

1

Introduction

1.1 The subject of this book

This book is about how tax expenditures might be defined and managed in a modern democracy. Others before us have ventured onto this terrain with a view to identifying an ideal approach to these matters. Unlike those commentators, we are not confident that there is an uncontroversial tax expenditure management framework that can be prescribed for any community at any time. The question that the book deals with is how this absence of an ideal approach should be dealt with in a community with ‘democratic’ aspirations. Some argue that such a controversial subject should be ignored by abandoning it altogether. However, we maintain that both tax expenditures and the process for dealing with the controversial aspects of the subject are too significant to ignore in a contemporary democratic setting.

1.2 What are tax expenditures?

At first blush, the concept of a tax expenditure is beguilingly simple. For present purposes¹ it is sufficient to note that a tax expenditure is generally understood to be a ‘tax break’ allowed to a taxpayer or a limited group of taxpayers, for example, by way of concession, deduction, deferral or exemption. Alternative phrases are also used to describe the same concept. In Europe, these ‘tax breaks’ are often referred to as ‘tax subsidies’,² whilst many OECD countries refer to tax expenditures as ‘tax reliefs’ or ‘tax aids’.³ They have previously been known in the United States as ‘tax preferences’.⁴ A layman may refer to them as ‘loopholes’ or ‘escapes from tax’.⁵

¹ In Chapter 2 we consider the tax expenditure concept in more detail.
² See EuroSAI, Report on the Coordinated Audit of Tax Subsidies (2008).
³ OECD, *Tax Expenditures in OECD Countries* (2010), 12.
⁴ Surrey and McDaniel, *Tax Expenditures* (1985), 25.
⁵ Surrey and McDaniel, *Tax Expenditures* (1985), 1; for discussion of the political colour of such terms see Bittker, ‘Income Tax “Loopholes” and Political Rhetoric’ (1973).

Where a taxpayer is entitled to a tax expenditure, the outcome is comparable to that taxpayer having paid the tax due under the normal tax structure and then having received a direct cash grant from the government that is equal to the amount of the tax expenditure. In other words, a tax expenditure is essentially a shortcut to a direct payment by a government as it saves the government from collecting tax and then paying money back to the same person.⁶

In Chapter 2 we note that the nature of the ‘tax expenditure’ concept will vary depending upon the purpose for which tax expenditures are being identified. First coined by Stanley Surrey in the late 1960s,⁷ the ‘tax expenditure’ oxymoron was intended to highlight the incorporation of ‘spending’ rules within the ‘taxation’ law. Surrey hoped to shock legislators into recognising that tax spending rules should be subjected to the same merits review as direct spending measures. Some suggest that Surrey’s motive was to abolish all tax expenditures, although this appears to reach beyond Surrey’s overt ambitions for tax expenditure ‘management’. More likely, Surrey hoped that budgetary committees would cast a cold eye upon all government spending with a view to weeding out unmeritorious spending no matter what form it took.⁸ To this end, Surrey adopted a limited tax expenditure concept that focused upon expressly legislated income tax rules that were substitutable for direct spending measures and that departed from what Surrey identified as a ‘normal’ income tax.⁹

One consequence of the limited definition of the tax expenditure concept adopted in the United States is that substantial tax breaks, more broadly understood, are ignored. For example, *excise* tax breaks are ignored because they do not arise under the income tax.¹⁰ Even if Surrey’s concentration upon ‘spending reform’ were maintained,¹¹ there is a good case for relaxing the concentration upon tax expenditures within the income tax alone. In Chapter 2 we note that a broader approach to identifying tax expenditure reaches beyond the narrowly targeted ‘spending reform’ envisaged by Surrey and that such broader approaches entail

⁶ Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (1973), 6–7.

⁷ Although note the earlier German recognition of the ‘tax spending’ phenomenon: Shannon, ‘The Tax Expenditure Concept in the United States and Germany: A Comparison’ (1986), 203.

⁸ Surrey and McDaniel, *Tax Expenditures* (1985), 5.

⁹ Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (1973), 6ff.

¹⁰ OECD, *Inventory of Estimated Budgetary Support and Tax Expenditures for Fossil Fuels* (2011), 30.

