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The use of tax expenditures in times of fiscal consolidation

Lovise Bauger



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Directorate-General for Economic and Financial Affairs

The use of tax expenditures in times of fiscal consolidation

Proceedings of the workshop organised by the Directorate General for Economic and Financial Affairs held in Brussels on 23 October 2013

Edited by Lovise Bauger

Abstract

Against the background of recovering growth and remaining fiscal consolidation needs, reforming tax expenditures may offer a promising avenue to raise revenue and, at the same time, improve efficiency of the tax systems. The workshop, held by DG ECFIN on 23 October 2013, addressed the economic and budgetary aspects of tax expenditures, including reporting practices, and discussed the rationale for business tax incentives and the distributional effects of tax reliefs in personal income taxation. The workshop was organised in two sessions: "Tax expenditures: measurement and macroeconomic implications" and "Tax expenditures in direct taxation". The proceedings gather together the views on these various dimensions of tax expenditures expressed by academics, national policy-makers and international institutions during the workshop.

JEL Classification: E62, H23, H24, H25.

Keywords: tax expenditures, tax incentives, business tax incentives, proceedings, measurement and macroeconomic implications of tax expenditures, distributional effects, direct taxation, work-related incentives

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1. Summary of the workshop

*Lovise Bauger**

Against the background of recovering growth and remaining fiscal consolidation needs, reforming tax expenditures may offer a promising avenue to raise revenue and, at the same time, improve the efficiency of tax systems. The aim of the workshop was to address the economic and budgetary aspects of tax expenditures, including reporting practices, to discuss the rationale for business tax incentives and address the distributional effects of tax reliefs in personal income taxation. The workshop, organised in two sessions, included speakers from academia, national authorities and international organisations (European Commission and OECD).

Marco Buti (*Director-General of the European Commission's DG ECFIN*) in his introductory statement recalled that tax reforms ranked high on the European policy agenda. According to a recent Eurobarometer poll, public opinion considers tax policy as a major area for reforms in the EU. He referred to the need for refocusing attention on the revenue side of the budget with the aim of improving the surveillance framework. Buti also pointed out that reforming tax expenditures could have substantial impact on Member States' budgets. Furthermore, broadening the tax base by removing unjustified tax expenditures makes compliance easier for citizens and businesses, and tax collection simpler for administrations. Finally, he stressed that regular and mandatory reporting on tax expenditures is crucial not only for ensuring their visibility in public accounts, but also for identifying possible improvements in fiscal and tax arrangements.

Gilles Mourre (*Head of the Tax Policy Unit in DG ECFIN*) delivered a keynote address presenting the main relevant results of the report "Tax reforms in EU Member States 2013", jointly written by DG ECFIN and DG TAXUD. The report illustrates recent trends in tax reforms and identifies areas of tax policy challenges relevant for macroeconomic performance in Member States. Mourre pointed out the specific focus on tax expenditures in the 2013 editions. He presented an overview of reporting practices for tax expenditures in Member States and reminded that Member States will need to regularly publish detailed information on the impact of tax expenditures on revenues in the context of the recent directive on requirements for budgetary frameworks. In his view, the lack of a consistent assessment to tax expenditures makes timely and transparent reporting even more important. He then gave examples of main tax expenditure items in personal income taxation in selected Member States with their estimated budgetary costs. He continued with an overview of areas of tax expenditures in corporate income tax considered in the report. In the wider context of the report, he highlighted the relatively high number of reforms aimed at increasing tax rates rather than at broadening tax bases.

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Session on measurement and macroeconomic implications of tax expenditures

The first session of the workshop, chaired by Philipp Rother (Chief Economic Analyst in DG ECFIN), covered different aspects related to measurement and macroeconomic implications of tax expenditures. Rother stressed that the purpose of this session was to look at the broader picture of tax expenditures, to address their economic, policy and budgetary aspects, and to gain insights on reporting practises.

Pierre LeBlanc (Acting Head of the Tax Policy and Statistics Division, The Organisation for Economic Co-operation and Development (OECD)) focused on reporting practises in non-EU OECD countries. He recalled that all these countries produce regular tax expenditure reports and pointed out some strengths and weaknesses. For instance, Australia's revenue gain estimates were acknowledged as closer to the budgetary effects and hence potentially more useful for policy makers. As for EU Member States, tax expenditure reporting for the area of social security contributions and taxes at regional or local level can be improved. LeBlanc also reminded that there are significant challenges in comparing tax expenditures across countries caused by differences in benchmark and completeness of tax expenditure estimation and reporting. Differences on the public spending side would also matter (e.g. take-up of private pension incentives will in part depend on public pension systems). He discussed the aggregation bias when summing up tax expenditures and showed that a country's reported total tax expenditures could vary significantly depending on the approach chosen. Despite measurement issues and cross-country inconsistencies, according to LeBlanc improvements could be achieved by comparing specific tax expenditures across countries and sharing best practices.

Leonard E. Burman (Professor and Research Associate at Syracuse University and the National Bureau of Economic Research (NBER), Affiliated Scholar at the Urbane Institute) illustrated the main criticism towards tax expenditures in the US, mainly linked to the occurrence and consequences of a "fiscal illusion". In his view, the most relevant issues for tax expenditures is that they might be not fully disclosed to the "average" voter, who might, therefore, not fully perceive their cost. Compared to spending programs, tax expenditures have a privileged status in the budget process, thus benefiting from a "policy bias" compared to traditional spending. Burman showed how this "fiscal illusion" could result in over-provision of tax subsidies and a larger-size of government. He claimed that exclusion of tax expenditures from the budget process is one reason the US budget is out of control. He emphasized furthermore that controlling tax expenditures would have a number of advantages, namely: (i) make government smaller and more efficient, (ii) have positive redistributive consequences and (iii) be part of a much needed tax reform that could simultaneously make the tax system simpler, fairer, and more efficient.

Serena Fatica (Economist in DG ECFIN) presented a forthcoming paper (DG ECFIN and European Commissions Joint Research Centre (JRC)) on work-related tax expenditures in the EU, and the related impact on tax revenues. The paper examines the revenue impact of a marginal reduction in actual tax reliefs and decomposes it into a mechanical (i.e. without behavioural reactions) and a behavioural component. The approach combines a simple theoretical model for labour supply with the EU-wide micro-simulation model EUROMOD

and heterogeneous labour supply elasticities taken from the empirical literature. In the first draft of the paper, France, Spain and the UK are covered (more countries to be covered in the final paper). The preliminary results suggest that the behavioural effects wash away at least one fifth of the mechanical impact of the reform, although clearly the mechanical impact of marginal shocks will depend on the initial size of the tax expenditures. Moreover, in line with the economic literature, the extensive margin of labour supply plays a much larger role than the intensive margin. All in all, the findings suggest caution in reducing those tax reliefs because they can be economically efficient, generating gains in terms of employment and GDP, and partly repaying themselves for this reason.

Chris Heady (Professor at University of Kent) summarized the insights of the session's presentations and expressed his scepticism about the feasibility in developing a common benchmark across countries, arguing that it would be better to focus on specific types of tax expenditures. Furthermore, he supported more developments in the estimation of the revenue cost for tax expenditures and favoured that such estimates should be provided in the annual budget making process to recognise full costs of government policies. He recalled that tax expenditures are not always harmful, but that their associated costs and benefits should be made transparent. In his view, research priorities could lay in improving the accuracy of both the cost estimates and the valuation of their benefits.

Martin Kjellqvist (Deputy Director of the Division for Tax Policy Analysis, Swedish Ministry of Finance) explained that the reporting of tax expenditures in Sweden serves two purposes: (i) to make visible the support to households and firms on the revenue side of the budget and (ii) to describe the degree of uniformity in the tax system. The Government reports tax expenditures to the Parliament along with the Spring Fiscal Policy Bill and in a supplement to the Budget Bill. Kjellqvist noted that a benchmark based on uniform taxation implies that no consideration is given to the motives underlying the tax expenditures and that some reliefs may contribute to improved economic efficiency. Therefore, the report also includes a section discussing tax expenditures and economic efficiency. Tax expenditures are also classified whether they affect the budget balance or not and if they are technically motivated or support a specific expenditure area. He pointed out that tax expenditures are often considered more appropriate than spending programmes because of administrative simplicity.

Session on tax expenditures in direct taxation

The second session of the workshop, devoted to tax expenditures in direct taxation, was chaired by Philip Kermode (Director of direct taxation, DG TAXUD European Commission). This thematic session discussed critically tax expenditures targeted to business and individual taxpayers. Among the former, are the Allowance for Corporate Equity (ACE), tax reliefs for small and medium sized enterprises (SMEs) and research and development (R&D) and accelerated depreciation. Typical examples for the latter are credits and allowances granted under the personal income tax system.

Steve Bond (Senior Researcher at the University of Oxford, Deputy Director of the Economic and Social Research Council at the Institute for Fiscal Studies (IFS)) started off by recalling that the concept of tax expenditures is rather complicated in the context of

business taxation as the logical choice of the benchmark tax system remains unclear. For instance, the existence of an ACE could be viewed as a tax incentive to promote the use of equity finance or regarded as part of the appropriate tax benchmark. He argued that an ACE could neutralize the different treatment of debt and equity financing, eliminating disincentives to investment and provide for a more efficient investment mix than under conventional corporate taxation. Towards accelerated depreciation and general tax incentives for SMEs he took a critical stand. For accelerated depreciation he stressed that this policy is often poorly targeted and difficult to time and that more appropriate policies are often available. In his view, general tax incentives for SMEs would not tackle the more specific sources of market failures and could even lead to productivity losses. He saw a potential justification for some forms of R&D tax incentives. He emphasised that as a general rule it would seem prudent to require a high threshold for evidence of market failures or spillovers in order to justify individual business tax incentives and a full consideration of alternative policy responses.

Thiess Büttner (Chair of Public Finance at FAU Erlangen Nuremberg) while supporting Mr Bond's conclusions on the pros and cons of different business tax incentives, he framed them in the broader context of international tax competition. He stressed that Member States apply tax expenditures to influence location and investment choices of businesses. He showed how the expansion of multinational companies went hand in hand with increased use of R&D tax incentives. He reminded that tax incentives might be rational for the individual government to attract foreign investment, but not necessarily efficient from a general economic perspective. If business tax incentives are provided by a set of competing governments, the policies might be mutually self-defeating and ultimately result in large revenue losses. In contrast, a coordinated elimination of those incentives might be preferable. He also noted that while specific subsidies and specific tax concessions to firms would violate EU state aid rules, more general tax expenditures could be used as a substitute to attract foreign direct investment.

Silvia Avram (Senior Researcher at University of Essex) presented results from the tax-benefit micro-simulation model EUROMOD on the distributional effects of tax allowances and tax credits in the personal income taxation legislation in six European countries (the Czech Republic, Denmark, Germany, France, Italy and Spain). Her aim was to examine if tax expenditures in those countries are regressive, as literature based on US data suggests. She finds that with a few exceptions, tax allowances and credits benefit large sections of the population and that they are a significant spending item relative to government revenue. She also finds that the distributional outcome depends on the type of measure. Tax allowances tend to benefit households higher up in the income distribution more. Tax credits, on the other hand, are more likely to benefit in particular low and middle income households.

Camille Landais (Lecturer at the London School of Economics) discussed the budgetary and economic aspect of tax expenditures in France. He noted that from an economic point of view subsidising a good via tax expenditure is essentially equivalent to a direct subsidy via government spending. In France most refundable tax credits are treated as public spending while most other tax expenditures are not. According to budget figures, tax expenditures seem to be massively on the rise in France and a large number of them are not quantified.

Landais also pointed out that also as a result of tax expenditures the share of capital included in the income tax base is decreasing over time, not only reducing the overall base, but also the progressivity of the tax system. In his view, better information on tax expenditures would give a more comprehensive understanding of the total redistribution operated by the tax-benefit system. He particularly stressed improvement in the quality of data collection and in the evaluation of the effectiveness and welfare effects of tax expenditures.

Concluding policy panel

The concluding policy panel discussion recalled the complexity of the concept of tax expenditures and advocated more transparency in the use of such reliefs. The common view emerged that the threshold of evidence for justifying new tax reliefs should be high, and that a thorough cost-benefit analysis is needed in any instances. In assessing and reviewing tax breaks, a more thematic approach focusing on specific types of tax expenditures or relevant grouping was recognised as a promising avenue. It was also recalled that international and regional tax competition creates pressure to introduce certain tax expenditures, and constitute a revenue challenge for jurisdictions. The administrative cost of tax expenditures and potential possibilities of over-reporting was also recognized. Finally, introducing caps on tax expenditures was discussed with different views towards their employability.

Lucio Pench (Director for Fiscal Policy in DG ECFIN) closed the workshop by envisaging need for further work in the area, with the view of establishing a sort of typology for assessing the desirability of different tax expenditures. He also saw benefits in exchanging information on national reporting practises to improve transparency.

2. Lessons from the 2013 report "Tax reforms in EU Member States"

*Gilles Mourre**

Introduction and general issues

The 2013 edition of the ECFIN/TAXUD tax reform report illustrates the recent trends in tax reforms in EU Member States, and represents a first attempt to identify tax policy challenges in Member States by using an indicator-based assessment, with the view to improving the contribution of taxation to growth-friendly consolidation and to macroeconomic performance. This implies reviewing critically not only the level of taxation, but most importantly its structure and the design of specific taxes, in order to minimise the negative impacts on employment and growth, and to enhance the prevention of macroeconomic imbalances (see also, Mourre, 2013). In this context, the Report provides some analytical underpinnings for the Country Specific Recommendations issued in the framework of the European Semester, and stimulates a dialogue on taxation between the Commission and Member States. In addition, the 2013 Report deepens the analysis of tax expenditures, including reporting, with a specific focus on the area of direct taxation (personal and corporate income taxation).

Tax expenditures can be defined as "provisions of tax law, regulation or practices that reduce or postpone revenue for a comparatively narrow population of taxpayers relative to a benchmark tax"¹. Tax expenditures can take a number of forms (e.g. allowances, exemptions, rate relief, deferrals, and tax credits). As instruments for promoting specific social or economic policies, they are functionally closely related to direct spending programmes.

From a public finance perspective, tax expenditures entail costs in terms of foregone revenue compared to a benchmark tax system. A precise quantification of such losses is not straightforward, notably because of behavioural responses, interactions with other tax bases and other methodological issues. One example is the abolition of tax reliefs on mortgages, which could indirectly increase tax revenues from dividend and interest income once households have readjusted their portfolios to accommodate the higher cost of mortgages.

Since the definition of the benchmark tax system varies across countries, the very same identification of what precisely constitutes a tax expenditure will differ. In the absence of a commonly agreed definition of the concept, the case for transparent reporting of tax expenditures is even stronger. In the transposition of the Directive on requirements for budgetary frameworks (Council directive 2011/85/EU), Member States will be required to provide information on the tax expenditures and their impact on revenues. Article 14(2) of

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¹ OECD (2010a) with reference to Anderson, B. (2008). Favourable tax treatment may also be given in connection with a specific sector or activity, e.g. reduced VAT for hotel services and accelerated depreciation for specific types of investment.

the Directive states that: "Member States shall publish detailed information on the impact of tax expenditures on revenues".

