TAX EXPENDITURES: A THEORETICAL REVIEW

Vjekoslav Bratić, MSc
Institute of Public Finance, Zagreb

Review article*
UDC 336.5(497.5)
JEL E62

Abstract

Tax expenditures are an instrument frequently used when a government wishes to achieve certain economic and social effects. But because of the increasing number and scope of tax expenditures, their proper use, quality of administration and record-keeping have become a major challenge for the tax authorities and the whole of the government.

The article considers and explains very diverse forms of tax expenditure such as reliefs, tax deductions, tax allowances, tax exceptions and special rates of taxation and the ways in which they are defined and calculated.

The key problems in the analysis are the absence of a single definition and of methodology for the calculations; these ultimately make it impossible to compare tax expenditures between or among countries.

Key words: tax expenditures, reliefs, credits, exceptions

1 Introduction

Part of the entire fiscal activity of some country may go unrecorded because it is hidden in the form of revenue deliberately or inadvertently not collected and not shown as public spending. Such activities in the broadest sense of the word are tax expenditures or outlay tax.[1] These activities can be contained in many forms, from tax exceptions, reliefs, exemptions or reductions of the tax base or of tax due.

* *Received:* May 9, 2006
Accepted: June 2, 2006

[1] According to the OECD and IMF classifications, taxes are also considered to include, in addition to the classic forms, customs duties, employers' and employees' and self-employed persons' social insurance contributions. However, such a wide coverage was not used in this investigation.

Tax expenditures are an instrument the government uses to favour certain groups or categories of taxpayers (sectors, firms or individuals) and to provide incentives to given economic activities or branches. In such a case, the government consciously concurs in the reduction of its own revenue. The same effect would be achieved if the government collected the taxes from all the bases, and later, allocated direct grants or aid from the expenditure side of the budget. The main distinction is that this manner would be incomparably more transparent.

Tax expenditures aim at achieving targeted public policy objectives by providing benefits to qualifying individuals or entities or by encouraging particular activities. They may also be intended to improve tax equity or offset imperfections in other parts of the tax structure. The same set of objectives (for example, financial assistance to families) can be achieved either through direct spending or through tax waivers or exemptions.

To determine whether a particular tax measure generates a tax expenditure it is necessary first to establish the normal tax structure from which this measure represents a departure. There is also a debate on the methodology used to assess the impact of tax expenditure, since some tax expenditures may have a different impact than direct spending, taking into account any resulting changes in behaviour of taxpayers. (OECD, 2004; Allen and Tommasi, 2004:60).

But tax expenditures also have their negative characteristics, above all because they distort the neutrality of the tax system. A neutral tax system assumes a broad tax base, without any tax expenditures and with a standardised system of taxation. The tax system should be particularly neutral when budgetary revenue increases (see more in OECD, 2001b). When a country decides to respect tax system neutrality, it should avoid the use of tax expenditures (OECD, 2001a). In addition, it is best for all those involved in the taxation system (both the tax authorities and the taxpayers) for all taxes to be as simple as possible to collect, and hence as cheap as possible for the tax administration that collects it, while for the taxpayer it is also important that the taxes are not so complicated as to be unintelligible.

Tax expenditures have many other negative aspects. They increase the costs of tax administration and reduce the transparency of the tax system and the public finance system as a whole because they are often not subject to the same system of internal control and statutory authorisations as the other kinds of expenditures; they are often introduced without complete understanding and analysis of the costs and benefits that might be involved, which has a direct effect on the reduction of the revenues of the central government exchequer; and they often distort some of the principles of taxation (the principle of equality, equity, productiveness, effectiveness, stability and efficacy). Because of the increasingly great number and scale of the very various forms of tax expenditures, their proper use, administration and recording have become a great challenge. This is a particularly big problem in countries that do not record them systematically, in which such losses of government revenue are not reported, or where the analysis of the cost-benefits of tax expenditure agendas is not carried out because of the lack of any accurate tax expenditure reports (Polackova, Valenduc and Swift, 2004:XI).

2 An overview of tax expenditures

A definition of tax expenditures

No simple, all-embracing definition of tax expenditures exists.

For the purpose of this research, we defined expenditures as all those items in existing tax forms that mean a loss of central government budgetary revenue because they reduce either the tax base or the tax due. This means that part of the revenue does not at all come into the process of assessment in the given form of tax. By so excepting given items from the tax base, revenue of the central government treasury is lost, and such an item constitutes tax expenditure.

