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# Reforming the Tax System in Portugal

**Chiara Bronchi,  
José C. Gomes-Santos**

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**REFORMING THE TAX SYSTEM IN PORTUGAL**

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by  
**Chiara Bronchi and José C. Gomes-Santos**

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## ABSTRACT/RÉSUMÉ

The Portuguese tax system has developed positively in the past decade. Following the 1989 tax reform, tax bases have been broadened and statutory tax rates lowered. The overall tax burden is not high by international comparison and the tax mix relies on the more neutral consumption taxes. However, further reforms should be envisaged to make the system more neutral, efficient, and equitable. The evidence reviewed in this paper suggests that main priorities for enhancing the overall performance of the tax system should include: further improving transparency and reliability of the tax system, while giving priority to a lower frequency of tax changes; making the taxation of dependent workers more equitable and less onerous *vis-à-vis* the self-employed and small businesses; and promoting a higher degree of tax compliance. Moreover, the base of the corporate income tax should be broadened and its rate lowered. This can be achieved by more tax neutrality across saving instruments and corporate tax regimes, and enhancing the effectiveness of tax incentives to investment. Finally, some of the tax burden could be shifted to other types of income, such as immovable property (property taxes are usually residence based and less difficult to evade) that at present is subject to an ineffective and irrational tax system.

*JEL classification:* H2

*Keywords:* taxation, tax policy, Portugal

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Le régime fiscal portugais a connu des évolutions positives au cours de la dernière décennie. Après la réforme fiscale de 1989, l'assiette des impôts a été élargie et les taux légaux d'imposition ont été réduits. Le niveau de la pression fiscale globale n'est pas élevé par rapport aux autres pays. Le système repose largement sur les impôts sur la consommation qui présentent une plus grande neutralité. Il faudrait cependant aller plus loin si l'on veut que le système fiscal soit plus neutre, plus efficient et plus équitable. Pour aller dans ce sens, l'analyse présentée dans ce document suggère que les principales priorités doivent être : améliorer la transparence et la fiabilité veillant prioritairement à modifier moins fréquemment la législation fiscale; imposer les salariés plus équitablement et moins lourdement par rapport aux travailleurs indépendants et aux petites entreprises; et favoriser en priorité un respect plus rigoureux des obligations fiscales. De plus, il conviendrait d'élargir l'assiette de l'impôt sur les sociétés et de diminuer son taux. Il faut pour cela que l'impôt soit plus neutre à l'égard des divers instruments d'épargne et de régimes d'impôt sur les sociétés et que les avantages fiscaux en faveur de l'investissement soient plus efficaces. Enfin, une partie de l'impôt pourrait être transférée sur d'autres types de revenus, notamment les revenus provenant des biens immobiliers (généralement, les impôts immobiliers mettent en œuvre le principe de la résidence et la fraude est plus difficile) qui, à présent, sont sujets à une imposition inefficace et irrationnelle.

*Classification JEL :* H2

*Mots-clés :* fiscalité, politique fiscale, Portugal.

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## REFORMING THE TAX SYSTEM IN PORTUGAL

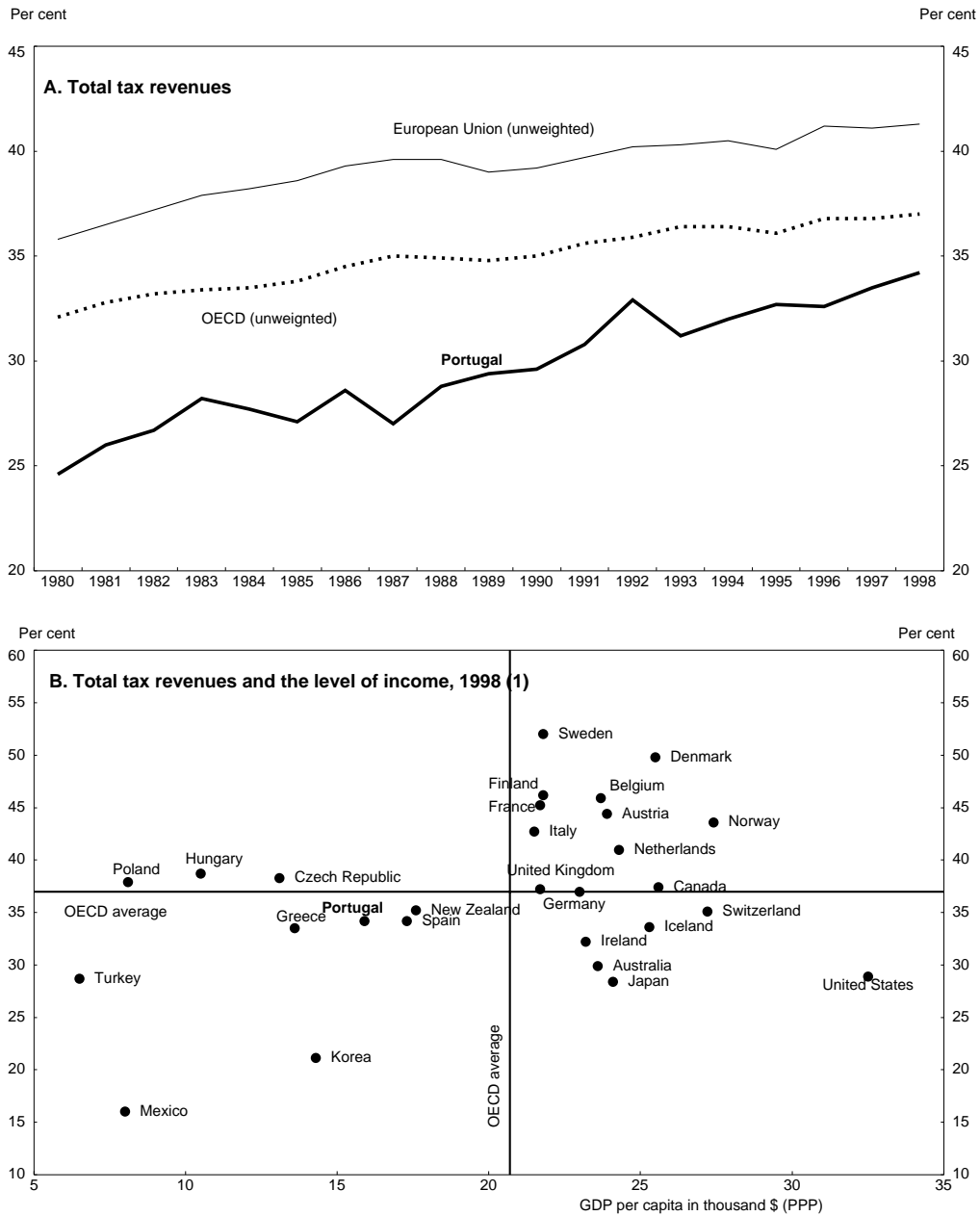
### Chiara Bronchi and José Gomes-Santos<sup>1</sup>

#### Introduction

1. Over the past decade, Portugal's tax system has developed along lines similar to other OECD countries. Following the 1989 tax reform, tax bases were broadened and rates lowered, thereby reducing the economic costs of taxation. More focus has also been placed on the redistributive role of the tax system. At 34 per cent of GDP, the overall tax burden (total tax revenue/GDP) is not high by international comparison or out of line with other OECD countries with similar per capita incomes (Figure 1).<sup>2</sup> However, the system has been criticised for a number of features -- many of which are legacies of the past -- which continue to add to the complexity of the system and make tax administration difficult, thereby creating loopholes which hamper efficiency and equity. There have been some changes since 1998,<sup>3</sup> but tax reform is back on the political agenda, government proposals having been put forward for a reform strategy to be implemented in two stages, beginning with the recently-approved December 2000 Tax Reform Act and the 2001 Budget Law, and finishing in the first half of 2002. The momentum for reform comes not just from the need to widen the tax base and strengthen the tax administration, but also from the need to address concerns raised by the tendency for tax bases to become increasingly mobile internationally. Against this background, this work first discusses the key forces shaping tax policy in Portugal. This is followed by an overview of the main features of the tax system, identifying its main weaknesses. The third section provides a review of the key issues that need to be addressed in improving the system, while the final section outlines the main options for reform.

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1. Chiara Bronchi is an economist in the Policy Studies Branch of the Economics Department of the OECD, José Gomes-Santos is an economist and invited professor at ISEG -- Faculty of Economics of the Technical University of Lisbon (Portugal). This paper was originally produced for the OECD *Economic Survey* of Portugal published in May 2001 under the authority of the Economic and Development Review Committee of the OECD. The authors are indebted to Andrew Dean, Jørgen Elmeskov, Michael Feiner, Chris Heady, Val Koromzay, Bénédicte Larre, Robert Price and other colleagues in the OECD secretariat, for valuable comments and drafting suggestions. Special thanks go to Anick Bouchouchi-Lotrous, Chantal Nicq and Sylvie Toly for technical support and to Anne Eggimann and Janice Gabela for secretarial assistance. The paper has also benefited from discussions with numerous Portuguese experts in the Ministry of Finance and in the Central Bank of Portugal.
  2. When measured according to national accounts, the tax/GDP ratio is higher (Figure 2). The difference mainly stems from imputed employer's social security contributions for government employees that are counted as taxes in national accounts but not in OECD revenue statistics (since the latter are based on cash flows). This does not change the position of Portugal with respect to the EU and the OECD averages, though.
  3. In 1999, some tax allowances were changed into tax credits; and a new Stamp Duty Code (in 2000), a new general tax law (Lei Geral Tributária) and the Taxpayer Defender, whose role is to facilitate interactions between taxpayers and the tax administration, were introduced.

Figure 1. Tax/GDP ratios in OECD countries



1. 1998 or nearest year available.  
 Source: OECD (1999b); OECD, National Accounts.

## Forces shaping the system

### *Administrative inadequacies and weak compliance*

2. The Portuguese tax system, which was created in its current form in 1989,<sup>4</sup> aims both at satisfying the financial needs of the country and at income redistribution. According to the 1976 Constitution, all income should have been subject to a progressive and comprehensive income tax in order to satisfy the ability-to-pay principle.<sup>5</sup> However, while the legislation opted for a progressive taxation of labour income and pensions, taxation of many types of non-labour income was subjected to a flat rate withheld at source. At the same time, the numerous allowances and exemptions inherited from the previous regime were left into place: as a consequence, different sources of income were subject to different effective tax rates. The distribution of income widened throughout the 1990s, putting the social and political acceptance of the tax system at serious risk.

3. The fact that the tax system in Portugal has not met with social and political acceptance partly explains the long-standing history of poor compliance. The informal economy seems to be important and is estimated to generate output equivalent to anything from 24 to 30 per cent of GDP,<sup>6</sup> tax collection being hampered by many factors: a workforce with a large share of self-employed; inefficiencies in tax administration; the lack of a modern and up-to-date land register; stringent bank secrecy for tax purposes; and the slow development of cross-checking information between the different tax authorities and between the tax and social security records. The complexity of tax laws, exacerbated by the frequent revisions and amendments that followed the 1989 tax reform, together with leniency of the laws against tax evasion, have also discouraged taxpayers' compliance.

### *Pressures from public spending and fiscal consolidation*

4. The tax-to-GDP ratio has increased markedly over the past 20 years. Between 1980 and 1995, the overall tax burden, which was among the lowest in the OECD, rose by 9 percentage points, with taxes on goods and services and income taxes sharing equally in the increase. The steady expansion in public spending, particularly commitments to the development of welfare provision, was part of the dynamic behind this rise (Figure 2). The period also saw marked reductions in the budget deficit and inflation tax, for which more orthodox tax sources needed to substitute.<sup>7</sup> In the period following 1995, pressure to reduce the deficit increased in the run-up to monetary union, while primary spending continued to grow, and has continued to do so despite the post-1997 commitment to the Stability and Growth Pact (see OECD, 2001).

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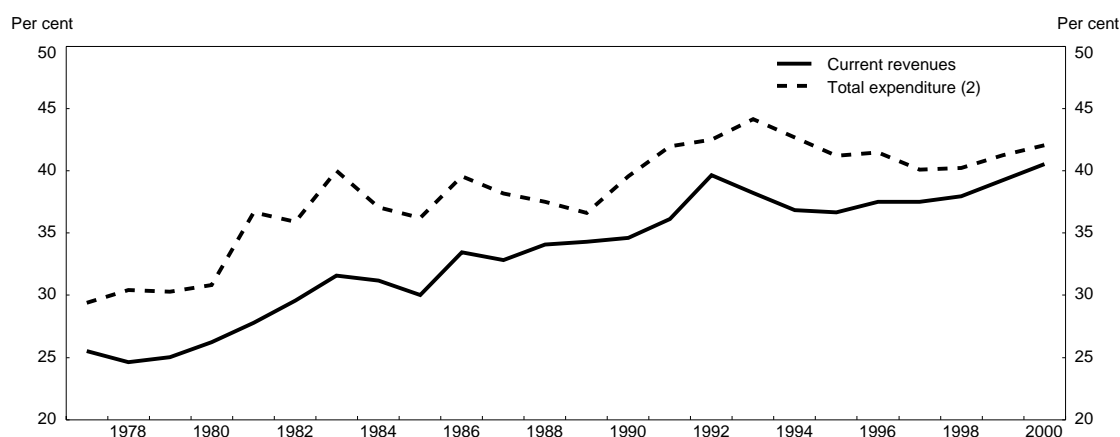
4. VAT was introduced three years earlier.

5. The Constitution (1997 Revision) is prescriptive about the tax system. It states the goals of the Portuguese tax system as follows: "alongside satisfying the financial needs of the country, the tax system has a redistributive role." It also outlines the objective of each tax. The personal income tax should redistribute income and hence be progressive and comprehensive. The corporate income tax should be levied on "real income" (usually in accordance with standard accountancy rules). Property taxes should also have a redistribution role. Finally, the taxation on consumption should be "designed to adjust the consumption structure to the development of economic and social justice requirements, and to charge luxury consumption".

6. Schneider *et al.*, 2000.

7. From 1979 to 1986 seignorage revenues (i.e. increases in the monetary base) averaged 4.2 per cent of GDP a year, equivalent to 11.9 per cent of total government revenues (Giavazzi, 1988). By 1995, this was reduced to 7.4 per cent.

**Figure 2. Trends in general government expenditure and revenues (1)**  
As a percentage of GDP



1. Break in series in 1986 and 1995. Adjustment for the statistical breaks have been made for GDP data; not for government revenue and expenditure.
  2. Includes net capital transfers.
- Source: OECD, National Accounts.

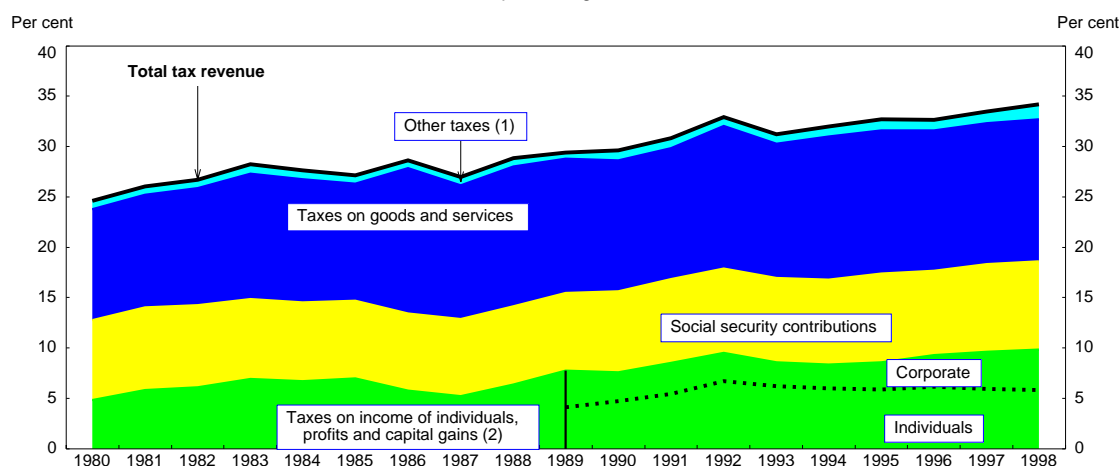
According to National Accounts, tax revenues reached 38.6 per cent of GDP in 1999. Growth occurred mainly in corporate income tax revenues, as a result of the reduction of some tax incentives and deductible costs, and in consumption taxes thanks to the strong contribution of domestic demand to GDP growth (Figure 3). Moreover, improved tax collection and some recovery of tax and social security arrears thanks to the *Mateus Plan*<sup>8</sup> contributed to the recent increase in tax revenues.

5. In the medium and long-term, the tax system will face increasing pressure from growing expenditures and further reduced reliance on deficit finance. The Stability and Growth programme implies the need to cut the structural deficit by around 2 percentage points of GDP over the next four years. Over the longer-term horizon, population ageing will, in the absence of reforms, raise public spending on pensions and health care. As indicated in the *OECD Economic Survey of Portugal* (OECD, 2001), in the absence of reforms on the spending side, population ageing may require raising the level of taxation. The extra tax burden would be likely to fall, *ceteris paribus*, mostly on labour, since pensions are mainly financed through wage-based contributions and capital is an increasing mobile base. Future enlargement of the EU would also imply smaller net transfers receipts, since additional net transfers to new members are expected to be partly financed by cuts in structural funds to current recipients and by savings associated with the common agricultural policy reform.

8. The Decree Law 124/96, known as the Plano Mateus (after Mr A. Mateus, Minister of Economy at the time), set the rules to help enterprises in financial difficulties to recover and at the same time it set the conditions to recover tax and social security arrears. The effects of this plan were mainly concentrated over the 1997-1998 period and generated additional revenues estimated at a cumulative 250 billion escudos (over 1.2 per cent of 1998 GDP).



**Figure 3. The evolution of tax revenue in Portugal**  
As a percentage of GDP



1. Includes taxes on property.

2. The system in place prior to 1989 relied on a turnover tax and schedular taxes, whereby different sources of income were assessed and taxed at different rates according to family situation and other parameters.

Source: OECD (1999b).

