

Tax Subsidies

Achievement of Accountability

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This is an English translation of the National Audit Office's report on "Tax Subsidies – Achievement of Accountability" (Audit report 141/2007). The report was written by Visa Pajaanen and Hannu Rajamäki. The audit was part of a parallel audit conducted by the European Supreme Audit Institute (EUROSAI) concerning the transparency of tax subsidies. A report on this audit will be given separately in spring 2008 at EUROSAI's congress.

Helsinki August 2007

A handwritten signature in black ink, appearing to read "Vesa Jatkola". The signature is written in a cursive style with a large, prominent initial 'V'.

Assistant Auditor General, Performance Audit Vesa Jatkola

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Abstract

Tax subsidies signify a deviation from the normal structure of taxation. The purpose of this deviation is to support a particular group of beneficiaries or a particular type of activity that is considered beneficial. Tax subsidies are estimated to total about 10 billion euros a year. Tax subsidies have a significant effect on the state's revenues, corresponding to around one-fourth of the state's annual income.

This audit investigated the Government's accountability to Parliament with regard to tax subsidies. The Constitution of Finland and the State Budget Act and Decree specify criteria concerning accountability. According to these criteria all known matters influencing appropriations and revenues must be taken into consideration in the state budget. In its report on the final central government accounts, the Government must provide correct and adequate information concerning compliance with the budget and social effectiveness. In addition to statutory criteria the achievement of accountability was evaluated on the basis of legislative development projects, the budget handling of appropriations and performance management procedures. Criteria were also borrowed from international recommendations concerning the handling of tax subsidies.

The main finding in the audit was that the handling of tax subsidies in state's financial management is not in line with their economic significance. The quantity and quality of handling has also weakened in recent years. In the 1990s tax subsidies were dealt with in an appendix to the state budget. In 2000 reporting was shifted to the Government's report on the management and state of central government finances and in 2005 to the report on the final central government accounts. At the same time the amount of information was also reduced and presently the Government covers tax subsidies in a one-page summary.

In the opinion of the State Audit Office, the Government should pay clearly more attention to tax subsidies as part of the state's financial management. Tax subsidies have a large impact on state revenues. They also signify the allocation of resources and costs in the state economy. In the State Audit Office's view this means that tax subsidies should be dealt with in reporting on the state economy both as factors influencing revenues and in connection with appropriations that are approved for the same purpose. Performance targets should be set for tax subsidies in the same way as appropriations and their achievement should be monitored and reported.

The Finnish tax reform at the beginning of the 1990s had the aims of a broad tax base and lower tax rates. Tax subsidies were also cut back at

that time. In recent years the number of tax subsidies has grown and the downward trend has been reversed. The risk is that tax subsidies will be used to circumvent the budget framework. The framework solution places a ceiling on appropriations. A new tax subsidy or an increase in an existing tax subsidy does not require an increase in appropriations. In this case it is possible to stay within the framework on paper but actually exceed it. In the opinion of the State Audit Office, selecting tax subsidies as a form of aid in order to stay within the budget framework is not proper. The choice between tax subsidies and direct subsidies as policy tools should be made on the basis of their relative effectiveness.

The audit observed that Government bills regarding specific tax subsidies have improved in recent years. In particular advance estimates of the amount of tax subsidies and the presentation of intended benefits and impacts have clearly improved. On the other hand monitoring plans are still not made and the achievement of objectives is not monitored to any real extent. In the opinion of the State Audit Office, the social effectiveness of significant tax subsidies should be evaluated regularly. There is no reason to deviate from the handling of appropriations with similar significance in this regard.

The audit looked closer at the effectiveness of tax deductions for voluntary pension insurance premiums. This system was changed in 2006. The objectives of the subsidy were not presented even at that time. This is a shortcoming that makes it impossible to evaluate the impacts of the subsidy from the viewpoint of accountability. The grounds for subsidizing voluntary pension insurance premiums should be clearly explained. This subsidy can be presumed to have two types of objective: to increase saving generally or to supplement citizens' statutory pension coverage. The subsidy appears to increase saving, but savings are not paid out in the same way as a normal pension. Instead they can easily be taken out in a fairly short time after a person reaches retirement age. There is not much difference between this and other forms of long-term saving. The need to explain grounds is also underlined by the observation that voluntary pensions are not worth taking out without tax subsidies.

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1 Introduction

Tax subsidies signify a deviation from the normal structure of taxation. The purpose of the deviation is to support a particular group of beneficiaries or a particular type of activity. The right to a tax deduction on the interest on housing loans can be considered a tax subsidy supporting a typical group of beneficiaries. The reduced rate of VAT on sports and cultural services is an example of a tax subsidy intended to promote a particular activity. Tax subsidies are estimated by the Government Institute of Economic Research (VATT) to total about 10 billion euros.¹ The amount is considerable and corresponds to one third of the state's annual tax-related income (31.1 billion euros in 2004) and around one quarter of the state's total annual income (38.5 billion euros).

In the past ten years tax subsidies have to some extent been disregarded in the debate on the reporting of public finances. Since the tax subsidy research report² undertaken in 1989, tax subsidies have been taken into account in the state's budgeting process. VATT began by compiling an appendix to the budget on tax subsidies. Then in the 1990s the information was shifted to the Government's report on the management and state of central government finances. Since 2005, information on tax subsidies has been presented in a very limited form in the general finance policy part of the report on the final central government accounts.

In the public debate, tax subsidies have always remained one enduring subsidy alternative. It is often easier to propose a tax subsidy to support something than a direct subsidy, because then there is no need to propose an increase in spending. In addition, taxation has remained part of national decision making, in contrast to many other policy tools previously used. The foreign exchange rate cannot be influenced nationally, and there is only limited scope for many business subsidies because of international commitments to deregulate trade and harmonize markets.

The state's income has been the National Audit Office's key focus of auditing for many years. In particular, the National Audit Office has not

¹ *There are several reasons for reservations about the estimate. Tax subsidies cannot be totalled as an entity. Moreover, individual subsidies are estimated without taking into account behavioural changes that a subsidy will cause. In addition, for a large proportion of individual subsidies, there are only order-of-magnitude estimates.*

² *Ministry of Finance 1989.*

previously audited tax subsidies. Tax subsidies significantly affect the state's income, so auditing of them would be a natural part of auditing the income.

The audit of tax subsidies aims to generate data for handling tax subsidies as part of the budget process and seeks possible improvements in handling tax subsidies. The information generated will be especially valuable to Parliament in deciding the budget and to the Government and Ministry of Finance in budget preparation.

2 Audit framework

2.1 Tax subsidies as an audit objective

The handling of tax subsidies as an entity became part of the state's financial management in the late 1980s. A basic study concerning tax subsidies was undertaken in the Ministry of Finance as part of tax reform³. The study concluded that the term "tax subsidy" should be used for the phenomenon. Another alternative term considered, "tax expenditure", would have highlighted the importance of the phenomenon for the budget. Both terms are in international use.

A tax subsidy is defined in the Ministry of Finance's basic study as a deviation from the normal structure of taxation in support of something. The normal structure is called the tax system norm. The definition of a tax subsidy or tax expenditure has remained basically the same in later international literature⁴. Three intrinsic criteria for a tax subsidy have been defined. First, it is a deviation from a general tax in the normal tax system that decreases revenue from taxes. Second, the purpose of the deviation is to support a particular activity or beneficiary. Third, the benefiting activity or group of beneficiaries is restricted in some way. A fourth criterion might be that the tax subsidy could be replaced by a direct subsidy.

The term chosen and adopted in Finland is intended to emphasize that a tax subsidy is a subsidy. A tax subsidy can be used to support a particular activity or a group of beneficiaries. The aim in using a tax subsidy to support a particular activity is to change behaviour. An example of such a tax subsidy is the reduced rate of value added tax on transport of people, which is intended to promote the use of public transport. An example of a tax subsidy with the objective of income transfer is the tax deductibility of interest expenses on housing loans, which is intended to support borrowers of housing loans. Often the objective of changing behaviour and the nature of the income transfer are in practice interrelated. A subsidy intended to change behaviour then has a clear group of beneficiaries that benefit from the subsidy. However, a tax subsidy with the objective of income transfer may cause a significant change in

³ *Ministry of Finance 1989.*

⁴ *For instance, Polackova Brixl et al. (2004).*

behaviour. Tax subsidies do not differ much from direct subsidies in their effects on behaviour or income transfer.

