The Auditor-General
Audit Report No.32 2007–08
Performance Audit

Preparation of the Tax Expenditures Statement

Department of the Treasury

Australian National Audit Office

ISSN 1036–7632

ISBN 0 642 81013 3

Australian National
Audit Office

Canberra ACT
8 May 2008

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the Department of the Treasury 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 and the accompanying brochure. 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

The Auditor-General is head of the Australian National Audit Office. The ANAO assists the Auditor-General to carry out his duties under the *Auditor-General Act 1997* to undertake performance audits and financial statement audits of Commonwealth public sector bodies and to provide independent reports and advice for the Parliament, the Government and the community. The aim is to improve Commonwealth public sector administration and accountability.

For further information contact:

The Publications Manager
Australian National Audit Office
GPO Box 707
Canberra ACT 2601

Telephone: (02) 6203 7505
Fax: (02) 6203 7519
Email: webmaster@anao.gov.au

ANAO audit reports and information about the ANAO are available at our internet address:

http://www.anao.gov.au

Audit Team

Kim Bond
Sean Neubeck
Ashley Davey
Katherine Sessions
Brian Boyd

Contents

Tables

Figures

Summary and Recommendations

Summary

Introduction

1. Tax expenditures and social welfare programs are the two oldest forms of financial assistance provided by the Commonwealth Government. Tax expenditures have no precisely agreed or fixed definition. In practice, what constitutes a tax expenditure can change over time and between jurisdictions. In Australia, the *Tax Expenditures Statement 2006* (TES 2006) defines a tax expenditure as:

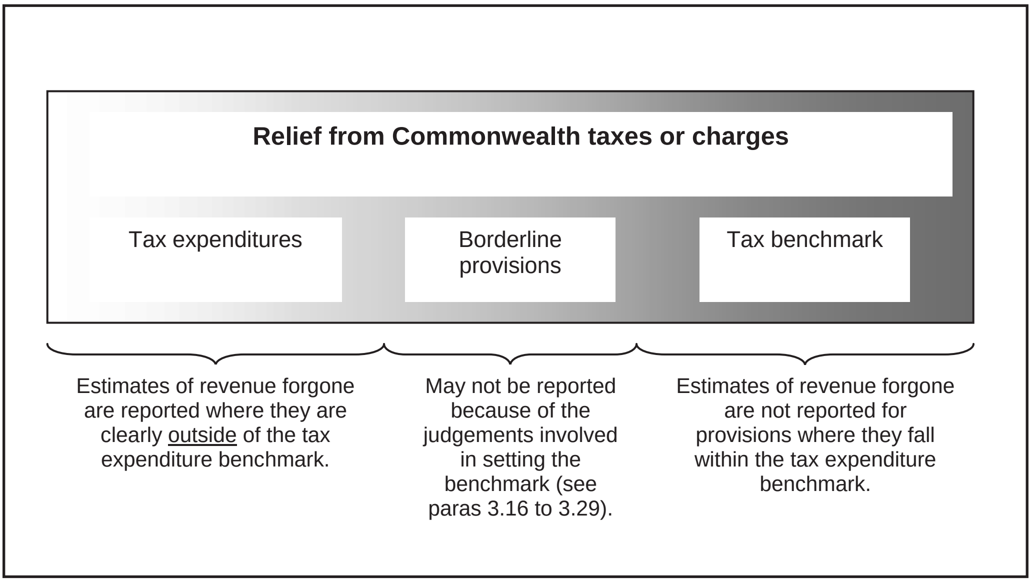
> a tax concession that provides a benefit to a specified activity or class of taxpayer… A tax expenditure can be provided in many forms, including a tax exemption, tax deduction, tax offset, concessional tax rate or deferral of tax liability.[1]

2. In preparing each TES, the Department of the Treasury (Treasury) measures tax expenditures by reference to a normative (or benchmark) taxation system. Under this approach, the selection of the benchmark is critical to the identification and quantification of tax expenditures. The concept is illustrated in the following diagram, which shows that concessions considered structural elements of the tax system are included within the relevant benchmark. Other concessions are to be reported as tax expenditures.

[1] Commonwealth of Australia, *Tax Expenditures Statement 2006*, February 2007, pp. 1–2.

Figure 1

Application of the tax benchmark concept



Source: ANAO analysis.

3. In 2006–07, tax expenditures provided over $41 billion of relief to taxpayers from Commonwealth taxes and charges.[2] Delivered mostly as tax exemptions, reduced rates of tax and tax rebates, total assistance through tax expenditures is similar in size to assistance delivered through the Commonwealth's largest spending (or outlay) programs. Tax expenditures incur an opportunity cost—they can represent revenue that, if collected, would have been available to fund spending programs (or outlays) to meet similar objectives or to increase the Budget surplus/reduce the Budget deficit.

4. The *Charter of Budget Honesty Act 1998* (the CBH Act) introduced two separate but related requirements for annual reporting on tax expenditures. Specifically:

- Division 1 of Part 5 (titled *Annual Government reporting*) of the CBH Act requires that an annual budget economic and fiscal outlook report be prepared and that it contain an overview of estimated tax expenditures for the budget year and the following three financial years.

[2] Tax expenditure estimates are calculated on an individual basis and do not take account of potential overlaps with other tax expenditures. In this respect, TES 2007 notes (p. 17) that 'While aggregate tax expenditure estimates can provide a guide to trends in tax expenditures over time, overlaps between the coverage of different tax expenditures and likely behavioural responses to their removal mean that such aggregates are not a reliable indicator of the overall budgetary impact of tax concessions.

Accordingly, an appendix to *Statement 5: Revenue* in Budget Paper No. 1 for 2007–08 *Budget Strategy and Outlook* included aggregate historical tax expenditure data for 2003–04 to 2005–06 together with projected tax expenditures for 2006–07 to 2009–10 and a preliminary projection for 2010–11; and

- Division 2 of Part 5 of the CBH Act requires the public release and tabling of a Mid-Year Economic and Fiscal Outlook (MYEFO) report and that it contain a detailed statement of tax expenditures. The purpose of the MYEFO report is to provide updated information to allow the assessment of the Government's fiscal performance against the strategy set out in the current fiscal strategy statement.

5. Since the CBH Act took effect, a separate TES has been published each year except 1999–2000.[3] In its March 2007 report titled *Transparency and accountability of Commonwealth public funding and expenditure*, the Senate Standing Committee on Finance and Public Administration noted that subsidies are generally provided by means of special appropriations and expressed the view that reporting of tax expenditures should be no less transparent than the reporting of special appropriations.[4] The Committee supported the publication of the TES as an essential accountability mechanism.[5]

Audit objective and scope

6. The objective of the audit was to assess the completeness and reliability of the estimates reported in *Tax Expenditures Statement 2006* (TES 2006). That is, the audit examined the development and publication of the detailed statement of actual tax expenditures required by Division 2 of Part 5 of the CBH Act. The development and publication of aggregated information on projected tax expenditures included in the Budget Papers pursuant to Division 1 of Part 5 of the CBH Act was not examined.

7. The Senate Standing Committee on Finance and Public Administration's March 2007 report referred to above noted the ANAO's forthcoming audit of the preparation of the TES. Consistent with a suggestion

---

[3] There was a one-year break in the publication of the TES during the transition to accrual budgeting and to *The New Tax System* and *The New Business Tax System*.

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

[5] ibid.

of the Committee, the ANAO audit has examined proposals for greater transparency in the reporting of tax expenditures made to the Committee during its inquiry. The audit also examined:

- the systems employed by Treasury—and the records supporting them—for the production and publication of TES 2006;
- the methods, models and data sources used by the Australian Taxation Office (ATO) to produce the reported estimates of tax expenditures; and
- the reporting of tax concessions by some other agencies responsible for administering Commonwealth taxing and charging laws so as to assess completeness of the TES. In particular, the Australian Customs Service (Customs) was included within the scope of the audit.

Audit conclusions

8. The purpose of the CBH Act was to establish an integrated fiscal framework to provide for greater discipline, transparency and accountability in fiscal policy. A key element of this integrated framework was that the MYEFO report was to include detailed estimates of both tax expenditures and outlays, thereby promoting the scrutiny of both forms of expenditure. However, due to methodological challenges, Treasury has not yet found a way to integrate the reporting of outlays and tax expenditures, with the result that the detailed estimates of tax expenditures are reported in a separate TES document. Treasury has advised ANAO that it is not possible to include the full detailed tax expenditure estimates in the MYEFO release without significant changes to the focus of the MYEFO document and without delaying the release of MYEFO itself.

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

- the benchmarks used in preparing the TES are selected by Treasury based on judgements with the result that benchmarks may vary over time and can be arbitrary;

- whilst the CBH Act requires the TES to be based on external reporting standards,[6] neither the Australian accounting standards or the economic reporting standard issued by the Australian Bureau of Statistics have been developed to account explicitly for tax expenditures. In particular, as few tax expenditures arise from direct transactions and other events of the kind commonly recorded in accounting systems, neither AAS31 nor GFS is designed to capture all the notional transactions involved in the majority of tax expenditures. The external reporting standards also do not address the selection of tax benchmarks;
- there are unreported categories of tax expenditures. Each TES from TES 1995–96 onwards has identified, on average, ten tax expenditures arising from tax concessions or relief already in place but previously unreported. In this respect, during the course of the audit, Treasury took or foreshadowed action to improve the coverage of the TES by reporting tax expenditures in relation to Customs Duty and Goods and Services Tax, as well as expanding the reporting of superannuation tax expenditures; and
- TES 2006 included quantified estimates for less than 60 per cent of those tax expenditures that were reported and, of these, two thirds were not based on reliable estimates. Modelling of the effect of tax expenditures and estimation of their cost has been made more difficult by the trend of reducing the compliance burden on taxpayers, which results in less information being collected from which estimates can be made. This situation also impedes analysis of whether individual tax expenditures are achieving their objectives.

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

- the development of standards to govern the integrated reporting of outlays and tax expenditures under the Charter of Budget Honesty,

---

[6] Defined in the CBH Act as:

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

drawing on international developments in this area. This should contribute to the development of a more comprehensive picture of total Commonwealth expenditure, irrespective of the manner in which it is delivered and provide more rigour over the selection of tax expenditure benchmarks;

- the identification of opportunities to better integrate the consideration of outlays and tax expenditures in the annual Budget process so that the cost of any new tax concession, and any potential offsetting savings, is fully considered; and
- improvements to the reliability of those tax expenditure estimates that are published, recognising that there is a balance to be struck between more reliable estimates and increasing the demands on taxpayers to provide additional information (the compliance burden).

11. Over the last 35 years there have been a number of Government and Parliamentary reviews of tax expenditures. However, few of the recommendations of these reviews have been adopted. As a result, each successive review reported similar shortcomings and made similar recommendations. ANAO notes that the Government has recently announced[7] that, before the 2008–09 MYEFO is released, it will undertake a program-by-program review of government spending and tax concessions with the objective of increasing efficiency, transparency and accountability.

Key findings by Chapter

Monitoring and reporting framework (Chapter 2)

12. Compared to outlays, existing tax expenditures are subject to a less comprehensive management and reporting framework, as shown in the following table. This hampers the effective monitoring and scrutiny of individual tax expenditures. In many cases, it is not possible to show whether objectives are being achieved and whether the actual benefits are proportionate to the costs.

[7] The Hon Lindsay Tanner MP, Minister for Finance and Deregulation, *Address to National Press Club Canberra Wednesday 6 February 2008*, p. 4.

Table 1

Comparison of key management arrangements for outlays and tax expenditures

Key oversight arrangements	Existing outlays	Existing tax expenditures
Estimates compiled according to independent standards fit for the purpose	Yes	No
Identified for all Commonwealth agencies	Yes	No
Subject to regular Budget review	Yes	Infrequently
Reported in Budget estimates	Yes, by outcome, generally not by program	Infrequently
Subject to Budget monitoring	Yes, by outcome	Infrequently
Costs monitored against estimates	Yes	Infrequently
Subject to annual agency reporting	Yes, by outcome and by appropriation	Infrequently
Subject to annual audit	Yes	No

Source: ANAO analysis.

13. These are long-standing issues, identified by successive reviews of tax expenditures, the first of which was conducted in 1974. Each found one or more major deficiencies, including:

- poorly defined aims;
- inadequate methods, information and data with which to estimate the cost and evaluate the effectiveness and efficiency of tax expenditures;
- insufficient budgetary scrutiny and consideration, both within government and by Parliament; and
- lack of regular and systematic review.

14. While significant improvements were suggested, including the integration of tax expenditures into the Budget process, very few of the recommendations of these reviews have been adopted. Notable exceptions are the 1986 agreement to regularly publish tax expenditures and the 1998 inclusion of tax expenditures in the reporting requirements of the Charter of Budget Honesty.

15. However, the tax expenditure reporting standards applied by the Charter of Budget Honesty have not been developed to account explicitly for identifying and estimating the costs of tax expenditures. Nor has there been any significant progress toward regularly evaluating tax expenditures against their objectives or integration of their consideration into the Budget process.[8]

Reporting all tax expenditures (Chapter 3)

16. Whether a tax concession is a tax expenditure and thus reported in the TES depends upon the tax benchmark adopted by Treasury. As Treasury stated in TES 2007:

> [*Benchmarks*] vary over time and across countries and can be arbitrary.[9]

17. Although there is widespread recognition of the existence of tax expenditures, there is no universally accepted definition of the expression 'tax expenditure'. Differentiating a tax expenditure from a benchmark tax concession is, in some cases, a matter of fine judgment. For example, different benchmarks for alcoholic beverages have been adopted notwithstanding that the consumption of alcohol, regardless of type, is a similar activity. By way of comparison, a single benchmark is used for all petroleum fuels and a single benchmark is also used for all tobacco products (on which commodity taxes are also imposed). As a result of the different benchmarks, reporting in the TES does not reflect the preferential taxation treatment (such as lower tax rates for low alcohol products) of some categories of alcoholic beverages compared to others.

18. The choice of benchmark can significantly affect the aggregate estimate of revenue forgone due to tax expenditures. For example, Customs duty, which has existed since 1901, was included for the first time in TES 2007. However, because of the chosen benchmark, the publication included the related tax expenditures as a negative tax expenditure (in effect, tax revenue). This had the effect of reducing the aggregate amount of reported tax

---

8 For example, the sequence of Budget consideration (outlay measures before revenue measures) means that related outlay and revenue programs are not usually considered in conjunction with each other. In addition, the offsetting and savings requirements for revenue measures are more restrictive than for outlays programs which has tended to discourage the replacement of tax concessions with equivalent outlays programs.

9 Treasury, *Tax Expenditures Statement 2007*, 25 January 2007, p. 21.

expenditures in 2007–08.[10] Similarly, reported tax expenditures were $2 billion lower as a result of the income tax benchmark being adjusted to treat, for the first time, assistance for low income earners as part of the benchmark rather than as a tax expenditure.

19. In light of the views expressed by the Senate Standing Committee on Finance and Public Administration (see paragraph 5), and recognising that judgements are currently made without the benefit of reporting standards that account explicitly for tax expenditures, there would be benefit in Treasury examining opportunities to provide supplementary information in the TES. In dealing with disclosure, if the financial effect can be reliably estimated, there would be benefit in such information being reported.

Reporting accuracy (Chapter 4)

20. Tax expenditures are measured in the TES as deviations from the tax benchmark (that is, the tax treatment that would normally apply). TES 2006 reported total measured tax expenditures of $41.32 billion for 2006–07,[11] or 17.6 per cent of that year's estimated value of all Government receipts (excluding the Goods and Services Tax). Not all tax expenditures are, or can be, estimated. Due to data limitations, TES 2006 provided quantifiable estimates for 162 (or fewer than 60 per cent) of the 272 tax expenditures that were identified. The remaining tax expenditures were unquantified.

Reliability of quantified estimates

21. The TES does not at present inform readers as to the reliability of the quantified estimates. In this respect, the methods used to calculate quantified estimates of individual tax expenditures reported in the TES vary. ANAO's assessment of the quantified tax expenditures was that:

- highly reliable estimates were available for 52 tax expenditures, approximately 20 per cent of all reported tax expenditures, which accounted for nearly two–thirds of the total value of all reported tax expenditure; and
- 110 tax expenditures (68 per cent) involving 35 per cent of the aggregate estimate were assessed as having medium or lower levels of

[10] Treasury advised ANAO that the impact of incorporating the zero tariff benchmark into the 2007 TES was a reduction in aggregate tax expenditures of around $3.7 billion in 2007–08.

[11] TES 2007 was published during the course of this audit. It reported total measured tax expenditures for 2006–07 of $50.12 billion.

reliability.[12] In many cases, these estimates were based not on detailed data, but on aggregate data compiled from a range of sources, reducing the inherent reliability of the estimates.

22. In many cases, the reliability of estimates could be significantly improved if ATO and Treasury were able to obtain more data from other Commonwealth agencies or from taxpayers. Treasury advised ANAO that the trend to reducing the compliance burden on taxpayers results in less information being reported from which estimates can be made and that this situation also affects alternative sources of information such as the Australian Bureau of Statistics.

23. ANAO also observed that the capacity of the ATO and Treasury to develop tax expenditure estimates depended, in large part, on adopting the less accurate *revenue forgone* method rather than the *revenue gain* method. Revenue forgone is easier to estimate as it does so with the minimum of data. However, it cannot easily incorporate estimates of behavioural effects as taxpayers respond to a tax concession.

24. Alternatively, the revenue gain method includes incentive effects and allows for the behaviour of taxpayers, though at the cost of greater analysis and consequential data requirements. Revenue gain is the method currently used for reporting estimates of new revenue measures in the Budget papers.

25. The different methodologies adopted in the Budget papers and in the TES impedes analysis of the actual cost of new tax expenditures in terms of what was expected when they were introduced. Accordingly, in the longer term there would be benefits in Treasury and the ATO identifying opportunities to produce estimates of large or otherwise significant tax expenditures using the revenue gain method.

Tax expenditures that are not quantified

26. In the case of some tax expenditures, especially those involving tax exempt transactions, such as fringe benefits, data sources are presently very poor or non-existent. As a result, TES 2006 reported 98 unquantifiable tax expenditures. For 77 of these, a general order of magnitude was indicated (ranging from around $1 billion down to zero), on the pragmatic basis that it is

---

[12] Among the major tax expenditures so affected are family tax benefit ($2 430 million in 2006–07), tax offsets for senior Australians ($1 870 million), care benefits ($1 070 million), exempt income support benefits, pensions or allowances ($970 million), deductions to charities ($640 million), local government tax exemptions ($570 million), withholding tax exemptions ($550 million), exempt war–related payments and pensions ($440 million), and child care benefits ($410 million).

better to report some estimate than no estimate at all. Nonetheless, for 21 tax expenditures, it was not possible for Treasury to estimate even a general order of magnitude, so deficient was the underlying data.

27. General estimates are available that would allow qualified reporting of approximately $15 billion tax expenditures which have yet to be quantified in the TES. They relate to the capital gains exemption of the sale of the principal residence (approximately $13 billion), the tax exemption of certain State and Territory business enterprises ($2 billion) and a negative tax expenditure relating to the deductibility of higher education charges ($110 million).

Improvement opportunities

28. The six audit recommendations are intended to improve the quality of information relating to tax expenditures over time so that the Government and the Parliament are better placed to be informed about the impact of relief provided from Commonwealth taxes and charges, and to be positioned to make decisions relating to trade-offs between such relief and other Budget priorities involving outlays. Specifically:

- Chapter 2 includes two recommendations aimed at establishing regular, risk-based reviews and evaluations of tax expenditure programs and encouraging the development of suitable standards for identifying and reporting tax expenditures, drawing on international developments. A further recommendation has been made in Chapter 2 aimed at encouraging greater scrutiny of tax expenditures in the annual Budget processes, by integrating their consideration with that given to outlays;
- Chapter 3 includes a recommendation that greater attention be given to identifying and collecting data on tax expenditures outside of the Treasury portfolio; and
- Chapter 4 includes two recommendations aimed at improving the reliability of new and ongoing tax expenditure estimates. For large or otherwise significant tax expenditures, one recommendation proposes that tax expenditure estimates be prepared using an approach that captures the behavioural and other effects of the concession. The other recommendation is aimed at promoting more reliable modelling irrespective of whether they are prepared under a revenue gain or revenue forgone approach.

Agency responses

29. Copies of the proposed report were provided to Treasury, the ATO and Customs. Each agency provided comments on the proposed report. Treasury also provided a response to each of the six audit recommendations with ATO providing a response to part of one recommendation and all parts of another recommendation.[13] In addition, Treasury and the ATO provided the following overall comments on the report.

Treasury overall comments

> The Treasury regards the publication of the annual TES as an integral part of the Australian Government's Budget reporting. The TES allows for greater scrutiny of government assistance to taxpayers and other interventions in the economy that are achieved through the tax system and contributes to the design of the tax system by promoting and informing public debate on the tax system. Treasury considers that the reporting of tax expenditures will continue to improve through greater use of data held by other agencies and disclosure of the reliability of estimates.
>
> Treasury notes that in respect of improving the reliability of the TES estimates, availability of data is the key constraint. In this regard the benefits from improving the reliability of estimates must be weighed against the cost of increasing the compliance cost burden on taxpayers.

ATO overall comments

> The ATO believes that TES estimates will continue to improve through the better use of data held outside the organisation. In addition, we agree that proposed commentary around the reliability of estimates will improve the transparency of the estimates adopted.
>
> The ATO does not believe there is much scope to directly impose additional compliance cost burdens on taxpayers where the sole purpose is to measure the value of tax expenditures.

[13] The ATO advised ANAO that it has administrative responsibility for the vast majority of the tax expenditures but that Treasury has responsibility for publishing the TES, and reviewing the existing program of tax expenditures. The ATO further advised that, in relation to the TES, its role is to assist the Treasury with their preparation and that, hence Treasury is better placed to respond to most of the audit recommendations.

Recommendations

Set out below are ANAO's recommendations.

Recommendation No.1

Paragraph 2.23

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.

Agency response: Treasury agreed to part (a) and agreed with qualification to part (b).

Recommendation No.2

Paragraph 2.38

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.

Agency response: Treasury agreed.

Recommendation No.3

Paragraph 2.49

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.

Agency response: Treasury agreed with qualification.

Recommendation No.4

Paragraph 3.39

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.

Agency response: Treasury agreed. The ATO agreed with part (b).

Recommendation No.5

Paragraph 4.16

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.

Agency response: Treasury agreed.

Recommendation No.6

Paragraph 4.49

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 effect of the proposed measure.

Agency response: Treasury and the ATO both agreed with parts (a), (b) and (c) and agreed with qualification to part (d).