Readers, nevertheless, must be aware that there are many other definitions. Different tax codes of different countries, particularly in the systems for taxing personal and corporate income tax, contain numbers of tax reliefs (sometimes called tax aid, incentives or subsidies), which depart from the usual tax structure and are brought in to favour a given industry, activity or category of taxpayer. The concept employed to signify this spending procedure is tax expenditure.

All tax incentives that the central government introduces as alternatives to direct government spending for the sake of obtaining given economic and social objectives can be considered tax expenditures. Similarly, the introduction of given modifications into a tax system in the form of reliefs, exemptions, deductions from tax due and tax exceptions is called a tax expenditure. Tax expenditures are every tax exemption, exclusion, deduction, credit, deduction from tax due, preferential tax rate, abatement or other device reducing the amount of revenue that would otherwise accrue to the central government (State of Illinois, 1998:1).

According to the OECD definition, also used by the World Bank (Polackova, Valenduc and Swift, 2004), in broad terms, tax expenditures are concessions that fall outside a tax norm or benchmark.[2] Tax norms include the rate structure, accounting conventions, the deductibility of compulsory payments, provisions to facilitate administration and those relating to international fiscal obligations (OECD, 1996:9). In other words, tax expenditure is "revenue forgone because of preferential provisions of the tax structure" of which the express aim is to achieve certain economic or social objectives.

In practice, tax codes and tax systems are differently defined in different countries, which make them difficult to compare. Just as there is no single accepted definition of tax expenditure, so there is also no broadly accepted methodology for calculating it. According to the majority of methodologies used, all items that are in fact a certain deviation or change from the existing tax system are considered tax expenditures. Typically, these deviations or distortions appear in the form of exceptions (when the income of a particular group of taxpayers is excepted from the tax base), deductions from the tax base (when for certain costs or other amounts the tax base is reduced), reduced rates, tax credits or reductions of the base (when a certain category of taxpayer or activity benefits from a reduction

[2] The Canadian department of finance defines tax expenditures in a similar way. For more see: http://www.fin.gc.ca/taxexp/2001/taxexp01_1e.html#_Toc519392242 i http://www.fin.gc.ca/taxexp/1999/taxexp 99_1e. html#Expenditure.

of the normal tax rate), reliefs, deferrals (when the normal rate for payment of the tax is postponed without any attendant interest or fine). But because this is such a wide range, it can be assumed that the list of tax expenditures will probably include some items that are not really expenditures. Hence for a high-quality and accurate analysis of tax expenditures it is necessary to give as much information as possible about deviations (concessions and changes) from the basic tax system (Government of Canada, 2004:60).

Investigations into tax expenditures

Tax expenditures reporting began in Germany and the United States in the late 1960s, with other countries introducing it in the late 1970s (Austria, Canada, Spain and the United Kingdom) and the remainder starting in the 1980s (OECD, 1996:9).

The manner, time and methodology of reporting about tax expenditures and their links with the budget process vary significantly across countries. In seven of the 14 OECD countries that report on tax expenditure programs - Austria, Belgium France, Germany, Portugal, Spain and the United States - the authorities are legally obliged to produce tax expenditures reports. In most of these countries, the report is currently produced annually, the exceptions being Germany (every 2 years) and Italy (sporadic). In Australia, Belgium, Finland, France, Portugal, and Spain, the tax expenditure report is linked explicitly to the budget process. Austria and Germany produce subsidy reports that use a broad concept of subsidy, including all forms of support through both direct spending and tax expenditures. In the other countries, tax expenditure reports mainly have been produced as separate documents. In the United States, a tax expenditure report is produced as part of the government's budget but is not integrated into the budget process (Polackova, Valenduc and Swift, 2004:212). Once a year, the federal government publishes a report about tax expenditures within the budgetary process in Congress. For example, the department of energy reports on tax expenditures that have an impact on the power industry, giving information about the main beneficiaries (producers of natural gas and ethanol) and assessments of total costs of these expenditures. Some of the individual states in the Union, such as California, Massachusetts and New York, require that tax expenditures and reports concerning the total amounts of these expenditures be incorporated into the finance bill, in such a way that all tax expenditures are classified according to kind of tax to which the given tax expenditure refers.

For illustration we quote the approach to tax expenditures in France.

