



# EVALUATING TAX EXPENDITURES

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**A Framework for Civil Society  
Researchers**

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The goal of any tax system is to raise the resources needed to pay for public services, the public goods, and investments.

Governments raise revenues by imposing taxes on income, wealth, or activities such as consumption or telecommunications. Tax expenditures are provisions that reduce the amount of revenue that is collected by providing special treatment to a particular class of individual, type of income, industry, or activity. This type of special treatment provided through the tax code is called a tax expenditure to make the point that the economic impact – the transfer of public resources for a particular activity or purpose – is conceptually equivalent to direct spending through the budget.

### **BOX 1: TAX EXPENDITURES OR TAX INCENTIVES?**

All tax incentives are tax expenditures, but not all tax expenditures are tax incentives. The term “tax incentive” traditionally refers to provisions that aim to influence investment decisions. Tax incentives include an array of provisions ranging from tax holidays to preferential treatment for activities in certain regions to lower rates on investment income or for targeted sectors of the economy. They are often aimed at encouraging foreign direct investment and/or job growth.

Tax expenditures are enacted to achieve a number of goals, such as encouraging investment in specific industries or regions; incentivizing a desired activity; or to provide a benefit to a category of taxpayer, such as families with children. Some improve the equity and efficiency of a tax system, while others

create disparities, make the tax code more complex and less transparent, and hinder efforts to ensure accountability. Tax expenditures can be an appropriate tool when they are used to provide broad-based benefits and there is little need for monitoring and evaluation. They can be used to provide benefits to large numbers of taxpayers at minimal cost based on information that can be easily collected on a tax return. They can also be an efficient means to make a tax system more equitable, such as by exempting or “zero-rating” necessities, such as cooking oil in a value added tax (VAT). However, tax expenditures often are used too frequently, are used ineffectively, or are used for purposes where direct government spending would be more appropriate, and many tax expenditures aimed at boosting investment reward activities that would have occurred in the absence of an incentive or that fail to produce promised benefits.

In many countries, tax expenditures significantly reduce revenue collections. In some Latin American countries, for example, the cost of tax expenditures equaling one-fourth or more of actual revenue collections.<sup>1</sup> In addition to their high cost, tax expenditures frequently increase inequality by providing disproportionate benefits to high-income taxpayers. Because of these impacts, civil society organizations (CSOs) across the globe are increasingly scrutinizing tax expenditures,

<sup>1</sup> Juan Carlos Gómez-Sabaíni and Dalmiro Morán, “Tax Policy in Latin America: Assessment and Guidelines for a Second Generation of Reforms” (Macroeconomics of Development Series, Economic Commission for Latin

America and the Caribbean, June 2014): 63. [http://repositorio.cepal.org/bitstream/handle/11362/36806/1/S1420166\\_en.pdf](http://repositorio.cepal.org/bitstream/handle/11362/36806/1/S1420166_en.pdf) (accessed on 5 March 2018).

seeking to boost domestic revenue collections and improve the equity of domestic tax systems.<sup>2</sup>

For many CSOs, evaluating the costs and benefits of tax expenditures can be challenging. In the ideal world, all of the information needed to assess the impact and effectiveness of tax expenditures would be available to the public through a single portal. However, the information needed for a comprehensive analysis is often not available, or the information that is available is incomplete, complicating efforts to analyze country policies and identify opportunities for reform.

Tax expenditure reports and statistics published by the Ministry of Finance or revenue authority are a good place to start a tax expenditure research project. This information can be supplemented by academic and donor-supported research studies; income, wealth, and consumption survey data; and reports and policy briefs published by CSOs.

This brief provides a guide to assessing a country's overall framework for establishing, reporting on, and evaluating tax expenditures using the criteria that experts agree characterize a good tax system: **transparency**,

**accountability**, **equity**, **efficiency**, and **adequacy**.<sup>3</sup> Some tax expenditures will clearly fail to meet these basic standards. In other instances, perhaps most, analysts must weigh the pros and cons of particular provisions within the context of the country's overall tax system.

## What Makes a Tax Expenditure “Good” or “Bad”? A Framework for Assessing Tax Expenditures?

Tax expenditures exist within, and should be judged as part of, a broader fiscal framework along with the political and policy context that influences opportunities for reform. The following framework is structured around the five criteria set out above that experts use to define a good tax system. It is designed to help CSOs assess whether a tax expenditure provides social and economic benefits that are commensurate with its costs, whether it is sufficiently transparent and accountable, and whether it increases or decreases the equity of the tax code. In many instances, there is no clear-cut answer, or the information needed to make a conclusive evaluation will not be available. In these instances, the answer will

<sup>2</sup> For a review of the literature on tax expenditures and inequality, see Jean Ross, “Tax Expenditures and Inequality in Latin America” (International Budget Partnership, Washington, D.C., 2018). <https://www.internationalbudget.org/publications/tax-expenditures-and-inequality-latin-america/>.

