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Topic 1.2

TAX EXPENDITURE: HOW TO MEASURE THE EROSION OF THE TAX BASE

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Case study

TOPIC 1.2 **TAX EXPENDITURE: HOW TO MEASURE THE EROSION OF THE TAX BASE**

Luiz Villela
Tax Specialist - Economist
Inter-American Development Bank
(IDB)

1. TAX INCENTIVES

The main objective of tax systems should be that of collecting the resources to finance government spending on a more efficient basis, as well as ensuring the equitable distribution of the tax burden. Governments still frequently avail themselves of tax systems to promote specific policies.

For a long time it has been a usual policy, in developed as well as developing countries, to grant tax incentives with different policy objectives such as, for example, the promotion of exports or foreign direct investment (FDI).

These incentives may be defined as those that, by reducing the tax burden companies are faced with, contribute to modify their behavior by encouraging them to invest in certain sectors or regions. They may be considered exceptions to the general tax regime. International research (UNCTAD, [2000]) shows that the reductions in the income tax rate and exemptions or tax holidays, are the most frequently granted tax incentives. They are followed by the reduction in machinery, equipment and indirect materials import duties; duty drawback systems; accelerated depreciation regimes; specific deductions for certain income from the income tax payment; deductions on reinvestment and reduction in social security contributions.

In developing countries, specifically, commercial policies have been replaced by tax incentives to attract foreign direct investment (Villela, Barreix [2002]). It seems clear that the role of these instruments is secondary, less relevant than factors such as the market size, infrastructure and country risk. The point has been and still is the object of numerous research efforts, and the strengths and weaknesses of tax incentives are still not clearly defined, since remarkable success stories are known, but also outright failures.

2. EXPORT INCENTIVES

Exports incentives have lost importance significantly, based on different reasons:

(i) because they are incompatible with and contrary to economic integration processes in which countries from Latin America and the Caribbean participate (CAN, CARICOM, MCCA and MERCOSUR), to the extent they introduce distortions in competition conditions;

(ii) although said agreements allowed the implementation of extra-market export incentives, the different tax responsibility programs have tended to reduce them;

(iii) the penalties applied by the importing countries following the rules of the World Trade Organization (WTO) also contributed to reinforce the reduction of these incentives.

On the other hand, given the current consensus on the fact that taxes may not be exported, the refund of indirect taxes paid in stages prior to exports may no longer be considered an incentive. The WTO allows the refund of said indirect taxes, provided the tax burden may be accurately calculated at the time of exporting.

3. INVESTMENT INCENTIVES

3.1. Regional Incentives

Incentives to the less developed regions are typical of countries with large extensions of land. Argentina, Brazil, Chile and Peru, for example, feature incentive programs for the development of certain regions: Tierra del Fuego and "Less Developed Provinces" -San Luis, Catamarca, La Rioja, San Juan and certain areas in Mendoza- in Argentina, Manaos, Amazonia and Northeastern Brazil, Inhospitable Areas (South and North) of Chile and the Peruvian Amazonia.

Incentives of this kind tend to be implemented in regions with comparative disadvantages given their distance from the main urban areas. Activities in these regions generally imply higher transportation and communications costs, which increase production and distribution costs. They may even imply additional costs to relocate labor in the region, which will call for higher salaries to move people to a region that lacks the services of urban areas.

International experience indicates that the first best is that the government develops the infrastructure in the area. As second best, the government could reward the investor for the cost of infrastructure development and training employees from the region, with employment subsidies instead of income tax reductions.

3.2. Incentives for Sectors

Certain countries, especially Asian, grant tax incentives –or of another nature- to investment in certain sectors, considered strategic for development. These incentives are more of an industrial policy instrument, that is to say, they pursue the development of certain activities, and not so much investment incentives, specifically, foreign direct investment.

The implicit rationale in the granting of incentives to sectors considered strategic is to overcome the market's failure to reflect future income stemming from the drop in unit costs in line with the sector's development. In time, with the increase in production, unit costs drop and the country gains a comparative advantage with the development of the benefiting industry. This is the classic argument to warrant protection of infant industry.

