

Talking to the Taxman about Nature Conservation

Proposals for the introduction of tax incentives for the protection of high conservation value native vegetation

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About this project

Incentives for remnant vegetation conservation

This report forms part of a larger project being undertaken by CSIRO Wildlife and Ecology which is identifying opportunities for the use of incentive-based instruments in the conservation of native remnant vegetation. The project is funded by Environment Australia and the Land and Water Resources Research and Development Corporation.

The report is one of five reports prepared to date which evaluate the role of local government in conserving native vegetation. The other four reports are:

Motivating People: Using management agreements to conserve remnant vegetation. This report addresses the role of financial incentives and legally binding management agreements in promoting the conservation of native vegetation on private land. It develops a conceptual framework for the project by identifying the situations in which different types of financial incentive can most effectively be used to conserve native vegetation.

Beyond Roads, Rates and Rubbish: Opportunities for local government to conserve native vegetation. This report evaluates the key policy and financial opportunities and impediments to local governments playing an active role in native vegetation management. It provides a synthesis of the findings of an extensive review of the role of local government and identifies policy options for all levels of government.

Opportunity Denied: Review of the legislative ability of local government to conserve native vegetation.

This report evaluates impediments to local governments using a range of innovative incentive-based instruments. A number of important legislative barriers to local government playing an effective role in native vegetation management are identified.

Talking to the Taxman about Nature Conservation: Proposals for the introduction of tax incentives for the protection of high conservation value native vegetation. This report reviews the impact of Commonwealth taxes on the conservation of native vegetation. It finds that conservation activities can in certain circumstances be highly taxed and puts forward proposals to address these situations.

The aim of the project is to address the issue of conserving native vegetation in a way that is relevant and attractive to all spheres of government: local, State and Commonwealth. It is only with each jurisdiction's active cooperation that the linkages between national policies for the conservation of native vegetation can be integrated with the economic, social and environmental interests of local communities.

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Executive summary

Conservation on land not used for commercial purposes is among the most highly taxed land uses in Australia. There are tax incentives to encourage people to conserve biodiversity on land used for commercial purposes, but there are no tax incentives for people who manage land solely for nature conservation.

This paper evaluates a range of proposals for providing tax incentives for the protection of native vegetation and biodiversity that is of high conservation value.

High conservation value sites are defined as sites which:

- are registered on the National Estate;
- are nationally important Ramsar listed wetlands;
- provide for the conservation of endangered or vulnerable species and communities as defined under relevant Commonwealth and State Acts; or
- contain ecological communities or ecosystems that are under-represented within the public reserve system.

It is recognised that there are considerable tax incentives available for conservation on land where a *bona fide* business is being carried out, because:

- businesses are allowed to deduct operating costs and depreciate plant and equipment associated with their operations; and
- a range of special incentives has been provided for the management of rural land, such as the recently announced 34% rebate for landcare-related works.

In short, if an area of land is used both for business purposes and for conservation, the conservation costs are deductible. If a person only wishes to protect the land, however, they are not. All costs are paid out of after-tax, not pre-tax, income. The result is an incentive to use, rather than to protect, lands of high and often unique conservation value.

Essentially, this report wrestles with the problem of how to increase the incentive for people to make significant contributions to conservation on private land.

The incentive structure is biased against conservation on the demand as well as the supply side. Financial contributions made to charitable organisations are tax deductible, but donations of high conservation value land are only deductible within one year of purchase, except when they are made to a National Trust body. Donations of conservation covenants that protect conservation values in perpetuity are *not* deductible under any circumstances. In March 1999, the Prime Minister announced that this policy will be changed from 1 July 1999. If legislative changes recognise the donation of covenants, then this inconsistency will be removed.

Landholders who purchase land and manage it for conservation may only add costs of the kind outlined above to the cost base of their land for capital gains tax purposes. As a result, expenses associated with the land can only be deducted from any capital gain at the time the land is sold. Whilst ultimately the net cost to tax revenue may be similar, the incentive provided to landholders is greatly diminished, particularly for landholders who are risk averse or who have no intention to sell their land.

From a nature conservation perspective, these incentive signals seem inconsistent with stated government objectives.

These conflicting approaches to policy analysis are brought together and compared in this report by evaluating current tax arrangements against the following policy benchmarks.

Tax neutrality – the tax system should treat all financial transactions in a *consistent* way, be administratively *simple* and have an *equitable* effect on all taxpayers.

Environmental impact – the tax system should have a positive impact on environmental values in the sense that the full social, environmental and economic costs of goods and services are reflected in prices.

Equity – the tax system should progressively redistribute income to poorer people.

Investment and development – the tax system should provide a positive incentive for investment and development, because they are important generators of financial wealth in society.

Analysis of current tax arrangements against these benchmarks clearly demonstrates that, in the absence of tax reforms, the amount of dedicated private investment in nature conservation in Australia will be less than optimal. Existing arrangements are causing significant irreversible losses of biodiversity in lands of high conservation value. This is especially likely to be the case along the coastal zone and near major urban centres where many of Australia's most vulnerable ecosystems are located.

Rather than depend upon public acquisitions of sites of high conservation value, which is expensive, there is an important opportunity to use tax incentives to encourage philanthropic investment in conservation. Philanthropic investment offers the opportunity to achieve the same outcome at much less cost to government. The focus of this report is on incentives for the protection of biodiversity on land that is not or should not be used for a business purpose.

- The potential conflicts between environmental and tax policies create a need to consider when tax incentives should be preferred over grant or outlay programs. The strength of grant programs lies in their flexibility. They are best suited to situations where there is a need for strong interaction and negotiation between the funding organisation and the grant recipient. This is particularly the case where large grants are made for undertaking conservation works on a regional scale.
- The strengths of tax programs lie in their accessibility and capacity to recruit and reinforce the motivations of landholders to privately invest in public goods. They are suited to situations where incentives are used to efficiently share costs with a wide range of landholders.

On the basis of these findings, a number of proposals for reform are evaluated. These are classified into three groups:

- proposals to tighten existing tax deductions;
- the use of conservation covenants to target tax incentives; and
- other proposals for targeted tax incentives.

The proposals and policy options for their implementation are summarised in Table 1, which includes, wherever possible, estimates of behavioural change and costs to revenue.

Particular attention is drawn to the potential to target tax incentives through existing State and Territory powers to negotiate legally binding conservation covenants with landholders. It is estimated that by coupling this mechanism with the recommended tax incentives, about 28 500 hectares of Australia's most vulnerable ecosystems could be conserved at an approximate cost, in terms of tax revenue, of between \$9 million and \$20 million over the next five years. The ongoing cost of managing this measure would be less than \$1 million. This is significantly less than the cost of any other politically viable means of achieving the same outcome. The cost of acquiring these sites, excluding ongoing costs associated with public management, is estimated to be in the order of \$100 million dollars. The additional outlays required for ongoing management would be in excess of \$4 million per annum. In short, the tax incentive provides a mechanism to achieve the same outcome for less than a quarter of the cost.

It should be noted that the costings presented in this report are likely to overestimate the costs to revenue of introducing tax incentives. Conservative or high cost assumptions have been used throughout and are summarised in Appendix B. Further, it can be expected that some of the upfront costs of introducing the proposed tax incentives would be recovered when land is sold and subject to capital gains tax.

We judge that these proposals represent the single most important opportunity to promote private investment in nature conservation in Australia in the next 10 years. If implemented, the result, will be cost-effective conservation, achieved by 'leveraging' large-scale philanthropic investment with modest public outlays.

Table 1: Summary of proposed tax incentives^a

Proposal	Policy options ^b	Behavioural impacts	Costs to revenue ^c	Priority
Proposals tightening existing provisions				
1. Ensure all expenses associated with clearing native vegetation are treated as capital expenses.	1a. Australian Taxation Office to issue ruling clarifying that existing arrangements require land clearing to be treated as a capital expense. 1b. Increase tax audits of landholders applying to clear native vegetation.	The behavioural impact is only likely to be significant in States and Territories where broadscale vegetation clearing controls are not in place.	Not costed A modest saving to revenue would be expected.	Not favoured Legislative mechanisms preferred.
2. Tighten the landcare rebate and/or deductions to better reflect landcare value.	2a. Extend the requirement that deductible activities be in accordance with an approved property management plan under section 387-55. 2b. Australian Taxation Office to clarify that the protection of native vegetation is deductible under section 387-55.	Improved targeting of major landcare works through the development of property management plans. Minor landcare expenses are generally deductible or depreciable under other provisions of the Act.	Minimal Savings less than \$1 million per annum.	Low Improved targeting with increased administrative complexity.
Using conservation covenants to target tax incentives				
3. Recognising conservation covenants.	3a. Register organisations able to enter nature conservation covenants on the register of environmental organisations under section 30-260 of the Act.	Significant incentive for each State and Territory to promote and use its capacity to enter conservation covenants.	Minimal Administrative costs.	Not applicable
4. Make donations of conservation covenants tax deductible.	4a. Allow a deduction of the change in land value covered by a conservation covenant. 4b. Clarify that creation of a conservation covenant has a neutral impact on capital gains tax.	Highly significant in promoting philanthropic investment in the purchase and management of sites of high conservation value native vegetation.	Moderate-high \$1 million in the first year rising to \$2.7 million per annum in the fifth year. The proportion of market value used can vary estimates.	High Incentive for cost sharing and securing private investment in nature conservation.
5. Make the costs of maintaining conservation covenants tax deductible.	5a. Give access to the 34% landcare rebate or tax deduction to sites covered by a conservation covenant. 5b. Allow deductibility of interest payments associated with conservation covenants.	Strong incentives for ongoing management of sites of high conservation value to maintain value.	5a. Low-moderate ^d \$500 000 to \$1 million per annum after five years. 5b. High ^d \$2.5 million to \$8 million per annum after five years.	5a. Very high Cost-effective measure with significant conservation benefits. 5b. Moderate Incentive for cost sharing but at a moderate to high cost.

Table 1: Summary of proposed tax incentives^a (continued)

Proposal	Policy options ^b	Behavioural impacts	Costs to revenue ^c	Priority
6. Extend 20% rebate for works on heritage buildings to conservation covenants.	6a. Extend 20% heritage rebate to include land protected by a perpetual conservation covenant. (Alternative to 5a)	Moderate incentive for ongoing management of sites of high conservation value.	Low-moderate \$250 000 to \$500 000 in the fifth year of the program.	Very high In the absence of 5a which is preferred.
Other targeted incentives				
7. Make donations of land to conservation organisations tax deductible.	7a. Make donations of land of high conservation value tax deductible. 7b. Remove the 12-month rule relating to gifts of property in Division 30 of the Act making all land donations tax deductible.	Unknown, a high degree of substitution between methods of donating to environmental organisations may be expected.	Not costed Between \$20 400 and \$46 019 per \$94 886 land donation. Cost to revenue mitigated by substitution from other tax deductible expenses.	High land donations could be treated on the same basis as other donations to charitable organisations.
8. Provide sales tax exemption to landcare groups.	8a. Amend section 75 of the Sales Tax Assessment Act 1992 to provide sales tax exemption.	Landcare groups purchase their own equipment rather than operating through third parties.	Minimal costs Savings from reduced involvement of third parties.	Moderate-high Simplify access of landcare groups to sales tax exemptions in the public interest.

- a. See relevant sections for full text of proposals, policy options and costings.
- b. Where possible the section that could be amended in the relevant Act has been identified. However, for any given outcome, a number of alternative approaches are likely to exist. If the proposals put forward in this paper are to be considered in formal decision-making processes, further work will be required to develop specific proposals in consultation with the Australian Taxation Office.
- c. The costings presented in this table are point estimates based on a range of assumptions contained in the text of the report. Care should be taken in the interpretation of these costings and they should be read in the context of the discussion of each policy option in the text. Appendix B provides further background to the costings put forward in this report.
- d. Note that existing tax arrangements allow these costs to be added to the cost base of the land for capital gains purposes and claimed at the time of disposing of the asset. The effect of the proposals is to make them deductible against income and hence shift the timing of the deduction forward with potentially little impact on net tax revenue.

1. Introduction

This report has been prepared in response to a request from Environment Australia to evaluate the potential impact of tax incentives on the conservation of remnant vegetation on private land. It is one of a series of reports that have been prepared as part of a three-year project: 'Opportunities for the use of incentive payments to conserve native vegetation', funded by Environment Australia and the Land and Water Resources Research and Development Corporation (LWRRDC).

The report evaluates the effectiveness of existing tax arrangements in providing positive incentives to private landholders to conserve native vegetation and biodiversity (Section 2). This provides a baseline against which proposals for any changes to existing tax measures can then be assessed. As a wide range of conservation incentives are already available to landholders who undertake business activities on rural land (for example, via landcare provisions), the focus is on other landholders keen, for philanthropic reasons, to protect Australia's natural heritage.

Proposals to use tax incentives to promote environmental outcomes are not new. As a result, the approach taken in this report is to provide specific advice on a number of targeted proposals for amending tax arrangements that have been proposed by range of organisations in recent years. The proposals considered are grouped under the following section headings in the report (the number before each proposal relates to the subsection of this paper in which it is discussed).

Proposals to tighten existing deductions

These proposals relate to ensuring that existing deductions and incentives available under the *Income Tax Assessment Act 1997* are tightly targeted and have a positive impact on the conservation of native vegetation and biodiversity.¹ A case could be made to offset the cost of any new proposals against savings realised through a tightening of existing measures. Specific proposals evaluated are:

Proposal 1

With the exception of regrowth or woody weed control, all expenditure on native vegetation clearance, including wetland drainage, should be treated as capital expenditure and not deducted as part of normal operating expenses.

Proposal 2

The definition of landcare activities in section 387-55 of the *Income Tax Assessment Act 1997* should be tightened to better reflect landcare values.

