Why worry about tax expenditures?

Developing and transition economies are increasingly using tax expenditures to pursue economic and social goals. But these instruments are often introduced without full understanding of their potential effects. What should be done?

Tax expenditures are concessions that fall outside tax norms or benchmarks. These norms include accounting conventions, the structure of tax rates, the deductibility of compulsory payments, provisions to facilitate tax administration, and norms related to international fiscal obligations. Tax expenditures are deviations from these norms, implemented to encourage behavior deemed desirable by policymakers, and can take a number of forms—including tax exemptions, allowances, credits, deferrals, and relief (see OECD 1996). The classic example is a tax deduction for charitable contributions, where the reduction in tax revenue is more than offset by the increase in support for charitable activities.

Tax expenditures are not a free lunch, however. They can lead to inefficiencies and inequities, stimulating no additional activity and making the tax regime more regressive. For instance, a tax concession granted to employers who hire unskilled workers might go to employers who would have hired such workers anyway. Tax expenditures also affect government budgets, because they imply forgoing revenue that could be used to fund direct government expenditures.

But unlike direct expenditures, tax expenditures are fully funded before discretionary programs and are open-ended entitlements. Once tax expenditures are enacted, they usually come under little scrutiny and are rarely repealed. This note argues that, to minimize their downside effects, tax expenditures should be treated similarly to direct government expenditures—meaning they should be included in annual budget reviews and subjected to careful fiscal analysis.

**Benefits and drawbacks**

The literature identifies several pros and cons of tax expenditure programs. Positive aspects include:

- Encouraging private sector participation in social programs.
- Promoting private rather than government decisionmaking.
- Requiring less government oversight of such spending.

Most of the drawbacks of tax expenditure programs are related to their potential inefficiencies and inequities, including:

- Paying beneficiaries to engage in activities they would engage in anyway, stimulating no additional activity.
- Narrowing the tax base, limiting the scope for tax rate reductions.
- Providing open-ended opportunities for government spending, making it more difficult to project tax revenues.
- Making tax laws more complex, increasing the cost of enforcing them.
- Making government spending non-transparent and free from budget scrutiny.
- Making the tax system more regressive—for example, by excluding nontaxpayers, who are among the poorest members of any society.

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**FROM THE DEVELOPMENT ECONOMICS VICE PRESIDENCY AND POVERTY REDUCTION AND ECONOMIC MANAGEMENT NETWORK**
**Tax expenditures affect government budgets because they substitute for direct government expenditures**

Tax expenditures affect government budgets because they are de facto substitutes for direct government expenditures. But unlike direct expenditures, tax expenditures are usually approved outside the budget, not subject to annual budget reviews, open-ended (without spending ceilings), and not subject to sunset clauses. This implies that tax expenditures are subjected to softer spending constraints than those imposed on direct expenditures.

**Horizontal and vertical inequalities**

Horizontal inequality between taxpayers emerges when tax expenditures allow people with similar incomes and expenses to pay different amounts of taxes depending on whether they engage in tax-subsidized activities—as, for example, with tax credits for college tuition payments, which benefit only taxpayers who pay college tuitions. Different tax liabilities for similarly situated taxpayers violate horizontal equity.

Similarly, vertical inequality emerges when not all taxpayers qualify for tax reductions that require minimum spending. Moreover, even if taxpayers with lower expenditures still qualify, they obtain fewer tax benefits because the value of the benefits increase with the taxable income level. This setup implies that tax expenditures disproportionately benefit higher-income groups, making the tax system less progressive and violating vertical equity.

The inequities of tax expenditure programs can be seen by examining the effective tax rate, defined as the ratio of an individual’s actual tax payments to actual income. Here actual income is essentially the income figure used on tax returns increased by income excluded from the income tax and by taxable income offset by personal exemptions and deductions. In Poland in 1997 higher-income taxpayers (income brackets 2 and 3) paid much lower effective tax rates (relative to statutory rates) than did low-income taxpayers (table 1).

**Managing tax expenditure programs**

As noted, tax expenditures affect government budgets because they are de facto substitutes for direct government expenditures. But unlike direct expenditures, tax expenditures are usually approved outside the budget, not subject to annual budget reviews, open-ended (without spending ceilings), and not subject to sunset clauses. This implies that tax expenditures are subjected to softer spending constraints than those imposed on direct expenditures.

