TEFISCON

Tax Expenditures and the Fiscal Contract

- A German-French collaboration project financed by Deutsche Forschungsgemeinschaft (DFG) and Agence Nationale de la Recherche (ANR) -

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1. Research objectives and hypotheses

The project aims at shedding light on a topic that has not been widely researched so far: **How does the use of tax expenditures in low- and middle-income countries impact on the fiscal contract?**

Tax expenditures are preferential tax treatments for specific taxable activities or groups of taxpayers. They are applied as reduced tax rates, exemptions, deductions from taxable income, tax credits or deferrals, among other forms. The available evidence indicates that tax expenditures often have a strong impact on the distribution of the tax burden within a given society, both in terms of horizontal equity (unequal taxation of similar activities or assets) and vertical equity (a shift of the tax burden in favour of the wealthier segments of society). We also find evidence that they have a sizeable fiscal impact that restricts the ability of governments to finance public services through direct spending. At the same time, the total fiscal impact of tax expenditures is often unknown and governments frequently fail to publish timely and encompassing information on the tax expenditures they use. Not least, we observe that tax expenditures are set up or maintained by means of decision-making processes that are often less transparent and less formalised than ordinary budget decisions or tax reforms.

We explore the impact of tax expenditures on the fiscal contract: This concept refers to an implicit agreement between the state and the taxpayers (both citizens and businesses) that links individual tax compliance and the distribution of the tax burden within a society to public service delivery and access to political decision-making. The concept has proven to be highly relevant to understand patterns and dynamics of taxation in countries worldwide, including low- and middle-income countries. Not every fiscal contract is rooted in democratic rule, or formalised in laws and constitutional dispositions. Fiscal contracts can be highly elitist and informal. Based on an extensive literature review, we distinguish fiscal contracts along two criteria: 1) *governance*, referring to the degree to which the tax burden is allocated through general laws as opposed to discretionary action and constant bargaining, and 2) *distribution*, referring to their exclusionary or inclusionary character (impact on horizontal or vertical equity).

It is important to note that the fiscal contract is based on objective factors, such as fiscal policies and their differentiated effect on taxpayers, but also on subjective factors such as taxpayers' perceptions of their tax burden compared to others, and their views on the ability or willingness of government to deliver public services. The cost-benefit relations of tax expenditures are often unknown, however. A growing number of governments estimate the costs of tax expenditures in terms of revenue forgone, but there are few cases where such costs are related to expected or real socio-economic outcomes.

Research gap and relevance

The project contributes to closing a significant research gap. Little is known about the impact of tax expenditures on the fiscal contract, partly due to lacking information on tax expenditures, particularly in low- and middle-income countries. The project will generate new evidence on the specific role tax expenditures play for fiscal contracts and the underlying causality paths that drive this relationship. Further, it will broaden the fiscal contract debate, which has focused mainly on individual taxpayers, by incorporating an additional focus on government-business relationships. This is a relevant contribution to academic research, with important repercussions on the political debate as well:

- Tax expenditures have, as most reports show, significant negative impacts on tax revenues. The worldwide long-term average of revenue forgone, according to the Global Tax Expenditures Database (GTED), stays at 4.0 per cent of GDP and 25.0 per cent of actual tax revenue.
- Developing countries are depriving themselves of significant revenues through the granting of numerous tax expenditures. Tax expenditures often tend to accumulate over time. They reduce the fiscal space of governments – at a time when governments all over the world are looking for funds to finance their fight against climate change and the impact of the COVID-19 pandemic.
- Tax expenditures tend to make the tax system complex and non-transparent.
- Contrary to the arguments put forward by their proponents, tax expenditures often run counter to equity and have a regressive distributional impact. In countries with high levels of informality, many tax expenditures fail to target that sector. This has significant distributional implications.
- Tax incentives aimed at promoting investments are often granted to compensate for poor infrastructure, imperfections in the tax system and failing institutions, but tend to have distortionary effects on markets and can be environmentally harmful.
- However, getting rid of useless or harmful tax expenditures can be challenging and often triggers widespread social protest.

Research hypotheses and work packages

Against this background, the project sets out to explore the impact of tax expenditures on the fiscal contract. The main hypothesis we want to put to a test is:

> H1: The use of tax expenditures changes the characteristics of the fiscal contract in low- and middle-income countries

Drawing from the academic literature we identify three basic mechanisms through which tax expenditures affect fiscal contracts: distribution, accountability and perceptions.