Using conservation covenants to target tax incentives

There is an opportunity to use tax incentives to conserve sites of high conservation value. These are sites where the highest valued use to Australian society is to encourage their protection and management for conservation. These are ecosystems that provide habitat for endangered or vulnerable species or ecosystems that are poorly represented within the formal public reserve system.²

1. References to the Act are to the *Income Tax Assessment Act 1997* and, where relevant, the *Income Tax Assessment Act 1936*. The 1997 Act is the outcome of a major initiative to simplify and rationalise the text of the 1936 Act. In making a transition to the new Act there is considerable potential for confusion as sections within the new Act are changed. For example, sections 75B and D of the 1936 Act are now sections 387-130 and 387-55 respectively in the 1997 Act.
2. There is a strong legislative and policy case for taking measures to protect high conservation sites, both through provisions of threatened species legislation at the Commonwealth and State level (already existing) and through policy commitments to secure the conservation of a comprehensive, adequate and representative sample of all ecosystems across Australia. Many ecosystems, for example, temperate woodlands within Australia's agricultural regions and lowland coastal communities, are largely privately owned and under continuing threat from fragmentation. It is ecosystems of this kind which are the focus of this paper.

There is an opportunity to use conservation covenants as a mechanism to target tax incentives to these sites. Specific proposals evaluated are:

Proposal 4

Donations of a conservation covenant over land of high conservation value and the resultant change in the value of land should be deductible against taxable income.

Proposal 5

Maintenance costs associated with land protected by a conservation covenant should be eligible for deductions under the land degradation provisions of the Act, irrespective of the status of the taxpayer.

Proposal 6

The 20% rebate for work on structures on a prescribed heritage list should be extended to include approved works on areas of high conservation value that are covered by a conservation covenant.

Other proposals for targeted tax incentives

A number of other tax incentives are evaluated in the fifth section of the paper. These include:

Proposal 7

Donations of land to approved conservation organisations should be made tax deductible irrespective of the date of purchase of the land.

Proposal 8

Consistent with sales tax provisions available to primary producers, purchases of equipment for environmental maintenance by landcare and other similar groups should be exempt from sales tax.

Criteria for assessment

Each of the proposals outlined above are evaluated in terms of their:

- value as an incentive for the conservation of native vegetation and associated biodiversity values;
- administrative feasibility; and
- impacts on tax revenue.

When evaluated against these criteria, a subset of the proposals examined are identified as having the greatest potential to promote the conservation of biodiversity values embodied in native vegetation. Section 6 summarises these and discusses the cost-effectiveness of these proposals.

2. What tax policy means for nature conservation

Benchmarks for evaluating tax arrangements

Any tax arrangement can only be evaluated against a series of benchmarks. A benchmark is a standard or objective against which the arrangement or proposal can be assessed. Without a benchmark, it is impossible to evaluate whether a positive, neutral or negative incentive to change behaviour is created. The most obvious benchmark to be considered in the context of this paper is the likely impact of a given tax arrangement on incentives to conserve biodiversity by protecting native vegetation. However, there are other benchmarks which need to be considered, especially those that relate to economic and social policy objectives. The following four benchmarks are put forward as a basis for evaluating the economic, social and environmental implications of tax policy.³ Each benchmark is presented as a extreme view of the particular policy objective being addressed.

Tax neutrality

The tax system must treat all financial transactions in a consistent way, be administratively simple and have equitable impacts on all taxpayers.

Neutrality ensures that the relative market values of all goods and services are not changed by the measure. Ideally, all transactions should be taxed at the same rate. Importantly, this argument explicitly

rejects the view that market failures should be corrected through the tax system. The use of Pigouvian (selective) taxes, which correct market failures, is explicitly rejected.

Environmental impact

The tax system should have a positive impact on environmental values in the sense that the full social, environmental and economic costs of goods and services are reflected in their price.

This benchmark requires taxes to be levied on goods and services differentially depending on their environmental impact. In conflict with tax neutrality, it seeks to address market failure. Goods and services that provide positive non-market environmental benefits, such as protection of an endangered species, should be taxed at a low level. Actions that have negative environmental impacts but are of no market consequence to the taxpayer, like water pollution, should be more heavily taxed.⁴ Alternatively, charges or tradeable permits should be introduced to achieve the same end.

Equity

The tax system should progressively redistribute income to poorer people. That is, taxes should be levied at a proportionately higher rate on higher incomes and on larger quantities of capital.

At the same time, however, there is a need to take into account the capacity of individuals to pay. Impacts on the asset rich but income poor can require special consideration. The aged and farmers are typically used as examples of asset rich people whose lifestyles might be adversely affected by progressive capital tax arrangements.

3. These benchmarks are based on criteria for the assessment of economic instruments developed originally by the Organisation for Economic Cooperation and Development. These criteria are reviewed in Young et al. (1996) in the context of biodiversity conservation. Criteria relating to administrative feasibility are addressed separately in relation to each proposed tax incentive.
4. At the extreme, this benchmark reflects a Pigouvian view where taxes are used to ensure the full costs of all goods and services are incorporated into their prices. Pushed to the extreme, no further interventions are required, as all market failures have been corrected through the pricing system. This is of course a somewhat naive view. It assumes that social objectives can be perfectly quantified and further that, as society's aspirations change, these changes can be reflected in changes to the tax system instantaneously. Nevertheless, there is a powerful argument that, as all taxes are distorting to some degree, taxes should be targeted at environmental negatives because then, at least, the tax system is working to improve environmental outcomes.

Investment and development

The tax system should provide a positive incentive for investment and development because they are important generators of financial wealth in society, which in turn increases prospects for other public objectives like employment.

Negative gearing and accelerated depreciation are examples of tax policies specifically targeted at promoting investment.

Performance of current arrangements against benchmarks

The tax treatment of expenditure on the protection of biodiversity values associated with native vegetation depends on the tax status of the landholder. A landholder who is carrying on a business for the purpose of gaining or producing assessable income from the use of any rural land in Australia may use the provisions of the tax Acts that are related to business and primary production. This would provide them the opportunity to, inter alia:

- deduct ongoing costs of management including wages and consumables as a business expense (s8-1);
- deduct interest payments associated with the land as a business expense (s8-1);
- claim a diesel fuel rebate;
- claim sales tax exemption for goods associated with the management of the land (Schedule 1 *Sales Tax (Exemptions and Classifications) Act 1992*);
- depreciate plant and articles associated with management of the land (s42-15);
- depreciate fences, dams and other structural improvements on farmland (s42-18);
- claim a three-year deduction for water storage and farm reticulation systems and an outright (100%) deduction for expenditure on capital works designed to prevent or combat land degradation on rural land or, from 1 July, claim a rebate or a tax credit for this expenditure at the rate of 34 cents in the dollar (s387-130 and s387-55).

These arrangements are not available to other landowners who, for example, may have purchased land to protect and manage conservation values. This is because they do not generate income from that activity. That is, the degree of tax incentive offered for conservation purposes depends upon the status of the land and its owner.

The implications of these arrangements are discussed under each of the benchmarks below.

Tax neutrality

Under current arrangements, there is a tax incentive for landholders to farm rather than conserve native vegetation. Costs of managing vegetation are deductible only if their management is an inherent and integral part of a business that produces assessable income. In relation to depreciation of assets, Peterson (1996) notes:

Tax policy distinguishes between wasting and non-wasting assets. Wasting assets are those which depreciate in value as they are used. Non-wasting assets either retain their value indefinitely, or change in value as a result of changes in market forces. Land is generally considered a non-wasting asset.

Ideally, to accord with Treasury's accepted benchmark tax base, outgoings would be allocated to different tax periods based on whether those outgoings have actually been used up during the assessment period.

From the perspective of tax policy, primary producers are subsidised to the extent that they can depreciate at an accelerated rate, or claim outright deductions for, wasting and non-wasting assets. For example, land improvements, such as tree planting or land clearing, would not generally be deductible in a 'neutral' tax system, as they are part of a non-wasting asset: land. Treatment of non-primary producers is tax neutral; treatment of primary producers is not tax neutral. *Lack of tax neutrality for primary production remains one of the prime causes of the loss of national natural environmental assets including sites of high conservation value.*

Note also, nature conservation not associated with primary production is not normally considered an

income producing activity. This means that the stream of non-market benefits that flow from this philanthropic activity must be financed from post-tax dollars. At the highest rate of 47.5 cents in the dollar plus a 1.5% Medicare levy, this means that \$194 of pre-tax income is needed to finance \$100 of fencing on land not used for primary production. However, only \$100 of pre-tax income is needed for land associated with primary production. Moreover, primary producers with low taxable incomes receive a subsidy equivalent to the difference between their tax rate and 34 cents in the dollar. For a primary producer with a taxable income less than \$20 700, only \$88 of pre-tax income is needed to fund \$100 of fencing.

The implication is that, for all vegetation to be treated equally by the tax system irrespective of the tax status of the landholder, tax officials would have to be convinced that biodiversity conservation through native vegetation management is a *bona fide* activity in the interest of the community. Moreover, they would need to be convinced that markets fail to encourage nature conservation to the level desired by society.

Overall, and when considered against this neutrality benchmark, existing tax arrangements have a negative impact because primary producers receive better than neutral tax treatment relative to other landholders undertaking conservation activities. An obvious way to extend native vegetation and biodiversity conservation in Australia is to extend the tax provisions available to primary producers to include all land that contains significant natural assets being managed for public benefit.

Environmental impact

The public benefits of conserving areas of native vegetation that are of high conservation value are greater than the benefits of developing them for production because their biodiversity values are not replaceable through revegetation. Since nature conservation is not considered an income producing activity, however, it is much more expensive to manage land for conservation than for production (Binning and Young, 1998).

The main effect of the current income tax system on nature conservation comes from two sources. The first is a failure of the tax system to recognise activities which are in the community's interest. This failure occurs because no financial transaction takes place, as the goods do not have a market value. The second is the failure of the system to recognise negative externalities, such as increased risk of soil degradation, which are not directly related to production. Interestingly, one of the main reasons for the introduction of section 387-55 was that land degradation is a prime source of water pollution. Consequently, there is a case for the public to invest via the tax system in the improvement of water quality.

Existing arrangements tend to promote activities that cause environmental damage and, with the exception of modest incentives to primary producers, do little to promote the conservation of native vegetation and the associated biodiversity values.

Overall, and when considered against this environmental impact benchmark, existing tax arrangements have a strong negative impact on the incentive for nature conservation.

Equity

The equity benchmark suggests that tax policy should favour or, at least, make it less expensive for low-income people who act in a manner consistent with community notions of duty of care. With the exception of the new 34 cents in the dollar rebate available for landcare activities, however, the majority of incentives available to landholders are provided through depreciation and deductions from assessable income, and these are more advantageous to high-income earners. For example, the Australian Bureau of Agricultural and Resource Economics (Mues et al., 1996) found that deductions under s75B and s75D of the *Income Tax Assessment Act 1936* were regressive, with the largest benefits received by a small group of individuals with high taxable income. Moreover, 10% to 20% of farmers received no benefits at all.

An interesting interpretation of this benchmark might conversely suggest that tax policy should

encourage wealthy philanthropists to make contributions to activities that are in the public interest; for example, by making donations to charities. In this way, tax incentives are used as 'leverage' to secure significant private investment in public goods. Applied to nature conservation, such arrangements could allow deductions for the purchase and management of properties of high conservation value, thereby averting the more expensive option of governments acquiring these sites. At present, however, philanthropic arrangements must be delivered through environmental organisations and are quite restrictive.

Overall, and when considered against this equity benchmark, existing tax arrangements have a slight negative impact because larger incentives are provided to landholders who are wealthy.

Investment and development

Leaving nature conservation to other regulatory and fiscal measures, this benchmark aims to encourage development and investment with little consideration of any aspect of the environment that does not provide a direct income or individual wealth-generating benefit. As a general rule, tax legislation provides strong signals for land development by maximising income generation opportunities from land subject to environmental regulations. The incentive is for compliance at only the minimum standard required, unless a marketing advantage can be generated from a higher standard. The only significant exception to this arrangement is the incentive for people to donate to registered environmental organisations.

Overall, and when considered against this investment and development benchmark, existing tax arrangements have a major positive impact on incentives to invest and develop. To the extent that such development is inconsistent with maintaining native vegetation of significant value for biodiversity conservation, this will have a negative impact on nature conservation objectives.

Relative effectiveness of tax and outlays or grant programs

The case for public investment and the use of economic instruments for achieving nature conservation objectives is well documented and will not be repeated here. See, for example, Industry Commission (1997a, 1997b), OECD (1996), Young et al. (1996), and Binning and Young (1997). Rather, the situations where tax incentives may be favoured over grant or outlay programs are discussed.

The tax system has potential advantages and disadvantages in providing assistance for vegetation management. Generally, it is argued that direct assistance through grants can be more effectively targeted, although at greater administrative cost, than taxes which use an existing infrastructure (Peterson, 1996). There are, however, exceptions, such as when an existing administrative mechanism is already in place and can be used to target tax incentives.

It is important, firstly, to set the context within which tax incentives need to be considered. There is a wide range of natural resource management programs within Australia that provide financial assistance to landholders seeking to conserve biodiversity and protect native vegetation. The view taken in this report is not to pose the question of whether an incentive, tax deduction or grant is to be generally preferred, but to evaluate the relative strengths and weaknesses of each approach and then identify the circumstances in which each may be most effectively used.

Arguments against the use of tax incentives

Costs associated with implementing a tax system are a function of its complexity. Moreover, deductions made before tax is paid are hidden from standard budget processes. Consequently, Treasury officials are understandably reluctant to use the tax system to provide assistance to meet social objectives like biodiversity conservation because this increases the complexity of tax law, may create perverse or unintended outcomes and may act as a precedent for other sectoral groups seeking assistance. In

short, any tax incentive works against the tax objectives of consistency, simplicity and equity discussed above. These are powerful arguments and have led the Commonwealth government to set the following conditions on changes to tax arrangements:

Taxation measures that lead to reduced Commonwealth revenues are now required to be funded out of existing portfolio allocations, for example, the National Vegetation Initiative. Departments also have to demonstrate that a taxation measure would be more efficient and effective than outlay measures, such as grants. (Treasury, pers. comm., 1997)

Another argument often raised against the use of tax measures is that they only benefit landholders with relatively high incomes. Thus low-income landholders, who are arguably in most need of assistance, will only receive very modest benefits from tax assistance. The use of rebates and tax credits, which provide the same benefit irrespective of income, has been raised as a possible means of addressing this concern. However, governments have historically been reluctant to use rebates and credits. The recent introduction of the 34 cent rebate option for section 387-130 and 387-55 is a notable exception.

