Summary for non-specialists
Occasional Papers No. 207 / December 2014
Occasional Papers index

# Tax expenditures in direct taxation in EU Member States

EU Member States make ample use of tax expenditures with a wide variety of aims including employment creation, innovation, education, entrepreneurship, homeownership and income redistribution. Tax expenditures are special tax provisions that allow certain groups of taxpayers to reduce their tax burden and, therefore, lead to lower tax revenues. In a context of serious public finance challenges, it is important to better understand the economic impact of such tax expenditures. Against the background of a low growth and fiscal consolidation needs in the EU, reviewing tax expenditures systematically and reforming the less useful ones may offer a promising avenue to raise revenue and, at the same time, improve the efficiency of the tax systems.

The economic relevance of tax expenditures could be assessed against a small number of criteria. A first group of criteria covers various facets of the microeconomic efficiency (internalising externalities, minimising distortions generated by taxation and remaining compatible with a sound functioning of the single market). The second group of criteria reflects the capacity to meet social or strategic objectives defined by the government with the most appropriate instruments, which are not necessarily tax expenditures. The last group of criteria relates to the efficient functioning of fiscal policy, which would include keeping the tax system simple and stable, while ensuring transparency and accountability. A thorough assessment of tax expenditures includes an evaluation of their impact according to these three dimensions.

The paper provides an overview of major categories of tax expenditures in direct taxation. It also points out that some well-designed expenditures can enhance positive spill-overs and increase welfare. At the same time, some tax expenditures may lead to large revenue losses, more administrative complexity, unfair and inefficient outcome and sometimes to undesired effects. It is thus important to ensure that tax expenditures do not cause economic distortions and that they are the most cost-efficient means of achieving economic and social policy goals. All in all, there is strong need for stringent monitoring, effective evaluations and transparent communication on the application of tax expenditures in Member States. Tax expenditures could be justified but their utilisation should be based on a clear analysis of costs and benefits. This paper intends to serve as a roadmap for identifying possible risks and challenges that Member States face in order to maximise the economic efficiency of tax expenditures and that are important to bear in mind when assessing policies applied or considered in Member States.

A careful assessment of the efficiency of tax expenditures requires identifying different policy areas and examining how tax expenditures could – or could not – help meet given economic objectives in these areas. A case-by-case analysis with the focus on specific groups of tax expenditures associated with specific economic issues is needed in order to identify policy options. Such a 'bottom-up or thematic' approach by type of economic issue is more fruitful than a comprehensive analysis of tax expenditures. A number of specific tax expenditures in personal income taxation deserve particularly close scrutiny in terms of their costs and benefits. As regards personal income taxation, the paper considers tax expenditures in the area of Making Work Pay policies, self-employment, private pension savings and homeownership. As regards corporate taxation, the paper looks into special corporate income tax regimes, reduced rates for SMEs and tax incentives for R&D.