Distribution

Tax expenditures are typically used to benefit social groups, economic sectors or activities by lowering their respective tax burden or improving access to specific (public) services. Hence, the fiscal contract also depends on the budgetary, economic and social consequences of tax expenditures. On the one hand, tax expenditures reduce the amount of tax revenues raised by governments and thus affect their ability to deliver public services. On the other hand, they have (or ought to have) an impact on economic growth, employment and access to basic goods and services.

We distinguish the distributional effect of tax expenditures on indirect taxes (value added tax – VAT – and excise taxes) from direct taxation (mostly corporate income tax – CIT – in developing countries). Tax expenditures on indirect taxes tend to generate wide-spread benefits. At the same time, their overall distributional effect on indirect taxation is sometimes regressive, meaning that they can have a negative effect on vertical equity. Tax expenditures on direct taxation tend to generate group-specific benefits that affect horizontal equity. In light of these trends we will test the hypotheses

> H2: A more extensive use of tax expenditures on indirect taxes is associated with more inclusionary fiscal contracts;
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> H3: A more extensive use of tax expenditures on direct taxes is associated with more exclusionary fiscal contracts;

where the extension of tax expenditure use can be assessed based on data from the Global Tax Expenditures Database (GTED), for instance in terms of revenue forgone (as percent of GDP or actual tax collection) or number of provisions in place, or even by looking at number of beneficiaries in those (few) cases where governments publish such figures.

Work Package 1 of the project will make use of GTED data to analyse how tax expenditures are used for distributional purposes, with a specific focus on low- and middle-income countries. Based on macro panel data regression analysis it will provide evidence on patterns of tax expenditure use and explore their relation with patterns of distribution, political rule, institutional capacity and public finance performance. While causal relations will be difficult to establish due to multiple confounding factors, the work package is expected to generate new evidence at the aggregate level on the association of tax expenditure use with the governance and distributional dimensions of fiscal contracts.

Accountability

Research on the motivational aspects of tax compliance and tax morale indicates that the degree to which taxpayers meet their payment obligations depends on a combination of enforcement, measures to facilitate compliance and trust or legitimacy beliefs. In this context, tax expenditures are often less visible than direct expenditures and less demanding in terms of accountability than other tax policy measures, thus shaping the quality of public finance systems as well as bargaining procedures underlying the respective fiscal contract. We will test the hypothesis

> H4: The use of tax expenditures makes fiscal contracts more discretionary.

Work Package 2 of the project will explore how the use of tax expenditures affects fiscal bargaining, both in terms of short-term negotiations and long-term institutional settlements. Research will focus on the political economy of tax expenditure bargaining in a specific country, Zimbabwe, where IDOS is currently implementing a research project on the evaluation of tax expenditures jointly with Zimbabwean partners. The work package will study the institutional structure and political processes leading to the set-up of individual tax expenditures and how they are maintained over time. Findings will be contrasted with the processes and structures driving "ordinary" tax policies in that country. This work package is expected to generate insights on the institutional setting and political economy of tax expenditures, thus contributing to the analysis of the governance dimension of fiscal contracts.

Perceptions

We assume that tax expenditures affect the way taxpayers (citizens and business) think about the tax system and fiscal policy in general, as well as the degree to which taxpayers comply with their obligations. Perceptions reflect a certain level of understanding of the tax system, the economic mechanisms involved and the actual effects of tax expenditures. They depend on individual characteristics, such as income and education level, gender, type of economic activity, among other factors. In the case of firms, perceptions of tax expenditures depend on ownership, size (turnover, number of employees), economic sector, competition, location, etc.

Tax expenditures on direct taxes often affect perceptions of horizontal equity, while tax expenditures on indirect taxes may be associated with different perceptions. Consequently, we will test the hypotheses

> H5: Taxpayers who benefit from tax expenditures on direct taxes are more likely to support the underlying fiscal contract, while those who do not benefit are more likely to perceive the underlying fiscal contract as unfair, and are less inclined to comply with their own tax obligations;

> H6: Taxpayers who benefit from tax expenditures on indirect taxes (which can be large parts of the population) are more likely to support the underlying fiscal contract, even in those cases where other parts of the society benefit more;