Overview of existing reporting requirement of tax expenditure in Member States

Table 1 provides an overview of reporting practices in the EU Member States at mid-2013. In particular, the table highlights the presence of reporting requirements according to national law, the coverage in terms of level of government and the categorisation of tax expenditures used. There is a national legally binding requirement to report tax expenditures in 9 out of the 17 Member States that reported them regularly in 2013. Countries differ markedly also in the levels of government covered by the reporting. While central government is widely covered, tax expenditures related to local taxes and social security funds seem to be less frequently recorded. This is partly due to the heterogeneity of the taxes applied by local and regional entities. There is also large variability in terms of the number of years covered by the national reports and regarding whether reporting has a forward looking component, thus including prospective budget impacts.

Table 1. Elements of regular reporting practices of tax expenditure (2013)

Country	Legal requirement	Levels of government covered				Time coverage	Categorization
		Central government	State government	Local government	Social security funds		
BE	X	X				t-5, t-4, t-3, t-2, t-1	tax base, purpose
DE	X	X	X	X		t-2, t-1, t, t+1	tax base, type of tax measure, purpose, sector
EE		X	n.a.			t, t+1	tax base, purpose
ES	X	X	X			t+1	tax base, type of tax measure, expenditure category
FR	X	X	n.a.		X	t-1, t, t+1	tax base, expenditure category
IT	X	X	n.a.	X		t, t+1, t+2	type of tax measure, purpose, sector
NL		X	n.a.			t-2, t-1, t, t+1, t+2, t+3, t+4	tax base
AT	X	X	X			t-3, t-2, t-1	tax base, sector
PT	X	X	n.a.			t-2, t-1, t, t+1	tax base, purpose
SK	X	X	n.a.	X	X	t-2, t-1, t, t+1, t+2, t+3	tax base
FI		X	n.a.	X		t-1, t, t+1	tax base, purpose
DK		X	n.a.	X		various years	tax base
LV		X	n.a.			t-2, t-1	tax base
HU	X	X	n.a.			t+1	tax base
PL		X	n.a.	X		t-1	tax base, purpose
SE		X	n.a.	X	X	t+1, t+2, t+3	tax base, type of tax measure, expenditure category
UK		X	n.a.	X		t-1, t	tax base

Note: In the column for time coverage "t" refers to the year of publication. "n.a." stands for "not applicable". See the report "Tax reforms in EU Member States 2013" for further details.

Source: Commission services based on national sources.

Tax expenditures are generally categorised according to the corresponding tax base (e.g. VAT, personal income tax, or corporate income tax) and often grouped according to i) the type of relief (e.g. allowances, rate relief, exemptions), ii) purpose (support to low income earners, housing, etc.) or iii) sector (households, businesses, or agriculture). Some countries also link tax expenditures to the expenditure side of the budget by referring to expenditure areas or more concretely even budget posts (e.g. Spain, France and Sweden).

Table 2. Main tax expenditure items in the personal income tax system

Country	Item	Cost (% GDP)	Reference year	Country	Item	Cost (% GDP)	Reference year
AT	Reduced tax rate for Christmas and holiday earnings	1.96	2011	FR	Tax deduction for household employees	1.96	2011
	Preferential treatment of severance and specific non-regular earnings	0.29	2011		Tax relief on pensions	0.16	2013
	Low taxation of other earnings (compensation for overtime, nights, Sundays and bank holidays etc.)	0.26	2011		Work credit	0.12	2013
	Allowance for invested profit	0.15	2011		Tax deduction for nursery services	0.09	2013
	Standard deduction for special expenses (related to insurances, housing and certain shares)	0.13	2011		Tax deduction for savings payments	0.07	2013
BE	Tax reduction for pensions	0.64	2010	IT	Tax credit for employment income, pensions and self-employment income	2.41	2012
	Tax deduction sole own dwelling	0.29	2010		Tax credit for dependent family members	0.67	2012
	Tax reduction for energy savings	0.21	2010	NL	Tax deduction for self-employed	0.31	2013
	Tax reduction housing saving	0.21	2010		Tax exemptions for certain capital payments	0.15	2013
	Tax reduction for 3rd pillar pension savings	0.14	2010		Tax deduction for debtless own dwelling	0.06	2013
DE	Exemption for labour income from shift work	0.08	2012		Tax deduction of donations	0.06	2013
	Tax subsidy for owner-occupied housing (incl. child bonus)*	0.05	2012		Tax deduction of schooling costs	0.04	2013
	Tax reduction for private renovation	0.06	2012	PL	Child tax credit	0.38	2011
	Tax incentives for old age private pension	0.05	2012		Joint taxation of spouses	0.2	2011
EE	Increased basic exemption in the event of pension	0.7	2013		Agricultural subsidies	0.15	2011
	Increased basic exemption from the second child	0.14	2013		Exemption of family benefits, family and nursing benefits, etc.	0.11	2011
	Deduction of mortgage interest	0.1	2013	SE	Relief on imputed rents on owner-occupied housing (single homes and apartments)	0.69	2011
	Deduction of training expenses	0.08	2013		Exemption of child benefits	0.43	2011
ES	Work-related allowances	1	2013		Relief on the return on pension savings	0.4	2011
	Deductions for investments in housing	0.18	2013		Deferred tax on capital gains from housing (single homes and apartments)	0.25	2011
	Allowances related to joint taxation	0.17	2013		Reduced tax on realised capital gains from housing	0.25	2011
	Allowances for social security contributions	0.11	2013	UK	Relief for registered pension schemes	1.4	2012-13
	Exemptions for awards from lottery, bets etc.	0.09	2013		Exemption of gains arising on disposal of only or main residence	0.64	2012-13
FI	Exemption of imputed rents	1.37	2011		Personal tax credits	0.25	2012-13
	Allowance for pension insurance contributions	0.84	2011		Relief for individual savings accounts	0.11	2012-13
	Allowance for labour income	0.79	2011		Relief for entrepreneurs' qualifying business disposals	0.11	2012-13
	Allowance in municipal taxation	0.74	2011				
	Exemption of capital gains on owner occupied housing	0.69	2011				

Source: Commission services based on national sources.

Tax expenditures in personal income taxation

Table 2 gives examples of large tax expenditure items in personal income taxation for selected Member States, alongside their estimated budgetary costs (in % of GDP). Given the cross-country classification and measurement issues mentioned above, the data do not lend themselves to any systematic and general cross-country comparisons.

A purely qualitative assessment on the types of tax expenditures most frequently used can however be attempted, on the basis of the policy objectives pursued: for instance, i) family-related expenditures, ii) provisions related to housing, different provisions favouring pension savings and iii) tax incentives favouring labour income and encouraging labour supply can be easily identified in the table. Provisions related to housing are relatively numerous and comprise exemption of imputed rents, deductibility of mortgage interest payments and several different types of reliefs on capital gains (taxed under personal income taxations). Tax incentives favouring labour income take different forms, and are relatively widely used

across the Member States. The budgetary impacts of reforming some of the work-related tax expenditures is analysed jointly by ECFIN and JRC. The preliminary results of this investigation is presented in in section 3.3 of these proceedings (Fatica, Barrios, Martinez-Lopez and Mourre, 2013).

Corporate tax expenditures

Tax expenditures in the corporate income tax systems are also relatively numerous, and in some cases rather generous. Table 3 indicates areas of corporate tax expenditures that may be worth assessing for each EU Member State. Furthermore, it identifies in particular Member States where a review seems warranted at first glance. Although some of the tax expenditure items may find their rationale in the achievement of specific policy objectives (growth, employment, innovation, etc.), the question remains whether they are effective and whether they are the best instruments for achieving their goals. The presentation by Steve Bond in the afternoon session will indeed be devoted to the general issues related to the use and design of business tax incentives.

Table 3. Corporate tax expenditures (2012)

Country	Corporate tax expenditures					Room for tax expenditure review
	Reduced rates for SMEs	Reduced rates for regions / sectors	Accelerated Depreciation	R&D Incentives	Investment Incentives	
BE	X	X	X	X	X	X
DE		X	X			
EE						
IE		X		X		
EL		X			X	
ES	X	X	X	X	X	X
FR	X	X	X	X		X
IT		X			X	
CY		X				
LU	X		X		X	X
MT		X		X	X	X
NL	X	X	X	X	X	X
AT				X		
PT		X		X		
SI	X	X		X	X	X
SK			X		X	
FI		X	X			
BG		X				
CZ			X	X	X	X
DK		X	X			
LV	X	X	X		X	X
LT	X	X	X	X	X	X
HU	X				X	
PL		X	X			
RO	X		X	X		X
SE						
UK	X	X	X	X		X

Note: Member States are considered to have a room for a tax expenditure review if they have an "x" in at least three categories in columns 2-6.

Source: Commission services, International Bureau of Fiscal Documentation (IBFD) and Taxes in Europe Database.

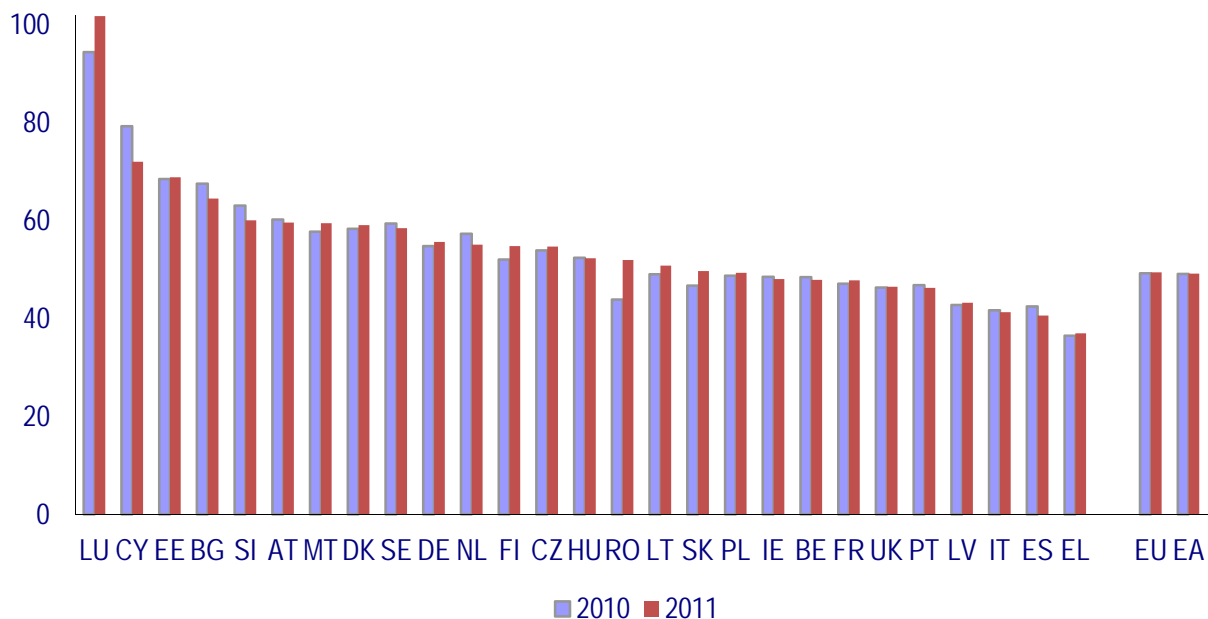
Broadness of VAT

VAT reduced rates and exemptions are often considered to represent tax expenditures. VAT revenues collected in the EU Member States fall generally short of the theoretical benchmark level achievable if all consumption items were taxed at the standard rate. Reduced rates and exemptions under the VAT, although allowed by the EU legislation, are often regarded as tax

expenditures in economic terms. However, some experts object this categorisation, since reduced rates in many cases (e.g. foods, pharmaceuticals) benefit all consumers potentially, and not specific groups.

VAT efficiency could be increased by having a broad base, limiting the use of exemptions and reducing the scope for a diversified rate structure. Figure 1 shows the actual VAT revenue as a percentage of theoretical revenues at standard rates in Member States. A low value suggests that exemptions, reduced rates, or tax evasion have a significant impact on VAT-efficiency. While about half of the Member States have introduced VAT reforms between 2012 and the first half of 2013, the majority of these corresponds to increases in statutory rates, rather than a streamlining of reduced rates (i.e. through a wider application of the standard rate). Thus, in many Member States, there is still scope for improving the structure of the VAT system, in order to increase revenue, achieve higher compliance, and simplify the tax system.

Figure 1. Actual VAT revenues as a percentage of theoretical revenues at standard rates, 2010 and 2011



Note: The ratio consists of actual VAT revenues divided by the product of the VAT standard rate and net final consumption expenditure, i.e. final consumption expenditure minus VAT receipts. The indicator is analogous to the ‘C-efficiency’ and ‘VAT revenue ratio’ computed by the OECD. The high value for Luxembourg is explained by the importance of the VAT collected on the sales to non-residents
Source: Commission services

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3 SESSION I: Tax expenditures: measurement and macroeconomic implications

3.1 Tax expenditures: An OECD-wide perspective

*Pierre LeBlanc**

As the Commission's report "Tax reforms in EU Member States 2013" presented by Gilles Mourre provides a good overview of reporting practices in EU member states, I will mainly focus on tax expenditure reporting in non-EU OECD countries. All those countries produce regular tax expenditure reports, with, however, differing scope and quality. Australia, Canada and Switzerland show some interesting approaches. Australia's revenue gain estimates performed for certain major tax expenditures take account of behavioural responses; since they come closer to budgetary effects, they are hence potentially more useful for policy makers. Canada's estimates for memorandum items (considered part of the benchmark, e.g. avoiding double taxation, loss carry-forwards and carry-backs) provide useful additional information as well. In Switzerland, the impact of the choice of benchmark is shown by using both the comprehensive income tax and the consumption tax benchmark. As for EU Member States, tax expenditure reporting of social security contributions and taxes at the sub central level is limited and could be improved.

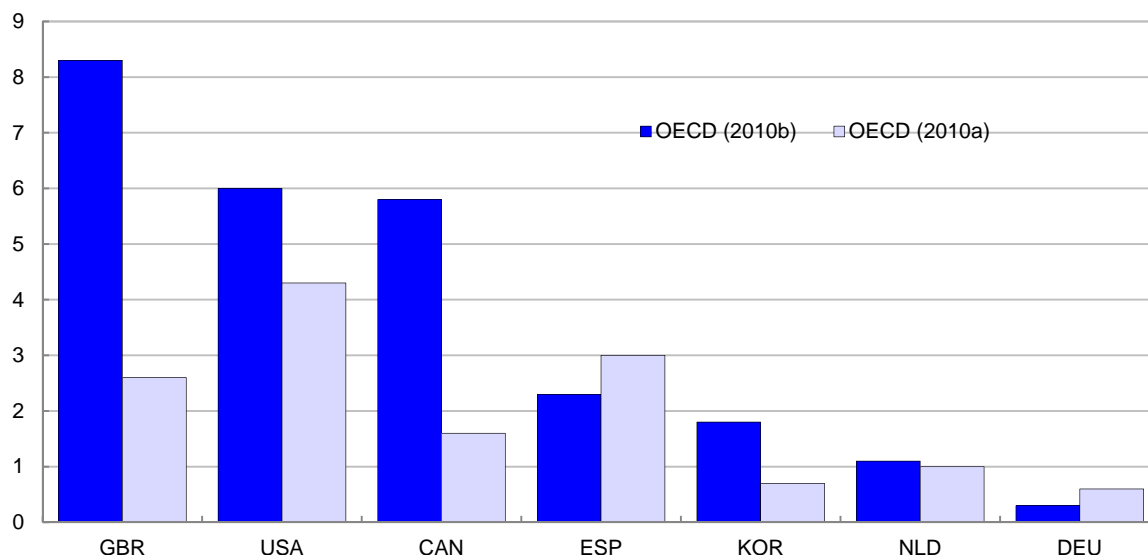
In EU Member States there is evidence of offsetting pressure on tax expenditures: on the one hand initiatives to reduce tax expenditures to meet fiscal consolidation requirements and on the other hand calls to boost investment, employment and growth by means of tax incentives. This tendency has also been present in some non-EU OECD countries, but to a lesser extent. One relevant exception to mention is Japan, where a planned consumption tax hike as response to a very large budget deficit in the context of a difficult economic situation is accompanied by additional tax incentives for business investment and salary growth. Another interesting case is the ongoing tax reform in Mexico with a significant increase in tax revenues involving also reductions in tax expenditures in VAT, CIT and PIT.