<sup>3</sup> See, for example, U.S. Government Accountability Office, “Tax Expenditures: Background and Evaluation Criteria and Questions.” (GAO-13-167SP, Washington, D.C., 28 November 2012). <https://www.gao.gov/assets/660/650371.pdf> (accessed on 5 March 2018).

require balancing a number of considerations, as well as alternatives for achieving similar goals.

## Transparency

Transparency is the first step in tax expenditure evaluation. Information on how much revenue a government foregoes through tax expenditures, and who benefits from them should be available to the public and policymakers on a timely basis, and tax expenditures should be structured in a manner that is understandable and that discourages abuse.

What you should look for when evaluating the transparency of tax expenditures:

- A list of all available tax expenditures, their cost, and the legal authority (laws and regulations) that govern their availability: this information should be easily available and should include the eligibility criteria and procedures required to qualify for a tax expenditure. Ideally, this information should be published annually and made available as part of the yearly budget process.
- Information on who benefits from a tax expenditure: this data ideally will include the number of taxpayers that qualify for a tax expenditure; the income level of beneficiaries; the size of the tax reduction; the geographic distribution of beneficiaries; and, for

provisions provided to businesses, the sector and identity of beneficiaries.

- The authority or department responsible for administering the tax expenditure.

Questions to consider include:

- Is the tax expenditure simple, transparent, and easily administrable? Does the law authorizing the tax expenditure state which agency(s) is responsible for its implementation and review? Laws and regulations should be written, to the extent possible, in language that is understandable and sufficiently precise to prevent abuse.
- For investment incentives, is the name of the beneficiary, along with the amount of benefit provided, available to the public? Public disclosures should include any data related to the fulfillment of eligibility requirements, such as employment levels or investments made.

## BOX 2: ATTRIBUTING CAUSALITY

Assessing the effectiveness of a tax expenditure can be challenging. One frequent criticism of tax incentives is that they provide a benefit to taxpayers who would have done the same thing in the absence of the tax incentive. This occurs when an investment, for example, is sufficiently profitable without incentive, or when there are no other alternative locations for a specific type of activity, such as the extraction of a rare mineral. In the absence of a rigorous evaluation, studies of similar provisions, as well as data on the cost and an understanding of the economic context can inform an assessment of the impact of an incentive. One important consideration is whether an incentive is large enough to encourage the desired behavior or investment. Incentives that are too small are unlikely to have an impact on a taxpayer's behavior and simply reward activities that would have occurred in the absence of the incentive. In other instances, the tax incentive may be larger than is needed to make an investment profitable and thus cost too much.<sup>1</sup> Incentives offered to businesses that cannot easily move to another location - such as those dependent upon scarce natural resources - are likely to have little or no impact on investment decisions. Other structural factors to take into account include the timing of tax benefits. Benefits awarded after the desired activity has taken place, for example, are unlikely to have an incentive effect. For example, a newly created tax credit based on the number of jobs added by a firm in the prior year would not have an incentive effect, since the firm wouldn't not have known that the incentive would be available when it added the additional employees.

<sup>1</sup> Maya Forstater, "The Good, the Bad, and the Ugly: How do Tax Incentives Impact Investment" (Center for Global Development, Washington, D.C., 16 October 2017). <https://www.cgdev.org/blog/good-bad-and-ugly-how-do-tax-incentives-impact-investment> (accessed on 19 January 2018).

- Are the laws and regulations authorizing a tax expenditure readily available to the public? Laws and regulations should be available at no cost, ideally both online and in hard copy upon request. Regulatory processes should include opportunities for public comment, and notice of comment periods and processes should be publicly available.
- Are eligibility criteria clearly defined? Do they state what happens if a taxpayer fails to fulfill the criteria? If, for example, a business must create a certain number of jobs in order to qualify for a tax incentive, is the taxpayer required pay back any benefits received if it fails to create the requisite number of jobs?

## Accountability

Experts agree that tax expenditures should be structured and administered in a manner that promotes accountability. They should have explicit goals and the extent to which they meet these goals should be periodically evaluated. Tax expenditures should be authorized by law with well-defined eligibility criteria.

What you should look for when evaluating whether a tax expenditure promotes accountability:

- The goal of the tax expenditure and the metrics that will be used to determine whether it achieves its goal.
- Whether the law that establishes the tax expenditure also provides for collecting the

data that will be needed to evaluate its effectiveness.