In order to be effective, these incentives must be directly geared at small companies in the middle of their expansion process, which generally lack access to credit markets, and must be appropriately selected: for example, reductions in the income tax rate or tax holidays are less efficient than fiscal credits that provide financing in advance.

Most of the tax incentives for sectors granted by developing countries are linked to the investment in the manufacturing industry, mining industry and, increasingly, tourism and related services.

Costa Rica, for example, applies tourism incentives for hotels, tourist transportation, travel agencies and car rentals. Singapore grants income tax for a 5-year term to companies that operate in less developed sectors of industry. The cases of Malaysia, Singapore and Philippines are exceptional in the sense they offer income tax reductions to services companies, a sector where this type of incentive is uncommon in developing countries.

International experience indicates that it is very difficult to succeed in developing this incentives' program. If the regime is discretionary, it becomes vulnerable to political pressure, lobbies and grafts, and if the regime is discretionary as well as automatic, bad decisions may be made in the selection of the beneficiary sectors, as was the case of Korea 15 years ago.

4. RESEARCH AND DEVELOPMENT (R&D) INCENTIVES

One objective of investment incentives tends to be the pursuit of technology transfer. Singapore and Malaysia, for example, have developed an incentives' program geared at research and development efforts and technological project. The tax benefits normally granted are: tax credit for R&D spending and employee training, deduction of payments for technical assistance and patents' use authorizations, and exemption from taxes on imports of machinery, equipment and instruments.

5. INCENTIVES AND TAX BENEFITS

In addition to the tax incentive with the aim of promoting a change in companies' behavior, tax systems also serve the purpose of providing assistance to taxpayers.

Every incentive implies a benefit, but not every benefit entails an incentive, even if both result in revenue losses, to the extent their outcomes are intentional measures to render financial assistance to taxpayers by means of a reduction in their tax liability. Incentives may be defined as benefits aimed at modifying economic agents' behavior equation with the ultimate purpose of increasing investment in certain sectors or regions, or obtain an increase in exports, etc. On the other hand, a benefit such as health expenses deductible from income tax, for example, is certainly not an incentive (to make people ill), but a form of financial support (indirect) for taxpayers.

6. TAX EXPENDITURES

The tax expenditures concept was used for the first time in 1967 by Stanley Surrey [Pathways to Tax Reform, 1973], at the time he was Assistant Secretary for Tax Policy at the Treasury Department of the United States. Surrey pointed out that deductions, exemptions and other benefits granted on income tax were not part of the inherent structure in the tax and were truly, government spending made through the tax system in lieu of direct spending, through budget items. That is why he called them Tax Expenditures.

This approach to fiscal benefits, such as expenditures compared to budget spending but granted through the tax system, was a novelty. The analysis of the tax expenditure stems from the principle that any tax is made up by two components:

(i) that which covers all the legal provisions that form the regulatory structure of a tax;

(ii) the special provisions that represent a deviation from the regulatory structure.

The former are indispensable in the definition of the tax itself: taxable event, taxpayer, taxed goods, rate structure, payment conditions, jurisdiction, additional taxpayers' obligations, necessary by virtue of tax administration purposes, or international agreements.

Special provisions, on the other hand, are deviations from the regulatory structure as defined and seek to serve government objectives that are unrelated to taxes. These are fiscal benefits in the broad sense of the term; that is to say, they include tax incentives and benefits that are not incentives. Tax expenditures may derive from exclusions, exemptions, deductions, credits, preferential rates or deferment of the tax liability payment.

Tax expenditures may frequently not be efficient, effective or equitable, which is the reason why information on those features may help policymakers to make more informed decisions on their use.

