



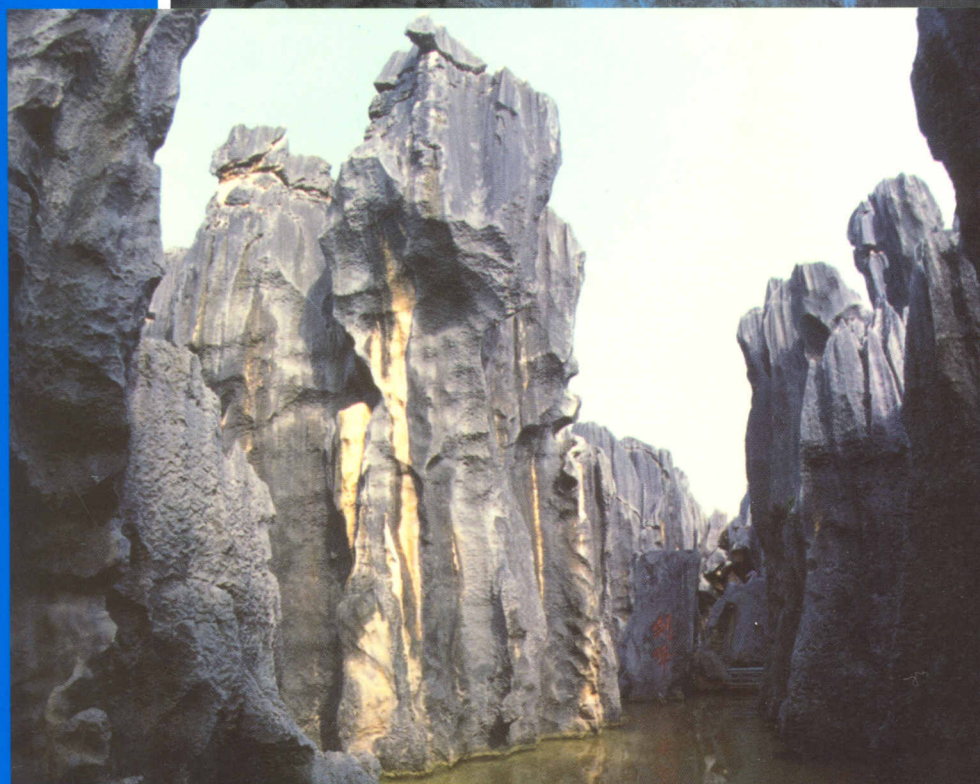
THE WORLD BANK

DIRECTIONS IN DEVELOPMENT

Tax Expenditures— Shedding Light on Government Spending through the Tax System

*Lessons from Developed and Transition
Economies*

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Tax Expenditures: General Concept, Measurement, and Overview of Country Practices

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Recently developing countries have focused attention on the usefulness of tax expenditures' in shaping prudent and transparent fiscal policy. In adopting a market economy, developing countries commonly use tax expenditures as major fiscal policy instruments. However, with limited theoretical understanding of, and ad hoc experience with, applying tax expenditures, developing countries now confront not only revenue losses higher than they had anticipated but also the erosion of their tax bases in systems that generally have been in existence fewer than 10 years.

Fortunately, the experience and practice of developed countries offer insights into understanding and applying tax expenditures. Most developed countries have established tax reporting systems, which provide empirical information on their tax expenditures. Such tax reporting systems tend to be part of a country's overall fiscal system for strengthening government finance and contribute significantly to fiscal transparency. Using the information available, several governments attempt to analyze the cost and economic effects of individual tax expenditures. Some governments even bring tax expenditures into the budgetary process and subject them to a level of scrutiny similar to that for direct expenditures.

This book contains several papers on how both developed and transition economies define and apply tax expenditure systems. The developed countries—Australia, Belgium, Canada, the Netherlands, and the United States—have established tax expenditure accounting and, in varying degrees, brought tax expenditures into budgetary process. The experience of China and Poland shed light on why it is important for developing and transition economies to ensure fiscal transparency and to perform systematic fiscal analysis when implementing tax expenditures, as well as how to address these issues in relatively new tax systems.

We do not provide international comparisons of the magnitude of tax expenditures, in part because countries use different benchmark tax sys-

tems and data are not comparable. Moreover, there is no agreement on the definition of the benchmark tax system and, consequently, on which provisions are considered tax expenditures and which are benchmark provisions.