- Whether there is a sunset date - a date when a tax expenditure expires unless it is reauthorized by the legislature.
- Objective eligibility criteria that are not subject to the discretion of the revenue authority or other government officials.

provide promised benefits, such as jobs or investment?

- Does the tax expenditure have a sunset date that allows for periodic review? Sunset dates provide an opportunity for the legislative body to review the effectiveness of a tax expenditure and to allow it to expire if it is overly costly or ineffective at achieving its stated goals.

Questions to consider include:

- What is the intended goal of a tax expenditure? Is it appropriately structured for achieving its intended goal(s)? Poorly defined eligibility criteria open the door to abuse. Tax expenditures that are granted outside of a statutory framework, such as through individual contracts with taxpayers, are more prone to abuse and create opportunities for corruption.
- Are there well-defined performance measures? Are the reporting requirements sufficient to determine whether a tax expenditure is achieving its goals? If the data needed to assess performance are not readily available, does the authorizing statute require its collection?
- Is the tax expenditure periodically evaluated to assess its effectiveness? Is there a “clawback” provision that requires the taxpayer to pay back the amount of the tax benefit they received if they fail to

## Equity

The evaluation of a tax expenditure should include an assessment of who benefits from the provision, whether it provides disproportionate benefits to the wealthy or the poor, and whether it makes the tax system as a whole more or less equitable. Ideally, this analysis would include data on the incidence of a tax expenditure measured as a percentage of taxpayers' income. While equity is a key factor to consider when evaluating a tax expenditure, data on the distributional impact - that is, who benefits and who does not - is often difficult to obtain or not available at all, particularly for special treatment provided through indirect taxes, such as a VAT.

What you should look for when evaluating the equity of a tax expenditure:

- Information on the beneficiaries of each tax expenditure: this data should be disaggregated by income, sector, region, and other criteria to the extent possible and show the amount of tax benefit provided to taxpayers by category (i.e., the cost of the tax expenditure by income group or sector). For tax expenditures granted through the personal or business income tax, equity can often be assessed by looking at whether low- or high-income taxpayers receive a disproportionate share of the benefits using administrative data.
- Incidence data that estimate the impact of a tax expenditure on taxpayers at various

### BOX 3: ASSESSING EQUITY

Provisions that provide a disproportionate share of benefits to lower-income taxpayers make the tax code more equitable, while those that provide disproportionate benefits to high-income taxpayers, make it less equitable. The impact of tax expenditures that are part of indirect taxes, such as a VAT, is harder to measure, since the entity that formally pays the tax (the business collecting the VAT) is not the same as the ultimate taxpayer (the consumer). Tax incidence models use administrative and/or survey data to examine the impact of tax policies. Incidence models can be used to look at how individual policies or provisions affect the equity of the tax system as a whole. Unfortunately, this type of model is not available in every country and many countries lack the basic data needed to build one. In the absence of an incidence model, consumer expenditure surveys and other data can be used to approximate the impact of indirect tax expenditures. Where there is little or no available data, results from a similar country can be used to estimate the distributional impact.

income levels, as well as information on how it affects the overall distribution of taxes paid for the tax system as a whole. Incidence analysis, where it exists, may only be available for provisions with a substantial cost or that are provided to a large number of taxpayers.

- For investment incentives, the names of taxpayers and the amount of tax benefit they receive.

Questions to consider include:

- Who actually benefits from the tax expenditure? How does this vary by income, geography, or industry sector?

## BOX 4: CONSIDERING THE IMPACT OF VALUE ADDED TAX CHANGES IN A BROADER FISCAL CONTEXT

Value added taxes (VATs) are generally regressive, since consumption accounts for a larger share of the incomes of low- to middle-income households than it does of higher-income households, who can afford to save a larger share of their income. One way to lessen the regressive impact of a VAT is to eliminate or “zero rate” the tax on essentials that make up a large share of the consumption of the poorest households, such as food. The degree to which exempting, or taxing, food affects the progressivity of a VAT varies from country to country based on factors such as the share of the population that relies on subsistence farming or informal trading that occurs outside of the tax system.