As stated above, the term "tax expenditure" is in international use for a tax subsidy. The term "tax expenditure" emphasizes the impact on the budget. It is intended to highlight better the decrease in the state's revenue from taxes, in other words the fiscal effect. As a policy tool, the term tax expenditure equates a tax subsidy to a normal appropriation.

2.2 Audit questions and criteria

The main question of the audit is:

- How is accountability achieved with regard to tax subsidies?

To answer the main question one must define what accountability with regard to tax subsidies means. In Finland an individual tax subsidy is always decided through a law, the preparation of which is covered by general instructions on bill drafting. In the audit, however, tax subsidies are considered as an entity. The audit investigated how accountability was achieved with regard to tax subsidies as a whole concerning compliance with the state's good financial management and whether in their contents they are in line with government-sector operations. Relating to this, the audit also evaluated through individual example cases questions about the effectiveness of tax subsidies.

The Constitution of Finland and the Budget Act specify criteria concerning accountability at statutory level. Because they are in practice interpreted narrowly, the audit has sought criteria for achievement of accountability concerning appropriate contents. Relating to this definition process, legislative development projects, the budget handling of appropriations and performance management procedures were used as sources in addition to statutory criteria. Criteria were also borrowed from international recommendations. They are considered in more detail in 3.1.1.

Under the Constitution of Finland (731/1999) 84 §, the budget principles require all known matters influencing appropriations and revenues to be taken into consideration in drafting the state budget. Under the Budget Act (423/1988) 17 § and 18 §, it is required that the Government in its final central government accounts shall provide "State annual accounts and all necessary other information on management of the central government finances and compliance with the State budget, together with information on the most important factors in terms of trends

in the social effectiveness and operative performance of the State's operations, and the most important information on trends in social effectiveness and operative performance in the sectors covered by the various ministries." The Budget Decree (1243/1992) 1b § sets requirements on the contents of the budget. Under it "Budget proposals shall comprise proposals for appropriations and revenue estimates, grounds for the appropriations, and other grounds intended to represent the views of Parliament and grounds in the explanatory parts of the Budget Proposal to be submitted to Parliament." In addition, this paragraph requires that the explanatory parts of the budget proposal include proposals for targets set by the Government for the effectiveness of state activity and finances in the policy sector of the ministry in question and the ministry's tentative performance targets for the effectiveness of state activity and financing in its policy sector. The legislation can be considered very demanding with regard to accountability. However, it hardly describes the contents of the requirements, so it must be appropriately interpreted at each time.

In addition to the statutory requirements presented above, budget drafting instructions and the requirements of good state financial management also specify the intrinsic contents of accountability. Instructions for drafting Government proposals, in particular with regard to evaluating the financial impact of a draft bill, have a vital role for tax subsidies. The latest proposal dealing with this matter is the working committee memorandum⁵ "Parempaan lainsäädännön taloudellisten vaikutusten hallintaan" (Finnish for "Better management of the financial impact of legislation").

According to the principles presented, when planning a tax subsidy, information is required as the basis of decision making, to inform those involved about the environment in which they will be operating, and for evaluating the subsequent accountability. Preliminary information is required on alternative methods of achieving the target set and rational grounds for choosing the method. In practice, this means information on the social effectiveness and costs of each method. The loss of revenue from taxes in future years must also be taken into account as a fundamental cost of a tax subsidy.

According to the instructions, a vital part of accountability is follow-up responsibility. To fulfil this, information is required on tax subsidy amounts accounted, and the costs and any side effects. The principle of

⁵ *Ministry of Finance, (2006).*

good follow-up responsibility includes transparently reporting the social targets achieved, in other words the social effectiveness.

2.3 Audit data and methods of analysis

The audit is divided structurally into four parts. The first part describes the tax subsidy phenomenon and the principle features of it. The second part evaluates one particular tax subsidy, the effectiveness of tax deductibility of voluntary pension premiums. The third part looks into the development of tax subsidy bills and their grounds, following the first VATT tax subsidy research report. The fourth part includes observations relating to individual tax subsidies.

In the first part the description of the tax subsidy phenomenon is based mainly on domestic and international literature. Considerable information has been obtained from expert seminars on EUROSAT's parallel audit on tax subsidies for analysing the subject.

In the second part the effectiveness of the tax deductibility of voluntary pension premiums is evaluated through empirical methods of economics. The analysis by VATT is based on material about taxes, allocated income and wealth. In addition, VATT has written a review of literature on research about the effectiveness of tax subsidies, which can be utilized later if necessary to supplement the viewpoint on effectiveness. The tax subsidy for pension insurance premiums was chosen as an audit subject because of its topicality and effect on income transfer. One aim of the audit was to evaluate a tax subsidy intended mainly to change behaviour. Energy tax subsidies were therefore initially chosen as an audit subject, but this subject is so significant that a separate audit on it will be started in 2007.

In the third part the development of grounds for legislation is evaluated in the audit through a series of questions. The preparation material for new and amended tax subsidies in effect after 1990 is evaluated on the basis of the same questions. The evaluation is limited to tax subsidies with an estimated effect, or change in effect, greater than 10 million euros per year in accordance with the criterion of relevance of the working group⁶ established by the Ministry of the Finance to improve management of the financial effects of legislation on public finances. The questions are based on principles for good governance and bill drafting instructions. The

⁶ Ministry of Finance, (2006).

series of questions is intended to evaluate the quality of the development of bill drafting in the past 15 years. The audit evaluates how well the bill drafting has met the requirements set for it.

In the fourth part is information gathered during the audit, and it includes very different types of matter. Among other things, tax subsidies were recorded in the audit that had not been noted in the VATT tax subsidy report. However, the audit does not include new comprehensive identification of tax subsidies, so there are likely to be tax subsidies on which there is not yet detailed information.

In the audit data were also gathered for the European Supreme Audit Institute's EUROSAI parallel audit, which concerns the transparency of tax subsidies. A report on this audit will be given separately in spring 2008 at EUROSAI's congress.

Feedback on the draft audit report was requested from the Ministry of the Finance. The comments received have been taken into account in the final audit report.

The audit was undertaken by auditors Visa Paajanen and Hannu Rajamäki, and the audit was supervised by audit director Jarmo Soukainen and head of auditing Arto Seppovaara.

3 Audit findings

3.1 Evaluation of tax subsidies

This chapter evaluates the characteristics of tax subsidies. In particular, the nature of tax subsidies is audited with regard to accountability, good central government finance management and good governance. In addition, the chapter evaluates the existing criteria for achievement of accountability and how accountability concerning tax subsidies is effected.

3.1.1 Tax subsidies as policy tools

There are very many different tax subsidies, so their use as policy tools varies. One group of tax subsidies comprises subsidies that from the citizen's point of view are only imputed. An example of such a tax subsidy is tax relief on housing income. The tax subsidy arises from the housing income imputed for living in one's owner-occupied home. Although currently this is not perceived as a tax subsidy, such imputed housing income was previously taxed. Another group comprises tax subsidies apparent mainly through the prices of goods and services. They may, for instance, derive from deviations from the general value added tax rate. A decrease in the rate of value added tax on food has recently been discussed. Foods are already taxed at a lower value added tax rate, so there is a tax subsidy on purchases of food. A third group comprises automatic tax allowances, for instance on employment income. A fourth group includes tax subsidies that citizens and companies receive on application. Obvious examples of these tax subsidies are domestic help credit and the low-pay subsidy.

The Ministry of Finance in its feedback on the audit report emphasized the difference between an actual tax subsidy and an indirect subsidy through the tax system. In contrast to tax subsidies, indirect subsidies through the tax system appear in the budget as appropriations. In these cases, the recipient of the subsidy may be different from the actual taxpayer. An example of such a subsidy through tax system is the subsidy for low-pay sectors. The subsidy takes the form of not requiring the employer to remit withheld taxes and tax at source. The state compensates for the losses of other tax recipients through an appropriation.

Advantages and disadvantages of tax subsidies

Tax subsidies have advantages and disadvantages as a policy tool. Viewpoints concerning the usefulness of tax subsidies in different situations presented in the literature and raised in interviews during the audit are analysed below. Finally, the recommendations of the World Bank and OECD for handling tax subsidies in the state's financial management and planning policy are summarized.

Tax subsidies are generally easier to administer and more cost efficient to allocate and monitor than direct subsidies. The cost efficiency stands out especially in relation to the amount of the subsidy. There is little information on the actual cost efficiency and effectiveness of tax subsidies. There is hardly any research data on whether tax subsidies achieve the desired impact with less input than for direct subsidies. In this respect, it is therefore impossible to draw general conclusions. In addition, it should be taken into account that some of the administrative costs relating to some tax subsidies have been transferred to taxpayers, and on the whole tax subsidies are not always more cost efficient than direct subsidies. There is also little information on the administrative costs and how they are allocated.

