

ECONOMIC ANALYSIS OF TAX EXPENDITURES IN
PAKISTAN



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CERTIFICATE

This is to certify that this thesis entitled: “**Economic Analysis of Tax Expenditures in Pakistan**” submitted by **Mr. Muhammad Saood Abdullah Khan** is accepted in its present form by the School of Economics, Pakistan Institute of Development Economics (PIDE), Islamabad as satisfying the requirements for partial fulfillment of the degree in Master of Philosophy in Economics and Finance.

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Authors Declaration

I Muhammad Saood Abdullah Khan, hereby state that my MPhil thesis titled "*Economic Analysis of tax Expenditures in Pakistan*" is my own work and has not been submitted previously by me for taking any other degree from PIDE or anywhere else in the country.

At any time if my statement is found to be incorrect even after the completion of my degree the university has the right to withdraw my MPhil degree.

Date: 15/01/2022


Muhammad Saood Abdullah Khan

DEDICATION

I dedicate this thesis to my beloved parents and siblings for their continued support and encouragement during my academic career.

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All praises are to **Almighty ALLAH**, the Omnipotent, the Omniscient, and the Creator of the universe. Many thanks to Him who bestowed us the perfect code of life through His beloved prophet, **Hazrat Muhammad (S.A.W)**.

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Abstract

Tax expenditures are an important fiscal policy tool being widely used around the globe. Many developed and developing nations have adopted better tax expenditure policies and reforms. In case of Pakistan, tax expenditures have been increasing over the years, but no framework for allocation and evaluation exists. This study intends to assess the economic impact of tax expenditures on the overall economic growth of Pakistan. For this purpose, both the qualitative and quantitative research methods have been applied to give a better and clear picture. For qualitative analysis, interviews with concerned departments were conducted, policy documents, reports and expert opinions were analyzed. The results showed that most of the tax expenditures are doing more harm than good and causing a huge loss to the national exchequer. These expenditures are being done to favor the few elites which misuse them to avoid and evade taxes. Furthermore, these expenditures are discriminatory as well as distortionary. Using quantitative research methods, this study aimed to figure out the growth impact of tax expenditures on economic growth. Due to data limitations of Pakistan, we used panel data for seventeen countries and five variables for the years 2003-2020. After checking the issues of heterogeneity and multicollinearity, we used the Hausman test. The Hausman test showed the negative impact of tax expenditures on GDP growth. This means that tax expenditures are a potential revenue loss and should be reconsidered.

Keywords: Tax Expenditures, Exemptions, Concessions, Income Tax, Sales Tax, Customs Duty, Fiscal Policy, Pakistan.

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List of Abbreviations:

| | |
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| TE | Tax Expenditures |
| FBR | Federal Board of Revenue, Pakistan |
| MoF | Ministry of Finance, Pakistan |
| PES | Pakistan Economic Survey |
| PFM Act | Public Finance Management Act, 2019 |
| OECD | Organization for Economic Cooperation and Development |
| IMF | International Monetary Fund |
| SRO | Statutory Regulatory Orders |
| AOP | Association of Persons |
| GDP | Gross Domestic Product |
| VAT | Value Added Tax |
| WHT | Withholding Tax |
| MEPS | Medical Expenditure Panel Survey |
| AFDC | Aid to Families with Dependent Children |
| TEDLAC | Tax Expenditure Database for Latin America and Caribbean |
| IRA | Individual Retirement Arrangements |
| CIT | Corporate Income Tax |
| PIT | Personal Income Tax |
| R&D | Research and Development |

| | |
|------|--|
| TEL | Tax and Expenditure Limitations |
| AGI | Adjusted Gross Income |
| EITC | Earned Income Tax Credit |
| NCAA | National College Athletic Association |
| GTED | Global Tax Expenditure Database |
| WDI | World Development Indicators |
| GFCF | Gross Fixed Capital Formation |
| GFCE | Government Final Consumption Expenditure |
| LFPR | Labor Force Participation Rate |
| BMR | Basic Metabolic Rate |
| FTA | Free Trade Agreements |
| PTA | Preferential Trade Agreements |
| SMEs | Small Medium Enterprises |
| EPZs | Economic Processing Zones |
| OLS | Ordinary Least Squares |
| ARDL | Auto Regressive Distributive Lags |
| ECM | Error Correction Model |
| CEM | Common Effect Model |
| FEM | Fixed Effect Model |
| REM | Random Effect Model |

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Chapter 1: Introduction

Tax expenditures are used by governments all over the globe as a policy alternative to accomplish social goals and encourage economic growth. The government, on the other hand, must make the best use of and manage tax expenditure policies. As a result, comprehensive revenue loss reporting and cost-benefit analysis are essential for fiscal administration. Because the tax expenditure estimates are unadjusted, scrapping or abolishing a particular tax exclusion may not unavoidably result in the rupee amounts stated. Implementation, taxpayer conformity, the efficient periods of law rescinding the exemption, the particular language of any law, and other considerations would determine actual revenues (Izhar, 2020).

Globally, there is no recognized classification of tax expenditures. It differs from one country to the next. Tax expenditures are described in Pakistan as *"the loss of tax income as a result of preferential law provisions provided to specific taxpayers/classes of taxpayers/sectors, resulting in lower tax revenue collection than would otherwise be the case."* (Ahmed & Ather, 2014). Tax expenditures are particular tax stipulations in the tax system that are exclusions to the general formation of the tax structure. They signify income that the administration foregoes to accomplish different public and fiscal goals by favoring a certain business, activity, or class of people. As a result, tax expenditures, instead of direct expenditure, loans, grants, or other methods of government assistance, are a choice for the government to accomplish its policy goals through the tax structure.

A tax expenditure is a different approach from a specified tax structure. When no deviations exist, a benchmark is a tax system that establishes what should be taxed in the normal course of business. As a result, the formal definition of "tax expenditure" is determined by the benchmark tax system's design. As a result, variations from this standard, whether mentioned in the law's main body or its schedules, are regarded as tax expenditures. A prescriptive or standard tax structure needs to be constructed to identify tax expenditures. There are no tax provisions in the normative or benchmark tax structure that is utilized to conduct government spending programs that benefit favored groups. The tax benchmark represents decisions made by authorities in a

country based on the capability of individuals to give the tax, as well as the tax's administrative, economic, and compliance costs.

Tax expenditures come in a wide range of forms and sizes. Allowances (amounts subtracted from the tax base before using the tax rate), credits (amounts subtracted from the tax obligation), exemptions (elimination from the tax base), rate relief (lower tax rates), and so on are common examples. Tax breaks and tax breaks are terms that are used interchangeably. Tax sanctions are a type of negative tax expenditure. A tax reprimand occurs when a tax is levied at a higher rate than usual.

Tax expenditures typically represent a huge portion of a government's unconstrained spending. If tax expenditures are not included in the budget process, the tradeoffs in allocations across functions, sectors, regions, and other target groups are limited to expenditures covered by net revenues. Tax revenues foregone as a consequence of several incentives and privileges offered to taxpayers through tax law provisions have already reduced such net revenues. Tax expenditures do not undergo the same level of budget scrutiny as regular budget spending since they are not budgeted for.

Setting up a proper tax expenditure structure would encourage fiscal culpability and comprehensibility. Unsatisfactory tax expenditure management is a source of worry for fiscal accountability and governance transparency. A core criterion of a civic sector budget is inclusiveness, which means that the budget should include all accessible funds and expenditure allocations to all functions for which the government has discretionary spending authority.

