

# **AUDIT OF PUBLIC REVENUES**

## **Sub-theme II**

# **The role of the SAI in the budgetary cycle**

## **Discussion paper**

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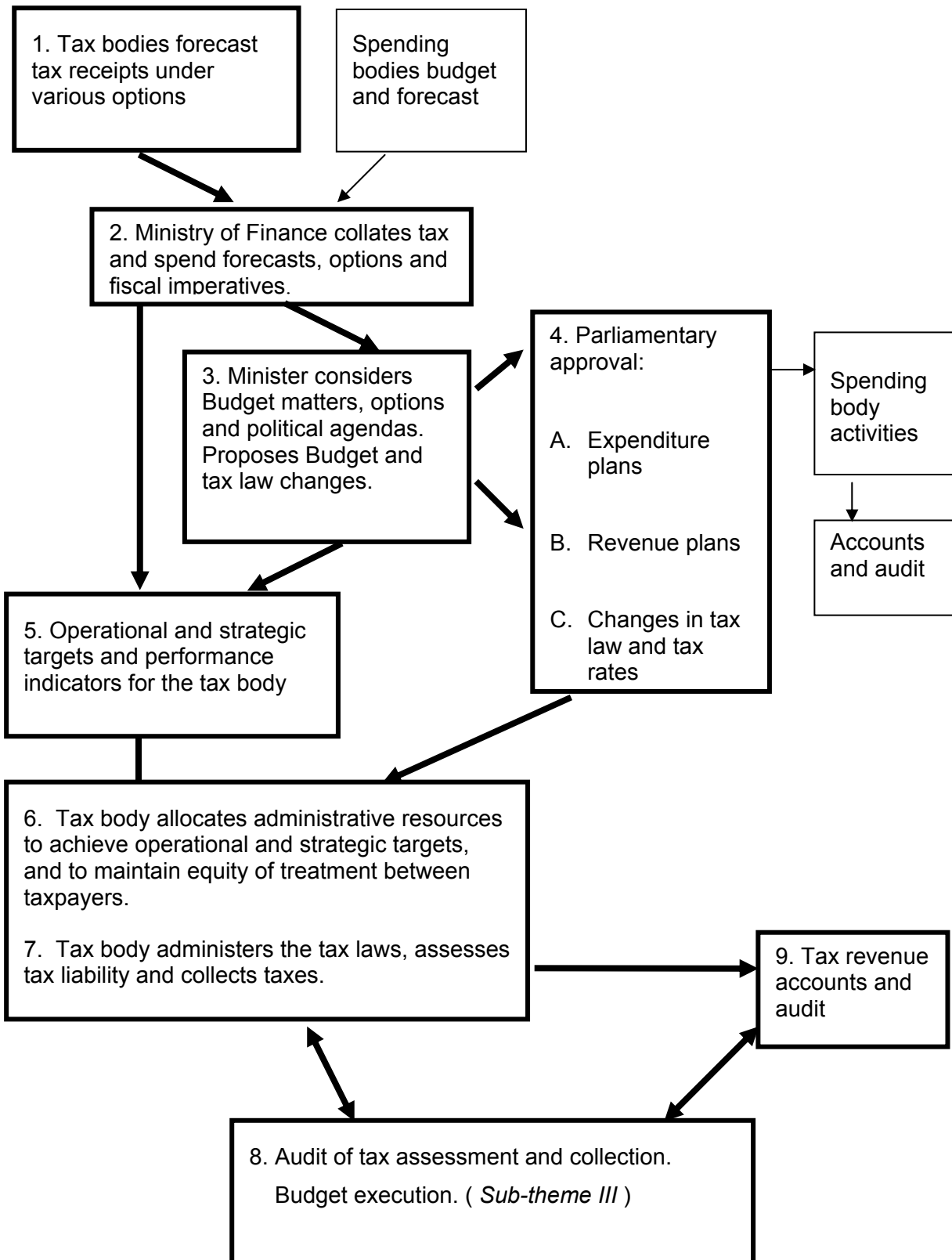
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1. The authors of this paper are deeply grateful those who contributed information, insights, suggestions and encouragement.