As the OECD and the European Commission have recognized, it is important to keep in mind that the applicability of international comparisons of tax expenditures is rather limited. Clear challenges stem from the use of different benchmarks and different coverage or completeness of tax expenditures even within one rather comparable benchmark. Some typical examples include the treatment of owner-occupied housing and the question whether the non-taxation of imputed rents or the interest deductibility for mortgages are regarded as a tax expenditure and the issue of whether accelerated depreciation is recalled as a tax expenditure or not. Differences in public spending also influence the take up and potentially need for tax expenditures in a policy area (e.g. take-up of private pension incentives will in part depend on the layout and generosity of public pension systems). Furthermore, summing

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up single tax expenditures items will lead to an aggregation bias which will vary across countries. The following figure shows how the measured total tax expenditures in terms of GDP vary even for two publications of the same year and by the same organization, namely the OECD.

Figure 1. Tax expenditures in PIT and CIT as % of GDP



Note: Different years between 2004 and 2008.

Source: Cournède, B. et al. (2013) based on OECD (2010a) and OECD (2010b).

Despite measurement issues and cross-country inconsistencies, insights could be gained from comparing concrete tax expenditures items across countries, rather than total tax expenditures, and from sharing best practices on for instance reforms of tax expenditures. More work on the relationship between tax expenditures and spending measures would also be of interest. Some examples of relevant OECD initiatives include work on tax expenditures related to education and training, research and development, "make-work pay" measures, tax expenditures for fossil fuels and the tax treatment of company cars.

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3.2 Economic, policy and budgetary aspects of tax expenditures

*Leonard E. Burman and Marvin Phaup**

For the past five years, the U.S. Congress and the president have debated how best to tackle the federal debt. Democrats have insisted that tax increases be part of any agreement while Republicans argue that all the cuts must come on the spending side.

Absent ideological objections, there really should be no conflict. Public finance economists and academic tax lawyers have long recognized that there are a number of spending programs run through the tax code. The biggest "tax expenditures" -the tax exclusion for health insurance and the mortgage interest deduction- are just subsidy programs run through the income tax rather than a program agency (see Table 1.). Repealing or curtailing some of those subsidies would simultaneously increase tax revenues and cut spending.

Table 1. Largest Tax Expenditures in FY 2011, In Billions of Dollars*

	Provision	Amount
1	Exclusion for employer-sponsored health insurance	177.0
2	Mortgage interest deduction	104.5
3	401(k) plans	67.1
4	Deduction for state and local taxes other than property taxes	46.5
5	Step-up basis of capital gains at death	44.5
6	Lower rate on capital gains	44.3
7	Charitable deduction (other than education and health)	43.9
8	Pensions (defined benefit)	44.6
9	Exclusion of net imputed rental income	37.6
10	Capital gains exclusion on home sales	31.3

Note: Provisions are ranked based on 5-year total cost, FY 2011-2015.

Source: US Budget, Analytical Perspectives, FY2011.

The tax expenditure concept dates back to 1967, when Treasury Assistant Secretary Stanley Surrey directed his staff to compile lists of "government spending for favored activities or groups, effected through the tax system rather than through direct grants, loans, or other forms of government assistance" (Surrey and McDaniel, 1985).

Some critics object to the notion that letting taxpayers keep more of their own money could be construed as spending. But most economists can readily see the duality between tax expenditures and traditional spending programs in the sense that they have nearly identical effects on the budget, resource allocation, relative prices, and the distribution of income. The only difference, typically, is in who administers the program.

* This contribution is adapted from Leonard E. Burman and Marvin Phaup, "Tax Expenditures: The Big Government Behind the Curtain", VoxEU.org, 17 November 2011. Leonard E. Burman who held the presentation at the workshop is professor of Public Affairs and a research associate at Syracuse University, an affiliated scholar at the Urban Institute, and research associate at the National Bureau of Economic Research (NBER).

The late economist, David Bradford (2003), famously illustrated this point by proposing, with tongue firmly in cheek, a Weapons Supply Tax Credit, which would allow arms manufacturers to sell their ordinance to the Pentagon in exchange for tax credits rather than cash. Instantly, the Defense Department's budget would decline by the amount of transformed spending. Tax revenues would fall by a similar amount (or more, if weapons suppliers demanded a premium on account of the complexities and uncertainties associated with the tax credit mechanism). But government would be doing exactly the same thing. Only the accounting would change.

A more substantive debate relates to the baseline against which tax expenditures are measured. (Donald Marron (2011) has an especially lucid discussion of the baseline and measurement issues.) Surrey thought a very comprehensive income tax should be the baseline, but others have pointed out that, against that yardstick, tax incentives for saving and lower tax rates on dividends and capital gains are counted as tax expenditures when those provisions would be the norm under a consumption-based tax system. Since the US income tax is really a hybrid combining aspects of income and consumption taxes –and many economists favor a consumption tax on efficiency grounds– it is not clear which baseline is most appropriate. Donald Marron and Eric Toder (2011), however, have estimated that about 70 percent of tax expenditures would be treated as such against either baseline. At 2011 levels, that would amount to about \$800 billion of spending that most economists would agree should be subject to scrutiny.

While Surrey thought that the sole function of the tax code was to raise revenue to finance the government, there may be good reasons to run some programs through the IRS. For example, when information on eligibility is already reported on tax returns or easily obtainable by the tax authorities, a tax expenditure might be easier to administer and comply with than a traditional spending program. But tax expenditures receive preferential treatment in the US political and budgeting process.

The basic problem is that tax expenditures are mostly hidden from public view. Political scientist Chris Howard (1997) aptly named them "The Hidden Welfare State". Another political scientist, Suzanne Mettler (2011), referred to "The Submerged State". Mettler contends that the relative invisibility of tax expenditures undermines democracy because their relative obscurity makes it more difficult for citizens to understand how government programs affect them. Lobbyists can sneak expensive ineffective subsidies into the tax code that would never pass muster as direct spending programs –think ethanol tax credits. Moreover, even relatively worthwhile programs (Mettler cites the Affordable Care Act) may be misunderstood when important provisions are run through the tax code.

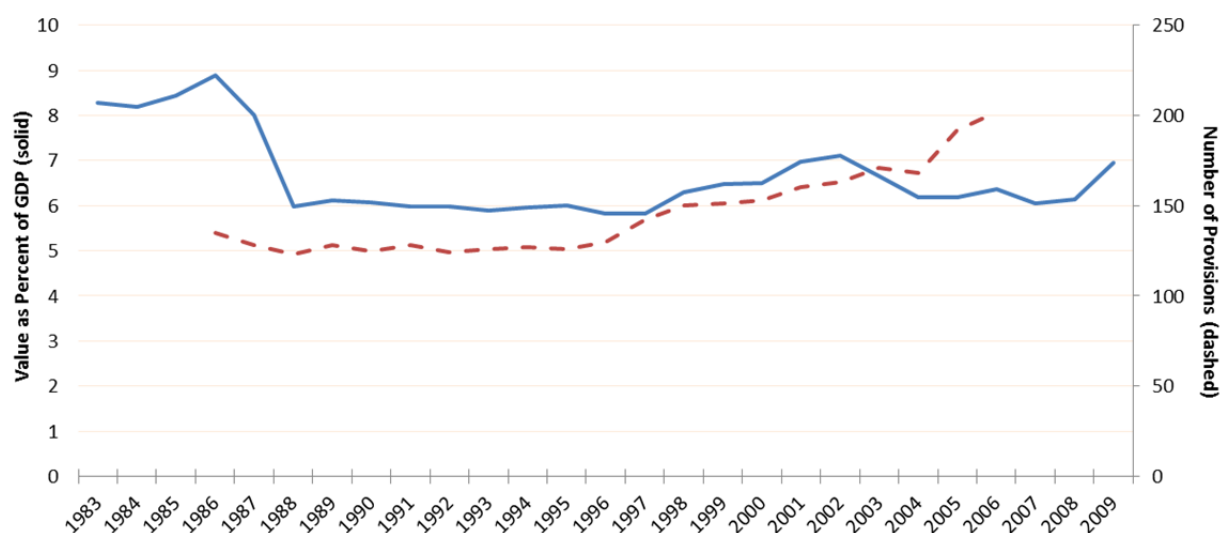
We (Burman and Phaup, 2011) have another concern: voters may not fully perceive the cost of tax expenditures, resulting in a government that is larger and less efficient than would prevail if citizens had full information. Tax expenditures have a privileged status in the budget process. A new tax credit or deduction is considered a "tax cut", and thus relatively immune from the "tax and spend" critique that would apply to a similar spending program. Tax expenditures are scored as reductions in revenues rather as a new spending program. As a result, both spending and taxes are understated. In a political context where both are

considered bad, this clearly creates a bias in favor of tax expenditures over traditional spending.

Burman and Phaup (2011) develop a simple model to illustrate the distortions that could be created from current treatment of tax expenditures. In this model voters value both tax expenditures and cash outlays, but they underestimate the cost of the former. This "fiscal illusion" lowers the relative price of tax expenditures compared with cash outlays, resulting in over-provision of tax subsidies and a higher overall level of government spending than would occur with an accurate perception of price. Taxes, either now or in the future, also are higher than they would be in the absence of this distortion. Indeed, if tax expenditures and cash outlays are complements, even traditional spending could rise. And there is a production inefficiency as more and more resources are diverted from cash outlays into increasingly inefficient tax expenditures.

It is not clear how to test this hypothesis empirically. As noted above, tax expenditures are quantitatively large--\$1.2 trillion by the Treasury Department's broad definition, and \$0.7-0.8 trillion under the narrower baselines suggested by Marron (2011). By comparison, individual income tax revenues in 2011 are an estimated \$1.1 trillion. But the size of tax expenditures has not varied greatly relative to GDP since the Tax Reform Act of 1986 eliminated a number of them (See Figure 1.). The largest determinant of the value of tax expenditures turns out to be marginal income tax rates –since deductions and exclusions are worth more at higher tax rates than lower ones– but that makes interpreting trends difficult.

Figure 1. Number and Value (as Percent of GDP) of Tax Expenditure Provisions, 1983-2009



Source: For tax expenditures as percent of GDP, GAO analysis of OMB, Analytical Perspectives, Budget of the United States Government, Fiscal Years 1985-2011; for count of provisions, Joint Committee on Taxation (annual tax expenditure compilations back to 1985), and author's calculations.

Perhaps a better metric is the number of tax expenditures, which has increased sharply since 1986. The Joint Committee on Taxation (2011) estimated that there were 202 tax expenditures in 2007, a 50 percent increase from 1986, when there were 135. Some of this

increase was due to a change in the way the JCT compiled tax expenditures. (Buckley 2011) So the specific estimates should be taken with a large grain of salt, but there's no doubt that the number has increased dramatically. However, Buckley also points out that many of the largest tax expenditures have been in the tax code for a very long time and survived the massive tax reform enacted in 1986, suggesting that there is little political will to revise these programs.

So far, we've emphasized that controlling tax expenditures is necessary to make government smaller and more efficient, an argument that would seem to appeal to conservatives, but there is also a liberal argument for subjecting tax expenditures to scrutiny. With the exception of refundable tax credits, which are available even to taxpayers with little or no income tax liability, tax subsidies are most valuable to people with higher incomes. (See Table 2.) Burman, Geissler, and Toder (2008) estimated that income tax expenditures reduced tax liability by 13.5 percent of income for taxpayers in the top 1 percent of incomes, compared with less than 7 percent for households with low or moderate incomes. Thus, if safety net programs like food stamps and Medicaid are on the chopping block, upper middle class tax entitlements like the mortgage interest deduction and tax-free health insurance should also be scrutinized.

Table 2. Tax Expenditures as a Percentage of After-Tax Income, Selected Quintiles, 2007

Type	<u>Bottom</u>	<u>Middle</u>	<u>Top</u>	<u>Top 1%</u>	<u>All</u>
Exclusions	0.6	4.0	4.3	2.5	4.0
Above-line deductions	0.0	0.1	0.1	0.1	0.1
Capital gains, dividends	0.0	0.0	2.1	5.9	1.3
Itemized deductions	0.0	0.4	3.0	3.4	2.1
Nonrefundable credits	0.1	0.3	0.1	0.0	0.1
Refundable credits	5.5	2.2	0.3	0.0	1.1
All provisions	6.5	6.8	11.4	13.5	9.6

Source: Burman, Geissler, and Toder (2008)

Finally, the most successful budget plan will be one that reduces the debt without impairing economic growth. Raising tax rates would entail significant economic costs while base broadening reduces the cost of taxation. (Saez, Slemrod and Giertz 2009) According to James Poterba (2011), "because [tax expenditures] distort behavior relative to a neutral tax code, it is possible that eliminating some or all of them could simultaneously raise revenue and reduce tax-induced distortions of economic activity". That is, curtailing tax expenditures can be part of much needed tax reform that could simultaneously make the tax system simpler, fairer, and more efficient.

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3.3 Work-related tax expenditures in the EU: impact on tax revenues

*Serena Fatica (with Salvador Barrios, Diego Martinez-Lopez and Gilles Mourre)**

Broadening tax bases is a recurrent policy recommendation in the context of tax reforms aimed both at enhancing tax collection capacity and at minimising the economic distortions brought about by taxation. A way to do so is to reduce tax expenditures.

However, some tax expenditures might also prove efficient from a fiscal perspective if their adverse impact on tax revenue is more than compensated by their incentive effects on economic activity. One emblematic example is making work pay (MWP) tax reliefs². These tax benefits aim, on the one hand, to make work more attractive by providing a financial incentive to unemployed or inactive individuals to become employed, and, on the other hand, to support those who are at risk of poverty or social exclusion even when employed. Over the past two decades, a growing number of EU Member States have implemented such schemes. In terms of policy design, the relief can be granted through a tax credit (that is, a direct reduction of the gross tax liability) or as allowance (generally, leaving a fraction of earned income tax exempt). In any case, an important feature is the tapering off of the benefit as earned income increases. Moreover, eligibility criteria other than income (e.g. based on household and individual characteristics) may determine the generosity of the relief.

