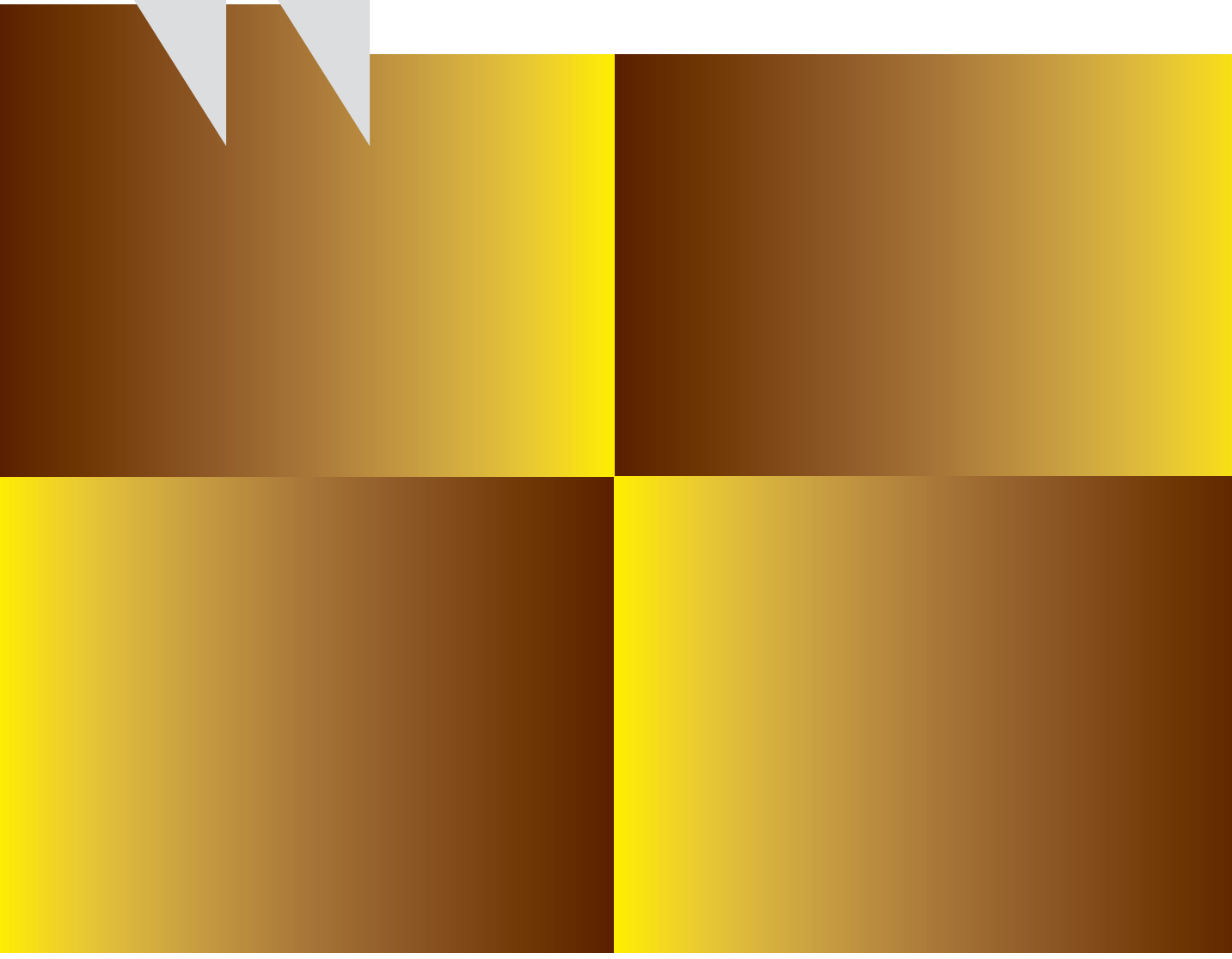
OECD Tax Policy Studies

Choosing a Broad Base – Low Rate Approach to Taxation



OECD

No. 19

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Please cite this publication as:
OECD (2010),*Choosing a Broad Base – Low Rate Approach to Taxation*, OECD Tax Policy Studies, No. 19, OECD Publishing.
http://dx.doi.org/10.1787/9789264091320-en

ISBN 978-92-64-09131-3 (print)
ISBN 978-92-64-09132-0 (PDF)

Series/Periodical:
ISSN 1990-0546 (print)
ISSN 1990-0538 (online)

Corrigenda to OECD publications may be found on line at: *www.oecd.org/publishing/corrigenda*.

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Foreword

Many countries are likely to have to raise taxes as part of fiscal consolidation over the next few years, but how is this best done – by broadening the tax base or raising tax rates? This study is intended to provide economic analysis that helps answer such questions.

As the OECD Secretary-General remarked at the G20 Summit held last June in Toronto, fiscal consolidation should be as growth-friendly as possible. In general tax base-broadening reforms are identified as growth-oriented reforms. To the extent that they reduce distortions to economic decisions, they should increase output and improve social welfare. Nevertheless, there might be also "good" economic reasons for targeted tax reliefs that correct market failures or contribute to redistributing income.

This report does not recommend abolishing all targeted tax reliefs. It does, however, discuss the need to evaluate existing tax provisions systematically to see whether the benefits of these preferential tax treatments continue to outweigh their cost.

It also recognises that political factors often constitute an obstacle to the legislation and implementation of base broadening reforms. However, while the final decision about broadening the tax base or using targeted tax reliefs is likely to be a political one, economic analysis of the pros and cons of particular tax reliefs can help make base-broadening reforms happen. A broader discussion of political obstacles to tax reforms, including base broadening measures, is presented in the Tax Policy Study No. 20.

This publication has been prepared in the OECD Secretariat by Ana Cebreiro. This study draws on input from Delegates to the Working Party No. 2 on Tax Policy Analysis and Tax Statistics of the Committee on Fiscal Affairs.

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List of Acronyms

ACE	Allowance for Corporate Equity
CIT	Corporate Income Tax
EC	European Commission
EET	"Exempt-Exempt-Taxed"
EITC	Earned Income Tax Credit
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GST	Goods and Services Tax
IFS	Institute for Fiscal Studies
IMF	International Monetary Fund
ITC	Investment Tax Credit
OECD	Organisation for Economic Co-operation and Development
PIT	Personal Income Tax
R&D	Research and Development
SME	Small- and Medium-sized Enterprises
TE(s)	Tax Expenditure(s)
TEE	"Taxed-Exempt-Exempt"
VAT	Value Added Tax
VRR	VAT Revenue Ratio

Country acronyms

AUS	Australia
AUT	Austria
BEL	Belgium
CAN	Canada
CHE	Switzerland
CHL	Chile
CZE	Czech Republic
DNK	Denmark
DEU	Germany
ESP	Spain
FIN	Finland
FRA	France
GBR	United Kingdom
GRC	Greece
HUN	Hungary
IRL	Ireland

ISL	Iceland
ITA	Italy
JPN	Japan
KOR	Korea
LUX	Luxembourg
MEX	Mexico
NLD	Netherlands
NZL	New Zealand
NOR	Norway
POL	Poland
PRT	Portugal
SVK	Slovak Republic
SWE	Sweden
TUR	Turkey
USA	United States

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Executive Summary

This Report discusses the various economic and political considerations that drive governments' decisions when considering the choice between broadening the tax base and using targeted tax reliefs (allowances, exemptions, preferential rates, tax deferrals…). In general, tax reforms that broaden tax bases and lower rates should reduce the extent to which tax systems distort work, investment and consumption decisions, increasing output and enabling improvements in social welfare. Nevertheless, despite trends over the past 20-30 years toward broader tax bases, targeted tax provisions continue to be significant in many countries.

Governments introduce tax reliefs for a wide variety of reasons including to correct externalities, to redistribute income, or to favour a particular interest group. Whatever the motivation, tax provisions entail a loss of government revenues, which necessarily means that other taxes have to be higher than otherwise (and/or government expenditure reduced). These higher rates may create additional efficiency losses, adverse effects on income distribution, and administrative and compliance costs.

This Report suggests, in particular, that VAT preferential treatments (including rate differentiation) are generally not well targeted to those in need, distort consumer choice, and impose additional administrative and compliance costs (related to the need of drawing borderlines between standard and reduced rate goods and services). In the case of personal income tax, the economic arguments for base-broadening can be less clear cut. Tax reliefs may reflect not only "ability to pay" concerns, but also economic efficiency arguments that may, for instance, point to lower rates of taxation on capital than on labour income. Nevertheless, many countries have a number of tax provisions that are not cost-effective ways of achieving either fairness or efficiency objectives.

This Report highlights that the overall effect of targeted tax provisions on efficiency, fairness and simplicity will depend on the design of the tax provisions. A country's specific circumstances, particularly regarding its tax revenue requirements, the redistribution preferences and the available policy options (*e.g.* scope for changes in the tax mix and level of taxes, the degree of development of the tax administration and the agency programmes) also play an important role in the overall effect of tax reliefs. This Report recommends periodically assessments of tax reliefs to evaluate whether their benefits actually outweigh their costs.

This Report also looks at the extent of tax provisions in OECD countries using available tax expenditure estimates. Tax reliefs in the form of exemptions from tax, reductions of the tax liability (deductions and credits) or tax rates that are lower than the "standard rate" are often called *tax expenditures,* because they can be seen as equivalent to public expenditure implemented through the tax system. While there is controversy around the definition and measure of tax expenditures, the estimates of revenue costs in these tax

concessions can provide a useful starting point for their evaluation. Tax expenditure data suggest that a wide range of tax concessions, both targeted and non-targeted, are still offered in many countries particularly on the personal income tax and the VAT. The major tax expenditures consist of provisions for owner-occupied housing, retirement savings, children and families, social benefits, food and necessities, small businesses and R&D expenditures.

The report highlights the need to assess these and other targeted tax reliefs to evaluate whether they continue to achieve their objective in a cost-efficient manner; *i.e.* in terms of minimising distortions, administrative costs and negative distributional impacts. In addition to increasing transparency of tax policy decisions, evaluation of targeted tax provisions may help identify possible candidates for base-broadening tax reform. A possible framework to evaluate the cost-effectiveness of a given tax provision is presented in this report. This evaluation framework is then applied to four examples: mortgage interest relief against personal income tax; the VAT exemption on sales and rentals of residential property; preferential tax treatments of retirement savings; and the VAT exemption on financial services. The analysis of these reliefs suggests that the design of tax reliefs, timing considerations and the tax treatment of close-substitute goods/services all play a key role on the cost-effectiveness of targeted tax provisions.

Finally, this report analyses the role of political and distributional factors in the legislation and implementation process of base-broadening reforms. It recognises that while the final decision is clearly a political one, economic analysis is a very useful tool when taking decisions. A strong economic case, while not guaranteeing success, may help obtain the political and social support needed for a particular base-broadening move. At the same time, economic analysis of targeted tax provisions may help increase government accountability regarding expenditure decisions made though the tax system.

Obstacles to the legislation and implementation of base-broadening reforms include the lobbying of influential interest groups, and presenting policy discussions on the abolition of a given tax relief in isolation (rather than as part of a wider package). In normal times the group of taxpayers that loses a tax-privilege strongly faces a strong incentive to lobby hard against such a tax reform; while, in contrast, a more diffuse wider population that would gain from their taxes being lower are often silent. It is possible, though, that the need of fiscal consolidation in the next few years may reinforce the voice of the often silent beneficiaries of a base-broadening reform and help therefore make such a reform happen.

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Introduction

Over the past 20-30 years, many countries have implemented tax reforms that have broadened tax bases and lowered rates. In general, such reforms should reduce the extent to which tax systems distort work, investment and consumption decisions, increasing output and enabling improvements in social welfare. Nevertheless, targeted tax provisions, notably tax expenditures, continue to be significant in many countries and in some countries may be increasing in number and significance. This report discusses the various economic and political considerations that drive governments' decisions when considering the choice between broadening the tax base and using targeted tax reliefs.

Chapter 1 discusses the economic arguments for base-broadening tax reforms and considers the circumstances in which targeted tax provisions may be appropriate. One of the main arguments in favour of broad bases is that tax reliefs will need to be financed by higher tax rates in order to obtain the same amount of required revenues. This suggests that, even when tax reliefs are motivated primarily by distributional concerns, there may be alternative ways of meeting those concerns but at a lower cost in terms of economic efficiency and lower administrative and compliance costs. Assessment of tax reliefs is thus desirable to evaluate whether their benefits actually outweigh their costs.

Tax expenditure reports are a useful starting point for policymakers when considering the pros and cons of broadening tax bases by reducing or removing tax reliefs. These reports, which are produced by many countries on a regular basis, list and estimate the costs of the main reliefs offered through the tax system. However, estimates in terms of revenue forgone need to be interpreted carefully. Chapter 2 discusses the pros and cons of these estimates and summarises OECD country experiences in tax expenditure reporting. Using tax indicators and country-specific data on tax expenditure, this chapter also explores tax reform trends throughout the OECD during the past few decades and the scope that current tax systems have for base-broadening reforms.

While there may be some cases in which the use of special tax reliefs is justified for redistribution purposes or to encourage specific economic behaviour, they need to be considered on a case by case basis. Chapter 3 highlights the desirability of periodic reviews to assess whether certain tax reliefs continue to be justified and examines some specific examples of targeted tax reliefs.

The economic case for a base-broadening reform may naturally influence political and public perceptions about its desirability. However, it does not always guarantee the adoption of such reforms. This suggests that while economic arguments may be useful, the final decision is likely to be a political one. Therefore obtaining the support of voters, politicians, lobby groups and the media is key to make base-broadening reforms happen.

In particular, uncertainty about the overall effects of these reforms on income distribution is often one of the main obstacles to their implementation. The choice of some

targeted tax reliefs over broad tax bases may also be explained by the fact that politicians see these reliefs as another policy measure to win elections. The lack of transparency and regular scrutiny of expenditures delivered through the tax system compared to direct spending may also make the use of tax reliefs attractive to politicians. Lobbying of interest groups, how and when the reform is "sold" to the different political actors and external constraints, may also influence the success or otherwise of broadening efforts. Some of the political and distributional obstacles to legislating and implementing base-broadening reforms are discussed in Chapter 4.

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Chapter 1

Broad Base – Low Rate Approach: Scope and Limitations

This chapter discusses the trade-offs between the standard desirable characteristics of a tax system (revenue raising, efficiency, equity and simplicity) by type of tax (VAT, PIT and CIT) in the context of a base-broadening and rate-cutting reform, and, at the same time, highlights the main limitations of this type of reform.

This chapter analyses the merits of revenue neutral tax reforms that involve reductions in tax reliefs to broaden the tax base and (*ceteris paribus*) enable lower tax rates. It focuses on specific (possibly quite modest) reforms that "improve" the tax system and increase economic welfare rather than broader issues about the overall "optimal" tax regime (Ahmad and Stern, 1991; Heady, 1993).

One advantage of this approach to the analysis of tax reform is that less information is likely to be required than for, say, an attempt to implement in full principles derived from the optimal taxation literature, since only behavioural changes in response to fairly small changes in taxes are needed for the analysis. (The results established in the optimal taxation literature may nevertheless be instructive – see relevant boxes later in this chapter.)

To consider whether a tax reform potentially improves economic welfare it is helpful to assess it in relation to the standard desirable characteristics of a tax system: efficiency, simplicity and fairness (equity).

a) Efficiency: all taxes distort behaviour (apart from the theoretical lump sum tax) and thus produce deadweight costs of lost production and economic welfare. One objective of tax policy is to minimise these costs.

b) Simplicity: ease of administration, low compliance costs and high rates of compliance are all important aspects of a good tax system.[1]

c) Fairness: both horizontal and vertical equity need to be considered. Taxpayers with similar characteristics and circumstances should be treated in the same way (horizontal equity). Second, the tax burden should be related to ability to pay (vertical equity).

These desirable features can conflict with each other and, hence, an empirical assessment is likely to be desirable to establish what the trade-offs between them are and to inform policy choices between them.

A tax system is considered efficient if, for any given amount of revenue to be raised, it distorts behaviour as little as possible.[2] A base-broadening and rate-cutting reform should reduce distortions by reducing overall tax rates and removing incentives for taxpayers to change their behaviour to take advantage of tax reliefs.

In considering the economic efficiency case for removing tax reliefs (often termed "tax expenditures" – see next chapter) and broadening the tax base the underlying need for revenue neutral reform is crucial. When tax reliefs are given, tax rates have to be higher than otherwise; and in standard economic theory the deadweight loss from taxation goes up by the square of the tax rate (Auerbach, 1985; Auerbach and Hines, 2002; Blundell *et al.* (eds.), 1994; Creedy, 1998 and 2003). There is thus a strong presumption (aside from cases where reliefs play a role in correcting externalities – see further discussion below) that reforms that enable a reduction in tax rates will increase economic efficiency.

Reducing the number of tax provisions that provide preferential treatments to certain activities/sectors may also increase economic welfare by cutting compliance and administrative costs, releasing resources to be more productively employed elsewhere.

Such reforms may also reduce incentives and opportunities for tax avoidance and evasion, activities that tend to worsen horizontal equity and require higher tax rates elsewhere in the tax regime to raise the required amount of revenues.

Broad bases simplify the tax system by reducing exemptions, allowances, credits and/or rates differentiation. This simplification may reduce compliance costs related to individuals and businesses in terms of tracking tax-preferred activities, understanding qualifying and reporting requirements, time required to complete tax returns and to get the relief. At the same time, a broad base approach may also reduce administrative costs in terms of defining the rules of preferential tax treatments, ensuring compliance with the rules (in terms of length of tax instructions and auditing time) or refund costs. A less complex tax regime may also be more effective in terms of achieving higher levels of taxpayer compliance; in turn enabling lower tax rates (for given revenue needs) and improving horizontal equity.

More generally, if there is strong support for the principle of a simpler, broad-based tax regime, there may be less incentive for seeking special tax concessions by interest groups,[3] as they are less likely to be successful.

There seem to be both theoretical and empirical evidence (see, for example, Heady, 1993; or Johansson *et al.,* 2008) that suggest that in most cases the benefits of a broader tax base reform outweigh its costs. However, this needs to be established empirically for each specific tax reform, taking account of the particular circumstances in individual countries and the means available for ensuring that the overall benefits from a reform are distributed fairly and equitably.

The remainder of this chapter discusses the trade-offs between revenue raising, efficiency, equity and simplicity by type of tax (VAT, PIT and CIT) in the context of a base-broadening and rate-cutting reform, and, at the same time, highlights the main limitations of this type of reform.

1.1. VAT

The case for a broad base and a single low rate

In the case of consumption taxes,[4] there is an extensive academic literature on the pros and cons of differential tax rates, going back to the first formulation of the "inverse elasticity rule" by Ramsey (Ramsey, 1927). In practice, the information required about consumers' behaviour needed to operate a differential tax regime that improves (rather than worsens) economic welfare is so extensive as to make such regimes impracticable – see Box 1.1 and references therein. Moreover, the few goods for which differential taxation can be justified are probably best dealt with by special excise taxes or direct subsidies rather than by a multi-rate VAT system (Heady, 1993; Ebrill *et al.,* 2001; Johansson *et al.*, 2008).[5]

Trade-off between efficiency and equity

Moreover, the inverse-elasticity rule may also raise fairness (vertical equity/ redistribution) concerns. It suggests higher tax rates on products in inelastic demand. These are typically basic goods (*e.g.* food) which make up a larger proportion of the expenditures of low income households and taxes on them are likely to be regressive.[6] In practice, many VAT reduced rates are applied to "necessities", such as food and clothing, in

Box 1.1. **Optimal taxation theory and consumption taxes**

From a pure efficiency point of view (*i.e.* raising a given amount of revenue at the least distortionary cost possible), optimal taxation theory (Atkinson and Stiglitz, 1976) argues for uniform commodity taxation, and in particular no commodity taxation. However, this result only holds under certain economic assumptions, such as that tastes (or preferences) are identical and weakly separable in leisure and other goods. Moreover, Naito (1999) shows that the uniform-commodity taxation result breaks down when wages and prices are endogenous.

In contrast, optimal taxation theory, and in particular the well-known Ramsey Rule (Ramsey, 1927), states that economic efficiency is maximised by taxing consumption goods at rates that are inversely proportional to their own-price elasticity of demand. Thus, while taxation changes the relative prices of consumption goods/services, tax-induced changes in consumption patterns will be minimised where higher tax rates are levied on goods/services whose demand is not very sensitive to price increases (*i.e.* changes in relative prices lead to small changes in demand).

However, this efficiency concept, if strictly applied, would be very difficult to implement due to very high administration costs. It would require not only reliable estimates of price-elasticities for every product (good or service) on the market, but also to regular updates of these elasticities to take account of changes in preferences and/or technology (which will imply, for example, the introduction of new goods that will affect the price-elasticities of products already in the market).[1] Moreover, by suggesting heavier taxation on commodities with inelastic demand, this efficiency concept may also raise fairness (vertical equity or redistribution) concerns, because price inelastic goods are typically basic goods (*e.g.* food) which are consumed in larger proportions by low-income households.

Moreover, this simple inverse-elasticity rule applies only as a very special case of the optimal tax problem in which all individuals are identical and demands are independent (cross-price elasticity equal to zero). When individuals differ only in their earnings ability and a nonlinear income tax is available in addition to potentially differentiated commodity taxes, the key demand characteristic relevant to revenue-raising efficiency is the degree of complementarity/substitutability with leisure (Corlett and Hague, 1953; Diamond and Mirrlees, 1971; Crawford *et al.*, 2008). In fact, under the assumption of zero cross-price elasticities, the good with the most inelastic demand curve will be also the good most complementary with leisure (Heady, 1987). The intuition of this result is that an increase in taxation on a good that is complementary with leisure (*e.g.* golf clubs) will discourage the consumption of leisure, increase labour supply, and thus partially offset the original distortion created by taxation (Heady, 1993; IFS, 2009). The question is then to identify which products are more complementary with leisure and whether selective excise duties (or differential capital income taxes)[2] would be more cost-efficient than VAT or sales tax differentiation (Heady, 1987; Ebrill *et al.*, 2001).

However, this result ignores differences in preferences between households and equity concerns. Introducing non-uniform preferences, theoretical and empirical evidence shows that direct payments are more effective than non-uniform commodity taxation for redistributive objectives (Deaton and Stern, 1986; Ebrahimi and Heady, 1988; Heady and Smith, 1995; Ebrill *et al.*, 2001).

When preferences are not separable in leisure and commodities (*i.e.* all commodities are not equally substitutable for leisure), optimal taxation theory (Christiansen, 1984; Saez, 2002b) suggests higher commodity taxes on goods/services for which high-income individuals

Box 1.1. **Optimal taxation theory and consumption taxes** *(cont.)*

tend to have a relatively strong taste. However, practical issues related to the difficulty in estimating (compensated) cross-price elasticities would still make difficult the implementation of this optimal differentiation of commodity taxes (Sørensen, 2007b and 2009).

Finally, optimal differential commodity taxation is also suggested in the presence of externalities (*e.g.* Sandmo, 1975), or on labour-intensive activities, such as housing repairs, gardening, cleaning (Kleven, Richter and Sørensen, 2000; and Kleven, 2004). The latter implies optimal reduced taxation on commodities that are close substitutes with self-supply or underground work. Although these services can be seen as complementary with leisure, higher tax rates may give incentives to discourage labour supply to the market (*i.e.* substituting away from market activities towards untaxed activities), while reducing the time that high-skilled individuals have to spend either on leisure activities or with their families (Sørensen, 2007b and 2009; Heady *et al.*, 2009). However, the trade-off between efficiency-equity considerations and high compliance and administrative costs, and the opportunities for tax avoidance and evasion may again outweigh the efficiency gains of differential taxation.

1. As Harberger (1990) argued, uniform taxation can be defended on pragmatic policy grounds, since it does not requires knowledge of demand and supply relations and is more robust to changes in preferences and technology.
2. In tax systems where (significant) direct excise taxation is not possible, an argument can be made for differential capital income taxes, given that capital taxes also affect the price of goods and services (to an unknown degree) and thus have "excise tax effects". A main difficulty is that differential capital income taxes will distort production decisions over competing factor inputs (OECD, 2001).

order to reduce the tax burden on low-income individuals (such as pensioners, low-paid workers and social security beneficiaries).

The natural question to ask then is whether reduced VAT rates on such goods and services are an effective way of achieving distributional objectives. The benefits of reduced VAT rates will be greater for better off households in absolute terms if, as is likely, their consumption of the tax-favoured goods and services is greater than that of poorer households (McLure, 1990; Cnossen, 1998; Copenhagen Economics 2007; OECD, 2008a; IFS, 2009). Thus poorer households may benefit from reduced rates of VAT on "necessities" but better off households gain even more.

This raises the question of whether raising the VAT rate and using direct transfers to poorer households to achieve distributional objectives would be a more effective policy. Could targeted PIT reliefs or benefits better achieve distribution goals (in terms of cost-efficiency)?[7] Deaton and Stern (1986) for instance show that direct lump-sum payments to households related only to their socio-economic characteristics are better in terms of both equity and efficiency. Transfers directly targeted to low-income households (including increased personal income tax allowances[8] and state benefits) may be also more effective in enhancing equity than VAT provisions (Atkinson and Stiglitz, 1976; Ebrahimi and Heady, 1988; Heady and Smith, 1995; Ebrill *et al.*, 2001).

A related issue is that it may well be difficult to define "necessities" in practice. For instance, a reduced rate may apply to all food including "luxury" items. Drawing distinctions tends to raise administrative costs (defining and monitoring) and compliance costs (identifying, understanding); and it encourages litigation to try to get products into the reduced rate category.

Other arguments for reduced rates include a desire to treat "merit" goods more favourably to encourage their consumption. "Merit goods" are considered to be goods that an individual or society should have on the basis of some concept of social/cultural need, rather than ability and willingness to pay (Musgrave, 1957). Thus, preferential tax treatments, by changing relative prices, may allow "cultural (merit) goods" to be more available for low-income households (*e.g.* books, newspapers, music and cultural events).[9] This approach can be criticised as paternalistic and often the goods in question are primarily consumed by high-income households. Furthermore, the preferential tax treatment of some cultural services may also raise neutrality concerns related to the high level of substitutability with goods that are taxed at standard VAT rates (in some countries), such as for example cinema.[10] The definition of a "cultural" good may also entail some controversy regarding "paternalism" judgements. For example, a symphony concert might qualify for a tax relief but a rock concert might not.

Distributional arguments in favour of VAT rate differentiation may be more persuasive where countries do not have the administrative capacity to provide more direct transfers to poorer households (Heady and Smith, 1995).[11] In low-income countries, significant and stable differences in consumption patterns between high and low-income groups allow for an easier and more efficient alleviation of poverty through exemptions from consumption taxes or low rates. In these countries low-income families purchase most of their goods from local small-scale producers whose output may either be exempted or escapes taxation, while high-income families are likely to buy more factory-made or imported goods that can be taxed more effectively (Copenhagen Economics, 2007). However, even in low-income countries, progressivity in consumption taxes could be better achieved through the selective use of excise duties (Heady, 2001).

VAT: Limitations in the application of a broad base and a single low rate approach

In addition to equity concerns, VAT rate differentiation may reflect: 1) the practicability of implementing a VAT regime given potential administrative and compliance costs (at the time the VAT regime was first introduced); or 2) attempts to correct for "market failures" (including the existence of externalities or spill-over effects). However, even in these cases, the benefits of a preferential treatment may not outweigh its costs.

For example, high administrative and compliance costs regarding the determination of the VAT base are often adduced to "explain" the VAT preferential tax treatment of financial services and immovable property. However, it is unclear that the benefits of these reduced costs outweigh the deadweight costs from the resulting distortion of consumption and production patters. In addition there may be further revenue losses (and distortions) arising from tax-planning strategies, and perhaps decreased equity (for a more detailed discussion, see Chapter 3).

Another example of reduced VAT rates may be locally-supplied services (*e.g.* gardening, hotels and restaurants). However, the question is whether the benefits from differentiated VAT rates (including compliance and administrative costs) are outweighed by the benefits that could be achieved from a wider tax base (*e.g.* in terms of hours shifted back to the formal economy and extra tax revenue).

Efficiency considerations may also justify reduced VAT rates for specific labour-intensive activities.[12] Low taxation of commodities that are close substitutes with self-supply or underground work (*e.g.* home improvement and repair services, gardening,

and hairdressers) may mitigate the unavoidable discouragement to work in and purchase from the formal economy created by the tax system. The argument is that high tax wedges (high income tax, social security contributions and VAT rates) make it very expensive to buy these services on the market and more attractive to do by oneself. The implication is that high-skilled professionals spend time on low-skilled work at home instead of spending time with their families or increasing their more productive labour supply.[13] Numerical simulations in Sorensen (1997) and Piggott and Whalley (1998) showed that the efficiency gains from reduced rates on this type of services could be significant.

Some empirical analysis (IFS, 2009) show that benefits outweigh costs in the case of reduced VAT on locally-supplied services. However, this result may change (and definitely, administration costs will be reduced) when a broad base-single rate VAT (set at a non-excessively high rate) is combined with a fairly high VAT threshold and a well-targeted audit programme (Heady *et al.*, 2009). In addition, if the theoretical motivation for these reduced rates is to raise demand for low-skilled labour by boosting the demand for such services, other policy instruments such as labour market reforms could be more efficient in achieving this objective (Copenhagen Economics, 2007).

It is sometimes argued that correcting externalities might justify VAT rate differentiation; for example, higher rates on goods that generate pollution or reduced rates on energy-saving appliances. In these cases, rate differentiation may improve efficiency if it means that private marginal costs of an activity are brought more into line with society's marginal costs.[14] However, VAT is a rather blunt instrument for correcting externalities, as it may be hard to target the actual source of pollution. For example, reduced rates on energy-saving appliances, by reducing the private marginal cost of these goods may boost demand for them and, therefore, stimulate consumption of these goods. However, the overall effect on CO_2 emissions of these energy-saving appliances is ambiguous (OECD, 2010). The reduced VAT rate may give incentives to shift from more to less energy consuming items (*e.g.* hair-dryers), but at the same time may also lead to a shift of overall consumption in the direction of energy-intensive products (*i.e.* consumers may buy more hair-dryers).[15]

Moreover, higher rates to correct for negative externalities (*e.g.* on goods that generate pollution, or a higher VAT rate on high energy-consumption appliances) rather than lower rates on goods with positive externalities, while improving economic efficiency may also have the advantage of raising tax revenue, which, in a revenue-neutral reform, could be used to reduce rates in other distortionary taxes, leading to further efficiency improvements.

1.2. Income taxation

Personal income taxation

The choice of a country's personal income tax schedule is likely to depend on how the trade-off between equity and efficiency is reconciled. Important influences on the design of the PIT include labour supply elasticities, the distribution of earnings capacity and revenue needs (see Box 1.2). Optimal taxation theory suggests that marginal tax rates on labour income should be higher: *i)* the less elastic is the supply of labour; *ii)* the more unequal is the distribution of earnings capacity, and the degree to which society sees this as an issue; *iii)* the more weight is given to low income/utility households relative to others; *iv)* the greater are the government's revenue needs; and *v)* for the middle rather than the lower income groups (Stiglitz, 1987).

Box 1.2. **Optimal taxation theory and income taxes**

Extending the Ramsey rule (see Box 1.1) to income taxation, optimal taxation theory suggests that taxing types of income and different income levels at the same rates may entail significant efficiency losses (Mirrlees, 1971; Tuomala, 1990; Salaine, 2003; Kaplow, 2008a).

Labour income

From a pure efficiency point of view, under certain assumptions, an optimal income tax schedule could often be approximated by a linear income tax and a transfer payment for incomes below the tax exemption level (Mirrlees, 1971). A flat tax system with few provisions probably raises fewer tax-induced distortions than other systems, and is also generally simpler to administrate. However, it puts less emphasis on redistribution (an important function of an income tax) and, moreover, it may require implementing a rather high tax rate in order to satisfy budget requirements, which make it difficult to predict the overall effect on efficiency (OECD, 2006).[1]

With non-linear tax schedules, which reflect the income redistribution objective of the tax system, economic efficiency is maximised by taxing labour income at rates that are inversely proportional to labour supply elasticities (Saez, 2001). However, while maximising efficiency (by minimising distortions on labour supply decisions), the pure implementation of this theory would imply a hump-shaped tax rate function of income. This shape would mean lower (marginal) income tax rates at the top and bottom tails of the income distribution, where labour elasticities are found more elastic. However, where governments use the tax system also for income redistribution objectives, lower marginal rates at the top of the income distribution may be seen to counter (vertical) equity principles.[2]

Moreover, the sensitivity of the optimal income tax schedule depends on underlying assumptions about the shape of the distribution ability, the social welfare function and labour supply elasticities (Heady, 1993; Mankiw *et al.*, 2009). Saez (2002a) shows that optimal marginal tax rates can be derived in terms of the relevant elasticities of labour supply and the properties of wage distribution. He then suggests lower optimal marginal tax rates at labour income levels with high labour effort elasticities and larger numbers of taxpayers. The intuition is that the efficiency loss from a rise in the marginal rate will be greater the more taxpayers who are affected by it and the stronger their labour supply responds to a change in the net gain from additional effort (*e.g.* women). Saez also suggests lower optimal marginal tax rates at labour income levels with high participation elasticities, initial participation tax rates (measuring the increase in net taxes imposed when a person moves from non-employment to into employment) and larger number of taxpayers. This result would suggest negative (rather than zero) marginal tax rates at the bottom of the labour income distribution in order not to discourage their participation, which could provide a role for "in-work benefits" (Sørensen, 2009).

Capital income

Applying optimal taxation theory to different income streams raises two issues: 1) whether capital income should be taxed; and, 2) whether all returns should be taxed at the same rate (neutral taxation of capital income). There is a considerable economic literature that argues that capital income should not be taxed (Diamond and Mirrlees, 1971; Atkinson and Stiglitz, 1976; Ordover and Phelps, (1979); Stiglitz, 1982).[3] However, this result is the consequence of assuming present and future consumption (*i.e.* saving) as equally substitutable for leisure (also weak separability and homogeneity of consumption preferences), and in practice it would imply either not taxing capital or introducing a cash flow expenditure tax (which, with a tax rate constant over time, implies a zero marginal effective tax rate on capital income).[4]

Box 1.2. **Optimal taxation theory and income taxes** *(cont.)*

In contrast, more recent analyses (Cremer *et al*., 2001; Saez, 2002a), by extending the Ramsey rule to heterogeneous consumption preferences, suggest that while capital income should be taxed to some extent, there is no reason for capital income to be taxed at the same rate as labour income (due to the complementarity of leisure and future consumption in a life cycle model; this complementarity might be the case where, for example, leisure tends to increase with age [Erosa and Gervais, 2002]). Saez (2002b) also argues that the desirability of commodity taxation suggests a positive capital income tax is part of an optimal tax system in the empirically relevant case where high-productivity individuals have a higher propensity to save than low-productivity individuals (Sørensen, 2007b).

In particular, lower taxation of savings can lead to a more uniform taxation of savings, although the literature does not provide insights on the optimal level of this taxation.In contrast, variations in the tax treatment of different forms of savings result in different firms facing different costs of capital. Therefore, the differential tax treatment of saving vehicles violates the production efficiency result, which requires all firms to face the same prices for all inputs and outputs (Heady, 1993). Empirical evidence shows that total savings is found not to be very responsive to taxation while the form in which savings are held is found to be very sensitive to taxation. This confirms the theoretical result that taxing capital income at a relative lower flat rate than labour income may minimise overall (domestic) distortions.[5]

On the other hand, as in the case of the Ramsey rule for commodity taxation, in sectors where the tax elasticity of capital demand is known with a high degree of certainty to be either very high (*e.g.* high mobile investments) or very low (*e.g.* location-specific rents), policy makers may want to accept some deviations from tax neutrality in order to reduce the distortionary effects of source-based capital taxation. This is in fact an application of the optimal "inverse elasticity rule for source-based capital taxation", which holds under the assumptions of fixed domestic factors and zero cross-price elasticities of capital demand (Sørensen, 2007b).

Furthermore, Saez *et al*. (2009)[6] show that changes in marginal income tax rates may create distortions not only on the individual's labour supply, but also on the individual's behaviour related to income reporting; including, for example, income shifting, income tax evasion and changes in the form of business organisation (see Box 1.3). All these changes will create dead-weight losses, since they are tax-induced distortions. They introduce the concept of elasticity of taxable income and support the optimal taxation of all income streams. Allowing provisions may both reduce the size of the tax base and increase significantly the elasticity of taxable income, thus increasing significantly the total dead-weight burden from the income tax. Moreover, the efficiency gains of a broader income tax base may be further increased if, in a revenue-neutral tax reform, extra revenues are used to decrease marginal personal income tax rates (or other distortionary taxes).

1. As well as redistribution considerations, assumptions on labour supply elasticities also play an important role in the design of the income tax schedule (Heady, 1993; Saez, 2001). Depending on these assumptions, the revenue effect of raising the tax rate may be negative, implying that there is a limit to how high the tax rate should be (see for instance Stern, 1976).
2. The equity-efficiency trade-off has been challenged by the new endogenous growth theory (Osberg, 1995). According to this theory, limiting inequality has a long-run positive impact on economic growth. While too much tax progressivity might create unfavourable distortionary effects, some progressivity might be desirable if the additional personal income tax revenues are redistributed so that all taxpayers obtain a similar opportunity to participate in the economy. As the increased participation favours long-term growth, a fair tax policy becomes efficient as well. In contrast, optimal taxation theory (Mirless, 1971) suggests that increased earnings potential at the top of the income distribution enables more redistribution toward the low-skilled, so that the increase in earning inequality does not translate into an increase in disposable income inequality (Mankiw *et al*., 2009).
3. Taxes on capital income distort the intertemporal allocation of consumption due to the compounding of effective tax rates over time. This distortion in turn creates a bias against saving. However, the distortion to the decision to save rather than spend is an inevitable consequence of choosing an income tax rather than a consumption tax.

Box 1.2. **Optimal taxation theory and income taxes** *(cont.)*

4. The production efficiency theorem of Diamond and Mirrlees (1971) argued that (second-best) optimal tax systems avoid production efficiency distortions provided that the governments can tax away pure profits and can tax all transactions between household and firms. However, in an open economy production efficiency would require effective system of information exchange between national and international tax administrations, which does not exists (yet) to allow the implementation of a residence-based taxation on worldwide income (in order to tax all returns of capital received by domestic residents from both domestic and foreign sources).
5. See for example OECD (2005a, 2007c).
6. Empirical literature also shows that taxable income of high-income workers is particularly elastic with respect to changes in tax rates; ceteris paribus, their taxable income decreases with higher tax rates (Feldestein, 1995; Gruber and Saez, 2002). This high elasticity suggests lower optimal marginal tax rates on high incomes. This elasticity is also particularly elastic for low-income workers. High tax rates on low-income workers may hence disincentive labour market participation of low-income individuals, by giving them incentives to either move to benefits programmes or to operate in the informal economy.

A broad-base tax reform of personal income taxation that focuses on standard tax allowances and tax rates needs to strike a compromise between economic efficiency and fairness, especially as the redistribution function of the tax system is mainly achieved by progressive personal income taxation. The progressivity of the personal income tax depends very strongly on the level of the tax threshold (the level of income at which an individual starts paying personal income tax). Thus, it is impossible to broaden the base of the tax by reducing the tax threshold without reducing the progressivity of the income tax.

Increasing marginal rates are another feature that influences the progressivity of income taxation (high marginal tax rates may also be explained by revenue needs). While in line with vertical equity, highly progressive income tax rates reduce incentives to work and to invest in human capital. Lower innovative activity and productivity may also be the result of migration of high-skilled and high-income earners to avoid increased average tax rates resulting from excessive high top marginal rates (Johansson *et al.*, 2008). Incentives for tax avoidance and tax evasion may also be increased with high progressivity and high tax levels, contributing to a larger informal economy, which may reduce tax revenues and undermine the fairness of the system.

In general, the distorting effects of taxes (deadweight losses) rise more than proportionately with marginal tax rates. On the other hand, a reduction of the top statutory personal income tax, while reducing distortions, also reduces the progressivity of the tax system because the relief will only reduce the tax burden for high-income taxpayers.

These two elements of progressivity (the personal threshold and the marginal tax rate schedule) are generally considered as structural components of the tax system, because they reflect the ability to pay of individuals; *i.e.* societal preferences about how tax liability should vary according to taxable income. On the other hand there will be limits to the extent to which reduced efficiency and lower output would be a price worth paying for greater fairness.

The ability to pay argument may be extended to justify joint family taxation as a structural element of the tax system. For example, if taxable income is defined for households rather than individuals (considering households as the principal unit of consumption) family-based taxation will increase vertical and horizontal equity in the taxation of households with different composition of income. However, the choice between family and individual taxation again involves a trade-off between equity concerns and

distortions on the labour supply of second-earners. Joint family taxation may create disincentives for (married) second-earners to enter the labour market and have adverse effects on GDP per capita. On the other hand, one problem with individual taxation is how to attribute non-labour income between the spouses. Should it be added to the income of the spouse with higher income, or should couples be able to freely choose? However, while this issue has equity implications, it is unlikely to significantly influence economic behaviour (Johansson *et al.*, 2008).

Ability to pay and tax provisions

Some preferential tax provisions may also reflect ability to pay, such as the tax reliefs introduced as a means of income distribution. These reliefs have the same purpose as social benefits and include, for example, tax deductions or tax credits for dependent children. The removal of these tax provisions in a move to a broader tax base would typically require their replacement by ordinary expenditure programmes and, therefore, would not provide an opportunity for a tax rate reduction (in a budget-neutral reform).

Moreover, the design characteristics of these reliefs play an important role in their overall impact on income redistribution.[16] For tax provisions with social objectives, the ability to pay principle implies that taxpayers should be able to claim a deduction from their taxable income that depends on the number of children and other social costs that they bear. The value of these deductions increases with income in tax systems with progressive tax rates, reducing consequently the average tax rates more for individuals facing high marginal rates than for those with low marginal rates. Therefore, these reliefs give greater benefits to taxpayers with higher incomes, which are also the people best able to meet these social costs. Where formulated as deductions (amounts deductable from taxable income), these targeted tax provisions will therefore generally reduce the progressivity of the tax system. This effect is known as the "upside down" subsidy effect (Surrey and McDaniel, 1980).

In contrast, if structured as tax credits (amounts deductable from tax liability), these tax provisions might increase the progressivity of the tax system. Furthermore, a tax credit will create uniform incentives and provide uniform benefits to all individuals if it is structured as a refundable (also called payable or non-wastable) credit, where a cash payment is made by the revenue authorities to the individual or family if tax liabilities before the credit are lower than the value of the credit.[17] This means that low-income households benefit fully from the credit, even if they do not have a sufficiently high taxable income.

On the other hand, if these provisions have the same purpose as social benefits, the natural question to ask about is why they are not delivered as ordinary expenditure programmes. Then, these provisions will be justified only when the most cost-efficient way to deliver these benefits is the tax system as opposed, for example, to ordinary expenditure programmes.

One reason to use the tax system is that tax administration may be seen as more efficient that the social welfare administration, but this difference in efficiency can be expected to vary between countries. Three other potential advantages of using the tax system to deliver social benefits are as follows. First, to the extent that there is any income targeting in the assistance, the tax authority already collects this information. Second, many tax authorities use a system of taxpayer self-assessment combined with rather infrequent audits, which is less costly than the more detailed controls that social welfare

departments typically use. On the other hand, the use of the tax administration to deliver social benefits would require devoting more resources to dealing with low-income households, who frequently have very different problems from the higher-income households with whom the tax administration is more familiar. This has caused difficulties in some countries. Third, the information collected by the tax authorities as well as their verification procedures may contribute to limit the probability of abuse or fraud when the assistance is delivered through tax systems.

Additionally, benefits provided as direct expenditure programmes are usually more bureaucratic, although it is not obvious that this necessarily has to be the case, since many of these provisions are simply claimed on the annual tax return and the only control is the chance of audit. However, if the only argument for providing an incentive through the tax system is to reduce bureaucracy in terms of administrative and compliance costs, it would be worth investigating whether a more appropriate policy would be to simplify the administration of the expenditure programmes. In addition, in some cases, social welfare agencies may reduce the timing needed for the beneficiaries to get the social payment. Moreover, in particular, households (and this argument also applies to firms) that pay little or no tax will receive little benefit from a tax provision unless it is made available as a refundable tax credit. Moreover, delivering these social benefits through the tax system also has the possible political advantages of a lower recorded tax-to-GDP ratio and a reduced legislative oversight.

In practice, the refundable tax credits introduced for social purposes are the tax provisions almost equivalent to an ordinary expenditure programme. In this particular case, the delivery of social benefits through direct spending leads to no significant alterations in terms of distribution of these benefits but also of design and administration costs, and the ability to pay argument for continuing to deliver this assistance through the tax system is removed.[18] However, high compliance and administrative costs may still support the tax system as the most cost-efficient mechanism of delivery.