Most developed countries have brought in an empirical reporting system about tax expenditures and about the amount and kind of total tax expenditures. This is a complex business, made additionally difficult because there are no detailed analyses, databases and comprehensive reports about tax expenditure agendas. Even when such reports do exist, they are frequently inappropriate and insufficiently detailed, which is common in countries in development and transition countries. Systems for reporting about tax trends (and hence about tax expenditures) are usually a component part of the overall fiscal system of the country, whose aim is to achieve as effective as possible allocation of budgetary resources and to increase the transparency of the whole system of public finance. Some countries also analyse costs and economic effects of the introduction of some tax expenditures, while some analyse tax expenditures during the budgetary process, in which they are subjected to detailed analyses, exactly as if they were direct budgetary expenses.

Box 1 Tax expenditures in France

The tax expenditure report has been published annually since 1980 as part of the report on ways and means appended to the finance bill laid before Parliament. The report covers all central government taxes. The taxes are classified in three ways: by the nature of the tax (personal and corporate income tax, wealth tax, stamp duties, payroll taxes, value added and other indirect taxes), the main purpose of the tax expenditure (economic development, savings, regional or sectoral support, housing and social policy) and by the category of beneficiary (households, enterprises or both).

In each case, the immediate beneficiary is identified; no attempt is made to take account of the shifting of the tax burden.

A formal definition of tax expenditure is used: "The designation 'tax expenditure' may be applied to any legislation or regulation the introduction of which entails a loss of revenue for the State, and hence an easing of the burden on the taxpayer by comparison with the charge that would have resulted from the application of the "norm", i.e. the general principles of French tax law".

The main tax expenditures in France include:

- the reduction of tax due to the family quotient that takes into account of the number of persons living off the income as this is regarded as an important indicator of ability to pay,
- exemptions of personal income tax for veteran's pensions, interest and bonuses on home ownership savings schemes, certain social security benefits and so on,
- allowances for the elderly and the disabled,
- additional standard deductions for certain business expenses,
- deduction of expenses for certain major housing repairs and improvements,
- allowances for certain dividends and interest income,
- common flat rate tax for farmers,
- various exemptions and special allowances for corporation tax,
- arrangements of overseas departments and special arrangements for VAT,
- exemptions or reduced rates from the internal tax on the consumption of petroleum products for certain ships, jet aircraft fuel, home heating and so on.

Source: OECD (1996)

Reports about tax expenditures usually contain seven main elements: a description of tax norms and tax bases, a description of taxable units, the distribution of tax rates and the tax period, and the estimate of the amounts of tax expenditures over the previous seven years. Apart from this, such reports should also contain the purpose and statutory basis for the existence of tax expenditures.

Problems in the analysis of tax expenditures

The analysis of tax expenditures, because of the numerous problems, from their definition and compass to the shortcomings of the necessarily wide-ranging analyses and the reports and manner of classification, is neither simple nor uncomplicated. For example, the concept and coverage of the idea of tax expenditure vary from country to country. In Canada it covers allowances for pension contributions and contributions for registered retirement savings programmes, deductions from tax due for charitable donations and incentives for firms to invest in research and development.[3] The aim is to give the reader sufficient information and calculation of individual expenditures, without entering into controversy or discussion of the definition and scope of tax expenditures. Each deviation from the closely defined tax structure is analysed in the report. This enables the individual reader to decide on whether a given tax procedure is a tax expenditure or not. The report has two parts. In the first, all the items that might be considered tax expenditures within a very broad (sometimes unrealistically so) definition are given. The second part contains all the other deviations in the tax system, which are called memorandum items. Canada has, thus, adopted a very wide approach and manner of reporting about tax expenditures, and has at the same time included tax expenditures in the process of auditing and control of the budget.

In the UK tax concessions are analysed in terms of three categories: 1) structural reliefs, 2) tax expenditures that contain tax procedures that are considered an alternative to direct spending and 3) tax reliefs that contain elements of the first two categories – both structural reliefs and tax expenditures, as well as those that cannot be unreservedly placed in either one of the two groups. Reports are written concerning all tax procedures, and the reader is given a direction for and manner of classifying each procedure in an appropriate manner. In the USA the method of reporting about tax expenditures is more complex because of the comparison of two different tax structures: the normal and the so-called reference law structure.[4] However, we shall not deal in detail with these calculations.