Tax incentives may also be difficult to target, particularly under a system of self-assessment. For example, it is difficult to measure the contribution of the landcare deductions to achieving sustainable land management practices (Mues, et al., 1996). It may be possible to target tax incentives by requiring an additional approvals process. However, such an approach may add to the administrative burden of the tax measure, making it hard to distinguish from a grant program. As discussed later in this report, where an existing approvals process exists, such as the registration of a conservation covenant, these costs may be minimised.

As tax incentives often provide ongoing assistance and access to funding, they may not be as effective as grant programs in providing short-term assistance. This is particularly so where strong interaction between the funding organisation and the land manager is desirable. Most grant programs

are directed toward assisting landholders in making a transition of this kind; that is, to meeting a duty of care for sustainable land management.

This case is summarised in the Natural Heritage Trust *Guide to new applications 1998–99*:

The Commonwealth owes it to taxpayers to ensure that its investment leads to long term change towards sustainability. The Commonwealth investment of \$1.25 billion will be directed largely through catalytic activities, which support and encourage stakeholders to overcome the barriers to sustainable management of land, water, native vegetation and biodiversity...In general, Natural Heritage Trust funds are designed to assist in overcoming impediments to sustainable environment and natural resource management. Trust funds will not be used to provide long term assistance to biodiversity conservation and natural resource management activities more properly addressed by land users and directly responsible jurisdictions. (Commonwealth of Australia, 1997)

In these cases a grant process that facilitates direct interaction between the funding body and the grant recipient may be preferred.

In contrast, tax incentives, such as section 387-55, may provide incentives where longer-term assistance is justified on the basis of ongoing public benefit. This is the case where a conservation service is provided by landholders who manage sites of high conservation value in the public interest.

Arguments for the use of tax incentives

There is also evidence to support the use of tax incentives for sustainable vegetation management in certain circumstances. Stakeholders, including landholders, consistently raise tax concessions as a primary mechanism through which conservation measures can be promoted. For example, the Australian Bureau of Agricultural and Resource Economics (Mues et al., 1996) found that 39% of broad-acre farms undertook landcare-related activities for which they generally claimed a

deduction either under normal operating expenses or under section 387-55.

Well-targeted tax incentives may have a greater effect on the behaviour of landholders than grants of an equivalent size for the following reasons.

- There are high transaction costs and considerable uncertainties associated with applying for grants, which will discourage landholders.
- There are information failures in terms of landholders becoming aware of government programs. The attractiveness of using the tax system to provide incentives lies in the fact that the tax system is, by definition, accessed by all landholders. Most landholders get professional advice on tax from tax agents and, hence, knowledge of a tax incentive would reach most landholders. In contrast, grants processes will only reach those landholders who become aware of, and are able to access, government programs. This may create significant inequities in access, with wealthy or well-educated landholders better able to access grants. In short, the tax system uses an existing infrastructure, which is in turn used by all landholders, making it potentially an effective way to inform people about and market native vegetation management programs.
- Perhaps most importantly, tax incentives may be perceived as an entitlement in contrast to a grant that must be applied for. This is because making use of a tax incentive is at the discretion of the landholder, who decides when to access it. Hence, the landholder remains the decision maker. Unlike grants, tax provisions are guaranteed entitlements, not applications subject to regulatory discretion.

These factors are extremely important in securing behavioural change. It needs to be recalled that the incentives discussed in this paper do not cover the full costs of undertaking conservation activities. Landholders are required to make a significant private investment. Tax mechanisms are identified as an efficient cost-sharing mechanism, not as a means to offset all costs. Frey (1992) and Binning

and Young (1997) discuss the benefits of maintaining and reinforcing the motivation of landholders rather than 'crowding it out' through regulatory processes that reduce their autonomy.

Tax incentives may also encourage wealthy individuals to invest in nature conservation. It is an interesting question as to whether this is actually desirable. Some 'Pitt Street' farmers receive primary production concessions, while making a very modest contribution to primary production. It may be desirable to encourage wealthy investors to redirect their investment towards nature conservation, particularly in regions close to urban centres. Tax concessions for private nature reserves covered by a covenant could provide very strong incentives, in the same way as tax concessions for other philanthropic investments. Private investment in the protection of sites of high conservation value would be secured for a relatively modest public investment.

It is often argued that Australia does not have a strong philanthropic market. The tax arrangements and innovative programs of the United States, however, make philanthropy a 'good' investment there. Some innovative Australian conservation organisations, such as the Victorian Trust for Nature and the Australian Bush Heritage Fund, are beginning to use arrangements of this kind. They are, however, limited by existing tax arrangements. A number of innovative approaches being used in the United States are described in Box 1.

When to favour different mechanisms

There are situations where tax incentives may be preferred to outlay programs and vice versa.

- The strength of grant programs lies in their flexibility. They are best suited where there is a need for strong interaction and negotiation between the funding organisation and the grant recipient. This is particularly the case where large grants are made for undertaking conservation works on a regional scale.
- The strengths of tax programs lie in their accessibility and capacity to reinforce the motivations of landholders to privately invest in public goods. They are suited to situations

where incentives are used to share costs with a wide range of landholders. They are also a well-established mechanism for promoting philanthropic investment in public goods. Tax incentives will be strengthened when clear criteria, which can be efficiently administered and enforced, are established.

The central mechanism through which Commonwealth government assistance is available for nature conservation activities is the Natural Heritage Trust. A wide range of local, regional, State-wide and national projects for the protection and management of biodiversity through the protection of native vegetation are being funded under this grants program. These projects involve a wide range of activities. The tax incentives discussed in this paper are aimed at complementing these existing programs rather than replacing them.

Box 1: The potential of tax incentives: the experience of the United States Nature Conservancy

The Nature Conservancy is a United States-based non-profit organisation committed to the protection of sites of high conservation value. The conservancy is ranked 23rd of all charitable organisations in the United States and is the only conservation group within the top 100 charities.

Donations of all kinds are deductible and enjoy considerable tax advantages, especially related to United States capital gains tax. Some examples include:

- Gifts of shares, stock and property are deductible at their full market value and are exempt from capital gains tax.
- Life gift arrangements are available through which the conservancy gives a 5% or greater return for life, with the asset held by the conservancy upon death.
- Investment funds for stock and funds are managed by the conservancy.
- Bequests and retirement plans allow arrangements to be made for donations in the event of death.

3. Proposals to tighten existing deductions

Proposal 1: Removing incentives and/or tax concessions to clear indigenous native vegetation

The proposal

With the exception of regrowth or woody weed control, all expenditure on native vegetation clearance, including wetland drainage, should be treated as capital expenditure and not deducted as part of normal operating expenses.

The savings made through tightening these provisions could offset the cost of introducing specific targeted measures to encourage the retention of vegetation.

Priority

Low, because the proposal does not require any change to existing tax law. Further tightening of administrative arrangements would be complex and might have unintentional adverse impacts on landholders.

Rationale

There are two possible rationales for this recommendation:

- that clearing of indigenous native vegetation should not be considered a deductible outgoing because clearing is of a capital nature⁵ (that is, clearing of native vegetation involves turning a non-income-earning asset into an income-earning asset); or
- as clearing of indigenous native vegetation is socially or environmentally undesirable, mechanisms should be put in place to ensure that this is not encouraged through the tax system.

Existing tax arrangements

Current tax arrangements are consistent with the proposal that land clearing should be treated as a capital expense and hence should not be deductible as a normal operating expense.

Incentives for land clearing were removed in 1983 when deductions under s75A of the *Income Tax Assessment Act 1936* were abolished. Section 75A provided for a 10-year write-off of costs associated with, inter alia:

- destruction and removal of timber, scrub or undergrowth indigenous to the land;
- preparation of the land for agriculture;
- ploughing and grassing the land for grazing purposes; and
- the draining of swamp or low-lying lands where that operation improves the agricultural or grazing value of the land.

These former provisions clearly allowed for the costs of clearing land to be deducted, albeit over a 10-year period.

However, it is still possible that a significant proportion of the costs of activities associated with land clearance may be deducted as a normal operating expense under section 8-1 of the Act.

Section 8-1 allows a deduction for all losses and outgoings to the extent to which they:

- are incurred in gaining or producing assessable income; or
- are necessarily incurred in carrying on a business for the purpose of gaining or producing such income.

Importantly, such deductions are not available for expenses that are of a capital, private or domestic nature. However, a deduction is available for repairs to capital under section 25-10, although the dividing line between a repair and a capital improvement is often difficult to draw. In general terms, a repair

5. Indigenous native vegetation is defined as that land which has never been cleared or improved and hence has always been covered by native vegetation.

involves the restoration of something to a condition it formally had, without changing its character. An improvement, on the other hand, results in substantial improvement of the asset concerned. The distinction is further blurred because consideration needs to be given to the state of the asset at the time of acquisition as this will also affect whether the action is considered an improvement or a repair (CCH Tax Editors, 1998).

These distinctions are important, because the clearing of native vegetation could generally be claimed as an outright deduction under section 25-10 if it is associated with the clearing of regrowth. However, clearing of indigenous native vegetation would be defined as a capital improvement and would not be deductible.

The capacity to claim a deduction for clearing regrowth is premised on maintaining or restoring an asset's productive capacity. For example, clearing of regrowth and re-establishment of pasture would generally be claimed as an outright deduction. Where a new owner cleared regrowth that was established at the time they purchased the land, it is less clear whether the cost would be deductible under current arrangements.

In addition to these provisions, the clearing of woody weeds is allowable as an outright deduction under section 387-55 of the *Income Tax Assessment Act 1997*, which allows for an outright deduction of expenditures incurred in 'an operation primarily and principally for the purpose of the destruction of weed or plant growth detrimental to the subject land'.

Hence, it is clear in law that vegetation clearance is a capital improvement and should be treated as such.

Clarification could, however, be sought from the Australian Taxation Office on how the clearing of regrowth should be treated when it has been re-established for a long period of time or when ownership of a property has changed hands.

Mechanisms for tightening administration

While no legislative changes are required to give effect to the proposal, the weakness of the existing arrangements relates to the interpretation and administration of the existing law for the following reasons.

- The costs associated with clearing small remnants of native vegetation are very difficult to identify as they may be hidden in normal operating expenses. This is particularly the case where owners use their own equipment to undertake clearing.
- The costs associated with broadscale clearing may be more easily captured within landholder accounts. The difficulty here is dependent on demonstrating that indigenous vegetation, rather than regrowth, has been cleared. While in the case of native forests this may be a relatively straightforward task, it becomes much more complex when considering grassland and temperate woodland ecosystems where the dividing lines between 'native' and 'improved' pasture are more difficult to define and observe.

To ensure that costs associated with clearing native vegetation are not incorrectly deducted, the following information would need to be available to the Australian Taxation Office.

Advice on clearing of indigenous native vegetation:

Advice of when indigenous native vegetation, as opposed to regrowth, is cleared and of the name of the owner of the land would need to be available. In States and Territories where vegetation-clearing controls are in place, the department or agency responsible for issuing clearing permits to the Australian Taxation Office could provide advice. Alternatively, in jurisdictions where land clearance is regularly monitored through aerial photograph interpretation techniques, advice could be provided on areas cleared between surveys, although this process is only likely to identify the clearing of trees and large shrubs.

Costs of clearing: Where native vegetation clearing is undertaken using on-farm machinery and labour, these costs will be very difficult to differentiate from other operating expenses. However, where contract labour and/or machinery has been used these expenses will be separately accounted for and therefore readily identified.

A further impediment lies in the self-assessment basis of Australia's tax system. Hence, landholders would need to be audited before any inappropriate deductions associated with clearing native vegetation could be identified. A coincidence of a tax audit and information on clearing activities and the costs of that clearing would be required to identify inappropriate deductions. In the past, this meant it would have been difficult to target vegetation clearing for auditing purposes (CCH Tax Editors, 1998). With the introduction of clearing controls in most States, however, it is now possible to audit compliance at relatively low costs.

Policy options

Policy options include:

- 1a The Australian Taxation Office could issue a ruling that clarifies:
 - that clearing of indigenous native vegetation is not an allowable deduction under section 8-1 of the Act;
 - the situations under which clearing of regrowth may be deducted under section 25-10; and
 - the treatment of clearing of regrowth on newly acquired land.
- 1b Increased effort could be made in auditing landholder costs by checking tax returns against applications for clearing permits to ensure that costs associated with this measure are not being claimed as an outright deduction in the year of expenditure.

Behavioural impacts and revenue implications

A number of factors will affect the response of landholders to any tightening of the administration of tax arrangements relating to the clearing of native vegetation, including:

- the rate of clearance of native vegetation, including the ability of landholders to clear land under State and Territory legislation;
- the extent to which landholders are inappropriately claiming an outright deduction for the costs associated with clearing (it should be noted that in Queensland up to three-quarters of the total clearing of native vegetation is claimed to be regrowth);
- landholders' assessment of the risks and costs associated with incorrectly claiming an outright deduction under self-assessment; and
- the significance of the difference between the costs of depreciating expenditure associated with land clearing as opposed to claiming an outright deduction.