This chapter highlights the main conceptual issues relating to tax expenditures. The first section briefly discusses the distinctions between tax expenditures, contingent liabilities, and direct spending. Then the general concept of tax expenditures is reviewed, including definitional differences, tax expenditure reporting, and estimation methods. Finally, a brief comparison of tax expenditure reporting is made among 10 Organisation for Economic Co-operation and Development (OECD) countries.

Tax Expenditures, Contingent Liabilities, and Direct Spending

The main objective of a tax system should be to raise revenue to finance public outlays in the most efficient way as well as to ensure a fair distribution of the tax burden. Governments, however, frequently use the tax system to promote specific policies. This practice results in tax expenditures.

Although governments generally rely on direct spending to finance their policies, tax expenditures are a common channel for financing government policies outside the budgetary framework. Contingent liabilities are another common channel for such "hidden" spending that tends to arise from a government's explicit and implicit promises of financial support.¹

Direct spending is more transparent than any other instrument. Any government outlay has to be approved by the country's legislature. The cost, allocative efficiency, and operational efficiency of government spending programs and related policies are thus subjected to scrutiny that tends to be detailed and in many countries open to the public before the government spending budget is approved. To promote aggregate fiscal discipline, government agencies tend to be accountable for implementing their spending budgets within their given ceilings and for delivering certain outputs and results for money spent.

The use of tax expenditures does not provide the same assurances. Tax expenditures are seldom exposed to extensive analysis and scrutiny. Their true fiscal cost is hidden as revenue forgone. Revenue forgone, even if analyzed, is sometimes difficult to estimate. Similarly, considerations of the allocative and operational efficiency of tax expenditures are rarely required in the decisionmaking process. Even if most developed countries have implemented tax expenditure reporting, the gap between the level of scrutiny and transparency of tax expenditures compared with direct spending remains wide. Unless, however, tax expenditures are exposed to adequate scrutiny, they may invite fiscal opportunism.

Contingent liabilities are similar to tax expenditures in that they represent instruments of fiscal policy requiring no cash spending at the time of their issuance. Contingent liabilities show their fiscal costs only later, in the form of sudden claims on the government budget. As with tax expenditures, contingent liabilities have been known to provide politicians with an opportunity to implement various initiatives without submitting them to the level of competition applied to budgetary expenditures and without revealing their future possible fiscal costs. Contingent liabilities thus raise concerns about transparency and appropriate use similar to the concerns that tax expenditures raise.

General Concept

Definitional Differences

In broad terms, tax expenditures are concessions that fall outside a tax norm or benchmark. The tax norm includes the rate structure, accounting conventions, deductibility of compulsory payments, provisions to facilitate tax administration, and international fiscal obligations. Tax expenditures may take a number of forms: exemptions, allowances, credits, preferential tax rates, tax deferrals, and so forth. Tax expenditure reporting measures the revenue that these deviations impart from the tax norm (OECD 1996).

In practice, tax norms are defined differently across countries, making it difficult to make comparisons. For example, country A may regard a tax allowance as tax expenditure, whereas country B may define the same item as a tax norm. In addition, some items could be on the borderline between tax expenditure and tax norm.

POSITIVE AND NEGATIVE ASPECTS OF TAX EXPENDITURES

When tax expenditures are used as policy instruments to achieve certain social and economic goals or to substitute for direct government financial assistance (such as grants, loans, and guarantees), both their positive and negative aspects should be carefully considered.

The positive aspects of tax expenditures include

- Encouraging private sector participation in economic and social programs where government plays a main role
- Promoting private decisionmaking rather than government decision-making
- Reducing the need for close government supervision of such spending

For example, in the area of social protection, U.S. regulatory mandates and tax incentives have been designed to prompt the private sector to

provide health care coverage, thus lessening the government's role in that area.

Recent OECD work on net social expenditures illustrates the magnitude of mandatory benefits and tax incentives. In 1997, direct spending for social protection amounted to 15.8 percent of gross domestic product (GDP) in the United States, which is the lowest among the 10 countries compared in table 1.1. Its net public spending (which is gross public expenditure adjusted by netting the associated tax burden and adding the estimated tax expenditures) was just 15 percent of GDP. However, because U.S. government spending was supplemented by voluntary private sector contributions of 8.4 percent of GDP (the highest of the countries shown in table 1.1), total social expenditure reached 23.4 percent.

