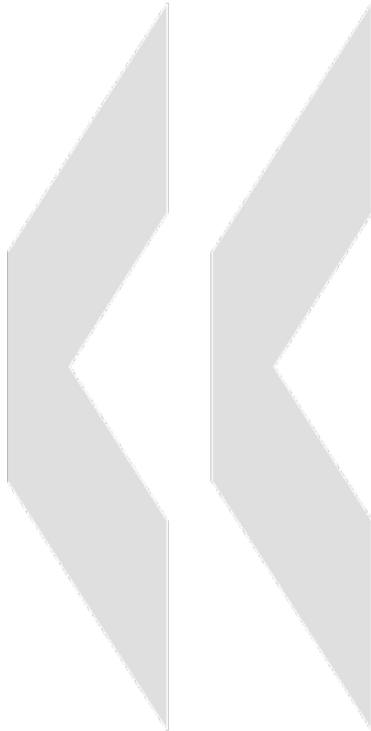




ORGANISATION FOR ECONOMIC  
CO-OPERATION AND DEVELOPMENT



# TAX EXPENDITURES IN OECD COUNTRIES

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**CED**

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# Introduction



Repeated thanks to my colleagues from the countries included in this research project.

All responsibility for statements in this paper rests with the author.

Thanks also to the OECD staff for their work with my computer document.

# Outline of the Paper

- **Definition of Tax Expenditures (TE)**
- **Reasons for and Advantages of TE**
- **Potential Adverse Effects of TE**
- **Causes of Growth in TE**
- **“Best” Practices for the Process of Considering TE**
- **The Budget Process and TE**
- **Fiscal Rules and TE**
- **Quantitative and Data Analysis**

**Numerical comparisons of tax expenditures across countries may attract attention, but they have profound limitations.**

**This is a pragmatic paper. Its goal is not so much to find definitive answers as to find good and useful questions.**

Consideration of process options may be more rewarding than numerical comparisons. However, no process options offer guaranteed success.

# Definition and Measurement

The literature emphasizes the choice of a **benchmark**.

- If a consumption tax benchmark is chosen, any taxation of capital is a negative TE (a “penalty”).
- If the benchmark taxes only of **real** capital income, then failure to adjust for inflation is a negative TE.
- But in practice, no country uses a consumption tax benchmark, or a benchmark fully corrected for inflation.

But there are much more subtle differences.

## Examples of subtle benchmark issues:

- Japan and Korea, for example, use very broad, almost undefined benchmarks. There appear to be more provisions that are exceptions, and thus defined as TE.
- In contrast, the Netherlands' benchmark implicitly is the “primary structure” of the tax system in place, which appears to yield fewer “exceptions,” or TE.
- So one question is, “Does Country A list TE that we believe are not TE?” But another is, “Does Country B *not* list a provision that we would think *is* a TE?” That question requires study, not of the list of TE, but of the entire remainder of the tax system.

# Definition and Measurement

There is also attention in the literature to the choice of a **measurement methodology**: initial revenue loss versus final revenue loss versus outlay equivalence.

- But again, in practice, every country uses the initial revenue loss (“revenue forgone”) method.
- The literature says that the final revenue loss method – which accounts for effects on behaviour – is preferable. In practice, however, this method is unworkable – precisely because accounting for behaviour is very difficult, and there is no single correct estimate.
- Some argue for outlay equivalence estimates, for the greatest comparability to spending programs. However, again because of complexity, only one country (Sweden) provides such estimates as supplementary information.

# Definition and Measurement

In sum, at this stage of the analysis – considering that we are looking only at tax expenditures, not at the entire tax system – the purpose of the data exercise in this paper is not to find answers. It is, rather, to find useful questions.

# Measurement and Review

Is the quality of measurement of TE comparable to outlay measures?

- Virtually every country would answer, “No.”
- In large part, this is the “might-have-bean” problem.
- It is also a question of priority in busy budget seasons.
- And why labour over revenue-forgone TE, which are not revenue estimates anyway?
- But even mandatory spending program review can be haphazard.
- Some countries are very unhappy with their TE review (or lack thereof). French law requires reviews, but they are reported to be pro forma. Of the 89 percent of TE that are estimated, France identifies 47 percent as “approximations” (as opposed to 24 percent “very good” and 29 percent “good”). But...
- France and others have begun systematic review procedures.
- Starting in 2004, the Netherlands will review every TE at least once every five years – jointly by MoF and a spending department.
- Germany will have independent research organizations review the 20 largest TE (nearly 92 percent of the total).

# Reporting

There are several important issues in the reporting of tax expenditures.

- Where? Should be in the budget with outlays, but no country does that; “beans” versus “might have beans.” Also, is it politically realistic to eliminate a TE, collect more taxes, and raise spending?
- Is reporting required? How often? Covering how many years?
- Covering all central government taxes? (Absence of measurement does not mean that there are no TEs.)
- Covering all levels of government, or central government only? (Ditto.)
- Presenting “memorandum items,” or not?