The handling of direct and indirect expenses is divided, according to critics of tax expenditures. Tax-writing committees can swap one direct expenditure for another, and the budget commission can swap one direct expenditure for another. As a result, direct spending replaces taxation. Resultantly, the lack of integration of tax exemptions into the budget process frequently overlaps or clashes with direct spending (Hungerford, *Tax Expenditures: Trends and Critiques*, 2006).

Tax expenditures are frequently used in place of other policy instruments like grants. As a result, rather than direct expenditures, national social and economic goals are sometimes addressed

through the tax law. Regardless, many analysts contend that tax expenditures are inefficient in achieving these essential economic and social goals when compared to direct expenditure programs. Other tax expenditures, on the other hand, appear to have no social or economic purpose. Tax expenditures, in general, tend to impair the income tax system's progressivity and increase its complexity from the taxpayer's perspective. Furthermore, unlike direct expenditures, many tax expenditures benefit taxpayers in the top income bracket, and they frequently finance an activity for which the taxpayer obtains a benefit.

The initial analyses give the impression that tax exemptions are a poor choice of budget policy. Tax expenditures are considered unjust, distortive, and expensive, as well as susceptible to hasty expansion in both size and number and resilient to abolition. Tax expenditures, on the other hand, are a component of all tax systems, and many are universally seen as effective and efficient, as well as politically untouchable. Alternative policy options — spending programs and possibly regulation — must be weighed against tax expenditures, which have their enactment, review, and implementation flaws, as well as introducing their own political and economic distortions. It's reasonable, and for the sake of debate, to separate the negative impacts of existing tax expenditures from their proclivity to spread and develop despite their defects and shortcomings. But firstly, it is critical to understand why tax expenditures continue to be a feature of tax structures around the world.

On the other hand, tax expenditures are a significant source of government funding aimed at achieving several economic and social goals. Tax expenditures provide for over a third of all government support geared toward attaining social policy goals. However, unlike social welfare direct expenditures, many tax expenditures benefit taxpayers in the top income brackets, and they frequently finance an activity for which the taxpayer obtains a benefit.

Governments' use of tax expenditures is widespread and growing. At a time when many government budgets are being challenged by population aging and negative cyclical developments, there is a compelling need to minimize unnecessary government activities, some of which may require tax expenditures. Governments in all OECD member nations gather revenue through taxes and redistribute it, frequently through mandatory spending on social programs like education or health care. Their tax systems typically feature provisions that allow

specific categories of people, such as small company owners, retirees, working mothers, or those who have engaged in certain activities, such as charitable giving, to pay less in taxes.

As a result, OECD countries have been assessing the revenue cost of tax expenditures, disseminating tax expenditure justifications, and counting projected expenditures in budget processes in recent decades to make the budget process more complete and subject all expenditures to the same level of transparency and budget scrutiny. The Federal Board of Revenue (FBR) in Pakistan is in charge of evaluating and reporting tax expenditures. These expenses, on the other hand, are the outcome of Statutory Regulatory Orders (SROs)¹ that are not launched by FBR, implying that they are determined by government ministries issuing SROs.

1.1. Problem Statement

There are concerns that Pakistan's revenue targets are achieved inefficiently, favoring certain economic activities and sectors over others. This means that a tax policy will be implemented that many people will find unjust and inequitable. Aside from taxation, the FBR has taken additional fiscal actions at the request of ministries that have been questioned. Tax Expenditures is one of them. The cost, effectiveness, and distributional effect of tax expenditures are often difficult to assess, if not impossible because accounting and reporting methods fall far short of those used for formal governmental outlays. The Pakistani government is required to improve the comprehensibility of tax policy by giving precise tax expenditure estimates (under the Public Finance Management Act, 2019), but it does not give any information on whether these expenditures have met their intended objectives.

In a developing country like Pakistan, government forgoes (referred to as tax expenditures) a large number of its revenues to achieve social objectives. This research aims to explore the cost-benefit analysis of tax expenditures and their role in improving economic growth.

¹ SROs stands for Statutory Regulatory Orders, which refer to all kinds of government regulations carried out by Federal Board of Revenue and different ministries through delegated powers.

1.2. Research Gap

The existing literature focuses on the evaluation and estimation of tax expenditures in developed economies. However, there is exceedingly rare literature for developing countries. In a developing country like Pakistan, a large number of tax expenditures is a major source of concern. Estimating tax expenditures is challenging due to the lack of data on companies, an association of persons (AOPs), and individuals with exempted categories. Estimation of tax expenditure is required to get a full overview of revenue lost due to exclusions and privileges granted under different tax laws (Ahmed & Ather, 2014).

Pakistan has been forgoing a substantial portion of its potential revenues during recent years. Every year this expenditure is rising significantly which means the government is losing its revenue to specific sectors and classes of persons. According to (Rizvi et al., 2020-2021), federal tax spending in FY 2019-20 was anticipated to be Rs. 1314.273 billion. Sales tax spending was the greatest at Rs. 578.456 billion (44 percent of total), followed by income tax expenditure at Rs. 448.046 billion (34 percent), and Customs expense at Rs. 287.771 billion (22 percent). The FBR collected Rs. 3,997.408 billion in taxes in the fiscal year 2019-20. As a result, the tax spending to total collection ratio is around 32.88 percent, and the tax expenditure to GDP ratio is approximately 3.15 percent.

Specifically, this study will consider the effect of tax expenditures on GDP growth, social indicators, and development in Pakistan.

1.3. Research Questions

Tax expenditures have never been reviewed in terms of objectives before. This study is based on the following few questions:

1. What is the policy framework for tax expenditures in Pakistan?
2. Who benefits the most from these expenditures?
3. Whether these specific expenditures are doing their best to participate positively or negatively in economic growth in Pakistan?

1.4. Objectives

The objectives of this study are:

1. To understand the framework, process, and evaluation method of tax expenditures in Pakistan.
2. To identify the sectors/industries benefitting from tax expenditures.
3. To evaluate the growth impact of these expenditures.

1.5. Significance of the Study:

Government revenues are reduced as a result of tax expenditures. Because most are not subject to annual parliamentary authorization and the reasons determining their cost are mainly out of government control, the income loss is not limited. Tax expenditures may also result in a misallocation of economic resources, as well as a loss of trust in the tax system. Tax expenditures reduce the amount of money that federal and state governments may collect without resorting to increased tax rates by reducing the tax base. They appear to lower the size of government because their financial expenses are reflected as reduced tax receipts rather than increased spending. As a result, tax subsidies have a great political appeal. Tax expenditures, on the other hand, are a unique way for the government to participate in the economy, and they, like direct spending, must eventually be funded by increased taxes or reduced spending elsewhere.

A tax expenditure restriction policy is urgently needed, and a tax expenditure report has to be issued as part of the authority's yearly budget paper as a starting point. The administration of tax expenditures, of which costing, and reporting are two significant components, should become an incorporated part of the budget process of the government. Before being enacted, however, tax expenditure management necessitates the construction of a framework for quantification, identification, and critical evaluation of the advantages of specific tax expenditures. Tax expenditure analysis should be updated regularly, considering legal and social adjustments over time. The government must regularly analyze the detailed explanation and cost for its most important tax expenditures, and explain them based on efficiency, distributional, or cost-effectiveness.