In 2016, Sri Lanka considered an increase in the country’s VAT rate, as well as removal of exemptions for telecommunications and health services. Researchers used consumer expenditure survey data to assess the impact of the proposed increase and found that the proposed revisions - the rate hike and elimination of several exemptions - did not significantly affect the regressivity of the country’s VAT and credited this to the fact that Sri Lanka exempts food products from the VAT.<sup>1</sup>

**Table 1: Inequality and Progressivity Measures Disaggregated at Population Quartiles<sup>2</sup>**

<i>Index based on expenditure</i>		<i>2011 VAT adjusted for 11%</i>	<i>2016 VAT adjusted for 15% with old exemptions list</i>	<i>2016 VAT adjusted for 15% with new exemptions list</i>
Gini	<b>National</b>	<b>0.393</b>	<b>0.391</b>	<b>0.394</b>
	1 <sup>st</sup> Quartile	0.299	0.298	0.299
	2 <sup>nd</sup> Quartile	0.242	0.241	0.242
	3 <sup>rd</sup> Quartile	0.249	0.247	0.249
	4 <sup>th</sup> Quartile	0.346	0.344	0.347
Theil	<b>National</b>	<b>0.288</b>	<b>0.283</b>	<b>0.289</b>
	1 <sup>st</sup> Quartile	0.163	0.161	0.163
	2 <sup>nd</sup> Quartile	0.106	0.104	0.106
	3 <sup>rd</sup> Quartile	0.115	0.113	0.115
	4 <sup>th</sup> Quartile	0.214	0.211	0.216
Kakwani	<b>National</b>	<b>0.135</b>	<b>0.134</b>	<b>0.136</b>
	1 <sup>st</sup> Quartile	0.082	0.081	0.082
	2 <sup>nd</sup> Quartile	0.055	0.054	0.055
	3 <sup>rd</sup> Quartile	0.058	0.057	0.058
	4 <sup>th</sup> Quartile	0.106	0.105	0.107

In 2009, Mexico also considered a VAT rate increase from 15 percent to 17 percent, as well as implementing a 2 percent tax rate on food and medicines, both previously untaxed. The government argued that the negative impact of taxing food and medicine would be offset by dedicating the revenues raised to cash transfer payments, targeted education spending, and health programs for the poor.<sup>3</sup> In this instance, researchers found that the tax proposal would disproportionately affect lower-income households, while the proposed expenditure increase would more than offset the negative impact of the tax increase on households in the bottom half of the income distribution. As a result, the combined impact of increasing a regressive tax and targeting the revenues raised on programs targeted on the poor was progressive. After considerable debate, Mexico increased the VAT rate from 15 percent to 16 percent, but rejected the tax on food and medicines. This analysis, however, demonstrates the value of examining tax and spending proposals within a comprehensive fiscal framework that considers both how revenues raised and how they will be spent.

**Table 2: Expenditure distribution per peso collected and spent in the proposal (Mexico)<sup>4</sup>**

<i>Income decile</i>	<i>Proposal's expenditure distribution 1/ A</i>	<i>VAT increase distribution 2/ B</i>	<i>Net transfer A-B</i>	<i>Federal government expenditure distribution 3/ C</i>	<i>Net transfer C-B</i>	<i>Combined Expenditure 80% proposal+20% states expenditure D=80% B+20% C</i>	<i>Net transfer D-B</i>
	100.00	100.00		100.00		100.00	
1	28.87	3.45	25.43	11.80	8.35	25.46	22.01
2	17.56	4.62	12.94	10.50	5.88	16.15	11.53
3	12.52	5.52	7.00	10.00	4.48	12.01	6.50
4	9.88	6.54	3.34	9.80	3.26	9.86	3.32
5	7.24	7.50	-0.26	9.40	1.90	7.67	0.17
6	7.60	8.78	-1.19	10.50	1.72	8.18	-0.61
7	5.45	9.89	-4.44	10.00	0.11	6.36	-3.53
8	4.37	11.65	-7.29	10.00	-1.65	5.49	-6.16
9	3.83	15.58	-11.75	8.90	-6.68	4.84	-10.74
10	2.68	26.47	-23.79	9.10	-17.37	3.97	-22.50

1/Following the expenditure distribution of column E in Table 6.

2/Given that this table only consider[s] the tax and expenditure at the margin, I am only considering the distribution of the tax burden increase. Note that this is different to the new VAT burden distribution show[n] in Table 3 where I consider not only the 2% increase.

3/As published in Minister of Finance (2010). This distribution is estimated using the same methodology that I am using in column A.

<sup>1</sup> P. Sivashankar, RMPS Rathnayake, Maneka Jayasinghe, and Christine Smith, "Incidence of Value Added Taxation on Inequality: Evidence from Sri Lanka" (Griffith Business School Discussion Paper Series No. 2017-04, Queensland, Australia, 2017). This study compared the Gini coefficient for households at different income quartiles before and after the revisions. A higher Gini coefficient indicates a more unequal distribution of income.

<sup>2</sup> Source: Sivashankar et al (2017), Table 5. Author's compilation using Department of Census and Statistics 2012 .

