Estimating of Revenue Foregone (Direct Taxes)

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Mikeladze Nino

www.mof.ge

n.mikeladze2@mof.ge

Ministry of Finance of Georgia

Outline

- Principles of Tax Expenditure Calculation
- Methodology
- CIT Tax Expenditure Calculation (Example)
- Operational Aspects

The Benchmark Tax System - ITE

- Relates to the idea of a reference tax system against which the presence of Tax Expenditures is evaluated;
- **The benchmark tax system** should be limited to the benchmark features of headline taxes. It should include general, statutory income and profit taxes;

➢ The Tax Code usually include CIT and PIT benchmark items, such as: foreign income earned by residents, and gifts and inheritances. Grants, state pensions, state compensation, state academic scholarships and other allowances.

Principles of TE Calculation

Principles of the Calculation Tax Expenditure

- **Tax benefit would be classified as a TE if it**:
  - Reduces tax revenues;
  - Represents a deviation from the standard provisions of the tax system (the benchmark);
  - Other features…
- The difference between the potential revenue in the absence of TEs and the estimated tax revenue (currently) raised in the presence of TEs.
- For TE costing, the **“revenue forgone”** method is used, assuming there is no change in taxpayers’ behavior in response to the elimination of given TEs;

Principles of the Calculation Tax Expenditure

- Any item included in the benchmark is not considered a TE;
- **Non-structural TE:** Non-structural measures are implemented to:
  - Achieve economic development and social policy goals;
  - Relief to households and firms;
  - Income tax exemptions or reduced rates for particular types of income;
  - Investment allowances; and
  - Deductibility of certain non-operating expenses.
- Non-structural TEs lead to revenue losses but, sometimes, they could be replaced by the targeted direct government spending measures if the evaluation analysis shows regressivity and poor targeting of TEs.

Income Tax Expenditure Inventory (example)

Description: Exemption of capital gains for assets owned for more than 2 years [residential apartment (house) and other personal property except vehicles]
Objective: Encourage earning of non-business income
Beneficiaries: Natural persons

Description: Exemption of interest income earned from a licensed financial institution: such income shall not be taxed at the source and shall not be included in gross income of the person earning interest
Objective: Encourage saving in licensed financial institutions
Beneficiaries: All but licensed financial institutions

Description: a natural person having the status of a micro business shall not pay income tax
Objective: Simplifying administration for GRS
Beneficiaries: Micro businesses

Description: Taxable income of a person having the status of small business shall be taxed at 1%, Taxable income of a person having the status of small business shall be taxed at 3% if gross income received from activities exceeds GEL 500 000
Objective: Promotion of small business activity
Beneficiaries: Small businesses

Methodology

The Methodology of CIT and PIT Tax Expenditure Calculation

- **The ITE for the CIT** regime is straightforward to calculate, since it is directly observable in Revenue Service tax return data. The TE from the CIT is the sum of profit (income) exempt from taxation, multiplied by the Corporate Income Tax rate;

- To calculate **the PIT ITEs**, all the exempted income items should be multiplied by the Personal Income tax rate;

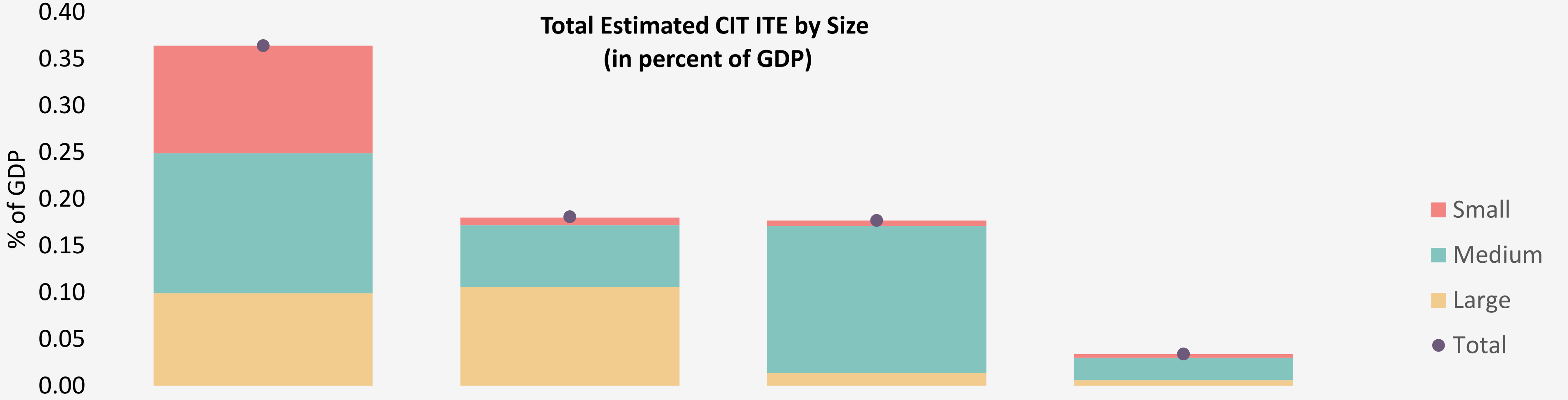
- Accurate data from the Revenue Service is crucial to better estimate revenue foregone and make an analysis!
  - Tax return data from the taxpayers;
  - Including provision references;
  - Detail information about the taxpayer: size, regime, NACE-2 code.

