is a difference between an outlay and actual cost to the Government, owing to the fact that the Government might recoup some of the outlaid amount through the tax system.

109 ibid., p. 38.

110 ibid., p. 39.

3.2 The Murray review as part of the Operation Sunlight reforms endorsed the need for a broad review of tax expenditures, and foresaw the benefit to be derived from ongoing scrutiny.[111] This report also encouraged the publication of tax expenditure reviews, to ensure that the reviews involved a credible, critical appraisal of the costs and benefits associated with each tax expenditure.[112] The subsequent December 2008 Operation Sunlight report stated that Government policy is to: 'require an independent up-front audit and assessment of existing concessions'; and '…set in place processes for their periodic review.' The report noted that the Government, through the Treasury and relevant agencies, was 'progressively reviewing all tax expenditures.'[113]

Reviews conducted in 2008 to inform the 2008–09 Budget

3.3 In December 2007, the Government agreed that the Treasurer would, in the context of the 2008–09 Budget, review 21 tax expenditure items and bring forward proposals for either abolishing, reducing or using more tax concessions effectively. The Treasury reviewed 19 of the 21 tax expenditure items, with the decision made to consider two of the items in another process. In reviewing the items, the Treasury typically included a cost assessment (including, for example, how the cost of the tax expenditure compares with original expectations) and a policy assessment of the tax expenditures. However, a full analysis of how the cost of the tax expenditure compared with original expectations was not possible for a number of the items, as:

- no estimates of the tax expenditures at the time they were introduced were able to be located, and/or;
- at the time of initial assessment they were considered to be unquantifiable.

3.4 Of the original 19 tax expenditure items reviewed, the Treasury, recommended: eight be abolished, eight be modified, two be deferred for consideration and one be retained in its current form. An additional five tax expenditures were also assessed by the Treasury in late 2007 and early 2008, but were not part of the formal review process, which commenced in September 2008.

[111] Senator Andrew Murray, *Review of Operation Sunlight: Overhauling Budgetary Transparency*, June 2008, p. 45.

[112] ibid., p. 46.

[113] *Operation Sunlight, Enhancing Budget Transparency*, December 2008, p. 13.

3.5 At this time, the Government also agreed that other tax expenditures would be reviewed following the 2008–09 Budget as part of a broader review of tax expenditures.[114] The Treasury advised ANAO in January 2013 that this commitment was effectively subsumed within the subsequently announced AFTS review. However, the Treasury has not provided any evidence to suggest that a formal decision was made to this end, and the review of AFTS did not attempt to evaluate all tax expenditures on a systematic basis (although it did examine the broader tax expenditure framework and some tax expenditures in the context of specific taxation areas).

Developing a strategic approach to tax expenditure reviews

Proposed approach to reviews

3.6 The Treasury advised the Treasurer in August 2008 that it had developed an approach to tax expenditure reviews whereby it would complete a prioritised 'rolling' review of tax expenditures with a view to reviewing all tax expenditures once every five years (that is, by 2013). In identifying the list of expenditures for review, the Treasury advised it would take a strategic approach, taking into consideration current Government policy priorities and any tax policy reviews already underway. A summary of the reviewed tax expenditures and the recommended outcomes was to be provided to the Treasurer for his consideration. Under the proposed approach, the Treasury would:

- analyse whether the tax expenditure was within the original cost expectations;
- review the purpose of the tax expenditure to determine its relevance and appropriateness;
- examine whether the tax expenditure was the most effective and efficient way of meeting its policy objectives and delivering outcomes;

[114] In turn, this was part of a broader review of all government expenditures. The then Minister for Finance and Deregulation's *Address to the National Press Club* of 6 February 2008 indicated that there would be a two–stage process to identifying government savings. The first stage involved identifying spending cuts for the 2008 Budget. The second stage involved an 'intensive program-by-program review of government spending and tax concessions to be completed before the 2008–09 Mid-Year Economic and Fiscal Outlook is released.' The Department of Finance and Deregulation advised ANAO in February 2013 that there is no evidence to suggest that tax expenditures were examined by the Expenditure Review Taskforce, and that tax related work within the Expenditure Review Taskforce appears to have been overtaken by the review of *Australia's Future Tax System*. The Taskforce was established in February 2008 to prepare for the second stage of the expenditure review.

- assess whether there were any significant regulatory impacts arising from the tax expenditure; and
- provide a recommendation to abolish, modify, replace or retain the tax expenditure, or defer consideration of the tax expenditure.

3.7 A template document was developed by the Treasury to capture this analysis, and distributed to relevant divisions undertaking the tax expenditure assessments. The document contained three major sections (cost assessment, policy assessment and recommendation), and asked a series of questions in relation to the tax expenditure's cost, policy objective, effectiveness and efficiency, and regulatory impact. It also contained a section for analysts to recommend what actions should be taken in respect to the tax expenditure (abolish, modify, convert to direct expenditure, retain in current form or defer consideration).

3.8 The template document developed by the Treasury to review each individual tax expenditure was a reasonable approach for the assessment.[115] However, there was no timetable developed at the outset of this process to determine which individual tax expenditures would be assessed in which year.

Reviews conducted from September 2008 onwards

3.9 In September and October 2008, the Treasury reviewed 15 tax expenditure items. These assessments were conducted using the template described above.

3.10 In October, November and December 2009, a further series of reviews were conducted. However, only seven were undertaken using the template. For the remaining 93 items, a simplified assessment was completed. These assessments were generally less thorough than those undertaken using the template document. They included an objective, assessment and recommendation section, although the information included in each section was often quite brief. For example, in one instance, relating to tax expenditures under the fringe benefits tax benchmark, 48 tax expenditure items were reviewed in the space of one page.

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[115] Other issues that could have been considered include: the interaction of the tax expenditure with other government programs (at both Commonwealth and state levels); the distributive impact of the tax expenditure; the compliance cost of the measure borne by taxpayers and the tax administrator; and the merits of using the tax expenditure mechanism rather than some other mechanism through which the benefit might be delivered.

3.11 In addition, 70 of the 93 tax expenditure reviews undertaken using this simplified assessment contained no analysis. For these, the reviews referred to the work conducted as part of the AFTS review, or (in one case) amendments before Parliament relating to the tax expenditure. ANAO's analysis indicates that only 30 tax expenditure items were substantively reviewed by the Treasury in this round of reviews.

3.12 In late 2010 and early 2011, a further 54 reviews were undertaken by the Treasury. Most of these were conducted using the template document. These were the last set of formal reviews conducted by the Treasury. It advised ANAO in December 2012 that 'the tax expenditure review [in 2011] was undertaken as part of the Budget savings process, so there was no separate review.'[116] ANAO considers that reviews conducted as part of the savings process will potentially focus on larger items (with the potential for greater savings). As such, smaller or unquantified items may not be identified for review, and consequently, this is not the most appropriate method to ensure tax expenditures are regularly evaluated.

3.13 In response to questions as to why formal reviews of tax expenditures had ceased, the Treasury further advised ANAO in January 2013 that:

> Partly this is a question of how limited Treasury resources are allocated across numerous competing priorities. In practice there is often a trade-off between undertaking relatively high level reviews of a large number of tax expenditures and undertaking fewer reviews in much greater detail.

3.14 The Treasury also advised ANAO that the Government has established several other processes for identifying and reviewing tax expenditures, including the Business Tax Working Group and the Tax Forum. ANAO notes that to date, this work has not been formally coordinated with the tax expenditure review process conducted by the Treasury, and does not obviate the need for an objective assessment of tax expenditures by the Treasury.

3.15 In total, 123 tax expenditure reviews were conducted between November 2007 and early 2011.[117] Of the 123 tax expenditure reviews

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116 The Treasury further advised ANAO in April 2013 that in some cases reviews of tax expenditures undertaken in the context of savings processes have led to the quantification of tax expenditures.

117 This includes five tax expenditures which were reviewed twice. See further at paragraph 3.20. The 123 comprises: the 19 tax expenditure reviews to inform the 2008–09 Budget; the additional five tax expenditure reviews in late 2007 and early 2008; the 15 tax expenditure reviews in September and October 2008; the 30 tax expenditure reviews in late 2009; and the 54 tax expenditures in late 2010 and early 2011.

undertaken, the Treasury recommended: 20 be abolished; five be abolished or modified; 19 be modified; 58 be retained in their current form and 11 be deferred for consideration. The remaining 10 reviews contained no recommendation, or indication that the tax expenditure had already concluded, or that the relevant legislation was in the process of being repealed.

3.16 Of the 364 tax expenditures listed in TES 2011, only 113 (31 per cent) have been reviewed, representing $32 billion, (or 29 per cent of estimated quantified total tax expenditures) in 2010–11. This lack of progress is an issue as the ongoing policy relevance of specific tax expenditures may not be reviewed in any other government context, potentially resulting in tax expenditures remaining in existence which are failing to meet their original policy objectives and/or having unintended consequences.

3.17 In addition, while Treasury advised it would take a strategic approach to prioritising reviews, in practice, there was no evidence of a systematic basis for selection of tax expenditure items for review.

ANAO analysis of reviews

3.18 ANAO reviewed the assessments undertaken by the Treasury. As previously noted, the template review proforma contained a section on cost assessment, to analyse how the cost of the tax expenditure compared with original expectations. However, in many cases, this was not complete, or the Treasury were unable to locate the costing at the time of establishment in order to determine what the original expectations were for the tax expenditure. Without an understanding of a policy's intended outcomes and costs, it is difficult to assess whether it is meeting its intended objectives. The Treasury advised ANAO in January 2013 that the costings from when a particular tax expenditure was established may not be available for several reasons, including:

- The measure giving rise to a tax expenditure may not have been separately costed prior to its introduction. That is, the measure may have been a package, or part of a package which included tax expenditures as elements of the policy. When a costing is done, the primary focus is receipts and revenue.
- Whether or not a particular feature of the tax system is considered to be a tax expenditure can change over time. Something that is now reported as a tax expenditure may not have been considered as such at the time of its introduction. This is particularly relevant for tax expenditures that are long-standing features of the tax system.