In certain cases, a tax subsidy could be regarded as having more of an incentive effect than a direct subsidy. To receive the tax subsidy, one has to act in a desired way, or have already obtained an income or some form of gain conferring entitlement to the subsidy. The incentive effect is obvious in these cases.

A very significant advantage of a tax subsidy is that, if required, decisions can be delegated to the right bodies. A good example is subsidizing research and product development. Through tax subsidies, the Government can give incentives for such activities without taking decisions in individual cases on subsidizing projects or sectors. The decision making in this regard is left to companies and is market-oriented.

Transparency is one of the most significant problems of tax subsidies. As regards tax subsidies, it is not always clear who benefits and by how much. The subsidies are not included in the regular annual budget review, so whether a tax subsidy is effective in the desired way is generally unanswered. Another negative aspect of tax subsidies relates to transparency. Tax subsidies are not generally defined as limited to an annual maximum total amount of subsidy. In English the term used is *open end spending*. In addition to the lack of an annual maximum total amount, this term also refers to the enduring nature of a tax subsidy: the subsidy continues over the years without being periodically evaluated.

Some of the tax subsidies in Finland have become so long-established that they are not necessarily perceived as tax subsidies.

The problems of the inefficiency of tax subsidies often arise because it can be more difficult to channel a tax subsidy to the desired group than a direct subsidy. A tax subsidy has to be specified quite generally, so the targeted group of beneficiaries will not be the only ones to benefit.

Tax subsidies are very problematic in relation to the principle of the neutrality of taxation. All tax subsidies are contrary to this principle. In addition, in Finland the aim since the tax reform at the start of the 1990s has been a broad tax base and a low nominal tax rate. Tax subsidies narrow this tax base. Moreover, tax subsidies complicate taxation, and increasing their number increases taxation costs. At some stage the benefit of an individual tax subsidy may be less than the cost arising from it in the overall tax administration. It should also be noted that tax subsidies decrease revenue from taxes. Tax subsidies therefore increase the level of other taxation.

International recommendations

International organizations have made best practice recommendations concerning tax subsidies as policy tools. However, they do not take a view on the use of tax subsidies, but instead provide guidelines for best practices related to them. Recommendations for good governance of public finances have been issued by the OECD and International Monetary Fund (IMF). The IMF regards transparency of the public sector as a key issue in good governance. Transparency means transparency of public sector structures, operations, finance policy objectives, accounting and finance policy actions. Transparency should apply to the preparation, implementation and subsequent reporting of decisions⁷.

The OECD has in its guidelines given a lot of practical advice on administering tax subsidies⁸. The following are translated summaries of the key guidelines given by the OECD:

- Tax subsidies should be defined and evaluated in relation to a so-called benchmark tax level (and not in relation to the equivalent direct subsidy).
- Tax subsidies should be presented in the budget together with reporting of corresponding expenditure for the same purpose.

⁷ *Manual on Fiscal Transparency. IMF.*

⁸ *Best Practice Guidelines – Off Budget and Tax Expenditures. OECD.*

- Tax subsidies should be taken into account in spending limits. Tax subsidies should be combined with spending limits for all spending, or a separate spending limit should be defined for tax subsidies.
- All tax subsidies should be handled in the budget process in an equivalent way to other spending or appropriations. This also applies to evaluation undertaken less than annually.
- Tax subsidies are the responsibility of the ministry responsible for the matter. Ministries should not use tax subsidies as a means of reducing spending (such as in a situation in which the spending limit of the ministry is about to be exceeded).
- The magnitude of a tax subsidy should be evaluated by means of the revenue lost from taxes (different evaluation methods are described in the following section).
- The Ministry of Finance should have overall responsibility for administering tax subsidies.

In practice, the OECD's guidelines lead to handling tax subsidies in the same way as appropriations are handled.

3.1.2 Methods of evaluating the magnitude of tax subsidies

Evaluation of the total size of a tax subsidy is an important part of tax subsidy research. There are three different methods of evaluation. The methods approach the amount issue from different points of view. The *revenue lost from taxes method* evaluates the revenue from taxes that the tax recipient does not receive. The evaluation also describes the tax benefit or tax subsidy that taxpayers receive. The evaluation is based on transactions that have occurred; it does not take into account changes in the total size of the tax subsidy due to the effect of the tax subsidy on behaviour. The *potential increase in tax subsidy method* also takes into account behavioural changes due to tax subsidies. In other respects, the method evaluates in the same way the revenue from taxes that the tax recipient will not receive or the tax benefit the taxpayer receives. The *spending equivalence method* evaluates the amount of direct subsidy equivalent to the tax benefit the taxpayer receives. This evaluation aims to identify the appropriation needed to compensate the recipient of benefit for the tax subsidy.

None of these methods as such provides accurate information on the total size of the tax subsidy. The revenue lost from taxes method is relatively easy to use, so it is most commonly used in evaluating tax

subsidies. Evaluations are done in Finland with this method. However, the revenue lost from taxes method does not indicate the real magnitude of the tax subsidy because the evaluation does not take into account the effects on behaviour caused by the tax subsidy. Evaluations must normally be done on one regulation at a time. Estimates of individual subsidies cannot in reality be added together because subsidies and deductions are linked and have effects on each other in various ways, and the tax bands they apply to vary. In this respect, there is similar uncertainty in evaluations by the potential increase in tax subsidy method and the spending equivalence method. It is not in reality possible to evaluate tax subsidies as whole with those methods, and with those methods the overall evaluation must be undertaken one subsidy at a time. However, in the general evaluation of tax subsidies, subsidies are handled as if they could be added together and figures are presented for totals of the tax subsidies.

3.1.3 Trend in magnitude of tax subsidies

A review of tax subsidies was first undertaken in Finland in 1988 by the planning secretariat of the Ministry of Finance⁹. In the review a framework for evaluation was devised, and the annual tax subsidy report has been made on that basis since then. In 1991 compilation of the report was transferred to the Government Institute of Economic Research (VATT), which commissioned a more recent research report on tax subsidy as an entity in 2004¹⁰.

In Finland the revenue lost from taxes method is used in tax subsidy reports. In addition, the trend in the total magnitude of tax subsidies has been monitored, and in this case the problem of the validity of adding together tax subsidies was not considered great. According to research reports, the total magnitude of tax subsidies has significantly decreased since the end of the 1980s. The main reason for this was the tax reform in the early 1990s. The objective then was to have the tax base as broad as possible, so a great number of different tax deductions were abolished. In recent years the total magnitude of tax subsidies calculated with the revenue lost from taxes method has remained fairly stable at about 10 billion euros.

From the tax recipients' point of view, the state has been a slightly greater loser than other tax recipients (municipalities and parishes). The imputed revenue lost by the state from taxes in 2002 was about 5 billion

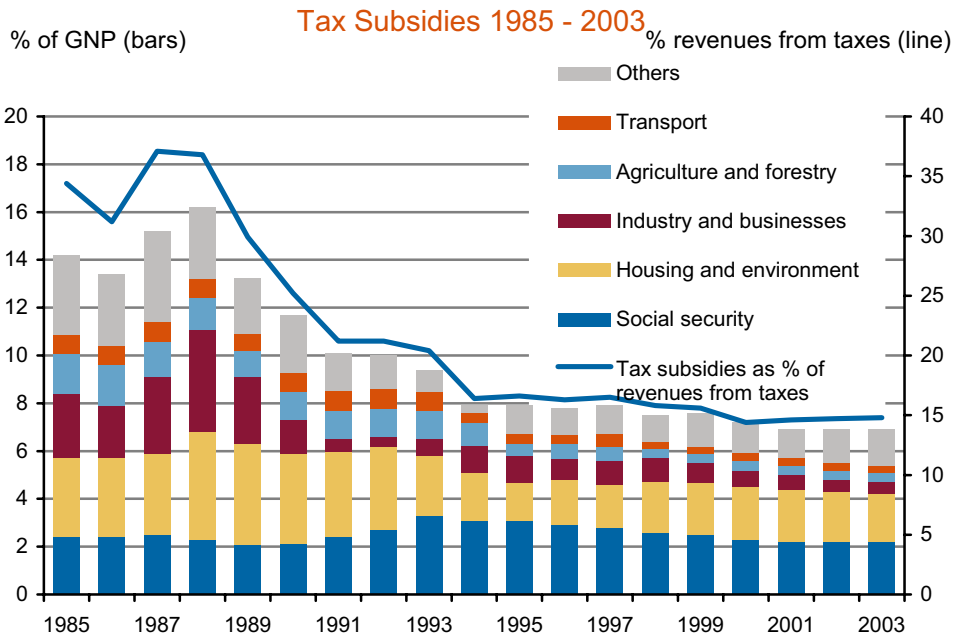
⁹ *Ministry of Finance 1989.*

¹⁰ *Kari, S. et al. (2004).*

euros, compared with in total about 4.6 billion euros lost by other tax recipients.

