BROADENING THE TAX BASE

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ADB Workshop on Tax Policy for Domestic Resource Mobilisation, 20-23 September 2018
A. Back to the economics…

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

• However, most of the tax expenditures go far beyond market failures and externalities, they just translate political preferences

• Tax expenditures may be right but...
  – They conflict with neutrality
  – They might subsidise economic activity that would have taken place anyway – how much “additional” activity (investment, saving, etc)?
  – They may hamper redistribution
  – Hidden cost (higher tax rates) for the non-privileged part of the tax base
  – They increase administrative and compliance costs
  – They reduce tax revenue in a non-transparent way
  – Benefits > Costs ?

• Need for a cost benefit analysis
  – 1st step: tax expenditures report
  – 2d step: more comprehensive analysis of costs and benefits
In general a tax expenditure is a provision that:

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

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

**Benchmark tax system**
- Revenue raising
- Redistribution

**Tax expenditures & incentives**
B. Benchmark PIT system: an example

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

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

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

• Revenue gain method
• Outlay equivalent method
C. The revenue cost of tax expenditures

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

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

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

• Tax expenditure reports may supplement and be integrated in the annual budget documents and (expenditure allowance) process
• Make the TE report publicly available
• Develop the scope and content gradually over time
E. C&B analysis of tax expenditures

Additional effects of tax expenditures and tax incentives

Intended Distributional Effects

- Revenue forgone
- Undesired effect on income distribution
- Behavioural effects/Non-neutral taxation/
  Final economic incidence
- Administrative and compliance costs
E. Assessing the distributional impact of Tax Expenditures in the VAT

All-country average tax expenditure from reduced rates on food (15 countries)
E. Assessing the distributional impact of Tax Expenditures in the VAT

All-country average tax expenditure from reduced rates on cinema, theatre and concerts (10 countries)
E. Assessing the distributional impact of Tax Expenditures in the VAT

• Reduced rates are a very poor tool for targeting support to the poor:
  – Reduced rates introduced to support the poor provide at least as large a tax saving to the rich, and generally more.
  – Reduced rates introduced for cultural, social good, industry support or other purposes provide a vastly greater tax saving for the rich than the poor.
E. Assessing the Marginal Effective Tax Burden on household savings

Averages across 40-countries, 2016

- Bank Deposits
- Shares: taxed as dividends
- Shares: taxed as capital gains
- Private Pensions: deductible contributions
- Residential property: equity financed; owner-occupied
- Residential property: equity financed; rented

Low income (67%AW)  Medium income (100%AW)  High income (500%AW)
E. Assessing the distribution of financial assets

Financial assets as a share of total financial assets
E. Assessing the distributional impact of Savings Tax Expenditures

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

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