6.1. Difficulties in Determining Tax Expenditures

Even on a theoretical basis, it is difficult to determine which provisions are deviations in the regulatory structure of a tax. It may be analyzed through situations about which different opinions may apply:

- If a VAT exemption is applied on the sale of certain food supplies, it may be considered that the tax is meant for advancement purposes, to the extent that these food supplies have a more relevant role in the family-shopping basket of lower-income individuals. But, in turn, if the exemption were considered a preferential treatment for certain individuals, it would become tax expenditure.
- On the other hand, it seems clearer that if the VAT rate structure evidences a general rate and a preferential rate, the latter applicable to products that make up the family shopping basket, it is the tax definition itself which sets forth this rate structure and therefore, the loss of revenue implied in not taxing basic food supplies at the general rate is not tax expenditure.
- There is frequently a disregard on the part of sub-national governments in their tax collection efforts, to the extent that federal government revenue sharing provides them with the necessary resources to operate. The basic tax structures of the taxes collected by said local governments are perfectly defined and there are no special provisions to the contrary. Then, should the loss of revenue described be deemed tax expenditure?
- Some time ago, indirect taxes' refunds paid by exporters in the production process of the good to be exported could be considered an exports' incentive and, therefore, the fiscal cost attached to this refund was tax expenditure. Nevertheless, after the consensus reached as to the fact that taxes cannot be exported, it is difficult to sustain the standing that it is tax expenditure.
- In the case of selective taxes since the tax by definition is only applied on certain items, loss of revenue for the ones excluded would not be deemed tax expenditure. Certain selective taxes, such as alcoholic beverages and cigarettes, are used as regulatory taxes; that is to say, regulations are introduced via the tax system instead of direct regulation. Therefore, any non-taxed transaction would probably represent an area that was not meant to be governed by regulations.

There are different methodologies to estimate tax expenditures. The loss of revenue method is an *ex post* manner to calculate the amount the government failed to collect based on the benefit. The method does not consider taxpayers' behavior reactions before the measure. Therefore, the tax expenditure for a tax credit is exactly the value thereof and for a deduction, its value times the marginal rate.

The revenue profit method is an *ex ante* form of calculation that considers the additional collection that would stem from the rejection of the legal provision that generates the tax expenditure. In this case, possible taxpayer's behavior reactions are considered, which calls for a good database and knowledge as to flexibilities (income, price and substitution). It is not an easy task.

The third methodology is that of equivalent expenditure, which attempts at estimating direct budget spending that would be required to render an equivalent taxpayer benefit or profit.

If determining and quantifying tax expenditures is theoretically difficult, it is even more so to make a comparison among countries. Tax regulations are determined differently in each country, and so are the deviations from the regulation, rendering international comparisons difficult (or rather, purposeless).

Therefore, any comparative analysis of the available measurements for tax expenditure must be very conservative. An additional problem arises in countries with a federal structure such as the Untied States of America, Argentina and Brazil, to estimate the tax expenditure of sub-national governments –provinces and states, respectively-. In the majority of the countries of the world, including federal ones, tax expenditures' estimations are only available for the central or (federal) government.

Maybe a way of making comparisons and relative measurements of tax expenditures instead of looking at other countries may be to consider historical series within the country itself and/or making comparisons with other macroeconomic indicators such as public spending, fiscal deficit and collection.

6.2 Tax Expenditures' Strengths and Weaknesses

Among the positive aspects of implementing tax expenditures the following may be outlined: 1) promoting private sector participation in social and economic programs, where the government generally plays a leading role; 2) promoting the private decision process, delegating initiatives and choices to private players; and 3) reducing the government involvement need in the implementation of certain government spending programs.

The negative aspects are generally linked to inefficiencies, inefficacies and inequalities. They are frequently inefficient when they answer the interests of specific groups with sufficient political power and fail to generate additional investment. They are frequently ineffective since they lack the capacity to counter the underlying economic conditions or being annulled or mitigated by other tax provisions, domestic or external. They are unfair in general terms, whether because they benefit taxpayers' who pay that tax – and not all citizens- and also regressive since they change tax burdens, from the vertical as well as horizontal standpoint.

Other negative effects are, in practice, the "open" public spending programs, concealing the true size of the State, and the unnecessary complexity of tax systems, paving the way for opaque rules, elusion and evasion.

Maybe, one of the most serious negative impacts is the erosion in tax bases, with the resulting increase of taxes for non-beneficiaries of the "benefits" and/or hindrance in fiscal balance and macroeconomic stability.