Audit Findings and Conclusions

1. Introduction

This chapter defines tax expenditures and describes their magnitude and scope. It includes an overview of the roles of the Department of the Treasury and the Australian Taxation Office, which are responsible for estimating and reporting tax expenditures, and it outlines the audit objective and approach.

Background

1.1 Tax expenditures and social welfare programs are the two oldest forms of financial assistance provided by the Commonwealth Government.[14] The term itself, however, is relatively new. It was coined in 1967 by Mr Stanley Surrey of the United States Treasury Department to describe the class of tax concessions that:

> favour a particular industry, activity, or class of persons [*and that*] represent government spending for favoured activities or groups, effected through the tax system rather than through direct grants, loans, or other forms of government assistance.[15]

1.2 Tax expenditures have no precisely agreed or fixed definition. In practice, what constitutes a tax expenditure can change over time and between jurisdictions. In Australia, the *Taxation Expenditures Statement 2006* (TES 2006) defines a tax expenditure as:

> a tax concession that provides a benefit to a specified activity or class of taxpayer… A tax expenditure can be provided in many forms, including a tax exemption, tax deduction, tax offset, concessional tax rate or deferral of tax liability.[16]

1.3 The Department of the Treasury (Treasury) puts this broad concept into action by selecting a 'normal' or benchmark tax system and identifying tax expenditures in relation to the tax benchmark (another concept not precisely

---

[14] Tax exempt invalid and old-age pensions were introduced in 1908, and tax exempt unemployment and sickness benefits were introduced in 1945. Tax concessions for agriculture and mining date from 1932 and 1940 respectively. Family assistance has been tax exempt since its introduction (as child endowment) in 1941. Accelerated depreciation provisions, introduced in 1952, have existed in various forms ever since. See Department of Social Security, *Developments in Social Security*, June 1983, for historical details of changes to the taxation of pensions and benefits and family payments. See also Part III of Coombs, H.C., *Review of the Continuing Expenditure Policies of the Previous Government*, June 1973, for the historical origins of major tax expenditures.

[15] Stanley, S., and McDaniel, P., *Tax Expenditures*, Cambridge Massachusetts, Harvard University Press, 1985, p. 3.

[16] Commonwealth of Australia, *Tax Expenditures Statement 2006*, February 2007, pp. 1–2.

defined). Those tax concessions that deviate from the benchmark are treated as tax expenditures and are reported. Those concessions defined to fall within the tax benchmark are not considered tax expenditures and are not reported. The definition of a tax expenditure is discussed in more detail in Chapter 3.

Reporting

1.4 Internationally, the first report of tax expenditures was provided in the Annual Report of the Secretary of the Treasury of United States in 1968. Canada followed suit soon after.

1.5 The 1968–69 Budget Papers were the first in Australia to contain fiscal information on certain forms of industry tax assistance. This reporting continued, supplemented by occasional information on some forms of tax assistance to individuals, for fiscal years up to and including 1982–83.[17]

1.6 In 1987, Treasury commenced the annual publication of a separate Taxation Expenditures Statement (TES). A TES has been prepared for each year (except for 1999–2000) up to and including 2007–08. To date, all TESs have been prepared by Treasury, drawing chiefly on estimates and advice from the Australian Taxation Office (ATO), with the aim of allowing:

> tax expenditures to receive a similar degree of scrutiny to direct expenditures, [*allowing*] for a more comprehensive assessment of government activity, and [*contributing*] to the design of the tax system, by promoting and informing public debate on all elements of the tax system.[18]

1.7 Tax expenditure reporting also aids the efficient action of global markets. It allows private investors to make investment decisions in the light of full information on taxation and government assistance in the Australian economy.

1.8 In December 2006, the *Tax Expenditures Statement 2006* (TES 2006) was published and tabled in the Parliament. It detailed 272 Australian Government tax expenditures that provide financial benefits and incentives to taxpayers. Not all tax expenditures are, or can be, estimated. Nonetheless, the aggregate value of those reported in TES 2006 was over $41 billion in 2006–07, or

---

[17] See pp. 8 and 9 of Economic Planning Advisory Council (EPAC), *Tax Expenditures in Australia,* January 1986. Budget estimates of certain tax expenditures for industry were provided for the years 1967–68 to 1983–84 inclusive, with some estimates for individuals provided for 1970–71 to 1972–73 and for 1974–75 to 1982–83 inclusive. Other relevant EPAC findings are cited in Appendix 1.

[18] TES 2006, p. 2. In addition, the ATO now details the estimates and outlays for significant cash transfers delivered through the tax system, among them fuel tax credits, family tax benefit and the private health insurance rebate (in ATO, *Annual Report 2006–07,* p. 31, tabled 12 February 2008).

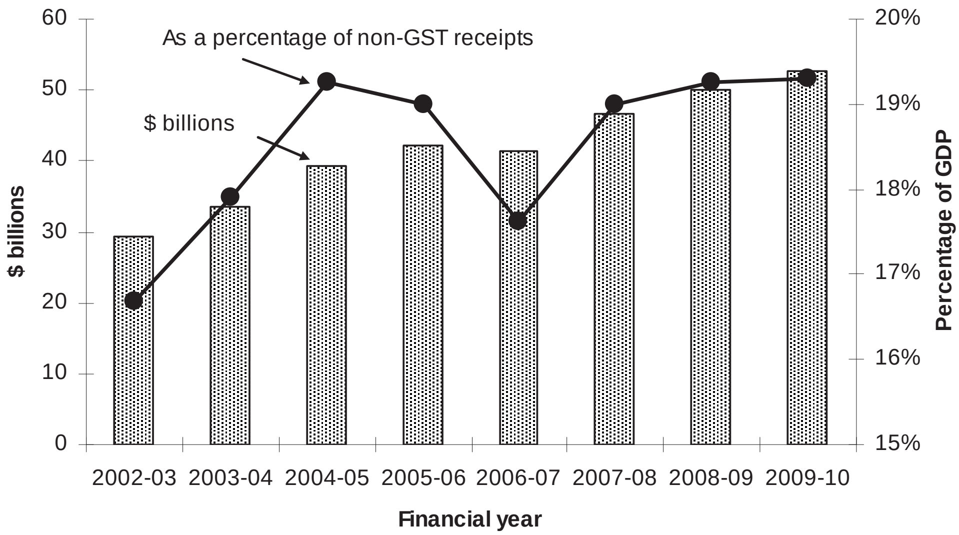
17.6 per cent of that year's estimated value of all Government receipts (excluding the Goods and Services Tax (GST)).[19]

1.9 The value of tax expenditures is forecast to increase in later years, as shown in Figure 1.1. In this context, a commentator recently said that:

> Tax expenditures, the numerous tax concessions and rebates, … need deep and searching examination.[20]

Figure 1.1

Estimated tax expenditures: 2002–03 to 2009–10



Source: ANAO analysis of TES 2006 and *Budget Strategy and Outlook 2007–08*.

1.10 The number and value of reported tax expenditures have grown steadily over time. The last ten TESs show, on average, 17 new tax expenditures each year, compared with an average of eight that have been retired. The number of tax expenditure has grown because of the identification of missed tax expenditures. There have also been new tax expenditures introduced over time to implement new policies.

---

[19] At the time of this audit, no GST-inclusive forward estimates of revenue were available.

[20] Stephen Bartos, former senior public servant and academic and currently a director of and consultant with Allen Consulting Group in *The Public Sector Informant*, The Canberra Times, December 2007, p. 6.

Audit approach

1.11 The objective of the audit was to assess the completeness and reliability of the estimates reported in TES 2006. In its March 2007 report titled *Transparency and accountability of Commonwealth public funding and expenditure,* the Senate Standing Committee on Finance and Public Administration noted ANAO's forthcoming audit of the preparation of the TES. Consistent with a suggestion of the Committee, the ANAO audit has examined suggestions for greater transparency in the reporting of tax expenditures made to the Committee during its inquiry. The audit also examined:

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

1.12 The second chapter of this report examines the evolution of tax expenditure reporting and analyses the reporting framework for tax expenditures.

1.13 The third chapter reports ANAO's assessment of the completeness of the TES. To determine whether all major forms of tax expenditure are reported in the TES, ANAO examined, among other tax relief measures, relief provided from the Commonwealth's taxing laws administered by agencies outside the Treasury portfolio, such as the Australian Customs Service (Customs).

1.14 The fourth and final chapter discusses the data, methods and techniques for estimating tax expenditures and tests the reliability of reported tax expenditure estimates. The audit paid particular attention to the construction of the large tax expenditure estimates for superannuation, family tax benefit, capital gains tax and income support payments. Where possible, the ANAO compared estimates to actual revenue forgone.

1.15 The audit was conducted under Section 18 of the *Auditor-General Act 1997* in accordance with the ANAO Auditing Standards at a cost of $440 000.

2. Monitoring and Reporting Framework

This chapter explores the nature and history of the reporting of tax expenditures; it provides a synopsis of the various reviews of tax expenditures that have been undertaken since 1973; and it examines the measurement and reporting requirements introduced in 1998 by the Charter of Budget Honesty Act 1997.

Background

2.1 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. Many tax expenditures reduce revenue that, if collected, would have been available to fund spending programs (or outlays) to meet similar objectives or to increase the Budget surplus/reduce the Budget deficit. Accordingly, their net effect on the Budget balance is similar to that of public spending programs; it is because of their resemblance to outlays that particular forms of tax relief are described as tax expenditures. Tax expenditures differ from outlays in some important respects, however.

- They often receive Parliament's attention only at the time they are introduced.[21]
- They are subject to a less comprehensive management and reporting framework than are outlays (see Table 2.1).
- Tax expenditures are also frequently harder to measure and are less transparent in their effect than comparable outlays. This can complicate attempts to evaluate them; in some cases, it renders meaningful evaluation impossible.
- Unlike most claims on outlay programs, most claims on tax expenditures are outside of the direct control of government officials.

---

[21] In this way and in their impact on the Budget balance, they closely resemble Special Appropriations: once approved by Parliament, tax expenditures provide ongoing financial benefits, independent of the Government's annual Budget priorities. See ANAO Audit Report No. 15 2004–05, *Financial Management of Special Appropriations*, Canberra, 23 November 2004, p. 21.

Table 2.1

Comparison of key management arrangements for existing outlays and existing tax expenditures

Key oversight arrangements	Existing outlays	Existing tax expenditures
Estimates compiled according to independent standards fit for the purpose	Yes	No
Identified for all Commonwealth agencies	Yes	No
Subject to regular Budget review	Yes	Infrequently
Reported in Budget estimates	Yes, by outcome, generally not by program	Infrequently
Subject to Budget monitoring	Yes, by outcome	Infrequently
Costs monitored against estimates	Yes	Infrequently
Subject to annual agency reporting	Yes, by outcome and by appropriation	Infrequently
Subject to annual audit	Yes	No

Source: ANAO analysis.

2.2 In this context, it is therefore unsurprising that, from time to time, the Parliament and governments have requested that the case be put to justify assistance through a tax expenditure rather than a direct outlay.[22] In some instances tax expenditures are more effective than direct outlays or may be the most practicable method of delivering support. Neither method of support is necessarily superior to the other and:

> the choice between the two has to be made on a case–by–case basis, giving due regard to common decision criteria relating to transparency, equity, efficiency, effectiveness and ease of administration.[23]

[22] See, for instance, p vii of the 1982 *Tax Expenditures* report of the then House of Representatives Standing Committee on Expenditure, which recommended that 'Where the proposed financial impact statement to be included in a Minister's second reading speech to a Bill relates to taxation expenditures, the Government incorporate an explanation as to why the taxation system is preferred to direct outlays for giving assistance'.

[23] Economic Planning Advisory Council, op. cit., p. 2.

Previous reviews of tax expenditures

2.3 As with outlay programs, determining whether the benefits of tax expenditures are proportionate to their costs depends on the effective monitoring and scrutiny of programs. Monitoring and managing tax concessions (including tax expenditures) poses special difficulties, a matter recognised and addressed by audits in the United States and Europe,[24] as well as previous reviews in Australia.

2.4 Governments have twice (in 1973 and 1997[25]) conducted detailed, systematic surveys of tax expenditures in an attempt to integrate them into the Budget process. With the same aim in mind, Parliament conducted its own review in 1982, as did the Economic Planning Advisory Council in 1986. Tax expenditures also received specific scrutiny by the National Commission of Audit in 1996 and the Review of Business Taxation in 1999. Table 2.2 lists the chief findings and outcomes of each review.

2.5 Over a 35 year period, each review has identified one or more major deficiencies hampering the effective management of tax expenditures, including:

- poorly defined aims;
- inadequate methods, information and data with which to estimate the cost and evaluate the effectiveness and efficiency of tax expenditures;
- insufficient budgetary scrutiny and consideration, both within government and by Parliament; and
- lack of regular and systematic review.

2.6 Very few of the recommendations of these reviews have been adopted by government. As a result, each successive review reported similar shortcomings and made similar recommendations. Appendix 1 sets out the main findings and recommendations.

---

[24] See, for instance, the September 2005 report of the United States Accountability Office, *Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined,* and the May 2005 report of the Swiss Federal Audit Office, *Tax Expenditures of the Swiss Confederation.* Both reports suggested that further work be undertaken to ensure that all tax expenditures were identified, estimated and reported. By mid-2008, European audit authorities expect to finalise common criteria for auditing tax expenditures.

[25] This review was conducted by Treasury, which is part of the Executive Government.

Table 2.2

Key findings and outcomes of tax expenditure reviews: 1973 to 1999

Year	Report and key findings	Outcomes
1973	**Review of the Continuing Expenditure Policies of the Previous Government** Examined 48 tax expenditures to help formulate the August 1973 Budget. It found many difficult to evaluate or to justify and suggested that industry tax assistance be time–limited.	Industry assistance recommendation not implemented
1982	**House of Representatives Standing Committee on Expenditure report on *Tax Expenditures*** Found little available information, and outcomes not measured. Made eight recommendations to help identify all tax expenditures, report them in the Budget and evaluate their effectiveness.	Partial implementation of recommendations to improve reporting
1986	**Economic Planning Advisory Council, *Tax Expenditures in Australia*** Suggested greater transparency of reporting cost and effectiveness of tax expenditures, integration into the Budget process, and consideration of 'outlay equivalent' estimates.	Suggestions not implemented
1996	**National Commission of Audit** Found Budget reporting, monitoring and costings to be inadequate, and that tax expenditures were not integrated into the Budget process. Noted that the lack of transparency was inconsistent with the Charter of Budget Honesty. Recommended that they be treated as much as possible like outlays programs in all fiscal reports and statements, and in Budget processes.	Recommendation not implemented
1997 and 1998	**Tax Expenditure Review** Found few tax expenditures reviewed or monitored, many without supporting data, and many of doubtful relevance or effectiveness. Recommended a significant number be retained and monitored, a small number be removed or converted to outlays and a large number be further evaluated. Recommended rolling reviews to ensure that every tax expenditure is reviewed at least once every three years in the Budget process.	Consideration delayed from 1997 to 1998. Recommendations not implemented
1999	**Review of Business Taxation** Found that business tax expenditures are not transparent and can have adverse economic effects. Recommended the periodic and systematic review of all tax expenditures to ensure they were still useful and best delivered through the tax system.	Recommendation not implemented.

Source: ANAO analysis of various reports.

2.7 In response to the findings of the June 1996 report of the National Commission of Audit, the Government moved to introduce legislation governing fiscal reporting. In the Budget speech of 20 August 1996, the Government announced that it would be 'examining the effectiveness of concessional taxation treatments' and that:

> The Government intends to review all existing tax expenditures to ascertain the extent to which they are contributing towards the achievement of its policy goals and whether some tax expenditures might be converted to outlays

programs to achieve a better outcome. In relation to new tax expenditure proposals, the government will consider whether assistance can be more effectively provided through outlays programs.[26]

2.8 Commencing in August 1996, the Taxation Expenditure Review (TER 97) was largely complete by early 1997. TER 97 was a wide–ranging examination of Commonwealth tax expenditures. It was not, however, a comprehensive stocktake and did not consider, for instance, tax expenditures arising from customs duty concessions or from other taxing and charging legislation administered outside the Treasury portfolio.

Outcomes of the 1997 review

2.9 TER 97 identified more than 372 tax expenditures, reviewed 277,[27] confirmed the shortcomings identified by the NCA and found that:

- the effectiveness of individual tax expenditures in meeting their objectives had previously been analysed in only a handful of cases;
- costings were available for little more than half the identified tax expenditures, with the lack of costings for many tax expenditures complicating the forecasting of tax revenue and compromising Budget certainty and integrity;
- in many instances, there was little documentary material or monitoring data available to inform an analysis of policy outcomes or fiscal impact. Ongoing monitoring and evaluation would require more taxpayer data, with potential increases in taxpayer compliance costs from redesigned or longer tax forms to be assessed by the ATO;
- in the majority of cases, the objective and the intended beneficiaries of tax expenditures were not clear and the objective at the time of introduction was rarely known. In addition, there was a very real possibility that, in many cases, the observed level of activity would have taken place in the absence of the tax expenditure, which had instead served mainly to redistribute income to the recipients; and
- in very few cases could the benefits delivered by the tax expenditure to the *intended* beneficiaries be measured, or could the *actual* beneficiaries

---

[26] See the Budget Speech 1996–97, delivered on 20 August 1996 on the Second Reading of the *Appropriation Bill (No.1) 1996–97,* by the Honourable Peter Costello M.P., Treasurer of the Commonwealth of Australia.

[27] Closely related tax expenditures were combined for review.

be determined, thus precluding any determination of net economic benefit.

2.10 TER 97 concluded that fewer than half (118) of the 277 tax expenditures reviewed should be retained, subject to a well–defined ongoing monitoring and evaluation process under a framework to be devised by Treasury. Of the remainder, action was flagged in either the 1997–98 or 1998–99 Budget cycles:

- to convert to outlays (15) or remove (another 15) tax expenditures;
- to consider another 65 for removal (31 did not appear to match Government policy and another 34 could not be shown to be effective); and
- to further analyse 49, to determine whether they should be converted to outlays (22) or removed (17 because they were not effective and another ten that did not appear to align with Government policy).

2.11 To incorporate tax expenditures into the Budget cycle, TER 97 recommended to government that Ministers be advised which tax expenditures were 'blowing out' and which were to be reviewed within a three–year cycle. Ministers were to become responsible for ensuring that the tax expenditures in their portfolio were relevant and effective, or for recommending that they should be removed or replaced by outlays. Ministers would also be asked to redress blow–outs and recoup losses to the Budget from within their portfolio.

2.12 Peak business organisations wrote to the Government during the course of TER 97, shortly before the findings were presented to the Government. Specifically, late in January 1997, the Business Council of Australia (BCA) and the Australian Chamber of Commerce and Industry expressed serious concerns about the timing and the possible outcomes of the review. Five peak business organisations (including the BCA) wrote again in April 1997, in the following terms:

> We have all previously expressed concern with your Government regarding this review. The process of review has been entirely internal. No opportunity has been given to business or industry to present its views. As well, review of these taxation measures could result in significant *de facto* and *ad hoc* changes to Australia's taxation system at the same time as the Government has deferred consideration of more broadly based tax reform.
>
> In considering the apparent purpose of the review of tax expenditures, business would be especially concerned by any moves to convert a legitimate

> tax deduction into an apparent government subsidy. Not only are the perceptions associated with subsidies undesirable, but the resulting annual review in the budget context would increase business uncertainty. Further, this approach would have the additional undesirable outcome and cost of introducing a process of Government selection for expenditure grants. Equally, business would be concerned if taxation measures which redress interventions, such as the taxation of business inputs, are implied to be subsidies or assistance to business.

2.13 Late in April 1997, the Government deferred consideration of TER 97 until after the May 1997 Budget. Shortly after the Budget, the Government canvassed criteria for broad–based reform of the taxation system and, in August 1997, announced the establishment of a tax–reform taskforce to prepare options for reform of the taxation system by the end of November 1997.[28] With the Government shifting its focus to broad taxation reform, consideration of the outcomes of TER 97 was delayed by a year.

2.14 The Government considered a revised report (TER 98) in April 1998. The revised report advocated retaining and monitoring almost all existing tax expenditures, subject to a systematic process of ongoing monitoring and evaluation to ensure that tax expenditure information was regularly updated, and that changes to existing government policies were reflected in changes to tax expenditure arrangements. This was publicly announced in October 1998:

> Following a review of existing tax expenditures, first announced in the 1996–97 Budget, the Government has decided to undertake periodic monitoring and evaluation of all tax expenditures through normal budget processes. Tax Policy Group will oversee this process. Information on the costs of tax expenditures will assist the Government in delivering assistance in an effective manner, and will be consistent with the requirements of the Government's Charter of Budget Honesty.[29]

2.15 Treasury was charged with preparing a framework for a rolling review of all tax expenditures every three years. Those that appeared to be 'blowing out' significantly or that might be converted to outlay programs were to be reviewed during the annual Budget process. Concurrently, the Department of

---

28 The 1997–98 Budget was delivered on 18 May 1997. The Prime Minister's canvassing of broad tax reform was reported on page 1 of the Australian Financial Review on 26 May 1997, under the headline 'PM's tax reform rules'. The tax reform taskforce announced in the Prime Minister's Media Release of 13 August 1997 comprised officials from Treasury, PM&C, the ATO, the Treasurer's office and the Cabinet Policy Unit. For further details, see Parliamentary Library, Background Paper Number 1 1997–98, *The GST debate, a chronology*.

29 Treasury, *Annual Report 1997–98,* October 1998, p. 48.

Finance and Administration (Finance) was to assess the potential for integrating tax expenditures into the Budget framework.

2.16 In July 2000, Treasury proposed deferring the tax expenditure review process beyond the 2001–02 Budget, on the basis that a substantial number of tax expenditures had been reviewed as part of broader reforms to the tax system, that over 60 Wholesale Sales Tax (WST) tax expenditures had been abolished with the introduction of the GST,[30] and that the majority of tax expenditures identified as candidates for review (some 40 in all) related to income tax and Medicare levy exemptions that were considered to be sensitive.

2.17 By October 2000, consideration was being given to deferring all remaining tax expenditure reviews until after the 2001–02 Budget. In February 2001, almost three years after the then Government had decided to implement the program of rolling reviews, Treasury recorded that no progress had been made to implement the government's decision, although:

> Through the tax reform process many tax expenditures had been reviewed (around 159 out of 236) and an additional number removed (around 60 [*chiefly those associated with the wholesale sales tax system*]). Around 77 remain unreviewed. In addition, 70 new tax expenditures have been created since the 1998 review.

