Tax Expenditures, Trust and Rent Seeking: what the evidence of OECD Countries says to us?

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Preliminary version, May 2019

Extended Abstract prepared for XXXI Annual Conference of the Italian Society of Public Economics

JEL Codes. H11, H50, H60
Keywords. Tax expenditure, corruption, trust, public debt, deficit

Tax expenditures are commonly and largely used in many OECD and developing countries. While their use was quite limited in the '70s, their significance is considerably increased in the last 30 years. Tax expenditures are nowadays one of the key part of public budget and their size and importance is largely increased in recent years. Many governments currently use tax expenditures as a normal ways to enforce tax policy, to change the distributive effects of taxation, to subside sectors and industries, to incentive specific taxpayers' behavior, to address externalities and market failure; but also, fundamentally, to reward more or less explicitly different interest groups close to governments in order to get their vote and political consensus.

There are many reasons that explain why governments have largely augmented the role, number and size of tax expenditures. First of all, contrarily to public expenditures, it is more easily to have these expenditures on the tax side be approved and implemented. Secondly, their visibility and therefore their cost is relatively hidden, since one does not know in advance the exact amount of foregone revenue and the number of people who would use them.

In the last 30 years we have had a gradually increasing numbers of studies on tax expenditures, especially on foregone revenue and possible distributive effect across income classes. Surprisingly, no studies at all have been carried out on the rationale and purpose to

use tax expenditures as a special technique of lobbying and rewarding special interested groups. In this paper, first of all, we try to make a possible comparison of the numbers and magnitude of various tax expenditures across OECD countries. This is a quite challenging exercise, since tax expenditures in many cases are not easily comparable. To our knowledge, this is the first attempt to address the issue of tax expenditures from a political economy perspective, where we assume that lobbying activity and special interests are the main purpose of spending through the tax system.

After reviewing the basic data on tax expenditures of a subset of OECD countries[1], both in absolute number, in % of GDP and total tax revenue, we estimate on the base of a cross sectional data set, the correlation with some exogenous variables, such as the degree of corruption measured with the "Corruption Perception Index" published by Transparency International, the usual variable of trust taken by the World Value Survey and the size of public deficit and public debt.

Our evidence shows that when we regress the value of tax expenditures measured as a percentage of GDP over a set of policy and fiscal variables we observe only two significant relationships: with "Justify claiming subsidies unduly" and "General Government Gross Debt" (see results in Table 1), both with the expected positive sign. Instead, when we regress the number of tax expenditures over the same set of policy and fiscal variables all the variables exhibit a significant correlation with our measure of tax expenditures. Moreover, in all cases we observe the expected signs (see results Table 2). In particular, the higher the number of tax expenditures the larger are the values for "Justify claiming subsidies unduly", "Corruption" and "General Government Gross Debt". On the contrary, the smaller the number of tax expenditures the lower are the values for "Trust" (toward people and government) and "General Government Overall Balance". The same evidence is provided in graphical terms with the pictures in Figure 1.

We also set up a very simple political economic model on the use of tax expenditures for the purpose of rewarding some special interest groups: for that purpose, we model a simple game between a representative politician (who uses the tax expenditure in order to increase its probability of being reelected and extend electoral votes) and the Treasury who is concerns with public deficit and debt.

Our model and estimates confirm the expectations that tax expenditures are quite commonly used for political purpose and for supporting rent seeking behavior.

[1] Greece, Italy, France, Great Britain, Australia, South Korea, Canada, United States, Sweden, Netherlands, Denmark, Germany, Norway, Finland, New Zealand.

Table 1 - Tax expenditure as a % of GDP regressed over a set of variables (OLS point estimates)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Trust people	-0.548							
	[0.274]							
Trust government		-0.720						
		[0.142]						
Justify claiming subsidies unduly			1.108					
			[0.055]*					
Corruption perception index				0.594				
				[0.318]				
General Government Gross Debt % GDP 2009					0.746			
					[0.190]			
General Government Overall Balance % GDP 2009						-0.701		
						[0.197]		
General Government Gross Debt % GDP 2016							0.940	
							[0.051]*	
General Government Overall Balance % GDP 2016								0.0214
								[0.933]
Observations	15	15	15	15	15	15	15	15
R-squared	0.184	0.338	0.520	0.220	0.332	0.327	0.553	0.253

*All variables are standardized, p-values in brackets where * = p<0.10 ** = p<0.05 *** = p<0.01*

Table 1 - Number of tax expenditure regressed over a set of variables (OLS point estimates)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Trust people	-0.607							
	[0.003]***							
Trust government		-0.613						
		[0.005]***						
Justify claiming subsidies unduly			0.525					
			[0.015]**					
Corruption perception index				0.656				
				[0.001]***				
General Government Gross Debt % GDP 2009					0.586			
					[0.010]***			
General Government Overall Balance % GDP 2009						-0.511		
						[0.044]**		
General Government Gross Debt % GDP 2016							0.681	
							[0.000]***	
General Government Overall Balance % GDP 2016								-0.258
								[0.122]
Observations	15	15	15	15	15	15	15	15
R-squared	0.560	0.570	0.419	0.653	0.521	0.396	0.703	0.101

*All variables are standardized, p-values in brackets where * = p<0.10 ** = p<0.05 *** = p<0.01*

Figure 1 – No. of tax expenditure vs policy and fiscal variables (All variables are standardized)