In general, the choice between different deliver instruments (including direct expenditure, tax provisions or regulation) depends on the effect that providing the incentive through the tax system would have on *i)* the effectiveness of the incentive, *ii)* the distributional effects of the incentive, and *iii)* the administrative and compliance costs related to the incentive.

Perhaps the strongest claim that the effectiveness of an incentive is higher when delivered through the tax system relates to "*in-work benefits*" or "*make-work-pay policies*" (OECD, 2006).[19] These provisions, which have been introduced by some OECD countries in their recent tax reforms, aim to reduce disincentives to participate in the labour market, at the same time that tackling inequality by especially targeting low-income and low-skilled households (see Chapter 3).

Capital income taxation

Optimal taxation theory suggests positive taxation of capital income at both the corporate and personal level (see Box 1.2). While a zero tax wedge on the return on saving/investment at the margin would avoid distorting such decisions, other considerations point to taxing such returns, but in a uniform manner. However, there may be a case for differential taxation if this can correct market failures and where there are location specific rents (as higher tax rates will not then discourage investment).

At the corporate level, economic theory suggests that a cash-flow corporate tax or any other variant of an expenditure tax would minimise distortions in marginal investment decisions and between sources of finance (OECD, 2007b). However, given the (revenue, complexity, avoidance/evasion and transitional) implications related to the replacement of current corporate tax regimes with a cash-flow tax, the efficiency considerations in this report focus on how best to minimise distortions through lower overall tax wedges and less dispersion between the wedges on different investments under current regimes.

The implementation of dual income tax systems (which combine a progressive tax schedule for labour income with a lower flat tax rate on personal capital income and corporate income) and lower tax rates of various forms of savings in some OECD countries reflect a trade-off between efficiency and equity. In particular, the relatively low rate of tax on capital income enabled the dual income tax countries to tax different forms of capital income in a more uniform manner than most other countries, as the incentive for particular groups to argue for special treatment is much reduced. However, at the same time, dual tax systems may be seen as violating horizontal and vertical equity. On the one hand, taxpayers with different mixes of capital and labour income are taxed differently. If year-to-year income is used as the basis for evaluation, this can be seen as violating horizontal equity. On the other hand, given that income from capital tends to be concentrated in the upper income brackets, dual tax systems also undermine vertical equity (OECD, 2006).

Moreover, the tax wedge between capital and labour income may create tax-arbitrage opportunities leading to reduced efficiency, reduced equity and revenues losses (see Box 1.3). For example, this wedge may give individuals incentives to incorporate and pay themselves with artificially low labour income and higher low-taxed dividends. These tax-arbitrage opportunities may limit the scope of CIT rate cuts in some countries where the tax wedge between capital and labour income is already high. In addition, these tax-arbitrage opportunities may also give the perception of an unfair share of the tax burden and, therefore, encourage further tax-planning strategies and increased informality.

Box 1.3. **Preferential tax treatments and tax arbitrage opportunities**

Where different types of income – including self-employment income, (dependent) employment income, dividends, capital gains, interest – are taxed at significantly different tax rates, owners of small businesses and in particular closely-held private companies may alter economic behaviour. In particular, the tax-induced gap created between labour and capital income may create distortions on decisions over business form (corporate *vs*. incorporate business), capital structure (debt/equity ratio), earnings distribution, and other financial policies, in order to reduce their overall tax liability.[1]

For example, a low corporate income tax rate (with distributed profits free of shareholder tax or taxed at a low final withholding rate) relative to high personal income tax and employee and employer social security contribution rates (on wages), an owner/worker of an incorporated small business may pay himself an artificially low wage (an amount less than an arm's length wage for his labour input), in order to receive not only capital income, but also some portion of returns on labour, as dividend income.[2]

To take another example, if capital gains on shares are tax-exempt, while wages and dividends are subject to personal income tax, incentives may be created for small business owners/workers to retain earnings in a company (earn tax-preferred capital gains on SME

Box 1.3. **Preferential tax treatments and tax arbitrage opportunities** *(cont.)*

shares), rather than receive them as wages or dividends and to invest the funds actively in productive capital, or passively in portfolio assets.

In addition to decreased efficiency, such tax-induced outcomes raise revenue losses and equity concerns. Moreover, public awareness of examples of tax relief obtained in this way (*e.g.* little tax paid on wages) may contribute to a general public sense that the tax system is unevenly applied and thus unfair, tending to erode voluntary compliance of others (including incentives for tax-planning and increased informality).

1. Tax arbitrage opportunities refer here to the exploitation of tax rate differences to minimise income tax for a given set of economic (as opposed to financial) variables (*i.e.* holding labour and capital fixed), by mischaracterising one form of income (*e.g.* wages) as another (*e.g.* capital income).
2. Auerbach and Slemrod (1997) show that the US drop of the top individual rate below the corporate tax rate (1986 Tax Reform Act) led to significant increase in business activity carried out in pass-through, non-corporate form.

Corporate income taxation

Taxing both personal and corporate income at the same flat rate could reduce tax-arbitrage opportunities and further improve efficiency (assuming credits were given in some way when taxing personal income for tax already paid at the corporate level), because a flat rate would reduce the tax incentives for income shifting between the personal and the corporate sector. However, having a flat tax on capital and labour income might require a rather high tax rate to meet revenue requirements, which would reduce the efficiency of the tax system especially if the tax bases are internationally mobile and international tax competition is high (OECD, 2006).

However, even with high capital mobility and international tax competition, efficiency arguments may support higher rates where corporations enjoy location-specific advantages; that is, when profits require investment (*i.e.* a physical presence) in a specific location, such as extraction of natural resources or the service provision of a restaurant (see Box 1.4). The tax burden on these location-specific rents may be increased up to the point where super-normal profit is fully taxed without discouraging investment. While this source of (non-distorting) tax revenue would allow reductions in other distortionary taxes (in a revenue-neutral reform), leading to an improvement in overall economic efficiency, the implementation of higher tax rates on location-specific profits is difficult. In contrast, in practice many countries provide preferential treatments to highly mobile investments (in some cases just responding to similar tax incentives offered by a neighbouring jurisdiction also competing for mobile foreign capital or high-skilled labour force, "neighbour effect"). These provisions, which are not targeted to incremental investment, entail revenue losses and tax-planning opportunities, and may undermine efficiency by requiring higher tax rates to finance them.

On the other hand, some moves to more neutral taxation may imply introducing rules that could be implemented only at significant administrative and compliance cost. Neutral taxation requires, for example, taxation of capital gains on an accrual basis rather than on a realisation basis (when assets are sold). This would require taxpayers and tax administrations to determine market values even where no observable market transactions had occurred; and it would generate tax liabilities that could create cash flow difficulties for businesses if they had not actually realised gains in the period.

Box 1.4. **Location-specific and location-dependent profits**

In addition to the existence of market failures, economic theory also suggests (OECD, 2001) efficient differential taxation (and relative higher rates) on location-specific rents. Where corporations enjoy location-specific advantages, that is, profits may require investment (*i.e.* a physical presence) in a specific location, the tax burden on these location-specific rents may be increased up to the point where economic profit is fully taxed without discouraging investment.

In considering location choice, a central question is how location-specific are potential profits for a given level of risk?* For certain investments, profit from meeting market demand for a final product or undertaking production part of a value-added chain may vary significantly across alternative locations, and in certain cases may be location-specific. With location-specific profit, costs in accessing required factor inputs (*e.g.* labour, raw materials, and energy) and/or costs in delivering outputs to market are generally significantly higher from other locations. In the case of privatisations, profits are generally time- as well as location-specific. Other examples include the extraction of natural resources (*e.g.* oil and gas), and the provision of restaurant, hotel and certain other services. In such cases, if the anticipated risk-adjusted return on capital meets or surpasses a required "hurdle" rate of return, investment can be expected.

Where an economy offers an abundant set of location-specific profits, policy makers may understandably resist pressures to adjust to a relatively low tax burden, to avoid tax revenue losses and windfall gains to domestic/foreign investors and/or foreign treasuries. Reducing the effective host country tax rate to levels observed in certain competing countries, while possibly attracting capital in elastic supply, would give up tax revenues on investment relatively insensitive to the host country tax rate on profit.

While this source of (non-distorting) tax revenue would allow reductions in other distortionary taxes (in a revenue-neutral reform), leading to an improvement in overall economic efficiency, the implementation of higher tax rates on location-specific profits is difficult. It may for instance require the creation of special tax regimes, *e.g.* for mineral extraction.

Some have argued for lower CIT rates on the most mobile investments. These lower rates on mobile investments may be seen as consistent with the "inverse elasticity rule for source-based capital taxation" suggested by optimal taxation theory under the assumptions of fixed domestic factors and zero cross-price elasticities of capital demand. This rule proposes relatively low tax rates on sectors where taxation tends to cause a relatively large capital export (Sørensen, 2007b). It is likely, though, to be difficult to devise such regimes without giving windfall benefits to large amounts of intra-marginal investment and without significant revenue losses.

* This distinction is based on the theory of the "OLI triad" – ownership, location, internalisation as the variables that govern FDI decisions (see, for example, OECD, 2008b; and Dunning, 1981). Under the OLI triad view, whatever the precise motivation or combination of motivating factors, the principal objective of FDI is to gain cost-efficient access to product markets (rather than exporting to those markets), often through exploiting comparative advantage, and/or to gain more cost-efficient access to resource (input) markets (*e.g.* natural resources, labour resources).

All countries allow the deduction from corporate income tax of all expenditures needed to undertake a firm's activity, including interest payments from debt. As a result, the corporate tax system in many OECD countries is not neutral regarding the source of finance and investment decisions. Interest payments are deductible from the corporate income tax base but the return on equity is taxed at the corporate tax rate.[20] This tax rule

provides corporate firms with a tax-induced incentive to finance investment with debt rather than equity.[21] This may make companies more prone to insolvency and discriminates against small companies and start-ups, which have reduced access to and less favourable terms on debt financing and thus often depend more on equity. Also corporate firms that own firm-specific assets against which it is difficult to borrow suffer a tax-induced competitive disadvantage (Cnossen, 1996; OECD, 2007b).[22]

As further discussed in OECD (2007b), these efficiency arguments may justify the introduction of base narrowing policies such as an allowance for corporate equity (ACE)[23] or moving to cash-flow corporate taxation to solve the debt-equity distortion at the corporate level. Moreover, these policies will increase overall efficiency by not distorting investment decisions at the margin (distortions created by the fact that equity is taxed and debt is not).

Similarly to the deductibility of interest payments from the corporate income tax base, the allowance for corporate equity (ACE) equals the product of shareholders' funds and an appropriate nominal interest rate. This allowance therefore approximates the corporation's normal profits. The corporate tax rate is then confined to economic rents, because corporate equity in excess of the ACE remains subject to corporate tax.

Taxation of savings

Preferential treatments of various forms of savings (*e.g.* provisions for homeownership, retirement income, tax-preferred savings accounts or insurance contracts, special education savings plans) implemented in some OECD countries also reflect a trade-off between efficiency and equity.

Saving provisions, by increasing the after-tax rate of return, may have two effects on saving decisions. On the one hand, preferential treatment of savings may raise total private savings if individuals finance increases in these tax-preferred assets by decreasing their current consumption or increasing their labour supply.[24] On the other hand, if individuals only change the composition of their portfolio (assets reallocation or reshuffling) these targeted tax provisions might have no effect on the total level of private savings.

The design of these provisions plays a key role on their efficiency and distribution effects (OECD, 2007c). In particular, these tax reliefs are more likely to encourage new savings when they are successful in attracting low and middle-income households (Benjamin, 2003; Engen and Gale, 2000). However, there is evidence that wealthier individuals are mainly taking up tax-preferred savings and benefiting the most from these provisions. These higher benefits are explained by the fact that wealthier individuals save a larger proportion of their income (OECD, 2005a and 2007c) and that these provisions take often the form of exemptions or deductions (which implies that the value of the benefit increases with the saver's marginal tax rate). This suggests that preferential treatment of savings may be subsidising savings that would have been done in the absence of the tax incentive, and, therefore, generating windfall gains to high-income individuals.

Moreover, the empirical literature suggests that non-uniform taxation of alternative savings vehicles leads generally to tax-induced distortions of the allocation of savings and wealth rather than increases in the savings level (OECD, 2005a and 2007c). This low (no) effect of saving provisions in encouraging additional savings (*i.e.* a total amount of savings larger than it would have been in the absence of the tax provision) is explained by low intertemporal elasticities of substitution between current and future consumption.

Nevertheless, even if savings provisions do not raise the level of private savings at all, there may be equity reasons to provide these reliefs to encourage savings from certain groups of taxpayers. This might be for instance the case of retirement income reliefs for low-income individuals. The question is then whether these provisions are achieving their goals in a cost-efficient manner; for example, whether these reliefs are successful in tackling poverty alleviation and encouraging adequate retirement standards of living for this income group.

Market failures and targeted tax provisions

Similarly to the case of consumption taxes, targeted income tax provisions (including tax rate differentiation) may be justified from an efficiency point of view where these reliefs address market failures (including the existence of externalities or spill-over effects, imperfect labour and/or capital markets, asymmetric information and imperfect competition) which may lead to an inefficient allocation of resources.

For example, possibly socially optimal levels of investment in innovative products and process may be not reached because positive externalities are not internalised in the benefits of individual firms. In particular, the spill-over benefits of the application of these innovative activities by other firms make marginal social benefits higher than marginal private benefits. By reducing the private cost of innovation, tax incentives for R&D expenditure (and, thus lowering the marginal effective corporate rate) may stimulate private-sector innovative activity, which improves productivity and, therefore economic growth.

The introduction of these reliefs, often called "incentives", is supported by efficiency arguments where these concessions can be expected to increase (or reduce) economic performance. For example, corporate tax incentives may increase the overall profitability of investments by encouraging socially productive investments that would otherwise not have been undertaken (*i.e.* incremental or marginal investment).[25] These reliefs hence may minimise tax revenue losses and "windfall gains" to investors, including tax-planning opportunities,[26] by targeting only incremental investment. However, it is technically impossible to restrict incentives only to investments that would otherwise not have been undertaken. Therefore, under revenue raising constraints, the revenue losses derived of tax-planning opportunities and the need to finance tax incentives by relatively higher tax rates (corporate or others) may largely undermine the efficiency of investment tax incentives (OECD, 2001).

While a low CIT rate benefits both existing and newly acquired capital (rather than incremental capital investment),[27] a broad base-low rate approach increases efficiency by avoiding many distortions associated with other forms of relief (*e.g.* discrimination among investment assets or investment sectors and distortions of types of finance). At the same time, this approach alleviates tax-planning pressures from the domestic tax base and increases simplicity of the tax system. However, it may also reduce the effectiveness of other reliefs in spurring investment, such as those formulated as deductions, since the lower is the CIT rate the lower is the total amount of these reliefs. Nevertheless, a reduction of the benefits of preferential tax treatments may further reduce incentives for tax-planning and lobbying for special tax treatments and also facilitate the broadening of the tax base.

A separate question is whether the tax system is the most cost-efficient mechanism to deliver incentives to encourage investment. Efficiency of these provisions implies that they achieve the objective of changing behaviour to correct for market failure at the lowest

costs. From a tax administration perspective, costs will be reduced particularly when, for example, the provisions simply involve minor modifications to existing deductions (*e.g.* enhanced depreciation). In contrast, when, for example, verification of qualification rules calls for specific expertise (*e.g.* R&D tax incentives), it may be better to have the incentive administered by the relevant ministry that has staff with the necessary expertise (rather the tax administration). In addition, since many tax provisions are simply claimed on the annual tax return and the only control is the chance of audit, the tax system may reduce bureaucracy.

On the other hand, when market failures exist, the overall effect of targeted tax reliefs on behaviour decisions is unclear. The design and implementation of a tax provision play a key role. For example, special tax provisions for small- and medium-sized enterprises (SME)[28] are often supported by arguments based on assumptions of positive spill-over benefits to society of SME investment that are not taken into account by private investors, which leads to under-investment. Market failure may also result from asymmetric information, leading to various forms of capital market imperfection (involving adverse selection or moral hazard), creating difficulties in raising financing or other impediments to SME investment. However, it is difficult to identify (it is not clear whether positive spill-over benefits and asymmetric information applies only in the case of SME) and target instances of market failure, and limit tax relief to just offset under-investment resulting from market failure. Given these difficulties, preferential tax regimes may cause misallocations of capital in certain areas and corresponding efficiency losses (with too much capital being directed to targeted investment, and/or capital being unwittingly encouraged towards (or away from) non-targeted investment).

In addition, targeted tax reliefs may create tax-planning opportunities, with attempts made to access tax relief to minimise tax paid and increase after-tax profit. The question is then whether these efficiency losses overweight intended efficiency gains from reducing market failures. While the objective may be to ensure an overall (net) efficiency gain by countering market failure, it is difficult to be confident *ex ante* that such an outcome will in fact occur.

Moreover, there is also an efficiency-equity trade-off when providing targeted tax incentives to correct for market failures. For example, differential tax treatment of savings may improve resource allocation where incomplete and asymmetric information problems exist. In particular, one of the purposes of the deductibility of the private retirement premiums is to avoid "moral hazard" of workers, who may otherwise be tempted to consume too much of their earnings during working life and "free ride" on the social safety net once they retire. However, a common criticism of tax incentives for private pensions (or homeownership) is that the individuals who benefit from them most are those with relatively high incomes, who can afford the items that receive the preferential tax treatment. An additional question is whether the tax system is the most cost-efficient mechanism to encourage savings, rather than, for example, direct regulation.

1.3. Conclusion

A base-broadening and rate-cutting tax reform needs to balance a number of tax policy objectives, including revenue raising, compliance and administrative simplicity, equity and efficiency. Broadening bases by reducing or removing tax reliefs and exemptions (apart from where these are effective ways of correcting externalities) should generally increase

economic efficiency and total output (and perhaps its growth rate too). There should thus be a potential increase in incomes (a potential Pareto efficiency improvement) that could in principle be used to address any concerns about fairness and equity.

In particular, the economic case for VAT preferential treatment (including rate differentiation) is weak. These provisions are generally not well targeted to those in need, distort consumer choice, and impose additional administrative and compliance costs (related to the need of drawing borderlines between standard and reduced rate goods/services).

Economic arguments suggest the desirability of including all types of income in the personal income tax base and, therefore, of minimising the available allowances, deductions or exemptions, other than the basic reliefs needed to achieve a socially acceptable degree of progressivity. However, when tax provisions are well designed to target those in need, the delivery of social benefits through the tax system may be cost-efficient, due to lower compliance and administrative costs compared to direct expenditure programmes.

While a broad base – low rate approach to the corporate income tax is likely to reduce the capital income tax wedge and the variation of the tax wedge between different investments and sources of finance, it may give rise tax arbitrage opportunities. There is particularly a risk that lower CIT rates will encourage businesses to incorporate for tax avoidance purposes. Achieving a more neutral tax regime thus depends also on the personal tax rates on interest, dividends, capital gains and labour income.

However, the overall effect on efficiency, fairness and simplicity will depend on the design of the tax provisions and the country's specific circumstances, particularly regarding its tax revenue requirements, the redistribution preferences and the available policy options (*e.g.* scope for changes in the tax mix and level of taxes, the degree of development of the tax administration and the agency programmes). At the same time, external elements such as the mobility of production factors and neighbour effects' (tax incentives offered in other countries competing to attract mobile investment capital) may also create pressures for deviating from the "optimal" amount of tax relief.

When deciding on whether to provide targeted reliefs and how much relief to provide, a key issue is the evaluation (*ex ante* and *ex post*) of such reliefs. This evaluation should include a comparative analysis of alternative policy instruments, within and outside the tax system, that may achieve the same objectives; *e.g.* a CIT reduction *versus* an investment allowance; the delivery of a given benefits through the tax system *versus* direct expenditure or market regulation.

Notes

1. Taxpayers' compliance costs include all costs in terms of understanding the tax rules and obligations (taxpayers' access to information, documentation, tax forms, taxpayers' assistance and education services) as well as those costs related to administration procedures (reporting and payments requirements, audit and appeal procedures).
2. In revenue-neutral reforms only the overall substitution effect of a tax change will prevail. Thereby, the average taxpayer does not have an income effect, only a substitution effect. For other taxpayers, while experiencing increases or reductions of taxes, the resulting income effects will likely approximately balance out. This result implies that only compensated (reflecting only the substitution effect while maintaining income constant) elasticities of demand and supply are important in the evaluation of distortionary effects (Heady, 1993; Blundell and MacCurdy, 1999; Gruber and Saez, 2002).

3. Once a preferential treatment is granted, it is not only difficult to repeal but will also open the door for additional lobbying by using horizontal equity arguments.
4. Regarding consumption taxes, this report includes a discussion on the broad base approach for VAT only, recognising that a properly designed VAT raises more revenue with lower administrative and economic costs (implying higher neutrality) than other broadly based consumption taxes. Unlike income taxes, a well-designed and administered VAT does not normally influence the forms or methods of doing business; the tax bill is the same for a product made in the corporate or non-corporate sector, with capital-intensive or labour-intensive technology, or for one made by integrated or specialised firms. The VAT (destination principle) also ensures neutrality in international trade by freeing exports of tax and by treating imports on a par with domestically produced goods (Cnossen, 1998).
5. In fact, this inverse elasticity rule is applied in practice to selective excise duties, for example on alcohol, tobacco or petrol, although the setting of these rates depends more on internalisation of externalities rather than on optimal taxation considerations (Heady, 1993).
6. A tax is considered regressive if it takes a higher proportion of income from lower-income households.
7. The increase in social benefits would not have to be as large as a VAT tax provision in order to achieve the same objectives.
8. Although this alternative approach will increase the overall marginal tax rate (with the increased level depending on household income) and, therefore, could discourage labour supply (direct payments will not).
9. In addition to redistribution (vertical equity) arguments, efficiency considerations (positive externalities), may also justify the rationale of preferential tax treatments of merit goods. The consumption of merit goods has societal values in excess of the consumption value for the individual consumer.
10. Additionally, as pointed out in Copenhagen Economics (2007), reduced rates on some merit goods and goods with positive externalities tend to create non trivial tensions with the functioning of the European Union internal market.
11. While theory (see for instance *Meade Report*, IFS (1978): *www.ifs.org.uk/publications/3433*) suggests that when government has at its disposal a fairly sophisticated range of instruments for redistribution, the contribution of commodity taxes to efficient revenue-raising could be limited, the available empirical evidence suggests that appropriate rate differentiation (taxing goods and services complementary with leisure) could reduce the overall distortionary costs of taxation (IFS, 2009).
12. See, for example, Kleven, Richter and Sorensen (2000) and Kleven (2004).
13. As Harberger (1990) pointed out, it is generally inefficient to try to tax activities that are close substitutes with activities that are exempt because they are too difficult to tax. Therefore, policymakers should deviate from uniformity only when there is a strong efficiency case for doing so.
14. However, the question is again whether excise duties would be more cost-efficient instruments to correct market failures.
15. Copenhagen Economics (2007).
16. Moreover, empirical analyses show that the net effect on distribution depends to some extent on the choice of income concept and inequality measure (Aronsson and Palme, 1998; Björklund *et al*., 1995). In addition to design features, reforms of personal income taxes are often difficult to evaluate in isolation from the rest of the tax and benefit system since changes in taxes often interact with existing benefits affecting the effective average (equity) and marginal tax rates (efficiency).
17. A number of OECD countries have replaced tax allowances by tax credits in recent years (see, for example, OECD *Taxing Wages*), although refundable tax credits are not widely used.
18. Toder (2000) provides examples of how direct outlays and tax incentives can be designed to have exactly the same effects on income distribution and resource allocation and cites circumstances under which either the tax code or direct spending may be the preferred method of payment.
19. "Make-work-pay policies" are in fact an application of the "inverse-elasticity" rule, which suggests levying lower labour income taxes at the bottom of the income distribution; where, as well as at the top of the income distribution, labour elasticities are found more elastic.

20. In some cases this no neutrality between debt and equity may be justified by financial market imperfections. As a result, financing-constraint firms might forego profitable investment opportunities.

21. However, the corporate advantage of debt might be lost if the interest payments are not entirely deductible from the corporate tax base. This might be the case if the firm's earnings are too low or because the firm possesses a large amount of other deductions, such as depreciation allowances and/or if (part of) the investment can be immediately expensed. These corporate tax shields are less likely to be lost when there are tax loss carry backs or carry forwards.

22. The preference of debt over equity as source of finance not only depends on the differences with respect to the corporate tax treatment. The debt-equity choice is also influenced by the taxes at the personal level on interest payments, dividends and capital gains. Moreover, the debt-capital ratio will also depend on other non-tax costs (*e.g.* bankruptcy costs and adverse selection problems in the credit market) and also on the use of newly developed financial instruments as, for instance, debt-equity hybrid securities (see OECD, 2007b).

23. As it is the case of the Belgium allowance for corporate equity.

24. Capital income taxation distorts both the labour supply and the choice between current and future consumption. By reducing the price of future consumption, a saving provision increases the reward from working to the extent that fewer earnings are needed today to fund a given consumption tomorrow (income effect), which discourages saving. On the other hand, future consumption will become more attractive compared to current consumption (substitution effect), which might increase current savings.

25. For a detailed discussion of the elements affecting the efficiency of corporate tax reliefs and their effect on attracting FDI see OECD, 2001.

26. For example, empirical results at the aggregate level (OECD, 2001) tend to confirm that a high statutory corporate income tax rate encourages borrowing in the host country, tending to erode the corporate tax base.

27. Targeting tax relief to newly acquired capital does not ensure either that windfall gains to investors are avoided, because some fraction of new investment that qualifies under a given tax incentive programme would have occurred in any event (OECD, 2001).

28. See OECD, 2009, for a detail discussion on the advantages and disadvantages of special tax incentives for SME.

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Chapter 2

Where is there Scope for Base-broadening?

This chapter summarises the OECD experience in tax expenditure reporting. It discusses the controversy around the definition of tax expenditures and proposes a categorisation of tax reliefs. By analysing the main tax expenditures estimates in OECD countries and other tax indicators, it then considers the extent to which these estimates provide useful measures of the "cost" of these reliefs, explores tax reform trends and the current scope for base-broadening reforms.

Most countries allow numerous tax reliefs in the form of exemptions from tax, reductions of the tax liability (deductions and credits) or tax rates that are lower than the "standard rate". These tax concessions are often called *tax expenditures,* because they can be seen as equivalent to public expenditure implemented through the tax system. Many countries prepare a report that includes a list of their main tax expenditures and estimates of the revenue cost of many of these provisions, *Tax Expenditure Report*. This chapter looks at the extent of tax reliefs in OECD countries using available tax expenditure (TE) estimates.

Tax expenditure reports play an important role in increasing the transparency of the tax regime. Their estimates of revenue costs, as this chapter will discuss, need to be interpreted carefully, but can provide a useful starting point for policymakers considering the pros and cons of broadening tax bases by reducing or removing tax reliefs.

Section 2.1 briefly summarises the OECD experience in TE reporting. The controversy around the definition of tax expenditures is presented in Section 2.2. Section 2.3 proposes a categorisation of tax reliefs based on their objective to facilitate the evaluation of these concessions when considering a move toward a broader base. The main objectives of TE reports are briefly discussed in Section 2.4. The main estimation methods of tax expenditures and their limitations are reviewed in Section 2.5. Section 2.6 presents the main TE revenue forgone estimates by type of taxes in OECD countries and considers the extent to which these estimates provide useful measures of the "cost" of incentives and other targeted tax reliefs. Using tax indicators and country-specific TE data, Section 2.7 explores tax reform trends throughout the OECD during the past few decades and the scope that the current tax system has for base-broadening reforms.

2.1. Tax expenditure reporting

Many OECD and non-OECD countries produce *Tax expenditure reports*, which include a list of their main tax provisions and estimates of the cost of such reliefs (mainly in terms of tax revenue forgone). TE reports, when originally developed in Germany and the United States in the late 1960s, were intended to improve transparency of the tax system (*e.g.* Surrey, 1973) and the budget process. In addition to clarifying the trade-off between tax and spending programmes in budget decisions, Surrey was also interested in using this instrument to build momentum for base-broadening tax reform (Joint Committee of Taxation, 2008; Altshuler and Dietz, 2008a; Burman *et al.*, 2008).

The first TE report was published by the US Treasury in 1969. Since then tax expenditure reporting has been embraced by many other countries. For example, of the 24 countries that completed an OECD questionnaire issued in 2008, 16 countries (Australia, Austria, Belgium, Canada, France, Germany, Greece, Mexico, Netherlands, Norway, Portugal, Spain, Switzerland, Turkey, United Kingdom and United States) answered that they currently produce full tax expenditure reports that are made public on a regular basis. In addition, Korea reported producing such a report regularly but not making it publicly available; Denmark stopped producing such a report in 2006; Italy produces annually an

official document with the revenue impact of new expenditure measures and a periodical internal report of all tax expenditures in force; and Poland has currently committed to elaborate its first tax expenditure report, which will be published by the end of 2010.

Most countries use the information available in TE Reports to analyse the cost of individual tax expenditures. A few governments bring tax expenditures into the budgetary process and subject them to a level of scrutiny similar to that for direct expenditures (see Chapter 4, Table 4.1).[1]

2.2. Tax expenditure definition

A tax expenditure can be seen as a public expenditure implemented through the tax system by way of a special tax concession – such as an exclusion, an exemption, an allowance, a credit, a preferential rate or tax deferral- that results in reduced tax liability for certain subsets of taxpayers (see for example Altshuler and Dietz, 2008b). In practice, tax expenditures are defined as deviations from a tax norm or a benchmark that result in a reduced tax liability for the beneficiaries, who are generally a particular group of taxpayers or an economic activity. The main challenge in any analysis of tax expenditures is to identify this reference point or benchmark tax system against which to establish the nature and extent of any tax concession.

In general, the benchmark tax system is set as the regular tax arrangements that apply to similar classes of taxpayers or types of activity. A definition of the benchmark involves taking a view about the tax base, the rate structure and the tax unit. This may involve an element of judgment on what the regular tax arrangements are. Consequently, benchmarks may vary across countries and also within countries over time (see Box 2.1). This lack of a

Box 2.1. **Definition of a benchmark tax system**

The definition of the benchmark tax system or tax norm is key in order to identify the provisions in the tax system that are part of this tax norm and the provisions that are considered to be tax expenditures. Since there is no consensus on this definition, some tax provisions that are regarded as tax expenditures in some countries may not be in others.

Three broad approaches may be identified when defining a benchmark (Craig and Allan, 2001):

1. a *conceptual approach* which uses a "normal" tax system based on a theoretical concept of income, consumption, or value-added (depending on the tax) modified to address data limitations and/or technical problems in implementing the pure/theoretical concept;[1]
2. a *reference law approach* which for the most part uses a country's own tax laws as a basis to define the benchmark, isolating special concessions judged as tax expenditures (*e.g.* targeted provisions that depart from general provisions to address specific policy objectives);[2] and
3. an *expenditure subsidy approach* which seeks to cost only those concessions that are clearly analogous to an expenditure subsidy.[3]

Most OECD countries follow some form of conceptual baseline (*e.g.* Australia, Belgium, Canada, Finland, Ireland, Portugal, and Spain). Several other countries use a reference law approach (*e.g.* Austria, France, Korea and the Netherlands). Germany follows an expenditure subsidy approach. The UK combines a conceptual and expenditure subsidy approach, while the US uses both a conceptual and a reference law approach, and Sweden follows a conceptual approach for income taxes and a reference approach for consumption taxes (see Table 2.1).

Box 2.1. **Definition of a benchmark tax system** *(cont.)*

Despite certain particularities, these approaches share implicitly or explicitly four elements. All approaches identify a special tax concession as a tax expenditure when: 1) it implies a reduction of tax revenue (tax liability); 2) it results in deviations from a "basic" tax structure; 3) it targets a particular group of taxpayers or economic activity; and, 4) it could be replaced by direct spending.

In addition, all approaches also involve certain judgments. Even where a conceptual definition is used (*e.g.* Haig-Simons), judgments are needed to arrive at a workable version, taking into account practical and other difficulties involved in implementing the theoretical concept. Virtually all benchmark definitions recognise elements to address taxpayer "ability to pay". Therefore, benchmark systems typically admit progressive tax rate schedules, basic/standard deductions, zero-rate bands, and deductions for expenses in earning income (perhaps subject to a cap). Provisions addressing vertical equity are thus considered to be part of the benchmark system.

Moreover, some countries have explicit definitions of the benchmark tax system (*e.g.* Australia. Belgium, Canada, Spain) while others have implicit definitions that can be only inferred from what is actually defined as a tax expenditure (*e.g.* Germany).

Benchmark definitions also vary among countries with respect to the degree of detail. For example, Canada and the United Kingdom have quite restrictive benchmarks, which tend toward the identification of numerous tax expenditures. In contrast, the Netherlands considers the "primary structure" of the actual tax system in place as the benchmark, identifying thus relatively few tax expenditures.

In some countries (*e.g.* France) the definition of the benchmark is allowed to evolve over time. For example, long-established provisions can be integrated into the tax norm, thereby losing their tax expenditure status.

Given difficulties in agreeing about a benchmark, certain countries take a more flexible and inclusive approach. The United States, for example, identifies more than one benchmark and measures TEs with respect to both baselines. Other countries list and, in some cases, report tax revenues forgone by certain provisions that may or may not be considered part of the benchmark, depending on judgements. This is the case in Canada (in the "memorandum items" of the report), and the United Kingdom (under the "structural provisions" heading). The United Kingdom goes one step further, and also considers a third category of tax provisions, which identifies tax reliefs with both a tax expenditure and a structural component.

1. The most notable "conceptual" benchmarks are the Haig-Simons concept for income taxes, and the "pure" VAT baseline for consumption taxes. Note that in the US, the conceptual benchmark is referred to as the "normal" tax structure.
2. Some countries even include in the law a detailed list of tax expenditures; this is for instance the case in Korea and in Japan; although Japan uses the term "special tax measures" instead of tax expenditures.
3. The German government limits the concept of tax expenditures to concessions that may be considered as a substitute for a direct cash expenditure subsidy.

Source: OECD (2010) and national sources.

clear dividing line between provisions in the tax system considered as part of the benchmark and those as special concessions means that some tax concessions that are regarded as tax expenditures in some countries may not be in others (*e.g.* accelerated depreciation or some dependants' allowances). In addition, some provisions could be on the borderline between a tax expenditure and the tax norm (*e.g.* tax reliefs for families with children).[2]

However, there is general agreement on the fact that a benchmark tax system should neither favour nor disadvantage similarly placed activities or classes of taxpayers. In practice, this implies that, regardless the applied benchmark definition, tax provisions that are generally applicable are often considered to be part of the benchmark, while provisions targeted to groups of taxpayer or activities are identified as tax expenditures.

In determining what constitutes a tax expenditure in relation to the tax treatment of the returns on saving and investment a key consideration is whether tax provisions are measured relative to some notion of comprehensive income or consumption. While tax expenditures are generally measured relative to a modified version of a comprehensive income tax (Bradford, 1999), current income tax systems typically include both income and consumption tax features (see Box 2.2). The absence of a clear cut standard treatment clearly complicates the definition of the benchmark tax system.

Box 2.2. **Income tax *versus* expenditure tax benchmarks**

The choice of tax base to use as the benchmark for measuring tax expenditures – income *versus* expenditure (or consumption) taxation – can have a significant impact on what is regarded as a tax expenditure and the estimated cost of a relief.

A broad-based consumption tax can be viewed as an income tax plus a deduction for net saving, which implies that the normal return on capital is not taxed. This follows from the definition of comprehensive income as consumption plus the change in net worth. Therefore, a key difference between an income and a consumption tax is the treatment of capital income. Consequently, many tax provisions that are considered as tax expenditures under an income tax benchmark are not TEs under a consumption tax benchmark, particularly those exempting from tax the return on savings.

For instance, under a consumption tax benchmark, sales of new housing, renovations and rentals would be included in the consumption tax base (since these values reflect the present value of the stream of services that housing is expected to yield) and, therefore, mortgage interest deductions for purchase of owner-occupied houses would be considered as tax expenditures. In contrast, the absence of a tax on net imputed rent (*i.e.* imputed rent minus appropriate deductions for taxes, depreciation and mortgage interest expenses) would be regarded as a tax expenditure in relation to a comprehensive personal income tax benchmark, since this rent reflects the net return of housing in terms of services flow to the homeowner (these arguments are further developed in Chapter 3).

Other provisions that may be considered as a hybrid between a consumption and an income tax base include: the net exclusion of pension and earnings from tax-deferred retirement plans, tax preferences for capital gains, exclusion of interest on public purpose, state and local bonds, and expensing and deferral of some forms of business income or non-discretionary spending.

2.3. Tax provisions categories

Distinguishing between different categories of tax provisions may help to identify guidelines on how to decide whether a particular tax relief should be considered or not as a tax expenditure. This section proposes to structure tax provisions according their purpose in four different categories:

1. Provisions for expenses incurred to generate income.

2. Provisions for ability to pay adjustments.

3. Provisions to change behaviour:

   3.1. for social reasons;

   3.2. for economic reasons.

4. Provisions for administrative and compliance reasons.

Some tax provisions often pursue more than one objective and, therefore, could be included in more than one category. Moreover, different components of particular provisions could be assigned to different categories.

It should be highlighted that not all provisions identified within a given a category are considered tax expenditures. As a general rule, all tax provisions that may have an impact on the neutrality and horizontal equity of a tax system and/or whose objectives could be achieved by alternative public expenditure policies are identified as tax expenditures.

1. Provisions for expenses incurred to generate income

This category includes the tax provisions that reduce taxable income by the actual expenses incurred in generating that income; for example, economic depreciation of capital investment and reliefs for "reasonable" work-related expenses.

Reliefs for reasonable costs incurred to generate income should not be considered as tax expenditures. However, there is no economic justification for excessive costs not to be included in the tax base. In general, country's current laws make explicit reference to the amount that is considered reasonable.

Mortgage interest deductions also belong to this category when considering comprehensive income as the benchmark. While net imputed rent from owner-occupied housing should be considered as taxable income (and, consequently as TE when exempted), mortgage interest deductions are cost incurred to generate this rent and should be allowed to reduce the taxable base.

Reliefs for taxes and interest paid related to income generation, to a certain limit, are included in this category as well.

2. Provisions for ability to pay adjustments

The objective of the provisions introduced for ability to pay adjustments is to take individuals' ability to pay into account when calculating the taxable base. This category includes elements of progressivity in the PIT system such as the zero-rate band and personal allowances, which are considered as structural elements of the PIT system in order to redistribute income. These provisions are considered as part of the benchmark in most OECD countries and, in many cases, TE estimates are not calculated.

This category also includes allowances available to taxpayers depending on their marital status, provisions for children and dependents and reliefs for low-income individuals/households and the exemption from VAT of necessities. A key question is to which extend these provisions achieve their objective of redistribution. Moreover, in general, reliefs introduced for redistribution policy objectives could be replaced by direct spending measures, which support the need to evaluate whether these reliefs achieve their objectives. For example, as discussed in Chapter 1, VAT exemptions on necessities benefit richer households to an even greater degree than poorer households. This may question the justification of this exemption from a cost-efficient redistributive point of view.

While in-work tax credits may also be included under this category, these provisions are discussed in the next category because its rationale also includes incentives to encourage a particular change in behaviour.

Tax provisions introduced to avoid double taxation (*e.g.* tax credit for foreign income, imputation credits) are another example of reliefs within this category that are not considered tax expenditures.

3. Provisions to change behaviour

Reliefs in this category of provisions to change behaviour are often called "tax incentives". These provisions may be subdivided in reliefs introduced to change behaviour for social reasons and those introduced to modify behaviour for economic considerations. The main characteristic shared between these two groups of targeted tax provisions is that their objective could be achieved by an alternative type of government intervention; for example, a direct expenditure programme (a feature that is also shared with provisions introduced for ability to pay considerations) or market regulations. However, efficiency, redistribution of benefits and compliance and administration costs are very likely to vary between these two groups (as discussed in Chapter 1). Moreover, these reliefs create tax-induced economic distortions (*i.e.* they reduce the neutrality of the tax system). All these characteristics suggest that provisions under this category should be considered as tax expenditures and that their cost-efficiency should be regularly evaluated.

3.1. Provisions to change behaviour for economic reasons

This category includes provisions introduced with the objective of changing labour supply, investment, consumption or savings behaviour of economic agents. Reliefs in this category include: in-work tax credits, preferential tax treatment of housing and other tax-favoured saving vehicles, reliefs for education expenses, reliefs for employer contributions to pensions and other retirement plans and those for employer provided health insurance. His category potentially includes tax reliefs intended to correct externalities.

Reduced CIT rates for small businesses, R&D tax credits and accelerated depreciation in the CIT are also examples that belong to this category. Excess of depreciation for tax purposes over economic depreciation should normally be considered as a tax expenditure. Some countries, however, justify including accelerated depreciation as part of the benchmark either because of its general applicability or because of the absence of robust information about true economic depreciation to use as a benchmark (when estimating cost of accelerated depreciation for tax purposes). Some countries recognise the difficulties to calculate economic depreciation and, therefore, include in their TE report estimates for accelerated depreciation relative to no depreciation, although they do not consider this provision as a tax expenditure (*e.g.* the United Kingdom). Other countries recognise and present accelerated depreciation as a tax expenditure but do not include any estimate (*e.g.* Canada).

Reduced CIT rates and R&D tax credits are, in addition to being generally targeted at a group of taxpayers/activities, clear examples of reliefs that could be replaced by subsidies while achieving the same objectives. They should be thus considered as TEs.

3.2. Provisions to change behaviour for social/cultural reasons

This category includes tax reliefs that encourage expenditures for social reasons. Examples of such concessions within the PIT include untaxed transfers to recipients of government programmes (cash and in-kind benefits), reliefs for healthcare and education expenses or donations to charity, and the exemption/deduction of interest received on government bonds.[3] VAT exemptions for the health and education sectors are also included in this category.

Many of the provisions in category "provisions to change behaviour" may also belong to the category of "reliefs introduced for ability to pay adjustments". However, a particular feature of these reliefs is that they could be divided into two components: a more structural part addressing redistribution concerns (which could be considered as part of the benchmark), and a component encouraging a change in behaviour (the pure incentive part). For example, a relief for education expenses consists of a structural part reflecting ability to pay and a non-structural component whose objective is to encourage individuals to invest in their human capital for social (and economic) reasons. The same applies for in-work tax credits, which aim at redistributing toward low-income households (structural component) and at the same time encouraging labour market participation (non-structural or incentive component).

While the splitting between structural and non-structural components may be difficult when estimating TE values, the assessment of the distribution impact of these provisions is a good approximation of the benefits of the structural component of these reliefs.

4. Provisions to reduce administrative and compliance costs

Some reliefs that reduce a particular tax base may be justified by the need to maintain an efficient tax administration. This is the case especially for those which ease administrative and compliance costs. Tax deferrals and taxation of capital gains on realisation rather than accrual basis are included in this category. Exemptions of some fringe benefits also belong to this category. While estimating the cost of these provisions may be difficult in practice, these reliefs clearly raise horizontal equity issues. The tax liability of an individual receiving a cash-equivalent of, for example, a company car, would be higher only because of the exemption of this income in-kind.

Simplified (presumptive) income tax regimes also belong to this category. In general these regimes are considered to be part of the benchmark system since they are generally applicable and aim at simplifying tax rules and reducing compliance costs. To the extent that simplified regimes are conceived as an alternative to the general regime, policymakers might find useful to assess the cost-effectiveness of these simplified regimes, including their opportunity cost. However, when these special regimes are targeted to certain taxpayers, the general applicability rule does not apply and these preferential treatments should be considered as TEs. Simplified VAT tax regimes are another example of provisions normally targeted to a group of taxpayers.

Exemption of some financial services from VAT is another example of a provision introduced to improve tax administration efficiency. However, it is unclear whether the costs of this provision outweigh its benefits (a more detailed analysis is included in Chapter 3) and, it therefore would advisable to consider this exemption as a tax expenditure and evaluate its cost-effectiveness.

2.4. Objectives of TE reports

The lack of a consensus about the definition of an appropriate benchmark raises the question of what an "ideal benchmark" would look like. Ideally, the choice of the benchmark tax system would be linked to the objectives that the government seeks when elaborating a TE report. In particular, tax expenditure reporting may assist policy-making in a number of areas, including:

- The cost-benefit assessment of incentives: an assessment of the net social benefit of tax reliefs targeted at a given activity and/or a taxpayer group requires an assessment of tax revenues forgone by these provisions. Tax expenditure measurements address in part[4] the "cost" element of such assessments and can be important when considering alternative policy instruments that might achieve the same objectives, such as for example direct spending.
- The distributional assessment of tax incentives: an assessment of the allocation of tax relief across different taxpayer groups enables government to consider the distributional impact of both tax expenditure provisions and any proposed adjustments to them.
- The management of budget allocations: government resources may be allocated to various policy areas through both direct spending and tax expenditures. Total allocations to specific policy areas can be addressed only when government has figures showing direct spending and targeted tax expenditures, since both impose an opportunity cost in terms of higher taxes, reduced spending and/or higher deficits.
- The management of the overall fiscal position: by estimating the revenue forgone from tax expenditures, the government is better able to measure the extent to which other taxes have to be higher than otherwise to maintain a given overall budget balance.
- Increasing transparency and fiscal accountability: by identifying/listing tax provisions with policy objectives that could be achieved through alterative policy instruments (*e.g.* direct spending or market regulation); by integrating tax expenditures reports in the budget process, which would help well-informed decisions on allocation of resources and policies coordination; by assessing the effectiveness of TEs (effects on efficiency of the tax systems, income distribution, revenues and compliance and administrative costs), which matters even more than for direct spending due to the open-ended nature of tax provisions.

