PRINCIPLES FOR HUMAN RIGHTS IN FISCAL POLICY

Tax spending and tax justice in Latin America: Recommendations from international financial institutions and civil society organizations

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SUMMARY

This paper addresses tax expenditures or tax benefits, understood as revenue foregone that reduce the amount of taxes paid by individuals or corporations in a government. The topic connects directly to Principle 10 of the Principles on Human Rights in Tax Policy, which states that governments should mobilize the maximum available resources to progressively achieve the full realization of economic, social, cultural, and environmental rights.

Governments can use tax expenditures for a variety of reasons, from promoting regional development or sustainable economies to attracting foreign investment. To date, there are an estimated 337 tax expenditures for the benefit of multinational companies alone throughout the Latin American region. Furthermore, their indiscriminate use can have negative impacts and imply that countries are under-utilizing their fiscal space, or imposing a heavier tax burden on certain groups without adequate justification. In this regard, both international financial institutions (IFIs) and civil society organizations (CSOs) have emphasized the need to improve their transparent and effective use, aimed at guaranteeing human rights.

The document reviews a series of recommendations made by IFIs and CSOs to ensure that tax expenditures comply with international human rights obligations. The suggestions are largely aimed at ensuring the principles of efficiency, transparency, and substantive equality in the way these tax instruments are implemented. For example, improving the quality of the information produced and its accessibility, and moving towards more in-depth cost-benefit evaluations that incorporate an analysis of their redistributive impacts and a human rights perspective.

1. INTRODUCTION

In the fight for tax justice and the guarantee of human rights in Latin America, the tax expenditure agenda deserves to be highlighted due to its impact on the tax collection capacity of the countries in the region. In a scenario where low-income countries collect only 16% of GDP in taxes, compared to 26% in developed countries (Akitoby *et al*., 2019), Latin America spends, on average, between 10% and 20% of its tax revenue and 4% of GDP per year on tax expenditures (TE) (Renzio, 2019). TEs, better known as tax breaks, are revenue forgone that reduce the amount of taxes paid by individuals and corporations to the government. They are called tax expenditures by specialized literature because they are indirect government expenditures on public policies, carried out through tax policy.

Governments use tax expenditures to achieve a number of objectives, such as: 1) improving the progressivity of the tax system; 2) promoting regional and sectoral development and protecting society's most vulnerable populations and the environment; 3) stimulating domestic investment and job creation; 4) attracting foreign direct investment (FDI) (Renzio, 2019; ECLAC & OXFAM, 2019). They also are policies that are relatively simple and quick to implement and less transparent, when compared to direct budgetary expenditures; therefore, they are usually instruments much used by corporate lobbies. These and other factors drive the widespread use of TEs throughout the region: estimations show that there are currently 337 tax incentives for multinational companies in Latin America (LATINDADD, n.d.).

International Financial Institutions (IFIs) and Civil Society Organizations (CSOs) in recent years have been trying to highlight the harms of indiscriminate use of tax expenditures, especially in developing countries. They point out to problems in transparency, accountability, the effectiveness of their use to promote human rights and socioeconomic development, and the reduction of fiscal space they cause.

In this sense, this paper aims to highlight suggestions from IFIs and CSOs for the use and revision of existing tax expenditures in Latin America. It is part of the Principles on Human Rights in Tax Policy (P&G) initiative, which aims to insert the human rights agenda into the fiscal agenda of Latin American governments. The research was based on a bibliographic review of documents produced by IFIs and CSOs. The organizations researched were:

- International Monetary Fund (IMF).
- Organization for Economic Cooperation and Development (OECD).
- Inter-American Centre of Tax Administrations (CIAT).
- G20.
- Oxfam.
- Economic Commission for Latin America and the Caribbean (ECLAC).
- The Latin America Tax Expenditure Research, Advocacy, And Learning Project (Lateral).
- Latin American and Caribbean Tax Justice Network (RJFALC).
- Latin American Network for Economic and Social Justice (Latindadd).
- Public Services International (PSI).
- Center for Economic and Social Rights (CESR).
- Institute for Socioeconomic Studies (Inesc).

The article begins with general considerations on the subject and then goes on to address recommendations related to institutional structure and the promotion of transparency; the evaluation, review, and reform of the TEs; and international cooperation.