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### *Mobility of the tax base*

6. Pressures for reform will intensify because capital, consumption and corporate tax bases are becoming more vulnerable to erosion. Tax base erosion pressures are likely to intensify with respect to the border with Spain, which has a lower effective tax rate on consumer goods. In addition, the trend toward globalisation in financial markets and the advent of cheap and rapid electronic links to overseas financial markets make it possible for investors and savers to shop around, and increasingly difficult to tax capital income effectively. In Portugal, ineffective information flows between financial intermediaries and tax administration -- including the past stringency of bank secrecy rules -- have made it difficult to fight against tax evasion. An aggravating factor is the development of offshore capital investment via the Internet, although security problems and a still relatively low penetration of Internet in Portugal still limit the expansion of these financial transactions. However, they are likely to expand rapidly in the medium-run, compounding problems related to the free-trade zones of Madeira and the Azores (see below). The advent of “smart” mobile phones, free Internet access, and cheaper telecom tariffs, are expected to boost e-commerce transactions.

### Main features of the system<sup>9</sup>

7. A distinctive characteristic of the Portuguese tax system is the relatively heavy reliance on consumption taxes, which now account for 41 per cent of total tax revenue, much above OECD and EU averages (Table 1). This rise became more steady following the introduction of the VAT system and a subsequent broadening of its base, and was also due to growth in excise taxes, especially taxes on petroleum products, motor vehicles and tobacco. The corporate income tax has also increased substantially in the past five years or so and its share is above the OECD average. Conversely, revenue from the personal income tax accounts for a smaller share of total revenues than in most other OECD countries, as do property taxes.

Table 1. **The structure of taxation by type of tax**

	1998				
	Corporate income taxes	Individual income tax	Social security and payroll taxes	Consumption taxes	Other taxes, including property taxes
	In per cent of total tax revenue				
<b>Portugal</b>	<b>11.6</b>	<b>17.1</b>	<b>25.5</b>	<b>41.3</b>	<b>4.4</b>
Canada	10.0	37.8	15.8	24.7	11.8
France	5.9	17.4	38.5	26.6	11.6
Germany	4.4	25.0	40.4	27.4	2.8
Greece <sup>1</sup>	6.4	13.2	32.2	41.0	7.2
Ireland	10.7	30.9	13.8	38.7	6.0
Italy	7.0	25.0	29.5	27.4	11.0
Japan	13.3	18.8	38.4	18.8	10.8
Spain	7.3	20.8	35.2	29.4	7.3
United Kingdom	11.0	27.5	17.6	32.6	11.3
United States	9.0	40.5	23.7	16.2	10.6
OECD average, unweighted	8.8	27.1	25.9	30.7	7.5
OECD average, weighted	8.8	29.1	27.8	24.0	10.3
EU average, unweighted	8.5	25.5	28.9	30.4	6.6
EU average, weighted	7.1	23.9	32.5	28.8	7.7

Note: Consumption taxes equal taxes on goods and services less "profits of fiscal monopolies" and "other taxes".

1. 1997 data.

Source: OECD (1999b).

### *Limited progressivity and complexity of the personal income tax system*

8. Both employees and independent workers pay the personal income tax, which applies a progressive schedule to all earned income net of the standard deduction and of deductible expenses. The current range of statutory tax rates, at 12 to 40 per cent, is nearer to the United Kingdom and Spain than to the core EMU economies (Table 2), while progressivity is average, measured as the difference between the

9. The Portuguese tax system is presented in detail in Annex 1.

Table 2. Personal income taxation in selected OECD countries

1999

	Portugal <sup>1</sup>	Canada	France	Germany	Greece <sup>1</sup>	Italy	Ireland	Japan <sup>2</sup>	Spain	United Kingdom	United States
<b>Labour income:</b>											
Taxes raised by central government											
Range of statutory rates (per cent)	<b>14-40</b>	17.51-31.3	10.5-54	0-53	5-45	18.5-45.5	24-46	10-37	15-39.6	20-40	15-39.6
Number of tax schedules <sup>3</sup>	<b>5</b>	4	6	4	5	5	2	4	6	3	5
Rates of sub-national taxes (per cent)	..	22.8	..	..	..	0.5	..	5-13	8.4	..	0-11.6
Marginal "all-in" tax rate for top income earners <sup>4</sup> (per cent)	<b>46.6</b>	54.1	62.9	55.9	53.7	50.8	50.25	50	48	40	48.1
Tax threshold (per cent of APW income) <sup>5</sup>	<b>0.7</b>	0.03	0.2	0.21	0.6	0.02	0.20	0.09	0.21	0.24	0.24
Highest rate starts at (proportion of APW income) <sup>5</sup>	<b>4.3</b>	1.8	2.2	2.1	4.7	3.5	0.7	7	4.6	1.8	9.7
<b>Tax rates on capital income:</b>											
Interest from bank deposits	<b>20</b>	54.1	25	55.9	15	27	24	20	48	40	46.6
Dividends	<b>30<sup>6</sup></b>	54.1	61.2	55.9	0	12.5	46	50	48	40	46.6
Financial capital gains	<b>0<sup>7</sup></b>	54.1	26	0	0	12.5	40	26	20	40	20

1. Statutory rates also apply in 2000.

2. Tax on dividends depends on the size of distribution. Tax credit is not included.

3. Excluding zero band or basic allowance.

4. It includes sub-national tax rates and employee's social security contributions.

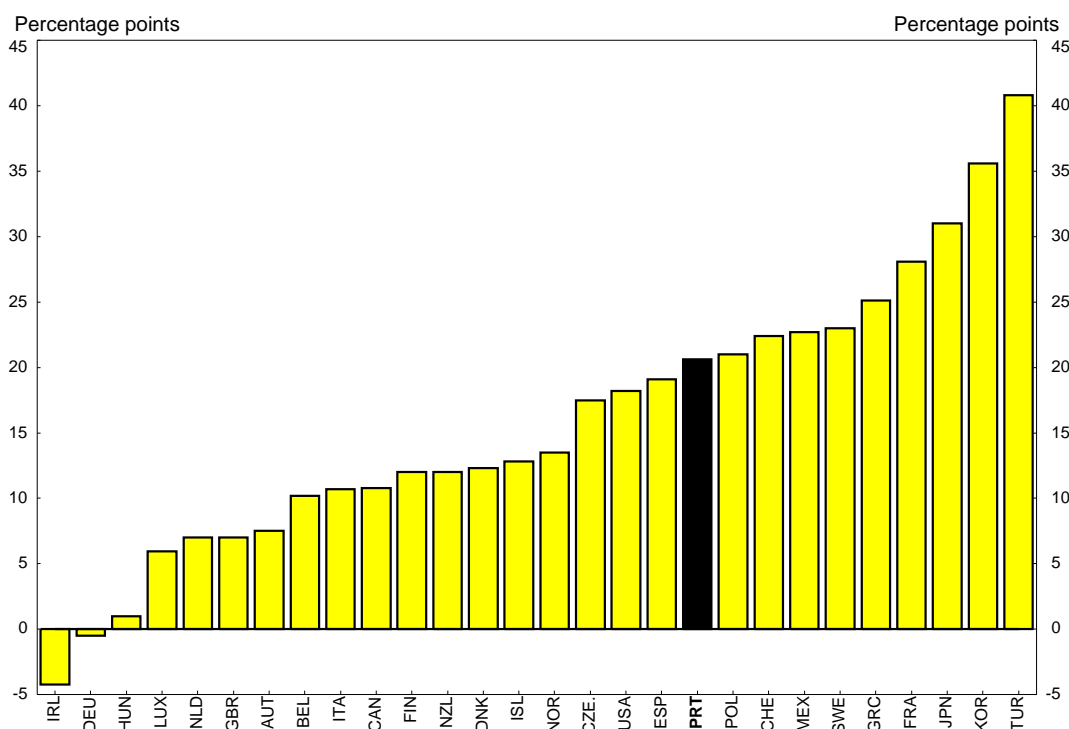
5. APW = average production worker in manufacturing, single, no children. APW salary is for 1998 and 2000, respectively, for Greece and Portugal.

6. Includes the gift and inheritance tax of 5 per cent. For listed shares, only 60 per cent of total dividends are subject to taxation in 2000 (and 80 per cent in 2001).

7. Capital gains resulting from the alienation of corporate rights (shares) and other marketable securities are liable to a 10 per cent withholding tax if shares are owned for less than twelve months.

Source: OECD Tax Database, 1999; OECD (2000a); Dalsgaard *et al.* (2000).

**Figure 4. Progressivity in the rate structure of the personal income tax (1)**  
In selected OECD countries, 1999

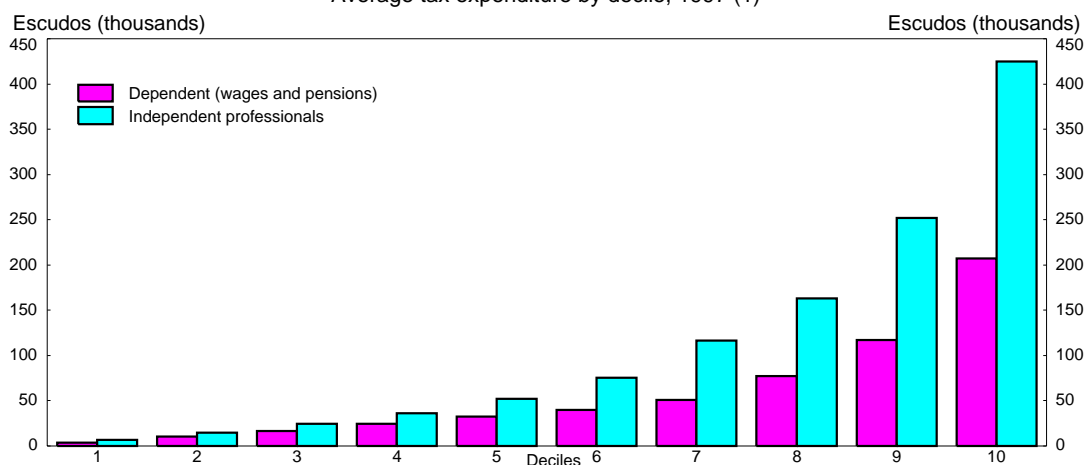


1. Progressivity is measured as the difference between the marginal "all-in" tax rate faced by a top wage earner and the marginal "all-in" tax rate for an average production worker. "All-in" rates include employees' social security contributions, surcharges and local taxes when applicable.  
Source: OECD (2000a); OECD.

marginal "all-in" tax rate faced by a top wage earner and the marginal "all-in" tax rate for an average production worker (Figure 4). Moreover, this crude measure of progressivity does not take into consideration the wide range of significant tax deductions and credits<sup>10</sup> that reduce effective progressivity in the personal income tax system. In 1998, only 60 per cent of the gross income declared by households was taxable<sup>11</sup> and a large share of tax expenditures was concentrated on taxpayers belonging to the highest income categories (Figure 5).

- 
10. To improve the redistributive impact of the income tax, in 1999, some individual tax allowances were converted into tax credits (*i.e.* for mortgage interest, education, health expenses, and savings). Their impact on the redistribution of income appears to be very small (Reis, 2000a).
11. The bulk (28 percentage points) of the reduction in taxable income was due to deductible expenses; 8½ percentage points was due to deductible health, education and mortgage-interest expenses; and the remaining 3 per cent was forgone to the benefit of retirement and housing saving accounts, acquisition of shares, etc.

**Figure 5. Tax expenditure by type and level of personal income**  
Average tax expenditure by decile, 1997 (1)



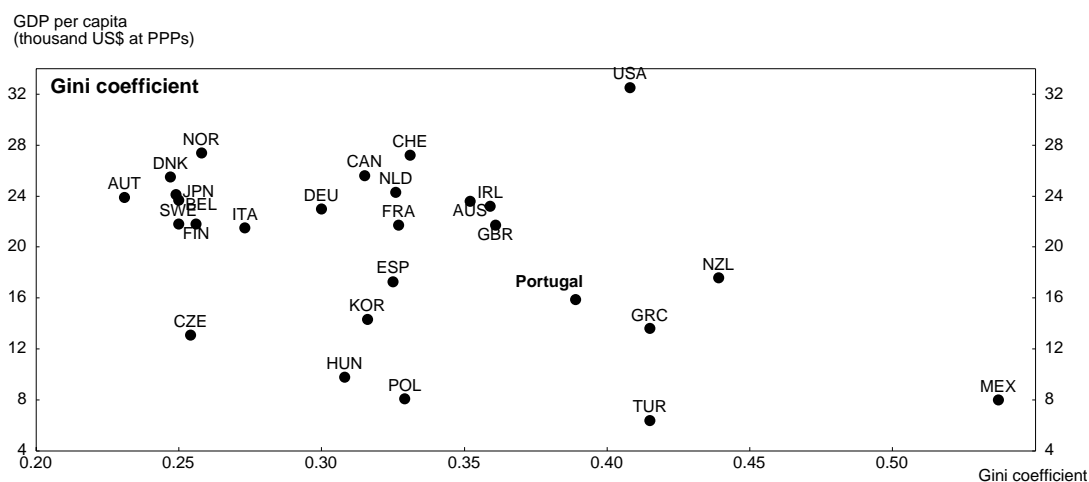
1. Average tax expenditure by decile is calculated as the difference between average tax revenues, including allowances and credits, and average tax revenues, net of allowances and credits, within each decile. In 1997, an average production worker, whose gross salary was estimated at 1 388 thousand escudos, belonged to the third decile.  
Source: Reis (2000a).

9. The different tax treatment for income from different sources and types of activity, although partly explained by the specificity of their nature, facilitates tax avoidance and evasion, and results in lower horizontal and vertical equity. According to Ministry of Finance estimates, 26 per cent of the self-employed, who often overstate business costs and understate revenues, declare taxable income below the minimum national salary.<sup>12</sup> Combined with the taxation of income from capital (*i.e.* interest payments and capital gains), which is considerably below the top rate in the progressive rate schedule, income taxation achieves little in the way of income redistribution. Indeed, according to some international studies, Portugal has one of the widest after-tax income distributions among OECD countries (Figure 6).<sup>13</sup>

12. The figure is inflated by taxpayers who have ceased their activity (thus having zero income from self employment), or who have another activity (for instance as employees and thus have only minor incomes from their self-employment activities, including taxpayers who receive income from intellectual property).

13. In 1997, with a Gini coefficient just below 0.40, after-tax income distribution in Portugal was one of the most uneven in the OECD. For the majority of countries the coefficients were between 0.25 and 0.35. Pre-tax personal income is also unevenly distributed. In 1994 the distribution of gross wage by decile showed a Gini coefficient of 0.41 with the top two deciles earning 52.5 per cent of total gross wage income (Gouveia and Duarte Neves, 1997). By 1997, gross wage income distribution had slightly widened and the Gini coefficient reached 0.42 (Reis, 2000a).

Figure 6 GDP per capita and income distribution (1)



1. The Gini coefficient is a measure of income inequality: the higher the coefficient, the wider the income distribution. Gini coefficients are for 1997 or nearest year available; GDP per capita are for 1998 except for Czech Republic, Hungary, Greece and Turkey : 1997.  
Source: KEPE (1999), REIS (2000) ; World Bank, World Development Indicators, 2000; OECD Analytical Database.

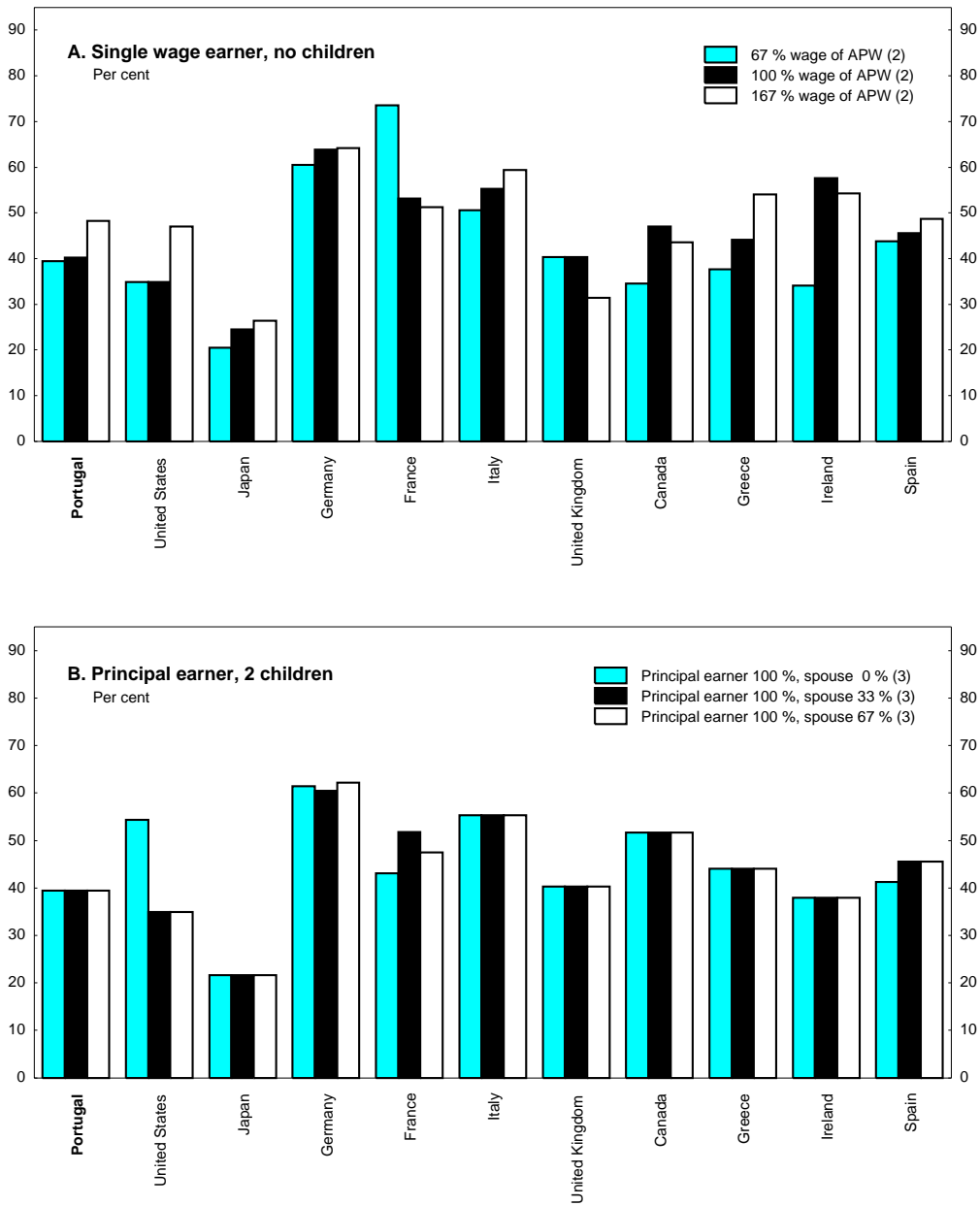
10. A positive element is that tax distortions in the labour market are limited. The combination of personal income and social security taxes creates a wedge between the cost of labour to the employer and the net take-home pay of the employee that, depending on its size and incidence, may have an adverse impact on the demand and supply of labour. In Portugal, though, both statutory and net (*i.e.* including the income tax deductibility) contribution rates fall within the range for OECD countries (Table 3),<sup>14</sup> while marginal tax wedges on labour income are somewhat below the OECD average for most wage and family situations (Figure 7). This implies that low and middle labour income earners, at least, are not abnormally discouraged by high marginal taxes.<sup>15</sup> The tax system also does not seem to discourage second-earner participation for all family income levels.<sup>16</sup> However, it is possible that the joint effects of the tax and transfer system create unemployment traps (Box 1). Moreover, while on sick-leave an employee is guaranteed revenues at an average replacement rate of 85 per cent of net salary and is relieved of the obligation to contribute to the social security system; at the same time the employer pays lower social security contributions and is dispensed from paying a salary. This can be used as a “safety-net” during economic downturns (employers may grant a sick leave instead of dismissing employees), especially since dismissal costs are relatively high and rules are stringent (see OECD, 2001).

