Guide to Transparency in Public Finances

Looking Beyond the Core Budget

2. Tax Expenditures

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Introduction

For more than a decade, civil society organizations around the world, as well as international financial institutions, have been pushing for governments to provide the public with more comprehensive budget information. The International Budget Partnership's (IBP) Open Budget Survey examines the accessibility in countries around the world of eight key budget reports that governments should publish in order to enable civil society, oversight institutions, and members of the public to participate effectively in budget processes and hold governments accountable for how they use public money. In two companion guides to the briefs listed below — the *Guide to Transparency in Government Budget Reports: Why Are Budget Reports Important, and What Should They Include?* and the *Guide to Transparency in Government Budget Reports: How Civil Society Can Use Budget Reports for Research and Advocacy* — the IBP describes the importance of each key budget report, the information that it should contain, and how civil society organizations can use them.

This is one of five briefs that goes beyond the eight key budget reports covered in the guides to examine other areas of public finance that are less well understood and especially vulnerable to efforts to shield them from public scrutiny. The other briefs are:

- Extra-budgetary Funds
- Quasi-fiscal Activities
- Contingent Liabilities
- Future Liabilities

All of the briefs examine the following questions:

- What are these issues or activities, and why are they of interest?
- What information should the government include in budget documents and other reports on these issues in order to provide a comprehensive picture of the government's fiscal position and increase the public's understanding of how their money is being utilized?
- How can civil society groups use information contained in these documents to achieve their research and advocacy goals?
- Where can further information, country examples, and "model reports" be found?

The briefs are based on existing guidance and practices related to these areas of public finance gathered from various sources. In some cases, concrete examples are scarce, as these are new and complex areas of public budgeting.

The IBP will continue to build on this material and identify further public finance issues and activities that are typically shielded from public scrutiny but may have a major bearing on a country's public finances. Any additional briefs will be added to the IBP's website at: www.internationalbudget.org.

Note: this brief draws heavily on a background paper written by Mark Burton and Miranda Stewart of the University of Melbourne. See Section D for further details.

Tax Expenditures

Tax expenditures are part of any government's toolbox, and in some cases they can be an effective way to provide incentives to citizens and firms. However, their impact on the budget tends to be much less visible than that of normal expenditures, and they receive little systematic scrutiny. They also can disproportionately benefit specific interest groups, who will lobby to maintain them. As tax expenditures can be very large compared to normal government spending, it is important for civil society organizations to monitor them, assess their impact, and push governments to publish detailed information and carry out periodic reviews.

A. What are tax expenditures, and why are they of interest?

Tax expenditures are usually defined as a government's estimated revenue loss that results from giving tax concessions or preferences to a particular class of taxpayer or activity. The revenue loss, or "expenditure," is calculated as the difference between whatever tax would have been paid under a defined benchmark tax law (which identifies what tax structure should normally apply to taxpayers) and the lower amount that was actually paid after the tax break. Tax expenditures are used instead of direct spending to deliver a government subsidy to a class of taxpayer or encourage a desired activity. They can take many forms, including tax exemptions; tax deductions; tax offsets (or credits); and concessional tax rates or timing rules, such as accelerated depreciation of capital assets, that either reduce or defer a taxpayer's tax liability. A typical example is a deduction on income tax that is allowed for interest paid on home mortgages, which is designed to encourage home ownership.

The tax expenditure concept recognizes the similarity between direct government spending and "spending" through the tax system. Consider two scenarios:

- a government collects $100 in tax from a taxpayer and then pays a direct subsidy of $100 to that same taxpayer (a direct government expenditure); or
- a government decides to reduce the tax liability by $100 for the same taxpayer (a tax expenditure).

In both scenarios, the direct monetary effect on the taxpayer is the same. The delivery of the tax expenditure, however, may be treated very differently by the government in its budget reporting and analysis. In fact, typically tax expenditures undergo less scrutiny than direct spending. Unlike many spending programs, tax expenditures are not usually subject to a direct appropriations vote in the legislature every year and thus are less likely to undergo periodic review.

A tax expenditure policy can be applied to any type of tax law. That is, a personal income tax, corporation tax, commodity tax (such as tariffs and excises), sales tax (or Value Added Tax [VAT]), property tax, wealth tax, or inheritance tax may all contain tax expenditures. In some cases, the total value of the revenue impact of tax expenditures can reach as high as 10 percent of GDP (OECD 2010).

There are particular characteristics of tax expenditures that may make them a more attractive policy tool than direct spending.

- If the government wants to provide a benefit to a large target population without separately assessing each applicant, a tax concession may offer the least cost path both for the government to administer and for taxpayers to comply with.