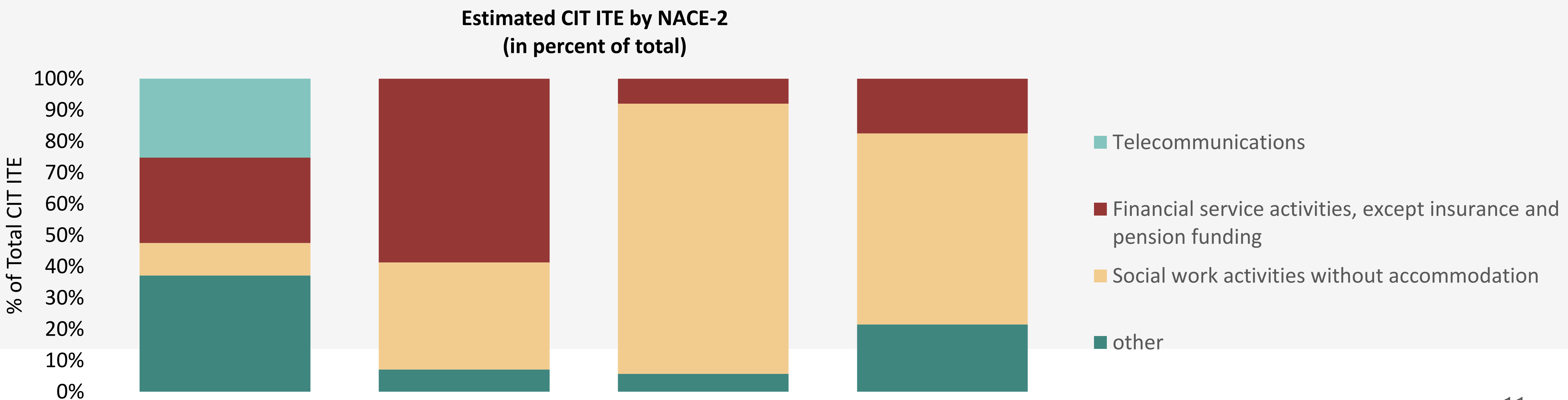
The Methodology of CIT Tax Expenditure Calculation

- Some CIT cannot be estimated directly
- need to consider different specifications
- Use complex calculation models
- More data is needed

Example: If only distributed profit (dividend) is taxed and not the re-invested income, calculation of ITE is different (TE from profit + TE from dividends)

Income Tax Expenditure – CIT: by Taxpayer Size and NACE-2 Sector





CIT Tax Expenditure Calculation

Example of CIT Tax Expenditure Calculation

More data you have, more analysis you can make

- **Example 1:** Amount of tax deduction claimed in 2022: $500
  - Statutory CIT rate = 24%

➔ revenue foregone from tax expenditure = $500*24% = $**120**

- **Example 2:** Amount of tax deduction claimed in 2022: $500
  - Statutory CIT rate = 24%
  - *profit is different ($1000, $250, -$500)*

Example of CIT Tax Expenditure Calculation

- **Example 2:** Amount of tax deduction claimed in 2022: $500 and profit is $1000/$250/-$500
    - Statutory CIT rate = 24%

	Profit / Loss	Tax deduction	Taxable Income	Tax Liability	Tax liability if deduction did not exist	Revenue Foregone
Company 1	$1,000	$500	$500	$500 * 24% = $120	$1,000 * 24% = $240	**$120**
Company 2	$250	$500				
Company 3	-$500	$500				

Example of CIT Tax Expenditure Calculation

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	Profit / Loss	**Tax deduction**	**Taxable Income**	**Tax Liability**	**Tax liability if deduction did not exist**	**Revenue Foregone**
Company 1	$1,000	$500	$500	$500 * 24% = $120	$1,000 * 24% = $240	**$120**
Company 2	$250	$500	$0	$0 * 24% =$0	$250 * 24% = $60	**$60**
Company 3	-$500	$500				

Example of CIT Tax Expenditure Calculation

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Company 2	$250	$500	$0	$0 * 24% =$0	$250 * 24% = $60	**$60**
Company 3	-$500	$500	$0	$0 * 24% = $0	$0 * 24% = $0	**$0**

Operational Aspects

Operational Aspects

- **Ministry of Finance** is responsible for the TE analysis:

  Responsibilities should be distributed among the relevant departments

  - Tax and Customs Policy Department (benchmark, inventory, TE descriptions);
  - Macroeconomic Department (TE estimation, data collection, methods, sensitivity analysis. Responsible for annual update of TER).
- **Data sources**: GEOSTAT, GRS, MOF, NBG. Smooth and timely coordination with these entities through email (having contacts of main people who can provide updated data upon request);
- Some data should be calculated manually or estimated considering the country characteristics;

Operational Aspects

- **Challenges**:
  - lack of availability of granular data (88X88 SUT, household survey);
  - Due to the lack of detailed data, some items are not costed individually (unclassified sectoral data in terms of 2-digit NACE codes; missing/misreported tax return data);
  - Digital tax return forms are recommended;
  - Lack of communication between the Revenue Service and taxpayers.
- **Methodological updates**, considering country-specific features:
  - ➢ Small Business Income TE – using average profit margins;
  - ➢ Interest Income TE – interest rate parity vs absent of interest rate parity;
  - ➢ VATE – how to treat informality sector in VAT expenditures.

Questions?

Thank You!

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