



Political Economy of Tax Expenditures

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**The views expressed are solely those of the author and do not necessarily represent the official views of the European Commission.*

Outline

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3. Political economy dynamics
4. Transparency and reporting
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1. Introduction

- Tax expenditures are reductions in government revenues through preferential tax treatment of specific groups of tax payers or specific activities.
- Countries often make extensive use of tax expenditures to promote public policies and in pursuing a wide variety of aims. Reported tax expenditures add up to a non-negligible share of GDP in many EU Member States.
- In a context of severe public finance challenges, it is important for governments to assess and reform tax expenditures. Not all tax expenditures are equal in terms of revenue forgone and economic effects.
- It is important to understand the political economy characteristics of tax expenditures, what makes some tax expenditures successful and what lessons could be learned.

2. General policy issues

- Problems of identification and reporting
 - ✓ various definitions
 - ✓ difficult to measure revenue costs
 - ✓ cross-country comparisons difficult to perform
- Issues when assessing tax expenditures
 - ✓ identifying proper criteria
 - ✓ microeconomic efficiency
 - ✓ achieving goals with more efficient means
- Based on these criteria, it is appropriate to assess
 - ✓ possible risks attached to the use of tax expenditures
 - ✓ dimensions to watch to ensure their economic efficiency
 - ✓ arguments in favour of specific tax expenditure items

3. Political economy dynamics

- Tax expenditures are sometimes not transparent and are not always included in the budget process.
- Tax expenditures are vulnerable to lobbying and abuse
 - ✓ Lack of co-ordination with related spending programs and control may increase the risk.
 - ✓ Strong political appeal: Governments risk to use tax expenditures to reduce the overall tax pressure or to provide preferential tax treatment to specific groups without increasing expenditures.

3. Political economy dynamics (cont'd)

- Tax expenditures are often quite persistent, even when their *raison d'être* has disappeared
 - ✓ due to a lack of transparency
 - ✓ due to the economic rents captured by a specific group of taxpayers, which is more important for them than the wide spread cost of financing by all taxpayers
 - ✓ due to electoral cycle
 - ✓ due to often less bureaucracy in implementation than with direct spending programs

3. Political economy dynamics (cont'd)

- Issues when evaluating and rationalizing tax expenditures
 - ✓ need to meet given economic objectives
 - ✓ impact on social equity
 - ✓ impact on competitiveness
 - ✓ foster entrepreneurship and growth
 - ✓ complement non-tax policy solutions
 - ✓ administrative and enforcement costs

➔ Overall need to create a culture of evaluation and transparency. Ideally case-by-case analysis with a focus on specific groups or categories of tax expenditures associated with specific economic issues (bottom up or thematic approach).

4. Transparency and reporting

- EC regularly emphasises the need to report and review tax expenditures
 - ✓ Under EU Directive on requirements for budgetary frameworks (2011/85/EU), Member States are asked to publish detailed information on the revenue impact of tax expenditures.
 - ✓ Assessing tax expenditure reporting. Tax Reforms in EU Member States
- Under ESA 2010 tax credits are recorded as public expenditures, rather than tax revenues.
- In 2014 there was a significant increase in reporting compared to 2013. A national legal requirement to report on tax expenditures was in place in 14 of the 19 MS that report regularly today.
- Differences across MS in reporting practices. General use of the revenue forgone method... but many differences in exact methodology.

4. Transparency and reporting (cont'd)

Member State	Legal requirement	Regular (annual)
BE	X	X
BG	X	X
CZ	X	X
DK	X	X
DE	X	X
EE		X
IE		
EL	X	X
ES	X	X
FR	X	X
IT	X	X
LU	X	
NL	X	X
AT	X	X
PT	X	X
SK	X	X
FI		X
LV		X
HU	X	X
PL		X
SE	X	X
UK		X