- Enacting a tax expenditure may prevent churning of tax revenue collection and public spending, enabling the government to efficiently deliver benefits by avoiding the administrative cost of collecting tax from a taxpayer only to return it to the same taxpayer in the form of a government payment.

- The tax system might be the best means of advertising the availability of government assistance, especially when there is a large target group of taxpayers required to submit tax returns. By asking taxpayers to consider whether they fit the requirements for the government assistance as part of mandatory tax filing, a government might ensure that assistance reaches the target group.

On the other hand, there are several reasons why tax expenditures may be less effective as a policy tool than another mechanism, such as direct spending or a regulation.

- It is more difficult to subject tax expenditures to legislative control, as often tax expenditures are a permanent part of a law that, unless specified in the law itself, does not require regular legislative review. Compare this to direct spending programs, which are budgeted for and, therefore, scrutinized in every budget cycle. As part of the tax code and not a specific spending program, tax expenditures do not fall under the responsibility of any particular functional agency that the legislature oversees. And, without a "sunset clause" to end the tax expenditure, it may remain in law after its usefulness as a policy tool has come to an end.

- Tax expenditures may generate unfair distributional outcomes between taxpayers, as in the case when only individuals who can afford tax advice are likely to learn about and access the concessions.

- Tax expenditures may create interest groups to defend and perpetuate them, especially when such expenditures are narrowly defined and targeted, which can lead to significant lobbying of politicians and more generally an environment not conducive to well-informed policy choices.

Tax expenditures vary with respect to how they affect the fundamental elements of a tax.

What is subject to tax? A tax expenditure might exempt or only partially subject some parts of the tax base (e.g., individual or corporate income or the value of a purchase of a taxed good or service) to tax. In Ghana, for example, the tariff code provides an exemption for energy saving compact fluorescent and LED lamps to promote energy savings and reduce power consumption.

Who must pay the tax? A tax rule might exclude particular taxpayers from taxation or might give favourable tax treatment to all taxpayers who possess certain characteristics, such as their age or family status. In a number of countries, for example, income tax law provides that the primary income earner of a household is allowed a deduction when the income earner's husband or wife has limited income.

What is the tax rate? The rate of tax may vary for particular categories of taxpayers or transactions. For instance, small business income or income comprising capital gains might be taxed at a lower rate than otherwise would apply, as in the case of South Africa.

B. What information should the government include in budget documents and other reports on tax expenditures?

The International Monetary Fund (2007) and the OECD (Organization for Economic Co-operation and Development) (2002, 2010) recommend that a government should estimate and report the revenue impact of at least key tax expenditures. A World Bank paper (Li Swift 2006) recommends the same. Tax expenditure reporting serves three important functions. First, it enhances the government's fiscal management by exposing all forms of government spending, both direct spending and indirect spending through the tax code, to the same level of scrutiny in the budget process. This facilitates informed decision making, as well as public understanding and advocacy. Second, reporting enables analysis that can help determine the best tools for government to use to achieve its policy goals (e.g., through public ownership of resources, regulation, direct spending, taxation, or tax expenditures). Tax expenditure analysis is no different from public policy analysis more generally, as it entails consideration of the best means of achieving a government's objectives. Third, tax expenditure reporting promotes analysis of tax policy principles, making tax expenditure advocacy one avenue by which civil society organizations can advance claims about the fairness and effectiveness of the tax system.

With the broader goals of the public and civil society organizations in mind, the following information should be included in a tax expenditure report.

- ***Definition of benchmark:*** the benchmark against which each tax expenditure is assessed (the tax structure that would normally apply to taxpayers in the absence of the expenditure) should be clearly stated and defended within the tax expenditure report.

- ***Credible measurement framework:*** the method used for estimating individual tax expenditures should be clearly set out in the report. A significant factor affecting the usefulness of a tax expenditure statement is the accuracy with which the cost of a particular expenditure is determined, so the degree to which each tax expenditure estimate is reliable ought to be clearly indicated.

- ***Detailed breakdown of aggregate tax expenditures:*** At a minimum, the revenue impact or "cost" should be reported by government function (e.g., health, social security, environment, industry assistance); with time-series data over a period of, say, five years (noting any variations to the tax law or benchmark in that time); and by levels of government, if possible.

- ***Additional information for each tax expenditure item, including:***

  the estimated cost of the tax expenditure, with an indication of the reliability of the estimate, including the quality of the data upon which the estimate is based;

  the source of the tax expenditure (e.g., tax law provision, administrative practice, or tax treaty);

  the duration of the tax expenditure (is it subject to a "sunset clause," or is it ongoing?);

  the type of tax expenditure (e.g., an exemption, a refundable tax credit, or a deduction);

  policy justification for each tax expenditure (the policy objective of the tax expenditure, and why it is the best means of achieving that objective);

  the distributional impact of major tax expenditures, to the extent that data is available, including where relevant gender analysis; and

  reference to the last government review for at least the most significant tax expenditures.