These percentages suggest that U.S. regulatory mandates and tax incentives have been successful in encouraging the private sector to contribute to social programs. However, the positive aspects of tax expenditures cannot be achieved without additional measures. In most cases, government regulation and the capacity of tax administration are catalysts. The U.S.

Table 1.1. Total Social Expenditures among 10 OECD Countries, 1997

Country	Total ^a	Net public social expenditure ^b	Private social expenditures		Gross public social expenditure ^c
			Mandatory	Voluntary	
Australia	21.9	17.6	1.2	3.4	18.7
Austria	24.6	23.0	0.9	0.9	28.5
Belgium	28.5	25.8	1.7	1.0	30.4
Canada	21.8	17.8	0.0	4.8	20.7
Denmark	27.5	26.7	0.4	1.1	35.9
Germany	28.8	25.5	1.3	1.1	29.2
Italy	25.3	24.1	1.5	0.1	29.4
Netherlands	24.0	20.2	0.8	4.7	27.1
United Kingdom	24.6	21.1	0.4	3.8	23.8
United States	23.4	15.0	0.4	8.4	15.8

Source: Adema 2001.

a. The total is a consolidated figure and may be less than the sum of the components.

b. Net public social expenditure is calculated as gross public social expenditure less direct taxes and social security contributions levied on social transfers and benefits income claimed back through taxes on consumption, plus tax breaks for social purposes.

c. Gross public social expenditure covers memorandum items such as sickness, services for the elderly and people with disabilities, survivors' pensions, family cash benefits, family services, active labor market programs, unemployment benefits, health care expenditure, and housing benefits.

case also illustrates that the existing required regulations and tax administration have played a role in achieving this result.

Most of the negative aspects of tax expenditures are related to their potential ineffectiveness, inefficiency, and inequity as follows:

- **Ineffectiveness.** Some tax expenditures are insufficient to override underlying economic forces or are offset by other domestic or foreign tax provisions (World Bank 2001).
- **Inefficiency.** Many tax expenditure schemes are a response to various interest groups rather than to actual needs. Such tax expenditure schemes would result in loss of efficiency by favoring some sectors and projects but not others, thus altering the relative profitability of projects and weakening overall investment (World Bank 2001).
- **Inequity.** Tax expenditure schemes tend to be regressive in modifying tax burdens across taxpayers, both vertically and horizontally. In particular, nonrefundable tax expenditure schemes, which most governments have applied, exclude nontaxpayers—who are among the poorest groups in society—from receiving benefits.

Other negative aspects include

- Eroding revenue bases, which limits the scope for tax rate reductions.
- Providing open-ended government spending, which makes it more difficult to estimate tax revenues.
- Adding complexity to tax laws, increasing the cost of enforcing them, and facilitating rent seeking.
- Making the size of government elusive. Because tax expenditures are often substitutes for direct spending, simply pursuing the objectives of direct spending programs through tax expenditures could reduce the apparent size of government.

Negative effects are plentiful. Because tax incentives greatly erode tax bases, Argentina, Brazil, Colombia, Indonesia, Jamaica, and Mexico had to undertake tax reforms in the 1980s and limit promotional incentives to broaden their tax bases. Base broadening is also a common characteristic of many tax reforms in OECD countries (for example, see OECD 2001c).

NEUTRALITY VERSUS INCENTIVES

It is usually argued that the tax system should be kept neutral while it raises revenue through the principles of equity, efficiency, and effectiveness (for example, see OECD 2001c). Neutral tax systems have a broad base, no tax expenditures, and uniform taxation. For example, the tax system would be neutral in the choice between the use of labor and capital

as production factors, the choice between equity and debt for financing investment, the location decision of firms, and the allocation of household savings among assets. In this optimal situation of tax system neutrality, resources are allocated according to relative prices and under perfect competition. The best example of a neutral tax system in OECD countries is New Zealand (OECD 2001b). If a government chooses to pursue neutrality in its tax system, it will eschew tax expenditures.

Tax Expenditure Reporting

Tax expenditure reporting is used in developing countries for fiscal transparency and for efficient resource allocation. Tax expenditure reports consist of several main elements, such as descriptions of tax norms, tax bases, taxable units, tax rate schedules, tax period, and tax expenditure estimates, which may cover a 7-year period. Such reports also may state their purpose, legal requirements, rationale, assessment, and similar aspects.

