BROADENING THE TAX BASE

Bert Brys, Ph.D.

Senior Tax Economist

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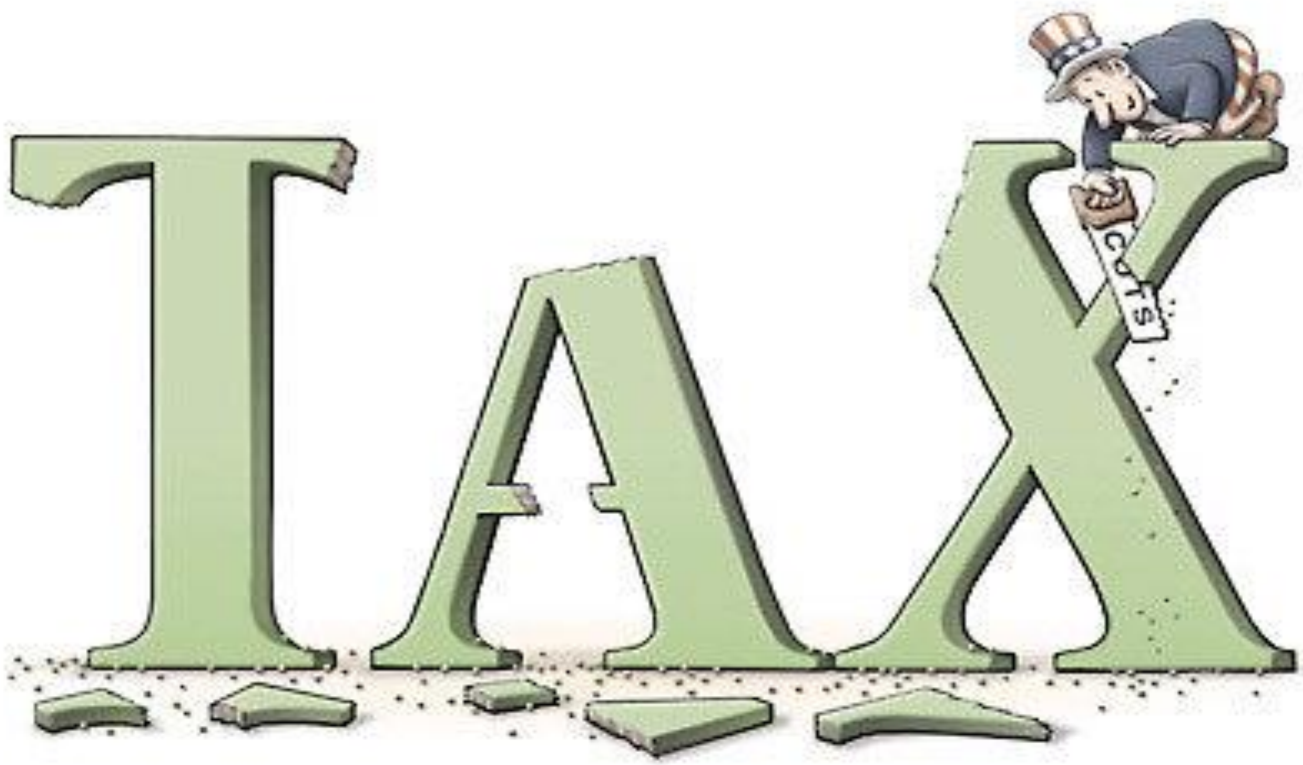
BETTER POLICIES FOR BETTER LIVES


TAX
CUTS

A. Back to the economics…

- Assuming perfect competition, there is a strong theoretical support for base broadening
- In the real world, tax expenditures and incentives are widely used
  - Market failures (credit rationing for SME'S)
    - The first best option is to address the market failure itself
    - Tax expenditures and tax incentives are 2nd best
  - Distributional objectives
  - Externalities (R&D)
    - Main difference with market failures: the market is UNABLE to take into account external effects
    - For example
      - Social return of R&D > Private return of R&D
      - If firm just consider the private return of R&D, there will be « under-investment »
      - But the government can increase the private return of R&D, to bring the R&D level close to the (social) optimum
    - So there are good reasons to implement tax expenditures/ tax incentives