14. The social security system was described in detail in the 1996 Survey of Portugal (OECD, 1996) and some of the more recent reforms have been described in subsequent structural surveillance chapters.

15. Reported tax wedges do not include indirect taxes and are therefore biased to different degrees across countries.

16. A study conducted by the Ministry of Finance shows that in 1997 the marginal tax rate on second earners was low for every income decile, (Reis, 2000b).

**Figure 7. Marginal tax wedge by family types and wage levels (1)**  
1999



1. Marginal tax rates covering employees' and employers' social security contributions and personal income taxes; they do not report indirect taxes and are therefore biased to different degrees across countries.  
 2. APW: Average production worker in manufacturing.  
 3. Refers to proportion of wage of APW.  
 Source: OECD (2000a).

Table 3. **Social security contributions of top wage income earners**  
2000 (as of 1 January)

Country	Employees' contributions		Employers' contributions	
	Statutory rate	Net rate <sup>1</sup>	Statutory rate	Net rate <sup>1</sup>
<b>Portugal<sup>2</sup></b>	<b>11.0</b>	<b>6.6</b>	<b>23.7</b>	<b>15.4</b>
Canada	6.5	cap	7.7	cap
France <sup>2</sup>	0.9	0.3	20.2	12.5
Germany <sup>2</sup>	20.5	cap	20.5	cap
Greece <sup>2</sup>	15.9	8.7	28.0	16.8
Ireland	2.0	2.0	12.0	cap
Italy <sup>2</sup>	10.2	5.4	39.9	25.2
Japan	12.8	cap	27.7	13.9
Spain <sup>2</sup>	6.4	cap	31.8	cap
United Kingdom	10.0	cap	12.2	8.5
United States	1.5	1.5	1.5	0.9

1. The net rate differs from the legal rate when employees' contributions are deductible from the personal income tax or when employers' contributions are deductible from the corporate income tax. Where a ceiling applies to all contributions, the legal rate indicates the contribution rate just before the cap applies.
2. In addition to these rates, employees and employers have to make contributions to occupational pension plans (shared equally between employers and employees).

Source: OECD, Tax database; De Sampayo Ribeiro (2000).

### Box 1. The impact of taxes and benefits on labour supply

The interaction of social benefits and labour income taxes may yield high marginal effective tax rates that discourage labour market participation especially at the lower end of the wage scale. Tax and benefit systems can interact, especially, to prevent formal part-time work, and thereby encourage fraud and long-term benefit dependency (OECD, 1997).<sup>1</sup>

Low-income households which receive social benefits often face a marginal effective tax rate above 100 per cent. In Portugal, this may be the case for a family with two children and no secondary earner, when the principal earner starts part-time work (OECD, 1999c). This result derives in part from the fact that after-tax replacement rate is fairly high even though eligibility rules are tight. This is mainly due to a generous benefit system, which is withdrawn as soon as a job is taken up, the marginal effective tax rate per se for a household earning two-thirds of the salary of an average production worker (APW) being only 11 per cent. An unemployed person is granted an average net replacement rate of 70 per cent of the last net salary. This entitlement is granted for up to five years of unemployment and is exempt from taxes and social security contributions. Although Portugal retains a relatively high employment rate, it is recognised that a relatively large share of the population is employed in the informal economy. Moreover, untaxed benefits for households with children, in particular, may create unemployment traps with marginal tax rates close to or in excess of 100 per cent<sup>2</sup> even though certain features of the system minimise this risk in Portugal. Indeed, the minimum income is relatively low for small families, eligibility criteria are strict and the system is fully integrated with employment services, as beneficiaries are required to accept job offers.

1. A recent survey of the ways in which benefits in EU countries (including Portugal) may influence the rate at which individuals exit from unemployment can be found in [http://europa.eu.int/comm/employment\\_social/soc-prot/missoc99/](http://europa.eu.int/comm/employment_social/soc-prot/missoc99/).
2. Low-income families are guaranteed a minimum income (RMG) which is based on the minimum social pension. In 2000, a family with three children and unemployed parents is entitled to a monthly RMG of 87 500 escudos that is above the monthly national minimum salary (63 800 escudos).



***The corporate income tax lacks a level playing field***

11. As noted above, the corporate income tax has contributed considerably to the increase of total tax revenues often exceeding budget-targets over the past five years or so. The burden, however, falls on a very small number of companies (Table 4).<sup>17</sup> Due to the difficulty of assessing revenues and costs of small companies, the infrequent controls on companies' books and abusive tax-avoidance practices, roughly a third of companies present losses for tax purposes (Table 5). In 1998, about 14 per cent of all companies declared no profit (a significant part of which may correspond to the large amount of inactive companies), while 50 per cent of those that did exercise an activity declared earnings below 30 million escudos (150 000 euros). Only 4.5 per cent of the total number of companies declared total profits above 500 million escudos (2.5 million euros) and of these 50 contributed 45 per cent of total corporate income tax revenues.

**Table 4. Corporate income tax (CIT) revenues by company size**

1998

Number of companies	CIT revenues (cumulative)	
	Amount (billion escudos)	Per cent of total
5 biggest	159	28
10 biggest	187	33
20 biggest	213	37
50 biggest	254	45
100 biggest	293	51
Total national	569	100

Source: Ministry of Finance (Tax Department).

**Table 5. Companies presenting tax losses**

	Total companies	Companies with tax losses	
	Number (1 000)	Number (1 000)	In per cent of total companies
1996	233	92	39
1997	230	89	37
1998	248	85	34

Source: Ministry of Finance (Tax Department).

17. Numbers in the first column of Table 4 must be interpreted with care, because they mainly represent groups of companies rather than single or individual businesses. Each group (in 1997 there were 170 integrating 1 300 enterprises) is considered as a single taxable entity by the tax code. If companies groups are ranked by size, it is likely that they are at the top level of the corporate profit distribution and that they tend to be the biggest tax contributors.

12. Portugal displays a statutory rate for corporate income tax of 35.2 per cent (32 per cent plus a 10 per cent surcharge collected by municipalities), which is close to the EU average. However, as a result of a range of tax incentives and wide tax evasion practices, the effective tax rate is much lower than the statutory rate in a degree that is probably higher than the average tax relief in the European Union.<sup>18</sup> Tax incentives, which are equivalent to tax expenditures, can be used to correct market failures faced by specific sectors or disadvantaged regions. However, to be effective they require precise definition and tight monitoring, which are both very difficult to achieve, otherwise they may distort resource allocation (Box 2). In Portugal the major corporate tax incentives are provided on a regional and sectoral basis. They

**Box 2. Adverse economic effects of tax incentives to the business sector**

While investors base their investment decisions on expected after-tax returns, the value to the whole economy of an investment is determined by its pre-tax return. If some investments are more lightly taxed than others, differences arise between the pre- and post-tax rankings of investment, resulting in investment patterns that do not generate the highest return from a national viewpoint. Lower and more even tax rates across investments (as well as organisational forms) reduce this distortion. Differences in marginal effective tax rates mainly arise due to varying depreciation rules and other tax concessions. Targeted tax incentives for certain sectors or activities are particularly harmful to the economy since they:

- Are difficult to target appropriately. Ideally tax incentives seek to remedy market failures, for instance perceived under-investment in R&D, but to identify such failures requires more information than is normally available or obtainable. The result is that incentives are often given too widely, which is overly expensive, or too narrowly, whereby they may have little effect.
- Encourage unassisted sectors to waste effort (from the viewpoint of the whole economy) in lobbying for concessions for themselves.
- Lead to increased avoidance and evasion (and costly administrative counter-measures) by attempts to characterise otherwise non-qualifying income or expenditure so that it qualifies for the concession. Therefore, subsidies may flow to unintended activities, persons or companies.
- Subsidise activity that would take place anyway.
- Imply a loss of revenue that is difficult to control.
- Are less transparent than explicit subsidies.

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18. In a comparative study for the EU, Nicodème (2001) finds that in 1998 the difference between statutory and effective corporate tax rates was the largest in Austria, Belgium and Portugal. This difference can be due either to more favourable depreciation and interest expenses deductibility rules or low enforcement of statutory rules. The study was computed on gross operating profit excluding financial activity, therefore, tax rate levels should not be interpreted *per se*. The study also finds evidence for different effective taxation across sectors and company sizes. This is a potential source of double discrimination : between companies of different sizes within one country and between companies of the same size in different countries. Buijink *et al.* (1999) find similar results. Recent estimates by the Ministry of Finance of Portugal, based on macro data (*i.e.* tax revenues over taxable base plus benefits by industry sector), show that the effective corporate income tax rate for the manufacturing sector as a whole (excluding activities in Madeira) was around 30 per cent in 1998, some 5 percentage points below the statutory rate. The OECD has also calculated average effective tax rates on capital for the economy as a whole, based on a different methodology, which includes corporate profit taxes, taxes on household capital income and various property taxes. According to these estimates, average effective tax rates on capital for Portugal are significantly lower than the EU average. For details, see D. Carey *et al.* (2000).

include investment tax credits, partial or total exemption of the tax base, lower statutory rates for micro-companies and companies operating in the region of the Azores, while entities registered in the free-trade zones of Madeira and the Azores are tax exempt (see Annex 2). The main beneficiaries are SMEs, all resident entities investing in R&D (a feature common to most OECD countries), undertaking large commercial and manufacturing projects (of at least 1 billion escudos) or projects designed to internationalise the Portuguese economy, and companies operating in financial markets. Total tax expenditures accruing to the corporate sector, including those related to the free-trade zones of Madeira and the Azores amounted to 1 per cent of GDP in 1999 (Table 6). However, tax exemptions in relation to the free-trade zones of Madeira and the Azores correspond to an effective tax expenditure only in part: without the tax exemption, there would probably be little income to tax.

Table 6. **Tax expenditure related to the corporate sector**  
1999 (provisional)

Incentives	Tax expenditure	
	Billion escudos	Per cent of GDP
Dividends from shares	7.6	0.0
Public debt interest	1.2	0.0
Investment incentives	9.0	0.0
Sub-total	17.8	0.1
Free zone of Madeira and Azores <sup>1</sup>		
Temporary exemptions	28.8	0.1
Permanent exemption	162.9	0.8
Total tax expenditure	209.5	1.0

1. Tax expenditure for the year 1998.

Source: Ministry of Finance, State Budget for 2000 and Tax Department.

13. The free-trade zones of Madeira and the Azores may become a problem for the Portuguese tax authorities. Under the state-aid rules of the European Union, Portugal was authorised to enact a special tax regime for some industry sectors (*e.g.* shipping and insurance companies) aimed at overcoming the structural under-development of the autonomous regions of Madeira and the Azores (see Annex 2 for details). Although these incentives have attracted an increasing number of new businesses to the regions, they seem not to have a proportional effect on the number of jobs,<sup>19</sup> while large amounts of tax revenues (about 0.8 per cent of GDP in 1998) are not collected. Moreover, the government has expressed its worries about tax-avoidance practices that emerge from the combination of these special tax regimes and inadequate auditing of inter-company practices such as *transfer-pricing* (Box 3). Finally, there is the possibility that these preferential regimes have an effect outside Portugal. The OECD Committee on Fiscal Affairs is currently examining these regimes under the recently adopted Guidelines for Dealing with Harmful Preferential Tax Regimes in the OECD member countries.<sup>20</sup>

19. According to estimates carried out by the Regional Government of Madeira (SRPC), between 1991 and 1999 one job was created for every four new companies opened in the free-trade zone of Madeira.

20. In May 1998, the OECD published the Report on Harmful Tax Competition (OECD 1998a). Luxembourg and Switzerland abstained from the adoption of the report in Council in April 1998. Following this, a Forum on Harmful Tax Practices was created. This set forth the Guidelines for Dealing with Harmful Preferential Regimes in Member Countries, and adopted a series of Recommendations for combating harmful tax practices. On 26 June 2000, the Forum issued a list of 47 preferential tax regimes that are potentially harmful in the OECD area (OECD, 2000c).

### Box 3. Anti-avoidance measures for international inter-companies activities

As for most other OECD countries, Portugal has in place anti-avoidance rules to counteract the incentives for residents to divert income through low-tax foreign entities as well as the free-trade zones of Madeira and the Azores, via practices such as transfer-pricing, thin-capitalisation and controlled foreign companies (CFC). Anti-avoidance measures are usually difficult to apply because, for example, no market against which assess the price of inter-company transfers of goods and services exists, and therefore their application requires highly qualified and experienced tax-inspectors who, at present, do not represent the majority of tax inspectors in Portugal.

#### *Transfer-pricing*

In general the *arm's length* principle governs transfer pricing in all transactions. The General Directorate of Taxes may adjust prices agreed between related parties that differ from prices contracted with independent customers in similar commercial transactions. Companies can, however, dispute this treatment if they properly document their transfer prices. There are no provisions regarding advanced price agreements.

#### *Thin-capitalisation*

When a company's debt to equity ratio exceeds prescribed limits, thin capitalisation rules may limit the deductibility of interest charges on loans. Interest paid on foreign loans provided by related parties in excess of the ratio 2:1 between the aggregate value of foreign debt and all equity of the company is not deductible for tax purposes. However, excessive debt is deductible if the taxpayer can prove that the loan conditions are comparable to those agreed by non-related trading partners in comparable transactions under the same circumstances.

#### *Controlled foreign companies*

Under CFC rules, corporations are subject to tax on their pro-rata share of the annual total income of CFCs (whether or not distributed) in which they own 25 per cent or more of a foreign affiliate; or 10 per cent or more of a foreign affiliate and at the same time 50 per cent or more of the shares of the corporation are owned (directly or indirectly) by residents in Portugal. Income in such corporations is taxed annually under the same general rules applied to income from domestic corporations and foreign branches. Residents may claim tax credits for foreign income taxes paid by CFCs up to the amount of tax that is payable under Portuguese law.

### ***An important role for consumption taxes***

14. VAT efficiency has improved dramatically in the past few years, thanks to a shift in household consumption preferences towards standard-rated goods and the *Mateus Plan* to recover tax liabilities. Both the effective VAT rate (the ratio of VAT revenue to consumption) and its productivity, measured as the ratio of the effective to the standard rate, are well above the OECD average (Table 7).<sup>21</sup> VAT was introduced in 1986 with an initial standard rate of 16 per cent, and subsequently raised to 17 per cent, which is close to the OECD average. Prior to 1992, besides the standard rate, there were a zero rate, a low rate of 8 per cent and a higher rate of 30 per cent. In 1992, the zero and the 8 per cent rate were replaced by a single reduced rate of 5 per cent. In 1995, the 30 per cent rate was abolished. Finally, an intermediate rate (12 per cent) was introduced in 1996. This was with a view to making sectors such as tourism more competitive *vis-à-vis* its nearest neighbour Spain, where the VAT rates are lower, and granting a tax relief for some socially-sensitive goods. As in several other EU member countries, at the beginning of 2000 the

21. This is measured as the ratio between actual VAT revenues and the revenues that would be expected if the VAT were successfully collected at its standard rate on all consumption goods. It therefore indicates the extent to which exemptions, zero-rating, reduced rates and tax evasion affect revenues.

Table 7. Value-added tax

## A. VAT in international comparison, 1998

	Value-added tax revenue	Standard rate <sup>1</sup>	Effective VAT rate <sup>2</sup>	Productivity <sup>2</sup>
	In per cent of GDP	Per cent		
		A	B	B/A
<b>Portugal</b>	<b>8.2</b>	<b>17.0</b>	<b>10.5</b>	<b>61.5</b>
Canada	2.6	7.0	3.4	49.2
Denmark	9.8	25.0	14.6	58.3
France	7.7	20.6	10.9	53.0
Germany	6.6	16.0	9.4	59.0
Greece <sup>3</sup>	8.2	18.0	9.5	53.0
Ireland	7.2	21.0	12.2	58.2
Italy	6.1	20.0	8.5	42.7
Japan	2.6	5.0	3.7	73.7
Spain	5.7	16.0	8.0	49.7
United Kingdom	6.7	17.5	8.8	50.1
OECD average <sup>4</sup>	6.7	17.7	9.7	56.3
EU average <sup>4</sup>	7.2	19.4	10.5	54.2

## B. Effective VAT rate in per cent of standard rate

	1990	1995	1998
<b>Portugal</b>	<b>46.0</b>	<b>59.0</b>	<b>61.5</b>
Canada	46.2	44.4	49.2
Denmark	53.0	57.2	58.3
France	61.1	50.4	53.0
Germany	63.8	63.4	59.0
Greece <sup>3</sup>	50.6	48.7	53.0
Ireland	43.6	51.9	58.2
Italy	41.7	42.2	42.7
Japan	68.2	73.0	73.7
Spain	60.1	44.8	49.7
United Kingdom	53.1	50.6	50.1
Average of above countries <sup>4</sup>	53.5	52.8	55.0

1. Position as of 1 January 1998.

2. Effective VAT rate is VAT revenue divided by base (i.e. consumption exclusive of VAT), productivity is the ratio of the effective over the standard rate. For Portugal, estimates for 1999 show that the effective rate was then 10.8 per cent and its productivity 63.7 per cent.