2.18 Citing resource constraints, including on legislative capacity, Treasury canvassed options for a six–year rolling review program, excluding tax expenditures affecting the rural sector and superannuation. As of September 2007, processes were not in place for the regular of review of tax expenditures, or to integrate tax expenditure assessments and estimates into the budget framework.

Consequences of tax expenditures not being reviewed

2.19 Regular and systematic reviews of tax expenditures help identify the benefits and shortcomings of particular tax expenditures and assess their attendant risks. For instance, a tax expenditure may:

- no longer be effective;
- no longer be relevant to government policy;
- compromise the Budget result, especially if it 'blows out';

[30] TER 97 cited 83 WST tax expenditures. All were abolished with the repeal of the sales tax laws, effective from 1 July 2000.

- have unintended consequences, especially through complex interactions with other parts of the tax system, the social security system or with commercial investment or other financial products and services;
- need to be adjusted or refined;
- no longer be the best way to deliver financial benefits to a particular group; and
- be open to legal challenge.

2.20 In the absence of systematic and regular reviews, successive governments have effectively inherited the tax expenditures of their predecessors, without a critical assessment of the risks and the benefits. Treasury advised ANAO that, in producing the TES, it reports the legislative basis for particular tax expenditures. However:

> Treasury is not in a position to assess the legal validity of taxation provisions that are enacted. Many provisions may be at risk from legal challenge, as is the administration of the law by the Australian Taxation Office. The revenue risks associated with legal proceedings and changes in the administrative rulings (which may change in response to legal challenges) are dealt with by monitoring those proceedings, reviewing the policy and revenue implications on an ongoing basis. The risk of legal challenge is not confined to tax expenditures and is best managed through broader processes rather than by tax expenditure reviews.

2.21 Treasury also advised 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.

2.22 In most circumstances, Treasury is the agency best placed to review and evaluate tax expenditures and report on their effectiveness and efficiency. On occasion, however, reviews by external bodies are commissioned by the government of the day or are conducted by Parliamentary committees. Recent examples of such reviews include the 1999 review of business taxation[31] and the 2000 review of employee share ownership plans.[32]

---

[31] See Table 2.2.

[32] House of Representatives Standing Committee on Employment, Education And Workplace Relations, *Shared Endeavours: An Inquiry into Employee Share Ownership in Australia,* 9 October, 2000.

Recommendation No.1

2.23 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.

Agency response

2.24 Treasury agreed to part (a) and agreed with qualification to part (b). The qualification was on the basis that Treasury considers that it is a matter for the Government to determine whether it will publish information about the outcome of tax expenditure reviews.

Introduction of a legislated reporting framework

2.25 In December 1996, the then Government introduced to Parliament a Bill to honour its election commitment to a Charter of Budget Honesty. The aim was to establish an integrated fiscal framework to provide for greater discipline, transparency and accountability in fiscal policy, and it proposed specific regular fiscal and economic reports:[33]

> The Budget and Mid–year Economic and Fiscal Outlook reports will provide fiscal projections for the three years following the budget year, together with the economic and other assumptions on which they are based.
>
> The reports should also include information on aggregate tax expenditures (revenue forgone by tax concessions and exemptions) in the budget year and forward estimates for the following three years. More detailed information on tax expenditures will be provided in a Tax Expenditures Report as part of the Mid–year Economic and Fiscal Outlook report documentation.[34]

2.26 The *Charter of Budget Honesty Act 1998* (CBH Act) received Royal Assent and came into effect on 17 April 1998. The Charter is set out in Schedule 1 to the CBH Act, and section 16 provides for a Mid Year Economic and Fiscal

[33] Charter of Budget Honesty statement by the Honourable Peter Costello, MP, Treasurer of the Commonwealth of Australia, 20 August 1996, p. 2.

[34] ibid., page 6. On 19 March 1997, the Joint Committee of Public Accounts delivered its advisory report on the Charter of Budget Honesty Bill. The committee concluded that the bill was another element in the improvement of the overall fiscal accountability framework.

Outlook (MYEFO) report,[35] to update key information contained in the Budget. In particular, the MYEFO is to:

> contain a detailed statement of tax expenditures, presenting disaggregated information on tax expenditures.[36]

2.27 On 2 March 1998, MYEFO 1997–98 (dealing with fiscal year 1997–98) became the first report published under the CBH Act. TES 1996–97, dealing with the same fiscal year, was separately published on the same day.

2.28 The then Government's 1996 election commitment, the Treasurer's 1997 Budget statement and Charter express the clear intention to ensure that the true state of the Budget and government finances is reported to Parliament in a timely fashion. That reporting—in MYEFO—is meant to include estimates (complete, accurate and timely) of both tax expenditures and outlays. Integrating both outlay and tax expenditure estimates would help ensure that tax expenditure measures received Parliamentary scrutiny, alongside spending programs, as an aspect of total government spending.

2.29 The Charter of Budget Honesty requires the Treasurer to publicly release and table the MYEFO by the end of January in each year, or within six months after the last budget, whichever is later.[37] Since the CBH Act took effect, no MYEFO has contained disaggregated tax expenditures as required: rather, a separate TES has been published each year except 1999–2000.[38] The separate TES has been prepared within the MYEFO timeframe.

2.30 The purpose of the CBH Act was to establish an integrated fiscal framework to provide for greater discipline, transparency and accountability in fiscal policy. For tax expenditures, this led to the Act being drafted so as to require that a detailed statement of tax expenditures be included within the MYEFO. However, because the disaggregated tax expenditure estimates are published separately in the TES, integration has yet to be achieved. As a result, the associated benefits from integration are also yet to be realised. Treasury has

---

[35] Section 12 of the Charter provides for a Budget economic and fiscal outlook report containing (among other things) aggregate estimated tax expenditures for the budget year and the following three financial years.

[36] Section 16(1)(b) of Schedule 1 of the CBH Act.

[37] Section 3(2) of the CBH Act provides that, 'Nothing in the Charter of Budget Honesty creates rights or duties that are enforceable in judicial or other proceedings'.

[38] In a footnote to p 1 of TES 2000, Treasury reported that, 'The previous TES, the *1997–98 Tax Expenditures Statement*, was published in July 1999. There was effectively a one-year break in the publication of the TES (a 1998–99 edition was not prepared) during the transition to accrual budgeting and to *The New Tax System* and *The New Business Tax System*.'

advised ANAO that it is not possible to include the full detailed tax expenditure estimates in the MYEFO release without significant changes to the focus of the MYEFO document and without delaying the release of MYEFO itself.

2.31 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. Treasury has advised ANAO that there is no evidence that the processes for outlays programs are any better coordinated than tax concessions and that cases of contradictory outlays programs also exist. Nevertheless, the publication of the TES provides an opportunity to contribute to policy development and refinement, particularly in circumstances where original policy decisions were not informed by an integrated approach to identifying and assessing the affect of various measures on the Budget.

2.32 For example, tax expenditures are provided both to encourage older workers to leave employment and to encourage them to remain in employment. Under these arrangements, an employee who retires from the service of an employer whose early retirement scheme is approved by the Commissioner may receive, tax free, $3 392 for each year of service. These arrangements have been in place since 1 July 1994. The retiree would, after serving any statutory waiting periods, be able to test their eligibility for income support payments, such as Newstart Allowance, with the potential consequence of increasing outlays. Should these retirees later re-enter the workforce, they may (since the 2004–05 income year) be able to claim the Mature Age Worker tax offset (estimated in TES 2006 to cost $490 million in 2006–07).

2.33 The estimated total cost of both tax expenditure measures is in the order of $1 690 million in 2006–07. This estimate excludes the likely downstream costs to the Budget of income support payments, such as Newstart allowance, to eligible early retirees.[39] TES 2006 records $300 million of the estimated $1 200 million revenue forgone by the concessional taxation of non-superannuation termination payments. ATO advised ANAO that, due to an oversight, TES 2006 does not show approximately $900 million is in respect of tax exempt payments for redundancies and early retirement schemes, usually based on years of service.

[39] An integrated approach was not adopted for the consideration of the Mature Age Worker tax offset—the likely costs of increasing social welfare outlays were not assessed against the likely benefits of either tax measure.

2.34 Competing revenue and outlays measures may also arise as a consequence of customary Budget processes. Under these, revenue measures (including most tax expenditures) are settled separately from and after outlays measures, so that related outlays and revenue measures are not commonly examined in conjunction. Outlays measures are considered by Cabinet's Expenditure Review Committee (ERC) and revenue measures by the Ad Hoc Revenue Committee (AHRC). AHRC usually meets only once during the Budget process, after ERC has finalised the Budget outlays measures.

2.35 Portfolio Ministers may, in conjunction with the Treasurer,[40] bring proposals for new tax concessions to AHRC, on the basis that Treasury has agreed the estimates and that the expense to revenue is offset by savings from within the Minister's portfolio.[41] In this regard, Treasury advised ANAO that:

> the best focus for controlling tax expenditures is at the policy development stage by ensuring that the Budget rules 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.

2.36 Importantly, portfolio Ministers may not usually claim as 'savings' any increases in revenue that might flow from a proposal to remove an existing tax expenditure. This means that the cost of a new outlay program cannot usually be offset by the abolition of a tax expenditure or tax concession. Accordingly:

- the sequence of Budget consideration (outlay measures before revenue measures) means that related outlay and revenue programs are not usually considered in conjunction; and
- the offsetting and savings requirements for revenue measures are more restrictive than for outlays programs. Historically, this has tended to discourage the replacement of tax concessions with equivalent outlays programs.

2.37 While a matter for the Government to decide, there is scope for the Budget processes to more strongly encourage trade-offs between tax expenditures and outlays, where this offers advantages such as better targeting of incentives or greater control over financial outcomes.

---

[40] Budget responsibility for revenue and for tax expenditure proposals usually lies with the Treasurer. This accords with the Treasurer's responsibility for economic and fiscal management, including for maintaining the integrity of the tax system.

[41] For an overview of the contemporary Budget process, see Webb, R., The Commonwealth Budget: process and presentation (updated January 2007), Parliamentary Library, Research Brief No. 7 2006–07,17 January 2007, especially p. 7–9.

Recommendation No.2

2.38 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.

Agency response

2.39 Treasury agreed to the recommendation.

Reporting standards

2.40 Charter of Budget Honesty reporting, including the reporting of tax expenditures, is governed by external reporting standards. Specifically, section 3 of Schedule 1 to the CBH Act applies:

(a) the concepts and classifications set out in GFS Australia; and

(b) public sector accounting standards developed by the Public Sector Accounting Standards Board.

2.41 The *Australian System of Government Finance Statistics* (GFS) is an economic reporting standard developed by the Australian Bureau of Statistics (ABS).[42] Australian Accounting Standard No. 31 *Financial Reporting by Governments* (AAS31) was first issued in 1996 and is the accounting standard for financial reporting by the Australian Government. It is based on full accrual accounting and identifies all expenses and revenues.[43]

2.42 Both standards are intended to capture transactions and other events, and their financial effect on the Australian Government, when they occur. However, as few tax expenditures arise from direct transactions and other events of the kind commonly recorded in accounting systems, neither AAS31 nor GFS is designed to capture all the notional transactions involved in the majority of tax expenditures. In this respect, ABS advised ANAO that, while GFS defines revenues, including taxation, and expenses:

> It does not, however, contain any references to 'tax expenditures'. Nor does it contain any reference to certain key concepts and methodologies that are

[42] It provides government financial information consistent with international standards, including those of the International Monetary Fund, within the framework of the Australian System of National Accounts.

[43] Developed for different purposes, GFS and AAS31 don't always agree and in some instances may conflict. The result is that, currently, two sets of financial reports (one GFS, the other AAS31) are required to meet current Australian whole-of-government reporting requirements. To arrive at a single set of Government reports that are auditable and comparable between jurisdictions, the Australian Accounting Standards Board is revising the government Australian Accounting Standards to harmonise reporting under the two standards.

> typically pivotal in compiling measures of tax expenditures, such as those relating to the normative benchmark tax base and tax forgone. In this context, it can therefore be said that the management and reporting of tax expenditures is only partially driven by the concepts contained in [*GFS*].

2.43 Treasury advised ANAO that GFS is used to classify provisions between revenue, expense and tax/non-tax revenue. Treasury further advised ANAO that:

> Neither GFS or the AAS31 standards are equipped to account for tax expenditures. Tax expenditures can only be measures by reference to a benchmark tax system, which is set out in Chapter 4 of the TES.

2.44 By way of comparison, the practice adopted in Canada is to report all measures that deviate from a narrow definition of the tax structure—measures that are unarguably tax expenditures along with a range of others that may or may not be so categorised. This allows the reader to decide whether or not a particular tax concession qualifies as a tax expenditure.[44] In addition to measures commonly regarded as tax expenditures, Canadian reporting identifies three types of 'memorandum items':

- tax concessions that are part of the benchmark system;
- tax relief where the data is not sufficient to separate the tax expenditure component from the tax concession component; and
- tax relief that could, arguably, be categorised as either a tax expenditure or a tax concession.

2.45 The Canadian practice allows the Government, the Parliament and the public to view the quantum of such concessions, including those—and there are many in Australia as in Canada and all jurisdictions—that may not usually be classed as tax expenditures. Estimates of revenue forgone under these concessions are not reported in Australia and many are hard to quantify, although the total quantum may be substantial.

2.46 The Canadian practice also offers the potential to provide information in the TES on circumstances where the administration of the taxation system results in the tax law operating in a manner that constitutes a departure from the benchmark taxation system. In this respect, the Senate Standing Committee

[44] A similar level of disclosure is achieved in the United States under the 'double benchmark' approach. The 'reference' tax benchmark is close to existing tax law and identifies mainly those tax expenditures with a special program target. The alternative 'normal' tax benchmark identifies a broader range of tax expenditures, including some which are, arguably, thought to be integral to the tax system.

on Finance and Public Administration suggested in its March 2007 report titled *Transparency and accountability of Commonwealth public funding and expenditure*,[45] that ANAO and Treasury examine proposals[46] to further improve the TES through additional disclosure, including in situations where the administration of the taxation system results in the tax law operating in a manner that constitutes a departure from the benchmark taxation system.[47]

2.47 Approaches similar to the Canadian practice aimed at improving the transparency of reporting of tax relief have been commended to legislatures in other jurisdictions. For example, in its May 2005 report *Tax expenditures of the Swiss Confederation: Examination of the reporting of the Federal Finance Administration,* the Swiss Federal Audit Office reported that the Canadian approach 'improves transparency and raises the information content of the reporting [of tax relief]'.

2.48 Treasury advised ANAO that some additional information on tax concessions is available from the ATO's annual *Taxation Statistics* report. However, this publication does not estimate revenue forgone, provides limited information on many tax concessions and tax expenditures (especially those claimed in aggregate in tax returns). Accordingly, within the timeframe of annual fiscal decision-making, the ATO's annual *Taxation Statistics* do not serve the purpose of disclosing estimates of revenue forgone in the manner envisaged by the CBH Act.

---

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

46 In November 2007, Dr Mark Burton, who had made the submission referred to by the Committee, provided ANAO with the following advice:

> Effective management of Australia's tax expenditure program requires information regarding the operation of the tax system 'on the ground', rather than merely providing information regarding the law 'in the books'. In practical effect, there is no difference between an expressly legislated tax expenditure and one which arises because the apparent meaning of tax legislation is not carried into effect. In both cases there is a departure from the stated benchmark with tangible fiscal effect. Prudence, transparency and accountability therefore indicate that operational tax expenditures ought be recorded and reported.

47 For example, the Commissioner of Taxation exercising a discretion over whether to take legal action to recover tax debts. Some, though not all, minor waivers and releases from tax liabilities are reported in the TES (see, for instance, waivers totalling $21 million cited at page 61 of TES 2007). However, neither the full range of waivers nor write-downs are reported. The Commissioner has instructed ATO staff on the circumstances appropriate for negotiating with tax debtors to settle a debt and when an agreement may be reached to accept an amount less than the full debt. ATO's Annual Report for 2006–07 reported 1 805 settlements but no estimate of the revenue forgone. The 2005–06 Annual Report disclosed 2 396 settlements.

Recommendation No.3

2.49 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.

Agency response

2.50 Treasury agreed with qualification to the recommendation. 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'.

3. Reporting Tax Expenditures

This chapter examines the completeness of Treasury's reporting of tax expenditures and identifies opportunities for more comprehensive reporting.

Introduction

3.1 As noted in Chapter 1, the expression 'tax expenditure' was originally coined with the object of highlighting that some tax provisions were, in effect, direct spending provisions executed through taxation law. Although there is widespread recognition of the existence of tax expenditures, there is no universally accepted definition of the expression 'tax expenditure'. This is because there is a divergence of opinion about the central concept that the expression describes. Concepts of a tax expenditure include:

- a tax provision directly substitutable for a spending program—for example, a child care tax rebate might be replaced by a child care subsidy;
- preferential tax treatment of one group of taxpayers by comparison to another group of taxpayers; and
- departure within the legislated tax law from a normative or benchmark taxation system (regardless of whether the departure meets the preceding two definitions).

3.2 In preparing the TES, the last of the above concepts is adopted. That is, Treasury has defined and measured tax expenditures by reference to a normative or benchmark taxation system. Under this approach, the selection of the benchmark is critical to the identification of tax expenditures. In this respect, the TES embodies a tripartite division of taxation law.

- **Core taxing rules** – these rules include:
  - provisions that are central to the operation of the taxation system;
  - rules consistent with international obligations (as under Australia's tax treaties); and/or
  - rules that fall within generally accepted taxing principles.
- **Boundary Rules**—rules not necessarily consistent with generally accepted taxing principles but that nevertheless have come to be

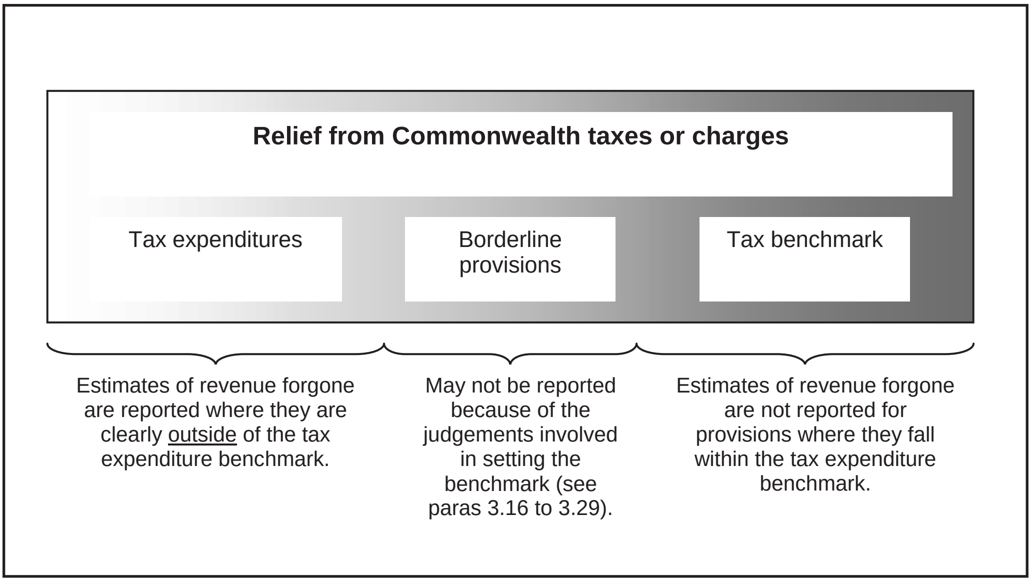
accepted as central to the operation of the relevant taxation law. For example, personal income tax is not applied until taxable income exceeds the tax–free threshold. The intention of this zero–rating of taxable income is to avoid taxing people with very low incomes; and

- **Tax expenditures** – rules that are neither part of generally accepted taxing principles nor have come to be accepted as integral to the taxation system. As these rules can operate to either increase or reduce the revenue, they can either be negative tax expenditures (a revenue raising measure) or positive tax expenditures (a cost to the revenue).

3.3 The last division, along with some borderline measures, comprises the majority of reported Commonwealth tax expenditures, as illustrated in Figure 3.1. The comprehensive reporting of tax expenditures depends, therefore, on identifying all concessions or other forms of relief and categorising those not regarded as integral to the taxation system—and that therefore fall that fall outside the tax benchmark.

Figure 3.1

Application of the tax benchmark concept



Source: ANAO analysis.

3.4 As noted in paragraph 1.3, the tax benchmark is selected by Treasury and the identification of tax expenditures is at Treasury's discretion. There can be competing views as to whether a measure is within the tax benchmark or whether it should be reported as a tax expenditure. Some jurisdictions accommodate competing views of these categorisations by reporting estimates of revenue forgone for measures in all categories.

3.5 It is also frequently the case that tax expenditures can go unrecognised, sometimes for many years. In this regard, each TES from TES 1995–96 onwards has included, on average, ten new tax expenditures arising from concessions or relief already in place but previously unrecognised.[48] This is in addition to measures reported (or no longer reported) due to alterations to tax benchmarks, new tax expenditures, and modifications to existing tax expenditures.

Reporting of legislated tax expenditures

3.6 Within the framework outlined above, TES 2006 reported 272 tax expenditures with an estimated aggregate value of $41.3 billion, assessed against the income tax, commodity and resource tax benchmarks. Of these, 249 tax expenditures were reported against five component income tax benchmarks, with commodity and resource tax expenditures making up the remainder, as shown in Table 3.1. The highest reported estimates of individual tax expenditures were reported against the personal, retirement and capital gains tax benchmarks.

[48] For instance, Appendix 5 describes the large, unquantifiable tax expenditure arising from capital gains tax forgone under the 'main residence six year rule'. While an exemption of long standing, it was not separately recognised or reported until TES 2006 but was included as part of the main residence exemption.

Table 3.1

Reported tax expenditure by tax benchmark 2006–07

Tax Benchmark	Aggregate estimated tax expenditures ($ million)	Number of reported tax expenditures
Personal income	12 609	70
Business income	2 787	97
Retirement income	17 940	9
Fringe benefits	2 607	50
Capital gains	5 562	23
Commodity taxes	–436	21
Natural resource taxes	250	2

Source: TES 2006, page 9 and Chapter 6. The aggregates of the reported tax expenditures are calculated by summing the individual tax expenditure estimates in each category, excluding those that are rounded to zero or are unquantifiable. In this respect, TES 2007 notes (p. 17) that 'While aggregate tax expenditure estimates can provide a guide to trends in tax expenditures over time, overlaps between the coverage of different tax expenditures and likely behavioural responses to their removal mean that such aggregates are not a reliable indicator of the overall budgetary impact of tax concessions.

3.7 Three classes of tax expenditures were not quantified and reported in TES 2006:

- those arising from GST exemptions;
- those for which a tax benchmark was not set or has changed significantly; and
- those for which data is not obtained by Treasury.

