



24 July 2015

Mr David Monk
Inquiry Secretary
House of Representatives Standing Committee on Tax and Revenue
PO Box 6021
Parliament House
CANBERRA ACT 2600

Dear Mr Monk

Inquiry into the Tax Expenditures Statement

Thank you for your invitation to the Australian National Audit Office (ANAO) to make a submission to the House of Representatives Standing Committee on Tax and Revenue's inquiry into the Tax Expenditures Statement (TES).

The inquiry covers the preparation of the TES by the Department of the Treasury (the Treasury), with a particular focus on recommendations from reports released by the ANAO, the Joint Committee of Public Accounts and Audit (JCPAA), and as part of Australia's Future Tax System (AFTS) Review.

This submission includes a summary of the findings of the ANAO's 2013 performance audit on the preparation of the TES, which also covered the implementation of recommendations of the JCPAA and, to a lesser extent, the AFTS. The submission does not provide a detailed discussion of these findings, as they are available in the audit report.¹ In preparing the submission, we have reviewed TES reports released since our audit was completed to gain an understanding of potential changes to the reporting, methodologies and processes for their preparation. In line with the terms of reference for the inquiry, consideration has been given to the improvements to the TES that the ANAO considers would yield the most benefit.

As stated by the Committee Chair, preparing the TES is challenging, and the Treasury and the Australian Taxation Office (ATO) must make a range of assumptions and work with limited data. The ANAO acknowledges the challenges in preparing the TES, but also considers that

¹ ANAO, Audit Report No. 34, 2012–13, *Preparation of the Tax Expenditures Statement*.

further improvements are needed to better inform policy development and contribute to public debate on all elements of the tax system.

Background

Tax expenditures are, broadly, tax concessions that fall outside a tax norm or benchmark, with the reporting of tax expenditures required under the *Charter of Budget Honesty Act 1998*. The Treasury commenced the annual publication of a separate TES in 1987, and has prepared a statement for each year (except for 1999–2000) up to and including 2014. These annual statements give Parliament and the general public the opportunity to examine existing tax expenditures. The statements contain details of each of the tax expenditures, and report 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.

In May 2008, the ANAO tabled Report No. 32, 2007–08, *Preparation of the Tax Expenditures Statement*, which concluded that monitoring and reporting of tax expenditures through the TES could be improved by the Treasury. The report included six recommendations designed to improve the quality of information relating to tax expenditures over time through regular review and evaluation of tax expenditure measures, and improvements to the data and reliability of the models used to quantify tax expenditures. The JCPAA conducted an inquiry into the above-mentioned audit in September 2008, and made three recommendations aimed at enhancing the Treasury's reporting of tax expenditures in the annual TES. Further, the AFTS Review report of December 2009 reinforced many of the ANAO's findings in relation to the consideration of tax expenditures by Cabinet, and made four recommendations relating to the tax expenditures framework.

The ANAO conducted a follow-up audit, Report No. 34, 2012–13, *Preparation of the Tax Expenditures Statement*, to assess the extent to which the Treasury and the ATO had 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. It also made reference to the implementation of the AFTS recommendations.

Findings of the 2013 ANAO audit

The ANAO's 2013 audit of tax expenditures found that progress by the Treasury and the ATO in implementing the recommendations in the 2008 audit and JCPAA review had been slow. The 2008 audit noted that there had been a number of government and parliamentary reviews of tax expenditures over time, each identifying similar shortcomings and making similar recommendations, yet few of these recommendations had been adopted.² Similarly, the 2013 audit found that, of the recommendations stemming from the 2008 audit and the subsequent JCPAA inquiry, only two ANAO recommendations had been fully implemented.³ The remaining recommendations, including those from the AFTS Review, had been only

² ANAO Audit Report No.32, 2007–08, *Preparation of the Tax Expenditures Statement*, p. 14.

³ The ANAO's 2013 report provides an overview of the progress of implementation of each of the previous ANAO and JCPAA recommendations.

partially addressed. The ANAO concluded that the implementation of remaining recommendations would enhance public confidence in the reporting of tax expenditures.

Specific findings

The ANAO's 2013 audit found that processes had been put in place by the Treasury to better integrate tax expenditures into the Budget process to improve transparency around Budget inputs.⁴ Notwithstanding these new processes, 21 of the 45 tax expenditure measures resulting from new policy proposals reported in TES 2011 did not involve consideration by the Expenditure Review Committee of Cabinet. While there will be occasions when matters are considered outside the normal committee processes of Cabinet, the extensive use of such arrangements can detract from the goal of achieving better integration of tax expenditures into the Budget process.