The trend and significance of tax subsidies from the tax recipients' point of view is highlighted by their proportion of revenue from taxes. According to the VATT research report, in 1987 tax subsidies accounted for about 37 % of the total revenue from taxes collected in public finances. The proportion since 2000 has been about 15 %. Tax subsidies have increased slightly as a proportion of revenue from taxes in very recent years.

The significance of tax subsidies in the state finances is demonstrated by comparing their total magnitude to the total accrued taxes of the state. In 2005 the state's revenue from taxes totalled 32.3 billion euros (and income totalled 39.0 billion euros). The total loss of revenue by the state and municipalities due to tax subsidies was about a quarter of the income of the state budget.



Source: VATT 2006

CHART 1. Tax subsidy trend 1985 – 2003.

Chart above clearly shows the impact of the 1990s tax reform. The objective then was to broaden the tax base and reduce the number of different tax subsidies. The chart also shows that the relative significance of tax subsidies in recent years has increased slightly. Like the relative significance, the absolute magnitude of tax subsidies in euros has increased in the years since 2000.

VATT's latest estimates of the magnitude of tax subsidies are for the year 2004. According to them, housing and social security are the most significant sectors for tax subsidies, each accounting for about 3 billion euros. The total size of the social security tax subsidy has been very stable. Social benefits are generally tax free. The most important of these are the deductibility of employees' statutory pension insurance contributions, the pension income allowance in municipal income taxation, the tax exemption of child allowances, the deductibility of voluntary pension insurance premiums and the tax exemption of subsistence support. The total size of the tax subsidy on housing has been increasing in recent years. The biggest tax subsidies on housing are the tax exemption of imputed housing income from living in an owner-occupied home, the tax exemption of capital gains from sales of one's own home and the partial deductibility of interest expenses on housing loans.

Together these total to well over four-fifths of the cost of tax subsidies on housing. A relative increase in housing costs, for instance, affects the magnitude of tax subsidy on housing costs.

A significant decrease in the magnitude of tax subsidy has occurred in the industry and businesses sector. Their tax subsidies total about 700 million euros. Tax subsidies for agriculture and forestry have also clearly decreased to currently about 550 million euros. The tax reform of the 1990s has greatly affected the tax subsidies for businesses. The aim then was to abolish various deductions, in other words tax subsidies, and to achieve a broad tax base. In recent years, there has been growth in tax subsidy that cannot be allocated to a specific state activity. The unspecified portion is over 2 billion euros. The recent growth of employment income allowance in municipal income taxation, employment income allowance now applying in state income taxation and domestic help credit have been major causes of this increase.

3.1.4 Tax subsidies in state's financial management

Handling of tax subsidies in reporting of state's financial management

In Finland an individual tax subsidy is always approved through a law, and the same obligations apply to preparing a tax subsidy bill as to any other legislation. For instance, the effects of the legislation should be proactively assessed before passing the bill. In this respect, the handling does not differ from other legislation.

Tax subsidies were dealt with in the state budget following the research report of 1988. Initially, the report was published as an appendix to the state budget. Since 2000 reporting has been transferred to the government report on the management and state of central government finances (status report). The change was partly due to the increasing number of pages in the budget, which it was intended to limit by placing the appendices in the new way. However, no preliminary estimates are made concerning tax subsidies, only a calculation of the effect they have had, so by their nature they also suit handling in the final central government accounts. In 2005 there was a transfer from the status report to the report on the final central government accounts. Also, the report on the final central government accounts includes tax subsidy information. However, the previous amount of information has been significantly reduced¹¹. The finance policy part of

¹¹ *Government's report on the management and state of central government finances in 2003. Report on the final central government accounts of 2004.*

the report on the final central government accounts includes a one-page summary on tax subsidies. In that part of the report on the final central government accounts for 2004, there is a reference stating that more detailed information can be found on VATT's website. However, updating has not taken place. In the state's report on the final central government accounts for 2005, there is a reference as regards tax subsidies to government reports on the management and state of central government finances for 2000-2004, and a statement that the figures included in them can also be found on VATT's website. From the formulation of the reference, it can be concluded that there is no intention any longer to present more detailed tax subsidy figures separately. The tax subsidy information therefore seems to be summarized so that it is not possible from the documentation to analyse tax subsidies by recipient sector. The section on revenue from taxes and income does not deal with tax subsidies and their effects on the amount of tax to be collected. It can be concluded that handling of tax subsidies has been transferred from the budget to the less important report on the final central government account. In addition, the presentation of tax subsidies has been changed from the planning stage to evaluation after the event, or rather presentation of the resultant trend. The amount of information presented has also decreased. On the whole, it would be no exaggeration to say that the handling of tax subsidies as part of the management of central government finances has been relaxed.

In the reporting on the management of central government finances, tax subsidies can also be handled in connection with income. The State Budget Decree (1243/1992) 1b § requires the Government to include in the explanatory part of the budget proposal targets and information on trends in the social effectiveness of the state's activities and funding. Corresponding information must also be included from ministries on the ministry's tentative performance targets for the effectiveness of state activities and funding in its policy sector. The Decree does not distinguish between appropriations and revenue estimates with regard to information required on effectiveness and targets. In practice, tax subsidies are taken into account as a factor affecting revenue in the year when the new tax subsidy becomes effective. After that, the effect of the tax subsidy is no longer taken into account as a factor affecting revenue. Lack of reporting on the objectives of tax subsidies and their social effectiveness is a clear shortcoming.

There is no statutory requirement to make a tax subsidy research report. The Government has therefore been able annually to define its contents and placing in the Government's documents on managing central government finances. In principle, publication of the research report could even have been discontinued. However, in practice all OECD countries

undertake some kind of evaluation of the magnitude of tax subsidies. Nevertheless, the research reports differ greatly in their purpose, status, connection with the budget process and frequency of publication. Only in a few countries such as Italy is a tax subsidy report undertaken under statutory requirements. In many countries the report is part of the budget or an appendix to it. However, even in these cases they mainly evaluate the magnitude of tax subsidies in previous years. In Canada a separate comprehensive research report of about 300 pages is undertaken which is used for preparing the budget. In most cases the purpose of the tax subsidy reports is to make the parliament aware of the costs of tax subsidies. Only in a very few cases is the report used for comparing different policy tools and for preparing the budget.

Differences in the handling of tax subsidies and appropriations

The handling of tax subsidies differs in many ways from the handling of appropriations in the state's budget process. The scope of the handling itself is different. The appropriation in the budget for a year, about 40 billion euros, is handled as part of the budget and the report on final central government accounts in about 1 000 pages. Coverage of tax subsidies, imputed at about 10 billion euros per year, has been reduced from about ten pages to about one page. Previously, tax subsidies were reported for each statute, whereas now role-specific totalled information suffices. Also, tax-recipient-specific (state, municipality, parishes) information and effects have been omitted from the evaluation.

As regards appropriations, their magnitude has generally been defined as fixed, either in the form of a fixed appropriation or a transferable appropriation. Variable appropriations are used in only a few exceptional cases. In addition, appropriations are specified annually after they have been subject to evaluation. However, the magnitude of tax subsidies is not specified. Often in draft bills the annual amount of tax subsidy has not even been estimated. This amount can vary significantly from year to year. For instance, fluctuations in interest rates could cause clear changes in the amount of tax subsidy on housing.

Currently, budgeting according to spending limits is used for the budget process. Thus expenditure for each government sector, in other words the spending limits, is agreed for future years. This procedure is intended to improve planning and also spending discipline. In practice, funding for new needs arising in each government sector, in other words new spending, must be found by cutting other activities. Tax subsidies are not generally considered and taken into account in setting the spending limits.

This can easily lead to a situation in which tax subsidies are considered an easier way of funding new needs. They enable a government sector to support an activity without having to reduce other spending.

The situation in Finland has not yet become very alarming. However, the number of tax subsidies is rising and the downward trend in their total amount has been reversed. In addition, many new tax subsidy draft bills have been proposed. In Sweden the situation has changed dramatically since 2000. The amount and number of tax subsidies have both increased by many times¹².