In India the Minister of Finance first presented the *Statement of Revenue Foregone*, which reports on various tax exemptions, in the 2006-07 Union Budget. The statement reveals some aspects of the distributional effects of tax expenditures but does not explicitly analyze them. It demonstrates that tax expenditures that give preferential treatment to the corporate sector are significantly greater than tax expenditures targeted at the nonprofit sector and individuals. In Chile, as in several other Latin American countries, there is a constitutional obligation to report tax expenditures. Every year the tax expenditure report is included in the *Budget of Public Finances*. This document presents the estimate made by the Chilean Tax Administration of the impact of tax expenditures relating to income tax and VAT, including projections of future impact. Its latest report showed that the value of revenue forgone through tax expenditures was equal to 4.27 percent of GDP.

C. How can civil society use tax expenditure reports for research and advocacy?

In its *Guide to Tax Work for NGOs* (IBP 2006: p. 60), the IBP stated:

Although a civil society group would not likely be in a position to estimate the revenue losses from tax expenditures, it may be able to compile a list of major tax expenditures. (This could require partnering with a tax lawyer or accountant.) By highlighting the existence of these subsidies, such a list could promote improved oversight and prompt discussions about the policy rationale for the provisions. It could also help pressure government to provide more information.

More generally, a tax expenditure report can be used by civil society organizations in a number of different ways, including:

- exposing "hidden" public welfare to more robust scrutiny;
- identifying inconsistent spending and tax programs — i.e., government might be promoting inconsistent policy outcomes by adopting contradictory spending and tax measures;
- identifying areas where the tax system is not operating in accordance with legislative intention (e.g., the tax administration has insufficient resources to enforce the law, or it has allocated enforcement resources to other matters);
- assessing a government's ongoing management of tax expenditures;
- identifying the best means of delivering a particular policy outcome (that is, direct spending may be a better alternative than a tax expenditure); and
- identifying aspects of the tax law that ought to be improved if the community's aspirations for its tax system are to be carried into effect.

Of key importance to civil society groups, in addition to the overall impact on revenue, is how tax expenditures distribute costs and benefits across different segments of taxpayers. This should be addressed to the extent possible using available data. The results of such an analysis can contribute significantly to civil society budget advocacy that aims to increase social justice outcomes as a result of taxing and spending policies. A distributional analysis may identify significant gaps in the impact of the budget on different groups; for example:

- ***Income/wealth analysis:*** How do low-income individuals or individuals with little wealth benefit compared to high-income or wealthy individuals?

- ***Gender analysis:*** Is there a differential impact on women and men? For example, if only men work in the manufacturing industry in a particular country, a tax expenditure that reduces the tax burden on workers in manufacturing will benefit men more than women. An analysis of this expenditure may also identify policy reasons for the focus on manufacturing.

- ***Minority analysis:*** Is the expenditure effectively reaching its target beneficiaries? A regional tax investment credit may have the goal of benefiting a minority group that lives in a particular region. The tax expenditure analysis may be able to identify if the credit is, in fact, benefiting that group.

A recent report published by the Center on Budget and Policy Priorities in the United States (Marr and Highsmith 2011) presents an interesting analysis of tax expenditures in the U.S., highlighting how they represent a very substantial share of federal spending, while being both inefficient and inequitable, with the wealthiest households receiving the largest tax subsidies.

D. Relevant materials, websites, and "model reports"

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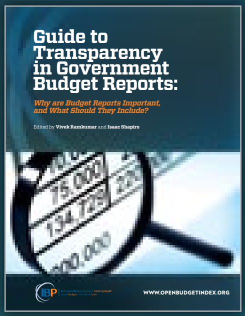
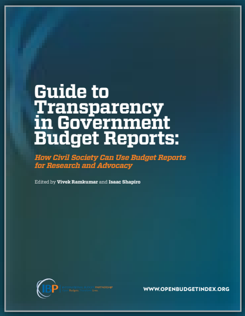
The Open Budget Initiative

This guide is part of a series that looks at public finance topics in terms of transparency and accountability. The Open Budget Initiative may produce additional guides around other important related topics in the future.

1. **Extra-budgetary Funds**
2. **Tax Expenditures**
3. **Quasi-fiscal Activities**
4. **Contingent Liabilities**
5. **Future Liabilities**

This series is a companion to two earlier **Open Budget Initiative** guides on public budget transparency — one for governments and one for civil society organizations.





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