Other problems too weigh upon the analysis of tax expenditures, such as the absence of large-scale analyses and reports about tax expenditures, which is actually in contravention of the *IMF Fiscal Transparency Code* (Kesner-Škreb, 2001) and one of the basic objectives that every executive government must aim at, that is, the detailed and comprehensive planning and analysis of the expenditure side of public finance. In such situations it is difficult, even impossible, to evaluate the costs, effectiveness and impact of given tax expenditures. Still more difficult is to evaluate the cost, efficiency, and equity impact of tax expenditures and the extent to which resources could be rationalized or better allocated to strengthen government finances and to support progress toward broader economic and social objectives (Polackova, Valenduc and Swift, 2004:XI). An additional problem is that data about the tax expenditures of different countries are not compatible because of the varying definitions and coverage of tax expenditures or because there is no single accepted definition of the benchmark tax system In defining tax expenditures other practical problems arise such as defining the reference or benchmark or basic tax structures and a determination of which exceptions from such a structure can really be considered a tax expenditure (ibid).

We can conclude that serious research into tax expenditure in the developed countries started in the 1970s. It turned out that the key problems in these investigations and

[3] http://www.fin.gc.ca/fin-eng.html

[4] For more see: http://www.fin.gc.ca/taxexp/2001/taxexp01_1e.html#_Toc519392242

comparisons of them were related to the absence of a single definition, scope and international model for the writing of reports about tax expenditures. This is the basic reason why the manners of classification, time and methodology of reporting about tax expenditures and their connections and relations with the budgetary process in different countries are so very diverse.

The usual types of tax expenditures

Tax expenditures are divided into those that reduce the tax base, and those that reduce the tax due. For personal income tax, for example, taxable income is reduced by allowances or deductibles, while tax credits are reductions of tax due.

Sometimes it is extremely hard to decide to which group or subgroup a given kind of tax expenditure belongs. And sometimes almost the same tax expenditure can be put into different groups. But irrespective of this and of the diversity of tax systems, tax expenditures mostly take forms such as tax reliefs, tax credits, deductions from tax, tax exceptions or preferential tax rates.[5]

Now, taking personal income tax and corporate income tax as examples, we shall briefly describe the benchmarks and the reductions of the tax base, and reductions of tax due.

A Reductions of the tax base or taxable personal or corporate income

Categories of tax deductibles (allowances) vary from country to country. On condition that other characteristics of the tax system remain unchanged, deductibles reduce the tax burden of a taxpayer by the product of the marginal tax rate and the amount of the deduction. The value is, then, proportional to the marginal tax rate of the taxpayer.

- *Tax preferences, reliefs or deferrals* are special deductions from personal or corporate income that are subject to the usual tax on these forms of income. This group includes higher depletion allowances, accelerated depreciation, intangible drilling costs and charitable donations.
- *Tax deductions or tax allowances* are amounts deducted from income subjected to taxation so as to determine the taxable income in systems for the taxation of personal income tax. Best known are training costs, contributions to pensions funds, charitable donations, life insurance premiums, mortgage interest, medical and dental expenditures, tax paid to other levels of government and losses from accident or theft.
- Tax laws may also stipulate the standard tax relief. This is a relief that is not related to any real expenditures that the taxpayer has incurred, but to which the taxpayer is entitled because of some particular circumstances (marital status, dependents, age, health insurance, source of income). In some systems tax relief can be deducted from tax due.
- There are also tax exceptions or deductions for members of the family, usually based on the number of family members. After the amount of the taxable income is de-

[5] For more concerning the various kinds of tax expenditures see: Arbutina and Ott (1999).

termined, as gross income reduced by deductions and exceptions, to this amount the marginal tax rates are applied in order to obtain the amount of the tax liability. Most systems of personal income tax allow the deduction of personal exceptions deeming that in this way the minimal amount of income that is required for the bare necessities can be excluded from the tax. Apart from that, the amount of the personal deduction greatly affects the progressiveness of a tax system. Even a system with a proportional marginal tax rate can become progressive if it recognises the personal deduction (for more, see Kesner-Škreb [et al.] (2001:176)). Like the allowances (with which they are often intermingled to such an extent that it is difficult to distinguish them, the two even being considered synonymous), exceptions also reduce the tax burden by the product of the marginal tax rate and the amount of the exception. Thus, their value is also proportional to the marginal tax rate of the given taxpayer.