There is no internationally consistent format for tax expenditure reports. Some reports provide more background and analytical information than others. For example, the U.S. Tax Expenditure Report, which is prepared by the Congressional Research Service, includes descriptions of tax norms, estimates of the revenue cost of tax expenditures, legal authorizations, descriptions of tax provisions and tax effects, rationales at the time of adoption, assessments, and bibliographic citations. The section describing tax effects includes quantitative data on the distribution of tax expenditures across income classes where relevant and where data are available. The rationale section contains details about the historical development of each provision. The assessment section summarizes major issues surrounding the tax expenditures. The bibliographic section is a starting point for further research.

The classifications in tax expenditure reports vary from country to country, depending on the needs of policymakers and data availability. Commonly used classifications include budgetary function, industry, region, type of taxes, beneficiary, and purpose of tax expenditure. The Belgian report on tax expenditures classifies them by taxes and budgetary function. Most countries classify budgetary function because doing so makes comparisons between spending and tax expenditures clearer.

Most countries produce annual tax expenditure reports. Some countries publish them once every 2 years or sporadically, according to the needs and capacity of the country.

In addition, some governments are required by law to produce tax expenditure reports. Other governments lack such requirements but choose to do so anyway. The relationship between tax expenditure

reports and other official financial documents also varies among countries. Some include tax expenditure reports as a part of budgetary documentation, but others do not.

A few countries try to set the budget ceiling for spending by means of tax expenditures. These countries use this process to bring spending constraints not only on direct expenditure but also on government spending through tax systems. But not many countries have done so.

Finally, several countries have tried to bring tax expenditures into their government budgetary framework. These countries tend to bind tax expenditures (and contingent liabilities) under the same type of cost ceilings as direct spending. They include tax expenditures in their fiscal analyses, looking at the possible effects of individual tax expenditure programs on future revenues. In the decisionmaking process, countries most advanced in the treatment of tax expenditures also raise the questions of efficiency and equity: Is the proposed tax expenditure program efficient in accomplishing its stated policy priorities? What would be its effect on the distribution of income and wealth in society?

Estimation Methodology

REVENUE FORGONE, REVENUE GAIN, AND OUTLAY EQUIVALENT METHODS

The costs of tax expenditures are estimated, on either a cash or accrual basis, by three approaches: revenue forgone, revenue gain, and outlay equivalent. The measurements are the main components of a tax expenditure report.

The *revenue forgone method* is an ex post calculation of the loss in revenue incurred by government. It does not take into account taxpayers' behavioral responses. Thus, for example, the cost of a tax credit is simply the amount of the tax credit. Accordingly, the cost of a tax allowance considered as tax expenditure will be the product of the total deduction and the marginal tax rate.

The *revenue gain method* is an ex ante calculation of the additional revenue that would accrue from repealing tax expenditures. Taxpayers' behavioral responses are included. Implementing this method requires a good understanding of taxpayer behavior and data on the critical elasticities. For example, the value added tax (VAT) rate—normally 21 percent—may be reduced to 12 percent on new housing construction. In applying the revenue gain method, we have to consider that 9 percent of the wholesales would have taken place even if the reduced VAT rate had not been introduced. Such estimation is not an easy task.

The third approach is the *outlay equivalent method*. It calculates the outlay that would have resulted in a similar gain for the taxpayer as the considered tax expenditure. For example, perhaps the tax code permits a 150

percent deduction of current research and development expenses, and the corporate income tax rate is 40 percent. The net effect for the corporation is an additional deduction of 50 percent of its current research and development expense. If both the corporate income and current research and development expense are 100, the tax liability is thus lowered by 20. This is the net effect for the taxpayer and equals the cost of the tax expenditure based on the revenue forgone method. The equivalent outlay is 20 if grants are not subject to corporate income tax but increases to $20/(1 - 0.4) = 33.33$ if grants are taxable.²

The effect of tax expenditures can also include deferring tax revenue, which is typically the case for depreciation rules that depart from accounting principles. Some countries use a present value approach that computes the revenue effect of such tax expenditures over the whole depreciation period. More generally, the present value approach is used to estimate tax deferral, as it is similar to a government loan with a zero interest rate.