3.19 In other reviews, there appeared to be very limited information available to support an assessment as to whether the policy was effective or not, illustrated by the following examples:

- the 2010–11 review of the *Deductibility of charitable entertainment*, states:

  > We are not aware of whether this measure is inducing taxpayers to undertake more charitable donations than they would have undertaken in the absence of the measure. There is also no evidence to suggest that this measure is not operating as intended. Removing the deduction would mean that businesses would no longer get concessional tax treatment for providing entertainment to the disadvantaged…;

- the effectiveness and efficiency section of the 2008–09 review of *Landcare Deduction for Primary Producers* states:

  > This concession does allow deductions for landcare activities as intended. There is no evidence to suggest it is not meeting its policy intent. This measure is monitored on an ongoing basis like other tax concessions. There is no evidence to suggest this measure is not operating as intended…;

- in relation to the tax expenditure item *Deduction for environmental protection activities*, which was reviewed as part of the 2008–09 reviews, the Treasury review states:

  > We are not aware of whether this measure is inducing taxpayers to undertake environmental protection activities that they would have undertaken in the absence of the measure.

3.20 At the time of the audit, the Treasury had not established a formal register of the tax expenditure reviews undertaken, which recorded the tax expenditure reviewed, when it was reviewed and the outcome of the review.[118] Establishing such a register would assist the Treasury in planning which items need to be reviewed in the future, prevent items being reviewed multiple times, and help to ensure that those recommended for 'deferred consideration' were subject to review in the future.

3.21 The reviews conducted by the Treasury highlight the lack of ongoing policy evaluation and monitoring of many tax expenditures. Specifically, a number of the tax expenditure reviews contained the statement 'there is no

[118] ANAO notes that five tax expenditures have been reviewed twice over the period examined. These are: Depreciation pooling for low value assets; Depreciation to nil value rather than estimated scrap value; Exemption of income earned by Australians from working on approved overseas projects; Exemption of income earned by Australians working in a foreign country; and Tax write off for horticultural plants.

ongoing monitoring or evaluation process' for a particular tax expenditure. For example, the 2009–10 review of *Exemption from excise for 'alternative fuels'* states that 'there is no ongoing monitoring or evaluation process', and 'it is unknown whether there has been a significant diversification of the liquid fuel supply due to the tax exemption….' The lack of ongoing monitoring and evaluation of tax expenditures in other forums also emphasises the importance of the Treasury continuing its tax expenditure review process.

Publishing the outcomes of reviews

3.22 The 2008 audit recommended that the Treasury publish, for each tax expenditure, information on the timing and outcome of the review. The Treasury agreed with qualification to this issue, on the basis that it is a matter for the Government to determine whether it will publish information about the outcome of tax expenditure reviews. In its advice to the Treasurer in August 2008 regarding an approach to reviewing tax expenditures, the Treasury advised that it would provide the outcome of reviews. This did not occur. While it is a matter for government to decide, the release of the reviews would provide increased transparency of the review process, as well as assist in informing the debate about the benefits and impacts of individual tax expenditure items.

Conclusion

3.23 The systematic review of tax expenditures highlights opportunities for improvements in quantification of the impacts of tax expenditures as well as ensuring they are periodically evaluated and continue to align with Government policy objectives.

3.24 The Treasury agreed to the ANAO's recommendation to develop an approach for the conduct of an ongoing prioritised review of tax expenditures, and commenced the formalised review process in September 2008, with the aim of completing all reviews by 2013. However, the reviews ceased in 2011. Treasury advised ANAO in April 2013 that it discontinued the formal review process due to the utility of the reviews relative to other priorities, particularly providing advice to the Government on its tax priorities.

3.25 In total, the Treasury conducted 123 tax expenditure reviews between November 2007 and early 2011.[119] Of the 364 tax expenditures listed in TES

[119] These reviews include five tax expenditures that were reviewed twice.

2011, only 113 (31 per cent) were reviewed as part of this process, representing $32 billion, (or 29 per cent of estimated quantified total tax expenditures) in 2010–11. While a comprehensive methodology was devised for the reviews undertaken, it was not always applied. In light of these factors which have impaired progress, Recommendation No. 1(a) from the 2008 audit has not been fully addressed. The ANAO considers that there is still a strong case for conducting a priority-based program of reviews—to assess tax expenditures that are most significant or where other information suggests a review would be beneficial.

3.26 In addition, the timing and outcomes of the reviews of individual tax expenditures have not been made publicly available. As such, Recommendation No. 1(b) from the 2008 audit has also not been fully implemented. The release of this information would improve the transparency of the tax expenditure review process, although ANAO recognises that this would be a decision for government.

4. Quality of Tax Expenditure Estimates

This chapter examines the Treasury's and the ATO's responses to recommendations of the 2008 audit regarding the quality of the tax expenditure estimates (Recommendation Nos. 4, 5 and 6).

Introduction

4.1 This chapter examines how the Treasury and the ATO have sought to improve the reliability of the tax expenditures statement, through obtaining information from other government agencies in accordance with Recommendation No. 4 from the 2008 ANAO audit. It then examines the adoption of the revenue gain methodology to prepare tax expenditure estimates, in response to Recommendation No. 5 from the 2008 ANAO audit. Finally, it examines whether the reliability of tax expenditure estimates has substantively improved, to address Recommendation No. 6 of the 2008 audit.

Improving tax expenditure reporting

4.2 The 2008 ANAO audit found that the annual TES excluded reporting of tax expenditures in revenue collection areas outside the Treasury portfolio, with the exception being certain customs duty data in the estimation of some excise tax expenditures. The audit identified a range of potential tax expenditures administered outside the Treasury portfolio.[120] At the time, the Treasury advised ANAO that the TES is focussed on tax revenue and related concessions rather than on non-tax revenues.[121] The ANAO report noted that, in some instances, there may be competing views as to whether a particular revenue is a tax and, in any case, reporting the substance of the transactions allowing revenue to be forgone may, in some instances, be more relevant than fine distinctions between tax and other revenue raising laws.[122]

4.3 In preparing tax expenditure estimates, the Treasury and the ATO rely on data from a range of other Commonwealth agencies including the:

[120] ANAO Audit Report No.32 2007–08, *Preparation of the Tax Expenditures Statement*, pp. 59–60.

[121] Non-tax revenues under the Government Finance Statistics rules include fee for services and payments that recover the costs of undertaking some administrative function on behalf of the taxpayer.ibid., p. 60.

[122] ibid., pp. 60–61.

Australian Customs and Border Protection Service (Customs and Border Protection); Department of Health and Ageing; Department of Human Services; and Australian Bureau of Statistics. In the context of obtaining data from other agencies, the ATO commented to ANAO at the time of the 2008 audit that:

> The ATO's main role here involves assisting Treasury with the preparation of the expenditure estimates. The ATO believes there would be significant benefit in formalising the arrangements whereby relevant data is obtained from outside the Treasury portfolio. This would involve deciding who will develop the arrangements for obtaining data, collaborating with other portfolios to agree on the provision of the data, the timetable for data provision, and agreement on the correct use of their data.[123]

4.4 Consequently, the 2008 audit made the following recommendation:

ANAO Recommendation No. 4
ANAO recommends that the Department of the Treasury promote more comprehensive reporting on taxation expenditures by: (a) liaising with Commonwealth entities that collect revenue to identify all entities that also administer forms of relief from Commonwealth taxes, including tax expenditures; and (b) developing arrangements, as part of the preparation of the annual Taxation Expenditure Statement, to obtain relevant data from entities outside the Treasury portfolio.
The Treasury agreed with the recommendation and the ATO[1] agreed with part (b) of the recommendation. In relation to part (b): the Treasury noted that there are arrangements already in place to obtain data from some entities outside the Treasury portfolio; and the ATO commented as at paragraph 4.3 above.

Note 1: Although the recommendation was directed at the Treasury, the ATO also responded to part (b) as it had responsibilities for obtaining relevant data.

4.5 In its report on the audit, the JCPAA recommended that the Treasury include information in the Budget Papers on the extent to which tax expenditure reporting has improved through the receipt of reliable data from other agencies.[124] The Treasury's response to the JCPAA recommendation in December 2009 did not directly address the issue of receiving quality data

[123] Ibid., p. 61.

[124] Joint Committee of Public Accounts and Audit Report 414, *Review of Auditor-General's Reports tabled between August 2007 and August 2008*, June 2009, Canberra, Recommendation No. 9, p. 56.

from agencies, but focussed more broadly on the overall reliability of the estimates:

> Information on the reliability of tax expenditure estimates is now being reported within the TES. The first such information was provided in the 2008 TES. In addition, summary information reporting on the number and value of quantified tax expenditures within each reliability category is also provided. This information will allow broad monitoring of improvements over time as more reliable data is identified and incorporated into estimates. Incorporating this information into the TES is more appropriate than including it separately in the Budget Papers.

4.6 The June 2008 Murray review as part of *Operation Sunlight* also commented that the Treasury should ensure that it liaises closely with other portfolios that administer tax expenditures to promote the careful collection of accurate information, 'which will be a precursor to the success of both the review[125] and ongoing scrutiny.'[126]

Actions to improve identification of tax expenditures

4.7 The Treasury commenced a process of writing to Commonwealth agencies to identify potential tax expenditures in 2008. The Treasury wrote to seven agencies, on the basis that they were the agencies, in addition to the ATO and Customs and Border Protection, that were most likely to administer tax revenue and potentially have associated tax expenditures.[127] The Treasury re-commenced the process of seeking relevant data from agencies in August 2010. Specifically, the Treasury wrote to all departments of state, seeking:

> details of any concessions, exemptions or deferrals in respect of any tax revenue administered by [the Department of State] or its portfolio agencies where that concession is not already reported in the current TES'; [and] 'any data that may be of assistance in producing estimates for newly identified or existing tax expenditures.[128]

[125] In his review, Senator Murray stated he endorsed the need for a broad review of tax expenditures.

[126] Senator Andrew Murray, *Review of Operation Sunlight: Overhauling Budgetary Transparency*, June 2008, p. 46.

[127] In the letter, the Treasury requested that the agency indicate what tax revenue it administers on behalf of the Government and what tax expenditures (if any) may exist under the legislation or regulations relating to this tax revenue.

[128] In five of the letters, the Treasury also sought additional information to assist in the quantification of four existing tax expenditure items, and in regards to two potential areas of tax expenditures.