¹¹ By contrast to reform of the legislative rules underpinned by tax policy principles: Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (1973), 30–1.

relaxation of some of Surrey's tax expenditure criteria.¹² Reaching beyond identifying tax expenditures as a vehicle for spending reform, we argue that identifying tax expenditures could be directed towards broader public policy objectives such as assessing the performance of a taxation system overall against a defined ideal tax system. We also consider whether non-legislative departures from a specified 'normal' tax should be recognised as tax expenditures. If the broader objective of reporting upon the performance of a tax system (or of a tax within a tax system) is adopted, there is no reason to restrict the tax expenditure concept to *expressly legislated*, *income tax* rules that are *substitutable* for direct spending measures.

1.3 Why single out tax expenditures?

In the preceding section we noted that the purpose for identifying tax expenditures will shape the tax expenditure concept. Specifying the purpose of identifying tax expenditures is therefore one controversial aspect of the tax expenditure concept. Indeed, some take this purposive inquiry to the point of questioning whether a community should focus upon tax expenditures as a separate subject at all. These commentators agree that critical appraisal of government policy needs to be enhanced, but argue that focusing upon 'tax expenditures' is at best a distraction from more fundamental matters of public policy. If a purpose of enhancing public administration is adopted, there is a view that a 'whole of government' approach ought to be adopted when assessing government action. From this broader standpoint, some commentators argue that there is no reason to segregate 'special' tax treatment in the form of tax expenditures from other forms of preferential treatment. These commentators observe that special government treatment can be found in other government mechanisms as well – such as the payment of a government subsidy, the disposal of public assets for less than their 'real' value, differential recognition of private property rights and/or differential regulatory treatment. From 'whole of government' viewpoints, tax expenditure management should not be undertaken in isolation because all government actions should be subjected to critical assessment against the same organising principle.¹³ Weisbach and Nussim, for example, argue that all government interventions should be assessed against an organisational standard that requires identification of measures

¹² Surrey only briefly considered the application of the tax expenditure concept to other taxes: Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (1973), 26–9.

¹³ Roin, 'Truth in Government: Beyond the Tax Expenditure Budget' (2003).

which are most effective in achieving a desired outcome.¹⁴ Similarly, a broader approach suggests that critical assessment of the ‘tax/transfer’ system should displace the appraisal of discrete ‘tax’ or ‘spending’ rules.¹⁵

Implementing such broad analyses of public policy would require considerable resources to gather and interpret all relevant information. If gathering, interpreting and analysing information were costless, it might readily be accepted that calling for more information is banal.¹⁶ However, as Downs noted,¹⁷ one of the key challenges confronting democratic government is the management of imperfect information in an environment where information is not costless. ‘Whole of government’ perspectives may not incorporate adequate consideration of the considerable resources necessary for such comprehensive assessments of government action. Further, the opportunity cost associated with devoting public resources to such inquiries should be considered. Finally, the pragmatic aspect of ‘whole of government’ analysis must be addressed – how could a government gather the requisite information in the face of opposition to what can be portrayed as intrusive government imposition of tax compliance costs upon the entrepreneurs in a market economy?

Every community, then, must make difficult choices about the procedures for making substantive policy choices with imperfect information and imperfect means of analysing and interpreting that information.¹⁸ The significance of this issue is perhaps most stark for a developing economy, where the benefit of comprehensive assessment of all government action may be outweighed by benefits derived from targeting limited resources upon specific aspects of tax administration. In such contexts, it is possible that a limited form of tax expenditure management delivers the greatest public benefit by refining the taxation system which underpins meritorious direct spending programmes.

1.4 Explaining the focus upon tax expenditures – the significance of tax expenditures

Recognising these costs of appraising public policy complicates the consideration of whether or not tax expenditures should be examined as a

¹⁴ Weisbach and Nussim, ‘The Integration of Tax and Spending Programs’ (2004).

¹⁵ Kaplow, ‘Taxation and Redistribution: Some Clarifications’ (2007). Hence greater policy emphasis upon the tax/transfer system. See, for example, Australia, *Australia’s Future Tax System* (2009), 15.

¹⁶ Shavero, ‘Rethinking Tax Expenditures and Fiscal Language’ (2004), 219.

¹⁷ Downs, *An Economic Theory of Democracy* (1957), 215.

¹⁸ McGarity, *Reinventing Rationality* (1991).

discrete subject. If there are insufficient resources to critically assess all government action, what should be done? We argue that tax expenditures require separate consideration because they are a special case of government action and also because they are so significant from several standpoints.