The choice of a benchmark system should help achieve these general objectives, but it is not necessarily critical. A list of TEs provides information about "public expenditure" delivered through the tax system, and does not say anything about the validity/efficiency/effectiveness of providing such relief. However, as it is the case for direct spending, evaluations of TEs should be regularly carried out to ensure that they achieve their objectives in an efficient and cost-effective manner. Having this evaluation objective in mind, estimating the cost of a particular TE is an essential part of the evaluation process.

Data availability may mean that there is an element of estimation in figures for the costs of TEs, but inclusion in the TE report still helps increase transparency and accountability. As it is currently the case in most – if not all – countries producing TE reports, improvements in data availability and estimation techniques allow countries to improve the reliability of estimates over time.

2.5. TE estimation methods

In addition to the list of tax expenditures, TE reports also include estimates of the cost of these concessions. While most countries estimate the value of tax expenditures in terms of revenue forgone, tax expenditures may be estimated using alternative approaches. Several different estimation techniques and data sets can also be used (see Box 2.3 for an illustrative example).[5]

Revenue forgone method

The revenue forgone method is an *ex post* calculation of the loss in government revenue incurred by a tax expenditure, holding all other factors constant. Revenue forgone estimates provide a figure based on the actual take-up of a relief. Therefore, for example, the cost of a tax credit in terms of revenue forgone is simply the amount of the tax credit. In the case of a tax deduction the revenue forgone will depend on take up and marginal tax rates. The benefits of this method include its relative simplicity, since neither individual nor government behavioural responses are considered.

However, revenue forgone estimates overestimate the direct revenue gain from abolishing or amending a given tax provision. For example, in most countries behavioural responses to eliminating tax breaks are ignored when using this method. For instance, if a tax relief for one type of saving is withdrawn, in practice individuals may switch to other tax-privileged forms of saving, but the revenue forgone method assumes that they pay their full (marginal) tax rate on their return.[6]

Revenue gain method

Another possible method is the revenue gain method, an *ex ante* estimate of the additional revenue that would accrue from eliminating a given tax expenditure when behavioural effects are taken into account. While this method would provide a better approximation of the cost of TEs in terms of revenue impact (making them more comparables to estimates of the revenue impact of budget measures), it requires a good understanding of taxpayers' behaviour and data on elasticities for its practical implementation; data that is not always available and/or reliable.

Differences between estimates calculated using the revenue gain and revenue forgone methods often vary across types of tax provisions, because of differences in elasticities (own-price and cross-price elasticities) and availability of substitutes (goods/services, investment/saving options, etc.). Required assumptions in the estimation regarding the order in which TEs are removed, grandfathering decisions and how activity would flow to alternative concessions would also explain some differences between the estimates obtained under these two methods. Box 2.3 illustrates these differences using recent estimates calculated by the Australian's Treasury.

Small differences would be expected when the abolished reliefs are on taxed goods/services with relative low own-price and cross-price demand elasticities. The availability of alternative (substitutes) tax-preferred investment/savings/goods/services would imply a lower cost of the relief that is planned to be eliminated under the revenue gain method because many taxpayers would still be able to claim benefits by changing their choice to the often tax-preferred options.

Box 2.3. **Revenue forgone and revenue gain tax expenditure estimates**

Following a recommendation of the National Audit Office, the Australian Tax Expenditure Report incorporates some estimates of tax expenditures based on the revenue gain approach starting in 2008 (estimates for 6 provisions were included in 2008, and in 2009 estimations were extended to some of the largest TEs). In addition the report also explains the main differences between the results obtained under the two methods. Three examples are included in this box to illustrate that these differences depend on the type of tax provision been analysed and the assumptions regarding the change of such provision. These estimations assume that TEs are prospectively abolished on 1 July 2009.

TE on retirement income (superannuation: Concessional taxation of employer contributions)

	Revenue forgone estimate (AUD m)				Revenue gain estimate (AUD m)			
Estimates	2009-10	2010-11	2011-12	2012-13	2009-10	2010-11	2011-12	2012-13
	11 400	12 100	13 250	14 550	8 250	9 250	10 150	11 150

Reason for difference	It is assumed that the Superannuation Guarantee remains and therefore compulsory contributions continue. Voluntary contributions are assumed to be directed to alternative tax preferred investments involving negative gearing. Because more voluntary contributions come from those with higher marginal tax rates, the average tax rate for residual compulsory contributions is lower.

VAT exemption: GST exemption on food – uncooked, not prepared, not for consumption on premises of sale and some beverages

	Revenue forgone estimate (AUD m)				Revenue gain estimate (AUD m)			
Estimates	2009-10	2010-11	2011-12	2012-13	2009-10	2010-11	2011-12	2012-13
	5 600	5 900	6 100	6 400	5 500	5 700	6 000	6 300

Reason for difference	Removing the GST exemption applicable to certain types of food would be expected to decrease demand for those items. However, the impact of this behavioural response is expected to be small as demand for GST-free food is likely to be relatively inelastic to changes in price.

Exemption of bonus: Exemption of tax bonus for working Australians

	Revenue forgone estimate (AUD m)				Revenue gain estimate (AUD m)			
Estimates	2009-10	2010-11	2011-12	2012-13	2009-10	2010-11	2011-12	2012-13
	2 070	95	0	0	2 882	134	–	–

Reason for difference	If the tax bonus were to be made taxable, the payment rate would have to be grossed up by an amount sufficient to offset the tax payable, in order for the tax bonus to have the intended impact. This would result in a larger revenue gain than indicated by the revenue forgone estimate. The fiscal impact of this revenue gain would be wholly offset by the increased expenditure necessary to gross up the payments, with the increased expenditure incurred in advance of the increased tax revenue.

Sources: Australian Tax Expenditures Statement, 2009; Australian National Audit Office, *Performance Audit Report No. 32 2007-08 – Preparation of the Tax Expenditures Statement*, Recommendation 5, p. 22.

Outlay equivalent method

A third possibility is the outlay equivalent method, which estimates tax expenditures associated with a given provision as the (gross-up) cash outlay that would be required if the subsidy where delivered outside the tax system. To take an example, consider a 150% R&D

Box 2.4. **Illustration of revenue impact estimates of "permanent" investment tax credit (ITC) at 50%**

We assume for illustrative purposes:

- investment (I) without ITC: 100
- investment (I) with ITC: 120

Direct revenue impact of ITC

	Ex ante	*Ex post*
Introduction of ITC	–50 (using observed I, ignoring behaviour)	–60 (using observed I)
	–60 (accounting for behavioural impact I ↑)	{revenue forgone method}
Removal of ITC	+60 (using observed I, ignoring behaviour)	+50
	+50 (accounting for behavioural impact I ↓)	
	{revenue gain method}	

This illustration reveals that:

1. *ex ante* estimates of the cost of introducing incentives *ignoring behavioural responses* – estimated at EUR 50 and based on observed investment without an ITC – tend to underestimate direct revenue losses (EUR 60);
2. *ex post* estimates of the cost of incentives *ignoring behavioural responses* – estimated at EUR 60 under the revenue forgone method and based on observed investment under the ITC – tend to overestimate the direct revenue gain from withdrawing incentives (EUR 50); and similarly
3. *ex ante* estimates of the gain from removing incentives *ignoring behavioural responses* – estimated at EUR 60 and based on observed investment under the ITC – tend to overestimate the direct revenue gain (EUR 50); and finally
4. *ex ante* estimates of the gain from removing incentives *including behavioural responses* – estimated at EUR 50 under the revenue gain method and based on lower investment without an ITC – may provide a closer estimate of the direct revenue gain.

Discrepancies between estimated and actual revenue losses/gains are generally larger the greater the sensitivity (elasticity) of the target variable (investment) to the tax incentive.

Other indirect considerations: impact on depreciation allowance claims, impact on corporate revenues through productivity gains (both depending on behavioural impact on investment).

allowance that allows firms to deduct 150% (rather than 100%) of current R&D expenses. If a firm spends EUR 100 on eligible R&D but can only deduct EUR 120 because it has insufficient taxable income to claim the full EUR 150, the revenue forgone method would compute a tax expenditure of EUR 10, assuming a 50% corporate income tax rate (50% of EUR 20). The outlay equivalent method would ignore the firms "taxable capacity" and compute a cash equivalent of EUR 25 (that is, 50% of the full EUR 50 in additional allowance) if the cash outlay is non-taxable (EUR 50 if the cash outlay is taxable).

Most countries (OECD and non-OECD) use the revenue forgone method to calculate their TE estimates. However, when relying on these estimates, several caveats need to be taken into account when interpreting and drawing conclusions from country-specific tax expenditure data. These estimates do not reflect the actual yield from tax expenditure

elimination (that is, the amount of revenues that would be raised if that tax expenditure were repealed) for three reasons:

- First, as already noted, by not taking into consideration behavioural effects, revenue forgone estimates tend to overestimate the direct revenue gain from eliminating an incentive, especially in cases where the underlying activity is significantly reduced when the subsidy is withdrawn.
- Second, a tax expenditure estimate for one provision is typically based on the assumption that other tax expenditure provisions remain intact. Each tax expenditure is estimated in isolation; that is without taking into account interactions between different tax expenditures[7] or between the tax expenditure and the tax system in general. Thus, individual tax expenditure estimates cannot be aggregated to arrive at an estimate of the total revenue gain if all tax expenditures were simultaneously removed (even if behaviour would be unaffected).[8]
- Third, where a tax relief is eliminated on a prospective basis – that is, if relief is provided retroactively (*e.g.* for investment already undertaken, or for expenditures already committed to) – grandfathered, or replaced by direct spending, then clearly the revenue loss associated with current activity cannot be taken as a measure of potential revenue gains.

Notwithstanding these limitations, TE analysis may still be useful in identifying options for base-broadening.

2.6. Data on TE estimates

This section presents some data and trends of tax expenditure estimates building on published TE reports and responses to a questionnaire on Tax Expenditure Trends that was circulated to OECD Delegates of the Working Party on Tax Policy and Statistics. It includes data provided by the following 22 OECD countries: Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, France, Germany, Greece, Italy, Korea, Mexico, the Netherlands, Norway, Poland, Portugal, the Slovak Republic, Spain, Switzerland, Turkey, the United Kingdom, and the United States.

Data was gathered for the main tax expenditures for personal income tax, corporate income tax and VAT. Country-specific details are shown in Figure 2.1. It should be highlighted that while caution is needed when interpreting and drawing conclusions from country-specific tax expenditure data, comparing tax expenditure information across countries is even more problematic.

International comparability of tax expenditures

International comparability of TE estimates is significantly limited by the different approaches undertaken by different countries when preparing tax expenditure reports. First, tax expenditure definitions differ across countries and over time due to differences in the benchmark tax systems. Secondly, while all of the countries that answered the OECD questionnaire primarily use the revenue forgone method for calculating tax expenditures, Denmark applied the outlay equivalent method for a number of tax expenditures and Australia included some estimates using the revenue gain method from 2008. The (quasi) universality in the use of the revenue forgone method could be seen as facilitating international comparisons. However, as discussed above, estimates of revenue forgone in tax expenditures do not reflect the additional yield from tax expenditure elimination.

Hence all the caveats regarding the use of the revenue forgone method also apply when using these estimates for international comparison purposes.

Additionally, as many tax provisions are formulated as deductions, the value of tax expenditures typically depends on the level of the marginal tax rates. Therefore, changes in tax expenditure estimates may only be reflecting changes in statutory tax rates (which form part of the benchmark) rather than amendments to these provisions. Some differences in tax expenditure values across countries may thus reflect different statutory rates rather than divergences in the number and extent of provisions (the higher the tax rate the larger the measured tax expenditure). Moreover, countries differ in preferences regarding income redistribution, in the strength of their tax administration, and in their tax revenue requirements. All these different factors have an impact on the choice between a broad base and use of tax expenditures, making international comparison more difficult.

Additional limitations to comparability include:

- While some countries report TE estimates for all levels of governments, others only report those related to central government.
- The range of taxes covered in TE reports tends to be incomplete. For example, very few countries include TEs related to social security contribution regimes.
- Trends in aggregates reflect changes in the extent to which individual TEs are accessed, changes in the benchmarks, changes in tax rates and changes in the number of TEs being reported.
- Countries also vary in the coverage and detail of TE estimates that were reported in the questionnaire. Many countries reported main TE values, *i.e.* those which correspond to the 80% of the total TE estimates. However, others only provided values for the largest 20 TE.

Table 2.1 presents the experience of selected OECD countries in terms of their choice of the benchmark definition, the coverage of taxes (types of taxes and whether tax provision granted by lower levels of government are reported), and the classification of TEs in their TE reports.

Share of main tax expenditures by tax type in OECD countries

Having in mind the limitations regarding international comparison explained in the previous section, some general trends may be drawn from available data (see Figure 2.1 for a graphical summary and the Annex A for further details). Tax reliefs related to personal income tax represent the largest value of tax expenditures in all countries except in Denmark, France, Mexico, and the United Kingdom, where the largest values are for VAT. In Australia, Canada, Korea and Norway, corporate tax is subject to comparatively higher level of tax expenditures. However, it should be noted that the cost of VAT exemptions and zero-rating will not be reflected in most of the TE data analysed in this report, since most countries consider these concessions as part of their benchmark system.

In Italy, Mexico, Spain and the United Kingdom the revenue forgone from VAT tax expenditures amount to more than one third of total VAT tax revenues; similar situation exists in Italy, Spain, and the United States for personal income TE (as percentage of PIT revenues). Corporate revenue forgone from tax provisions accounts for more than one fifth of total corporate tax revenues in Australia, Belgium, Canada, Spain, Turkey and the United Kingdom.

Table 2.1. **OECD country experience in tax expenditure reporting: Benchmarks, coverage and classification**

Country experience	Benchmark definition	Taxes covered	Levels of government	Classification
Australia	A conceptual base is used for all benchmarks. For personal and corporate taxes this conceptual base is based on an adjusted Haig Simons to reflect practical issues.	Eight benchmarks are used classified in 3 categories: ● Income tax benchmark: income tax (both personal and business), superannuation, fringe benefits and capital income tax benchmarks. ● Consumption tax benchmark: commodity tax, natural resource tax and goods and services tax benchmark. ● Externalities benchmark (from 2009): the emissions trading benchmark.	Central government.	By broad economic function, by type of taxpayer affected, and by the particular benchmark to which they relate.
Austria	A reference law benchmark is employed. The estimates cover only indirect subsidies arising out of "revenue forgone to individuals or juristic persons for the private activities performed in the interest of the general public".	Personal and corporate taxes only.	All levels of government.	By type of tax and by beneficiary.
Belgium	A conceptual benchmark is employed. Tax expenditure is defined as "revenue forgone due to tax incentives in the form of dispensations from ordinary taxation… which could be replaced by direct subsidies". There is no benchmark definition in the report presented annually to Parliament.	Personal and corporate income taxes, VAT, non-resident tax, real estate and securities taxes, vehicle tax, excise duties, registration fees and inheritance tax.	Federal government.	By whether the treatment constitutes tax expenditure, by type of tax, and by intended purpose.
Canada	A conceptual benchmark based on an adjusted Haig Simons concept is used for income and corporate taxes. A national definition is used for GST/HST baseline (broadly based, single rated (7%), multi-stage value-added tax collected according to the destination principle and using a tax credit mechanism to relieve the tax in the case of business inputs).	Personal income tax, corporate income tax, and goods and services tax (GST/HST).	Federal government (some provinces generate their own estimates).	By type of tax, and within a tax by functional categories (*e.g.* education, employment…).
Chile	A conceptual benchmark is used. Tax expenditures are defined as revenue forgone due to the application of exemptions or special tax regimes, which are designed to support or encourage certain economic sectors, activities, regions, or agents.	Personal income tax, corporate income tax and VAT.	Central government.	By type of tax, beneficiary, economic sector and by type of tax expenditure (exemptions, credits, deductions, etc.).
Denmark	A reference law approach is used. Tax expenditures are defined as departures from the normal tax rules which cause lower tax revenue than the general rule.	Personal and corporate income taxes, VAT exemptions, and other indirect taxes.	Central government (also municipal tax).	By type of tax.
Finland	A conceptual benchmark based on an adjusted Haig Simons concept is used for income tax analysis. A reference benchmark is used for the VAT and other commodity taxes. Both positive and negative tax expenditures are evaluated.	Personal and corporate income taxes, VAT, excise duties, transfer tax, real estate tax, inheritance tax, gift tax, social security contributions.	All levels of government.	By type of tax and functional categories.

n.a.: Information not available.

Sources: National sources; *Fiscal Transparency, Tax Expenditures, and Budget Processes: An International Perspective*, J. Craig and W. Allan, 2004 (mimeo).

Table 2.1. **OECD country experience in tax expenditure reporting: Benchmarks, coverage and classification** *(cont.)*

Country experience	Benchmark definition	Taxes covered	Levels of government	Classification
France	Appears to use a pragmatic reference law baseline. "Tax expenditures are defined as legal or statutory measures whose implementation induces a lower tax revenue for the State in comparison with the application of the norm."	Personal and corporate taxes, other direct taxes (solidarity tax on wealth, imposition forfaitaire annuelle), registry fees and stamp duties, VAT, tax on the consumption of petroleum products, other fees and duties, and since 2007 some local taxes (*e.g.* tax on economic activities – taxe professionnelle – or council tax – taxe d'habitation).	Central government (local measures included when having a direct impact on central government's budget).	By types of the tax, by main purpose and by beneficiary.
Germany	Tax expenditure is characterised as being analogous to an expenditure subsidy benefiting industry. Items such as tax reliefs for families constitute part of the benchmark and are not shown as tax expenditure (but are shown separately). Pensions arrangements assume an expenditure tax baseline and hence no tax expenditures are shown for this item.	Personal and corporate income tax, net worth tax, business tax, turnover tax, insurance tax, motor vehicle tax, excise taxes, betting and lottery tax, property tax and inheritance tax.	All levels of government.	By industrial sector and within these sectors, by type of tax.
Greece	n.a.	Personal and corporate direct taxes, VAT, excise taxes, customs duties and other indirect taxes?	Central government.	By type of tax and by beneficiary.
Ireland	There is no formal concept of benchmark but a pragmatic conceptual baseline for direct taxes only. Indirect tax concessions are not evaluated in the annual report.	Personal and corporate income taxes.	Central government.	By type of tax and within each tax by tax expenditure type.
Italy	There is no formal concept of benchmark. Tax expenditure is defined as "an exception to the principles of generality, uniformity, and progressivity of taxation".	Personal and corporate income taxes and some indirect taxes.	Both central and local government.	By type of tax, by main sector involved, by aim, by beneficiaries and by local entity.
Japan	A reference law benchmark is employed. Special tax provisions are listed in "Special Tax Measures Law" as the departures from the general tax laws (ex. Income Tax Law, Corporate Tax Law, Consumption Tax Law) which determine baseline tax base and tax rates. Among those provisions, those pursuing reduction of tax burdens for special policy purpose are considered as tax expenditures.	All taxes (including personal and corporate income taxes and indirect taxes).	Central government.	By type of tax.
Korea	Tax expenditures are evaluated against a reference law baseline that specifies a list of over 200 concessions.	Personal and corporate income taxes and indirect taxes.	Central government.	By type of tax and function.
Mexico	A conceptual approach is used. Tax expenditure is defined as "tax exemptions, reductions and allowances which are a deviation from the 'normal structure' of any tax, which constitute a favourable fiscal regime for certain income type or economic activity and that have non-fiscal or economic policy purposes".	Personal and Corporate Income Taxes, Business Flat Rate Tax (IETU), VAT and excise taxes.	Federal government.	By type of tax, and within each tax by tax expenditure type.

n.a.: Information not available.

Sources: National sources; *Fiscal Transparency, Tax Expenditures, and Budget Processes: An International Perspective*, J. Craig and W. Allan, 2004 (mimeo).

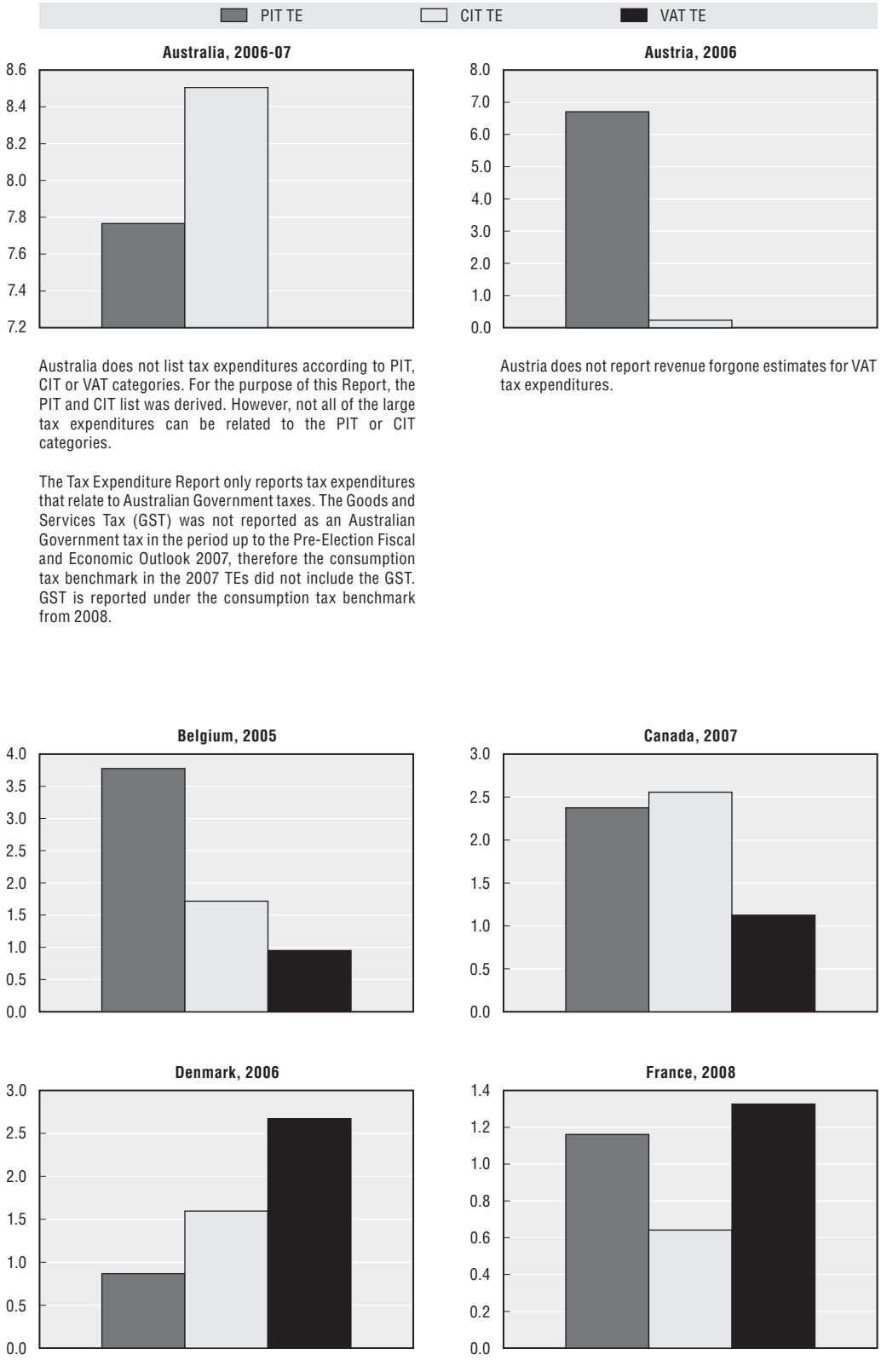
Table 2.1. **OECD country experience in tax expenditure reporting: Benchmarks, coverage and classification** *(cont.)*

Country experience	Benchmark definition	Taxes covered	Levels of government	Classification
Netherlands	A reference law determination of the baseline is followed. Tax expenditure is measured as a "loss or deferment of tax revenue arising from a statutory provision in so far as that provision does not accord with the basic levy system provided for by the law".	Wage and income taxes, corporate income tax, VAT, excise taxes, energy tax, motor vehicle tax, estate and gift tax and social insurance contributions.	Central government.	By purpose of tax expenditure (direct taxes) and by type of tax (indirect taxes).
Portugal	A conceptual benchmark is employed. Tax expenditures are defined as exceptional measures with public interests more important that the interest of the tax that is reduced/eliminated.	Personal and corporate income taxes, VAT, tax on energy and petrol products, motor vehicle taxes, taxes on tobacco and alcohol.	Both central and local government.	By type of tax and within each type by origin of benefit.
Spain	A conceptual benchmark is employed. A provision is considered as a tax expenditure if it lowers tax revenues (central government)/reduces taxpayer' tax liability. A tax expenditure needs to satisfy 6 explicit conditions including: possibility of elimination from a legal point of view; lack of other compensations of the TE in the tax system; not created from technical, accounting or administrative reasons; and not aimed at simplifying or facilitating compliance.	Personal and corporate income taxes, VAT, excise duties, tax on insurance premiums and central government fees.	Central government.	By type of tax and by function (purpose of expenditure).
Sweden	A Haig Simon conceptual benchmark for income tax analysis is employed, and a reference benchmark is used for the VAT and other commodity taxes. Both positive and negative tax expenditures are evaluated.	Income tax, labour tax, social security contributions paid by employers, VAT and some excise taxes (energy tax and carbon dioxide tax). No tax expenditures are shown for taxes on motor vehicles or duties on alcohol and tobacco.	Central government.	By type of tax, by main purpose and divided into two broad categories: tax expenditures affecting the budget balance and expenditures not affecting the budget balance.
Switzerland	In its forthcoming report, the Federal Tax Administration uses two alternative conceptual benchmarks: A comprehensive income tax and a consumption tax. The VAT is only measured against its own benchmark (consumption tax).	Personal and corporate income taxes, VAT, withholding tax, stamp duties, different excise taxes.	Central government.	By type of tax and by benchmark.
United Kingdom	A conceptual and expenditure subsidy benchmarks are combined. Only reliefs that are seen as alternatives to public spending are labelled as tax expenditures; reliefs that are an integral part of the tax structure or simplify administration are called structural reliefs; and a third category includes reliefs with both structural and expenditure components.	Personal and corporate income tax, capital gains tax, inheritance tax, stamp duty, national insurance contributions, VAT.	Central government.	By tax expenditure, structural relief and relief with tax expenditures and structural components; under each of these categories by type of tax.
United States	Two separate presentations are made for income taxes: a conceptual benchmark (the "normal tax structure") based on the Haig Simons concept; and a reference law benchmark that covers "special exceptions in the tax code that serve programmatic functions." A separate benchmark applies to transfer taxes but there is no measure of tax expenditures against indirect taxes such as excises or customs, nor for social security contributions.	Personal income tax, corporate income tax, estate and gift taxes and social security contributions.	Federal government.	By type of tax and within each tax by budgetary functional category.

n.a.: Information not available.

Sources: National sources; *Fiscal Transparency, Tax Expenditures, and Budget Processes: An International Perspective*, J. Craig and W. Allan, 2004 (mimeo).

Figure 2.1. **Share of main PIT, CIT and VAT tax expenditures in total tax revenues**

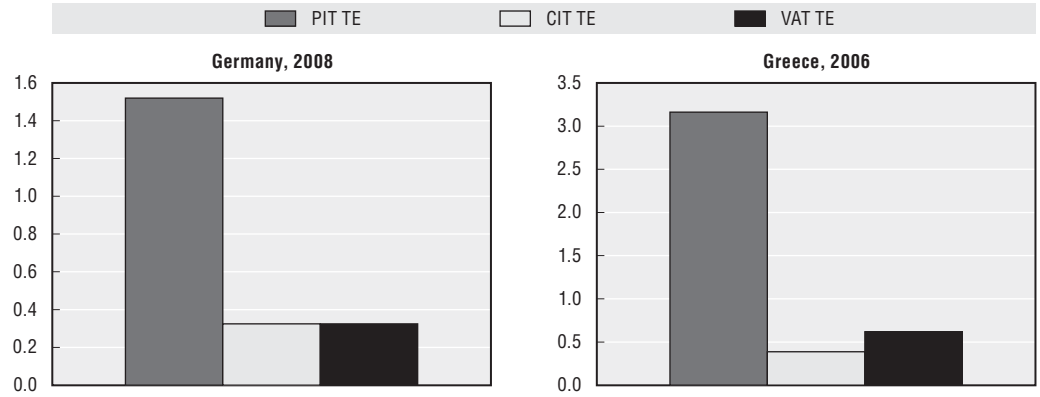


Australia does not list tax expenditures according to PIT, CIT or VAT categories. For the purpose of this Report, the PIT and CIT list was derived. However, not all of the large tax expenditures can be related to the PIT or CIT categories.

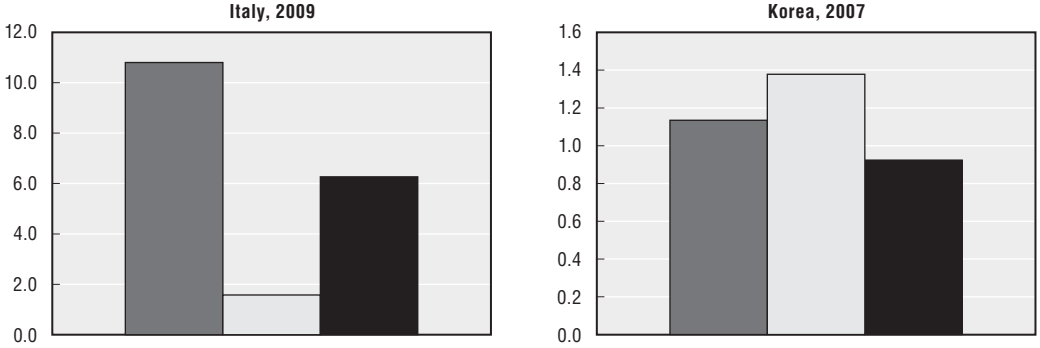
The Tax Expenditure Report only reports tax expenditures that relate to Australian Government taxes. The Goods and Services Tax (GST) was not reported as an Australian Government tax in the period up to the Pre-Election Fiscal and Economic Outlook 2007, therefore the consumption tax benchmark in the 2007 TEs did not include the GST. GST is reported under the consumption tax benchmark from 2008.

Austria does not report revenue forgone estimates for VAT tax expenditures.

Figure 2.1. **Share of main PIT, CIT and VAT tax expenditures in total tax revenues** *(cont.)*



Germany does not list tax expenditures according to PIT, CIT or VAT categories. For the purpose of this Report, the PIT and CIT list was derived. This figure shows the 20 largest tax expenditures, which represent 88.9% of the total amount of tax expenditures.



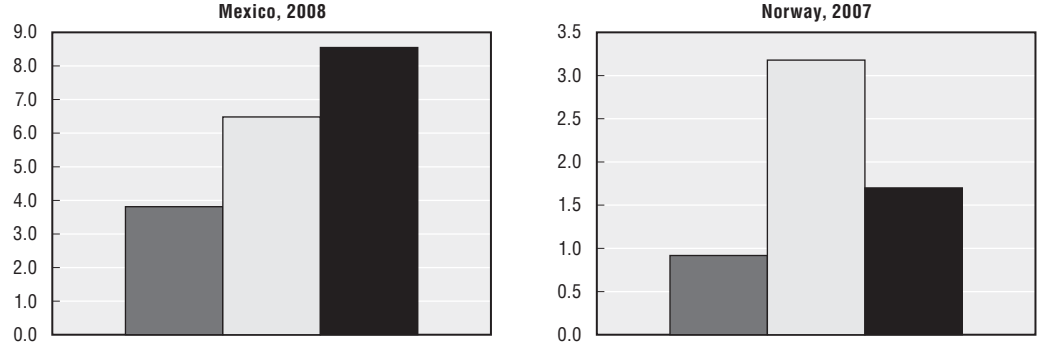
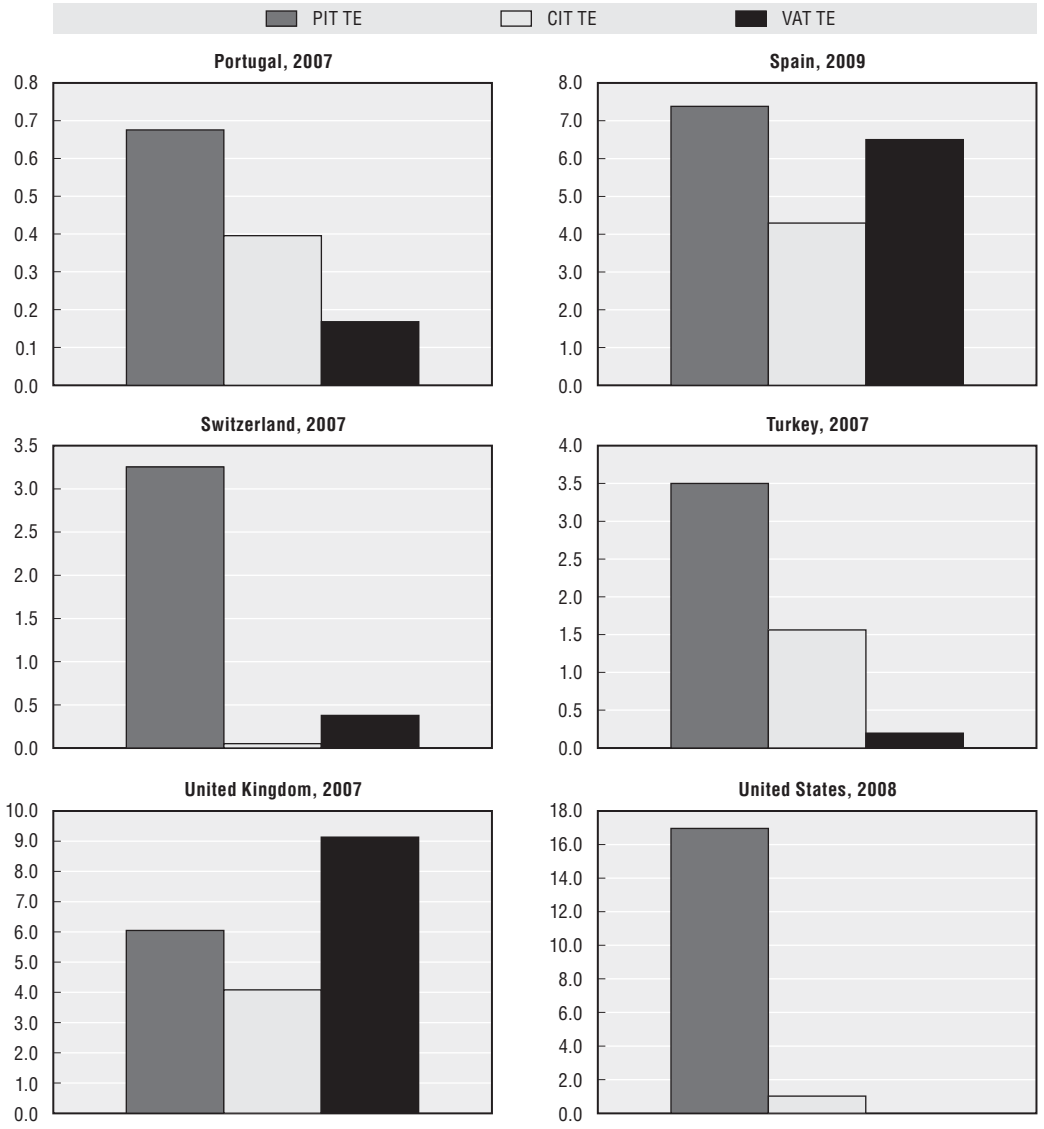


Figure 2.1. **Share of main PIT, CIT and VAT tax expenditures in total tax revenues** *(cont.)*



In the United Kingdom tax expenditures are categorised as *Tax Expenditures, Reliefs with Tax Expenditure and Structural Components,* or *Structural Reliefs*. This figure includes reliefs with both tax expenditures and structural components.

Notes: It is recommended that data included in these charts be used only for country-specific analysis. International comparability of TE estimates is significantly limited for the reasons explained in the main text and the Annex A.

Aggregate figures do not include allowance for joint tax declaration (Spain), double taxation reliefs (the United Kingdom), personal allowances (Italy and the United Kingdom), and tax deferrals (the United States).

Sources: National TE reports and responses to a questionnaire on Tax Expenditure Trends that was circulated to OECD Delegates of the Working Party on Tax Policy and Statistics; Tax Revenue Data from *OECD Revenue Statistics*.

2.7. Main TEs and the broadness of the tax bases in OECD countries

The main policy objectives underlying the use of tax provisions reflect to a large extent the main categories of tax expenditures reported in the Annex A: Social and family policies, supporting home building and improvement, encouraging savings, promoting

R&D, and reducing the price of necessities. Several countries cited the promotion of employment and economic development as reasons for certain tax reliefs. One country also mentioned that tax expenditures were sometimes chosen over direct expenditures because they were a more appropriate way to administer concessions.

Table 2.2 gives a brief summary of the main changes over the past ten years in terms of tax expenditures and base-broadening measures in the 22 OECD countries that provided detailed information. Almost all countries present a mixed picture of both removing and adding tax expenditures. However, in general countries report increasing trends in the use of tax expenditures particularly for personal income tax. It appears that the removal of tax expenditures is often accompanied by a tax rate reduction but the introduction of new tax expenditures is not explicitly linked to increased rates.

Political obstacles are often the greatest obstacle to removing tax expenditures – in particular opposition from those who would lose from the change can often be insurmountable. However, a few countries reported the opposite, *i.e.* that no political obstacles prevented abolishing tax incentives.

Using tax indicators and TE data, the remainder of this section analyses the broadness of the VAT, PIT and CIT bases in OECD countries.

VAT

Figure 2.2 shows the standard VAT rates in OECD countries on 1 January 2010 and their evolution since their implementation.[9] These rates range from 5 per cent (Japan and Canada) to 25 per cent (Denmark, Hungary, Iceland, Norway and Sweden) and 25.5 per cent in Iceland, although most rates vary between 15 per cent and 22 per cent.[10] They have remained relatively constant since 1996. Australia introduced its GST in 2000. Over the period 1996-2010, the standard VAT rate increased in twelve OECD countries: Japan (3 to 5 per cent), Switzerland (6.5 to 7.6 per cent), Mexico (15 to 16 per cent), Turkey (15 to 18 per cent), Germany (15 to 19 per cent), Portugal (17 to 20 per cent), the Netherlands (17.5 to 19 per cent), Chile and Greece (18 to 19 per cent), Italy (19 to 20 per cent), Norway (23 to 25 per cent), and Iceland (24.5 to 25.5 per cent).[11] The rate decreased in four OECD countries: Canada (7 to 5 per cent), France (20.6 to 19.6 per cent), the Czech Republic (22 to 20 per cent), and the Slovak Republic (23 to 19 per cent).

Despite strong economic arguments supporting uniform commodity taxation, in practice VAT preferential treatments are widely used in OECD countries (see Table 2.3). Most of these differentiated rate structures appear to have been introduced for equity or social objectives (*e.g.* exemptions on basic essentials or specific sectors such as health, education or charities). In addition, VAT preferential rates are introduced for practical (*e.g.* financial and insurance services) or historical reasons (postal services, letting of immovable property, supply of land and buildings). However, exemptions beyond these core items are numerous and cover a wide diversity of sectors such as culture, legal aid, passenger transport, public cemeteries, waste and recyclable material, water supply, precious metals and certain agricultural inputs.

VAT preferential treatment in OECD countries takes the form of exemptions (in all countries), reduced rates (in twenty-two countries), a domestic zero-rate (in fifteen countries)[12] and specific rates applied within particular regions (in seven countries). The combination of these different concessions also varies noticeably across countries.[13] Additionally, an exemption applied to particular firms (*e.g.* small firms, or non-resident

Table 2.2. **Summary table on TE main trends**

Australia	Total tax expenditures quite stable until 2004 but increasing trend afterwards, particularly for personal income tax. On business taxation: reduction of rate and abolition of accelerated depreciation.
Austria	More than 10 years ago (reform 1993-94): implementation of lower rates and broader bases only for budgetary consolidation.
Belgium	Total tax expenditures stable until 1999 but increasing trend in recent years. PIT: new tax expenditures (*e.g.* energy saving investment) and tax allowance for housing widened in 2005. Mortgage capital repayments and interest deductions deductible against earned income. CIT: change in benchmark – ACE substituting coordination centre regime. 2003: tax shelter for the film industry introduced, investment reserve created, standard and reduced rates decreased. New small business exempted from advance tax payment system. VAT: 2002 – introduction of reduced rates for labour-intensive services (EU agreement).
Canada	Revenue forgone in tax expenditures quite stable as percentage of total tax revenues in period 1999-2008. 1999-2008: substantial reduction of tax burden while maintaining constant the relative importance of targeted tax expenditures – substantial reduction of the small business rate advantage: 16 percentage points in 2000 (12% compared to a general rate of 28%) and 8.5 percentage points in 2008 (11% compared to 19.5%). – elimination of 3 tax expenditures: the most important being the special low rate for manufacturing and processing income. – modification to the tax credit for Scientific Research and Experimental Development and introduction of 7 new measures.
Czech Republic	1998-2001: several tax incentives introduced (tax holidays for large investments mainly in manufacturing industry, tax allowances for pension and life insurance, etc.). 2003-04: CIT rate gradually decreased from 31 to 24 per cent, tax base broadened (*e.g.* investment allowance of 10 per cent of the amount of investment and tax credit for tax withheld on dividends abolished). 2005: new tax allowance of 100% of R&D costs introduced. 2006: the two lowest marginal tax rates reduced from 15 to 12 per cent and from 20 to 19 per cent, standard tax allowances replaced by tax credits. 2008: Introduction of PIT flat rate of 15% and base-broadening (by abolishing the possibility of deduction of social security contributions and by adding social security contributions paid by employers to the tax base of employees). VAT reduced rate increased from 5 to 9 per cent.
Denmark	Lower rates + broader base but no decrease of tax expenditures because provisions abolished considered as part of benchmark.
France	Increasing trend of tax expenditures (30% between 1997 and 2008). Main changes in tax incentives: decrease of PIT through tax schedule reform, Make Work Pay incentives, reduced VAT rate on targeted sectors.
Germany	2000 and 2008 reforms: income and corporate rates reduced and partially compensated with base-broadening measures (more realistic depreciation and some employment benefits reduced). Tax expenditures have been decreasing for personal income tax, increasing for VAT and stable for corporate income tax.
Italy	Financial Law for 2008: CIT rate reduced to 27.5%, abolition of some depreciation allowances and anticipated depreciation, introduction of new fiscal rules for interest expenses.
Mexico	Personal income tax expenditures have shown a downward trend but no clear trend for corporate income tax or VAT. CIT: no base-broadening, but the Business Flat Rate Tax (*Impuesto Empresarial a Tasa Unica, IETU*), a minimum and complementary income tax that indirectly fosters the broadening of the income tax base, was introduced in 2008. CIT rate reduction: from 35% in 1999 to 28% in 2007.
Netherlands	2001 PIT reform: One of measures was a cut in PIT tax expenditures. 2007 CIT reform: Base-broadening measures: limitations of loss carry-forward, new valuation rules for work in progress and restrictions to rules for depreciation on certain assets and goodwill (but these provisions not considered as tax expenditures).
Norway	2004-06 Fundamental tax reform: – several exemptions and allowances removed particularly in PIT – extensive base-broadening in wealth tax. But taxation of imputed rent of owner-occupied housing was removed in 2005 and the tax relief for employee pension contributions has been increasing.
Poland	CIT: rates reduced from 36% in 1998 to 19% in 2004, followed by the abolition of some tax exemptions. PIT: brackets reduced, with highest rate reduced from 40% to 32%. For the last 10 years, some allowances abolished but a few also introduced.
Portugal	In general base-broadening approach but some exceptions. PIT: in 2005, many tax credits abolished to compensate for a general cut in marginal rates, but in 2006 tax credits for contributions to retirement savings plans and pension funds, and reliefs for the purchase of personal computers reintroduced. CIT: in 2005, statutory rate reduced to 25%, Investment Tax Credit abolished; but in 2006, rates for companies operating in less developed inland areas reduced from 25% to 20% (re-establishment of 5% differential to general regime).
Slovak Republic	2004 reform: broader base and lower rate approach (introducing a flat rate of income tax at the level of 19 per cent), unifying VAT rates, abolishing tax on dividends, abolishing many exemptions, deductions, and special treatments in income taxation. 2006: re-introduced lower VAT rate at 10% for drugs, medical tools and books.
Spain	PIT: an increasing trend in tax expenditures. CIT: lower rate and broader base approach – gradual elimination of many existing tax deductions as well as reduction of rates.
Switzerland	Currently increasing trend in tax expenditures.