A. Back to the economics…

- However, most of the tax expenditures go far beyond market failures and externalities, they just translate political preferences
- Tax expenditures may be right but…
  - They conflict with neutrality
  - They might subsidise economic activity that would have taken place anyway – how much "additional" activity (investment, saving, etc)?
  - They may hamper redistribution
  - Hidden cost (higher tax rates) for the non-privileged part of the tax base
  - They increase administrative and compliance costs
  - They reduce tax revenue in a non-transparent way
  - Benefits > Costs ?
- Need for a cost benefit analysis
  - 1st step: tax expenditures report
  - 2d step: more comprehensive analysis of costs and benefits

B. The concept of tax expenditures
Definition

In general a tax expenditure is a provision that:

- *lowers tax revenues,*
- *derogates from the **benchmark tax system**,*
- *aims to encourage a specific behaviour or obtain a well defined objective (redistribution, simplification, etc.),*
- *(and that could be replaced by a direct spending program).*

- We need to define the « benchmark tax system » from which tax expenditures (and tax incentives) derogate

Benchmark
tax system

- Revenue raising
- redistribution

Tax expenditures &
incentives

B. Benchmark PIT system: an example

- ***Tax unit:*** individual or household
- ***Tax base***
  - ‘pure’ income tax base: consistent with Haig-Simmons measure of comprehensive income (consumption+change in net worth)
  - reference tax base: includes (excludes) certain provisions that cannot be excluded (included) for practical/technical/computational reasons
- ***Tax rate structure***
  - progressive rate structure generally viewed as part of benchmark (ability to pay)
- ***Benchmark PIT system normally admits ‘non-discretionary’ provisions that adjust tax burden for ‘ability to pay’:***
  - provisions providing for progressive taxation: graduated tax rate structure, standard/basic tax allowance, zero-rated/exempt amount.
  - provisions providing relief in respect of expenses incurred in earning taxable income: travel allowance; deduction for interest on funds borrowed to generate (taxable) investment income
- ***Other benchmark adjustments to address ‘ability to pay’:***
  - provisions providing relief in respect of dependents: child allowance or tax credit, spousal allowance or tax credit (where tax unit is household)

C. The revenue cost of tax expenditures

- Usual approach:« Revenue forgone »
  - Ex-post calculations, holding all other factors constant
  - For example: allowance of 100, marginal tax rate = 40%, revenue loss = 40
  - No behavioural responses
    - Strong assumption
    - But taking into account behavioural responses is an heavy task..
    - Budget allocations to spending programs also assume « no behavioural responses »

Implication – cannot add up individual tax expenditure estimates to give an accurate estimate of overall tax expenditure.

- Revenue gain method
- Outlay equivalent method

C. The revenue cost of tax expenditures

- Is the revenue forgone the right estimate of the potential yield of base broadening ?
  - No, because its quantification assumes no behavioural response
  - No, because it assumes that none of the tax expenditures will be replaced by a spending program
    - *EITC, tax credits for social benefits*
  - « Revenue forgone » overstates the potential yield of base broadening

D. Tax Expenditure reporting

- **Assist in management of overall fiscal position and budget allocations (direct (cash) spending + TEs)**
- **Input to cost-benefit assessment of tax incentives**
- **Enable distributional assessment of tax relief (reliance on micro-data).**
- **Increase transparency and reduce risk of abuse**
- **Inform policy-making**
  - assessment of impact of tax relief on budget, resource allocation, income distribution, and cost/benefit results – useful policy information.
  - helps steer policy decisions to continue, amend, replace or abolish tax relief.

D. Format of TE Reports

- What the TE document should look like (experience varies widely, but there is a minimum):
  - Discussion of choice of methodology and changes over time
  - A list of TE (by legal source, type of tax, budget function): when the measure was introduced, why it was introduced (economic/social objective pursued), and changes over time
  - TE estimates for current year based on more recent data (optional past/future)
  - Extension of analysis over time: estimates distributed by firms and sectors, individuals and income groups; projections for 1 to 3 years

- Tax expenditure reports may supplement and be integrated in the annual budget documents and (expenditure allowation) process
- Make the TE report publicly available
- Develop the scope and content gradually over time