1.6. Organization of the Study

This thesis is divided into six chapters. The first chapter of this research is devoted to the introduction, which comprises the research questions and objectives. It also contains a summary of the research's relevance. The literature review is included in Chapter 2 of this research, and it covers many research issues. Chapter 3 describes the research technique, including the theoretical foundation, sampling, and data collecting units. The fourth chapter is a quantitative study in which a panel data estimate approach is utilized to determine the influence of tax expenditures on GDP growth. To further comprehend the framework, Chapter 5 includes a qualitative study in which policy papers and expert opinions were studied and key department personnel was questioned. Chapter 6 contains the study's conclusions based on the findings and debates, as well as policy recommendations.

Chapter 2: Literature Review

2.1. Background

This chapter discusses the cross-country trends of tax expenditures. The concept of tax expenditures was first introduced by Stanley S. Surrey (Assistant Secretary of Tax policy, USA) in 1967. Since then, many countries have adopted this concept to achieve various social goals through taxation. Tax collection and then disbursing the amount to intended beneficiaries is an uphill task. So, Surrey came up with this idea by forgoing tax revenue to selective individuals and entities. Many economists have worked on tax expenditures theoretically and empirically to evaluate the impact of these expenditures. Numerous studies are discussed below:

2.2. Theoretical Literature

The late Stanley Surrey coined the term tax expenditures during his tenure as Assistant Secretary for Tax Policy in the U.S. Treasury Department. Surrey (1970) described tax reform as the endeavor to replace tax expenditures with direct spending programs whenever government assistance is demonstrated to be essential. He went on to discuss the benefits and drawbacks of prospective alternative programs in three sectors affected by tax spending provisions: local and state government assistance, personal charity help, and assistance for owner-occupied and rental housing. He firmly believed that identification and analysis of tax expenditure provisions would be effective “pathways to tax reform” (Surrey, 1973). Ambiguities in the definition of tax expenditures, difficulties in their measurement, and problems in identifying winners and losers have put obstacles in the path Surrey envisioned. The 1986 Act’s base-broadening, rate-reducing reform seems an aberration in view of the extensive expansion of tax expenditures enacted in 1997.

The New Zealand tax legislation allowed farmers to transfer exemptions linked with development spending up to certain time frames. Farmers and advisors regularly encountered intricate challenges with the timing of tax exemption petitions (Cartwright, 1968). This research looked at methods for dealing with this and similar issues. Although linear programming might be employed, an alternate technique was developed for agricultural advisers who had restricted

access to computational equipment. The latter technique was designed to be used in conjunction with projected budgeting in farm development planning.

In India, Gupta (1984) critically studied topics such as tax expenditure accounting, tax expenditure provisions in tax laws, and the level of government aid supplied through these provisions. He claimed that if these concerns with tax expenditures improved the tax system would become less complex. 1. The public's confidence in the tax structure would be restored if tax expenditures were properly managed, as privileged groups avoided taxes by paying little or no tax, while the common person had to pay his taxes. 2. Provide precise information on tax expenditures to make the tax system more open. 3. Create conditions that influence the system's ability to reduce the number of unproductive actions.

Several researchers have proposed shifting the focus of public policy research away from programs and agencies and toward policy tools like regulations and loan guarantees. They had created a theoretical underpinning for the tools approach as well as a description of the politics of specific tools. They expected various ways in which policy instruments would differ but provided little empirical data to show that significant differences exist? Howard (1995) compared tax expenditures to direct spending, two significant policy tools, to see how much they varied. This comparison yields varied results, indicating the need for more empirical research and clarification of how tools matter. The decision between tax expenditures and direct spending, in particular, proved to matter more for the enactment of new programs than for their ongoing expansion and administration.

The state sales tax, according to Derrick and Scott (1995), was an intrinsically deteriorating resource of income. That gave rise to initiatives to mitigate regressivity through changes to the fundamental sales tax system via exemptions and credits. Two innovative substitutes to simple credits and exemptions appear to offer practical and theoretical benefits over simple exemptions and credits: the usage of debit cards to provide negative credit and sales tax credits connected to anticipated tax liabilities. They enjoyed the hypothetical benefits of both the exemption and the credit without the governmental hassles of the revenue loss of the exemption or the credit. Empirical research of the *Consumer Expenditure Survey and the Maryland tax code* revealed that the state could decrease deterioration and earn a significant income with any option. The

projected improvements might be realized with improved revenue stability, low administrative costs, and minimal influence on parallel parity or efficacy.

A framework for endogenous commodities taxes was integrated with models of parliamentary negotiation and commission polling (Dharmapala 1998). He compared a 'tax commission' (enacting tax expenditures) with a devolved structure of specialist commissions to examine the influence of law-making commission composition on policy results (undertaking direct spending). The key finding was that the tax commission formation resulted in lower subsidy levels in a variety of situations. However, social welfare was higher in the tax committee system only under more restricted assumptions.

Tax expenditures protect taxpayers from taxation while depriving the government of its legitimate resources in the budget process (Saxton, 1999). He believed this viewpoint to be incompatible with the idea that income belonged to the taxpayers and that the levy burden was established by democratic processes and bureaucratic assumptions. This approach established a bias in the decision-making process by adopting an expansive view of income as the underlying premise of the tax expenditure concept.

The Polish government intended to eliminate (or at least reduce back) existing tax spending programs. Tax expenditure programs slowed the momentum for personal income tax reform. They had also curtailed the government's ability to reduce tax rates unilaterally. Cavalcanti and Zhicheng Li (2000) sought to provide an analysis of tax expenditure programs to assist make the case for upgrading their management. Poland had just recently begun reforming its tax structure. The VAT and excise taxes were being aligned with EU directives, suggesting increased VAT rates on unprocessed foodstuffs, municipal services, and building materials, as well as higher excise tax rates on cigarettes and alcohol. Concerns were raised regarding the fairness of a rate cut for higher-income taxpayers.

Jen (2002) investigated tax expenditures in Michigan, with a focus on comparisons to federal data. There were three key subjects covered: (1) tax expenditure distribution advantages by income class, (2) tax expenditure increases over time, and (3) resource allocation by program

area. Resource allocation findings were consistent with federal findings only, signifying those simple theories may be inadequate to systematically characterize tax expenditures.

The best treatment of tax expenditures was studied by Saez (2004), who discovered that the most advantageous grant on charitable contributions is susceptible to parameter size and should be lesser than the income tax rate. The ideal contribution good subsidy increased the amount of contribution price elasticity, the size of the crowding-out effect of public contributions on private contributions, and the size of the contribution good are a public good effect.

Armingeon et al. (2004) discovered substantial empirical evidence for significant inter-cantonal variance in welfare state policy. However, the sub-regimes were not functionally related. Their variance was associated with various sets of factors, showing a shaky functional relationship between them. Developments and causal structures were unique to each sub-regime. Furthermore, socioeconomic determinants, rather than politico-institutional ones, had the most influence on the overall structure of cantonal welfare regimes.

Employment-related health insurance was funded by exclusions from state and federal income taxes, as well as Medicare levies and social security (Seldon and Gray, 2006). Proposals to change this subsidy were a recurring topic of policy discussion. They offered tax-subsidy forecasts derived from a novel data resource created by combining the establishment and household elements of the Medical Expenditure Panel Survey (MEPS). They estimated that the overall federal and state tax subsidies for active employees' employment-related coverage would reach \$200 billion in 2006. They gave tax-subsidy estimates per worker as well as a study of insurance incidence by establishment characteristics.