3. For 1998, VAT revenues are from national accounts.

4. Simple average over available countries.

Source: OECD (1999b); OECD (1999d).

low rate was extended to activities deemed “labour-intensive” and where it is common practice to evade VAT, such as building renovation. This was mainly to improve the collection of VAT from small businesses that represent a problem for the tax authorities (Box 4).

#### Box 4. Small businesses pay little VAT

A major concern for the government is that only a small share of businesses pays VAT. In 1998, the number of VAT taxpayers was 1 366 890. Among small VAT taxpayers (*i.e.* those without regular accounting books), around 25 000 were covered by the small retailer simplified regime, while 486 497 -- about a third of the total number of VAT taxpayers -- fell into the special exemption scheme. Overall, around 50 per cent of taxpayers were entitled to special schemes, either for their alleged small size, or for carrying out VAT-exempt operations.<sup>1</sup> The other half was subject to the normal regime.

When VAT collection is disaggregated by turnover brackets, it becomes evident that a large share of VAT revenues is paid by a reduced number of taxpayers -- only 0.1 per cent of total liable entities (661) declared a turnover above 250 million escudos (about 1.25 million euros) and these paid more than 50 per cent of the VAT collected in 1998. Around 91 per cent of tax revenues were paid by 40 000 taxable enterprises, representing only 6.3 per cent of all taxpayers who submitted periodical tax returns. The large majority of taxable small retailers that is 650 000 (93.7 per cent of the total), declared a turnover below 2.5 million escudos (about 12 500 euros) and paid only 8.8 per cent of tax. This, together with figures above, gives an indication of the potentially significant level of tax avoidance among small businesses.<sup>2</sup>

#### *Improving the collection process*

Besides the administrative difficulty of controlling and auditing such a large number of small taxpayers, the problem might be worsened by the mistrust in the private sector towards a tax administration, which has the reputation of being slow and cumbersome in repaying tax credits.<sup>3</sup> Among the OECD countries that are characterised by a large number of small businesses and self-employed, several countries (*e.g.* Greece and Italy) have a lower turnover threshold for VAT exemption. Moreover, Italy has introduced the *versamento unificato* as a measure to speed up the collection process, increase auditing of returns and reduce the incentives to cheat (OECD, 2000c). This is a single form of tax declaration for all taxpayers registered with the VAT registry. From the viewpoint of the taxpayer, the main attraction is the opportunity to offset tax credits against any tax liability in a single tax form. This simplifies the refund procedure and reduces the time lag between the claim and the actual refund. At the same time, the Government has reached an agreement with banks and post offices by which they can collect tax payments and communicate the related pieces of information to the fiscal authority electronically within up to seven days from the date of payment.

1. Small retailers with a turnover below 10 million escudos (about 50 000 euros) per year pay quarterly 25 per cent of the VAT included in the value of their purchases. Taxpayers with a turnover below 2 million escudos (about 10 000 euros) per year are exempt on sales (exemption regime).
2. This can be aggravated by the problem of collecting corporate income tax (above) and income tax from the self-employed (below).
3. Confederacao do Comercio e Servicos de Portugal, 8 August 2000.

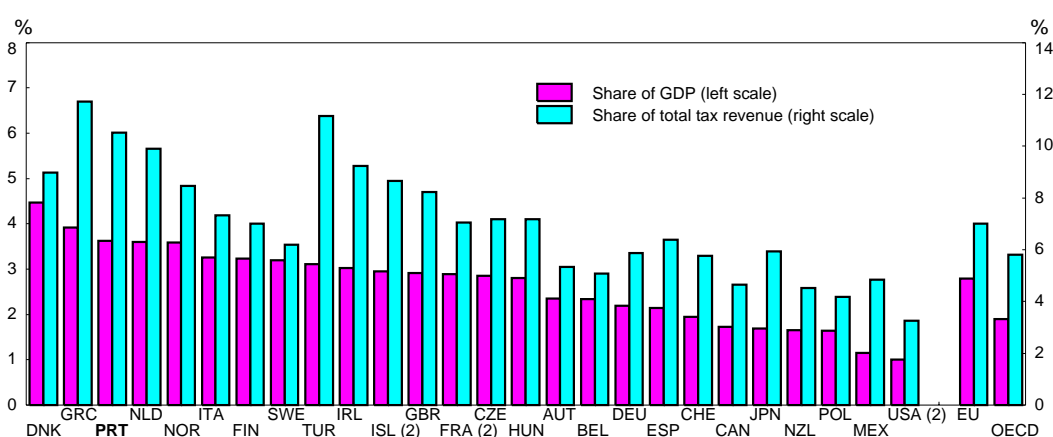
15. Excise taxes -- estimated at 24 per cent of total revenues in 1999 -- are also a major source of consumption tax revenues. These are levied on petroleum products, alcoholic beverages, tobacco, cars, trucks and motorcycles. With the exception of excises on vehicles and motorcycles, tax legislation has been harmonised with the associated EU directives. Consumption taxes (such as those on petroleum products) have sometimes played a role as a short-term instrument for smoothing inflation in Portugal (see OECD,2001). However, indirect taxes by their nature have essentially transitory effects on inflation.

#### *Environmentally-related taxes are ineffective for pollution control*

16. Environmentally-related tax revenues are among the highest in the OECD as a share of GDP, but this is mainly due to fuel tax receipts (Figure 8); they are not, so far, very effective as economic instruments for pollution control and are not well geared to controlling environmental pressures arising

from industrial development and the fast growing transport, energy and tourism sectors.<sup>22</sup> Electricity for industrial usage is exempt and the tax on diesel is well below the tax on gasoline -- the CO<sub>2</sub> content of gasoline is higher than diesel, but other environmental costs associated with diesel are larger.<sup>23</sup> As with energy, water pricing does not succeed in internalising environmental externalities or in reflecting its relative scarcity. Pressures on available water mainly result from increasing use for irrigation and, to a lesser extent, from households. Households pay some charges on water consumption that can be important

**Figure 8. Revenues from environmentally-related taxes (1)**  
In per cent of GDP and total tax revenue, 1997



1. These data do not reflect environmentally-related provisions in other taxes, including personal and corporate income-taxes, such as accelerated provisions or tax credits for energy-saving and pollution-reducing equipment.

2. 1995 instead of 1997.

Source: Environmentally-related taxes database, OECD.

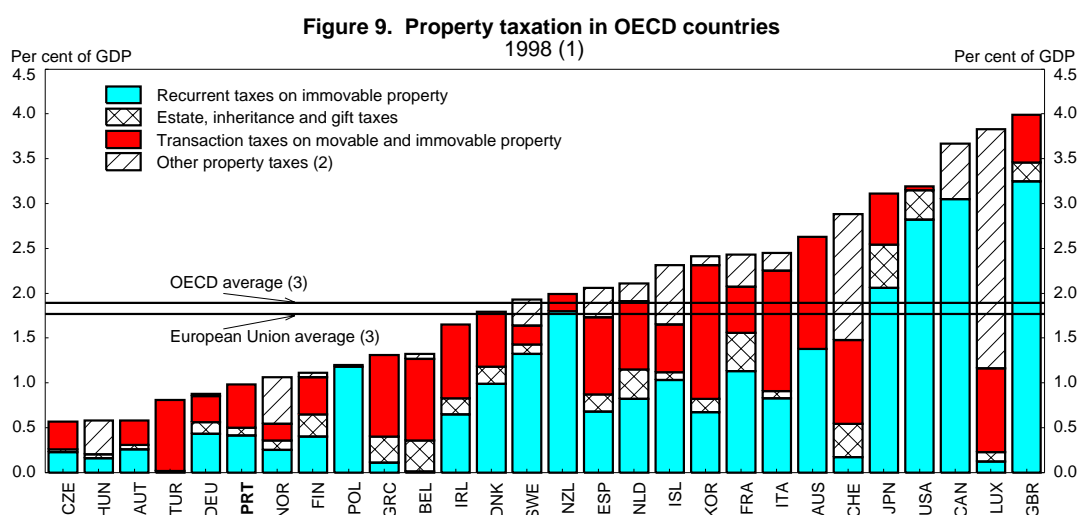
in some municipalities. Farmers are not charged either for the extraction of irrigation water or for the significant pollution of ground and surface water resources caused by a generally intensive use of pesticides and fertilisers.<sup>24</sup> Wastewater charges apply only to industries in areas equipped with treatment

22. According to the EU burden-sharing agreement, the target for Portugal is to restrict average 2008-2012 emissions to 127 per cent of the 1990 level. According to national sources, in 1998 greenhouse gas emissions were 117 per cent of the 1990 level (<http://ghg.unfccc.int/>) and without further action they are bound to overshoot their target. Unless Portugal is prepared to buy in emission permits, it may need to raise post-tax prices of various forms of energy in order to reduce the yearly growth rate of greenhouse emissions.
23. See the *OECD Environmentally Related Taxation in OECD Countries: Issues and Strategies* (forthcoming).
24. A large irrigation project -- heavily financed by EU transfers -- is under construction (the Alqueva project) and expected to be completed by 2024. Currently, there is a debate in Portugal about how the operating and maintenance, and capital costs should be distributed among the various user sectors (OECD, 1999e).

plants, and a flat rate charge is calculated on the volume of effluents rather than on pollution or toxic load, thus providing no incentive for industry to adopt production processes that minimise effluents.

### *Property taxation is unfair and revenue ineffective*

17. The taxation of immovable property is highly inefficient and unfair. The municipal tax on property transactions (SISA) and local tax on the value of real estate (*Contribuição Autárquica, CA*) account for 90 per cent of total property tax revenue. Other components include the central government gift and inheritance tax that is levied on the transfer of both immovable and movable property. However, despite high statutory rates, property taxation accounts for only 0.8 per cent of GDP, well below the OECD average (Figure 9). The complex web of tax rules and generous tax breaks, the widespread practice of both buyers and sellers to under-state the value of real estate transactions to minimise SISA payments and the lack of an up-to-date national land and real estate registry can explain the poor performance of property taxes, but also the popular perception of their unfairness.<sup>25</sup> Moreover, transactions taxes tend to hinder



1. 1997 data for Greece.

2. Including recurrent taxes on net wealth and some non-recurrent taxes on property (for instance land development permission charges).

3. Unweighted.

Source: OECD (1999b).

25. Since real-estate and land prices are updated (for SISA, but not necessarily for CA purposes) to market prices only when they are sold, new and recently-purchased properties are heavily taxed while those which have not been on sale for a long time are very lightly taxed. This also creates unequal situations, whereby property taxes can vary substantially among apartments of the same type and/or within the same building.



mobility. Since 1996, the taxation of immovable property has been the object of a wide, technical and political discussion, but no final consensus on how to deal with it has been reached (Box 5).

#### Box 5. Problems and issues relating to the taxation of immovable property

The taxation of immovable property has been the object of extensive technical and political discussion at national level since 1996. Debate has been mainly based on the report submitted by the Government to the Parliament, as well as on an independent report (the Medina Carreira report) prepared for the Commission on the Reform of Net Wealth Taxation. In the first quarter of 2001, the Government is planning to submit a proposal for taxation of urban immovable property, as well as a schedule for its implementation expected by the beginning of 2002.

The main criticisms addressed against the present system are based on the fact that real estate valuation for tax purposes has no link with real market values, being based on lease market values that do not reflect the movement in house prices in recent years. Property taxation has evolved into a complex, inefficient and unequal system characterised by high legal rates and narrow bases. However, while there is general consensus on the urgent need to reformulate the taxation of immovable property, there is no consensus on how to reform it.

The proposals and models so far analysed and submitted to Parliament for public discussion are four:

- **Proposal I:** Re-assessment of the entire real estate stock. This would be the main way to produce a comparatively reliable result. However, the task seems virtually unfeasible in a short period of time, since there are already 17 million properties on the real estate register in Portugal.
- **Proposal II:** Re-evaluation of new immovable property and updating of old property by reference to broad adjustment coefficients. This proposal would be easier to implement and would offer the advantage of reducing the present gap between new property and old property values.
- **Proposal III:** Creation of a single tax on net wealth to replace the tax on property transactions (SISA), the tax on the value of real estates (CA), the gift and inheritance tax, the tax on motor vehicles and the levy for sewerage maintenance (known as the Medina Carreira proposal). Together with movable and immovable property, the tax base would include private vehicles, credit entitlements of individuals, bank deposits and the net worth of enterprises and corporations. Criticism has mainly focused on the risk of double taxation of capital (shareholders would have to pay a tax on the ownership and the income) and the negative impact on small savings. Implementation would also need a proper revaluation of property.
- **Proposal IV:** Imposition of VAT on the sale price of new property, while abolishing SISA and simplifying CA. The simplification of the CA would occur by splitting it into two parts -- a fixed rate (lump sum) for each owner and a variable rate applicable to the real estate value as calculated in conformity with coefficients established by law and dependent on factors such as the location, age and type of use of the estates. This is an innovative proposal (known as the Sidónio Pardo proposal) both in its targets and technical coefficients that would endorse the *exemption method*, prescribed in the Sixth Directive of the EU. Lack of previous experience and absence of an efficient tax administration could be the main hindrances. Also, depending on the structure of the new VAT system and on the elasticity of the demand of new buildings vs. old ones, the new system may introduce distortions into the housing market. Moreover, strict enforcement of the system would be required to reduce the risks of tax evasion.<sup>1</sup>

1. Under the *exemption method*, prescribed in the Sixth Directive of the EU, the sale and rental of immovable property is, in principle, exempt, but newly-constructed buildings, as well as alterations and maintenance of the existing building stock, are taxable while VAT on inputs can be recovered. The *exemption method* needs a definition of specified non-residential use, such as hotel accommodation, boarding houses, camping facilities, and parking space, all of which are taxable. Furthermore, since commercial use and sale of existing immovable property are exempt, an opportunity for optional registration must be provided to avoid potential discrimination and cumulating tax (OECD, 1998b). The application of this directive varies from country to country. No EU member seems to apply the pure exemption method, with the exception of the Netherlands. According to the European Mortgage Federation (1997) several countries, such as Denmark, Germany, Greece, Ireland and Finland do not levy VAT on the sale of residential housing.

*Local governments have limited tax autonomy*

18. Excluding the autonomous regions of the Azores and Madeira<sup>26</sup>, local governments have very limited tax and spending autonomy. In 1998, the own-taxes of sub-central levels of government accounted for only 6 per cent of total tax revenues (including social security contributions). That is among the lowest in the OECD (Table 8). Local authorities seem to prefer to pay a commission to the central tax administration to manage and collect their tax revenues and hence collect an even smaller part of that amount directly. Local taxes include, *inter alia*, a surcharge on the Corporate Income Tax (*Derrama*), the CA and the SISA. Local authority finances largely depend on grants that do not provide adequate incentives to contain spending.<sup>27</sup> This has not been a problem so far, thanks to close monitoring by the central government: there is tight regulation of local provision of health care, education and social services.

Table 8. Tax revenues by level of government

Per cent of total tax revenues

	Central government			Local government			Social security funds		
	1985	1995	1998	1985	1995	1998	1985	1995	1998
<b>Portugal</b>	<b>70.6</b>	<b>66.6</b>	<b>66.6</b>	<b>3.5</b>	<b>5.6</b>	<b>6.1</b>	<b>25.9</b>	<b>27.9</b>	<b>26.7</b>
Czech Republic	..	46.2	43.9	..	12.9	11.9	..	40.8	44.1
Denmark	69.1	65.6	64.7	28.4	31.3	31.8	2.5	3.1	3.1
Finland	55.8	48.9	52.4	22.4	21.9	22.1	21.8	29.2	25.2
France	47.8	43.9	44.1	8.7	10.4	10.4	43.5	45.7	45.2
Greece <sup>1</sup>	63.4	69.3	68.8	1.3	1.2	1.2	35.3	29.5	30.0
Hungary	..	63.8	62.5	..	2.5	4.5	..	33.6	33.0
Iceland	81.4	79.6	77.1	18.6	20.4	22.9	..	..	..
Ireland	84.1	84.8	86.0	2.3	2.4	2.0	13.6	12.8	11.1
Italy	63.0	63.1	58.6	2.3	5.4	11.7	34.7	31.5	29.4
Japan	43.7	39.5	36.2	26.0	24.2	25.4	30.3	36.2	38.4
Korea	..	73.2	71.4	..	19.8	17.6	..	7.0	11.1
Luxembourg	67.7	67.2	68.4	6.5	6.4	6.2	25.8	26.4	25.1
Netherlands	53.3	55.4	55.8	2.4	2.7	3.0	44.3	41.9	39.9
New Zealand	93.5	94.7	94.2	6.5	5.3	5.8	0.0	0.0	0.0
Norway	59.7	58.1	59.4	17.7	19.6	18.3	22.7	22.3	22.2
Poland	..	62.1	58.8	..	7.5	9.0	..	30.4	32.3
Spain	47.8	50.9	47.8	11.2	13.3	16.9	41.0	35.8	34.9
Sweden	54.1	44.4	58.2	30.4	32.6	30.4	15.6	22.9	11.0
Turkey	75.5	75.1	69.1	10.2	12.8	16.6	14.3	12.1	14.3
United Kingdom	72.0	78.6	78.0	10.3	3.9	3.8	17.8	17.5	17.6
Unweighted average	64.8	63.4	62.9	12.3	12.5	13.2	24.3	25.3	24.7

1. 1997.