- A tax relief that takes into account special personal circumstances of the taxpayer, such as the additional responsibilities of taxpayers who have dependent children and other dependent kin (personal tax reliefs), is usually claimed by the deduction of a standard amount from personal income in the calculation of the amount to be taxed.
- Non-standard allowances can also be allowed on the basis of differing costs of life insurance, contributions for pensions funds and so on. These are sometimes called personal allowances.
- *Special (most commonly reduced) rates of the tax set for given taxable values* such as the reduced rate of the standard tax rate for capital gains in comparison with the taxation of regular personal income, and by tax holidays.
- *Tax exemptions.* Tax codes often contain certain exceptions for persons, items or transactions that would otherwise be taxable. Exceptions are most often granted for some social or economic purposes, but not always. A natural person can, for example, be exempted from the payment of personal income tax (in the sense of a relief) because of low income or a basic exemption can be granted from a certain fixed amount in the calculation of the personal income tax liability in such a way that a taxpayer that does not cross a tax threshold (level of personal/corporate income that is the trigger for the application of the tax) is exempted from the payment of the personal/corporate income tax (for more see Arbutina and Ott, 1999:132,343).
- *Exceptions (exclusions) from personal or corporate income tax.* Exceptions are income that is excluded from the calculation of gross income or that is not included in it (reduction of the tax base is in a way similar to that of tax deductions); unlike deductions or amounts that have to be displayed within the gross income allowance but can be deducted when the calculation of taxable income is made.
- *Tax incentives.* Tax incentives are very popular instruments in the personal and corporate income tax system that relate to research and development or regional incentives for investment that contribute to the growth of employment and productivity.

B Reductions of tax due – tax credits.

After the personal income tax due is assessed (the product of marginal tax rate and taxable income), the resulting amount can be further reduced by a certain fixed amount that is called a reduction of the tax due or tax credit. It usually relates to reliefs granted to households with very low income or many children.

Various reductions of the amount of the tax are a possibility of reductions from tax due or of the direct factoring of the reduction into the amount of the tax due. The reduction of tax due is an alternative method of giving tax relief pursuant to the personal circumstances of the taxpayer.

- In some tax codes personal exceptions are replaced by reductions of the tax due. This has been the practice in Hungary since 1995, for instance. In this way the equity of the tax system is increased, for reductions of tax due reduce the tax burden by the same nominal amount for all taxpayers, irrespective of the marginal tax rate.

We can conclude, then, that tax expenditures are divided into those that reduce the tax base (the income) and those that reduce the tax due. Sometimes it is extremely difficult to determine and differentiate to which group or subgroup a given kind of tax expenditure belongs.

How are tax expenditures viewed by different authors?

In order to show certain dubieties within the research effort into tax expenditures, we shall present some of the definitions of familiar authors and organisations.

OECD (1996) and Sandford (2000)

Sandford (2002) took over the most frequently applied definition of the OECD (1996) and distinguished five categories of tax expenditures:

1) exemptions – income excepted from the tax base (including special forms of exemptions),

2) allowances – amounts deducted from gross income so as to obtain taxable income,

3) deductions from tax due or tax credits – a deduction from the tax that may not exceed the amount of the tax from which it is deducted is called a wastable, and a deduction from paid tax that can be paid to the taxable entity up to an amount that exceeds the tax from which it is or can be deducted is called a non-wastable,

4) rate reliefs – reduced tax rate various for a bracket of taxpayers or an activity,

5) tax deferrals – a relief in the form of a permitted postponement of tax payment. Here, the costs to the government treasury are identical to the interest that will have to be paid on the amount of the deferral for the period in which the deferral holds.

Rosen (1999)

Rosen (1999:371-381) distinguishes exceptions and deductions in the system of the taxation of personal income.

1) Exceptions. Income excepted from the tax based. The amounts are adjusted for inflation and cease to apply to taxpayers who earn income above a certain level. Exceptions can be looked at as a method of providing tax reliefs to families with low incomes. The higher the exception, the greater the gross income before the obligation to pay tax applies.

2) Deductions. The taxpayer can choose a deduction that minimises the tax due.

Itemised deductions are deductions for specific expenditures stated in the law. The taxpayer in the return has to state each individual item separately and be capable of showing (at least in principle) that the expenses have really been incurred. Within this category come non-reimbursed expenditures for medical treatment that exceed 7.5% of adjusted gross income, local and government income and assets taxes, costs of interest (some forms of interest payments are deductible and some are not) as well as charitable contributions.

Deductions from tax base according to tax credits is a reduction of the tax due (not of taxable income) and hence its value is independent of the marginal tax rate of the taxpayer (the higher the marginal rate, the greater the value of the deduction in dollars).