2.

TAX EXPENDITURES IN LATIN AMERICA

There are several definitions of tax expenditures used by the researched organizations. The most widely used, however, is found in the IMF's 2007 Fiscal Transparency Manual, which defines TEs as:

> *Concessions or exemptions to a "normal" tax structure that reduce government revenue collections and, because government policy objectives can be achieved alternatively through subsidies or other direct disbursements, their granting is considered equivalent to a budgetary expenditure. Accurately defining and estimating tax expenditures requires defining the normal basis as well as determining the most appropriate way to evaluate the cost (IMF, 2007, p. 143).*

Tax Expenditures can include the following types of revenue forgone (Heady, Mansour, 2019):

- Exemptions: exclusion from the tax base.
- Provisions: amounts deducted from the tax base before the rate(s) are applied.
- Credits: amounts deducted from the tax liability;
- Rate relief: a reduced tax rate.
- Tax deferral: a delay in the payment of a tax liability.

The multiplicity of definitions for TEs cause, therefore, different applications of these concepts by Latin American governments. The main difference, which makes it difficult to draw comparisons among countries, relates to the definition of what would be the "normal" base, the tax benchmark; divergences from this benchmark are classified as tax expenditures. Decisions such as whether or not to include temporary benefits and tax arrears within the benchmark increase or decrease the number of tax expenditures accounted for. Other differences in Latin American reports are the formulas for calculating the TEs and the sources that feed the formulas. This conceptual and methodological information often does not appear in the TE disclosure reports, which limits the reproducibility and transparency of the information (Heady & Mansour, 2019).

Despite these differences and opacities, important progress has been made in recent years, and currently 16 countries in the region officially and periodically publish a quantification of tax expenditures –with the exception of Cuba, Haiti, Nicaragua, and Venezuela. Another Latin American commonality is that none of the countries consider subnational incentives in their estimates– only national ones–which underestimates the total impact of tax expenditures on the countries' revenues (ECLAC & OXFAM, 2019).

With regard to reports, the coverage of documents and their detail vary greatly across the region. The countries with the most thorough reports are Brazil and Bolivia, while countries like Colombia and Costa Rica have a longer way to go. From an accountability standpoint, all the countries in the region leave a lot to be desired. Overall, the reports remain silent on several key aspects of tax expenditures, such as political objectives and performance appraisals, and do not include information on the beneficiaries of the TEs. Furthermore, they also lack detail on the processes by which decisions are made regarding the creation, review, and evaluation of tax expenditures (Renzio, 2019).

There is no uniformed trend in the evolution of TEs over the past 12 years: while countries such as El Salvador and Brazil have increased tax expenditures relative to GDP, others such as Mexico and Chile have decreased them, and yet others experienced erratic behaviors, such as the Dominican Republic and Ecuador (ECLAC & OXFAM, 2019). When compared to developed countries, however, Latin American countries disburse less on tax expenditures relative to GDP: while on average Latin America spends the equivalent of 4.2% of GDP, in North America and Europe this percentage is around 5.0% (CIAT, 2019). On the other hand, research suggests that for Latin America the biggest beneficiaries belong to the high-income sector and the extractive industry. For example, in Mexico the data provided in the annual tax expenditure report illustrate the disproportionate tax benefits received by the country's largest taxpayers (ROSS, 2018).

However, this comparison hides the fact that, for developing countries, the results of incentives on companies' investment decisions are less expressive than in developed countries, since tax expenditures are only part of the private investment decision-making process. Factors such as infrastructure and political stability are more important in defining investments in Latin America than the TEs offered to companies. Moreover, tax incentives in the region are largely provided to multinationals, which, by investing, occupy the space of national investment, rather than complementing it. Studies show that the TE impacts of tax incentives in Latin America in terms of employment, growth, and economic development are limited (ECLAC & OXFAM, 2019).

More broadly, analyses conducted by CSOs alert that, despite the fiscal incentive policy, Latin American economies continue to depend on the primary-export model, since there is no relationship between incentives and social welfare. Using TEs for the promotion of socioeconomic development is not what is most common; rather, they are used to attract FDI, which in regional terms causes a "race to the bottom," reducing tax collection capacity and increasing inequalities (LATINDADD, n.d.). An additional consequence of the widespread granting of TEs, which affects all countries but especially developing countries, is a drop in "tax morale": people are generally less willing to pay taxes if they observe that others are being exempted (Brosio *et al*., 2018).