Annual performance targets are set for appropriations and users of appropriations, and achievement of the performance targets is also evaluated subsequently. Performance targets for tax subsidies have very rarely been set. Targets are also set only when the tax subsidy statute is issued. Generally, targets presented in government bills have related to the effects of the tax subsidy on the beneficiaries. Hardly any targets for social or state financial effects have been set. Subsequent evaluations have been made of the success of some tax subsidies or tax subsidies as a part of some specific policy. In these cases, the targets set for the tax subsidy have generally had to be deduced from its effects, because targets were not set in the draft bill. A good example of this is deductibility of pension insurance premiums, which in this audit is analysed in more detail in section 3.2.

3.1.5 Conclusions about tax subsidies

In magnitude, tax subsidies are a significant part of state management of central government finances. They account for about a quarter of the appropriations in the budget, and the state's direct loss of revenue from taxes is about 15 per cent of the appropriations in the budget. The financial importance of tax subsidies should also be evaluated from the viewpoint that they greatly increase the amount of other taxation.

The total amount of tax subsidy has no longer been decreasing in the years since 2000, and it has started to increase slightly as a proportion of revenue from taxes. The trend is no longer consistent with the principles set in the tax reform of the early 1990s. Then the objective set was a broad tax base enabling lower progressive tax rates. The risk this entails has also been noted by the Government. In the decision on spending limits of

¹² *Information from Swedish National Audit Office's (Riksrevisionen) working papers.*

2006¹³, it was stated that deterioration of the tax base is a long-term risk if subsidies are channelled more than before indirectly through the tax system. In addition, the increasing number of different types of tax relief complicates the tax system, lessens equality and increases opportunities for tax evasion.

The financial importance of tax subsidies is not reflected in how they are handled in state financial management. Official handling has even been relaxed in recent years. This trend is not similar to the trend in handling appropriations. Ensuring achievement of the performance targets and accountability regarding appropriations has developed significantly in recent years. Nor has existing practice met the requirements set for handling tax subsidies as part of state financial management in international recommendations (for more detail, see section 3.1.1).

The State Budget Act (1216/2003) and Decree (1243/1992, amended 254/2004) and guidelines by the Ministry of Finance for preparing final central government accounts¹⁴ enable even more comprehensive handling of tax subsidies. In particular, guidelines for preparing final central government accounts enable significantly stricter interpretation of subsequent evaluation of the magnitude and level of tax subsidies than currently. The guidelines could also in fact be regarded as requiring this. According to the State Budget Act, the report on final central government accounts shall provide accurate and necessary information on state income and expenditure. The statute is quite general in nature. The State Budget Decree regulates how the Government must report information on the social effectiveness and performance targets in the state budget proposal and the final central government accounts. Tax subsidies greatly affect the state's revenue from taxes. They total about 10 billion euros per year, so handling them in the general explanatory part of the budget proposal would be justified. In the income estimate of the budget proposal bill, tax subsidies are taken into account only when they become effective. The effects of previously issued tax subsidies on revenue from taxes is not taken into account later. Statutes, however, require reporting on factors that also affect income.

Under the Budget Decree, information is required from Ministries on social effectiveness for the budget proposal and the report on final central government accounts. According to the Decree, information on actions and costs should be provided when presenting information on social

¹³ *State finance spending limits for 2007-2011: Memorandum, Ministry of Finance 2006.*

¹⁴ *Ministry of Finance 8/032/2005*

effectiveness. The costs could and should be interpreted in a broader sense than just using appropriations. Tax subsidies would then also be taken into account as spending in evaluating effectiveness. Moreover, the starting point in guidelines for preparing the report on final central government accounts is that spending on targets should be reported as well as their achievement. It is inconsistent with the principles of performance orientation that there is hardly any requirement to report spending and effectiveness that especially relate to tax subsidies. In many government sectors, tax subsidies comprise a significant part of the total spending of the government sector.

The currently used practice of spending limits should also require taking tax subsidies into account. Really adhering to spending limits would require at least that new tax subsidies be taken into account when setting spending limits. The method of funding would not affect the choice of policy tool. The appropriation could be compared with the tax subsidy, in other words in practice the decrease in income. Tax subsidies could not be used to evade spending limits, but the choice between an appropriation and a tax subsidy could be based on, for instance, the difference in their efficiency or difference in their effectiveness in an ideal case.

Current legislation and guidelines do not prevent resolving the problems presented in the Budget process. In this respect development actions would not require amendment of legislation.

3.2 Voluntary pension insurance premiums

The example case in the audit concerns only Finland, so the English language version of the report omits more detailed handling of the case. However, the report includes the conclusions drawn from the example case. The example case is in full in the Finnish language version. It can be obtained from www.vtv.fi.¹⁵

¹⁵ For more information, please contact Senior Auditor Visa Paajanen (visa.paajanen@vtv.fi) or Senior Auditor Hannu Rajamäki (hannu.rajamaki@vtv.fi).

3.2.1 Conclusions about the deductibility of voluntary pension insurance premiums

A crucial shortcoming in evaluating achievement of accountability regarding the tax deductibility of voluntary pension insurance premiums is that objectives have not been set for this system in relation to the essential impact of the system, in other words improving pension coverage and increasing general saving. The underlying objectives must be concluded from the impact of the system.

Deviating tax treatment for pension saving has been justified in Finland by among other things the fact that it provides an opportunity to compensate for gaps in statutory pension coverage. Particular groups of beneficiaries cited in this respect have been entrepreneurs, mothers at home and persons who for one reason or another have had a short working career and low employment pension coverage. Statutory contributions are in practice deductible. It could be justified to offer the same treatment for supplementary voluntary pension saving too. A key change regarding operations of pension systems in recent years has been amendments to employment pension systems that weaken the level of pension payments, especially when reaching the end of the pension accrual phase. Uncertainty arising about the adequacy of the pension level and the level of public services in future is justified. There is a new need for voluntary saving for the financial needs of old age. Against this background, it is fair to say that changes in circumstances, reforms in taxation and demographic changes in the pension savers group have increased the relevance of the system.

On the other hand, the tax deductibility of pension insurance premiums has been justified on the grounds of increasing long-term saving. This justification has been criticized because voluntary pension saving should be considered in the same way as other financial saving. The neutrality objective of taxation would then require that a uniform taxation basis applies to all forms of saving.

Voluntary pension saving has greatly increased in recent years. The research report does not clearly indicate whether the tax deductibility of voluntary pension insurance premiums creates new saving or transfers saving from other forms. If the aim of increasing saving is to compensate for deterioration in the security that the employment pension system offers, the system works in the assumed way in decreasing the uncertainty.

Voluntary pension saving entails features of tax planning. The research report clearly shows that without the tax subsidy, voluntary pension insurance would not be cost-effective as regards yield. Clear evidence for

this is that even the highest-earning taxpayers do not save more in pension insurance than their eligibility for tax benefit. The tax benefit for high earners has decreased due to a change in the premiums subject to relief and amended tax regulations.

It would be very beneficial to investigate the grounds for the tax subsidy for voluntary pension insurance premiums. If the objective is to increase saving, is subsidizing voluntary pension insurance the right means and are the terms of the tax subsidy consistent with the objective? Voluntary pensions as a saving alternative are cost-effective only because of the tax subsidy. Pension insurance does not necessarily have the nature of a pension, which it is assumed to have. In practice, savings can be withdrawn in four portions within two years. In practice, one alternative for consideration would be to harmonize the treatment of all saving. However, if the aim is to subsidize citizens to prepare for future risks and to take more responsibility themselves, the pension and insurance nature of voluntary pension insurance should be developed. Then increasing savings would in practice take the form of a monthly pension. This would better suit preparing for the risks of old age.

3.3 Development of tax subsidy preparation

As regards accountability, in current practice tax subsidies are subject to analysis mainly at the bill drafting stage. Targets are then set for the tax subsidies, their effects are evaluated and any future evaluation of effects is planned. This section analyses the development of tax subsidy preparation.

3.3.1 Framework for evaluation of tax subsidy preparation

The drafting of tax subsidy bills has been evaluated using a framework developed for evaluation. Bill drafting instructions have developed over the years and become more demanding. The reference framework used in this evaluation to a large extent corresponds to the current ideal. Some of the draft bills audited were prepared when much less strict requirements were in effect. The evaluation is intended to illustrate the development of tax subsidy legislation, not to evaluate how individual proposals meet the requirements. Tax subsidy laws are often part of a larger entity or comprehensive political solutions, but the framework now used focuses on the viewpoint of state finances.

