



TAX EXPENDITURES IN OECD COUNTRIES

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Introduction

- My presentation is based on a draft paper, “Tax Expenditures in OECD Countries”, written by Joe Minarik, Committee for Economic Development, Washington, DC, in response to interests of the OECD Working Party of Senior Budget Officials (SBO).
- Purposes of the paper include:
 - To discuss potential ill effects of tax expenditures;
 - To note a number of important trends:
 - They are pervasive and growing;
 - They are easier to enact and keep;
 - They can be used to avoid fiscal rules;
 - To obtain data on tax expenditures.
- Final paper to be presented at OECD SBO meeting in Vienna next June.

Outline of My Presentation

- **Definition of Tax Expenditures (TE)**
- **Potential Ill Effects of TE**
- **Potential Good Effects of TE**
- **Causes of Growth in TE**
- **“Make-Work-Pay” TE**
- **“Best” Practices for the Process of Considering TE**
- **The Budget Process & TE**
- **Fiscal Rules and TE**
- **Quantitative and Data Analysis**

Definition of Tax Expenditures (TE)

- ❑ Provisions of tax law, regulation, or practice that reduce or postpone revenue for a comparatively narrow population of taxpayers relative to a benchmark tax.
- ❑ TE may take a number of different forms:
 - **allowances:** amounts deducted from the benchmark to arrive at the tax base;
 - **exemptions:** amounts excluded from the tax base;
 - **rate relief:** a reduced rate of tax applied to a class of taxpayer or taxable transactions;
 - **tax deferral:** a delay in paying tax;
 - **credits:** amounts deducted from tax liability.

Alternative Ways to Measure TE

- **Initial revenue loss (gain):** the amount by which tax revenue is reduced (increased) as a consequence of the introduction (abolition) of a tax expenditure, based upon the assumption of unchanged behavior and unchanged revenues from other taxes.
- **Final revenue loss (gain):** the amount by which tax revenue is reduced (increased) as a consequence of the introduction (abolition) of a tax expenditure, taking into account the change in behavior and the effects on revenues from other taxes as a consequence of the introduction (abolition).
- **Outlay equivalence:** the direct expenditure that would be required in pretax terms to achieve the same after-tax effect on taxpayers' incomes as the tax expenditure if the direct expenditure is accorded the tax treatment appropriate to that type of subsidy or transfer in the hands of the recipient.

Potential III Effects of TE

- **Fairness:** TE can benefit least needy
- **Efficiency & Effectiveness:**
 - Difficult to measure
 - Permanent nature of TE is not conducive to evaluations
 - Tax authorities lack program knowledge which increases the potential for fraud
 - Most budget presentations don't compare TE with direct spending
- **Complexity:** perceived favouritism and unintended interactions
- **Revenue Sufficiency:**
 - Difficult to estimate
 - Tradeoff between general rate reduction and TE
- **Understates Size of Government:**
 - Creates new program with no measured spending & lower taxes

Potential Good Effects of TE

- **Fairness:** for example, TE can bridge the gap between a neutral benchmark tax system, such as one based on income, & a normative tax system, such as one targeted at income above a threshold minus local tax liabilities
- **Efficiency:** TE can reduce or eliminate tax collections &/or check writing

Causes of Growth in TE

- **Administratively efficient**
 - No need for a new government ministry
 - No need to write checks
 - Utilizes existing reporting requirements
- **Politically attractive**
 - No measured spending AND lower taxes
- **Not subject to regular scrutiny**
 - Not even reported or estimated in some countries
 - The difference between “beans” and “might-have-beans”!
- **Repeal of a TE can be portrayed as a tax increase**

“Make-Work-Pay” (“M-W-P”) TE

- Payroll taxes, benefit programs, & progressive tax systems can provide disincentives to work.
- “M-W-P” TE—including refundable tax credits for earned income & child care—can help offset these disadvantages.
- “M-W-P” TE also has advantages over increases in minimum wages [they don’t add to employer costs] or in welfare payments [they don’t reward non-work].

But the costs of “M-W-P” TE can grow rapidly

1. Existing spending programs might be changed to new “M-W-P” TE.
2. New additive “M-W-P” TE might be created.
3. Existing TE might be made more generous.
4. Population growth (including immigration) might increase the population eligible for “M-W-P” TE.
5. Recession might push workers’ incomes down & make them eligible for TE.
6. Secular economic decline might have the same effect.
7. Improved administration & outreach might find more eligible people & encourage them to apply.
8. “M-W-P” TE can be effective because as they increase net pay, more people may work more.
9. *Manipulation and/or fraud might increase costs.*
10. *Estimation & projection error might make the estimates of future costs too low.*

And there can be some new & unique issues

- Tax authorities are expert in collecting money—not giving it away.
- Innovative techniques [claiming more income, not less] can be used to get larger, but fraudulent, payments.
- Delivery of benefits in real time is critical, but tax reporting is usually done annually.

