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Tax Expenditures and Inequality in Latin America

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Paper

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This publication was developed as part of the Latin America Tax Expenditure Research, Advocacy, and Learning (LATERAL) project.

The goal of the LATERAL project is to support civil society work to increase the transparency, equity, and accountability of tax expenditure policies at the country and regional levels in Latin America. Through LATERAL, the International Budget Partnership, partnering with ten Latin American civil society organizations (CSOs), seeks to promote policy reform by shedding light on the impact of tax expenditures on inequality across the region, raising public awareness of the importance of the issue, and pursuing a coordinated advocacy effort both within individual countries and at the regional level.

LATERAL is an innovative, collaborative research, capacity building, and advocacy initiative launched by IBP and CSO partners in 2016. With coordination and assistance from IBP, our ten civil society partners have undertaken analyses comparing tax expenditure policies and practices across the region, and examining the impact of these policies and practices on inequality. The LATERAL project has built an energized regional community, where CSO members learn from and help each other improve research, advocacy, and communication around tax issues.

The LATERAL project partners are:

- ACIJ - Asociación Civil por la Igualdad y la Justicia (Argentina)
- CAD – Ciudadanos al Día (Peru)
- Dejusticia (Colombia)
- ICEFI – Instituto Centroamericano de Estudios Fiscales (Guatemala)
- INESC – Instituto de Estudos Socioeconômicos (Brazil)
- ISD – Iniciativa Social para la Democracia (El Salvador)
- Fundación Solidaridad (Dominican Republic)
- Fundar – Centro de Análisis e Investigación (Mexico)
- Grupo Faro (Ecuador)
- Sonora Ciudadana (Mexico)

EXECUTIVE SUMMARY

Fiscal policies — how public resources are raised and spent — are governments' most direct tool for addressing inequality. Historically, attention has focused on the role of public investment and public services in addressing poverty and inequality, particularly the role of transfer payments. More recently, an emerging body of research has examined the role of tax policies in creating and mitigating inequality. This paper briefly reviews the structure of Latin American tax systems and their role in widening or narrowing inequality and then reviews the use and impact of tax expenditures in the region. It concludes with a set of recommendations for improving the equity and accountability of countries' tax systems.

Historically, Latin America has been distinguished by high levels of inequality dating back to the colonial period. While some progress has been made since the 2000s, it has been uneven, and Latin America remains one of the most unequal regions of the world; in some countries, recent gains are threatened. This is important, since redistributive public policies are responsible for much of the improvement. There are disparities within the region as well, with the tax systems of some countries, such as Argentina and Brazil narrowing inequality, while those of others, such as El Salvador and Honduras, serving to widen the gaps.[1]

This paper explores one aspect of tax policy — tax expenditures — and its impact on inequality. Tax expenditures are provisions that reduce the amount of tax that is paid by providing special treatment to a particular class of individual, industry, or activity. They can impact inequality directly, by giving preference to certain groups over others, or indirectly, by reducing the revenues available for redistributive spending. Tax expenditures are significant in the Latin American context because of the magnitude of the revenue loss they cause and the resulting impact on public spending. They also affect the distributional impact of a tax system; that is, whether taxes are disproportionately paid by the wealthy or by low- and middle-income households.

Effectively addressing this issue is important, as high levels of inequality can impede growth; conversely, countries with low levels of inequality tend to sustain higher growth rates over longer periods of time. Additionally, where inequality is high, economic growth is less effective at reducing poverty.

CONCLUSIONS AND RECOMMENDATIONS

Tax expenditures should be viewed as part of broader fiscal policy structure. A good revenue system is based on taxes that are simple, fair, and efficient. Tax expenditures risk compromising these principles to the extent that

[1] Bruno Martorano, "Taxation and Inequality in Latin America" (International Budget Partnership, Washington, D.C., January 2018).

they complicate the tax system, create inequities, are less effective than programmatic spending, and forgo revenue that could have been spent more productively or would need to be replaced in other and more damaging ways. Reforms can improve the transparency and accountability of tax expenditures by ensuring that policymakers and the public have access to the information needed to assess their cost, impact, and effectiveness. Distributional analyses that examine who benefits by income level can provide the information needed to determine whether a tax expenditure makes a tax system more or less equitable.

Tax expenditures should be publicly reported on and reviewed regularly. While "on-budget" spending is typically reviewed on an annual basis, the cost and impact of spending through the tax code is often hidden from public view. Lawmakers should periodically review the revenue loss attributable to tax expenditures, ideally as part of the annual budget process. Considering the cost of tax expenditures as part of the budget process provides lawmakers with a more complete picture of how public resources are allocated and facilitates a more informed dialogue about public policies and priorities. Annual review also allows lawmakers to consider the long-term impact of the choices they make, since revenues that are foregone in good times may contribute to fiscal distress when economic times are bad. A separate review, or no oversight at all, privileges tax expenditures relative to other public priorities and makes it difficult for policymakers and the public to understand their true cost and impact on the budget.

Most Latin America countries publish a tax expenditure report that is available to the public. However, not all countries publish a comprehensive report. Elements of a comprehensive report include:

- A list of tax expenditures, with a clear description (i.e., the type of preference provided), the effective and sunset dates, and the law or decree that provides the legal basis for each provision .
- The stated policy objective of each tax expenditure.
- The estimated cost in revenues foregone for the upcoming and future years, and the actual cost for prior years.
- A discussion of the methodology used to estimate the cost of tax expenditures.
- Supplementary material, such as an analysis of the distributional impact by type of taxpayer (e.g., for corporate income tax expenditures, by size and sector).

Tax expenditures should have a statutory basis in tax law. Tax expenditures, particularly investment incentives, should be prescribed by law, not negotiated on a case-by-case basis. Tax incentives that are provided through contracts, decrees, and regulations often lack proper oversight and transparency, and can be prone to abuse. A solid legal framework facilitates cost-benefit analysis and limits opportunities for corruption that can occur when an incentive is tailored for a specific firm or project. It also ensures that the legislative body has an opportunity for review and provides a structure for public comment, oversight, and, if necessary, repeal or modification.

Tax expenditures should be granted in accordance with a comprehensive policy framework and should have clear goals, well-defined eligibility criteria, and objective, measurable outcomes. Tax expenditures should be considered within a policy framework that considers which strategies are best suited for achieving identified policy goals. Investment incentives, for example, should be evaluated as part of a broader economic development and macroeconomic policy framework. The purpose of a tax expenditure should be clearly identified and each tax expenditure should have measureable outcomes, clearly defined eligibility criteria, and a requirement that recipients report the data needed to assess whether a provision is effective at achieving its stated goals. Progress toward achieving the identified goals should be regularly communicated to lawmakers and the public as part of an annual tax expenditure reporting and review process.

Authority for tax expenditures oversight should be centralized within the Ministry of Finance and administered by the revenue agency. To facilitate the comparison of tax expenditures and on-budget spending, a single agency — usually the finance ministry — should have primary authority for administering and tracking the cost of tax expenditures. Ministries with programmatic authority — for example, a Ministry of Mining that controls incentives for extractive projects — should coordinate their activities with the ministry charged with overall fiscal responsibility. Programmatic ministries lack the “big picture” perspective needed to balance the impact of lost revenues against competing programmatic demands. Implementation and enforcement of tax expenditures should be vested in the revenue agency, which has the expertise needed to administer the tax law.