The evaluation analysed government proposals that included proposed tax subsidy draft bills or amendments to them. The evaluation includes tax subsidy laws issued after the basic research report undertaken by the Ministry of Finance, in practice statutes since 1989. However, some tax subsidies originated earlier, but they have been evaluated because they have been amended during the period of audit.

The tax subsidies regarded as significant according to magnitude criteria were finally selected for the reference framework evaluation. The criteria used were the definitions in the project on development of the management of public finance effects of legislation¹⁶ established by the Ministry of Finance. According to them, statutes are considered to have *very extensive or significant* financial affects if the *annual revenue or cost effects of the statute on public finance exceed one thousandth of the gross national product*. According to figures for 2005, this would mean effects of about 160 million euros or more. Statutes are considered to have *extensive or significant* financial effects if their *annual revenue or cost effects are more than 10 million euros* or if the draft bill would mean *at least 10 per cent change in revenue or costs* relative to the starting point situation.

3.3.2 Evaluation questions and results

The framework for evaluating how legislation preparation has developed has been used to analyse the following aspects of tax subsidy bill drafts:

- how policy targets have been presented;
- how the choice of policy tool has been justified through quantitative or qualitative benefits;
- how the costs created by the proposed solution have been specified and evaluated;
- how costs and benefits have been compared with each other;
- how tax subsidies have been compared with other possible policy tools;
- how tax subsidy legislation and other legislation are linked to each other;
- how risks relating to each tax subsidy have been handled in the preparations;
- how international obligations have been presented in the preparations.

¹⁶ Ministry of Finance, (2006).

Appendix of the report presents the questions and results of the evaluation in more detail in table format.

3.3.3 Conclusions on the development of tax subsidy legislation

According to the evaluation undertaken, tax subsidy legislation preparation and proposals have clearly improved in the past fifteen years. This trend is consistent with the trend in the preparation of other legislation. One reason for this is development of more detailed instructions on general bill drafting during this period. In particular, there has been an improvement in defining and recording objectives for tax subsidies. Some kind of quantitative estimates have started to be presented for tax subsidies, and the effects of subsidies have been evaluated in advance. However, there are many shortcomings in the quantitative estimates. The most general shortcoming is that quantitative estimates do not take into account behavioural changes caused by the subsidy. In addition, estimates often only take into account comparison with the pre-existing situation. The total size of a tax subsidy has not in reality been evaluated in comparison with a total absence of any tax subsidy.

Despite the improving trend, draft bills have differed a lot in their quality. With a few exceptions, proposals do not meet the requirements of bill drafting instructions either. As regards accountability, the biggest problem is that proposals have not included plans for subsequent evaluation of the effects of tax subsidies. In contrast to appropriations, achievement of objectives set for tax subsidies cannot be systematically monitored in the budget process. Another type of planned monitoring would therefore be crucially important for tax subsidies. In addition, quantitative estimates, setting targets or proactive evaluation of possible effects may be totally lacking in some proposals for smaller estimated tax subsidies.

Totally new and as regards their significance rather small tax subsidies have been thoroughly prepared. Quite well prepared, for instance, is the act on the refund of production tax on some energy products used in agriculture¹⁷. An example of good tax subsidy legislation preparation is the act on domestic help credit and amendments¹⁸. At the starting point of

¹⁷ *Act on the refund of production tax on some energy products used in agriculture 603/2006.*

¹⁸ *Act on domestic help credit 728/1997, Government proposals HE 85/1997, HE 72/1999, HE 140/2000, HE 146/2004, HE 256/2002, HE 117/2005.*

bill drafting, definite objectives were set and possible effects estimated. The effects were also evaluated more thoroughly than normal. In the legislation preparations, different alternative means of achieving the objective were considered in an exceptional way. The effectiveness of different means were even tested in practice and a less effective model was rejected. In addition, objectives for social effectiveness and achievement of operative performance targets were continuously monitored. The alternative selected was developed on the basis of analysis of its social effectiveness and financial effects. The most significant problem as regards domestic help credit is that it is evaluated separately, and it was not linked to any main title of the budget.

3.4 Observations about individual tax subsidies

Individual tax subsidies revealed in the audit to be in some way significant or problematic as regards achievement of accountability are considered in this section. The cases are also of more general importance from the point of view of the efficiency and effectiveness of the subsidies.

3.4.1 Energy tax refund in agriculture

The energy tax refund in agriculture is a good example of how for practical reasons a tax subsidy has been chosen as the form of subsidy in a situation for which an appropriation in the budget could have been chosen. Energy tax relief in agriculture formed part of the Government's decision taken in 2005 on spending limits for the years 2006 - 2009. Then it was agreed to give agriculture an additional annual subsidy of 21.5 million euros. The subsidy is for professional agricultural business proprietors and the size of a single subsidy depends on the amounts of electricity and fuels used. Article 88 item 3 of the treaty establishing a single Council and a single Commission of the European Communities requires that the Commission must be notified of actions that can be considered government subsidies. Tax relief¹⁹ can be considered one such. The

¹⁹ *The energy tax directive also mentions tax exemptions, tax reductions, tax differentiation and tax refunds as possible government subsidies. Council Directive 2003/96/EU.*

Commission had not yet given permission to implement the planned energy tax refund while the audit was in progress.

Tax subsidy was chosen as the form of subsidy because EU and national subsidies had been fully utilized in Southern Finland, and it was not possible to increase direct subsidies further. Without this restriction, the subsidy could also have been in the form of an appropriation. The subsidy was also paid for 2005. In this respect the refund in practice had the characteristic of an appropriation. However, in the first supplementary budget for 2006, under the Ministry of Finance's main title of expenditure item 28.99.43 it is called an energy tax subsidy, because formally it is a refund of energy production taxes.

As regards the subsidy for 2005, the subsidy has been taken in the budget under the Ministry of Finance's main title of expenditure, even though it is clearly an agricultural subsidy. For transparency of the subsidy, it should have been included in the Ministry of Forestry and Agriculture's main title of expenditure. In future years, the subsidy given as a tax subsidy will not meet the normal gross principle for budget drafting, according to which all expenditure should be taken into account in the budget. In addition, in normal cases a particular income should not be linked to certain spending. Tax relief has been approved by law to be effective until further notice. This leaves open how long the subsidy will be effective. However, the spending limits to which the subsidy has been linked in the Government's proposal were set for the years 2006 - 2009. By law the annual subsidy is specified as fixed, but in such a way that administration costs are finally deducted from the subsidy going to the farmers. It is unclear whether the subsidy would decrease if administration costs increased.

The energy tax refund in agriculture is also exceptional in that the subsidy is complicated to administer. The subsidy is applied for from the tax administration. The cost of establishing and operating the subsidy system was about 1.5 million euros in the first year and is estimated at 650 000 euros per year afterwards. A common ground cited for tax subsidies is normally the simplicity of administering them compared with the costs of a direct subsidy.

One general agricultural aim is that the new subsidy should not affect the proportions of total subsidies going to different types of agricultural production. The calculation in the government proposal for the new tax subsidy clearly indicates that it benefits grain producers most and milk

producers least²⁰. Linking the subsidy to energy use is also inconsistent with current environmental policy.

3.4.2 Subsidy for foreign vessel traffic

Subsidies for foreign vessel traffic are abundant everywhere. Tax competition has resulted in hardly any taxes being collected in many countries from vessels in international traffic. The intensifying tax competition is highlighted by the introduction of new forms of subsidy and continuous changes in policy tools in Finland, too. It is likely that in Finland too there will be a transition to so-called tonnage tax, meaning that shipping companies do not pay tax on their profits; instead, tax is specified according to the tonnage of a vessel. Because of the constant changes in subsidy policy, this matter will not be analysed in more detail.

Currently (autumn 2006), the most significant issue relating to tax subsidies is the difference between cargo and passenger vessels as regards traffic subsidies. Cargo vessels receive a direct subsidy. In contrast, the subsidy for passenger vessels is called a tax subsidy. In practice, shipping companies retain for themselves their employees' taxes. According to information received in an interview, tax subsidy was chosen because of the decision on limitation of budget spending. By formally calling the subsidy a tax subsidy, it was possible to avoid increasing government spending by the amount.