Swift (2006) investigated the concept/definition, amount, and fiscal responsibility as well as consequences of tax expenditures, and clarity in tax expenditure outlay. Tax expenditures have an impact on (1) the possibility for misuse by politicians, taxpayers, and government employees, (2) the efficiency and efficacy of fiscal resources, (3) budget priorities in allocation, and (4) the budget balance. This fiscal policy tool needed to be enhanced after examining present methods in tax expenditures against the standards of fiscal transparency and responsibility. According to the study, a revenue-raising component of the tax system, known as benchmark tax structure, should

be developed. The normative/benchmark tax structure needs to be legally specified and explicit under tax legislation. The tax revenues generated by this benchmark tax system should be measured and made public. Because such data was now accessible, many nations might disclose estimated tax income from normative/benchmark tax schemes. Only by similarly publishing attributed tax income as other budget factors (tax expenditures, direct expenditures, fiscal balance, and tax revenue received) might a budget structure be genuinely translucent in terms of expenditure activities and revenue-raising. Furthermore, when raising tax revenue activities are codified, the fundamental tax expenditures aspect is revealed. As a result, to calculate total government expenditure, tax expenditures better be combined to direct expenditures. Furthermore, the traditional idea of government expenditure size must be fixed by incorporating both tax and direct expenditures.

Tax expenditures should become an important component of the government's spending agenda, according to Glenday and Swift (2006). They outlined a strategy for establishing tax standards and recognizing tax expenditures, as well as constructing appropriate and trustworthy databases and tax simulation models for calculating tax expenditures. They also went over the methods for creating tax expenditure accounts and incorporating them into the budgeting process in order to achieve fiscal transparency.

Hungerford (2006) studied tax expenditure trends, arguments for and against tax exemptions, tax expenditure composition, and who benefits from specific tax expenditures. He had various reservations about tax expenditures. First, tax expenditures constitute a significant financial commitment from the federal government in terms of foregone revenues. Second, because tax expenditures are not evaluated throughout the annual budget process, they are another type of entitlement spending. Third, due to the progressive character of the income tax system, higher-income taxpayers gain disproportionately from tax expenditures.

The annual tax expenditure accounts of the Canadian Department of Finance were scrutinized by Boadway (2007). It began with a discussion of measurement concerns that arose when tax expenditures were linked, or tax payments were postponed. The obstacles and uncertainties involved in developing a baseline tax system from which tax expenditures are departures were then examined. The document's list of tax expenditures was examined, and suggestions were

made to add some items, remove others, and designate some tax expenditures as memorandum items, and vice versa. The study concluded with suggestions for adding more information to tax spending accounts in order to improve their effectiveness.

Burman and Phaup (n.d.) investigated how to keep track of tax expenditures and the challenges they pose. They showed how the way tax expenditures are portrayed leads to excessive spending, larger deficits, higher taxes, and resource misallocation away from monetary spending programs in favor of tax expenditures. While striving for policy goals of reducing greenhouse emissions and petroleum usage, Metcalf (2008) found tax expenditures to be ineffective at best and harmful at worst. Tax expenditures were discovered to represent a substantial source of help for energy-related activities in the federal budget, outnumbering direct energy budget assistance by roughly six to one.

Fuest and Reidel (2009) investigated the role of tax expenditures and other revenue mobilization variables in empirical estimates of tax gaps, that is, tax revenue losses owing to tax avoidance and evasion in developing countries. Villela et al. (2010) reviewed the conceptual features of tax expenditures, the key obstacles in assessing them, and the typical procedures used to calculate, present, and approve them in OECD nations, Latin America, and the Caribbean. Tax expenditures were helpful to taxpayers, according to Wyszowski (2010), and tax systems had answers for ambiguous tax escalations, resulting in additional money for the budget. Negative tax expenditures were given to these cryptic taxes as a result of the weight of additional liabilities imposed by tax regulations. He asked that any additional revenue be identified and accounted for in regular tax receipts, as well as a complete examination of the amount of new revenue.

The contentious subject of the National Collegiate Athletic Association's (NCAA) tax-exempt status was addressed by Colombo (2010). Congress asked the NCAA to defend its tax-exempt status in 2006. Since then, many people have advocated for a change in that status. The purpose of this article was to explain how tax rules apply to the NCAA's Division I football and basketball programs. Congress may impose conditions on NCAA sporting programs if they do not fit into the predetermined paradigm.

Caiumi (2011) used a matching approach to analyze the local tax incentives for corporate investment in Italy. This means that for each subsidized firm, an identical unsubsidized

counterpart is found that is similar in every way except tax benefits. We can expose tax-price elasticity and test investment-sensitive decisions to the accessibility of internal funds by evaluating the dynamic composition driving capital accretion. The endogeneity of firms' involvement decisions, as well as the numerous routes through which tax incentives work, were addressed with this novel method. Using time series data from 1990 to 2006 and different regression models, Dandan (2011) analyzed the impact of government spending on economic growth in Jordan. According to the findings, government expenditure had a positive effect on GDP growth at the aggregate level, which is in line with Keynesian theory. Interest payments have little effect on GDP growth, according to the findings.

Garcia (2012) used cointegration, Granger causality, and unit root to show a unidirectional causation link between public revenue and public expenditure in Spanish Autonomous Regions. The size of the public sector at a regional level was determined by the resources available, such as taxes and subsidies, rather than the necessity for spending, according to this result.

Thone (2012) commented on a study of Germany's twenty largest tax expenditures, which was commissioned by the federal government in 2007 and completed in 2009 by a three-member team of European research institutes. Using a methodological framework established for the consistent evaluation of varied tax expenditures, the research team looked at tax breaks totaling more than 18 billion euros, or 85 percent of all official German tax incentives. Corporate and value-added tax (VAT) exemptions, as well as energy taxes and personal income taxes, were all investigated. This was one of the most comprehensive tax spending evaluations ever undertaken.

Tax expenditure budgets offered insight into anticipated tax policy (Mikesell, 2012). An analysis of individual state sales-tax spending budgets indicated substantial misunderstanding regarding the tax policy objective. Many states might benefit from a deliberate conversation with legislators on the optimal revenue objective of their retail sales taxes.

Brien and Sjoquist (n.d.) investigated the impact of government-financed estate tax farmhouse exclusions on property tax liability. This type of exemption is distinguished by funding made by the federal to local governments to compensate for the loss in property tax income caused by the exclusion. According to the median voter model, a portion of the farmhouse exemption will be

utilized in raising expenditure. Furthermore, the fiscal illusion may limit the usefulness of this form of assistance in lessening the tax burden. They used panels of school system data and county-level data to assess these forecasts for Georgia's Homeowner's Tax Relief Grant program. They discovered that more than one-third of the funds sent to districts out of this course are utilized to enhance revenue rather than to give tax relief. They discovered indications of a possible fiscal deception for school districts.

Public perceptions of direct and indirect government spending and assistance for similar social programs is often greater when they are depicted as being supplied through tax expenditures rather than direct spending in the USA (Faricy and Ellis 2013). The public attitude toward the hidden welfare state would be firm if political elites, government officials, and the media provided explicit information about tax expenditures (Guardino and Mettler (n.d.)).