Other issues identified by IFIs and CSOs are failures and inconsistencies related to the management of tax expenditures by governments. Due to the specificity of the laws that determine the creation of each incentive, TEs complicate the tax system, making enforcement difficult and increasing the scope for corruption (Renzio, 2019). Nevertheless, most developing countries do not have specialized bodies in their ministries of finance that focus on monitoring and granting TEs, as well as providing the technical and analytical support needed to inform government decisions. Such fragmentation results in a lack of transparency and control of these expenditures (Heady & Mansour, 2019).

Therefore, CSOs and IFIs recommend that Latin American governments devote the same attention and caution to controlling and monitoring tax expenditures as they do to budget expenditures (Heady & Mansour, 2019). TEs should be seen in Latin America as part of a broad tax policy that prioritizes the observance of human rights and tax justice, in addition to the Sustainable Development Goals (SDGs) (RJFALC, 2012). Moreover, they should be subject to scrutiny by government and society through practices of transparency, social participation, and accountability (Renzio, 2019). In the next section, we will examine how these general recommendations are disaggregated by CSOs and IFIs into guidance for various aspects related to tax expenditures.

3.

RECOMMENDATIONS FROM INTERNATIONAL BODIES AND CIVIL SOCIETY ORGANIZATIONS FOR TAX EXPENDITURES

3.1 Institutional and transparency promotion recommendations

Improving the use of TEs in Latin America begins with institutional strengthening and transparency of these benefits, two factors that go hand in hand, because only government agencies with technical and political strength will implement the best practices for the monitoring and transparency of incentives.

Starting with the institutional framework, the TE oversight process should be centralized in the Ministry of Finance or its equivalent, preferably in a specialized body associated with the Ministry. The body should be present in all phases related to the operation of the TEs, managing them and monitoring their costs in a comprehensive manner. To be able to accomplish this task, the body must have the necessary technical capabilities by improving its management, governance, and human resources practices, attracting qualified personnel, and investing in the technical capabilities of its staff and collection agencies. In addition, both the ministry and the agencies should have the power to request information on TEs from taxpayers and other ministries (Akitobi *et al*., 2019).

Regarding the incentive creation process, all TEs must have their legal grounding in tax law and cannot be negotiated on a case-by-case basis nor promoted through decrees, contracts, or regulations, so as to ensure the transparency of the process (Renzio, 2019). TEs are often created as a result of pressure from corporate groups on lawmakers, who, when proposing new bills, do not estimate the revenue loss stemming from the new TE or assess the impacts of this possible loss on the implementation of other policies.

The Ministry of Finance, therefore, must have some power over the creation of new TEs. For example, it may be designated by law to be the one with the power to propose new tax expenditures to congress, with other ministries being obliged to submit their proposals to it (Heady & Mansour, 2019). The other ministries should also not be able to change the definition or methodology for estimating the TEs established by the Ministry of Finance. Apart from this centralization, popular participation –especially from the communities or sectors most affected by the new TE– is key to ensuring human rights compliance in the implementation of the incentive.

The monitoring of TEs should also be a responsibility of the Ministry of Finance, the body with the greatest interest in reliable and transparent fiscal information, and it should be conducted mainly through annual reports. Such reports need to be sent to the Legislative Branch along with the budget proposal to ensure that the final budget takes the TEs into consideration.

3.1.1 In order for these reports to be comprehensive and transparent, the IMF (Heady & Mansour, 2019) proposes a number of best practices, such as:

Defining and publishing the tax benchmark used, identifying the elected tax expenditures through comparison with the benchmark. The benchmark should be simple, guided by the principles of neutrality, efficiency, and equality, and limited to the key points of the country's major taxes. It should exclude tax provisions that favor specific groups of people or sectors.

Publishing the following information per TE: Title; Legal reference; Tax involved; Type of benefit (exemption, reduction, etc.); Objectives; Beneficiaries; Reason why the TE is not part of the framework; Data sources; Estimation method; Estimated costs (Year t, t+1, t+2, and t+3); Duration and expiration; Date of next review.

