Classification

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Classification of "Tax Expenditures"

There are a number of ways to classify tax expenditures. We consider two methods, one being the classic method and the second being a recently introduced alternative (that appears to have been largely abandoned).

The first method is to divide tax expenditures into three categories: (1) those designed to modify behaviour by providing incentives or dis-incentives; (2) those designed to re-distribute income and act similar to social benefits programs; and (3) technical tax expenditures that exist for administrative convenience and efficiency. Some people further divide the category of social benefit tax expenditures into two subcategories: (2a) those provisions that have the same purpose as social benefits; and (2b) those provisions that provide preferential treatment of social benefits.

As with any classification scheme, the categories chosen are rarely water tight, and one must approach classification with caution. For tax expenditures, it's not always easy to distinguish between provisions designed to modify behaviour and those designed to provide social benefits because a provision may do both to some degree. We should, however, be able to identify the dominant purpose of a provision by looking at its substance in reference to the above two categories.

(1) Tax expenditures designed to modify behaviour are either tax incentives or tax dis-incentives. They are generally justified as being needed to correct some efficiency or neutrality loss introduces by the tax system - thus they aim to correct 'market failures'. When considering these kinds of tax expenditures one should ask whether (i) it is desirable to modify the behaviour (and what behaviour is preferred); and (ii) whether the tax system is the best means of modifying that behaviour (effectiveness, distributional effects, costs and side-effects, etc).

(2a) Tax expenditures that have the same purpose as social benefit programs can be identified by looking at what governments would need to do if these provisions were not there. Generally, if these types of tax expenditures were removed, they would need to be replaced with direct spending programs, such that their removal would not increase or decrease government revenues. However, what ought to be included in this category (or even provided for at all) is subject to political debate and ideology.

(2b) Tax expenditures that give preferential treatment to social benefits are those that either do not tax or tax at a lower rate social benefits delivered through direct spending programs. By fully or partially removing these payments/benefits from taxable income government is only lowering the cost of delivering the benefits, since if they were taxed, governments would need to increase the amount of pre-tax benefit provided.

(3) Technical tax expenditures are justified on the basis that they make for more efficient administration of the tax system or on the basis that they make the system easier to administer (lower administration and compliance cost sufficient to outweigh their cost).

The second alternative way of classifying tax expenditures was proposed by the US Joint Committee on Taxation staff. The basis for introducing this alternative was that tax expenditure classification on the basis of deviations from the Haig-Simmons benchmark was seen as arbitrary and therefore subject to easy attack.

The Staff of the Joint Committee proposed to divide tax expenditures into two broad categories: (1) Tax Subsidies; and (2) Tax-induces Structural Distortions.

(1) Tax subsidies are those provisions that are "deliberately inconsistent with an identifiable general rule" of the tax codes, such that it results in less revenue being collected than would under the general rule. This was further classified into three subcategories:

<u>(1a) Tax Transfers</u> include all transfers made to taxpayers, and include transfers made to those who have no tax liability (refundable tax credits).

<u>(1b) Social Spending</u> provisions are those that provide subsidies that promote particular activities or provide support for particular persons

<u>(1c) Business synthetic spending</u> provisions are tax subsidies that are meant to subsidize or promote behaviours that affect business activities and investment choices.

(2) Tax-induced structural distortions are defined as those structural elements of the tax law that materially affect economic decisions in a manner that imposes substantial efficiency costs. The focus here is on efficiency only, with no attention paid to equity or administrative simplicity.