Reforming tax expenditures may offer a viable path to boost revenue while also improving tax system efficiency in the context of recovering growth and ongoing fiscal consolidation demands. Baugar (2013) detailed the workshop proceedings, which covered the economic and fiscal elements of tax expenditures, including reporting methods, and explored the justification for corporate tax incentives as well as the distributional consequences of tax reliefs in personal income taxes. The workshop was divided into two sessions: "Tax expenditures: measurement and macroeconomic consequences" and "Tax expenditures under direct taxation." The proceedings compile the perspectives stated by academics, national officials, and international institutions during the workshop on these diverse facets of tax expenditures.

Based on the entity type, O'Hare et al. (2013) assessed the benefits of tax expenditure provisions for small enterprises in the United States. The identification and evaluation of tax expenditures provides a mechanism for examining the use and efficacy of specific elements of the federal income tax system. Despite accounting for about 90% of all enterprises in the United States, small businesses only accounted for a modest portion of total tax expenditures. Corporate tax expenses would not reflect tax reductions for sole proprietorships, partnerships, and small businesses. Additional sorts of tax expenditures for retirement savings would be available to these owners.

Using regional variation in tax expenditures across the United States, Chetty et al. (2013) developed a framework to investigate the influence of tax expenditures on intergenerational mobility. They used the pay connection between parents and children to determine intergenerational mobility at the local (census commuting zone) level. They discovered that the amount of local tax expenditures (as a percentage of AGI) is positively related to intergenerational mobility, and that this relationship holds even after controlling for local area factors. They looked at the greatest tax expenditures in further detail to better understand the factors driving this link. The amount and progressivity of state income taxes were found to be favorably related to intergenerational mobility.

Ahmed and Ather (2014) provided a thorough analysis of Pakistan's tax expenditures, as well as a structure and technique for calculating them. The study's goal was to conduct a thorough examination of Pakistan's tax expenditures, including developing an adequate definition and techniques for calculating them. On an annual basis, a great deal of effort was invested into developing and establishing a system for discovering, assessing, and crucially appraising the merits of tax expenditures. They attributed Pakistan's government's troubles with rising inflation, higher fiscal deficit, and higher current account deficit to the country's poor tax collection efforts.

Andrew et al. (2014) investigated the relationship between economic growth and government spending in an experimental setting. Total government spending, public debt spending, health-care spending, and education-related spending were all broken down into four categories. The ordinary least squares (OLS) test was used to find the short-run relationship between variables in the equation, but the Augmented Dickey-Fuller (ADF) test was used to assess the long-run relationship between variables. The test results revealed an inverse association between government spending on economic growth and health, with education investment deemed insufficient to meet Nigeria's spending sector's objectives. Increased government spending in Nigeria might also boost international and domestic investment, according to the report. The study advocated for increased government spending on critical macro-variables such as health, infrastructure, and power. It was expected that prudent government spending would propel the administration's reform goal while also spurring development in the Nigerian economy.

Removing or restricting tax expenditure legislation can sometimes enhance all of our goals (Schizer, 2014). Those "grand slam" opportunities may arise, if a tax expenditure could be repealed that only delivered minimal advantages, or if a tax expenditure could be capped whose minimal advantages lessen considerably as a person engages in more of the chosen activity. The aspects of this study's framework are frequently at odds in other contexts. Steps to maintain programming enticements, for example, could create an extra liability and undermine distributional aims. This research showed that different boundaries equalize these tradeoffs in different methods. Most elements are a settlement among the two. In a given situation, we should pick the tradeoff that produces the best balance of advantages and costs.

Ghana had been a net borrower since the country frequently runs fiscal deficits. Policymakers could enact measures that broadened the tax base to raise tax revenue. Such a program might be difficult to implement in a country with a high proportion of black-market activity. As a result, such measures would necessitate collaborative efforts on the part of policymakers and economic stakeholders. To persuade people to support these measures, policymakers must first accept accountability for the funds earned through taxation. Productive government expenditure would appeal to Ghana's economic participants, but ineffective and unaccountable government spending would not. In Ghana, Takuma and Iyke (2015) investigated the effect of tax revenue on economic growth. Their research differed from previous studies in that they focused on causation rather than effect. The causation evaluation in this work was based on a multivariate setting, which allowed for crucial power factors to mediate the relationship between economic development and tax revenue. Such a strong background could prevail over variable exclusion prejudice, permitting useful estimations of the Granger causality test statistics. In addition, to eliminate pretesting bias, they used the Toda-Yamamoto test rather than the standard Granger causality test. They discovered substantial evidence of unidirectional causal flow from tax income to economic development in Ghana using a quarterly dataset spanning the time 1986Q1-2014Q4. This study supported the previous finding that taxes had an impact on economic growth. The policy implication was obvious.

In five European countries, Barrios et al. (2015) looked at the fiscal and welfare implications of small changes to work-related tax relief. They combined a theoretical labour supply model with

micro-simulation data from an EU-wide model to capture the interplay between the specific tax inducement and other relevant tax-benefit structure provisions over the whole earnings distribution. Changes in labour supply decisions – both at the broad (participation) and fine (hours worked) margins – had a significant impact on the income gain from the simulated reforms, they observed. According to their results, a minimum of one-fourth of the increased tax income gained by a decrease in work-related tax incentives was washed away as a result of labour supply changes, resulting in lower contributions.

According to Feldstein (2015), the United States of America (USA) faces a serious financial problem due to the prospect of exceptionally large future deficits and a rapidly growing national debt. To limit such disparities, and therefore the growth in the national debt, the expansion of healthcare and retirement systems has to be curtailed. This might be aided by additional tax revenue. Limiting tax expenditures would boost revenue while keeping marginal tax rates same. It would also be the same as decreasing government spending, which is presently accomplished through tax cuts for a wide range of consumer spending and income. An effective strategy to decreasing tax expenditures would be to set a limit on the overall tax reduction in obligations that each individual may accomplish via the use of deductions and exclusions.

Implementation of data reportage for charity tax deductions in Denmark in 2008 resulted in a repetition of the number of tax deductions taken and a 15% increase in total claim value, which could be attributable to previously unclaimed deductions (Gillitzer and Skov, 2016). This disproved the theory that evasion was the major reason for noncompliance with deductions and that the use of information reporting boosted revenue collections. An audit was undertaken before the change did not uncover the unclaimed deductions, suggesting that audits overstate evasion when compared to significant margin under-reporting. They identified evidence that compliance costs, passive choice, and excessive withholding all contributed to reduced deduction self-reporting.

According to Redonda (2016), fiscal policy had a substantial impact on a wide demonstrable program that included long-term social, environmental, and economic objectives. Though a plethora of players examined the tax system and explicit government expenditure in terms of their influence on durability, a major aspect of fiscal policy had only to some extent entered the

prolonging argument. Benefits provided via preferential tax treatment that diminish government income from the individual receiving them are tax expenditures. There had been little investigation on the linkages between sustainability and these schemes, with most studies focusing on a single tax expenditure or a collection of tax expenditures following similar policy aims, the impact of tax expenditures on a particular measurement of sustainability, a specific region, nation, or trade alliance. In light of this argument, the purpose of this debate was three-fold: 1) overall significance of tax expenditures and to introduce the concept to the reader; 2) to sketch up a logical background for assessing the impact of a certain collection of TEs on sustainability; and 3) to present an overview of particular TEs, covering TEs in both developing and developed countries, and to evaluate their alignment with a broader sustainability agenda, as well as their efficacy and efficiency.