## **Introduction and bases of audit and other work by the SAI**

2. It is clear from the contributions of SAIs that their involvement in the revenue budget cycles in their countries varies widely. It is also clear that the variation reflects a wide variation in the government arrangements for compiling and validating revenue budgets, and differing parliamentary approvals. Further, the nature of revenue budget approvals and controls is different from approval of expenditure budgets. At the simplest level, a spending body may have almost complete control over how much it spends, whereas a tax raising body is dependent upon the behaviour of the economy and the constraints of tax law, among many other external factors. For this reason, in many countries a tax revenue “budget” is not set or subject to parliamentary approval in the same way as the expenditure budgets.
3. The range of constitutional arrangements within EUROSAI countries render meaningless any attempt to define a “best” answer for the role of an SAI in the revenue budget cycle.
4. Responses to the EUROSAI questionnaire show that those SAIs that do undertake work on the budget setting and approval process, report in some cases to the ministers and in some cases to parliament. In some cases reporting is published and in some cases it is not. Parliaments typically do not debate explicitly the SAIs reports on budget setting matters. Nevertheless, they have that independent view available when debating the revenue budget. Responses also show that in some countries there are other committees that scrutinise the revenue budgets. In nearly all countries governments publish a good level of detailed information about the revenue budget that can be used by analysts and commentators to inform their analysis.
5. The classical cycle of expenditure budget preparation, approval, execution and discharge does not model well the revenue budget cycle. For the purposes of this paper the following diagram is used to describe the revenue budget cycle and to offer a structure for discussion of the involvement of SAIs.

## Revenue Budget Cycle



## **Involvement of SAIs in the preparation and approval of revenue budgets**

6. SAIs are involved to different degrees in the revenue budget preparation phase of the budgetary cycle. Several SAIs have little involvement and have emphasised that it is their work on budget execution which provides the effective overall control, including post hoc reviews and assessments of revenue budgets against outturn. This is covered under sub-theme III of the EUROSAI Conference.
7. Some SAIs consider that the budget setting process is essentially a political process and that the SAI should not be involved significantly so as to preserve independence of audit action and reporting at the end of the budget cycle. Some would argue that the uncertainties in the revenue budget forecasts are not capable of being audited to normal standards of audit.
8. In a few cases SAIs have been asked to advise or “quality assure” elements of revenue budget bids made by tax authorities. The audit output served to give assurance to the central Ministry of Finance and to the Minister that the underlying tax authority forecasts were based on reasonable assumptions and achievable. The wording of the SAI conclusion in these cases is careful not to give unreasonable assurance or to compromise future audit work.
9. Compiling the overall revenue Budget involves political, economic, fiscal and administrative judgements. Some of the most important judgements, such as the response of the country’s economy to tax changes, are far removed from the traditional areas of audit work. However, they are also potentially at the centre of parliamentary debate and disagreement. Parliament and other commentators might well value a respected and authoritative independent view of the judgements that lie behind the revenue budgets. The SAI may want that role, or may want to avoid it for reasons of independence. In some countries the SAI is debarred from this sort of work by their legal framework.
10. The SAI has a particularly privileged, independent and important role in validating revenue budget data, assumptions and forecasts. The SAI may be the only body with independent access to the detailed underlying data.
11. It is also clear that governments’ emphases on fiscal stability – whether as part of European agreements or as a general discipline – may have reduced historical tendencies for wildly optimistic and misleading revenue budget forecasting.

Thorough post hoc audit of revenue outcomes may also highlight, and thereby deter, unrealistic budgets. However, not all SAI revenue execution audits go so far as to examine revenue outcomes compared with budgets.

