MONITORING TAX INCENTIVES

Assessing Revenue & Other Impacts

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DEFINITION & BENCHMARK

Definitions

Tax expenditures are "provisions of tax law, regulation or practices that reduce or postpone revenue for a comparatively narrow population of taxpayers relative to a benchmark tax" (Anderson, 2008)

For government, a ***tax expenditure*** is a loss in revenue; for a taxpayer, it is a reduction in tax liability. … often better known as tax reliefs, tax subsidies & tax aids (Schick, 2007)

"A ***tax incentive*** is an aspect of a country's tax code designed to *incentivise*, or encourage a particular economic activity"
(Wikipedia, 2016)

The benchmark

- Tax expenditures are explicitly or implicitly defined by the “benchmark tax system” from which they derogate
- Choosing a benchmark is subjective & country-specific
  - E.g., a lower tax rate for a particular product can be viewed as a tax expenditure in one country, but as an integral feature of the tax system in another country;
  - One consideration is whether a feature is a structural part of the tax system (benchmark) or a deviation from it (tax expenditure)
  - Cross country comparisons are not possible as there is no common benchmark
- Conceptually, a benchmark is the consistent taxation of either income or consumption
- Practically, it is the treatment that “would have applied” in the absence of the tax expenditure
- Benchmark question is foundational for revenue assessment and monitoring

MONITORING TAX EXPENDITURES: OVERVIEW & KEY CONCEPTS

Key questions for tax expenditure assessment

Assessing Tax expenditures

Efficacy

How effective is the tax expenditure in delivering its objectives? Is there a more cost effective way to achieve these objectives?

Equity & distributional impacts

What are the impacts of the tax expenditure on different groups & on progressivity?

Broader tax system impacts

How does the tax expenditure affect the revenue raising capacity of the tax system in the short & long term?

Macro-economic impacts

What are the impacts of the policy on growth, and productivity ? What distortions does it introduce?

Compliance & administrative burden

How is the policy administered & what compliance costs does it impose?

Procedural & constitutional considerations

Who governs the tax expenditure? How transparent is the expenditure & its cost?

Assessing tax expenditures

- First step: introduce or improve Tax Expenditure reporting
- Second step: Cost-benefit analysis

Is social benefit greater than social cost?

TAX EXPENDITURE REPORTING & REVENUE FOREGONE

Tax Expenditure reporting

- Key first step in assessing tax expenditures within a jurisdiction
- Increases transparency and brings tax expenditures under more effective control and fiscal management
- No internationally agreed format and country protocols differ, but key elements common in many countries:
  - List of all tax expenditures, tax affected, administering authority, and objectives
  - Where possible, quantification of the revenue cost of each measure
  - Description of benchmarks and methodology used to calculate revenue cost
- Good practice
  - Prepared and published regularly (even if only for internal use)
  - Ideally, by central revenue or finance authority

Calculating foregone revenue

- Where possible, a tax expenditure report quantifies the revenue foregone for each tax expenditure
- Requires calculation of the “benchmark” tax treatment; more straightforward for some taxes than others
- Ex-post calculations, for example:
  - Lower tax rate for one good under excise system = (normal rate – lower rate) * amount of good imported/produced
  - Deduction against tax base of individual or company: deduction of $100, marginal tax rate = 25%, revenue loss = $25
- If used in cost-benefit analysis, each dollar of public revenue foregone should be inflated by an indicator reflecting the scarcity of public funds
  - “marginal cost of public funds” or the social cost of a dollar of tax revenue

Caution: revenue foregone is not revenue potential

- Revenue foregone overstates the potential yield of removing tax expenditures:
  - behavioural responses are not typically included in the calculation of revenue foregone
  - Interaction of tax expenditure with other elements of tax system
  - Assumes that none of the tax expenditures will be replaced by a spending program
- Example: lower tax levels on diesel vs gasoline
  - Foregone revenue (assuming gasoline is the benchmark):

    (Gasoline rate – diesel rate) * number of litres of diesel consumed
  - However, this overstates revenues because:
    - Consumers may choose to use less diesel after the tax expenditure is removed (more gasoline or other fuels, and/or less driving)
    - Business customers will have higher costs, which will lead to higher expense deductions under income taxation