4.8 The Treasury undertook a similar exercise for the purposes of preparing TES 2011 and TES 2012.

4.9 The Treasury identified 38 new tax expenditures within its own portfolio since TES 2008[129] (which were not previously recognised as tax expenditures), and the ANAO identified five potential tax expenditures in its 2008 audit. However, only four additional items were identified through this correspondence with relevant agencies, with all being in the Broadband, Communications and the Digital Economy portfolio. This result would suggest that this approach may not be the most effective way of identifying new tax expenditures in portfolios outside of the Treasury. When seeking to identify new tax expenditures in non-portfolio agencies, there is scope for the Treasury to adopt a more active approach, including identifying and arbitrating in those instances where there is some question as to whether or not the item is a tax.[130]

Data to inform existing tax expenditures

4.10 In writing to agencies to identify new tax expenditures for the purposes of preparing the TES 2010, TES 2011 and TES 2012, the Treasury also sought any data that may be of assistance in producing estimates for newly identified or existing tax expenditures. A number of agencies have provided data as part of this request. However, the process has had limited success in terms of improving the reliability of tax expenditures, based on reported reliability ratings (on a scale from very low to high) published by the Treasury in the TES against tax expenditure estimates. For example, in relation to the 2010 request for data, the Treasury sought specific data from three agencies in relation to four existing tax expenditure items. Although these agencies provided information about the items, the TES 2010 and TES 2011 reported the estimates as 'not available' or 'nil'.[131]

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[129] Twenty-two of these 38 tax expenditures related to GST items in TES 2008.

[130] The 2008 audit noted (p. 60) that in some cases there may be competing views as to whether a revenue is a tax.

[131] The Treasury advised ANAO in April 2013 that it is incorrect to infer that because data was provided by agencies it follows that a tax expenditure may be quantified, as data may be deemed unsuitable to provide a sensible estimate of a tax expenditure (not available) or may reveal that there is currently no tax expenditure (nil). Nevertheless, an intent to improve the reliability of estimates should inform data requests from external agencies, although the ANAO acknowledges that this will not always result in improvements to the reliability of estimates.

Request for provision of data by the Australian Taxation Office

4.11 In August 2007, in the context of concerns raised by ANAO regarding the age of some of the data being used to prepare existing tax expenditure estimates, the ATO commenced a formal process of writing to selected Commonwealth and State government agencies seeking data.[132] Further data requests were made, respectively in 2008 (of three agencies), 2009 (of eight agencies), 2010 (of four agencies), 2011 (of two agencies) and 2012 (of eight agencies).

4.12 A review by ANAO of the six items against which data was requested for the first time in TES 2009, and for which data was received from relevant agencies, indicates that each of their reliability ratings remained the same between TES 2008 and TES 2009, with the ATO not achieving the increase in reliability it was seeking. The ATO has advised ANAO that requests to agencies for data are typically prompted by the identification by individual analysts of the need for updated data for particular tax expenditure items. Most of these requests have resulted in the provision of data, although the data was not always complete and in accordance with the ATO's requirements.[133]

4.13 The ATO also advised that one data source that has assisted in improving the quality of estimates is the increased use of payment summary data.[134] For example, in preparing the 'exemption of war related payments and pensions' model for the 2009 TES, the ATO relied on publicly available data on payment rates, and data provided by the Department of Veterans' Affairs (DVA) on how many clients received the payments. In preparing the model for the 2010 TES, the ATO obtained individual welfare payment summary data from DVA that was then matched to individual taxpayer income tax returns, in order to more accurately quantify the average marginal tax rate, and calculate gross tax including and excluding the non taxable payment.[135] The ATO

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[132] Specifically, in August 2007, the ATO wrote to five Commonwealth agencies (the then Departments of: Employment and Workplace Relations; Education, Science and Technology; Families, Community Services and Indigenous Affairs; and Defence; as well as Centrelink) seeking information on a range of estimates. The ATO received responses from three of the five agencies. No responses were received from the then Department of Families, Community Services and Indigenous Affairs, and Centrelink. The ATO advised ANAO in October 2012 that, for these agencies, the data was unavailable, and a new method developed in the next year made use of more accurate ATO unit record data instead. ATO wrote to State government agencies in later data requests.

[133] For example, the Department of Families, Housing, Community Services and Indigenous Affairs advised the ATO of certain drawbacks in using its data on age pension recipients in July 2012.

[134] Under the pay-as-you-go tax withholding system, businesses must give each of their employees and other payees a payment summary showing the payments made to them and the amounts of tax withheld from those payments during a financial year.

[135] ANAO notes that the reliability estimate did not change for this tax expenditure between 2009 and 2010. In both TES 2009 and TES 2010 this item was rated medium-low.

informed ANAO in January 2013 that, over the time of the 2008, 2009 and 2010 TES publications, four estimates moved from external data to ATO held unit record payment summary data.[136]

4.14 The ATO has also indicated that attempts to improve data reliability occur in the broader context of the Government attempting to reduce the time and effort spent by business on reporting to Government. For example, the Business Tax Return Label Review Project, commissioned in 2008, sought to review and verify the use of all of the labels on main business income tax returns and associated schedules, to identify those labels that were of only marginal or no use and could be removed. This project found that almost all of the labels were used in critical ATO business processes. However, the ATO advised that the removal of labels has not affected TES calculations.

4.15 The Treasury has introduced a formalised process for obtaining additional data from other agencies to improve the quality of existing estimates and identify possible tax expenditures. The ATO has also introduced new processes to obtain information from external agencies to inform the tax expenditure estimates. Overall, however, the additional data collection from agencies by the ATO and the Treasury has not significantly improved the reliability of the estimates.[137] A more systematic approach to obtaining data, including reviewing non-Treasury portfolio data to identify possible tax expenditures, and identifying where a lack of data is reducing the reliability rating of an estimate, is required if the reliability of individual estimates within the TES is to be improved. The approach would potentially be aligned with a program of prioritised reviews of tax expenditure items.

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136 These were (from TES 2011): Tax Offset for recipients of certain social security allowances or benefits (A34); Exemption of certain income support benefits, pensions or allowances (A41); Exemption of Certain Veterans' Pensions, Allowances or Benefits, Compensations, and particular World War-related payments for payments for persecution (A47); and Senior Australians' and Pensioners' Tax Offset (A32).

137 In its report on the audit, the JCPAA recommended (Recommendation No. 9) that the Treasury include information in the Budget Papers on the extent to which tax expenditure reporting has improved through the receipt of reliable data from other agencies. This recommendation has not been met, in that Treasury has not kept records on the extent to which tax expenditure reporting has improved through the receipt of particular data from other agencies (nor published this data in the Budget Papers)

Estimating methodologies

4.16 There are three approaches to measuring the cost of tax expenditures:

- the outlay equivalent method. This approach estimates the extent of direct expenditure that would be required to provide a benefit equivalent to the tax expenditure[138];
- the revenue forgone method. This approach compares the amount of revenue raised under current law with the revenue that would have been raised if the tax expenditure provision alone did not exist.[139] It does not take into account changes in taxpayer behaviour. Therefore, the amount calculated as revenue forgone would not necessarily be the amount of revenue collected from the abolition of the tax expenditure; and
- the revenue gain method. This approach measures how much revenue could increase if a particular tax concession was removed.[140] It attempts to take into account behavioural changes in taxpayers. For example, the removal of a tax concession would be expected to reduce the level of this activity. This method takes this reduction into account.

4.17 The revenue forgone approach is used by the ATO and the Treasury for producing TES estimates. The 2008 ANAO audit noted that a major advantage of the revenue forgone method is that it requires the least amount of data with which to estimate a tax expenditure.[141] In addition, the revenue forgone method provides the present cost of a tax expenditure and also underpins any distributional analysis of tax expenditures (as the revenue forgone method entails knowing who is claiming the benefit and by how much, and then aggregating those amounts). It is the approach most commonly used in other countries.[142] The revenue gain approach provides information on the fiscal effect of abolishing particular tax expenditures. In view of the information provided through the revenue gain method, the 2008 audit put forward Recommendation No. 5:

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[138] Department of the Treasury, *Tax Expenditures Statement 2011*, p. 16. A 2010 OECD report that analysed 10 countries' tax expenditure reporting indicates that this approach is not widely used. (Organisation for Economic Co-operation and Development, 2010, *Tax Expenditures in OECD Countries,* p. 71*).*

[139] ANAO Audit Report No. 32 2007–08, *Preparation of the Tax Expenditures Statement*, p. 63.

[140] Department of the Treasury, *Tax Expenditures Statement 2011*,pp. 16–17.

[141] ANAO Audit Report No.32 2007–08, *Preparation of the Tax Expenditures Statement*, p. 63, paragraph 4.6.

[142] ANAO Audit Report No. 32 2007–08, *Preparation of the Tax Expenditures Statement*, p. 63.

ANAO Recommendation No. 5
ANAO recommends that the Department of the Treasury and the Australian Taxation Office identify opportunities to develop estimates of large or otherwise significant tax expenditures using the revenue gain method.
The Treasury agreed to the recommendation. The Treasury commented that preparing estimates of selected large tax expenditures using the revenue gain method may assist readers of the TES to understand the difference between the 'revenue gain approach' and the 'revenue forgone approach' to estimating tax expenditures. The ATO did not respond to the recommendation.

4.18 The JCPAA considered the use of the revenue gain and revenue forgone methods at its hearing into the 2008 audit. In its report, the Committee noted that it was 'not convinced with the Treasury's reasons for using the revenue forgone method, as it does not indicate ongoing revenue effects over time'[143], and 'the discrepancies between the Budget Papers and the TES greatly weaken the credibility of the revenue forgone method.' Accordingly, the JCPAA recommended:

> That Treasury publish a paper for inclusion in the Tax Expenditures Statement calculating the twenty largest tax expenditures using both the revenue forgone and revenue gain methods to allow comparison with the Budget Papers.[144]

4.19 The Treasury's formal response to this recommendation to the Chair of the JCPAA in December 2009 was that:

> Estimates of six tax expenditures using the revenue gain approach were published in the 2008 Tax Expenditures Statement. The tax expenditures were chosen to highlight the impact of behavioural assumptions on estimates (that is, the differences between the revenue gain and revenue forgone approaches). It is also intended that the 2009 TES include a limited number of estimates of tax expenditures using the revenue gain approach. This time it is intended to focus on the largest tax expenditures (on a revenue forgone basis). It should be noted that there remain practical difficulties in making revenue gain estimates including the information or assumptions needed for the behavioural responses of taxpayers to policy changes and the assumptions [that] must be made regarding the policy specifications for removing each tax expenditure.