Tax expenditures are significant by virtue of their number, distribution,¹⁹ impact upon the fiscal position of states, constitutional significance, impact upon public administration in general and tax administration in particular and also because of their relevance to the legitimacy of democratic governments. These and other impacts are considered in Chapter 4. However, at this point it is appropriate to outline some of the impacts of tax expenditures for two purposes. The first purpose is to reject the 'whole of government' proposition that tax expenditures should not be examined in isolation. The second purpose is to justify the book upon the basis that tax expenditures warrant further consideration to which, we hope, this book makes a useful contribution.

1.4.1 *The pragmatic politics of tax expenditures in contemporary democracies*

Tax expenditures are a special case of government action because of the unique and politically powerful combination of 'tax' and 'spending'. As many commentators have noted, tax expenditures are politically significant in contemporary democracies because they afford politicians the opportunity to combine the politically powerful message of providing a 'tax cut' while simultaneously delivering government 'spending' upon politically significant issues such as welfare, small business, the environment and other substantive policy areas.²⁰

1.4.2 *Economic significance*

From a fiscal perspective, the most significant impact of a government's tax expenditures programme is the scale of the programme both in terms of gross revenue foregone²¹ and also relative to the scale of direct spending. By virtue of their scale, tax expenditures are a major feature of government policy in many countries.²²

¹⁹ OECD, *Tax Expenditures in OECD Countries* (2010), 14.

²⁰ Howard, *The Hidden Welfare State* (1997).

²¹ The difficulties of measuring the cost of tax expenditures are discussed in section 2.6.

²² The significance of tax expenditures is reflected in the work that the OECD has undertaken in this area. In 1984 and 1986 the OECD published studies specifically dealing

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Assuming that the fiscal needs of a government remain constant, the effect of a tax expenditures programme is to shift part of the tax contribution from the beneficiaries of that programme to the broader tax community. By relieving some taxpayers from paying at least some tax that they would otherwise have paid, governments can use tax expenditures to favour particular activities over others, and hence induce private investors to invest in the favoured sector. Thus, tax expenditures are a way that governments affect the *allocation* of a community's limited resources to particular activities. 'Neoclassical' economic theory holds that the 'invisible hand'²³ of self-interest ensures that perfectly functioning free markets are the best means for a society to extract the greatest benefit from its limited resources. Some tax expenditures can be defended upon the basis that they minimise the social cost of imperfect markets. However, there are empirical difficulties in demonstrating that the tax expenditure maximises social welfare. This is because of the difficulty of establishing that the social cost of a tax expenditure is less than the social benefit generated by introducing the tax expenditure (i.e. the reduction of the social cost caused by the market imperfection).²⁴

By favouring some taxpayers over others, tax expenditures also affect the *distribution* of income and wealth within a community. While many tax expenditures are justified upon the basis that they redistribute resources to those with lower incomes, many other tax expenditures favour those with higher incomes. For example, the rationale of taxing income rather than other tax bases is that progressive taxation of income constitutes a fairer means of distributing a community's tax burden than other tax bases would allow²⁵ and are also one means of pursuing

with tax expenditures. In 2003 it issued a special feature about tax expenditures in Revenue Statistics (*Special Feature for the 2003 Edition of Revenue Statistics: Note by the Secretariat*). The OECD document *Best Practices for Budget Transparency* (2002) contains basic guidelines for the treatment of tax expenditures. In 2004, it elaborated on these guidelines in *Best Practice Guidelines – Off Budget and Tax Expenditures*. Canada, the Czech Republic, Germany, France, Greece, Hungary, Italy, Mexico, the Netherlands, New Zealand, Norway, Poland, Spain, Sweden, the United Kingdom and the United States were represented at the expert meeting to discuss the 2004 document. Australia and Japan provided written information.

²³ Smith, *The Wealth of Nations* (1993), para IV.2.

²⁴ Burton, 'The Australian Small Business Tax Concessions – Public Choice, Public Interest or Public Folly?' (2006).