Revenue impact of tax expenditures

- There are no figures on tax expenditures that are internationally comparable:
  - Methodologies differ in calculating revenue foregone
  - Often difficult to arrive at a total figure because summing is not necessarily accurate
  - Benchmarks differ, even within countries
  - Even then, caution about revenue foregone vs revenue potential
- However, the revenue impact of tax expenditures can be significant
- Range of estimates in the literature(warning – not comparable!!)
  - OECD countries: Netherlands: 2% of GDP (2002); Australia: 4% of GDP (2003); Canada and the USA : 7% of GDP (2003)
  - Mortaza and Begum, 2006: Bangladesh: 2.52% of GDP, India: 4.49% and Pakistan: 0.381% (2005),
  - Swift, 2006: Turkey: 5% of GDP; China: >10% in 2002;
  - Munyentali and Bizumugabe, 2017: Rwanda ~8% of GDP
  - IMF estimates (Article IV reviews): 6% in 2006 for Barbados, 1.7 % of GDP in 2002 for Tunisia; and 0.5% of GDP for the Philippines in 2007

Example: Tax Expenditure reporting in NZ

(Re)-introduced by the Treasury in 2010 as part of the Budget process; voluntary

1. **What is a tax expenditure?** Defines tax expenditure and criteria for inclusion in the document:
    1. Is the concession available to a targeted group or type of activity?
    2. Does the provision represent a targeted reduction in a tax obligation relative to current tax practice?
    3. The provision is not primarily administrative or motivated by a (domestic of international) double taxation objective?
    4. Is the provision significantly motivated by a non-revenue policy objective?
    – *If answer to all question is yes, measure is included in the Tax Expenditure Report*
2. **Current tax expenditures:** Lists current tax expenditures in two tables:
    – Quantified tax expenditures
    – Unquantified tax expenditures

•http://www.treasury.govt.nz/budget/2017/taxexpenditure/b17-taxexpstmt.pdf

Quantified tax expenditures

- Lists names and provides costs over last 5 years, plus forecast cost for the next year
- Annex provides details of how each element has been estimated (mostly through tax return data from companies and individuals)
- No total given for revenue foregone

Quantified tax expenditures	Value of expenditure 2011/12 (actual)	Value of expenditure 2012/13 (actual)	Value of expenditure 2013/14		Value of expenditure 2014/15		Value of expenditure 2015/16		Value of expenditure 2016/17 (forecast)
			As at April 2017	Estimated Actual	As at April 2017	Estimated Actual	As at April 2017	Estimated Actual	
Charitable or other public benefit gifts by a company: deduction	22	20	*17*	17	*31*	31	*18*	21	21
Charitable or other public benefits: tax credit	235	225	*234*	234	*241*	244	*235*	247	247
Independent earner tax credit	223	223	*221*	223	*219*	223	*208*	223	223
Māori Authorities: donations	0.5	0.7	*0.9*	0.9	*2.5*	2.5	3.7	3.7	3.7

Unquantified expenditures

- Revenue impacts not quantifiable because:
  - Uncertainty or disagreement about the appropriate benchmark
  - Lack of data
- Details included:
  - Notes which provision in law the tax expenditure is made under
  - Categorises it by type of provision (Business, Social, Other)
  - Includes a description of the expenditure and its policy rationale
  - Notes whether revenue impact is (one-off, ongoing, or timing)

Tax Expenditure	Sections/ Classification	Comment	Policy Rationale	Type			Impact		
				Social	Business	Other	Historic	Timing	Permanent
Local and regional promotional bodies: exempt income	*Section CW 40* *-Exemption*	The income derived by a charitable association or society is exempt income, if it is primarily established for beautification purposes.	To encourage local and regional beautification/advertisement.	✓					✓
Māori Authorities: deduction	*Section DV 12* *-Deduction*	A Māori authority is allowed a deduction for a cash donation that it makes to a Māori association as defined in the *Māori Community Development Act 1962*. It is also allowed a deduction for charitable or other public benefit cash gifts. This deduction is limited by net income.	Tax incentives for charitable donation.	✓					✓
Non-profit organisations	*Section DV 8* *-Deduction*	Non-profit organisations are entitled to an income tax deduction for the lesser of $1,000 and their net income.	To reduce compliance costs.	✓					✓

COST-BENEFIT ANALYSIS

Cost-benefit analysis gives a more complete picture

Additional effects
of tax expenditures
and tax incentives

Intended
Distributional
Effects

?