Based on existing evidence, the most significant factor affecting the scale of land clearing in Australia is the presence or absence of broadscale clearing controls in each State and Territory. The status of legislation that effectively regulates the clearance of native vegetation varies among States and Territories, ranging from well-established tight controls in South Australia to minimal regulation in Tasmania. Legislative controls and estimates of the current rate of clearing of native vegetation in each State and Territory are summarised in Table 3.1.⁶

6. Estimates of the rate of woodland clearing are from the National Greenhouse Gas Inventory Committee (1997 and 1998). The estimates include clearing of regrowth and exclude clearing of native grasslands, which in some jurisdictions may affect these estimates. For a comprehensive analysis of legislative controls, see Cripps et al. (1998).

Table 3.1: Current legislative restrictions on clearance of native vegetation

State or Territory	Legislative controls	Estimated hectares cleared per annum
Tasmania	Minimal controls through Forests Code of Practice and local government planning schemes.	4000
Victoria	Broadscale control through vegetation overlay of the planning provisions of the <i>Planning and Environment Act 1987</i> .	1828
South Australia	Broadscale controls through the <i>Native Vegetation Act 1991</i> .	Negligible
Western Australia	Broadscale controls in agricultural regions through a Memorandum of Understanding between the Commissioner for Soil and Land Conservation, Environmental Protection Authority, Department of Environmental Protection, Agriculture Western Australia, Department of Conservation and Land Management and the Water and Rivers Commission.	6917
Queensland	Regulation of leasehold land through a permit system. No control on freehold land except where local government controls exist.	262 000
New South Wales	Broadscale clearing controls in place since 1995, with recent introduction of controls under the <i>Native Vegetation Conservation Act 1997</i> .	54 874
Australian Capital Territory	Tight controls implemented via controls on lease conditions.	Negligible
Northern Territory	Some controls implemented via controls on lease conditions.	Negligible

Table 3.1 shows the strong correlation between the introduction of legislative controls and the rate of clearing in each State and Territory. The potential exception to this rule, New South Wales, has only recently introduced legislation, which is still in the process of being implemented across the State. It is also important to note that not all native vegetation clearance is undesirable or inappropriate. The general legislative approach is to set guidelines against which applications for clearing native vegetation can be assessed.

Legislation that regulates vegetation clearance would appear to have significantly reduced clearing rates in all States and Territories where it has been introduced. Further, regulation can be targeted to take account of situations where clearing is appropriate or desirable. As a result, legislative controls should be considered as the most appropriate and effective mechanism for regulating broadscale clearing of native vegetation.

The behavioural effects of tightening the administration of tax deductions relating to clearing are difficult to quantify, as data are not available in relation to many of the factors that will influence landholder behaviour. An exploratory audit of landholders who were issued clearing permits

would yield estimates of the degree to which inappropriate deductions are being made. The issue is essentially one of principle, in ensuring that landholders are unable to make a decision to clear indigenous native vegetation solely on the basis of the extent of tax incentives.

In considering this proposal, decision makers will also have to take into account the potentially negative impact on landholder attitudes of linking clearing permits to tax audits. A backlash from rural landholders who are following regulatory processes can be envisaged. Indeed, a strong signal may be given to landholders to attempt to bypass the regulatory approvals process to avoid the risk of a future tax audit.

Due to the negative signal created and the administrative complexity involved, implementation of this proposal is not favoured.

Proposal 2: Tightening the definitions of sections 387-55 and 387-130

The proposal

Tighten the definition of landcare activities in sections 387-55 and 387-130 of the *Income Tax Assessment Act 1997* to better reflect landcare values.⁷

Rationale

The tax incentives contained in sections 387-55 and 387-130 are often criticised for being poorly targeted. It is alleged that a significant proportion of normal business expenses, such as fencing, are being claimed as expenses necessary to care for the land. To minimise the potential for inappropriate claims, it is suggested that the definitions of eligible expenditure be tightened under both these sections of the Act.

The benefits of tightening the definitions would be related primarily to improved environmental outcomes through more effective targeting of the measures. Performance against equity and tax neutrality benchmarks may also be marginally enhanced.

Priority

Low, because the tightening of existing landcare provisions would result in only modest savings to tax revenue and would potentially have a negative impact on the uptake of landcare incentives by landholders.

Existing tax arrangements

Sections 387-130 and 387-55 allow for the following deductions to be made.

Section 387-130 – Facilities to conserve or convey water

Section 387-130 allows a deduction for facilities to conserve or convey water.

Capital expenditure on a water facility that is primarily and principally for conserving or conveying water for use in a primary production business in Australia is deductible. The deduction is spread over three years.

Section 387-55 – Landcare-related provisions

Expenditure on the following operations qualifies for deduction under section 387-55:

- (a) the eradication or extermination of animal or vegetable pests from the land;
- (b) the destruction of weed or plant growth detrimental to the land;
- (c) preventing or combating land degradation, otherwise than by erection of fences on the land ('land degradation' includes not only soil erosion but also other effects detrimental to the land, such as decline of soil fertility or structure, degradation of natural vegetation, deposits of eroded material or salinisation);
- (d) the erection of fences (including any alteration, extension or addition to fences) on the land to exclude livestock or vermin from areas affected by land degradation (see above) in order to prevent any aggravation of degradation in those areas and to assist in the reclamation of those areas;
- (e) the erection of fences (including any extension, alteration or addition to fences) to prevent land degradation where the fences separate different land classes and are erected in accordance with an approved land management plan in respect of the whole or part of the land;
- (f) the construction on the land of levee banks or similar improvements having like uses;
- (g) the construction on the land of surface drainage works or sub-surface drainage works for the purpose of controlling salinity or assisting in drainage control (this would include, for example, the sinking of drainage bores and the laying of surface or sub-surface piping in the

7. Formerly, sections 75B and D of the *Income Tax Assessment Act 1936*.

course of constructing floodwater drainage work (Taxation Ruling T/R 351) – however, the drainage of swamp or low-lying land is not included).

Note that an approved land management plan must have been prepared or approved by an authorised officer of a State or Territory government department or authority responsible for land conservation or by an approved farm consultant and show:

- the land classes;
- the location of fences necessary to separate land classes to prevent land degradation; and
- the kind of fencing and how it would prevent land degradation.

More recently, a choice of a 34% rebate has been introduced to improve the access of low-income earners. The rebate is available for a maximum of \$5000 expenditure in any given year (CCH Tax Editors, 1998).

Mechanisms for tightening administration of existing arrangements

Tightening the administration of the landcare-related deductions could be achieved by either:

- tightening the definitions of eligible activities; or
- tightening eligibility criteria for landholders.

Discussion of the definition of eligible activities

The drafting of the existing deductions for the costs of conserving and conveying water in section 387-130 are of a general nature and not specifically targeted to landcare activities. Water management activities that are principally of a landcare focus would appear to be covered under paragraphs (c) or (f) of section 387-55. Hence, section 387-130 would appear to be targeted at a broader range of objectives relating to water management and farm productivity. A judgement relating to the scope of this section is beyond the scope of this study. Nevertheless the policy options identified below in

relation to section 387-55 could potentially be applied to this section of the Act to improve the targeting of its delivery.

The drafting of the provisions of section 387-55 is quite specific and it is difficult to envisage how the definitions could be tightened to leave little or no scope for activities that are not consistent with the landcare objectives. Actions related to conserving native vegetation are specifically addressed under the definition of land degradation under paragraphs (c) and (d). Hence, the solution would appear, once again, to lie in ensuring that these provisions are used appropriately through tax audit and compliance mechanisms.

An issue worth considering is that many landholders have claimed that section 387-55 cannot be used to protect native vegetation as this is not specifically addressed in the section, although degradation of native vegetation is included within the definition of land degradation. There may be a role for the Australian Taxation Office to clarify the interpretation of land degradation to ensure it includes measures taken to manage and conserve areas of native vegetation.

Proposals to tighten eligibility

Rather than amending the definitions of activities deductible under these sections of the Act, limits could be placed on how landholders can access the deductions. Two proposals are worthy of consideration:

- extending the requirement contained in paragraph (e) of section 387-55 by requiring that all claims under the section be undertaken in accordance with an approved property management plan (processes for gaining approval of property management plans would be based on existing arrangements); and/or
- eligibility could be made dependent on undertaking an accredited training course.

The intent of these suggestions is to improve the decision-making and on-ground practices of landholders rather than restricting the range of activities permitted under the Act. We would favour the first option because the second would tend to

exclude well-informed landholders who are unable or unwilling to participate in community-based activities. Anecdotal evidence suggests a significant proportion of Australian farmers can be characterised in this way.

Policy options

- 2a Extend the requirement contained in paragraph (e) of section 387-55, that activities must only be undertaken in accordance with an approved property management plan, to all eligible activities under sections 387-55 and 387-130.
- 2b The Australian Taxation Office could clarify that measures relating to the protection and management of native vegetation are covered within the definition of land degradation contained in section 387-55.

Behavioural impacts and revenue implications

The behavioural implications of the proposals put forward in this section are likely to result in a modest saving to tax revenue. This is because the preparation and approval of a property management plan imposes higher compliance costs on landholders. The benefit is that expenses deducted under sections 387-55 and 387-130 should be more effectively targeted at meeting their objectives.

The Australian Bureau of Agricultural and Resource Economics (Mues et al., 1996) estimated the behavioural impact of the introduction of sections 75B and 75D, now sections 387-55 and 387-130, of the Act.⁸ Key findings of the study included:

- 39% of farms have landcare-related expenditures that could have been claimed under sections 75B and 75D;
- average expenditure on landcare related expenses was \$3487, although the study excluded expenses related to the fencing of riparian vegetation and the conservation of remnant vegetation;

- only 28% of farms with landcare expenditure intended to make a claim under sections 75B and 75D (10.92% of all farms) (because expenditures on items not of a capital nature, such as weed control, could be claimed as an outright deduction under section 51, now section 8-1, of the Act); and
- claims under sections 75B and 75D are generally for large capital investments that could not be deducted under section 51 and would typically have to be depreciated under section 54 of the Act.

For these reasons, the behavioural impacts of tightening eligibility to section 75B and section 75D are likely to be modest. Indeed the Australian Bureau of Agricultural and Resource Economics (Mues et al., 1996) concluded:

The current landcare provisions are offered at a relatively modest cost in terms of taxation revenue foregone. The present value of revenue foregone arising from claims under the provisions for expenditures in 1993–94 is estimated to be \$12.4 million – \$1.5 million for section 75B and \$10.9 million for section 75D. If intended claims, instead of total expenditures are used to represent claims under these provisions then the estimated value of taxation revenue foregone is around \$6.2 million. However, if the landcare provisions were removed and if individuals could have claimed some of these expenditures under other provisions, then all of these estimates of revenue foregone would be overestimates. For example, if the capital items could otherwise have been depreciated over six years then the present value of taxation revenue foregone as a result of claims under both provisions may be less than \$3 million.

The introduction of the 34% rebate from 1997–98 is likely to have an impact on this finding because landholders with low incomes, that is, less than \$20 700, will face strong incentives to claim all landcare expenditures under this provision as it will

8. The study was based on surveys of a sample of the 86 003 broadacre and dairy establishments in Australia that have an estimated value of agricultural operations in excess of \$22 500. This represents a subset of all agricultural enterprises which the Australian Bureau of Statistics estimates at 143 202.

yield an extra 14 cents in the dollar. Based on the Australian Bureau of Agricultural and Resource Economics study, this would be of benefit to approximately 60% of primary producers (Mues et al., 1996).

Hence the rebate, rather than proposals to tighten eligibility arrangements, is more likely to have a behavioural impact. However, this impact may be mitigated by the fact that lower-income earners may not have the excess income required to make these investments, and that landholders may prefer to continue to claim under the provisions outlined above rather than prepare a property management plan.

Requiring the development of an approved property management plan is likely to result in modest savings to revenue. We would expect smaller ongoing costs of management to be claimed under normal operating expenses until a larger investment that cannot be claimed under other provisions triggers the development of a property management plan. Given the Australian Bureau of Agricultural and Resource Economics' estimate that the overall cost of claims is less than \$3 million, it would be expected that savings would be less than \$1 million per annum.

The proposals put forward here are not so much targeted at changing the level of landcare expenditure but at seeking to ensure landcare investments are made in a manner that is of the greatest public benefit. The benefit of improved targeting would, however, have to be balanced against reduced participation by landholders who are willing to prepare a property management plan.

The proposal must also be considered in the context of other property management planning initiatives of governments. In particular, there is a danger that voluntary property management planning programs that are not linked to landcare funding may be undermined. The existing requirement for an approved land management plan is very limited and is largely in the hands of the State and Territory governments and not the Federal government. The cooperation and agreement of the States and Territories would be required.

For this reason, any attempt to tighten existing provisions must be carefully balanced against the potential for reduced landholder uptake of landcare incentives.

4. Using conservation covenants to target tax incentives

Introduction

This section of the paper assesses proposals for targeting tax incentives for the conservation of high conservation value sites.

A frequent criticism of tax incentives is that they are more difficult to target than outlays programs and, hence, may be an inefficient way of promoting the conservation of biodiversity by protecting native vegetation, particularly where the action required is site-specific.

A mechanism will need to be found to identify and target sites of high conservation value. Further, the mechanism chosen must be more cost-effective than an outlays program and, because of the longer-term nature of tax incentives, will require a significant commitment from government. These criteria may be met by tying eligibility to existing processes, such as entering a binding conservation covenant.

There are, however, constraints on the ability of the Commonwealth to target tax incentives. In particular, care needs to be taken so as not to discriminate among States and Territories, as outlined in s51(ii) and s99 of the Constitution:

s51. The Parliament shall, subject to this Constitution, have power to make laws for the peace, order, and good government of the Commonwealth with respect to [inter alia]:

...

(ii) Taxation; but so as not to discriminate between States or parts of States.

s99. The Commonwealth shall not, by any law or regulation of trade, commerce, or revenue, give preference to one State or any part thereof over another State or any part thereof.

This means that the tax incentives must be based on criteria that are not region, State or Territory based. Our understanding is that, as long as tax incentives are applied consistently, it should be possible to target incentives to areas of high conservation value. For example, it should be possible to provide an incentive for landholders to enter conservation covenants as long as the criteria for eligibility and the size of the incentive are consistent among States and Territories.