“Best” Practices for the Process of Considering TE

- **Sound process and rules can help to fend off an out-of-sight, out-of-mind mentality** that can keep important TE issues from coming to debate.
 - However, once the debate begins, it is up to **political will and compelling analysis** to lead to action.
- One thing that rules can do is **put known important issues on the agenda**.
 - Rules can also **force policymakers to take explicit action** that acknowledges through their votes and statements that they are violating widely accepted “best” practices.
 - Rules and processes can also force advocates of one perspective or another **to articulate the unstated premises** of their arguments.
- So, consider “best” practices for TE in:
 - Reporting TE
 - Review and Oversight of TE
 - Potential Additions to the Legislative Process

Reporting TE

- **Include in budget** along with similar spending programs in addition to a separate TE section
- **List TE on the basis of the broadest possible benchmark tax** (all income, all value added)
- **Report refundable tax credits** as:
 - Reductions in taxes, or
 - Spending , or
 - Some combination of the above?
- **Subject to same oversight** as spending programs
- **Tax authorities**, working with spending ministries, **should estimate costs of TE**

Review and Oversight of TE

- Although the ideal of **regular, rigorous analysis of all TE** by governments, feeding back into their policy decisions & proposals, can be difficult to achieve, it is still the goal.
- “As we move forward in shaping government for this century, the federal government cannot accept all of its existing programs, policies, functions, & activities as ‘givens.’ Outmoded commitments and operations constitute an encumbrance on the future that can erode the capacity of the nation to better align its government with the needs & demands of a changing world & society. Reexamining the base of all major existing federal spending & tax programs, policies, functions, & activities by reviewing their results & testing their continued relevance & relative priority for our changing society is an important step in recapturing our fiscal flexibility & bringing the panoply of federal activities into line with 21st century trends & challenges.” US Government Accountability Office.

Potential Additions to the Legislative Process for TE

- Regulatory Impact Statements
- Reporting of the amount of tax reduction that could be financed by the TE
- Legislative sunsets
- Make line ministers co-responsible with the Minister of Finance for tax expenditure legislation

The Budget Process & TE

- **Measured** TE are an imperfect target for a budget control strategy.
 - The initial revenue loss method does not account for taxpayer behavior, & the final revenue loss method is very difficult to estimate either before or after enactment of a TE provision.
 - 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 any other government policies, including spending programs & 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
- “Spending”-based rules
 - Inherently counter-cyclical, but to be effective should 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

Quantitative and Data Analysis

- Examples of conceptual issues
- Institutional research and analysis
- Next steps
- Sample of Information Sought in the Questionnaire

Examples of Conceptual Issues

- Benchmark system selected, especially with reference to the treatment of the taxation of capital
 - If a consumption tax benchmark is used, any taxation of capital is a negative TE
- Effect of inflation
- Taxation of imputed income, such as from owner-occupied housing
- Separate benchmarks for corporate & individual or family income

Institutional Research & Analysis

A goal of the paper will be to assess the handling of TE in OECD countries.

- What government offices provide the accounting for TE?
- What can be said about the quality of the measurements?
- Are TE reviewed more or less carefully or often than similar mandatory spending programs?
- How much of the recent growth of TE is accounted for by “M-W-P” provisions?
- Are those provisions as effective as would be equivalent mandatory spending programs?
- To what degree are TE integrated into the budget process?
- Is the budget process effective in disciplining the enactment or growth of TE?

Next Steps

- Questionnaire
- Presentation based on grouped responses if possible
 - That is, there will not be an attempt to force all responses together and produce totals
- Emphasis on presentation in budget
- Raise issues of scoring of refundable tax credits & the treatment of TE within budget processes & rules
- Present final paper in Vienna

Sample of Information Sought in the Questionnaire

- Provide the stated definition of TE & the benchmark tax system, & whether some “structural” provisions (progressive rates or personal exemptions) are included in the benchmark & thus not considered TE, & on what taxes are covered.
- List where the data are reported (in the budget document, or in some other document) & how often TE are reported.
- List what is specified about the estimation methods used, & what levels of government are covered. Also list the estimation & reporting methods of future costs for entitlements.
- Are “M-W-P” TE administered exclusively by the tax authorities & is there only an annual accounting process for the individual taxpayer. Also, is there any evidence from the enactment of such “M-W-P” TE concerning why the TE form was selected, rather than a government outlay program.
- Does the budget process include fiscal rules & TE or revenue amounts.
- Does the budget report on differences of actual revenues from projected estimates.
- Does the budget process allows for use of any unanticipated increase in revenues.
- Must tax reductions be offset (for example, through some kind of PAYGO process).
- Are TE reviewed regularly in the budget process, & is there any data on expirations & required reauthorizations of mandatory and tax law provisions.
- Provide any listing of new TE recently enacted & their cost.