Provide mechanisms for public participation and transparency. Citizen participation improves compliance and strengthens the social contract between governments and the governed. The public should have access to the information needed to assess the impact of tax expenditures, including information on who benefits, the cost of the benefit received, and progress toward meeting defined outcomes and eligibility criteria. Analysis of tax incentives is data intensive. Often the information needed for cost-benefit analysis and evaluation is not reported as part of a standard tax return. In some countries, additional staff and/or legal authority may be needed in order to ensure that data is gathered and tax expenditures are monitored appropriately.

Tax expenditures should have sunset dates and be periodically evaluated to assess their cost-effectiveness and the extent to which they meet the stated objectives. Once established, tax expenditures generally remain in effect, unless they are subject to a sunset date. Sunset dates require legislators to periodically consider whether a tax expenditure has achieved its goals, as well as the impact of lost revenues. Review criteria, as well as findings, should be reported publically. Measures that are cost effective and efficient can be renewed, while those that are ineffective can be allowed to sunset or can be modified.

Governments should work together in order to avoid harmful tax competition. In many cases tax incentives are created to respond to what neighboring countries and competitors are offering or perceived to be offering. Hence the issue of tax incentives cannot be tackled in isolation. Governments should work together to avoid a race to the bottom that occurs when countries vie for foreign investment by creating competing incentives. Efforts to enhance regional cooperation should span a broad range of tax and non-tax provisions that are designed to attract foreign investment, such as cash subsidies and loan guarantees.

Tax expenditures should be considered within a broader, rights-based framework. Tax expenditures should be evaluated within the context of the tax and fiscal system as a whole and on the degree to which they limit governments' ability to promote the realization of human rights. Comprehensive analyses can assess whether tax expenditures contribute to greater equality by providing benefits to low- and middle-income residents, or widen inequality by reducing the resources available to meet the obligation of economic and social rights. Tax expenditures should also be examined to determine whether they provide disproportionate benefits to the wealthy, property owners, or a specific region that may violate the principles of nondiscrimination.

CONTENTS

1. INTRODUCTION

Fiscal policies — how public resources are raised and spent — are governments' most direct tool for addressing inequality. Historically, attention has focused on the role of public investment and public services in addressing poverty and inequality, particularly the role of transfer payments. More recently, an emerging body of research has examined the role of tax policies in creating and mitigating inequality. Tax systems work both directly and indirectly to address inequality. Indirectly, they raise the revenues needed to support transfer payments, education, and other services. Tax systems can also be used to address inequality directly, by minimizing amounts paid by the poor and taxing forms of income and assets that are disproportionately held by the wealthy.

Historically, Latin America has been distinguished by high levels of inequality dating back to the colonial period. While some progress has been made since the 2000s, it has been uneven, and Latin America remains one of the most unequal regions of the world; in some countries, recent gains are threatened. This is important, since redistributive public policies are responsible for much of the improvement. There are disparities within the region as well, with the tax systems of some countries, such as Argentina and Brazil narrowing inequality, while those of others, such as El Salvador and Honduras, serving to widen the gaps.[2]

This paper explores one aspect of tax policy — tax expenditures — and its impact on inequality. Tax expenditures are provisions that reduce the amount of tax that is paid by providing special treatment to a particular class of individual, industry, or activity . They can impact inequality directly, by giving preference to certain groups over others, or indirectly, by reducing the revenues available for redistributive spending. Tax expenditures are significant in the Latin American context because of the magnitude of the revenue loss they cause and the resulting impact on public spending. They also affect the distributional impact of a tax system; that is, whether taxes are disproportionately paid by the wealthy or by low- and middle-income households.

2. INEQUALITY IN LATIN AMERICA

Latin America is the world's most unequal region with respect to income distribution.[3] Inequality widened during the Washington Consensus period of the 1990s, when governments held down taxes and limited public spending.[4]

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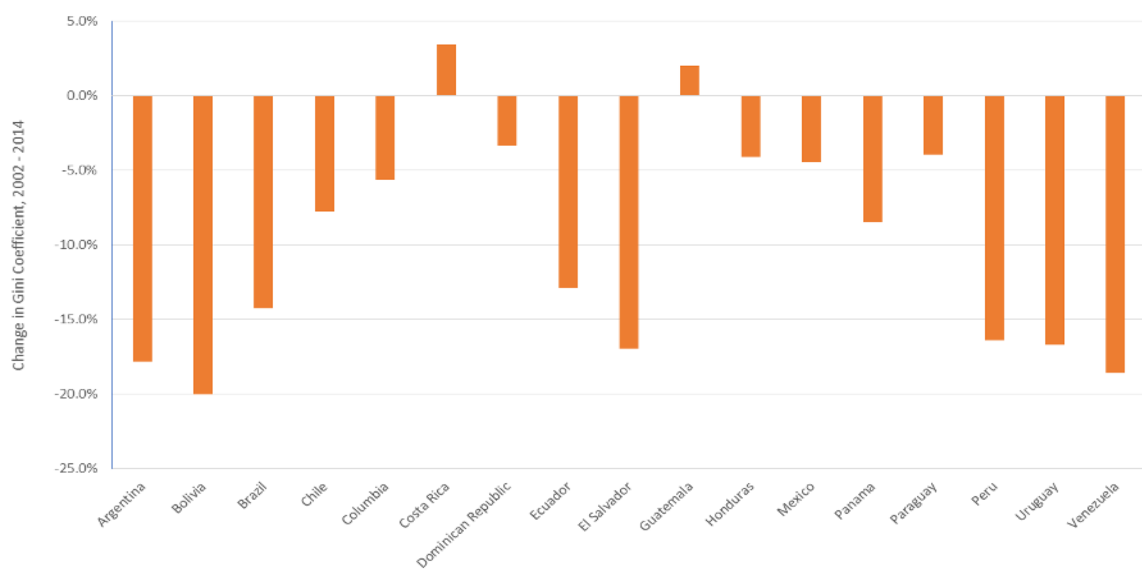
[2] Bruno Martorano, "Taxation and Inequality in Latin America" (International Budget Partnership, Washington, D.C., January 2018).

[3] Nora Lustig, "Most Unequal on Earth," *International Monetary Fund Finance and Development* 52, No. 3 (September 2015). Downloaded from: http://www.imf.org/external/pubs/ft/fandd/2015/09/lustig.htm on 29 September 2016.

[4] Edwin Goñi, J. Humberto Lopez, and Luis Servén, "Fiscal Redistribution and Income Inequality in Latin America" (World Bank Policy Research Working Paper No. 4487, Washington, D.C., 1 January 2008): 1.

Since 2002 inequality has declined, significantly so in many Latin American countries (Figure 1).[5] Inequality fell in countries with high growth, as well as those with lower growth; in countries with left-leaning governments, as well as those with center to center-right leaning governments; and in resource-exporting countries, as well as importers.[6] Research attributes the reduction to two primary factors: a reduction in the inequality of hourly wages and an expansion in government transfer payments. Moreover, evidence suggests that the reduction in wage inequality is largely due to rising skills due to increased educational attainment.[7]

FIGURE 1. INEQUALITY DECLINED IN MOST LATIN AMERICAN COUNTRIES BETWEEN 2002 AND 2014 (MEASURED AS PERCENTAGE CHANGE IN GINI COEFFICIENT)



Source: ECLAC, Social Panorama of Latin America 2015
Note: Data for each country are the Gini Coefficients for 2002 and 2014 except for Argentina (2012), Venezuela (2013), Brazil (2001), Chile (2001, 2013), El Salvador (2001), Honduras (2013), Bolivia (2001, 2013).