MICROSIMULATION MODEL AND TAX STATISTICS

The revenue effect of tax expenditures can be estimated by using microsimulation models or by relying on detailed tax statistics. Microsimulation models are used to estimate tax expenditures if full data for estimating the cost of tax expenditures are not available. Such models consist of a set of algorithms and a database. The algorithms, built into software, calculate the cost of tax expenditures on the basis of tax data of a sample of taxpayers in economic and institutional settings. Tax data are available from a tax database, which consists of data from taxpayers' returns. These models are mostly used because the available tax data are not sufficient at the time of calculation. They are usually used in estimating the cost of tax expenditures for projections over several years.

Tax Expenditure Reports among OECD Countries

Developed countries have a relatively long history of compiling tax expenditure reports. The concept of tax expenditures was adopted in these countries in the 1960s and 1970s, with compiling tax expenditure reports occurring at different intervals in these countries.

A comparison of 10 OECD countries' tax expenditure reports illustrates the differences among them and can provide guidance for other countries that are considering adopting the tax expenditure report concept. First, we will compare tax expenditure reports with respect to purpose and usage, legal obligations, relationship to the budget, frequency, and method of estimation; then we will compare the definitions used in tax expenditure reports, the items included, the types of taxes and levels of government covered, and the classifications.

Purpose and Usage, Legal Obligations, Relationship to the Budget, Frequency, and Method of Estimation

PURPOSE AND USAGE

Tax expenditure reports generally have the same purposes in all 10 OECD countries: to facilitate budget consultation for better allocating resources efficiently and to analyze the effect of tax expenditure schemes in the tax system. In addition, tax expenditure reporting is used to monitor tax expenditure trends and to analyze the effect of tax expenditure schemes on the economy.

Table 1.2 indicates why the 10 countries analyzed produce tax expenditure reports. Australia, Canada, France, Germany, the Netherlands, the United Kingdom, and the United States use tax expenditure reports to facilitate government budgetary considerations. Australia, Austria, Belgium, and the United States associate tax expenditure reports with shaping the tax system and with tax reform. In addition, for the European Union (EU) countries analyzed—Austria, Belgium, France, Germany, Italy, the Netherlands, and the United Kingdom—tax expenditure reports also serve as a monitoring device to keep their tax systems in line with EU tax expenditure policy guidelines.

LEGAL OBLIGATIONS

Each country has its own regulations. Table 1.2 points out that the Australia, Austria, Belgium, France, Germany, Italy, and the United States have legally required their governments to produce tax expenditure reports. The other three countries—Canada, the Netherlands, and the United Kingdom—have not established any statutory obligations on the part of the government to produce such reports. However, the appropriate financial authorities of these countries have chosen, in accordance with the recommendations of their respective expenditure committees, to produce tax expenditure reports.

RELATIONSHIP TO THE BUDGET DOCUMENTS

Germany includes the tax expenditure report as a part of budget document called a subsidy report. Austria, Belgium, France, the Netherlands, and the United States annex tax expenditure reports to budget documents. Australia, Canada, and Italy treat tax expenditure reports as separate government documents that can be used as references to prebudget consultation. The United Kingdom attaches the tax expenditure report as a statistical supplement to its revenue statement.

FREQUENCY

Eight of the 10 OECD countries surveyed compile these reports annually, regardless of their legal obligation. Germany produces one once every 2

Table 1.2. Why Countries Produce Tax Expenditure Reports: A Comparison of 10 OECD Countries

<i>Country</i>	<i>Purpose and usage</i>	<i>Legal requirement</i>	<i>Relationship to the budget</i>	<i>Frequency</i>	<i>Method of estimation</i>
Australia	Facilitating tax expenditure assessment alongside direct expenditures, contributing to the design of the tax system, and informing the public debate	Legal obligation	Separate government document	Annual	Revenue forgone on an accrual basis
Austria	Shaping tax reform and facilitating the budget process	Legal obligation	Annex as part of a subsidy report to budget documents	Annual	Revenue forgone on an accrual basis
Belgium	Assessing the impact of various tax measures on revenue	Legal obligation	Annex to the budget	Annual	Revenue forgone on a cash basis
Canada	Providing Parliamentarians and the public with information on the estimated cost of tax measures	No statutory obligation	Not directly linked to budget, but provides additional background information	Annual	Revenue forgone on a cash basis
France	Facilitating the budget process	Legal obligation	Annex to the budget bill	Annual	Revenue forgone on a cash basis
Germany	Reducing subsidies and expenditures	Legal obligation	Part of budget called the subsidy report	Every 2 years	Revenue forgone on a cash basis
Italy	Evaluating tax expenditure on the basis of its cost, objective criteria, and its consistency with budget; evaluating its effects for particular sectors and geographical areas compared with its original aims; and being in line with EU tax expenditure policy guidance	Legal requirement	Independent document (not linked to budget process or as annex to budget document)	Sporadic	Revenue forgone on an accrual basis
Netherlands	Providing the parliament with insight into budgetary cost of tax expenditures and possible budgeting	No legal obligation	Annex to the budget memorandum (not directly linked to the budget but serves as additional background information for the parliament)	Annual	Revenue forgone on an accrual basis
United Kingdom	Facilitating annual budget discussion and debate	No statutory obligation, but as a recommendation from the Expenditure Committee	Part of statistical supplement to Autumn Statement (revenue), not linked to budget process or annexed to budget document	Annual	Revenue forgone on an accrual basis
United States	Shaping tax reforms and reducing deficit	Legal obligation	Part of annual budget documents, but not integrated into the budget process	Annual	Revenue forgone, outlay equivalent, and present value on a cash basis