<sup>3</sup> Jaime Acosta-Margain, "Tax Benefit Incidence of Value Added Tax on Food and Medicine to Fund Progressive Social Expenditure" (Society for the Study of Economic Inequality, Working Paper 194, March 2011). <http://www.ecineq.org/milano/WP/ECINEQ2011-194.pdf> (accessed on 5 March 2018).

<sup>4</sup> Source: Acosta-Margain (2011), Table 5, ENIGH (2008) and Minister of Finance 2010

- What sectors and types of businesses benefit from investment incentives? Do domestic firms receive the same benefits as foreign firms? Do they go mostly to large, highly profitable firms, or do they benefit smaller businesses, as well?
- Does a tax expenditure benefit a very narrow constituency, or even a single taxpayer, or does it provide benefits to a large number of taxpayers sharing similar characteristics? Tax expenditures can be an appropriate tool for providing assistance

to a large number of taxpayers at relatively low cost, particularly if eligibility can easily be determined based on the tax form.

Provisions that benefit very few taxpayers can be prone to abuse and can undermine citizens' confidence in the fairness of the tax system as a whole.

### BOX 5: WHO BENEFITS FROM INCOME TAX DEDUCTIONS IN MEXICO?

Data provided in Mexico's annual tax expenditure report illustrates the disproportionate benefits received by the country's highest income taxpayers from a number of tax deductions.<sup>1</sup> The wealthiest 10 percent of taxpayers, for example, received 86.1 percent of the benefits of tuition deductions. Similarly, the poorest 70 percent of taxpayers received less than 5 percent of the benefit of mortgage interest deductions. In 2017 tuition deductions cost an estimated 2,752 million pesos (US\$144 million), while the mortgage interest deduction cost an estimated 8,797 million pesos (US\$460 million).

**Table 3: Personal income tax deductions by deciles, 2015**

Income Decile	Donations	Voluntary contributions for the pension system (SAR)	Special savings accounts	Compulsory school transportation	Insurance premiums for medical expenses	Medical and dental fees and hospital expenses	Tuition fees	Actual interests of mortgage loans	Funeral expenses
1	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
2	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.0%	0.1%
3	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%	0.1%	0.2%
4	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
5	0.1%	0.0%	0.1%	0.2%	0.2%	0.2%	0.2%	0.3%	0.2%
6	0.2%	0.1%	0.1%	0.2%	0.3%	0.4%	0.5%	0.7%	0.6%
7	0.5%	1.8%	0.5%	0.6%	0.7%	1.1%	1.2%	3.5%	1.6%
8	2.0%	7.2%	15.2%	1.4%	1.4%	2.8%	3.0%	15.7%	5.6%
9	4.9%	17.4%	36.0%	3.4%	4.6%	8.2%	8.7%	26.0%	14.9%
10	92.3%	73.4%	48.0%	93.9%	92.6%	87.0%	86.1%	53.5%	76.6%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Table 5, *Presupuesto de Gastos Fiscales 2017, Mexico*, page 38.

[https://www.gob.mx/cms/uploads/attachment/file/236020/PGF\\_2017.pdf](https://www.gob.mx/cms/uploads/attachment/file/236020/PGF_2017.pdf)

<sup>1</sup> *Presupuesto de Gastos Fiscales 2017* (Secretaría de Hacienda y Crédito Público, Mexico, 2017): 38.

[https://www.gob.mx/cms/uploads/attachment/file/236020/PGF\\_2017.pdf](https://www.gob.mx/cms/uploads/attachment/file/236020/PGF_2017.pdf) (accessed on 15 December 2017).

## Efficiency

Tax expenditures should be evaluated periodically to assess whether they are a cost-efficient means of achieving their stated goal. This process should consider not only the direct cost in foregone revenues but also government's costs for administering the tax expenditure under review and the taxpayer's cost in complying with eligibility and reporting requirements. This assessment should also consider whether a tax expenditure duplicates other government programs, and whether there are other more efficient or more transparent means to achieve similar outcomes.

What you should look for when evaluating the efficiency of a tax expenditure:

- The revenue loss attributable to a tax expenditure. Governments should report the actual cost in prior years, as well as the estimated cost in the current and future budget years.
- Evaluation reports that document both the cost (revenue loss) associated with a tax expenditure, as well as its social and economic benefits.
- The total cost of tax administration and, ideally, an estimate of the share of that cost attributable to tax expenditure administration.
- Information on “on budget” programs – programs supported through budgetary spending – that have similar goals to a tax expenditure, including the cost of these programs and information on associated social and economic benefits.

