

Session 2: Establishing a Benchmark

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Introduction

- What is a Benchmark Tax System (BTS)
- Two approaches in theory
- Defining the BTS in practice
- Principles and Criteria
- A middle-ground? The British & Canadian approach
- Conclusion

What is a Benchmark Tax System (BTS)?

- Simply put: a reference point against which to measure revenue foregone
- Any provision not part of the 'benchmark system' is thus costed in the TE Report.
- Definitions differ from country to country.
- There is no 'right' way to define a BTS
 - But guiding principles can be useful
- Important to first start with a definition of tax expenditures

Defining the Benchmark Tax System

- The BTS defines the scope of provisions to be costed in a TE reported and evaluated further down the line
- Fairly universally accepted that a benchmark system **should** be defined, however the choice over **how** this is done is less clear cut; CIAT (2011), for example, note that this process is one of the “most complex” parts of compiling a TE report.
- Broadly, the choice comes down to one of two methods, namely
 - 1. A “normative” approach
 - 2. A “legal” approach (positive approach)

Defining the Benchmark Tax System

■ 1. The Normative Approach

- Involves comparing a country's tax system to some 'ideal', which is usually rooted in ideas around what constitutes an "optimal" tax system
- It requires the policymaker to first define what – for a specific country – an optimal tax system would look like before identifying the places in which the national system deviates from this.
- In practice, almost no countries define their BTS according to the normative approach

Defining the Benchmark Tax System

▪ 2. The “legal” approach

- Grounded in a country’s tax (or other) legislation:
 - i.e., look at tax legislation and identify any deviations from ‘general’ system as tax expenditures.
- Strictly speaking, a “*perfectly*” positive analysis would be free from *any* value judgement and would merely constitute a descriptive account of “what is”.
- But in practice, not usually done;
- Some guiding principles are therefore useful:

Defining the Benchmark Tax System

- Starting point for defining BTS is likely the “general” tax regime. Main factors that define this :

Tax Head	(I) Tax Unit	(II) Tax Base	(III) Tax Rate
CIT	Firm	(Taxable) profit*	Statutory CIT rate
PIT	Individual (household, if joint filing)	(Taxable) employment or self-employment income*	PIT schedule
VAT	Final consumer	Final consumption (applied on a destination basis)	VAT rate
Excise duty	Final consumer	Consumption	Schedule of duty rates
Customs duty	Importer	CIF value	Tariff code

(+ the tax ‘period’ – usually annual / monthly / quarterly)

Defining the Benchmark Tax System

- Defining the BTS *wholly* on the General Tax Regime is perhaps the most “**black and white**” method. But:
 - i. Many provisions are almost universally accepted as part of BTS
 - ii. Significant “grey areas” exist in all countries.

Some common reasons for provisions to be included in the BTS...

Defining the Benchmark Tax System

▪ Provision is part of International or Regional Law

▪ *International Conventions*

- Provisions in international agreements can be decided at the international level; international law can take precedence over national and local law. E.g., **Nairobi protocols, Chicago Convention, Florence agreement**

▪ *Regional Agreements*

- E.g., a customs union, for example, where the common external tariff is the norm for customs duties.
 - In Uganda, EAC and COMESA imports are treated as part of the BTS

▪ Provision relates to the Taxation of Foreign Aid Projects

- Many countries have historically treated tax relief on aid projects as part of the BTS; growing debate around the practice → resulted in the development of (non-binding) guidelines (see United Nations, 2021).
- An evaluation of the cost of such exemptions would shed light on impact and could persuade the authorities to encourage those bilateral partners that have committed to paying taxes to do so.