3.8 As detailed in Table 3.2, ANAO estimates the total revenue forgone for tax expenditures in these three classes at more than $40 billion in 2006–07.

Table 3.2

Estimated revenue forgone for tax expenditures not reported in the TES: 2006–07

	GST tax expenditures ($ million)	Benchmark difficulties ($ million)	Data not obtained ($ million)
Estimated revenue forgone 2006–07	20 985	over 4 300	over 15 000

Source: ANAO analysis of data from Treasury, ATO, Customs and other agencies.

GST tax expenditures

3.9 At the time of compiling TES 2000, Treasury and the ATO identified 26 major tax expenditures associated with the GST.[49] However, following a decision in December 2000 by the then Government, GST tax expenditures have not been reported in any TES.[50] TES 2007, published in January 2008, stated that:

> [*TES 2007*] reports Australian Government tax expenditures up to the *Pre-election Economic and Fiscal Outlook 2007*. In this period the GST was not treated as Australian Government revenue in budget publications. Subsequently, the Government has decided to treat the GST as Australian Government revenue. The [*TES 2008*] will identify and estimate GST tax expenditures.

3.10 As with other items, the inclusion of GST tax expenditures in the TES will require judgements concerning the tax benchmark. Inclusion will also require judgements to be made concerning which items of GST forgone represent a tax expenditure and therefore require separate identification and, where possible, quantification.

3.11 Treasury advised ANAO that its estimate of the upper bound for GST tax expenditures in 2006–07 was $20.985 billion (see Table 3.2). The largest

---

49 Some have multiple components, such as the GST exemption of medical expenses with 16 components. Some are specified in detail, such as the GST-free treatment of food and food packaging for the specific kinds of foods and beverages cited in Schedules 1 and 2 respectively of the GST Act.

50 TES 2000 reported, on 6 February 2001 at page 29 that, 'Only tax expenditures that relate to Commonwealth taxes are reported in [*TES 2000*]. As the GST is imposed and collected by the Commonwealth on behalf of the States, and the proceeds of the GST are not reported as Commonwealth revenue, this Statement does not cover GST.' Consistent with this view, prior to 2006–07, the Government's consolidated financial statements did not recognise, as revenue, the taxes associated with the GST. Nor did they recognise, as expenses, the associated payments to the States and Territories. The audit opinion on the financial statements of the Australian Government prior to 2006–07 was qualified in relation to the non-inclusion of the GST.

element of this figure relates to the substantial exemptions made to secure the passage of the GST legislation through the Senate. These exemptions apply to food, medical services and education services and accounted for $17 billion of the 2006–07 figure.

3.12 By way of comparison, ANAO estimated[51] that revenue forgone under GST could be as high as $59.8 billion. Major items not included in the Treasury estimate include:

- $22 billion in GST revenue forgone due to the then Treasurer's determination exempting specified Commonwealth Government taxes, fees and charges from the GST;[52] and
- GST revenue forgone from the then Treasurer's exemption of some 6 000 specified State and Territory taxes, estimated at $4.5 billion.

3.13 In respect to the revenue forgone under the then Treasurer's determination, Treasury advised ANAO that it did not view the revenue forgone due to the Treasurer's determination under Division 81 of the GST Act (which exempts listed Commonwealth and State government taxes and charges from GST) to be a tax expenditure. Treasury advised ANAO that:

> These taxes are not consumption expenditure and are therefore outside the scope of the GST base. The Division 81 determination is a mechanism to ensure that result and does not constitute a tax expenditure. It is necessary because the design of the GST is intended to cast a wide net as to what constitutes a supply.

3.14 To illustrate the judgements involved, ANAO noted that TES 2006 reported other large tax expenditures arising from the exemption from income tax of certain State and Territory bodies. If the GST had been charged on the previously mentioned taxes and charges, it would have been returned to the States and Territories under the terms of the *Intergovernmental Agreement on the Reform of Commonwealth State Financial Relations.*[53]

---

[51] The aggregate estimate comprises revenue forgone estimated by Treasury and the ATO and, for some components, ANAO estimates based on information reported in the Commonwealth's Consolidated Financial Statements or in the ABS *National Accounts*.

[52] A New Tax System (Goods and Services Tax) (Exempt Taxes, Fees and Charges) Determination 2004 (No. 2), which came into effect from 1 January 2005.

[53] 'Tax-and-return' is an accepted arrangement, illustrated by the case of constitutionally invalid state taxes levied on Commonwealth places. Under the *Commonwealth Places (Mirror Taxes) Act 1988,* the states and territories collect these taxes as valid Commonwealth taxes and are returned the amounts collected via the special appropriation in that Act. Notes to the Commonwealth's *Consolidated Financial Statements for the Year Ended 30 June 2006* show, at p. 253, Mirror Taxes collected and paid back to the States and Territories of $307 million in 2004–05 and $328 million in 2005–06.

3.15 Resolution of the appropriate and transparent treatment of forgone GST and other revenue would be assisted by the development of standards to govern tax expenditure reporting, as recommended by ANAO in Chapter 2. In the interim, in light of the views expressed by the Senate Standing Committee on Finance and Public Administration (see paragraph 2.46), there would be benefit in Treasury examining opportunities to provide supplementary information in the TES on GST revenue forgone.

Tax benchmark difficulties

3.16 Tax benchmarks are not defined in law or in accounting standards. Instead, a tax benchmark is an abstraction derived from Treasury's analysis of the Australian taxation system as it stands at a given point in time.

3.17 Applying tax benchmarks poses a number of significant practical difficulties. It is necessary to define and catalogue the structural elements of the tax system, and then to identify the tax expenditures that arise from all other concessional tax treatments. As noted by the Economic Planning and Advisory Council (EPAC) in its review (see Chapter 2):

> Reconciling these two criteria often involves an element of judgement; in particular, there may be different views on which structural elements to include in the benchmark. Consequently, benchmarks vary over time and across countries.
>
> …A pragmatic approach has been used in those countries where procedures for estimating tax expenditures are most developed.[54]

3.18 The history of the reporting of tax expenditures relating to Wholesale Sales Tax (WST) is illustrative. In TES 1995–96, Treasury published the first list of WST tax expenditures, although without estimates of revenue forgone. TES 1995–96 included a general description of the WST tax benchmark, with the caveat that it was under development and posed significant difficulties.[55]

3.19 Notwithstanding the difficulties, in the course of TER 97 (discussed in Chapter 2) Treasury identified 83 WST tax expenditures, accounting for estimated aggregate revenue forgone of almost $16.5 billion for 1995–96. In the event, however, WST was abolished before Treasury was able to report an established tax benchmark and estimates of WST tax expenditures.

---

[54] Economic Planning Advisory Council, op. cit., p 4.

[55] See TES 1995–96, pp. 3, 72 and pp. 60 and 61 for the list of WST tax expenditures.

Alcoholic beverages

3.20 Volumetric taxes (that is, taxes charged as a fixed proportion of the quantity of the commodity sold) are imposed on the consumption of beer and spirit with ad valorem taxes (that is, taxes charged as a fixed proportion of the volume of the commodity sold) charged on the consumption of wine. At present, the TES is prepared using three benchmarks reflecting each type of alcohol. Specifically, the benchmark excise rate for:

- lower alcohol content beverages is the volumetric rate that applies to full-strength packaged beer (including the excise-free threshold of the first 1.15 per cent of alcohol);
- higher alcohol content beverages is the volumetric excise rate on spirits other than brandy; and
- wine and alcoholic cider is the ad valorem wine equalisation tax rate.

3.21 The different benchmarks for alcoholic beverages have been adopted notwithstanding that the consumption of alcohol, regardless of type, is a similar activity. By way of comparison, a single benchmark is used for all petroleum fuels and a single benchmark is also used for all tobacco products (on which commodity taxes are also imposed).

3.22 The adoption of a uniform benchmark for alcohol (beer, spirits and wine) would be consistent with the principle that a tax benchmark should represent a consistent treatment of similar activities or classes of taxpayers. It would also provide useful information by better reflecting the preferential taxation treatment (such as lower tax rates for low alcohol products) of some categories of alcoholic beverages compared to others.

Customs duty tax expenditures[56]

3.23 Benchmark issues are cited as the reason for the lack of reporting of customs duty tax expenditures until the publication of TES 2007 in January 2008. Treasury resolved these longstanding difficulties by adopting a *zero* rate as the customs duty tax benchmark. This ensures that all customs duty revenue constitutes a *negative* tax expenditure, estimated to be in the order of *minus* $3.7 billion in 2007–08.

3.24 Customs duty tax expenditures are well established, having commenced on 4 October 1901. They were brought to the attention of government in the 1973 *Review of the Continuing Expenditure Policies of the*

[56] Appendix 2 provides a fuller account of Customs duty tax expenditures.

Previous Government[57] and again in 1982, at which time the House of Representatives Standing Committee on Expenditure observed that:

> In line with the view that a tax expenditure list should be comprehensive rather than restrictive, the Committee has incorporated customs and excise duties in the scope of such a list.[58]

3.25 TESs for 1986, 1987 and 1988 stated that there were difficulties in establishing a tax benchmark for customs duties, similar to those reported for the WST tax benchmark. Until TES 2007, subsequent TESs excluded any reporting of customs duty tax expenditures,[59] instead referring to summaries of industry assistance published by the Productivity Commission (or its predecessor, the Industries Assistance Commission).[60]

Customs duty revenue forgone

3.26 Customs has provided ANAO with estimates of almost $3 billion in customs duty revenue forgone for 2006–07 under tariff concession schemes (over $2 billion) and free trade agreements (almost $1 billion). However, these estimates are not reported under the zero rate customs duty tax benchmark adopted by Treasury in January 2008. These concessions are now effectively incorporated into the benchmark, with the effect of *lowering* the aggregate reported estimate of tax expenditures in 2007–08 to the reported total of $51.4 billion, or 4.6 per cent of Gross Domestic Product (GDP).

3.27 If, instead, Treasury had adopted a tax benchmark that identified the revenue forgone under tariff concessions[61] and free trade agreements as tax expenditures, aggregate tax expenditures would instead have *risen* to more than $58 billion in 2007–08 or approximately 5.2 per cent of GDP, a change of some 13 per cent over the reported aggregate estimate. This, along with the

---

[57] Coombs, op. cit., items 132, 133 and 135 at pp. 339–346.

[58] House of Representatives Standing Committee on Expenditure, *Taxation Expenditures*, August 1982, p. 13.

[59] Except for Treasury's inclusion of estimates of excise-equivalent customs duty in particular excise tax expenditures.

[60] The Productivity Commission advised ANAO in July 2007 that it does not collect or hold customs duty data. Its annual Trade and Assistance Review advises readers that, 'The estimates do not aim to capture all Australian government support for industry; nor, apart from some minor agricultural assistance, do they include State government assistance. Quantification constraints also limit the precision of some of the estimates, and care is needed when drawing inferences from them.'

[61] For example, ANAO's examination of the schedule of customs tariffs showed variation in customs duty within categories of dutiable goods such that one good (for instance, Portland cement) is subject to customs duty at a lower rate than another (in this case, alumina cement). It is apparent that concessional duties apply to many items in the tariff schedules though, under the recently adopted benchmark, their fiscal impact is not estimated, examined or reported.

fuel excise examples in Appendix 3, illustrates the sensitivity of tax expenditure estimates to the choice of tax benchmark.

3.28 Major customs duty tax concessions are also not reported under the customs duty tax benchmark.[62] These include a statutory provision that prescribes goods imported into Australia, the customs value of which does not exceed $1 000.[63] Customs advised ANAO that such arrangements have been in place since the introduction of Customs Regulation 49 of 1962. Over time, they have been modified to assist the efficiency of Customs' administration, most recently through the October 2005 alignment of thresholds for imports by post, air and sea, in support of Customs' Integrated Cargo System (through *Customs Act 1901* By-law No. 0540003).

3.29 Customs advised ANAO that it reports against the customs duty tax benchmark of zero as set and required by Treasury. In addition, Treasury advised ANAO that:

> Treasury, the ATO and Customs agree that the customs duty benchmark set in the 2007 TES is appropriate. Treasury considers that the alternative approach suggested by the ANAO is not appropriate because it would result in an inconsistent treatment of domestically produced and imported goods and is inconsistent with the programmed reduction in tariff assistance to Australian industry. The uniform zero tariff benchmark adopted in the 2007 TES recognises that tariffs are a penalty imposed on importers (who are the affected taxpayers) in order to assist domestic industry.

Tax expenditures outside the Treasury portfolio

3.30 The financial reporting requirements for Australian Government agencies and authorities are contained in the Finance Ministers Orders (FMOs) made under section 63 of the FMA Act and section 48 of the CAC Act. The FMOs provide minimum mandatory disclosure and reporting requirements for each agency and authority.

3.31 In accordance with the Australian Accounting Standards, specifically *AAS29 Financial Reporting by Government Departments*, Australian Government agencies are required to report both taxation and non–taxation revenue. As

62 These customs duty tax concessions are important revenue controls, balancing commercial requirements (such as timely customs clearance) with the need to maintain control of important revenue streams. Additional operational tax expenditures outside the Treasury portfolio are discussed later in this chapter.

63 With certain exceptions, including tobacco, tobacco products or alcoholic beverages and goods imported by a passenger or member of a crew of a ship or aircraft arriving from a place outside Australia.

illustrated by Figure 3.2, in relation to taxation revenue, entities are required to discriminate between the various categories of income tax, indirect tax and other taxes.

Figure 3.2

Requirements for the disclosure of taxation revenue: 2006–07

Notes to the Schedule of Administered Items

Note 18: Income Administered on Behalf of Government[1]

Reference		2007 $'000	2006 $'000
AAS29.12.9a	***Revenue***		
	Taxation revenue		
AAS29.12.9a	**Note 18A: Income tax**		
	Individuals	-	-
	Companies	-	-
	Superannuation funds:		
	Contributions and earnings	-	-
	Superannuation surcharge	-	-
	Fringe Benefits Tax	-	-
	Petroleum resources rent tax	-	-
	Total income tax	-	-
AAS29.12.9a	**Note 18B: Indirect tax**		
	Goods and Services Tax	-	-
	Excise duty	-	-
	Wine equalisation tax	-	-
	Luxury car tax	-	-
	Sales Tax	-	-
	Other	-	-
	Total indirect tax	-	-
AAS29.12.9a	**Note 18C: Other taxes**		
	Superannuation guarantee charge	-	-
	Levies (other than agricultural)	-	-
	Other	-	-
	Total other taxes	-	-

Source: Finance Ministers Orders 2006–2007, Requirements for the Preparation of Financial Reports, Annexure A PRIMA (FMA), p. 14.

3.32 The ATO is the Australian Government's principal revenue collection agency and one of the largest payers of government benefits. Significant revenue, in 2006–07, was also collected by a number of other Commonwealth entities including:

- the Australian Customs Service ($6 163 million);

- the Department of Immigration and Citizenship ($635 million); [64]
- the Department of Agriculture, Fisheries and Forestry ($609 million);
- the Australian Securities and Investments Commission ($558 million);[65] and
- the Australian Communication and Media Authority ($466 million).

3.33 In its 1982 report, the House of Representatives Standing Committee on Expenditure stated that:

> The Treasury submission was only concerned with taxes for which the Treasurer has principal responsibility, namely, income tax, sales tax and the Australian Capital Territory pay–roll tax and stamp duties. With regard to customs duties, Treasury commented in evidence that customs duties as such are not generally levied for revenue raising purposes but for industry protection purposes with the exception of the 2 per cent revenue duty. Whether the various concessions inherent in the customs duty structure in fact constitute taxation expenditures is open to debate. In line with the view that a tax expenditure list should be comprehensive rather than restrictive, the Committee has incorporated customs and excise duties in the scope of such a list and recommends that:
>
>> The Treasurer consult with other Ministers to ensure that the listing covers taxation expenditures in areas outside the Treasurer's principal responsibility.[66]

3.34 The Government's March 1985 response to that report stated that this recommendation was 'generally accepted'.[67] The only reservation stated was with respect to whether Customs duties should be reported.[68] However, subsequent reporting in Budget Papers and, more recently, the TES has continued to exclude reporting of tax expenditures in areas outside the Treasury portfolio. The only exception is the inclusion of certain customs duty data in the estimation of some excise tax expenditures.

---

[64] Principally taxation revenue from visa application and related charges, as discussed at p. 102 of ANAO Audit Report No. 7 of 2006–07, *Visa Management: Working Holiday Makers.*

[65] Principally regulatory fees and charges under the *Corporations Act 2000,* many of which are licence fees or fees for regulatory services.

[66] House of Representatives Standing Committee on Expenditure op. cit., pp. 12 and 13.

[67] *Hansard*, House of Representatives, 27 March 1985, p. 997.

[68] The Government response stated that, except for the two per cent revenue duty, there is no ready benchmark to identify Customs duty tax expenditures, other countries do not report Customs duty tax expenditures and the then Industries Assistance Commission already published information on assistance to industry provided by way of tariffs and quantitative import restrictions.

3.35 Examples of potential tax expenditures identified by ANAO that are administered outside the Treasury portfolio included:

- $140 million in 2006–07 revenue forgone by exempting certain Commonwealth authorities and companies from income taxation;[69]
- the Minister for Immigration being empowered to declare certain applicants or classes of applicants for visas under the *Migration Act 1953* to be exempt from the Visa Application Charge, although no revenue forgone for 2006–07 was reported;
- the Department of Education, Science and Training reporting discounts of $15 529 000 on lump–sum repayments under the Higher Education Loan Program (HELP);
- section 81 of the *Education Services for Overseas Students Act 2000* exempting from tax certain income of the ESOS Assurance Fund, resulting in revenue forgone of approximately $200 000 for 2005–06;[70] and
- since 1959, certain Government stocks or securities issued under the *Loans Securities Act 1919* have been exempt from Commonwealth taxes.[71]

3.36 All of the instances cited, with the exception of HELP lump sum discounts, potentially result in revenue forgone under taxing laws. None are reported in the TES. Treasury advised ANAO that:

> The focus of the TES is on taxation revenue and related concessions rather than on non-taxation revenues. Non-tax revenues are distinguished under the GFS by amounts paid being either a fee for service or a payment where the amount charged recovers the costs of undertaking some administrative function on behalf of the taxpayer.

3.37 However, in other cases, such as for the Visa Application Charge, there may be competing views as to whether the revenue is a tax. The HELP lump sum discounts example demonstrates the potential for significant amounts of revenue to be forgone under exemptions, waivers and discounts applying to non-tax revenue laws, without a necessary connection to cost recovery.

[69] ANAO estimates based on audits of entity financial statements for 2006–07.

[70] ANAO estimate, based on the *ESOS Assurance Fund Annual Report 2006*, produced by PriceWaterhouseCoopers, the fund manager. Contributions by education service providers are exempt from income tax. The fund is intended to underwrite tuition fees paid by overseas students to registered Australian providers of educational services.

[71] The exemption is provided by section 6B of the Act.

Reporting the substance of the transactions allowing revenue to be forgone may, in some instances, be more relevant than fine distinctions between taxation and other revenue raising laws. In this regard, Treasury advised ANAO that:

> Where agencies outside the Treasury portfolio administer taxation revenues (such as the case for Customs duties) Treasury agrees that concessions related to those revenues should be reported in the TES.

3.38 ATO also commented to the ANAO that:

> The Tax Office's main role here involves assisting Treasury with the preparation of the expenditure estimates. The Tax Office believes there would be significant benefit in formalising the arrangements whereby relevant data is obtained from outside the Treasury portfolio. This would involve 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.

Recommendation No.4

3.39 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.

Agency response

3.40 Treasury agreed with the recommendation and the ATO agreed with part (b) of the recommendation. In relation to part (b):

- 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.

4. Reporting Accuracy

This chapter assesses the reliability of TES 2006 estimates. It includes an analysis of the methodologies currently employed to estimate tax expenditures and suggestions for improving the quality of estimates.

Introduction

4.1 Tax expenditures can only be estimated when data is available, and reliable estimates can only be produced when the data is of high quality. The ATO is responsible for developing and maintaining the mathematical models and data for 250 of the 272 tax expenditures published in TES 2006. The remaining models, which combine ATO tax data with Customs duty data, are maintained by Treasury.

4.2 The ATO makes tax expenditure estimates as a part of its wider responsibility for estimating the revenue from new tax policies or changes to tax policies. The ATO builds mathematical models based on the main features of each tax expenditure, along with relevant assumptions, including Treasury estimates of key economic parameters such as forecast rates of economic growth, or employment. The models are populated with data from tax returns and regulatory returns lodged with the ATO. They may also draw on data from the ABS or from other sources. Before publication, the ATO provides Treasury with its models and their output to be checked for quality and accuracy.

Estimating methodologies

4.3 There are three main methods of estimating the cost of tax concessions.

Outlay equivalent

4.4 TES 2007 described the outlay equivalent method as measuring the direct expenditure required, in before-tax dollars, to achieve the same after-tax dollar benefit as the tax expenditure where the direct expenditure receives the tax treatment appropriate for that type of income in the hands of the recipient. Some jurisdictions, notably the Unites States, produce outlay equivalent estimates, mainly derived from initial estimates of revenue forgone. These are estimates of the direct outlays required (in pre-tax dollars) to achieve the same after-tax dollar benefit provided by a tax concession. The perceived advantages of outlay equivalent estimates persuaded the Economic Planning Advisory Council (p. 5) that:

> It might be profitable to explore the potential for providing tax expenditure estimates on an outlay equivalent basis, as has been done in recent years in the United States, rather than on the revenue forgone bases used today in Australia. [*The*] outlay equivalent method has the advantage that tax expenditures are estimated on the same basis as direct outlays and may allow a better assessment of their comparative merits. The outlay equivalent approach might also better facilitate integration of tax expenditures into the budget process.

Revenue forgone method

4.5 Revenue forgone is the method adopted by ATO and Treasury for the production of the TES estimates.[72] It estimates the amount by which revenue is reduced by comparing the revenue raised under current law with the revenue that would have been raised if the tax expenditure provision alone did not exist, assuming all other parts of the tax law remain constant and that taxpayer behaviour is unchanged.[73]

4.6 A major advantage of the revenue forgone method is that it requires the least amount of data with which to estimate a tax expenditure. It is the approach most commonly used in other countries. However, the estimate would only be a measure of cost to revenue if all the taxpayers benefiting from the current concession were to continue their current economic behaviour even if the concession was withdrawn. In economic terms, this is similar to assuming taxpayer behaviour does not respond to changes in price, notwithstanding the fact that many concessions are specifically intended as incentives. In terms of the revenue forgone method, the EPAC review stated that:

> The revenue forgone estimate is *not* able to capture with complete accuracy the amount by which government revenue would increase if the provision were repealed, since such a repeal would cause changes in taxpayer behaviour which would generally reduce the revenue gain.[74]

---

72 Treasury advised ANAO in February 2008 that the outlay equivalent approach 'does not necessarily provide better estimates than the revenue forgone method and can become difficult to estimate under progressive income tax scales.' In July 2000, the ATO had advised Treasury that the revenue forgone method was used for almost all tax expenditures, except for four fringe benefit tax expenditures arising from salary sacrifice arrangements. The ATO further advised that no tax expenditures were prepared on an outlay equivalent basis.