The source of the decline in inequality demonstrates the importance of fiscal policies, since adequate tax revenue is necessary to support both education and transfer payments. The ability of tax and spending policies to act as an

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[5] Economic Commission for Latin America and the Caribbean, "Social Panorama of Latin America 2015," (Santiago, Chile, February 2017): 13-14. While progress has been made, inequality remains severe. In 2014 the wealthiest 10 percent of the population had an average per capita income 14 times that of the poorest 40 percent.

[6] Lustig, "Most Unequal on Earth"

[7] Nora Lustig, Luis F. Lopez-Calva, and Eduardo Ortiz-Juarez, "Deconstructing the Decline in Inequality in Latin America" (Tulane Economics Working Paper Series, Tulane University, 3 April 2013): 6-7. Downloaded from http://econ.tulane.edu/RePEc/pdf/tul1314.pdf on 29 September 2016.

equalizing force is demonstrated by the fact that a number of countries often identified as having high degrees of equality, such as the Nordic countries, have pre-tax and transfer levels of inequality similar to those in Latin America. These countries reduce inequality through high levels of taxation and a robust program of transfer payments.[8] In contrast, Latin American tax systems have been of little help in reducing inequality.[9] Not only are their tax systems regressive, in most countries they fail to raise sufficient resources to finance redistributive spending policies.[10]

2.1 LATIN AMERICAN TAX SYSTEMS DO LITTLE TO ADDRESS INEQUALITY

Tax policy can be both a key driver of inequality and a critical tool for addressing it. A well-functioning tax system redistributes wealth from high- to lower-income households. Regressive or "upside down tax systems" – those where lower income households pay a larger share of their income in taxes than wealthier ones – widen disparities. Tax systems that rely heavily on consumption taxes, such as value added taxes (VAT), are likely to be regressive. This is because low- to middle-income households spend a greater share of their income on consumption than wealthier households, who tend to spend more on investments and savings, which are often not taxed or are taxed at preferential rates. Tax policies also determine the amount of revenue that is available to support social transfers and investments that, evidence suggests, can play an even larger role in reducing disparities between rich and the poor.[11]

[8] Edwin Goñi, J. Humberto Lopez, and Luis Servén, "Fiscal Redistribution and Income Inequality in Latin America," 6.
[9] Edwin Goñi, J. Humberto Lopez, and Luis Servén, "Fiscal Redistribution and Income Inequality in Latin America."
[10] Ibid., 3.
[11] See for example, "Inequality Matters: Report on the World Social Situation 2013" (United Nations, Economic and Social Affairs, 2013): 37. Downloaded from http://www.un.org/esa/socdev/documents/reports/InequalityMatters.pdf on 27 December 2017.

TABLE 1. AVERAGE TAX STRUCTURE IN LATIN AMERICA AND THE OECD

	Latin America				Organization for Economic Co-operation and Development		
	1990 (% of GDP)	2000 (% of GDP)	2012 (% of GDP)		1990 (% of GDP)	2000 (% of GDP)	2012 (% of GDP)
Taxes on Income and Profits	3.0	3.2	5.2		12.5	12.5	11.4
Individuals	0.8	1.1	1.6		10.1	9.3	8.5
Corporations	2.2	2.1	3.6		2.4	3.1	3.0
Social Security Contributions	2.4	3.0	3.8		7.6	8.9	9.1
Payroll taxes	0.2	0.3	0.2		0.3	0.4	0.4
Property taxes	0.8	0.7	0.9		1.8	1.9	1.8
Subtotal Direct Taxes	6.3	7.2	10.1		22.2	23.7	22.7
Taxes on general consumption	3.2	5.3	6.5		5.8	6.8	6.9
Value added taxes	2.8	4.9	6.3		5.3	6.6	6.6
Sales taxes and others	0.4	0.4	0.2		0.5	0.2	0.3
Taxes on specific goods and services	3.7	3.7	3.3		4.0	3.8	3.5
Excise	1.4	1.9	1.8		2.7	2.9	2.7
International trade and transactions	2.3	1.6	1.1		0.6	0.3	0.1
Other	0.0	0.2	0.4		0.7	0.6	0.7
Other taxes	0.3	0.1	0.9		0.9	0.9	1.0
Subtotal Indirect Taxes	7.2	9.1	10.7		10.7	11.5	11.4
Total Tax Revenues	**13.6**	**16.4**	**20.7**		**32.9**	**35.2**	**34.1**

Source: J. Gómez-Sabaíni and D. Moran, "Tax Policy in Latin America: Assessment and Guidelines for a Second Generation of Reforms," Macroeconomics of Development Series, No. 133 (United Nations Economic Commission for Latin America and the Caribbean and GIZ, June 2014): Table 3.

The role of taxation as a determinant of inequality in Latin America has evolved in recent decades. During the 1980s and 1990s, indirect taxes — which are disproportionately paid by low- and middle-income populations — rose across the region as a whole, while taxes on income, predominantly business income, fell (Table 1).[12] More recently, the share of revenues raised by direct taxes — which are generally progressive — has increased. However, taken as a whole, Latin American tax systems remain disproportionately reliant on indirect taxes relative to those of Organization for Economic Co-operation and Development (OECD) member countries.[13]

[12] Bruno Martorano, "Taxation and inequality in Latin America," 5.

[13] J. Gómez-Sabaíni and D. Moran, "Tax Policy in Latin America: Assessment and Guidelines for a Second Generation of Reforms," Macroeconomics of Development Series, No. 133 (United Nations Economic Commission for Latin America and the Caribbean and GIZ, June 2014): 16.

TABLE 2. TAX INCIDENCE STUDY RESULTS, SELECTED COUNTRIES AND YEARS

Country	Year	Pre-tax Gini	After-tax Gini	Percentage Change
Argentina	2008	0.4839	0.4804	-0.7%
Bolivia	2004	0.5560	0.5670	2.0%
Brazil	2009	0.5909	0.6116	3.5%
Chile	2006	0.5791	0.5764	-0.5%
Columbia	2004	0.5370	0.5370	0.0%
Costa Rica	2004	0.5770	0.5720	-0.9%
Dominican Republic	2004	0.5106	0.5126	0.4%
Ecuador	2004	0.4100	0.3900	-4.9%
El Salvador	2006	0.5034	0.5109	1.5%
Honduras	2005	0.5697	0.5707	0.2%
Nicaragua	2001	0.5963	0.5946	-0.3%
Panama	2003	0.6364	0.6274	-1.4%
Peru	2004	0.5350	0.5430	1.5%
Uruguay	2006	0.4995	0.4974	-0.4%
Argentina	2008	0.4839	0.4804	-0.7%

Sources: J. Gómez-Sabaíni and D. Moran, "Tax Policy in Latin America." Countries were ranked according to the estimated value of the Reynolds-Smolensky index for each of the countries where a positive value of the difference between the Gini coefficients after and before taxes indicates a positive redistributive impact. For more information on these calculations, please refer to the original source. The year refers to the period analyzed.