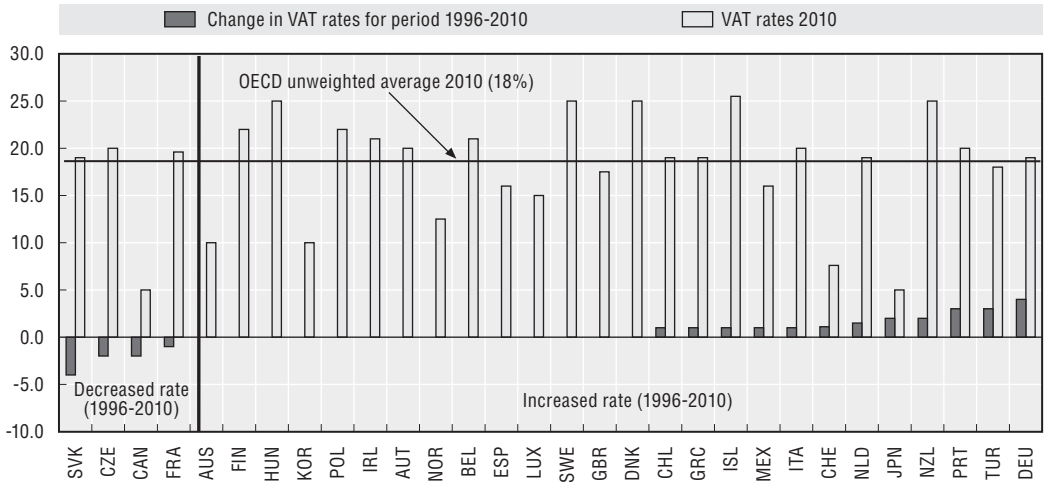
Source: OECD countries replies to an OECD questionnaire.

Table 2.2. **Summary table on TE main trends** *(cont.)*

Turkey	2006 PIT: tax brackets changed, minimum living allowance enforced. CIT: rate decreased. VAT: several rates reduced.
United States	In general tax expenditures has been on the rise. Lower rates and tax preferences expanded. Tax relief for low income individuals and families.

Source: OECD countries replies to an OECD questionnaire.

Figure 2.2. **Changes in the OECD VAT standard rates**



Note: Countries are ranked according to the change in the VAT rates (position as at 1 January 2010) over the period 1996-2010 in increasing order. For Australia the change is calculated between the implementation year (2000) and 2010.

Source: OECD Tax Database.

suppliers) is also introduced through registration or collection thresholds, which also differ widely.[14] VAT reduced-rates have been particularly introduced in the last decade to target particular sectors. For example, in 2002 some European countries introduced reduced-rated for labour-intensive industries.

One measure of the broadness of the VAT base, the extent of preferential rates and the effectiveness with which taxes are collected is the so-called "VAT Revenue Ratio" (VRR).[15] The VRR expresses the revenue collected from the actual VAT in a country as a proportion of the revenue that would be raised if the main standard rate of VAT were applied to all consumption. A ratio close to 1 suggests a uniformly applied VAT on a broad base with effective tax collection, while a low ratio may indicate an erosion of the tax base either from exemptions, reduced rates, the application of taxation/registration thresholds for small traders, poor compliance or weak tax administration or a combination of these. Therefore, these three main factors (preferential rates and thresholds, compliance rates and efficient enforcement) affecting the performance of VAT systems need to be taken into account when deriving conclusions from VRR values.

In addition, this measure should be interpreted carefully because the base used for the calculation of the VRR ratio is not necessarily the "ideal" VAT base. The figures of national consumption currently used to calculate the VRR are taken from the national accounts (there is currently no internationally agreed method to assess a VAT theoretical base), but "consumption" in the national accounts is not necessarily an appropriate VAT base. Whether and if so how to

Table 2.3. **Value added and goods and services tax: Rates and thresholds in OECD countries, 2010**

	Implemented	Standard rate	Reduced rate	Domestic zero rate[1]	Specific rate applied within specific region	General thresold (USD)	VRR (2005)
Australia	2000	10.0	–	Yes	–	51 197	0.57
Austria*	1973	20.0	10.0/12.0	No	19.0[a]	33 783	0.60
Belgium*	1971	21.0	6.0/12.0	Yes	–	6 119	0.50
Canada	1991	5.0	–	Yes	13.0[b]	25 172	0.52
Chile	1975	19.0	–	No	–	None	
Czech Republic	1993	20.0	10.0	No	–	68 389	0.59
Denmark	1967	25.0	–	Yes	–	5 923	0.62
Finland	1994	22.0	8.0/13.0	Yes	–	8 803	0.61
France	1968	19.6	2.1/5.5	No	0.9/2.1/8.0/3.0[c] 1.05/1.75/2.1/8.5[d]	87 265	0.51
Germany	1968	19.0	7.0	No	–	20 473	0.54
Greece	1987	19.0	4.5/9.0	No	3.0/6.0/13.0[e]	13 519	0.46
Hungary	1988	25.0	18.0/5.0	No	–	36 914	0.49
Iceland	1989	25.5	7.0	Yes	–	3 733	0.62
Ireland	1972	21.0	4.8/13.5	Yes	–	80 071	0.68
Italy	1973	20.0	4.0/10.0	No	–	35 302	0.41
Japan	1989	5.0	–	No	–	86 969	0.72
Korea	1977	10.0	–	Yes	–	None	0.71
Luxembourg	1970	15.0	3.0/6.0/12.0	No	–	10 800	0.81
Mexico	1980	16.0	–	Yes	10.0[f]	None	0.33
Netherlands	1969	19.0	6.0	No	–	1 548	0.61
New Zealand	1986	12.5	–	Yes	–	37 891	1.05
Norway	1970	25.0	8.0/14.0	Yes	–	5 755	0.58
Poland	1993	22.0	7.0	Yes	–	50 702	0.48
Portugal	1986	20.0	5.0/12.0	No	4.0/8.0/14.0[g]	14 962	0.48
Slovak Republic	1993	19.0	10.0	No	–	90 311	0.53
Spain**	1986	16.0	4.0/7.0	No	2.0/5.0/9.0/13.0[h]	None	0.56
Sweden	1969	25.0	6.0/12.0	Yes	–	61 450	0.55
Switzerland	1995	7.6	2.4/3.6	Yes	–	None	0.76
Turkey	1985	18.0	1.0/8.0	No	–	None	0.53
United Kingdom	1973	17.5	5.0	Yes	–	102 808	0.49

Notes: (position as at 1 January 2010)

* In these countries, a collection threshold applies. All taxpayers are required to register for VAT/GST, but will not be required to charge and collect VAT/GST until they exceed the collection threshold.

VAT Revenue Ratio = (VAT revenue)/([consumption – VAT revenue] * Standard VAT rate).

Country notes:

Austria (*a*) A standard rate of 19% applies in Jungholz and Mittelberg.

Canada (*b*) The provinces of Newfoundland and Labrador, New Brunswick, and Nova Scotia have harmonised their provincial sales taxes with the federal Goods and Services Tax and levy a rate of GST/HST of 13%. The provinces of Ontario and British Columbia have proposed to harmonise their provincial sales taxes with the federal Goods and Services Tax effective 1 July 2010, the proposed rates of GST/HST for the provinces is 13.0% and 12.0%, respectively. Other Canadian provinces, with the exception of Alberta, apply a provincial tax to certain goods and services. These provincial taxes apply in addition to GST.

France (*c*) (*d*) Rates of 0.9%; 2.1%; 8.0%; 13.0% apply in Corsica; rates of 1.05%; 1.75%; 2.1%; 8.5% apply to overseas departments (DOM). There is no VAT in French Guyana.

Greece (*e*) Rates of 3.0%; 6.0% and 13.0% apply in the regions Lesbos, Chios, Samos, Dodecanese, Cyclades, Thassos, Northern Sporades, Samothrace and Skiros.

Mexico (*f*) A VAT rate of 10.0% applies in the border regions (the border zone is up to 20 kilometres with respect to the northern and southern Mexican borders), plus the whole territory of the states of Baja California, Baja California Sur, Quintana Roo, and part of Sonora.

Portugal (*g*) The standard VAT rate in the Islands of Azores and Madeira is 14.0%; reduced VAT rates in these areas are 4.0% and 8.0%.

Spain ** The standard VAT rate was increased from 16.0% to 18.0% and the reduced rate from 7.0% to 8.0% on 1 July 2010.
(*h*) Rates of 2.0%; 5.0%; 9.0%; 13.0% apply in the Canary Islands.

Source: OECD Tax Database.

apply VAT to public consumption, the services from residential property investment, banking and insurance remains controversial. A combination of these factors together with the stitching tax effects of exemption in the value chain may lead to a VRR above 1.

These limitations suggest that while this ratio is limited when used as a tool for comparing countries with each other, it is still a very useful tool for measuring a single country's performance over a number of years.

The last column in Table 2.3 shows the considerable variation in the VRR across OECD countries, from 0.33 in Mexico to 1.05 in New Zealand and 0.81 in Luxembourg.[16] Most VRR are below 0.65 (24 of 29, and 7 countries with a ratio below 0.50). This suggests that VAT regimes with their multiple reduced rates and exemptions have significant tax expenditures compared to a "pure" VAT regime. This also suggests that, between one half and one third of potential revenues are not subject to taxation or, if they are, are not collected.

The evidence of narrow VAT bases suggested by the VRR is supported by available data on TE particularly in the case of Italy, Mexico, Spain and the United Kingdom (see Table 2.4). However, it should be noted that in some countries exemptions and/or zero-rates are considered as structural TE, and in those cases TE estimates are generally not calculated. In addition, not all countries have reported all TEs (*e.g.* Canada's answer to the questionnaire only included targeted reliefs designed to influence private agents' behaviour). Moreover, while the VAT standard rate *does* have an influence on the TE values, since it is used as the benchmark, it appears to have limited influence on the VRR. This is reflected in the very different VRRs observed in countries with comparable standard rates in Table 2.3. On the other hand, the low VRR for Mexico probably result from a combination of an extended use of the domestic zero-rate (which it is also reflected in the TE value for this category), a reduced rate for the sale of goods in the border regions and a lower compliance rate.

The evolution of VRR across time may be also useful to analyse whether countries are moving towards a broader base. Figure 2.3 shows that most countries' VRRs have slightly increased (from 0.54 to 0.58), which might indicate a broadening of the VAT base but also improved compliance and enforcement of the VAT rules. However, some variations are observed across countries. Six countries (Luxembourg, Czech Republic, Ireland, Spain, Australia and Korea) have increased their VRR by more than 0.1 point (by 0.24; 0.15; 0.15; 0.11 and 0.10, respectively). As explained in OECD (2008), in Luxembourg this increase may well be explained by the strong growth of the financial sector and rising prices in the construction sector; in Australia it is likely explained by the progressively successful implementation of the new GST system introduced in 2000. In the Czech Republic the rapid increase in the VRR between 2003 and 2005 (0.17) corresponds to major tax reforms during that same time, including a reduction of the scope for reduced VAT rates and a decrease of the standard VAT rate from 22% to 19% (although a reduced-rate of 10% was re-introduced in 2006 for drugs, medical tools and books). A similar effect can also be seen in the Slovak Republic where a flat VAT rate of 19% was introduced in 2003 (down from a standard VAT rate of 23% in 1999) while the VRR increased by 0.6 between 2003 and 2005.

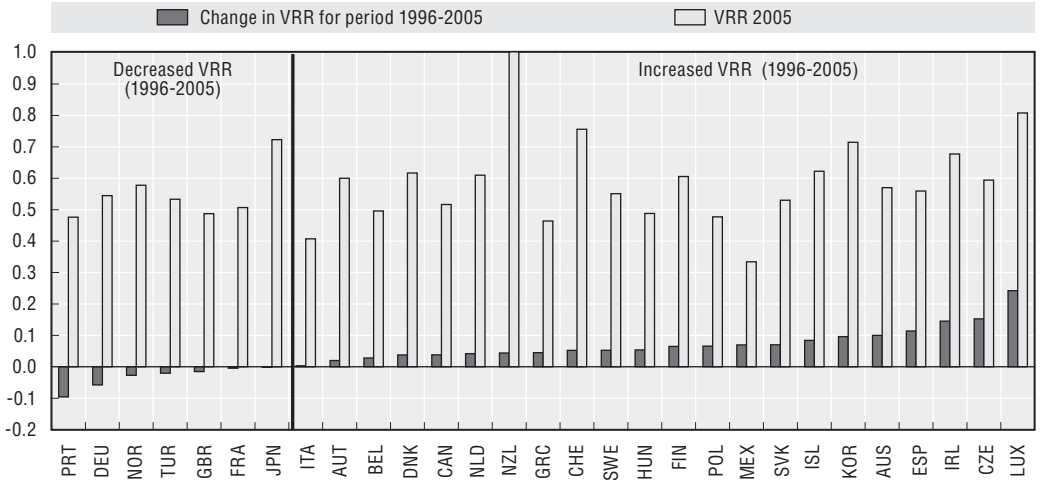
On the other hand, the VRR decreased in Portugal by 0.08 between 2003 and 2005 following an increase in the standard rate from 19% to 21%. A comparable evolution occurred in Norway. The standard VAT rate increased from 23% to 24% in 2001 (the reduced rates also increased by 1 percentage point) while the VRR decreased by 0.11 between 2000 and 2003. However, although the standard VAT rate increased again in 2005, the VRR also increased between 2003

Table 2.4. **VAT TE estimates as percentage of VAT tax revenues**

		% VAT tax revenues			
		Total	Exemptions	Zero-rate	Reduced-rate
Belgium	2006	5.80	Bench	0.20	5.56
Canada	2008	13.50	5.84	7.66	–
Denmark	2006	12.90	1.41	Bench	2.04
France	2008	8.17	Bench	–	8.17
Germany	2008	1.67	Bench	–	1.67
Greece	2006	2.71	1.13	–	1.59
Italy	2009	45.83	0.86	–	44.97
Korea	2007	5.52	2.50	3.02	–
Mexico	2008	45.96	9.49	33.17	3.29
Netherlands	2008	11.77	Bench	–	7.35
Norway	2007	8.95	0.75	1.72	6.48
Portugal	2007	0.70	0.70	–	Bench
Spain	2009	41.78	14.17	–	27.61
Switzerland	2007	2.90	Bench	Bench	2.90
Turkey	2007	1.17	n.a.	n.a.	n.a.
United Kingdom*	2007	50.14	13.63	32.87	3.64

Notes:
"Bench" refers to TE categories considered as part of the benchmark system.
Belgium, Denmark and the Netherlands: Difference = category other.
United Kingdom: Some TE figures include structural components, which would be generally considered as part of the benchmark in most countries.
n.a.: not available.
Source: Information provided by OECD countries through a questionnaire.

Figure 2.3. **The VRR ratio: 1996-2005**

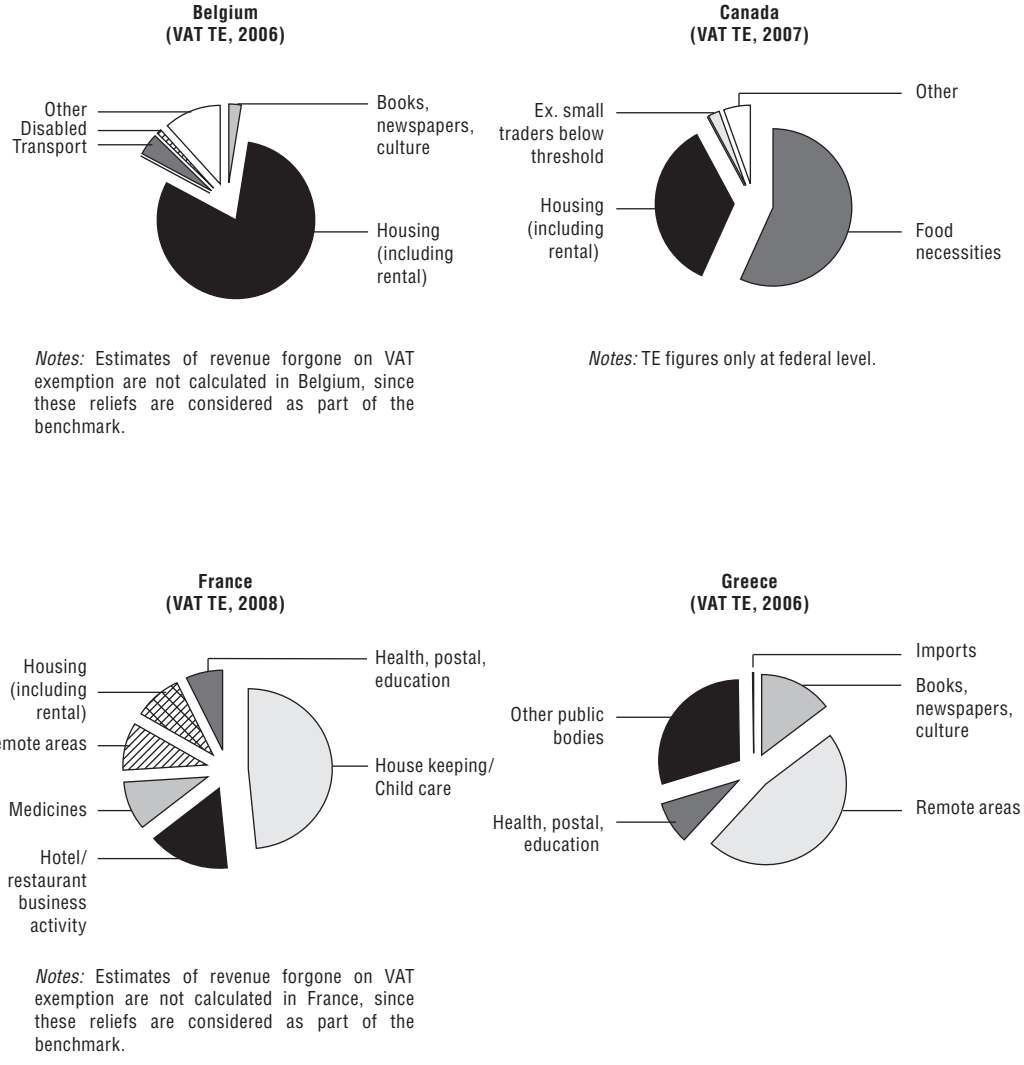


Notes: Countries are ranked according to the change in the VRR over the period 1996-2005 in increasing order.
VAT Revenue Ratio = (VAT revenue)/([consumption – VAT revenue] * Standard VAT rate).
For Australia, the difference is calculated for the period 2000-05 since the Australian GST was introduced in 2000.
For the Slovak Republic, the difference in the VRR is calculated for the period 2000-05 since data for 1996 is not available.
The calculation for Canada is for federal VAT only.
Source: OECD, *Consumption Tax Trends*, 2008.

and 2005 (by a more modest 0.02). This apparent contradiction might be explained by the broadening of the VAT base to include transport services (previously exempt) in 2003.

Figure 2.4 shows a graphical summary of the major VAT TEs in the OECD countries that reported detailed information for this category. These graphs suggest the provisions for

Figure 2.4. **Main VAT tax expenditures in selected OECD countries**



Notes: Estimates of revenue forgone on VAT exemption are not calculated in Belgium, since these reliefs are considered as part of the benchmark.

Notes: TE figures only at federal level.

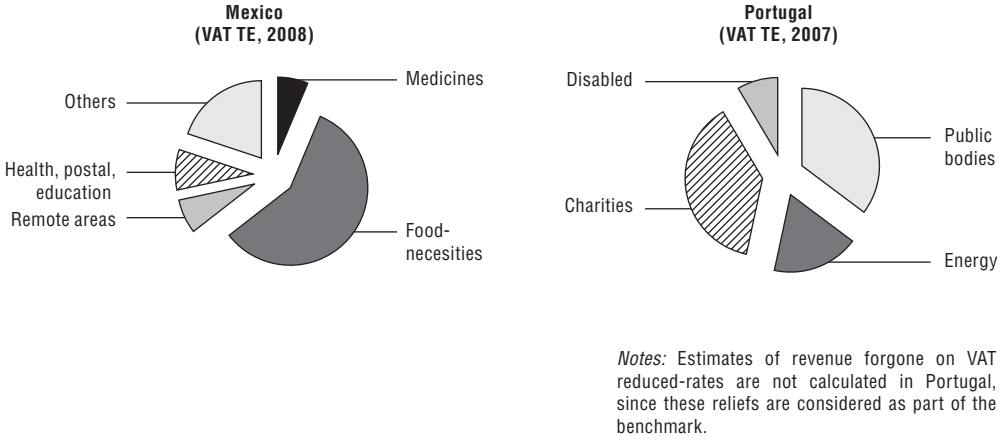
Notes: Estimates of revenue forgone on VAT exemption are not calculated in France, since these reliefs are considered as part of the benchmark.

necessities and those for housing as the largest VAT TEs. Once again, it should be highlighted that TE estimates are not comparable across countries for the reasons mentioned earlier in this chapter.

Personal income taxation

An increasing trend of PIT TE (in absolute terms) is observed in many OECD countries particularly in recent decades: Australia (particularly since 2004), Belgium (2005), France, Spain, Switzerland and the United States. In contrast, PIT provisions have decreased in the Czech Republic (in 2006, standard allowances were replaced by tax credits; and in the 2008 flat tax reform) Germany (the 2000 and 2008 reforms reduced some employment benefits), Mexico, the Netherlands (2001 reform), Norway (2004-06 reform), and the Slovak Republic (2004 flat tax reform). In Portugal, while many provisions were abolished in 2005 to compensate for a general cut in marginal rates, new provisions were introduced in 2006 (see Table 2.2). Denmark reports that in general base-broadening moves are not reflected in TEs trends because the abolished provisions were part of the benchmark system.

Figure 2.4. **Main VAT tax expenditures in selected OECD countries** *(cont.)*



Notes: Estimates of revenue forgone on VAT reduced-rates are not calculated in Portugal, since these reliefs are considered as part of the benchmark.

Notes: Many of the estimates of VAT revenue forgone in the United Kingdom include a structural component (particularly in the case of exemptions). In many countries this type of reliefs would be considered as part of the benchmark and, consequently, estimates would not be calculated.

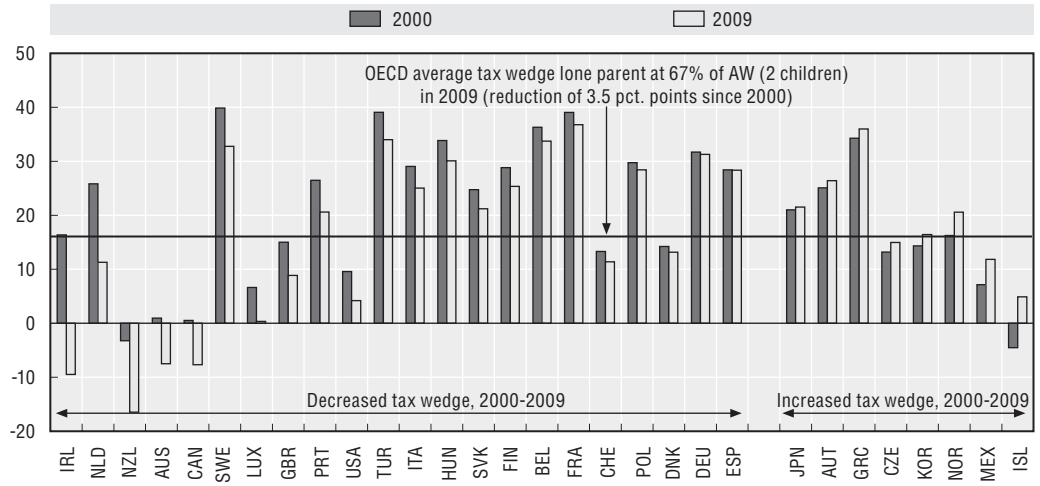
Sources: National TE reports and responses to a questionnaire on Tax Expenditure Trends that was circulated to OECD Delegates of the Working Party on Tax Policy and Statistics.

In particular, the tax system has been increasingly used as a vehicle to deliver social benefits in many countries in the last decades. In general, while not many social reliefs have been eliminated, their value has often fluctuated over time as tax rates have been rising or falling. Reliefs for children and dependent care are one of the most important tax expenditures not only in terms of revenue forgone but also because their expanded use in most OECD countries. PIT reliefs targeted to low-income individuals/households have been also increasingly provided for redistributional purposes. In some countries, the design of these social reliefs has changed reflecting a significantly move towards tax credits (*e.g.* in the US since 1986) to better target low-income households. However, while typically these reliefs are most efficient if structured as refundable tax credits, this is not generally the case in many countries. In 2009, only eleven OECD countries offered non-wastable child tax

credits (Austria, Belgium, Canada, France, Germany, Italy, Luxembourg, the Slovak Republic, Spain, United Kingdom and United States).

The effects of the increasing use of cash benefits and tax credits for low-income families with children may be illustrated by the evolution of the tax wedge, including income tax plus employee and employer social security contributions net of cash benefits, for a single parent with two children, earning 67 per cent of average earnings (see Figure 2.5). The tax wedge for this family type dropped in 22 OECD countries during the period 2000-09. On average, it was reduced by 3.5 percentage points, from 20.4 per cent in 2000 to 16.9 per cent in 2009. The reduction was particularly large in Ireland, where the tax wedge dropped by 25.9 percentage points (from 16.4 per cent in 2000 to –9.5 per cent in 2009), the Netherlands (from 25.8 per cent to 11.3 per cent), and New Zealand (from –3.3 per cent to –16.5 per cent). The reductions accounted for more than five percentage points also in eight more countries (Australia, Canada, Sweden, Luxembourg, United Kingdom, Portugal, United States and Turkey). Four OECD countries had a negative tax wedge in 2009 for this type of family reflecting cash benefits as well as the value of any applicable non-wastable tax credits exceeding the income tax and social security payments: Australia, Canada, Ireland and New Zealand. The tax wedge for this family type dropped significantly in the EU15 as well (–4.2 percentage points), to 21.4 per cent in 2009. Three countries experienced increases of more than 3 percentage points: Iceland (9.4 percentage points), Mexico (4.7 percentage points), and Norway (4.3 percentage points).

Figure 2.5. **Tax wedge for single parent with 2 children at 67 per cent of average earnings**[1]



1. The tax wedge is calculated as income tax plus employee and employer social security contributions less benefits as a percentage of total labour costs (gross wage plus employer social security contributions).

AW refers to average wage.

Countries are ranked according to the highest difference between the tax wedges in 2009 and 2000.

Source: Taxing Wages, 2009.

In particular, "in-work benefits" have been a core element of tax reform in many OECD countries, following the example of the Earned Income Tax Credit (EITC) in the United States.[17] "Make-work-pay" policies are now in use in 18 of the 31 OECD countries (Australia, Belgium, Canada, Finland, France, Germany, Hungary, Ireland, Spain, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, the Slovak Republic, Sweden, the United Kingdom

and the United States). There is evidence[18] that these employment- conditional cash transfers to individuals facing particular labour-market challenges have a significant effect on in-work incomes and are effective in raising the employment rates of the targeted groups. However, these targeted reliefs are structured as refundable tax credits only in six OECD countries,[19] Canada, France, Luxembourg, Mexico, the United Kingdom, and the United States[20] (Immervoll, 2008; and OECD *Taxing Wages* Publication). The extended use of deductions, exclusions and non-refundable credits across OECD countries put in question the positive effect of these provisions on income distribution at the bottom of the income scale. Households in the bottom half of the income distribution will receive relatively less benefit from these TEs and nothing in the case of families who owe no income tax.[21]

While child/family benefits and working tax credits are currently extensively offered in many OECD countries, available TE data underestimate the total volume of these reliefs. The main purpose of these concessions is to adjust the household's tax liability according to its ability to pay and, therefore, countries often consider these provisions as part of their benchmark system. This is in particular the case of child/family reliefs. OECD countries that include estimates of (some of) these reliefs in their tax expenditures reports are Canada, France, Belgium, Mexico, the United Kingdom, and the United States.

PIT TE estimates also show that tax provisions to encourage particular savings vehicles are widely provided in OECD countries. This is particularly the case for the preferential treatment of home ownership (and in particular for mortgage interest deductions[22]) and retirement plans. Many of these reliefs have been in force since more than two decades, while additional provisions have been introduced/increased in the last decade. For example, in 2005 Belgium and Norway increased their housing provisions. Belgium added interest deductions to the already existing deduction for mortgage capital repayments, and the taxation of imputed rent of owner-occupied housing was eliminated in Norway. At the same time, a new relief for energy-saving investments was also introduced in Belgium and the provisions for employee pension contributions were increased in Norway. Tax credits for contributions to retirement savings plans and pension funds, and the purchase of personal computers were reintroduced in Portugal in 2006, after being eliminated the year before.

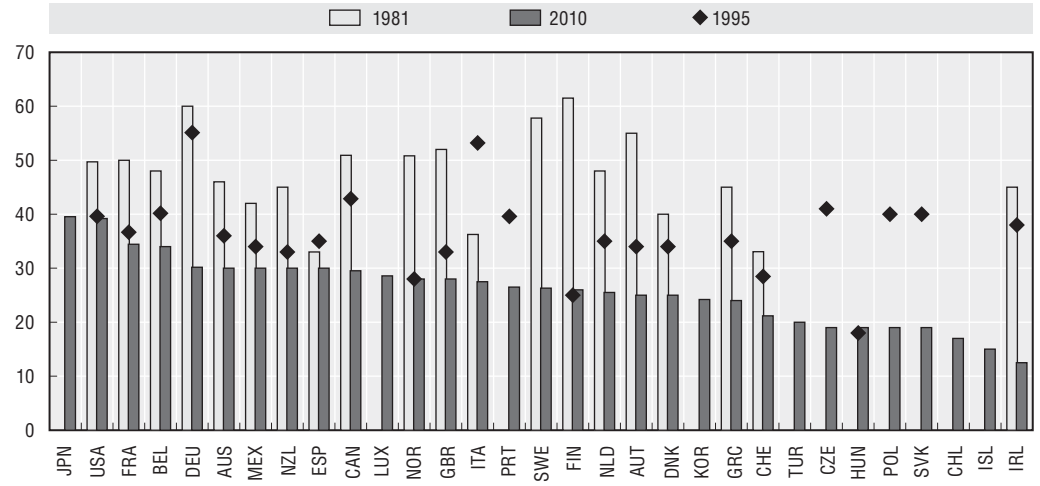
These preferential treatments targeted to specific types of income entail a high cost in terms of revenue forgone while at the same time raise equity, efficiency and simplicity concerns. This suggests that these provisions should be particularly assessed when considering a broadening move of the PIT base.

Some countries show an increased trend in reliefs for expenses incurred to generate income that are reported in the PIT. This trend is mainly explained by the introduction of news reliefs as well as the expanded scope of existing tax preferences, which are generally in the form of deductions and exemptions. For most countries main reliefs under these categories include concessions for work-related expenses (travel, meals, computers, and cars) and other provisions targeted to the self-employed. A key consideration is to which extent these provisions are linked to income generation and to which to windfall gains.

Corporate income taxation

In the last decades, personal income tax cuts have been accompanied by cuts in corporate tax rates. In the OECD, the unweighted average corporate tax rate[23] has dropped from 47.5% in 1981 to 36.6% in 1995 and to 25.9% in 2010.[24] During the period 1995-2010, the largest reductions were observed in the Czech Republic, Germany, Ireland, Italy, Poland and Slovak Republic (see Figure 2.6 and *OECD Tax Database*). In many countries, the corporate tax

Figure 2.6. **Combined central and sub-central (statutory) corporate income tax rates**



Countries are ranked according to the highest rates in 2010.
Source: OECD Tax Database.

rate reductions have been partially financed by corporate tax base-broadening measures, in particular by implementing less generous tax depreciation allowances, reducing the use of targeted tax provisions and enacting stricter corporate tax enforcement policies.[25] The experience of corporate tax base-broadening and rate reduction in OECD countries is generally judged to have been beneficial, reducing distortions and maintaining corporate tax revenues.[26] However, it is possible for base-broadening to go too far, for example the reduction of depreciation allowances below that of economic depreciation could be expected to increase the distortion of investment decisions.

Most countries reported a stable or increasing trend in CIT TEs in the last decade. While lower tax rates reduced the estimated revenue loss from tax expenditures, the expanded scope of existing tax preferences and the introduction of new provisions contributed to an increase in tax expenditures. However, increases in CIT TEs are in general much lower than those in PIT TEs. This fact may be explained in particular by three main factors: 1) the elimination of some TEs; 2) the reduction of CIT rates, since most CIT TEs are in the form of deductions and exemptions; and 3) because countries typically levy more PIT than CIT.

While business preferences have been cut back in some countries (*e.g.* the 1986 tax reform in the United States, which particularly removed the investment tax credit), TEs data shows that many OECD countries still maintain investment allowances/tax credits, as well as other targeted provisions. Most commonly CIT tax provisions, in terms of high revenue forgone include accelerated depreciation and other investment incentives, R&D tax incentives, and tax reliefs for SME (including preferential tax rates).[27] Some countries also reported the introduction of new targeted CIT concessions in the last decade; for example, Belgium introduced in 2003 a tax shelter for the film industry and an investment reserve. Reduced rates targeted to less developed areas were implemented in Portugal in 2006. New CIT incentives have also been re-introduced in Slovenia after the 2005 base-broadening reform.

Tax provisions for small businesses

The preferential tax treatment to small businesses varies across OECD countries. Eleven OECD countries levied a reduced corporate income tax rate on small businesses with profits that were below a certain ceiling in 2009: Belgium, Canada, France, Hungary, Japan, Korea, Luxembourg, Netherlands, Spain, the United Kingdom and the United States (see Table 2.5). Targeted rates (combined central and sub-central) ranged from 5% in Turkey and 11% in Korea to 25% in Spain and 27.55% in Luxembourg. In some countries, businesses have to fulfil other conditions in order to benefit from the reduced rate; for example, certain legal requirements that are related to the employment of workers. In addition, some countries offer small businesses special corporate tax provisions, such as expensing of investments. TEs data confirm the importance of preferential tax concessions for small businesses only for a few countries including Canada, Spain and United States. However, this may be explained by the fact that simplified regimes are often considered to be part of the benchmark system.

Tax provisions for Investment in Research and Development

A growing feature of corporate tax systems is the use of tax credits or special deductions for research and development (R&D) expenditures. These are now available in over half of OECD countries, with the generosity of these tax subsidies varying across countries (see Figure 2.7). The variation in the generosity of these provisions across countries is also reflected in TE data. Some countries provide more generous tax subsidies for R&D in small- and medium-sized enterprises than for large companies (*e.g.* Canada and the Netherlands).

While R&D investment has undoubtedly positive externalities, governments need to carefully consider the design of R&D tax incentives. It is unclear whether the existing reliefs target investment with large spillovers and whether the tax system is the most cost-efficient way to encourage this type of investment. These reliefs must be designed to ensure that windfall gains are minimised by targeting the benefit to additional investment. However, targeting has also a cost in terms of compliance and administrative costs, which may overweight the benefits of such reliefs. Windfall gains may be reduced by, for example, limiting the amount of the credit to a proportion of the tax liability; *i.e.* eliminating the possibility to carry forward indefinitely unused credits. This credit limitation would be unlikely have a significant adverse impact on R&D investments while relieving current government's fiscal pressure. R&D decisions of taxpayers with large amounts of unused credits are unlikely to be affected by their ability to stockpile additional credits.[28]

2.8. Conclusion

VAT Revenue Ratios and TE data suggest some moves towards broadening the base, although some countries have moved in the opposite direction. TE data show an unclear trend in the case of PIT and CIT. However, in many countries that report increases in CIT TEs, these increases are lower than their increases in PIT TEs. Moreover, while some countries report a general downward trend in PIT and CIT TEs, this may simply reflect a reduction in tax rates, which automatically reduces the size of TEs. TE trends thus need to be interpreted with caution since they may also reflect changes in the benchmark and improvements of data and estimation techniques over time.

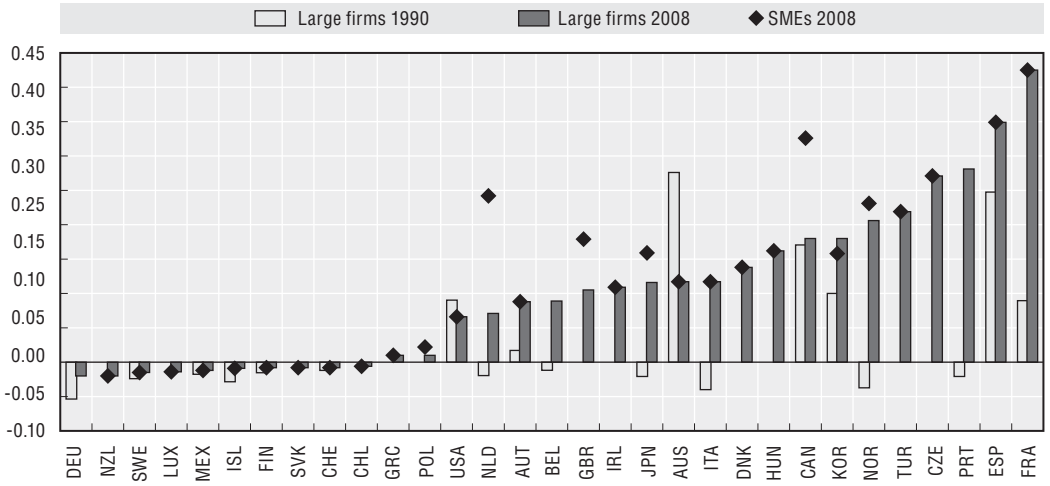
Table 2.5. **Standard and reduced (targeted) corporate income tax rate for small businesses, 2010**

	Standard corporate income tax rate (%)[1]	Small business corporate (combined) tax rate(s) (%)[2]	Range of taxable income where the reduced rate applies	Other conditions to benefit from the reduced rate(s) and/or additional qualifications[3]
Belgium	33.99	24.9775 31.93 35.535	EUR 0-25 000 EUR 25 000-90 000 EUR 90 000-322 500	The company cannot be an investment company; entitlement to the reduced rates is not granted to companies of which at least 50% of the shares are held by one or more other companies and to companies whose dividend distributions exceed 13% of the paid-up capital at the beginning of the financial year.
Canada	29.52	15.5[4]	CAD 0-500 000	
France	34.43	15.0	Profits: EUR 0-38 120	Firms owned at least for 75% by individuals and with a turnover of EUR 7.63 million or less.
Hungary	19.0[5]	14[5]	HUF 0-50 000 000	The taxpayer is *i)* not enjoying any corporate tax reliefs; *ii)* employing at least one person; *iii)* paying a minimum of social security contributions; *iv)* paying corporate income tax at least on the basis of the minimum income/tax base; and *v)* fulfilling certain legal requirements that are related to the employment of workers. The benefit that arises as a result of the preferential 10% rate has to be used for investment or employment purposes.
Japan	39.54	24.79 25.57	JPY 0-4 000 000 JPY 4 000 000-8 000 000	Reduced rates only for corporations with capital of JPY 100 million or less.
Korea	24.2	11.0	KRW 0-200 million	
Luxembourg	28.59[6]	27.55[6]	EUR 0-10 000; Firms with taxable income between EUR 10 000-15 000 pay 20.8% on profits up to EUR 10 000 and 23.92% on remainder such that at EUR 15 000, they pay an average rate of 21.84% (standard central CIT rate). The sub-central rate of 6.75% has to be added to these rates.[6]	
Netherlands	25.5	20	EUR 0-200 000	
Spain	30	25	EUR 0-120 202.41	
United Kingdom	28	21 21/29.75	Profits: GBP 0-300 000 Firms with profits between GBP 300 000-1 500 000 pay 21% on the first GBP 300 000 and 29.75% on the remainder so that by GBP 1.5 million they pay an average rate of 28%.	All limits for taxable profits are proportionately reduced in cases where there are associated companies, and where the accounting period is less than 12 months. Rates as of 1 April.
United States	39.21	20.16[7]	USD 0-50 000	

1. Combined rate refers to central government and sub-central government standard (top) corporate tax rate.
2. Combined central government and sub-central government corporate tax rate typically applying for or are targeted at "small (incorporated) business", where such "targeting" is on the basis of size alone (*e.g.* number of employees, amount of assets, turnover or taxable income) and not on the basis of expenditures or other targeting criteria.
3. This Table summarises the main arguments presented in the Explanatory Annex to Table II.2 of the *OECD Tax Database*.
4. Includes a sub-central government small business tax rate which is an average of provincial corporate income tax rates, weighted by the provincial distribution of the federal corporate taxable income taxed at the small business rate.
5. As from 1 September 2006, taxpayers are obliged to pay a surtax of 4% on the basis of (adjusted) profit before taxation. Without this surtax, the combined corporate tax rate is 15% and the preferential corporate income tax rate is 10%. The rates do not include the turnover based local business tax, the innovation tax, the credit institutions' surtax and the energy suppliers' surtax.
6. Includes the representative sub-central government corporate income tax rate for Luxembourg City. The rate is 3% (general rate) times 225% ("taxe communale").
7. The federal income tax rate of 15% applies to taxable income under USD 50 000; 25% applies to taxable income over USD 50 000 and under USD 75 000; 34% applies to taxable income over USD 75 000 and under USD 10 million; and 35% applies to taxable income of USD 10 million or more. The benefit of lower rates is recaptured for taxable incomes between USD 100 000 and USD 18 333 333. The federal rates have to be increased with the sub-central rate, which is a weighted average state marginal income tax rate.

Source: OECD Tax Database.

Figure 2.7. **Tax reliefs for one USD of research and development in OECD countries**



Notes: This figure shows the amount of tax relief for a unit of R&D expenditure compared to the benchmark situation of the immediate expensing of the R&D expenses. Negative values do not necessarily imply that R&D is not taxed favourably but only imply that R&D receives a tax treatment that is less generous than would be the case under full immediate expensing.

Source: OECD Scoreboard.

A wide range of tax concessions, both targeted and non-targeted, are still offered in many countries particularly on the personal income tax and the VAT. These provisions amount to a considerable proportion of revenues collected in the corresponding category of tax. The major TEs consist of provisions for owner-occupied housing, retirement savings, children and families, social benefits, food and necessities, small businesses and R&D expenditures. While some of these reliefs may be justified if they are cost-effective in achieving their objective (minimising distortions, administrative costs and negative distributional impacts), their cost-efficiency needs to be assessed.

Tax expenditure estimates present a number of shortcomings particularly when making cross-country comparisons. These limitations are derived from differences in the benchmark system and the methods of estimation and reporting. However, TE analysis is a useful tool to assess tax provisions and for informed tax policy in general despite of the shortcomings. Even when TE estimates are calculated in terms of revenue forgone and, thus, they do not consider behavioural effects, they are still a valid estimation of the opportunity cost of public funds (compared, for example, to direct spending).

However, these estimates are only one element of any evaluation of tax reliefs. In addition to the revenue impact, further analysis is needed to assess their effectiveness including externality correcting effects of these reliefs, their impact on the efficiency of the tax system, their effects on income distribution and those on administrative and compliance costs. Analysis of the behavioural effects of removing them should also be considered. Identifying the rationale of a given tax provision and setting a target in its objective(s) is a key feature in this assessment, since they may help evaluate the performance of such provisions. Proper country-specific tax expenditure analysis may then facilitate the identification of cost-efficient base-broadening measures.