5. Evaluation

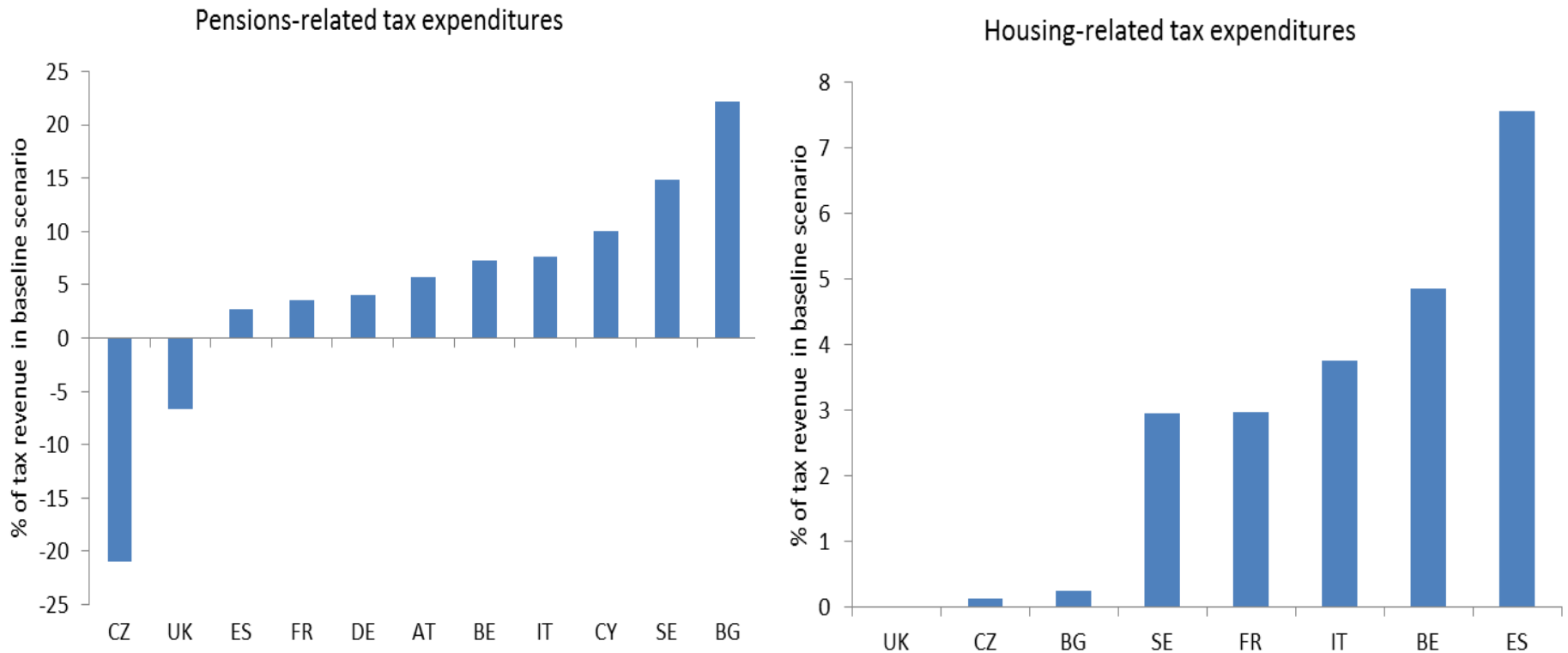
Arguments in favour	Points to watch	Reasons to remove tax expenditures
<ul style="list-style-type: none">• Internalising externalities• Distributional effects• Minimising distortions generated by taxation• May complement non-tax policy solutions	<ul style="list-style-type: none">• Revenue effects• Possible implications of creating a complex tax design• Administrative and compliance costs• Rent-seeking behaviour• Lack of transparency of tax measures	<ul style="list-style-type: none">• Potential revenue shortfall• Too expensive• Design too complex• Scope for fraud• Alternative measures more efficient

6. Recent analysis of tax expenditures

- Recent work on analysing tax expenditures with EUROMOD microsimulation model. The model is based on EU-SILK data and harmonised for the EU-28 (ECFIN, JRC-Seville).
- Recent studies cover:
 - ✓ Work-related tax expenditures (Barrios et al., 2014)
 - ✓ Housing- and pension-related tax expenditures (Barrios, S., Figari F. and S. Riscado, 2015)
- Quantification of revenue impact and distributional effects by comparing the baseline scenario, of no tax expenditures, with the actual tax regimes currently in place in selected Member States.

6. Recent analysis and work on tax expenditures (cont'd)

Budgetary impact of tax expenditures
(in % of tax revenues in baseline scenario, July 2013)