Fortunately, States and Territories are increasing the use of conservation covenants as a means to identify areas where a site's ecological values are of national significance (see Appendix A). This means that a cost-effective targeting mechanism is in place and identified in a manner that makes self-assessment possible.

Before turning to identify and discuss specific proposals for tax incentives, it is necessary to develop an overarching framework through which conservation covenants can be recognised. This issue is addressed in the first of the proposals discussed in this section.

Proposal 3: Recognising conservation covenants

Conservation covenants, which are entered voluntarily but are binding on title in perpetuity, are one of the most acceptable and cost-effective mechanisms for conserving sites of high conservation value on private lands (Binning and Young, 1997). However, there are no significant incentives for landholders to enter covenants of this type in Australia. Conversely, there are significant administrative, legal and personal costs associated with entering these arrangements. As a result, the uptake of covenants has, to date, been relatively slow.

Proposals for tax incentives need to be considered in the context of defining:

- criteria for establishing what sites of high conservation value are;
- criteria for eligibility, including defining conservation covenants and how these may be entered; and
- processes for monitoring, enforcement and ongoing management to ensure conservation values are maintained in the long term.

Defining high conservation value sites

Proposed criteria for sites to qualify as having high conservation value are set out below.

High conservation value sites are sites which:

- are registered on the National Estate;
- are nationally important Ramsar listed wetlands;
- provide for the conservation of endangered or vulnerable species and communities as defined under relevant Commonwealth and State Acts; or
- contain ecological communities or ecosystems that are reserved within the public reserve system.

Each of these criteria relates to policy processes to which all jurisdictions in Australia are committed. The first three criteria relate to lists of sites and species that are established in legislation and where there is a responsibility placed on jurisdictions to promote their conservation. The final criterion relates to the commitment by all governments to establish a national reserves system that is comprehensive, adequate and representative, based on guidelines agreed by the Australian and New Zealand Environment and Conservation Council (ANZECC, 1997).

The data required to identify sites are readily available for the first two criteria and for those individual species currently listed under endangered species legislation, or its equivalent, in each State and Territory.

Databases relating to the definition and spatial distribution of communities and ecosystems are less well developed. However, a simple test is available which would require the relevant conservation agency in each State or Territory to determine whether a proposed site would contribute to the conservation of an ecological community that is currently inadequately reserved within the public reserve system.

Defining conservation covenants to establish criteria for eligibility for incentives

In broad terms, a conservation covenant is a legally binding agreement between a landholder and a third party regarding the use and management of their land. Entry into conservation covenants is generally voluntary, but binding in perpetuity once entered. In the context of conservation, a covenant will exclude land uses that are incompatible with maintaining a site's conservation value and will put in place arrangements to ensure ongoing management.

It would appear reasonable that secure arrangements should be in place before significant incentives are offered to enter conservation agreements.

The following criteria are suggested as the basis for a covenant to be accepted:⁹

1. The covenant should be registered on the title to the land and be binding in perpetuity.
2. The covenant should cover land that is of high conservation value.
3. A management plan that meets agreed standards for sustaining conservation in the long term should be put in place.
4. The covenants should be entered after introduction of the tax incentive. However, all covenanted properties could be made eligible for incentives for ongoing management.

Organisations that are able to enter covenants that meet the above criteria could be registered as being accredited to negotiate covenants eligible for deductions. In administrative terms, the Commonwealth Minister for the Environment could add organisations meeting these criteria to the register of Environmental Organisations under section 30-260 to section 30-275 of the Act.

Binning and Young (1997) have reviewed the use of covenants for nature conservation in Australia. Nature conservation covenants in Australia have a specific statutory basis, are generally entered with the State Minister for conservation, are registered on title and are binding in perpetuity.

The status of organisations able to enter covenants within each State is outlined in Table A1 at Appendix A, which also summarises the number of agreements currently in place and incentives that are currently available for entering covenants.

It is important to note that all States have the legislative capacity to enter statutory conservation covenants. Not all States have active programs, although Western Australia and Tasmania are in the process of actively developing programs of this kind. Consideration would need to be given to how to incorporate leasehold land into the program so as not to discriminate between regions, particularly in

the Northern Territory and the Australian Capital Territory. In these cases, conditions equivalent to those contained in a covenant could be included in the lease conditions. A constraint on renewing leasehold conditions is that they may only be amended by the agreement of both parties or at the time of renewing leases.

Not all conservation covenants cover land that is of high conservation value. All agencies that currently manage covenanting programs have the capacity to assess the conservation value of sites. Covenanted sites not meeting the criteria for establishing high conservation value outlined above could be excluded, although consideration should be given to the benefits of maintaining the motivation of all landholders willing to undertake conservation activities in the public interest.

Sites of high conservation value are often quite small and do not cover the whole of a property. If incentives were to be well-targeted, the incentives would have to be restricted to that portion of a property covered by a covenant. This issue has been dealt with through an exemption from rates to covenanted land in the *NSW Local Government Act 1993*:

[Land exempt from rates includes:]

s555(1)(b1) subject to subsection (3), land that is the subject of a conservation agreement (within the meaning of the *National Parks and Wildlife Act 1974*),

s555(3) If land to which subsection (1)(b1) applies comprises part of a single parcel of land for rating purposes, that part is exempt from all rates. However, rates may be made and levied on the other part of that parcel proportionately.

Processes for monitoring, enforcement and ongoing management

All of the covenanting programs available in Australia include mechanisms for the monitoring,

9. Note that, because of the relatively low number of covenants involved, tax incentives could be made available to all covenants over the first five years of the program. This would then be reviewed after the initial period (see Appendix B for further information).

enforcement and ongoing management of land covered by a covenant.

Ongoing management of covenanted land is essential for the maintenance of conservation values. The Victorian Trust for Nature is perhaps the most advanced in this area. The trust employs a full-time land manager who provides advice and performs ongoing monitoring of key sites. The trust seeks a \$3000 contribution from the landholder towards the ongoing management of the site. The Australian Taxation Office could clarify that contributions of this kind would be deductible as a gift to a registered environmental organisation.

Policy option

- 3a Amend sections 30-260 to 30-275 of the *Income Tax Assessment Act 1997* to include criteria that allow the Minister for the Environment to register environmental organisations able to enter legally binding conservation covenants that are registered on title in perpetuity on a sub-list of the register of environmental organisations.

Proposal 4: Donation of a conservation covenant

The proposal

Donations of a conservation covenant over land of high conservation value should be tax deductible against taxable income. The deemed value of the donation would be the value of any decline in land value caused by the covenant less the value of any payment made. The donation would need to occur at the time the covenant was executed.

Priority

High, because a significant upfront incentive to conserve high conservation lands by entering covenants would be provided to landholders. However, the application of capital gains tax and a range of administrative issues would have to be clarified before the introduction of this tax incentive.

Rationale

By voluntarily entering a covenant, a landholder is essentially donating a part of their property right to land ownership to the covenanting organisation. Land ownership can be described as a bundle of property rights which place a range of entitlements and obligations on landholders. For example, under present laws, a landholder may or may not have an entitlement to clear vegetation, draw ground water, cultivate erodible soils and so on. A conservation covenant removes a number of land use entitlements and may place additional responsibilities on landholders.

For these reasons, the donation of a covenant has a value; a gift or donation has been made. From the perspective of tax neutrality and environmental impact, the gift of a covenant should be treated in the same way as other charitable gifts that are in the public interest.

Existing tax arrangements

There is currently no scope to deduct the value of a voluntary donation of a conservation covenant to a registered environmental body or government agency.

As far as we are aware, entering a conservation covenant will not affect tax arrangements relating to the land in any way. The only possible effect, consistent with the neutrality benchmark, is that, to the extent that entering a conservation covenant decreases or increases the value of a property purchased after 19 September 1985, the liability of the landholder to pay capital gains tax upon disposal of the land will be decreased or increased.

Capital gains tax provisions that relate to the creation of incorporeal assets, that is, a property right such as a restrictive covenant, are complex and difficult to interpret. Where a right is created and vested in another person section 160M(6) of the Act provides that an asset has been created, disposed of and acquired by another party. If no financial transaction takes place, no capital gain will arise, although costs associated with creating the right or covenant may be deductible in certain circumstances. If a money or other consideration has been paid, the parties will be deemed to have acquired or disposed of a capital asset for tax purposes (CCH Tax Editors, 1998).

Although s160M(6) applies to restrictive covenants, it is unclear of the provision's implications for conservation covenants, which are a form of restrictive covenant although they have a separate statutory basis. If no payment is made, the transaction would be considered neutral from a capital gains perspective and any capital loss would be accounted for through diminished sale price and, hence, reduced liability for capital gains tax at the time of sale of the affected property.

If incentives are paid for the covenant, however, the situation becomes unclear. Tax rulings relating to payment for restrictive covenants to date have focused on business transactions which bear little relation to the situation where a conservation covenant is entered (see Taxation Ruling TR95/3). However, it is possible that incentives paid for entering a conservation covenant may be subject to capital gains tax. Alternatively, losses associated with gifting a covenant could also be interpreted to result in a capital loss. If this provision were to be used, care would need to be taken that 'double dipping' would not occur between claims at the

time of entering a covenant and claims at the time of selling the property.

We are not aware of s160M(6) being used in relation to any existing conservation covenant. Clarification on this issue could be sought from the Australian Taxation Office.

Approaches to administration

Division 30 of the *Income Tax Assessment Act 1997* could be amended to allow gifts of conservation covenants to be deductible from income in a manner consistent with deductions available for other gifts (see the discussion relating to the donation of land). Alternatively, as discussed above, a capital loss could be attributed to the transaction under s160M(6).

For the donation of a covenant to be deductible, the value of the covenant would need to be determined. This task of valuation could be approached in two ways.

1. The reduction in land value resulting from entering the covenant could be assessed. If this approach was chosen, consideration would need to be given to:
 - whether existing land use restrictions, particularly native vegetation clearing controls, are to be taken into account; and
 - whether the market, unimproved, or other value of the land should be used as the basis for calculating loss of value.
2. The value of the deduction could be based on the value of the covenant to the community, consistent with cost-sharing arrangements based on the beneficiaries-pays principle, which attributes costs on the basis of the benefit derived by the different parties to an agreement. In this case, the value of the covenant to the Australian community would be valued and used as the basis for the deduction.

From the perspective of tax neutrality, the first approach may be favoured as a more equitable

approach because it reflects the real financial size of the gift being made by the landholder. The donation would be defined as occurring at the time the covenant is created. Adoption of this approach would simply bring forward deductions that would result from capital losses at the time the property was sold (see below).

On the other hand, under an environmental benchmark, the need to provide incentives for ongoing stewardship would provide a strong case for the calculation of deductions on the basis of the beneficiaries-pays principle. In this case, the public benefit associated with conserving the site would be allowed as the deduction. Given that this is presumably the highest valued use of the land, this would be broadly equivalent to the land's full market value. Alternatively, a fixed proportion of the land's market value could be allowed as a deduction. The choice of value is somewhat arbitrary and is related to the size of the incentives governments are seeking to create. This issue is discussed in further detail below.

From a pragmatic viewpoint, consideration needs to be given to the size of the incentive provided. There is considerable evidence from recent studies that the presence of native vegetation on land does not have any significant quantifiable effect on the land value.¹⁰ This result suggests that entering a conservation covenant might be unlikely to have a significant effect on land values. Indeed, anecdotal evidence suggests that in some circumstances the market value of the property may rise, giving rise to a capital gain on which tax would be paid.

On balance, we favour the use of the first approach, as using the change in market value is more consistent with existing tax policy. We note, however, that an approach based on a fixed proportion of the land's value is likely to provide a more effective and administratively simple tax incentive.

An additional issue that needs consideration is the treatment of conservation covenants in relation to capital gains tax. Table 4.1 sets out an hypothetical

10. Recent studies by Walpole, S et al. (1998) in New South Wales and Victoria have found that the presence of native vegetation on properties has a minimal impact on their resale value.

situation through which options for capital gains treatment can be considered.

Table 4.1: Scenario of \$20 000 conservation covenant¹¹

Year	Value without covenant	Value with covenant
Year of purchase	\$100 000	(a)
Year covenant entered	\$150 000	\$130 000
Year of sale	(b)	\$200 000

- (a) The value of this figure is unknown, because assumptions of the value of the covenant in the year of original purchase would be required.
- (b) The value of this figure is unknown, because assumptions about the market value of the land without the covenant on it would have to be made.

In Table 4.1, two alternative approaches to calculating the capital gains on the property following sale of the land with covenant could be taken.

1. A capital gain of \$200 000 minus (a) would be calculated if entering a covenant was deemed to have changed the value of the asset.
2. A capital gain of \$100 000 would be calculated as if the covenant had not changed the value of the value of the asset for the purposes of calculating capital gains tax.

If the deduction associated with donating a conservation covenant is based on market value, the first method of calculating the capital gain would be used. In this case, the deduction allowed at the time of donating the covenant simply moves forward the point at which capital gains or losses are calculated, resulting in considerable administrative costs in relation to separating the value of the covenant from the other values of the land.

If, on the other hand, the deduction were considered an incentive payment, the second approach to calculating capital gains would be more pragmatic and reflect that the original deduction

was not directly related to the capital value of the asset.

Policy options

- 4a Landholders with covenants entered with an environmental organisation registered under policy option 3a could be allowed to deduct the value of the donation covenant under Division 30 of the Act.¹² The value would be determined by an independent assessment by a qualified valuer of the change in land value caused by the covenant, net of any direct payments received as compensation.
- 4b The Australian Taxation Office could clarify that arrangements for the creation and disposal of conservation covenants would be deemed to have a neutral impact on capital gains tax.

Costs to revenue

Estimates are not available of the change that entering a conservation covenant has on the market value of land. Accurate measures of the costs of the policy proposals would require valuation of a sample of existing covenants to estimate what the average loss of value is likely to be.