E. C&B analysis of tax expenditures

Additional effects
of tax expenditures
And tax incentives

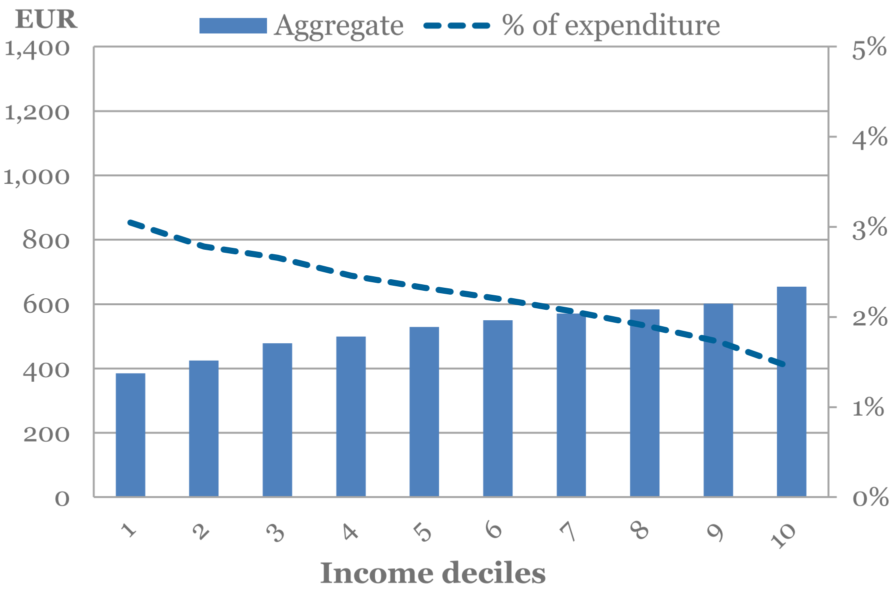
Intended
Distributional
Effects

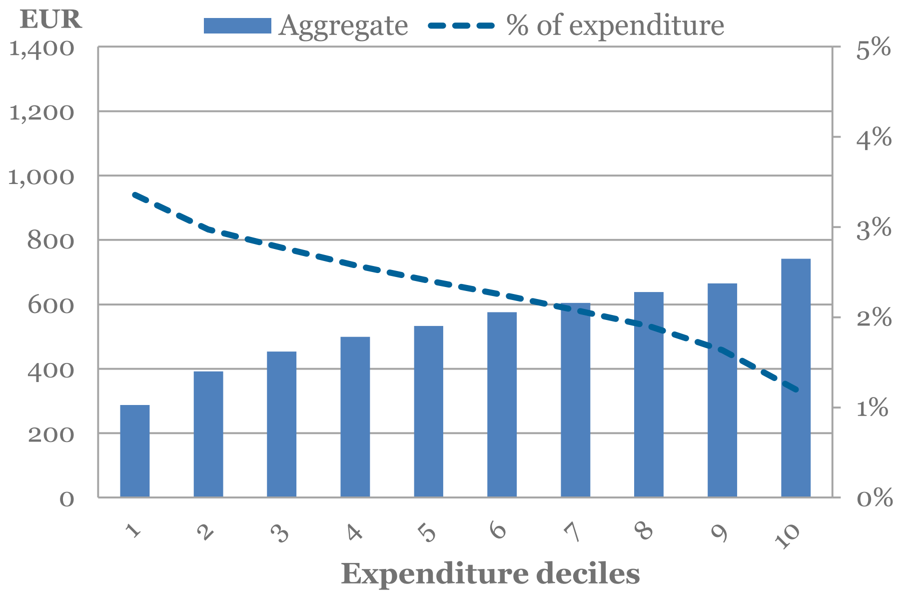
?

-Revenue forgone
-Undesired effect on income distribution
-Behavioural effects/
Non-neutral taxation /
Final economic incidence
-Administrative
and compliance costs