Source: Based on OECD 1996, with recent updates, when available, from the respective countries.

years, and Italy produces one sporadically, perhaps because of the extensive coverage and classification in the tax expenditure report.

METHODS OF ESTIMATION

All countries studied use the revenue forgone method. The United States also uses the outlay equivalent method for comparison with direct outlay and the present value approach for items such as tax deferral and accelerated depreciation. In addition, Australia, Austria, Italy, the Netherlands, and the United Kingdom use accrual accounting for their budget expenditures, as well as for estimating the cost of tax expenditures. Other countries apply the cash accounting method.

Measuring tax expenditures can be labor intensive because some items, although small, require time to estimate. Therefore, not every single tax expenditure can be estimated, especially for countries that produce an annual report.

Definitions and Inclusions, Coverage, and Classification in Tax Expenditure Reports

Table 1.3 provides a comparison of the tax expenditure reports within the 10 OECD countries surveyed in terms of the definition of tax expenditures and items included in the report; the coverage, including type of taxes and level of government; and the classification of the report. There are both similarities and differences in these reports.

DEFINITIONS AND INCLUSIONS

Australia, France, and the United States define tax expenditures in accordance with formal definitions and tax norms, so their tax expenditure reports include those items that deviate from tax norms. Canada uses a very narrow definition of tax norm, in which only the most fundamental structural elements of the tax system are considered to be part of the tax norm. Austria, Italy, the Netherlands, and the United Kingdom have tax expenditure reports consisting of all tax preferences, including structural, nonstructural, and borderline. Instead of a tax expenditure report, Germany uses a subsidy report that embraces both direct subsidies and tax concessions. Belgium defines a tax expenditure as a loss of revenue resulting from a departure from a benchmark tax system; therefore, all elements of the tax system that affect government revenue are included in its report.

COVERAGE

All countries surveyed report personal and corporate income taxes; they also include VAT, except the United States, which has no VAT. Australia,

Table 1.3. What Countries Include in Tax Expenditures Reports: A Comparison of 10 OECD Countries

Country	Definitions and inclusion	Coverage		Classification
		Types of taxes	Levels of government	
Australia	Uses a formal definition of a tax expenditure and applies the norm	Personal income tax, retirement benefits tax, fringe benefits tax, business tax, and excise tax	Commonwealth government (central government)	By broad economic function, by type of taxpayer affected, and by the particular benchmark to which they relate
Austria	Uses tax norm to define tax expenditures or indirect subsidies uses three-way classification in tax expenditures, relief in benchmarks, and some in-between classification or combination of the two	Direct and indirect taxes	All levels of government	By type of tax and by beneficiary
Belgium	Defines tax expenditure as a deviation from the benchmark system resulting in a loss of revenue; includes all exemptions, deductions, and allowances that affect government revenues	Personal income tax, corporate income tax, excise taxes, mortgage registry fees, VAT, and annual tax on insurance policies	Federal government	By whether the treatment constitutes a tax expenditure, by type of tax, and by intended purpose
Canada	Uses a very narrow definition of the norm in which only the most fundamental structural elements of the tax system are considered to be part of the benchmark; includes structural and nonstructural tax preferences	Personal income tax, corporate income tax, and goods and services tax	Federal government	Personal income tax by budgetary functional category; corporate income tax and VAT by type of tax provision: for example, rate reductions, exemptions, deductions, deferrals, rebates and credits

(Table continues on the following page.)