²⁵ Stanley, *Dimensions of Law in the Service of Order* (1993); Fleming and Peroni, 'Reinvigorating Tax Expenditure Analysis and its International Dimension' (2008).

a community's aspirations to economic democracy.²⁶ To the extent that income tax expenditures redistribute a community's resources to those with higher incomes/wealth, tax expenditures undercut the legitimacy of the income tax.²⁷

1.4.3 *Public administration*

From a public administration perspective, tax expenditures can reach into any domain across the policy spectrum – from social welfare to industry assistance to national security. Typically tax expenditures are administered by the tax authority because of the formal categorisation of these 'spending' rules to the tax law. This is the case notwithstanding the fact that any particular tax expenditure might be managed more effectively within the relevant substantive government portfolio where there is greater policy expertise and understanding of the interaction of the tax spending with other government programmes.

Further, the integration of a plethora of public policy measures within the tax framework engenders challenges surrounding the administration of tax expenditures,²⁸ particularly in the context of a system where taxpayers self-assess their taxation liability. If the tax authority concentrates upon revenue collection and is perceived not to have devoted sufficient resources to the spending aspects of the tax law, the legitimacy of the taxation system can be threatened with consequent negative impacts upon taxpayer voluntary compliance.²⁹

1.4.4 *The uneasy case for examining tax expenditures in isolation*

In a perfect world communities would be able to subsume critical appraisal of tax expenditures into a 'whole of government' selection of the best means of achieving a desired public policy. However, the direct costs and political challenges associated with this course of action mean that a comprehensive whole of government analysis is not feasible. Tradeoffs must be made between competing objectives and this means that a comprehensive, whole of government approach must be compromised. At

²⁶ For an illustration of this theme in the popular media see: Stiglitz, 'Of the 1%, for the 1%, by the 1%' (2011).

²⁷ Fox, *If Americans Really Understood the Income Tax* (2001), ch. 5.

²⁸ United States of America, *A Reconsideration of Tax Expenditure Analysis* (2008), 41; Brooks, 'Comment' (1988).

²⁹ See section 4.6.

the other end of the ‘information requirement continuum’ are those who suggest that information difficulties mean that public government should be kept to a minimum.³⁰ If government policy cannot rest upon a firm empirical basis, they say, government should not interfere. We disagree with this libertarian view. Leaving a justification for an interventionist state for another day, suffice to say that contemporary democratic governments are some considerable distance from libertarian minimalism.³¹ In the present era it is difficult to imagine a truly non-interventionist state where ‘whole of government’ analysis could be achieved at little social cost because the scope of government was so small.

Once both comprehensive, whole of government analysis and libertarian minimalism have been excluded upon pragmatic grounds, a point on the ‘uneasy’ middle ground between these two extremes must be adopted. A more selective approach must be adopted, notwithstanding the limitations of such selectivity. We suggest that the practical significance of tax expenditures means that they should be selected for critical scrutiny. In itself, this selection of tax expenditures is controversial.

1.5 What else is controversial about tax expenditures?

1.5.1 *The tax expenditure benchmark*

Even if it is accepted that a community should focus its limited resources upon examining the ‘proper’ functioning of its taxation system, it could be argued that the community should critically assess the operation of its *entire* taxation system as a routine part of its budgetary process. However, for the same reasons as were noted in section 1.4, in most if not all communities limited public resources are insufficient to allow such a comprehensive analysis of an entire taxation system on a routine basis. Further, a judgement must be made regarding the likely benefits relative to the costs of such ongoing systemic review. In this context, focusing a community’s attention upon particular aspects of its tax framework is a pragmatic response.

³⁰ See the discussion of libertarian political theory in section 5.4.

³¹ And perhaps even if government is restricted to libertarian minimalism, as comprehensive, whole of government analyses of alternate policy options with respect to the minimalist domains of property and national defence could, in themselves, absorb considerable resources. In this regard, note Epstein’s more nuanced appreciation of the limitations of simplistic libertarianism: Epstein, ‘Taxation with Representation: Or, The Libertarian’s Dilemma’ (2005).