3.4.3 Low-pay sector subsidy

Tax subsidies are generally regarded as simpler and cheaper to administer than direct subsidies. This seems not to be the case for the low-pay sector subsidy²¹. The subsidy is new, introduced in 2006. The objective of the subsidy is to increase demand for low-pay work and promote employment of older people in low productivity sectors. The subsidy is implemented by exempting employers from paying the tax withheld or collected at source from employees eligible for the subsidy up to the amount of the subsidy. The state compensates other tax recipients for their loss of taxes (budget appropriation 28.99.41, 100 million euros for 2006).

There is no specific documentation on the use of the subsidy and its effects. However, it seems that the popularity of the subsidy is clearly less

²⁰ *Government's proposal 56/2006*

²¹ *Act on temporary low-pay subsidy for employers 1078/2005.*

than preliminarily estimated. One reason for this seems to be the complexity of the application process and the cost caused to the business applying for it. Based on information obtained in the interviews, small businesses in particular have ignored applying for the subsidy even though they are entitled to it. Preliminary estimates by businesses were that the process of applying for the subsidy was too complicated for employers²². This was already anticipated in the government proposal, which stated that if an employer considers the obligations relating to the subsidy outweigh the benefits received, the employer can decline to utilize the subsidy. The majority of those entitled to the subsidy do not apply for it because of the costs, which suggests it is also of little significance to those who have applied for it.

Administrative costs of this tax subsidy have been transferred to businesses. However, the amount of costs transferred was not evaluated in the government proposal, even though in this case these costs would be greater than costs to the administration. The transferred costs would be essential information in evaluating the usability and estimated effectiveness of the subsidy. All in all, in Finland there has been little research into the costs transferred to others by the administration and the significance of problems relating to this.

3.4.4 Forest taxation

Many tax subsidies relate to forest taxation. VATT's tax subsidy report mentions altogether five different subsidies totalling 90 million euros. The tax subsidies include a tax subsidy relating to evaluation of forest income and partial tax exemption for logging work.

However, as regards forest taxation, VATT's tax subsidy calculation does not give an accurate picture of the size of the subsidy. According to the Finnish Forest Research Institute (METLA)²³, VATT has not taken into account in its calculation an amendment to the tax system changing from an area-based tax to capital gains tax. Owing to the change, in the period 1993-2005 area-based tax and capital gains tax were both in use. Since the beginning of 2006, only capital gains tax has been in effect. In its report VATT assumed all forest owners were subject to area-based taxation. In addition, VATT's report assumes that logging by the forest owner is 100 per cent the owner's own work when in fact half of it is done by external persons. VATT regards the subsidy's exemption from tax to be

²² *Pasanen, V. (2006).*

²³ *Aarnio J. (Ed.) 2004.*

a tax subsidy. The matter is not clear in capital gains taxation, because as regards capital gains taxation, the tax exemption benefit is not 100 per cent, because the subsidy is for operations that would otherwise be tax deductible. In its report VATT estimated the amount of tax subsidy at over 1.5 times METLA's estimate.

In absolute figures, the difference between VATT's estimate and METLA's estimate is not very large compared with the total amount of tax subsidies. Size class estimates vary from 90 to 155 million euros. More problematic is the outdated grounds of VATT's estimate and the use of a basic research report of 1988 without updating. If there are similar mistakes in other tax subsidy estimates, and especially in significant ones, VATT's tax subsidy estimates must be regarded with caution.

3.4.5 Deductibility of interest expenses on housing loans

The deductibility of interest expenses on housing loans is relevant to a large number of citizens. The objective of the subsidy is to decrease the living costs of borrowers that have acquired owner-occupied homes. The deduction is problematic in two respects.

First, the tax subsidy induces purchasers of homes to invest more in homes than they would in a neutral situation without the right to deduct interest expenses²⁴. In practice, the subsidy increases housing prices. As with many other subsidies, it does not solely benefit the target recipients of the subsidy. Significantly, the subsidy also benefits real estate agents and those moving to smaller housing with a lower price.

Secondly, the subsidy is problematic from the point of view of monitoring. Most household borrowing is housing loans. In addition, the security for other borrowing is generally one's own home. It is not certain whether the borrowing will be used for acquiring a home. The situation is generally clear when acquiring a home; the loan is for acquiring the home. However, later by changing the loan amount, a household can to some extent choose its consumption level. In that case it becomes unclear whether the loan is borrowing for housing. New services from banks are also changing the situation. A borrower for housing can at the same time save regularly in investment funds with the objective of repaying the housing loan at one time with the yield from the investment funds. The importance of the problem of monitoring usage of the tax subsidy has greatly increased in recent years. The total amount loaned for housing has

²⁴ *Howard, C. (1997).*

increased more rapidly than housing prices. This is partly explained by the increase in the proportion of the home purchase price loaned. However, detailed research on this matter is lacking.

3.4.6 Tax subsidies missing from VATT's report

The audit found that some tax subsidies were not taken into account in VATT's tax subsidy report. For some of these subsidies, an estimate of their size is available or could be made.

The tax subsidy due to exemption of transfer tax on first homes was not taken into account in VATT's report. The estimated value of the annual subsidy based on first homes purchased is 30 - 40 million euros.

Health care and medical treatment, social welfare and education are outside the scope of value added tax because they are financed mainly through public funds. Financial services are not subject to value added tax because taxation of financial services entails problems and in the EU financial services are generally not subject to value added tax. Insurance services are outside the scope of value added tax. The tax subsidies due to these types of tax relief have not been taken into account in VATT's report.

Prior to 2004, business operations were subject to value added tax if the amount exceeded 8500 euros per year. If the amount exceeded the lower limit, the whole of the business operations was liable to value added tax. This was considered to hinder expansion of small-scale businesses. Because of the problems, since the beginning of 2004 the lower limit of value added tax liability has been changed to a sliding scale. The tax must be paid in full amount when the annual turnover exceeds 20 000 euros. In the Government's proposal²⁵, the relief is estimated to generate an annual tax subsidy of 36 million euros. The tax subsidy due to this relief was not taken into account in VATT's report.

3.4.7 Conclusions

The audit found that VATT's tax subsidy report does not cover all tax subsidies used. In addition, the amounts in the report have been criticized. Instead of just updating the tax subsidy report, a better picture of the current situation as regards tax subsidies could be obtained by undertaking a totally new research report. This observation is supported by the fact

²⁵ *Government proposal 135/2003*

that many new tax subsidies have been introduced in recent years. A new research report would also give a more detail picture of to what extent tax subsidies have increased in number or magnitude. This is especially important with regard to evaluating strategic aspects of tax policy, because the objective of it has been a broad tax base and a low tax rate.

For some tax subsidies identified in the audit, tax subsidy was chosen as the form of subsidy mainly to avoid exceeding a spending limit. That is not an appropriate ground for choosing the form of a subsidy and can lead to inefficient solutions. Analysis of individual subsidies supports the observations made earlier in the audit. To improve the effectiveness of subsidy policy, tax subsidies should be included in the budget proposal with spending limits. Then the choice of the form of the subsidy would not be affected by the way it is financed, and the choice could be based on the effectiveness of the form of subsidy. This would also improve the transparency of subsidy policy.

4 The National Audit Office's conclusions and recommendations

Tax subsidies are defined as a deviation from the normal structure of taxation that decreases the state's revenues or the tax income of other recipients of tax income. An individual tax subsidy is always decided through a law. Tax subsidies have a significant impact on the state's finances. The imputed impact is equivalent to about a quarter of the state's annual expenditure, in other words about 10 billion euros. Tax subsidies were evaluated in the audit from the viewpoint of accountability: what information is available on tax subsidies as grounds for decision making, and what information is available on tax subsidy magnitudes, costs and impact, and how they are reported?

The finding of the audit was that the handling of tax subsidies in the state's financial management is not consistent with their economic significance. In addition, the quality and the extent of this handling have deteriorated in recent years. Previously, the estimate of the total magnitude of tax subsidies formed an appendix to the state budget. Later, it was presented in the Government's report on the management and state of central government accounts. In the latest reform, the reporting has been transferred to the report on the final central government accounts. Following this reform, the number of pages in the report has been reduced from eight pages to a one-page summary. The estimated total sizes of individual tax subsidies are no longer reported.

In the National Audit Office's view, the Government should take tax subsidies into account as part of the state's financial management much more decisively than currently. Tax subsidies have a significant impact on the state's income. In addition, in the state's financial management, tax subsidies also represent consumption of resources and costs. In the National Audit Office's view, this means that in reporting of the state's financial management, tax subsidies should be handled as factors affecting income and the appropriations allocated for the same purpose. Performance targets should be set for tax subsidies in the same way as for appropriations, with their achievement monitored and also reported.