12. Nevertheless, there remains a case that parliamentary debate is well served by the SAI being part of a process of independent quality assurance over important revenue budget assumptions and fiscal models. Indeed, government may find it convenient to have the auditors' endorsement. The SAI might want to develop a suitable role, while remaining alert to the risk that government overstate the auditors' assurance and put at risk the auditor's independence.
13. Auditing standards defined internationally and in each country typically do not mention explicitly the audit of revenue budgets or forecasts. Auditors may review the management processes that control the revenue budget forecasts so as to determine whether those processes are effective controls over quality. Internal audit may conduct extensive work on revenue budgets and forecasts and the SAI may be able to rely upon that work to some extent. Since few SAIs are involved in this sort of work it is perhaps unsurprising that each operates its own audit standards and techniques for this work. There is no common form of audit conclusion or report on the reasonableness of revenue budget forecasts or assumptions.
14. Within the revenue budget or other fiscal statements there may be straightforward projections and assumptions based on continuation of existing regulations and work by the tax body. However there will also be specific changes such as the special tax avoidance initiatives taken in the UK in 2004. The Chancellor's revenue budget documentation quantified the expected additional tax yield likely as a result of new initiatives. The NAO audited the reasonableness of the projected additional yield and reported independently at the time of the Chancellor's budget. The NAO will re-examine the special measures during their three-year implementation.
15. Assumptions and forecasts about future behaviours of taxpayers are clearly difficult to validate by any party, be they auditors or other professionals. Often those assumptions in revenue budgets will be influenced by purely political factors. For these reasons some auditors may consider that there is too much risk to them being involved in auditing those assumptions. Others may feel comfortable with the risks only if they can specify the terms and conditions under which they work and report so as to maintain their independence and reputation.

Central to that consideration may be the strength of the SAI's reporting route and the ability to spell out fully the caveats on the SAI's conclusions.

16. There are many structures for revenue budgets presented to Parliament. The traditional annual Budget may be supplemented by "mini-budgets" which announce fiscal measures at other times of the year. There may be separate announcements of Social Insurance contribution levels. Sub-theme I discussion paper notes that social contributions are rising in many countries. The main Budget may be preceded by Pre-Budget statements. Revenue budgets may be for a single year but are typically for 3 to 5 years. Each of these sorts of statements or announcements may include revenue forecasting data which the SAI may examine and validate in the same way as the main Budget.
17. In considering the role of parliamentary approval of budgets, it is clear that there are at least three elements of approval that impact most on tax bodies and which thereby influence audit work of the SAI. As with all other government-funded bodies, there will typically be an approved budget for the administrative cost of the tax body. This may be supplemented with minor amounts of income generated by the tax body, such as penalties in legal cases, but the tax body will not have freedom to keep back tax collected to pay for its administrative costs without some parliamentary approval of the extent of that cost. The second element is that parliament approves the tax laws and tax rates, even if these are not formally part of the revenue budget. Tax receipt targets are typically not approved by parliament, but see also the next paragraph. These three approvals drive the tax body's work and provide the benchmarks for auditors. The extent of parliamentary debate and formal approval of these various elements varies, of course. Hence the scope for the SAI to inform parliamentary debate will also vary.
18. Auditors' work on tax assessments and collection often suggests areas of tax that are not being identified or collected by the tax authority. In most cases the tax authority has difficult choices to make about how to allocate its administrative resources so as to generate the best tax impact. That impact may be simply generating the maximum tax but it may also be to maintain equity between taxpayers in the same circumstances, regardless of the additional tax take generated. The tax audit policy and levels of tax compliance work expected of the tax authority are typically not approved by parliament, in the experience of members of EUROSAI, as is noted in sub-theme I papers. If a parliament were to approve levels of compliance work, it could, raise the possibility of the SAI

auditing the basis for the level of compliance work planned. This may become a more important issue as administrative resources become more limited and harder choices have to be made on tax collection priorities.

19. Ministers together with the Ministry of Finance may set objectives and performance indicators of varying detail for the tax authority. These may provide a useful benchmark for subsequent SAI audit of the budget execution. But the SAI may consider that the targets set are unreasonably undemanding, or unachievable. The setting of targets may itself be considered to be an essentially political matter and therefore not subject to audit. Tax authorities will typically report their achievements against the targets set and this reporting may be subject to audit. This falls to be considered best under Sub-theme III.