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One means by which efforts might be focused is by separating less contentious tax policy decisions from those which a community considers to be more contentious. Identifying tax expenditures by separating them from 'normal' taxation rules fulfils this function. In Chapter 2 we review the literature regarding various ways that this crucial aspect of tax expenditure management has been undertaken. Suffice to say that identification of the 'normal' rules is undertaken by identifying an ideal taxation system against which the present taxation rules can be compared. Surrey's ideal tax system was framed upon the basis of what he proclaimed to be tax policy principles that were grounded upon a consensus amongst tax policy experts.³² Surrey therefore constructed a position from which he could criticise the taxation law enacted by a 'democratic' legislature. Those rules which do not correspond with the ideal taxation rules would be tax expenditures and would be subjected to tax expenditure analysis – critical assessment of their merits as spending measures. Classification of a rule as a 'tax expenditure' does not mean that the rule should be abolished – it simply means that the rule should be subjected to closer scrutiny under a routine process of tax expenditure management.³³ That is, it should be critically assessed against specified public policy principles.

Surrey's approach reflects the confidence of his time in a science of public policy.³⁴ Like the scientific study of material phenomena, there was a general portrayal of, and faith in, good public policy constructed upon rational grounds. Like all scientists, Surrey hoped that his rational approach to tax expenditure management would dispel subjective judgments from the realm of tax policy. He constructed his 'view from nowhere' upon the 'general consensus' among tax policy experts, purportedly free of any subjective element, from which he could identify tax expenditures. However, the foundations of Surrey's concept were quickly subjected to critical assessment pointing to the insecure foundations upon which his tax expenditure analysis was constructed.³⁵ The scorn with which Bittker described the use of 'tax expenditure' in the pejorative terms of 'political' and 'rhetoric' sounds through the ages.³⁶ More recently, others similarly

³² Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (1973), 17.

³³ Surrey and McDaniel, *Tax Expenditures* (1985), 5–6.

³⁴ For consideration of an early instance of this presentation of the science of tax policy, see Murnane, 'Selling Scientific Taxation: The Treasury Department's Campaign for Tax Reform in the 1920s' (2004).

³⁵ Bittker, 'A "Comprehensive Tax Base" as a Goal of Tax Reform' (1967), 985.

³⁶ Bittker, 'Income Tax "Loopholes" and Political Rhetoric' (1973). For discussion of the concept of rhetoric which conveys the scorn with which positivist social scientists use the term see McCloskey, *The Rhetoric of Economics* (1998), ch. 1.

have attempted to construct an apolitical ‘view from nowhere’,³⁷ but their efforts are subject to the same criticism that they are just another form of partisan pleading dressed in the ‘objective’ robes of ‘policy science’.³⁸

In chapters 2 and 3 we describe and explore these controversies in more detail and, we should confess now, throw some fuel upon the fires of controversy by suggesting that the concept of a tax expenditure could be expanded to include what we call non-express tax expenditures. Non-express tax expenditures include a legislative rule which accords with the benchmark but that is not applied in practice. A non-express tax expenditure also includes the case of a government simply not enacting an entire taxation law notwithstanding that the benchmark suggests that such a law should be enacted.

1.5.2 Tax expenditure measurement

There are also considerable empirical controversies which we explore in chapters 3 and 4. Even if a community could agree upon a tax expenditure concept and upon the appropriate benchmark taxation system, the measurement of tax expenditures is challenging for all sorts of reasons.³⁹ While it is difficult to measure the fiscal cost of tax expenditures as addressed in Chapter 3, measurement issues extend beyond the mere dollar reporting as highlighted in Chapter 4. Identifying the true beneficiary of a tax expenditure, as opposed to the formal legal beneficiary, involves speculation as to the interaction of market and non-market transactions in relation to the recipient’s benefit. Moreover, the impact of a tax expenditure might reach beyond immediate cash transactions – as where an environmentally damaging tax expenditure creates negative impacts for the health of a person living in a future time and in another country to that where the tax expenditure was provided.

1.6 The irresolvable nature of these tax expenditure controversies

The seemingly simple concept of a tax expenditure, created upon a rationalist foundation for the apparently noble objects of objectively improving budgetary process and outcomes, has been mired in controversy.

³⁷ United States of America, *A Reconsideration of Tax Expenditure Analysis* (2008).

³⁸ Fleming and Peroni, ‘Can Tax Expenditure Analysis Be Divorced from a Normative Tax Base?: A Critique of the “New Paradigm” and Its Denouement’ (2010).

³⁹ Fleming and Peroni, ‘Can Tax Expenditure Analysis Be Divorced from a Normative Tax Base: A Critique of the “New Paradigm” and Its Denouement’ (2010), 178–9.