E. Assessing the distributional impact of Tax Expenditures in the VAT

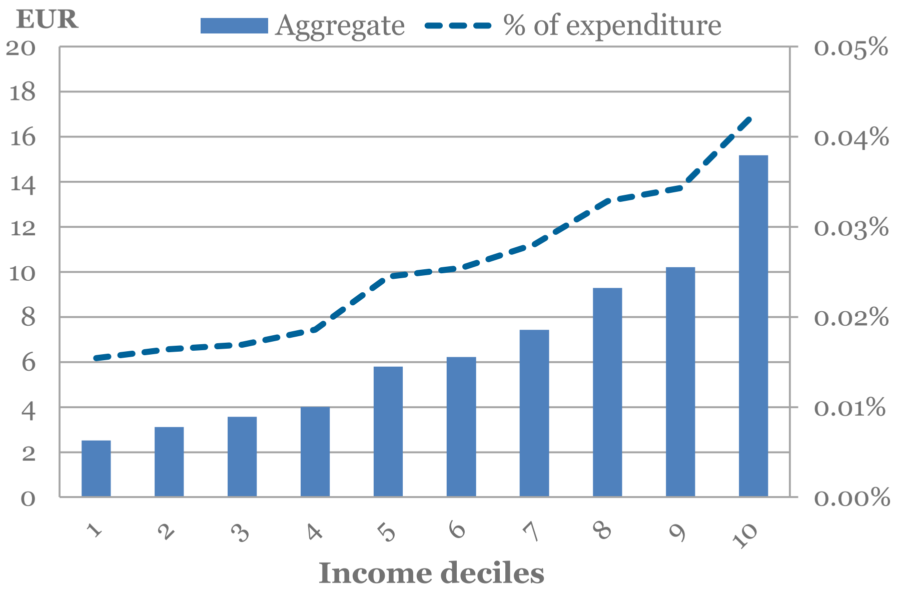
All-country average tax expenditure from reduced rates on food (15 countries)

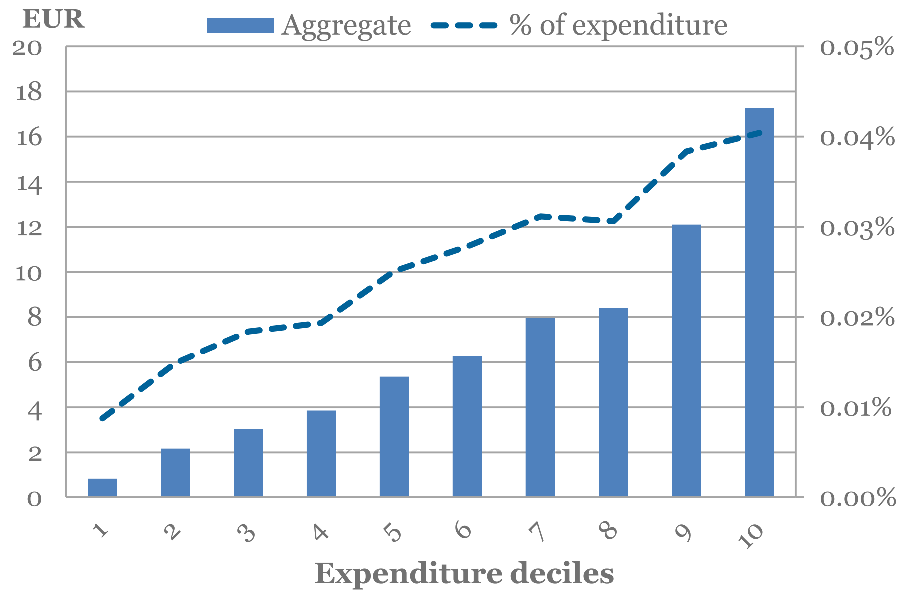




E. Assessing the distributional impact of Tax Expenditures in the VAT

All-country average tax expenditure from reduced rates on cinema, theatre and concerts (10 countries)

