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3A Identifying Tax Expenditures and the Benchmark Tax System

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Tax Expenditures

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Introduction

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- **Defining TE**
- **Defining the Benchmark Tax System**
- **A middle ground?**
- **Group Activity**
- **Conclusion**

What is a Benchmark Tax System (BTS)?

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- Simply put: a reference point against which to measure revenue foregone from TE
- Any provision not part of the ‘benchmark system’ is thus costed in the TE Report.
- Definitions differ from country to country.
- There is no ‘right’ way to define a BTS
  - But guiding principles can be useful
- **Step Back**: start with a definition of tax expenditures

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(What is a Tax Expenditure?)

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- First defined in the 1960s by Stanley Surrey (Assistant Secretary of the US Treasury).

  - *"…provisions, often called tax incentives or tax subsidies, are departures from the* ***normal tax structure*** *and are designed to favor a particular industry, activity, or class of persons. They take many forms, such as permanent exclusions from income, deductions, deferrals of tax liabilities, credits against tax, or special rates. Whatever their form, these departures from the* ***normative tax structure*** *represent government spending for favored activities or groups, effected through the tax system rather than through direct grants, loans, or other forms of government assistance."*

(Surrey and McDaniel, 1985)

(What is a Tax Expenditure?)

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- CIAT (2011): reviewed definition in 10 Latin American countries, found that:
  - All made reference to '**revenue loss generated**' and 'deviations from a general provision'.
  - 6 stated that TEs exist to '**pursue an economic or social policy objective**'
  - 3 suggested that TEs '**increase the economic capacity of the taxpayer**'

- OECD (2010) points to the simple rule of thumb that a TE leads to ***revenue loss for government, but a reduction in tax liability for the taxpayer***

- **Good practice to adopt a national definition**

Defining the Benchmark Tax System (BTS)

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- The BTS defines the scope of provisions to be **costed** in a TE report (and hopefully **evaluated** further down the line)

- It is well accepted that a benchmark system ***should*** be defined, however the choice over ***how*** this is done is less clear cut; one of the “most complex” parts of compiling a TE report.

- In theory , the choice comes down to one of two methods, namely
  - 1. **A “normative” approach**
  - 2. **A “legal” approach** (positive approach)

- But in practice, elements of both approaches are normally incorporated.

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- **1. A Normative Approach**
  - Involves comparing a country's tax system to some 'ideal', which is usually rooted in e.g., ideas around what constitutes an "optimal" tax system
  - Requires the policymaker to first define what – for a specific country – an optimal tax system would look like before identifying the places in which the national system deviates from this.
    - **E.g.,** a normative benchmark excise duty rate on alcohol might be set at the rate where the external costs of consuming a unit of alcohol are fully internalised.
    - Any excise rate per unit below this would represent a TE.
- In practice, almost no countries define their BTS (wholly) according to the normative approach

Defining the Benchmark Tax System

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- **2. The “legal” approach**
  - Grounded in a country’s tax (or other) legislation:
    - i.e., look at tax legislation and identify any deviations from ‘general’ system as tax expenditures.
  - Often adopted due to ease of measurement,
  - But, **of course, a country’s tax legislation is likely based on normative ideas of what constitutes an appropriate tax system.**

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- Legal Approach: 4 'components' of each tax head.

Tax Head	(i) Tax Unit	(ii) Tax Base	(iii) Tax Rate
CIT	Firm	(Taxable) profit*	Statutory CIT rate
PIT	Individual (household, if joint filing)	(Taxable) employment or self-employment income*	PIT schedule
VAT	Final consumer	Final consumption (applied on a destination basis)	VAT rate
Excise duty	Final consumer	Consumption	Schedule of duty rates
Customs duty	Importer	CIF value	Tariff code

(+ **the tax 'period**' – usually annual / monthly / quarterly)

…Any provision that adjust the **unit, base, rate or period (in favour of the taxpayer)** is therefore a candidate TE

Defining the Benchmark Tax System

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- Defining the BTS *wholly* on the General Tax Regime is a reasonably straightforward approach

i. Many provisions are almost universally accepted as part of BTS.

ii. Significant debate over certain provisions exists in all countries.