73 Government Accounting Office of the United States, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and need to be Reexamined* –GAO-05-0690 (Washington DC, September 2005) p. 8.

74 Economic Planning Advisory Council, op. cit., p. 5. The Economic Planning Advisory Council noted that the revenue forgone method was implicitly endorsed by the House Of Representatives Standing Committee on Expenditure in its 1982 report on taxation expenditures.

4.7 Similarly, Treasury advised the ANAO that:

> the revenue forgone approach means that the 'tax expenditures [*reported in the TES*] are likely to overstate the aggregate impact on the revenue estimates and make those estimates inconsistent with expenditures estimates.

4.8 These disadvantages are particularly apparent when estimating the large tax expenditures available for superannuation savings. In this case, the tax expenditures have important interactions with other parts of the tax system, have effects that flow on to outlays programs such as pension payments, and could be affected by taxpayers investing some of their savings elsewhere if the tax concessions for superannuation were reduced or removed. As Treasury warns readers of the TES, changing or abolishing major superannuation tax concessions is unlikely to produce the future stream of additional revenue shown by the TES estimates of revenue forgone:

> This is because the increase in tax revenue arising from the elimination of the tax expenditure with respect to a particular year would cause the superannuation tax base to be smaller for the next year. For example, if contributions and fund earnings in 2004–05 had been taxed according to the [*higher rate of the*] superannuation benchmark, superannuation fund assets and fund earnings in 2005–06 would be lower than if the concessional tax treatment had applied in the previous year.
>
> In addition, changes to the taxation of superannuation could be expected to have behavioural impacts, to the extent that people may alter their saving behaviour as a result.[75]

4.9 Estimates of superannuation tax expenditures have been subject to adverse comment for this reason (and in respect of the tax benchmark used) and have also been the subject of questioning by Parliamentary committees.[76]

Revenue gain method

4.10 The revenue gain approach is more comprehensive than the revenue forgone approach. It endeavours to account for potential changes in taxpayer behaviour, as when taxpayers respond to the withdrawal of a tax concession by changing their tax affairs to take advantage of alternative tax concessions, and other 'second order' effects, such as interactions with other tax policies.

---

[75] TES 2006, p. 166.

[76] For instance, see Association of Superannuation Funds of Australia, *The facts on the concessional taxation treatment of superannuation,* February 2003, and Hansard, House of Representatives Economics, Finance and Public Administration Committee, Friday 10 February 2006, p. EFPA 69.

4.11 The revenue gain method is comparable to those methods used to cost outlay changes, which incorporate assumptions of likely behavioural and other 'second order' effects, including interactions with the tax system. Budget estimates of outlay measures are typically agreed with Finance, after scrutiny of the data and assumptions underlying the estimates, including behavioural and 'second order' assumptions.

4.12 The revenue gain approach can produce more accurate estimates of tax expenditures to give estimates of total tax assistance and which are comparable with significant outlay measure estimates. Compared to the revenue forgone approach, however, revenue gain estimates require more thorough modelling using more data of higher quality.

4.13 Treasury advised ANAO that the revenue gain approach is used for new revenue measures announced in the Budget, as these 'are generally incremental changes to the taxation system which can be more readily measured than the whole stock of taxation concessions.' The revenue gain method is especially preferable for large tax expenditures, including those sensitive to relatively minor changes in the law, in taxpayer behaviour or in economic conditions. For these, the potential costs to revenue may justify collecting and modelling the extra data necessary to account for more complex interactions and behavioural effects.

4.14 The ATO had previously advised ANAO that its calculation of tax ;liabilities applied tax concessions (including tax expenditures) in a set sequence based on taxation law. Accordingly, it is feasible to apply the same regime to assist to produce revenue gain estimates of tax expenditures, reflecting the actual treatment of tax assessments. However, the adoption of the revenue gain approach also requires modelling of behavioural effects. In commenting, Treasury advised ANAO that:

> It is not feasible to produce comprehensive tax expenditure estimates on a revenue gain basis because of issues relating to the ordering of concessions, the overlap between concessions and behavioural effects. As large tax expenditures tend to overlap each other, the costings of revenue gain would have to be on a 'stand alone' basis for each tax expenditure examined. Alternatively, the order in which tax expenditures are abolished would need to be specified to take account of the cumulative effect of substitution effects.

4.15 Treasury further advised ANAO that it favoured publishing estimates of selected large tax expenditures using both the revenue gain and revenue forgone approaches so as to illustrate the differences between the revenue estimates and tax expenditures and to highlight how these estimates could be interpreted.

Recommendation No.5

4.16 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.

Agency response

4.17 Treasury agreed to the recommendation. 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.

Reliability of tax expenditure estimates

4.18 The reliability of estimates produced by either method of estimation depends largely on the data available and the modelling *techniques* applied. Three established modelling techniques are regularly applied to produce estimates of tax expenditures: distributional modelling, micro-simulation and aggregate modelling.[77] In general, the first two techniques require more data but produce more reliable results if that data is available. Aggregate models can, in certain circumstances, also provide reliable estimates, as discussed below.

Distributional modelling

4.19 Where data is available of sufficient quality and detail, the ATO constructs models of revenue forgone using the technique of distributional modelling:

> Distributional modelling is used to estimate tax expenditures for personal income tax concessions when the cost is related to a taxpayer's taxable income. For these concessions, data on income distribution and tax concessions by greater taxable income can be used to estimate the cost of tax expenditures for those concessions.[78]

[77] This discussion assumes that, like all current tax expenditure models, the intention is to produce static (or 'steady state') rather than dynamic models.

[78] TES 2006, p. 163.

4.20 The output of distributional models can, with few exceptions, be considered robust and reliable.

Microsimulation

4.21 In cases where reliable datasets are available, tax expenditures can be estimated by microsimulation, an approach involving the examination of detailed data sets (such as taxpayer records) to determine the value of taxable transactions and to estimate the value of the same transactions under the benchmark tax. Estimates of tax expenditures can then often be made by calculating the difference between the actual and simulated taxation transactions.

> Microsimulation modelling requires either a comprehensive database of all taxpayers or a detailed sample that can represent the population. [*It is*] used to estimate tax expenditures that are closely tied to particular taxpayer groups (for instance, benefits subject to detailed eligibility tests) and concessions where the payment rate varies considerably according to taxpayer behaviour or circumstance.[79]

4.22 In practice, microsimulation is more often used to construct important estimates of parameters (such as average tax rates) to be used in other models of tax expenditures:

Aggregate modelling

4.23 In the absence of detailed data sets, tax expenditure estimates can be made on the basis of aggregate modelling, using information on the total volume of transactions. This approach is best suited to estimating tax expenditures, where:

> the impact can be represented as a simple proportion of the total transactions concerned. [*This approach*] is used typically to estimate tax expenditures for fuel excise.[80]

4.24 In other circumstances, aggregate modelling may be less suitable: for instance, where the taxation rate is not a simple proportion or when it varies in accordance with taxpayer circumstances as with personal income taxation. Nonetheless, where detailed taxpayer data is not available, it may be the only technique available to estimate tax expenditures.

---

[79] TES 2006, p. 164.

[80] TES 2006, p. 163.

Reliability of TES 2006 estimates

4.25 The TES informs users that the methods used to calculate the estimates of individual tax expenditures vary and that data availability is a major factor influencing the reliability of the estimates.[81] However, the detailed information provided in TES for each quantified individual tax expenditure does not at present indicate the reliability of the estimate.

4.26 ANAO examined all of the tax expenditure models for the 272 tax expenditures reported in TES 2006, with a view to understanding each model's construction (in relation both to the data and to tax law), establishing the quality of the data underpinning the models, and assessing the reliability of each model.

4.27 To form an opinion on the reliability and robustness of the tax expenditure estimates, ANAO considered the quality of the data available and the techniques applied to the data to construct models of estimates. When examining the models, ANAO took into account key factors advised by the ATO:

- the reliability of the models is highly dependent upon the availability of good quality data;
- where good quality data is used, the estimates for earlier years are usually the best, corresponding closely to the actual revenue forgone;
- the best forward estimate is for the current year of the TES. For TES 2006, the best forward estimate was that for the 2006–07 financial year, with lower reliability and accuracy for each successive year;
- reliability was somewhat dependent upon the maturity of the tax expenditure. Recently introduced tax expenditures tended to show less consistent (and therefore less predictable) patterns of taxpayer behaviour, are less likely to produce settled data, and are less likely to produce reliable forward estimates; and
- in some cases, the underlying data is so inherently volatile that reliable forward estimates cannot be constructed.

4.28 Overall, quantifiable estimates were provided for 162 (or fewer than 60 per cent) of the 272 tax expenditures reported in TES 2006.[82] Appendix 5

---

[81] See, for example, TES 2007, p. 185.

[82] There are 12 tax expenditures that are separately identified in the TES but for which the estimates are incorporated into those of another tax expenditure.

provides details. In respect of TES 2006, reliable estimates (indicated in Table 4.1 by a rating of High or Medium–High) were provided for 52 tax expenditures, or fewer than 20 per cent of all reported tax expenditures; these account for nearly two–thirds of the total value of all reported tax expenditures.

Table 4.1

Reliability of quantifiable tax expenditure estimates, TES 2006

Category	Number	Aggregate estimates ($m)
Very low • Very little data and of poor quality, model relying heavily on data assumptions. • Almost no information on potential taxpayer behaviour.	19	866
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.	38	3 738
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.	20	5 107
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.	33	7 445
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.	11	20 156
High • High quality tax data. • Modelling with few or no assumptions. • Well established tax expenditure with stable and predictable taxpayer behaviour.	41	11 359
Note: To ensure the full value of all tax expenditure estimates is reflected in this analysis, all *negative* tax expenditures are treated as *positive*, giving a total value of tax expenditures for 2006–07 of $48 671 million, compared to the *net* value of $41 319 million cited in TES 2006.		

Source: ANAO analysis of ATO and Treasury tax expenditure models, estimates for 2006–07 from TES 2006.

Highly reliable estimates

4.29 Estimates for all the 41 tax expenditures with High reliability—with an estimated aggregate value of over $11 billion—were underpinned by high quality data, generally drawn from the returns taxpayers must lodge in order to receive the benefits. The data available to the ATO in these cases—mostly from tax returns and excise claims—allows high quality modelling and analysis.

4.30 In some cases, the available data was of sufficient quality and detail to allow reliable and robust distributional modelling of the tax expenditure. In other cases, especially for excise tax expenditures, aggregate modelling is sufficient.

4.31 Tax expenditures relating to excise, superannuation and personal income–tax make up the bulk of the tax expenditures with a High reliability. This group also contains the largest quantifiable capital gains tax expenditure and some business tax expenditures, though this latter group is underrepresented.

4.32 The class of highly reliable estimates does not include either of the resource rent tax expenditures or any of the 50 tax expenditures associated with fringe benefits tax. Further, none of the latter can be assigned a Medium–High level of reliability. Indeed, only three of the tax expenditures for Fringe Benefits Tax can be assigned a Medium level of reliability, with the remainder assigned a level of reliability of Medium–Low, Low or Very Low.

Concessional treatment of funded superannuation

4.33 The tax expenditure associated with the concessional treatment of funded superannuation accounted for over $17 billion of the $20 billion categorised as evidencing Medium–High reliability. It is made up of ten component tax expenditures, some of which were of High reliability, others less so.[83] For example, the estimate of $7.65 billion revenue forgone in 2006–07 due to the concessional taxation of employer contributions does not account for all contributions. While figures are not available for 2006–07, ATO advised that the underestimate of revenue forgone for 2005–06 was $230 million.

[83] Details of the ten components were provided in an appendix for TESs up to and including TES 2006. In the TES 2007 published in January 2008, Treasury expanded the reporting of superannuation tax expenditures and provided details of individual estimates in the body of the report.

Other estimates of Medium–High reliability

4.34 The estimates of the tax expenditures for pensioner and beneficiary rebates and the private health insurance rebate were also assessed as being of Medium–High reliability. While these tax expenditures can be modelled with some precision, both estimates could be significantly improved if based on more detailed data on income–support recipients and on health insurance policy–holders. ATO advised ANAO as follows:

> The pensioners and beneficiaries' tax offset required data from a number of departments including Education, Science and Training, Employment and Workplace Relations and Families, Community Services and Indigenous Australians as they were then known. While the respective departments were cooperative there were still issues with obtaining data that provided sufficient detail to ensure a more reliable estimate model for these two tax expenditures. We think [*that the audit recommendations*] could lead to improvements whereby both parties work more closely to ensure a shared understanding of the data needed to prepare more reliable estimates.

4.35 Also in the Medium–High reliability category are estimates of the research and development tax concessions. They are based directly on tax data but rely on, and are sensitive to, assumed rates of growth, to the assumed timing of expenditure on research and development plant, and to the assumed proportion of research and development company profits likely to be distributed as dividends. Neither the ATO nor Treasury has more reliable data on these factors.

Tax expenditure estimates with lower levels of reliability

4.36 Of the 162 quantified tax expenditures, 110 (68 per cent) involving 35 per cent of the aggregate estimate were assessed as having Medium or lower levels of reliability. In many cases, the models are based not on detailed data, but on aggregate data compiled from a range of sources. This reduces the inherent reliability of the models, and tax expenditure estimates of Medium reliability include:

- Family Tax Benefit ($2 430 million in 2006–07);
- exempt income support benefits, pensions or allowances ($970 million);
- exempt war–related payments and pensions ($440 million); and
- Child Care Benefit ($410 million).

4.37 In each case, these tax expenditures are available to eligible claimants who may not have to lodge tax returns or who may not have to report exempt income for tax purposes. Without more detailed data on each of these payments from the agencies responsible for their administration, it is not possible for Treasury or the ATO to build more accurate and reliable models.

4.38 In the case of the tax expenditure arising from the concessional taxation of non–superannuation termination benefits (estimated at $300 million in 2006–07), the model did not include the exempt income available to taxpayers as bona fide redundancy payments. ATO advised ANAO that the tax expenditure had been estimated solely on the reported taxable component of these eligible termination payments. Consequently, the tax expenditure was underestimated by approximately $800 million in 2006–07. Inclusion of this tax expenditure in the TES may have helped to draw attention to the interaction with the Mature Age Worker tax offset (estimated in TES 2006 at an expense of $390 million in 2006–07).

4.39 Appendix 5 details other tax expenditure estimates with low levels of reliability for reasons such as:

- assumptions used rather than reliable data;
- modelling based on lower quality aggregate data rather than specific details of claims or deductions; and
- volatile data affecting the estimates.

4.40 Treasury advised ANAO that obtaining detailed data is rendered more difficult:

> by the trend to reducing compliance burdens on taxpayers, which results in less information being reported from which estimates can be made. The same trend also affects alternative sources of information such as the Australian Bureau of Statistics.

4.41 ATO noted in particular:

> the competing need to minimise the compliance cost burden on taxpayers. It is unlikely in the current environment that we will seek to expand requirements for taxpayers to provide data to the Tax Office for the purpose of measuring tax expenditures. Our key driver for seeking additional information from taxpayers, beyond that which is required to determine their final tax liability, is usually to improve compliance or seek out non-compliance with the law.
>
> However, we can expect that the Tax Office will continue to implement improved means of collecting currently available data that is held outside the

> Tax Office. For example, the current initiative of pre-filling of tax returns provides data on income from other sources and the improved data collection through e-tax and Electronic Lodgement System lodgers provides data not necessarily available from taxpayers who lodge a paper tax return.
>
> In addition we are looking to improve the data used in our estimating models by obtaining more detailed and timely data from other Commonwealth government agencies.

Unquantified tax expenditures

4.42 TES 2006 reported 98 tax expenditures for which estimates were not quantified. Estimates of the general order of magnitude of unquantifiable tax expenditures were introduced in TES 2005. They are not included in estimates of the total value of tax expenditures. Readers are advised that the order of magnitude estimates are indicative only, are produced without the benefit of detailed data and:

> are based on assumptions and judgement and as such should be treated with caution. [*For*] a tax expenditure where neither an estimate, nor an order of magnitude could be assigned, a 'na' classification has been adopted.

4.43 TES 2006 provided estimates of the general order of magnitude of tax expenditure for 77 of the 98 unquantified tax expenditures (see Table 4.2). ATO and Treasury consider that no reliable estimates can be made for the remaining 21 tax expenditures.

Table 4.2

Summary of unquantifiable tax expenditure, TES 2006

Tax expenditures which cannot be readily estimated						
Magnitude	$0 on average	$0–$10m	$10m–$100m	$100m–$1 000m	Over $1 000m	Unknown
Number	4	33	30	9	2	21

Source: TES 2006, page 45, and ANAO analysis

4.44 There was no data available for estimating 81 of the 98 unquantifiable tax expenditures, and limited data for the remaining 17. In many cases, this was because it is not necessary for taxpayers to make explicit claims in order to receive the tax benefit. Specifically:

- 71 of the 98 unquantifiable tax expenditures arise because all or part of a transaction is exempt from tax. It is not necessary for taxpayers to disclose exempt income in tax returns, and there is therefore no tax data on these transactions;
- another 15 arise from deductions claimed in tax returns in a lump sum with other deductions. Individual deductions cannot be disaggregated from the total deductions claimed and cannot be separately quantified;
- a further five unquantifiable tax expenditures result from tax liabilities that are effectively deferred.[84] When, however, the tax liability is eventually realised, it will not be able to be associated with the original deferral or related to the amount of the original tax liability. Nor will the period of deferral necessarily be known, preventing any estimation of the tax expenditure; and
- the remaining tax expenditures cannot be quantified because useful data to inform a costing is not available for a range of other reasons. For instance, while there was an estimated $452 million revenue forgone under off–market share buy–back schemes in 2005–06, the volatility of the available data precludes the development of forward estimates.[85]

Estimates of large unquantifiable tax expenditures

4.45 ATO and Treasury have produced preliminary estimates of three large unquantifiable tax expenditures: the capital gains tax exemption of the income from the sale of a taxpayer’s main residence; the income tax exemption of certain State and Territory government business enterprises (GBEs); and the extra revenue gained by not allowing taxpayers to deduct certain repayments of their Higher Education Contribution Scheme (HECS) or Higher Education Loan Program (HELP) debts.[86]

---

[84] For instance, taxpayers may increase their deductions by depreciating certain assets to nil value, rather than the scrap value. Any gain on the subsequent disposal of the asset is treated as income and taxed at that time (see p. 98 of TES 2006).

[85] See p. 79 of TES 2006.

[86] Particularly where the debt was incurred studying for the purposes of their employment.

4.46 In each case, the preliminary models met the minimum criteria for establishing a credible model:[87]

- aggregate data relating to the tax expenditure is available from a credible source;
- the beneficiaries of the tax expenditure can be identified with reasonable certainty; and
- data on average taxation rates derived from micro–simulation can be applied with some confidence to estimate revenue forgone.

4.47 The resulting estimates, which have not previously been published, amount to almost $15 billion in 2006–07 (see Table 4.3) and are set out in more detail in Appendix 5. These three measures indicate the significance of the potential revenue forgone from tax expenditures currently reported as unquantifiable. However, it is important to note that Treasury has not agreed to these estimates.

Table 4.3

Estimates of large unquantifiable tax expenditures: 2006–07

Capital gains tax exemption ($ million)	Tax exempt State and Territory GBEs ($ million)	Non–deductibility of HECS/HELP repayments ($ million)
13 000	1 980	–110

Source: ANAO analysis of ATO and Treasury models.

4.48 Both Treasury and the ATO expressed reservations about publishing these estimates, as they were concerned about either their reliability or that the models could produce a wide range of estimates. In particular, ATO advised as follows:

> The Tax Office and the Treasury are already working towards preparing estimates of the revenue forgone for a number of the previously unquantifiable tax expenditures. Our concerns are that we do not wish to publish estimates where we are not sufficiently confident of the reliability of the model. Sufficient time to review models is important where large estimates are involved.

---

87 However, the estimate of capital gains tax forgone is conservative and does not include revenue forgone due to what is known as the 'six year rule', which may be used inappropriately to gain a tax advantage.

For some policy decisions the Tax Office is asked by the Treasury to assess the likely revenue, departmental and compliance cost impacts of new policy proposals, including tax expenditures. However, data collection that would allow reliable measurement of new tax expenditures is not normally our highest priority. Minimising taxpayer compliance costs and the Tax Office's departmental costs typically govern the design of administrative arrangements.

Recommendation No.6

4.49 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 effect of the proposed measure.

Agency response

4.50 Treasury and the ATO both agreed with parts (a), (b) and (c) and agreed with qualification to part (d). 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 Treasury are already working towards preparing estimates of the revenue foregone 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): Treasury note 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 commented that:

  For many policy decisions the ATO is asked by the Treasury to assess the likely revenue, departmental and compliance cost impacts of new policy proposals, including tax expenditures. However, data collection that would allow reliable measurement of new tax expenditures is not normally the highest priority. Minimising taxpayer compliance costs and the ATO's departmental costs typically govern the design of administrative arrangements. Accordingly the ATO has no objections to this recommendation subject to the competing need to minimise the compliance cost burden on taxpayers. It is unlikely in the current environment that we will seek to expand requirements for taxpayers to provide data to the ATO for the purpose of measuring tax expenditures. Our key driver for seeking additional information from taxpayers, beyond that which is required to determine their final tax liability, is usually to improve compliance or seek out non-compliance with the law.

  However, the ATO will continue to implement improved means of collecting currently available data that is held outside the ATO. For example, the current initiative of pre-filling of tax returns provides data on income from other sources and the improved data collection through e-tax and ELS lodgers provides data not necessarily available from taxpayers who lodge a paper tax return.

  In addition the ATO is looking to improve the data used in our estimating models by obtaining more detailed and timely data from other Commonwealth government agencies. Our progress here will be assisted by the implementation of your Recommendation 4(b).