In a forthcoming paper (Barrios et al., 2014), we aim at quantifying the tax revenue impacts of reforms affecting MWP tax reliefs accounting also for the potential effects from increased labour supply. For this purpose, we combine results from the microsimulation model EUROMOD with a theoretical framework that captures labour supply both at the extensive and at the intensive margin, as put forward by Saez et al. (2002), and expanded by Kleven and Kreiner (2006). We explicitly allow for heterogeneity across countries and individuals by appropriately calibrating the labour supply elasticities, which we draw from the empirical literature. The analysis so far, to be extended, covers three European economies, namely France, Spain and the United Kingdom. The MWP policy is well identified for these countries³.

* Fatica and Mourre: European Commission, Directorate General for Economic and Financial Affairs. Barrios: European Commission, Joint Research Centre (JRC) – Institute for Prospective Technological Studies (IPTS). Martinez-Lopez: Universidad Pablo de Olavide.

² A discussion of the rationale for such tax reliefs as well as of the experience in selected Member States is provided in European Commission (2013).

³ The MWP policies we consider (as in 2010) are the following. For France: the Employment Bonus (Prime pour l'emploi – PPE) is an individual tax credit, whose amount depends on earned income, the tax unit income, the number of hours worked. It increases with the number of dependent children, and is phased out above €16,251 (for single earners). For Spain: non-refundable tax allowance (lost if the allowance exceeds taxable income) for taxpayers who receive “employment income”. The amount of the allowance diminishes as the level of net employment income increases, varying between €2,652 and €4,080. For the UK: the working tax credit (WTC) is an income-tested refundable tax credit. WTC contains a number of elements depending on family composition (basic, couple and lone parent element), health (disability and severe disability element), number of hours worked and age of the claimant.

Moreover, the countries give rise to a very diverse set of policy configurations, for instance in terms of type (credit vs. allowance) and design (e.g. conditionality on family characteristics) of the work-related tax expenditures, and, more in general, of the overall tax-benefit system.

The overall change in revenues (dR) following a generic marginal tax reform affecting disposable income can be expressed in a compact way as:

$$dR = \underbrace{dM(T_i)}_{\text{mechanical}} + \underbrace{dB^{INT}(\tau_i, \varepsilon_i)}_{\text{intensive margin}} + \underbrace{dB^{EXT}(a_i, (T_i - T_0), \eta_i)}_{\text{extensive margin}}. \quad (1)$$

behavioural

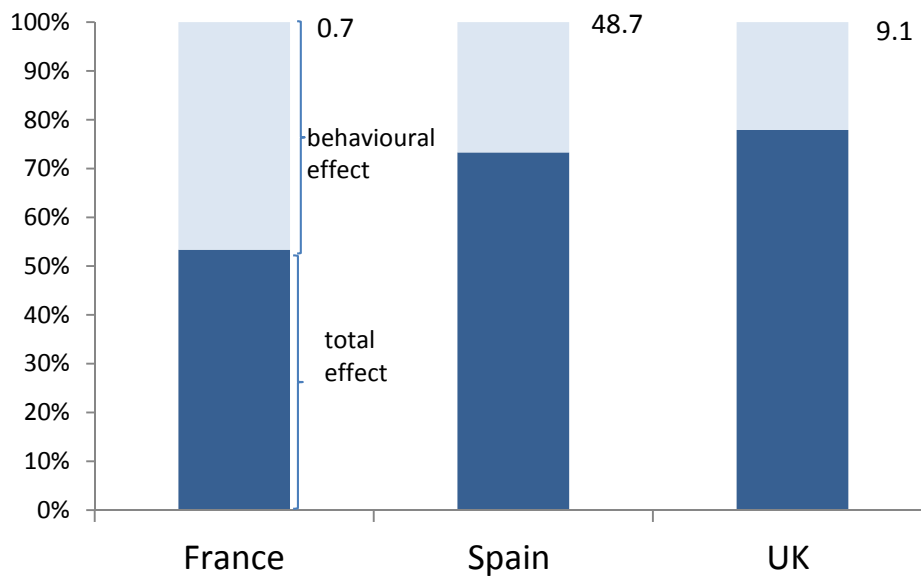
In equation (1), the overall revenue impact from the tax reform – obtained as an aggregation over the groups of individuals in the income decile i – can be decomposed into two separate parts, namely the mechanical and the behavioural components, which are influenced by both economic and fiscal parameters. While the mechanical effect gauges the static impacts of the policy reform, the behavioural part quantifies the change in revenue following individual reactions to the new policy environment. The latter effect can be further decomposed into two separate effects, corresponding to the behavioural reactions on hours worked and on participation. In particular, the first term captures the adjustment along the intensive margin, which depends on the marginal effective tax rate (τ_i) and the intensive labour supply elasticity (ε_i). The second term in the behavioural component represents the adjustment along the extensive margin, and is a function of the change in the tax liability in the transition from unemployment into work ($T_i - T_0$), on the extensive elasticity (η_i), and on the participation tax rate (a_i). The tax parameters are microsimulated using EUROMOD. As such, they reflect the country-specific income distributions and tax-benefits systems. The labour supply elasticities are obtained from empirical estimates and allowed to vary across countries, income decile and specific groups of individuals (singling out in particular lone parents and married women). They are combined in two scenarios, differentiated by the degree of heterogeneity factored in.

In all of the baseline simulations, we define our policy shock as a 1% reduction in the taxpayer-specific amount of the tax expenditure. As such, the country-specific size of the shock is not fully comparable across countries. This lack of comparability is partly endogenous, stemming directly from the different design of the tax provisions in place in the countries considered. However, the "marginal approach" used here is in line with the findings of the political economy literature, suggesting that even radical tax reforms are likely to be introduced gradually.

Figure 1 shows the minimum erosion in the revenue gain stemming from decreased labour supply. The different magnitudes at stake can be appreciated looking at the numbers reported on top right of the bars, which give the mechanical revenue effect (in million EUR per month) of a 1% reduction in the MWP tax reliefs across countries. The static budgetary gains range from less than 1 million EUR per month in the case of France, where the tax credit is strongly targeted at the bottom of the income distribution, to nearly 50 million EUR per month in Spain, where the relief takes the form of a deduction from the tax base. Indeed, the tax credit in France is means-tested and phased out relatively soon, whereas in Spain the amount of the allowance is conditional only on the level of earned income. Figure 2 further pictures the erosion effect with a larger degree of heterogeneity in labour supply responses

along the extensive margin from married women and lone parents. As is apparent, behavioural reactions wash away at least one-fifth of the revenue gain from cutting back on the tax relief. In the case of policies targeting the working poor (like in the case of France), the revenue loss is more pronounced, and particularly so when strong participation reactions from vulnerable categories (stemming from more elastic labour supply) are allowed for.

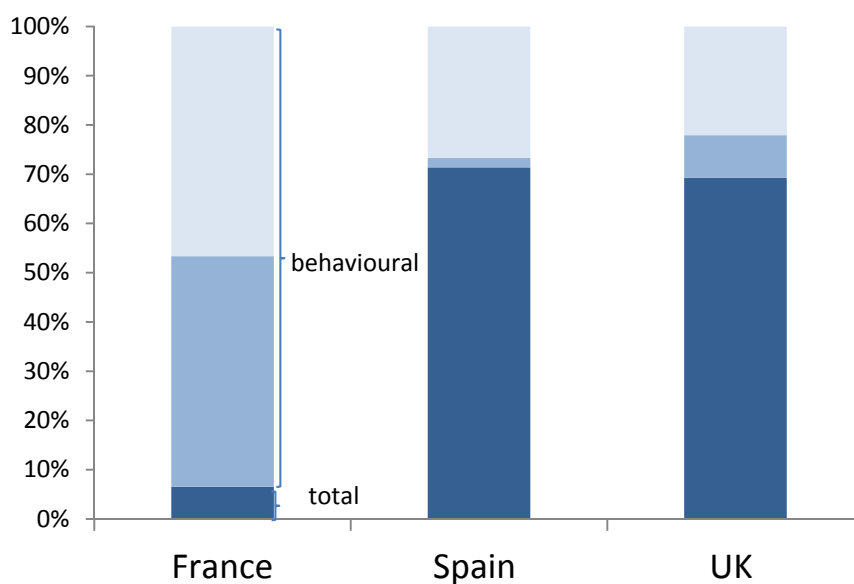
Figure 1. Total revenue impact after (min) behavioural effect from 1% reduction in MWP tax expenditure



Source: Authors' calculations

Note: the figures indicate the (monthly) static revenue gain from 1% reduction in MWP tax expenditure in €million.

Figure 2. Total revenue impact after (max) behavioural effect

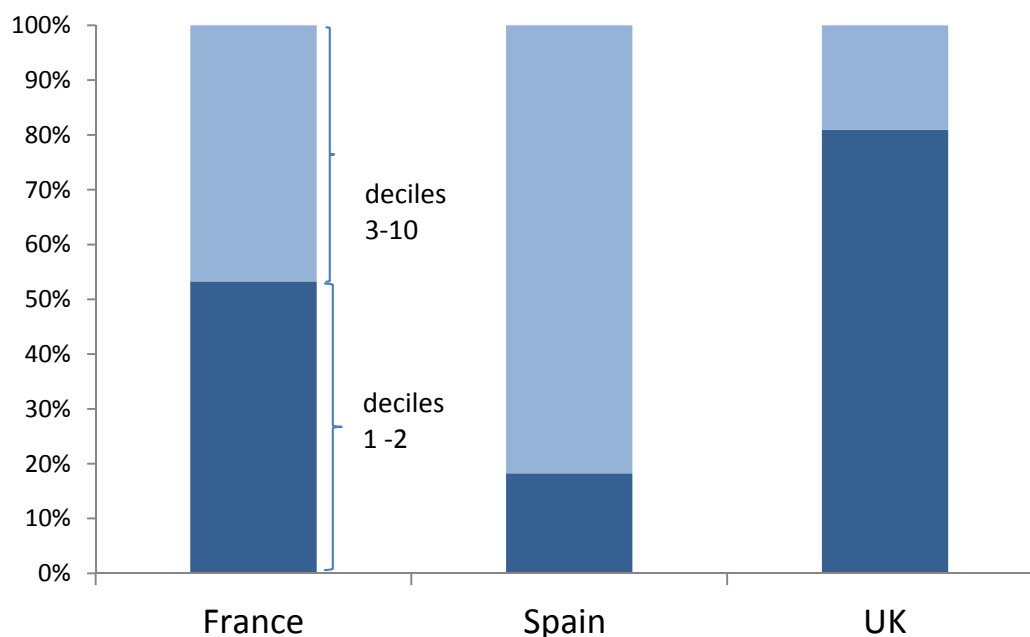


Source: Authors' calculations

Looking more closely at the decile-specific results shows indeed that individuals' heterogeneity plays a significant role in the design, and ultimately the budgetary effects, of tax policy. Figure 3 gives a flavour of that by singling out the contribution of the bottom two deciles to the overall mechanical revenue gain. While, unsurprisingly, this is roughly proportional in Spain, it accounts for roughly half in France and reaches a striking 80% of the total mechanical effect in the UK. To capture in a synthetic way the importance of the behavioural reactions at the bottom of the income scale, figure 4 reproduces figure 3 only for the lowest two deciles. The results are quite heterogeneous across countries, and clearly depend on the specific policy design and also on the interaction with the benefit system. In particular, in the case of the UK, where the MWP tax relief is conditional upon individual and family characteristics, the maximum behavioural effect reduces the mechanical revenue gain in decile 1 and 2 by roughly one-third. In Spain, the erosion is in the order of 50%, whereas in France the revenue gain obtained from the bottom of the income distribution is more than compensated by lower revenues following reduced labour supply from those workers, leading to a net loss for the budget.

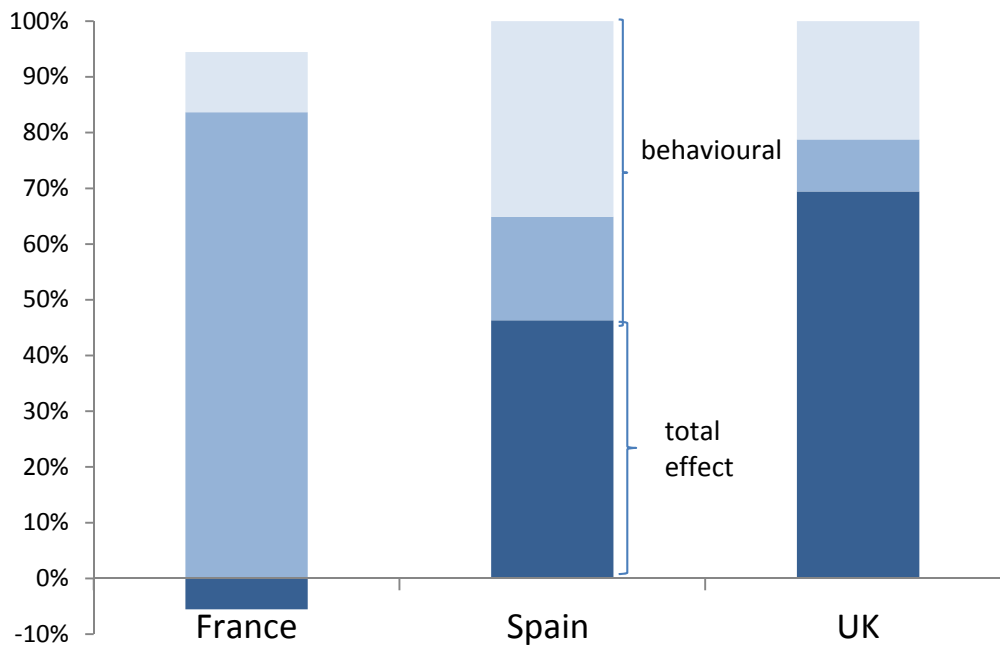
All in all, although the budget consolidation needs currently faced by many European countries call for increasing government revenue, particularly by reviewing and reducing tax exemptions and reliefs, our results suggest some caution with respect to which tax expenditures might more efficiently be reduced. In particular, reducing work-related tax reliefs appear particularly costly, both in terms of the revenue erosion and in terms of the welfare costs to society following behavioural responses in labour supply. Put in a more positive way, the budgetary cost of tax expenditures in MWP policies turns out to be much lower when taking into account the behavioural effects, while they generate significant gains in terms of both economic activity - induced by a stronger labour supply- and welfare - caused by higher consumption.

Figure 3. Mechanical effect by income decile



Source: Authors' calculations

Figure 4. Total revenue impact after (max) behavioural effect - deciles 1 and 2



Source: Authors' calculations

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3.4 Discussion of presentations by Pierre LeBlanc, Leonard E. Burman and Serena Fatica

*Chris Heady**

Introduction

Tax expenditures are a very interesting and important topic, on which I worked when I was at OECD and on which I am currently working in a UK context as part of the new Tax Administration Research Centre (TARC).

Between the three papers that I have been asked to discuss there are several important points:

- There are serious difficulties in both measurement of tax expenditures and international comparisons.
- Tax expenditures tend to distort government decisions.
- There is a need for clear reporting in order to minimise such distortions.
- It is important to take account of behavioural responses in measuring both the costs and benefits of tax expenditures.

Pierre LeBlanc's presentation

Pierre made a number of important observations on the reporting of tax expenditures in OECD countries:

- There has been progress in reporting tax expenditures but improvements are still needed in the areas of incorporating behavioural responses, the reporting of sub-central tax expenditures and the inclusion of tax expenditures related to social security contributions.
- There are pressures to increase tax expenditures in the hope of encouraging economic growth after the financial crisis but there are also pressures to reduce them in order to help with budgetary consolidations.
- There are very serious dangers in international comparisons of tax expenditures, including differences across countries in their benchmarks and in the completeness of their coverage.
- There are also dangers of adding tax expenditures for any particular country because of the way in which tax expenditures interact with one another.