At the same time, tax revenues as a share of economic activity, measured as a percentage of Gross Domestic Product (GDP), are also low in all but a handful of countries, depressing the resources available for public investment. While most countries in the region have expanded social spending, at least through 2013, these increases have often been financed through taxes on consumption.[14] The net result is that most Latin American countries' tax systems have little impact on inequality, as measured by a comparison of the before and after-tax Gini coefficient (Table 2).[15] There are four factors that account for the relatively modest redistributive impact of Latin American tax systems:

- **An overreliance on consumption taxes**. Latin American countries raise a disproportionate share of their total tax revenues from consumption taxes.
- **An under reliance on income and profits taxes**. Latin American countries raise a relatively small share of their total tax revenues from taxes on personal and investment income and business profits.
- **In some countries, an overreliance on revenues from extractive industries**. Revenues from natural resource exploitation provide a large share of the revenues of Mexico, Ecuador, and Bolivia and a

[14] Nora Lustig, "Taxes, Transfers, and Income Redistribution in Latin America," *World Bank: Inequality in Focus* 1, No. 2, July 2012; and ECLAC, Social Panorama of Latin America 2015, 21.

[15] J. Gómez-Sabaíni and D. Moran, "Tax Policy in Latin America," 54. The Gini coefficient (or index) is a commonly used measure of inequality. A Gini score of 0 represents perfect equality, while a score of 1 represents absolute inequality.

somewhat lower share of revenues in a number of other countries. These countries raise relatively low revenues from other tax sources and have suffered from declining revenues due to the fall in commodity prices.

- **Low taxes on property and other forms of wealth**. Latin American countries raise a relatively small share of their revenues from taxes on property and other forms of wealth, such as inheritances.

BOX 1. WHY DO WE CARE ABOUT INEQUALITY?

- Inequality of incomes creates unequal access to health and education, which in turn, results in inequality of social and economic opportunities. Countries with high levels of income inequality have lower levels of intergenerational mobility.
- The relationship between inequality and economic growth is complex, but high levels of inequality can impede growth and countries with low levels of inequality tend to sustain higher growth rates over longer periods of time. And where inequality is high, economic growth is less effective at reducing poverty.
- Even in countries with comprehensive public health programs, low-income children are more likely to have adverse health outcomes than those from higher income households.
- Inequality is a major driver of disparities in educational attainment. Low-income students, those in rural areas, indigenous people, and immigrants are less likely to have access to secondary or post-secondary schooling and are more likely to attend schools that lack adequate resources.
- Widening disparities undermine the trust that is necessary for a healthy democracy and can lead to increasing social stratification and residential segregation. High levels of inequality undermine the legitimacy and stability of policies and institutions, discouraging investment needed for economic growth.
- Inequality of incomes contributes to unequal access to political influence that enables the wealthy to engage in activities that contribute to even wider disparities, such as lobbying for preferential tax treatment that limits governments' ability to support redistributive fiscal policies and the realization of human rights.

Sources: "Inequality Matters: Report of the World Social Situation 2013" (United Nations, Department of Economic and Social Affairs, 2013): 64; Ibid.," 47-48; Ibid., 55 and 89; and Edwin Goñi, J. Humberto Lopez, and Luis Servén, "Fiscal Redistribution and Income Inequality in Latin America," 1.

Since lower-income households pay a larger share of their income in consumption taxes than higher- income households, this leads to wider inequality. Higher-income households, in contrast, pay a larger share of their income in income and profits taxes. Latin American counties as a whole collected 31.1 percent of their revenues from general taxes on consumption and 25.1 percent from taxes on incomes and profits. In contrast, OECD member countries collected 20.2 percent of their revenues from general consumption taxes and 33.4 percent from taxes on incomes and profits.

2.2 DISPARITIES WITHIN THE REGION

Regional averages mask a number of significant differences among Latin American countries with respect to the level of tax collections measured as a share of GDP, as well as the distribution of tax collections by type of tax (Table 3). Key differences include the following:

- In Brazil and Argentina, tax revenues as a share of GDP are slightly higher than those for the OECD as a whole. Columbia, Mexico, Peru, Guatemala, Nicaragua, Panama, Paraguay, Honduras, El Salvador, and Venezuela all have relatively low rates of revenue collection.[16]

- El Salvador and Peru raise a larger share of their total revenues from taxes on incomes and profits, which are generally more progressive. Ecuador, Honduras, Guatemala, and the Dominican Republic raise a large share of their revenues from taxes on goods and services, a generally more regressive tax.

- The tax systems of Ecuador and Argentina were mildly redistributive during the 2000s, while those of the Dominican Republic, Guatemala, Peru, and Brazil increased inequality.[17]

[16] J. Gómez-Sabaíni and D. Moran, "Tax Policy in Latin America," 13. Low-tax countries are those which raised less than 20 percent of the country's GDP in tax revenues in 2012.
[17] Ibid., 53.

TABLE 3. REVENUE BY TYPE OF TAX AS A PERCENTAGE OF TOTAL TAXATION, 2014

	Income and profits	Social security	Payroll	Property	Goods and services	Others
Argentina	18.9	21.6	0.0	9.1	49.5	0.9
Bahamas	0.0	16.5	0.0	7.0	66.1	10.4
Barbados*	26.5	20.1	0.0	4.3	47.9	1.2
Bolivia*	14.4	4.7	0.0	0.7	63.9	16.2
Brazil	20.7	26.2	2.6	5.8	41.7	3.0
Chile	33.0	7.2	0.0	4.3	55.3	0.2
Colombia	32.7	12.6	1.7	10.4	37.3	5.3
Costa Rica	18.2	34.0	4.5	1.9	40.3	1.1
Dominican Republic	31.7	0.4	0.0	4.5	63.5	0.0
Ecuador	21.7	24.6	0.0	0.0	53.0	0.7
El Salvador	36.7	10.7	0.0	0.6	52.0	0.0
Guatemala	30.9	14.2	0.0	1.5	52.9	0.6
Honduras	26.8	15.4	0.0	2.6	55.2	0.0
Jamaica*	35.9	3.9	0.0	1.6	55.1	3.5
Mexico**	30.2	15.5	1.7	1.5	49.8	1.3
Nicaragua	28.3	24.3	0.0	0.6	46.6	0.1
Panama	25.2	35.2	1.7	4.2	30.0	3.7
Paraguay*	15.6	23.9	0.0	1.3	58.6	0.6
Peru	40.8	11.0	0.0	2.0	44.0	2.2
Trinidad and Tobago	71.1	6.1	0.0	1.5	20.8	0.6
Uruguay	21.3	28.0	0.0	6.7	43.8	0.2
Venezuela*	32.7	5.0	0.0	0.2	60.7	1.4
Unweighted average						
LAC*	*27.9*	*16.4*	*0.6*	*3.3*	*49.5*	*2.4*
OECD**,***	*33.7*	*26.1*	*1.1*	*5.6*	*32.7*	*0.6*

Source: OECD/ECLAC/CIAT/IDB (2016)

Note: The figures exclude local government revenues for Argentina (but include provincial revenues), Bahamas, Barbados, Bolivia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Honduras, Jamaica, Nicaragua, Panama, Paraguay, Peru, and Venezuela due to lack of data.

*The data are estimated.

**The data for 2013 are used.

***Represents a group of 22 Latin American and Caribbean countries. Chile and Mexico are also part of the OECD (34) group.