A universal problem: Some data resources (for TEs reported on income tax returns) are better than others (for VAT TEs, for example).

Some countries have strict reporting requirements, but have done poorly (United States, France). Other countries have weaker reporting requirements, but have done better (Canada).

# Reasons for and Dangers of TE

**The goal of this paper is a balanced, pragmatic approach.**

**A tax expenditure may be the best, or even the only, feasible way to pursue an important policy objective. There are legitimate reasons for some TE. TE are not going away.**

- **Administrative economies of scale and scope.**
- **Useful when limited probability of abuse or fraud.**
- **Can provide a wide range of taxpayer choice, with limited bureaucratic interference.**
- **Can help in measuring taxpaying capacity.**
- **Can ease tax administration. But...**

# Reasons for and Dangers of TE

- **Tax expenditures can be politically tempting**
  - No measured spending AND lower taxes
  - That is, more government activity from a SMALLER measured government.
- **Not subject to regular scrutiny**
  - TEs not even reported or estimated in some countries
  - Tax law is typically permanent
  - “Beans ” versus “might-have-beans”! Limited transparency
  - Possible unfair distributional effect.
- **Can be advantaged in the legislative process**
- **Repeal of a TE can be portrayed as a tax increase**

# Reasons for and Dangers of TE

**Are tax expenditures necessarily bad?**

**The role of the benchmark.**

**The role of practices of review.**

**Note that spending programs are often poorly reviewed as well – the concept of “uncontrollable spending.” Tax expenditures are not necessarily reviewed any less effectively.**

# The Budget Process and TE

- **Measured** TE are an imperfect target for a budget control strategy.
  - The initial revenue loss method (used by all countries) does not account for taxpayer behavior, and estimates of individual TE are not additive.
  - TE interact with each other in varying ways.
  - Faster income growth could push taxpayers into higher tax rate brackets, increasing measured TE even if the underlying law does not change.
  - TE can evolve through changes in taxpayer practice or tax regulations, even without legal action.
- On the other hand, individual TE **policies** should be candidates for action to reduce deficits along with all other government policies, including spending programs and structural tax features.
  - Thus, TE should be a part of efforts for fiscal consolidation.

# Fiscal Rules and TE

- Deficit or Debt-based rules
  - Cover TE but are inherently pro-cyclical
  - Easy to ignore in good times; enforcement can be unthinkable in bad times
- “Spending”-based rules
  - Inherently counter-cyclical, but to be effective must include revenues [and TE]
  - PAYGO is a method to do so
  - If spending rules don’t include TE, they provide a way to avoid fiscal restraints

# Institutional Research And Analysis – Some Answers

How much of the recent growth of TE is accounted for by “Make Work Pay” provisions? Not much.

- Few countries in this sample enacted “M-W-P” TE recently. Japan and the Netherlands have no such provision.
- Korea just enacted a “M-W-P” TE, but it has not yet begun to function.
- Canada very recently restructured its “M-W-P” TE, but no longer counts it as a tax expenditure.
- Countries report “M-W-P” TE differently. France considers its TE to be a tax program. The U.S. and U.K. divide the EITC between outlays and revenue reduction. Sweden’s EITC is not considered a tax expenditure at all. Germany’s program is identified as spending.
- So recent increases in measured TE do not appear to be due to “M-W-P” TE. Concern about their efficiency is still warranted, but some countries probably would have outlay programs if not “M-W-P” TE.

# Institutional Research And Analysis – Some Answers

To what degree are TE integrated into the budget process?

- Some have no role for TE, or even taxes more broadly, in their budget processes. (Canada has a non-binding spending cap.)
- Sweden had a spending cap but no control on TE. Numerous “spending” programs were enacted as TE writing tax-credit checks directly to beneficiaries. The budget deteriorated as a result. Sweden reformed its system, and repealed those TE, or reenacted them as spending programs. Sweden’s new budget system restrains TE the same as spending programs, with a cap adjustment.
- France has constitutional constraints on spending proposals that could similarly make tax expenditures easier to enact.
- Each new government in the Netherlands establishes a “coalition agreement,” which over several iterations is reported to have become an effective discipline on the budget in general and TE in particular. The latest coalition agreement limits TEs.

# Institutional Research And Analysis – Some Ideas

To what degree are TE integrated into the budget process?

Some interesting ideas...