Mawejje and Munyambonera (2016) contributed to a growing corpus of research on the determinants influencing tax revenue performance in impoverished countries, particularly in Sub-Saharan Africa. They calculated the tax elasticities of sectoral output growth and government expenditure in particular. Their paper has two distinct characteristics: First, they developed a fundamental analytic standard for tax revenue implementation that considered major structural characteristics that are typical in developing countries with large informal economies. Second, they applied ARDL bounds testing techniques using Ugandan time series data to evaluate the model predictions. The agricultural and informal sectors were found to be the most significant impediments to tax revenue performance. Furthermore, trade openness, industrial growth, and development expenditure were all favorably related to tax revenue performance. They advocated strategies to encourage the growth of enhanced relations between the industrial and agricultural sectors whilst highlighting the importance of releasing the possibly enormous subsidies of the informal sector to broaden the tax base.

Brosio et al. (2017) gave three policy recommendations as well as an explanation of the challenges that arise with tax expenditures. 1. Concerns regarding the benefits of technical cooperation on tax expenditure estimation, economic repercussions, and best practices. 2. Tax exemptions for development aid should be phased out. 3. Demands that measures to phase out fossil fuels, including tax exemptions, be stepped up. Fiscal policy impact was investigated by

From 2001 to 2015, Pasichnyi (2017) focused on ensuring economic progress in developed and developing countries. The study discovered that the budget (in particular) and the state (in general) are playing a bigger role in social and economic regulation. Economic regression methods were used to study the interrelationships between GDP growth and government expenditure in distinct groups of nations. The study looked at ways to improve the positive impact of fiscal policy on economic growth in emerging countries. This could be accomplished through the coordination of tax structure and burden, improved budget funds use, systematic budgetary expense processes, and the development of budget and financial institutes, as well as the implementation of fiscal restraints and guidelines, and the formation of basic fiscal policy indicators.

Using a tax-benefit microsimulation model, Avram (2017) evaluated the distributional implications and size of tax credits and tax allowances in six European countries. The findings revealed that tax advantages and credits benefited a large percentage of the population, not only the rich, and that they resulted in substantial financial losses. With a few exceptions, they had a small influence on disparity. Tax exclusions tended to be regressive, whereas tax credits tended to be proportional or progressive. Tax allowances and credits, on the other hand, have a convoluted and often surprising redistributive effect. Other factors of the income tax system were equally as important as the nature of the tax allowances/credits themselves in determining the degree and direction of the redistributive effect. In certain cases, instruments that were inversely related to taxable income may be more helpful to high-income families. As a result, tax breaks and credits looked to be unsuitable for directing resources to households at the bottom of the income distribution.

Many aspects of Research & Development tax incentives were thoroughly examined by Pfeiffer and Spengel (2017). It outlined the business case for government funding of R&D as well as the various types of funding available. It also included a description of current R&D tax incentives in Europe, as well as a thorough review of empirical studies on the impacts of fiscal incentives. OECD data on international patent cooperation was used to experimentally test the model's postulated hypothesis. There are at least two reasons why input-oriented R&D tax incentives, such as tax credits and tax super-deductions, are a better tool for supporting R&D than output-

oriented incentives, according to the study's primary results. Firstly, there was solid support in the experimental works that adopting input-oriented tax incentives had a favorable influence on a firm's creative activities, but research on output-orientated tax enticements was unable to support the thesis. Secondly, according to their theoretical and empirical assessments, output-oriented R&D tax incentives could be utilized by multinationals for tax planning as opposed to their intended aim of supporting research and development.

Longinotti (2018) provided a comprehensive analysis of tax expenditures in Latin America based on the TEDLAC inquiry, stressing the observable findings in major dimensions as well as the analytical opportunities presented by this instrument. The accounting and classification of the numerous items followed the guidelines laid forth in the CIAT Manual of Good Practices for Tax Expenditure Measurement, allowing for a comprehensive investigation of the phenomena from a number of angles. Tax expenditures are one of the elements of the cost-benefit equation that the policymaker must consider. To that extent, the measurement, disclosure, and identification of tax expenditures were crucial since they allowed for the identification of individuals, areas, activities, the magnitude of the phenomena, and sectors.

Using time-series data from 1970-2017, Alkasasbeh et al. (2018) looked into the effect of fiscal policy on economic growth in Jordan and found a positive significant influence of tax exemption and government spending on economic growth. They also discovered a long-term link between tax expenditures, government expenditure, and economic growth. Economic growth was emancipated as a result of budgetary reduction since governments' operations were politically motivated and productive.

Many public policy actions and aims, according to Michael (2018), might be addressed by programmes funded by direct appropriations, tax expenditures, or both. When determining which mechanism to use, legislators and other policymakers should consider a variety of factors, many of which are covered in this introduction (but not all). These concerns range from which strategy is best for achieving the stated aims to how to survive the legislative process and attract enough public money to prosper and stay in business. In comparison to a generalized policy initiative, it was difficult to generalize about such aspects or their advantages and downsides. Rather, deciding which to pursue necessitates an examination of the specific initiative or aims at hand, as

well as a rigorous, fact-specific assessment of the benefits and drawbacks of each mechanism in that context. In reviewing, it is advised to seek advice and direction from both tax and programs administrators, as well as policymakers.

Caldeira et al. (2018) proposed a method for assessing the budgetary costs of capital gains tax, personal income tax, withholding tax, and corporate income tax exclusions (CIT). This method was based on publicly available tax data from the two entities in charge of such fees and taxes: the tax administration and customs. The recommended method was developed using the knowledge of FERDI's tax spending inquiry professionals. This research had a clear goal, which explains the wide range of scenarios and calculation methods employed. The scope was broad since tax expenditure assessments had to be tailored to each country's review region, tax system, and data availability. Evaluating the fiscal cost of tax expenditures required three processes, each of which is covered in detail in this book.

Kulik and Eramsova (2018) investigated the impact of Tax Expenditure Limitations (TELS) on several categories of governmental spending. This study presented a comparative analysis of several forms of tax expenditure restrictions at the state level, intending to determine the impact of TEL strategy on government expenditure arrangements. Using panel data analysis, they discovered that countries with tax expenditure limitations (TELS) were related with greater levels of state spending for prisons and lower levels of national expenditures for highways, police, natural resources, and parks, in addition to financial considerations. This association was statistically and substantively significant when looking at 50 states from 2006 to 2011.

Government-imposed local Tax and Expenditure Limits (TELS) were constraining local governments' ability to earn revenue across the United States, according to Wen et al. (2018). Based on the range of tax limits, they created a 50-state index to quantify the severity of TELS for each kind of local government: county, municipality, and school district (tax ceilings, rate limit, etc.). They observed that counties were more limited in states with stricter TELS, but cities reduced their reliance on property taxes, increased their reliance on alternative sources of income, and amassed more debt. The amount of assistance provided by the government was insufficient to cover the gap. TELS wreaked havoc on local governments across the board, but counties were the worst impacted.