****Represents the unweighted average for OECD member countries.

3. THE ROLE OF TAX EXPENDITURES

The remainder of this paper examines the impact of one aspect of tax policy — tax expenditures — on inequality in Latin America. Tax expenditures, the laws and practices that provide preferential treatment for particular sectors or activities, can increase or decrease inequality. Well-constructed child allowances, for example, particularly those that are targeted to the poor, can make tax systems more progressive and reduce inequality.[18] Many other tax expenditures — such as those aimed at encouraging investment or lower tax rates for capital income — reduce the share of tax paid by the wealthy, reduce the total amount of resources available to support redistributive spending, and shift a larger share of the cost of financing public services to low- and middle-income households. These provisions widen inequality.

This paper focuses on tax expenditures because, in addition to the direct impact discussed above, research suggests that the widespread prevalence of tax preferences is a major factor contributing to the relatively low level of tax collections in Latin America.[19]

3.1 TAX EXPENDITURES DEFINED

The goal of any tax system is to raise the resources needed to pay for public services, the public goods and investments paid for by the state. Governments raise revenues by imposing taxes on income, wealth, or activities such as consumption or telecommunications. Tax expenditures are provisions that reduce the amount of tax that is owed by providing special treatment to a particular class of individual, industry, or activity. Economists call this type of special treatment a tax expenditure to make the point that the economic impact — the transfer of public resources for a particular activity or purpose — is conceptually equivalent to that of direct government spending.[20] While tax expenditures and direct government spending are conceptually similar, there are practical differences that are important to consider.

Tax expenditures are defined, and their cost is estimated, in comparison to a “benchmark” or “reference” tax system. There are different approaches to defining the reference system, which can either be an ideal or optimal system, or the actual system in place in the absence of special preferences.[21] While the choice of the benchmark tax system is important, particularly for cross-country comparisons and understanding estimates of foregone revenues, the basic concept of what constitutes a tax expenditure is consistent across measurement systems.

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[18] Child allowances or child credits are provisions of the tax code that provide a reduction in taxes based on the number of children in a family. These allowances are typically a fixed dollar amount and, as a result, provide a larger percentage reduction in taxes owed by low- and middle-income families than those of higher-income households.

[19] Edwin Goñi, J. Humberto Lopez, and Luis Servén, “Fiscal Redistribution and Income Inequality in Latin America,” 10.

[20] Tax incentives that are aimed at encouraging investment in commercial activity are often referred to as tax incentives. This report will use the two terms interchangeably.

[21] Most Latin American countries define tax expenditures in comparison to the legal framework for the country’s tax system. See Inter-American Center of Tax Administrations, *Handbook of Best Practices on Tax Expenditure Measurements: An Iberoamerican Experience* (Panama, 2011), 38.

Tax expenditures can be used for a variety of purposes, such as encouraging investment in specific industries or locations, encouraging a desired activity, or providing a benefit to a category of taxpayer. Tax expenditures can also be provided in different forms, including:

- *Exclusions or exemptions*: provisions that do not tax certain types of incomes, products, or activities, such as income from the sale of appreciated assets (capital gains).
- *Credits*: amounts that can be deducted from the final amount of tax that would otherwise be owed, such as a child tax credit.
- *Deductions*: amounts that can be subtracted from the income that is subject to tax, such as the interest paid on a mortgage used to purchase a home.
- *Deferrals*: provisions that allow for the payment of taxes owed to be delayed or that change the timing of when taxes are owed.
- *Preferential tax rates*: provisions that impose a lower tax rate on certain types of income or activities, such as income earned from financial investments being taxed at a lower rate than salaries and wages.

BOX 2. BASIC CONCEPTS

The **base** and **rate** determine the amount of revenue collected from a tax.

The "base" of a tax is the universe of goods or types of income that are taxed. Taxes are often described as having a **narrow** or **broad** base. A narrow-based tax applies to relatively few items, while a broad-based tax is imposed on most of the potential base. A tax **rate** is used to calculate the amount of tax owed and is generally expressed as a percentage of income, value, or sales price or as a fixed amount per quantity, such as cents per liter of fuel. The same tax rate will raise more revenue when applied to a broad base than if applied to a narrow base. While broad-based taxes are often preferable from an economic and revenue raising standpoint, there are good reasons for narrowing the base of some taxes. Excluding food from the base of a value added tax, for example, reduces the amount of tax paid by poor families, who spend more of their income on necessities.

Tax rates are often expressed as a **marginal** or **effective** rate. The marginal income tax rate is the rate applied to the highest dollar of income or profit earned. The effective tax rate is the average paid on the total income or profit earned.

Most simply, the cost of a tax expenditure is measured as the difference between the amount of tax that would be collected in the absence of the provision and the amount that is collected with the provision in place. Some tax expenditures — such as tax credits — are reported on tax forms and can be directly measured. Others require an indirect approach, such as the exclusion of food from a value added tax (VAT) or the exclusion of income from capital gains. Consumption or income survey data can be used to estimate the cost of tax expenditures in these instances. Tax expenditures can be used in any type of tax, including corporate income taxes, commodity taxes, value added taxes, and property taxes. Some tax incentives — such as a lower tax rate for manufacturing firms — apply to an entire sector, while others are awarded to attract a specific project or activities within a designated place.

3.2 THE PROS AND CONS OF TAX EXPENDITURES

Tax expenditures can be used for a number of reasons. Some improve the equity and efficiency of a tax system, while others create disparities, make the tax code more complex and less transparent, and hinder efforts to ensure accountability. Tax expenditures can be an appropriate tool where they are used to provide broad-based benefits and there is little need for monitoring and evaluation. They can also be an efficient means to make a tax system more equitable. In most countries, however, tax expenditures are used too often, ineffectively, or for purposes where direct government spending would be more appropriate.

BOX 3. THE RELATIONSHIP BETWEEN TAX EXPENDITURES AND HUMAN RIGHTS

Article 2 of the International Covenant on Economic, Social, and Cultural Rights (ICESCR) requires all signatories to "(T)ake steps, individually and through international assistance and co-operation, especially economic and technical, to the maximum of its available resources, with a view to achieving progressively the full realization of the rights recognized in the present Covenant by all appropriate means, including particularly the adoption of legislative measures." The Covenant binds signers to recognize and work to ensure that the right to education, health care, housing, among other services, along with the ability to fully participate in cultural and political life, are protected and advanced.

Signatory governments are also obliged to use the maximum of available resources to progressively realize economic, social, and cultural rights. This requires governments to raise the necessary tax revenues to achieve these rights, to the extent that doing so does not undermine long-term growth and economic sustainability. Tax expenditures infringe upon governments' obligation to use the maximum of available resources when they:

Deploy resources ineffectively and inefficiently. Tax expenditures that are not evaluated or that have been evaluated and shown to be ineffective violate governments' requirement to use the maximum available resources to advance economic, social, and cultural rights. Governments have a proactive responsibility to use all appropriate means, including an assessment of whether funds are used effectively, toward the realization of rights.

Allocate financial resources for non-essential purposes, such as poorly targeted tax expenditures, while leaving fundamental human needs unfulfilled. Article 2 requires governments to give "due priority" in the use of expenditures – including those through the tax code – to the goal of realizing human rights. Tax expenditures can deprive governments of the funds needed to ensure access to education, food, clothing, and housing that are all guaranteed rights under the ICESCR, as well as destabilize the systems of governance that are required to protect fundamental human rights.

Disproportionately benefit high income households. Many tax expenditures favor types of income – such as income from investments or businesses – that disproportionately benefit the well off, and others – such as tax deductions – are worth more to higher income individuals than the poor or middle-income households. Tax expenditures can also increase governments' reliance on consumption taxes or other revenue sources that have a disproportionate impact on low- and middle-income households in violation of Article 2's requirement that governments act in a nondiscriminatory manner to advance the achievement of human rights.