143 The revenue gain method can give a better indication of the true cost of a tax expenditure because it takes account of behavioural responses to abolition of a tax expenditure, which might 'wash out' over several years or more.

144 Joint Committee of Public Accounts and Audit Report 414, *Review of Auditor-General's Reports tabled between August 2007 and August 2008*, June 2009, Canberra, pp. 50–52.

4.20 In the context of its analysis of measuring tax expenditure, and noting that the revenue gain approach is useful when reviewing a tax expenditure as it indicates the revenue that could be realised for government if the tax expenditure was abolished, the review of AFTS noted that revenue gain estimates for significant tax expenditures should continue to be published in the annual TES.[145]

Activities undertaken since the previous audit to apply the revenue gain approach

4.21 The Treasury has included revenue gain estimates for certain items in its tax expenditures statements from 2008 onwards. The number of tax expenditure items prepared on a revenue gain basis has risen marginally—from six in TES 2008, to eight in TES 2009, and to 10 in TES 2010 and TES 2011.[146] In TES 2011, the Treasury outlined the difficulties in producing estimates of the value of tax expenditures on a revenue gain basis for all 364 tax expenditures, namely:

- estimating the revenue gain from removing tax concessions requires the application of ad-hoc policy assumptions;
- estimating revenue gain requires information about existing taxpayer behavior and the behavioural response of taxpayers to specific policy changes for estimates, which in most cases is not available; and
- calculating comprehensive revenue gain estimates that provide a reliable estimate of aggregate tax expenditures would require the specification of assumptions regarding the order in which tax expenditures are removed and how activity would flow to alternative concessions.[147]

4.22 Table 4.1 outlines the various items which have been prepared on a revenue gain basis since 2008.

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145 *Australia's Future Tax System, Report to the Treasurer*, Part Two Detailed Analysis, Volume 2 of 2. December 2009, p. 732.

146 Ten revenue gain estimates were also published in TES 2012. These were not examined as part of the audit.

147 Department of the Treasury, *Tax Expenditures Statement 2011*, p. 208.

Table 4.1

Items prepared on a revenue gain basis in the TES since 2008

Tax Expenditures Item	2008	2009	2010	2011
Superannuation—concessional taxation of employer contributions	×	√	√	√
Superannuation—concessional taxation of superannuation entity earnings	×	√	√	√
GST—food; uncooked, not prepared, not for consumption on premises of sale and some beverages	×	√	√	√
GST—health; medical and health services	×	√	√	√
GST—education	√	√	√	√
Customs duty	×	√	√	√
GST—financial supplies; input taxed treatment	×	√	√	√
Exemption of Family Tax Benefit, Parts A and B, including expense equivalent	×	×	√	√
Higher rate of excise levied on cigarettes not exceeding 0.8 grams of tobacco	×	×	×	√
Exemption from interest withholding tax on certain securities	×	×	√	√
Small Business and General Business Tax Break	×	×	√	×
Exemption of Tax Bonus for Working Australians	×	√	×	×
Accelerated depreciation for software	√	×	×	×
Exemption from excise for 'alternative fuels'	√	×	×	×
Concessional rate of excise levied on draught beer	√	×	×	×
Capital gains tax small business retirement exemption	√	×	×	×
GST – child care	√	×	×	×
TOTAL BY YEAR	**6**	**8**	**10**	**10**

Source: TES 2008, 2009, 2010 and 2011.

4.23 The Treasury noted in TES 2011 that the six items selected for revenue gain estimates in TES 2008 were chosen in order to highlight the effect of the difference in approaches on the tax expenditure estimates.[148] In this context, five of the six items prepared on a revenue gain basis in 2008 have not been reported again on a revenue gain basis.

[148] Department of the Treasury, *Tax Expenditures Statement 2011*, p. 207.

Revenue gain estimates contained in TES 2011

Items chosen for preparation of revenue gain estimates

4.24 Treasury advise in the TES 2011 that its approach to selecting estimates prepared on a revenue gain basis is largely informed by their size. The Treasury noted that the TES 2011 contains estimates: 'from 10 of the largest tax expenditure items' and these tax expenditures were chosen because they 'best illustrate the considerable differences that can arise between estimates calculated on the revenue forgone basis and those prepared on the revenue gain basis, and how these differences can vary between tax expenditure items.'[149]

4.25 However, the two largest tax expenditures for the 2011–12 financial year were not prepared on a revenue gain basis, being 'Capital Gains Tax Main Residence Exemption-Discount Component' and 'Capital Gains Tax Main Residence Exemption.'[150] In this context, the Treasury notes in the TES 2011 that:

> Estimates for the revenue gain from the Capital Gains Tax (CGT) concessions for housing and the CGT discount for individuals and trusts have not been quantified because these estimates are either very small and uncertain (housing) or because of the significant uncertainty regarding the magnitude of response effects to a change (CGT discount).[151]

4.26 The Treasury provided additional information to the ANAO on this matter in January 2013, noting that the volume of the underlying tax concession and the vast uncertainty about the behavioural response to these concessions means that the potential upper and lower bounds of any such revenue gain estimate may be billions (and possibly even $5–10 billion per annum) of dollars per year apart.

4.27 There are a range of criteria on which Treasury's decision to prepare an estimate on a revenue gain basis is made. These criteria include: the size of the estimate; the potential difference between the revenue forgone and revenue gain estimates; the level of uncertainty around the behavioural response; and

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149 Department of the Treasury, *Tax Expenditures Statement 2011*, pp. 207-208. All of the 10 revenue gain estimates published in TES 2011 were among the 20 largest expenditure items.

150 The other two items in the top 12 positive tax expenditures which were not quantified on a revenue gain basis were E17 (Capital gains tax discount for individuals and trusts) and C3 (Concessional taxation of non-superannuation termination benefits), which were ranked 6th and 11th respectively in size. The two largest negative tax expenditures were also quantified.

151 Department of the Treasury, *Tax Expenditures Statement 2011*, pp. 207–208.

the effect of the uncertainty on the estimate. Within the context of the TES, there would be benefit in the Treasury clearly specifying the criteria, and providing reasons in terms of these criteria as to why the revenue gain method has not been used for large tax expenditure items.

4.28 ANAO also notes that the Treasury is currently some way from meeting the JCPAA's recommendation that it publish information on the 20 largest tax expenditures using both the revenue forgone and revenue gain methods. To satisfy the intent of the JCPAA recommendation, the Treasury should include, in future TES publications, revenue gain estimates for the 20 largest items or reasons why this is not possible.

Methodology for preparing revenue gain estimates

4.29 TES 2011 notes that the revenue gain estimates involve a standard set of assumptions, namely that for that year, the tax expenditures concerned are removed with effect from 1 July 2011 and apply prospectively to transactions entered into after that date.[152] The Treasury also notes that the revenue gain estimates incorporate the impact of direct behavioural responses from the change where these are expected to have a significant impact on the estimates, but do not include any allowance for second round effects[153], because of the considerable uncertainty regarding the magnitude and timing of such impacts.[154]

4.30 In order to prepare robust revenue gain estimates, it is important that the assumptions used are reasonable, and based on up-to-date and reliable data. In this context, the Treasury advised the JCPAA in 2008 that it endeavored to be as rigorous as possible when measuring behavioural responses, as behavioural change had potentially large ramifications.[155] ANAO reviewed the key behavioural assumptions used in the models underlying the revenue gain estimates for TES 2011. The assumptions are not always based on

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152 Department of the Treasury, *Tax Expenditures Statement 2011*, pp. 208–209.

153 Direct impacts (or first order effects) include the immediate behavioural response to a policy and any offsetting changes in other activities that arise as a result of the target group for the change switching resources from those other activities. Second round effects refer to the impacts on tax revenues that arise from the responses of non-target groups and from the further economic implications from a policy change, for instance due to changes in the level of demand, supply, prices or wages flowing on from the introduction of a new policy. In this context, the reported revenue gain estimate for 'Exemption of Family Tax Benefit, Parts A and B, including expense equivalent' is the same as the revenue forgone estimate for TES 2011, as the Treasury considers there are no quantifiable first round effects, only second round effects (in the form of changes to the labour supply).

154 Department of the Treasury, *Tax Expenditures Statement 2011*, p. 209.

155 Joint Committee of Public Accounts and Audit Report 414, *Review of Auditor-General's Reports tabled between August 2007 and August 2008*, June 2009, Canberra, p. 52.

specific data or systematic analysis. For example, in respect of C5 (Superannuation-concessional taxation of employer contributions), total employer contributions are assumed to fall by 20 per cent, and the average marginal tax rate is reduced by one per cent. In October 2012, ANAO queried the bases on which these assumptions were made, as there was no documentation available to support the assumptions. The Treasury advised ANAO that:

> …the comments on page 210 of the 2011 TES give the essential reasons. Compulsory SG continues but voluntary contributions become much less desirable and are directed to other tax preferred investments. This is why employer contributions fall. Clearly the 20 per cent can't be precise because behavioural change is involved.
>
> Similarly the reason for the assumed drop in marginal tax rate is given on page 210 [of the TES 2011]. More voluntary contributions come from those on higher marginal rates and when voluntary contributions fall, the average marginal tax rate falls. Analysis of the Tax file can inform the extent of the fall to some extent.

4.31 Other key assumptions for the revenue gain estimates, including the elasticity of demand figures, are derived from a range of sources, including academic literature and overseas government websites. The Treasury advised ANAO in January 2013 that in most cases the revenue gain behavioural assumptions have no historical precedent, such as behavioural responses to the abolition of all superannuation tax concessions, and that the assumptions are highly uncertain and the estimates are not reliable.