Tax subsidies should be taken into account in the spending limit of the state's finances. In some cases, tax subsidies have clearly been used to evade the spending limit. In the National Audit Office's view, it is not

appropriate to choose a tax subsidy as the form of subsidy so as not to exceed spending limits. The choice of policy tool between a tax subsidy and a direct subsidy should be based on any difference in their effectiveness.

In recent years, the number of tax subsidies has risen and the longlasting downward trend in their total size has reversed. This development is contrary to the neutrality objective of taxation embraced in the 1990s. Tax policy in the early 1990s also included the objective of a broad tax base and consequent low tax rates. Increasing tax subsidies is contrary to this objective too. The National Audit Office also notes that increasing tax subsidies increases the level of other taxation.

In recent years, the tax subsidy report undertaken annually has deteriorated as regards its information value. The reporting has been transferred from the budget to the report on final central government accounts. The audit noted inaccuracies and shortcomings relating to the contents of the report. In the National Audit Office's view, the Ministry of Finance should pay attention to improving the contents of data relating to tax subsidies to enable evaluation of tax policy and its effects. It would be justified to undertake a new tax subsidy report, instead of updating annually the 1988 report.

The Government's proposals concerning individual tax subsidy legislation has improved since 1988. In particular, there has been a clear improvement in the reporting of preliminary estimates of the magnitude of a tax subsidy and the intended benefits and effects. However, there are still no plans for monitoring, and achievement of targets is not monitored. In the National Audit Office's view, the social effectiveness of significant tax subsidies should be evaluated regularly. In this respect, there is no justification for handling tax subsidies differently from corresponding significant appropriations.

The audit evaluated one tax subsidy in more detail, the tax subsidy for voluntary pension insurance premiums. The subsidy system has been amended since 2006. The objectives of this subsidy were not presented when introducing the amendment. This is a shortcoming that makes it impossible to evaluate the effects of the subsidy and achievement of accountability. The grounds for the tax subsidy for voluntary pension insurance premiums should be investigated in more detail. The subsidy seems to increase saving, but the savings created are producing hardly any pensions from the insurance. The need for a more detailed account of the grounds is supported in the audit by the observation that the voluntary pension insurance premiums would not be cost effective for subscribers of the insurance without the tax subsidy.

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10.10.2005	Ministry of Finance, Budget Department
13.10.2005	Ministry of Finance, Budget Department
25.10.2005	Ministry of Finance, Budget Department
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27.10.2005	Ministry of Finance, Budget Department
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8.12.2005 Government's Institute for Economic Research
24.1.2006 Government's Institute for Economic Research
27.1.2006 Government's Institute for Economic Research
30.3.2006 Government's Institute for Economic Research
26.3.2006 Ministry of Social Affairs and Health
12.9.2006 Riksrevisionsverket, National Audit Office of Sweden
28.9.2006 National Board of Taxes
13.11.2006 Government's Institute for Economic Research

22.-23.2.2006 EUROSAT, Tax Subsidy Seminar, Bonn.

28.8.2006 EUROSAT, Tax Subsidy, Transparency and Subsidy Reporting
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Appendix

Tax Subsidy Acts	Value estimate of tax subsidy A	Information of goals B	Influence mechanism C	Estimation of benefits D	Estimation of costs E	C/B analysis F	Relation between other acts G	Risk analysis H	Relation to international agreements I
<i>Tax-exempt revenue from housing (personal income tax act 1535/1992 53§)</i>	++	+++	++	++	++	-	+++	+	+++
<i>Tax-exempt capital gains when selling household's permanent residency (personal income tax act 1535/1992 48§)</i>	++	-	-	-	+	-	+	-	-
<i>Transfer tax-free when nature conservation area is sold to the state (personal income tax act 1535/1992 48 ja 49 §)</i>	-	-	-	+	-	-	-	-	-

Capital transfers tax-free when agricultural land is transferred to the next generation (personal income tax act 1535/1992 49 §)	-	-	-	-	-	-	-	-	-
Partially tax-free capital gains when household effects are sold (personal income tax act 1535/1992 48§)	-	-	-	-	-	+	-	-	-
Deductibility of interest expenses on housing loans (personal income tax act 1535/1992 58 §)	+++	-	+++	++	++	++	+	-	-
Tax-exempt housing subsidies (personal income tax act 1535/1992 92§)	+++	-	-	-	-	+	-	-	-
Deductibility of trade union fees (personal income tax act 1535/1992 95§)	+++	-	+++	++	++	-	-	-	-

Reduced VAT on medicines (VAT Act 1501/1994, 85\$)	+	-	+	-	+	-	-	-	+	+	+	+	+	+	+
Reduced VAT on public transportation (VAT Act 1501/1994, 85\$, Government's proposal 76/1994)	+	-	+	-	+	-	-	-	+	-	-	-	-	-	+
Reduced VAT on food and animal feed (VAT Act 1501/1994, Government's proposal 111/1997)	+	-	+	-	+	-	-	-	+	-	-	-	-	-	+
Reduced VAT on TV-licences (VAT Act 1501/1994, 85\$)	+	-	+	-	+	-	-	-	+	-	-	-	-	-	+
VAT-exempt prescribed newspapers and magazines (VAT Act 1501/1994 55\$)	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Reduced VAT on sport and cultural events admission fees (VAT Act 1501/1994 85\$)	+	-	+	-	+	-	-	-	+	-	-	-	-	-	+

	+++	+++	+++	-
	+	-	++	-
	+++	+++	+++	++
	+++	-	++	+
	+++	++	+++	+
	+++	++	+++	+
	+++	+++	++	-
	+++	+++	+++	++
	++	++	+++	++
<i>ployer, (personal income tax act 1535/1992 69§ and 71§, government's proposal 83/2000)</i>				
<i>Amending act on the excise duty of electricity and particular fuels and liquid fuels (Act 1168/2002)</i>				
<i>The relief from VAT's lower limit (VAT Act 1501/1994 149§, government's proposal 135/2003)</i>				
<i>Act on temporary exemption tax withholding from seamen's income earned on particular passenger vessels (Government's proposal 94/2004)</i>				
<i>Deductibility of obligatory insurance premiums, employees' pension payments and unemployment insurance premiums</i>				

(personal income tax act 1535/1992 95, 96, 96a§, government's proposal HE 1115/2005)	+++	+++	-	-
Deductibility of obligatory insurance premiums, daily allowance payments of the health insurance (personal income tax act 1535/1992 96§, government's proposal 1115/2005)	+++	+++	+	++
Act on temporary low-pay subsidy for employers (Act 1078/2005, government's proposal 146/2005)	+++	+++	-	-
Tax-exempt interest income (interest from revenues bonds etc.) of person with limited tax liability (personal income tax act 1549/1995 9§)	+++	+++	-	++
Tax-exempt employee benefits, sports voucher	++	++	-	-
	+++	+++	-	++
	+++	+++	-	++
	++	+++	-	+
	++	+++	-	++
	+	++	-	-
	+++	+++	-	++

<i>Earned income allowance in state tax, (personal income tax act 1535/1992 125 § act 1128/2005, government's proposals 117/2005 and 144/2006)</i>	+++	+++	+++	++	++	+++	++	+++	+++	+	+	+++	-	-
<i>Reduced-tax employee benefits, employment relationship linked public transportation ticket (personal income tax act 1535/1992 64 §, government's proposal 1128/2005)</i>	++	+++	+++	+++	+++	+++	++	+++	+++	+	+	+	-	-
<i>Act on the refund of production tax on some energy products in agriculture (Act 603/2006)</i>	+++	+++	+++	+++	+++	+++	+++	+++	+++	+++	+++	+++	+++	+++

The evaluation above concerns the documentation of the drafting of the legislation. The evaluations have been made by making the following questions.

- A: Has the amount of the tax subsidy estimated by the method of revenue forgone? Are behavioural changes taken into account when estimating the amount of tax subsidies. Are there pre and post estimations?
- B: Are the goals specified? Are other impacts specified?

- C: Is the influence mechanism specified?
- D: Which target group gains benefits? Which are quantitative and qualitative benefits?
- E: What are costs? Loss of tax revenue? Administrative costs? What is the administrative burden transferred to private sector?
- What are the costs of possible side effects?
- F: Is there c/b analysis made? Are there comparisons between tax subsidy and other possible policy means?
- G: Are there presented tax subsidy's relation to other acts?
- H: Is risk analysis made?
- I: Is tax subsidy's relation to international agreements presented?

Scale:

- +++ Excellent (all relevant information presented)
- ++ Fair (some information presented).
- + Poor (mentioned).
- No information.



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