Arguments against tax expenditures include:

- **Lack of transparency**. Tax expenditures are typically subject to less oversight and are less transparent than "on budget" spending. While policymakers approve budgeted expenditures on an annual basis, tax expenditures are often permanent features of law and lack periodic oversight. Separating the review of tax expenditures from the annual budget process makes it harder for lawmakers to have a comprehensive understanding of how public resources are deployed and complicates their ability to prioritize among competing demands.

- **Cost**. Tax expenditures reduce the amount of revenue that governments collect from a given tax rate. This either requires a higher tax to raise sufficient revenues or forces lower spending to bring the budget into balance. The revenue loss is significant since public resources are considered to have a higher social value than the equivalent level of private income, because they are available to finance public services and investment that meets a social need.[22]

- **Ineffective**. Many tax expenditures are poorly designed or ill-suited to produce their stated goals. Tax expenditures are often ineffective because they provide benefits to firms for doing exactly what they would have done in the absence of an incentive. Surveys of investors find that a high level of investment would have been made even if no incentive had been provided.[23]

- **Inefficient**. Economists argue that tax expenditures distort investment decisions, leading firms to make decisions based on tax considerations, rather than an investment's underlying economic value. When this happens, capital shifts from where it can produce the greatest benefit to a less productive activity.

[22] International Monetary Fund, "Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment" (paper presented to the G-20 Development Working Group in September 2015 and to the Executive Board of the IMF in October 2015): 10.
[23] Ibid., 1.

- **Prone to abuse**. Tax expenditures can be prone to corruption and are often awarded in response to inappropriate political influence. Firms may rearrange their structure in order to qualify for an incentive or move within a country to take advantage of incentives that are geographically targeted.

- **Inequitable**. Tax expenditures generally favor people and firms with higher incomes because they owe more in taxes and have more to gain from preferential treatment. Some tax expenditures — deductions and exemptions — provide greater benefits to those who are taxed at higher rates. The lowest income households, who often earn too little to pay tax, receive no benefit from many personal income tax expenditures.[24]

- **Complexity**. Tax expenditures make the tax code more complex. The existence of preferential treatment for some increases the perception that a tax system is unfair. Tax expenditures increase the cost of tax administration and, when tax administration is weak, can create opportunities for corruption and abuse.

While a narrow analysis might suggest that the sole function of a tax system should be to raise revenues, there are some instances where tax expenditures can be a cost-effective tool for achieving desired policy goals. Tax expenditures make sense where:

- **The goal is to provide assistance to large numbers of people and eligibility is easy to define.** Tax expenditures can be an efficient tool for providing assistance when the information needed to establish eligibility is already gathered on the tax form or can easily be determined. In these circumstances, a tax expenditure can be administered for a much lower cost than spending through a separate public agency. Child tax credits are an example of this, as are VAT exemptions on staple foods or medicines.

- **There is minimal risk of fraud or abuse.** Tax expenditures can be an appropriate tool where there are reporting schemes or where detailed reporting is not needed to establish eligibility for a tax expenditure. Examples of this type of situation is where there is parallel reporting by the seller and purchaser under a VAT or where employers and individuals both report, such as for an employee's cost of insurance coverage.

[24] This occurs when deductions and exemptions are provided in systems that have multiple tax rates at different income levels. A $1,000 deduction, for example, is worth $100 to a taxpayer subject to a 10 percent rate, but only $50 to a taxpayer subject to a 5 percent rate.

The most common argument in favor of tax incentives for business and investment is that they spur economic growth. Research generally finds these type of tax expenditures to be costly and of limited, at best, effectiveness.

3.3 THE RACE TO THE BOTTOM

Tax incentives are tax expenditures that are granted to encourage investment (see Box 4). In developing countries, they are often targeted at foreign direct investment (FDI). Investment incentives are premised on the belief that the value of the investment that is subject to an incentive has greater social value than the lost revenues that are attributable to the incentive. Unfortunately, the social value of an incentive can be difficult, at best, to calculate. First, it is difficult to assess whether the investment would have occurred in the absence of an incentive. Second, tax incentives offered by one country can lead to pressure on neighboring countries to enact similar benefits. The cycle of providing larger and larger incentives to compete creates a “race to the bottom” that reduces public revenue collections and limits countries’ ability to invest in the education and infrastructure needed to promote equitable development. Incentives targeted at increasing FDI can also crowd out domestic investment and research suggests that promised beneficial spillover effects are too limited to positively impact economic growth.[25] Lastly, they complicate the tax code, often lack transparency, and often lack the level of oversight and review that is accorded to traditional “on budget” spending.

BOX 4. TAX EXPENDITURE OR TAX INCENTIVE?

All tax incentives are tax expenditures, but not all tax expenditures are tax incentives. A tax incentive is designed to encourage a particular type of behavior, often related to investment. VAT exemptions for food, electricity, and drinking water are examples of tax expenditures that are not incentives. The goal of the VAT exemption is to reduce the cost of basic necessities, not change consumption patterns or investment. A lower tax rate for income earned in a border region, such as Mexico’s reduced tax rate in Baja California, is an example of an incentive aimed at encouraging businesses to invest in Mexico, rather than the United States.

While tax incentives are widely used by countries at all levels of development, evidence suggests that they can be a costly and ineffective strategy for encouraging investment. Other factors — such as economic and political stability, and the availability of skilled labor — typically rank higher in surveys of investors and can suffer when tax

[25] Alexander Klemm and Stefan Van Parys, “Empirical Evidence on the Effects of Tax Incentives” (International Monetary Fund, Fiscal Affairs Department, July 2009): 19-20.

revenues are lost to incentive packages (see Box 5). While there is evidence that some tax incentives are associated with higher levels of FDI, there is no clear evidence that incentives increase overall private investment or economic growth.[26] In fact, where tax incentives increase foreign investment, domestic investment may be displaced.[27] Research also suggests that high tax rates may be more detrimental to a country's investment climate than a lack of incentives.[28] Yet the use of incentives can perversely lead to higher tax rates in order to offset the revenue loss due to the use of incentives.

[26] Ibid., 4. This finding comes from a study of data from 47 countries in Africa, Latin America, and the Caribbean over 20 years.

[27] International Monetary Fund, "Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment," 14.

[28] Sebastian James, "Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications," (Investment Climate Advisory Services of the World Bank Group, September 2013): 1.

BOX 5. WHAT FACTORS OTHER THAN TAXES INFLUENCE INVESTMENT DECISIONS?

Taxes are just one of a number of factors that influence investment decisions. Other important factors include: stable fiscal and economic policies; adequate physical, financial, and institutional infrastructure; transparent and accountable public administration regimes, including tax administration; an educated and skilled workforce; the cost of raw materials and labor; availability of local suppliers; and access to export markets.

Tax incentives that reduce revenue collections can increase fiscal instability and hinder governments' ability to invest in education and infrastructure that can have a much greater impact on investment decisions than the presence or absence of a tax incentive. Research findings suggest that:

- higher tax rates have a negative impact on foreign direct investment, but the impact is less in developing countries than in OECD countries, and does not effectively compensate for poor infrastructure, economic instability, weak governance, or lack of markets;

- extending tax holidays also increases FDI, but also at a much lower level than in OECD countries; and

- the percentage of investors that would have invested even without an incentive exceeded 70 percent in 10 out of 14 surveys examined in one review of the research.