When TEs favor legal entities, disclosing TEs per beneficiary, estimating how much each company receives as an incentive[01].

Prioritizing the "revenue-forgone approach" methodology to calculate the cost estimate of each TE. This approach, however, does not take into account behavioral changes induced by the introduction or removal of TEs, which should therefore be considered at the benefits assessment stage.

3.2 Recommendations for Evaluation and Review of TEs

There are few evaluations of TEs in Latin America, mainly related to the cost-benefit of these incentives and analyses comparing them with budget spending policies that have similar objectives. However, these evaluations are fundamental to policy decision-making and to the TE review process. The recommendations of OXFAM and ECLAC on how to conduct cost-benefit evaluations point to the importance of verifying whether there is economic efficiency, distributive justice, or other reasons that justify an exceptional State intervention, as well as proving that the tax benefit is effective and efficient in achieving its objectives, and that there are no alternative instruments to achieve it in a better way. Most studies conducted with this methodology have concluded that TEs in Latin America are not cost-efficient (ECLAC & OXFAM, 2019).

A less rigorous method of evaluation, but more applicable to the Latin American reality, is a monitoring of TEs that contrasts the purposes of each TE with its results in terms of indicators and with the governments' overall economic and social objectives (LATINDADD, n.d.). Regardless of the methodology, evaluations also need to feature distributional analyses that examine who benefits from the incentives by income bracket, in order to determine whether the assessed TEs make the tax system more or less equal (ROSS, 2018).

In addition to the per-spending assessment, comprehensive analyses of TEs should also be conducted to determine whether they are contributing to greater equality and the realization of human rights (e.g., by providing benefits to low- and middle-income populations) or widening inequality (by disproportionately benefiting the wealthy, as well as large corporations) and reducing the resources available to meet the economic and social rights obligation (ROSS, 2018).

Beyond the issues mentioned here, Latin American civil society organizations have already made progress in proposals for how to evaluate TEs from a human rights perspective. They are not specific works on this agenda, but important tools that mention it. For example, the Principles on Human Rights in Tax Policy has one of the principles related to the TEs (DP/HR/FP, 2021); the Budget and Rights methodology of Inesc has one of its pillars on resource mobilization where it inserts this agenda (Inesc, 2018); and the Center for Economic and Social Rights published a report on how to carry out the monitoring of human rights impacts of fiscal consolidation that also presents the evaluation of benefits as a necessary path (CESR, 2018).

Finally, the question remains as to who will carry out these evaluations. The primary responsibility lies with governments, but they should also provide the necessary information for other actors to conduct them, as well as to encourage independent assessments. Through such evaluations, governments should conduct periodic reviews of the TEs. The review process should be participatory, grounded in the law, and have its periodicity disclosed in the annual TE reports (Renzio, 2019).

3.3 For a Tax Spending Reform

In addition to evaluations and reviews of existing expenditures, IFIs and CSOs demand that governments undertake a comprehensive review of TEs and their role in the tax policy of Latin American governments. The various impediments to the good use of TEs that we observed in the previous sections and the possibility of increasing the fiscal space for public spending, lead organizations to recommend a general reduction of TEs. CSOs conclude that, if we do not know whether the TEs are actually promoting socioeconomic development, and the evaluations available so far show that they are not cost-effective, the only certainty we have is that they are ways to avoid paying taxes and therefore prevent the maximum allocation of resources for the guarantee of rights. Thus, they should be the exception of the tax system, not the standard, and should be subject to regular control and evaluation (PSI, 2020; RJFALC, 2012).

01 | IBP/Lateral's (Renzio, 2019) suggestion of "Duration and Maturity" and "Date of Next Review" was added to the IMF recommendations, as was the proposed disclosure of benefits per company favored by tax expenditures

Nevertheless, caution is needed when initiating a TE reduction process. Removing an incentive may lead to an increase in tax evasion, stifling the effect of increased tax collection. Therefore, institutional strengthening is fundamental to ensure compliance. On the other hand, reducing the number of TEs simplifies the tax system and facilitates the work of the authorities, which can strengthen their enforcement actions (Heady & Mansour, 2019).