- Canada had an “envelope system,” which gave the line agencies a single sum that could be used for TE or spending – each agency had to allocate their money between the two in the budget. It worked for a while, but then was abandoned; it was not perceived to have worked evenhandedly, or to have controlled TE.
- Korea and Japan both require sunsets for all TE (France recently). Korea’s number of TE has dropped significantly over the last five years – but Korea is not pleased with its system, because over a longer period, TE are up. (The U.S. experience with sunsets is not encouraging – but the U.S. does not sunset ALL tax expenditures.)
- The U.S. auctions off subsidy tax credits for low-income housing; any excessive richness in the credit is recaptured through the price.
- Could these systems be implemented more effectively?

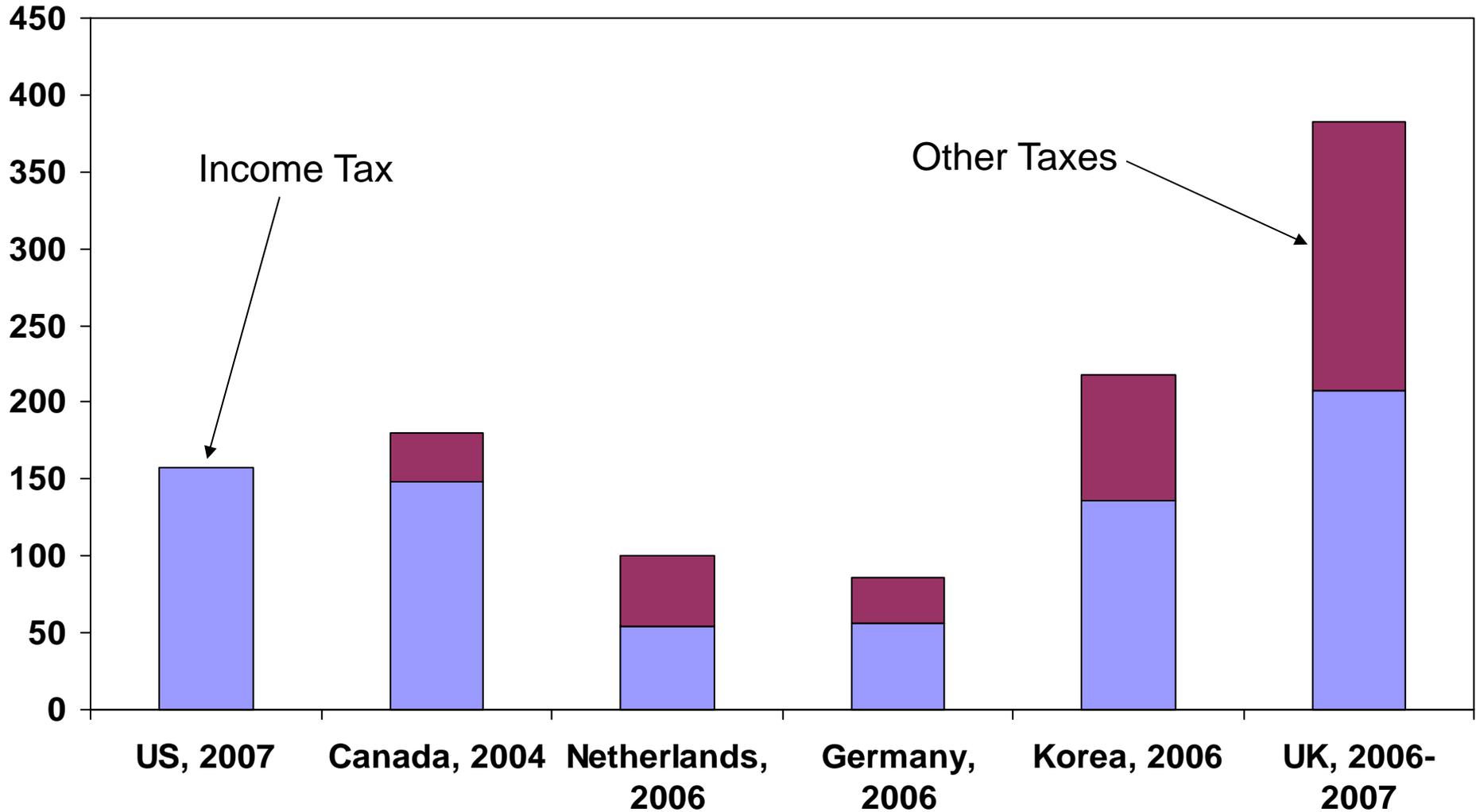
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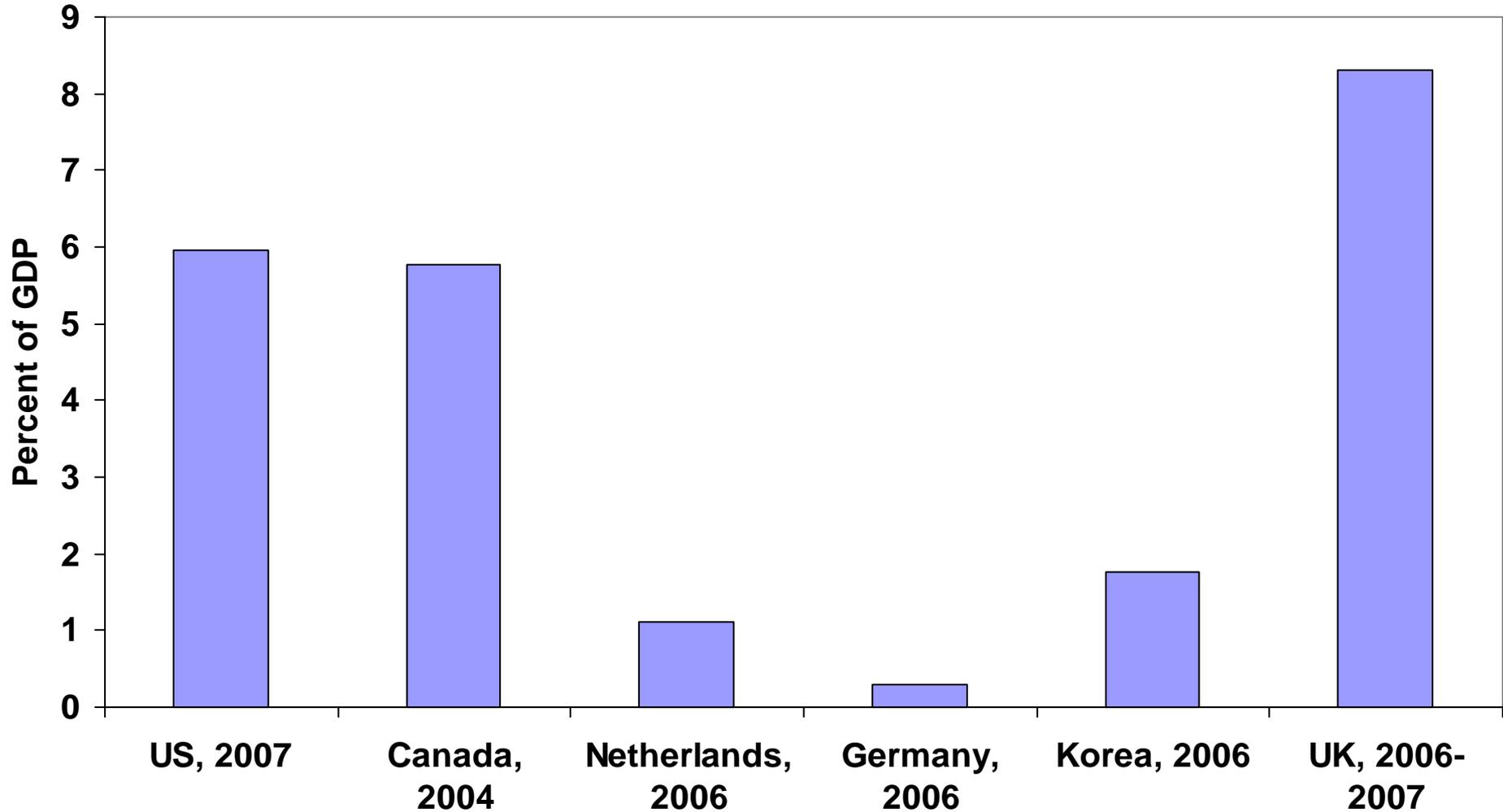
Some interesting ideas...