4.32 Notwithstanding the difficulties in specifying behavioural assumptions, revenue gain estimates can provide valuable information to inform the Parliament and the public about the possible effects of removing particular tax expenditures. Accordingly, the continued focus by the Treasury on this methodology and providing information in the TES would be beneficial.

Improvements made to the reliability of published tax expenditure estimates

4.33 The 2008 audit outlined that the reliability of estimates produced depends largely on the data available as well as the modelling techniques used.[156] At that time, the TES did not provide a reliability estimate for each of the tax expenditure items. In this context, the audit formed an opinion on the reliability and robustness of each of the 162 quantifiable tax expenditure estimates. The audit also noted that there were many unquantified tax expenditures. The audit made the following recommendation based on these findings:

Recommendation No.6
ANAO recommends that the Department of the Treasury: (a) develop an approach to prioritise improvements to the reliability of published tax expenditure estimates; (b) examine options for disclosing in the TES information on the reliability of individual tax expenditure estimates; (c) work with the Australian Taxation Office to develop reliable models to estimate the revenue forgone for existing tax expenditures that are large or otherwise significant; and (d) when developing advice for Ministers on policies that are expected to result in a tax expenditure, assess options for the reliable measurement of the proposed measure.
Agency response[1]: The Treasury and the ATO both agreed with parts (a), (b) and (c) and agreed with qualification to part (d). The Treasury and/or the ATO made comments on parts (b), (c) and (d) as follows: • Part (b): the ATO commented that it includes its assessment of the reliability of its tax expenditure estimate when providing this information to the Treasury and that it sees no reason why this information could not be included in the TES publication; • Part (c); the ATO commented that it and the Treasury are already working towards preparing estimates of the revenue forgone for a number of the previously unquantifiable tax expenditures. The ATO further commented that the 2005 TES saw the introduction of range of magnitude estimates for unquantifiable tax expenditures and that it would prefer to only publish estimates where there is sufficient confidence in the reliability of the modelling; and • Part (d): The Treasury noted that, to the extent that this would require additional information to be collected from taxpayers, it may be inconsistent with the objective of reducing compliance costs for taxpayers and would have to be assessed against that policy objective. The ATO made extensive additional comments on this part (see page 77 of the 2008 audit report) including that 'minimising taxpayer compliance costs and the ATO's departmental costs typically govern the design of administrative arrangements' and that 'accordingly the ATO has no objections to this recommendation subject to the competing need to minimise the compliance cost burden on taxpayers.'

Note 1: Although the recommendation was directed at the Treasury, the ATO also responded as it had responsibilities for the estimation of tax expenditure items.

[156] ANAO Audit Report No.32 2007–08, *Preparation of the Tax Expenditures Statement*, p. 66.

Development of an approach to prioritise improvements to the reliability of published tax expenditure estimates

4.34 The Treasury advised ANAO in August 2012 that there has not been a formally documented approach to prioritise improvements to the reliability of published tax expenditure estimates. Specifically, the Treasury advised:

> Improvements to the TES (including to model and estimates) are identified in a post mortem note by TES coordinators at the end of the production process, based on the experience of those involved in the production.
>
> The approach taken to improvement in the reliability of tax expenditure estimates has been through the process of improving costings of policy more generally. This has been an ongoing process rather than a formally documented project, and is a continuing process.
>
> Improvements in models arising from costing work undertaken by Treasury and the ATO are carried over to tax expenditure estimates on an ongoing basis. This includes developments in data and costing methodology arising from costings of proposals in areas related to particular tax expenditure estimates (for example, improved analysis of company taxation leads to better company tax costings and this can flow on to estimates of company tax expenditure estimates).

4.35 In response to the ANAO's request for specific examples of where improvements in models arising from costing work have been carried over to tax expenditure estimates, the ATO advised in January 2013 of five TES estimates 'which have improved directly as a result of examining issues in the context of new policy costings in recent years...' However, these improvements are not necessarily reflected in improvements in reliability ratings. The reliability rating improved for two of the estimates, fell for two of the estimates and remained the same for one estimate. The Treasury provided an additional four examples, two of which had improved in reliability and two had remained the same.

4.36 The Treasury prepared a 'post-mortem' summary note at the end of preparing TES 2010 and TES 2011. These were both less than one page, and contained very little information on the calculation and methodology of specific estimates. The notes were more focussed on formatting and procedural issues than on improving the reliability and quality of individual estimates.

4.37 In addition, the Treasury and the ATO do not keep a centralised record of when particular tax expenditure models are developed, and whether the methodology has been re-visited since that time. Without such records, it is difficult to determine whether the models have improved in any way.[157] Similarly, there are no records kept on the extent to which tax expenditure reporting has improved through the receipt of particular data from other agencies.[158] The Treasury has not met ANAO's Recommendation No. 6(a) to develop an approach to prioritise improvements to the reliability of published tax expenditure estimates. Further, Treasury's own ratings show that the reliability of estimates are not improving[159] and indicate the need for a more formal and structured approach to improve the reliability of estimates. This approach could include an objective of improving the level of reliability of the estimates to a certain level, by a certain date. In this context, the Treasury advised the JCPAA in December 2009 that summary information reporting on the number and value of quantified tax expenditures within each reliability category in the TES would allow broad monitoring of improvements over time as more reliable data is identified and incorporated into estimates. However, a review of the published reliability ratings (see Table 4.3) indicates reliability has not improved since 2008.

Disclosure of reliability estimates

4.38 As recommended in the 2008 audit, reliability ratings have been publicly disclosed against individual tax expenditure estimates in the annual TES since 2008.

4.39 The 2008 audit estimated the reliability of each of the quantifiable estimates reported in 2006. In undertaking this assessment, ANAO developed a table containing six categories (ranging from very low to high), and a description of models that may fit within each of the categories. Since 2008 (and the introduction of reliability ratings), this table has been published in the annual TES, and been used as an assessment tool by both the ATO and the

[157] ANAO notes that some tax expenditure estimates are not updated on an annual basis, with the final number in the series rolled over to the next year. In addition, some estimates are only partially updated, with models extended with reference to a growth parameter. For TES 2011, the ATO noted in its relevant Section Minutes that those estimates less than $10 million (quantifiable or unquantifiable) were not to be updated. ANAO compared the tax expenditure estimates in the years 2007–08 to 2013–14 in TES 2010 and TES 2011 (the estimates common to both TES years), and found that 168 items (of which 110 were fully unquantified in these years) remained the same. For the TES 2012, the Treasury formalised the updating process. Matured estimates under a threshold, and unquantifiable, small and nil estimates, were to be reviewed every three years.

[158] The JCPAA recommended that the Treasury include information in the Budget Papers on the extent to which tax expenditure reporting has improved through the receipt of reliable data from other agencies.

[159] The number of estimates with a 'medium-high' or 'high' rating fell from 16 per cent of all reliability ratings in TES 2008 to 12 per in TES 2011.

Treasury. This table (included in the 2008 audit report) is set out in Appendix 4.

4.40 The percentage of fully/partially quantified estimates with a reliability rating in TES 2011 has been relatively steady since 2008, as illustrated in Table 4.2.

Table 4.2

Percentage of quantified estimates with reliability ratings for TES 2008 to TES 2011

Year	Number of fully/partially quantified estimates[1]	Number with a reliability rating[2]	Percentage of fully/partially quantified estimates with reliability ratings
TES 2008	225	204	91
TES 2009	231	206	89
TES 2010	239	214	90
TES 2011	249	232	93

Note 1: There are a number of items in each TES year which are fully/partially quantified, and which do not have a reliability estimate. For TES 2011, this comprised four items which were included in other estimates, 10 items which were a combination of * (estimate not available) and '-'(nil), one item which is a combination of a number and * (estimate not available), one item which is a combination of '..' (not zero but rounded to zero) and * (estimate not available), and one item with all '-' (nil).

Note 2: In contrast to Note 1, ANAO also notes that there are a number of items in each of the TES where items are fully unquantified, however, there is also a reliability rating against the estimates. For example, for TES 2011, there are nine items which are fully unquantified, but have a reliability rating against them. These comprise one 'very low' estimate, seven 'low' estimates, and one 'medium' estimate. These are errors.

Source: Annual Tax Expenditures Statements published by the Department of the Treasury.

Levels of reliability since 2006

4.41 The 2008 audit assessed the reliability of the quantifiable tax expenditure estimates in TES 2006. These estimates were agreed by the Treasury and the ATO at the time. As outlined in Table 4.3, the level of the reliability of the estimates changed significantly between 2006 and 2008. Most significantly, the number of estimates with a 'high' reliability rating fell from 25 per cent of estimates with a reliability rating, to 4 per cent, whilst the number of estimates with a 'medium' reliability rating increased from 20 to 40 per cent of all estimates with a reliability rating. ANAO's review of a selection of items rated high in 2006 indicates that there was not a substantive change in methodology for costing during that period, which was confirmed by the Treasury in January 2013. The Treasury advised in April 2013 that the reliability measures are 'subject to a high degree of judgment' and that the level of reliability ratings between 2006 and 2008 could be due to a 'revision in the views about these levels'.

4.42 Since that time, reliability levels have largely stabilised, as outlined in Table 4.3. The number of estimates with a 'medium-high' or 'high' rating has remained quite low, representing only 12 per cent of all reliability ratings in TES 2011, and down four percentage points from 16 per cent in 2008. In April 2013, Treasury noted that an improved understanding of the reliability of the estimate can actually result in a fall in the reliability rating. Although this is a possibility, ANAO's analysis does not support that this would result in lower overall rating levels. As noted at paragraph 4.35, the reliability of some tax expenditure estimates improved following additional costing work, while the reliability of some tax expenditure estimates deteriorated.

Table 4.3

TES reliability ratings by year for 2006 to 2011

	Reliability Rating					
	Very Low	Low	Medium-Low	Medium	Medium-High	High
2006	19 (12%)	38 (23%)	20 (12%)	33 (20%)	11 (7%)	41 (25%)
2007	N/A. No reliability estimates included in TES.					
2008	9 (4%)	49 (24%)	32 (16%)	81 (40%)	25 (12%)	8 (4%)
2009	9 (4%)	50 (24%)	39 (19%)	81 (39%)	24 (11%)	6 (3%)
2010	8 (4%)	60 (27%)	41 (19%)	82 (37%)	21 (10%)	8 (4%)
2011	9 (4%)	73 (30%)	43 (18%)	88 (37%)	21 (9%)	7 (3%)

Note 1: Totals may not equal 100 per cent due to rounding.