Individual tax expenditures, which are one of the country's fiscal weapons, were the focus of Kirschnerová and Janouková (2018). They were primarily focused on pension policy, housing policy, and charitable giving in the Czech Republic, and the question was how much tax expenditures may influence taxpayer decisions. The goal of this study was to see how individual tax exemptions in the form of tax withdrawals for retirement savings, social policy, and housing assistance affected the economy. They also looked at whether the tax loopholes met the stated budgetary reasons, as well as the extent to which people took advantage of them. The analysis was based on secondary statistical data from the Czech Republic's Financial Administration in terms of methodology. The impact of tax deductions was reduced by the elimination of the increasing rate of personal income taxes and the implementation of a uniform 15% tax rate. Tax deductions for retirement savings had little motivating influence and had no impact on taxpayers in the context of public policy. Mortgage interest deductions might be viewed as a sort of considerable housing support, but they were tied to taxpayer income and favored people with greater incomes.

National expenditure plans might affect those that were less likely to submit federal tax returns, such as elderly and low-income households, more effectively. Tax expenditures may be more likely to take advantage of existing government targeting and enforcement services than spending programs. Flexible expenditure and, in certain situations, failing tax expenditures were further likely to require parliamentary activity than obligatory expenditure and enduring tax expenditure schemes. Unrestricted expenditure options also gave enhanced budget certainty to Congress through the use of budget power, whereas obligatory spending and tax expenditure resources were contingent on program beneficiaries' participation and benefit choices. Driessen (2019) identified the largest spending and tax expenditures across eight major categories of federal activity: (1) international affairs and defense (2) natural resources, space, and technology, general science, agriculture and the environment (3) transportation, regional and community development, and housing and commerce (4) social services, training, employment, and education (5) income security (6) social security (7) Medicare supplementation. If all other activities were held equal, tax expenditures raised net budget deficits. The dimensions and content of government expenditure and tax expenditures might have different consequences for how each was employed through significant areas of the state budget.

The cost of tax expenditures must be identified, measured, and reported to compare the monetary worth of tax expenditures to outlay expenditures. Heady and Mansour (2019) focused on how to account for tax expenditures and how to use such data in fiscal management. The focus was on developing and emerging economies, where the adoption of such accounts was still in its early stages due to data limitations, a lack of human and capital resources, and limited fiscal resources. They underlined the importance of carefully managing tax expenditures as well as outlay expenditures to make the most of limited financial resources. Tax expenditures are used by governments to stimulate innovation, employment, and investment. Though, these plans are typically obscure, expensive, and frequently inefficient in achieving their professed objectives. They also commonly cause unfavorable side effects.

To improve the efficacy of these instruments, Redonda et al. (2019) presented three concrete policy ideas: To begin, governments should increase the transparency of tax advantages. Members of the G20 must take the lead in this area by regularly and thoroughly reporting on tax spending. To lower the composition of dividend income and detrimental spillover effects within and among developing nations, G20 governments should improve the design of tax incentives. Governments should bring attention to tax expenditures that are harmful to the environment, such as tax subsidies for fossil fuels and other programs that encourage inefficient use of natural resources.

Branco and Costa (2019) analyzed public tax exemptions as a tool of social policy, considering their broader political and social ramifications, such as deteriorating distributive effects, the establishment of non-state provider markets, and the goal of social protection. Using OECD figures and government budgets, they looked at 'tax advantages for social purposes' in Portugal from the 1980s, focusing on hospital, house loan, and educational spending. Prior to the Great Recession, Portugal enjoyed a high level of tax credits for social purposes. Why? Using Portugal as a theory-development case, the paper argued that, at a serious stage following the late, double evolution to the democratic system and structural economic reform, tax and welfare state developments combined to create social tax expenditures as a modality of targeted social expenditure benefiting the upper and middle strata. Once in place, an amalgamation of strong entrenched concerns, obfuscated policymaking, reverting income allocation, and a high take-up

rate across taxpaying groups produced a path-dependent result that kept inequitable and expensive fiscal benefits expanding throughout difficult fiscal times.

Calahorrano and Stowhase (2020) attempted to shed some light on the tax-deductibility of childcare expenditures in Germany. They calculated usage rates utilizing survey data on real childcare costs and official tax-return data on child-care tax deduction. Using a subsample of the tax-return data, they also examined the predictors of use among individuals who filed a tax return. Their estimation results revealed that the chance of utilizing (possible) tax benefits is strongly positively connected with the likelihood of utilizing. More types of deductions were also extremely considerable, implying that understanding tax legislation and opportunity costs are important. Furthermore, they model the consequences of a policy change that increases the munificence of tax deduction on the used rates. Such a change would significantly enhance use. Their findings suggested that usage reactions are more significant than prospective labor supply responses.

Johannsen et al. (2020) investigated that tax evasion by transnational organizations was more widespread in developing nations using a worldwide dataset containing information on 210,000 corporations from 142 countries. They presented a unique technique to study cross-border profit-shifting that required comparatively little statistics and was thus predominantly well-suited to the setting of poor nations. The findings repeatedly demonstrated that the understanding of stated profits to profit-shifting enticements was inversely associated with the level of institutional and economic development. That might clarify why, despite pressing revenue demands and harsh restrictions on the use of alternative tax bases, many emerging nations choose low corporation tax rates.

Sadiq and Mehmood (2010) investigated the short-run and long-run relationships between fiscal scarcities, which result from excessive government spending relative to tax revenue collection, and poverty. Based on time-series data from 1976 to 2010, the findings show a negative link between government spending and poverty. The ECM model and the Johnson Cointegration test, respectively, identify the short- and long-term correlations between poverty and other factors. The findings indicate that there is a long-run and short-run association between poverty and government spending.

Using Pakistani data, Farooq (2016) found that the study's findings not only confirmed the favorable influence of government spending on economic activity but also demonstrated that main recurrent spending was almost as essential as public investment in boosting economic activity. This was perhaps because the Pakistani government's development spending had higher intrinsic inefficiencies than recurring expenditures since extended economic difficulty had reduced the latter to "bare bones" to limit enormous inefficiencies. This, however, meant that just constructing structures and infrastructure would not be sufficient to stimulate economic growth. To get the best benefits, each building had to be appropriately supported for operation and maintenance, which was accomplished by recurring spending. As a result, this study suggested reconsidering the role of government spending and its influence on growth, particularly the mix of spending.

2.3. Summary of Literature

It is evident from the above literature that tax expenditures are done everywhere around the globe. But the issues related to them also exist in terms of evaluation, reporting, and entitlements. Lack of information about the beneficiaries benefitting from tax expenditures and misuse of the revenue forgone creates distortions in the economy leading to higher fiscal deficits. Tax expenditures can help improve the economy's progress if managed and implemented properly, as the cost of tax expenditures is lower than direct expenditures and other spending programs.

A developing economy like Pakistan forgoes a large portion of its rightful revenue with which it can improve its deficits and use this huge amount in education, health, and infrastructure development. Instead of collecting this revenue, the government takes loans at high-interest rates from IMF, World bank, etc. which increases the fiscal deficit.

Chapter 3: Research Methodology

To address the research questions, we have used both quantitative and qualitative approaches in this research. Panel data econometric method is used for this regression. For qualitative data, we held interviews with relevant government officials and experts in the field. Further content analysis was done by reviewing the FBR laws and other policy documents available.

3.1. Research Strategy

In this study, we have explored the tax expenditure framework and its impact on economic growth. We held interviews with relevant FBR/MO Finance officials for understanding the processes and procedures. Emphasis on the quantitative and qualitative research strategy was to capture the political, institutional frameworks which are operative in this regard.

3.2. Research Design

This study is based on qualitative interviews and the use of secondary data. We collected the data from relevant stakeholders via interviews and from published data sources for Pakistan-specific Data. Whereas for cross country data established sources are used.