6.3. Tax Expenditures' Reports or Budgets

These are reports that countries prepare for the purpose of fiscal transparency and the quest for the efficient allocation of government resources. Formats based on "patterns" are not available to file these reports. In general terms, they describe tax regulations, legal power to deviate from regulations; the grounds or rationale to enjoy the benefit; and the revenue loss estimates.

The classifications employed in these reports also vary, and depend on the availability of data and the policymakers' needs. In general, countries classify tax expenditures according to budget functions to facilitate comparison with direct spending. Productive sectors and regions are also frequently used, in addition to type of tax, beneficiaries and purpose. There are countries considering the tax expenditure estimation based on income decile of beneficiary taxpayers.

In the majority of the countries that draft said reports, a legal provision exists for that purpose, but some do it based on Parliament's sole interest in better evaluating government revenue decisions and spending. According to a World Bank study in [2004] based on data for 10 OECD countries, Canada, United Kingdom, and Netherlands do so without a legal provision. In Austria, Belgium, France, Germany, Netherlands and United States, they are documents attached to the budget, while in Australia, Canada and United Kingdom, they are separate documents.

As to the frequency, in eight out of the ten countries it is annual, only occasionally in Italy and biannual in Germany. The ten countries employ the revenue loss method, and only the United States additionally uses the equivalent expenditure method.

The reports from Austria and Italy are the only ones to consider the national and local government levels. The rest only take into account the central or federal government level. As to the taxes considered, the Tax Expenditures reports from these 10 countries include the main sources of revenue, which entail, among others, income tax and VAT, except for the USA.

6.4. Tax Expenditures in the USA

A recent study from the US Government Accountability Office GAO [2005] allows us to perform a very good assessment of tax expenditures' evolution in the last 30 years, in value, number and compared to income, expenditures and GDP.

The estimations of tax expenditures in the USA are carried out by the Office of Tax Analysis of the US Department of the Treasury as well as the US Congress Joint Committee on Taxation. The estimations from both institutions differ, but are not significant overall, in the number of Tax Expenditures as well as regarding their value. They are considered income taxes for individuals and corporations, as well as inheritance taxes and social security contributions. The great majority of tax expenditures are included in Income Tax, especially on individuals.

Treasury estimations are incorporated on an annual basis as supplementary information to the Federal Budget. The estimation of revenue loss is performed separately for each one of the Tax Expenditures individually, comparing the income obtained according to current legislation and that which would apply in case the provision was not in effect, assuming that all the other provisions in the tax code would remain constant and the taxpayer's behavior would not change. Since the estimation does not consider taxpayers' behavior-based reactions (flexibilities, for example), it does not necessarily represent the revenue amount that the administration would collect in case the provision was rejected.

In addition to the estimated revenue loss, the Treasury estimates tax expenditures based on equivalent expenditures, in other words, the amount of budget spending required in case the government decided to provide the taxpayer the same amount of net revenue (after tax) that it receives according to tax expenditures. This form of estimation, in general terms, produces higher values than those for revenue loss. The GAO study indicated that the estimated tax expenditures based on equivalent-expenditures have remained reasonably stable around 7.5% of GDP in the last 10 years.

The disaggregated and independent form of estimation of each tax-expenditure may lead to arguments as to the overall amount. This is a methodological problem of tax expenditures' measurement that all countries are faced with, and mandate a conservative interpretation of the results added, since it does not consider the interactions that may exist according to the different legal provisions that generate tax expenditures. That is why neither the Treasury nor the JCT make an aggregation and do not submit the total amount of the different tax expenditures.

The United States have been performing systematic estimations of tax expenditures since 1974, and since then and until 2004, their number has increased from 67 to 146, with some that expired or were rejected and others that were created. In that same period, the total revenue loss has increased from US$240 billion to US$730 billion in constant dollars.

The 14 main tax expenditures accounted for 75% of the federal revenue loss in 2004. The greatest amount of tax expenditures is relative to benefits to individuals (89%). The main areas that benefit are housing (22%), health (14%) and pensions (13.1%).

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