Note 2: The published totals of reliability estimates in the annual TES did not always equal the actual totals of ratings of reliability estimates. The numbers above are the actuals.

Source: ANAO Audit Report No.32 2007–08 (p. 69) and annual TES.

Methodology for determining reliability ratings

4.43 At present, there is a high level of judgement involved in categorising tax expenditure items into reliability rating categories. As a result, there have been some inconsistent ratings applied by analysts within both the Treasury and the ATO as outlined at Table 4.4.

Table 4.4

Inconsistent ratings across estimates

Tax expenditure estimate	ANAO assessment
H3 (GST- Financial Supplies; reduced input tax credits) and H2 (GST-Financial Supplies; input taxed treatment)	The calculation of the estimates for a reliability rating for H3 and H2 is very similar, both relying on the same data sources and applying similar modelling techniques. However, the reliability rating for H3 in TES 2011 was low, whilst the reliability rating for H2 in TES 2011 was medium.
A30 (the Flood and cyclone reconstruction levy)	This item was allocated a reliability rating of medium in the TES 2011. However, the data sources used in this model are strong. Broadly, the model calculates tax expenditure by calculating the levy an individual would be charged in a given taxable income range, multiplying by the forecast number of net taxpayers in that income range, and then summing the results across the income groups. Timing assumptions were then applied, and the effects of three exemptions (representing approximately 7 per cent of the total tax expenditure) were removed.[160]
A43 (Exemption of Family Tax Benefit, Parts A and B, including expense equivalent)	The estimate is broadly calculated by multiplying the average marginal tax rate by the amount of family tax benefit provided by 50 per cent. The 50 per cent represents the percentage of Family Tax Benefit that is assumed to be non-taxable, reflecting that many recipients of Family Tax Benefit are low income earners or unemployed. ATO are unable to further substantiate this assumption. Given the significance of this assumption to the total expenditure amount, and the lack of data to support it, a medium rating appears quite high.[161]
B16 (Exemption from interest withholding tax on certain securities)	This item was rated at a low reliability in TES 2011. This estimate uses aggregate modelling, and relies on company tax return data, and has limited assumptions associated with it. Accordingly, its rating appears overly low.

Source: ANAO analysis of ATO and the Treasury data.

160 In this context, the Treasury advised ANAO in October 2012 that: 'A reliability rating of medium is likely to have been allocated to this item because incomplete data from secondary sources were used to calculate the impact of exemptions from the levy. Though Treasury acknowledges this is a matter of judgement as to whether a higher rating may also have been appropriate.'

161 In the methodology document associated with this tax expenditure, the ATO notes that it may 'consider the validity of assuming 50 per cent of participants are non taxable' in actions for TES 2012.

4.44 The inconsistencies in approach are also evident in different ratings being initially applied by analysts within the Treasury/ATO, and subsequently being adjusted prior to publication. Adjustments may be necessary in order to ensure reliability ratings are consistently applied across different groups. However, the high rate at which this occurs would suggest a lack of shared understanding of the meanings of particular reliability ratings. From an examination of the reliability ratings associated with the 20 largest tax expenditure estimates, five had different levels of ratings applied by analysts within the Treasury/ATO from that ultimately allocated in the TES 2011. In respect to one of these estimates ('Exemption from interest withholding tax on certain securities'), which was rated as 'low' in TES 2011, but rated at a 'medium' reliability by the ATO analyst, the ATO advised ANAO in January 2013 that:

> Reliability ratings may be adjusted as part of the quality assurance process and this is what happened here. Ratings are based on our best judgement but the ATO may accept a different view after analysis by, and discussion with Treasury. This can be especially the case with an estimate like this, where the data is volatile and the question of data quality is a matter of judgement.

4.45 The categories originally developed by the ANAO to inform its 2008 audit opinion, and subsequently adopted by the Treasury, have not been further developed into a standardised process for ATO and Treasury analysts to effectively rate the reliability of individual estimates. One area in particular which would benefit from more detailed guidance is how to assess reliability ratings with a mixture of high and low quality data. At present, these types of estimates are being treated inconsistently within the TES. For example, in relation to A30 (the 'Flood and cyclone reconstruction levy'), the various exemptions, comprising only seven per cent of the final tax expenditure estimate for 2011–12, were considered to reduce the level of reliability of the estimate to 'medium'.

4.46 Similarly, in respect of C6 ('Superannuation-concessional taxation of superannuation entity earnings'), ATO officials advised ANAO that C6 is a 'low' level of reliability due to the unverifiable data assumptions associated with the pension phase. This typically comprised around 20 per cent of the total tax expenditure. In contrast, the unverifiable assumption associated with A43 ('Exemption of Family Tax Benefit, Parts A and B, including expense equivalent'), which reduced the total level of the tax expenditure by 50 per cent, did not appear to significantly affect the level of reliability rating for this item, which was assessed as 'medium' for the TES 2011.

4.47 ANAO has identified a range of other areas where there could be more information provided within reliability categories to assist analysts in categorising particular estimates. For example, the reliability categories could contain information on:

- the inherent reliability of certain key models used in the preparation of tax expenditure estimates, and what effect this has on the reliability estimate. For example, the five largest GST models all rely heavily on the Price Revenue Incidence Simulation Model (PRISMOD), a large scale, disaggregated model of the Australian economy using national accounts data from the Australian Bureau of Statistics;
- the effect of the sensitivity of the model to changes in assumptions and input data, and the impact of this on the reliability estimate assessment. For instance, in relation to E5 ('Capital gains tax main residence exemption') and E6 ('Capital gains tax main residence exemption-discount component'), the Treasury notes that 'the estimates are to small changes in assumptions and input data, and their reliability has not been quantified'; and
- whether the estimate reliabilities relate to the entire eight years (both prior year estimates and forecasts), and whether greater emphasis is placed on the out years when assessing reliability.

4.48 The Treasury advised ANAO in January 2013 that one of the issues that adds complexity to TES reliability ratings is when the data and behavioural response volatility do not align well. For example, a tax expenditure estimate may be based on high quality tax data (implying a 'medium-high' or 'high' reliability rating) but also involve taxpayer behaviour which is very dependent on factors outside the tax system (implying a 'low' rating).

Unquantified estimates of tax expenditures

4.49 As mentioned previously, the 2008 audit recommended that the Treasury work with the ATO to develop reliable models to estimate the revenue forgone for existing tax expenditures that are large or otherwise significant.[162]

[162] ANAO Audit Report No.32 2007–08, *Preparation of the Tax Expenditures Statement*, p. 76.

4.50 A review of TES 2006 indicates that there were nine fully unquantified estimates with order of magnitude ranges from +/-$100 million to more than +/-$1 billion. Of these, two have been quantified since TES 2006, 'Exemption for health care benefits provided to members of the Defence Force' and 'Capital gains tax main residence exemption'. More generally, of the 86 fully unquantified estimates included in the TES 2006, nine have been quantified since that time.

4.51 Of the three large unquantifiable items specifically mentioned in the 2008 audit which had unpublished estimates associated with them, one has been quantified ('Capital gains tax exemption of the income from the sale of a taxpayer's main residence'), whilst two remain unquantified ('Income Tax Exemption for Commonwealth, State and Territory public authorities, and State and Territory entities' and 'Denial of deductibility for certain self-education expenses').

4.52 The number of unquantified estimates[163] as a percentage of the total tax expenditure estimates has remained fairly stable since 2006, as outlined in Table 4.5, and still represents a significant portion of tax expenditure items.

Table 4.5

Unquantified estimates of tax expenditure items

TES year	Number of estimates in TES	Number of unquantified estimates	Percentage of estimates that are unquantified
2006	272	86	32
2007	299	91	30
2008	324	99	31
2009	337	106	31
2010	349	110	32
2011	364	115	32

Source: Annual TES issued by the Department of the Treasury.

163 For the purposes of this analysis, 'unquantified estimates' are taken to be those that have 'no estimate available' for any of the eight years (that is, they have a '*' against each year).

Process of considering the quantification of unquantified estimates

4.53 At the start of each annual TES process, the ATO and the Treasury meet to decide if any items can be quantified. For example, for the purposes of TES 2011, 166 tax expenditure items were examined that were fully or partially unquantified or had an estimate of zero.[164] Of these items, a decision was made not to attempt to quantify or alter 144 items. For the remaining 22 items, a decision was made to attempt to quantify 17 estimates, delete three items and insert an order of magnitude for two items. Ultimately, the Treasury was able to fully quantify two estimates, and provided an additional year's estimate for six partially unquantified estimates.

4.54 In this regard, the Treasury advised ANAO in August 2012 that:

> There is an objective to quantify estimates (both tax expenditures and costings of new policy) wherever possible. The meetings with the ATO regarding the TES at the start of the process do seek to determine whether particular estimates can be quantified but are not the only input to the process. Other inputs are the results of costings of new policy undertaken on an ongoing basis and the TES checking process itself.
>
> The process of determining whether an unquantifiable estimate can be quantified involves determining whether any new data has become available and on what developments have been made in modelling techniques and methodologies. In some cases, tax expenditures have been quantified as a result of specific research work undertaken in particular areas, for instance, the quantification of housing tax expenditures.
>
> Examples of where unquantifiable estimates have become quantified include: condensate (data was identified in the lead up to the 2005 TES); and housing tax expenditures were first quantified in the 2008 TES, based on work undertaken by [the Retirement and Inter-generational Modelling and Analysis Unit].

4.55 The Treasury does not maintain a list of why certain tax expenditures are not quantified, and/or any attempts in the past to quantify certain tax expenditures. Maintaining such a list would help to ensure that time is not wasted in attempting to quantify items which are almost impossible to quantify and would assist in prioritising the quantification process. Treasury also advised that in many cases a complete absence of data may make it almost

164 This included estimates which were zero/rounded to zero; or were a combination of quantified and zero/rounded to zero.

impossible to estimate some tax expenditures and, that while one possible answer is to collect additional information on tax returns, this usually increases the compliance burden on taxpayers which the ATO actively seeks to minimise where possible.