### **Other influences on SAI work on revenue budgets**

20. In some countries there are independent budget review panels that offer important checks on the budget process. Some argue that in recent years the comprehensive availability of fiscal, economic and government budgetary data has made it easier for commentators, academics and critics of the government's revenue budgets to analyse the figures and assumptions directly without needing to depend upon an independent audit or review authority. Of course the extent of revenue budget data varies between countries. The SAI may consider that it has some responsibility to enhance the transparency of government data, so as to help commentators and parliamentarians.
21. The period over which revenue budget changes occur tends to be longer than for expenditure budget changes. A simple increase or decrease in a tax rate can result in a direct and immediate impact on receipts, whereas a special initiative to counter tax avoidance would typically take months or years to bring in significant additional income. Corporate taxpayers are interested in stability and predictability in tax liability and rapid changes are often seen to be against the interest of the economy overall and fiscal stability. Where tax allowances are designed to encourage a particular economic or social behaviour, the effect and tax consequences are often only seen in the longer term. These and other factors support a view that important parts of the revenue budget cycle are much longer than the annual cycle of expenditure budgets. This too has an impact upon the role and work of an SAI.

22. Changes in the tax regime will produce changes in amounts of revenue, but some tax changes are also designed to cause changes in general economic behaviour in some sectors, to incentivise some behaviours and to discourage others. For example in the UK, contaminated land tax gives tax advantage to companies that clean up contaminated land (subject to detailed conditions). The auditor's involvement in this sort of tax may be considered under sub-theme III of the EUROSAI conference. The Sub-theme I discussion paper notes that typically Ministers do not report on the effectiveness or efficiency of tax allowances.

### **Conclusions and Congress issues for discussion:**

23. There are no easy overall conclusions to this sub-theme, other than noting a wide range of roles and work by SAIs in different countries, for good reasons. Key observations and matters for discussion are:

24. A tax revenue "budget" is not set or subject to parliamentary approval in the same way as the expenditure budgets. Revenue budget cycles are much longer than the annual cycle of expenditure budgets.

25. SAIs are involved to different degrees in the revenue budget preparation phase of the budgetary cycle. Several SAIs have little involvement and have emphasised that it is their work on budget execution which provides the effective overall control.

26. Parliamentary debate is well served by the SAI being part of a process of independent quality assurance over important revenue budget assumptions, fiscal models and transparency of government data.

27. Auditing standards defined internationally and in each country typically do not mention explicitly the audit of revenue budgets or forecasts. There is no common form of audit conclusion or report on the reasonableness of revenue budget forecasts or assumptions.

28. Assumptions and forecasts about future behaviours of taxpayers are clearly difficult to validate by auditors or other professionals. Often assumptions in revenue budgets will be influenced by purely political factors. Auditors may consider that there is too much risk to them from auditing those assumptions.



29. Distinct elements of Parliamentary approval impact on tax authorities and thereby influence the audit work of the SAI: (a) approved budgets for administrative costs; (b) approved tax laws and tax rates, (c) tax receipt targets (although these are typically not approved by parliament).
30. The tax authority has difficult choices to make when allocating its administrative resources so as to generate the best tax impact. That impact may be generating the maximum tax; but it may also be to maintain equity between taxpayers in the same circumstances.
31. The tax audit policy and levels of tax compliance work expected of the tax authority are typically not approved by Parliament.
32. **Congress Issue area 3:** Is it good for SAIs to become involved in estimating tax revenues? Would an involvement of SAIs in forecasting tax revenues be useful or would it be preferable for SAIs to limit their involvement to an *ex post* verification and evaluation of the method and results of forecasting tax revenues?
33. **Congress Issue area 4:** What are the merits of the SAIs' involvement in the preparation undertaken by government and Parliament of revenue budgets? Would it be beneficial to extend SAIs' mandates to advise government and Parliament on revenue matters throughout the budgetary cycle?
34. **Congress Issue area 5:** Is revenue auditing limited to verifying whether the revenue/tax authority levies taxes timeously, completely and in compliance with legal provisions, or should SAIs also address the quality and practical application of revenue legislation and advise Parliament and the government in the legislative process? Should SAIs also advise Parliament on the quantum and focus of tax authority work and the setting of targets? Should SAIs help develop worthwhile performance indicators to enable Parliament to reliably assess the implementation of legislation by tax authorities?