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- It is more useful for policy improvements to concentrate on specific areas of tax expenditures rather than overall totals.

Leonard E. Burman's presentation

Leonard concentrated on the issue of how tax expenditures distort government decisions. He argued that they made government too large, as much of the government's activities do not appear on the expenditure side of the budget. He also argued that they bias government action towards areas where tax expenditures are readily applicable. He attributed these distortions to the idea of fiscal illusion, that voters underestimate the costs of tax expenditures. This led him to call for improved budget presentation to reduce the bias.

Serena Fatica's presentation

Serena focussed on making work pay policies, using an innovative methodology. This involved using the EUROMOD micro-simulation model to estimate the effects of policies and combining it with estimates of labour supply elasticities, differentiated by groups. This allowed for comparisons across countries as well as between population groups within one country.

The presentation provided a very good example of the benefits of focusing on one area and illustrates the importance of behavioural responses. It would be interesting to see studies that include a more detailed differentiation of groups.

Some thoughts on the issues

These interesting presentations have further clarified my understanding of tax expenditures, particularly in the areas of international comparisons and estimates of revenue costs.

On international comparisons, I believe that it will never be possible to reach agreement on a benchmark tax system that can be applied to all countries. There are several areas in which agreements are difficult but perhaps the most difficult is in the choice between basing income taxes on the individual or on the couple/family. The differences between countries on this choice reflect very strong cultural views and are often reflected in countries' constitutions.

This implies that, while international comparisons of tax expenditures have some role to play, there is no point in devoting large resources to improving international comparisons. It would be better to focus on specific types of tax expenditures, as defined by specific provisions in a country's tax law.

Turning to estimates of revenue costs, the presentations today have strengthened my belief that it is very important to estimate and model the behavioural responses of taxpayers to tax expenditures. The analysis of these behavioural responses should include a recognition that taxpayers sometimes have a choice between which tax expenditures to exploit. This means that it may be better to estimate the costs of a group of related tax expenditures together, rather than estimating their costs individually. These estimates need to be used as part of the annual budget making process, to recognise full costs of government policies.

Final Thoughts

Tax expenditures are not always harmful, unless the benchmark against which they are measured is an optimal tax system. The problem they raise is in making their costs and benefits transparent, a process that can increase measured government expenditures by several percentage points. The research priorities are to improve the accuracy of both the cost estimates and the valuation of their benefits.

3.5 Measuring and evaluating tax expenditures: the experience of Sweden

*Martin Kjellqvist**

The Swedish Government has ever since 1996 reported tax expenditures, i.e. deviations in the tax structure resulting in lower or higher than benchmark tax levels for certain groups of tax payers and how these deviations affect the tax revenues. The reporting of tax expenditures serves two purposes: to make visible the support to households and firms on the revenue side of the budget and thus serve as basis for political priorities, and to describe the degree of uniformity in the tax system.

The tax expenditure report builds upon the principle of uniform taxation and the aim is to include all deviations from the benchmark⁴. Also tax expenditures that may be regarded as highly motivated, for efficiency reasons or optimal taxation considerations, are included in the report.

The Government report tax expenditures to the Parliament in an official letter published every spring along with the Spring Fiscal Policy Bill. Tax expenditures are also re-reported in the policy area supplements to the Budget Bill. The report is produced by the Division for Tax Policy Analysis at the Ministry of Finance and tax expenditures are calculated for four years: the current year (t), the preceding year (t-1) and two years ahead (t+1 and t+2).

The tax expenditures are classified in two separate ways. First, the tax expenditures are classified as affecting or not affecting the budget balance. Tax expenditures that do not affect the budget balance are tax free transfers, where the tax exemption in itself does not affect the budget balance. However, transfers are defined as income and should according to the benchmark be taxed. The tax expenditure in this case corresponds to the extra amount that needed to be added to the transfer if they were taxed in order to keep the recipients unaffected. Tax expenditures affecting the budget balance are the lion's share of tax expenditures. These are divided into four main categories – income taxation, indirect taxation of labour income, VAT and excise duties. Tax expenditures are also classified according to their purpose: each tax expenditure is either technically motivated or classified as support within a specific expenditure area.

The benchmark used in the tax expenditure report is based on the principle of uniform taxation, which means that taxation within each tax category in principle should be uniform and without exceptions. A separate benchmark is defined within each of the tax categories income tax, indirect taxes on labour (social security contributions and wage taxes), VAT and excise duties. A benchmark based on uniform taxation implies that no consideration is given to the motives underlying the tax expenditures. Some tax expenditures may however contribute to improved economic efficiency. Because of this, from 2010 and onwards the

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⁴ The main exception concerns excise duties.

report includes a section that discusses the issue of tax expenditures and economic efficiency. Based on economic theory a number of indicators is listed to help evaluate if a tax expenditure increases economic efficiency or not.

Tax expenditures are calculated and reported as revenue forgone. A factor for converting this figure to the outlay equivalent is also stated.

A large part of the Swedish tax expenditures can be viewed as support to specific expenditure areas and thus comparable to direct support through the expenditure side of the budget. There are different reasons for giving support through the revenue side of the budget. The most commonly stated reason is administrative simplicity – it is sometimes easier to reduce the tax rate for a particular group of tax payers than it is to distribute targeted allowances to the same group.

Deviations and exemptions in the tax system is, if not explicitly temporary, to be regarded as permanent. A difference between tax expenditures and support through the expenditure side of the budget is that tax expenditures do not undergo the same annual review in the budget process. This makes tax expenditures less transparent. This is one of the motivations for the annual tax expenditure report from the Government to the Parliament and it is mainly for this reason the figures from the tax expenditure report are re-reported in the Budget Bill. Measuring consolidation efforts on the tax side can be done according to two approaches. The traditional approach is a top-down one, correcting the revenue from the cyclical component, i.e. the component that depends on the cycle and which is independent of government actions. As in times of large shocks, this approach does not always give an accurate reflection of the discretionary fiscal efforts on the revenue side, consolidation efforts are also measured by adding up all the individually defined discretionary measures. This approach acts bottom-up and regroups the discretionary measures in taxation and social security contributions under the name 'discretionary tax measures' (DTM). The collection of those measures allows having an additional method to measure consolidation efforts on the revenue side.

4 SESSION II: Tax expenditures in direct taxation

4.1 Business tax incentives

Steve Bond *

The concept of business tax incentives refers to a range of departures from what would otherwise be the standard tax treatment of business income. These may include higher tax allowances for certain costs incurred by businesses, and lower tax rates for business income from certain sources, or for certain types of business. These tax incentives are intended to promote particular activities undertaken by businesses, such as investment in fixed capital or research and development (R&D), or to promote particular business forms, such as small and medium-sized enterprises (SMEs). One obvious question to consider when evaluating any individual business tax incentive is whether it is effective in stimulating the activity that it seeks to promote. If the answer is yes, a harder but more important question is then whether the same outcome could be achieved more efficiently (for example, at lower revenue cost to the government, or with fewer undesirable side-effects) using other, non-tax policy measures (for example, grants or subsidies) or using better targeted tax measures.

One issue that should be addressed in seeking to classify or measure the extent of business tax incentives is ambiguity about the standard tax treatment of business income. The standard corporate income tax used in most developed countries is itself highly distortionary, with an important source of these distortions being differences in the treatment of costs associated with financing investment from either debt or equity sources. Belgium and Italy have recently introduced tax allowances known as an Allowance for Corporate Equity (ACE) which is intended to equalise the treatment of debt and equity finance, and this approach has been advocated more generally (see, for example, the recent Mirrlees Review). The practical question, which we do not seek to resolve here, is whether the presence of an ACE should be viewed as a tax incentive intended to promote the use of equity finance, or as part of the appropriate reference tax base, compared to which we judge departures.

Three examples will be discussed briefly and used to illustrate some of the more general considerations which are involved in the evaluation of business tax incentives. These are accelerated depreciation provisions which are intended to stimulate business investment; tax incentives for business R&D expenditures; and tax incentives which are targeted at SMEs.

Accelerated Depreciation Provisions

Purchases of tangible fixed capital assets such as buildings, vehicles, machinery and equipment can normally be written off against taxable income over a sequence of years, in a

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similar fashion to the treatment of depreciation charges in commercial accounts. Allowing a given purchase to be written off over a shorter period, or at a faster rate, increases the value of this sequence of tax deductions, and effectively lowers the net-of-tax cost of making the investment. Accelerated depreciation refers to tax provisions which allow investment purchases to be written off more quickly than any reasonable estimate of underlying depreciation rates. A particular case is a 100% first year allowance or expensing treatment, in which all of the purchase can be deducted against taxable income in the year that the investment is made. Such provisions may be used to promote investment in certain types of assets which are thought to be socially desirable (for example, in energy-efficient equipment, on environmental grounds), or to stimulate business investment more broadly at particular times (for example, the bonus depreciation provisions used in the USA in the period 2001-04 and again after 2008).

There is considerable evidence that making investment cheaper can have a sizeable effect on the level of business investment. This evidence includes cross-country studies of aggregate investment which exploit differences in tax treatments both across countries and over time (see, for example, Bond and Xing, 2010), as well as studies which exploit differences in the way that particular tax reforms have affected particular firms or sectors (see, for example, Cummins, Hassett and Hubbard (1994) in relation to the 1986 US tax reform, and Mahon and Zwick (2013) in relation to the US bonus depreciation provisions).

Yet there is a considerable gap between showing that accelerated depreciation can be used to stimulate business investment and concluding that accelerated depreciation should be used to stimulate business investment. Environmental objectives, for example, can be pursued arguably more directly by taxing the production or consumption of fossil fuels, or by supporting research into greener technologies. Macroeconomic objectives can be pursued arguably more flexibly using monetary policy measures. Tax incentives run the risk of being poorly targeted or poorly timed, and measures which may appear to be justified on a temporary basis often prove difficult to revoke. Recognising these issues does not imply that tax incentives should never be used to promote any forms of business investment, but does suggest that the choice between accelerated depreciation and other policy responses may be finely balanced.

R&D Tax Incentives

The benefits of knowledge generated by research may not accrue only to the investor that funds the research. In the context of business expenditure on R&D, an investment by one firm is likely to have positive externalities or spillover benefits for the performance of other firms, particularly those in the same locality and/or line of business. The presence of these spillover effects suggests that private enterprises are likely to underinvest in R&D, and provides a *prima facie* case for policy interventions to raise the level of business R&D up towards the socially optimal level. Tax incentives for business expenditure on R&D are one of the main tools in this context.

Spending on R&D has the economic characteristics of an investment, requiring an outlay now in anticipation of some return in the future. Nevertheless, most R&D spending –for example, in the form of wages paid to researchers, and purchases of materials for researchers to work

with– is classed as current expenditure in commercial accounts. Tax rules generally follow this practice, so that most R&D can be expensed against taxable income in the same year. We can note that this treatment is already more favourable than the treatment of most forms of investment in tangible fixed capital assets. R&D tax incentives then provide a still more favourable treatment than this expensing benchmark.

These incentives may take the form of a super-deduction – allowing, for example, 150% of R&D expenditure to be deducted against taxable income – or an explicit tax credit – in which case the tax liability is first calculated in the standard way but then reduced by, for example, 10% of the enterprise’s R&D expenditure⁵.

As with other forms of business investment, there is considerable evidence that making R&D cheaper can be an effective way of stimulating business R&D. The available evidence again includes both cross-country studies (see, for example, Bloom, Griffith and Van Reenen, 2002) and studies of the impact of particular reforms (see, for example, Guceri (2013) in relation to the introduction of new tax incentives for R&D in the UK in 2002).

One criticism of R&D tax incentives is that the boundary between R&D and non-R&D expenditures can be fuzzy, leading to complaints from tax authorities that firms seek to classify routine expenditures as R&D, and at the same time complaints from firms that tax authorities take too narrow a view of what constitutes qualifying R&D expenditures. Another concern is that tax incentives for R&D may bid up the wages paid to scientific researchers, whose supply may be limited, particularly in the short term. This may result in higher expenditure on R&D because a given level of R&D activity becomes more expensive, rather than producing a higher level of R&D activity.

Other policies which can be used to stimulate R&D, such as patent protection and direct government funding of R&D expenditure by firms, also have their drawbacks. Patent protection is relatively effective where the knowledge generated by R&D can easily be codified, but less effective for forms of R&D which lead to tacit knowledge. Direct funding through grants can in principle be targeted towards forms of R&D where spillover benefits are thought to be particularly important, but the abilities of government bureaucracies to identify or select these particular types of R&D projects may be somewhat imperfect.

Recent years have seen an upward trend in both the prevalence and the generosity of incentives for business R&D in the tax systems of developed countries. It is at least arguable that these tax incentives have a part to play in the appropriate mix of policy responses to private sector underinvestment in R&D.

Tax Incentives for SMEs

Recent years have also seen a proliferation of tax measures which favour smaller enterprises. These may take the form of lower tax rates, more generous allowances, exemption from tax for an initial band of profits, and tax reliefs for providers of finance to SMEs.

⁵ For a tax-paying firm, these two examples would be equally valuable if the tax rate happened to be 20%.

These measures are often supported by claims that SMEs are particularly dynamic or innovative, with strong potential for growth. This may well be true for *some* small enterprises; however this argument ignores evidence that the population of SMEs is itself highly *heterogeneous*, with many SMEs being 'lifestyle' businesses, with very little potential or desire for growth.

Indeed it is hard to think of a market failure for which a universal tax relief provided to *all* SMEs would constitute an appropriate policy response. Moreover, there is convincing evidence that the *average* small firm is less productive than the average large firm, and also inferior in many other measureable dimensions (for example, wages, job security, training, and health and safety). There are certainly costs associated with policies which skew the size distribution of businesses towards SMEs.

More serious arguments in favour of *some* tax incentives for SMEs relate to the high cost and/or difficulty in accessing finance for investment, particularly for start-up firms in high tech and/or high risk sectors. These arguments point towards tax reliefs which are linked to measureable outlays on investment (for example, accelerated depreciation or expensing provisions), and perhaps targeted at younger firms and/or riskier sectors, rather than preferential tax rates for all SMEs.

Conclusion

Two general lessons that we take from these examples are that strong evidence of particular market failures or spillover benefits should be required before business tax incentives are considered, and that full consideration should be given to alternative policy responses before business tax incentives are introduced or considered to be justified. Casual arguments for vague benefits from interested lobby groups should be viewed with suspicion.

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4.2 Discussion of Steve Bond "Business tax incentives"

*Thiess Büttner**

In his talk, Prof. Bond has emphasized that the concept of tax expenditures is difficult to apply to business tax incentives since the usual definition of the tax base is rather imperfect. The large literature on corporate taxation deals with the tax distortions of business investment and the financial structure of firms and has proposed alternative definitions of the tax base that avoid to give rise to such distortions. The current tax systems implemented by the member states, however, are subject to these imperfections, and various business tax incentives may actually help to mitigate the distortions. Accelerated depreciation, R&D tax credits, and provisions for SME's are key examples and I think Prof. Bond gave an excellent discussion of the pros and cons of such measures.