In an attempt to provide some preliminary estimates, Tables 4.2 and 4.3 set out the costs of providing a deduction on a fixed proportion of the full market value of land against each marginal tax rate. The estimates are based on land values between the median and average value of covenants negotiated by the Victorian Trust for Nature between 1992 and 1995, that is, \$38 650 and \$94 866 respectively. Most of the covenants signed by this Trust are over small areas of land near urban and coastal areas where land prices are relatively high.

11. All values are in constant real dollar terms, that is, indexed at the rate of inflation to the year of disposal.

12. Alternatively, s160M(6) could be used to deem that donating a covenant does result in the creation and disposal of an asset resulting in capital gains or losses to be calculated at the time of donation.

Table 4.2: Estimated cost to tax revenue of making donations of conservation covenants tax deductible based on average values in the range \$38 650 to \$94 886

Deduction as a percentage of land value	Allowable deductions	Cost to revenue by marginal tax rate ^a			
		21.50%	35.50%	44.50%	48.50%
20%	\$7730 – \$18 977	\$1662 – \$4080	\$2744 – \$6737	\$3439 – \$8445	\$3749 – \$9204
33%	\$12 755 – \$31 312	\$2742 – \$6732	\$4527 – \$11 115	\$5675 – \$13 934	\$6185 – \$15 186
55%	\$21 257 – \$52 187	\$4570 – \$11 220	\$7546 – \$18 526	\$9459 – \$23 223	\$10 309 – \$25 310
66%	\$25 509 – \$62 624	\$5484 – \$13 464	\$9055 – \$22 231	\$11 351 – \$27 868	\$12 371 – \$30 373
100%	\$38 650 – \$94 886	\$8309 – \$20 400	\$13 720 – \$33 684	\$17 199 – \$42 224	\$18 745 – \$46 019

a. A Medicare levy of 1.5% has been added to each of the marginal rates although the thresholds and rates of levy are different from those for income.

Table 4.3: Estimated cost to tax revenue of allowing deductions of donations of conservation covenants based on average land values of \$38 650 to \$94 886

Year	Number of agreements	20% deduction at a marginal tax rate of 40%	100% deduction at a marginal tax rate of 40%
1	50	\$154 600 – \$379 544	\$773 000 – \$1 897 700
2	127	\$392 684 – \$964 041	\$1 963 420 – \$4 820 158
3	205	\$633 860 – \$1 556 130	\$3 169 300 – \$7 780 570
4	282	\$871 944 – \$2 140 628	\$4 359 720 – \$10 703 028
5	360	\$1 113 120 – \$2 732 717	\$5 565 600 – \$13 663 440
Total	1024	\$3 166 208 – \$7 773 061	\$15 831 040 – \$38 864 896

Table 4.3 explores the total revenue implications of this option, assuming either 20% or 100% of the value of the land is made deductible and an average marginal tax rate of 40%. The costings are based on the assumptions set out in Appendix B. Fifty agreements are signed in the first year. This increases to 360 agreements per year in five years.¹³

The results in the table reflect a very wide range of values, depending on the options chosen and the basis for valuing land.

If it is assumed that:

- average land values are \$94 886, reflecting that a number of very valuable covenants will need to be negotiated from time to time to keep the average value of a covenant in the order of two-and-a-half times the median of \$38 650;

- a deduction of 20% of the market value of the land is assessed; and
- the average marginal income tax rate is 40% among people interested in making such a donation,

then tax revenue would decline by approximately \$18 977 per agreement. This would mean that the total cost of the program would start at \$1 million in the first year and rise to \$2.7 million per annum after five years, at a total cost of approximately \$7.5 million over the five-year period.

The uncertainty surrounding the effect on land values of entering conservation covenants must be taken into account in considering this scenario. However, it is interesting to note that these costings suggest that a deduction of 20% of the land value would provide a significant incentive to

13. Note that these costings are based on a significant increase in the uptake of conservation agreements. Hence it is assumed that registered environmental organisations and government departments have greater success in negotiating covenants as a result of the incentive offered.

landholders. Further, a deduction of 100% of the land value should be considered improbable as it is likely land subject to a conservation agreement will retain much of its original land value.

As discussed above, an alternative approach would be to allow deductions of a fixed proportion, say 20%, of the land value as a direct incentive to entering conservation covenants. Such an approach would overcome many of the administrative difficulties associated with costing the loss in land value associated with entering a conservation covenant.

Proposal 5: Deduction of costs associated with ongoing management of conservation covenants

The proposal

Maintenance costs associated with land protected by a conservation covenant should be eligible for deductions under the land degradation provisions of the Act, irrespective of the status of the taxpayer.

Priority

Very high, because significant incentives can be provided for the ongoing management of covenanted properties at a low cost to tax revenue.

Rationale

If the conservation value of high conservation value sites is to be sustained in the long term, incentives that maintain the motivation of landholders will be required (Binning and Young, 1997).

The proposal advocates that, on the grounds of tax neutrality, land protected by a covenant should be able to be managed at a cost similar to land used for primary production. From a benchmark of environmental impact, the public interest in securing quality management of sites of high conservation value is likely to be greater than that in land used for undertaking a business. Hence against this benchmark, special incentives available to primary producers, such as landcare provisions, should be made available to landholders managing for conservation.

Existing tax arrangements

Individuals carrying out a business on their land, including primary producers, are currently able to deduct costs associated with the management of their land in the year of expenditure. Direct deductions of this kind are not available to other landholders.

Primary producers also have access to a number of special provisions, such as section 387-55, that allow for upfront deduction of landcare works. These special incentives are also available to other

businesses undertaking works on rural land. However, land that is managed for conservation does not have access to these provisions.

People who own land as a capital asset for non-personal use, including land that is purchased and managed for conservation, are, however, able to add the costs of both a capital and non-capital nature to the cost-base of the asset. The cost base of an asset is indexed and deducted from the sale price of the asset upon its disposal for capital gains tax purposes. This means that all reasonable costs of management, including the costs of interest payments on the purchase of land, can be added to the cost base of the land and deducted from any capital gain or loss at the time of sale of the property.

The essential difference between land that is managed for conservation and land that is managed as part of a business, including land managed for primary production, is the timing of any allowable deduction plus the risks and cash flow implications of delay. Land managed for conservation is penalised to the extent that an upfront deduction is not allowed. Whilst the net present value of the tax deductions may be approximately equivalent, it is not on this basis that many landholders make a decision to invest in landcare works. A stronger signal to undertake conservation works is provided to individuals who undertake a business on their land for a number reasons:

- The provisions allowing expenses to be added to the cost base of land are of no benefit to landholders who purchased land prior to 19 September 1985 when capital gains tax was introduced.
- Landholders managing for conservation who have significant off-farm income may seek to invest in land to minimise taxable income in the immediate term.
- While the cost base of capital assets is indexed, individuals may use a higher discount rate in evaluating the cost of forgone income, particularly where there is no intention to sell the land.

Approaches to administration

Deductions against income could be provided for costs associated with ownership and management of land covered by a conservation covenant. The deductions and incentives that are available to primary producers can be broadly classified into two categories (CCH Tax Editors, 1998):

- deductions associated with the carrying on of a business, for example, the deduction of interest payments associated with land ownership under section 8-1 of the *Income Tax Assessment Act 1997*; and
- special incentives made available specifically to primary producers, such as deductions for landcare activities under section 387-55 of the Act.

Under the first approach, owners of land covered by a conservation covenant could be given primary producer status and, hence, have access to the full range of incentives available to primary producers. This approach would ensure all high conservation sites are subject to the same tax arrangements. However, such an approach would conflict with a core principle of tax policy: that only *bona fide* income-earning businesses should be eligible for business deductions.

Alternatively, consistent with the second category, landholders could be given access to a smaller range of special incentives of the kind only available to primary producers; in particular, those relating to the ongoing costs associated with land management, such as deductions for landcare-related expenses.

While the first option would undoubtedly provide strong incentives for nature conservation and could be justified on the grounds of public benefit, it is difficult to see how the conflict with tax policy could be reconciled. The following options could be considered:

1. **Minimalist option** – extend the provisions for outright deduction or the 34% rebate of landcare-related expenses to properties covered by a conservation covenant.

2. **Moderate option** – minimalist option plus deductions of interest payments associated with loans for the purchase of land covered by a nature conservation covenant; this would provide a strong incentive for initial investment in high conservation value land.

3. **Primary producer option** – give landholders who enter a nature conservation covenant primary producer status by amending section 995-1 of the *Income Tax Assessment Act 1997*.

Once again, a balance must be struck between maintaining the principles of tax policy and providing an adequate incentive. A strong case, both in terms of equality of treatment and environmental outcomes, can justify the minimalist option. Consideration could be given to adopting the moderate option or primary producer option on the basis of public benefit.

Policy options

- 5a Section 387-55 of the Act, which allows landholders to claim a 34% rebate or deduction for landcare works, could be extended to sites covered by a conservation covenant.
- 5b Interest payments associated with loans for the purchase of land covered by a conservation covenant could be made deductible against income. This would require a special provision within the Act.

Costs to revenue

Costs for each of the options are discussed below. It should be noted that these costs reflect the full upfront cost of shifting expenses from the capital cost base of land to the income of the landholder. The net impact on revenue should be close to neutral because deductions allowed under the proposed policy options could ultimately be included in the cost base of the land and deducted from a capital gain or loss at the time of disposal. As discussed, the net effect is to move the deduction forward and thereby give landholders an incentive to undertake works independently of their decision of when to sell the land.

The upfront costs to revenue of giving covenanted properties access to landcare deductions under section 387-55 are set out against different marginal income tax rates in Tables 4.4 and 4.5 based on the following assumptions:¹⁴

- Uptake of the incentives is consistent with the scenario developed in Appendix B, that is, in the first year, 50 covenants are negotiated, increasing to 360 per annum after five years.
- Deductions lie in the range of \$2821 (that is, the average section 75D claim found by Mues et al. (1996)) to \$5000, the maximum deduction allowed under the new 34% rebate.
- 39% of properties covered by a covenant undertake management activities in any given year, consistent with findings by Mues et al. (1996).

- 50% of covenants are negotiated on properties used for primary production and, hence, there is no loss to revenue.
- All existing and new covenants have access to the incentive.
- There are currently approximately 1331 covenant agreements in Australia.

These estimates are surprisingly modest compared with alternative arrangements. Assuming an average 40% marginal income tax rate or rebate, they lie in the range of \$500 000 to \$1 million per annum after five years of operation.

As these costs are recurrent, it is important to consider costs in outlying years. If the rate of negotiating new covenants after the fifth year continues at 360 agreements per year, costs will double in the 13th year when 4875 agreements will have been negotiated.

Table 4.4: Estimated revenue loss based on an average claim of \$2821

Year	Number of Agreements	34.00%	35.50%	44.50%	48.50%
1	1381	\$258 292	\$269 687	\$338 058	\$368 445
2	1508	\$282 045	\$294 488	\$369 147	\$402 329
3	1713	\$320 386	\$334 521	\$419 329	\$457 022
4	1995	\$373 129	\$389 591	\$488 361	\$532 258
5	2355	\$440 461	\$459 893	\$576 486	\$628 305

Table 4.5: Estimated revenue loss based on an average claim of \$5000

Year	Number of agreements	34.00%	35.50%	44.50%	48.50%
1	1381	\$457 802	\$477 999	\$599 181	\$653 040
2	1508	\$499 902	\$521 957	\$654 284	\$713 096
3	1713	\$567 860	\$592 912	\$743 228	\$810 035
4	1995	\$661 343	\$690 519	\$865 581	\$943 386
5	2355	\$780 683	\$815 124	\$1 021 776	\$1 113 621

14. Note that 34% is used as the minimum return based on the 34 cent rebate that now applies to landcare expenditure.

Table 4.6: Costs to revenue based on allowing deductions of interest payments

Year	Number of agreements	33% of landholders negatively gear	50% of landholders negatively gear	100% of landholders negatively gear
1	50	\$366 861	\$555 850	\$1 111 700
2	127	\$931 827	\$1 411 859	\$2 823 718
3	205	\$1 504 130	\$2 278 985	\$4 557 970
4	282	\$2 069 096	\$3 134 994	\$6 269 988
5	360	\$2 641 399	\$4 002 120	\$8 004 240

These figures are based on the best available data.

Greatest uncertainty surrounds:

- the number of agreements that will be negotiated, although the figure of negotiating 360 per annum per year is ambitious and represents a high estimate;
- the assumption that only 39% of landholders claim in any given year, based on ABARE estimates (if all landholders claim, costs would rise to between \$1 300 000 and \$2 700 000 in the fifth year of the program); and
- the assumption that 50% of agreements are with primary producers and hence have no effect on revenue.

The costs associated with allowing deductibility of interest payments associated with loans for the purchase of land are set out in Table 4.6 based on the following assumptions:

- Only new agreements have access to the scheme and, consistent with the scenario being used for costings, 1024 agreements are negotiated in the next five years.
- 100% of the funds are borrowed at the average value of \$94 886 of the Victorian Trust for Nature's covenants.
- Each loan has interest payments of \$55 585 associated with it over a period of 10 years at 10% per annum yielding a net present value of interest payments of \$38 512.¹⁵
- Deductions are made by people at an average marginal income tax rate of 40%.

15. Undiscounted values are used to derive the totals presented in the paper.

Proposal 6: 20% rebate for the management of covenanted sites of high conservation value

The proposal

The 20% rebate for work on structures on a prescribed heritage list could be extended to include approved works on areas of high conservation value that are covered by a conservation covenant.

Priority

This proposal is an alternative arrangement to Proposal 5 for the deduction of management costs. Proposal 5 is strongly favoured over this proposal, which is more administratively complex.

Rationale

Effectively, the proposal gives philanthropists an economic incentive to contribute to the maintenance of Australia's natural heritage, through the management of high conservation value sites, as well as its built heritage.