Unquantified items in the 2011 TES

4.56 There remains a significant number of unquantified estimates, some of which are very large in size. For TES 2011, of the 115 fully unquantified estimates, 113 had been given an order of magnitude range.[165] Of these, most items (92, or 81 per cent) were between 0 and +/-$100 million. However, 16 items were given an order of magnitude range of between +/-$100 million and +/-$1 billion and three items were given an order of magnitude range of +/-$1 billion.[166] The three largest unquantified items with an order of magnitude estimate in TES 2011 are:

- 'Income Tax Exemption for Commonwealth, State and Territory public authorities, and State and Territory entities' (B3);[167]
- 'Philanthropy-Income Tax Exemption for charitable, religious, scientific and community service entities' (B69); and
- 'Quarantining of capital losses' (E32).

4.57 Of the 27 new tax expenditures listed in TES 2011, 17 were not quantified in TES 2011. Nine of these relate to tax expenditures created under the natural resources taxes benchmark. These items were also not quantified in TES 2012. In this respect, the Treasury advised ANAO in February 2013 that:

> The new tax expenditures relating to the revised natural resources benchmark were not able to be quantified in the 2011 or 2012 TES because of a lack of data to allow estimates to be produced; the MRRT revenue model does not allow such estimates to be generated and there were no outcomes data on which estimates could be based. In particular, the MRRT model utilises a "top down" approach, rather than a "bottom up" approach. Over time, more detailed information on the MRRT will become available, particularly through MRRT annual tax returns. As more information becomes available, Treasury and the ATO will review whether these nine tax expenditures can be estimated.

[165] There were also an additional two items marked 'na', relating to B102 (Research and Development-Immediate deduction for expenditure on core technology) and E15 (Capital gains tax-roll-overs not otherwise recognized).

[166] Two items were given an order of magnitude range of zero on average.

[167] The 2008 audit noted that there was a preliminary estimate available for this item (Tax exempt State and Territory Government Business Enterprises).

Measurement of new tax expenditures

4.58 ANAO requested the Treasury's advice on the status of its response to Recommendation No. 6(d) of the 2008 audit relating to assessing options for the reliable measurement of proposed measures when advising Ministers. In this context, the Treasury advised ANAO in January 2013:

> Treasury's response to Recommendation No. 6(d) of the ANAO's original audit was that it agreed with qualification. As noted at that time, to the extent that improved measurement of a tax expenditure would require additional information to be collected from taxpayers, it may be inconsistent with the objective of reducing compliance costs for taxpayers and would have to be assessed against that policy objective. This remains Treasury's position. Further, actions that might improve the measurement of particular tax expenditures could also risk detracting from the dominant purpose of the tax system-to raise revenue.

Conclusion

4.59 Tax expenditure estimates are based on often complex economic models. To run these models, the Treasury and the ATO need to draw on a variety of data sources and the accuracy and timeliness of data can vary.[168] Consequently, tax expenditure estimates have differing degrees of reliability. In order to make reporting on tax expenditures as useful to readers as possible, a focus on improving the reliability of estimates over time is important. As well, consideration of behavioural impacts on estimates is desirable.

4.60 Since 2008, the Treasury has corresponded with a range of Australian Government agencies to obtain information on possible unidentified tax expenditures.[169] However, only four additional items were identified through correspondence with relevant agencies. In contrast, the Treasury identified 38 items within its own portfolio from 2008 to 2011 that were not previously recognised as tax expenditures. These different results suggest there are potential benefits in the Treasury adopting a more active approach towards identifying new tax expenditures in other portfolios, including assisting in

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[168] In this context, the Treasury advised ANAO that in many cases, a complete absence of data may make it almost impossible to estimate some tax expenditures, particularly where tax expenditures arise due to the exemption from tax of certain income or activities.

[169] These correspondence activities have been in line with Recommendation No. 4(a) of the 2008 ANAO audit. Further, in its report on the audit, the JCPAA recommended that the Treasury include information in the Budget Papers on the extent to which tax expenditure reporting has improved through the receipt of reliable data from other agencies.

those instances where there may be some question as to whether the item was a tax.

4.61 Similarly, there is little evidence that additional data collected from agencies by the ATO and the Treasury has significantly improved the reliability of the estimates.[170] A more systematic approach to obtaining data, including reviewing non-Treasury portfolio data to identify possible tax expenditures, and identifying where a lack of data is reducing the reliability rating of an estimate, is required if the reliability of individual estimates within the TES is to be improved. The approach would potentially be aligned with a program of prioritised reviews of tax expenditure items.

4.62 The 2008 audit suggested that tax expenditure reporting could be improved through the introduction of significant revenue gain estimates. Revenue gain estimates seek to take into account behavioural changes among taxpayers, unlike the revenue forgone approach which is the standard methodology used to prepare estimates in the TES. The Treasury has included revenue gain estimates in their TES from 2008 onwards (meeting Recommendation No. 5 of the 2008 ANAO audit). However, Treasury is some way from meeting the JCPAA's recommendation that it publish information on the 20 largest tax expenditures using both the revenue forgone and revenue gain methods. Only 10 revenue gain estimates were published in TES 2011, all of which were among the 20 largest expenditure items. To satisfy the intent of the JCPAA[171], the Treasury could include, in future TES publications, revenue gain estimates for the 20 largest items or reasons why this approach was not adopted.

4.63 Since TES 2008, the Treasury has disclosed information on the reliability of individual tax expenditure estimates in the annual TES. This addresses Recommendation No. 6(b) of the 2008 audit. However, there remain a number of areas for improvement in relation to the reliability of estimates, notably that the Treasury has not developed a formal, documented approach

[170] This relates to Recommendation No. 4(b) of the 2008 audit.

[171] The Treasury advised the JCPAA in December 2009 that: 'Estimates of six tax expenditures using the revenue gain approach were published in the 2008 TES … It should be noted that there remain practical difficulties in making revenue gain estimates including the information or assumptions needed for the behavioural responses of taxpayers to policy changes and the assumptions must be made regarding the policy specifications for removing each tax expenditures ...'.

to prioritise improvements to reliability.[172] There were also inconsistencies identified in the approach taken by analysts within the Treasury and the ATO to assigning reliability ratings to estimates. The rating categories originally developed as part of the 2008 ANAO audit and subsequently adopted by the Treasury have not been further developed into a standardised process for analysts to effectively rate the reliability of individual estimates. In this context, ANAO has made the following recommendation:

Recommendation No.1

4.64 To improve the consistency of the reliability ratings disclosed in the annual Tax Expenditures Statement, ANAO recommends that the Department of the Treasury and the Australian Taxation Office review and standardise their internal methodology for allocating reliability ratings to tax expenditure items.

ATO response: *Agreed.* **Treasury response:** *Agreed.*

Ian McPhee

Auditor-General

Canberra ACT

9 May 2013

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[172] As set out at Recommendation No. 6(a) of the 2008 audit. In addition, the number of unquantified estimates as a percentage of total tax expenditure estimates has remained fairly stable since 2006 and there are a number of large estimates which featured in TES 2006 that have not yet been quantified. As such, Recommendation No. 6(c) of the 2008 audit has only been partially addressed.

Appendices

Appendix 1: Agency Responses

Australian Government
The Treasury

22 April, 2013

Ms Barbara Cass
Group Executive Director
Performance Audit Services Group
Australian National Audit Office
GPO Box 707
CANBERRA ACT 2601

Dear Ms Cass

TREASURY RESPONSE TO S.19 REPORT ON THE PREPARATION OF THE TAX EXPENDITURES STATEMENT

Thank you for your letter of 21 March inviting Treasury to formally respond to the report on the follow-up audit of the preparation of the Tax Expenditures Statement.

The Treasury agrees with the recommendation made in the section 19 report.

Please find attached Treasury's response to the report, including response to the recommendation and comments for inclusion in the audit report (Annexure A) as well as detailed comments on the report (Annexure B).

I thank the ANAO and its officers for the professional manner in which they have undertaken the audit. They have demonstrated a co-operative approach in working with Treasury officers throughout the analysis phase of the audit and in finalising the report.

If you have any further queries regarding the report, please contact Marty Robinson, Principal Adviser, Tax Analysis Division (6263 2740).

Yours sincerely

Rob Heferen
Executive Director
Revenue Group

Annexure A

Treasury response to recommendations

ANAO Recommendation 1: To improve consistency of the reliability ratings disclosed in the Tax Expenditures Statement, ANAO recommends that the Treasury and the Australian Tax Office review and standardise their internal methodology for allocating reliability ratings to tax expenditure items.

Treasury response: Agree.

Treasury comments for inclusion in the audit report

The annual publication of the Tax Expenditures Statement (TES) continues to be regarded by the Treasury as an integral part of the Australian Government's Budget reporting. It allows tax expenditures to receive a similar degree of public scrutiny as direct expenditures and contributes to public debate on the elements of the tax system. The Treasury welcomes scrutiny of the TES itself, including from the ANAO in this follow-up audit. The Treasury agrees with the report's recommendation to take steps to standardise the allocation of reliability ratings of estimates published in the TES.

Improvements have been made in a number of areas of the TES since the 2007-08 audit and subsequent recommendations by the Joint Committee of Public Accounts and Audit (JCPAA). The inclusion of reliability indicators and liaison with other Commonwealth agencies has resulted in greater transparency and bolstered ongoing efforts to identify new tax expenditures and improve the reliability of existing tax expenditures. This is in addition to work being undertaken in the Treasury and the Australian Taxation Office (ATO) to improve the quantification of tax expenditures through the development of new models and inclusion of new data sources. These efforts are acknowledged in the report.

The Treasury also welcomes the ANAO's acknowledgment that improvements in the integration of tax expenditures in the Budget process have been made. The Government's Budget Process Operational Rules (BPORs) are designed to ensure the proper scrutiny of revenue and spending proposals. The BPORs allow for the Prime Minister to have policy considered through the ERC or other means such as another committee of Cabinet or correspondence between Ministers. While the Expenditure Review Committee (ERC) did not consider all policies that resulted in new or modified tax expenditures, the ANAO found that the BPORs were adhered to in all of these cases.

