

Identifying Tax Expenditures and the Benchmark Tax System

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May 2024

Kathmandu

Follow-up Technical Meeting on
Tax Expenditures

#TaxDev

What is a Benchmark Tax System (BTS)?

- A reference point against which to measure revenue foregone from TE.
 - Any tax provision that is not part of the 'benchmark system' is thus included – and (hopefully) costed - in the TE Report.
- The specifics of the BTS and how it is defined differ across countries and this can sometimes make comparisons of TE reports a bit tricky.
- Before exploring how to define the BTS, useful to step back and start with a definition of tax expenditures

(What is a Tax Expenditure?)

- 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. ...**represent government spending**...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?)

- So, a TE is
 - A departure from the benchmark tax system that favour a particular group of taxpayers, industry or activity
- Little debate here...
- But ongoing (challenging!) debate on the exact set of provisions that should be part of the benchmark system and which should be included as tax expenditures.

- The BTS defines the scope of provisions to be **costed** in a TE report (and hopefully **evaluated** further down the line).
- Broadly / Conceptually a couple of approaches could be taken
 - 1. A “**normative**” approach [**Normative** = *what should be*]
 - 2. A “**legal**” approach (positive approach) [**Positive** = *what is*]
- But in practice, elements of both approaches are normally incorporated.

Defining the Benchmark Tax System

■ 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 per unit of alcohol might be set at the rate where the external costs of consuming a unit of alcohol are fully internalised by the tax..
 - Any excise rate per unit below this would represent a TE.

Defining the Benchmark Tax System

■ 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.
 - e.g., a reduced tax rate for a certain subset of taxpayers vs. the ‘headline’ rate.
- But a country's tax legislation is likely rooted in normative ideas of what constitutes an appropriate tax system...

Defining the Benchmark Tax System

- 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	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 adjusts the **unit, base, rate or period** (in favour of the taxpayer) is therefore a candidate TE*

Defining the Benchmark Tax System

Many provisions are almost universally accepted as part of BTS, whilst for others, significant debate – and potential inconsistency – across countries

Some common provisions – that otherwise fit the definition of TE – that are included in the BTS:

- **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.
 - There is no TE on intra-EAC trade as Benchmark Rate is 0%!

- **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.

Defining the Benchmark Tax System

- **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.

- **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;

Defining the Benchmark Tax System

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.**
- Thus, any analysis of this government support vis-à-vis the 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

- In the United Kingdom, ‘tax 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)

2. Tax Expenditures *or*

3. Reliefs Exhibiting features of both

- In Canada, structural tax reliefs are defined as tax measures “whose main objective is internal to the tax system” (Department of Finance Canada, 2023).

Structural and Non-Structural Reliefs

- 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 whilst also recognising that all reliefs do provide some benefit to the taxpayer
- 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

- Countries will, ultimately, have different criteria for what constitutes TE:
 - 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 France (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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Structural and Non-Structural Reliefs

- There are numerous areas where a provision might exhibit 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!