Source: OECD (1999b).

The government has, however, started a slow process of decentralising government competencies, so far largely limited to spending powers. Policy aims at improving public administration and the efficiency of public goods delivery, and at a better relationship between citizens and the State. This raises questions about potential imbalances between spending and revenue-raising responsibilities at the sub-national

26. The own taxes of these regions account for about 3 per cent of total tax revenues (OECD, 1999f).

27. The new 1998 law for local finances clarified the rules governing transfers from the central government to local authorities and raised the total value of grants to 33 per cent of average revenues from direct taxes and VAT.

government and whether bolder moves towards tax decentralisation would be desirable to ensure local authority accountability *vis-à-vis* its voters. At present, there are three levels of sub-national governments with spending responsibilities that overlap across levels of governments (including the central government). The risk is that weak co-ordination and overlapping competencies create excessive expenditure that are unchecked by limited incentives to raise revenues at the local level.

### **Economic and administrative issues**

19. Based on the above analysis, the tax/GDP ratio in Portugal seems to be in line with other OECD countries. Moreover, the fact that the tax mix is clearly biased towards indirect taxes (with consumption taxes accounting for 10 percentage points more in the total tax take than in other European countries)<sup>28</sup> can be regarded as a positive feature from an economic perspective, given the greater neutrality of consumption taxes *vis-à-vis* savings, investment and labour-market decisions. Most positively, the tax and benefit system does not seem to be a big impediment to labour market participation. However, the system has important flaws which have significant economic implications:

- i) The complexity and inequity of the income tax system biases activity towards self-employment and small businesses;
- ii) The corporate tax system contains features which might adversely affect the allocation of labour and capital inputs;
- iii) The ineffectiveness and inequity of the taxation of immovable property throws up similar allocation problems.

These issues are discussed in detail below. There then follows a discussion of the extent to which these problems can be dealt with by further strengthening the tax administration, notwithstanding the measures introduced over the past years.

### ***Need for increased tax neutrality***

20. While statutory rates on most bases are at the same level in Portugal as in the majority of OECD countries, average tax rates are generally low when measured in effective terms, because of relatively narrow tax bases. In general, low average effective tax rates should help limit the overall tax-induced distortions to factor allocations, savings and investment. However, to the extent that they are the result of evasion and avoidance -- a point emphasised earlier -- this does not follow. Moreover, wide differences in the tax treatment of various sources of income can significantly distort economic choices and erode allocative efficiency.

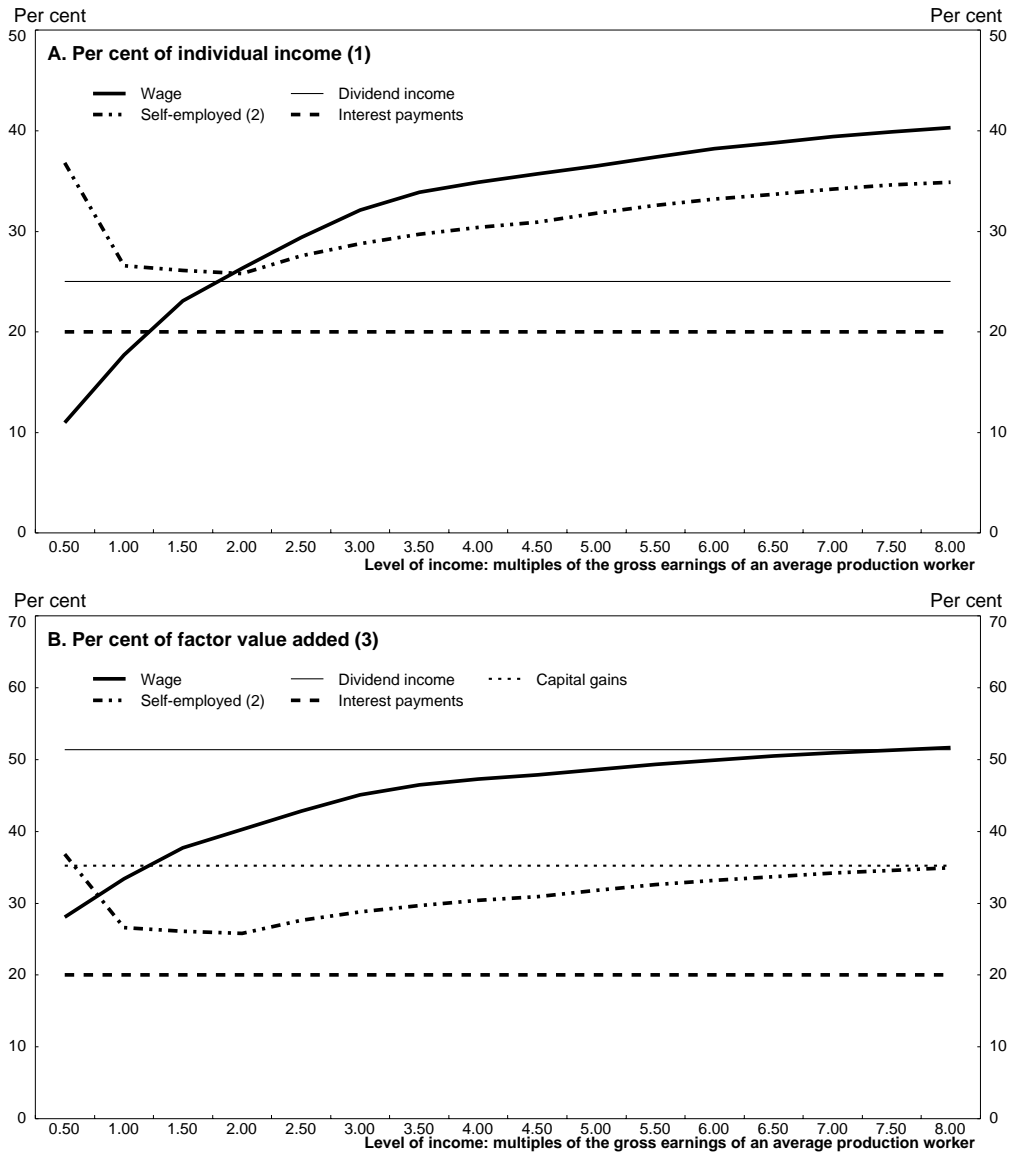
### ***Bias in favour of self-employed and small businesses***

21. Estimates for 2000 show that the average statutory tax rate (including employee and self-employed social security contributions) depends heavily upon the source and level of income (Figure 10,

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28. Total tax revenue/GDP is around 38 per cent, including social security contributions, below the EU average, but slightly above Spain and Greece. A distinctive feature in Portugal is the relatively high reliance on consumption taxes: these account for 42 per cent of total tax revenue, compared with 30 per cent on average in the OECD. On the other hand revenue from personal income tax and social security contributions accounts for a smaller share than in most other European countries.

**Figure 10. Average statutory tax rates by level and type of income**  
2000

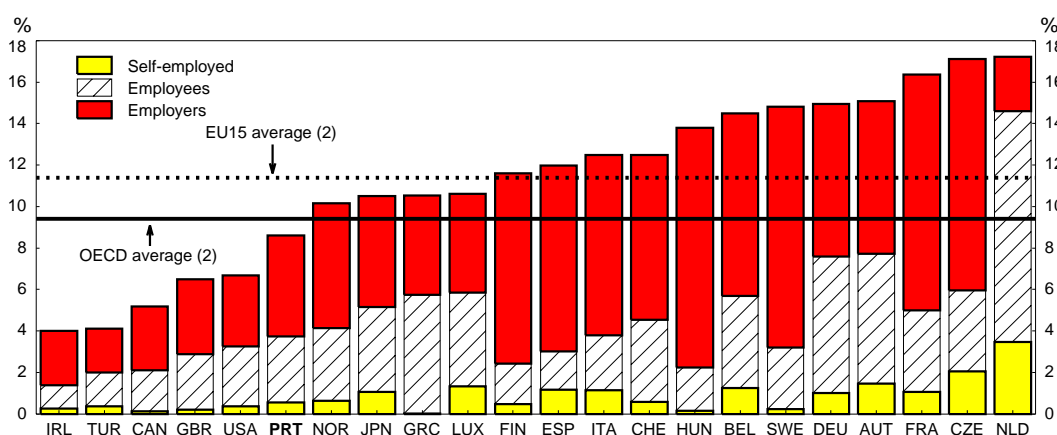


1. Includes personal income taxes paid by the employees and the self-employed.  
 2. It is assumed that self-employed pay 32 per cent rate on a monthly base equivalent to the minimum national monthly remuneration (63 000 escudos in 2000).  
 3. Includes personal income taxes and social security contributions paid by the employees, the employers and the self-employed.  
 Source: OECD.

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panel A). Wages and income of the self-employed are taxed at the highest rate, while interest payments bear the lowest rate.<sup>29</sup> When employers' social security and corporate income taxes are included (panel B),<sup>30</sup> interest payments are still taxed at the lowest rate, while the next least taxed are the earnings of the self-employed. In this case, the average statutory tax rate on self-employment income is substantially lower than that on wages for all levels of income. The difference stems principally from the fact that the self-employed pay low social security contributions,<sup>31</sup> this being reflected in a low proportion of self-employed contributions in the total (6.5 per cent) (Figure 11). The bias in favour of the self-employed may

**Figure 11. Social security contributions**  
As a percentage of GDP, 1998 (1)



1. 1997 for Greece and the Netherlands.  
2. Unweighted average.  
Source: OECD (1999b).

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29. The statutory rate for capital gains is in fact the lowest (zero rate) but it is not shown in panel A because it is assumed that shares are held for longer than twelve months. For shorter holding periods the rate is 10 per cent. These rates were in place until 31 December 2000.
30. Interest payments are deductible from the corporate income tax base and only subject to the final withholding tax levied at the individual level of 20 per cent. Capital gains are not taxed in the hands of the shareholder and not deductible from the corporate income tax base, therefore the overall statutory rate is identical to the corporate income tax rate. Dividends are not deductible for corporate income tax purposes, but are taxed at both firm and individual level. The overall tax on dividends for 2000 was 51.4 per cent.
31. Estimates of the Instituto de Gestão Financeira da Seguranca Social (IGFSS), which manages the general system of the social security contribution in Portugal, show that the self-employed tend to pay the highest legal rate -- to benefit from the broad coverage of the social security system -- but choose the lower base allowed by the system (*i.e.* the minimum national remuneration) in order to minimise taxes without losing the associated benefits.

in part explain why their share in total employment has remained one of the highest in the OECD area. This factor is compounded by ease of evasion and a relatively tight employment-protection legislation.<sup>32</sup> It is also commonplace for senior employees of Portuguese firms to set themselves up as independent consultants or independent workers. Companies can afford to pay them more at no additional cost, while they continue to work for the same employer. More generally, the tax system favours activities undertaken by the self-employed because, as in other OECD countries, they are more difficult to tax and can thus under-report business activity with a low probability of sanction (Box 6). Besides the revenue forgone, this creates a sense of unfairness among taxpayers that may lower the degree of social and political acceptance of the tax system and encourages non-compliance.

#### Box 6. The taxation of the self-employed

The self-employed are not required to keep separate bank accounts (one private and one for the professional activity). They can evade taxes through the deduction of some of their private consumption as business expenses, as well as benefit from most of the tax allowance granted to incorporated companies.<sup>1</sup> Moreover, subject to certain turnover limits (20 times the national minimum wage), book-keeping is not compulsory for the self-employed.

Although the Ministry of Finance has no estimate of the degree of compliance among the self-employed, the level of under-declared income is likely to be high. In 1998, dependent workers and pensioners, who account for three-quarters of taxpayers, contributed 90 per cent of personal income tax revenues. The average yearly revenue of independent workers and small business activities ranged between 400 000 escudos in agriculture to 800 000 escudos in professional services, while the corresponding average revenue for dependent workers was around 2.2 million escudos. Almost all independent workers (99.6 per cent) were able to keep simplified accounting books for their transactions and operations and 18 per cent of the total presented negative returns.

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1. For example, as for the business sector, depreciation allowances are available for tangible and intangible assets and losses for tax purposes can be carried over for six years (see Annex 1). It is also common among the self-employed to try to deduct private costs as professional costs, and in any case the self-employed remain, as in other OECD countries, the most difficult tax group to audit.

#### *The taxation of capital is uneven*

22. Different forms of capital income are taxed at significantly different rates (Table 9). With the main exception of rents from land and buildings, almost all of the income from capital accruing to individual savers is taxed under a separate flat-rate regime at statutory rates ranging between 0 and 25 per cent, depending on the manner in which the income is invested and distributed to the final investor. Such disparities tend to affect both the allocation of capital and firms' financing decisions.<sup>33</sup> The difference between the effective tax rate on distributed earnings from equity holdings and interest payments is a case in point. It arises from two principal sources: *i*) the personal income tax rate levied on different forms of income from capital, and *ii*) the extent to which these earnings are subject to corporate income taxation

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32. See Centeno (2000). For a comparison of employment protection legislation among OECD countries see OECD (2001).

33. Graham and Lemmon (1998) document that firms facing high corporate tax rates tend to have high levels of debt. This result confirms work by Schulman *et al.* (1996) for Canada and New Zealand, as well as that of Desai (1997), who reports a positive cross-sectional correlation between debt and taxes across a sample of 51 countries. More recently, Graham (1999) found that an increase in corporate taxes has a positive effect on debt finance, while an increase of personal taxes on interest relative to equity income has a negative effect.

(directly or indirectly through deductions allowed for some kinds of distribution). Depending on the manner in which earnings are distributed, they are taxed at any rate between 20 and 59.6 per cent. Interest payments from both bank deposits and bonds are taxed at a flat rate of 20 per cent, being fully deductible from the base of the corporate income tax. The overall tax paid on equity holdings that are distributed through dividends is exceptionally high and depends upon the route that the dividend takes before arriving in the hands of the individual shareholder or an investment fund. The rate is 51.4 per cent in the case of dividends paid directly to a shareholder. The distribution is subject to a second round of taxation when dividend payments pass through a second firm and the overall rate rises especially in the case of a non-qualifying participation. This difference in rates may create an incentive to concentrate risk in the hands of few shareholders and may hinder the widening of share ownership and the reallocation of funds from mature, slow-growing companies to more innovative firms.<sup>34</sup> Financial capital gains, which are taxed at 10 per cent (or exempt if shares are held for more than twelve months) at the level of the individual, are among the next most favoured forms of passing on profits.

Table 9. Taxation of capital income by type of distribution

Rates applicable in 2000

	Dividends <sup>1</sup>				Financial capital gains <sup>7</sup>	Interest payments	
	Direct	Qualifying participation <sup>2</sup>	Non-qualifying participation <sup>2</sup>	Mutual funds <sup>2</sup>		Bank deposits	Government and corporate bonds
Corporate income tax <sup>3</sup>	35.2	35.2	35.2	35.2	35.2	0	0
Initial distribution <sup>4</sup>	25	2	17	25	0	20	20
Subsequent distribution <sup>5</sup>	n.a.	25	25	0	n.a.	n.a.	n.a.
Overall tax rates <sup>6</sup>	51.4	52.3	59.6	51.4	35.2	20	20

Note: n.a. = not applicable

1. Dividends are distributed from a non-listed company. Calculations assume that the shareholder opts for the flat rate on dividends.
2. It is assumed that dividends flow through a different company or mutual and pension fund before reaching the final shareholder, while capital gains are from the sale of a stock held for more than twelve months.
3. As a per cent of pre-tax profit (excluding interest payments and the inheritance and gift tax).
4. As a per cent of profit net of corporate income tax.
5. As a per cent of distributed profits to the final shareholder.
6. As a per cent of pre-tax profit under the assumption that all profit is distributed.
7. Financial gains are from the sale of shares held for more than twelve months.

Source : OECD.

### *Bias in favour of debt finance*

23. Compared with other OECD countries, the tax system shows a relatively strong degree of discrimination across sources of finance (Table 10).<sup>35</sup> The overall standard deviation, which is a rough

34. As in the majority of OECD countries, there is a slight incentive for taxpayers to invest in pension funds because 25 per cent of the amount deposited in a pension plan can be set off against personal income tax liabilities, subject to a limit, while dividends are taxed at the individual level.

35. The tax system is neutral towards corporate financing and investment decisions if the overall tax rate (*i.e.* the combined corporate and personal tax burden) is equal across financing instruments and capital assets, whether the return takes the form of interest payments, dividends, or capital gains.

measure of non-neutrality, across corporate financing, is high in Portugal.<sup>36</sup> As with most OECD tax systems, Portugal favours debt finance, since corporate interest payments — as opposed to distributed profits — are deductible from the corporate tax base and this heavily penalises new equity finance.<sup>37</sup> With respect to investment, machinery and equipment are taxed at relatively low marginal rates, which is mainly due to a shorter depreciation period. Inventories are more heavily taxed (as indeed they are in most countries) because they do not benefit from any depreciation allowance.<sup>38</sup>

Table 10. **Marginal effective tax wedges in manufacturing – selected OECD countries<sup>1</sup>**

1999, percentages

	Sources of financing <sup>2</sup>				Type of assets <sup>3</sup>				Overall	
	Retained earnings	New equity	Debt	Standard deviation	Machinery	Building	Inventories	Standard deviation	Average <sup>4</sup>	Standard deviation
<b>Portugal</b>	<b>1.13</b>	<b>2.50</b>	<b>-0.25</b>	<b>1.12</b>	<b>0.48</b>	<b>0.94</b>	<b>1.26</b>	<b>0.32</b>	<b>0.78</b>	<b>0.83</b>
Canada	4.48	5.63	1.98	1.52	2.74	4.21	5.33	1.06	3.72	1.31
France	3.58	7.72	0.67	2.89	2.25	3.45	4.02	0.74	2.98	2.14
Germany	0.89	2.53	1.28	0.70	1.05	1.50	1.11	0.20	1.19	0.54
Greece	0.92	0.92	-0.58	0.71	0.15	0.34	1.03	0.38	0.40	0.57
Ireland	1.52	4.12	0.69	1.46	1.15	1.45	2.32	0.49	1.49	1.12
Italy	1.27	1.27	0.39	0.41	0.72	1.18	1.23	0.23	0.96	0.34
Japan	3.30	5.50	-0.09	2.30	1.41	3.74	2.64	0.95	2.33	1.77
Spain	3.20	2.23	1.65	0.64	2.36	2.72	2.81	0.20	2.56	0.49
United Kingdom	2.88	2.40	1.55	0.55	1.99	2.31	3.30	0.56	2.37	0.57
United States	1.66	4.79	1.42	1.54	1.48	2.50	2.04	0.42	1.89	1.17
OECD average, Unweighted	1.81	2.81	1.01	0.74	1.25	1.78	2.33	0.44	1.63	0.61

1. These indicators show the degree to which the personal and corporate tax systems scale up (or down) the real pre-tax rate of return that must be earned on an investment, given that the household can earn a 4 per cent real rate of return on a demand deposit. Wealth taxes are excluded. See OECD (1991) for a discussion of the methodology. Calculations are based on an inflation rate of 2 per cent.