I would like to take the opportunity to point at an additional rationale for granting business tax incentives, that has gained importance in the European integration process. Faced with increasingly mobile investment, member states and also subnational jurisdictions tend to provide tax incentives that aim to get firms reconsidering their location choices and to invest in the own country or local jurisdiction. While there are plenty of such preferential tax regimes in Europe, this phenomenon is by no means confined to the EU. In fact, the provision of local business tax incentives is also observed in federal countries with much more harmonized tax systems.

An interesting example is the case of State tax incentives in the US federation, studied by Chirinko and Wilson (2008). They report that the number of states with an investment tax credit has substantially increased over the years from 1969 to 2004. At the same time, however, the corporate income tax rate levied by the US States has not been lowered to a major extent. As Wildasin (2006) notes, a possible interpretation is that the US States have kept taxes high on immobile investment while taxing mobile investment at a lower rate. This is rational from a local perspective, since the perceived deadweight loss associated with taxes on mobile investment is larger.

This interpretation suggests that in the European case, the recent move to introduce R&D tax incentives rather than granting depreciation allowances for investment in fixed assets is a response to the emergence of multinational firms and the increasing importance of immaterial property.

But of course, though tax incentives might be rationalized for the individual government as a measure of location policy, it is not necessarily efficient from a general economic perspective. Basically, if business tax incentives are provided by a set of competing governments, the policies might be mutually self-defeating. In fact, as the large literature on tax competition has emphasized, individual governments will tend to underestimate the revenue losses of lowering taxes. As a consequence, there might be too much and too

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generous business tax incentives and a coordinated elimination of those incentives might be preferable. It is interesting to note here that there is some relationship to the issue of government subsidies to firms. While specific subsidies and specific tax concessions to firms would violate State aid rules, a local policy that aims at attracting FDI through more general business tax incentives might serve as a substitute.

The European experience with taxing multinational firms suggests that providing location tax incentives by individual governments might also open up further profit-shifting opportunities for large firms. This would imply that further revenue losses are associated with local business tax incentives.

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4.3 The distributional effects of income tax expenditures

*Silvia Avram**

Interest in tax expenditures has recently resurfaced in the context of growing public deficits and a reluctance to increase tax rates for fear of hurting national competitiveness and discouraging economic activity. By lowering the final tax liability for some groups of taxpayers, tax expenditures effectively narrow the tax base. Previous work on tax expenditures has generally suggested that higher income groups are likely to capture a disproportionately large share of resources distributed via tax relief and thus that they are most likely to benefit from this type of policies (Howard 1997; Burman, Geissler et al. 2008; Toder, Harris et al. 2009). Nevertheless, this result is to a large extent based on studies of the US income tax system in which deductibility of various types of expenditures figures prominently.

In this study, we examine the distributional consequences of two types of tax expenditures, i.e. tax allowances and tax credits present in the personal income taxation legislation in six European countries. These are the Czech Republic, Denmark, Germany, France, Italy and Spain. We focus on household and individual taxation as this is the area where tax expenditure instruments are more likely to include a "social", i.e. distributional objective.

We calculate tax allowances and tax credits at the taxpaying unit level using EUROMOD⁶, the European tax-benefit micro-simulation model (Sutherland and Figari 2013). EUROMOD calculates theoretical entitlements to benefits and theoretical tax liabilities based on the tax-benefit rules as expressed in national legislation. One of the elements that are simulated in all countries is personal income tax. Tax allowances and tax credits are simulated as part of the usual income tax simulation. Thus, our measures are based on simulated entitlements and not on actual claims in tax records.

We construct our measures of tax allowances / tax credits by taking the difference in the net tax liability attributable to the existence of the tax allowance or tax credit respectively. These are calculated by 'abolishing' tax allowances and / or tax credits and re-calculating via simulations the net tax liability for all tax-paying units.

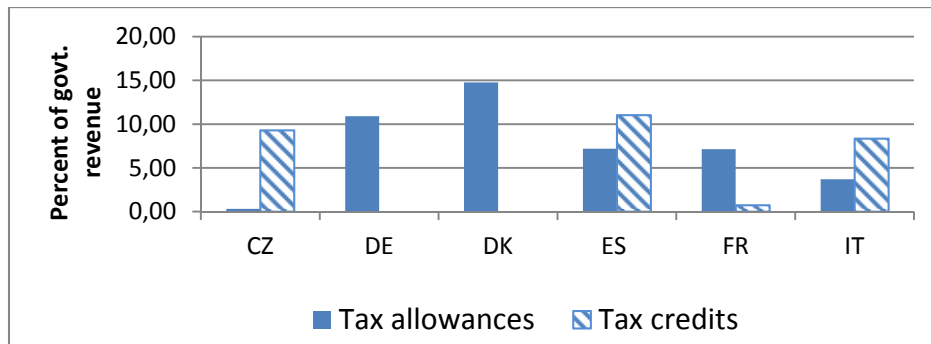
Before examining the distributional aspects, we estimate the relative size of tax allowance and tax credits expenditures. Figure 1 shows the total annual revenues forgone as a result of tax allowances and tax expenditures in each of the six countries respectively as a percentage of total government revenue⁷. From a budgetary perspective, tax expenditures are an important element. For example, in the Czech Republic tax credits cost more than the entire revenue collected via the personal income tax system. Likewise, foregone revenue due to either tax allowances or tax credits exceeds 10% of total government revenues in Denmark, Germany and Spain.

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⁶ We use version F6.36.

⁷ We cannot simulate comprehensively tax expenditure in all of the six countries and as such, the figures are not strictly comparable cross-nationally.

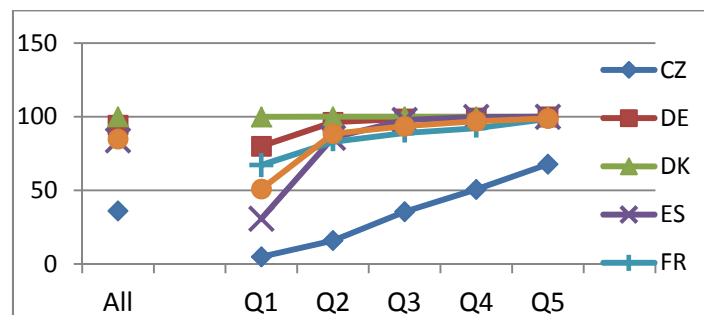
Figure 1: Annual total lost revenue due to tax allowances and tax credits as a % of government revenue-2010



Source: Own calculations based on EUROMOD F6.36

Another way of assessing the importance of tax allowances and tax credits is by looking at their incidence. Figures 2 and 3 show the proportion of individuals in households who receive some tax relief via tax allowances and tax credits overall and by quintile group of household disposable income calculated when the respective tax instruments (i.e. either allowances or credits) are not present (rank HDI)⁸. The receipt of tax allowances is widespread in Denmark, Germany, Italy, Spain and France. The only country where tax allowances are not quasi-universal is the Czech Republic.

Figure 2: Proportion of individuals in households entitled to tax allowances by quintile - 2010



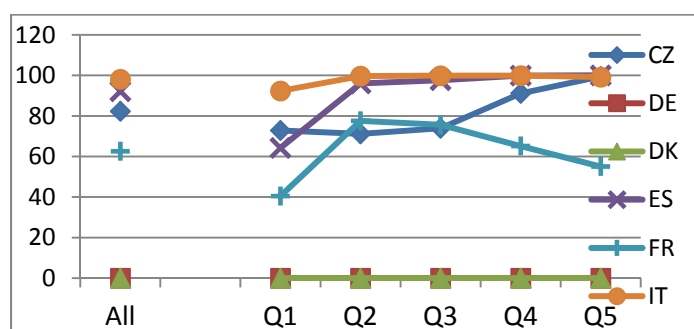
Note: Quintiles have been constructed based on household disposable income calculated in the absence of tax allowances
Source: Own calculations based on EUROMOD F6.36

Tax credits are completely absent in Germany and Denmark but widespread in the other four countries that use them. They are received by over 80% of the population in Italy, Spain and the Czech Republic. Thus, in a majority of countries, both tax allowances and tax credits can

⁸ Rank household disposable income is essentially a counterfactual; to avoid any errors coming from the fact that tax allowances and tax credits change the relative position of households in the income distribution, we use household disposable income calculated in the absence of tax allowances and tax credits respectively to construct quintiles throughout; we term this income concept rank disposable income to differentiate it from the "full" household disposable income which is defined in the usual way.

be seen as near universal instruments able to reach a large share of the population not just the very rich.

Figure 3: Proportion of individuals in households entitled to tax credits by quintile-2010



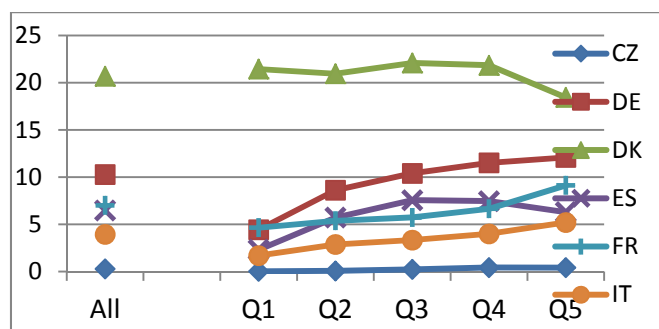
Note: Quintiles have been constructed based on household disposable income calculated in the absence of tax credits
Source: Own calculations based on EUROMOD F6.36

In addition to the overall share of beneficiaries in the population, Figure 2 also shows the extent to which the likelihood of being able to claim tax allowances varies with income. With the exception of Denmark where receipt of tax allowances is very close to 100% in all quintiles, there is a clear income gradient in the probability of receipt.

In the case of tax credits, the pattern is somewhat different. In Spain and to a lesser extent in Italy, it is only the first quintile that is unable to take advantage of tax credit provisions. In France, the second and the third quintiles are the ones most likely to benefit from tax credits. Finally, in the Czech Republic the most notable difference is between the bottom three quintiles and the rest.

A clear indication of the potential of tax allowances and tax credits to redistribute can be obtained by assessing the extent to which tax allowances and tax credits contribute to increasing disposable income proportionally more at the bottom compared to the top of the income distribution. Figure 4 plots the share of tax allowances in household disposable income by rank HDI quintile group. The first thing to notice is that tax allowances are slightly upward sloping in their effect in all countries with the exception of Denmark. This indicates that tax allowances are worth more in relative terms to households higher up in the income distribution compared to the bottom, and thus tend to increase inequality.

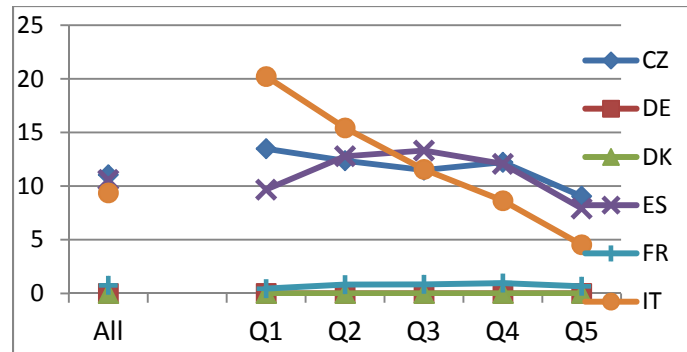
Figure 4: Average values of tax allowances as a % of rank HDI, by quintile-2010



Note: Quintiles have been constructed based on household disposable income calculated in the absence of tax allowances
Source: Own calculations based on EUROMOD F6.36

The share of tax credits in rank household disposable income is shown in Figure. Unlike tax allowances, tax credits are likely to be relatively more important at the bottom and middle of the income distribution compared to the top. There is a very steep negative income gradient of tax credits in Italy. Quintiles in the middle of the income distribution are the largest beneficiaries of tax credits in Spain whereas in the Czech Republic there is a modest negative quasi-linear relationship between income and the share of tax credits in rank household disposable income.

Figure 5: Average values of tax credits as a % of rank HDI, by quintile-2010



*Note: Quintiles have been constructed based on household disposable income calculated in the absence of tax credits
Source: Own calculations based on EUROMOD F6.36*

To sum up, we find that tax expenditure is a significant spending item relative to government revenue. Additionally, with a few exceptions, tax allowances and/ or tax credits are able to reach large sections of the population. From a distributional perspective tax allowances tend to benefit households higher up in the income distribution more. Tax credits on the other hand are more likely to benefit low and middle income households.

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Appendix: List of tax allowances and tax credits used in the calculations

Table A1: List of tax allowances in the Czech Republic, Denmark, Germany, France, Italy and Spain

Tax allowances	Simulated
Czech Republic	
Non-taxable portion of pensions	yes
Allowance for charitable donations	no
Mortgage interest re-payments	yes
Complementary pension insurance deduction	yes
Allowance on private life insurance payments	no
Allowance on labour union fees	no
Denmark	
Employee labour market contributions	yes
Self-employed labour market contributions	yes
Supplementary labour market contribution for employees	yes
Unemployment benefit contribution and early retirement benefit contributions	yes
Contributions for private pension plans	yes
Maintenance payments	yes
Earned income tax credit	yes
General personal allowance	yes
Unused part of spouse's general personal allowance	yes
Negative investment income of partner	yes
Tax allowance for investment income	yes
Mortgage interest payments	yes
Transport allowance	no
Special occupational deductions	no
Deposit on company start-ups	no
Give deductions	no
Other employee expenses above minimum threshold	no
Other allowances related to capital income	no
Germany	
Non-taxable part of income from public pensions	yes
Non-taxable part of income from private pensions	yes
Income related expenses-pension income	yes
Income related expenses-employment income	yes
Tax allowance on alimonies paid	yes
Tax allowance for high contribution pensioners	yes
Tax deduction on old-age expenses	yes
Tax allowance on other insurance contributions	yes
Deductions for agriculture and forestry	yes
Tax allowance for the elderly	yes
Tax allowance for lone parents	yes

Child tax allowance	yes
Basic 0 tax band (tax free portion of taxable income)	yes
0 rate band on capital income	yes
Deduction of other expenses	yes
Income exempted from the solidarity surcharge	yes
Tax allowance on child-care costs, alimonies and other expenses	yes
Other deductible expenses	no
Spain	
Employee social insurance contributions	yes
Self-employed social insurance contributions	yes
Social insurance contributions paid by the unemployed	yes
Employment income tax allowance	yes
Employment income tax allowance-supplement for older workers	yes
Joint taxation allowance	yes
Tax allowance for workers who accept a job in a different city	no
France	
Employee social insurance contributions	yes
Self-employed social insurance contributions	yes
Deductible part of the CSG	yes
Tax allowances on category 1 income (Employment, sickness benefit, taxable pensions, unemployment benefit)	yes
Deductions on rent income	yes
Deductions on investment income	yes
Tax allowance for children older than 18 and dependent ascendants	yes
Deduction of private pension contributions	yes
Tax allowance on maintenance payments	yes
Tax allowance for low-income disabled and elderly	yes
Basic 0 rate tax band	yes
Exemption from paying CSG for low income pensioners	yes
Italy	
Employee social insurance contributions	yes
Self-employed social insurance contributions	yes
Tax allowance on paid alimonies	yes
Tax allowance for private pension contributions	yes
Tax allowance for various expenses	yes
Basic 0 rate tax band for low income tax payers in Bolzano	yes
Non –taxable rent income	yes
Cadastral value of the main residence	yes

Source: Information on existing tax allowances and their simulation is taken from both the EUROMOD model and the corresponding Country Reports (Ochmann and Fossen 2011; Adiego, Levy et al. 2012; Ceriani, Figari et al. 2012; Kühn, Nielsen et al. 2012; Münich and Pavel 2012; Denis and Tranoy 2013).