From the perspective of tax neutrality, it may be argued that natural and cultural heritage should be treated in an equitable manner. From the perspective of environmental impact, tax incentives for the ongoing management of high conservation sites can be justified on the grounds of public interest.

Existing tax arrangements

This proposal aims to extend the 20% rebate currently available for works on structures on a prescribed heritage register to high conservation sites covered by a conservation covenant under sections 159U to 159UY of the *Income Tax Assessment Act 1936* and administered by the Department of Communications and the Arts.¹⁶

Key features of the scheme as it applies to heritage buildings include:

- the owner must apply for the rebate before work commence for works of a minimum of \$5000 and a maximum of \$300 000;
- the applications are assessed by the Minister for Communications and the Arts, who will issue a provisional certificate to works that qualify for assistance;
- assistance is capped at \$1.9 million per year, meaning that only the most highly ranked applications receive funding in any given year;
- once the conservation works are completed, the owner applies for a final certificate; and
- if works are completed to a satisfactory standard, a final certificate is issued by the Minister, which can then be lodged with the owner's tax return to qualify for the rebate.

(CCH Tax Editors, 1998; Environment Australia pers. comm. July 1998).

Approaches to administration

The rebate could be put in place by extending the provisions of sections 159U to 159UY that relate to the rebate for heritage conservation works to high conservation value sites that are covered by a registered conservation covenant.

In addition to the processes for registering organisations and covenants put forward before, consideration would have to be given to options to:

- reduce the minimum payment for conservation works to below \$5000 (as noted previously, average landcare expenditure per property is well below this figure at \$2821);
- rank applications; and
- set a revenue cap (see below).

16. References to the Act in this section refer to the *Income Tax Assessment Act 1936* rather than the *Income Tax Assessment Act 1997*.

This scheme is less attractive than the proposal to give all covenant holders access to landcare provisions under section 387-55. The rebate is small relative to the 34 cent rebate currently available to all primary producers. Moreover, the approvals process associated with the rebate would be administratively complex. Environment Australia has estimated that a section of 3 to 4 people would be required to administer a scheme for sites of high conservation value.

The rebate has many of the characteristics of an outlays or grants program; for example, requiring ministerial approval on two separate occasions. The rationale for such close administration would appear to be that the department has a close interest in guiding works on sites with high conservation values. An example might be a Ramsar listed wetland in private ownership which would benefit from changes to drainage infrastructure.

The attraction of using covenants to determine eligibility for a rebate or deduction of conservation works is that it effectively removes the need for these administrative arrangements. This is because the organisation entering conservation covenants will be required to have processes in place for ensuring conservation values are sustained in the long term.

Finally, the revenue implications of the rebate for works on buildings and structures are quite high, with demand outstripping the revenue cap of approximately \$1.9 million. As discussed below, the revenue implications of incentives for covenants are likely to be significantly lower.

Policy option

- 6a Put in place similar mechanisms to sections 159U to 159UY of the *Income Tax Assessment Act 1936* that would allow a 20% rebate for approved work associated with the protection of high conservation value sites covered by a conservation covenant.

Costs to revenue

Costs to revenue are based on the assumptions used in Proposal 5 and are outlined in Table 4.7.

In summary, revenue losses in the range of \$250 000 to \$500 000 would be expected in the fifth year of the program if average landcare expenditures, based on Mues et al. (1996), are assumed. If the assumption that only 39% of properties claim in any given year is relaxed and it is assumed that 100% of properties claim in any year, then the cost to revenue would be approximately \$1 million per annum.

Table 4.7: Costs to revenue of 20% rebate on differing sized claims

Year	Total number of agreements	Claim: \$2821	Claim: \$5000	Claim: \$10 000
1	1381	\$151 936	\$269 295	\$538 590
2	1508	\$165 909	\$294 060	\$588 120
3	1713	\$188 463	\$334 035	\$668 070
4	1995	\$219 488	\$389 025	\$778 050
5	2355	\$259 095	\$459 225	\$918 450

5. Other proposals for targeted tax incentives

Proposal 7: Donations of land

The proposal

Donations of land to approved conservation organisations should be made tax deductible irrespective of the date the land was purchased.¹⁷

Priority

Very high, because a strong incentive to donate high conservation lands to charitable organisations would be provided. Implementation of the proposal is also administratively simple.

Rationale

There are two arguments for allowing donations of land to conservation organisations to be made tax deductible.

Firstly, sites of high conservation value could be made deductible if donated to an organisation committed to their management for nature conservation. In this way, gifts of high conservation value sites would be promoted.

Secondly, land is like any other asset and, if donated to a charitable organisation, should be deductible from income in the same way donations of money are deductible. After all a landholder could simply sell the land and make a monetary donation to the organisation.

Existing tax arrangements

Under Division 30 of the Act, a deduction from assessable income is available for gifts of \$2 or more made by an individual to an eligible organisation,

subject to the following conditions (CCH Tax Editors, 1998):

- the gift must not be made by will;
- each gift must be of \$2 or more either in money or in property other than money, for example, shares or land; and
- if property other than money is given, the property must have been purchased by the person making the gift not more than 12 months before the gift is made and the amount deductible is the lesser of the cost price of the property or its value at the time it is given.

The rationale of the 12-month rule relating to property other than money appears to be an attempt to prevent donors taking the opportunity to avoid capital gains tax by donating an asset that has accrued value while in their ownership.

Exceptions to the above general rules are provided for gifts of works of art to eligible bodies, gifts of national heritage properties to National Trust bodies, or gifts of trading stock (that is shares). In all of these cases, the deduction is based on the market value of the asset on the day of donation and the 12-month rule is relaxed (CCH Tax Editors, 1998).

Approaches to administration

Implementation of the proposal would appear to be fairly straightforward, requiring only those provisions relating to art works, property of national heritage significance or trading stock under section 30-15 of the Act to be extended to property. Effectively, the exception for all National Trust bodies in relation to donations of land would be extended to apply to any environmental organisation. To accommodate large donations, consideration could also be given to allowing the deduction to be claimed over a number of years.

17. In March 1999, the Prime Minister announced that from 1 July 1999 the government would give effect to this recommendation.

Consistent with the two rationales for allowing deductions for donations of land, two approaches could be adopted:

- Land that is assessed to be of high conservation value or national heritage value donated to a registered environmental organisation could be made tax deductible following a due application process. The Register of Environmental Organisations could include an expanded list of those organisations suitable to receive donations of land (see Appendix A).
- The 12-month rule relating to gifts other than money could be removed from Division 30 on the basis that donations of land are equivalent to donations of other kinds such as trading stock.

The first option would require these organisations to be registered by the Minister for the Environment in the same way as proposed for organisations receiving donations of covenants (see Proposal 3). Criteria for receiving donations of land could be:

- only land of high conservation value would be eligible; and
- the organisation would be required to demonstrate that it has the capacity to manage the site to maintain its value in perpetuity.¹⁸

The second option would only require a simple amendment to the Act.

Policy options

- 7a Make land that is assessed to be of high conservation value or national heritage value donated to a registered organisation tax deductible under section 30-15 of the *Income Tax Assessment Act 1997* irrespective of the date of purchase. Organisations would be registered in a similar way to that proposed in Proposal 4.
- 7b Remove the 12-month rule relating to gifts other than money from Division 30 of the Act on the basis that donation of land should be treated on the same basis as other donations.

Costs to revenue

Costings would be similar to those relating to a 100% deduction of the market value of a conservation covenant discussed under Proposal 4.

The cost to revenue of a \$94 886 land donation would be between \$20 400 and \$46 019, depending on the marginal income tax bracket of the donor. It should be borne in mind that the costs of this policy option are likely to be reduced because, in many cases, it can be expected that land donations will act as a substitute for other donations eligible for a tax deduction.

Estimates on the rates of land donation are not available, making a full costing of this proposal impossible.

18. The agreements developed for the recent inclusion of private lands in the National Reserves Program would provide a useful model to draw on in setting benchmarks for this criteria.

Proposal 8: Sales tax exemption for landcare groups

The proposal

Consistent with sales tax provisions available to primary producers, purchases of equipment for environmental maintenance by landcare and other similar groups should be exempt from sales tax.

Priority

Medium, because although this proposal is supported in principle, it provides tax benefits that are not available to other community groups.

Rationale

There are two possible rationales for this incentive:

- Landcare works justify an exemption on the basis of public benefit, in the same way that public authorities are exempt from sales tax.
- Under existing sales tax arrangements, primary producers are exempt from sales tax on inputs to production. Landcare groups are made up of members who carry on businesses of primary production and, in a number of cases, they buy equipment collectively as a means of preventing land degradation and improving landscape management. The tax neutrality and environmental improvement benchmarks would suggest that landcare groups and other similar organisations should have status equivalent to that of their members. Sales tax exemption for landcare groups would increase the incentive for them to purchase and pool plant and equipment for nature conservation.

Existing tax arrangements

There is currently no arrangement to provide landcare groups with an exemption from sales tax.

There are a range of mechanisms through which exemptions from sales tax may be provided to individuals and businesses. The most relevant of these is the ability of an individual or organisation to register for sales tax exemption under section 78 of the *Sales Tax Assessment Act 1992* if they 'do things that would satisfy the requirements of an

exemption [R] item' (items that are marked with an [R] in Schedule 1 of the *Sales Tax (Exemptions and Classifications) Act 1992*). The majority of business inputs are [R] items. To be eligible for an exemption, a registered individual would need to use the good mainly (more than 50%) as a business input. Once registered, an individual or organisation may claim an exemption from sales tax by quoting their sales tax registration number under sections 27 or 28 of the *Sales Tax Assessment Act 1992* (CCH Tax Editors, 1998).

There is, however, no precedent for giving sales tax exemptions to community groups similar to landcare groups.

Approaches to administration

It would appear that a simple change to the interpretation of section 75 of the *Sales Tax Assessment Act 1992* would allow landcare groups to qualify for an exemption from sales tax of business input [R] items. Consideration would need to be given to which activities of landcare groups would qualify.

Advice would need to be sought as to whether changing the interpretation of section 75 would require legislative change.

Policy option

- 8a Amend or change the interpretation of section 75 of the *Sales Tax Assessment Act 1992* to allow landcare groups to register from exemption of sales tax for business input [R] items.

Costs to revenue

It is expected that this provision would have minimal impact on tax revenue. Anecdotal evidence suggests that landcare groups generally work through organisations that have sales tax exemptions, such as local governments, to purchase equipment for on-ground works. Hence the benefits of the proposal result from landcare groups being able to directly access the exemption.

The case for this exemption is weakened by the fact that other similar community-based groups are not generally exempt from sales tax.

6. Summary and discussion of cost-effectiveness

A variety of policy options have been discussed in this report. This final section of the report provides an overview of the outcomes of the analyses in the previous sections. The cost-effectiveness of the various proposals in meeting conservation objectives is then discussed.

In Section 3, proposals to tighten existing deductions for clearing indigenous native vegetation and landcare works are discussed. Considerable difficulties are identified in tightening eligibility to these existing deductions. In broad terms, existing arrangements are appropriate and any issues with their implementation result from their administration. Further, it is expected that only modest savings could be achieved.

In Section 4, proposals to target tax incentives through conservation covenants are discussed. The

discussion of targeted tax incentives reveals three policy options which have the potential to act collectively to provide a strong incentive to landholders to enter conservation covenants. Table 6.1 summarises the proposals and their associated costs based on the scenario used in this report that 50 new covenants are negotiated in the first year rising to 360 in the fifth year of the program; that is, 1024 new conservation agreements are negotiated over a five-year time frame.¹⁹ The proposal to extend the 20% rebate for structures on a prescribed heritage list is not included in the table because the proposal to extend the 34% landcare rebate is preferred.

Finally, Section 5 of the report evaluates the potential to deduct donations of land to charitable organisations from income and provide sales tax exemptions to Landcare groups. These proposals are supported but detailed costings are not provided because there is expected to be a high rate of substitution from activities that already enjoy a tax deduction. As a result it could be expected that the revenue implications of these recommendations would be low.

Table 6.1: Costs of targeted incentives for 1024 agreements over five years

Policy options	Costs
4a. Make donations of conservation covenants tax deductible.	Based on 20% deduction of average land values and an average marginal tax rate of 40%: \$18 977 per agreement \$7.8 million for 1024 agreements.
5a. Give access to the 34% rebate or tax deduction for maintaining conservation covenants tax deductible under section 387-55.	Based on an average claim of \$5000 by 39% of landholders per annum at an average marginal tax rate of 40%: total of \$900 000 for first five years ^a \$400 000 per annum each year after five years.
5b. Allow interest payments associated with conservation covenants to be deducted.	Based on 50% of properties negatively gearing a loan for the average value of land (\$94 886) at an interest rate of 10%: \$11 383 808

a. This figure is different to that reported in the body of the report as it sums the per annum cost of the incentive over five years and excludes the 1331 pre-existing conservation covenants.

19. The sensitivity of these costings is discussed in the relevant section of the report. The background to the scenario developed for costings is outlined in Appendix B.

Based on the assumptions set out in Table 6.1, the cost of entering 1024 conservation covenants would be in the order of \$20 million with an ongoing annual cost of \$400 000 arising from deductions associated with management. If the proposal relating to interest payments is omitted, this cost falls significantly to approximately \$9 million. It should be noted that these costs are likely to be overestimated for the reasons outlined in Appendix B and because the deductions associated with management costs and interest payments are only brought forward from the cost base of the land's capital value.²⁰

A relevant question is the cost-effectiveness of tax incentives of this kind compared to alternative strategies for conservation. The average size of sites used for the costings developed in this paper is 27.92 hectares, thus 1024 covenants could be expected to cover in the order of 28 500 hectares of high conservation value land. The potential costs and benefits of alternative programs are discussed below.