3.4 TAX EXPENDITURES IN LATIN AMERICA

Virtually every country uses tax expenditures to carry out policy objectives. However, the share of revenue that is lost through these provisions varies significantly from country to country (Table 4). In Guatemala, for example, tax expenditures equaled 79 percent of central government tax revenues, while in Argentina, tax expenditures equaled 11.1 percent of total central government tax collections in 2012.[29]

[29] Miguel Pecho Trigueros, "Tax Expenditures in Latin America 2008-2012" (CIAT Tax Studies and Research Directorate Working Paper 2-2014, March 2014): 6. In Guatemala, the cost of tax expenditures equaled 79.3 percent of central government tax

TABLE 4. TAX EXPENDITURES IN LATIN AMERICA AS A PERCENTAGE OF CENTRAL GOVERNMENT TAX REVENUES, 2008-2012

	2008	2009	2010	2011	2012
Argentina	10.0	9.9	10.9	11.2	11.1
Brazil	16.3	22.3	21.4	18.5	22.5
Chile	26.3	33.3	27.7	26.6	24.5
Columbia	23.2	24.7	26.5	-	-
Costa Rica	-	-	42.7	41.5	42.6
Dominican Republic	43.0	47.8	43.3	39.9	38.3
Ecuador	-	32.6	30.4	36.3	33.1
El Salvador	-	-	25.1	-	-
Guatemala	73.8	77.7	76.4	71.5	79.3
Honduras	-	-	-	41.7	43.4
Mexico	57.7	40.6	37.8	43.4	45.2
Panama	-	-	-	-	17.4
Paraguay	18.5	15.7	15.9	-	-
Peru	12.5	14.1	14.0	11.9	11.9
Uruguay	29.6	29.6	32.4	32.4	33.3
Simple Average	**31.1**	**31.7**	**31.1**	**34.0**	**33.6**
Source: Miguel Pecho Trigueros, "Tax Expenditures in Latin America 2008-2012" (CIAT Tax Studies and Research Directorate Working Paper 2-2014, March 2014): Table 2. Downloaded from http://www.un.org/esa/ffd/wp-content/uploads/2015/03/2015TIBP_CIATwp02-2014.pdf on 27 December 2017.					

The cost of tax expenditures stayed roughly constant in most Latin American countries between 2008 and 2012, but increased by over a third (38.0 percent) in Brazil and fell by 21.7 percent in Mexico, both measured as a percentage of central government revenues over the same period of time.[30]

As a region, Latin America has a strong history of tax expenditure reporting. The Inter-American Center of Tax Administrations (CIAT), the association of tax authorities in the region, has taken an active role in promoting best practices in tax expenditure reporting and evaluation.[31] Most of the countries in the region issue publicly available tax expenditure reports, often in connection with the proposed budget. While these reports provide a solid foundation, many countries' practices lack important information, such as the actual cost of individual tax expenditures or the identity of the beneficiaries of investment incentives. Several Central American countries, along with Venezuela, fail to publish even basic information (Table 5).

revenue collections in 2012, although a portion of the disparity results from the method used by Guatemala to calculate the cost of a tax expenditure. See J. Gómez-Sabaíni and D. Moran, "Tax Policy in Latin America," 62.

[30] Miguel Pecho Trigueros, "Tax Expenditures," 8.

[31] See, for example, Inter-American Center of Tax Administrations, *Handbook of Best Practices on Tax Expenditure Measurements: An Iberoamerican Experience* (Panama, 2011).

TABLE 5. TAX EXPENDITURE REPORTING PRACTICES IN LATIN AMERICA

	Year tax expenditure measurement institutionalized*	**Are tax expenditure reports attached to the draft budget?**	**Are tax expenditure reports public?**
Argentina**	1999	Yes	Yes
Bolivia	2013	No	Yes
Brazil**	1989	Yes	Yes
Chile	2001	Yes	Yes
Colombia	2004	Yes	Yes
Costa Rica	2011	No	Yes
Ecuador	2010	Yes	Yes
El Salvador	2013	No	No
Guatemala	2002	Yes	Yes
Honduras***	-	-	-
México**	2002	Yes	Yes
Nicaragua***	-	-	-
Panamá[3]	-	-	-
Paraguay	2015	Yes	Yes
Perú	2002	Yes	Yes
Dominican Republic	2008	Yes	Yes
Uruguay	2008	No	Yes
Venezuela**	-	-	-

Source: Inter-American Center of Tax Administrations (CIAT)
* Institutionalized as used here refers to a continued effort by the country's authorities
**At the federal government level
*** There are estimates by consultants or international organizations

3.5 TAX EXPENDITURES AND INEQUALITY

Tax expenditures contribute to Latin America's high degree of inequality by limiting the resources available for redistributive spending and by forcing governments to resort to regressive taxes, such as VAT, to make up for lost revenues. Some preferences — such as lower tax rates for capital income than for wage income — directly increase inequality, since the wealthy derive a greater share of income from investments than low- and middle-income households. Similarly, tax incentives aimed at increasing business investment largely benefit high-income individuals and/or foreign investors, and often fail to produce the promised growth in jobs and economic activity.

A comprehensive evaluation of the impact of tax expenditures — singularly or as a whole — on a country's tax system requires complex distributional analysis. There is relatively little of this type of research available for Latin America.[32] Recent studies examining the impact of personal income tax expenditures in Ecuador and Chile found that an overwhelming majority of the benefits went to the highest income individuals.[33] This is consistent with

[32] Bruno Martorano, "Taxation and inequality in Latin America."
[33] Bruno Martorano, "Taxation and inequality in Latin America."

research on the U.S. tax system, which finds that the highest income households receive a disproportionate share of the benefits from personal income tax expenditures. One recent study found that a full 27 percent of the benefits of U.S. personal income tax expenditures went to households earning in the top 1 percent of income.[34] It is important to note, however, that tax expenditures can also be used to reduce inequality. A study from Columbia, for example, found that tax expenditures made that county's VAT less regressive by reducing the amount of tax paid by lower-income households measured as a share of income by a greater amount than wealthier households.[35]

In the absence of incidence analysis — data that looks at who benefits from a tax expenditure by income level — the answers to some basic questions can provide an indication of who is likely to benefit from a tax expenditure:

- Does a tax expenditure apply to basic necessities (such as unprocessed food and water) that constitute a large share of the budgets of lower-income households?

- Does the tax expenditure apply to a tax that is disproportionately paid by low- and middle- income households (such as a VAT) or by higher-income households or businesses (such as a personal or corporate income tax)?

- What is the purpose of a tax expenditure? If it is designed to benefit lower-income households, is there a logical relationship between the structure of the tax preference and the goals it is designed to achieve?

- Is the cost of providing a benefit through the tax code lower than comparable assistance provided through on budget spending?

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[34] Yifan Zhang and Daniel Berger, "Who benefits from tax expenditures?" (Tax Policy Center, Washington, D.C.: 28 September 2016) downloaded from http://www.taxpolicycenter.org/taxvox/who-benefits-tax-expenditures on September 30, 2016.
[35] This occurs because low-income households pay a greater share of their income in VAT than do the wealthy.