Ian McPhee
Auditor-General

Canberra ACT
8 May 2008

Appendices

Appendix 1: Earlier Reviews of Tax Expenditures

Review of the Continuing Expenditure Policies of the Previous Government, 1973

1. The first broad review of tax expenditures was part of the 1973 *Review of the Continuing Expenditure Policies of the Previous Government.*[88] The Review had a fiscal focus and was intended to assist the Government formulate its August 1973 Budget. It assessed the success of 94 outlays programs and 48 tax expenditure programs at improving the distribution of income, sustaining full employment, or altering the allocation of resources to meet defined ends, such as:

> [ensuring the] supply of important community services e.g. defence, education, health services, national parks, arts and entertainment; to ensure the supply of basic producers' services, e.g. transport, communication, research; to achieve special objectives which are judged to be strategic economic policy at the time, such as to stimulate exports, to reduce unemployment or to sustain rural incomes; and to develop publicly owned enterprises and other components of the 'National Estate.'[89]

2. It found a number of programs hard to justify in the light of the apparent results. In particular, some programs designed to reallocate resources produced substantial income benefits to those not in need of such aid. Describing most tax expenditures as disguised expenditures, the report drew attention to the anomalous results and unintended consequences of tax concessions, as well as the difficulties of assessing their effectiveness. For instance, in respect of industry assistance, it suggested that:

> Continuing plans for assistance or tax concessions should, as a rule, provide a limit for any firm of, say, three years and assistance by taxation concession or by protection against imports could be replaced by direct subsidy so that the cost could receive Parliamentary review in the budget.[90]

The House of Representatives Standing Committee on Expenditure, 1982

3. Parliamentary concerns and interest in the reporting of tax expenditures prompted an inquiry by the House of Representatives Standing

[88] Coombs, op.cit.

[89] ibid, p. 5

[90] ibid, p. 23.

Committee on Expenditure. The Committee's 1982 report, *Taxation Expenditures*, found that although costs could only be estimated for 65 per cent of the tax expenditures identified, their indicative aggregate cost was in the order of 15 per cent of total Budget outlays in 1981–82:

> Yet, unlike direct expenditures, there is a dearth of information on these indirect taxation expenditures. There a dearth of information on their scope and annual cost to the Budget. There a dearth of updated information on the purposes of taxation expenditures.
>
> The thrust and major theme of this Report then is to seek and obtain remedies to the deficiencies in the information provided to the Parliament on taxation expenditure. [91]

4. In the Committee's view, comprehensive information would help Parliament to call the Executive to account through more informed debate and assist budgetary control and evaluation, which it found to be deficient. It commended the Canadian approach of reporting broadly on tax expenditures, rather than more narrowly.

5. The Committee found that, while tax expenditures were a useful tool in some situations, they were generally regressive in nature, were not certain of reaching only those people for whom they were intended, were difficult to evaluate, and frequently involved a trade–off between equity and efficiency. However, they are often used because:

> Firstly, they are undoubtedly popular with individuals and industry. Secondly, they are a convenient way of helping governments stay within their expenditure limits because they are recorded as revenue losses rather than as expenditure increases. Thirdly, lack of visibility of taxation expenditures has also been given as a principal reason for their use. Another reason is that of stability, for taxation expenditures may be less likely to be changed, because of a lack of scrutiny at Budget time. For all these reasons, taxation expenditures are a politically attractive alternative to direct expenditures. [92]

6. The Committee observed a clear link between tax expenditure and tax avoidance and a corresponding reduction in the effectiveness of the taxation system. For this and related reasons, the Committee recommended that, for Bills relating to tax expenditures, the Government should provide an explanation as to why the taxation system was preferred to direct outlays.[93]

---

[91] House of Representatives Standing Committee on Expenditure, op. cit., p. 1.

[92] ibid, p. 5.

[93] ibid, recommendations on p. vii, other commentary on pp. 5 to 7 and pp. 16 and 17.

7. The Committee's final view was that incomplete information on tax expenditures had serious implications. Citing Surrey, the originator of the concept, the Committee warned that:

> A moment's thought should indicate how serious are the consequences of asserting that taxation expenditures cannot be identified or, if identified, that their costs cannot be ascertained. At bottom, this would be an assertion that the fiscal experts of the country do not know what is contained in the income–tax or how much particular programs cost government. The assertion would be an admission that the country has lost control of both its tax policy and its budget policy.[94]

8. Accordingly, the Committee made the following Recommendations to Government:

1. The Government gives the Parliament an undertaking to provide comprehensive information on taxation expenditures within three years from the tabling of this report.
2. All taxation expenditure items together with their objectives be listed in the Budget Papers.
3. The Treasurer consult with other Ministers to ensure that the listing covers taxation expenditures in areas outside the Treasurer's principal responsibility.
4. In addition to the listing of all taxation expenditures and their objectives, the information in the Budget Papers contain the estimated cost to revenue of the major taxation expenditures for the Budget year that is current and the two preceding years.
5. Individual taxation expenditure items be classified in functional groupings similar to the classification of direct outlays.
6. The functional classification of taxation expenditures be cross–classified according to the departments responsible for the direct spending equivalents.
7. Taxation expenditure information be presented as a separate Budget Statement in the Budget Papers.
8. Where the proposed financial impact statement to be included in a Minister's second reading speech to a Bill relates to taxation expenditures,

[94] Surrey, S., and McDaniel, P., 'The Tax Expenditure Concept: Current Developments and Emerging Issues', *Boston College Law Review,* Vol.XX, January 1979, No.2, p. 242, cited in House of Representatives Standing Committee on Expenditure, *Taxation Expenditures*, August 1982, p. 17.

> the Government incorporate an explanation as to why the taxation system is preferred to direct outlays for giving assistance.

9. Some information on tax expenditures were published in Budget Papers prior to 1985. In March 1985, the Government committed to publishing annually updated costings of tax expenditures based on Treasury's submission to the Committee. The first tax expenditures statement was published and tabled in Parliament early in 1987.

Economic Planning Advisory Council, 1986

10. In January 1986, the Economic Planning Advisory Council (EPAC) considered the size and scope of tax expenditures and ways to improve their reporting, evaluation and accountability.[95] EPAC recognized the importance of tax expenditures as a component of public sector activity while noting the need for greater transparency, for estimates of cost and for assessments of overall effectiveness.

11. EPAC observed that the use of the term 'tax expenditures' emphasises their similarity to direct government outlays, thus stressing the need that both be subject to the same budgetary review and control. In EPAC's view, regular and consistent tax expenditure data was the first step towards integrating tax expenditures into the normal budget process of review and assessment.

12. EPAC concluded that there was value in estimating the value of tax expenditures on an outlays equivalent basis, so that they might be evaluated on the same basis as direct outlays. Along with a review of all tax expenditures and reporting akin to the Canadian system, outlays equivalent estimates would help integrate tax expenditures into the normal Budget process of review and assessment. EPAC stated that:

> Attempts to incorporate tax expenditures into budgetary decision–making processes have the potential to improve resource use and planning in the public sector considerably.[96]

The National Commission of Audit, 1996

13. In June 1996, the National Commission of Audit (NCA) delivered its report to the Treasurer and the Minister for Finance on 'management and financial activities of the Commonwealth Government and how they are

---

[95] Economic Planning Advisory Council, op.cit., p. iii.

[96] ibid, p. 19.

recorded'.[97] Among other things, the NCA considered tax expenditures. Its findings are reproduced in full below.

> One area where current budget reporting is clearly inadequate is the cost of tax concessions (that is tax expenditures). Treasury noted that a forthcoming OECD publication shows that Australian reporting of tax expenditures currently falls short of overseas best practice.
>
> The different budgetary processes that apply to tax concessions and expenditure programs in Australia have contributed to the lack of transparency of tax expenditure reporting.
>
> First, spending on tax concessions is not monitored to the same extent as spending on programs. Treasury noted in its submission to the Commission that it can be three years before a tax expenditure is fully costed.
>
> Second, consideration of tax concession proposals is hampered by the general difficulty of accurately costing them. This difficulty stems in part from the lack of resources devoted to monitoring tax concessions compared with those devoted to monitoring programs, and the consequent insufficient level of information about tax expenditures.
>
> Third, unlike tax concessions, control of program expenditure is enhanced by individual Ministers being held responsible for spending by their portfolio.
>
> Finally, established procedures exist for the Department of Finance and the responsible portfolio to examine ways of containing blowouts in program expenditure but not blowouts in tax concessions.
>
> As a result of all these factors, tax concessions are a largely non–transparent form of assistance. This lack of transparency makes less visible the effect of tax concessions on the budget and reduces accountability. It also increases the likelihood that poorly targeted concessions will remain on offer.
>
> This lack of transparency is also inconsistent with the Charter of Budget Honesty's objectives to ensure greater transparency for the decisions and operations of government.
>
> Treasury's submission to the Commission also noted that 'lack of transparency and minimal accountability for tax concessions have made them a popular vehicle for those seeking government assistance'.
>
> While largely non–transparent, tax expenditures nonetheless represent a relatively significant component of the resources over which the Commonwealth Government has direct control. As was noted in Treasury's submission to the Commission:

[97] National Commission of Audit, *Report to the Commonwealth Government*, June 1996, p. iii.

> *The published cost of tax concessions in 1994–95 was $17.9 billion, an amount equal to almost 15 per cent of total Commonwealth outlays. This figure underestimates the full budgetary costs of tax concessions associated with, for example, wholesale sales tax, nor major concessions associated with capital gains taxation and fringe benefits tax, where either no benchmark is available against which to cost the concession or data to enable a costing are not available.*

Further, because tax concessions, like entitlement based programs, are almost open ended (that is they are available to all those who meet certain criteria) they can blow out in spectacular fashion. As noted by Treasury:

> *An example of this is the massive blow out in the cost of the R&D concession. This concession was originally estimated (in 1985–86) to cost $67 million annually; the cost in 1995–96 has now been estimated to approach $700 million.*

For these reasons, it is preferable that tax expenditures are treated as much as possible like program expenditure in an Australian fiscal reporting Act. This would entail the inclusion, where possible, of estimates of the revenue cost of tax concessions in budget documents and the scrutiny of tax concessions along with program expenditure in the lead up to the budget.

As recommended in Chapter 3, this reform needs to be preceded by a comprehensive review of all existing tax concessions. Such a review would facilitate regular and ongoing monitoring of the cost and effectiveness of tax concessions and would be consistent with the objectives of the Charter of Budget Honesty. While outside the Commission's terms of reference, the review could also assess the extent to which tax concessions are meeting policy objectives.

> **Recommendation 11.19: Treatment of tax expenditures**
> Tax expenditures should be treated as much as possible like program expenditures in all published fiscal reports and statements and in all budgetary processes.

Taxation Expenditure Review 1997 and 1998

14. Commencing in August 1996, the Taxation Expenditure Review (TER 97) was largely complete by early 1997. It identified more than 372 tax expenditures and other concessions extant in the taxation system at that time. Treasury and portfolio departments undertook reviews of 277 tax expenditures, having combined the review of groups of closely related tax concessions. A summary of the terms of reference of TER 97 is shown in Figure A 1.

Figure A 1

Summary of terms of reference of the Tax Expenditure Review

Tax Expenditure Review – Terms of Reference

Departments, in conjunction with Treasury and Finance, to examine each tax concession and:

- establish its objective at the time of its introduction *and* at the time of TER;
- evaluate its effectiveness in meeting those objectives, noting where this is *not* possible;
- assess the extent to which the tax concession aligns with current Government priorities;
- in conjunction with the ATO, estimate the cost at the time of introduction and at the time of TER, noting where this is *not* possible;
- separately identify the associated indirect costs including (where possible), taxpayer compliance costs, the costs of monitoring and evaluation and the costs of administration;
- identify the major beneficiaries and whether the concession is well targeted to those it is designed to assist; and
- identify the extent to which the objectives of the tax concession could be delivered through either existing outlays programs (particularly those having the same or similar objectives) or through a new outlays program.

Source: ANAO analysis of Treasury documents.

15. Focusing almost entirely on measures within the Treasurer's portfolio, it confirmed the shortcomings identified by the NCA review and found that:

- the effectiveness of individual tax expenditures in meeting their objectives had been analysed in only a handful of cases;
- costings were available for little more than half the identified tax expenditures; and
- in many instances, there was minimal documentary material or monitoring data available to inform any analysis of policy outcomes or fiscal impact.

16. In the majority of cases, the objective and intended beneficiaries of tax expenditures were not clear and the objective at the time of introduction was rarely known. Many were cited in TER 97 simply (and solely) as a means of supporting a particular industry or sector. With few or no clear criteria against which the effectiveness of the tax expenditure could be assessed, evaluation was in many cases not possible.

17. TER 97 found very few tax concessions for which the extent of resources actually delivered to the *intended* beneficiaries could be measured, or for which the *actual* beneficiaries of the tax expenditure could be determined. This precluded any determination of net economic benefit. It also left open the risk that the observed level of activity would have taken place in the absence of the tax concession. If so, this would have served mainly to redistribute income to the recipients of the tax concession.

18. The lack of costings for many tax expenditures was found to have complicated the forecasting of tax revenue and compromised budgetary certainty and integrity. For instance, no estimates of value were available for a large number of tax concessions relating to business. Any changes in the number of claims against those concessions or changes in the values of those claims were difficult to anticipate, complicating the task of forecasting company tax revenue in particular.

19. There was little evidence of monitoring or review or of continuing Government endorsement of many individual tax concessions. TER 97 found that the purpose of many tax expenditures had not been reconsidered since the date they had originally been legislated, often many decades before.[98]

Tax concessions should be monitored like outlays

20. TER 97 concluded that there was a lack of systematic monitoring and evaluation of, and information on, the cost to revenue of many tax expenditures. Unlike outlay programs, TER 97 found that decisions not to collect tens of billions of dollars of potential revenue had not been reviewed and the revenue forgone could not be accurately monitored.

21. Accordingly, TER 97 suggested that less than half (118) of the 277 tax expenditures reviewed should be retained, subject to a well–defined ongoing monitoring and evaluation process under a framework devised by Treasury. Specifically:

- 15 tax expenditures were flagged for removal and a further 15 for conversion to outlays, in either the 1997–98 or 1998–99 Budget processes;
- 31 tax expenditures did not appear to match Government policy; and
- another 34 tax expenditures could not be shown to be effective.

22. However, within the time available, Treasury and relevant Departments had not been able to resolve whether, in the case of a further 49 tax expenditures:

- 22 tax expenditures could be converted to outlays;

[98] For instance, certain income tax exemptions of insurance policy income apparently date from 1915 and a Parliamentary expectation that the payments were a return of capital rather receipt of income.

- 17 tax expenditures were effective in meeting their aims; and
- the other ten tax expenditures aligned with Government policy.

23. For these 49 tax expenditures, it was recommended that the review process should be extended (under similar terms of reference) to report again in time for the 1997–98 Budget cycle. More generally, it was suggested that, prior to each Budget:

- Ministers would be advised which tax expenditures had blown out over the forward estimates and which were to be reviewed within a three–year cycle of rolling reviews;
- Ministers would be asked for information on the effectiveness of the targeting of specific tax expenditures, whether tax expenditures continued to be consistent with government policy, and whether any might be converted to outlay programs; and
- where tax expenditures had blown out, the Treasurer and relevant Minister(s) were to bring forward Budget proposals to either bring the tax expenditure back to forward estimates or to provide offset–setting portfolio savings.

24. The intention was to better align the fiscal treatment of tax expenditures and outlay programs, so that any significant cost increases could be addressed and so that tax expenditures could be re–evaluated in light of changing government priorities.

25. TER 97 noted that ongoing monitoring and evaluation would require a larger number of and improved costings of tax expenditures. This could not be achieved without collecting more taxpayer data. Potential increases in taxpayer compliance costs (from redesigned or longer tax forms) were to be assessed by the ATO.

TER 98

26. In the context of the then Government's focus on broad-based reform of the taxation system,, consideration of the outcomes of TER 97 was delayed by a year. In April 1998, Government considered a revised report (TER 98), which advocated the retention and monitoring of almost all existing tax expenditures, as shown in Table A 1.

27. Where Treasury and responsible departments had earlier agreed that tax expenditures were either of doubtful effectiveness (34 cases) or did not align with Government policy (31 cases), these were now referred for review and monitoring, along with the 49 tax expenditures over which Treasury and the relevant Department had not previously been able to agree.

28. The then Government decided on a systematic process of ongoing monitoring and evaluation to ensure that tax expenditure information was regularly updated, and that changes to existing government policies should be reflected in changes to tax expenditure arrangements. This was publicly announced in October 1998, with the tabling of Treasury's Annual Report, as follows:

> Following a review of existing tax expenditures, first announced in the 1996–97 Budget, the Government has decided to undertake periodic monitoring and evaluation of all tax expenditures through normal budget processes. Tax Policy Group will oversee this process. Information on the costs of tax expenditures will assist the Government in delivering assistance in an effective manner, and will be consistent with the requirements of the Government's Charter of Budget Honesty.[99]

---

[99] Department of the Treasury, *Annual Report 1997–98,* October 1998, p. 48.

Table A 1

Tax Expenditure Review outcomes, 1997 and 1998

Category	TER 97	TER 98
Retain and monitor		
Costed	80	140
Uncosted	38	96
Convert to outlays	15[1]	15
Remove	15	11
Disagreement between Treasury and responsible Department over:		
Conversion to outlays	22	0
Effectiveness of the tax expenditure	17	0
Alignment with Government policy	10	0
Agreement between Treasury and responsible Department that:		
There are problems with the effectiveness of the tax expenditures	34	0
The tax expenditures do not align with Government policy	31	0
Subject to other reviews	8[2]	3
Announced in the 1996–97 Budget	7	7
TOTAL	**277**[3]	**272**

Notes:

1. Two tax expenditures moved into 'retain and monitor' in 1998, one removed altogether.
2. Four tax expenditures moved into 'retain and monitor' in 1998, one into 'convert to outlays'.
3. The 1997 TER report contains six tax expenditures not cited in 1998.

Source: ANAO analysis of Treasury's TER 97 and TER 98 documents.

29. Treasury was to prepare a framework for a rolling review of all tax expenditures every three years. Tax expenditures which appeared to be increasing significantly over the forward estimates period or which might be converted to outlay programs were to be reviewed during the annual budget process. Concurrently, Finance was to assess the potential for integrating tax expenditure reviews into the accruals framework.

The Review of Business Taxation, 1999

30. The Review of Business Taxation (Ralph Review) reported to the Government in July 1999. Among the matters considered by the Ralph Review were tax concessions and expenditures, which it referred to as 'tax preferences'. Consistent with previous reviews of tax expenditures, the Ralph Review recommended as follows:

> **Recommendation: Ongoing review of tax preferences**
> **That an ongoing process be implemented to periodically and systematically review all tax preferences to determine whether the objectives for their introduction are:**
>
> **(i) still current; and**
>
> **(ii) most appropriately delivered through the taxation system.**
>
> Tax policy design principle 10, proposed in *A Strong Foundation* (page xxi), suggested that 'Tax incentives should only be provided following a formal assessment of their net impact on the national taxation objectives and only where assessed to be an essential or superior form of government intervention.' This principle is attached to the proposed Charter of Business Taxation (see Recommendation 1.3) and should apply equally to all existing as well as proposed new tax incentives.
>
> The Government is committed to reviewing certain tax concessions arising from special legislation — such as the Pooled Development Funds program — on a regular basis. In this report, the Review has also recommended future reviews in relation to its scrip–for–scrip and venture capital proposals. However, such processes do not cover the operation of non–program tax preferences that arise from provisions in the tax law where those provisions are not the subject of a separate administrative process.
>
> Three classes of preferential treatment will remain:
>
> - those delivered through the income tax base;
> - those delivered through the entity structure; and
> - those delivered through classes of income being taxed preferentially.
>
> In some cases, preferential taxation treatment can have adverse economic efficiency consequences. Special treatment can also compromise the structure

and integrity of the law. Without proper evaluation, the true cost to the nation of these provisions cannot be ascertained.

The processes for the evaluation and review of tax expenditures will be facilitated through the collection of appropriate information from taxpayers — the subject of Recommendation 3.10. [100]

[100] Ralph, J., *A Tax System Redesigned*, July 1999, p. 275.

Appendix 2: Customs Duty Tax Expenditures

1. Customs duty tax expenditures were first identified in 1973[101] and again in 1982. The first TES, published in October 1986, outlined two alternative tax benchmarks against which customs duty tax expenditures might be measured, although it concluded that:

> No decision has been made on this issue in this [*Tax Expenditure*] statement. On an interim basis, a benchmark, based on the latter approach, has been adopted for the 2 per cent customs duty on imports, which was introduced for revenue purposes, viz, an across–the–board duty at a rate of 2 per cent of all imported goods not otherwise dutiable at high rates of customs duty. Tax expenditures, relative to this benchmark are listed in Table 9.[102]

2. Table 9 provided a list of tax expenditures, without associated estimates of revenue forgone as these were considered 'not cost–effective to produce.'[103] Almost identical reporting was provided the following year, with the additional information that:

> Comprehensive measures of the costs of protection, including the gross subsidy equivalent of the tariff and estimates of nominal and effective rates of protection, are already provided by the Industries Assistance Commission. In view of the alternative sources of information and the uncertainties surrounding an appropriate choice of benchmark, this statement does not provide costings on tax expenditures arising under the customs duty.[104]

3. On this basis, customs tax expenditures were mentioned in TES 1988.[105] They were not recognised in a TES again until February 2001, in TES 2000, which reported that:

> Tax expenditures related to customs duty concessions have not been identified in previous editions of the TES. Consideration will be given to include in customs duty tax expenditures in future editions of the TES.[106]

4. These considerations came to fruition in TES 2007 (issued January 2008) which established a benchmark for customs duty tax expenditures, as follows:

---

101 Coombs, op.cit., pp. 339, 341 and 345.

102 Department of the Treasury, *Tax Expenditures Statement*, October 1986, p. 10.

103 ibid., p. 33.

104 Department of the Treasury, *Tax Expenditures Statement*, December 1987, p. 7.

105 Department of the Treasury, *Tax Expenditures Statement*, December 1988, footnote on p. 1.

106 Commonwealth of Australia, *Tax Expenditures Statement 2000*, February 2001, p. 20.

> Under the customs benchmark, goods imported into Australia are subject to the same taxes on consumption as domestically produced goods. Under this benchmark, goods imported into Australia are free from customs duty, except to the extent that the customs duty imposed is equivalent to taxes imposed on domestically produced goods, such as excise equivalent customs duties.
>
> Customs duty, other than excise equivalent duty, collected on certain goods imported into Australia is reported as a negative tax expenditure in this Statement.
>
> Estimates of the value of assistance provided to various industries, including tariff arrangements, appear in the Productivity Commission's *Trade & Assistance Review*.[107]

5. The approach taken involves, in effect, taking the forward estimates of customs duty revenue as tax expenditures. This approach to the long-standing issue of identifying and measuring Customs duty tax expenditures illustrates one of the key features of the benchmark tax approach: the choice of benchmark can obscure the fiscal and economic impacts of incentives and administrative arrangements incorporated into the tax system. In the case of the benchmark adopted for Customs duty tax concessions, it results in no estimates of:

- structural customs duty tax expenditures;
- tax expenditures under customs duty concessions; or
- revenue forgone under free trade agreements.