The Treasury agreed to the ANAO's 2008 audit recommendation to develop an approach for the conduct of an ongoing prioritised review of tax expenditures. While the systematic review and evaluation of tax expenditures was commenced by the Treasury in 2008, with an aim of reviewing all expenditures once every five years (that is, by 2013), it was ceased in 2011 without publicly reporting the results.

The ANAO's 2008 audit also highlighted that the development of external reporting standards could provide a stronger conceptual underpinning to the TES, enhance the transparency and reliability of the statements and promote comparability between years. The ANAO's 2013 audit found, however, that the Treasury had not advanced the development of standards or pursued international methods of reporting since the earlier audit.

A strong focus on improving the reliability of estimates over time is needed to ensure that the reporting on tax expenditures provides useful information to stakeholders. Since TES 2008, the Treasury had disclosed information on the reliability of individual tax expenditure estimates in the annual TES. However, there had been no measurable improvement to the reliability and quantification of the Treasury's tax expenditure estimates over time, and the Treasury had not developed a formal, documented approach to prioritise improvements to reliability.

Further, the ANAO's 2013 audit identified inconsistencies in the approach taken by analysts within the Treasury and the ATO to assigning reliability ratings to estimates, with a high level of judgement involved in categorising tax expenditure measures into reliability rating categories. The rating categories originally developed as part of the 2008 ANAO audit, and subsequently adopted by the Treasury, had not been further developed into a standardised process for analysts to effectively rate the reliability of individual measures.

In its 2013 audit, the ANAO made one further recommendation to improve the consistency of the published reliability ratings by standardising the methodology for allocating ratings. This recommendation was agreed by both the Treasury and the ATO.

⁴ There was, however, scope to increase the quantification of tax expenditures resulting from new policy proposals in the relevant Budget Papers.

The Treasury's response

In response to the ANAO's 2013 audit, the Treasury noted that the annual publication of the TES was an integral part of the Australian Government's Budget reporting processes, and that:

Improvements have been made in a number of areas of the TES since the 2007–08 audit and subsequent recommendations by the 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 ATO to improve the quantification of tax expenditures through the development of new models and inclusion of new data sources.

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 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.

ANAO observations on subsequent TES publications

In preparing this submission, the ANAO reviewed TES publications released since the 2013 audit was tabled in May 2013 (TES 2012, TES 2013 and TES 2014), to gain an understanding of, and changes to, the presentation and/or preparation of the TES. This review does not constitute an audit.⁵

The Treasury has, particularly in the case of TES 2013 and TES 2014, more clearly disclosed issues in relation to the formulation, reliability and use of tax expenditures. This increased disclosure reflects a greater understanding of issues relating to the integrity of tax expenditures data. However, it is also likely to have reduced stakeholders' confidence in using the estimates of tax expenditures. The Treasury's improved understanding of issues relating to the integrity of tax expenditures, and increased concerns regarding the aggregation of individual expenditures⁶, also resulted in TES 2013 and TES 2014 not including any aggregate or trend information. The exclusion of such information is likely to have made it more difficult for stakeholders to assess the overall impact of tax expenditures on the Budget position or policy objectives and decisions. There is also little information included in the TES reports published since 2011 to demonstrate that the Treasury has made substantial improvements to the measurement of expenditures.

Of note, TES 2011 and TES 2012 included an overview (Chapter 1) that provided trends in measured tax expenditures across a range of factors, including the subject of the expenditure (such as superannuation), type of tax, function (such as social security or defence, and including a comparison to direct expenditures), and overall as a proportion of Gross Domestic Product. Similar information was not, however, included in TES 2013 and TES 2014, with

⁵ The ANAO did not contact the Treasury to collect information or obtain its advice about any improvements since the earlier audit.

⁶ TES 2013 noted that 'previous editions of the TES have stated that tax expenditure estimates are not strictly additive, for example, because the removal of one tax provision will affect the utilisation of other provisions for accounting and behavioural reasons. Tables aggregating tax expenditures have therefore been removed from the 2013 TES. This issue will be reviewed for the 2014 TES'.

Chapter 1 instead focussing on the caveats or shortcomings in the tax expenditure measures. The two latest TES reports also did not contain any comparisons with direct expenditures or indicate the overall quantum or relative importance of the expenditures.⁷

The ANAO's review of new or modified tax expenditures since TES 2011 indicated that tax expenditures had not been subject to significant review and revision by the Treasury since the 2013 audit. The extent to which new measures were quantified at the time of their consideration as part of Budget processes was also limited, with only seven of the 12 new tax expenditures quantified in the initial TES. The incidence of unquantified estimates had increased from 32 per cent in TES 2011 to 49 per cent in TES 2014, while levels of reliability remained constant. In addition, the reports published since the earlier audit provided little evidence of improved methodologies for quantifying tax expenditures, with only four of 101 modified expenditures arising from modelling updates.⁸

Potential areas of focus

The Committee noted that the TES is an important document and expressed an interest in improvements that would yield the most benefit.