Questions to consider include:

- What is the cost of the tax expenditure in terms of foregone revenues? How does that cost compare to the intended outcome? For provisions that have job creation as a goal, for example, what is the revenue loss (cost) of each job added by the taxpayer?
- What are the social and economic benefits generated by the tax expenditure? Ideally, these benefits should be quantifiable, however, it may be desirable to consider less tangible benefits - such as the benefits to communities of increased homeownership attributable to tax deductions for mortgage interest.
- Particularly for investment incentives, is there an independent and rigorous review of costs and benefits? Is the provision comparable to, smaller, or larger than those offered by countries that may be competing for the same type of investment? Investment incentives are often criticized for creating a “race to the bottom” where countries compete to attract foreign investors. Regional cooperation can help

stem this problem by seeking to standardize tax policies among countries.

### **BOX 6: EVALUATING THE IMPACT OF INVESTMENT, PRODUCTION, AND EXPORT INCENTIVES IN MALAWI**

Special studies prepared by academic researchers, consultants to donor agencies, or other interested stakeholders can be a valuable source of information on the cost effectiveness and efficiency of various tax expenditures. A United Nations Development Program (UNDP)-supported study examined Malawi's incentive regime within a regional context and made a number of recommendations aimed at bringing the country's incentives into alignment with broadly accepted best practices.<sup>1</sup>

The report's recommendations included:

- consolidating the administration of incentives with that of the corporate tax system as a whole under the Ministry of Finance and Malawi Revenue Authority, rather than sector ministries;
- avoiding discretionary fiscal and financial incentives due to their opacity and the potential for abuse;
- gradually eliminating blanket incentives from the corporate income tax and ensuring that incentive policies are time-limited; and
- periodically measuring the effectiveness of incentives and moving towards performance-based incentives.

<sup>1</sup> PricewaterhouseCoopers Advisory Services Limited, "A Comprehensive Analysis and Review of Investment, Production and Export Incentives in Malawi" (Report submitted to the United Nations Development Programme, Malawi, 19 December 2016). [https://info.undp.org/docs/pdc/Documents/MWI/Final\\_report\\_%20Fiscal%20Incentives%2019-12-2016.pdf](https://info.undp.org/docs/pdc/Documents/MWI/Final_report_%20Fiscal%20Incentives%2019-12-2016.pdf)

- Does the tax expenditure duplicate or conflict with other public programs or policies? Where multiple policies have similar goals, are there alternative approaches for achieving the same outcome at a lower cost or with greater transparency and accountability?
- How likely is the recipient of a tax expenditure to have done the same thing in the absence of a tax incentive? This can be difficult to determine, but some evidence can be obtained by looking at the size of an incentive, general economic trends and practices, surveys of taxpayers, and other information.

### **Adequacy**

The primary purpose of a tax system is to raise sufficient revenue to support public services. Competing demands on scarce budgetary resources is an important consideration when evaluating whether a tax expenditure is of higher or lower priority than other public spending. A report prepared for the G-20 Development Working Group notes that, "\$1 of tax revenue has a higher social value than \$1 of private income, because it is the greater value of the public expenditure it finances that justifies transferring resources from public to private sectors through distortionary taxes."<sup>4</sup> Tax expenditures should be considered as part of an overall fiscal plan that takes into account

<sup>4</sup> "Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment: A Report to the G-20 Development Working Group by the IMF, OECD, UN and World Bank" (Washington, D.C., 15

October 2015): 10. <https://www.oecd.org/tax/tax-global/options-for-low-income-countries-effective-and-efficient-use-of-tax-incentives-for-investment.pdf> (accessed on 7 March 2018).

the full range of policies and programs that rely on the budget for support.

What you should look for when evaluating the impact of tax expenditures on the budget:

- Information on the overall fiscal condition of the government, including whether there is a budget surplus or a deficit.
- Competing demands on the budget, as well as how spending levels compare to global and regional standards and norms.

Questions to consider include:

- Are there other public priorities that are of equal or greater importance to the tax expenditure? How does public spending on education, infrastructure, health, and other programs compare to global and regional norms?
- Is there a sunset date or other mechanism for repealing a tax expenditure if a country's fiscal condition worsens?
- Are there ways to reduce the cost of a tax expenditure through more restrictive eligibility criteria, reducing its size, or other means?

## Case Study: Free Trade Zones in the Dominican Republic

Many countries provide tax incentives and other benefits to firms operating in specific parts of the country. In the Dominican Republic, incentives are provided through the country's *Zonas Francas Exoneradas* program. This program has often been cited as a successful example of the use of special economic zones and was credited with fueling economic growth in the 1980s and 1990s.<sup>5</sup> More recently, however, questions have arisen regarding the cost and the effectiveness of *Zonas* program. The following case study uses the criteria outlined above to examine the *Zonas* program based on information that is easily available online.