Defining the Benchmark Tax System

- **Provision exists due to administrative efficacy**
 - Certain provisions that exclude activities from the tax system or provide relief might exist as part of the tax structure:
 - (i) to ensure that a certain tax can function,
 - (e.g., a VAT registration threshold)
 - (ii) because taxing a certain activity is not feasible or cost-effective.
 - E.g., financial services that have no observable value added are exempted from VAT; agriculture activities are sometimes simpler to exclude from the tax system due to a multiplicity of challenges, including high levels of informality, physical remoteness

Defining the Benchmark Tax System

- **Provision exists due to National Tax Policy Choices (Cultural or Social “Norms”)**
 - Gov't might decide to consider some tax relief as 'normal' e.g., as an integral part of a policy to provide support to a particular sector of the economy (e.g., health, agriculture).
 - These reliefs are often included as part of the BTS and not costed
 - E.g.: Income tax allowances for handicapped persons and single parents are part of the BTS in Spain but constitute tax expenditures in France. (Kassim and Mansour (2018))
 - E.g.: In Germany, value-added-tax (VAT) reductions for some basic foodstuffs are considered part of BTS (Hallerberg (2014))
- **But this practice precludes any monitoring and evaluation of the reliefs** and thus any analysis of their effectiveness vis-à-vis their original goal is not possible.
 - A TE may not be the most effective way to achieve a stated policy goal, but without TE reporting, one cannot begin to assess

Defining the Benchmark Tax System

- Some questions to ask to determine whether provision should be part of BTS...
 1. Can a country unilaterally change the provision?
 2. Is a taxpayer / sector /activity administrable?
 3. Is the tax owed by a public entity?

Measurability is not a good criteria!

Structural and Non-Structural Reliefs

- Is there a middle - ground?

- In the United Kingdom & Canada, reliefs are categorized as:
 1. **Structural Reliefs**

 2. **Tax Expenditures** *or*

 3. **Reliefs Exhibiting features of both**

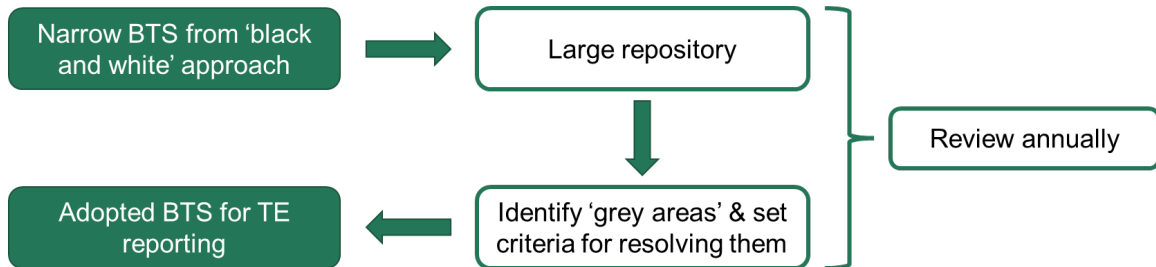
Structural and Non-Structural Reliefs

- A 'structural relief' applies to a provision that could “reasonably be regarded (or partly regarded) as an integral part of the tax structure” or are required in order to “define the scope of the tax” (HMRC, 2021)
 - An example' in the UK is the tax-free allowance on personal income tax. This exists as a part of the progressive rate structure in the UK, but it is not considered as a TE.
- There are numerous areas where a provision exhibits features of both a structural relief and a tax expenditure
 - Consider a capital allowance: the part of the allowance that accounts for economic (or commercial) depreciation could (reasonably) be considered as a part of the tax system, whilst any accelerated depreciation allowance *over and above the rate of economic depreciation* might be considered as a TE.

Defining the Benchmark Tax System

- There is no 'correct' way to define BTS; all countries differ. But guidelines and criteria should be considered.
 - But where possible, adopting criteria and using them as guidelines for decision making is useful and helps to remove any subjectivity from the process. But not always easy.
 - Reporting on decisions taken = good for transparency!
- Ultimately, A narrow benchmark (larger repository of TEs) = higher transparency
 - Can help to inform monitoring effectiveness of provisions, evaluating alternatives, or contributing to wider discussions (e.g. the taxation of foreign aid activities).

One potential approach:





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