Some common reasons for provisions to be included in the BTS:

(**NB** not a statement or judgement that they *should*)

Defining the Benchmark Tax System

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- **Provision is part of International or Regional Convention / Agreement**
  - *International Conventions*
    - Provisions in international agreements can be decided at the international level; international law can take precedence over national and local law. E.g., **Nairobi protocols**, **Chicago Convention**, **Florence agreement**
  - *Regional Agreements*
    - E.g., a customs union, for example, where the common external tariff is the norm for customs duties.
      - In Uganda, EAC and COMESA imports are treated as part of the BTS

- **Provision relates to the Taxation of Foreign Aid Projects**
  - Many countries have historically treated tax relief on aid projects as part of the BTS; growing debate around the practice → resulted in the development of (non-binding) guidelines (see United Nations, 2021).
  - An evaluation of the cost of such exemptions would shed light on impact and could persuade the authorities to encourage those bilateral partners that have committed to paying taxes to do so.

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- **Provision exists due to administrative efficacy**

  Certain provisions that exclude activities from the tax system or provide relief might exist as part of the tax structure:

  - (i) **to ensure that a certain tax can function**,
    - (e.g., a VAT registration threshold)
  - (ii) **because taxing a certain activity is not feasible or cost-effective**.
    - E.g., financial services that have no observable value added are exempted from VAT; agriculture activities are sometimes simpler to exclude from the tax system due to a multiplicity of challenges, including high levels of informality, physical remoteness

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- **Provision exists due to National Tax Policy Choices**
  - Gov't might decide to consider some tax relief as 'normal' e.g., as an integral part of a policy to provide support to a particular sector of the economy (e.g., health, agriculture).
    - E.g.: Income tax allowances for handicapped persons and single parents are part of the BTS in Spain but constitute tax expenditures in France. (Kassim and Mansour (2018))
    - E.g.: In Germany, value-added-tax (VAT) reductions for some basic foodstuffs are considered part of BTS (Hallerberg (2014))
- **Taxation of a public entity**
  - Taxes owed *by* government are owed *to* government and might be seen as an internal transfer, with the net liability amounting to zero.
    - There is a significant transparency case for including such provisions as TEs.
    - The choice over how to report on revenue foregone from government activity is likely to differ from country to country.

Defining the Benchmark Tax System

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Remember:

- In the framework of TE management and governance, any provision which is considered a part of the benchmark tax system is **outside the scope of the TE report and unlikely to be subject to any TE evaluation process.**

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- Thus, any analysis of their effectiveness vis-à-vis their original goal is not possible.
- A TE may not be the most effective way to achieve a stated policy goal, but without TE reporting, one cannot begin to assess

Structural and Non-Structural Reliefs

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- Is there a middle - ground?

- In the United Kingdom & Canada, reliefs are categorized as:

1. **Structural Reliefs**

a provision that could "reasonably be regarded (or partly regarded) as an integral part of the tax structure" or are required in order to "define the scope of the tax" (HMRC, 2021)

1. **Tax Expenditures** *or*

2. **Reliefs Exhibiting features of both**

Structural and Non-Structural Reliefs

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- There are numerous areas where a provision might exhibits features of both a structural relief and a tax expenditure
  - Consider a capital allowance:
  - Your data for a given taxpayer (firm) might just state **total capital allowances deducted**.
    - But what if there is, e.g., initial allowance (or up-front capital allowance), which is > 'normal' depreciation for a given asset class?
- The part of the allowance that accounts for economic (or commercial) depreciation could (reasonably) be considered as a part of the tax system, whilst any accelerated depreciation allowance *over and above the rate of economic depreciation* might be considered as a TE.
  - But we can't always separate these, even with detailed data!

Structural and Non-Structural Reliefs

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- Reporting in this manner allows for
  - (i) a greater level of transparency (by reporting on all identifiable provisions, whether considered structural or not),
  - (ii) discretion on the part of policy-makers on those provisions that are identified as TE.

- Documenting and, where possible, costing structural reliefs also provides valuable evidence to inform potential policy reforms, if required, or comparison with alternative policy instruments.

Conclusion

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- There is no 'correct' way to define BTS; all countries differ.
  - e.g., income tax allowances for handicapped persons and single parents are part of the BTS in Spain but constitute tax expenditures in France (Kassim and Mansour, 2018).
  - VAT reliefs on some basic foodstuffs part of BTS in Germany (and Uganda) but often viewed as TE elsewhere. (Hallerberg, 2014))

- Ultimately, A narrow benchmark (larger repository of TEs) = higher transparency
  - Can help to inform monitoring effectiveness of provisions, evaluating alternatives, or contributing to wider discussions (e.g., the taxation of foreign aid activities).

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