Work Package 3 will explore how the use of tax expenditures affects perceptions of tax fairness as well as tax compliance. Macro-level research will rely on pooled cross-sectional regression analysis of data obtained from international surveys such as the World Value Survey and Afrobarometer, combined with data used in the first work package, to find out how patterns of tax expenditure use are associated with perceptions of tax morale and compliance at the level of individual taxpayers. This relationship will be analysed more deeply in two case studies (Uganda and Morocco), based on individual taxpayer surveys and target group interviews. Further, to tease out the relationship of perceptions and tax compliance related to business, two case studies will be carried out in Uganda and Colombia that focus on CIT exemptions and will conduct business surveys. We expect this line of research to generate evidence on the impact of tax expenditures on the attitudinal dimension of the fiscal contract.

Further, we assume that changes in taxpayers' information can lead to mind shifts regarding individual tax expenditures and beyond. We test the hypothesis

> H7: Taxpayers with more information on the total fiscal cost and overall as well as individual distributional impact of tax expenditures (how do they benefit compared to other taxpayers) are more likely to oppose the measures and the underlying fiscal contract.

Work Package 4 analyses the effect of knowledge on taxpayers' perceptions. In particular, it studies how additional and personalised information on the real distributional effects of tax expenditures leads to shifting attitudes (mind shifts) towards the respective tax expenditures and the underlying fiscal contract. Our research will first study the impact of VAT exemptions on inequality in a specific country (Morocco), based on taxpayer micro-data. It will then conduct randomised information treatment testing to measure how simple and targeted information on the gap between perceived and real effects affects tax morale and compliance. This line of research is expected to generate new evidence on the relevance of information and transparency in fiscal contracts.

Finally, *Work Package 5* will bind the above-mentioned work streams together in order to address the overarching research question. The function of this work package is to map the contributions of the different work streams, produce synthesising papers for the academic debate and engage with a wider public on the key messages that can be derived from the project at the interface of science and policy.

2. Positioning relative to the state of the art

The project seeks to generate new insights at the intersection of two academic debates. On the one hand, the granting of tax expenditures has attracted growing attention in recent years, as scholars have come to realise the large extent to which these mechanisms are used by governments to pursue distributional, economic and other policy objectives. So far, however, this field of academic scrutiny has relied mainly on case-specific research covering high-income countries. Comparative cross-country analysis and research on low- and middle-income countries have both been hampered by a critical lack of reliable data. Only very recently has such data been made available by the Global Tax Expenditures Database (GTED).

On the other hand, a well-developed and diversified body of research studies the characteristics and determinants of the so-called fiscal contract. Fiscal contract theory helps us to understand that taxation is not primarily a technical but rather a political issue. Its main focus is on taxes actually levied – or taxes avoided and evaded, for that matter. But what happens when governments voluntarily abstain from collecting certain taxes? How does the use of tax expenditures impact on the different dimensions of the fiscal contract? And what role does transparency play in this context, given the fact that tax expenditure reporting is often highly deficient?

Previous project-related activities by the consortium

The project builds on previous and ongoing research undertaken by the project partners. Since 2018 the *German team*, in cooperation with the Swiss think tank Council on Economic Policies (CEP), has developed the above-mentioned Global Tax Expenditures Database (GTED). The database and GTED website (www.GTED.net) were launched in June 2021. Ongoing activities include the continuous actualisation of data, which will give the TEFISCON project team first-hand knowledge on current trends and new developments in worldwide tax expenditure reporting. Presently, the project gathers additional evidence on the evaluation and political economy of tax expenditures in several work streams, which will complement and support the research activities outlined here. One of those work streams is a pilot study on the evaluation of tax expenditures in the mining sector in Zimbabwe, implemented jointly with the Zimbabwean Ministry of Finance and Economic Development, the Revenue Authority and the Zimbabwe Economic Policy and Research Institute (ZEPARI).

Beyond its specific expertise on tax expenditures, the German project team has been engaged in research and policy advice on taxation and development since 2008. Its main focus has been on the political economy of domestic revenue mobilisation in developing countries. IDOS has contributed to fiscal contract research by looking at the impact of political regime types on tax collection and the effects of institutional patterns and trust on tax compliance. It has produced assessments of the determinants of tax effort in developing countries, both at national and subnational levels. This work has covered behavioural as well as institutional aspects of taxation. Members of the project team have conducted field research on tax issues at national and subnational levels in Latin America (Colombia, Peru), Africa (Mozambique) and Asia (Indonesia). On several occasions, surveys have been conducted to obtain micro-level data on perceptions and attitudes. IDOS has also led a randomised control trial project on subnational taxation in Mozambique. Members of the project team have conducted statistical analyses based on panel data from a large number of countries as well as qualitative case study research involving individual countries or theory-guided comparisons between cases.