Notes

1. While the production of tax expenditures reports contribute significantly to fiscal transparency, making it publicly available increases transparency and accountability of the government.
2. In general, most countries categorise tax relief that reflect "ability to pay" as part of the benchmark regime rather than tax expenditures. However, this distinction implies a subjective judgement, which in some cases could categorise a particular provision either way. For example, a tax relief for families with children is generally introduced to address ability to pay. However, it could be also seen as a relief targeted to a particular household and, therefore, be categorised as a tax expenditure.
3. The main purpose of tax reliefs on government bonds is to help government raise funds, which can be seen as having both social and economic benefits. These reliefs not only distort economic choices between alternative investment assets, but also increase horizontal inequity. Due to their exemption/deduction structure, they also generate windfall gains, which could be avoided by directly transferring funds from the central government in the case of sub-central government bonds.
4. Compliance and administrative costs related to tax expenditures are generally not included in TE reports. Although difficult to measure, governments are encouraged to include them in cost-benefit analyses.
5. Most OECD countries use micro-simulation models based on detailed information from tax records to estimate the cost of PIT and CIT tax expenditures. Aggregate modelling – based on national accounts, input-output tables, aggregates from tax records – is generally used for estimating VAT tax expenditures.
6. In Canada, the revenue forgone methodology does include some form of tax minimising "behaviour". For example, the Canadian micro-simulation model allows for an increased use of prior-year losses to offset an increase in taxable income that would result from the elimination of a tax relief. In Canada, carry-forward losses are considered part of the benchmark. Therefore, for example, if a firm has unused non-capital losses, the model would apply these unused non-capital losses to minimise any increase in the amount of taxes paid by the firm as a result of the elimination of a tax relief (*e.g.* the elimination of the deductibility of charitable donations).
7. Burman *et al.* (2008) using a microsimulation tax model showed that interactions among federal tax expenditures in the United States can be quite significant and, in some cases, counterintuitive. Moreover, they show that combined tax expenditures for individual taxpayers disproportionately benefit those with higher incomes. However, they also found that while adding separate tax expenditure to compute total costs produces significant errors for some subgroups of provisions, the aggregate value (and for many subcategories) comes close to the correct sum.
8. For example, interactions among different tax measures and the progressivity of the personal tax systems mean that the simultaneous elimination of a set of tax expenditure items may lead to a very different cost estimate than might occur when tax expenditures are estimated individually and then added together. Thus, the interaction among tax expenditures may raise revenues mainly where eliminating some of these provisions pushes taxpayers into a higher marginal rate bracket, raising the revenue gain from eliminating additional ones (assuming no behavioural effects).
9. A detailed analysis of consumption taxes trends (including those of VAT) may be found in the OECD (2008) Consumption Tax Trends publication. Member States of the European Union are bound by common rules regarding VAT rates (VAT Directive 2006/112/EC). These rules provide that supplies of goods and services are normally subject to a standard rate of at least 15%. Two reduced rates of not less than 5% may be applied to goods and services enumerated in a restricted list as well as to certain labour intensive services. However, these rules are complicated by a multitude of derogations granted to many Member States (OECD, 2008).
10. The United States is the only OECD country that has not implemented a VAT.
11. The standard VAT rate in Iceland increased 1 per centage point in 2010. From 1 July 2010, Spain increased the standard VAT rate from 16.0% to 18.0%.
12. A domestic zero rate means that VAT/GST is not levied on goods and services consumed within the country but deduction of input tax is allowed.
13. Higher rates were abolished in the early 1990s and since then no country has had a VAT rate above 25%.
14. For a detailed list of these preferential rates see the 2010 OECD *Consumption Tax Trends* publication.
15. This ratio is derived from the "C-efficiency ratio" (see Ebrill, Keen, Bodin and Summers, 2001), but has been amended and re-named to more accurately reflect what it measures. The main change has been amending the calculation basis used to assess the potential tax base (*i.e.* consumption).

Consumption is normally taken from national accounts and measured at market prices – including VAT – and it is more accurate to remove VAT revenues from this amount since the theoretical basis for taxation should not include the tax itself (OECD, 2008).

16. New Zealand is an exception with a VRR of 1.05. This figure appears to be due to a combination of factors including a broad base with limited exemptions and a limited use of one zero-rate. Additionally, the proportionally high value of investments in residential housing that generates GST revenues distorts the ratio as these investments are not included in the consumption figures provided in national accounts. On the other hand, Luxembourg's high ratio may be indicative of significant revenue being raised through the exemptions applied to the financial services sector, which provides additional VAT revenue due to the cascading effect. Cross-boarding shopping may also bias the VRR in Luxembourg (OECD, 2008).

17. Nonetheless, some OECD countries have also followed alternative approaches, such as cuts in employers' social security contributions, which if properly design could also achieve both employments and distributional objectives.

18. See, for example, Brewer *et al.,* 2006; Grogger, 2003; and Sterdyniak, 2007.

19. In Belgium, a refundable tax credit ("employment bonus") is granted for low earned income other than wage income (more information in the OECD *Taxing Wages* Publication).

20. Since 1994, an earned income credit applies to families without children, which is non-wastable since 2008.

21. For instance, in the US more than two-fifths of all households – and over half of those with children – have no federal income tax liability and thus cannot benefit from deductions, exclusions and non-refundable tax credits (Batchelder *et al*., 2006).

22. Mortgage interest payments can be deducted from the personal income tax base in many countries, but not in Canada, Germany, France (they became partly deductible in 2007) and the United Kingdom. Some countries, like Belgium and Spain, even allow for a deduction of the principal repayments.

23. Basic combined central and sub-central (statutory) corporate income tax rates given by the adjusted central government rate plus the sub-central rate.

24. The unweighted average corporate tax rates do not include data for Chile, Iceland, Korea, Luxembourg and Turkey in 1995 and 1981, and for Hungary, Poland and Japan in 1981.

25. Some OECD countries (*e.g.* the United States and Mexico) have implemented an alternative minimum tax, which is a tax that eliminates many tax reliefs and so creates a tax liability for an individual or corporation with high income who would otherwise pay little or no tax.

26. Stable (and even increasing) corporate tax revenues may be also explained by the increase of businesses in the corporation form. Statutory corporate tax rates have been decreasing considerably more than top statutory personal income tax rates, increasing incentives for businesses to incorporate (De Mooij and Nicodème, 2007) showed that this has been especially the case in the European Union). This distortion means that lower corporate tax rates will therefore partly result in lower revenues from personal income taxes (OECD, 2007b).

27. Regarding the latter, it should be noted that there is not a consensus whether progressive schedules for CIT should be considered as part of the benchmark or a TE. In fact, in practice this classification varies across countries.

28. California Legislative Analyst's Office (LAO) estimates that in this state more than USD 10 billion of unused state R&D credits are being "carry over" for future use (LAO; "Tax Expenditures and Revenue Options", April 2008).

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Chapter 3

Evaluating Tax Provisions: Some Examples

This chapter briefly presents a possible framework to evaluate the cost-effectiveness of a given tax provision. This framework is then applied to four examples: mortgage interest relief against personal income tax; the VAT exemption on sales and rentals of residential property; preferential tax treatments of retirement savings; and the VAT exemption on financial services.

Governments introduce tax reliefs for a wide variety of reasons, *e.g.* to correct externalities or to favour a particular interest group. Even when these reliefs have justified redistribution and economic policy objectives, they entail an opportunity cost of government revenues, which necessarily means that other taxes have to be higher than otherwise. These higher rates may create additional efficiency losses, adverse effects on income distribution, and administrative and compliance costs. It may therefore desirable to periodically review whether certain tax reliefs continue to be justified.

Ex ante assessments (*i.e.* before the provision has been implemented) and *ex post* evaluations (*i.e.* after the provision has been implemented for some time) of targeted tax provisions are not a general practice across OECD countries. Only 8 countries out of 18 that answered the questionnaire reported a regular evaluation of tax provisions. In very few cases these analysis were undertaken before the introduction of tax provisions. Most of the reported *ex post* evaluations were targeted to some particular provisions and undertaken by external institutions. Only two countries reported plans to introduce periodical assessments of targeted tax provisions. In general, data and the difficulties of undertaking rigorous evaluations explain the limited number of provisions that are evaluated on a systematic basis in OECD countries.

A complete evaluation should ideally include assessments of the effectiveness, efficiency, distributional impact and compliance and administrative costs of a given tax provision in relation to an appropriate counter-factual (*i.e.* a benchmark of what would otherwise have happened).

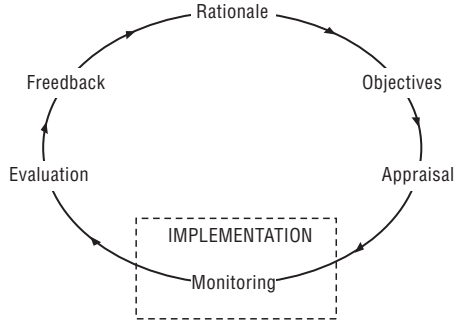
This chapter briefly presents a possible framework to evaluate the cost-effectiveness of a given tax provision. This framework is then applied to four examples: mortgage interest relief against personal income tax; the VAT exemption on sales and rentals of residential property; preferential tax treatments of retirement savings; and the VAT exemption on financial services.

3.1. An evaluation framework

Many OECD and non-OECD countries have guides describing standards for programme evaluation; for example, *Treasury Board manuals* (Canada); *Petit guide de l'évaluation des politiques publiques* (France); *ROAMEF* (UK); *OMB Circular A-94* (US). Most of these guides propose to include the evaluation of a programme in a broad cyclical policy process involving (*ex ante* and *ex post*) appraisals of a given programme and its policy alternatives (see Figure 3.1). Three stages may be identified in applying this process to the *ex ante* appraisal of a tax break:

- *Examining the rationale for the provision:* whether there is a need for government intervention and why and how a tax break would address that need.[1]
- *Identifying and setting the objectives of the provision:* setting out clearly desired outputs and outcomes, and when possible targets. Ideally outputs and outcomes should be specific,

Figure 3.1. **Evaluation cycle of governments' programmes**



Source: The Green Book: Appraisal and Evaluation in Central Government, UK Government.

measurable, achievable, relevant and time-bound (SMART). These objectives will also help identify the full range of alternative policy options that may be available to deliver them.

- *Appraising the provision against alternative options:* estimating distributional, behavioural and revenue effects of each option.

Once the best option to meet the objectives has been identified, an *implementation process* starts, which ideally should include consultation with all the social and political actors to explain advantages/disadvantages of the change in policy, analysis of implementation options and processes, and a plan to monitor the programme.

When a measure has been implemented it is a good practice to *monitor* its effects and use the information obtained to undertake a more systematic evaluation (against a suitable counterfactual). Even with administrative and other data collected to assist monitoring (and the estimation of tax expenditure figures) a rigorous evaluation of the impact of a tax break may be difficult. The nature of tax provisions means that it is likely to be hard to identify a "control" group to compare with the "treatment" group, as in a randomised control trial; and other approaches to identifying an appropriate counter-factual are likely to be needed. An evaluation process, even where the existing provision is confirmed as the best option to meet the objectives, may provide information that could improve its effectiveness. This means that the evaluation process of a tax provision is a cycle that will start again after the feedback from the evaluation stage is incorporated. Figure 3.1 shows a graphic representation of this cycle.

The remainder of this section applies this evaluation framework to some existing tax incentives with the objective of providing some guidance on the economic arguments that may support the renewal/adjustments/abolition of such reliefs. While in some cases arguments for/against a particular alternative policy option will be also given, detailed analysis of alternative polices are outside the scope of this report. Whatever the specific alternatives to a particular tax relief, there is of course the option of using the revenues from eliminating that relief to enable a (revenue neutral) reduction in other distortionary taxation.

3.2. Tax provisions for housing

A key issue when evaluating housing tax provisions is whether housing should be taxed as consumption (*e.g.* through VAT) and/or as the return on investment (through personal income taxation).[2] This judgement will have implications for the appropriate benchmark to use as a counter-factual.

On the one hand, if owner-occupied housing is considered to be an investment good and a comprehensive personal income tax to be an appropriate benchmark, individuals would buy housing out of taxed income (*i.e.* housing savings are made out of taxed earnings), would pay taxes on the accrual return on these savings (*i.e.* imputed rent net of repairs and maintenance and mortgage interest costs), and the capital gain would be taxed when the asset (in this case, the house) is sold.

In practice, however, in most countries the benchmark for owner-occupied housing provisions seems to be closer to be an expenditure tax, *i.e.* a tax treatment that imposes no tax wedge between pre-tax and post-tax returns on a marginal investment, as other long-term savings vehicles such as pensions are usually taxed on such a basis (see section on retirement savings provisions). This would occur when individuals buy housing out of taxed income and then do not get taxed on the return. This treatment is equivalent to a "taxed-exempt-exempt" regime (TEE) which is equivalent to the usual EET regime for pension saving (assuming that the tax rate is constant over time). Against such a benchmark, however, exempting imputed rent and at the same time allowing a deduction of mortgage interests from PIT implies a tax treatment of owner-occupied housing even better than an expenditure tax treatment – post-tax returns exceed pre-tax returns. A deduction for the costs to generate income is allowed when the income itself is not taxed.

Residential housing (which includes both owner-occupied and rental property) could also be considered as personal consumption, like the consumption of durable goods such as a refrigerator, a television, or a private car. In the case of rental property, given the existence of an observable market value, taxing consumption would involve levying VAT on the value of the rentals. However, taxing current consumption of owner-occupied housing has generally been regarded as impracticable because of (aside from political and historical reasons) the high administrative and compliance costs that would be needed to obtain good and fair estimates of housing services. As a consequence, most countries do not include housing services from residential property in their VAT base on a yearly basis.[3]

An alternative is to levy VAT on the first sale of residential property (and on maintenance and renovations costs), as this sale price likely reflects the discounted present value of the consumption of housing services over the life of the house. When a VAT standard rate is applied on these values, this alternative taxation broadly satisfies the horizontal equity, neutrality and feasibility criteria.[4]

A particular distortion towards the consumption of housing may then arise when countries provide both VAT preferential tax treatments of residential property and mortgage interest relief for owner-occupied housing (while not taxing imputed rents or capital gains). This section seeks to evaluate briefly two types of housing provisions: the VAT exemption on sales and rental of residential property and the PIT mortgage interest deduction.

Tax provisions for owner-occupied housing under the PIT

Tax reliefs for home ownership in many countries are available under the personal income tax system and generally take the form of mortgage interest deductions and/or exemption of imputed income from the use of owner-occupied homes. This section focuses on economic arguments for/against the former, although some related issues are also raised regarding the exemption of imputed income.

a) Rationale

Tax reliefs for owner-occupied housing in general and mortgage interest deductions in particular are often motivated by a social policy objective. They aim to promote home ownership by ordinary citizens, and in particular to assist middle-and-low income groups in acquiring a home. Such provisions are intended to give citizens a stronger stake in their communities (relative to renters), and to be more committed to the larger political system. Homeowners may also take better care of their houses and contribute to reduce crime. Any of these behaviours could lead to a rise in property values, which will spread benefits to people other than the homeowner (spill-over effects).[5]

b) Objectives

According to the rationale of these provisions, the main objective of these reliefs is to give incentives to middle-and-low income groups to acquire residential property. Within the tax provisions framework identified in Chapter 2, tax provisions for home ownership may be categorised as a *tax provision to change economic behaviour*.

c) Assessment

c.1) alternative policy instruments

Mortgage interest deductibility is only one of several policy instruments (on the demand side) available to governments to encourage home ownership. Other policy options include exemption of imputed rent, direct subsidies for home purchases, government guarantees for mortgages and government low-interest mortgages. Additionally, governments may intervene on the supply side of the market by, for example, regulating housing selling prices or publicly supplying housing.

Ideally, when assessing a given tax provision all alternative reliefs that could achieve the same objectives need to be evaluated as well. However, the economic arguments presented in this section focus only on mortgage interest deductibility since a detailed analysis of all possible alternatives is out of the scope of this paper.

c.2) estimation of costs and benefits

1. Administrative and compliance costs

Tax provisions on housing add significant complexity to the tax code, which implies additional compliance and administrative costs in term of identifying the relief, filing the tax return and auditing, especially if relief is given at a taxpayer's marginal rate. However, the most significant impacts of these provisions are those related to efficiency, tax revenues and income distribution.

2. Impact on efficiency

If home ownership is considered to be a form of investment, taxing home ownership at the same rate as other capital income would avoid distortions on individuals' investment choices. An efficient tax system would set similar tax wedges on the returns on all investments at the margin. To achieve such an outcome under a comprehensive income tax would require the net return to housing; *i.e.* imputed income, net of depreciation and mortgage interest payments has to be taxed under the (progressive) personal income tax (or the capital income tax that is levied at the personal level in the case of dual income tax systems). Capital gains and losses would then respectively be taxed or deductible under the capital gains tax regime.

However, in most countries, imputed rent is not taxed (or underestimated by using undervalued market rentals as a proxy, or only partially taxed)[6] mainly because of the high administrative and compliance costs related to its measurement, and/or capital gains of owner-occupiers are not taxed – even if other property taxes offset this tax relief to some extent. As a result, the wedge between pre-and post-tax returns on owner-occupied housing may not even be positive. There is in effect a tax subsidy encouraging private capital to be diverted into the housing sector due to the asymmetry between the taxation of net capital income from housing and other forms of capital income.

A reform towards a more neutral (but also more complex) comprehensive income tax approach would be to impute a rental value of owner occupation and tax both this rental value and any capital gains (net of mortgage interest payments). However, given inelastic supply especially in the short term, tax changes are likely to be capitalised to some degree into house prices, there could be associated transition costs in terms of declines in house prices and a risk of solvency problems.

In any case the politics of introducing a tax on imputed rents are likely to be difficult. And a zero tax wedge on the return on owner occupation may be a more realistic benchmark, especially as other forms of longer-term saving are generally taxed on "expenditure tax" lines. This could be achieved by eliminating mortgage interest deductions, while also not taxing imputed rental income. This will enhance the simplicity of the tax code and facilitate tax compliance. However, this type of measure could still leave housing more favourably taxed than many other types of savings/ investment.

Mortgage interest deductibility may create additional distortions. For example, it may encourage debt finance of property purchases, which could increase the (macro) vulnerability of an economy to adverse shocks. In addition, for revenue neutrality, the revenues forgone by providing these tax subsidies must be made up by raising marginal rates of other taxes, and those higher tax rates by themselves introduce distortions in behaviour.

When high administrative and compliance costs related to the measurement of imputed rental income are the main difficulty to tax owner-occupied housing, the denial of mortgage interest relief and the use of property taxes – instead of taxing the imputed return under the (personal or capital) income tax – can provide a "second best" approach for taxing owner-occupied housing (Heady *et al*., 2009).

3. Distributional impact

In addition to the economic distortions in terms of allocation of resources, mortgage interest reliefs also raise equity concerns. Tax reliefs for owner occupation introduce inequality of after-tax treatment between otherwise similarly-situated home owners and home renters, which is against horizontal equity. These incentives also introduce vertical inequities in the sense of the "upside down" subsidy effect. As these tax reliefs are generally designed as tax deductions, they give proportionately greater government subsidies to taxpayers with higher incomes (as discussed in Chapter 1).

An alternative option to mortgage interest deductibility to avoid this upside-down effect could be a homebuyer's tax credit. These tax credits would have the same value for all taxpayers, if they pay a sufficient amount of taxes, although at the cost of additional complexity.[7] Furthermore, if structured as refundable credits, these reliefs would create uniform incentives and provide uniform benefits to all individuals (where a cash payment is made by the revenue authorities to the individual or family if tax liabilities before the credit are lower than the value of the credit). This would mean that even low-income

households benefit fully from the credit, even if they do not have a sufficiently high taxable income. In practice, a non-wastable owner-occupied tax credit thereby becomes equivalent to an income transfer.

The distribution impact of mortgage interest relief provisions suggests that in general (although depending on their design) only a small share of the benefits of this tax concession accrues to people who would not own their homes in absence of this deduction; *i.e.* the relief is not targeted to incremental investment in housing. In addition, this provision may open tax-planning opportunities. These unintended tax effects will therefore generate "windfall gains" to some investors leading consequently to a negative effect on tax revenues.

Moreover, because taxes and tax provisions are likely to be capitalised to some degree in the price of the assets, new purchasers of tax-privileged assets are not necessarily the beneficiaries of these tax provisions. The price of owner-occupied houses, for instance, will be influenced by the presence and generosity of mortgage interest payments deductions (and the possible absence of a capital gains tax). Households that consider buying a house will take into account the after-tax return on the investment, including the benefits of the mortgage interest deduction. The seller of the property will therefore be able to ask a higher price for the property and the buyer will be willing to pay a higher price than in the absence of these tax preferences. The final incidence of these tax provisions will then depend on how the gains of the tax privileges are shared between sellers and buyers (Leape, 1990). Since abolishing mortgage interest relief may lead to a fall in house prices, the distributional effects of this need to be taken into account in any plans for phasing it out (OECD, 2010).

4. Impact on tax revenues

Tax expenditure estimates for mortgage interest deductibility will depend on the benchmark regime chosen (*e.g.* a comprehensive income tax or an expenditure tax regime). In addition, as pointed out in Chapter 2, revenue gain rather than revenue forgone tax expenditure estimates will be more appropriate when assessing the revenue impact of repealing this relief since the former does not take into account behavioural effects. The elimination of the mortgage interest deduction would provide some taxpayers with an incentive to rearrange their portfolio by selling off assets and pay off their mortgage debt, because other assets would generate taxable income not offset by interest deductions. Therefore, revenue gain estimates should be expected to be lower than static revenue forgone estimates (see for example Poterba and Sinai, Todd, 2008; Gale *et al.*, 2007; or Follain and Melamed, 1998).

5. Effects on homeownership (effectiveness)

A key consideration when evaluating the cost-effectiveness of mortgage interest deductions is whether these incentives generate net increased saving in housing or whether they are subsiding savings that would have occurred in absence of these provisions. Evidence supports the latter effect (see Engen and Gale, 2000) suggesting that this relief does not achieve its objectives in a cost-efficient manner.

A more practical question is whether mortgage interest deductions are in fact efficient in changing behaviour regarding owner-occupied housing and in particular for low-income buyers, to whom they are supposed to be addressed. There is much evidence[8] that suggests that the mortgage interest deductions have little, if any, positive effect on homeownership rates. For example, Glaeser and Shapiro (2003), using time-series models, found no effects on

homeownership in the US Gale (2001) shows double-digit increases in homeownership rates in the United Kingdom during the same period as huge reductions in mortgages subsidies.[9]

Regarding low-income buyers, one piece of evidence comes from comparisons across US states. Connecticut, Illinois, Massachusetts, Michigan, New Jersey, Ohio, Pennsylvania, and West Virginia all have a personal income tax, but do not allow for this deduction. The homeownership rate in these states, however, is higher than the US national average (*www.lao.ca.gov/2007/tax_expenditures/tax_expenditures_1107.pdf*).

This evidence raises the question of whether incentives to middle-and-low income groups to acquire residential property may be more effective when they are targeted to those households that "really need" them by, for example, providing means tested reliefs or direct transfers. For example, Gale *et al.* (2007) show that a first-time buyers tax credit (which is financed by full or partial repeal of the mortgage interest deduction) or subsidised savings accounts for prospective first-time home buyers, would be less expensive, more progressive and more effective in raising homeownership in the United States. Moreover, it is questionable whether the benefits of these targeted reliefs will outweigh the increased compliance and administrative costs related to targeting them. However, as discussed in Chapter 1, the cost-effectiveness of providing these benefits through the tax system depend on the available policy options to a particular country and the development of its tax administration and agency programmes.

VAT provisions for residential property

The VAT treatment of immovable property differs across countries.In general, construction, alteration and maintenance of immovable property are taxed. However, the tax treatment of sale and rental of immovable property generally differs between residential and non-residential (or commercial) property.[10]

In general, the standard VAT rate applies to sales of a new commercial property. For sales and rentals of "old" commercial property the default liability is exempt. However, there are circumstances when VAT could be charged. The most common is where the VAT option to tax is invoked.

On the other hand, for residential property, while maintenance expenditure and renovations are generally subject to VAT (though perhaps at a reduced rate) there is some variation in the taxation of new housing – taxation at the standard rate, at a reduced or even zero rate and exemption (with no refund of input tax). The sale of "old" property does not lead to new value added and is not included in the VAT base.[11] Rentals of residential property are generally not subject to VAT. Hereafter, this chapter will refer to VAT provisions for sales of new housing, maintenance and renovations as VAT provisions for residential property.

a) Rationale

VAT provisions for residential property are mainly justified by a social policy objective, to help ensure that housing is affordable to ordinary citizens.

b) Objectives

The final objective of VAT provisions for residential property is therefore to encourage consumption of housing particularly by low-and-middle income household. Therefore,

these provisions may be categorised as a *tax provision to encourage change of behaviour,* according to the categories identified in Chapter 2.

c) Assessment: estimation of costs and benefits

1. Impact on efficiency

A consistent application of VAT to immovable property would imply all building activities, forms of leasing and sales to be taxed at the standard rate. VAT provisions for residential property create a potentially significant tax-induced distortion towards the consumption of housing, though the scale of this may be hard to quantify (*e.g.* given the difficulties of estimating effective incidence where capitalisation of tax reliefs may occur). In addition, on the supply side, these provisions (often zero or reduced rates) encourage the conversion of both existing residential and commercial buildings into new residential or commercial units, on which a preferential VAT rate is applied while at the same time VAT input credits for the undertaken works could be claimed.

Timing and transitional issues are both elements that should be carefully analysed when considering the elimination of provision for residential properties. These both elements would need to be adjusted according to the particular circumstances of the housing market of a particular country.

2. Impact on income distribution

VAT provisions for residential property also raise equity concerns. Given the proportional nature of VAT (a tax as a percentage of the final price of a good/service) and the fact that high-income households are likely to buy/rent more expensive houses, they benefit the most from a VAT provision on residential property.

Additionally, VAT reliefs on consumption of housing services apply, in most cases, indiscriminately to both principal and secondary residences. This also raises equity concerns, since high-income individuals will hence be receiving higher benefits from this relief.

Moreover, it is not clear that housing should be favoured over other household necessities, and whether for redistributive objectives a VAT provision is more efficient than, for example, direct subsidies to low-income households.

3. Impact on tax revenues

The treatment of the exemption and zero-rated VAT as tax expenditures varies across countries. When these provisions are considered to be part of the benchmark, estimates in terms of revenue forgone are generally not calculated. However, even when these estimates were available, revenue gains estimates would be more appropriate when considering repealing this preferential treatment. In particular, behavioural effects would need to be carefully considered during a transitional implementation period.

Moreover, the negative impact that the repealing of these reliefs may have on the housing cost for low-income households may lead to the need of replacing the reliefs with a direct expenditure, at least for the low-income group. While increasing equity (making the tax system to appear fairer), such a replacement may reduce the expected budgetary savings or the scope for lowering rates of other distortionary taxes and, hence, the extent of increased overall efficiency.

3.3. Provisions for retirement savings

Many tax systems of OECD countries include tax incentives to encourage savings for retirement.[12] The extent of these incentives varies widely across OECD countries. This variation mainly reflects the differences in public pension systems, in taxation and in capital market regulations. The discussion in this section will focus on the EET ("exempt-exempt-taxed") regime, since a vast majority of OECD countries apply such a regime or a variant of it.[13]

Under a EET regime the income that is contributed to a given scheme is exempted (E), the income accruing by the savings scheme is also exempted (E), and then the capital is taxed when is paid-out at retirement (T).Variants of the EET regime include withdrawals that are generally taxed more leniently than in the pure EET or contributions that are granted as a tax credit rather than a full deduction.[14]

The EET regime simply allows the deferral of tax payments until retirement, and leaves the taxpayer with the same present value of post-tax income to consume in the first period or consume later at retirement.[15] In other words, the EET regime achieves fiscal neutrality between current and future consumption (assuming that the tax rate is the same in each period). The EET tax treatment of retirement savings is thus equivalent to the treatment under a pure expenditure tax regime.[16]

In general, the final objective of any provision for savings is to encourage additional savings. When evaluating retirement savings provisions, it is essential, therefore, to compare the tax treatment of this form of savings with its close substitutes (*e.g.* life insurance plans or housing provisions) to ensure that differential taxation across different saving vehicles do not undermine the objectives of these provisions by encouraging portfolio reshuffling rather than new savings.

In addition, the design characteristics of preferential treatments of retirement savings provisions play a key role on the cost-effectiveness of these concessions. Targeting these provisions to low-and-middle income individuals may not only be desirable from a strict equity perspective but it may also lead to better results in terms of boosting private savings.

a) Rationale

While preferential tax treatment of retirement savings may be justified by redistribution and equity concerns, the main rationale for the introduction of tax incentives to encourage pension savings is the existence of market failures (*e.g.* imperfections in insurance markets) and individuals' myopia (*i.e.* decision-making failures). Government intervention regarding provisions for retirement savings is explained by "adverse selection" and "moral hazard" arguments. Insurance companies cannot determine the riskiness of all individuals. Such factors may lead insurance companies to charge high premiums that lead to individuals' private investment in long-term savings being below a socially optimal level.

Individuals' myopia about the future may arise for a number of reasons (*e.g.* information failures) leading many workers to consume too much of their earnings during their working life and only beginning to make provisions for their old age when it is too late. As a consequence, they will need government support through the social safety net once they retire (and a belief in the likely existence of such a safety net is itself a possible "moral hazard", discouraging making private provision for retirement).

b) Objectives

The preferential tax treatment of retirement savings aims at encouraging additional individuals' private savings for retirement by increasing the net rate of return of these saving vehicles. Moreover, with ageing populations, many countries have an increased need to rely less on pay-as-you-go pensions and, thus, encourage a significant increase in private retirement savings.[17]

This provision belongs to the category *tax provision to change economic behaviour,* among the categories identified in Chapter 2.

c) Assessment: estimation of costs and benefits

1. Impact on income distribution

Taxpayers with higher incomes benefit relatively more from preferential tax treatments of retirement savings for several reasons (where there are no caps on the amount of relief available). First, these provisions generally take the form of exemptions and deductions, entailing more benefits to individuals with higher marginal income tax rates ("upside-down" subsidy effect). Additionally, high-income individuals save a larger proportion of their income and are more likely to work in firms with more advantageous pension coverage (OECD, 2005a and 2007c). This suggests that preferential treatment of savings may be subsidising savings that would have been made anyway in the absence of the tax incentive, and, therefore, generating gains to high-income individuals without raising total savings. On the other hand, relief for pension contributions may help to reduce the *de facto* top marginal income tax rate, so improving work incentives. Taxpayers at the very top of the income distribution may, however, benefit less as a percentage of their income because generally there are limits on the amounts that may enjoy preferential tax treatment (Toder *et al*., 2009; and Valenduc, 2006).

Valenduc (2006) utilised the effective tax rate methodology to illustrate that the distributional effect of EET provisions depends on the length of the contract of the pension schemes; *i.e.* the shorter the contract, the higher the tax subsidy per unit invested. Given the age-related exit date, these results indicate that these provisions relatively benefit more those individuals that enter the schemes when they are close to their retirement age.

The net distributional impact and overall effect on savings from eliminating these provisions will also depend on how the additional revenue is used. If this revenue is used to cut taxes or make transfer payments to the same group of individuals with increased tax liability as a consequence of the elimination of the relief, there would be little income effect. On the other hand, if the additional revenue is used to cut taxes or make transfer payments to younger people, then there would be a net income effect that would work against the substitution effect, assuming that the young have a higher propensity to save.

In addition, there is evidence that the financial institutions that manage pension savings and provide pensions often "cream off" a significant part of the tax advantages for pensions (Valenduc, 2006; *Cooper Review*, 2010).

Furthermore, incidence issues specially need to be analysed when considering the abolishment of these provisions, because pensioners have no longer the opportunity to adjust their labour market behaviour in response to the change in the personal income tax system (OECD, 2010).

2. Impact on efficiency and effectiveness

Preferential tax treatments of retirement savings are likely to increase the post-tax return on saving through a pension vehicle compared with other savings. This increase in the rate of return may have two effects on the individual's decision to save. It may change the total amount that an individual will save[18] and change the composition of that savings toward this tax-preferred form of savings. In this case, tax concessions on retirement savings would imply tax-induced distortions in the allocation of savings, which would lead to deadweight losses and, therefore, reduced economic efficiency. This does not contradict, however, the idea that in the short-run tax incentives encouraging retirement savings might help in a transition to a new regime with less reliance on pay-as-you-go benefits and more on private retirement savings.

Standard economic models (see for example OECD, 2005; or Attanasio and DeLeire, 2002) show that the overall effect of tax-favoured saving schemes on total private savings depends on the elasticity of intertemporal substitution of consumption.[19] In other words, the net effect on total savings depends on the response of consumption growth to the real interest rate. The tax-favoured scheme will increase savings only when this elasticity is negative. These standard theoretical models find in general relative small positive effects of tax-favoured savings schemes on generating new savings.

Empirical evidence (for example, OECD, 2004 and 2007; Valenduc, 2006; Börsch-Supan, 2004) also suggests that only relatively small fractions of the funds going to tax-advantaged saving vehicles can be considered "new" savings, while the vast majority of funds represent reshuffling of existing portfolios. This is mainly explained by the low participation rate of low-and-middle income individuals in voluntary pension schemes; income groups that would be more likely to generate new savings in response to these incentives (Benjamin, 2003; Engen and Gale, 2000). The low participation of these income groups suggests that the design of these provisions plays a key role on both their efficiency and distribution effects.

One reason why optional schemes may fail to attract (very) low-income individuals is that for these group of individuals saving may be neither accessible nor optimal, in particular for those whose income prospects have clear chances of improving over time (so that saving more later is a realistic option). Relatively high replacement rates in countries with a highly redistributive public pension pillar may also reduce incentives to participate in tax-favoured schemes for low-income earners. A possible option to enhance participation of low-and-middle income individuals could therefore be to introduce compulsory participation, which is currently the case in a number of countries. Another option could be to replace the tax deduction/exemption with a non-wastable tax credit set at a flat rate (Antolín *et al*., 2004).[20]

A different question is whether retirement savings incentives can be more effective when provided by personal pension plans or occupational schemes. The main advantage of the latter is the relative simple and easy individuals' access to pension plans that these schemes may provide. In particular, occupational schemes facilitate making the enrolment in a pension plan a default option, which has been shown to be effective in boosting participation rates (Mitchell and Utkus, 2003). On the other hand, the main disadvantage of occupational schemes is the potential costs for business of the administrative costs and responsibilities of sponsoring a pension plan (Antolín *et al.,* 2004).

3. Impact on tax revenues

As illustrated in the previous chapter, retirement savings provisions represent an important share of GDP in terms of revenue forgone for many OECD countries (if measured in relation to some approximation to a comprehensive income tax baseline).

However, as in the case of housing provisions, revenue gain rather than revenue forgone tax expenditure estimates will be more appropriate when assessing the revenue impact of repealing this relief. Revenue gain estimates should be expected to be lower than static revenue forgone estimates because the elimination of this provision would provide some individuals with an incentive to rearrange their portfolio by shifting their assets towards other tax-preferred investment vehicles. Moreover, the scale of the reliefs for pension contributions is likely to mean that any significant changes to reliefs could have systemic impacts that are perhaps best analysed in a general equilibrium framework, rather than in a simple cost/benefit framework.

3.4. VAT exemption on financial institutions (banking and insurance sector)

The VAT is a tax on final (household) consumption expenditure, but levied on the basis of turnover at each stage of the supply chain (with provisions for relief of input tax). Full input credits granted along the entire transaction chain, except for the final consumer, make the VAT neutral with respect to production (independent of the nature of final and intermediary goods/services) and consumption decisions. In addition, a zero rate on exports and taxation of imports at domestic rates also ensure VAT neutrality in international transactions, since under the destination principle VAT is paid in the country where final consumption takes place.[21]

While in general a single VAT rate would be optimal to minimise collection (administration and compliance) costs, most activity of the financial (banking and insurance) sector has been historically VAT exempt in most countries that have introduced a VAT system. In Europe this is set out in the Sixth Directive dating from 1977. The main reason for this exemption was originally the technical difficulty of establishing the taxable amount in respect of financial intermediation (banks) and risk pooling (insurance) generated by the financial sector's activity.

In the case of financial services based on explicit fees and commissions, such as safe-keeping services or issuance of travel cheques, there is no conceptual difficulty in levying VAT in the same way that other non-financial services, such as for example admission charges to sport events. However, difficulties in identifying a taxable base arise for services that imply a transfer of funds from savers to investors and consumers. The technical problem is then to identify the value added generated as an implicit charge in the form of a margin between the two sides of these transactions; for example, the margin between the return paid to lenders and that charged to borrowers (similarly in the case of insurance contracts or other forms of financial intermediation).[22] In many cases it is not easy to isolate the actual margin associated with this financial intermediation in a particular transaction (although this margin may be potentially measurable on aggregate basis).[23]

Therefore, exemption (also called "input taxing") of financial services from VAT breaks the VAT chain. This break means that financial institutions incur significant amounts of VAT paid on their inputs which they cannot recover as they cannot charge VAT on their sale of services (so-called "hidden VAT" cost). Moreover, the application of this exemption significantly varies across countries.[24] In most countries, this exemption system has not

been updated despite considerable changes in the nature and the design of the financial services and the products provided, partly as consequence of this preferential tax treatment, the introduction of new financial instruments and increased international transactions.

Some economic arguments to help evaluate this tax provision are presented below within the proposed evaluation framework.

a) Rationale

Determining the VAT base of the activities of the financial sector could involve high administrative and compliance costs, given the nature of the services/products provided by this sector and the diversity of financial institutions in terms of size (*e.g.* national, European and worldwide institutions), activities (*e.g.* retail *versus* wholesale banking, investment funds, insurance companies) and structure (*e.g.* subsidiaries, branches, vertical integration structures).

From an efficiency point of view, the VAT should be levied only on the intermediation charge, which reflects the actual value added created by the financial institution. This would minimise distortions in the allocation of resources, and, therefore, the net cost to society in terms of excess burden. However, the intermediation charge cannot be easily separated from the pure interest rate.

b) Objectives

The main objective of the (partial) exemption of financial services is hence to reduce administrative and compliance costs in determining the VAT tax base for financial institutions, particularly those related to the deductible part of the taxable base. These high costs will be reflected in a total tax burden on these institutions.[25]

Therefore, a VAT exemption of financial services might be justified for practical reasons. Consequently, using the categories identified in Chapter 2, this provision might be categorised as a *tax provision to reduce administrative and compliance costs*.

c) Assessment

c.1) alternative policy instruments

The objective of this provision of minimising compliance and administrative costs could be also achieved by other alternative policy options, including replacing the partial exemption system by:

a) Imposing VAT on all financial services

b) Levying a zero-rated VAT on business-to-business financial transactions

c) Introducing a cash-flow tax on financial services activities (instead of VAT)

A complete economic and social evaluation of exemption would involve assessing the impact of each of these alternatives (and other alternative options) on compliance and administrative costs, efficiency, tax revenues and income distribution. However, this task is outside the scope of this paper. Nevertheless, economic arguments related to exemption are discussed below and, when appropriate, some brief discussion on alternative policy options will be included.

Moreover, the overall effects of the exemption or any other alternative policy option will depend on several factors including the structure of the market (including, for example, the relative importance of this sector in the national economy, international

openness, characteristics of the financial institutions operating in the country), the demand and supply elasticities of financial services and those of complement/substitute services, the existing standard VAT rate, and the interaction of the VAT with other taxes (such as other indirect taxes, payroll taxes, impact on social security and unemployment costs). These factors need to be considered when evaluating the exemption system and, therefore, sensitivity analysis needs to be carried out.

c.2) estimation of costs and benefits

1. Tax compliance and administration costs

In theory, compliance and administrative costs are lower under an exemption system, at least for those related to the exempt activity. However, these costs may be higher when only one part of the activity is exempt, as is the case in the financial services sector.

In particular, the exemption of financial services includes the following costs:

- Compliance costs related to:
  - ❖ the need to track and identify exempt and taxable products/activities;
  - ❖ input VAT (accounting) allocation: producers selling both exempt and taxable outputs need to assign input VAT to both outputs, while they will get a credit only for the input for the taxable and not for the exempt transactions. The part of these costs corresponding to taxable outputs will be at least partially offset with the benefits of receiving the VAT credits. Moreover, there will be also some inputs that cannot be directly attributable to either taxable or exempt transactions. However, once the taxable base has been identified, the costs associated with completing the VAT tax return are sunk costs and should not be included in the evaluation of the exemption system. The tax return needs to be completed anyway, even when all services are exempt;
  - ❖ some uncertainty about the development of tax liability and higher risk of double taxation, when the exemption regimes vary across countries.[26]
- Administration costs related to:
  - ❖ the need to define financial activities/products, identify and update the list differentiating between exempt and taxable products/activities;
  - ❖ auditing VAT input allocation and VAT credits;
  - ❖ extra enforcement costs:
    - – due to the incentives for tax avoidance, including tax-planning opportunities, created by loopholes on the allocation of input VAT between taxable and exempt outputs for producers selling both. Consequently, these avoidance strategies will also lead to higher administrative costs in terms of enforcement;
    - – due to decreased compliance as a consequence of the perception of not having a fair share of the tax burden among producers;
  - ❖ litigation costs (which are of increasing importance in Europe), due to the interpretation of the old rules and their application to new situations/products in the financial sector;
  - ❖ VAT collection costs: once the tax base has been identified, collection costs are sunk costs and should not be included in the evaluation of the exemption system, because the collection for the taxable services needs to be undertaken anyway.

2. Impact on tax revenues

Exemption implies that VAT revenues are no longer directly proportional to the sale price for final consumers. The net effect on revenues raised by VAT depends where in the chain of supply the break occurs. If this break is immediately prior to final sale and with enterprises making a margin, the VAT tax base on outputs (services) should be higher than that on inputs; therefore we should expect reduced tax revenues with the exemption system.

However, if the exemption occurs at some intermediate stage the net effect on tax revenues is not clear. Because exemption breaks the VAT input chain, businesses will not be able to recover all the VAT paid on inputs (which implies an input tax on financial institutions) and, therefore, the negative impact on VAT tax revenues collected from households' consumption of financial services may be partially (or fully) offset (this implies that the value added prior to the exempt stage is effectively taxed more than once). The overall impact may not only vary from country to country, but also across institutions and types of services (*e.g.* banking *versus* insurance companies).

Potential revenue losses may also arise from changes of behaviour induced by the exemption system in terms of tax avoidance and evasion strategies. For example, businesses may decide to change their structure and self-supply some services such as accounting or cleaning services in order to minimise their tax liability. Additionally, increased international cross-trading may also increase the level of zero-rated services as a proportion of activity in all countries.

3. Impact on efficiency

Exemption of the financial services from VAT breaks the VAT chain and, therefore, the neutrality principle of the VAT. This break means that financial institutions incur significant amounts of (unrecoverable) VAT paid on their inputs but which they cannot recover as they cannot charge VAT on their sale of services, the so-called "cascading effect". This leads to economic distortions including:

- Distortions on businesses decisions:
  - ❖ distortions on input choices (production inefficiency): the unrecoverable VAT levied on some intermediate inputs may induce producers to substitute away from those inputs and/or prefer exempt input suppliers;
  - ❖ tax-induced incentives to change businesses structure and that of their suppliers either to benefit from preferential rates, favourable administrative procedures (*e.g.* VAT grouping) or loopholes. For example, financial services will have an incentive to integrate vertically (*i.e.* to self-supply certain inputs as in-house printing, and certain services such as in-house legal, accounting and tax advice services) to avoid paying unrecoverable VAT that they would have to pay in the case of obtaining these services from third parties. While self-supply may mitigate (but not eliminate) the production (and delivery) inefficiency problem associated with exemption,[27] it does so only at some revenue cost;
  - ❖ advantages to large enterprises relative to small ones, given the former's relatively higher accessibility to complex mechanisms; for example, in terms of vertical integration for accounting and legal services;[28]
  - ❖ incentives to substitute margins for explicit fees and commissions to be able to claim input VAT; or in contrast to categorise all value added as margins in order to minimise VAT payments;

- ❖ distortions of international competition between financial institutions:
  - – the unrecoverable VAT rate differs across countries and, therefore, the rates that will have to be charged to customers (or the profit margins of financial institutions) will also differ across countries (although the net effect will depend on some incidence issues which will be explained below);
  - – exemption implies that the unrecoverable VAT on inputs is proportional to the VAT applicable to the inputs of the exempt activity. The higher is the VAT rate, the higher are this input tax and the cascading effects. Therefore, given the different rates applied across countries, exemption may also distort location decisions;
  - – favour imports over domestic production: exemption may give incentives for companies to import services which are free of tax in preference to buying from local providers whose services may include unrecoverable input VAT. However, there is no empirical evidence suggesting that this is actually happening.

- Businesses and customers decisions:
  - ❖ Private consumers might also face an incentive to excessively consume financial services compared to other goods and services because no VAT is explicitly levied (implying lower relative prices).
  - ❖ We can differentiate 2 extreme cases:
    - *a)* When financial services are provided directly to consumers, the exemption system implies that VAT is not applied on the actual sale to consumers, and, therefore, financial services are taxed less heavily than other goods and services (since the effective tax rate is determined by the value of inputs to financial institutions rather than the value of the final product).
    - *b)* Tax incidence issues play a more important role when financial services are supplied as an intermediate step in the production process (*i.e.* as business inputs) of a final taxable good/service. In this case, the overall effect on consumption of financial services will depend on whether the unrecoverable input VAT may be fully embedded in the charges that financial institutions make to their business customers, and whether the latter may also pass them through to higher final personal consumption prices of taxable goods/services. If the unrecoverable VAT may be passed through higher final consumer prices, goods and services incorporating financial services will be over-taxed and, therefore, exemption will give an incentive to under-consume these goods/services.

Therefore, from a cost-efficient point of view, the only justified exemptions (without relief for input tax) could be those on goods and services provided to final consumers and that take place at the last stage of the distribution process. However, while this targeted preferential tax treatment may minimise distortions in terms of cascading effects, it may do so at an excessive tax revenue cost (depending on tax incidence issues).