- Germany requires (non-binding) that each TE be phased down in law, and that TE be converted to outlay programs if possible.
- France now caps tax credits (with exceptions) for each taxpayer.
- Korea requires by law that the sum of all tax expenditures grow at a maximum 0.5 percent over a three-year moving average. (Question whether this excessively enshrines measured TE, and their sum, for policy purposes.) France has a new non-binding limit.
- The United States had a “paygo” system, which worked for a while...
- Korea has just enacted a similar “paygo” system.
- Should there be regulatory (e.g., paperwork) impact statements?
- Show how much tax rate reduction could be financed by a TE?

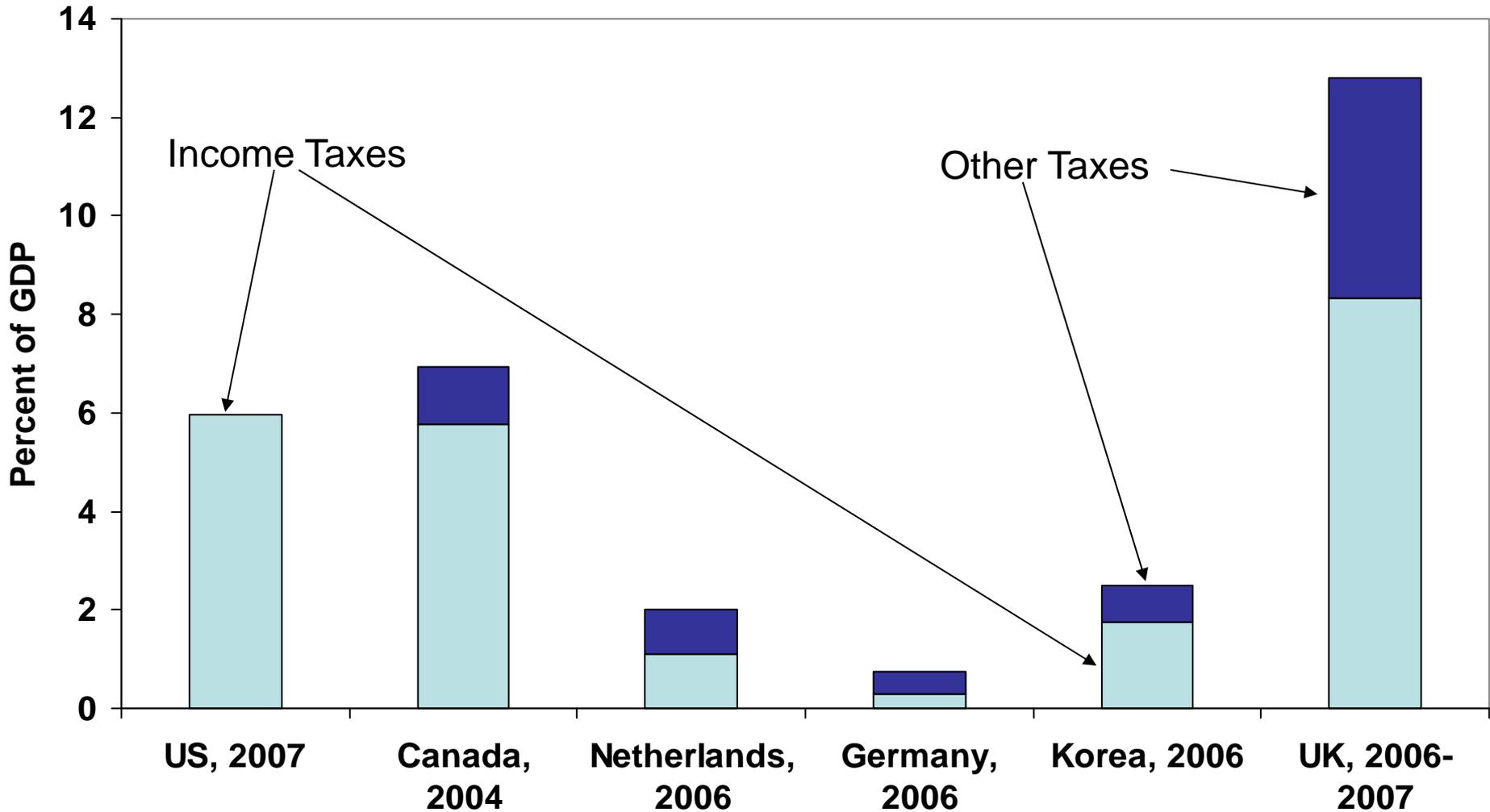
# Number of Tax Expenditures



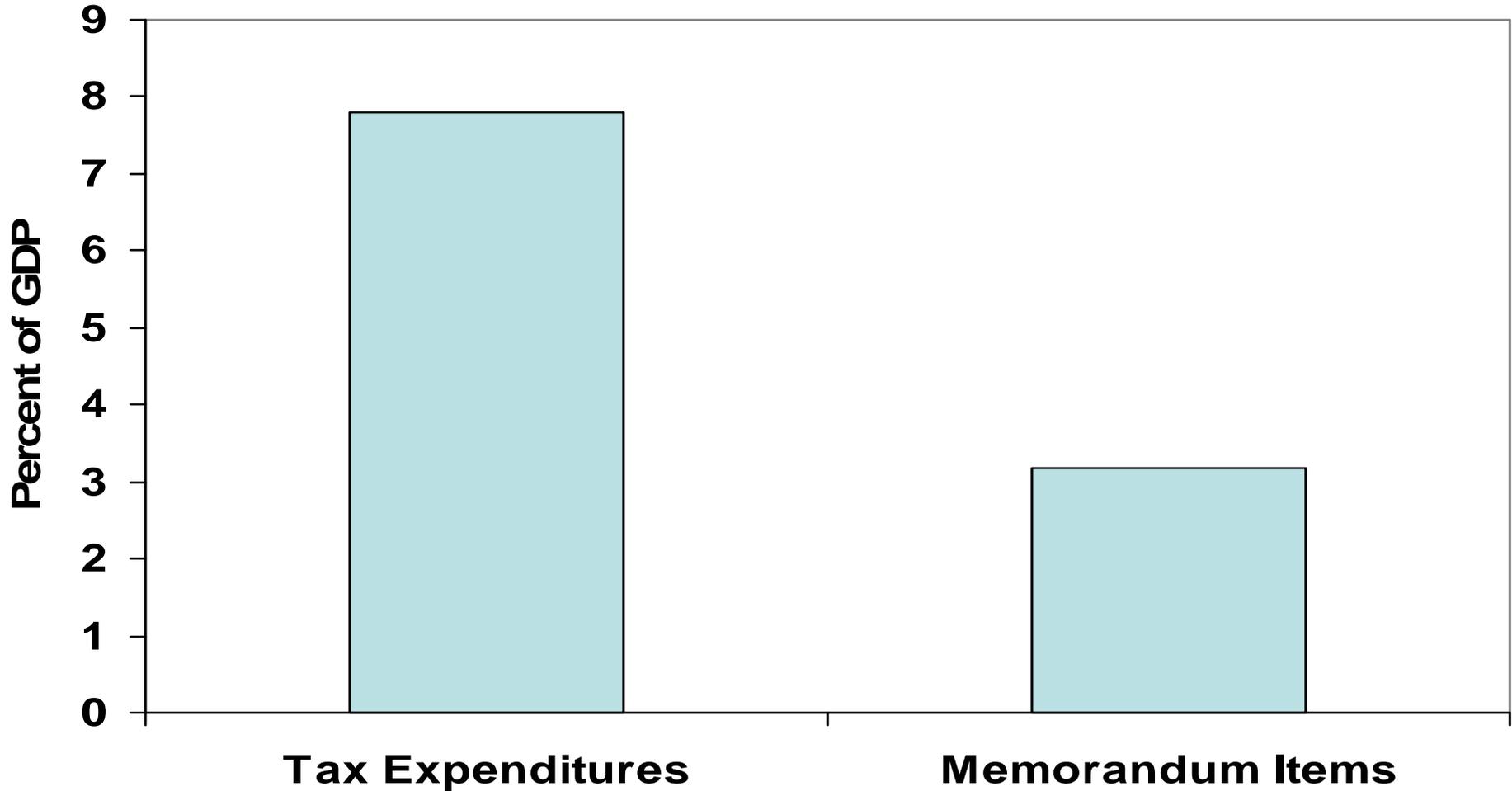
# Income Tax Expenditures



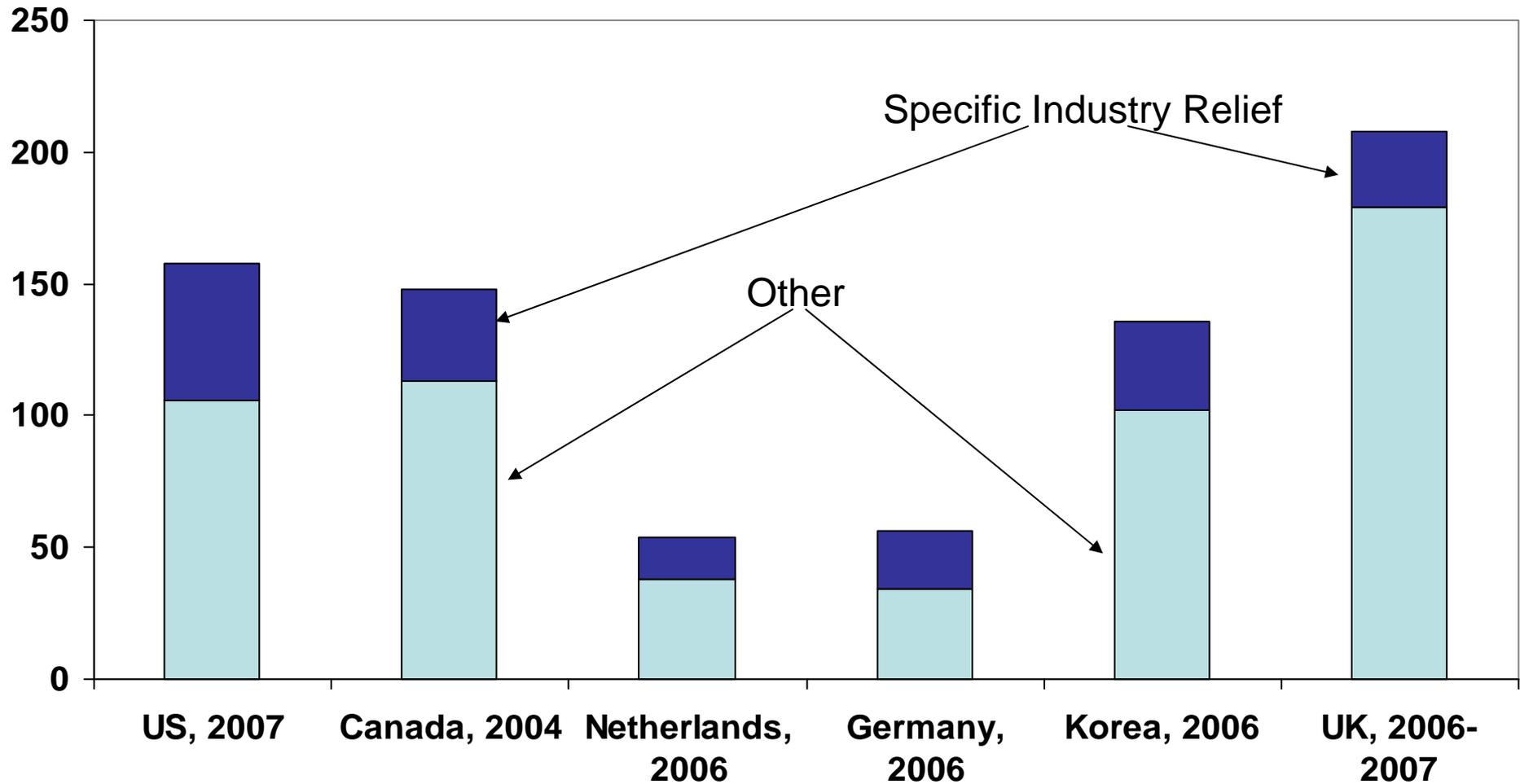
# All Tax Expenditures



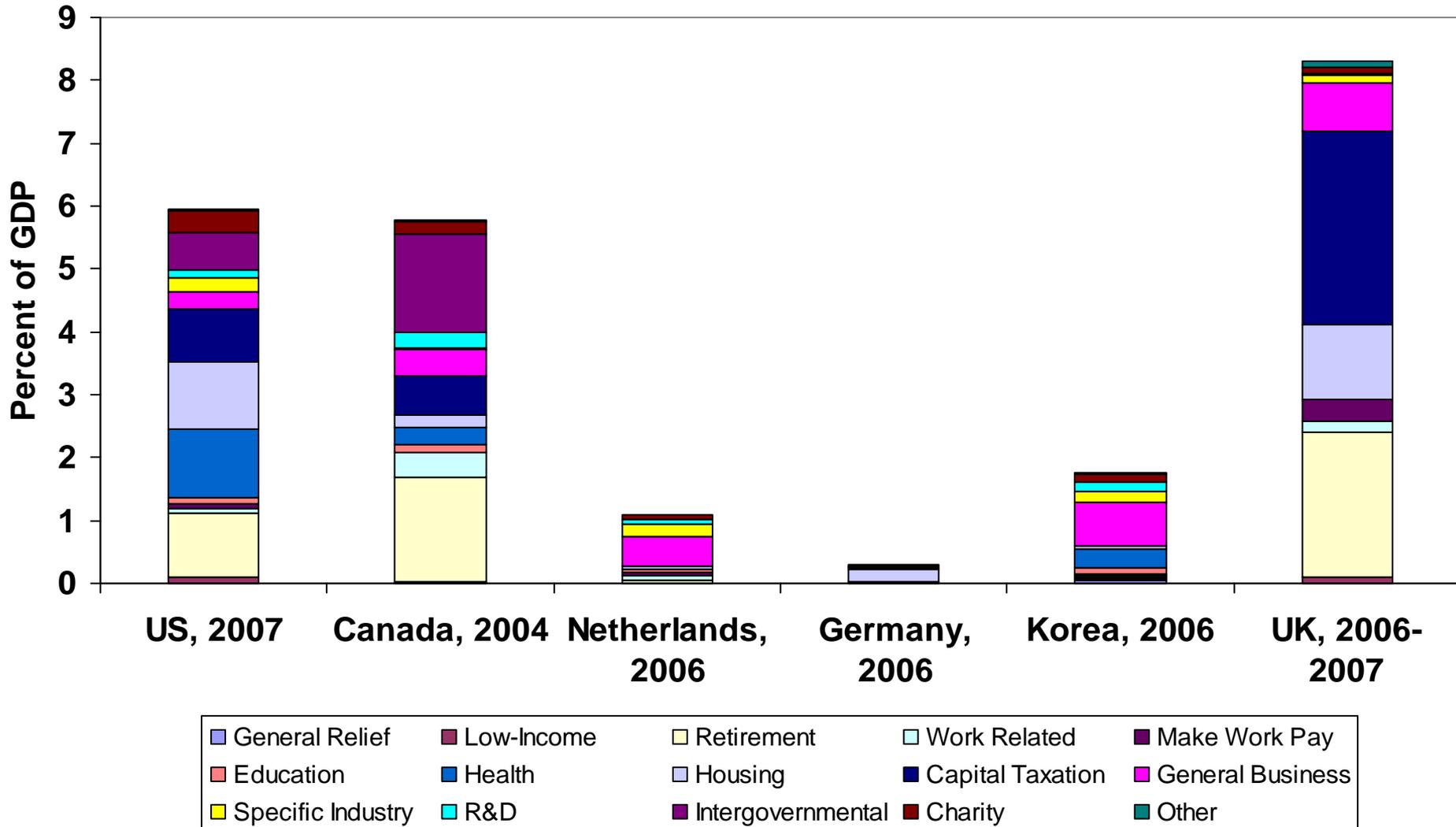
# Canada's "Memorandum Items"