- Revenue forgone
- Effect on income distribution
- Non-neutral taxation/ final economic incidence
- Administrative and compliance costs

Possible benefits from tax expenditures

- Inducement of positive externalities:
  - where an activity has benefits to society that are not captured by the owner, tax incentives may be warranted to increase investment in that activity
  - Examples include: investment in R&D, environmental tax preferences, or to improve incentives for education
- Inducement of behaviour:
  - To an incentivise taxpayers to do (or increase) an activity that the taxpayer might not be willing to do without the incentive
  - e.g. investment in a particular sector or region
- Improved fairness
  - Tax expenditures may be used to address poverty or equity concerns (e.g. through expenditures targeted to households), or
  - to reduce the impact of the tax system on particular groups (e.g. SMEs)

Measuring additional effects

- What matters is not the number of taxpayers that use a given tax incentive, it is the additional effect.
  - Redundancy: investment that would have occurred anyway
  - Displacement: relocation of investment to qualify for the tax expenditure
  - Crowding out: investment may substitute for investment that no longer takes place
- How can we measure it?
  - First best: difference in difference approach
    - Treatment group vs control group
      - Data before (Tb) and after (Ta) the introduction of a tax incentive
    - If the changes in the treatment and control group are similar, there is no additionality
  - Second best: look at the main factors explaining the take-up of tax incentives, & make your judgement on targeting

Final economic incidence

- The final incidence of a tax expenditure may differ from the primary one
  - Housing incentives may be capitalised in higher pre-tax prices
  - Reduced VAT rates translates into higher pre-tax prices, due to imperfect competition
  - Lower interest rates on savings accounts counteract the effect of tax exemption
- Most of the benefit accrues to middle-higher income households

Costs of tax expenditures

- Direct costs can be high:
  - redundancy – tax expenditure benefits activities that would have happened any way
  - Revenue leakage through avoidance & evasion (e.g. company churning, income shifting, interest deductibility)
  - Revenue losses require other fiscal adjustments
- Tax expenditures also have indirect costs:
  - Introduce economic distortions (stimulate low productivity investments, distort technical decisions)
  - High compliance & administrative costs
  - Tax preferences create inequities & have a hidden cost
  - They are often non-transparent and have poor accountability
- Alternative instruments can be more cost-effective

Measuring cost & benefits of a tax incentive

1. Identify taxpayers that will likely access the incentive
2. Measure additional activity that takes place as a result of the incentive & the benefits of this activity
3. Determine the likely revenue costs over a time period
4. Isolate the likely welfare costs from the distortion of economic activity & windfall gains
5. Identify the increase in governments & taxpayers administrative & regulatory costs

Calculate the Benefits-to-Costs ratio

- Using an appropriate discount rate, calculate the Total Benefits and Total Costs
- Calculate Benefits-to-Costs Ratio
  - This should be positive - do not implement TIs with a negative ratio
  - Ideally, the higher the ratio the better, although choices may also depend on other factors (e.g. scale of project, distributional impact of investment).
- Calculate internal rate of return and compare with pre-determined social rate of return

Difficulties in assessing effectiveness

- Lack of data
- Assessing additionality
- Determining which activities were not undertaken by taxpayers because of incentive
  - Taxpayers don't increase overall investment, but shift to different type of investment to access the incentive
- Determining impact of incentive on prices

Other options to analyse tax expenditures

- Descriptive tax statistics
- Ex-ante tax analysis
  - Tax indicators (ETRs, tax depreciation calculator)
  - Micro simulation models
  - CGE models
- Ex-post evaluations
  - Econometric analysis
  - Case studies
  - Surveys

OPTIONS FOR REFORM

Should all tax expenditures be removed?

- Difficult to expand the base further than the “practical” application of the benchmark
  - Non taxation of unrealised capital gains, imputed rents..
- Some tax expenditures may need to be replaced by a spending program
  - Tax credits or exemptions for social benefits
- Tax expenditures may have their own rationale or may be efficient
  - Externalities (e.g. R&D), imperfect competition (2nd best)

Options for reform

- Removal of tax expenditures
  - This can be done in one action, or a path can be established for gradual removal over time to allow time to adjust
  - Possibility to introduce non-tax measures to address objectives or provide compensation
  - Does not necessarily need to be done as part of a tax reform, but could be part of BBLR package
- Scale back: limit the scope of the objective: restrict eligible recipients or activities, limit use in time (e.g. loss carry-forwards only for a finite period)
- Change type: change the form of tax expenditure to reduce economic distortions – pathway to reform
- Improve administration: publish reports on cost & effectiveness; centralise administration; audit activities to ensure they are compliant

Conclusions

- Regular monitoring is essential to ensure tax expenditures are effective and costs are limited
- Tax expenditure reporting is an important first step provides transparency and estimates of revenue foregone
- Cost benefit analysis can provide deeper understanding of the efficiency of particular tax expenditures
- Options for reform include removal as well as limiting the scope of the tax expenditure or moving towards less harmful forms of expenditures

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