In order to correct for the VAT cascading effect and, therefore, reduce distortions and increase efficiency, exemption could be replaced by either "zero-rating" business-to-business financial transactions or levying VAT on financial services and allowing input tax credits in the normal way. However, these policy alternatives might have a significant cost in terms of revenue forgone due to increased claims of input VAT, especially in countries with major financial service sectors (Holmes, 2008). And it is uncertain whether the extra VAT revenue collected from taxing the value added of the financial institutions

would more than offset this revenue forgone, which will depend on demand and supply elasticities of financial services. In addition, the net revenue effect would also depend on the interaction of VAT with other taxes; for example, some existing indirect taxes such as insurance premium taxes may have to be repealed of reduced.

Moreover, while imposing VAT on all financial services would still imply high administrative and compliance costs to identify the taxable base of financial activities, the evolution of accounting and information systems may help the implementation of complex but accessible methods that may help define this tax base (EU Commission, 2006; IMF, 2004; Buydens, 2007).

The question is then whether the costs of levying a VAT on all financial services (in terms of administrative and compliance cost) would more than compensate its benefits in terms of reduced distortions (by bringing the VAT closer to a "pure" tax on final consumption) and additional tax revenue (if any).

3.5. Conclusions

In addition to increasing transparency of tax policy decisions, evaluation of targeted tax provisions may help identify possible candidates for base-broadening tax reform. In general, resource limitations (in particular data and human resources) explain the reduced number of provisions that are evaluated on a regular basis in OECD countries.

While revenue forgone figures represent only a first step in the evaluation of tax provisions, they may help prioritise which provisions to evaluate first. However, behavioural considerations need to be taken into account when evaluating a given tax provision because of their impact not only on tax revenues, but also on efficiency and income distribution.

A complete evaluation should ideally include assessments of the effectiveness, efficiency, distributional impact and compliance and administrative costs of a given tax provision and also of possible policy alternatives that could achieve the same social and economic objectives.

The design of tax reliefs, timing considerations and the tax treatment of close-substitute goods/services all play a key role on the cost-effectiveness of targeted tax provisions. The net effects of these provisions also depend also on how they are financed.

While the final decision on whether to eliminate/extend/introduce targeted tax provisions is clearly a political one, economic analysis is a very useful tool to provide indications about the magnitude of the various elements to consider when taking this decision. This economic analysis may also help increase government accountability regarding expenditure decisions made though the tax system. At the same time, it may help obtain the political and social support needed for a particular base-broadening move.

Notes

1. The problem of TEs with a poor economic rationale proliferating in countries may be exacerbated where the power to grant TEs and exemptions is spread amongst many Ministries, Ministers and officials. Further such an institutional setting is unlikely to promote tax transparency and stability, and can create governance problems. An important first step in rationalising the use of TEs and controlling their cost is to centralise the powers to make decisions on the granting of TEs in the Finance Ministry.

2. The difference between consumption expenditure and investment expenditure is that the former consists of consumption to meet the needs of a given period (one year), while the latter includes consumption that lasts for more than one year (OECD, *National Accounts at Glance*).

3. An alternative option to apply VAT to current consumption of housing could be, for example, a tax levied on the 50 per cent of the market value of the property, which would reflect a hypothetical real return of 3 per cent with a standard VAT rate of 16 per cent. However, the problems associated to the high costs of regular valuations to establish fair market values would remain. At the same time, it would be also necessary to abolish/reform existing taxes on residential property, given the similar nature of these two taxes.

4. Note that the up-front taxation with VAT of building, maintenance and renovation costs is not necessarily against the investment good perspective. The return on all other investment goods is usually taxed first at the corporate and personal level and afterwards with the VAT when this return is consumed. In case of housing, the VAT is taxed up-front and the return on investment (when taxed) is taxed afterwards (OECD, 2010).

5. While there are some theories supporting these external effects from homeownership (*e.g.* Glaeser and Shapiro, 2003), little evidence is available supporting these arguments, which does not prove however that these arguments are wrong (Gale and Gruber, 2007).

6. Belgium, the Netherlands, Norway and Sweden are the only OECD countries that tax imputed rental income under the income tax.

7. The objective of a homebuyer's tax credit is to boost sales activity in the housing market. Its main advantages include: 1) it is likely less costly than interest deductibility (particularly if designed as a short-term incentive) in terms of revenue forgone; 2) it does not encourage people to borrow as much as possible; 3) it can avoid the upside-down effect if a limit is established on expensive houses purchases, 4) tax-planning opportunities (*e.g.* two homebuyers sell their home to each other next year only to flip them back the year afterwards) can be reduced if it benefits only to buyers who purchase new or foreclosed homes. The main disadvantage is that housing prices are likely to increase, although there is little evidence to know the extent of this increase.

8. In theory, on the supply side, the effect of this relief on the quantity and price of housing would depend on the supply elasticity of housing. The more inelastic supply is the higher the deduction and the higher the increase in prices. However, the elasticity of supply of housing is likely to vary across countries, regions and within regions, depending mainly on land availability (see for example Green, Malpezzi and Mayo, 1999). On the other hand, the demand for homeownership, given the stock of housing, depends on the relative price of owning *versus* renting a house, which may also vary across countries, regions, etc.

9. Some of this increase in the United Kingdom may be explained by the privatisation of public housing in the 1980s. In contrast, Rosen and Rosen (1980) showed that about one quarter of the growth of homeownership in the post-World War II period was a consequence of the favourable tax treatment in the United States.

10. In contrast, taxation of land widely varies across countries.

11. The fact that VAT is not levied on the sale of "old" property does not mean no-taxation. Many countries levy registration duties and (high) transaction taxes on the purchase of houses.

12. This section discusses the tax treatment of funded pension plans including both occupational and personal schemes.

13. In a pure comprehensive income tax system, savings are made out of taxed earnings and the accrual return on funds accumulated is also subject to an income tax. In return, the withdrawal of assets from such saving vehicles is fully exempted from taxation. Such arrangements are known as "taxed-taxed-exempt" (TTE) schemes.

14. Other regimes applied in some OECD countries are the ETT, TET, TTE, TEE, TTT; where E stands for exempt, and T for taxed.

15. A tax preferential treatment does not necessarily always entail tax deferral. For a given tax rate, an equivalent incentive can be provided under a TEE regime, commonly referred to as a "pre-paid" expenditure tax. In the case where the discount rate is equal to the rate of return, and contributions and withdrawals are subject to the same marginal income tax rate, the EET and the TEE regimes deliver the same net present value of revenues to the government. Conversely, tax-deferral is not necessarily synonymous to tax preference given that under similar conditions, an ETT regime is identical to the TTE regime in terms of the net present value of revenues to the government (OECD, 2005).

16. Under the TEE regime, a taxpayer pre-pays income tax on pension savings in the first period. The EET and TEE regimes deliver the same value of the post-tax retirement income for the taxpayer, and the post-tax rate of return on pension savings, and the same tax revenue for the government. The TTE regime is common to interest-bearing assets in most OECD countries. Since the post-tax rate of return is lower than the pre-tax rate of return, the TTE and the ETT regimes create a disincentive to save, and a taxpayer ends up with less money when he decides to save and consume later at retirement. Under the TTE and ETT regimes, a taxpayer is neutral between consuming and saving in the first period, because savings is treated in the same way as consumption (OECD, 2005).

17. Tax provisions for retirement savings have been introduced in some countries as a mechanism to accelerate the transition from pay-as-you-go systems to funded systems (and to spread the transition burden equally across several generations). However, promoting private pension as a substitute for public pensions raises issues regarding risk bearing and administrative costs (Boskin, 2003; Auerbach, Gale and Orszag, 2003).

18. An additional question is whether these provisions have a positive effect on total national savings. If that is the case, the cost-effectiveness analysis of these incentives also needs to take into account the benefits of increased national savings in terms of increased capital stock. This in turn should boost profits as well as wages and therefore tax revenues on capital return and labour income (Antolín *et al*., 2004).

19. In two-period standard models the overall effect on savings is ambiguous depending on the income (present consumption is more expensive relative to future consumption, which should increase savings) and substitution (individuals need to save less to achieve the same level of wealth) effects. In models with more than two periods there is also a wealth effect that tends to increase savings (OECD, 2005).

20. Participation rates may also be encouraged by providing jointly tax incentives and information about individuals' needs in retirement and financial education. Wise (2001) argues that these complementary programmes explain for example the great success of individual retirement accounts (so called "IRAs") and employer-sponsored retirement saving plans (so-called "401(k) plans") in the United States. However, where irrational behaviour is seen as the main reason for the "inadequacy" of retirement savings patters, alternative design characteristics of tax provisions may help solve these problems (see OECD, 2005).

21. See International VAT/GST guidelines at *www.oecd.org/taxation*.

22. See Ebrill *et al*., 2001; and IMF, 2004.

23. The addition method (levying tax directly on the sum of wages and profits, the latter defined on cash flow basis with investment immediately expensed) and the subtraction method (levying tax on global accounting value added, which is calculated as the difference between taxable and deductible turnover) are two examples of taxing aggregate value in the financial sector. However, neither method allows for a systematic crediting system. While a VAT applied on cash flow basis could be in principle an alternative, it will imply high administrative and compliance costs (see Ebrill *et al*., 2001; Buydens, 2007).

24. For example, for details on the exemption system of financial services in the European Union, see Buydens (2007), or PriceWaterhouseCoopers (2006).

25. The European Commission estimated that the the rate of input VAT recovery for financial institutions ranges from 0% to 74%. The different rates are mainly explained by the available option for taxation in some countries as regards their exempt financial transactions, the composition of the institutions' clientele, the scope of the exemptions under national law, and concessional arrangements applicable to institutions operating in the financial sectors of the various Member States (European Commission, 2006).

26. Taxation of financial services may vary across countries for different reasons including: lack of a common definition of these services, different tax design (*e.g*. full *versus* partial exemption, different pro-rata methods for VAT credits), and different interpretation of VAT rules for this sector.

27. Vertical integration may constitute a considerable lost opportunity with potential important implications for the competitiveness of the wider financial sector, when outsourcing is reported to be resulting in substantial savings for large firms in this sector (ref: Financial Sector Study, PricewaterhouseCoopers, 1996).

28. This can give, for example, a perverse incentive for banks to grow too much (and maybe too quickly), which increases their vulnerability in case of bankruptcy.

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Chapter 4

Base-broadening and Targeted Tax Provisions: Political and Distributional Considerations

This chapter analyses the role of political and distributional factors in the legislation and implementation process of base-broadening reforms, including: getting the support of a broad group of political actors, the lobbying of interest groups, the framing and the timing considerations of a particular tax policy change, the existence of tax revenue constraints or international rules/legislations.

Previous chapters have indicated that there could be base-broadening reforms in many countries that would be worthwhile on economic grounds; that is, where benefits of such reforms exceed costs within a revenue-neutral envelope, and GDP could be higher. In practice, however, there are often obstacles to legislating and implementing such reforms.

In general, getting the support of a broad group of political actors – including voters, politicians, political parties, lobby groups and the media – is essential to get reforms legislated and implemented. The framing and the timing considerations of a particular tax policy change, the existence of tax revenue constraints or international rules/legislations, and the lobbying of interest groups may all be important. Country-specific political processes and institutions will of course play a role in the success or otherwise of reform attempts to broaden the tax base (Olofsgard, 2003).

This chapter analyses the role of a number of these factors in the legislation and implementation process of base-broadening reforms.

4.1. The merits of the economic case for a reform

The strength of the economic case for a base-broadening reform will naturally influence political perceptions about its desirability. This in turn points up the need for good tax policy analysis, including international comparisons, estimates of revenue and behavioural effects and assessment of winners and losers.

However, the persuasiveness of the economic case for a particular reform measure may vary. Simply putting the evidence before ministers, the legislature and the general public may not itself be sufficient to secure, say, the abolition of a tax expenditure. This may be because the economic gains from abolition may be harder to articulate (*e.g.* changes to VAT exemptions) but other (political) factors may also be involved.

Resources devoted to tax policy analysis could thus make a significant difference, whether inside or outside of government. For instance, governments may use independent bodies to evaluate the effects of particular tax reform proposals, for example on firms' and households' behaviour, tax revenues, income distribution, etc.[1]

4.2. Politicians' views and use of tax policy

Politicians' views about the role of tax policy and what constitutes "good" tax policy may explain why some targeted tax provisions are chosen over base-broadening measures. Some politicians may see tax policy as an instrument that can be used actively to support economic, political and social goals, while others may be more concerned to ensure that tax does as little as possible to distort economic activity and incentives, has low administrative and compliance costs and does not offer significant tax planning opportunities and avoidance opportunities. The latter view – where tax policy considerations play a relatively independent role *vis-à-vis* other policy areas – is more likely to support a base-broadening strategy.

On the other hand, politicians may see tax policy more narrowly, as another instrument to help them win elections. This could explain the failure of some base-broadening moves regardless of their economic merits. When adapting policy choices to voter preferences in order to win elections, politicians may prefer to use "more visible" policy instruments like targeted tax provisions and public expenditure subsidies to encourage particular behaviours or reward favoured constituencies and lobby groups. Base-broadening reforms may be in particular difficult to "sell" when economic concepts need to be used to explain efficiency (*e.g.* excess of burden) or income distribution (*e.g.* Gini coefficients) gains. However, politicians may find broader bases attractive if these measures are seen as a means to finance tax rate reductions, because of the "visibility" and popularity of lower rates.

The introduction of special tax concessions can be less difficult than implementing spending programs for several reasons. In general, while pre- and post-implementation evaluation of objectives and impact is generally required for spending programmes, this is less commonly the case for tax reliefs. Moreover, special tax provisions may sometimes be the most attractive option available to private interests who seek government support for their chosen activities, since explicit industry-specific subsidies (being more transparent) might be seen by electorates as unfair.

Targeted tax provisions may also be attractive for politicians because they enable them to discriminate among taxpayers and target benefits that can be very visible to their beneficiaries. At the same time, the costs of these provisions (in terms of higher tax rates or lower spending elsewhere) can be spread (more thinly) over all taxpayers. This allows politicians to attract "swing voters" (*i.e.* those electorate groups that are most mobile across parties) and interest groups (Ashwortth and Heyndels, 2001; Besley and Case, 1995; Profeta, 2007). Moreover, the "political cost" of these tax reliefs might be borne by the supporters of another political party. Politicians may also have incentives to implement tax reforms that are highly supported by a large amount of voters (Profeta, 2007). However, the introduction of preferential tax treatments might also create incentives for interest groups to lobby for new special provisions (Ashworth and Heyndels, 2001).

Moreover, favourable tax treatments to particular groups could prove difficult to remove and may grow over time. The favourable tax treatment guaranteed to a group may create a constituency for expanding that favourable treatment. For example, in 2001 the UK government enlarged and extended the R&D tax credit from small to large firms. Alt *et al.* (2008) explain that at the time of its introduction, large firms did not lobby for its creation, even though they could expect to benefit from it. However, once the policy was in place, they lobbied actively to maintain and extend it.

Opposition to abolishing preferential tax treatments may be explained by the theory of *status quo* bias (Fernandez, R. and D. Rodrik, 1991). Improving a tax system means starting from an existing situation, the *status quo*, and convincing politicians and voters to reform the system in order to move towards a new situation. This process may create uncertainty, and reforms typically have losers and winners. By the very nature of a reform process that removes tax breaks, those who stand to lose from the reform are easily identifiable, compared to those who stand to gain by (perhaps marginally) lower tax rates than otherwise. This individual uncertainty generates a double hurdle for reforms: a reform must attract both *ex ante* and *ex post* majority support; *i.e.* it must overcome the *status quo*

bias. This bias means that voters will impose more conditions to move from a *status quo* A to a new tax system *B*, than to remain in *B* once the latter has been in existence for a while.

The *status quo* bias illustrates that a pure economy approach focused on aggregate (efficiency) gains is necessary but not sufficient for making reforms happen. This *status quo* bias has been, for example, illustrated by Valenduc (2006) in his analysis of the possibility of introducing an income flat tax in Belgium. According to the principles of the flat tax, marginal rates would be decreased, but the tax base broadened, and many tax allowances and expenses would be removed. Valenduc shows that the reform would not get *ex ante* majority support due to the uncertainty about the gainers of such a reform. His simulation results show that the *ex ante* constraint can definitely not be met in Belgium: post-tax wage inequality would increase dramatically, and only the top two deciles would really gain (the impact is almost nil for the 7th income decile). Among socio-economic groups, some wage earners and self-employed people would gain, but unemployed, disabled, and retired people would lose, making the reform politically infeasible in Belgium.

Governments may try to circumvent this *status quo* opposition by tailoring their reform strategy. One possibility is to pursue gradual reforms, for example, by splitting a reform into different components such that each targets a different group at a different moment in time (see section on timing considerations). Governments may also try to explicitly link the abolition of a preferential tax treatment which is only beneficial to some taxpayers with the introduction of tax measures from which most taxpayers will gain (see section on distributional effects and section on framing a reform). This strategy might engage the normally silent majority because they explicitly gain if the new tax policy is introduced. This support may then be used to counter the criticisms of the losers who prefer that the special tax provision is not abolished.

The increasing trend in the introduction of preferential tax treatments in some OECD member countries could also arise from a perceived need by some politicians to be seen to be active (*e.g.* before an election) in supporting the interests of particular interest groups or constituencies. Direct or indirect campaign contributions may also affect politicians' decisions regarding tax policy (Olofsgard, 2003) and in particular the choice of targeted tax provisions. As argued by Alt *et al.* (2008), contributions by business can persuade politicians to grant special tax treatments, even when these provisions are not the voters' most preferred policy. Furthermore, existing tax concessions may be difficult to remove due to firms' willing to contribute enough to persuade politicians to maintain these reliefs, even when they did not contribute to creating the policy in the first place.

4.3. Transparency and accountability

Transparency and accountability of government's decisions may also play a crucial role in the design and implementation of base-broadening measures. In democratic societies, it is ultimately up to the voters to determine the extent and nature of the government intervention. Governments and politicians need to be accountable to citizens (voters) in particular for the effective and efficient use of public resources and the collection of taxes.[2]

Voters' lack of understanding of the tax system and its elements may allow politicians to pursue their own agendas; and these may not be always in line with voters' preferences (Alt *et al.*, 2008). This imperfect information may induce voters and other political parties to block "good" tax policy reforms. However, there is a limit to how well-informed one can

expect the electorate to be for the purpose of holding the government to account and ensuring good quality tax policy. In general, voters lack the information and skills needed to understand and evaluate tax policy alternatives. Moreover, collecting information about each policy is unlikely to be worthwhile for a voter who has virtually no chance of affecting election outcome (Downs, 1957).

For example, Alt *et al.* report that in general politicians are unwilling to broaden the VAT base to include "essential" items because of the unpopularity of such measures. The main cause of this unpopularity is the imperfect information on the potential positive revenue and redistributional impact of these base-broadening measures.[3] A consultation may then contribute to improving information sharing and getting stakeholders support (see section on timing considerations).

Improvements in transparency and public understanding may help not only increase public support to particular reforms, but also policy visibility and government's accountability. This would weaken political incentives to manipulate tax and expenditure policies for purposes of electoral gain. Moreover, systematic assessments of existing policies may enable governments to make well-informed decisions on the ineffective or outdated tax reliefs and expenditures that could be eliminated, while updating those to be retained.

Fiscal information, and in particular a transparent budget process,[4] contributes to greater transparency in tax policy. In general governments provide sufficient documentation to be considered accountable for their choices regarding taxes collected and direct spending, mainly through the budget documentation. However, comprehensive information on spending through the tax system (*i.e.* tax reliefs) is still an area for potential improvement. Tax reliefs have a significant effect on overall tax burdens but also on the budget and fiscal flexibility (due to the opportunity cost in terms of higher tax rates elsewhere, increased deficits and debt, and/or reduced public spending). At the same time, tax reliefs contribute to the growing complexity of the tax system. Unlike spending programmes, it is often unclear who benefits, why and how much. Also, in contrast to direct spending programmes, tax reliefs are not generally submitted to periodic scrutiny.

As summarised in Table 4.1 (see also Chapter 2), many OECD and non-OECD countries produce and publish regularly tax expenditures (TE) reports, which include a list of their main tax reliefs and estimates of the cost of such concessions (in general in terms of tax revenue forgone). Some governments even bring TE reports into the budgetary process. However, systematic, periodic assessments of the effectiveness and efficacy of tax provisions are still exceptions rather than normal practice. Greater transparency of and accountability for tax provisions could be improved by reporting better information on their rationale, objectives and performance (see Chapter 3).

If properly designed and implemented, a TE report makes tax reliefs more transparent by providing information on the government's use of public resources and whether these measures are achieving their intended purposes and designed in the most efficient and effective manner.[5] A TE report also encourages accountability by enabling policymakers and voters (and other political actors) to evaluate individual tax reliefs – in terms of their net social benefit and distributional impact – and make well-informed decisions on whether to eliminate/continue them. Finally, a TE report contributes to the management of budget allocations and the overall fiscal position by estimating the opportunity cost of these reliefs in terms of higher taxes, reduced spending and/or higher deficits.

Table 4.1. **OECD Experience in tax expenditure reporting**

	Purpose and usage	Legal requirement	Relationship to annual budget	Frequency	Estimation method
Australia	Facilitating tax expenditure assessment alongside direct expenditures, contributing to the design of the tax system and informing the public debate.	Legal obligation.	Separate government document.	Annual.	Revenue forgone on an accrual basis. From 2008: some figures on a revenue gain basis.
Austria	Shaping tax reform and facilitating the budget process.	Legal obligation.	Annex as part of a subsidy report (Foerderungsberichte) to budget documents.	Annual.	Revenue forgone on an accrual basis.
Belgium	Informing the Parliament of the impact on revenues of various tax measures.	Legal obligation.	Annex to the budget.	Annual.	Revenue forgone on a cash basis.
Canada	Providing Parliamentarians and the public with information on the estimated cost of tax measures.	No statutory obligation.	Not directly linked to budget, but provides additional background information.	Annual.	Revenue forgone on a cash basis.
Chile	Informing Parliamentarians about the cost of tax expenditures. Providing a mechanism of fiscal transparency with information of objectives, beneficiaries and costs of tax incentives. Evaluating the performance of the tax System and facilitating evaluation of new sources of incomes.	Legal obligation.	Integrated in a separate report (Informe de Finanzas Publicas) that is enclosed to the budget.	Annual.	Revenue forgone on a cash basis.
Denmark	A report is not produced on a regular basis, but information on changes in existing/or introduction of new tax expenditures is provided during the legal process.	No legal obligation.	During the period 1997-2006 the report was included in an appendix to the Budget Proposal (finansloven). From 2010 the parliament will have a yearly technical audit on the status of tax expenditures.	No list published after 2006. A list of new/changed tax expenditures is updated on a yearly basis at the Ministry of Finance webpage.	Revenue forgone.
France	Facilitating the budget process and providing Parliamentarians and the public with information on the estimated cost of tax measures.	Legal obligation.	Annex to the budget bill.	Annual.	Revenue forgone on a cash basis.
Germany	Reducing subsidies and expenditures. Estimates of tax exemptions that are not considered subsidies are also included.	Legal obligation (only for TE on businesses).	Part of Budget called the Subsidy Report.	Every 2 years.	Revenue forgone on a cash basis.

Notes: Korea is revising in 2010 its tax expenditure measurement and reporting system. Information included in the table is reflecting procedures in place before the 2010 review process.
n.a.: information not available.
Sources: National sources; *Fiscal Transparency, Tax Expenditures, and Budget Processes: An International Perspective*, Jon Craig and William Allan, 2004 (mimeo).

Table 4.1. **OECD Experience in tax expenditure reporting** *(cont.)*

	Purpose and usage	Legal requirement	Relationship to annual budget	Frequency	Estimation method
Greece	Providing Parliamentarians and the public with information on tax concessions (list mainly since not many estimates are provided).	Legal requirement.	Separate document which is enclosed to the budget.	Annual.	Revenue forgone on a cash basis.
Italy	Evaluating tax expenditure on the basis of cost, objective criteria and consistency with budget; evaluating effects for particular sectors/geographical areas compared with original aims and being in line with EU tax expenditure policy guidance.	Legal requirement.	Independent document (not linked to budget process or as an Annex to budget document).	Annually a document with the revenue impact of new tax expenditure measures and periodically, since 2008, an internal report with all tax expenditures.	Revenue forgone on an accrual basis.
Japan	Informing the Parliament of the impact on revenues of various tax measures.	No legal obligation.	Separate government document.	Annual.	Revenue forgone.
Korea	Providing information on the reduction of national tax revenues that result from the application of special tax provisions and to manage them more effectively.	Legal requirement from 2010.	Report submitted to the National Assembly but not publicly available. From 2010 will be included in budget documents.	Annual.	Revenue forgone.
Mexico	Providing information on the opportunity areas of each tax, with the purpose to improve them (fairness and neutrality), and recover their revenue potential. It is also important for the fiscal policy analysis and for the transparency on the transfer of resources to the private sector.	Legal obligation.	Separate government document which is published in advance to the Budget documents.	Annual.	Revenue forgone on cash basis.
Netherlands	Providing the Parliament with insight into budgetary cost of tax expenditures and possible budgeting.	No legal obligation.	Annex to the budget memorandum (not directly linked to the budget but serves as additional background information for the parliament).	Annual.	Revenue forgone on a cash basis.
Poland	A report is not produced on regular basis but information on budgetary effects of new tax regulations is provided during the legal process. Currently elaborating a TE report.	No legal obligation.	Some PIT and CIT TE data published in annual reports on settlement of CIT, PIT and lump sum PIT separately.	Annual.	Revenue forgone.
Portugal	n.a.	Legal obligation.	Part of budget.	Annual.	Revenue forgone.
Spain	Providing Parliamentarians and the public with information on the estimated cost of tax measures.	Legal obligation.	Part of budget.	Annual.	Revenue forgone on a cash basis.

Notes: Korea is revising in 2010 its tax expenditure measurement and reporting system. Information included in the table is reflecting procedures in place before the 2010 review process.
n.a.: information not available.
Sources: National sources; *Fiscal Transparency, Tax Expenditures, and Budget Processes: An International Perspective*, Jon Craig and William Allan, 2004 (mimeo).

Table 4.1. **OECD Experience in tax expenditure reporting** *(cont.)*

	Purpose and usage	Legal requirement	Relationship to annual budget	Frequency	Estimation method
Sweden	Facilitating the budget process and providing Parliamentarians and the public with information on the estimated cost of tax measures.	Legal obligation.	Separate government document.	Annual.	Revenue forgone and outlay equivalent.
Switzerland	Taking stock – a counterbalance to the existing subsidy report, which uses a less strict reference law benchmark.	No legal obligation. There is a legal obligation for the less exhaustive subsidy report.	None.	Irregular (the subsidy report normally every six years).	Revenue forgone.
United Kingdom	Facilitating annual budget discussion and debate.	No statutory obligation, but as a recommendation from the Expenditure Committee.	Part of statistical supplement to Autumn Statement (revenue) not linked to budget process or annexed to budget document.	Annual.	Revenue forgone on an accrual basis.
United States	Shaping tax reforms and reducing deficit.	Legal obligation.	Part of annual budget documents. Not integrated into the budget process.	Annual.	Revenue forgone and present value on a cash basis.

Notes: Korea is revising in 2010 its tax expenditure measurement and reporting system. Information included in the table is reflecting procedures in place before the 2010 review process.
n.a.: information not available.
Sources: National sources; *Fiscal Transparency, Tax Expenditures, and Budget Processes: An International Perspective*, Jon Craig and William Allan, 2004 (mimeo).

Government analysis of the impact of a particular base-broadening reform may be reinforced by analysis undertaken by independent bodies. Alt *et al*. (2008) argue that external organisations provide some level of scrutiny and accountability. They maintain that the input of external research organisations could help improve the tax legislation and make it more likely that the economic impact of the tax reform proposals is fully considered. Furthermore, making these external assessments available to the public may also increase the credibility of the impacts of base-broadening reforms and, therefore, reduce uncertainty and increase public support.

4.4. External drivers and constraints

In some circumstances introducing constraints up front, as highlighted in OECD (2010), might help governments to build support for base-broadening reforms. Governments could, for instance, commit to implement only tax reforms that are distributionally neutral, do not lower total tax revenues or that continue to favour some cherished objective (albeit perhaps in a different way).

However, setting up front constraints regarding some of the key tax objectives might imply that some (Pareto-efficient) tax reforms are not considered because they are not in accordance with one of these constraints. Ackerman and Altshuler (2006) argue that it is nearly impossible to design a tax reform that reduces the tax rates financed by base-broadening measures that is both revenue and distributionally neutral. They argue that although imposing up front constraints on the tax reform process can be beneficial, the trade-off is a greater likelihood that the reform that actually is implemented will consist of tax changes that do not dramatically reform the tax system. Policymakers need therefore to be careful in setting too strong constraints up front because they could dictate the outcome of any tax reform effort.

Base-broadening reforms may also be easier to legislate and implement when governments face pressures to raise more tax revenues in order to strengthen the public finances. Thus the need to reduce budget deficits following the financial crisis and recession may provide an opportunity for base-broadening reforms. The urgent need of tax revenues might undermine the power of vested interest groups and reduce political and public opposition by changing views of what is "good" tax policy. The current fiscal imbalances have also reinforced the need to undertake periodic assessments of existing policies. This may enable governments to make well-informed decisions on the ineffective or outdated policy measures that need to be eliminated (see section on politicians' views and use of tax policy). On the other hand, the crisis might make these reforms even more difficult to implement, especially because large groups of taxpayers have and will be strongly negative affected by the adverse economic situation (OECD, 2010).

International constraints (*e.g.* coming from the IMF or the European Commission) may also help introduce unpopular tax reforms with reduced political costs because they may reduce the possibility of burden shifting across political groups and the delay of the reform (Alesina and Drazen, 1991). For example, EU binding legislation (like the VAT Directive) may help broadening moves of the VAT base, since the derogations for reduced rates granted to Member States which joined the EU before 1 January 1995 are currently only valid until the end of 2010. Decisions rendered by the European Court of Justice on discrimination issues related to particular tax reliefs and the EU rules on State Aid to avoid distortions on competition are other examples of these international constraints.

On the other hand, it is often argued that special tax reliefs are introduced in response to tax competition. These incentives may be seen as necessary where similar reliefs are being offered by a neighbouring jurisdiction also competing for mobile foreign capital or high-skilled labour force; the so-called "neighbour effect" (see Chapter 1). These reliefs are, however, likely to give windfall benefits to large amounts of intra-marginal investment and create significant tax revenue losses. When deciding on whether to provide reliefs and how much relief to provide, governments are then encouraged to evaluate the cost-effectiveness of these incentives and of different alternative policy instruments such as direct spending or market regulation.

4.5. Distributional effects

Public perceptions of the effects on income distribution of base-broadening measures or the way that these effects are reported by the media may be key to getting public acceptance of reforms. In particular, effects on the real income of poorest households and/or the distribution of income between rich and poor may be decisive on getting voters' support.

Base-broadening measures may be seen as unfair and, therefore, unpopular in particular because of the uncertainly and/or lack of information about their distributional impact. This perception of unfairness may thus explain tax policy moves away from efficiency towards more emphasis on income distribution considerations,[6] seeking particular electoral interests and voter behaviour. Political support may be sought by identifying the winners and losers and compensating for, when necessary, the negative impact on income distribution.

Ashworth and Heyndels (2001) explain that targeted tax provisions are a tool to serve particularly swing voters and special interest groups. The underlying rationale for this is linked to the fact that the benefits from these reliefs can be targeted to these groups while the costs – the reduction in overall tax revenue or higher tax rates – are difficult to identify because may be spread over all taxpayers and over time. While there are good arguments for introducing targeted tax provisions in some cases, the politicians that introduce these reliefs do not necessarily internalize all the cost of these concessions. This political economy process then leads to higher levels of tax reliefs instead of broader tax bases.

When benefits and costs are diffuse (in revenue neutral reforms), there is a lower probability that new interest groups will be formed and, therefore, a base-broadening reform may be easier to implement (Barbaro and Suedekum, 2006). Tax reforms that split the burden of forgone tax privileges evenly among many groups in society or, alternatively, that compensate the losers for their large loss (symmetric reforms), are politically more feasible than asymmetric tax reforms where the winners and losers are not the same individuals.

A cut in tax reliefs might hurt a relatively small group of taxpayers strongly while a large group would be affected positively. Assuming a revenue neutral tax reform, the individual gains of the latter group might however be small and have therefore no impact on their voting behaviour. The group of taxpayers that loses strongly faces a strong incentive to lobby hard against the tax reform. Lobbing may include exert a political influence either directly through their ability to block enactment of the reform within the parliament or indirectly through the ability to influence politicians to choose for the *status quo* instead of launching a tax reform proposal (Olofsgard, 2003). In contrast, the winners of tax reform are indeed often silent, in particular when the abolition of these tax reliefs leads only to a small reduction in total taxes for most taxpayers (OECD, 2010).

In addition, targeted tax provisions may be in particular implemented when a tax policy reform is biased towards measures that favour influential lobby groups. This may be particularly the case when these interest groups contribute directly or indirectly to politicians' election campaigns; for example, when these special interest groups consist of swing voters that have an influence on the outcome of the next election (Olofsgard, 2003), or when different groups of taxpayers face different transaction (lobbying) costs (Holcombe, 1998).

The introduction of some tax reliefs may also be explained by the need of politicians to reform the tax system in order to signal to voters that they care about taxpayers' welfare. This might give rise to a sequence of incremental tax reforms that try to create "winners" without making "losers". By reforming for the sake of reforming, however, politicians might not take into account the long-term implications of these reforms, as for instance the negative impact on future tax revenues and the fact that tax complexity might breed further tax complexity (Bradford, 1999). This process also entails the risk of making the tax system more complex without tackling the underlying economic problems and tax issues in the most efficient way (OECD, 2010).

Some economic studies support this theory that targeted tax reliefs may be implemented in certain cases to allow politicians to highlight redistribution objectives, regardless of the inefficiencies that they may create (Myerson, 1993; Lizzeri and Persico, 2001, 2004 and 2005; Crutzen and Sahuguet, 2009). As suggested by Castanheira and Valenduc (2006), this may explain for instance the use of special tax exemptions for small and medium-sized enterprises in Belgium to promote their activity and address some of their liquidity constraints, despite that some empirical studies (*Conseil supérieur des finances,* 2001; De Mooij and Nicodème, 2008) have suggested that these reliefs are significantly encouraging businesses to incorporate just for tax purposes.

4.6. Framing and packaging a reform

The success of base-broadening reforms may also depend on the government's capacity to frame tax reforms in different areas in order to provide a broad set of reform measures making clear that there is give and take across different population groups. In particular, a base-broadening reform would be more acceptable if the tax system is seen as a *system* rather than to consider its different elements in isolation (Alt *et al.*, 2008) and when accompanied by a tax reduction (Stliglitz, 2002). Furthermore, the framing or bundling of tax policy measures may help not only inform taxpayers about the interconnectedness of the tax system, but also reduce lobby's arguments against a particular element of a base-broadening tax reform.

The need for tax policy framing particularly applies to base-broadening reform efforts because of the important equity concerns that these reforms often entail. A reform package that generates a lot of inter-group redistribution compared to the size of expected efficiency gains is likely to be politically more sensitive and feasible (Rodrik, 1996). When elements are viewed in isolation, the *status quo* may be seen as genuinely redistributive in relative terms, which may prevent voters from supporting the reform (see also section on politician's views and use of tax policy). This is for instance the case when the costs of a reform package may be immediately perceived – *e.g.* eliminating of VAT zero-rating for children's clothing – while the benefits may be not immediately apparent – *e.g.* increasing the child benefits (Alt *et al.*, 2008).

The importance of including significant changes to the VAT (particularly those involving the removal of reduced rates) within a wider reform package may be illustrated by the 2004 tax reform in the Slovak Republic. Framing the move to a uniform VAT within other reforms intended to neutralise the equity impact of uniformity, including increased generosity of in-work support, was identified as a key element for the success of this reform.[7]

Framing also helped the implementation of a PIT base-broadening-tax cutting reform in Denmark in 2009, whose main objective was to reduce the relative high top marginal income tax rates. Distributional issues were accommodated by offering targeted special concessions to groups of taxpayers within a broad income range. Other factors facilitating the legislation of this reform were its announcement well in advance and that the reform, and especially the financing of the reform, has been phased in gradually so that tax cuts exceed financing during the first years of reform (*source:* paper presented to the OECD WP2, 2009).

A comprehensive ("big bang") approach to tax reform, where different taxes are reformed at the same time, may also facilitate the introduction of base-broadening reforms (see for example Olofsgard, 2003; and OECD, 2010). This was for example the case of the 1986 reform in the United States and the 1990-91 reform in Sweden.[8]

Bundling tax reforms that are *a priori* not necessary related may also help obtain political support in the process of building a coalition to make reforms politically feasible. Deferral/acceleration of some aspects of the reform may also play a crucial role in this coalition process (see section on timing considerations).

Moreover, the framing of tax policy debates may be crucial (Alt *et al.*, 2008) in base-broadening efforts. In particular, allowing the tax reform discussion to only focus on a particular good in isolation or on a particular tax only could enforce the public's lack of understanding of the overall effects of a particular reform. For example, broadening the VAT base might be difficult to achieve if the tax policy debate frames the discussion of VAT reduced rates on particular goods in isolation, for example on children's clothing. This may for instance explain the historical zero-rated VAT on children's clothing maintained in the United Kingdom, as in many other countries. Lobby groups might have an incentive to frame particular tax policy reforms in isolation, but this approach might not be in the interest of the general public.

Furthermore, as suggested by Zelinsky (2005) and Kleinbard (2010), many voters and policymakers are susceptible to "framing effects" in which the outcome to a policy question is presented. In particular, opponents to the repeal of a given tax relief would deliberately defend the existing tax concession by framing its elimination as a "tax increase". In contrast, the introduction of new tax reliefs are often framed in a way that policymakers and the public are unaware that they are actually making a choice between alternative policy options; in particular between a tax relief and a direct government outlay.

Framing the distributional impact of base-broadening reforms may also make them easier to legislate and implement (see section on distributional effects). There is a lower probability that new interest groups would be formed when the same individuals gain and lose as a result of a particular reform process (Barbaro and Suedekum, 2006).

4.7. Timing considerations

The proper timing of every phase of the tax reform may be important in base-broadening reforms. Timing considerations include allowing a period to obtain political support (within and among parties) before the reform is announced, assessing the

"right" moment to publicly announce it, establishing a consultation period, assessing and anticipating implementation needs, etc.

However, evidence suggests that is hard to define the "right timing" for base-broadening reforms. Quick and simultaneous reforms have been proven to be the best in some cases, while extensive consultation periods and a sequential implementation and/or phasing in have been key elements of success in other cases.

For example, an extensive consultation and adaptation period with the business community was identified as a key element of the successful move to a uniform VAT (so-called Goods and Services Tax) in New Zealand (1984 tax reform). Additionally, an extensive public relations programme aimed at informing taxpayers was also undertaken under the auspices of the Goods and Services Tax Coordinating Office. The 1984 reform in New Zealand may also illustrate that the timing of tax reforms may be facilitated during economic, political or social difficult periods. It could be argued that an important factor in the acceptance of the uniform VAT reform in New Zealand in 1984 was the desperate need of reforms due to a difficult political situation. These circumstances might also have contributed to reduce opposition by making the reform happen quicker. However, this cannot be generalised since it could be also the case that crisis might make reforms even more difficult to implement, in particular when a large group of taxpayers need to be compensated by the adverse effects of economic downturns (see section on external drivers and constraints).

Introducing tax changes gradually, in contrast to quick and simultaneous reforms, may help get political support in some cases; *e.g.* a progressive increase in the tax rate of previously untaxed income sources. This was, for example, an important element in the success of some income base-broadening moves in the United Kingdom, in particular the phased removal of the married couples allowance (1999 tax reform) and the mortgage interest tax reliefs (2000 tax reform). The gradual phasing out of these special tax privileges and the implementation during a period when it was feasible to cut/rationalise other taxes undoubtedly contributed to make them politically feasible (Alt *et al*., 2008).

Governments might also allow for grandfathering rules, which implies that changes in tax rules would not apply to some existing situations and that would only apply to future situations (in general after the reform has been legislated and/or implemented). This strategy might be considered in particular if agents no longer have the opportunity to adjust their behaviour in response to the new tax rules because they are, for instance, already retired and have therefore no longer the opportunity to work longer. However, grandfathering rules that are not well-targeted may reduce the gains that may be realised by reforming the tax system, for instance because agents defer their change in behaviour until the new tax rules come into force. Moreover, grandfathering rules may also increase the complexity of the tax code, which would result in increased compliance and enforcement costs and they might reduce the tax revenues gains of these reforms. The old rules might possibly be phased out over time, implying that after a number of years only one set of tax rules will apply. Government would then have to decide upon a proper length of this phase-out phase (OECD, 2010).

The mere announcement of the introduction of a new tax incentive might have an impact on agents' behaviour before the provision is actually implemented. The announcement of the elimination of an investment tax credit might, for example, encourage economic agents to change their investment decisions before the provision is

abolished. While such anticipatory effects may be welcome in some circumstances, this may not always be the case (*e.g.* changes in taxes on capital gains can have large effects on when gains are realised). These announcement effects might therefore create obstacles to the implementation of pro-growth tax reforms, especially if government cannot implement the tax reform immediately, for instance because the tax administration has to make changes to the way it works, has to collect additional data, etc.

The announcement of the abolition of certain provisions may also encourage the mobilisation of groups of "losers" to lobby hard against this change. In some cases, therefore, postponing tax reforms announcements until economic analyses are conducted may facilitate the reform process by preparing politicians for criticism and opposition and helping the government to obtain the political support needed for the legislation process.

Temporary tax provisions may also be beneficial in particular circumstances. However, preferential tax treatments may be difficult to remove after having being implemented for a period of time (see section on politicians' views and use of tax policy). Expiry sunset clauses imposed on temporal tax concessions signal the temporary nature of the special tax reliefs and may contribute to reduce pressures from lobby groups to extend such tax privileges. At the same time, they enable governments to reconsider the temporal tax measure, ideally after a cost-effectiveness evaluation.

4.8. Leadership

In some cases a strong political leader(s), who is prepared to put their reputation on the line, may facilitate base-broadening moves by overcoming the *status quo* bias. A strong political will exemplified by one or more political champions has been sometimes considered as an essential requirement for a successful tax reform (Bird, 2004). Political champions would have typically built a reputation during their political career of being good reformers. This reputation may help to reduce uncertainty, which would very likely increase the political and public support for a particular tax reform.

However, the charisma of politicians and the political mood are also considered to be key variables to attract swing voters (Lindbeck and Weibull, 1987; Dixit and Londregan, 1998), and may explain why similar tax reforms are often proposed (and implemented) by both left- and right-wing parties. In general, these swing voters are the individuals more ideologically neutral, whose votes can be more easily influenced by a policy targeted in their favour (see section on politicians' views and use of tax policy).

4.9. Conclusion

A strong economic case may be a necessary but not sufficient condition for successfully legislating and implementing base-broadening reforms. Political and distributional considerations may tend to tip governments' choices towards targeted tax reliefs.

Special tax concessions may be particularly attractive to politicians when they see tax policy as primarily a policy instrument to win elections. The use of the tax system for expenditure purposes may allow politicians to target benefits to particular groups of taxpayers in a very visible manner, while at the same time leaving uncertain the political accountability of the costs that are associated with these reliefs (in terms for example of higher tax rates of other taxes or decreased tax revenues). This is particularly the case when taxpayers do not have access to clear information and/or cannot understand specific government tax policy measures. More transparent budget processes and framing tax

measures to highlight the overall positive or neutral impact on income distribution may then help to get the needed public and political support to make base-broadening measures to happen.

Other obstacles to the legislation and implementation of base-broadening reforms are often the lobbying of influential interest groups, presenting policy discussions on the abolition of a given tax relief in isolation (rather than as part of a wider package of measures). However, there are also cases in which political and distributional elements may likely contribute to the success of base-broadening reform efforts; for example, the need of tax revenues or the existence of international constraints.

In addition, choosing the right timing for a base-broadening reform and the drive of a strong political leader may increase the support for base-broadening reforms. Evidence shows however that successful base-broadening reforms do not suggest a clear and general timing pattern in terms of the pace and sequence of the announcement (including consultation periods), legislation or implementation of a particular reform. And that the charisma of politicians and the political mood has also often been used as an instrument to attract votes by offering special tax concessions.