Table A2: List of tax credits in the Czech Republic, Denmark, Germany, France, Italy and Spain

Tax credits	Simulated
Czech Republic	
Personal exemption	yes
Spouse exemption	yes
Disability exemption	yes
Student exemption	yes
Child tax credit (incl. refundable part)	yes
Refundable part of child tax credit	yes
Increased tax credit for severely disabled individuals	no
Spain¹	
Mortgage tax credit	yes
Tax credit for renting the main residence	yes
Personal tax credit	yes
Child tax credit	yes
Tax credit for dependent parents	yes
400 euro tax credit	yes
Tax credit for multiple births for parents satisfying certain income and number of children conditions -Andalucia	yes
Regional tax credit for lone parents- Andalucia	yes
Regional tax credit for dependent parents-Andalucia	yes
Care it assistance to the individual tax credit-Andalucia	yes
Regional disability tax credit-Andalucia	yes
Regional rent tax credit for young taxpayers-Andalucia	yes
Tax credit for the birth of the 3rd or successive child-Aragon	yes
Tax credit for the birth of the 3rd or successive child-supplement for low income families-Aragon	yes
Regional tax credit for the care of disabled or dependent persons -Aragon	yes
Regional tax credit for renting the main residence-Asturias	yes
Regional tax credit for large families-Asturias	yes
Regional tax credit for lone parents-Asturias	yes
Regional tax credit for the self-employed-Asturias	yes
Regional tax credit for old-age -Illes Balears	yes
Regional tax credit for disability-Illes Balears	yes
Regional tax credit for educational expenses -Illes Balears	yes
Regional rent tax credit for young taxpayers-Illes Balears	yes
Regional childbirth tax credit-Canarias	yes
Regional tax credit on child-care expenditures-Canarias	yes
Regional tax credit for disability-Canarias	yes
Regional large families tax credit- Canarias	yes

¹ The working mother tax credit is de facto treated as a means-tested benefit and not included in the list of tax credits.

Regional rent tax credit-Canarias	yes
Regional unemployment tax credit-Canarias	yes
Regional tax credit for dependent children and dependent parents/ disabled-Cantabria	yes
Regional rent tax credit-Cantabria	yes
Regional childbirth tax credit-Castilla yLa Mancha	yes
Regional tax credit for dependent parents-Castilla y La Mancha	yes
Regional tax credit for old-age-Castilla y La Mancha	yes
Regional childbirth tax credit-Castilla y Leon	yes
Regional tax credit for large families-Castilla y Leon	yes
Regional tax credit for child-care expenses-Castilla y Leon	yes
Regional rent tax credit for young persons -Castilla y Leon	yes
Regional childbirth tax credit-Catalunya	yes
Regional rent tax credit-Catalunya	yes
Regional mortgage tax credit-Catalunya	yes
Regional rent tax credit-Extremadura	yes
Regional employment tax credit- Extremadura	yes
Regional childbirth and young children tax credit-Galicia	yes
Regional tax credit for large families-Galicia	yes
Regional tax credit for child care expenses- Galicia	yes
Regional rent tax credit for young taxpayers-Galicia	yes
Regional childbirth credit -Madrid	yes
Regional rent tax credit for young persons-Madrid	yes
Regional tax credit for low income families with children-Madrid	yes
Regional tax credit for child care expenses- Murcia	yes
Regional childbirth tax credit-Rioja	yes
Regional childbirth tax credit-Valencia	yes
Regional tax credit for multiple births-Valencia	yes
Regional tax credit for large families-Valencia	yes
Regional tax credit for old-age and disability-Valencia	yes
Regional housework tax credit-Valencia	yes
Regional tax credit for childcare expenses-Valencia	yes
Regional tax credit for dependent parents-Valenc	yes
Regional working mother tax credit-Valencia	yes
Regional rent tax credit-Valencia-	yes
Regional tax credit low income families with children -Valencia	yes
Tax credits for charitable donations	no
Special tax credits in Ceuta and Melilla	no
Domestic help tax credit -Andalucia	no
Fostering self-employment tax credit-Andalucia	no
Tax credit for cohabiting dependent elderly over 65-Asturias	no
Fostering self-employment for females and young individuals -Asturias	no
Child adoption tax credit -Illes Balears	no
Fostering self-employment – tax credit Illes Balears	no

Expenditures on child's studies out of the residence island tax credit -Canarias	no
Mortgage cost increase tax credit-Canarias	no
Disability tax credit -Castilla-La Mancha	no
Children or parents' disability tax credit -Castilla- La Mancha	no
Elderly and disabled taxpayers with caring needs tax credit -Castilla y Leon	no
Death of partner tax credit -Catalunya	no
Disabled family members care tax credit -Extremadura	no
Disabled taxpayers over 65 with care needs tax credit -Galicia	no
Fostering self-employment tax credit-Galicia	no
Hosting of non-family elderly or disabled individuals tax credit -Madrid	no
Child hosting tax credit -Madrid	no
Mortgage cost increase tax credit Madrid	no
For educational expenses -Madrid	no
Fostering self-employment for youth -Madrid	no
Disabled child's birth or adoption tax credit -Valencia	no
Renting housing for activities in different municipalities' tax credit -Valencia	no
Mortgage cost increase tax credit -Valencia	no
Public benefits towards maternity tax credit-Valencia	no
France	
Tax rebate (Decote)	yes
Tax credit for child care expenses	yes
Tax credit on educational expenses	yes
Tax credit on mortgage interest expenses	yes
Complementary reduction for disabled persons affected by IMAX	yes
Low-earners refundable tax credit	yes
Tax credit for green investments	no
Tax credit for employment services	no
Italy	
Personal tax credit-employment	yes
Personal tax credit-self-employment	yes
Personal tax credit-pensions	yes
Mortgage interest tax credit	yes
Education expenses tax credit	yes
Health expenses tax credit	yes
Charity donations tax credit	yes
Other expenses tax credit	yes
Building and refurbishing tax credit	yes
Life insurance premium credit	yes
Funeral expenses tax credit	yes
Tax credit on low pensions	yes
Dependent spouse tax credit	yes
Dependent parent tax credit	yes
Child tax credit	yes
Additional tax credit for the lone parent	yes

Compensation on the child tax credit to the other spouse	yes
Tax credit for tenants subject to controlled rent	no
Tax credit for employees relocating closer to work	no
Tax credit on energy conservation expenses	no

Source: Information on existing tax credits and their simulation is taken from both the EUROMOD model and the corresponding Country Reports (Ochmann and Fossen 2011; Adiego, Levy et al. 2012; Ceriani, Figari et al. 2012; Kühl, Nielsen et al. 2012; Munich and Pavel 2012; Denis and Tranoy 2013).

4.4 Tax expenditures and income taxation in France

*Camille Landais**

I would like to offer a quick overview of what a general framework to think about tax expenditures should look like, and in particular I would like to stress what types of empirical information is required to assess the welfare impact of different tax expenditures structures. To do so, I will illustrate my points with examples from the French tax system.

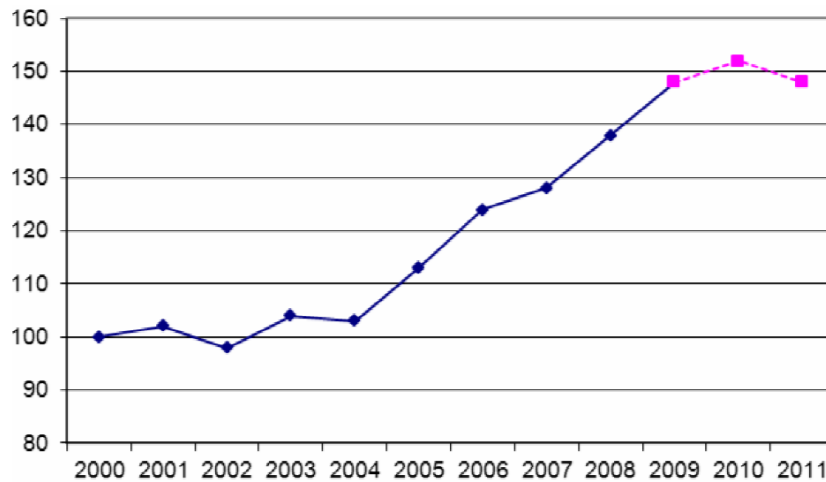
Defining and measuring tax expenditures

The first obvious difficulty lies in defining tax expenditures. The concept of tax expenditure is still very elusive. To put it bluntly, for economists, the only thing that matters are relative prices between goods and activities. The effective tax rate or subsidy rate imposed on each good or activity by the tax and transfer system is therefore the only thing that economists care about. This also means that subsidising a good via a tax reduction or a tax credit (a tax expenditure) is totally equivalent to a direct subsidy via government spending. In this respect, tax expenditures are a non-existing issue. But most countries do pay a lot of attention to "tax expenditures". France, as most countries, defines tax expenditure in reference to the "tax norm", from which the tax expenditure is a deviation. But the definition of the norm is potentially very arbitrary. The French "prime pour l'emploi" (equivalent of the US EITC) is considered a tax expenditure in France while "Quotient familial" (the French family income-tax splitting system) is not, for instance.

However, we should at least be happy that some information is gathered about tax expenditures (rather than none, as was the case not so long ago). Better information in the area of tax expenditures helps us get a better sense of the total redistribution operated by the tax and transfer system. It also helps us monitor the size of the tax base, which is important for efficiency reasons. Unfortunately, there is still a lot of variability in accounting practices of tax expenditures. In France for instance, since SCN-2008, most refundable tax credits are treated as public spending (instead of tax revenue losses). But most other tax expenditures are not (adjustments, non-refundable tax credits, etc.). Most tax expenditures are therefore not subject to the same controls/requirements in the budgeting process than direct public spending. Tax expenditures are for instance simply itemized in an appendix to the French Budget.

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Figure 1: Evolution of the amount of tax expenditures in France (2000-2011), basis 100=2000



Source: Cour des Comptes, Rapport Public Annuel 2011.

The most striking fact about tax expenditures in France is that they are massively on the rise. As shown in figure 1, the amount of tax expenditures has increased by more than 50% between 2002 and 2010. The personal income tax base is the most affected by this steady upward trend. In 2012, Budget appendix (Voies et Moyens II) reveals that there are approximately 470 tax expenditures, for a total cost (in terms of foregone revenues) of roughly B€70, out of which B€35 correspond to tax expenditures related to personal income tax (IRPP). Less than B€9 are refundable tax credits counted as direct public spending in public accounts. The most worrisome fact is maybe that the Budget appendix dedicated to tax expenditures acknowledges that for 237 tax expenditures out of 470, a cost cannot be estimated or that only a rough order of magnitude can be given.

Figure 2: Distribution of tax expenditures > M€100 across tax bases (2010)

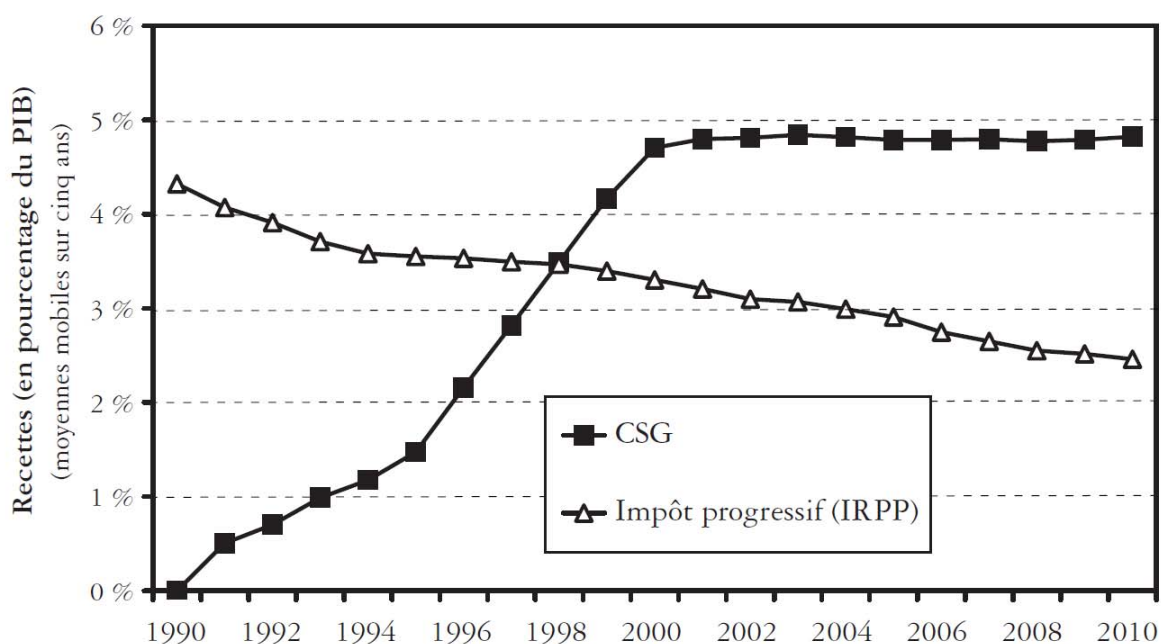
Impôt	Nombre de mesures	Enjeux financiers (M€)
Impôts divers (DIV) ⁴¹	1	487
Droits d'enregistrement et de timbre (ENR-TIM)	1	470
Fiscalité directe locale (FDL) ⁴²	1	1 376
Impôt sur le revenu (IR)	53	32 485
Mesures communes à l'impôt sur le revenu et à l'impôt sur les sociétés (IR-IS) ⁴³	6	4 260
Impôt sur les sociétés (IS)	5	2 216
Impôt sur la fortune (ISF)	3	984
Taxes intérieures de consommation sur les produits énergétiques (TICPE)	6	5 454
Taxe sur la valeur ajoutée (TVA)	18	13 490
Total	94	61 222

Source: Rapport du Comité d'Evaluation des Dépenses Fiscales et des Niches Sociales, 2011.

The increase in the number and amounts of tax expenditures has not only considerably eroded the tax base of the personal income tax in France (as shown in figure 3, in comparison to the evolution of tax revenues of the broad base Contribution Sociale Generalisee), it has also affected the overall progressivity of the French income tax system. As shown in figure 4, while the share of earnings included in the income tax base (panel A.) is extremely large

(more than 90%) and slightly increasing over time, the share of capital income included in the tax base (panel B.) is much smaller, and decreasing over time, especially for the personal income tax (IRPP). As top incomes are predominantly made of capital income, this erosion of the tax base has the effect of reducing the overall progressivity of the tax system (panel C.) as the fraction of gross income included in the tax base decreases sharply at the top end of the income distribution.