The standard deduction is a fixed amount that is available to all taxpayers and it is inflation-linked.

The list of tax expenditures in the USA has more than 100 items.

Musgrave and Musgrave (1993)

Musgrave and Musgrave (1993:374) discuss the concepts of tax expenditures, exceptions and deductions. In their view, income from all sources, except those that are excluded, determines total income, which includes wages, interest, dividends, rents, income from royalties, extra-enterprise operational profits. From the sum, certain income adjustments are deducted to arrive at adjusted gross income. Such an adjusted gross income is reduced by the allowed amount of personal exceptions (fixed amount per taxpayer). Of what is left, the further amount of untaxed income is determined, and this is called the standard allowance or deduction and is inflation-linked. Instead of demanding this amount, taxpayers can request the determination of itemised deductibles (mortgage interest, certain government and local taxes, contributions to charity, high medical expenditures, costs incurred by accidents and so on). It is mainly taxpayers whose deductions exceed the standard deductions or those taxpayers with high income that choose to make an itemised claim. Thus the amount of the non-taxable income is equivalent to exceptions and deductions (standard or itemised).

But some forms of earnings such as imputed income simply do not appear, and others are excluded from adjusted gross income. Key items in the group of exceptions are exceptions of income, or non-realised profits (realised profits not completely incorporated into the tax base) savings, retirement insurance and transfer receipts (welfare, veterans' grants, scholarships).

The expression tax expenditure is used because failure in the revenue collection created because of losses in the base of taxable income is actually equivalent to the amount that would be gained if the tax were collected, and then this tax were once again paid out to the taxpayer so that the taxpayer's position remains unchanged. Tax preferences or tax costs result in an incomplete definition of taxable income and hence of poor uniformity of tax on personal income tax in a horizontal and vertical point of view. Special reliefs are given to taxpayers with low incomes via certain deductions (deduction from tax by earned income that gives a relief to the recipient of the income that supports dependents and a tax deduction for child welfare that gives a relief to taxpayers with low income and to a dependent member or dependent members of the family).

Brümmerhof (2000)

Brümmerhof (2000) thinks that "it is practically impossible to cover tax expenditures in an appropriate manner. Tax expenditures can arise by changes in the tax base, tax rate or tax credits. Tax preferences can, further, be final or can take on the form of a postponement of payment, and in this case the tax preferences can be comprehended only partially, via the effects of the interest rate or the effect of the tax rate on the total tax due. And one always has to settle the issue of the reference magnitude, according to which the preferences are given, or the reliefs or exemptions. The reference magnitude contains essential elements of the definition of the tax base and the tax rate. This magnitude is often extremely hard to distinguish, when the law is being first passed or in later amendments, from provisions concerning expenditures".

Similarly "special expenditures that can be excepted from the total amount of receipts are certain statutorily defined expenditures that are neither business expenditures nor costs incurred in connection with the generation of the income". In general these are expenditures for the satisfaction of basic necessities, for which an allowance from the tax base is permitted for the purpose of meeting various objectives. The set of special expenditures includes disbursements for maintenance of divorced partners who live permanently apart when this is requested by the giver with the consent of the recipient (the so-called limited real division, along with set boundaries), rents and permanent burdens that are based on particular obligations and that are not economically connected with receipts, expenditures for insurance (contributions for private and obligatory health insurance, accident insurance, retirement insurance, unemployment and guarantee insurance, and contributions to housing savings that can be deducted up to half of the amount), tithes, costs of tax advisers, expenditures for business training or further training for a new job – and for a spouse also, expenditures for contributions made to science, a church and for general social benefits, as well as contributions and gifts to political parties.

In short, we can say that various authors who have investigated tax expenditures agree that there is no single definition and scope of coverage of tax expenditures. Most of them adjust the definition and scope of the tax expenditure to the actual tax systems that they are researching. The specificities of the local tax system accordingly determine the kind, manner of working and scope of the tax expenditures perceived.

Pros and cons of introducing tax expenditures

During the introduction of tax expenditures a government has to be aware of their good and bad sides.

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 decisionmaking;
- reducing the need for close government supervision of such spending (Polackova, Valenduc and Swift, 2004:3).