6. The new Customs duty tax benchmark also illustrates the sensitivity of the tax expenditure estimates to the choice of benchmark. In this case, the benchmark adopted by Treasury has the effect of *lowering* the aggregate reported estimate of tax expenditures by $3.7 billion in 2007–08 to the reported total of $51.4 billion, or 4.6 per cent of Gross Domestic Product (GDP). If Treasury had instead adopted a tax benchmark that identified as tax expenditures only those quantifiable tax concessions discussed in this Appendix, aggregate tax expenditures would instead *rise* to at least $58.1 billion in 2007–08 or approximately 5.2 per cent of GDP, a change of some 13 per cent.

---

107 TES 2007, p. 33.

Structural customs duty tax expenditures

7. In 1986, at the time of the production of the first tax expenditure statement, Treasury reported the possibility of setting one benchmark to measure the protective component of customs duties and another to measure the tax concessions arising 'where an import is treated differently, relative to other imports and generally'.[108]

8. Measurements of the protective component of customs duties are likely to generate negative tax concessions. While conceptually difficult to construct and to interpret, they may be useful if, for instance, the Government and the Parliament wished to gauge levels of tariff protection and how they are changing over time.

9. In practical terms, setting a benchmark would involve examining the effects of the various rates of duty applying to the many individual imports and classes of imports. These are set out in more than 6 000 individual lines of tariff codes in schedules to the *Customs Tariff Act 1995*.

10. Many of the individual lines cite a tariff rate of 'Free' for particular goods or classes of goods. In other cases, different tariff rates apply to different goods within a class of goods. For instance, different tariffs apply to varieties of cement within the class of cements. Imports of portland cement attract the rate of 'Free', while imports of other hydraulic cements attract a tariff of five per cent. This gives rise to three possible calculations of revenue forgone due to import duties on cements, as follows:

- the benchmark rate could be set at 'Free', giving rise to a negative tax expenditure equal to five per cent of the value of imports of other hydraulic cements; or
- the benchmark rate could be set at five per cent, giving rise to a positive tax expenditure equal to five per cent of the value of imports of portland cement; or
- the benchmark rates could be set as 'Free' for portland cement and at five per cent for other hydraulic cements, with the result that no revenue is forgone. This approach is equivalent to treating the tariff schedules as an integral part of the taxation system, generating neither tax concessions nor tax expenditures.

[108] Department of the Treasury, *Tax Expenditures Statement*, October 1986, p. 10.

Customs duty concessions

11. Since 2000–01, Customs' Annual Reports have shown selected estimates of customs duty forgone under some customs duty concession arrangements. Customs advised ANAO in September 2007 that these summary reports are based on data contained in Customs' quarterly internal statistical reports. This data has been compiled into Table A 2, showing up to $2 089 million in 2006–07 arising from customs duty concessions for the assistance of particular industries or particular sectors of the Australian economy.

Table A 2

Customs duty forgone to assist industry ($ million)

	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Tariff Concessions where substitutable goods are not produced in Australia	391	436	487	478	548	1 038	1 225
Concessional rate of duty for certain cheeses and curds	9	10	11	12	13	13	13
Concessional duty on capital goods in mining and resource processing, agriculture, food processing and packaging industries	7	15	7	n/a	n/a	n/a	n/a
Concessional duty on capital goods in mining, resource processing, food processing and packaging, manufacturing, agriculture and gas supply industry sectors	n/a	n/a	5	23	43	25	54
Concessions for Textiles, Clothing and Footwear	43	40	39	27	20	14	14
Concessions to firms who assemble garments and footwear overseas from Australian materials and then imported into Australia for local consumption	6	6	6	5	5	3	3
TRADEX – no customs duty and GST on goods intended for re–export	103	155	139	129	93	66	80

	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
or as inputs to exports							
ACIS – duty credits for eligible automotive industry participants	89	602	556	587	531	464	574
Miscellaneous	92	99	98	105	113	115	126
TOTALS	**740**	**1 363**	**1 347**	**1 366**	**1 366**	**1 738**	**2 089**

Source: Customs' advice to ANAO, March 2008.

Revenue forgone under free trade agreements

12. Free trade agreements are entered into where the economic and social benefits outweigh the costs, including the cost of revenue forgone. Estimates of actual fiscal effects are therefore an important component of the overall assessment of free trade agreements and a necessary element of their ongoing monitoring of their continuing effectiveness. Differences between the actual and estimated revenue forgone may also indicate changes in the composition of the trade between the countries.

13. Customs has also monitored revenue forgone under free–trade agreements, under which customs duties applying to goods originating from agreement countries are either lowered or removed. Customs duty forgone under free trade agreements has risen to $935 million in 2006–07 and are shown in Table A 3.

Table A 3

Customs duty forgone under free trade agreements ($ million)

	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Australia – US FTA	–	–	–	–	156	288	291
Singapore FTA	–	–	–	–	6	11	13
Thailand FTA	–	–	–	–	69	166	261
SPARTECA	46	41	40	39	33	23	24
ANZCERTA	222	222	246	259	247	244	252
CANATA	6	5	8	7	8	7	7
Developing Country Concessions	61	63	75	84	99	69	87
TOTALS	**336**	**332**	**369**	**389**	**617**	**808**	**935**

Source: Customs' advice to ANAO, March 2008.

14. Demonstrating the value of reporting this type of information in the TES, ANAO notes that Customs' records of actual duty forgone differ from the estimates provided to Parliament during its consideration of the recent free trade agreements with the USA, Thailand and Singapore, as follows:

- the Regulation Impact Statement (RIS) for the US free–trade agreement estimated the financial cost to the Government based on expected loss of tariff revenue from imports to be $400 million in 2005–06 and $420 million in 2006–07, significantly higher than the actual revenue forgone recorded by Customs;
- the RIS for the Singapore free–trade agreement estimated revenue forgone of $35 million for 2005–06 and 2006–07, almost three times the actual level of revenue forgone; and
- in respect of the free–trade agreement with Thailand, the RIS estimates of $90 million revenue forgone for 2005–06 and $100 million in 2006–07 are half the level of the actual revenue forgone.

15. In April 2008, Customs advised ANAO that:

> In reality it is generally the case that estimates will need to be reviewed and updated over time in the light of actual experience.

Appendix 3: Fuel Excise Concessions

1. For fuels used in certain industrial applications and for home heating, the tax benchmark was initially set so that there were no exemptions for classes of taxpayers or activities, with a benchmark rate equal to the excise rate on unleaded petrol.[109] Until TES 2004, tax expenditure statements recorded significant excise concessions on fuel oil, heating oil and kerosene, rising to $255 million by 2006–07. Table A 4 below shows these estimates and the subsequent effect of changes to the benchmark.

Table A 4

Selected fuel excise tax expenditures, 2002–03 to 2006–07 ($ million)

	2002–03	2003–04	2004–05	2005–06	2006–07
TES 2003: • Estimated revenue forgone under fuel excise concessions	265	250	250	255	255
TES 2006: • Benchmark change and revised estimates of revenue forgone under fuel excise concessions	–65	–90	–85	–90	–440
Benchmark difference	**–330**	**–340**	**–335**	**–345**	**–695**

Source: ANAO analysis of relevant TESs.

2. TES 2004 changes to the tax benchmark for fuel excise result in negative tax expenditures, such that they are not comparable to earlier estimates; as follows:

- the estimates from TES 2003 derive from a benchmark fuel excise rate of 38.143 cents per litre and showed a positive amount ($255 million in 2006–07) for the revenue forgone due to the concessional excise rate of 7.557 cents per litre;
- the estimates from TES 2006 derive from a new benchmark of 0 cents per litre. This gives a *negative* tax expenditure of –$90 million for 2005–06, representing the revenue *gained* by levying excise of 7.557 cents per litre rather than the benchmark rate of 0 cents per litre;

[109] TES 2000, pp. 25 and 19.

- the negative tax expenditure grows to –$440 million for 2006–07 with the abolition of the concessional excise rate of 7.557 cents per litre. The revenue gain shown is for excise collected at the rate of 38.143 cents per litre upon the introduction of Fuel Tax Credits;
- theoretically, claims of fuel tax credits will entirely offset the negative tax expenditure, indicating *no net effect* on the Budget outcome; and
- fuel tax credits claimed in respect of domestic electricity generation and non-profit emergency vehicles or vessels are not assessable income[110] and are likely to result in revenue forgone.

3. The ATO advised ANAO that the first year's outlays of Fuel Tax Credits are included in the ATO's financial statements aggregated with other tax refunds and other assistance under the special appropriation available to the Commissioner at section 16 of TAA53. As a result, it is not be possible to distinguish the Fuel Tax Credits refunding the excise levied on fuel oil, heating oil and kerosene from those refunding excise levied on fuel products used for purposes other than as fuel, or either of these amounts from fuel tax relief provided to road transport businesses.

4. Treasury advised ANAO that the benchmark for fuel excise was changed as a result of the 2004 Energy White Paper ('*Securing Australia's Energy Future*') and that the changes in the fuel tax benchmark identified above took account of the revised taxation framework outlined in the Energy White Paper which formed the basis of changes in the fuel tax regime.

[110] See <www.ato.gov.au>, *Fuel tax credit guide—domestic electricity generation and non—profit emergency vehicles or vessels*, NAT 15621.

Appendix 4: Reliability of Tax Expenditure Estimates

Tax expenditure estimates with a High reliability

1. This category of estimates includes eight major tax expenditures, each estimated to result in revenue forgone in the order of $400 million or more in 2006–07, namely:

- the 50 per cent capital gains tax discount for individuals and trusts, estimated at $4 980 million revenue forgone in 2006–07;
- the concessional rate of excise levied on aviation gasoline and aviation turbine fuel, estimated at $805 million revenue forgone in 2006–07;
- the exemption from excise for 'alternative fuels', with estimated revenue forgone of $750 million in 2006–07;
- the tax offset for low income earners, with estimated revenue forgone of $640 million in 2006–07;
- the mature age worker tax offset, with estimated revenue forgone of $490 million in 2006–07; and
- the exemption of income earned by Australians from working on approved overseas projects, with estimated revenue forgone of $450 million in 2006–07.

2. This category also includes estimates of significant amounts of *additional* revenue collected in respect of the Medicare levy surcharge and the luxury car tax. In both cases, the imposition of additional tax is considered a departure from the taxation benchmark and estimates are reported in the TES as negative numbers:

- ATO estimated that $320 million additional revenue would be collected by the luxury car tax in 2006–07; and
- ATO advised ANAO, that, while the estimate of the additional $330 million revenue collected by the Medicare surcharge in 2006–07 was based directly on taxation data, the estimates of future years' additional revenue from this measure was sensitive to the assumed rate of growth.

Other tax expenditures with 'High' reliability

3. Table A 5 on the pages overleaf shows the remaining 33 tax expenditures with estimates of High: reliability, grouped according to their TES benchmark tax category. Ten of the remaining 33 are estimated to result in less than $10 million revenue forgone in 2006–07.

Table A 5

Other tax expenditure estimates of ‘High’ reliability

Tax expenditure and TES 2006 code		Estimate for 2006–07 ($ million)
Personal income tax expenditures		
Tax offsets for dependant spouse, child–housekeeper and housekeeper who cares for a prescribed dependant	A31	380
Medical expenses tax offset	A21	340
Tax rebate for child care	A36	325
Zone tax offsets	A48	190
Exemption of the Baby Bonus	A44	25
Tax offsets for taxpayers supporting a parent, parent–in–law, or invalid relative	A28	20
Income averaging for authors, inventors, performing artists, production associates and sportspersons	A50	8
Tax offset on certain payments of income received in arrears	A63	4
Tax offset of interest on certain government securities	A68	0
Part–Year Tax Free Threshold	A54	–35
Business tax expenditures		
Exemption from non–commercial losses provisions (primary producers and artists)	B92	105
Three year write–off for expenditure on water facilities for primary producers	B33	30
Deemed tax credits under tax sparing provisions in Australia's tax treaties	B69	5
Deduction for environmental protection activities	B45	4
Landcare and water facility offset	B36	..

Tax expenditure and TES 2006 code		Estimate for 2006–07 ($ million)
Transitional tax exemption for certain life insurance management fees	B94	0
Superannuation related tax expenditures		
CGT exemption on the sale of a small business at retirement	C6	185
Capped taxation rates for lump sum payments for unused recreation and long service leave	C4	100
Taxation of five per cent of unused long service leave accumulated by 15 August 1978	C5	70
Small business 15 year CGT exemption	C8	30
CSS restructuring rollover	C7	0
Capital gains tax expenditures		
Small business capital gains tax 50 per cent reduction	E12	390
CGT rollover relief for small business	E13	110
Capital gains tax roll–over for transfer of Public Sector Superannuation Fund assets to pooled superannuation trust	E21	50
Excise tax expenditures		
Concessional rate of excise levied on draught beer	F11	160
Concessional rate of excise on low–strength packaged beer	F9	15
Certain exemptions for diplomatic missions and foreign diplomats	F20	8
Concessional rate of excise levied on brandy	F18	5
Higher rate of excise levied on leaded petrol	F2	0
Higher rate of excise levied on high sulphur diesel	F3	0
Concessional excise for snuff	F8	0
Concessional rate of excise levied on brew on premise beer	F12	..
Wine equalisation tax cellar door rebate	F15	0

Source: ANAO analysis of ATO and Treasury tax expenditure models, estimates for 2006–07 from TES 2006.

Tax expenditures with a Medium–High reliability

Superannuation

4. The concessional treatment of funded superannuation, with estimated revenue forgone of $17 110 million in 2006–07, is the largest single tax expenditure reported in TES 2006. It is the aggregate of ten component tax expenditure estimates, cited at Appendix B of TES 2006. The component tax expenditures are modelled using data from the tax returns of superannuation funds and individuals. The models are frequently distributional and incorporate important assumptions, among them assumptions about the rate of growth of contributions to funds, fund earnings and the pension and lump sum entitlements that superannuation beneficiaries may receive.

5. The quality of the underlying data and the conservative nature of the assumptions give these estimates high levels of reliability. For instance, the largest component is the concessional taxation of fund earnings, estimated at $8 250 million in 2006–07. The estimate is based on superannuation fund taxation returns and reasonable expectations of the growth of superannuation fund earnings. On this basis, this figure was assessed by ANAO as a highly reliable component of the total estimate.

6. By way of comparison, the estimate of another important component, the $7 650 million revenue forgone in 2006–07 due to the concessional taxation of employer contributions, was not assessed as being as accurate and reliable. This component is estimated on the basis of the total employer contributions into funds 'that are in a net tax payable position'.[111]

7. During examination of this tax expenditure, ANAO sought ATO advice on whether the concession applied regardless of the taxation position of the fund, and whether it would be more consistent with the revenue forgone approach to base the estimate on the total employer contributions to *all* funds, regardless of whether the funds were in a 'net tax payable position'. ATO advised ANAO that it had re-examined the model for this tax expenditure and identified an estimated understatement of the reported tax expenditure of approximately $230 million.

8. The aggregate tax expenditure also includes estimates of the 33⅓ per cent capital gains discount available to superannuation funds. This measure is

[111] ATO advice to ANAO, 16 August 2007.

inherently volatile and is estimated to account for $510 million of the total tax expenditure in 2006–07.

9. Finally, the aggregate tax expenditure includes estimates of two components affected by new superannuation policy announcements,[112] namely:

- the revenue forgone due to an increased rate of take–up of tax offsets for low income earners making personal contributions. The estimates rise sharply from a figure of $80 million revenue forgone in 2004–05 to $250 million in 2005–06 and $300 million in 2006–07; and
- the degree to which the tax on excess undeducted contributions offsets the aggregate tax expenditure. This is a new component of the aggregate tax expenditure, added as a direct consequence of the recent policy changes. Along with the estimated offset from *tax on funded pensions* (an existing component of the aggregate tax expenditure) this component cannot be estimated with accuracy, though it is thought to be 'indeterminate, but likely to be small or insignificant'.[113]

10. This combination of factors reduces the reliability of the aggregate estimate, notwithstanding the fact that it is based on data extracted from tax returns and on conservative assumptions.

Pensioners and beneficiaries' tax offset

11. The pensioners and beneficiaries tax offset is available to certain income support recipients with low earnings and was estimated to result in $1 150 million revenue forgone for 2006–07. The ATO's model is based upon tax return data and the published expenditure and other data of the agencies administering the various pensions and benefits which might attract the offset. However, ATO advised ANAO that, in the context of preparing the TES, it was not possible to ensure that agencies provided timely and accurate information, nor were agencies compelled to do so.

12. The relatively high reliability of this estimate reflects that it is necessary to lodge a tax return to be able to claim the offset. Therefore a sound basis exists for determining much of the eligible population. The reliability of the estimate would have been assessed as higher if, however:

---

[112] *A Plan to Simplify and Streamline Superannuation*, 9 May 2007.

[113] TES 2006, p.172.

- the ATO estimates were constructed using detailed income support recipient data from the administering agencies, rather than aggregate expenditure and other published data;
- the estimate had included a small but significant group of income support recipients whose income is so low that they need not lodge a tax return. It is not possible to accurately estimate the value of the tax expenditure available to these so–called 'non–lodgers', who the ATO calculates to be 20 per cent of those eligible; and
- detailed income data was available from the agencies administering income support payments so that better estimates could be made of the marginal taxation rates of income support recipients (on which the model depends).

13. In this case, the absence of detailed data has led to the ATO relying upon aggregate modelling, rather than a distributional model.

Private Health Insurance Rebate (PHIR)

14. The bulk of the PHIR tax expenditure arises from the tax exemption of the 30 per cent private health insurance rebate paid through the tax system, and its expense equivalents (the health insurance premiums paid directly to health insurers by the Department of Health and Ageing, and the small portion being paid directly to individuals through Medicare offices). Less than six per cent of all claims are made through the tax system, although this is the population on which the ATO has the best data on which to estimate the tax expenditure for all claimants.

15. In a similar fashion to the pensioners and beneficiaries' rebate, the reliability of the tax expenditure estimate of is reduced because the detailed data necessary for a more reliable estimate is not provided by the administering agencies and it is therefore not possible to construct a distributional model. Consequently, the estimate relies on aggregate expenditure data from the administering agencies, and is sensitive to marginal tax rates estimated through the taxation system:

Research and development tax concession

16. The research and development tax concession tax expenditure was estimated at $380 million in 2006–07.[114] The data underpinning the estimates of the research and development tax concession were derived directly from tax returns by companies and are therefore regarded as being of good quality.

17. The tax expenditure estimate, while based on good quality data, is sensitive to assumptions made in relation to:

- the rate of growth of expenditure on research and development;
- the pattern of expenditure on research and development plant, which tends to be greatest in the first years; and
- estimating the proportion of research and development companies' profits that will be distributed as dividends and later 'clawed back' as dividend imputation credits.

Other tax expenditures with a 'Medium–high' reliability

18. Table A 6 tabulates the seven remaining tax expenditures with estimates of 'Medium–High' reliability. It highlights that, in each case, the reduction in reliability is due primarily to the reduced quality of data underpinning the estimates.

19. In relation to the negative tax expenditure resulting from increased tax rates applying to certain minors, and the excise concession for microbreweries, estimates are derived indirectly from ATO data, which does not explicitly record the details of the concession provided. For example:

- minors are identified by analysing tax returns selected on the basis of the age of the taxpayer and then matching these returns with other relevant data; and
- the excise concession for microbreweries is estimated by matching excise collection data to industry data.

20. The models estimating the concessional tax treatment of income of offshore banking units and of unfunded superannuation lump sums are based mainly on ATO data, but rely on additional assumptions which cannot be checked against the data.

---

[114] Treasury advised the Senate Estimates committee in June 2007 that an error had been found in the tax expenditure model which had inflated earlier estimates by approximately a quarter. The model had been corrected for the 2006 TES, which included corrected estimates for the previous years.

Table A 6

Other tax expenditure estimates of 'Medium–High' reliability

Tax expenditure and TES 2006 code		Estimate for 2006–07 ($ million)	Factors reducing the reliability of the estimates
Increased tax rates for certain minors	A52	–6	Derived from ATO data
Income tax exemption for the Australian Film Finance Corporation	B13	0	Derived from Australian Film Corporation financial statements
Excise concession for microbreweries	F13	0	Derived from ATO data
Land Transport Infrastructure Borrowings Tax Offset Scheme	B91	5	Derived from DOTARS' data
Concessional tax treatment of income of offshore banking units	B73	90	ATO data, reliant on assumptions
Concessional taxation of unfunded superannuation lump sums	C2	145	ATO data, reliant on assumptions
Exemption of payments made under the First Home Owners Grant Scheme	A49	320	Derived from ABS data and Budget estimates

Source: ANAO analysis of ATO and Treasury tax expenditure models, estimates for 2006–07 from TES 2006.

21. In three cases, including the estimated $320 million revenue forgone in 2006–07 due to the exemption from taxation of payments under the First Home Owners Grant Scheme, the estimates are based on aggregate data from other Commonwealth agencies.