In addition to reducing the TEs that are currently provided in Latin America, organizations also demand the replacement of the incentives that remain, in favor of using tax expenditures that have proven to be more effective in promoting expected socioeconomic gains. In summary, CSOs demand the reduction of TEs related to taxes on profits in favor of incentives on company investments, as they are more targeted, neutral, with a lower fiscal cost and established time limits. While OECD countries use the most effective tax incentives –such as accelerated depreciation, specific deductions, tax credits for investments, or the use of reduced tax rates– Latin American countries rely more heavily on tax holidays and other tax exemptions and provide these incentives for longer periods of time (PSI, 2020; ECLAC & OXFAM, 2019).

Finally, ECLAC recommends that the evaluation and review of TEs be oriented towards the SDGs, adopted by the UN in 2015. Given the possible disadvantages of tax expenditures compared to budget expenditures, such as regressivity and their difficult administration and oversight, classifying the TEs within the SDGs and assessing whether each incentive is contributing to or undermining the agreed targets is an additional tool for monitoring these expenditures (ECLAC, 2019).

3.4 Latin American cooperation

A final set of recommendations relates to the inherently cross-border nature of tax expenditures. The creation of tax expenditures may be aimed at attracting FDI or fostering international trade, affecting countries with similar economies. In Latin America, this practice is recurrently used and has as a consequence the growth of interstate competition and the race to the bottom (or tax war), which significantly reduces taxes and regulations across the region.

CSOs therefore recommend coordination among similar economies that seeks to harmonize their tax regimes and avoid a race to the bottom. Ultimately, regional and sub-regional integration spaces should be used to create a common system for the application of tax incentives (LATINDADD, n.d.).

International cooperation should also act in the sphere of transparency and enforcement of tax incentives. Tax base erosion and profit shifting are consequences of a volatile international monetary system, marked by subterfuges that reduce the incidence of taxation on corporate profits. Tax expenditures contribute to part of this scenario by complicating fiscal systems, creating loopholes for tax evasion. Latin America in particular is a region characterized by the combination of many TEs, low taxation, and tax evasion, with studies pointing out that corporate income tax evasion reaches almost 70% in some countries in the region (COMUNICARSE, 2018).

In this sense, a group of 130 countries and jurisdictions, coordinated by the OECD, has been working since 2015 on an Inclusive framework for Base Erosion and Profit Shifting (BEPS). Action 5 of this project is related to legality, transparency, and fairness of tax expenditures and aims to prevent preferential regimes from leading to tax base erosion and profit shifting. It is a minimum requirement for participation in the Inclusive Framework and obliges countries to undergo an annual peer review of their tax regimes. In this regard, Inclusive Framework members evaluate the preferential regimes of their peers on five key factors (OECD, 2017):

- If the regime imposes zero or low effective tax rates on income from financial activities or other geographically mobile services;
- If the regime is isolated from the rest of the domestic economy;
- If the regime lacks transparency;
- If there is no effective exchange of information regarding the regime;
- If the regime stops requiring substantial activities.

The recommendation is for Latin American countries to actively participate in the BEPS and use its methodology to assess all their TEs. Thus, demonstrating that there are several possibilities for regional cooperation in favor of more effective tax expenditures that promote human rights.

4.

CONCLUSIONS

Tax expenditures are widely used public policy instruments in Latin America; however, they do not show the desired performance in terms of socioeconomic development, reduction of inequalities, and promotion of human rights in the region. The IFIs and CSOs have several recommendations to improve this scenario. The IFIs emphasize technical issues, such as the need for improved TE reporting, transparency, and government fiscal institutions. CSOs, on the other hand, suggest more profound and structural changes in the way Latin American governments perceive and use incentives in the region. Both aspects are complementary for defining an agenda for tax expenditure reform in Latin America.

A good revenue system is based on fair and efficient taxes. TEs in Latin America undermine these principles in that they complicate the tax system, make it opaquer, are not systematically evaluated, create inequalities, are less effective than budget spending, and forego revenues that could be spent directly on public policy. Reforms undertaken by countries in the region have the power to improve the transparency and cost-effectiveness of tax expenditures by ensuring that policymakers and the public have access to the information needed to evaluate their cost, impact, and effectiveness. Ultimately, Latin American countries need to work individually and jointly to ensure that TEs aim at the progressive realization of human rights, the achievements of socioenvironmental justice, and increased equality in Latin America.

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