Notes

1. Alt, Preston and Sibieta (2008) argue that external organisations provide some level of scrutiny and accountability. They argue that the input of external advising organisations could help improving the tax legislation and make it more likely that the economic impact of the tax reform proposals are fully thought through.
2. In the last few years, research has drawn the attention of the international development community towards taxation as a fundamental part of the process for constructing effective states and markets. This would allow an "exit from aid". An effective state requires a political settlement among elites to collect revenues. That agreement then enables a social contract between the state and its population to pay taxes in return for delivering basic freedoms and essential public goods. There remain many countries in the world where the tax system fails to meet this basic goal. The international community is now devoting more effort to dealing with these failures (see for example Everest-Phillips, 2010; *www.oecd.org/tax/globalrelations*).
3. For example, the Institute for Fiscal studies in the United Kingdom shows that eliminating reduced VAT rates in the UK would raise about GBP 23 billion. Using GBP 12 billion of this revenue to increase means-tested benefit and tax credit rates by 15% would leave the poorest three deciles of the population better off (Crawford *et al.*, 2008).
4. "Transparency – openness about policy intentions, formulation and implementation – is a key element of good governance. The budget is the single most important policy document of governments, where policy objectives are reconciled and implemented in concrete terms. Budget transparency is defined as the full disclosure of all relevant fiscal information in a timely and systematic manner" – OECD *Best Practices for Budget Transparency*, OECD *Journal on Budgeting* 1(2):7-14, Paris, 2002.
5. Since the classification of a particular provision as a tax expenditure may have some elements of judgement (see Chapter 2), including in the TE report the list (and if possible estimates) of special tax concessions that could be or could be not considered TEs depending on these judgements, for example as miscellaneous, is a good practice on government's transparency and accountability.
6. See Castanheira, Galasso *et al.* (2006) for case studies in various sectors and countries.
7. The Slovak Republic unified its two VAT rates in 2004; however a reduced rate was reintroduced in 2007.
8. For an evaluation of the 1990-91 tax reform in Sweden see Agell *et al.* (1998).

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ANNEX A

Revenue Forgone Estimates of Main Tax Expenditures in OECD Countries

This Annex presents tax expenditure (TE) data for 20 OECD countries: Australia, Austria, Belgium, Canada, Denmark, France, Germany, Greece, Italy, Korea, Mexico, the Netherlands, Norway, Poland, Portugal, Spain, Switzerland, Turkey, the United Kingdom and the United States.

Limitations to international comparability

It is recommended that data included in this Annex be used only for country-specific analysis. International comparability of TE estimates is significantly limited for several reasons, including:

1. Tax expenditure definitions differ across countries due to differences in the definition of their benchmark tax systems. Factors that have an impact on the choice between a broad base and use of tax expenditures include own country's preferences regarding income redistribution, the strength of its tax administration, and its tax revenue requirements. Most, if not all, of these factors differ across countries, making international comparison more difficult.
2. As many tax provisions are formulated as deductions, the value of tax expenditures typically depends on the level of the marginal tax rates. Therefore some differences in tax expenditure values across countries may reflect different statutory rates rather than divergences in the number and extent of provisions (the higher the tax rate, the larger the measured tax expenditure).
3. While some countries report TE estimates for all levels of governments, others only report those related to central government.
4. Countries vary in the coverage and detail of TE estimates that were reported in the OECD questionnaire. Many countries reported main TE values, *i.e.* those which correspond to the 80% of the total TE estimates. However, others only provided values for the largest 20 TE.

Limitations of revenue forgone estimates

Revenue forgone estimates provide a figure of the loss in government revenue incurred by a tax expenditure, holding all other factors constant.

For each country, this Annex presents aggregate values of tax expenditure estimates within each tax category. However, each tax expenditure is estimated in isolation; that is, without taking into account interactions between different tax expenditures or between

the tax expenditure and the tax system in general. It should be highlighted therefore that *aggregate TE figures do not provide an estimate of the total revenue gain* if all TE were simultaneously removed.

For a particular TE, moreover, revenue forgone estimates do not reflect the actual amount of revenues that would be raised if that tax expenditure were repealed for two additional reasons:

- Revenue forgone estimates tend to overestimate the direct revenue gain from eliminating an incentive by not taking into consideration behavioural effects.
- If an abolished relief is still provided retroactively (*e.g.* for investment already undertaken, or for expenditures already committed to), grandfathered, or replaced by direct spending, then clearly the revenue loss associated with current activity cannot be taken as a measure of potential revenue gains.

Table A.1. **Main tax expenditures in Australia**[1]

Country	Australia
Year	Fiscal year 2006-07 (from 1st July)
From *OECD Revenue Statistics*: (millions AUD)	
GDP	1 088 795.5
PIT revenues	119 793.0
CIT revenues	69 585.0
VAT revenues	41 208.0
Sum (PIT, CIT, VAT)	230 586.0
Total tax revenues	320 287.0

PIT

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Capital gains tax discount for individuals and trusts	7 420.0	0.68	6.19	3.22	2.32
Exemption of family tax benefit, Parts A and B, including expense equivalent	2 510.0	0.23	2.10	1.09	0.78
Concessional taxation of non-superannuation termination benefits	1 550.0	0.14	1.29	0.67	0.48
Application of statutory formula to value car benefits	1 500.0	0.14	1.25	0.65	0.47
Senior Australians' tax offset	1 160.0	0.11	0.97	0.50	0.36
Tax offset for recipients of certain social security benefits, pensions or allowances	1 150.0	0.11	0.96	0.50	0.36
Exemption of 30 per cent private health insurance refund, including expense equivalent	980.0	0.09	0.82	0.43	0.31
Exemption of certain income support benefits, pensions or allowances	970.0	0.09	0.81	0.42	0.30
Superannuation – deduction and concessional taxation of certain personal contributions	790.0	0.07	0.66	0.34	0.25
Deduction for gifts to approved donees	710.0	0.07	0.59	0.31	0.22
Exemption from the medicare levy for residents with a taxable income below a threshold	650.0	0.06	0.54	0.28	0.20
Mature age worker tax offset	510.0	0.05	0.43	0.22	0.16
Superannuation – measures for low-income earners	510.0	0.05	0.43	0.22	0.16
Capped exemption for public benevolent institutions (excluding public hospitals)	430.0	0.04	0.36	0.19	0.13
Tax offsets for dependent spouse, child-housekeeper and housekeeper who cares for a prescribed dependant	430.0	0.04	0.36	0.19	0.13
Exemption of child care benefit	400.0	0.04	0.33	0.17	0.12
Medical expenses tax offset	355.0	0.03	0.30	0.15	0.11
Exemption of payments made under the first home owners grant scheme	315.0	0.03	0.26	0.14	0.10
Exemption for certain payments to approved worker entitlement funds	290.0	0.03	0.24	0.13	0.09
Tax offset for child care	290.0	0.03	0.24	0.13	0.09
Capped exemption for certain public and non-profit hospitals	260.0	0.02	0.22	0.11	0.08
Exemption of certain war-related payments and pensions	240.0	0.02	0.20	0.10	0.07
Exemption for eligible work-related items	210.0	0.02	0.18	0.09	0.07
Zone tax offsets	200.0	0.02	0.17	0.09	0.06
Exemption of the baby bonus	185.0	0.02	0.15	0.08	0.06
Deduction for donations to prescribed private funds	160.0	0.01	0.13	0.07	0.05
Superannuation – concessional taxation of unfunded superannuation	160.0	0.01	0.13	0.07	0.05
Exemption for certain fringe benefits provided to religious practitioners	135.0	0.01	0.11	0.06	0.04
Capped taxation rates for lump sum payments for unused recreation and long service leave	130.0	0.01	0.11	0.06	0.04
Exemption for remote area housing and reduction in taxable value for remote area housing assistance	90.0	0.01	0.08	0.04	0.03
Medicare levy exemption for non-residents, repatriation beneficiaries, blind pensioners and foreign government representatives	80.0	0.01	0.07	0.03	0.02

PIT *(cont.)*

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Taxation of five per cent of unused long service leave accumulated by 15 August 1978	80.0	0.01	0.07	0.03	0.02
Exemption for free or discounted commuter travel for employees of public transport providers	60.0	0.01	0.05	0.03	0.02
Exemption for certain benefits received by Australian government employees in receipt of military compensation payments	50.0	0.00	0.04	0.02	0.02
Partial rebate for certain non-profit, non-government bodies	50.0	0.00	0.04	0.02	0.02
Exemption from the medicare levy for Australian Defence Force members and their relatives and associates	50.0	0.00	0.04	0.02	0.02
Exemption of pay and allowances earned by members of the Australian Defence Force in operational areas	49.0	0.00	0.04	0.02	0.02
Exemption of pay and allowances for part-time Australian Defence Force Reserve personnel	40.0	0.00	0.03	0.02	0.01
Capped exemption for charities promoting the prevention or control of disease in human beings	35.0	0.00	0.03	0.02	0.01
Tax offsets for taxpayers supporting a parent, parent-in-law, or invalid relative	35.0	0.00	0.03	0.02	0.01
Exemption of utilities allowance and seniors' concession allowance	30.0	0.00	0.03	0.01	0.01
Exemption of the first child tax offset (baby bonus)	26.0	0.00	0.02	0.01	0.01
Release from particular tax liabilities in cases of serious hardship	21.0	0.00	0.02	0.01	0.01
Discounted valuation for car parking fringe benefits	20.0	0.00	0.02	0.01	0.01
Discounted valuation of stand-by travel for airline employees and travel agents	18.0	0.00	0.02	0.01	0.01
Exemption for small business employee car parking	16.0	0.00	0.01	0.01	0.00
Capital gains tax discount for investors in listed investment companies	15.0	0.00	0.01	0.01	0.00
Exemption of income from certain educational scholarships, payments to apprentices or similar forms of assistance	15.0	0.00	0.01	0.01	0.00
Superannuation – spouse contribution offset	15.0	0.00	0.01	0.01	0.00
Exemption of rent subsidy payments under the Commonwealth/state mortgage and rent relief schemes	11.0	0.00	0.01	0.00	0.00
Exemption from income tax and medicare levy of residents of Norfolk Island	7.0	0.00	0.01	0.00	0.00
Exemption of certain allowances and bounties and the value of certain rations and quarters to Australian Defence Force personnel	7.0	0.00	0.01	0.00	0.00
Income averaging for authors, inventors, performing artists, production associates and sportspersons	7.0	0.00	0.01	0.00	0.00
Exemption for certain benefits provided under the Defence Service Homes Act	6.0	0.00	0.01	0.00	0.00
Exemption for structured settlements and structured orders	6.0	0.00	0.01	0.00	0.00
Exemption for free or discounted travel to and from duty by police officers on public transport	5.0	0.00	0.00	0.00	0.00
Capital gains tax scrip-for-scrip roll-over relief	4.0	0.00	0.00	0.00	0.00
Tax offset on certain payments of income received in arrears	3.0	0.00	0.00	0.00	0.00
Deduction for contributions with an associated minor benefit	3.0	0.00	0.00	0.00	0.00
Discounted valuation for board fringe benefits	2.0	0.00	0.00	0.00	0.00
Deduction for expenses incurred by election candidates	2.0	0.00	0.00	0.00	0.00
Exemption of post-judgment interest awards in personal injury compensation cases	2.0	0.00	0.00	0.00	0.00
Deduction for payment of united medical protection limited support payments	1.0	0.00	0.00	0.00	0.00
Threshold for the deductibility of self-education expenses	–9.0	0.00	–0.01	0.00	0.00
Increased tax rates for certain minors	–18.0	0.00	–0.02	–0.01	–0.01
Superannuation – tax on funded lump sums relating to pre-July 1983 service	–30.0	0.00	–0.03	–0.01	–0.01
Part-year tax free threshold	–40.0	0.00	–0.03	–0.02	–0.01
Superannuation – tax on funded lump sums relating to post-June 1983 service	–160.0	–0.01	–0.13	–0.07	–0.05
Medicare levy surcharge on income earners who do not hold private health insurance	–330.0	–0.03	–0.28	–0.14	–0.10
PIT total	**24 874.0**	**2.28**	**20.76**	**10.79**	**7.77**

CIT

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Superannuation – concessional taxation of superannuation entity earnings	12 750.0	1.17	18.32	5.53	3.98
Superannuation – concessional taxation of employer contributions	9 400.0	0.86	13.51	4.08	2.93
Superannuation – capital gains tax discount for funds	1 550.0	0.14	2.23	0.67	0.48
Income tax exemption for municipal authorities and other local governing bodies	700.0	0.06	1.01	0.30	0.22
Off-market share buy-backs	660.0	0.06	0.95	0.29	0.21
Small business capital gains tax 50 per cent reduction	405.0	0.04	0.58	0.18	0.13
Research and development tax concession	390.0	0.04	0.56	0.17	0.12
Income tax exemption for registered health benefit organisations	240.0	0.02	0.34	0.10	0.07
Statutory effective life caps	230.0	0.02	0.33	0.10	0.07
The simplified tax system	230.0	0.02	0.33	0.10	0.07
Accelerated depreciation for mining buildings	220.0	0.02	0.32	0.10	0.07
Capital gains tax small business retirement exemption	200.0	0.02	0.29	0.09	0.06
Premium tax concession for additional research and development expenditure	180.0	0.02	0.26	0.08	0.06
25 per cent entrepreneurs' tax offset	130.0	0.01	0.19	0.06	0.04
Capital gains tax roll-over for small business	120.0	0.01	0.17	0.05	0.04
Exemption from non-commercial losses provisions (primary producers and artists)	100.0	0.01	0.14	0.04	0.03
Valuation of livestock from natural increase	90.0	0.01	0.13	0.04	0.03
Depreciation pooling for low value assets	80.0	0.01	0.11	0.03	0.02
Farm management deposit scheme	75.0	0.01	0.11	0.03	0.02
Income tax averaging for primary producers	65.0	0.01	0.09	0.03	0.02
Small business capital gains tax exemption for assets held more than 15 years	55.0	0.01	0.08	0.02	0.02
Capital gains tax roll-over for transfer of public sector superannuation fund assets to pooled superannuation trust	50.0	0.00	0.07	0.02	0.02
Capital protected borrowings	35.0	0.00	0.05	0.02	0.01
Three year write-off for expenditure on water facilities for primary producers	30.0	0.00	0.04	0.01	0.01
Income tax exemption for certain promotion and development not-for-profit societies	25.0	0.00	0.04	0.01	0.01
Capital expenditure deduction for mining, quarrying and petroleum operations	20.0	0.00	0.03	0.01	0.01
Accelerated depreciation for software	20.0	0.00	0.03	0.01	0.01
Extension to the capital gains tax roll-over relief for statutory licenses	20.0	0.00	0.03	0.01	0.01
Income tax exemption for certain not-for-profit societies	15.0	0.00	0.02	0.01	0.00
Infrastructure bonds scheme	15.0	0.00	0.02	0.01	0.00
Deduction of the capital cost of telephone lines and electricity connections	15.0	0.00	0.02	0.01	0.00
Income tax exemption for trade unions and registered organisations	10.0	0.00	0.01	0.00	0.00
Capital gains tax concession for carried interests paid to venture capital managers	10.0	0.00	0.01	0.00	0.00
Deduction for environmental protection activities	10.0	0.00	0.01	0.00	0.00
Development allowance	10.0	0.00	0.01	0.00	0.00
Concessional tax treatment for pooled development funds	8.0	0.00	0.01	0.00	0.00
Land transport infrastructure borrowings tax offset scheme	5.0	0.00	0.01	0.00	0.00
Accelerated depreciation for grapevine plantings	5.0	0.00	0.01	0.00	0.00
Film licensed investment company scheme – two year extension	4.0	0.00	0.01	0.00	0.00
Tax write-off for horticultural plants	4.0	0.00	0.01	0.00	0.00
Deductions for boat expenditure	–4.0	0.00	–0.01	0.00	0.00
Accelerated depreciation for Australian trading ships	–8.0	0.00	–0.01	0.00	0.00
Forestry managed investments – prepayment rule	–10.0	0.00	–0.01	0.00	0.00
Tax incentives for film investment	–13.0	0.00	–0.02	–0.01	0.00
Exemption of refundable research and development tax offset payments	–65.0	–0.01	–0.09	–0.03	–0.02
Accelerated depreciation allowance for plant and equipment	–840.0	–0.08	–1.21	–0.36	–0.26
CIT total	**27 241.0**	**2.50**	**39.15**	**11.81**	**8.51**

1. Australia does not list tax expenditures according to PIT, CIT or VAT categories. For the purpose of this Report, the PIT and CIT list was derived. However, not all of the large tax expenditures can be related to the PIT or CIT categories. Tax Expenditures in Australia are classified by broad economic functions, by type of taxpayer affected, and by the particular benchmark to which they relate.

Tax expenditures were classified as PIT if they were measured against the personal income benchmark or CIT if they were measured against the business income benchmark.

For tax expenditures measured against another specific benchmark category (for example, the retirement income or capital gains), they were classified as PIT or CIT tax expenditures after a review of the concession. Some tax expenditures benefit both individuals and companies therefore their classification into a PIT and CIT category was difficult. In these circumstances, the classification applied was based on whether individuals or companies derived, on average, most of the benefit from the concession (please note, in many cases the distinction between PIT and CIT was very arbitrary).

The Australian *Tax Expenditure Report* only reports tax expenditures that relate to Australian Government taxes. The Goods and Services Tax (that is, the GST – Australia's VAT) was not reported as an Australian Government tax in the period up to the *Pre-Election Fiscal and Economic Outlook 2007*, therefore the consumption tax benchmark in the 2007 TE did not include the GST. In the 2008-09 Budget the GST was included as an Australian Government Tax for the first time. As a result, GST is reported under the consumption tax benchmark from the 2008 TE.

Table A.2. **Main tax expenditures in Austria**[1]

Country	Austria
Year	2006
From *OECD Revenue Statistics*: (millions EUR)	
GDP	257 294.5
PIT revenues	24 006.0
CIT revenues	5 625.1
VAT revenues	19 756.7
Sum (PIT, CIT, VAT)	49 387.8
Total tax revenues	107 585.7

PIT

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Flat rate taxation of leave and Christmas bonus	5 300.0	2.06	22.08	10.73	4.93
Preferential treatment of severance and other non-regular pays	250.0	0.10	1.04	0.51	0.23
"Special expenses"	530.0	0.21	2.21	1.07	0.49
Average rate taxation	200.0	0.08	0.83	0.40	0.19
F&E and education allowances	200.0	0.08	0.83	0.40	0.19
F&E tax credits	241.0	0.09	1.00	0.49	0.22
Tax credit for investment increments	238.0	0.09	0.99	0.48	0.22
Apprentices training tax credit	134.0	0.05	0.56	0.27	0.12
Tax credit (premium) for building banks investments	119.0	0.05	0.50	0.24	0.11
Tax exempt supplements for overtime and hard/dangerous work	770.0	0.30	3.21	1.56	0.72
Different exemptions	300.0	0.12	1.25	0.61	0.28
Other tax expenditures	198.0	0.08	0.82	0.40	0.18
PIT total	**7 212.0**	**2.80**	**30.04**	**14.60**	**6.70**

CIT

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Pay-outs of (life) insurance companies	250.0	0.10	4.44	0.51	0.23
Tax allowance for public welfare corporations	5.0	0.00	0.09	0.01	0.00
Different exemptions	n.a.				
Tax-free profits from international holdings	n.a.				
CIT total	**255.0**	**0.10**	**4.53**	**0.52**	**0.24**

1. Austria does not report revenue forgone estimates for VAT tax expenditures.
n.a.: not available.

Table A.3. **Main tax expenditures in Belgium**

Country	Belgium
Year	2005
From *OECD Revenue Statistics*: (millions EUR)	
GDP	302 112.0
PIT revenues	41 199.7
CIT revenues	10 435.3
VAT revenues	21 481.5
Sum (PIT, CIT, VAT)	73 116.5
Total tax revenues	135 186.8

PIT

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Social benefits – Pensions	2 026.0	0.67	4.92	2.77	1.50
LT – investment and housing – Housing-saving (insurance premiums and mortgage capital repayments)	894.0	0.30	2.17	1.22	0.66
Tax-exempt savings accounts	464.0	0.15	1.13	0.63	0.34
LT – investment and housing – 3rd pillar pension savings	327.0	0.11	0.79	0.45	0.24
LT – investment and housing – Insurance premiums and mortgage capital repayments (LT – investment)	238.0	0.08	0.58	0.33	0.18
Social benefits-sickness	224.0	0.07	0.54	0.31	0.17
Travelling home – work – exempt part of sums reimbursed by employer	141.0	0.05	0.34	0.19	0.10
Social benefits-Unemployment	138.0	0.05	0.33	0.19	0.10
Social benefits – Tax credit low income	96.0	0.03	0.23	0.13	0.07
Childcare	92.0	0.03	0.22	0.13	0.07
LT – investment and housing – Sole own dwelling	88.0	0.03	0.21	0.12	0.07
LT – investment and housing – 2nd pillar pension savings	87.0	0.03	0.21	0.12	0.06
LT – investment and housing – Mortgage interests – additional deduction	74.0	0.02	0.18	0.10	0.05
LT – investment and housing – Energy savings	73.0	0.02	0.18	0.10	0.05
Gifts	49.0	0.02	0.12	0.07	0.04
Service cheques and "local employment agencies" cheques	39.0	0.01	0.09	0.05	0.03
No withholding tax on pension savings scheme	29.0	0.01	0.07	0.04	0.02
Overtime pay	26.0	0.01	0.06	0.04	0.02
Miscellaneous	76.0	0.03	0.18	0.10	0.06
PIT total	**5 181.0**	**1.69**	**12.39**	**6.98**	**3.78**

CIT

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Coordination centres	2 042.0	0.68	19.57	2.79	1.51
Investment deduction	165.0	0.05	1.58	0.23	0.12
Investment reserve	71.0	0.02	0.68	0.10	0.05
Handicraft and lodging	33.0	0.01	0.32	0.05	0.02
Tax shelter audiovisual sector	10.0	0.00	0.10	0.01	0.01
fixed foreign tax credit	93.0	0.03	0.89	0.13	0.07
Other	48.0	0.02	0.46	0.07	0.04
CIT total	**2 321.0**	**0.77**	**22.24**	**3.17**	**1.72**

VAT

Reduced rates

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Reduced rate immovable goods	956.0	0.32	4.45	1.31	0.71
Notaries, lawyers, bailiffs	141.0	0.05	0.66	0.19	0.10
Supply of ships, vessels and aircraft	54.0	0.02	0.25	0.07	0.04
Total	**1 151.0**	**0.38**	**5.36**	**1.57**	**0.85**

Zero-rates

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Zero-rate – newspapers and weekly publications	38.0	0.01	0.09	0.05	0.03
Zero-rate – motor cars bought by invalids	13.0	0.00	0.03	0.02	0.01
Total	**51.0**	**0.02**	**0.12**	**0.07**	**0.04**
VAT total	**1 208.0**	**0.40**	**5.50**	**1.65**	**0.89**

Table A.4. **Main tax expenditures in Canada**[1]

Country	Canada
Year	2008
From *OECD Revenue Statistics*: (millions CAD)	
GDP	1 586 217.0
PIT revenues	190 504.8
CIT revenues	54 467.9
VAT revenues	42 469.0
Sum (PIT, CIT, VAT)	287 441.7
Total tax revenues	510 276.8

PIT

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Charitable donations credit	2 585.0	0.2	1.36	0.90	0.51
Non-taxation of business-paid health and dental benefits	2 605.0	0.2	1.37	0.91	0.51
Employee stock options	1 090.0	0.1	0.57	0.38	0.21
Age credit	1 800.0	0.1	0.94	0.63	0.35
Pension income credit	930.0	0.1	0.49	0.32	0.18
Pension income splitting	700.0	0.0	0.37	0.24	0.14
Reduced inclusion rate for capital gains on donations of securities	47.0	0.0	0.02	0.02	0.01
Working income tax benefit	555.0	0.0	0.29	0.19	0.11
Children's fitness tax credit	160.0	0.0	0.08	0.06	0.03
Tax credit for public transit passes	240.0	0.0	0.13	0.08	0.05
Treatment of alimony and maintenance payments	110.0	0.0	0.06	0.04	0.02
Deduction for clergy residence	71.0	0.0	0.04	0.02	0.01
Student loan interest credit	59.0	0.0	0.03	0.02	0.01
Overseas employment credit	55.0	0.0	0.03	0.02	0.01
Lifetime capital gains exemption for farm/fishing property	390.0	0.0	0.20	0.14	0.08
Lifetime capital gains exemption for small business shares	510.0	0.0	0.27	0.18	0.10
Deduction of allowable business investment losses	40.0	0.0	0.02	0.01	0.01
Labour-sponsored venture capital corporations credit	120.0	0.0	0.06	0.04	0.02
Investment tax credits[2]	58.0	0.0	0.03	0.02	0.01
PIT total	**12 125.0**	**0.76**	**6.36**	**4.22**	**2.38**

CIT

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Scientific research and experimental development investment credit	4 755.0	0.30	8.73	1.65	0.93
Deductibility of charitable donations	400.0	0.03	0.73	0.14	0.08
Low rate for manufacturing and processing	0.0	0.00	0.00	0.00	0.00
Low tax rate for small businesses	4 215.0	0.27	7.74	1.47	0.83
Atlantic investment tax credit	396.0	0.02	0.73	0.14	0.08
Apprenticeship job creation tax credit	205.0	0.01	0.38	0.07	0.04
Deductibility of gifts of cultural property and ecologically sensitive land	14.0	0.00	0.03	0.00	0.00
Canadian film or video production credit	210.0	0.01	0.39	0.07	0.04
Dividends	1 035.0	0.07	1.90	0.36	0.20
Interest on corporate debt	470.0	0.03	0.86	0.16	0.09
Interest on deposits	180.0	0.01	0.33	0.06	0.04
Other interest	315.0	0.02	0.58	0.11	0.06
Rents and royalties (including R&D)	134.0	0.01	0.25	0.05	0.03

CIT *(cont.)*

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Copyright royalties	32.0	0.00	0.06	0.01	0.01
Management fees	84.0	0.01	0.15	0.03	0.02
Low tax rate for credit unions	77.0	0.00	0.14	0.03	0.02
Deduction of allowable business investment losses	26.0	0.00	0.05	0.01	0.01
Corporate mineral exploration tax credit	31.0	0.00	0.06	0.01	0.01
Film or video production services tax credit	130.0	0.01	0.24	0.05	0.03
Taxation of life insurance investment income	95.0	0.01	0.17	0.03	0.02
Special treatment of progress payments to contractors	50.0	0.00	0.09	0.02	0.01
Non-taxation of non-profit organisations (other than charities)	195.0	0.01	0.36	0.07	0.04
CIT total	**13 049.0**	**0.82**	**23.96**	**4.54**	**2.56**

VAT

Zero-rates

Description	Absolute value (millions)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Zero-rating of basic groceries	3 255.0	0.21	7.66	1.13	0.64
Total	**3 255.0**	**0.21**	**7.66**	**1.13**	**0.64**

Exemptions

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Rebates for registered charities	245.0	0.02	0.58	0.09	0.05
Rebates for non-profit organisations	60.0	0.00	0.14	0.02	0.01
Rebates for new housing	880.0	0.06	2.07	0.31	0.17
Rebates for new residential rental property	50.0	0.00	0.12	0.02	0.01
Rebates for visitors/Foreign convention and tour incentive program	10.0	0.00	0.02	0.00	0.00
Exemption for residential rent (long-term)	1 100.0	0.07	2.59	0.38	0.22
Small suppliers' threshold	135.0	0.01	0.32	0.05	0.03
Total	**2 480.0**	**0.16**	**5.84**	**0.86**	**0.49**
VAT total	**5 735.0**	**0.36**	**13.50**	**2.00**	**1.12**

1. These figures show estimates only for taxes at federal level.
2. Personal tax portion of business investment tax credits

This table only includes selective targeted measures designed to influence the behaviour of private agents:

- Measures related to investment income are not included.
- Temporary accelerated depreciation on machinery and equipment used in manufacturing and processing are not included.
- Measures to avoid double taxation or transfer of tax-paid amounts, as well as GST/HST credit are not included since considered structural tax relief (in benchmark).
- Memorandum items are considered as part of the benchmark and, therefore, are not included.

Table A.5. **Main tax expenditures in Denmark**

Country	Denmark
Year	2006
From *OECD Revenue Statistics*: (millions DKK)	
GDP	1 545 257.0
PIT revenues	403 791.0
CIT revenues	70 697.0
VAT revenues	167 471.7
Sum (PIT, CIT, VAT)	641 959.7
Total tax revenues	808 319.0

PIT

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Taxable value of properties	3 385.0	0.22	0.84	0.53	0.42
Lower tax rates for people working for a Danish shipping company	614.0	0.04	0.15	0.10	0.08
Others	3 001.0	0.19	0.74	0.47	0.37
PIT total	**7 000.0**	**0.45**	**1.74**	**1.09**	**0.87**

CIT

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
R&D expenses	2 858.0	0.18	4.04	0.45	0.35
Lower valuation of production land	1 306.0	0.08	1.85	0.20	0.16
Others	8 736.0	0.57	12.36	1.36	1.08
CIT total	**12 900.0**	**0.83**	**18.25**	**2.01**	**1.60**

VAT

Reduced rates

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Lower tax on diesel than petrol	3 409.0	0.22	2.04	0.53	0.42
Total	**3 409.0**	**0.2**	**2.0**	**0.5**	**0.4**

Exemptions

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Exemptions to the financial sector	2 353.0	0.15	1.41	0.37	0.29
Total	**2 353.0**	**0.2**	**1.4**	**0.4**	**0.3**

Others

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Others	15 838.0	1.02	9.46	2.47	1.96
VAT total	**21 600.0**	**1.4**	**12.9**	**3.4**	**2.7**

Table A.6. **Main tax expenditures in France**

Country	France
Year	2008
From *OECD Revenue Statistics*: (millions EUR)	
GDP	1 201 018.8
PIT revenues	145 773.0
CIT revenues	56 846.0
VAT revenues	136 271.5
Sum (PIT, CIT, VAT)	338 890.4
Total tax revenues	839 988.0

PIT

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Make work pay	4 230.0	0.35	2.90	1.25	0.50
Reduction for sustainable development investments	2 400.0	0.20	1.65	0.71	0.29
Reduction for the employment of a salary at home	2 300.0	0.19	1.58	0.68	0.27
Reduction for donation to charity	820.0	0.07	0.56	0.24	0.10
PIT total	**9 750.0**	**0.81**	**6.69**	**2.88**	**1.16**

CIT

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Reduced taxation on long term capital gains	4 000.0	0.33	7.04	1.18	0.48
R&D Investments	1 390.0	0.12	2.45	0.41	0.17
CIT total	**5 390.0**	**0.45**	**9.48**	**1.59**	**0.64**

VAT

Reduced rates

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Housing upkeep work	5 400.0	0.45	3.96	1.59	0.64
Hotel business activity	1 750.0	0.15	1.28	0.52	0.21
Repaid drugs	1 090.0	0.09	0.80	0.32	0.13
DOM/TOM	1 070.0	0.09	0.79	0.32	0.13
Social housing sale	1 040.0	0.09	0.76	0.31	0.12
School, administrative or firms dinners	790.0	0.07	0.58	0.23	0.09
Total	**11 140.0**	**0.93**	**8.17**	**3.29**	**1.33**
VAT total	**11 140.0**	**0.93**	**8.17**	**3.29**	**1.33**

Table A.7. **Main tax expenditures in Germany**[1]

Country	Germany
Year	2008
From *OECD Revenue Statistics*: (millions EUR)	
GDP	2 491 400.0
PIT revenues	243 013.0
CIT revenues	46 932.0
VAT revenues	176 188.0
Sum (PIT, CIT, VAT)	466 133.0
Total tax revenues	907 707.0

PIT

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
(First home buyer allowance)	4 481.0	0.18	1.84	0.96	0.49
(First home buyer allowance, supplement for children)	2 184.0	0.09	0.90	0.47	0.24
(Tax reduction for renovation)	2 185.0	0.09	0.90	0.47	0.24
(Promotion of privately, capital funded old age provisions by means of supplementary allowances)	560.0	0.02	0.23	0.12	0.06
(Determination of taxable income of merchant ships)	500.0	0.02	0.21	0.11	0.06
(Tax exemption of the supplements for night- and Sunday work and bank holidays)	2 000.0	0.08	0.82	0.43	0.22
(Tax exemption limit for income from investment of capital)	1 059.0	0.04	0.44	0.23	0.12
(Tax exemption for half of the gain from sale of property and buildings)	325.0	0.01	0.13	0.07	0.04
(Credit amount in terms of tariff for profit income, limited to the year 2007)	500.0	0.02	0.21	0.11	0.06
PIT total	**13 794.0**	**0.55**	**5.68**	**2.96**	**1.52**

CIT

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Investment allowance for equipment assets	285.0	0.01	0.61	0.06	0.03
CIT total	**285.0**	**0.01**	**0.61**	**0.06**	**0.03**

VAT

Reduced rates

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
(Tax discount for cultural, entertaining services)	1 815.0	0.07	1.03	0.39	0.20
(Tax discount for passenger transport in local public transport)	750.0	0.03	0.43	0.16	0.08
(VAT reduction on the transaction volume of dental technicians)	380.0	0.02	0.22	0.08	0.04
Total	**2 945.0**	**0.12**	**1.67**	**0.63**	**0.32**
VAT total	**2 945.0**	**0.12**	**1.67**	**0.63**	**0.32**

Consumption taxes

Description	Absolute value (million)	% GDP	% sum (PIT, CIT, VAT)	% total tax revenues
(Tax benefits for electricity, used in the sectors of industry and agriculture and forestry)	1 850.0	0.08	0.42	0.21
(Tax benefits for industrial enterprises that are considerably burdened by electricity tax	1 700.0	0.07	0.38	0.19
(Benefits for industrial enterprises, businesses in agriculture and forestry, electricity suppliers as well as for combined heat and power generation plant)	1 300.0	0.05	0.29	0.15
(Promotion of biomass fuel)	670.0	0.03	0.15	0.08
(Tax benefits for the sectors of industry and agriculture and forestry)	440.0	0.02	0.10	0.05
(Tax exemption for mineral oils used for the maintenance of operation while producing mineral oils)	400.0	0.02	0.09	0.05
(Mineral oil tax exemption for consumables of the aviation business	395.0	0.02	0.09	0.05
Total consumption taxes	**6 755.0**	**0.28**	**1.52**	**0.77**

1. Germany does not list tax expenditures according to PIT, CIT or VAT categories. For the purpose of this Report, the PIT and CIT list was derived. Tax expenditures are classified by industrial sector and within these sectors by type of tax.

This table lists the 20 largest tax expenditures, which represent 88.9% of the total amount of tax expenditures.

Table A.8. **Main tax expenditures in Greece**

Country	Greece
Year	2006
From *OECD Revenue Statistics*: (millions EUR)	
GDP	213 207.2
PIT revenues	9 866.0
CIT revenues	5 689.0
VAT revenues	15 183.0
Sum (PIT, CIT, VAT)	30 738.0
Total tax revenues	66 598.0

PIT

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Tax credits – EUR 1 500 increased tax free bracket for wage earners and pensioners compared to free-lancers.	508.6	0.24	5.16	1.65	0.76
Tax credits – Related to the number of children/residence in border areas	297.8	0.14	3.02	0.97	0.45
Tax credits – 3%-5% for real estate amortisation	135.2	0.06	1.37	0.44	0.20
Tax credits – Partnerships rewards	73.0	0.03	0.74	0.24	0.11
Tax credits – 50% decrease in tax paid by underage (for heritage reasons) shareholders	73.0	0.03	0.74	0.24	0.11
Tax credits – 1.5% discount on the withholding tax paid by wage earners and pensioners	62.9	0.03	0.64	0.20	0.09
Tax credits – Tax paid for income of real estate proceedings cannot be greater that net income tax, if the property is less than 300 m^2	36.9	0.02	0.37	0.12	0.06
Tax credits – 50% increased tax free threshold for tax payers living in island areas with population of less than 3 100	10.5	0.00	0.11	0.03	0.02
Tax credits – For self-taxed income (dividends, etc.)	1.7	0.00	0.02	0.01	0.00
Exemptions – Social security contributions	329.0	0.15	3.33	1.07	0.49
Exemptions – Loan interests payments	154.4	0.07	1.56	0.50	0.23
Exemptions – Life insurance fees	136.0	0.06	1.38	0.44	0.20
Exemptions – Medical expenses	102.5	0.05	1.04	0.33	0.15
Exemptions – Miscellaneous expenses of handicap persons	61.2	0.03	0.62	0.20	0.09
Exemptions – Tuition fees	49.6	0.02	0.50	0.16	0.07
Exemptions – New farmers	23.7	0.01	0.24	0.08	0.04
Exemptions – Gifts and donations	22.2	0.01	0.23	0.07	0.03
Exemptions – Rental expenses (students and main residences)	17.6	0.01	0.18	0.06	0.03
Exemptions – Mutual funds	3.7	0.00	0.04	0.01	0.01
Exemptions – Relocation expenses (for labour reasons)	3.3	0.00	0.03	0.01	0.00
Exemptions – Palimony expenses	2.0	0.00	0.02	0.01	0.00
Exemptions – Natural gas installation expenses	1.6	0.00	0.02	0.01	0.00
PIT total	**2 106.4**	**0.99**	**21.35**	**6.85**	**3.16**

CIT

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Income tax exemption for profits derived from the sale of shares circulated in the Athens stock exchange	140.0	0.07	2.46	0.46	0.21
Decrease rate (7% instead of 10%) for income of several legal entities belonging to Orthodox church derived from real estate proceedings	54.0	0.03	0.95	0.18	0.08
Expenses according to investment incentives laws	47.9	0.02	0.84	0.16	0.07

CIT *(cont.)*

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Tax paid for income of real estate proceedings cannot be greater that net income tax	15.5	0.01	0.27	0.05	0.02
40% tax rate reduction for legal entities located in island areas with less than 3 100 population	0.8	0.00	0.01	0.00	0.00
CIT total	**258.2**	**0.12**	**4.54**	**0.84**	**0.39**

VAT

Reduced rates

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
30% decrease in tax rate for all the Aegean Islands	194.0	0.09	1.28	0.63	0.29
Rate of 4.5% for special goods (books, newspapers, periodicals and theatre tickets)	46.8	0.02	0.31	0.15	0.07
Total	**240.8**	**0.11**	**1.59**	**0.78**	**0.36**

Exemptions

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Total exemption for imports run by the public sector	119.9	0.06	0.79	0.39	0.18
Total exemption for all the postal services	34.9	0.02	0.23	0.11	0.05
Total exemption for all the national broadcasting services (radio, television)	13.7	0.01	0.09	0.04	0.02
Total exemption for imports run during diplomatic missions, by international organisations, etc.	1.3	0.00	0.01	0.00	0.00
Special exemptions during imports	0.9	0.00	0.01	0.00	0.00
Total exemption for the Black Sea Trade and Development Bank	0.3	0.00	0.00	0.00	0.00
Total exemption for imports run during cultural events, congresses, exhibitions, etc.	0.01	0.00	0.00	0.00	0.00
Total	**171.0**	**0.08**	**1.13**	**0.56**	**0.26**
VAT total	**411.7**	**0.19**	**2.71**	**1.34**	**0.62**

Table A.9. **Main tax expenditures in Italy**[1]

Country	Italy
Year	2009
From *OECD Revenue Statistics*: (millions EUR, 2008)	
GDP	1 572 243.1
PIT revenues	181 742.0
CIT revenues	58 154.0
VAT revenues	92 811.0
Sum (PIT, CIT, VAT)	332 707.0
Total tax revenues	678 715.0

PIT

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Allowance for medical expenses in cases of serious and permanent physical handicap or disability	77.82	0.00	0.04	0.02	0.01
Allowance for compulsory contributions to welfare and pension schemes, and for voluntary contributions to the mandatory pension scheme of the relative profession group	4 436.70	0.28	2.44	1.33	0.65
Allowance for contributions to complementary pension schemes, as those funded in European member states	1 650.00	0.10	0.91	0.50	0.24
Allowance for contributions to funds supplementary to the national health care system	12.90	0.00	0.01	0.00	0.00
Taxation at the reduced rate of 11% for returns accrued on pension funds	19.20	0.00	0.01	0.01	0.00
Tax credit for expenses related to means necessary to assist and ease the self-sufficiency of disabled individuals; tax credit for expenses related to guide dogs for blind people; tax credit for interpretation services	73.59	0.00	0.04	0.02	0.01
Tax credit for expenses related to individuals appointed to personal assistance services in cases of non self-sufficiency in the actions of everyday life	8.20	0.00	0.00	0.00	0.00
Exemption from personal income tax for pensions and allowances paid to victims of terrorist attacks	3.60	0.00	0.00	0.00	0.00
Exemption from personal income tax for remunerations of any kind, pensions and TFR payments made to people employed by the Vatican State	10.00	0.00	0.01	0.00	0.00
Exemption from personal income tax for incomes earned by ambassadors and diplomats of foreign States	119.00	0.01	0.07	0.04	0.02
Tax credit for wage income and similar incomes; for income from pensions and income earned by the self-employed and by minor companies	42 899.67	2.73	23.60	12.89	6.32
Tax credit for medical expenses and health assistance services	2 250.47	0.14	1.24	0.68	0.33
Tax credit for insurance premiums paid for whole-life policies, and policies against the risk of permanent disability and non self-sufficiency	1 318.86	0.08	0.73	0.40	0.19
Tax credit for gifts and contributions to approved donors (hospitals, cultural association "La Biennale di Venezia", central government and local government units carrying out study, research or documentation activities of a relevant cultural or artistic value, no-profit entities operating in the show business activities, ONLUS involved in humanitarian activities, mutual aid associations, amateur sporting associations and social promotion associations, political parties)	64.33	0.00	0.04	0.02	0.01
Deduction for gifts and contributions to: entities belonging to the "third" sector (Onlus, Ong, voluntary organisations); non-government organisations; Catholic Church; universities and controlled public research bodies; regional and national parks and reserves	41.69	0.00	0.02	0.01	0.01
Income from land equal to 30%, in case of missed cultivation for a whole year and for reasons not related to the technique used	8.50	0.00	0.00	0.00	0.00
Income from land equal to zero, in case of loss of at least 30% of harvest, as a consequence of natural phenomena	13.20	0.00	0.01	0.00	0.00
Agrarian income equal to zero in the cases described above	11.80	0.00	0.01	0.00	0.00

PIT *(cont.)*

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Exemption for land income	17.00	0.00	0.01	0.01	0.00
Tax credits for expenses related to public transport services; veterinary and funeral expenses (only for tax period 2008; extension of the tax expenditure to 2009 has been proposed)	220.80	0.01	0.12	0.07	0.03
Exclusion from taxation of wage incomes up to EUR 8 000	26.50	0.00	0.01	0.01	0.00
Tax allowance for payments to the spouse, with the exception of child-maintenance payments, as a consequence of legal and *de facto* separation, the dissolution or annulment of marriage, or the termination of its civil effects	171.12	0.01	0.09	0.05	0.03
Special taxation methods for: travelling expense allowances, forfetary expense refunds, premiums and other compensations paid within amateur sporting activities by national sports leagues, sports promotion organisations, etc.	102.00	0.01	0.06	0.03	0.02
Forfetary tax allowance for incomes deriving from the economic utilisation by the author of intellectual achievements, industrial patents, processes, formula or information relative to experience acquired in the manufacturing sector	46.00	0.00	0.03	0.01	0.01
Contribution for the purchase of cars and vehicles up to 31st December 2009, to be registered not later than 31st March 2010	5.6	0.00	0.00	0.00	0.00
Tax credit for interests paid on mortgage loans for the purchase of the principal house	11 61.20	0.07	0.64	0.35	0.17
Tax credit for interest paid on loans related to the agricultural sector	20.70	0.00	0.01	0.01	0.00
Tax credit for principal house rental	1 022.40	0.07	0.56	0.31	0.15
Tax allowance for the cadastral rent of the owner-occupied house and of the relative outbuildings	1 984.00	0.13	1.09	0.60	0.29
Further reduction of 30% of taxable income from identified contracts: contracts based on a pre-arranged rent, contracts with university students and contracts stipulated by local government units that need temporary accommodation	58.80	0.00	0.03	0.02	0.01
Tax credit for house rents paid by university students	116.00	0.01	0.06	0.03	0.02
Tax credit of 36% of expenses related to interventions of recovery of existing buildings, and of some restoration and maintenance works realised on whole buildings	184.00	0.01	0.10	0.06	0.03
Tax credit of 55% of expenses related to interventions of energy requalification of existing buildings	82.50	0.01	0.05	0.02	0.01
Tax credit of 20% of expenses related to the substitution of refrigerators and freezers with others of an energy class not lower than A+, and of 20% of expenses for the purchase and installation, or the substitution of high-efficiency motors	118.10	0.01	0.06	0.04	0.02
Tax allowance on rents and other burdens charged on incomes deriving from buildings that are part of the total income	41.30	0.00	0.02	0.01	0.01
Tax credit for expenses related to the maintenance, preservation and reconstruction of bounded houses	7.43	0.00	0.00	0.00	0.00
Forfetary tax allowance: taxable income deriving to the owner of a rented building (income that is calculated as the greater amount between the rent defined in the contract and the cadastral rent of the same building) is reduced by 15% (or 25% in particular cases) by way of forfetary tax allowance of expenses	1 085.00	0.07	0.60	0.33	0.16
Exemption from income taxes for some categories of capital income	193.00	0.01	0.11	0.06	0.03
Exemption for capital gains reinvested in firms that are no more than 3 years old, that carry out the same activity of the company whose shares or quotas have been released	60.70	0.00	0.03	0.02	0.01
Tax credit for dependent relatives	12 168.00	0.77	6.70	3.66	1.79
Tax credit of 19% of expenses related to the attendance of nurseries	21.11	0.00	0.01	0.01	0.00
Tax credit for the annual subscription of children between 5 and 18 years old to gyms, swimming pools and sporting clubs	98.00	0.01	0.05	0.03	0.01
Reduced taxation for overtime work and productivity bonus (only from July to December 2008)	960.00	0.06	0.53	0.29	0.14
Reduced taxation for overtime work by hauliers (only for 2009)	30.00	0.00	0.02	0.01	0.00