2. The weighted average uses the following weights: machinery 50 per cent, buildings 28 per cent, inventories 22 per cent.

3. The weighted average uses the following weights: retained earnings 55 per cent, new equity 10 per cent, debt 35 per cent.

4. The weighted average uses weights indicated above (footnotes 2 and 3).

Source: OECD.

36. The marginal effective tax wedge reflects the difference between the required pre-tax rate of return an investment has to earn in order to provide a personal investor with the same after-tax return as a bank deposit earning a pre-tax 4 per cent real rate of interest. The estimates shown in Table 10 are based on the King-Fullerton methodology (Gordon and Tchilinguirian, 1998, and OECD, 1991). The results should be interpreted with caution since for some investment and financing decisions they may not adequately reflect the effects of taxation on these incentives. For instance, special depreciation measures are not reflected in the calculations. Other simplifying assumptions are also applied, including perfect competition, a rudimentary treatment of financial structures and the intermediation process, the absence of uncertainty, perfect loss offsetting and capital irreversibility.

37. The system would be completely neutral if dividends were exempt at the individual level and the rate of withholding tax on interest payments were the same as the corporate income tax rate. Alternatively, the system would be neutral if all distributed profits were deductible from the base of the corporate income tax and taxed, on an accrual basis, at the same rate as interest at the shareholder level.

38. Estimates for 2000 suggest that using the 35.2 per cent corporate income tax rate (including derrama) the marginal effective tax wedge for equity would be 2.37 per cent, that for debt -0.16 per cent, and that for capital gains 1.3 per cent. Among assets types, they would be 0.47 per cent for machinery, 0.89 per cent for buildings and 1.19 per cent for inventories.



24. Investment in owner-occupied housing also receives a preferential tax treatment. As in most OECD economies, the imputed rent on an owner-occupied dwelling is tax exempt. In addition, although subject to relatively low ceilings, 30 per cent of mortgage interest or related expenses is creditable against the personal income tax liability, while money invested in housing saving accounts gives the right to a 25 per cent tax credit. Finally, net gains from the sale of property are tax exempt if re-invested with the same purpose. These incentives, along with the absence of an effective and developed house-renting market (largely due to an old inheritance of restrictive house rent legislation), are reflected in a very high share of owner-occupied housing in the residential housing stock.<sup>39</sup> Such tax breaks may pose some problems. First, they have questionable distributional consequences since they benefit medium and higher income groups. Second, given the low responsiveness of housing supply to demand -- partly reflecting the scarcity of residential land near urban areas — tax incentives have probably largely been capitalised into higher land and housing prices, diverting capital from more productive physical investments and raising incentives to property tax evasion. Finally, tax advantages for owner-occupied housing are likely to lower the mobility of workers.

### *Tax administration is slowly moving in the right direction*

25. While the wide disparity in average effective taxation across sources of income and economic sectors is partly due to the statutory design of the system, it also reflects poor tax administration and compliance enforcement. A number of measures have been implemented in the past few years to enhance tax administration (Box 7). A new supervisory body, the General Tax Administration was created in 1999 and the structure of the overall tax administration was completely reorganised with the aim of improving its effectiveness. Finally, recently approved changes include partial easing of bank secrecy for tax purposes (see below). Although these modifications are already achieving results, some measures have not been fully implemented as yet and several deficiencies are still in place.<sup>40</sup> The tax law is subject to frequent revisions and amendments that have not simplified the system; tax court trials are slow (36 to 69 months), while tax evasion can only be pursued subject to invalidation by prescription that takes place after a lapse of four years.<sup>41</sup> There is still no cross-checking between income taxes and social security registers, and no updated national land registry. Moreover, auditing resources are substantially concentrated on large companies. Finally, the number of tax inspectors with the expertise to tackle difficult international cases (such as those related to transfer-pricing and thin-capitalisation practices) seems to be insufficient, so it is not unlikely that a large share of corporate profits remains untaxed. These features increase opportunities for tax-expenditure abuses, while discouraging tax compliance and making tax collection inefficient.<sup>42</sup>

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39. In the past couple of years, with low interest rates and generous subsidies and tax incentives, housebuying and housebuilding boomed, and property prices rose.

40. For example, the implementation of RITTA is behind schedule: taxpayers can submit their tax form and receive a notification of the amount of tax to pay, but internet tax payments are not feasible as yet. Payments via automated teller machines (Multibanco) are widely used, though.

41. In 1998, the period before invalidation was reduced from five to four years. On the one hand, the rationale behind this measure was to improve taxpayers' guarantees against delayed tax inspections by the tax administration, which used to schedule its auditing activity at the limit of this period. On the other hand, it gave the wrong incentive to taxpayers who saw the probability of being inspected diminish.

42. In 1997, the cost of collecting taxes in Portugal, roughly measured as the budgetary appropriation (net of new investment costs) of the tax administration, amounted to 1.2 per cent of total revenues (excluding local and social security taxes), which is on the high side among OECD countries (Bronchi, 2001).

### Box 7. Recent changes in tax administration

Changes made to improve tax administration include: the Mateus Plan to recover tax arrears; the unification into one register of separate direct taxes (excluding social security contributions) and VAT (which has facilitated the introduction of a tax identification number and its association to the taxpayer's address); and the introduction of an automated taxpayer database system (RITTA) in 1996. Measures specifically aimed at enhancing taxpayer services, such as the Virtual Tax Office, which permits access to a wide number of services on line, have also been put into place.

In September 1999 a new tax administration body, the General Tax Administration (AGT), was created (nominations took place in July 2000). The main purpose of this body is to co-ordinate auditing, training and the strategic planning of the three general tax directorates (Directorate General for Taxation (DGCI); Directorate General for Customs and Excise Taxes (DGAIEC) and Directorate General for Information Assistance to Taxation and Customs Services (DGITA)). At the same time, the internal organisations of DGCI and DGAIEC were radically changed from a tax-specific structure (personal income taxes, corporate taxes, consumption taxes) to a functional structure (assessment, collection, auditing, taxpayer services and tax justice). This follows the approach adopted in several other OECD countries.

The Tax Training Institute has been reformed and training is now provided for tax inspectors in new areas of taxation and customs policy and in the planning of information systems. About 2000 highly-qualified tax employees have been hired, of which 250 are tax inspectors. This is part of the objective of renewing the tax administration staff, in terms of age and qualifications, in order to meet personnel needs in areas such as tax auditing and fiscal justice.

### Assessment and agenda for reform

26. Reform of the tax system has become a policy priority of the Portuguese government. In November 2000, it put forward a tax reform proposal that was approved in December. The tax reform is implemented in two phases. In the first phase, changes in the personal income tax (IRS) the corporate income tax (IRC) and tax incentives statute (EBF) have been approved in the budget for 2001 and in the 2000 Tax Reform Act. The aims are to reduce the tax burden on dependent workers and low-to-medium income families and complying companies and to promote a more competitive tax environment to support rapid and sustainable growth. The second phase of the reform is expected to be completed by the end of June 2001 and will cover two main aspects, the taxation of immovable property and energy and vehicle taxation. The actions taken so far should be seen as only first steps. Further options for reform are discussed in the second part of this section.

### *Recent reform initiatives*

27. Details of the 2000 Tax Reform Act and 2001 Budget tax measures are given in Box 8. In summary, the Act aims to simplify the personal income tax system, limiting excessive cost deductions and introducing a single income category for incomes derived from business activities and independent workers and subject to the same assessment regime. A minimum taxable income will be introduced for independent workers and small individual businesses; and tax auditing will be supported by the expedient of assessing personal taxable income against an income presumption deduced from wealth indications. As of 1 January 2002, financial capital gains and dividends will be taxed as ordinary income under the progressive income tax schedule. As for the corporation tax, the tax rate will be reduced to 30 per cent in

## Box 8. Tax policy measures for 2001

### *The 2001 Budget Law*

The 2001 budget marks the first stage of the reform and includes the following provisions

- An increase in family tax benefits (*e.g.* the tax credit for each dependent child will go up by 33 per cent and a similar rise will take place for education tax credits) with the main purpose of improving family protection and fostering savings and housing.
- Changes in the income schedule with a reduction of the tax rate mainly for the lowest brackets (Annex 1).

### *The December 2000 Tax Reform Act*

#### *Personal income tax (IRS)*

The main features of the personal income tax reform are as follows:

- In order to simplify the system and limit excessive cost deductions, incomes derived from business activities and independent personal services will be assessed under a single income category and subject to the same assessment regime. Agricultural income is excluded from taxation when yearly gross amount is below the national minimum wage.
- Independent workers and business activities with yearly incomes below 30 million escudos or services supplied for a value inferior to 20 million escudos will be subject to a simplified IRS tax regime -- a minimum taxable income -- based on coefficients fixed by law. A floor equivalent to 50 per cent of the yearly national minimum wage applies. Those who so desire can opt for keeping accounting books and related tax obligations subject to general rules.
- Tax auditing will be facilitated by the possibility of assessing taxable income against an income presumption deduced from wealth indications: indirect evaluation in case of non-submission of the tax return or where the declared income and lifestyle appear incompatible (*i.e.* declared income is less than 50 per cent of purchased assets such as property, cars, boats, planes). In these cases the taxpayer is allowed to produce substantiated evidence.
- Financial capital gains (as 1 January 2001) and dividends (as 1 January 2002) will be taxed as ordinary income under the progressive income tax schedule. As far as capital gains are concerned, only 75 per cent of the net gain is subject to taxation if the stock is held for less than 12 months; 60 per cent between 12 and 24 months; 40 per cent between two and five years and 30 per cent over five years. More restrictive conditions will apply to net gains distributed to non-residents for exemption purposes.

#### *Corporate income tax (IRC)*

The principal elements of the corporate income tax reform are as follows:

- The corporate income tax rate will be reduced to 30 per cent in 2002. Depending on the tax base, a progressive reduction will follow to reach 25 per cent in 2005.
- A simplified tax regime for the determination of taxable profits under IRC similar to the one that applies to individuals will be in force for small businesses with yearly profits not exceeding 30 million escudos.
- Introduction of a number of rules and methods for determining prices for tax purposes in inter-company transactions (transfer pricing), including transactions with non-resident entities subject to "privileged tax regimes".

**Box 8. Tax policy measures for 2001** (continued)

- Change from a consolidated tax regime to a less permissive tax integrated regime as far as the method of tax assessment for company groups is concerned: taxable profits will be the sum of net profits (or losses) realised by each company within the same group.
- Creation of an Investment Tax Credit (those previously in force having ceased) together with a legislative authorisation in order to encourage investments in R&D.
- Holding companies (SGPS): abolition of the *de facto* exemption of re-invested financial capital gains -- they are now taxed in a deferred way according to equal amounts distributed by a ten-year period (for capital gains realised before 2001), and a five-years period after that.

*Free Zone of Madeira (and the Azores)*

- Greater precision and accuracy as far as it concerns the definition of non-residents as well as operations carried out by entities operating in Madeira Free Zone with non-residents. Certification of eligibility as non-resident is required.
- Gradual introduction of taxation financial activities via a moderate tax rate.

*Bank secrecy*

- Access to any information protected by professional secrecy or bank secrecy will still require tax court authorisation. The novelty is that there will be no need for authorisation and no suspensive measure will take place in case of the taxpayer's disagreement if the taxpayer benefits from tax incentives or he/she refuses to present documents supporting accounting records. However, the taxpayer will be entitled to judicial appeal with suspensive effect when the tax administration requires to lift bank secrecy as a consequence of the following facts:
  - it is not possible to substantiate and have a direct appraisal of taxable income;
  - income subject to IRS is incongruent with income standards;
  - there is circumstantial evidence of malicious fraud (*dolus*), namely fake invoices ;
  - there is a need to give proof of application of public grants or aids.

***Announced measures to be completed in 2001****Taxation of immovable property*

- Elimination of the municipal tax on transfer of properties (SISA) planned to enter into force on 1 January 2002.
- Re-examination of the local tax on real estate (CA), revised measures will be implemented in 2002.

*Energy and vehicle taxation*

- Assessment of measures concerning the energy sector in view of harmonisation with the EU directives.
- Replacement of the present tax on motor vehicles (IA) (effectively levied on the buyers of new vehicles) with two new taxes: a "registration tax" (levied at purchase -- similar to old IA but with lower rates) and an annual "circulation tax" (levied on old and new vehicles).

2002, the objective being to bring the rate down to 25 per cent in 2005. A simplified tax regime for the determination of taxable profits, similar to that applying to individuals, will be available for small businesses. In general, access to any information protected by professional secrecy or bank secrecy will still require legal authorisation. This protection is, however, considerably diluted where it is not possible to substantiate and have a direct appraisal of taxable income, where declared income is incongruent with income standards, where there is circumstantial evidence of malicious fraud (*dolus*), or where there is a need to give proof of application of public grants or aids. For instance, there will be no need for authorisation if the taxpayer refuses to present documented proof of his accounting records.

### ***Further options for reform***

#### *Improving tax compliance and enforcement*

28. Steps towards raising tax compliance have been taken in recent years and have been reflected in higher revenues. However, tax evasion is still deemed to be high and Portugal still faces important challenges in terms of applying tax laws even-handedly while raising compliance. The government needs to take further steps to enhance tax enforcement and redress the fairness and non-transparency of the tax system. Every year, taxpayers and tax administrators are faced with several revisions and amendments to the tax legislation. It can thus be difficult for businesses and citizens to identify the full requirements of the law. In order to reduce the extent of uncertainty and raise the predictability of the tax system's administration, clearer and definitive rules should be introduced guiding the tax administration, including tax cost and deduction rules. Moreover, court processes should be speeded-up. The recent government initiative to set deadlines for the resolution of claims could be a move in the right direction if it is complemented by a more efficient performance of tax administration services. To remove the perception of taxpayers, and in particular of the large group of the self-employed and small businesses, that the probability of being investigated for infringements of the tax law is low, tax evasion should be prosecuted effectively.

29. As noted, the government's approach to the non-compliance issue is based on the introduction of a simplified tax assessment system. However, the tax administration should not rely wholly on the newly-approved pre-determined formulae and criteria to determine a taxpayer's tax liability. More frequent and comprehensive tax auditing is also needed. The necessary steps towards greater fairness and efficiency would include: *i*) the updating of a land and property register to improve cross-checking; *ii*) giving priority to the tax auditing of all businesses, putting in place cross-checking of the personal income tax and the social security register (this is technically feasible thanks to the new data base system RITTA but not implemented as yet); *iii*) imposing separate bank accounts for individual companies (one for private and one for business purposes); *iv*) making effective use of the new possibility to access bank information for tax purposes and taking further steps in this direction. The reform in progress can thus be regarded only as an interim step towards a comprehensive administrative overhaul.

#### *Broadening the income tax base*

30. Further re-evaluating and reducing allowances and credits, as well as improving the taxation of the self-employed and capital income, should be a government priority. This would broaden the personal income tax base and eliminate some market distortions. The wide family tax credits along with the recently approved lowering of tax rates for the lowest brackets, should be sufficient to keep a substantial proportion of low income earners out of the income tax net, as at present, but in a more simple and efficient manner. Allowances and credits are generally aimed at legitimate social and political purposes, such as stimulating family formation, encouraging long-term savings and human capital investment. However, low-income

groups do not have sufficient tax liability that can be set off against these (unrefundable) tax breaks. It is therefore unclear whether these objectives are achieved in the most efficient way, if achieved at all, and the benefits should be tested against the social cost of high tax rates. In many cases, they add to the complexity of the tax system. Moreover tax expenditures have inherent disadvantages over direct expenditures as instruments of policy. Their cost in terms of revenue forgone is more difficult to estimate because the value of the subsidy to taxpayers is indeterminate, so that budgetary oversight tends to be lacking. In general, they do not enable the same degree of agency discretion as direct programs do, largely because they are provided automatically and are not means-tested.

31. The difficulty of taxing the self-employed and small businesses on an equal basis with dependent workers is common to OECD countries. The seriousness of the problem depends on the share of the self-employed and small businesses in the total labour force, the tax rules applied to them and the enforcement of their income reporting. Portugal's tax base is particularly exposed to this problems: the number of self-employed and small (micro) businesses is large; they receive several tax incentives that include a lower statutory tax rate of 25 per cent; and enforcement has been lax. The government approach to this problem includes the possibility of bolstering the tax auditing process by evaluating taxable income against certain wealth indicators, with the burden of proof on the taxpayer. The introduction of the simplified regime is meant to serve the same objective. An alternative approach could be the promotion of self-employment assessment and reliable book-keeping through tax credits. The *versamento unificato* system in Italy (see Box 4) and the "blue return" system in Japan<sup>43</sup> have had some success in encouraging the self-employed and small businesses to keep regular books. The possibility of setting all tax credits against tax liability in the same year may encourage self-employed and small businesses to report close-to-truth taxable income and VAT liabilities. To facilitate tax auditing, this system could be complemented by what in Italy is known as *Studio di Settore*; its success rests in the agreement between the tax administration and professional associations to co-operate through exchanges of information (OECD, 2000c). Finally, the turnover thresholds for VAT exemption could be lowered to bring in more small businesses into the tax base.