### What information is available?

The Ministry of Finance publishes an [annual tax expenditure report](#) that lists tax expenditures, their cost, authorizing statutes, and the benefit provided by sector. A description of the *Zonas Francas* program, including a mission and vision statement, is provided in the annual [budget act](#), along with the cost of program administration. However, the report does not provide the number or names of firms receiving benefits. Information on program benefits and eligibility

<sup>5</sup> Trade and Competitiveness Global Practice, "Special Economic Zones in the Dominican Republic: Policy Considerations for a More Competitive and Inclusive

Sector" (World Bank Group, Washington, D.C., November 2016).

requirements can be easily found in a [Quick Guide](#) to the program posted on the website of the government's Center for Exports and Investment. The government publishes a detailed [report](#) on the number of zones, types of activities conducted within zones, employment, and other information, but does this report does not discuss the cost of tax incentives or provide firm-specific information. The [budget act](#) includes a line item for data collection on the zone program as a whole. A quick survey identified a number of reports evaluating various aspects of the program, including a 2016 World Bank report that notes that while the amount of "value added" by *Zonas* firms has increased over time, there are also a number of weaknesses in the current program that could provide the basis for future reforms.<sup>6</sup> Several older reports, as well as recent media coverage, also discussed the wages and working conditions of workers in the zones.<sup>7</sup> These reports identify issues that could provide the basis for further research and policy reforms.

## What does the available information tell us?

Available information on the *Zonas* program paints a mixed picture. While there is evidence that the program has been important to the

Dominican Republic's economic development, the program is also costly, provides tax benefits that may be larger than necessary, and many of the jobs at firms that benefit from the program are low-wage jobs. While a substantial amount of information, including some in-depth research reports, is available, several key pieces of information are not available.

Available information includes:

- basic information, such as the cost of *Zonas Francas* incentives, the program structure, authorizing statutes;
- a description of how tax incentives are part of a broader strategy that is included in the annual budget act; and
- the government's annual report on the *Zonas Francas* program.

However, key pieces of information are not easily available, such as:

- the number and identity of firms receiving special tax treatment;

<sup>6</sup> See, for example, Trade and Competitiveness Global Practice, "Special Economic Zones" (November 2016); and José Caraballo Cueto, "Free trade zones, liberalization, remittances, and tourism for what?: Jobless growth in the Dominican Republic," *International Journal of Development Issues*, 15, no. 2 (July 2016): 181-200.

<sup>7</sup> Human Rights Watch, "Pregnancy-Based Sex Discrimination in the Dominican Republic's Free Trade Zones: Implications for the U.S. - Central America Free

Trade Agreement (CAFTA)," Briefing Paper (April 2004), [https://www.hrw.org/legacy/backgrounder/wrd/cafta\\_dr04\\_04.htm](https://www.hrw.org/legacy/backgrounder/wrd/cafta_dr04_04.htm) (accessed on 8 March 2018); and IndustriALL, "Workers in the Dominican Republic Free Trade Zones achieve historic increase in minimum wage," (12 September 2017), <http://www.industrial-union.org/workers-in-the-dominican-republic-free-trade-zones-achieve-historic-increase-in-minimum-wage> (accessed on 8 March 2018).

- information on the size and annual income of firms receiving special tax treatment; and
- specific metrics for measuring success and statutory requirements for firms receiving special tax treatment to meet specified goals.

Using the criteria described in the framework above, a number of policy issues can be identified. These issues can serve as the basis for more in-depth research and/or development of reform proposals. Issues warranting further attention include:

- **The size of the tax reduction provided by zone incentives:** the *Zonas Francas* program provides a 100 percent exemption from the constitution tax, taxes on construction and real estate, customs tariffs, and the tax on transfer of Industrialized Goods and Services (ITBIS) for 15- and 20-year periods.<sup>8</sup>
- **Administrative discretion:** the program includes discretionary elements, such the *Zona Franca Especiales*, that grant administrative discretion over the awarding of benefits.<sup>9</sup>
- **Job quality and impact on domestic businesses:** the World Bank research identified areas of potential concern, such as the prevalence of low-skilled jobs generated; lack of linkage between firms operating in the zones and domestic businesses; a decline in inflation-adjusted zone wages in certain sectors and occupations; the potential for slowing employment growth; and the potential for zone firms to displace domestic producers.<sup>10</sup>
- **Projected budget shortfalls:** the [projected budget](#) for 2018 forecasts a deficit equal to 2.2 percent of the country's gross domestic product. The projected shortfall is approximately equal to the actual deficit experienced in recent years. Interest on the public debt accounts for 19.5 percent of projected 2018 expenditures (RD\$134,634 million), which is nearly twice the amount budgeted for health (RD\$78,219 million) and just slightly less than the budget for education (RD\$161,051 million).
- **High program cost:** the Dominican Republic's [tax expenditure budget](#) estimates the total cost of tax expenditures at RD\$231,125 million in 2017. The *Zonas Franca* Industrial program accounts for an