The French team at UCA/CERDI has been conducting research on tax issues for more than two decades, as well as providing expertise and technical assistance to the governments of low- and middle-income countries at the request of institutions such as the IMF, World Bank, African Development Bank, European Union and the French Development Agency (AFD). Moreover, through its Master in Public Finance in Developing Countries, UCA/CERDI trains students from developing countries as well as officials from tax administrations with which cooperation agreements have been signed (for instance, Guinea, Togo). The UCA/CERDI team's research is closely linked to the academic debate on fiscal contracts by focusing on the political economy of tax reform, for example in Morocco. The team has also studied the impact of tax coordination in the countries of the Community of West African States (ECOWAS). In addition, the team has contributed to the literature on tax potential and tax effort by considering non-resource tax revenues, applying new non-parametric approaches to explain VAT tax effort and by creating a new database on tax revenue of sub-Saharan African countries (SSA) over the period 1980-2015, which includes estimates of tax effort for these countries.

The members of the CERDI project team have extensive field experience in African countries, both Franco- and Anglophone, through a large number of tax expertise missions. This expertise has been particularly focused on tax expenditure evaluations in individual countries (for instance, Guinea, Mali, DRC, Togo), but also on the preparation of strategic guideline documents for regional institutions such as ECOWAS (Methodological Guide for a Regional Evaluation of Tax Expenditures, 2021). Members of the UCA/CERDI team are currently drafting an ECOWAS directive on the regional evaluation of tax expenditures. Several workshops and conferences on the evaluation of tax expenditures have been organised or supported in 2022 (Nigeria, Benin, Chad).

Concerning the work packages, the French team members have mastered panel data econometrics on macro- and micro-data. They have also carried out micro-simulations to analyse the impact of tax policy reforms. Further, team members have a good knowledge of survey techniques and questionnaire design. CERDI cooperates on tax issues with international organisations such as the IMF, World Bank and African Development Bank, and research centres in the North and South, including Hassan II University in Casablanca (Morocco), with which the project team will collaborate on WP3 and WP4. These two work packages will also allow the project team to work closely with the Moroccan General Directorate of Taxes.

3. Methodology

Multi-method approach

The project will employ a multi-method approach that uses several qualitative (case-specific) and quantitative (statistical) methods for data collection and analysis. As outlined in the preceding chapter, research at the intersection of tax expenditures and fiscal contracts has not yet produced a consolidated body of theoretical approaches and empirical insights. Hence, the project will combine theory-guided conceptualisation, with empirical research using inductive as well as statistical inference. The work programme foresees a combination of desk study research at the two project partner institutes and field research in four case study countries, Zimbabwe, Colombia, Uganda and Morocco.

Work Package 1: Patterns of tax expenditure use and distribution

WP 1 analyses how tax expenditures are used for distributional purposes, distinguishing tax expenditures granted on direct and indirect taxes. The work package provides evidence on tax expenditure use across the world (zooming in on low- and middle-income countries) and explores their relation with patterns of distribution, political rule and institutional capacity. Based on this aggregate view, the work package then focuses on the specific relationship between tax expenditures and public finance systems. In terms of methodology, the work package will rely on panel data regression analysis, employing data from the Global Tax Expenditures Database (GTED) and other international data sources, as well as information on public finance systems and world market integration provided by international organisations such as IMF, World Bank and WTO.

Work Package 2: Accountability

WP 2 focuses on the political economy of tax expenditure regimes. It seeks to find out how the use of tax expenditures affects fiscal bargaining, both in terms of short-term negotiations and long-term institutional settlements. The work package will conduct an in-depth case study in Zimbabwe. The country was chosen due to the fact that IDOS is currently implementing a research project on the evaluation of tax expenditures in the mining sector jointly with Zimbabwean partners. This ongoing activity will provide the informational basis upon which WP2 will be implemented.

The work package will rely on a qualitative research design that reconstructs the fiscal bargaining patterns and governance structures which determine the introduction and continuity of tax expenditures, and contrasts those with the procedures and structures that drive “ordinary” tax policies. Based on an institutional and stakeholder mapping, it will conduct semi-structured interviews with relevant actors.