PIT *(cont.)*

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Tax credit for educational expenses	274.90	0.02	0.15	0.08	0.04
Tax credit of 19% of coaching and professional training expenses undertaken by teachers	42.00	0.00	0.02	0.01	0.01
Tax credit for voluntary money donations to schools, targeted on technological innovation of the school, the improvement of its buildings and the widening of the school education supply	23.00	0.00	0.01	0.01	0.00
PIT total	**73 360.7**	**4.7**	**40.4**	**22.0**	**10.8**
PIT total less personal allowance	**73 334.2**	**4.7**	**40.4**	**22.0**	**10.8**

CIT

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Agricultural firm – calculation of income on cadastral basis	45.00	0.00	0.08	0.01	0.01
Special optional tax regime (tonnage tax) for the calculation of income deriving from the utilisation of ships included in the international Registration Board	26.37	0.00	0.05	0.01	0.00
Limited deduction from IRAP tax base (Italian regional tax on business activity) for non-temporary employees	5 200.00	0.33	8.94	1.56	0.77
Concessional tax regime for new entrepreneurships, with the application of an alternative tax rate of 10%	156.00	0.01	0.27	0.05	0.02
Tax credit for new entrepreneurships	2.00	0.00	0.00	0.00	0.00
Forfetary tax allowance from corporate tax income in favour of people managing fuelling establishments	53.00	0.00	0.09	0.02	0.01
Tax credit in favour of agricultural and food firms – purchase of capital goods (only for 2009)	10.00	0.00	0.02	0.00	0.00
Tax credit for the agricultural sector, disadvantaged areas – tax credit on the purchase of capital goods	30.00	0.00	0.05	0.01	0.00
Tax credits for new investments in the following Regions: Calabria, Campania, Puglia, Sicilia, Basilicata, Sardegna, Abruzzo and Molise	449.60	0.03	0.77	0.14	0.07
Tax credit in favour of shipping companies	77.81	0.00	0.13	0.02	0.01
Only 20% of income from the use of ships included in the international Registration Board is included in the corporate taxable income	62.43	0.00	0.11	0.02	0.01
Tax credit for the hiring of new personnel in the following Regions: Calabria, Campania, Puglia, Sicilia, Basilicata, Sardegna, Abruzzo and Molise	200.00	0.01	0.34	0.06	0.03
Tax credit for diesel consumption	80.00	0.01	0.14	0.02	0.01
Tax credit for the purchase of gas-powered, diesel-powered or electricity-powered vehicles, or for the settlement of gas or diesel fuelling systems	150.00	0.01	0.26	0.05	0.02
Exemption from corporate income tax for incomes realised by agricultural cooperatives and related groups through farming and manufacturing of agricultural and zootechnic products	101.09	0.01	0.17	0.03	0.01
Exclusion from the taxable income of cooperative societies of the portion of annual profits that form the statutory minimum reserve	420.41	0.03	0.72	0.13	0.06
Sums allocated to indivisible reserve are not included in the taxable income of cooperative societies, if certain conditions are satisfied. The application of this rule is partially limited for mutual cooperative societies	255.95	0.02	0.44	0.08	0.04
Tax allowance in favour of cooperative societies and their groups for the sums distributed between members as a partial refund of prices paid for purchased goods and services, or as an increased compensation for contributions made by the members	154.67	0.01	0.27	0.05	0.02
Tax credit for e-commerce	20.00	0.00	0.03	0.01	0.00
Tax credit of 10%, to be increased in some cases up to 40%, of the costs borne to carry out industrial research and competitive development activities (only for 2009)	610.00	0.04	1.05	0.18	0.09

CIT *(cont.)*

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Tax credit in favour of small and medium enterprises to carry out scientific research activities	18.00	0.00	0.03	0.01	0.00
Tax credits for the development of cinematographic activities	69.92	0.00	0.12	0.02	0.01
Forfetary tax allowance of transportation expenses borne by SME, with reference to transports carried out by the entrepreneur within the municipality where the firm is based (this is a temporary tax expenditure)	68.00	0.00	0.12	0.02	0.01
New simplified tax regime for small entrepreneurs and professional workers. Personal income taxes, the related surtaxes and the Italian Regional Tax on Business Activities (IRAP) are replaced by an alternative tax levied with a rate of 20%. The tax-payers can however opt for ordinary taxation	142.50	0.01	0.25	0.04	0.02
Tax credit in favour of small and medium enterprises for the adoption of measures to prevent the risk of thefts, robberies and other crimes	15.00	0.00	0.03	0.00	0.00
Tax credit for holders of taxi-rental license	20.00	0.00	0.03	0.01	0.00
Tax credit in favour of public and private chemists for the purchase of software	1.00	0.00	0.00	0.00	0.00
Incentives to the trade and tourism sectors: tax credit in favour of small and medium enterprises for the purchase of capital goods	1.00	0.00	0.00	0.00	0.00
Tax credits for the creation or the development of associated offices	13.80	0.00	0.02	0.00	0.00
Reduced taxation of profits reinvested in the cinematographic sector (deadline 31st December 2010)	10.00	0.00	0.02	0.00	0.00
Tax credit for cinema keepers, proportionate to the fees net of value added tax	20.00	0.00	0.03	0.01	0.00
Exemption from corporate income tax for bonuses and other interests produced by Italian Government securities	2 200.00	0.14	3.78	0.66	0.32
CIT total	**10 683.5**	**0.68**	**18.37**	**3.21**	**1.57**

VAT

Reduced rates

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Tax rate reduced at 10% for reconstruction works	197.0	0.01	0.21	0.06	0.03
Tax rate reduced at 4% for goods falling into specified categories, including some basic food products, books, periodicals, identified cases referred to new residential buildings (contracts for new buildings and related purchase of raw materials)	15 136.0	0.96	16.31	4.55	2.23
Tax rate reduced at 10% for goods falling into specified categories, including some food products, by-products of animals and vegetables, electricity, oil, gas and other fuels, semi-processed materials for housing, identified cases referred to new residential buildings (contracts for new buildings), etc.	26 400.0	1.68	28.44	7.93	3.89
Total	**41 733.0**	**2.65**	**44.97**	**12.54**	**6.15**

Exemptions

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Special regime for agricultural producers	250.0	0.02	0.27	0.08	0.04
Special regime for the publishing sector	173.0	0.01	0.19	0.05	0.03
New simplified tax regime for small entrepreneurs and professional workers The tax-payers involved can benefit from the exemption from VAT, though they can opt for ordinary taxation	375.6	0.02	0.40	0.11	0.06
Total	**798.6**	**0.05**	**0.86**	**0.24**	**0.12**
VAT total	**42 531.6**	**2.71**	**45.83**	**12.78**	**6.27**

1. TE figures for year 2009, GDP and all revenue figures only available for 2008.

Table A.10. **Main tax expenditures in Korea**

Country	Korea
Year	2007
From *OECD Revenue Statistics*: (millions KRW)	
GDP	975 013 000.0
PIT revenues	43 276 000.0
CIT revenues	38 963 000.0
VAT revenues	40 942 000.0
Sum (PIT, CIT, VAT)	123 181 000.0
Total tax revenues	258 670 000.0

PIT

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Income deduction for credit card use	1 250 600.0	0.13	2.89	1.02	0.48
Special deduction of earned income for educational expense	881 200.0	0.09	2.04	0.72	0.34
Earned income exemption for health insurance premiums	804 000.0	0.08	1.86	0.65	0.31
PIT total	**2 935 800.0**	**0.30**	**6.78**	**2.38**	**1.13**

CIT

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Temporary tax credit for investment	1 752 900.0	0.18	4.50	1.42	0.68
Special tax reduction for SME	1 017 700.0	0.10	2.61	0.83	0.39
Tax credit for R&D	793 300.0	0.08	2.04	0.64	0.31
CIT total	**3 563 900.0**	**0.37**	**9.15**	**2.89**	**1.38**

VAT

Zero-rate

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
VAT zero-rate application to agricultural, livestock and fishery equipment	1 305 300.0	0.13	3.02	1.06	0.50
Total	**1 305 300.0**	**0.13**	**3.02**	**1.06**	**0.50**

Exemptions

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
VAT tax credit for credit card use	682 200.0	0.07	1.58	0.55	0.26
VAT exemption for oils used for agriculture and fishery	400 600.0	0.04	0.93	0.33	0.15
Total	**1 082 800.0**	**0.11**	**2.50**	**0.88**	**0.42**
VAT total	**2 388 100.0**	**0.24**	**5.52**	**1.94**	**0.92**

Table A.11. **Main tax expenditures in Mexico**

Country	Mexico
Year	2008
From *OECD Revenue Statistics*: (millions MXN)	
GDP	12 040 414.4
PIT revenues	n.a.
CIT revenues	n.a.
VAT revenues	457 248.3
Sum (PIT, CIT, VAT)	n.a.
Total tax revenues	2 457 666.7

PIT

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Small taxpayers regime	17 043.6	0.14			0.69
Subsidies for disabilities, educational scholarships for workers or their children, day care, cultural and sport activities, and other similar social benefits except the exemption for provisions vouchers	5 939.2	0.05			0.24
Exemption for provisions vouchers	17 954.7	0.15			0.73
Other exempt wage and salary income	43 401.8	0.36			1.77
Deduction for medical, dental and hospital expenses	3 335.0	0.03			0.14
Other authorised personal deductions	1 710.5	0.01			0.07
Others	4 280.1	0.04			0.17
PIT total	**93 664.9**	**0.78**			**3.81**

CIT

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Employment subsidy	34 756.2	0.29			1.41
Accelerated depreciation of fixed assets	23 214.7	0.19			0.94
Deduction of voluntary private contributions to pension funds	13 520.2	0.11			0.55
Fiscal consolidation regime	31 801.0	0.26			1.29
Others	56 005.8	0.47			2.28
CIT total	**159 297.9**	**1.32**			**6.48**

VAT

Reduced rates

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Lower rate of 10% in the border regions	15 063.0	0.13	3.29		0.61
Total	**15 063.0**	**0.13**	**3.29**		**0.61**

Zero-rates

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Zero rate for food	122 192.5	1.01	26.72		4.97
Zero rate for medicines	13 290.9	0.11	2.91		0.54

Zero-rates *(cont.)*

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Other goods and services	16 188.8	0.13	3.54		0.66
Total	**151 672.2**	**1.26**	**33.17**		**6.17**

Exemptions

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Exemption for educational services	17 762.8	0.15	3.88		0.72
Other	25 633.0	0.21	5.61		1.04
Total	**43 395.8**	**0.36**	**9.49**		**1.77**
VAT total	**210 131.0**	**1.75**	**45.96**		**8.55**

n.a.: not available.

Table A.12. **Main tax expenditures in the Netherlands**[1]

Country	Netherlands
Year	2008
From *OECD Revenue Statistics*:	
GDP (millions EUR 2008)	594 608.0
PIT revenues (millions EUR 2007)	43 484.0
CIT revenues (millions EUR 2007)	18 552.0
VAT revenues (millions EUR 2007)	42 216.0
Sum (PIT, CIT, VAT) (millions EUR 2007)	104 252.0
Total tax revenues (millions EUR 2007)	212 863.0

Direct taxes (PIT and CIT – 2008)

Description	Absolute value (million)	% GDP	% PIT + CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Self-employment deduction (PIT)	1 272.0	0.21	2.05	1.22	0.60
Fiscal pension reserve (PIT)	215.0	0.04	0.35	0.21	0.10
Exemptions for certain capital payments (PIT)	692.0	0.12	1.12	0.66	0.33
Investment in R&D (wage tax reduction for employers)	417.0	0.07	0.67	0.40	0.20
Income exemption from certain company saving schemes	224.0	0.04	0.36	0.21	0.11
Tax credit for working elderly	200.0	0.03	0.32	0.19	0.09
Tax credit for none/low mortgage	232.0	0.04	0.37	0.22	0.11
Deduction of charitable and other donations	254.0	0.04	0.41	0.24	0.12
Red. succ. duty for donations to institutions with a public interest	221.0	0.04	0.36	0.21	0.10
Others (< EUR 200 mill.)	2 064.0	0.35	3.33	1.98	0.97
Total PIT and CIT	**5 791.0**	**0.97**	**9.33**	**5.55**	**2.72**

VAT (2008)

Reduced rates

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Reduced VAT-rate for food in hotel and catering industry	1 200.0	0.20	2.84	1.15	0.56
Reduced VAT-rate for transportation of persons	688.0	0.12	1.63	0.66	0.32
Reduced VAT-rate for books, magazines, newspapers	586.0	0.10	1.39	0.56	0.28
Reduced VAT-rate for labour intensive services	389.0	0.07	0.92	0.37	0.18
Reduced VAT-rate for the supply of accommodation	240.0	0.04	0.57	0.23	0.11
Total	**3 103.0**	**0.52**	**7.35**	**2.98**	**1.46**

Others

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Others	1 866.0	0.31	4.42	1.79	0.88
VAT total	**4 969.0**	**0.84**	**11.77**	**4.77**	**2.33**

1. TE and GDP figures for year 2008, all revenue figures only available for 2007.

In 2008, the Netherlands reported 98 tax expenditures, of which 52 relate to PIT/CIT and the remaining 46 to indirect taxes, mainly VAT. This table lists the most important tax expenditures for the year 2008 in terms of revenue forgone (≥ EUR 200 million).

Table A.13. **Main tax expenditures in Norway**

Country	Norway
Year	2007
From *OECD Revenue Statistics*: (millions NOK)	
GDP	2 277 111.0
PIT revenues	219 589.0
CIT revenues	258 067.0
VAT revenues	188 704.0
Sum (PIT, CIT, VAT)	666 360.0
Total tax revenues	993 433.0

PIT

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Childcare expense deduction	1 670.0	0.07	0.76	0.25	0.17
Additional personal allowance for one-income families and sole parents	1 595.0	0.07	0.73	0.24	0.16
Tax allowance for commuters' daily work travel and visits to main residence	1 455.0	0.06	0.66	0.22	0.15
Union fee deduction	840.0	0.04	0.38	0.13	0.08
Special tax rules for tax payers in Nord-Troms and Finnmark	665.0	0.03	0.30	0.10	0.07
Tax-free car allowance	600.0	0.03	0.27	0.09	0.06
Home computer arrangement with tax benefits	500.0	0.02	0.23	0.08	0.05
Tax allowance for commuters' excess expenses in connection to lodging and meals	490.0	0.02	0.22	0.07	0.05
Tax allowance for donations to charities	410.0	0.02	0.19	0.06	0.04
Healthcare deductions	335.0	0.01	0.15	0.05	0.03
Special deductions for taxable foreigners	190.0	0.01	0.09	0.03	0.02
Special tax rules for free meals for seamen, fishermen and offshore employees	180.0	0.01	0.08	0.03	0.02
Tax exemption for lodging compensation above documented expenses	100.0	0.00	0.05	0.02	0.01
Tax free wage supplement for seamen	85.0	0.00	0.04	0.01	0.01
Fund scheme for active athletes	5.0	0.00	0.00	0.00	0.00
PIT total	**9 120.0**	**0.40**	**4.15**	**1.37**	**0.92**

CIT

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Employee premiums and contributions to occupational pension schemes	16 000.0	0.70	6.20	2.40	1.61
Regionally differentiated employers' national insurance contributions	9 410.0	0.41	3.65	1.41	0.95
Tax exemption for ordinary CIT for shipping companies	1 900.0	0.08	0.74	0.29	0.19
Tax deductions for research and development	900.0	0.04	0.35	0.14	0.09
Tax allowance for farmers	830.0	0.04	0.32	0.12	0.08
Depreciation rate on machinery	675.0	0.03	0.26	0.10	0.07
Tax allowance for seamen and fishermen	570.0	0.03	0.22	0.09	0.06
Home savings scheme (BSU)	410.0	0.02	0.16	0.06	0.04
Occupational pension, employer premium fund	340.0	0.01	0.13	0.05	0.03
Social security contributions by farmers, forestry and fishermen	260.0	0.01	0.10	0.04	0.03
Special tax rules for forestry	105.0	0.00	0.04	0.02	0.01
Special valuation of forests for net wealth tax purposes	100.0	0.00	0.04	0.02	0.01
Depreciation rate on fishing vessels and domestic navigation	65.0	0.00	0.03	0.01	0.01
Tax allowance for reindeer farming	7.0	0.00	0.00	0.00	0.00

CIT *(cont.)*

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Tax allowance for state workers	3.0	0.00	0.00	0.00	0.00
CIT total	**31 575.0**	**1.39**	**12.24**	**4.74**	**3.18**

VAT

Reduced rates

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Lower rate on goods/services (mainly food)	12 225.0	0.54	6.48	1.83	1.23
Total	**12 225.0**	**0.54**	**6.48**	**1.83**	**1.23**

Zero-rates

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Newspapers	1 250.0	0.05	0.66	0.19	0.13
Books	1 200.0	0.05	0.64	0.18	0.12
Electric power mv. i Northern Norway	605.0	0.03	0.32	0.09	0.06
Periodicals	110.0	0.00	0.06	0.02	0.01
Electric cars	10.0	0.00	0.01	0.00	0.00
Others	75.0	0.00	0.04	0.01	0.01
Total	**3 250.0**	**0.14**	**1.72**	**0.49**	**0.33**

Exemptions

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Education services and driving schools	300.0	0.01	0.16	0.05	0.03
Concerts	60.0	0.00	0.03	0.01	0.01
Amusement parks, circus and discotheques	300.0	0.01	0.16	0.05	0.03
Ticket sales to sports events	50.0	0.00	0.03	0.01	0.01
Dental services	600.0	0.03	0.32	0.09	0.06
Other services	100.0	0.00	0.05	0.02	0.01
Total	**1 410.0**	**0.06**	**0.75**	**0.21**	**0.14**
VAT total	**16 885.0**	**0.74**	**8.95**	**2.53**	**1.70**

Table A.14. **Main tax expenditures in Poland**[1]

Country	Poland
Year	2007
From *OECD Revenue Statistics*: (millions PLN)	
GDP	1 175 266.0
PIT revenues	62 341.0
CIT revenues	32 195.0
VAT revenues	96 152.0
Sum (PIT, CIT, VAT)	190 688.0
Total tax revenues	409 679.0

PIT

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Tax credit for children	5 432.0	0.46	8.71	2.85	1.33
Expenditures for rehabilitation purposes	445.4	0.04	0.71	0.23	0.11
Expenditures for Internet access	289.4	0.02	0.46	0.15	0.07
An allowance for interest expenses on mortgage loans	357.9	0.03	0.57	0.19	0.09
Relief for training trainees	108.8	0.01	0.17	0.06	0.03
Donations	78.7	0.01	0.13	0.04	0.02
Relief for training trainees (in lump sum)	20.7	0.00	0.03	0.01	0.01
An allowance for interest expenses on mortgage loans (in lump sum)	8.8	0.00	0.01	0.00	0.00
Expenditures for Internet access (in lump sum)	0.4	0.00	0.00	0.00	0.00
Expenditures for rehabilitation purposes (in lump sum)	0.2	0.00	0.00	0.00	0.00
Donations (in lump sum)	0.1	0.00	0.00	0.00	0.00
Others	2.8	0.00	0.00	0.00	0.00
PIT total	**6 745.1**	**0.57**	**10.82**	**3.54**	**1.65**

CIT

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Tax exemptions of income intended for statutory purposes	2 747.9	0.23	8.54	1.44	0.67
Income tax exempt on the basis of the Act on Special Economic Zones and executive acts	1 002.6	0.09	3.11	0.53	0.24
Other tax exemptions	2 188.0	0.19	6.80	1.15	0.53
Donations	67.1	0.01	0.21	0.04	0.02
Deductions of expenditures for purchase of new technologies	0.8	0.00	0.00	0.00	0.00
Deductions of investment expenses	0.4	0.00	0.00	0.00	0.00
Deductions of expenditures for activity of sport clubs	0.02	0.00	0.00	0.00	0.00
Other tax allowances	2.6	0.00	0.01	0.00	0.00
Deduction of tax paid for received dividends and other types of revenue gained as a share in income of legal entities with head office in Poland	129.8	0.01	0.40	0.07	0.03
Deduction of tax paid in other country	86.10	0.01	0.27	0.05	0.02
Other tax credits	94.9	0.01	0.29	0.05	0.02
CIT total	**6 320.3**	**0.54**	**19.63**	**3.31**	**1.54**

1. Poland is currently elaborating its first Tax Expenditure Report, which will be published by the end of 2010. This report identifies and estimates a wider range of TEs.

Table A.15. **Main tax expenditures in Portugal**

Country	Portugal
Year	2007
From *OECD Revenue Statistics*: (millions EUR)	
GDP	163 179.3
PIT revenues	9 374.6
CIT revenues	6 028.7
VAT revenues	14 338.8
Sum (PIT, CIT, VAT)	29 742.1
Total tax revenues	59 416.7

PIT

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Disabled persons	170.1	0.10	1.81	0.57	0.29
Retirement savings plans and pension funds	112.6	0.07	1.20	0.38	0.19
Health Insurance	31.8	0.02	0.34	0.11	0.05
Acquisition of personal computers	29.6	0.02	0.32	0.10	0.05
Donations to churches, charities, etc.	16.8	0.01	0.18	0.06	0.03
Exemption with progression for income derived from cooperation and international missions, members of international organisations, etc.	15.3	0.01	0.16	0.05	0.03
Sportsmen	9.0	0.01	0.10	0.03	0.02
Acquisition of equipment for using renewable energies	6.6	0.00	0.07	0.02	0.01
Housing savings accounts	4.7	0.00	0.05	0.02	0.01
Intellectual property	4.6	0.00	0.05	0.02	0.01
Stock savings plans	0.1	0.00	0.00	0.00	0.00
Legal advice expenses	0.1	0.00	0.00	0.00	0.00
VAT on restaurant, home refurbishment and car repair services	0.1	0.00	0.00	0.00	0.00
PIT total	**401.4**	**0.25**	**4.28**	**1.35**	**0.68**

CIT

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Deductions from income	83.7	0.05	1.39	0.28	0.14
Tax credits	77.4	0.05	1.28	0.26	0.13
Rate reduction	40.1	0.02	0.67	0.13	0.07
Permanent exemptions	37.5	0.02	0.62	0.13	0.06
Tax liability assessment	–3.5	0.00	–0.06	–0.01	–0.01
CIT total	**235.2**	**0.14**	**3.90**	**0.79**	**0.40**

VAT

Exemptions

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Charities (IPSS)	38.1	0.02	0.27	0.13	0.06
Military and Security Forces	23.7	0.01	0.17	0.08	0.04
Catholic Church	17.6	0.01	0.12	0.06	0.03
Cars for disabled persons	8.5	0.01	0.06	0.03	0.01
Diplomatic missions	8.4	0.01	0.06	0.03	0.01

VAT

Exemptions *(cont.)*

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Firemen associations and corporations	3.1	0.00	0.02	0.01	0.01
Political parties and electoral campaigns	0.5	0.00	0.00	0.00	0.00
Total	**99.9**	**0.06**	**0.70**	**0.34**	**0.17**
VAT total	**99.9**	**0.06**	**0.70**	**0.34**	**0.17**

Table A.16. **Main tax expenditures in Spain**

Country	Spain
Year	2009
From *OECD Revenue Statistics*: (millions EUR)	
GDP	1 095 163.0
PIT revenues	77 007.5
CIT revenues	29 982.1
VAT revenues	56 232.7
Sum (PIT, CIT, VAT)	163 222.3
Total tax revenues	361 418.0

PIT

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
a) Tax allowances					
1. Work-related tax relief	8 420.2	0.77	10.93	5.16	2.33
2. Extending labour market participation	19.6	0.00	0.03	0.01	0.01
3. Geographic mobility	12.5	0.00	0.02	0.01	0.00
4. Disabled active workers	225.1	0.02	0.29	0.14	0.06
5. House renting	264.4	0.02	0.34	0.16	0.07
6. Joint tax declaration	1 856.3	0.17	2.41	1.14	0.51
7. Contributions to social protection schemes	1 945.9	0.18	2.53	1.19	0.54
8. Endowment contributions for the disabled	1.1	0.00	0.00	0.00	0.00
b) Food annuities	*83.2*	*0.01*	*0.11*	*0.05*	*0.02*
c) Tax deductions					
1. Acquisition of own residence	4 268.1	0.39	5.54	2.61	1.18
2. Renting own dwelling	350.0	0.03	0.45	0.21	0.10
3. Economic activities	11.1	0.00	0.01	0.01	0.00
4. Sales of goods produced in the Canary Islands	0.9	0.00	0.00	0.00	0.00
5. Reserve for investments in the Canary Islands	45.7	0.00	0.06	0.03	0.01
6. Gifts	109.5	0.01	0.14	0.07	0.03
7. National heritage	0.4	0.00	0.00	0.00	0.00
8. Income from Ceuta and Melilla	93.9	0.01	0.12	0.06	0.03
9. Corporate savings accounts	1.4	0.00	0.00	0.00	0.00
10. Work income and self-employed tax rebate	5 826.5	0.53	7.57	3.57	1.61
11. Maternity tax deduction	904.2	0.08	1.17	0.55	0.25
12. Children birth or adoption	1 043.6	0.10	1.36	0.64	0.29
d) Exemptions					
1. Reinvested capital gains in own dwelling	1 239.8	0.11	1.61	0.76	0.34
2. Lottery prizes	1 233.2	0.11	1.60	0.76	0.34
3. Literary, artistic and scientific awards	1.3	0.00	0.00	0.00	0.00
4. Invalidity pensions	262.1	0.02	0.34	0.16	0.07
5. Terrorism public aids	1.5	0.00	0.00	0.00	0.00
6. AIDS and hepatitis C public aids	0.3	0.00	0.00	0.00	0.00
7. Unemployment severance payments	146.8	0.01	0.19	0.09	0.04
8. Children and family benefits	119.9	0.01	0.16	0.07	0.03
9. Civil war pensions	4.3	0.00	0.01	0.00	0.00
10. International mission fees	4.0	0.00	0.01	0.00	0.00
11. Unemployment lump-sum benefits	5.2	0.00	0.01	0.00	0.00
12. Sportsmen grants	1.1	0.00	0.00	0.00	0.00
13. Expatriates work income	2.8	0.00	0.00	0.00	0.00
14. Welcomed minors, disabled or aged over 65	1.4	0.00	0.00	0.00	0.00
15. Public scholarships	15.6	0.00	0.02	0.01	0.00

PIT *(cont.)*

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
16. Burial benefits	0.5	0.00	0.00	0.00	0.00
17. Social protection benefits for the disabled	1.4	0.00	0.00	0.00	0.00
18. Dependency benefits	0.3	0.00	0.00	0.00	0.00
19. Other public benefits	7.0	0.00	0.01	0.00	0.00
e) Financial operations tax relief	*7.2*	*0.00*	*0.01*	*0.00*	*0.00*
PIT total	**28 539.0**	**2.61**	**37.06**	**17.48**	**7.90**
PIT total without joint declaration	**26 682.8**	**2.4**	**34.6**	**16.3**	**7.4**

CIT

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
a) Tax base adjustments	*947.5*	*0.09*	*3.16*	*0.58*	*0.26*
1. Free depreciation and other special schemes	179.0	0.02	0.60	0.11	0.05
2. Reserve for investments in the Canary Islands	760.1	0.07	2.54	0.47	0.21
3. Other public grants and indemnities	8.4	0.00	0.03	0.01	0.00
b) Reduced tax rates	*2 253.9*	*0.21*	*7.52*	*1.38*	*0.62*
1. SME	1 907.8	0.17	6.36	1.17	0.53
2. Investment companies	67.4	0.01	0.22	0.04	0.02
3. Other companies	278.7	0.03	0.93	0.17	0.08
c) Tax liability rebates	*588.5*	*0.05*	*1.96*	*0.36*	*0.16*
1. Specially protected cooperatives	51.5	0.00	0.17	0.03	0.01
2. Entities operating in Ceuta and Melilla	53.6	0.00	0.18	0.03	0.01
3. Export activities and provision of public local services	109.7	0.01	0.37	0.07	0.03
4. Financial operations	67.5	0.01	0.23	0.04	0.02
5. Shipping companies in the Canary Islands	65.2	0.01	0.22	0.04	0.02
6. Sales of goods produced in the Canary Islands	109.1	0.01	0.36	0.07	0.03
7. House renting entities	131.8	0.01	0.44	0.08	0.04
d) Tax liability deductions	*2 971.4*	*0.27*	*9.91*	*1.82*	*0.82*
1. Environmental protection	61.4	0.01	0.20	0.04	0.02
2. Job creation for the disabled	5.3	0.00	0.02	0.00	0.00
3. R&D and technical innovation activities	253.1	0.02	0.84	0.16	0.07
4. Cinema productions	18.9	0.00	0.06	0.01	0.01
5. National heritage	0.4	0.00	0.00	0.00	0.00
6. Export activities	99.0	0.01	0.33	0.06	0.03
7. Professional training	24.2	0.00	0.08	0.01	0.01
8. Book's edition	1.3	0.00	0.00	0.00	0.00
9. ITC activities public support	7.0	0.00	0.02	0.00	0.00
10. Road transport vehicles	1.1	0.00	0.00	0.00	0.00
11. Investments in the Canary Islands	215.9	0.02	0.72	0.13	0.06
12. Roll-over investment provisions	1 477.9	0.13	4.93	0.91	0.41
13. Employer contributions to pension plans	23.3	0.00	0.08	0.01	0.01
14. Gifts	122.5	0.01	0.41	0.08	0.03
15. Child-care facilities for workers	0.2	0.00	0.00	0.00	0.00
16. Public interest events	212.0	0.02	0.71	0.13	0.06
17. Remaining investment tax incentives from previous years	448.0	0.04	1.49	0.27	0.12
CIT total	**6 761.3**	**0.62**	**22.55**	**4.14**	**1.87**

VAT

Reduced rates

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Super reduced tax rate	3 359.3	0.31	5.97	2.06	0.93
Reduced tax rate	12 165.7	1.11	21.63	7.45	3.37
Total	**15 525.0**	**1.42**	**27.61**	**9.51**	**4.30**

Exemptions

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Exempted	7 969.4	0.73	14.17	4.88	2.21
Total	**7 969.4**	**0.73**	**14.17**	**4.88**	**2.21**
VAT total	**23 494.3**	**2.15**	**41.78**	**14.39**	**6.50**

Table A.17. **Main tax expenditures in Switzerland**[1]

Country	Switzerland
Year	2007
From *OECD Revenue Statistics*: (millions CHF)	
GDP	521 067.7
PIT revenues	53 075.3
CIT revenues	15 960.2
VAT revenues	19 684.5
Sum (PIT, CIT, VAT)	88 720.0
Total tax revenues	150 558.5

PIT

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
2nd pillar contributions	2 700.0	0.52	5.09	3.04	1.79
2nd pillar returns	1 400.0	0.27	2.64	1.58	0.93
Child deductions	800.0	0.15	1.51	0.90	0.53
PIT total	**4 900.0**	**0.94**	**9.23**	**5.52**	**3.25**

CIT

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Transitory tax holiday for firms investing in certain rural areas	75.0	0.01	0.47	0.08	0.05
CIT total	**75.0**	**0.01**	**0.47**	**0.08**	**0.05**

VAT

Reduced rates

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Reduced rate foods and necessities	420.0	0.08	2.13	0.47	0.28
Reduced rate hospitality sector (lodging)	150.0	0.03	0.76	0.17	0.10
Total	**570.0**	**0.11**	**2.90**	**0.64**	**0.38**
VAT total	**570.0**	**0.11**	**2.90**	**0.64**	**0.38**

1. These figures show estimates only for taxes at federal level. Cantonal and community taxes as well as church taxes are not considered.

Table A.18. **Main tax expenditures in Turkey**

Country	Turkey
Year	2007
From *OECD Revenue Statistics*: (millions TRY)	
GDP	856 386 731.7
PIT revenues	34 446 780.0
CIT revenues	13 750 623.0
VAT revenues	43 285 274.0
Sum (PIT, CIT, VAT)	91 482 677.0
Total tax revenues	203 053 211.0

PIT

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
	7 107 631.3	0.83	20.63	7.77	3.50
PIT total	**7 107 631.3**	**0.83**	**20.63**	**7.77**	**3.50**

CIT

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
	3 173 053.3	0.37	23.08	3.47	1.56
CIT total	**3 173 053.3**	**0.37**	**23.08**	**3.47**	**1.56**

VAT

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
VAT total	**401 807.6**	**0.05**	**1.17**	**0.44**	**0.20**

Table A.19. **Main tax expenditures in the United Kingdom**

Country	United Kingdom
Year	2007-08 fiscal year
From *OECD Revenue Statistics*: (millions GBP)	
GDP	1 381 565.0
PIT revenues	150 993.0
CIT revenues	47 713.0
VAT revenues	92 026.0
Sum (PIT, CIT, VAT)	290 732.0
Total tax revenues	505 941.0

PIT

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Personal allowance	45 100.0	3.22	29.64	15.46	8.93
Personal tax credits	4 700.0	0.34	3.09	1.61	0.93
Age-related allowances	2 500.0	0.18	1.64	0.86	0.49
Registered pension schemes[1]	17 500.0	1.25	11.50	6.00	3.46
Individual savings accounts[1]	1 950.0	0.14	1.28	0.67	0.39
British government securities where owner not ordinarily resident in the United Kingdom[1]	1 460.0	0.10	0.96	0.50	0.29
Child benefit (including one parent benefit)[1]	1 200.0	0.09	0.79	0.41	0.24
Income of charities[1]	1 250.0	0.09	0.82	0.43	0.25
PIT total	**75 660.0**	**5.4**	**49.7**	**25.9**	**15.0**
PIT total without personal allowance	**30 560.0**	**2.2**	**20.1**	**10.5**	**6.0**

CIT

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Small companies' reduced corporation tax rate	4 500.0	0.32	9.47	1.54	0.89
Double taxation relief[1]	15 000.0	1.07	31.58	5.14	2.97
First year allowances for SME[1]	640.0	0.05	1.35	0.22	0.13
R&D Tax Credits[1]	500.0	0.04	1.05	0.17	0.10
CIT total	**20 640.0**	**1.5**	**43.4**	**7.1**	**4.1**
CIT total without double taxation relief	**5 640.0**	**0.4**	**11.9**	**1.9**	**1.1**

VAT

Reduced rates

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Domestic fuel and power	3 100.0	0.221	3.368	1.063	0.613
Certain residential conversions and renovations	150.0	0.011	0.163	0.051	0.030
Energy-saving materials	50.0	0.004	0.054	0.017	0.010
Women's sanitary products	50.0	0.004	0.054	0.017	0.010
Total	**3 350.0**	**0.2**	**3.6**	**1.1**	**0.7**

Zero-rates

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Food	11 850.0	0.85	12.87	4.06	2.35
Domestic passenger transport	2 600.0	0.19	2.82	0.89	0.51
Books, newspapers and magazines	1 700.0	0.12	1.85	0.58	0.34
Drugs and supplies on prescription	1 400.0	0.10	1.52	0.48	0.28
Water and sewerage services	1 300.0	0.09	1.41	0.45	0.26
Children's clothing	1 250.0	0.09	1.36	0.43	0.25
Ships and aircraft above a certain size	700.0	0.05	0.76	0.24	0.14
Vehicles and other supplies to disabled people	350.0	0.02	0.38	0.12	0.07
Construction of new dwellings (includes refunds to DIY builders)[1]	8 700.0	0.62	9.45	2.98	1.72
International passenger transport (UK ortion)[1]	200.0	0.01	0.22	0.07	0.04
Supplies to charities[1]	200.0	0.01	0.22	0.07	0.04
Total	**30 250.0**	**2.2**	**32.9**	**10.4**	**6.0**

Exemptions (includes structural component)

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Rent on domestic dwellings[1]	3 750.0	0.27	4.07	1.29	0.74
Supplies of commercial property[1]	200.0	0.01	0.22	0.07	0.04
Private education[1]	50.0	0.00	0.05	0.02	0.01
Health services[1]	900.0	0.06	0.98	0.31	0.18
Postal services	200.0	0.01	0.22	0.07	0.04
Burial and cremation	100.0	0.01	0.11	0.03	0.02
Finance and insurance[1]	4 500.0	0.32	4.89	1.54	0.89
Betting and gaming and lottery duties[1]	1 200.0	0.09	1.30	0.41	0.24
Small traders below the turnover limit for VAT registration[1]	1 650.0	0.12	1.79	0.57	0.33
Total	**12 550.0**	**0.9**	**13.6**	**4.3**	**2.5**

Others (refunds-structural reliefs)

Description	Absolute value (million)	% GDP	% VAT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Northern Ireland government bodies of VAT incurred on non-business purchases under the Section 99 refund scheme	300.0	0.021	0.326	0.103	0.059
Local authority-type bodies of VAT incurred on non-business purchases under the Section 33 refund scheme (includes national museums and galleries under the Section 33A refund scheme)	7 850.0	0.561	8.529	2.691	1.553
Central government, health authorities and NHS trusts of VAT incurred on contracted-out services under the Section 41 (3) refund scheme	4 350.0	0.311	4.726	1.491	0.861
Total	**12 500.0**	**0.9**	**13.6**	**4.3**	**2.5**
VAT total	**58 650.0**	**4.2**	**63.7**	**20.1**	**11.6**
VAT total (without refunds)	**46 150.0**	**3.3**	**50.1**	**15.8**	**9.1**

1. Includes structural component.

This table lists the most important tax expenditures for the fiscal year 2007-08 in terms of revenue forgone (over 80% of total TE).

In the United Kingdom, tax expenditures are categorised as either: ***Tax Expenditures***, *e.g.* relief for savings in individual savings accounts (ISAs); ***Reliefs with Tax Expenditure and Structural Components***, *e.g.* age related allowances for pensioners or ***Structural Reliefs***, *e.g.* personal allowance for income tax. In most countries structural reliefs are considered as part of the benchmark system.

Table A.20. **Main tax expenditures in the United States**[1]

Country	USA
Year	2007
From *OECD Revenue Statistics*: (millions USD)	
GDP	13 741 600.0
PIT revenues	1 479 663.0
CIT revenues	426 310.0
VAT revenues	–
Sum (PIT, CIT, VAT)	1 905 973.0
Total tax revenues	3 888 059.0

PIT

Description	Absolute value (million)	% GDP	% PIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Exclusion of employer contributions for medical insurance premiums and medical care	133 790.0	1.0	9.04	7.02	3.44
Exclusion of workers' compensation benefits	5 740.0	0.0	0.39	0.30	0.15
Exclusion of interest on life insurance savings	17 370.0	0.1	1.17	0.91	0.45
Exclusion of interest on public purpose State and local bonds	16 130.0	0.1	1.09	0.85	0.41
Exception from passive loss rules for USD 25 000 of rental loss	7 840.0	0.1	0.53	0.41	0.20
Capital gains exclusion on home sales	31 480.0	0.2	2.13	1.65	0.81
Step-up basis of capital gains on assets held at death	32 600.0	0.2	2.20	1.71	0.84
Lower tax rate on capital gains realised	53 230.0	0.4	3.60	2.79	1.37
Deductibility of non-business State and local taxes other than on owner-occupied homes	37 500.0	0.3	2.53	1.97	0.96
Deductibility of charitable contributions, other than education and health	36 830.0	0.3	2.49	1.93	0.95
Deductibility of mortgage interest on owner-occupied homes	84 850.0	0.6	5.73	4.45	2.18
Deductibility of State and local property tax on owner-occupied homes	19 120.0	0.1	1.29	1.00	0.49
Child credit	30 910.0	0.2	2.09	1.62	0.79
Social Security benefits for retired workers	17 690.0	0.1	1.20	0.93	0.45
Accelerated depreciation of machinery and equipment	11 650.0	0.1	0.79	0.61	0.30
Accelerated depreciation on rental housing	9 240.0	0.1	0.62	0.48	0.24
Deferral of tax from employer retirement plans	47 060.0	0.3	3.18	2.47	1.21
Deferral of tax from 401(k) retirement plans	46 000.0	0.3	3.11	2.41	1.18
Deferral of tax from Keogh self-employed retirement plans	11 000.0	0.1	0.74	0.58	0.28
Deferral of tax from individual retirement accounts	9 500.0	0.1	0.64	0.50	0.24
PIT total	**659 530.0**	**4.8**	**44.6**	**34.6**	**17.0**
PIT total less deferrals	**545 970.0**	**4.0**	**36.9**	**28.6**	**14.0**

CIT

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Credit for increasing research activities	10 260.0	0.1	2.41	0.54	0.26
Credit for low-income housing investments	4 660.0	0.0	1.09	0.24	0.12
Exclusion of interest on life insurance savings	2 540.0	0.0	0.60	0.13	0.07
Exclusion of interest on public purpose State and local bonds	7 410.0	0.1	1.74	0.39	0.19
Exclusion of interest on hospital construction bonds	870.0	0.0	0.20	0.05	0.02
Exemption of credit union income	1 310.0	0.0	0.31	0.07	0.03
Inventory property sales source rules exception	1 940.0	0.0	0.46	0.10	0.05
Deduction for US production activities	7 380.0	0.1	1.73	0.39	0.19
Deductibility of charitable contributions, other than education and health	1 370.0	0.0	0.32	0.07	0.04

CIT *(cont.)*

Description	Absolute value (million)	% GDP	% CIT revenues	% sum (PIT, CIT, VAT)	% total tax revenues
Alternative fuel production credit	2 800.0	0.0	0.66	0.15	0.07
Expensing of research and experimentation expenditures	5 090.0	0.0	1.19	0.27	0.13
Graduated corporation income tax rate	5 400.0	0.0	1.27	0.28	0.14
Special ESOP rules	1 100.0	0.0	0.26	0.06	0.03
Expensing of certain small investments	730.0	0.0	0.17	0.04	0.02
Excess of percentage over cost depletion, fuels	710.0	0.0	0.17	0.04	0.02
Special Blue Cross/Blue Shield deduction	620.0	0.0	0.15	0.03	0.02
Accelerated depreciation of machinery and equipment	14 760.0	0.1	3.46	0.77	0.38
Accelerated depreciation on rental housing	620.0	0.0	0.15	0.03	0.02
Deferred taxes for financial firms on certain income earned overseas	2 370.0	0.0	0.56	0.12	0.06
Deferral of income from controlled foreign corporations	12 490.0	0.1	2.93	0.66	0.32
CIT total	**84 430.0**	**0.4**	**12.7**	**2.8**	**1.4**
CIT total less deferrals	**69 570.0**	**0.3**	**9.2**	**2.1**	**1.0**

1. This table lists the 20 largest personal and corporate tax expenditures for fiscal the year 2007 in terms of revenue forgone.

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OECD PUBLISHING, 2, rue André-Pascal, 75775 PARIS CEDEX 16
(23 2010 18 1 P) ISBN 978-92-64-09131-3 – No. 57607 2010

OECD Tax Policy Studies

Choosing a Broad Base – Low Rate Approach to Taxation

Many countries will likely face the need to increase tax revenues, as part of fiscal consolidation, during the next few years. But how is this best done? And what are the considerations when choosing between raising tax rates and broadening the tax base by scaling back or abolishing targeted tax provisions (such as allowances, exemptions and preferential rates)? This report aims to answer such questions by taking a close look at the economic and political factors that influence governments' tax decisions.

Although many countries have broadened their tax bases over the past 30 years, targeted tax provisions, notably tax expenditures, continue to be significant. Like public expenditure, targeted tax reliefs mean that (other) tax rates need to be higher in order to finance these reliefs. This report therefore discusses whether such tax provisions continue to be worthwhile. It includes an annex covering country-specific revenue forgone estimates of tax expenditures for selected OECD countries.

This report also identifies political factors, including the lobbying of influential interest groups, as the main obstacles to base-broadening reforms, and it considers how reforms can be best packaged and presented to overcome such obstacles.

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Please cite this publication as:

OECD (2010), *Choosing a Broad Base - Low Rate Approach to Taxation*, OECD Tax Policy Studies, No. 19, OECD Publishing.
http://dx.doi.org/10.1787/9789264091320-en

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No. 19

OECDpublishing
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ISBN 978-92-64-09131-3
23 2010 18 1 P