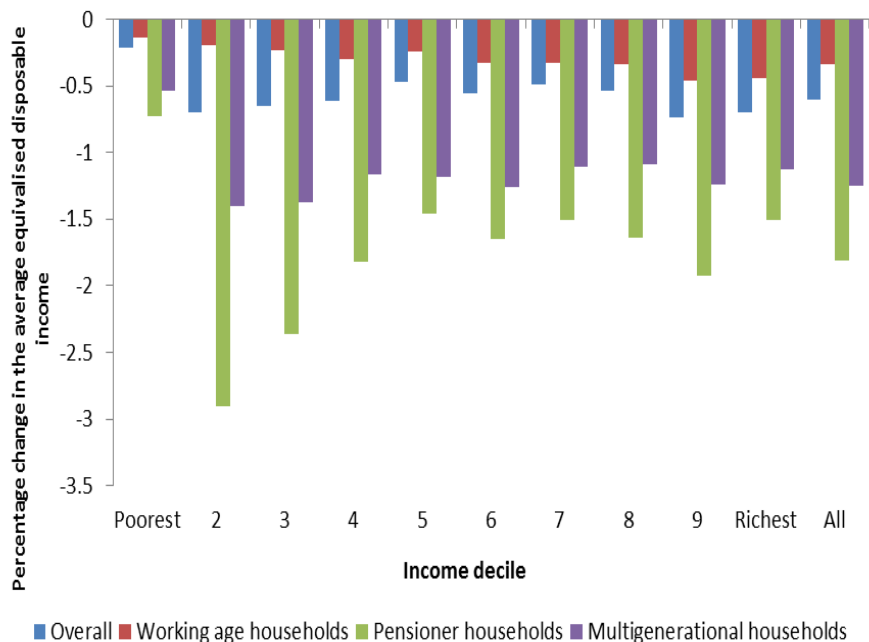


Note: In Spain, the estimated budgetary cost of housing-related tax expenditures do not yet reflect the wide-ranging measures that have been introduced in recent years to reduce tax expenditures in this area.

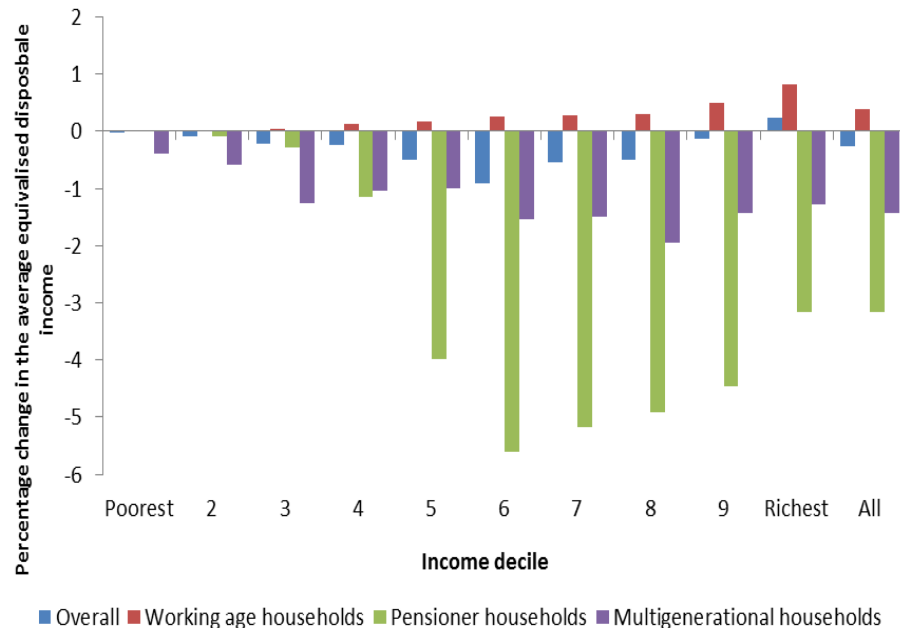
6. Recent analysis and work on tax expenditures (cont'd)

Distributional effects of tax expenditures in selected EU Member States
 Three types of households: working age, pensioners, and multigenerational households

Pensions-related tax expenditures (France)



Pensions-related tax expenditures (Spain)



7. Conclusions

- A careful assessment of the efficiency of tax expenditures requires identifying different policy areas and examining how tax expenditures could – or not – help meet given economic and policy objectives in these areas.
- While some well-designed expenditures can enhance positive spill-overs and welfare, it is important to ensure that tax expenditures do not cause economic distortions and that they are the most cost-efficient means of achieving economic and social policy goals.
- Such an assessment will help the efficient application of tax expenditures to cases where considerable market failures exist and where administrative advantages over comparable spending programs can be identified.
- Overall need to create a culture of evaluation and transparency, which may help address political economy aspects.

Thank you

Further Reading:

- Kalyva et al. (2014). Tax expenditures in direct taxation:
http://ec.europa.eu/economy_finance/publications/occasional_paper/2014/pdf/ocp207_en.pdf.
- Report 'Tax Reforms in EU Member States':
http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip008_en.pdf.
- The use of tax expenditures in times of fiscal consolidation,
(Workshop, DG ECFIN 2014):
http://ec.europa.eu/economy_finance/publications/eedp/dp003_en.htm

- OECD (2010). Tax Expenditures in OECD Countries.
- Burman, et al. (2008). How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?", The American Economic Review (Papers and Proceedings).
- Burman, et al. (2011). Tax Expenditures, the Size and Efficiency of Government, and Implications for Budget Reform", NBER Working Paper.