32. Social security charges on the self-employed should be levied as a proportion of their net earnings (or at least their labour component). At present the employer's and employee's combined social security contribution rate for a skilled worker is around 34 per cent and the total (wage and non-wage) cost of employing an average production worker is 1.2 times his gross salary. The self-employed normally contribute the equivalent of 16 per cent of the gross salary of an average production worker. In addition to reducing the bias in favour of self-employment, the broadening of the tax base would permit a lowering in social security taxes, removing some of the incentive to work in the underground economy and the possibility of unemployment traps.

#### *Achieving greater neutrality in investment and savings*

33. Reducing and strictly regulating the tax incentives given to the business sector would broaden the corporate tax base and help to achieve greater neutrality. Moreover, incentives complicate tax administration and tax laws, increase compliance costs and pave the way for unintended loopholes, abuse and evasion. Above all, tax incentives are difficult to target and their budgetary cost is difficult to quantify unless tax expenditure ceilings are imposed. Tax incentives in Portugal should be limited to a strict

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43. The main objective of the blue return is to encourage the self-employed and small and medium-sized businesses to keep a minimum set of accounting records. To promote the system, significant tax advantages are offered to corporations and individuals opting for the blue return (Dalsgaard, 2000).

minimum and only provided in areas, such as generic R&D and training, where there is evidence that market failures may lead to under-investment.<sup>44</sup>

34. The presence of a separate incentive regime for the free-trade zone of the regions of Madeira and the Azores (shipping companies and offshore companies) should also be reconsidered to take account of both domestic and international concerns. They represent a further distorting feature of the Portuguese corporate tax system and should be phased-out to minimise incentives for tax-planning by companies or investors that are in a position to choose between these regimes. The potential base-broadening that would arise from reforming the system of corporate tax incentives would enhance the efforts made by the government to reduce the corporate tax rate.<sup>45</sup> A lowering of the corporate income tax rate would make the system more neutral by reducing the existing rate differentiation in favour of both small companies and the autonomous regions; it would also reduce tax avoidance incentives.

35. One important issue for tax reform in Portugal is how to achieve a more neutral taxation of capital income. A solution that would preserve the advantages of the current system's reliance on easy-to-administer withholding taxes might be envisaged. One possibility, which has been applied in some OECD countries (for instance, in Norway and Finland), would be to equalise the overall tax rate on capital income. This could be achieved by exempting dividends from personal taxation and setting the withholding tax on interest income equal to the corporate income tax rate. In this way, all three forms of income from capital (*i.e.* dividends, interest and capital gains) would be taxed at the same rate.<sup>46</sup> Dividends and interest distributed from pension funds and collective investment institutions should also be subject to the same overall tax rate. An alternative solution would subject all income (both capital and labour earnings) to the same progressive income tax schedule, improving vertical and horizontal equity, by offering tax credits to individuals equal to the amount of taxes withheld at the firm level. While perhaps technically superior, this would be much more difficult to administer.<sup>47</sup> In its tax reform, the Portuguese government has made some moves towards the second approach by subjecting dividends and a share of net capital gains from the sale of securities to the progressive income tax schedule, but they have worsened the bias in favour of debt finance, since interest payments remain taxed under the flat rate regime.

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44. For instance, tax incentives to SMEs in Portugal do not seem to be particularly well targeted since SMEs have always represented a high percentage of businesses. This is an indication that not all of them operate in sectors and geographical areas that are subject to market failures.

45. The corporate statutory tax rates was reduced from 36.5 per cent in 1989 to the present 32 per cent, and will fall to 30 per cent in the 2002. The extent to which a lower corporate income tax rate is feasible will depend on whether a widening of its base is sufficient to counteract the loss in revenues from the rate cuts. However, since most companies are already paying a low effective corporate income tax rate, the impact on total corporate income tax revenues should be small, especially if this measure is taken in tandem with a general broadening of the tax base and more effective tax enforcement.

46. The first two are taxed by the corporate income tax rate, while interest payments (which are deductible from the firm tax base) are taxed in the hands of recipients, at a flat tax rate identical to the corporate income tax rate.

47. Even though the full integration of corporate and personal income taxes (full imputation system) would be more neutral with respect to financing decisions (debt *versus* equity), there are several problems related to its implementation. First, taxing retained corporate profits at the personal level is very difficult. Second, it is administratively cumbersome to impute corporation profits to individual shareholders if shares frequently change hands within the fiscal year. Third, it would be extremely difficult to evaluate non-realised capital gains on shares in unquoted private companies. Fourth, there are severe practical problems related to changing the corporate tax system to a full imputation system, not least with respect to international tax agreements (see for instance Messere, 2000). At present, there is no clear tendency in one direction or the other among the OECD countries.

36. The generosity of tax-breaks for owner-occupied dwellings should also be reconsidered. Given the practical difficulty of taxing imputed rents for owner-occupied dwellings, the general trend is to phase out the mortgage interest relief. The United Kingdom has already phased it out in full, progress is more modest in Denmark, France, the Netherlands, and Spain. A phasing-out of tax incentives to owner-occupied housing would help remove underlying distortions in the allocation of savings. Priority could be given to progressively removing the possibility of crediting mortgage interest against personal income tax liabilities. This may induce a more even distribution of its burden, as these tax privileges benefit the medium-high income taxpayers. Finally, this could provide an impetus to the development of the rental housing market and take away some of the pressure on house prices especially in urban areas.

37. Property taxes should be reconsidered. At present the government is considering replacing the inefficient and costly tax on transactions (SISA) with VAT (allowing for deduction of input VAT) and at the same time to simplify the CA system. In this light, the rapid updating of the National Land Registry with an accurate record of all real estate in the country and market valuation of land and buildings would be desirable. The CA could then be levied on close-to-real value assets and its base be broadened. At the same time, the revenue-raising power of local governments would rise and the link with their spending powers and local accountability improve. The introduction of a VAT system for new residential buildings could represent an improvement towards horizontal equity and neutrality of the taxation of property. However, its implementation is not easy, and an optional registration must be provided to avoid potential discrimination and cumulation of tax.<sup>48</sup>

*Relying more on environmental taxes to strengthen local government finances*

38. Taxing powers of local governments could also be improved by relying more on the “user/polluter pays” principle (e.g. for example for wastewater). The tax base should be fixed at the national level but the rates applied for localised polluting activities (that have no spillovers to other regions) should be set locally so as to reflect local tastes and the carrying capacity of local environment. Better pricing should go hand in hand with the simplification of administrative procedures (e.g. to grant wastewater discharge permits) and preferential tax treatment granted to heavy polluters, in particular agriculture and energy-intensive manufacturing industries, should be removed. Charges on industrial electricity could be introduced and differentiated by carbon content and the taxation of diesel could be brought in line with gasoline. Lasting and effective implementation of energy policies may encourage the development and use of energy-efficient technology. Also water charges should be based, where possible, on pollutant load and toxicity to provide incentives for industry and agriculture to adopt production processes that minimise effluents.

*Summing up*

39. The Portuguese tax system contains some commendable features that contribute to limiting non-neutralities and distortions to incentives. The overall tax burden is not high by international comparison and the tax mix relies on the more neutral consumption taxes. Moreover, statutory average tax wedges on labour income are relatively modest for most wage levels and family types and steps towards further simplification of tax administration have been taken. However, further reforms should be envisaged to make the system more neutral, efficient, and equitable. As Portugal cannot afford to reduce taxes without reconsidering expenditure, and needs to avoid further increases in tax pressure, the main options for a revenue-neutral tax reform should include actions on a wide front. Transparency and reliability of the

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48. See OECD (1998b) for further details on the application of VAT on immovable property and the experience of some other OECD countries.



tax system should be further improved, while giving priority to a lower frequency of tax changes. The taxation of dependent workers should be made more equitable and less onerous *vis-à-vis* the self-employed and small businesses. Promoting a higher degree of tax compliance should also be a priority. Some of the tax burden could be shifted to other types of income, such as immovable property (property taxes are usually residence based and less difficult to evade) and income from savings. The base of the corporate income tax should be broadened and its rate lowered. This can be achieved by more tax neutrality across saving instruments and corporate tax regimes, and enhancing the effectiveness of tax incentives to investment.

*Annex 1***Main features of the Portuguese tax system**

2000

Tax	Nature of tax	Deductions, credits and exemptions	Rates								
			Taxable income (values in 1 000 escudos)	Rate							
<b>1. Income taxes</b>	<p>IRS is levied on income derived by individuals resident in Portugal (including income from abroad) and by non-residents receiving taxable incomes originated in Portugal.</p> <p>There are nine categories of income (identified by letters A to I), that include dependent employment, self-employment, pensions, business income, agricultural income and income from real estate. It is also levied on other net worth accruals resulting from extraordinary proceeds or windfall gains (e.g. capital gains and winnings from gambling).</p> <p>Methods for income determination and tax collection may vary according from category to category.</p> <p>It is paid annually on the basis of the household income tax return that must be submitted from February to April of the following year.</p> <p>Discharged from production of such tax return are individuals who only derived incomes taxed at final withholding rates and not opting for their aggregation as well as those persons who only obtain income from pensions not exceeding the year amount of domestic minimum wage.</p>	<p>Social security subsidies and allowances, meal allowances, allowances for occasional losses, travel and lodging allowances if lower than limits established by law, and capital-gains from alienation of investment units and other public debt securities and equity if owned for more than 12 months are exempt.</p> <p>Capital gains from the sale of a dwelling are exempt if reinvested in another property with the same purpose.</p> <p>Only a share of the income from literary, artistic and scientific property, as well as earned income and pensions received by disabled people is taxed (50 per cent and 30 per cent respectively).</p> <p>Special deductions are made from gross income derived for each income category:</p> <ul style="list-style-type: none"> <li>• Category A (employment): 70 per cent of amount received without exceeding a maximum limit fixed each year, or 72 per cent of 12 times national minimum wage, if greater.</li> <li>• Category B (self-employment): expenses connected with the exercise of a professional activity, mostly subject to a individual limit (10 per cent of gross professional income and a overall limit (up to 25 per cent of overall income);</li> <li>• Categories C (business activity) and D (agriculture): business costs effectively incurred; income from agricultural activity is transitorily taken into consideration by 40 per cent of its amount;</li> </ul>	Up to 730	14							
1.1. Personal income tax (IRS)			<p>Over 730 up to 1 149</p> <p>Over 1 149 up to 2 840</p> <p>Over 2 840 up to 6 581</p> <p>Over 6 581</p> <p><b>Schedule for 2001</b></p> <p>Up to 800</p> <p>Over 800 up to 1 210</p> <p>Over 1 210 up to 3 000</p> <p>Over 3 000 up to 6 900</p> <p>Over 6 900 up to 10 000</p> <p>Over 6 581</p>	15	25	35	40	12	14	24	34

Tax	Nature of tax	Deductions, credits and exemptions	Rates
Final withholding rates	<p>The income of the spouses and their dependants is aggregated, and the tax is determined according to the splitting system (division by 2).</p> <p>Beneficiaries of earned income from self-employment or from a commercial, industrial or agricultural activity are required to pay three annual instalments whenever the tax exceeds certain limits.</p> <p>Income from employment (in accordance with a schedule published each year) as well as income from capital, self-employment, real estate and commercial, industrial or agricultural activity under certain conditions are subject to withholding at source at the rates provided by law.</p> <p>In relation to non-residents, withholding is final and is levied on earned income and pensions (at a 25 per cent rate), winnings from gambling (35 per cent) and income from capital (rate variable according to type of income).</p> <p>Withholding at source and payments on account give rise to a refundable tax credit that is set off against the tax liability.</p>	<ul style="list-style-type: none"> <li>• Category F (income from real estate): repairs and maintenance expenses effectively incurred;</li> <li>• Category G (Capital-gains): only 50 per cent of the net annual gain is taxable; this rule does not apply to realised gains from the sale of financial assets (where a 10 per cent special rate is in force)</li> <li>• Category H (pensions): up to the maximum threshold fixed each year (1 482 000 escudos for 2000).</li> </ul> <p>Losses in one income category cannot be deductible from credits in other categories (excepting F), but they can be carried-forward for five years.</p> <p>Certain expenses can be credited against the IRS tax liability:</p> <ul style="list-style-type: none"> <li>• Health and education expenses, costs incurred with homes for old-age care, insurance, renewable energy sources;</li> <li>• Amount payable under CA;</li> <li>• 25 per cent of the amount deposited in a saving account destined to finance the purchase, construction or restoration of primary residence with an annual limit of 107 100 escudos per taxpayer;</li> <li>• 25 per cent of the contributions to a private pension and education investment plan with an annual ceiling of 109 200 escudos per taxpayer;</li> <li>• Payments on account and withholding at source.</li> </ul> <p>Credits are non-wasteable. However, no negative tax is granted, excessive credit can be carried forward within the same income category.</p>	<p>10 per cent on capital-gains resulting from the sale of shares, quotas and other securities;</p> <p>15 per cent on capital-gains resulting from the transfer of know-how ;</p> <p>15 per cent on dividends from quoted shares in 2000 (only 60 per cent being taxable) and 20 per cent in 2001 (only 80 per cent being taxable);</p> <p>20 per cent on qualifying payments made by real estate investment funds.</p> <p>20 per cent interest on deposits and securities;</p>

Tax	Nature of tax	Deductions, credits and exemptions	Rates		
			25 per cent dividends from unquoted shares; 35 per cent winnings from gambling		
			Rates		
			Employee	Employer	Combined
1.2. Social security contributions	<p>Social security contributions are shared between employers and employees according to the scheme presented in the next table.</p> <p>The tax base for general employees is the gross salary. No ceiling applies.</p> <p>Members of corporate boards may contribute 10 per cent, but the base of their contributions is subject to a maximum of 12 times the minimum salary for all companies together.</p> <p>Independent workers; intellectual workers and artists; members of group agricultural companies, and members of production and services co-operatives can opt between two social security schemes: at rate of 25.4 per cent for compulsory minimum coverage and at rate 32 per cent for broader coverage.</p> <p>Those who begin an independent activity at the age of 55 years or more can select a tax base with a maximum limit of 6 x SMN</p>	<p>Dependent workers</p> <p>General rates</p> <p>Disabled workers</p> <p>Members of corporate boards</p> <p>Clergy</p> <p>Soccer professionals</p> <p>Domestic services</p> <p>Agricultural workers</p>	<p>11</p> <p>11</p> <p>10</p> <p>4</p> <p>11</p> <p>11</p> <p>8-9.5</p>	<p>23.7</p> <p>12.5</p> <p>21.25</p> <p>8</p> <p>17.5</p> <p>20.6</p> <p>21-23</p>	<p>34.7</p> <p>23.5</p> <p>31.25</p> <p>12</p> <p>28.5</p> <p>31.6</p> <p>29-32.5</p>
			Rates		
			Employee	Self-employed	Combined
			25.4-32	n.a.	25.4-32
			Exemptions, deductions and depreciation		
1.3. Corporate income tax (IRC)	<p>IRC is levied on corporate income earned by resident companies.</p> <p>Non-resident entities with a permanent establishment in Portugal are taxed on profits attributed to them or, if there is no such permanent establishment, on incomes from different categories, as such defined under IRS.</p>	<p>The main entities that are exempt from the IRC are the State, Regional and Local Administration, public social security and solidarity institutions (excluding capital income); agricultural, cultural, consumption, housing and social solidarity co-operatives, and pension funds.</p>	<p>32 per cent: increased by a local surcharge (<i>derrama</i>) that can reach 10 per cent of the IRC rate (i.e. 32 per cent + 3.2 = 35.2 per cent) - on profit obtained by resident entities exercising as their main activity a commercial, industrial or agricultural activity, and non-residents with a permanent establishment in Portugal;</p>		

Tax	Nature of tax	Exemptions, deductions and depreciation	Rates
Withholding at source	<p>For the purposes of determining the taxable base, a distinction is made in respect of resident entities whether they exercise or not as their main activity a commercial, industrial or agricultural activity. In the first case (e.g. trading companies, co-operatives, public enterprises, etc.), IRC shall be levied on their profits; in the second case (e.g. associations and foundations), IRC charges the sum of incomes from different categories, as defined under IRS.</p> <p>IRC is paid annually, on the basis of tax return and payable, as a general rule, upon submission of the tax return.</p> <p>Resident entities exercising as their main activity a commercial, industrial or agricultural activity, as well as non-residents with a permanent establishment must pay IRC on three instalments based on 85 per cent of the IRC paid in the previous year, the difference will be set upon delivery of the annual tax return of the subsequent year.</p> <p>Tax withheld at source has the nature of an advance payment and has the same rates as IRS withholding taxes. For income paid to non-residents that are not a permanent establishment, the withholding tax is final, with the exception of income from real estate.</p>	<p>Capital gains derived from the alienation of corporate rights and other marketable securities by non-resident legal persons are exempt, except if such entities are, directly or indirectly owned for more than 25 per cent by resident entities.</p> <p>Costs incurred and deemed as absolutely necessary for the realisation of profits are deductible.</p> <p>Losses for tax purposes can be carry forward for up to six subsequent fiscal periods.</p> <p>Depreciation allowances are available for tangible and intangible assets that are used for business purposes. Inventories cannot be depreciated, however a tax deduction may be granted if at the end of a financial year the market value is less than the historic cost. Both straight-line and declining balance methods are allowed.</p>	<p>25 per cent applies until 2005 to real estate management and investment companies.</p> <p>20 per cent applies to small businesses with an average turnover below 30 million escudos.</p> <p>25 per cent: on income obtained by non-resident legal persons and not attributable to a permanent establishment, except if derived from intellectual or industrial property, or from the supplying of know-how (15 per cent), from bonds and debentures and other income from capital (20 per cent), or winning from gambling (35 per cent).</p> <p>Confidential or non-substantiated expenses, as well as entertainment expenses and motor vehicles charges: taxed autonomously at 32 per cent and 6.4 per cent, respectively</p>
Special issues	<p><b>Fiscal transparency regime:</b> for the purpose of neutrality, prevention of tax avoidance and elimination of the economic double taxation on profits between company members, under certain conditions (e.g. professional companies and ACE's - Complementary Enterprise Groupings) there shall be attributed to members thereof their share in profits, regardless of these being distributed or not.</p> <p><b>Mergers and separations:</b> the special regime contained in Directive 90/434/EEC applies.</p> <p><b>Capital gains from tangible assets:</b> deferral of tax in case of reinvestment up to the end of third subsequent fiscal period.</p>		