Work Package 3: Perceptions

WP 3 explores how the use of tax expenditures affects perceptions of tax fairness as well as tax compliance. The work package will have two work streams. The first work stream analyses how the use of tax expenditures affects perceptions of tax fairness among individual taxpayers. The second work stream studies how the use of tax expenditures affects the tax compliance of firms. With Uganda, Morocco and Colombia, we selected a low-, a lower-middle- and an upper-middle-income country as well as an English-, French- and Spanish-speaking country. The work package will combine large-N statistical analysis, using existing cross-country international survey data on tax morale and tax compliance, with case study research, conducting taxpayer surveys.

The project team will focus on the business sector in Colombia, reflecting the fact that business-related tax expenditures, in particular the use of special economic zones, have been a widely discussed topic in that country. In Morocco, a household survey will explore individual taxpayers' perceptions of tax fairness. With this focus, WP3 will at the same time conduct preparatory work for WP4 (see below). In Uganda, we will conduct household as well as business surveys.

Work Package 4: Mind shifts

WP4 will analyse the effect of information on taxpayers' perceptions. More specifically, it studies how additional information on the real distributional effects of tax expenditures leads to shifting attitudes (mind shifts) towards the respective tax expenditures and the underlying fiscal contract. This will be achieved in a two-staged process. First, we will measure the impact of VAT exemptions on inequality (real effects of VAT exemptions) in Morocco, based on taxpayer micro-data from the tax administration and the Institut National de Statistique et d'Economie Appliquée. Second, we will conduct a randomised field experiment with information treatments to measure if simple and targeted information can have an impact on the perceptions (or misperceptions) of the effects of VAT exemptions. Morocco has been selected as a case study due to the existence of in-depth tax expenditures evaluations since 2006, data availability and a pre-existing record of cooperation between CERDI and the University of Hassan II in Casablanca on conducting surveys.

4. Impact and consequences of the project

A project based on French-German synergies

The ambition of the project is to combine disciplinary, methodological and regional expertise of both partners to generate scientific insights and policy-relevant knowledge on a broader scale. In this context, the French-German cooperation between CERDI and IDOS will create important synergies. First, the regional expertise each partner brings into the project enables us to carry out in-depth analyses and cross-country comparisons in two different world regions, Latin America and Africa, as well as three languages, French, Spanish and English. Second, while the CERDI team led by Prof Brun has built a strong reputation in applied economic research on taxation over the years, the IDOS team led by Dr. von Haldenwang is one of few research groups that focuses on political science analysis of taxation in developing countries. Both types of knowledge are required to address the research questions outlined above. Third, partners pool their methodological skills in qualitative case-study research, survey-based and experimental approaches, and statistical analysis that jointly make up the multimethod framework of this project.

In academic terms, the findings produced by the project will add an important layer of evidence to the international fiscal contract debate. So far, tax expenditures have not received the academic attention that they would deserve, given their fiscal relevance in most countries. This is particularly true for low- and middle-income countries. The TEFISCON project will thus contribute to closing an important research gap.

The findings of the project will be relevant for the academic as well as the broader public debate on tax expenditures. It is fair to say that the topic has clearly attracted more attention in recent years, witnessed by the growing number of countries publishing tax expenditure reports. At the level of individual countries, the public has taken note of generous tax breaks granted to multi-national corporations, for instance in the extractive industries. At the international level, multilateral organisations such as the Addis Tax Initiative (ATI) and the Platform for Collaboration on Tax (PCT) have taken up the issue, asking governments to publish comprehensive and timely information on tax expenditures, to rationalise the governance structure of tax expenditures, and to evaluate the impacts these mechanisms have. The findings of the TEFISCON project will enable these organisations to obtain a clearer picture of the impact tax expenditures have on the fiscal contract in low- and middle-income countries. Such information is key for the design and, even more, the implementation of tax expenditure reforms.

Results of the project will also be relevant to political decision-making in development policy of both the German and the French government. Both governments support tax reforms and capacity-building in tax administrations in a large number of partner countries, but also at the level of international organisations. Further, both project partners have ample experience in providing policy advice to their respective governments. The findings of the project will also inform public debates and policy decisions in the regions where the project is conducting field research. The project partners will rely on their regional and country-level networks to feed the results of the project into public and academic debates.