<sup>8</sup> Centro de Exportacion e Inversion de la Republica Dominicana, "Mapa Ruta del Inversionista Guía Rápida Sector Zonas Francas de Exportación" (no date). [http://www.cei-rd.gov.do/mapa\\_ruta/MRI/presentacion/web/pdf/zonasfrancas/zona-franca.html](http://www.cei-rd.gov.do/mapa_ruta/MRI/presentacion/web/pdf/zonasfrancas/zona-franca.html) (accessed on 30 October 2017).

estimated RD\$39,690 million, which is approximately equivalent to half the health budget (RD\$78,219 million).

This example illustrates the challenge of classifying tax expenditures as either “good” or “bad.” On the one hand, firms participating in the Dominican Republic’s zone program account for a sizeable share of the nation’s exports and a significant number of jobs (approximately 140,00 in 2014, according to the World Bank study cited above). While there are specific gaps - such as the lack of firm-specific data - basic information is readily available online. At the same, available research suggests a number of potential concerns that, taken together with the program’s substantial annual cost, suggest the need for review and reform.<sup>11</sup>

## For more information

There are a number of “best practices” guides to tax expenditure reporting and evaluation.

For more information, see:

- Inter-American Center of Tax Administrations publishes a *Handbook of Best Practices in the Measurement of Tax Expenditures: an Ibero-American Experience* (2011), available at <https://www.ciat.org/tax-expenditures/?lang=en>

- International Monetary Fund, “Options for Low Income Countries’ Effective and Efficient Use of Tax Incentives for Investment: A Background Paper to the Report to the G-20 Development Working Group by the IMF, OECD, UN and World Bank” (15 October 2015), available at <https://www.imf.org/external/np/g20/pdf/101515a.pdf>
- U.S. Government Accountability Office, “*Tax Expenditures: Background and Evaluation Criteria and Questions*” (28 November 2012), available at <https://www.gao.gov/assets/660/65037/1.pdf>
- Organisation for Economic Co-operation and Development, “Principles to Enhance the Transparency and Governance of Tax Incentives for Investment in Developing Countries” (no date), available at <http://www.oecd.org/ctp/tax-global/transparency-and-governance-principles.pdf>

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<sup>11</sup> Comisión Interinstitucional Coordinada por la Dirección General de Política y Legislación Tributaria, “Gastos tributarios en República Dominicana Estimación para el Presupuesto General del Estado del año 2017” (Ministerio de Hacienda, Republica Dominicana,

Septiembre 2016): 19. <https://www.dgii.gov.do/informacionTributaria/publicaciones/estudios/Documents/GastoTributarioRD2017.pdf> (accessed on 8 March 2018).

*California Budget Project (renamed the California Budget and Policy Center) and has also worked on tax policy in government and philanthropy.*

*The goal of the LATERAL project is to support civil society work to increase the transparency, equity, and accountability of tax expenditure policies at the country and regional levels in Latin America. Through LATERAL, the International Budget Partnership, partnering with ten Latin American civil society organizations (CSOs), seeks to promote policy reform by shedding light on the impact of tax expenditures on inequality across the region, raising public awareness of the importance of the issue, and pursuing a coordinated advocacy effort both within individual countries and at the regional level.*

*LATERAL is an innovative, collaborative research, capacity building, and advocacy initiative launched by IBP and CSO partners in 2016. With coordination and assistance from IBP, our ten civil society partners have undertaken analyses comparing tax expenditure policies and practices across the region, and examining the impact of these policies and practices on inequality. The LATERAL project has built an energized regional community, where CSO members learn from and help each other improve research, advocacy, and communication around tax issues.*

*The LATERAL project partners are:*

- *ACIJ - Asociación Civil por la Igualdad y la Justicia (Argentina)*
- *CAD - Ciudadanos al Día (Peru)*
- *Dejusticia (Colombia)*
- *ICEFI - Instituto Centroamericano de Estudios Fiscales (Guatemala)*
- *INESC - Instituto de Estudos Socioeconômicos (Brazil)*
- *ISD - Iniciativa Social para la Democracia (El Salvador)*
- *Fundación Solidaridad (Dominican Republic)*
- *Fundar - Centro de Análisis e Investigación (Mexico)*
- *Grupo Faro (Ecuador)*
- *Sonora Ciudadana (Mexico)*