Tax	Nature of tax	Exemptions, deductions and depreciation	Rates														
<b>2. Taxes on property</b>	A municipal tax is levied on the net worth of property situated within the territory of each municipality and is payable by all owners (resident or non-resident individuals or legal persons).  Insofar as the Evaluation Code is not published, the net worth of real estate is determined, in most cases, by way of an updating of values inscribed in respective registers.  Payment of tax can be made in two yearly instalments if it exceeds 50 000 escudos.	Exempted are, <i>inter alia</i> , real estate owned by the State and other public entities, including their associations and federations, real estate classified as national monuments, as well as real estate owned by private social welfare institutions, teaching establishments, public associations, trade union and employers confederations and associations.  Residential housing may benefit from a temporary exemption (for a maximum of ten years).  In relation to real estates of construction companies liability to the local tax takes place after a five-year (building land) or three-year (other immovable property) period.	0.8 per cent: on rural (non-built) property;  0.7 to 1.3 per cent on urban buildings (the rate is fixed by each municipality annually)														
2.1. Local tax on real estate																	
2.2. Municipal transfer tax ("Sisa")	Municipal tax levied on the purchase price of immovable property; the tax is born by the buyer.	There are different kinds of exemptions and rate reductions, such as exemption provided for the acquisition of buildings for resale, under certain conditions, as well as acquisition of a dwelling if its value does not exceed the amounts fixed each year (P11.4 million escudos for 2000).	10 per cent: on the transfer of urban property or building land;  8 per cent: on other immovable property.  In case of transfer of residential property, the tax rates are as follows:														
			Rates														
			<table border="1"> <thead> <tr> <th>Taxable amount (values in 1 000 escudos)</th> <th>Rate applicable to amount in excess</th> </tr> </thead> <tbody> <tr> <td>Up to 11 400</td> <td>0</td> </tr> <tr> <td>Over 11 400 to 15 620</td> <td>5</td> </tr> <tr> <td>Over 15 620 to 20 820</td> <td>11</td> </tr> <tr> <td>Over 20 820 to 26 020</td> <td>18</td> </tr> <tr> <td>Over 26 020 to 31 520</td> <td>26</td> </tr> <tr> <td>Over 31 520</td> <td>10</td> </tr> </tbody> </table>	Taxable amount (values in 1 000 escudos)	Rate applicable to amount in excess	Up to 11 400	0	Over 11 400 to 15 620	5	Over 15 620 to 20 820	11	Over 20 820 to 26 020	18	Over 26 020 to 31 520	26	Over 31 520	10
Taxable amount (values in 1 000 escudos)	Rate applicable to amount in excess																
Up to 11 400	0																
Over 11 400 to 15 620	5																
Over 15 620 to 20 820	11																
Over 20 820 to 26 020	18																
Over 26 020 to 31 520	26																
Over 31 520	10																
			Proportional rate														
		Exemptions, deductions and depreciation	Rates														
2.3. Gift and inheritance tax (ISD)	Tax levied on the transfer, free of charge, of movable and immovable property, payable by the beneficiaries of such transfer (heirs and legatees).  In determining the applicable rate, there shall be aggregated all assets received from the donor, even if in different periods of time.	There are some exemptions that depend on the amount transferred and on the degree of kinship between the donor and the beneficiary. E.g. the first 730 000 escudos are exempt if the recipient is the spouse and immediate descendants, 350 000 escudos if first degree ascendants.	Progressive rates by brackets in accordance with kinship degree between the donor and the beneficiary (from 3 per cent [transfer in behalf of spouses and major descendants not exceeding 2 860 000 escudos] to 50 per cent [transfer between "third persons" over 71 240 000 escudos]).														

Tax	Nature of tax	Exemptions, deductions and depreciation	Rates
3. <b>General taxes on goods and services</b>	Tax is payable by instalments every six months up to a maximum of 16 instalments.	Inheritances, legacies and bequests in favour of public utility legal persons, museums, libraries, schools and other institutions belonging to the State and other public services are exempt.	<p>Reduced rate (5 per cent): applicable to essential foodstuff, water, electricity, passenger transport, public shows and entertainment, certain building contract jobs, accommodation in hotel establishments, and agricultural goods.</p> <p>Intermediate rate (12 per cent): applicable to some food items, ornamental flowers and plants, and supply of restaurant services (meals and beverages).</p> <p>Standard rate (17 per cent): applying to all supplies of goods and services not covered by the reduced and intermediate rate or exempt.</p>
3.1. Value added tax (VAT)	VAT is a tax levied on the consumption of goods and services, applicable in all stages of the economic circuit within the Portuguese territory. In its statutory structure, it adopts the Community model in force, as established by Directive 77/388/EEC, of 17 May 1977.	<p>Exemptions are established within very strict limits, along the lines drawn by VAT Common System.</p> <p>Other than exports and assimilated operations which are exempted under the destination principle, there are some exemptions (the so-called single exemptions) within the scope of certain activities – doctors; health services; culture and sport services supplied by non-profit making entities, by public law legal persons or by private welfare institutions; banking and financing operations; insurance and reinsurance operations; gambling, lotteries and betting; conveyance liable to “SISA”; lease of immovable property; agricultural products.</p>	<p>Intermediate rate (12 per cent): applicable to some food items, ornamental flowers and plants, and supply of restaurant services (meals and beverages).</p> <p>Standard rate (17 per cent): applying to all supplies of goods and services not covered by the reduced and intermediate rate or exempt.</p>
Special regimes	<p>Liable to VAT are the supply of goods, services, imports, intra-Community acquisition of goods and intra-Community acquisition of new means of transport.</p> <p>As a general rule, the taxable amount will correspond to the effective price of goods or services (including taxes, duties and levies other than VAT), but tax liability for each business operator is calculated according to the tax credit method after deduction of tax borne on acquisitions made during that same period of time.</p> <p>Tax is paid monthly or quarterly according to the business operator's turnover.</p> <p><b>Small retailers:</b> In relation to taxpayers not keeping an organised accounting and whose acquisitions do not exceed 10 million escudos, tax is estimated quarterly by applying a coefficient of 25 per cent on the amount of tax borne on the acquisition of goods intended for resale.</p> <p><b>Exemption regime:</b> Small taxpayers not keeping an organised accounting and whose turnover did not exceed in the previous year 2 million escudos may benefit from a special VAT regime, being not required to assess VAT in the exercise of their activity and not deducting VAT from their acquisitions.</p> <p><b>Other special taxation regimes:</b> special regime for fuel; special regime for tobacco; regime applying to travel agents and operators; regime for second-hand goods, art or collection works and antiques.</p>	<p>Operators covered by these exemptions are not requested to assess tax, but are not allowed to deduct tax borne on their inputs.</p> <p>The State and all other public law legal persons shall not be liable to tax if their activity consists in the exercise of authority powers.</p>	<p>Intermediate rate (12 per cent): applicable to some food items, ornamental flowers and plants, and supply of restaurant services (meals and beverages).</p> <p>Standard rate (17 per cent): applying to all supplies of goods and services not covered by the reduced and intermediate rate or exempt.</p>

Tax	Nature of tax	Exemptions, deductions and depreciation	Rates
3.2. Excise taxes (IEC)	<p>Levied on manufactured tobacco, alcohol, alcoholic beverages and petroleum products, according to the relevant EU directive.</p> <p>Taxation occurs upon the entry into consumption of these goods, the production and processing of which is carried out under a tax suspensory scheme in fiscal warehouses; tax self-assessment is operated on the basis of entry into consumption statements</p>		<p>Rates vary according to the product:</p> <p>For cigarettes the tax has two components: a specific one - fixed on a given amount, and an <i>ad valorem</i> ;</p> <p>for alcoholic beverages the tax depends on alcohol content or hectolitre volume;</p> <p>For petroleum products the tax is calculated by reference to brackets set each year.</p>
3.3. Tax on motor vehicles (IA)	<p>The IA is levied on light motor vehicles imported (as new or second-hand) or newly acquired, including those assembled or manufactured in Portugal and immatriculated therein. It covers light passenger vehicles and vehicles for the transport of goods not exceeding 2 500 kg where object of conversion.</p> <p>It is a specific single-stage tax payable by importers or acquirers of motor vehicles.</p>	<p>There are some exemptions applicable in case of transfer of residence to Portugal by Portuguese or Community citizens, diplomats, public utility institutions or of relevant social interest, disabled persons.</p> <p>Imported second-hand motor vehicles benefit from a tax relief under certain conditions.</p>	<p>The rate is determined according to cylinder capacity brackets and type of motor vehicle.</p>
3.4. Stamp duty (SELO)	<p>Tax levied on deeds, contracts, documents, securities, books, papers and other facts described by law, payable by whoever holds an economic interest in the taxable operation.</p> <p>Financial deeds and operations (checks, bills of exchange and promissory notes, loans, guarantees, etc.) represent the main base.</p>	<p>It is not levied on operations subject to VAT and other operations linked to life insurance, financing operations within the same group of companies, subventions, etc.).</p> <p>The State and all other public entities, including regional and local authorities; social security institutions; public utility legal persons; and private social welfare institutions are also exempt.</p>	<p>Lump sum of 5 000 escudos for each notary deed;</p> <p>In the case of a loan, a rate is applied on the amount requested. The rate varies between 0.04-0.06 per cent depending on the period of availability of the loan.</p>
3.5. Municipal tax on motor vehicles (IMV)	<p>Tax due by the owner of motor vehicles and payable in the municipality of residence, corresponding to taxation levied on the use or the right to use light and mixed passenger vehicles, private aircraft, private pleasure boats and motorcycles.</p> <p>Tax is paid each year usually during the months of June and July.</p>	<p>Among others, there are exemptions in favour of the State and other public entities, local authorities and respective federations and unions, public utility legal persons, disabled people.</p>	<p>Tax rates vary according to the type of vehicle (age and cylinder capacity for motor vehicles and motorcycles; maximum weight at takeoff for aircraft; and gross gauge tonnage, propelling power and age for pleasure boats).</p>

Source: Ministry of Finance.



## *Annex 2*

### **Tax incentives for corporate income tax purposes<sup>49</sup>**

1. Tax incentives for corporate income tax purposes are set forth in national tax legislation laid down in the Corporate Income Tax Code (CIRC), the Tax Incentives Statute (EBF), the Patronage Statute (Maecenas Statute) and decree laws, as well as in legislation enacted by the autonomous regions of the Azores and Madeira. The most important incentive regimes are presented below.

#### **Incentives under national legislation**

##### *Financial derivatives*

2. To encourage domestic trade in financial derivatives, only 80 or 90 per cent of the net income or losses arising yearly on futures and options closed on the exchange market for purposes other than hedging is included in taxable income in 2000 and 2001, respectively. Special rules apply to loss carry-forwards.

3. Furthermore, an exemption from IRC applies to income derived in connection with swap transactions entered with resident credit institutions by non-resident financial institutions without Portuguese-based permanent establishment.

##### *Free-trade zones of the Azores and Madeira*

4. Under the state-aid rules of the European Union, Portugal was authorised to enact a socio-economic programme aimed at overcoming the structural underdevelopment of the autonomous regions of the Azores and Madeira.

5. Qualifying industrial, shipping, international services (holdings, trusts other than engaged in financial activities, trading companies) and financial entities (banking insurance, investment funds) licensed within the Madeira Free Trade Zone or Santa Maria Island Free Trade Zone (Azores) are eligible for exemption from IRC until 31 December 2011. In addition, only non-resident shareholders and partners without a Portuguese-based permanent establishment (other than based in the said Free Zones) deriving income from their holdings are exempt from IRC withholding. Exceptions regard to holdings owned by residents in companies operating in the Industrial Park of the Free Trade Zone and or in shipping companies.

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49. *Source:* De Sampayo Ribeiro (2000).

6. Other salient features of this incentive include:

- Royalties, fees for technical assistance, know-how and leasing of equipment, agency commissions and business-related fees paid by licensed entities to non-residents without a Portuguese permanent establishment (other than based on the free zones) are exempt from IRC withholding.
- Exemptions from stamp duty, municipal real estate tax and transfer tax, inheritance and gift tax, local charges of any kind, notary and registrar fees; and
- Companies licensed in the free zones qualify as Portuguese tax residents, unless treated otherwise under a tax treaty.

### *Contractual tax incentives*

7. Industrial investment projects from 1999 through 2010 which involve 1 billion escudos or more and are deemed to be of a strategic interest to the domestic economy and encourage job creation, technological innovation and domestic scientific research are eligible for contractual tax incentives. The incentives, which are granted by the central government on a case-by-case basis for a maximum period of ten years, include a 5 to 20 per cent investment tax credit and an exemption from or reduction of real estate tax, transfer tax and stamp duty.

8. Also eligible for contractual tax incentives are direct investment projects in listed activities carried out in 1999 through 2010 by Portuguese-based companies abroad (excluding tax-free zones and tax jurisdictions considered as reduced tax territories or countries listed in a government decree) involving at least 50 million escudos and designed to internationalise the Portuguese economy. The incentives are granted for a maximum period of five years and include:

- A 10 to 20 per cent investment tax credit, limited each year to the lower of 25 per cent of the taxpayer's IRC liability and 200 million escudos; and
- A 95 per cent exemption for dividends received by a resident parent from its 25 per cent or more owned non-resident subsidiary (provided that the investment abroad resulted in a newly-created non-resident company or the acquisition of an existing non-resident company).

9. With respect to investment projects in EU member states, the contractual tax incentive scheme is available only to small and medium-sized enterprises, as defined by EC law.

### *Investment credit for small and medium-sized companies*

10. An extraordinary investment tax credit is available to qualifying enterprises to promote their self-financing and to increase their equity and productive investment from 1998 through 2000.

11. Qualifying companies may credit against their IRC liability (as shown on their annual tax return) 10 per cent of the amount by which the current year's investments (during 1998 through 2000) in new plant and machinery used in the investor's business in Portugal exceeds the average investment cost in the two preceding years. The credit is limited to 30 per cent of the investor's IRC liability. The limit is 40 per cent, however, if either the enterprise's taxable profit in the year of investment is at least 20 per cent higher

than the taxable profit of the preceding year and the enterprise retained profits in an amount equal to such 20 per cent.

### ***Micro enterprises***

12. Qualifying IRC taxpayers, other than corporations (SAs), whose average turnover over the period 1997/98 did not exceed 30 million escudos are subject to IRC at a rate of 20 per cent. In addition, where the qualifying taxpayer makes investments in backward areas during the years 2000 through 2002, the IRC rate is 15 per cent. Furthermore, a credit against their tax liability of 15 per cent of the amount of additional investments up to the limit of 35 per cent of the investor's IRC liability applies. Any share capital increases are exempt from all taxes, fees and charges.

### ***Tax credit for research and development investments***

13. An investment credit is available for resident entities and Portuguese permanent establishment of non-resident entities in respect of qualifying research and development (R&D) expenses. The amount creditable against the taxpayer's IRC liability is the sum of a basic investment tax credit equal to 8 per cent of the qualifying expenses incurred plus an additional credit equal to 30 per cent of the amount (limited to 50 million escudos) by which the qualifying costs for the relevant years exceeds the average R&D expenses incurred in the two preceding years; any unused investment tax credit may be carried forward for three years.

## **Incentives under regional tax legislation**

### ***Autonomous region of the Azores***

14. Effective from 1 January 1999, the Azores introduced a reduction of the general IRC rate by 30 per cent; thus for 2000, the rate is 22.4 per cent. The reduced rate applies to the following taxpayers:

1. Legal entities with their legal seat, place of effective management or permanent establishment in the Azores.
2. Legal entities with their legal seat or place of effective management in Portugal and with branches, agencies, offices or any other form of permanent representation without legal personality in more than one area (*circunscrição*); and
3. Legal entities without their legal seat, place of effective management or permanent representation in Portugal. In this case, the reduced tax is withheld as a final tax on income derived within the Azores.

15. Special rules determine the tax liability of taxpayers mentioned in *ii*). In addition, regarding those taxpayers, the turnover derived abroad is imputed to the Azores only if the permanent establishment in which the accounting records are centralised is based in the Azores.

16. Furthermore, the taxpayers may credit against their IRC liability an amount corresponding to a percentage of eligible business or agricultural profits reinvested. The percentage varies depending on the location of the investment. The credit is limited to the amount of the taxpayer's IRC liability and can be

carried forward for three years. Special rules define the eligible investments and the profits eligible for reinvestment.

17. The deduction mentioned above can be accumulated with other benefits of the same nature which are available under national law.

18. With regard to the tax incentives which may be granted under a contractual basis (see above), the Azores Regional Government can grant favourable tax treatment for IRC and municipal real estate tax purposes.

19. For the Santa Maria Island Free Trade Zone, see provisions under national legislation, above.

### *Autonomous region of Madeira*

20. Qualifying IRC taxpayers with their legal seat, place of effective management or a permanent establishment in Madeira may credit against their IRC liability an amount equal to 15 per cent of the profits reinvested in tax years 2000 through 2002. This credit is limited to the amount of the taxpayer's IRC liability and can be carried forward for three years. Specific requirements apply to both the assets and the taxpayer. This benefit cannot be accumulated with any other tax benefit of the same nature.

21. The national regime on contractual tax incentives (see above) has been adapted to regional specific interests. Investment projects in productive units regarded of significance to enhance regional strategic sectors, job creation, technological innovation and regional scientific research made by 31 December 2010 and involving 350 million escudos or more may benefit for a period of ten years of a 10 to 30 per cent investment tax credit, exemption or reduction; exemption or reduction from municipal real estate tax and transfer tax on qualified premises; and exemption from stamp duty. In addition, projects involving at least 100 million escudos may qualify for the referred tax benefits provided that the requirements set forth by the regional government are complied with.

22. For the Madeira Free Trade Zone, see provisions under national legislation above.

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