

## Response to PAC Hearing Questions - 21 November 2016

To ensure there is no ambiguity, our response considers this question as it applies to the Office of State Revenue's (OSR) tax gap studies .

### Question 1: How have the findings of these studies enhanced OSR's collection of tax revenue?

Our Literature Review, feasibility study and engagement of tax gap experts is being used to inform our approach to measuring a tax gap. It is the use of these tax gap estimates that is planned to enhance OSR's collection of revenue . Recommendation 2b) *build a stronger evidence base for setting compliance revenue targets and modelling different resource levels to optimise tax revenue collection* is dependent on the successful work of recommendation 2a) referring to tax gap work.

The tax gap will be applied to our risk based compliance program and our feasibility study outlines:

- Tax gap estimates lead to better selection of returns for examination which results in maximising scarce compliance resources and lowering burden on compliant taxpayers<sup>1</sup>. Tax gap analysis identifies which areas the tax administration should place greater emphasis on in their future compliance programs
- Undertaking a tax gap analysis will aid OSR to determine what levels of non-compliance are 'tolerable'. Factors we would consider to determine 'tolerable' levels of non-compliance include cost, level of red tape and community impacts. In recent times, there has been increasing focus on increasing upfront and voluntary compliance activities by tax administrations around the world

As stated in the hearing , this study and research is critical to having a usable measure at the end of the process,

'...unless you plan and work through the methodology very carefully you can spend a lot of time, effort and resource and have almost nothing at the back end. There are issues to do with the data availability, the degree of accuracy in that data you are using, the timeliness of the data you are using and how you apply that to come to some sort of measure of tax gap. There are serious issues for us to consider in terms of what methodology to apply. '

*Stephen Brady, Deputy Secretary  
Page 1 Hearing transcript, final paragraph*

The Literature Review is attached for the Committee's information.

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<sup>1</sup> IRS Treasury Inspector General for Taxation, "The Internal Review Service needs to improve comprehensiveness, accuracy, reliability, and timeliness of the tax gap estimate" (August 2013)  
<<https://www.treasury.gov/tigta/iereports/2013reports/2013IER008fr.pdf>>.

## Question 2: What changes have you made to setting compliance revenue targets or setting resource levels to optimise tax revenue collection as a result of these studies?

As stated previously, recommendation 2b) *build a stronger evidence base for setting compliance revenue targets and modelling different resource levels to optimise tax revenue collection* is dependent on the successful work of recommendation 2a) referring to tax gap work.

Applying the tax gap to revenue targets will occur once the tax gap work is complete and it's applicability agreed.

### Setting compliance revenue targets

OSR has commenced work understanding the applicability of tax gap to setting compliance revenue targets. While being mindful of limitations, OSR will identify opportunities to using the tax gap to help inform our compliance revenue targets. Our feasibility study identified these two areas to be mindful of when setting compliance revenue targets:

- Her Majesty's Revenue and Customs (HMRC) in the United Kingdom does not use tax gap estimates to measure its performance target due to the limitation it presents where there are 'significant uncertainties inherent in the tax gap estimates, which preclude the level of precision necessary for performance monitoring.'<sup>2</sup>
- The tax gap calculation is also misleading as a comparison from year to year as its size depends on a number of factors which have nothing to do with whether the correct amount of tax is being paid, for instance the applicable rates of tax. This gives rise to further limitations as tax gap as a performance measurement in particular for individual staff, where HMRC had mistakenly done in the past.

### Resource levels

OSR has also commenced work understanding the effectiveness of applying a tax gap to resource levels. Our studies indicate that by understanding the causes of the tax gap, compliance agencies will be able to reallocate their resources and refocus their activities to tackle non-compliance more efficiently<sup>3</sup>. Tax gap estimates also lead to better selection of returns for examination which results in maximising scarce compliance resources and lowering burden on compliant taxpayers<sup>4</sup>. Tax gap analysis identifies which areas the tax administration should place greater emphasis on in their future compliance programs. Commissioners of the Internal Revenue Service in the United States have expressed that "the process to develop the tax gap led to a better selection of returns for examination which in turn leads to maximising scarce compliance resources and lowering burden on compliant tax payers<sup>5</sup>".

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<sup>2</sup> Thackray M, HM Revenue and Customs, 2013, 'Applied Tax Gap Analysis in the United Kingdom: Its use in tax administration, and future research'.

<sup>3</sup> Toro J, Ogata K, Hutton E, Caner S for IMF, 2013, 'Assessment of HMRC's Tax Gap Analysis'.

<sup>4</sup> IRS Treasury Inspector General for Taxation, "The Internal Review Service needs to improve comprehensiveness, accuracy, reliability, and timeliness of the tax gap estimate" (August 2013) <<https://www.treasury.gov/tigta/iereports/2013reports/2013IER008fr.pdf>>.

<sup>5</sup> IRS Treasury Inspector General for Taxation, "The Internal Review Service needs to improve comprehensiveness, accuracy, reliability, and timeliness of the tax gap estimate" (August 2013) <<https://www.treasury.gov/tigta/iereports/2013reports/2013IER008fr.pdf>>, 10.

### **Question 3: You note that the pilot study will be unique in Australia, and possibly internationally, for payroll tax.**

Tax gap methodology is an emerging area of expertise, with no published research on labour based tax gaps in Australia and, internationally, a limited IRS study of employment taxes. In fact, the Audit Office stated in their report that

‘... reliable tax gap analysis remains a challenge for many jurisdictions, there is opportunity for OSR to establish itself as a leader in this field.’<sup>6</sup>

The difficulty in being such a leader is reflected in the time to develop relevant and robust methodology. The Audit Office indicated the lack of directly comparable methodologies in the report:

‘Much has been written over the last two decades about the complexity of calculating the tax gap, particularly as it relates to specific types of taxes and work in this area is evolving. Most research in this area has focussed on measuring the tax gap as it relates to income tax. The development of a broader evidence base for other forms of taxation has been slower to develop. There are issues related to the development of a robust methodology for calculating the tax gap and often tax gap measures tend to be quite specific for both the jurisdiction and the type of tax or duty being assessed.’<sup>7</sup>

- **Will the findings of the pilot study be applied to tax revenue streams other than payroll tax?**

We are currently proceeding with pilots for tax gaps in payroll tax and land tax. The results of our feasibility study and pilot will inform our approach for other revenue streams.

The study and pilots will also be considered alongside the benefits of measuring each particular revenue stream. As stated in the Hearing, application of the tax gap

‘.. varies depending on the nature of the tax. For some taxes that we collect we believe there will be value, but for some of the other taxes we think that the value might be quite limited and not warrant significant investment in measuring the tax scale. For instance I give the example of gaming revenue, which is run through the machines, it is fully audited.’

*Stephen Brady, Deputy Secretary  
Page 1 Hearing transcript, paragraph 10*

- **Has there been any interest in the pilot study from other jurisdictions?**

Revenue Offices always work collaboratively on the many issues they face. Where feasible, jurisdictions share knowledge and best practice. We will continue to apply this approach to all aspects of our business, including the tax gap work.

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<sup>6</sup> Audit Report *Efficiency and effectiveness in tax collection*, Page 3

<sup>7</sup> Audit Report *Efficiency and effectiveness in tax collection*, Page 8