The negative aspects of tax expenditures are:

- iIneffectiveness. Some tax expenditures are insufficient to override underlying economic forces or are offset by other domestic or foreign tax provisions,
- 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 favouring some sectors and projects but not others, thus altering the relative profitability of projects and weakening overall instruments and the whole tax system tends to become more regressive (Polackova, Valenduc and Swift, 2004:5). Numerous kinds of tax expenditures favour various interest groups more than they satisfy real and actual needs.[6] Once introduced, tax expenditures are often not controlled and seldom rescinded. This is why tax expenditures need incorporating in the annual budget and should be subjected to the same detailed analysis that direct government expenditures have to endure during the budgetary process,
- inequity.[7] Tax expenditure schemes tend to be regressive in modifying tax burdens across taxpayers, both horizontally and vertically. Horizontal inequity is the situation in which tax expenditures enable persons with equal incomes and costs to pay different amounts of tax depending on the kind of activity they do (whether there are or there are not tax breaks for this kind of activity).[8] Vertical inequity exists when not all taxpayers have the same ability to make use of tax reductions that require a minimum of spending. Even when taxpayers with lower expenditures can claim this entitlement, they have less benefit (benefits from tax expenditures are the greater the greater the degree of taxable income). This means that taxpayers in the high income brackets have disproportionately greater benefits from tax expenditures. In this manner vertical equity is distorted and the tax system becomes less progressive,
- another problem is that non-refundable tax expenditure schemes, which most governments have applied, exclude non-taxpayers – who are among the poorest groups in the society – from receiving benefits (ibid).

[6] For example, tax reliefs given to employers who take on untrained labour can be used by employers who would take on this kind of labour anyway.

[7] Inequity in tax expenditure programmes is best seen if we compare the effective tax rate (for example, really paid income tax as a proportion of totally acquired income). Total earned income is the amount of income obtained from the tax refund enlarged by income that was excepted from the payment of personal income tax, the counter-value of taxable income and various personal exceptions and deductions.

[8] An example of this can be found in deductions from the tax due for the payment of school fees, the benefit of which can be reaped only by those taxpayers who pay school fees.

Other negative effects include:

- erosion of revenue bases, which limits the scope for tax rate reductions. Such government losses could be used for the financing of direct government expenditures and which limits the ability to reduce tax rates),
- 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 enables lobbying and using government to make additional rents,
- incomprehensibly exaggerated size of government,
- increase of repressiveness of the tax system.

Because of all these factors it is necessary to bring in high-quality management and control of programmes of tax expenditures. If one wishes to increase the efficiency, equity and efficacy of a tax system, it is necessary to enlarge the degree and quality of management of tax expenditure programmes. This is the reason why many OECD countries have increased their control of tax expenditures.

It can be seen that tax expenditures have both positive and negative impacts. For this reason it is necessary to take extra care of the quality of management and control of programmes of tax expenditures. Tax expenditures reduce central government budgets, are often not part of the budgetary system, and their amounts are not controlled or audited, nor is the upper limit of these costs defined, and they are not the subject of contracts. This means that tax expenditures are subjected to milder constraints than direct expenditures. All these factors lead to the conclusion that direct expenditures are cheaper, more effective and more transparent instruments of financing government outlays.

3 Conclusion

At the end we can say that almost all countries use tax expenditures, and they use them to achieve certain effects of economic and social policy. But because of the increasing number and scope of tax expenditures, their proper use, quality administering and auditing have become a major challenge for the tax authorities and for the whole government. Tax expenditures necessarily increase administration costs and reduce the revenue of the central government exchequer.

There is no single and all-encompassing definition of tax expenditures. The different authors who deal with these topics agree on this. Most of them tailor the definition and the scope of tax expenditures to the particular systems they are researching. The particular features of a given tax system determine the kinds, manner and scope of tax expenditures.

For this investigation, tax expenditures are defined as each item in the existing tax forms that represents a loss of revenue to the central government budget by reducing the tax base or reducing the tax due. Thus, some of the revenue does not come into the process of calculating the appropriate tax form at all. By this kind of exclusion of a certain item from the tax base, revenues of the government treasury are lost, and such an item constitutes tax expenditure. This investigation was carried out according to the method of lost revenue to which, by bringing in various tax expenditures, a given country has been deliberately exposed. In other words, the calculation of the losses of tax revenue was made ex post. There is no single scope or international pattern for the making of reports about tax expenditures, and the manners, time and methodology of reporting on tax expenditures and their connections and relations with the budgetary process since given countries greatly differ.