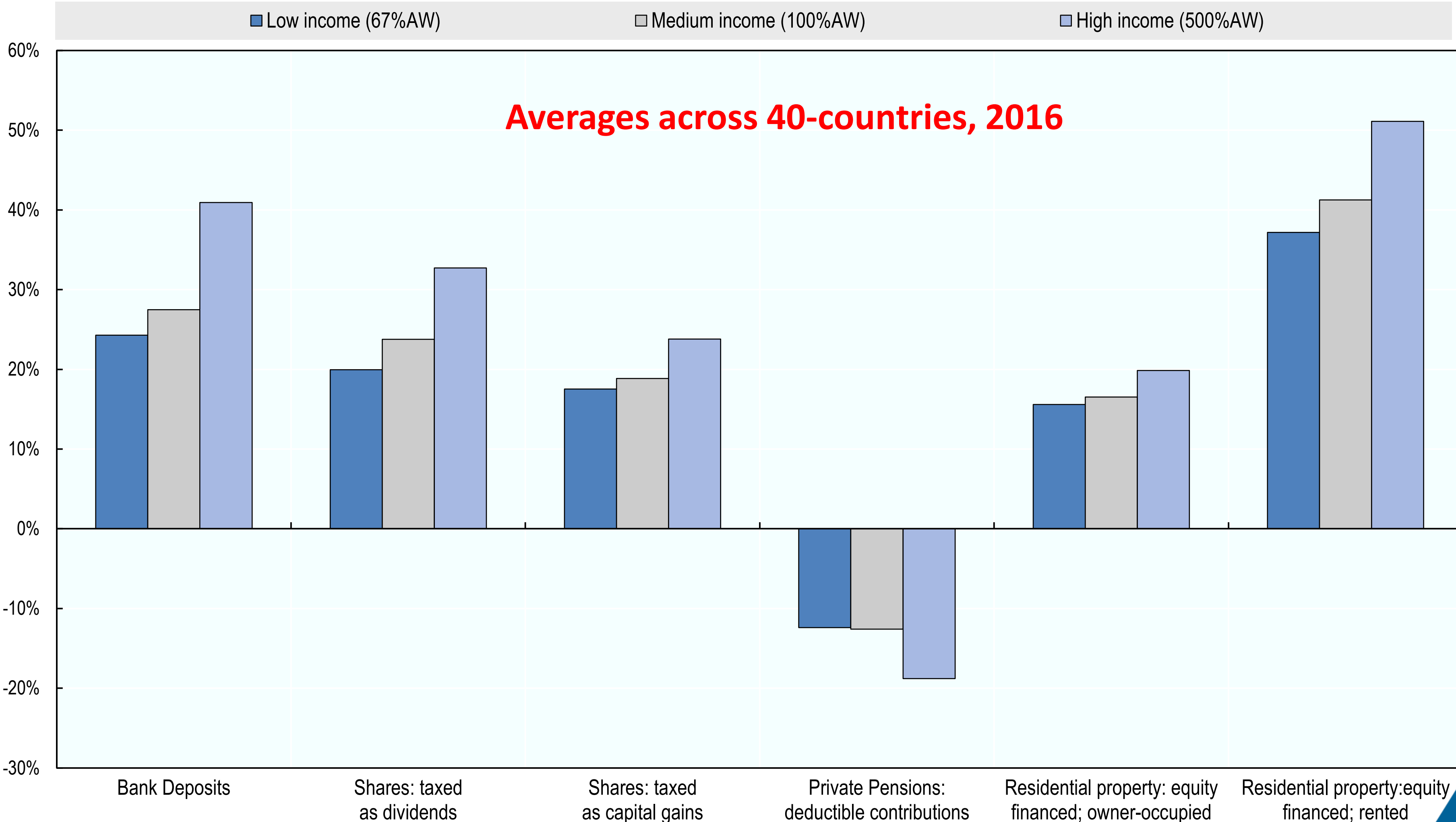




E. Assessing the distributional impact of Tax Expenditures in the VAT

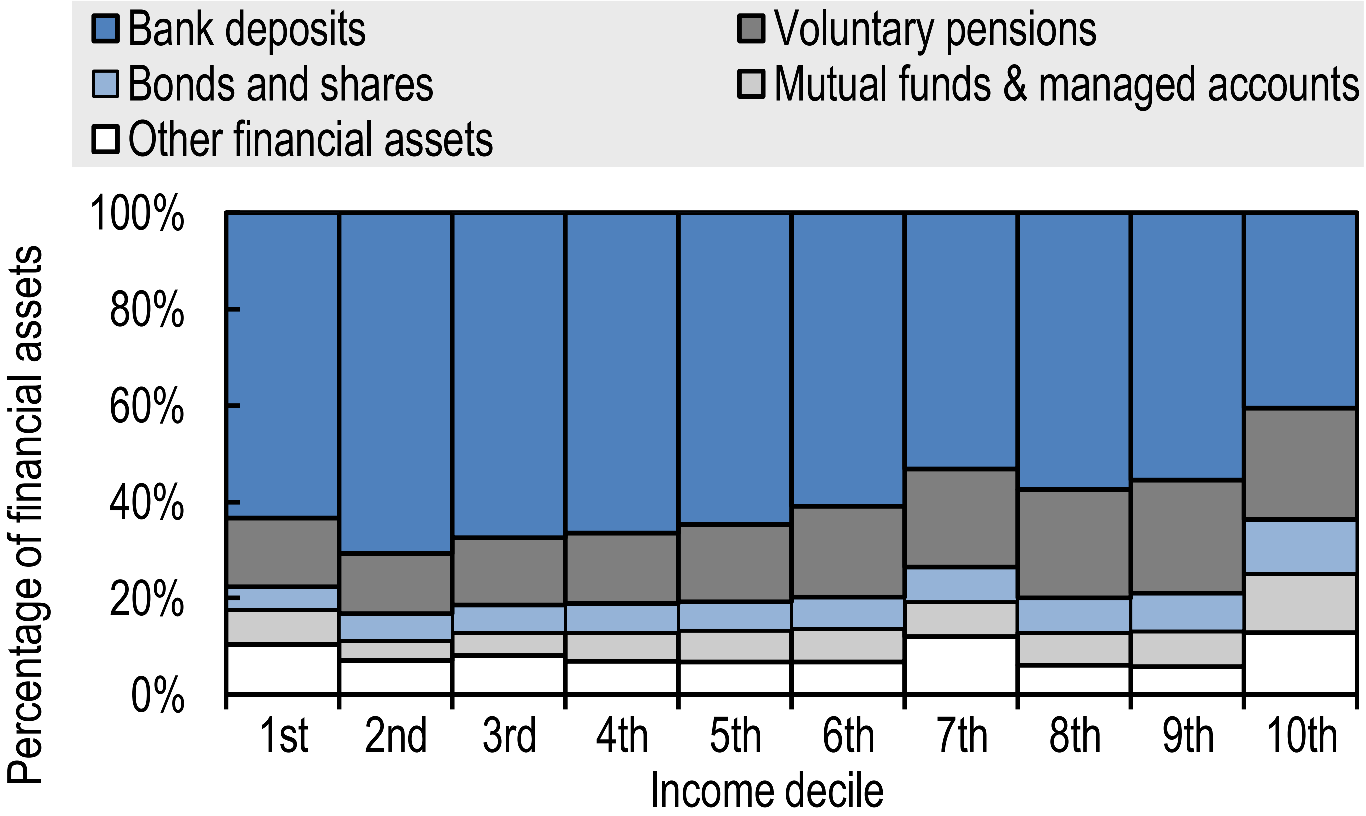
- Reduced rates are a very poor tool for targeting support to the poor:
  - Reduced rates introduced to support the poor provide at least as large a tax saving to the rich, and generally more.
  - Reduced rates introduced for cultural, social good, industry support or other purposes provide a vastly greater tax saving for the rich than the poor.

E. Assessing the Marginal Effective Tax Burden on household savings



E. Assessing the distribution of financial assets

Financial assets as a share of total financial assets



E. Assessing the distributional impact of Savings Tax Expenditures

- Poorer households hold a larger share of their wealth in bank accounts than richer households – and the tax burden on bank accounts is typically very high
- Richer households hold a greater share of their wealth in investment funds, pension funds and shares than poorer households – and those tax vehicles are tax privileged
- The very poorest households do not own residential property – also the house benefits from generous TEs
- Richer households hold a larger share of wealth in second properties

F. Monitoring and evaluation of Tax Expenditures

- Laser-like targeting impossible: difficult to draft clear, precise and unambiguous legislation.
- Moreover, taxpayers will seek to re-characterise existing income/ expenditure to qualify for relief
- Significant tax administration costs
- Administrative discretion on qualifying investment encourages corrupt practices and additional loss of revenue
- Unintended outcomes e.g. due to lack of co-ordination with other policies and laws
- Unintended distortions to competition

Bert Brys, Ph.D.

Senior Tax Economist

Head Country Tax Policy Team

Head Personal and Property Taxes Unit

Tax Policy and Statistics Division
Centre for Tax Policy and Administration

2, rue André Pascal - 75775 Paris Cedex 16
Tel: +33 1 45 24 19 27 – Fax: +33 1 44 30 63 51

Bert.Brys@oecd.org || www.oecd.org/ctp