Analyzing tax expenditures

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Commentary

Federal law requires, since 1974, that a list of "tax expenditures" be included in annual federal budget documents. Tax expenditures are defined as "revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential tax rate, or a deferral of liability." The federal Office of Management and Budget has identified more than 170 such preferences in the U.S. tax code.

Similarly, we in Puerto Rico have dozens of tax preferences in our tax code. The problem is that we do not know how much they are costing us in terms of forgone revenue nor do we know if they are accomplishing the objectives for which they were enacted.

That is why we recommend that the Puerto Rico Treasury Department produce a yearly report on tax expenditures. This report should have the following features. First, the report should be accessible. This means it should be published regularly, incorporated into the annual budget process, and available on the Web.

Second, the report should be complete. It should cover tax expenditures related to all taxes and include all tax preferences, including those with lower costs or those benefiting only a few taxpayers, and cover explicit as well as implicit tax expenditures.

Third, the report should be detailed, meaning it should include: a cost estimate of tax expenditures using current data; an analysis of their cost in future years, to allow comparison with proposed expenditures; a description of each tax preference; the relevant legal citation of the law and year in which it was enacted; and a description of the taxpayers who benefit from the tax expenditure.

Finally, the report should be analytical. It should classify tax expenditures using the same categories as direct spending; state the purpose of each tax expenditure; evaluate the extent to which that purpose has been accomplished; and analyze the distribution of benefits by income level and size of business.

It is important to highlight that tax expenditures cost money in much the same way as direct spending for schools, health care, or road construction. If the government decides to fund a program through direct expenditures, in order to avoid any increase in the deficit it will have to either increase taxes or reduce other direct spending by the same amount. Similarly, if a government decides to promote certain activities through the use of tax preferences it will also have to increase other taxes or reduce direct spending in an amount equal to the forgone revenue in order to keep the budget deficit from rising.

The fundamental difference between direct spending and tax expenditures is that the former typically requires extensive documentation and is subject to careful analysis during the budget process, while the latter usually receive far less public scrutiny. For the most part, policymakers do not regularly examine tax expenditures, nor does the government document their effectiveness the same way it does for on-budget expenditures.

Most tax expenditures are discreetly written into the tax code with little or no debate — usually in abstruse language — and generally continue in effect indefinitely unless the legislature acts affirmatively to discontinue them. Without information on the costs and benefits of each tax expenditure, lawmakers cannot make an informed decision on whether their continuation is in the public interest.

Tax expenditures also constitute a powerful incentive for rent-seeking behavior and the outright corruption of the political process. Puerto Rico's decadent materialism and moral bankruptcy provide a nurturing environment for the many special interest groups that seek government handouts. The costs associated with this behavior in Puerto Rico are enormous. Countless millions are wasted on both legal and illegal efforts to obtain special tax privileges from the government. Many "businessmen" spend more time lobbying government for corporate welfare than running their companies. At the same time, copious reports of public corruption inevitably erode the public's trust in — and weaken the legitimacy of — its government.

If properly designed and implemented, a tax expenditure budget makes tax expenditures more transparent by showing policymakers and the public how the state is spending its money, who benefits from these tax preferences, and what the government is accomplishing, if anything, through those tax breaks. A yearly tax expenditure report will not eliminate corruption in Puerto Rico nor restore the moral integrity of our political class, but it will provide a useful tool to increase the transparency and accountability of our government.

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