Areas of particular focus

The ANAO considers that there would be merit in the Treasury focusing on the following two areas:

- establishing a program of prioritised reviews to inform improvements in tax expenditure measures; and
- reporting more fully in the TES to allow greater consideration of tax expenditures in comparison to direct outlays.

In the course of the 2013 audit, the Treasury informed the ANAO of its resource constraints and competing priorities, and cited these factors as major reasons for not progressing improvements to tax expenditure estimates more rapidly in recent years. Notably, the Treasury identified these constraints and competing priorities as prime reasons for discontinuing a rolling review of tax expenditures in 2011. The establishment of a program of prioritised reviews of tax expenditure measures, rather than a rolling review of all tax expenditures as commenced in 2008, would allow the Treasury to focus on those measures assessed as having low reliability but high importance.⁹ Such a review could consider the formulation of tax expenditure measures, improvements to the nature and reliability of the data used for priority measures, and whether measures are meeting their intended policy aims. The reviews would also assist the Treasury to address existing problems¹⁰ with the base

⁷ Based on information in TES 2014, the ANAO estimated that quantified tax expenditures totalled around \$120 billion in 2013–14 and the unquantified estimates totalled around \$15 billion that year.

⁸ Another 20 tax expenditure measures had been subject to reporting modifications, which often involved merged expenditure measures.

⁹ The level of importance would be informed by the magnitude of the measure and/or the likelihood of it being subject to scrutiny or modification.

¹⁰ As outlined earlier, almost half of all tax expenditures in TES 2014 were not quantified, and only 13 per cent of the quantified expenditures were rated as having high or medium-high reliability.

measurement of tax expenditures (which is undertaken using the revenue forgone method¹¹). These problems potentially reduce confidence in, and the use of, tax expenditures in policy development and Budget processes.

The exclusion of the aggregate, trend and comparative reporting of tax expenditures in TES 2013 and TES 2014 has also resulted in reduced visibility of the overall magnitude and relative importance of tax expenditures. To better inform policy development and Budget processes, there would be benefit in the Treasury considering ways of providing aggregate and comparative information about tax expenditures in future TES.

Additional areas of focus

In addition to the priority given to the areas outlined earlier, two further areas of potential focus for the Treasury include improving the consideration of tax expenditures in the Budget processes and standardising measures of reliability.

The ANAO's 2013 audit identified scope for greater consideration of tax expenditures in Budget processes, particularly in: quantifying estimates at the time of their consideration; and considering a higher proportion of new and modified tax expenditures together with outlay measures through the Expenditure Review Committee. In addition, as tax expenditures are not subject to ongoing Parliamentary scrutiny through appropriation bills, unlike government outlays, it is important that appropriate processes are in place for Parliament to assess whether tax expenditure items have achieved their policy aims. As such, there would be benefit in the Treasury exploring options for greater parliamentary scrutiny of tax expenditures, for example by including these expenditures within MYEFO as specified in the Charter of Budget Honesty.

As reliability ratings impact on stakeholders' confidence in using tax expenditures for policy development and Budget purposes, and given their role in prioritising measures for review, it is important that these ratings are assigned consistently. There would be merit in reliability ratings being considered as part of the proposed prioritised review of individual tax expenditures and the Treasury adopting standardised processes for rating individual measures.

On the basis of first aiming to improve confidence in existing tax expenditures, lower priority areas of focus would include: increasing the number of additional tax expenditure measures reported in the TES through greater collaboration with other Australian Government entities to identify potential expenditures; extending the use of revenue gain methodologies¹² to a greater number of tax expenditures (such as to the 20 largest); and commencing processes to set external standards for tax expenditures.

Conclusion

While the Treasury has taken steps to improve tax expenditure measures in response to earlier audits and reviews, improvements to TES processes have been limited. The reliability of tax expenditures remains generally low, and transparency has reduced with the exclusion of aggregate or comparative reporting of tax expenditures in the current TES (2014). To help guide further improvements to future tax expenditure measures, there would be benefit in the

¹¹ 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.

¹² This approach measures how much revenue could increase if a particular tax concession was removed, by attempting to take into account behavioural changes in taxpayers.

Treasury establishing a prioritised review of tax expenditures with low reliability but high importance. There would also be benefit in the Treasury reconsidering the level of aggregate or comparative reporting of tax expenditures. Further areas of focus could include introducing processes to enable greater parliamentary scrutiny of tax expenditures and standardising measures of reliability.

Further contact information

Should the Committee require further information in relation to the matters raised in this submission, please contact Mr Andrew Morris, Executive Director, on [REDACTED] or at [REDACTED]

Yours sincerely

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