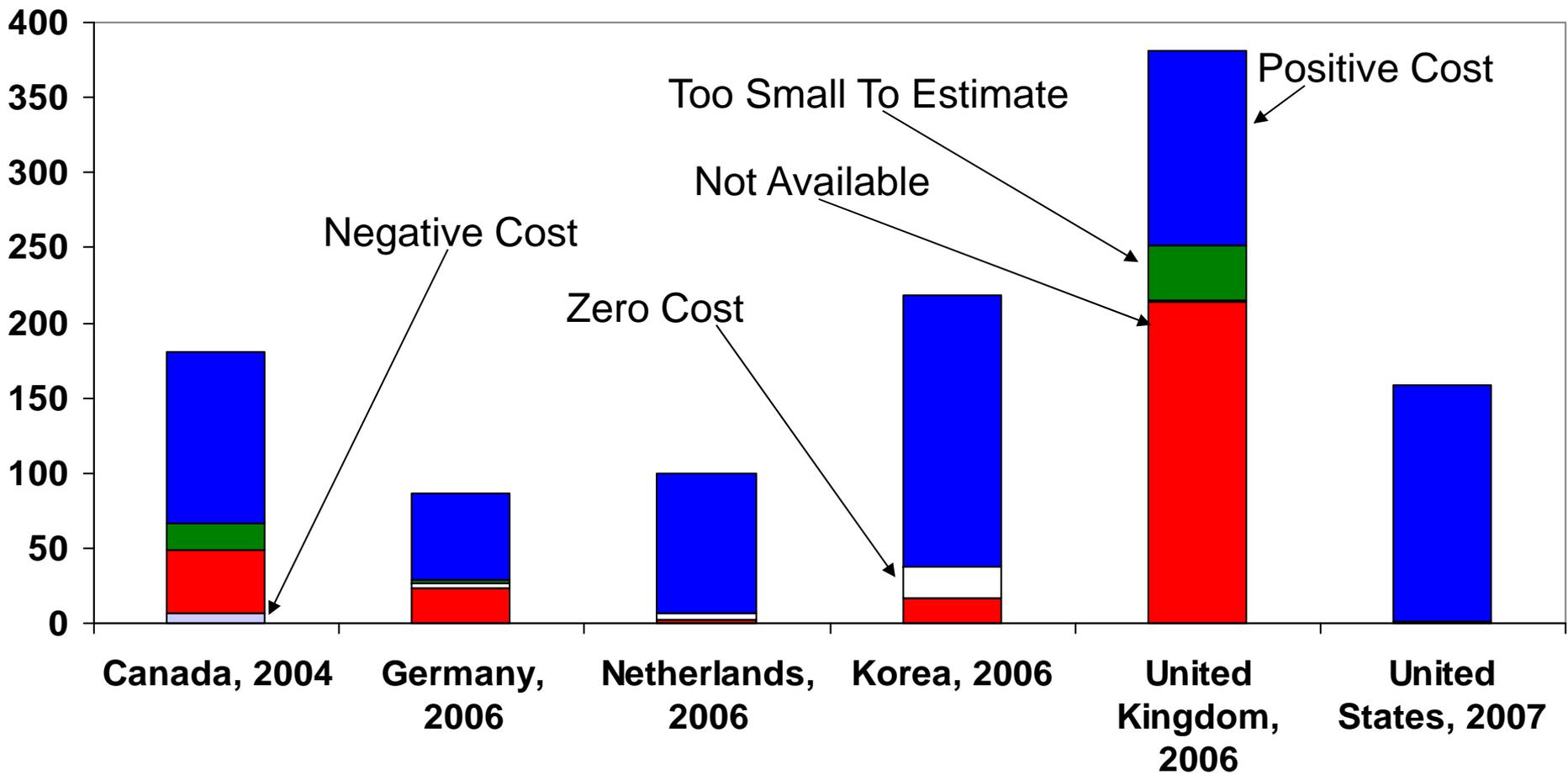
# Numbers of Income Tax Expenditures



# Income Tax Expenditures



# Number of Total Tax Expenditures



# Cost of 10 Largest Tax Expenditures