Table 1.3. (continued)

Country	Definitions and inclusion	Coverage		Classification
		Types of taxes	Levels of government	
France	Uses a formal definition of a tax expenditure and applies the norm	Personal income tax, corporate income tax, registry fees and stamp duty, VAT, payroll tax, and internal tax on the consumption of petroleum products	Central government	By type of the tax, by main purpose, and by beneficiary
Germany	Uses a subsidy report, which includes both direct subsidies and tax concessions	Personal income tax, corporate income tax, net worth tax, business tax, turnover tax, insurance tax, motor vehicle tax, excise taxes, betting and lottery tax, property tax, and inheritance tax	Federal government	By industrial sector and, within these sectors, by type of tax
Italy	Uses all favorable tax treatment provisions—structural and nonstructural	Personal and corporate direct taxes, VAT, excise taxes, customs duties, and other indirect taxes	Both federal and local governments	By type of tax, by main sector involved, by aim, by beneficiaries, and by locality
Netherlands	Uses formal definition of a loss or deferment of tax revenue resulting from a tax provision insofar the tax provision is not in accordance with the benchmark tax structure; uses a pragmatic approach for defining the benchmark tax structure	Wage and income taxes, corporate income tax, VAT, excise taxes, energy tax, motor vehicle tax, estate and gift tax, and social insurance contributions	Central government	By purpose of tax expenditure (direct taxes) and by type of tax (indirect taxes)
United Kingdom	Includes all tax reliefs according to three categories: structural relief, nonstructural relief, and borderline relief	Personal and corporate income tax, capital gains tax, inheritance tax, stamp duty, national insurance contributions, and VAT	Central government	By tax expenditures, by structural relief, or by relief, with tax expenditures and structural components under each tax if possible
United States	Defines a tax expenditure as a preferential exception to the baseline provisions of the tax structure; includes all tax expenditures according to the definition; baselines include normal tax baseline and reference law baseline	Personal income tax, corporate income tax, estate and gift taxes, and social security contributions	Federal government	By budgetary functional category

Source: Based on OECD 1996, with recent updates, when available, from the respective countries.

Belgium, the Netherlands, and the United Kingdom include additional tax types. Austria, France, Germany, and Italy cover all direct and indirect taxes in their tax expenditure reports. Most countries cover only the central government in tax expenditure reports; however, Austria and Italy cover all levels of government.

CLASSIFICATION

The 10 countries use various classifications in their tax expenditure reports. In principle, classifications pertain to economic development and budget allocation needs. Such classifications may help answer the following questions: (a) Is the favorable tax treatment provision consistent with the country's budget? (b) Is the original objective still valid? (c) Is the tax expenditure needed to favor particular economic sectors and geographical regions? (d) Does the favorable tax treatment have to be applied only for the period of time initially deemed necessary to achieve its aims?

The U.S. government uses the budget functional classification only. By contrast, Canada uses various classifications according to tax type, such as classification by function for personal income tax expenditures and by types of provisions (for example, tax rate reductions, tax exemptions and deductions, tax deferrals, tax rebates, and tax credits) for both corporate income tax and goods and services tax expenditures. Finally, Italy uses various kinds of classifications to evaluate the cost-benefit outcome for intended beneficiaries. Classifications include tax type, main sectors, aim, beneficiaries, and locality.

Conclusions

This chapter illustrated that the use of tax expenditures concept poses a number of unresolved methodological and institutional issues in countries. Tackling these issues, however, is a requirement for governments that seek to optimize the use of tax expenditures and reduce their mostly hidden costs.

The rest of this book illustrates how different countries have approached tax expenditures in terms of their definition, disclosure, analysis, and inclusion in budgetary and broader fiscal management frameworks. In particular, the practices pursued by the five developed countries provide good references for developing countries producing tax expenditure estimates. The last chapter then outlines the emerging policy options toward better management of tax expenditures.

Notes

1. For a detailed discussion of government contingent liabilities, see Brixi and Schick 2002. *Contingent liabilities* are defined as obligations triggered by a discrete but uncertain event. They are explicit or implicit, depending on the nature (legal versus political or moral) of government commitment. Common examples include government credit guarantees, government insurance programs, and government contingent support programs to bail out troubled banks or state-owned enterprises.

2. Equivalent outlay = revenue forgone / (1 - tax rate).

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