Tax expenditures are divided into those that reduce the tax base and those that reduce the tax due. They have the most varied forms, such as tax reliefs, tax reductions, tax deductions, exceptions or preferential tax rates. They have both positive and negative effects. For this reason it is necessary to have proper management and control of tax expenditure programmes. As well as reducing the central government budgets, they are often not part of the budgetary system, nor are their amounts controlled or audited, and they are not the subject of any contract. All these factors lead to the conclusion that direct expenditures are a cheaper, more effective and more transparent instrument of financing government outlays.

LITERATURE

Allen, R. and Tommasi, D., 2004. *Upravljanje javnim izdacima: priručnik za zemlje u tranziciji* [online]. Available from: [www.finance.gov.mk/mk/brosuri/javni_sredstva/managing_public_expenditures_1.pdf].

Arbutina, H. and Ott, K. (trans.), 1999. *Porezni leksikon s višejezičnim rječnikom*. Zagreb: Institut za javne financije.

Bartlett, W., 2001. "The End of Tax Expenditures as We Know Them?" [online]. *IRET Policy Bulletin,* No. 84. Available from: [http://www.heartland.org/pdf/80001m.pdf].

Brümmerhoff, D., 2000. *Javne financije.* Zagreb: Mate.

Datta, L. and Grasso, G. P., 1998. *Evaluating Tax Expenditures: Tools and Techniques for Assessing Outcomes*, No. 79. San Francisco: Jossey-Bass Publishers.

Government of Canada. *Tax Expenditures* [online]. Canada: Government of Canada, Department of Finance. Available from: [http://www.fin.gc.ca/toce/1999/taxexpe.html], [http://www.fin.gc.ca/taxexp/2001/taxexp01_1e.html#_Toc519392242] i [http://www.fin.gc.ca/taxexp/1999/taxexp99_1e.html#Expenditure].

Howard C., 1997. *The Hidden Welfare State: Tax Expenditures and Social Policy in the United States.* New Jersey: Princeton University Press.

Kesner-Škreb, M. (trans.), 2001. "Kodeks fiskalne transparentnosti" [online]. *Newsletter,* no. 8.Available from: [http://www.ijf.hr/newsletter/8.pdf].

Kesner-Škreb, M. [et al.], 2001. "Progresivnost poreza na dohodak u Hrvatskoj u razdoblju od 1995. godine do 1999. godine". *Financijska teorija i praksa*, 25 (2), 139-260.

Messere K., 1993. *Tax Policy in OECD Countries: Choices & Conflicts.* Amsterdam: IBFD.

Musgrave, R. and Musgrave, P., 1993. *Javne financije u teoriji i praksi*. Zagreb: Institut za javne financije.

OECD, 1996. *Tax Expenditures – Recent Experiences.* Paris: OECD.

OECD, 2001a *OECD Economic Studies: 2000-2001: New Zealand.* Paris: OECD.

OECD, 2001b "Tax and the Economy: A Comparative Assessment of OECD Countries". *OECD Tax Policy Studies,* No. 6. Paris: OECD.

OECD, 2004. *Managing Public Expenditure: A Reference Book for Transition Countries.* Paris: OECD.

Polackova, H. B., Valenduc, M. A. C. and Swift, L. Z., 2004. *Tax Expenditures – Shedding Light on Government Spending through the Tax System, Lessons from Developed and Transition Economies*. Washington, D.C.: The World Bank.

Rosen, S. H., 1999. *Javne financije.* Zagreb: Institut za javne financije.

Sandford, C., 2000. *Why Tax Systems Differ: A Comparative Study of the Political Economy of Taxation.* Bath: Fiscal Publications.

State of Illinois, 1998. *Tax Expenditure Report* [online]. Available from: [http://www.comptrollerconnect.ioc.state.il.us/ioc-pdf/98TaxExp.pdf].

Surrey, S. S. and McDaniel R. P., 1985b. "International Aspects of Tax Expenditures: A Comparative Study". *Series on International Taxation*, No. 5, Deventer: Kluwer Law : Taxation Publishers.

Surrey, S. S. and McDaniel, R. P., 1985a. *Tax Expenditures.* Cambridge, Mass.; London: Harvard University Press.

World Bank, 2003. "Why Worry About Tax Expenditures?" [online]. The *World Bank PREMnotes, Economic Policy*, No. 77. Available from: [http://www1.worldbank.org/prem/PREMNotes/premnote77.pdf].