With respect to the presentation of revenue gain estimates in the TES, Treasury notes that the extension to reporting 10 of the largest tax expenditures under this approach is sufficient to demonstrate that the revenue forgone approach is not always representative of the gain to revenue from the removal of a tax expenditure. Treasury maintains the view, however, that the presentation of the TES on the revenue forgone approach is the most appropriate means of ensuring comparability with outlays estimates provided in the Budget.

The Treasury is committed to the ongoing improvement of the TES, including through the quantification of new and existing tax expenditures and improvement in the reliability of estimates, where this is cost effective. The ability to quantify or improve the reliability of tax expenditures is generally restricted where relevant taxation data is not available. Relevant tax data may be unavailable where the ATO considers that the additional compliance burden on taxpayers and other groups outweighs the benefits of collecting the information. The Treasury will continue to pursue improvements in the TES in future, including through progressing recommendations made by the ANAO and JCPAA, with regard to the available resources and in the context of Government priorities.

Australian Government
Australian Taxation Office

SECOND COMMISSIONER OF TAXATION

Ms Barbara Cass
Group Executive Director
Performance Audit Services Group
Australian National Audit Office
GPO Box 707
CANBERRA ACT 2601

Dear Ms Cass

Australian National Audit Office Performance Audit of Preparation of the Tax Expenditures Statement

Thank you for your letter of 21 March 2013 and the opportunity to provide comments on the proposed report on the *Preparation of the Tax Expenditures Statement*.

I would also like to thank the Australian National Audit Office for the co-operative and professional way in which this audit was conducted.

The ATO is happy to accept the recommendation in the report. Attached is the ATO response to recommendation 1 (Annexure 1) and summary of our comments to be used in the report (Annexure 2).

If you require further information on this matter, please contact Julia Neville, Assistant Commissioner, Revenue Analysis Branch, on 02 621 61350.

Yours sincerely

Neil Olesen
Acting Second Commissioner
Australian Taxation Office
22 April 2013

cc ANAO auditors

Appendix 2: ANAO Audit Report No. 32 *Preparation of the Tax Expenditures Statement* recommendations

ANAO recommendations and agency responses
1. ANAO recommends that the Department of the Treasury: (a) develop an approach for the conduct of an ongoing prioritised review of the existing program of tax expenditures; and (b) publish for each tax expenditure information on the timing and outcome of the review.
The Treasury agreed to part (a) and agreed with qualification to part (b). The qualification was on the basis that the Treasury considers that it is a matter for the Government to determine whether it will publish information about the outcome of tax expenditure reviews.
2. ANAO recommends that the Department of the Treasury examine and advise Ministers on options to better integrate the consideration of outlays and tax expenditures in the annual Budget process.
The Treasury agreed to the recommendation.
3. ANAO recommends that the Department of the Treasury develop standards to govern the integrated reporting of outlays and tax expenditures under the Charter of Budget Honesty, drawing on international developments in this area.
The Treasury agreed with qualification to the recommendation. The Treasury commented that it already monitors international developments in the reporting of tax expenditures and looks for ways to better integrate the reporting of tax expenditures with outlays, but noted the difficulty with integrated reporting because of inconsistency with definitions of 'tax expenditures' and 'outlays'.

ANAO recommendations and agency responses	
4.	ANAO recommends that the Department of the Treasury promote more comprehensive reporting on taxation expenditures by: (a) liaising with Commonwealth entities that collect revenue to identify all entities that also administer forms of relief from Commonwealth taxes, including tax expenditures; and (b) developing arrangements, as part of the preparation of the annual Taxation Expenditure Statement, to obtain relevant data from entities outside the Treasury portfolio.
The Treasury agreed with the recommendation and the ATO agreed with part (b) of the recommendation. In relation to part (b): the Treasury noted that there are arrangements already in place to obtain data from some entities outside the Treasury portfolio; and the ATO commented that: 'The ATO's main role here involves assisting Treasury with the preparation of the expenditure estimates. The ATO believes there would be significant benefit in formalising the arrangements whereby relevant data is obtained from outside the Treasury portfolio. This would involve deciding who will develop the arrangements for obtaining data, collaborating with other portfolios to agree on the provision of the data, the timetable for data provision, and agreement on the correct use of their data.'	
5.	ANAO recommends that the Department of the Treasury and the Australian Taxation Office identify opportunities to develop estimates of large or otherwise significant tax expenditures using the revenue gain method.
The Treasury agreed to the recommendation. The Treasury commented that preparing estimates of selected large tax expenditures using the revenue gain method may assist readers of the TES to understand the difference between the 'revenue gain approach' and the 'revenue forgone approach' to estimating tax expenditures. ATO did not respond to the recommendation.	

ANAO recommendations and agency responses	
6.	ANAO recommends that the Department of the Treasury: (a) develop an approach to prioritise improvements to the reliability of published tax expenditure estimates; (b) examine options for disclosing in the TES information on the reliability of individual tax expenditure estimates; (c) work with the Australian Taxation Office to develop reliable models to estimate the revenue forgone for existing tax expenditures that are large or otherwise significant; and (d) when developing advice for Ministers on policies that are expected to result in a tax expenditure, assess options for the reliable measurement of the proposed measure.

The Treasury and the ATO both agreed with parts (a), (b) and (c) and agreed with qualification to part (d). The Treasury and/or the ATO made comments on parts (b), (c) and (d) as follows:

- Part (b): the ATO commented that it includes its assessment of the reliability of its tax expenditure estimate when providing this information to the Treasury and that it sees no reason why this information could not be included in the TES publication;
- Part (c); the ATO commented that it and the Treasury are already working towards preparing estimates of the revenue forgone for a number of the previously unquantifiable tax expenditures. The ATO further commented that the 2005 TES saw the introduction of range of magnitude estimates for unquantifiable tax expenditures and that it would prefer to only publish estimates where there is sufficient confidence in the reliability of the modelling; and
- Part (d): The Treasury noted that, to the extent that this would require additional information to be collected from taxpayers, it may be inconsistent with the objective of reducing compliance costs for taxpayers and would have to be assessed against that policy objective. The ATO made extensive additional comments on this part (see page 77 of the 2008 audit report) including that 'minimising taxpayer compliance costs and the ATO's departmental costs typically govern the design of administrative arrangements' and that 'accordingly the ATO has no objections to this recommendation subject to the competing need to minimise the compliance cost burden on taxpayers.'

Appendix 3: Joint Committee of Public Accounts and Audit recommendations relating to tax expenditures

JCPAA recommendations and Treasury response
That Treasury publish a paper for inclusion in the Tax Expenditures Statement calculating the twenty largest tax expenditures using both the revenue forgone and revenue gain methods to allow comparison with the Budget Papers. **[Recommendation No. 7]**
Treasury advised the JCPAA in December 2009 as follows: Estimates of six tax expenditures using the revenue gain approach were published in the 2008 Tax Expenditures Statement (TES). The tax expenditures were chosen to highlight the impact of behavioural assumptions on estimates (that is, the differences between the revenue gain and revenue forgone approaches. It is also intended that the 2009 TES include a limited number of estimates of tax expenditures using the revenue gain approach. This time it is intended to focus on the largest tax expenditures (on a revenue forgone basis). It should be noted that there remain practical difficulties in making revenue gain estimates including the information or assumptions needed for the behavioural responses of taxpayers to policy changes and the assumptions must be made regarding the policy specifications for removing each tax expenditure.
That Treasury further investigate the merits of the Canadian model of taxation expenditure reporting, publishing its findings in the paper proposed in Recommendation 7. **[Recommendation No. 8]**
Treasury advised the JCPAA in December 2009 as follows: Treasury had conducted further investigation of the Canadian model of tax expenditure reporting. In particular, it has noted the use of 'memorandum items' alongside tax expenditures in order to provide information on Canada's tax system. Treasury does not intend to move further in that direction at this time. However, Treasury will continue to monitor international developments in the reporting of tax expenditures and will incorporate developments, as appropriate, that will improve the content and usefulness of Australia's TES. Treasury also notes that Australia takes a broad view of what constitutes a tax expenditure and incorporates a substantial amount of information regarding benchmarks and individual tax expenditures. This information is more comprehensive than that provided by most other countries. Information on a number of the memorandum items identified under the Canadian system, such as tax deductions, are published in detail in the ATO's annual *Taxation Statistics* report.

JCPAA recommendations and Treasury response
That Treasury include information in the Budget Papers on the extent to which tax expenditure reporting has improved through the receipt of reliable data from other agencies. [**Recommendation No. 9**]
Treasury advised the JCPAA in December 2009 as follows: Information on the reliability of tax expenditure estimates is now being reported within the TES. The first such information was provided in the 2008 TES. In addition, summary information reporting on the number and value of quantified tax expenditures within each reliability category is also provided. This information will allow broad monitoring of improvements over time as more reliable data is identified and incorporated into estimates. Incorporating this information into the TES is more appropriate than including it separately in the Budget Papers.

Source: Joint Committee of Public Accounts and Audit, Report 414, Review of Auditor-General's Reports tabled between August 2007 and August 2008, June 2009.

Appendix 4: Reliability of quantifiable tax expenditure estimates: Table from 2008 ANAO audit

Category	Description
Very low	• Very little data and of poor quality, model relying heavily on data assumptions. • Almost no information on potential taxpayer behaviour.
Low	• Little data, much of it low quality, with important unverifiable data assumptions. • Taxpayer behaviour is volatile or very dependent on factors outside the tax system.
Medium-Low	• Basic data only, mainly from sources other than tax. Includes important reasonable assumptions that cannot be readily checked. • Significant new tax expenditures or existing tax expenditures for which taxpayer behaviour is hard to predict.
Medium	• Incomplete data, often from high quality secondary sources, with a number of verifiable assumptions. • New or changed tax expenditures with considerable behavioural changes or dependent on factors outside the tax system.
Medium-High	• High quality tax data. • Modelling with few assumptions. • May involve a new or changed tax expenditure for which future taxpayer behaviour is fairly predictable.
High	• High quality tax data. • Modelling with few or no assumptions. • Well established tax expenditure with stable and predictable taxpayer behaviour.

Source: ANAO Audit Report No.32 2007–08, *Preparation of the Tax Expenditures Statement*, p. 69.

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