- **Acquisition:** The cost of acquiring these sites is in the order of \$97 million, excluding any ongoing costs of management. Management of the sites at the same level used for costing tax incentives would be approximately \$4.5 million over the first five years and \$2 million in each subsequent year.
- **Regulation:** Development control regulations exist in most States and Territories to control the clearance of native vegetation. Where existing planning approvals exist, these controls may do little to protect high conservation value sites. Further, regulations do little in themselves to secure ongoing management of these sites. The presence of tax incentives may be seen as a 'carrot' that is complementary to the 'stick' of regulation.

- **Grants:** As discussed in Section 2, grant and tax incentive programs have different strengths and weaknesses. Grants of equivalent size to these tax incentives could be used to much the same effect as tax incentives. It is unlikely, however, that grants will be as effective at encouraging private investment in conservation lands.

It can be seen that the tax incentives identified in this report are much more cost-effective than the acquiring high conservation value sites, the traditional strategy of conservation agencies in Australia. The reason for this is that considerable private investment is still required from the landholder. Hence, the uptake of these tax incentives will critically depend on capturing the private benefits associated with conserving high conservation value sites.

Their fragmented nature makes many of Australia's most vulnerable ecological communities, particularly within coastal zones and agricultural heartlands, dependent on voluntary private conservation initiatives. Tax incentives could play a significant role in promoting the conservation of these communities by catalysing private investment.

20. This means that the same deductions are currently available at the time of disposing of the land.

Appendix A: Defining eligible environmental organisations

Table A1: Organisations that could receive donations of high conservation value land and/or covenants

State or Territory	Organisation	Donations of land	Legislative capacity to enter conservation covenant	Number/area covered	Comments/incentives
National New South Wales	Australian Bush Heritage Fund	Yes	Not available	8 properties	Only purchases land at this time
	NSW National Parks and Wildlife Service	Yes	National Parks and Wildlife Act (s69C) – voluntary conservation agreement	40 covering approximately 5000 ha	Discretionary Fund (\$200 000)
	Department of Land and Water Conservation		Native Vegetation Conservation Act (s42-44) – property agreement		Potential access to incentives fund from Native Vegetation Conservation Act
Queensland	Department of the Environment	Yes	Nature Conservation Act (s51) – conservation agreements can be noted in the Administrative Advice File	11 – some of which bind successors in title	Funding for priority regions and rate relief in some areas
Victoria	Trust for Nature Department of Natural Resources and Environment	Yes	Victorian Conservation Trust Act (s3A) – covenants can be entered with the Victorian Trust Conservation, Forests and Lands Act (s69) – land management agreements (s71 and s72)	230 covering over 8000 ha	No incentives
South Australia	Department for Environment, Heritage and Aboriginal Affairs	Yes	Native Vegetation Act 1991 Heritage Act (s34) – Heritage agreement must be noted on title	1050 covering over 550 000 ha	Assistance payment, fencing, and management fund. 650 received payment in recognition of reduced property rights at a cost of approximately \$70 million
Western Australia	National Trust of Western Australia Department of Conservation and Land Management (CALM)	Yes	Soil and Land Conservation Act (s30B) – conservation covenant and agreements to reserve can be registered Heritage of Western Australia Act 1990 (s29)	None	Both the National Trust and CALM are currently developing programs
Tasmania	Department of Environment and Land Management	Yes	National Parks and Wildlife Act Part V A (s37A to s37H) conservation covenants may apply to land for which approval is sought for a timber harvesting plan	None	No incentives currently
Northern Territory	Department of Lands, Planning and the Environment	Yes	Leasehold conditions	2 covering 11 000 ha	Unknown
Australian Capital Territory	ACT Parks and Wildlife Service	Yes	Leasehold conditions	Unknown	Mechanisms for ensuring the protection of high conservation value sites are currently being developed for rural leases

(Binning and Young 1997, Cripps et al., 1998).

Appendix B:

Expected behavioural impacts and costs

To identify the potential costs and benefits of the tax incentives proposed in this paper, it is necessary to consider what the expected impacts of the measures on the behaviour of landholders might be and what the implications for revenue outlays are likely to be.

As a short-term study, this paper only contains broad estimates derived from existing data. The estimates provided are based on a number of different scenarios and aim to identify the range of impacts associated with each of the proposals discussed.

The full revenue implications of tax proposals will depend on a wide range of factors, including:

- the change in behaviour associated with each proposal;
- the size of claim made, which will depend, inter alia, on the value of the land and cost of management activity;
- the extent to which changed behaviour causes a shift from expenditure which is not tax deductible to expenditure which is eligible for a deduction; and
- the extent to which substitution between tax deductible expenditures occurs, say, from primary production to conservation.

An attempt is made to estimate the possible impact of tax incentives on the first of the factors outlined above by developing a scenario for future increases in the number of conservation covenants negotiated nationally. Data on the second factor, the average size of claims, can be estimated from the average value of properties and are discussed below. Estimates for the final factors, the degree of

substitution between deductible and non-deductible expenditure, are not available. As a result, estimates have generally been derived by assuming that all claims will be new and, hence, the costs derived should be considered to be overestimated.

The objective of these costings is to determine the approximate order of magnitude of tax revenue forgone. If any of the proposals put forward are to be formally considered by governments, these estimates will need to be refined and formal estimation models developed.

In the remainder of this Appendix, we provide background to the estimates developed for the tax incentives relating to conservation covenants discussed in Section 4 of the paper.

Behavioural impacts of incentives to enter conservation covenants

Predicting the behavioural impacts of proposals to provide incentives to landholders to enter conservation covenants or donate land to conservation organisations requires an understanding of:

- the uptake by landholders of the conservation covenant programs;
- the proportion of covenants that could meet criteria for being of high conservation value; and
- the change in uptake expected as a result of the introduction of tax incentives.

Current experience with conservation programs in Australia is outlined below and used as the basis for generating an uptake scenario that is used for the costings presented in this paper. It is not possible within the scope of this study to develop formal econometric models for evaluating the changes in behaviour that will result from the introduction of tax incentives. Rather, other factors that will influence the uptake of conservation covenants are discussed and a best case scenario used for costings.

Table B1: Summary of performance of each State in negotiating conservation covenants

State	Total number of agreements	Agreements negotiated per annum
NSW	40	10 – 15
Victoria	230	20 – 30
Tasmania	0	Program starting as an outcome of Regional Forest Agreement
South Australia	1050	Less than 10
Western Australia	0	Programs being developed by National Trust and Department of Conservation and Land Management
Queensland	11	Less than 10

Uptake rates

Table B1 contains a summary of current conservation covenant programs derived from Appendix A.

The current performance of organisations negotiating conservation covenants tells us that 30 to 50 covenants are being negotiated annually within Australia. Given current arrangements, the maximum rate of any single program is approximately 30 agreements per year.

If tax incentives and program support were provided to organisations negotiating conservation covenants, it could be expected that these uptake rates would increase significantly. Anecdotal evidence shows that the following factors have the most significant impact on uptake rates.

- Staffing levels – as the negotiation of conservation agreements is fairly resource-intensive, the capacity to enter agreements is limited by staffing levels. For example, the Victorian Trust for Nature employs six part-time regional officers who are responsible for negotiating agreements with landholders. If their time was increased, the volume of agreements would also increase.
- The degree of targeting – that is, the extent to which only sites of high conservation value are accepted by the organisation (see below).
- Incentive to enter the agreement – entering a conservation covenant is a significant commitment. With the exception of South Australia, strong incentives are not offered to people who enter management agreements.

Without empirical research it is difficult to make a judgement on the effect tax incentives will have. In South Australia, incentives that were equivalent to the market value of land were paid for landholders to enter conservation agreements at a cost of approximately \$70 million.

If additional program support and tax incentives for entering conservation covenants are introduced, there will undoubtedly be a significant increase in the number of agreements negotiated.

Developments in a number of jurisdictions suggest that the number of agreements negotiated in the next 5 to 10 years is likely to increase significantly. These developments are described below.

- As an outcome of the Regional Forest Agreement in Tasmania, processes for entering binding conservation agreements with landholders are being developed.
- The recent enactment of the *Native Vegetation Conservation Act 1997* in New South Wales allows for the negotiation of property agreements as a key mechanism for delivering sustainable native vegetation management.
- The Department of Conservation and Land Management and the National Trust in Western Australia are developing programs for entering conservation covenants.
- A number of local councils, such as Brisbane City Council, are developing conservation agreement programs that may in time have the capacity to register agreements on title and hence meet the criteria for tax incentives.

Based on these factors the following scenario is used as the basis for costings in this paper.

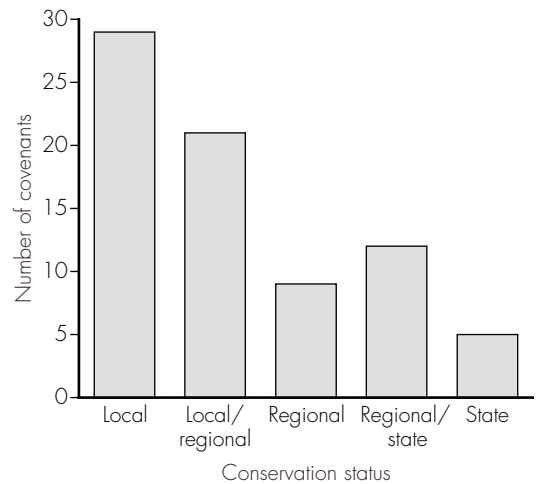
In the first year after introduction of the scheme 50 agreements are negotiated, rising to 360 per annum in the fifth year.

Growth of this kind within covenanting programs would have to be at an unprecedented and sustained rate to meet this scenario. On this basis the scenario is considered to be conservative.

Proportion of covenants that are of high conservation value

Figure B1 summarises data from covenants entered by the Victorian Trust for Nature between 1992–93 and 1994–95. It shows that of the 76 covenants entered in that period only 17 (or about 22%) were of Statewide or regional/Statewide significance. If agreements were to be targeted only at sites of high conservation value there would be considerable scope for tightening access to tax incentives.

Figure B1: Victorian Trust for Nature conservation covenants by conservation status



It is important to note, however, that all the organisations involved in negotiating conservation covenants have standards in place to ensure only sites of considerable conservation value are accepted. Given the relatively low number of covenants involved, tax incentives could be made available to all covenants over the first five years of the program. This would then be reviewed after this first five-year period.

Value of claims

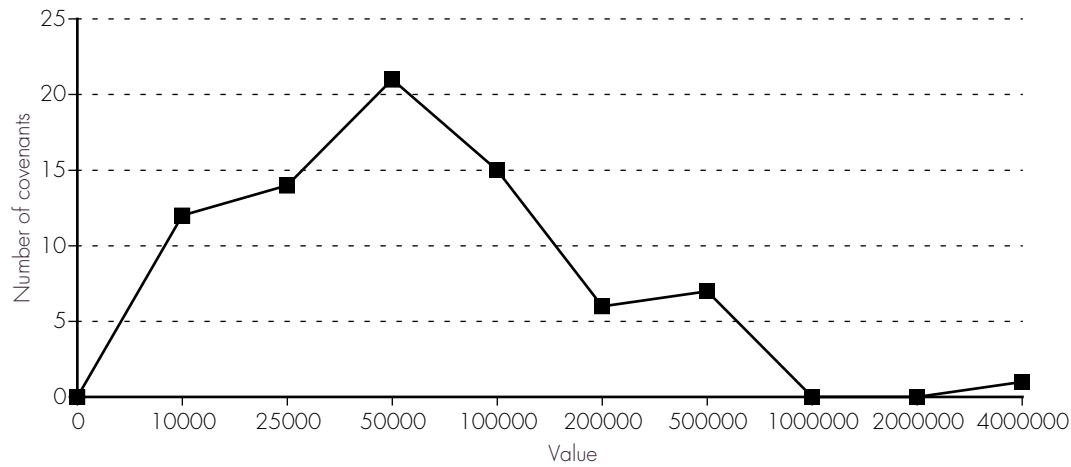
Estimates on the value of claims made in the report are based on data from the Victorian Trust for Nature on the value of properties covered by a conservation covenant. Table B2 and Figure B2 summarise the full market value of the land covered by the covenant.

Table B2: Average and median values of conservation covenants entered by the Victorian Trust for Nature, 1992–93 to 1994–95.

	Hectares	Value	Value per hectare
Average	27.91	\$94 886	\$3398
Median	11.64	\$38 650	\$2141

It can be seen that the distribution of the value of covenants is skewed, with a larger proportion of covenants being valued at less than the average value. This reflects that a small number of high value sites near urban centres can have a significant impact on the overall value of covenants and hence the cost of any proposed tax incentive. As a result, both the median and average values have been used in the estimates in the main body of the text. Although high, the average value is considered a more accurate estimate, as one of the principal objectives of the tax incentives proposed is to secure the conservation of high value sites near urban centres.

Figure B2: Distribution of the market value of land covered by a Victorian Trust for Nature conservation covenant, 1992–93 to 1994–95.



Factors affecting the estimates of costs

As a general rule, the estimates of revenue forgone for each particular proposal are likely to be overestimates for a number of reasons.

- The growth of negotiation of conservation covenants to 360 agreements per year in the fifth year of the program is unlikely to be exceeded.
- Access to tax incentives has been based on making them available to all covenanted properties. If criteria relating to the conservation value of sites were tightened, there would be considerable scope to reduce costs. Indeed, if costs to revenue became excessive, this would be the suggested mechanism for reducing outlays.
- The average land value used, based on the Victorian Trust for Nature covenants, is very high at \$3401 per hectare. This presumably reflects that many of these agreements were entered near or within the Melbourne district. In this case, the figures outlined above would be reduced by a factor of between three and four. The median land value of \$2141 per hectare is still relatively high and may be a better base for assessment. Rural land prices vary greatly and generally lie in the range of \$50 to \$10 000 per hectare.
- A number of landholders are likely to substitute from one tax deductible activity to another. For example, near urban centres strong incentives to enter covenants, rather than meet primary producer criteria, would exist.

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