Tax expenditures with a Medium or lower level of reliability

22. Table A 7 summarises those significant tax expenditures assessed by ANAO as having a Medium or lower reliability.

Table A 7

Significant positive quantifiable tax expenditures with Medium, Medium/Low and Low reliability

Tax expenditure and TES 2006 code		Estimate 2006–07 ($ million)	Reliability	Factors affecting reliability
Exemption of Family Tax Benefit, Parts A and B, including expense equivalent	A40	2430	Med/Low	ATO and aggregate agency data, very sensitive to estimated marginal taxation rates
Senior Australians' Tax Offset	A30	1870	Med	ATO and aggregate agency data, marred by significant non–lodgers
Application of statutory formula to value car benefits	D24	1070	Med/Low	ATO data, very sensitive to the assumed rate of private use of vehicles
Exemption of certain income support benefits, pensions or allowances	A39	970	Low	No ATO data, aggregate agency data, very sensitive to estimated marginal taxation rates
Deduction for gifts to approved donees	A64	640	Med	ATO has good data from personal income tax returns and no data from company tax returns
Income tax exemption for municipal authorities and other local governing bodies	B96	570	Low	Derived from ABS data
Exemption from interest withholding tax on widely held debentures	B81	550	Med	Limited ATO data subject to some volatility
Low income Medicare levy exemption	A20	460	Med	ATO data, marred by significant non–lodgers
Exemption of certain war–related payments and pensions	A45	440	Med/Low	ATO and aggregate agency data, very sensitive to estimated marginal taxation rates
Exemption of Child Care Benefit	A42	410	Med	ATO and aggregate agency data, relying on estimated marginal taxation rates
25 per cent entrepreneurs' tax offset	B30	370	Low	Proxy variables derived from ATO data
Concessional taxation of non–superannuation termination benefits	C3	300	Low	Some ATO data but does not capture considerable exempt income
Exemption for certain fringe benefits provided to religious practitioners	D32	290	Med/Low	Proxy variables derived from payment summary data, ABS and other ATO data

Tax expenditure and TES 2006 code		Estimate 2006–07 ($ million)	Reliability	Factors affecting reliability
Exemption for eligible work–related items	D48	270	Low	Treasury costing, based on data from ABS and other sources
Capped exemption for public benevolent institutions (excluding public hospitals)	D11	250	Med	Proxy variables derived from payment summary data and other data
Condensate excise–free status	G2	250	Med	Agency and ABS data, but no direct excise data
Capped exemption for certain public and non–profit hospitals	D6	240	Med	Proxy variables derived from payment summary data and other data
Statutory effective life caps	B51	230	Med/Low	Some retrospective ATO data, some commercial data of expected purchases
Exemption for certain payments to approved worker entitlement funds	D46	230	Low	Little data, ATO model driven mainly by assumptions
Accelerated depreciation for mining buildings	B49	220	Low	No ATO data, derived from ABS data

Source: ANAO analysis of ATO and Treasury tax expenditure models.

Data availability

23. Where exempt income cannot be estimated from other agency sources, ATO cannot construct distributional models of revenue forgone and must rely on less satisfactory estimates based on aggregate data. This applies in particular to the estimates of revenue forgone from the income tax exemption for municipal authorities and other local governing bodies ($570 million in 2006–07) and the exemption from interest withholding tax on widely held debentures ($550 million in 2006–07). It is also particularly evident in the estimates of tax expenditures arising from exemptions from Fringe Benefits Tax.[115]

24. In some cases, detailed data is available for only part of the eligible population. For example, it is difficult to model the full effect of either the Senior Australians Tax Offset or the low income Medicare Levy exemption

[115] The ATO may, for some classes of claims, be able to derive estimates by cross–tabulating details from the aggregate tax payment summaries provided by employers with the characteristics of taxpayers in particular classes of employment. This is done, for instance, to estimate fringe benefits tax exemptions for employees of religious institutions, certain benevolent institutions and hospitals. The proxy variables thus created are, however, inherently less reliable than the taxpayer data which underpins other, more reliable, models.

(estimated at $1 870 million and $460 million respectively in 2006–07), as not all affected taxpayers are required to lodge a tax return. There are significant numbers of taxpayers to whom these offsets may well apply, though they may not, after considering all circumstances, have a tax liability, and thus are not necessarily required to lodge a tax return. There is therefore no data on these populations of ‘non–lodgers’ and, to estimate the tax expenditure, the ATO must employ assumptions which cannot be readily checked against available data.

25. In other cases, the estimate of the tax expenditure is sensitive to assumptions which, in the absence of data, must be employed if an estimate is to be provided. For instance:

- while the ATO has significant tax return data on car fringe benefits, the estimated tax expenditure of $1 070 million in 2006–07 is sensitive to the assumed proportion of private use (as distinct from business use) of the motor vehicles in respect of which tax is paid; and
- the estimate of $270 million revenue forgone in 2006–07 from the fringe benefits tax exemption for eligible work–related items is largely based on external sources of data.

26. Another factor leading to an assessment of a medium or lower level of reliability is that tax return forms do not always capture the full detail of deductions which are claimed by taxpayers. During the process of deriving taxable income, many deductions, particularly those relating to the expenses of carrying on a business, are aggregated before they are subtracted from gross income. In some cases, the individual deductions are separately recorded on supplementary schedules to tax returns and these may be available for ATO analysis. However, there are a number of significant tax expenditures that derive from individual deductions incorporated into the aggregate deductions and, where these are not reported separately, the ATO must rely on estimates. For instance:

- while the ATO has significant personal income tax return data on the *amounts donated to eligible donees*, there is no equivalent data from company tax returns. Consequently, the tax expenditure estimate of $640 million in 2006–07 is sensitive to the ATO’s assumption of the amount of corporate donations to eligible donees;
- the revenue forgone from the *accelerated depreciation of mining buildings* ($220 million in 2006–07) is estimated by apportioning the depreciation

expenses of taxpayers from the mining sector on the basis of estimates derived from ABS data; and

- a similar method is applied to estimate the revenue forgone from the accelerated depreciation available for certain assets purchased by aviation, road transport, oil and gas companies as a result of statutory caps being placed on the effective life of these assets (*statutory effective life caps*, estimated at $230 million in 2006–07).

Data volatility

27. In some cases, it is in the nature of the tax expenditure that taxpayer behaviour may fluctuate considerably from one period to the next. This presents challenges in modelling estimates of future tax expenditures. Two such examples are the tax expenditures in relation to Farm Management Deposit scheme, and the off–market share buy–backs.

28. TES 2006 estimates for the Farm Management Deposit scheme are shown in Table A 8, along with analysis of the data underpinning the estimates and its effect on the reliability of the estimates. The prior year tax expenditure estimates for the Farm Management Deposit scheme are underpinned by data drawn directly from tax returns and closely represent the *actual* cost of revenue forgone. However, the inherent volatility of the scheme, which allows farmers to deposit earnings in one year and withdraw funds during later years of low income, does not permit reliable tax expenditure estimates to be made in future years income. The pattern of deposits and withdrawals can depend (for instance) on variations in weather conditions.

Table A 8

Farm Management Deposit Scheme, 2002–03 to 2009–10

<table>
<tr><th colspan="9">B83: Farm Management Deposit scheme</th></tr>
<tr><th></th><th>2002–03
$m</th><th>2003–04
$m</th><th>2004–05
$m</th><th>2005–06
$m</th><th>2006–07
$m</th><th>2007–08
$m</th><th>2008–09
$m</th><th>2009–10
$m</th></tr>
<tr><td>Estimate</td><td>410</td><td>245</td><td>95</td><td>115</td><td>5</td><td>*</td><td>*</td><td>*</td></tr>
<tr><td rowspan="2"></td><td colspan="4">Highly reliable</td><td>Low reliability</td><td colspan="3">Not able to be estimated with any reliability</td></tr>
<tr><td colspan="4">Underpinned by data drawn directly from tax returns, closely representing the actual cost of revenue forgone.</td><td colspan="4">The estimates are very sensitive to variations in the amounts deposited and withdrawn in any year.</td></tr>
</table>

Source: ANAO analysis of ATO model.

29. Tax expenditure estimates of the revenue forgone through off market share buy–backs share a similar volatility in taxpayer behaviour, combined with less reliable data, as shown in Table A 9. The ATO provides tax expenditure estimates relating to market share buy–backs based on publicly disclosed information, as there is no requirement that taxpayers explicitly provide such data in tax returns. This is because the tax expenditure arises from the ordinary treatment of the proceeds paid to shareholders. Part of those proceeds is a return of capital and part is a dividend, which may have already been taxed, and thus attract franking credits. It is up to the individual taxpayer to identify the relevant components, to report the relevant income and claim any relevant credits in their tax return.

Table A 9

Off–market share buy–backs, 2002–03 to 2009–10

<table>
<tr><th colspan="9">B9: Off–market share buy–backs</th></tr>
<tr><th></th><th>2002–03
$m</th><th>2003–04
$m</th><th>2004–05
$m</th><th>2005–06
$m</th><th>2006–07
$m</th><th>2007–08
$m</th><th>2008–09
$m</th><th>2009–10
$m</th></tr>
<tr><td>Estimate</td><td>80</td><td>276</td><td>551</td><td>452</td><td>*</td><td>*</td><td>*</td><td>*</td></tr>
<tr><td rowspan="2"></td><td colspan="4">Low reliability</td><td colspan="4">Estimated to be between $100 million and $1 000 million</td></tr>
<tr><td colspan="4">Earlier year estimates based on analysis of publicly disclosed share buy–backs, rather than definitive tax return data</td><td colspan="4">No data</td></tr>
</table>

Source: ANAO analysis of ATO model.

30. For the purposes of lodging a tax return and for assessing tax, there is no necessity to identify that the income or any associated franking credits arise from a share buyback scheme. Consequently, the ATO does not collect the data and it therefore has no definite data on which to estimate this tax expenditure over the forward years. The ATO is able only to estimate its general magnitude as being between $100 million and $1 billion per annum.

Appendix 5: Estimates of Major Unquantifiable Tax Expenditures

Exemption from capital gains tax of income from the sale of the main residence

1. The capital gains or losses on the disposal of a taxpayer's main residence (and up to two hectares of adjacent land) are exempt from capital gains tax. The exemption is based on the premise that, in most instances, the proceeds of the sale of residents will be used to purchase another residence. Thus, the exemption was extended in 1996 to the capital gains or losses arising on the disposal of rights to occupy accommodation in a retirement village.

2. The lack of an estimate has been the subject of comment by observers, both with regard to the importance of estimating the benefits to taxpayers who are homeowners,[116] and with respect to comparable estimates reported in other countries with similar tax exemptions.[117] For instance, the Australian Housing and Urban Research Institute estimated this tax expenditure at $13 billion in 2001.[118] However, both Treasury and the ATO have reservations about the reliability of estimates and the wide range of estimates that can be obtained.

3. TES 2006 reported, for the first time, long–standing extensions of the income tax exemption on the capital gains from the sale of the primary residence. These extensions include:

- the exemption of capital gains from the sale of a nursing home residence interest;
- the exemption of certain capital gains arising from a deceased estate (another related Capital Gains Tax expenditure is also reported in TES 2006);
- the recently announced capital gains tax roll–over relief for the transfer of assets on the breakdown of a marriage (reported as a separate tax expenditure in TES 2006); and

---

[116] For instance, the major benefit of the tax exemption has been argued to flow mainly to high income home owners rather than low-income homeowners. See Yates, J., *A Distributional Analysis of the Impact of Indirect Housing Assistance*, Australian Housing and Urban Research Institute, 2003, p. 2.

[117] In the United States, Canada and the United Kingdom the respective costs of this tax expenditure are provided. See United States of America, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2006*, 2005, pp. 350–351.

[118] See Yates, J., *AHURI Research and Policy Bulletin*, 'Tax concessions and subsidies for Australian homebuyers and home owners', Australian Housing and Urban Research Institute, 2003, p. 1.

- the so–called 'six year rule', which applies when a dwelling is used to produce income after the owner has moved out of it. Providing the total period of such use does not exceed six years, capital gains from the disposal of the property will attract the main residence exemption.

4. The intention of the 'six year rule' was that the application of Capital Gains Tax ought not disadvantage or treat harshly those homeowners who may move out of their principal residence for non–commercial reasons, such as temporarily moving for work, for reasons of health or to care for relatives. However, the Government was advised in 1998 that:

> It appears possible that some home owners may see this provision as a loophole whereby they could move out of an owner–occupied residence into a rented dwelling in the same city and achieve tax advantages from negative gearing their principal residence, while also avoiding Capital Gains Tax liability on any appreciation of that residence.
>
> To the extent that this represents a significant portion of the overall cost to revenue of this provision, it would then be an unintended consequence and detract from the effectiveness of the provision.

5. At that time, the then Government was advised that estimated revenue forgone under these exemptions was in the order of $30 million per annum, and could potentially be much greater if the rate of real appreciation in housing values increased,[119] which it did in subsequent years. This tax expenditure is currently assigned an order of magnitude estimate of between $100 million and $1 000 million dollars. However, aside from private rulings of the Commissioner of Taxation or relevant ATO compliance findings, there is little data on the extent to which dwelling owners may be using it inappropriately to gain a tax advantage. Treasury advised ANAO that:

> There are significant costs and rental risks involved in moving to another dwelling with the sole purpose of claiming interest deductions on a main residence that is rented out under the six year absence rule. Such costs and risks would mitigate the extent of homeowners seeking to take advantage of the six year absence rule inappropriately.

Income tax exemption of State and Territory Government Business Enterprises

6. The income tax exemption of State and Territory Government Business Enterprises applies principally to the government business enterprises of State

[119] TER 1998, pp.255–256.

and Territory governments, with the exception of their insurance and superannuation businesses. The exemption is available, for example, to energy, water and transport utilities in which a State or Territory government is the principle shareholder.

7. *The Intergovernmental Agreement on the Reform of Commonwealth–State Financial Arrangements*[120] signed in 1999 included provisions for reciprocal taxation arrangements.[121] The purpose of reciprocal taxation arrangements is to ensure that the government business enterprises of State and Territory governments make payments to their respective treasuries equivalent to the Commonwealth income taxes which would otherwise apply to equivalent commercial enterprise. These enterprises would thus be moved onto the same footing as their commercial counterparts, achieving competitive neutrality without the Commonwealth endeavouring to extend its taxation coverage.

8. The National Tax Equivalent Regime (NTER) regime is administered by the ATO on behalf of the State and Territory governments. Data for the cost of the exemption of State and Territory government business enterprises estimates comes from NTER tax returns and notifications of PAYG instalments lodged with the ATO. On the basis of this aggregate data, the ATO estimated revenue forgone of $1 890 million in 2005–06, as shown in Table A 10. Similar to some other published estimates, this estimate was based on an assumed percentage of State/Territory bodies participating in the NTER.

---

[120] The Agreement provides at clause 4 that 'The Commonwealth will attach the Agreement as a schedule to the *A New Tax System (Commonwealth-State Financial Arrangements) Act 1999*. The Commonwealth will use its best endeavours to ensure the Act will require compliance with the Agreement. The States and Territories will attach the Agreement as a schedule to relevant State and Territory legislation. The States and Territories will use their best endeavours to ensure their legislation will require compliance with the Agreement.'

[121] At clause 21 of the Agreement.

Table A 10

ATO estimates of revenue forgone through the income–tax exemption applying to certain State and Territory government business enterprises

B95: Income–tax exemption for State and Territory bodies								
	2003–04 $m	**2004–05 $m**	**2005–06 $m**	**2006–07 $m**	**2007–08 $m**	**2008–09 $m**	**2009–10 $m**	**2010–11 $m**
Estimate	1 710	1 930	2 500	2 630	2 760	2 900	3 040	3 190

Source: ANAO analysis of ATO model.

The denial of deductibility for the repayment of course fees and interest in respect of the Higher Education Contribution Scheme or Higher Education Loan Program

9. Treasury identified, for the first time, the denial of deductibility for the repayment of course fees and interest in respect of the Higher Education Contribution Scheme (HECS) or Higher Education Loan Program (HELP) as a new tax expenditure for TES 2006. Denying taxpayers the capacity to deduct the repayment of their course fees and interest in respect of assistance they have received through HECS or HELP is a significant negative tax expenditure. It is a revenue raising measure which departs from the benchmark treatment of self– education expenses. Treasury estimated the negative tax expenditure at –$124 million in 2005–06, as shown in Table A 11.[122]

[122] It is usually the case that self–education expenses are deductible if the purpose of the self–education is to maintain or improve skills or knowledge which the taxpayer uses in their current income earning activities. That is, the deduction may be considered a legitimate work–related expense, and, quite possibly, part of the income–tax benchmark. As such, the deduction would be allowed, taxable income reduced, though no tax expenditure would arise. However, course fees and interest repayments for a HECS or HELP place funded by the individual are not tax deductible, even for the proportion that relates to their income earning activities.

Table A 11

ATO estimates of additional revenue collected by denying the deductibility of certain HECS HELP repayments

A19: Denial of deductibility of certain HECS HELP repayments								
	2001–02 $m	2002–03 $m	2003–04 $m	2004–05 $m	2005–06 $m	2006–07 $m	2007–08 $m	2008–09 $m
Estimate	n/a	n/a	–105	–116	–124	–110	n/a	n/a

Sources: ANAO analysis of Treasury model.

10. The ATO estimate is based on tax data and aggregate data published by the Department of Education, Employment and Workplace Relations. Accordingly, similar to other published estimates, while the underlying data is of high quality (HECS and HELP debts and repayments are managed through the taxation system) the model is sensitive to assumptions (in this case, proportion of taxpayers whose repayments are in respect of study directly associated with their income earning activities).

11. The inclusion of this negative tax expenditure highlights the absence of reporting in the TES of the revenue forgone in relation to other HECS and HELP schemes, namely:

- the revenue forgone by allowing a ten per cent discount for the up–front payment of a HECS fee. This discount reduces the institution's revenue from students, a result that is factored into the total Commonwealth funding to institutions delivered by way of grants; and
- the discounts offered for lump–sum repayments of HECS and HELP debts, which reduces the total revenue the Commonwealth would otherwise collect on these debts. The debts comprise a principal amount, and a notional interest amount related to the rate of the consumer price index. The discounts serve to reduce the amount of notional interest collected and may also serve to reduce the amount of principal.

Series Titles

Audit Report No.1 2007–08
Acquisition of the ABRAMS Main Battle Tank
Department of Defence
Defence Materiel Organisation

Audit Report No.2 2007–08
Electronic Travel Authority Follow-up Audit
Department of Immigration and Citizenship

Audit Report No.3 2007–08
Australian Technical Colleges Programme
Department of Education, Science and Training

Audit Report No.4 2007–08
Container Examination Facilities Follow-up
Australian Customs Service

Audit Report No.5 2007–08
National Cervical Screening Program Follow-up
Department of Health and Ageing

Audit Report No.6 2007–08
Australia's Preparedness for a Human Influenza Pandemic
Department of Health and Ageing
Department of Agriculture, Fisheries and Forestry

Audit Report No.7 2007–08
The Senate Order for Departmental and Agency Contracts (Calendar Year 2006 Compliance)

Audit Report No.8 2007–08
Proof of Identity for Accessing Centrelink Payments
Centrelink
Department of Human Services

Audit Report No.9 2007–08
Australian Apprenticeships
Department of Education, Science Training

Audit Report No.10 2007–08
Whole of Government Indigenous Service Delivery Arrangements

Audit Report No.11 2007–08
Management of the FFG Capability Upgrade
Department of Defence
Defence Materiel Organisation

Audit Report No.12 2007–08
Administration of High Risk Income Tax Refunds in the Individuals and Micro Enterprises Market Segments
Australian Taxation Office

Audit Report No.13 2007–08
The Australian Taxation Office's Approach to Managing Self Managed Superannuation Fund Compliance Risks
Australian Taxation Office

Audit Report No.14 2007–08
Performance Audit of the Regional Partnerships Programme:
Volume 1–Summary and Recommendations
Volume 2–Main Report
Volume 3–Project Case Studies
Department of Transport and Regional Services

Audit Report No.15 2007–08
Administration of Australian Business Number Registrations: Follow-up Audit
Australian Taxation Office

Audit Report No.16 2007–08
Data Integrity in the Child Support Agency
Child Support Agency
Department of Human Services

Audit Report No.17 2007–08
Management of the IT Refresh Programme
Centrelink

Audit Report No.18 2007-08
Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2007

Audit Report No.19 2007–08
Administration of the Automotive Competitiveness and Investment Scheme
Department of Innovation, Industry, Science and Research
Australian Customs Service

Audit Report No.20 2007–08
Accuracy of Medicare Claims Processing
Medicare Australia

Audit Report No.21 2007–08
Regional Delivery Model for the Natural Heritage Trust and the National Action Plan for Salinity and Water Quality
Department of the Environment, Water, Heritage and the Arts
Department of Agriculture, Fisheries and Forestry

Audit Report No.22 2007–08
Administration of Grants to the Australian Rail Track Corporation
Department of Infrastructure, Transport, Regional Development and Local Government

Audit Report No.23 2007–08
The Management of Cost Recovery by Selected Regulators

Audit Report No.24 2007–08
DIAC's Management of the Introduction of Biometric Technologies
Department of Immigration and Citizenship

Audit Report No.25 2007–08
Administering Round the Clock Medicare Grants
Department of Health and Ageing

Audit Report No.26 2007–08
Tasmanian Forest Industry Development and Assistance Programs
Department of Agriculture Fisheries and Forestry

Audit Report No.27 2007–08
Emergency Management Australia
Attorney-General's Department

Audit Report No.28 2007–08
Defence's Compliance with the Public Works Committee Approval Processes
Department of Defence

Audit Report No.29 2007–08
Parent School Partnerships Initiative
Department of Education, Employment and Workplace Relations

Audit Report No.30 2007–08
The Australian Taxation Office's Use of Data Matching and Analytics in Tax Administration
Australian Taxation Office

Audit Report No.31 2007–08
Management of Recruitment in the Australian Public Service

Current Better Practice Guides

The following Better Practice Guides are available on the Australian National Audit Office Website.

Public Sector Internal Audit	
An Investment in Assurance and Business Improvement	Sep 2007
Fairness and Transparency in Purchasing Decisions	
Probity in Australian Government Procurement	Aug 2007
Administering Regulation	Mar 2007
Developing and Managing Contracts	
Getting the Right Outcome, Paying the Right Price	Feb 2007
Implementation of Programme and Policy Initiatives:	
Making implementation matter	Oct 2006
Legal Services Arrangements in Australian Government Agencies	Aug 2006
Preparation of Financial Statements by Public Sector Entities	Apr 2006
Administration of Fringe Benefits Tax	Feb 2006
User–Friendly Forms	
Key Principles and Practices to Effectively Design and Communicate Australian Government Forms	Jan 2006
Public Sector Audit Committees	Feb 2005
Fraud Control in Australian Government Agencies	Aug 2004
Security and Control Update for SAP R/3	June 2004
Better Practice in Annual Performance Reporting	Apr 2004
Management of Scientific Research and Development Projects in Commonwealth Agencies	Dec 2003
Public Sector Governance	July 2003
Goods and Services Tax (GST) Administration	May 2003
Managing Parliamentary Workflow	Apr 2003
Building Capability—A framework for managing learning and development in the APS	Apr 2003
Internal Budgeting	Feb 2003
Administration of Grants	May 2002
Performance Information in Portfolio Budget Statements	May 2002

Some Better Practice Principles for Developing Policy Advice	Nov 2001
Rehabilitation: Managing Return to Work	June 2001
Business Continuity Management	Jan 2000
Building a Better Financial Management Framework	Nov 1999
Building Better Financial Management Support	Nov 1999
Commonwealth Agency Energy Management	June 1999
Security and Control for SAP R/3	Oct 1998
Controlling Performance and Outcomes	Dec 1997
Protective Security Principles (in Audit Report No.21 1997–98)	Dec 1997