Strengthening the administration of tax expenditure programs is an important first step toward ensuring their effectiveness, efficiency, and equity. For instance, over the years OECD countries have increased their scrutiny of tax expenditures toward levels normally applied to direct expenditures.

One of the best practices comes from Canada, which integrates tax expenditures into the budget review process by including them in the overall expenditure envelopes for each government function (for example, the economic development envelope, the social development envelope, and so on). At the planning stage, federal tax and direct expenditure programs are split into “envelope” targets. The ministers responsible for the programs under these envelopes are also responsible for meeting these targets. If they want to expand certain programs or pursue new initiatives, they must cut back on other programs. This approach avoids the risk of ministers escaping direct expenditure limits.

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**Table 1  Effective personal income tax rates in Poland, 1997**

<table>
<thead>
<tr>
<th>Income bracket, statutory rate</th>
<th>Taxable income</th>
<th>Exemptions from income tax</th>
<th>Deductions from income tax</th>
<th>Actual income</th>
<th>Taxes paid</th>
<th>Effective tax rate (percent)</th>
<th>Effective rate/statutory rate (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1, 20%</td>
<td>171,722,513</td>
<td>3,136,473</td>
<td>2,485,172</td>
<td>177,344,158</td>
<td>25,168,838</td>
<td>14</td>
<td>71</td>
</tr>
<tr>
<td>2, 33%</td>
<td>27,741,684</td>
<td>1,189,689</td>
<td>896,722</td>
<td>29,828,095</td>
<td>4,733,368</td>
<td>16</td>
<td>50</td>
</tr>
<tr>
<td>3, 44%</td>
<td>24,553,612</td>
<td>2,089,551</td>
<td>1,027,193</td>
<td>27,670,356</td>
<td>6,875,381</td>
<td>25</td>
<td>56</td>
</tr>
</tbody>
</table>

*Note: Data are totals for each income bracket. Actual income is the sum of taxable income, exemptions, and deductions. Effective tax rate is calculated by dividing taxes paid by actual income.*

*Source: Poland Ministry of Finance 1998; World Bank staff estimates.*
by proposing new or expanded tax expenditure programs. Although ministers can still propose new or expanded tax expenditure programs, the fiscal cost of these programs is debited against the overall envelope spending limit. This “envelope target” approach provides a level playing field between direct and tax expenditure programs.

Although scrutiny of tax expenditures in other OECD countries has not reached the levels in Canada, there are still substantial reporting requirements. The U.S. government, for example, produces an annual report on tax expenditures that is included in the Congressional budget process. The U.S. Department of Energy reports on tax expenditures affecting the energy industry, with information on the main beneficiaries (natural gas and ethanol producers) and estimates of total costs. In addition, several U.S. states—including California, Massachusetts, and New York—require that budget proposals include tax expenditures and estimates of their costs, listed according to the taxes to which they pertain.

As part of budget estimates, Germany’s federal government submits a report on tax concessions to Parliament and the Federal Council every two years. And France’s government publishes an annual report appended to the finance bill presented before Parliament.

Another reason for subjecting tax expenditure programs to scrutiny and control is the effect they have on the tax system, because the number and size of these programs affect the tax rates required to generate a desired net tax revenue. Tax expenditure programs reduce the effective tax schedule across income tax brackets, reducing overall tax revenue (figure 1). Only when tax expenditure programs compete on a level playing field with direct expenditures can policymakers have a yardstick against which to measure the opportunity costs of these programs.

**Conclusion**

Tax expenditures hold an attraction for policymakers as a way to stimulate markets and encourage certain behavior among taxpayers. But 25 years of experience with tax expenditure programs in OECD countries suggest that policymakers need to guard against these programs’ potential downsides. To minimize their risks, tax expenditures should be subjected to the same scrutiny as direct expenditures by being included in annual budget reviews.

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**Figure 1 Statutory and effective personal income tax rates in Poland, 1997–98**

![Graph showing statutory and effective personal income tax rates in Poland, 1997–98](image)

*Source: Poland Ministry of Finance 1998.*
Further reading


This note was written by Zhicheng Li Swift (Research Analyst, PREM Unit, Europe and Central Asia Region) and Carlos B. Cavalcanti (Senior Economist, PREM Unit, Latin America and Caribbean Region).

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