Figure 3. Income tax revenues in France (IRPP vs CSG)



Source: *Pour une révolution fiscale, 2011.*

Two rationales for tax expenditures

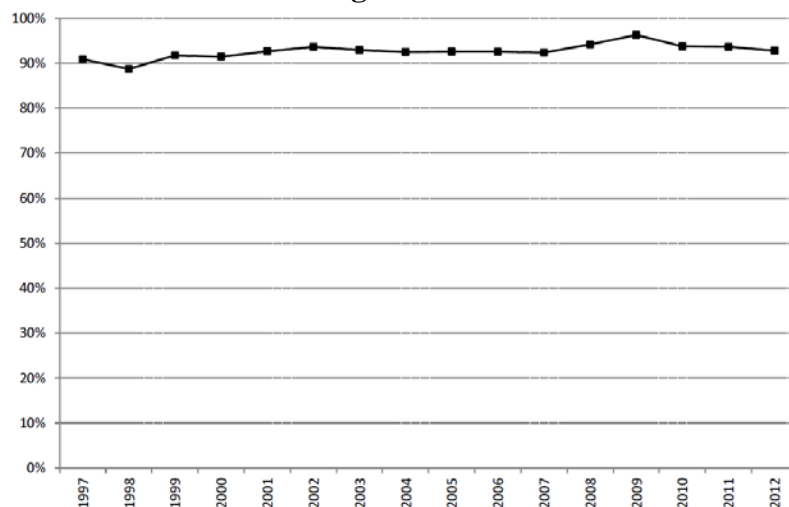
There are essentially two main rationales for tax expenditures. The social planner may first use tax expenditures for **Pigouvian corrections** of externalities. The idea is that subsidizing or taxing certain goods or activities through the tax system is a way to align private and social marginal returns. The issues faced by the implementation of Pigouvian taxes are well-known. In practice, it is complicated to estimate the size of the various external effects that one may want to correct. So Pigouvian subsidies should be limited to cases with very well-defined externalities.

The second rationale is **redistribution**. Tax expenditures enable tailor-made redistribution, in various dimensions (across income levels, activities/occupations, across time, or places, across families, etc.). In that sense, having many different tax expenditures may just be the sign of a very sophisticated redistribution. The problem is always that the level of redistribution is subject to a standard equity/efficiency trade-off: too many tax expenditures may narrow the tax base, increase costly substitution across goods and activities, and eventually increase the deadweight loss of taxation.

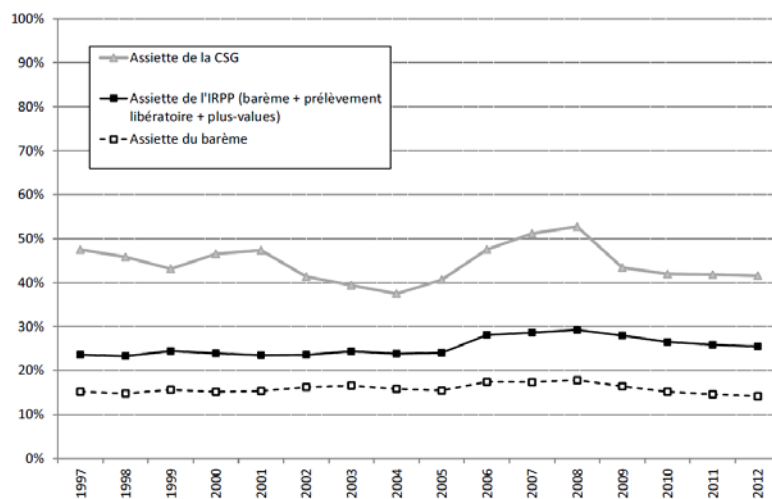
Whatever rationale the government chooses, it is important to be able to determine the welfare effects of the different tax expenditures. The problem is that most administrations only estimate the static cost of tax expenditures which is mostly irrelevant from a welfare perspective. Any relevant (partial equilibrium) welfare evaluation requires at least some estimates of the social marginal cost or benefit function to measure the size of the external effect (in case of Pigouvian corrective subsidies) and precise estimates of the demand and supply elasticities in the relevant market. The level of information and data required to properly evaluate the welfare costs and benefits of tax expenditures therefore extends far beyond a mere calculation of the static cost of these expenditures.

Figure 4. Income tax base and progressivity in France

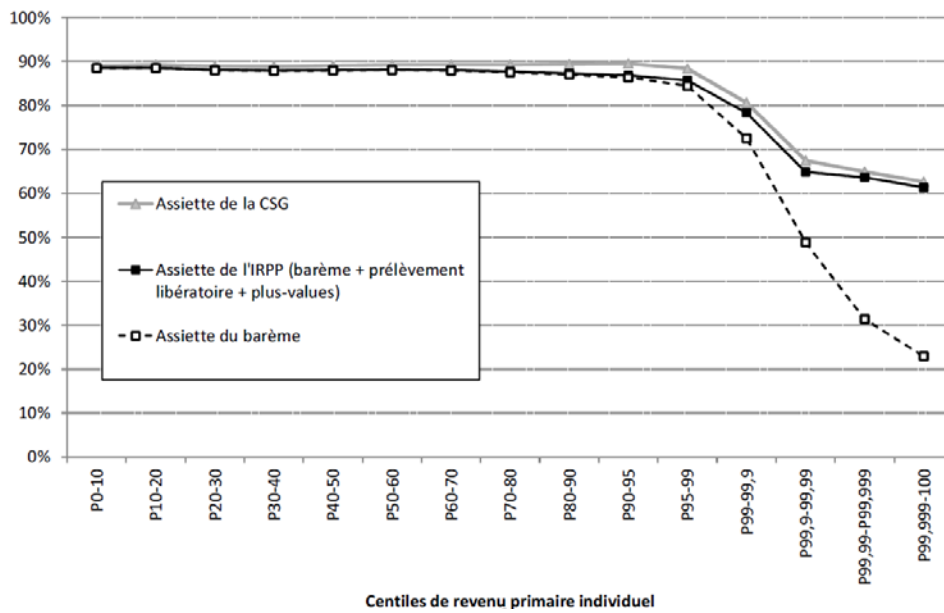
A. Fraction of total earnings included in the income tax base



B. Fraction of capital income included in the income tax base



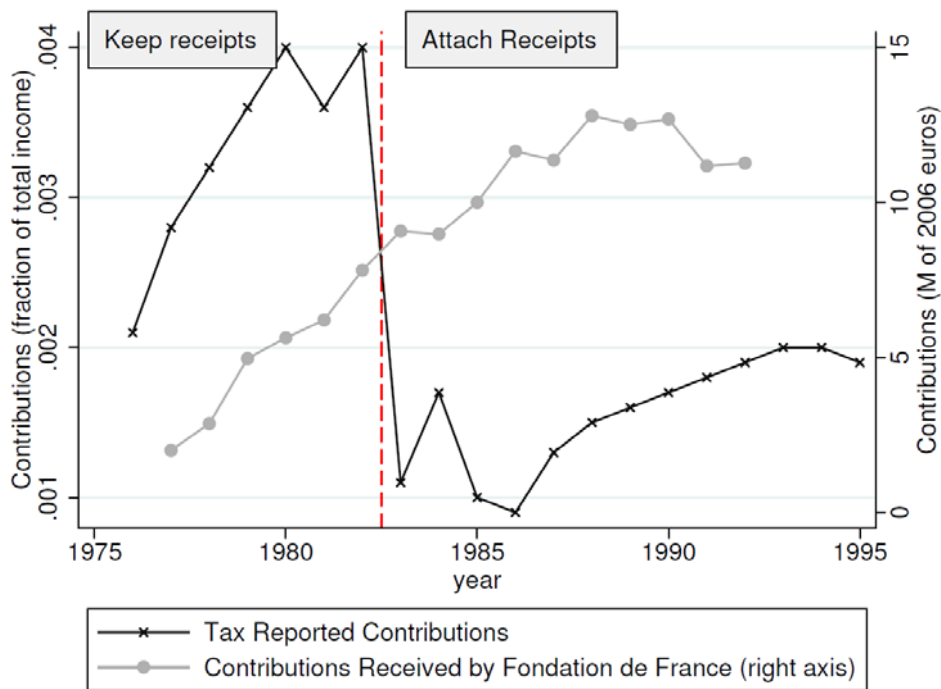
C. Fraction of total gross income included in the income tax base, by gross income groups



Source: TAXIPP, Fiscalité et Redistribution, Institut des Politiques Publiques, 2012.

Administrative issues

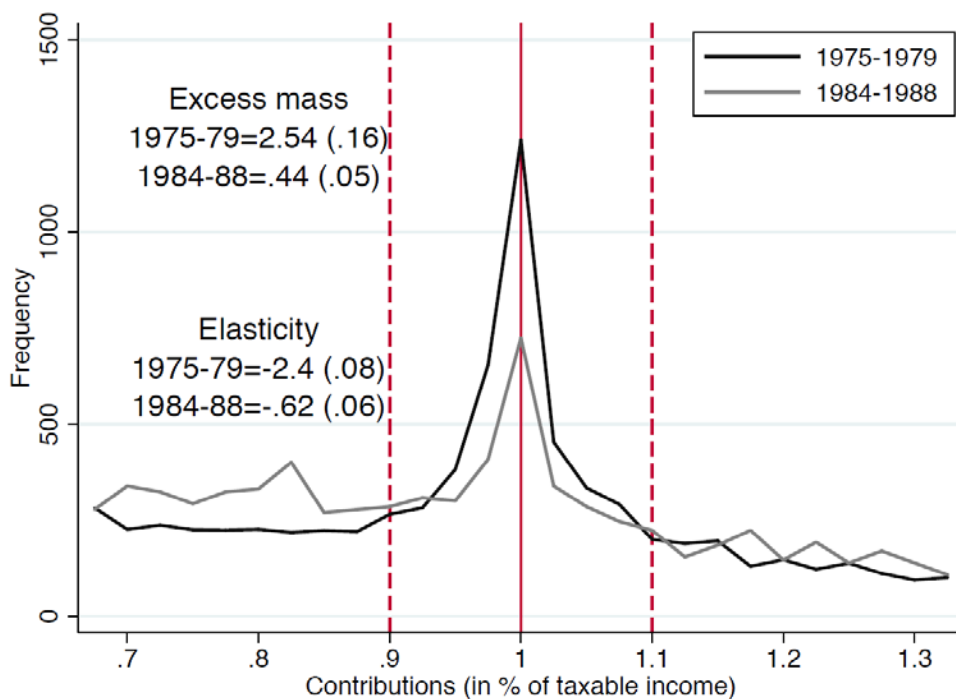
Figure 5. Evolution of reported charitable giving, France



Source: Fack & Landais (2013).

When implementing tax expenditures, additional administrative issues should be considered. First, tax enforcement matters. Tax expenditures can encourage tax evasion / avoidance. This may in turn increase distortions and the total deadweight loss of taxation by increasing the elasticity of taxable income above its optimal level. A good example of this type of problems is given in Fack & Landais (2013). In 1983, the tax enforcement of the charitable deduction in the personal income tax was changed in France. Before 1983, individuals had to keep of receipt of all their contributions, but after 1983 taxpayers were required to attach their receipts to their tax return in order to be able to claim the deduction. Figure 5 plots the evolution of reported charitable contributions over time and shows that the reform led to a substantial drop in the amount of contributions reported to the administration, which can be credibly attributed to overreporting of charitable contributions before the reform, rather than to a real change in giving behaviours. Interestingly, the reform was also associated with a substantial decline in the absolute value of the elasticity of reported contributions, as can be inferred from figure 6 showing the amount of bunching at the 1% cap of the charitable deduction.

Figure 6. Distribution of charitable contributions around the 1% deduction threshold, France



Source: Fack & Landais (2013).

The second important administrative issue relates to salience of the tax rules and its impact on the take-up rate of tax expenditures. Most tax expenditures do not have automatic take-up: taxpayers need to claim it in order to get it. When tax rules become very opaque and complicated due to the multiplication of tax expenditures, the complexity, instead of delivering the sophisticated redistribution we may aim for, might simply reduce take-up. This is a bad thing because a lot of people you target do not get the subsidy you intend to give them. The lack of take-up also reduces behavioural responses; for redistribution, this might

be a good thing, because you reduce distortions and the equity/efficiency trade-off, but for the Pigouvian motive, this is just the opposite: smaller behavioral responses mean that you have a smaller effect on the external effect you intend to correct. More generally, there is a broader debate about the effectiveness of Pigouvian price subsidies when bounded rationality or salience issues affect people's ability to take active decisions.

Conclusion

It is clearly urgent to improve the quality of data collection and the evaluation of the effectiveness and welfare effects of tax expenditures. There already seems to be a consensus that a lot of the existing tax expenditures are ineffective, either because they do not affect the externalities they are supposed to address, or because they are not delivering the redistribution they are supposed to achieve. This means that, moving forward, the question of the removal of a lot of existing tax expenditures is going to take center stage. Here the political economy of base-broadening tax reforms needs to be taken into account. And a "clean slate" solution, like a tax reform deal *à la* TRA86, seems more politically feasible than shutting down tax expenditures sequentially, one after the other. Such a deal could involve trading-off a broad tax base reform for the redefinition of the tax schedule and would only allow the introduction of tax expenditures after a moratorium of 2 or 3 years with some independent evaluation of external effect as a necessary condition.

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ANNEX

Programme

ECFIN Taxation Workshop *"The use of tax expenditures in times of fiscal consolidation"*

Brussels – Charlemagne Building, room Jean Durieux
Wednesday 23 October 2013

Programme

- 8:30-9:00 *Registration and welcome coffee*
- 9:00-9:10 **Introduction** by Marco Buti (European Commission's DG ECFIN)
- 9:10-9:30 **Keynote address** by Gilles Mourre (DG ECFIN). Lessons from the 2013 report "Tax reforms in EU Member States"
- 09:30-12:40 *Session 1: Tax expenditures: measurement and macroeconomic implications*
(Chair: Philipp Rother, DG ECFIN)
- 09:30-10:00 **Tax expenditures: An OECD-wide perspective** - Pierre LeBlanc (OECD)
- 10:00-10:30 **Economic, policy and budgetary aspects of tax expenditures** – Leonard E. Burman (Syracuse University, NBER, Urbane Institute)
- 10:30-11:00 **Work-related tax expenditures in the EU: impact on tax revenues** – Serena Fatica (DG ECFIN), Salvador Barrios and Diego Martinez (European Commissions Joint Research Centre (JRC)).
- 11:00-11:30 *Coffee break*
- 11:30-12:00 *Discussant:* Chris Heady (University of Kent)
- 12:00-12:20 **Measuring and evaluating tax expenditures: the experience of Sweden**
Martin Kjellqvist (Swedish Ministry of Finance)

- 12:20-12:40 **General discussion** and floor open to the audience
- 12:40-14:00 **Lunch break**
- 14:00-16:20 *Session 2: Tax expenditures in direct taxation* (Chair: Philip Kermode – European Commission's DG TAXUD)
- 14:00-14:30 **Business tax incentives** – Steve Bond (University of Oxford, IFS)
- 14:30-15:50 *Discussant*: Thiess Büttner (FAU Erlangen Nuremberg)
- 15:50-15:20 *Coffee break*
- 15:20-15:50 **The distributional effects of income tax expenditures** - Silvia Avram (University of Essex)
- 15:50-16:20 **Tax expenditures and income taxation in France** – Camille Landais (London School of Economics)
- 16:20-16:50 **Closing panel discussion**
- Presenters: Leonard E. Burman, Steve Bond, Pierre LeBlanc, Gilles Mourre and Silvia Avram
- 16:50-16:55 **Closing address** by Lucio Pench (DG ECFIN)

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