BOX 6. TAX EXPENDITURES CAN BE A TOOL FOR REDUCING INEQUALITY

Policy discussions of tax expenditures often focus on their negative attributes, such as cost, complexity, and questionable effectiveness. In some instances, tax expenditures can be a cost-effective and efficient tool for directing benefits to low- to middle-income households. Tax expenditures can be an appropriate tool to reduce the impact of a VAT by exempting food, water, medicine, and other necessities that account for the large share of the purchases of low- and middle-income households. They can also be used to provide child allowances or other transfer payments that have broad eligibility criteria and that don't require complex monitoring. Structural factors that affect the equity of a tax expenditure include whether it:

- is structured as a tax credit, which provides dollar for dollar benefits regardless of a taxpayers' income level, or a deduction or exemption, which provides greater benefits to the well-off, who are generally taxed at a higher rate, by reducing the amount of income that is subject to tax;
- is available to all households, including those in the informal sector, or only those that participate in the formal economy; or
- applies to a type of income that is received almost exclusively by the wealthy, such as capital gains, or a type of consumption that accounts for a large share of poor families' budgets.

For example, many countries' income tax laws provide a deduction for the interest paid on a mortgage used to buy a home. Structuring this benefit as a deduction provides greater benefits to high-income households, who pay taxes at a higher marginal rate. Restructuring the preference as a tax credit equal to a percentage of the interest paid would provide the same dollar benefit to high- and low-income households. Take a family subject to a 10 percent income tax rate that pays $1,000 in mortgage interest. This family receives a $100 benefit from the mortgage interest deduction, while a lower-income family subject to a 5 percent tax rate would receive a benefit of $50. A tax credit equal to 7.5 percent of mortgage interest paid would provide the same $75 benefit to both families

4. CONCLUSIONS AND RECOMMENDATIONS

Tax expenditures should be viewed as part of broader fiscal policy structure. A good revenue system is based on taxes that are simple, fair, and efficient. Tax expenditures risk compromising these principles to the extent that they complicate the tax system, create inequities, are less effective than programmatic spending, and forgo revenue that could have been spent more productively or that needs to be replaced in other and more damaging ways. Reforms can improve the transparency and accountability of tax expenditures by ensuring that policymakers and the public have access to the information needed to assess their cost, impact, and effectiveness. Distributional analyses that examine who benefits by income level can provide the information needed to determine whether a tax expenditure makes a tax system more or less equitable.

Tax expenditures should be publicly reported on and reviewed regularly. While "on-budget" spending is typically reviewed on an annual basis, the cost and impact of spending through the tax code is often hidden from public view. Lawmakers should periodically review the revenue loss attributable to tax expenditures, ideally as part of the annual budget process. Considering the cost of tax expenditures as part of the budget process provides lawmakers with a more complete picture of how public resources are allocated and facilitates a more informed dialogue about public policies and priorities. Annual review also allows lawmakers to consider the long-term impact of the choices they make, since revenues that are foregone in good times may contribute to fiscal distress when economic times are bad. A separate review, or no oversight at all, privileges tax expenditures relative to other public priorities and makes it difficult for policymakers and the public to understand their true cost and impact on the budget.

Most Latin America countries publish a tax expenditure report that is available to the public. However, not all countries publish a comprehensive report. Elements of a comprehensive report include:

- A list of tax expenditures, with a clear description (i.e., the type of preference provided), the effective and sunset date, and the law or decree that provides the legal basis for each expenditure.
- The stated policy objective of each tax expenditure.
- The estimated cost in revenues foregone for the upcoming and future years, and the actual cost for prior years.
- A discussion of the methodology used to estimate the cost of tax expenditures.
- Supplementary material, such as an analysis of the distributional impact by type of taxpayer (e.g., for corporate income tax expenditures, by size and sector).

Tax expenditures should have a statutory basis in tax law. Tax expenditures, particularly investment incentives, should be prescribed by law, not negotiated on a case-by-case basis. Tax incentives that are provided through contracts, decrees, and regulations often lack proper oversight and transparency, and can be prone to abuse. A solid legal framework facilitates cost-benefit analysis and limits opportunities for corruption that can occur when an incentive is tailored for a specific firm or project. It also ensures that the legislative body has an opportunity for review and provides a structure for public comment, oversight, and, if necessary, repeal or modification.

Tax expenditures should be granted in accordance with a comprehensive policy framework and should have clear goals, well-defined eligibility criteria, and objective, measurable outcomes. Tax expenditures should be considered within a policy framework that considers which strategies are best suited for achieving identified policy goals. Investment incentives, for example, should be evaluated as part of a broader economic development and macroeconomic policy framework. The purpose of a tax expenditure should be clearly identified, and each tax expenditure should have measureable outcomes, clearly defined eligibility criteria, and a requirement that recipients report the data needed to assess whether a provision is effective at achieving its stated goals. Progress toward achieving the identified goals should be regularly communicated to lawmakers and the public as part of an annual tax expenditure reporting and review process.

Authority for tax expenditures oversight should be centralized within the Ministry of Finance and administered by the revenue agency. To facilitate the comparison of tax expenditures and on budget spending, a single agency — usually the finance ministry — should have primary authority for administering and tracking the cost of tax expenditures. Ministries with programmatic authority — for example, a Ministry of Mining that controls incentives for extractive projects — should coordinate their activities with the ministry charged with overall fiscal responsibility. Programmatic ministries lack the “big picture” perspective needed to balance the impact of lost revenues against competing programmatic demands. Implementation and enforcement of tax expenditures should be vested in the revenue agency, which has the expertise needed to administer the tax law.

Provide mechanisms for public participation and transparency. Citizen participation improves compliance and strengthens the social contract between governments and the governed. The public should have access to the information needed to assess the impact of tax expenditures, including information on who benefits, the cost of the benefit received, and progress toward meeting defined outcomes and eligibility criteria. Analysis of tax incentives is data intensive. Often the information needed for cost-benefit analysis and evaluation is not reported as part of a standard tax return. In some countries, additional staff and/or legal authority may be needed in order to ensure that data is gathered and tax expenditures are monitored appropriately.

Tax expenditures should have sunset dates and be periodically evaluated to assess their cost-effectiveness and the extent to which they meet the stated objectives. Once established, tax expenditures generally remain in effect, unless they are subject to a sunset date. Sunset dates require legislators to periodically consider whether a tax expenditure has achieved its goals, as well as the impact of lost revenues. Review criteria, as well as findings, should be reported publically. Measures that are cost effective and efficient can be renewed, while those that are ineffective can be allowed to sunset or can be modified.

Governments should work together in order to avoid harmful tax competition. In many cases tax incentives are created to respond to what neighboring countries and competitors are offering or perceived to be offering. Hence the issue of tax incentives cannot be tackled in isolation. Governments should work together to avoid a race to the bottom that occurs when countries create competing incentives to attract foreign investment. Efforts to enhance regional cooperation should span a broad range of tax and non-tax provisions that are designed to attract foreign investment, such as cash subsidies and loan guarantees.

Tax expenditures should be considered within a broader, rights-based framework. Tax expenditures should be evaluated within the context of the tax and fiscal system as a whole and on the degree to which they limit governments' ability to promote the realization of human rights. Comprehensive analyses can assess whether tax expenditures contribute to greater equality by providing benefits to low- and middle-income residents, or widen inequality by reducing the resources available to meet the obligation of economic and social rights. Tax expenditures should also be examined to determine whether they provide disproportionate benefits to the wealthy, property owners, or a specific region that may violate the principles of nondiscrimination.