3.3. Data and Methodology

Since for Pakistan number of observations is low hence, we have used the panel data for estimating the econometric model to address objectives of the study. For panel data analysis, secondary data is taken from the Global Tax Expenditure Database and the World Development indicator for 17² countries for the year 2003-2020.

Descriptive analysis is done by making consistent subheads of income tax, sales tax, and customs tax and their ratio to GDP (at current prices) would be estimated and graphical analysis would be used to show the effect of tax expenditures on economic growth in Pakistan. Data is taken from the FBR yearbook and Pakistan Economic Survey for fiscal year (2006-2020) for three categories of tax expenditures i.e., Income tax, Sales Tax, and Customs Tax.

A further appropriate econometric model is used to estimate the impact of tax expenditures on desired economic objectives/economic growth.

² The 17 countries used in the study are Canada, Germany, Japan, Sweden, Australia, Brazil, USA, Spain, Netherlands, France, Iceland, Israel, Argentina, Mexico, Austria, Morocco and Pakistan. These countries are selected based on minimum 18 years of data availability.

3.4. Theoretical Model

Expansionary fiscal policy has many pros and cons. For instance, according to the policy if we increase the government expenditure then it will lead to shift the aggregate demand towards the right and this will lead to increase the output of the country, however, it has many drawbacks due to this being a discretionary policy of the government. Briefly, we can say that the government increases its expenditure to complete the political agenda. We know that discretionary policies lead to distortion in economic stability. Similarly, tax cut in the form of revenue forgone i.e., another expansionary policy tool will distort the economic stability. In this way, the goal of this research is to explore the correlates of the revenue forgone in Pakistan.

Tax expenditures are a form of government expenditures that are done as an alternative to direct expenses. Government has to incur a huge cost for the collection of tax revenue and later on doing expenditures in form of development, health, education, infrastructure, etc. So, the government finds it convenient to forgo a portion of its potential revenue to certain taxpayers, sectors, economic activities, or entities. Around one-third portion of tax revenue has been lost by the government in the form of tax expenditures. This revenue-expenditure gap leads to a budget deficit. To cover up this budget deficit, the government borrows money in form of loans or debt backed by interest rates. The amount of debt keeps on accumulating, as government cannot repay all of the debt at once.

3.6. Econometric Equation:

To estimate the impact of tax expenditures on the GDP growth, we used the following model:

$$GDP\ growth = f(Investment, Trade\ openness, Labor\ force, Govt\ Exp, TE_i)$$

The econometric equation is as follows:

$$Y = a_0 + a_1Inv + a_2TO + a_3LF + a_4GE + a_5TE_i + \varepsilon$$

GDP growth is a dependent variable while investment, labor force, trade openness, government expenditures, and tax expenditures are independent variables.

Tax expenditure (%age of GDP) is taken from Global Tax Expenditure Database while data for GDP growth (annual %age), investment (%age of GDP), the labor force (%age of total

population), and trade openness (%age of GDP) are taken from World Development Indicator (WDI).

3.5 Variable Description:

3.5.1 Dependent Variable:

GDP growth (annual percentage) has been taken as a dependent variable. GDP's yearly percentage growth rate at market prices in constant local currency. Aggregates are calculated using constant 2015 pricing. Gross domestic product (GDP) is calculated as the total of the gross value contributed by all resident producers in the economy, plus any product taxes and minus any subsidies not included in the product value. It is computed without regard for depreciation of manufactured assets or depletion and deterioration of natural resources.

3.5.2 Independent Variables:

Gross fixed capital formation (GFCF) has been taken as a proxy for the investment. Land improvements (fences, ditches, drains, and so on), plant, machinery, and equipment purchases, and the construction of roads, railways, and the like, as well as schools, offices, hospitals, private residential dwellings, and commercial and industrial buildings, are all examples of gross fixed capital formation (formerly gross domestic fixed investment). Capital creation also includes net acquisitions of valuables.

General government final consumption expenditure (GFCE) has been taken as a proxy for government expenditure and is taken as a percentage of GDP. All government current expenditures for procurement of goods and services are included in general government final consumption expenditure (previously general government consumption) (including compensation of employees). It also covers the majority of national defense and security spending but excludes government military spending that is part of government capital formation.

Labor force participation rate is the fraction of the population aged 15 and above who is economically active: all persons who provide labor for the production of goods and services within a certain period.

Trade is the total of goods and services exports and imports expressed as a percentage of GDP.

Revenue forgone (%age of GDP) has been taken as a proxy of tax expenditures. Revenue forgone includes the potential revenue loss resulting from various exemptions, concessions, and reduced rates from income tax, sales tax, and customs duty.

Chapter 4: Quantitative Analysis

4.1. Model Specification:

A panel data set, also known as longitudinal data, contains two magnitudes: a time series and a cross-sectional, with all cross-sectional units monitored throughout time. We can tell the difference between balanced and unbalanced panel data. Because of the recurrence of observations, potentially very large panel data sets are created. The outcome of using N units and T periods is NT . The primary benefit is the big sample size, which is ideal for estimating, but the main problem is the dependency on others! Observations are most likely not independent. Different models are developed when considering potential dependency.

A fixed panel is a form of balanced panel, making it a unique example. In this arrangement, all persons must be present at all times. An imbalanced panel is one in which people are seen at different times than they should be, as a result of missing data, for example. We are only interested in balanced and fixed data. Overall, balanced data models outperform cross-sectional models in terms of efficiency since observing a single person over a longer time minimizes variation when compared to repeated random choices of people.

4.2. Panel data Models:

Panel data may be used to investigate a variety of topics, including:

- Time series variation vs. cross-sectional variation (unobservable in cross-sectional data).
- Individual heterogeneity (observable vs. unobservable).
- Hierarchical structures.
- The dynamics of economic behavior
- Individual and group impacts
- Effects of time

The current study relies on panel data, which is a blend of cross-sectional and time-series data. Panel data provides more flexibility, less collinearity, more information, and more efficiency.

Panel data utilized three fundamental methodologies, and these models discuss intercept behavior. There are three of them: the Common Effect Model (CEM), the Fixed Effect Model (FEM), and the Random Effect Model (REM).

4.2.1. Common Effect Model:

The pooled ordinary least squares (OLS) model is another name for the common effect model. Both the slope and the intercept in this model stay constant over the time series and cross-section.

4.2.2. Fixed Effect Model:

When there is a probability of a link between the individual-specific intercept and the other regressors, the fixed-effect model is used. To address the issue of heterogeneity, the model employs fixed dummies.

Panel data may be estimated using two methods: FEM and REM. To compare the REM to the FEM, the F test must be performed. For this aim, a REM with equal constant terms and a FEM with unique intercepts were constructed independently. The F test is then used to determine whether there is no difference between the REM and FEM utilizing the REM. The Hausman test is used to compare FEM with REM. When we assume that the stochastic error term and explanatory variables have no connection, these statistics are asymptotically distributed as chi-squares. In this case, the REM should be utilized instead of the FEM. According to the model, FEM outperforms REMs.

4.2.3. Redundant Fixed Effect Test:

FEM models are those parameters that are either constants or non-constant values. Mixed models and random effects, on the other hand, are models in which all or a portion of the model parameters are random variables. The phrase "Redundant Fixed Effects Test" simply refers to the process of assessing whether or not to include a certain fixed effect term in one's model.

The FEM is criticized because it captures individual-explicit effects employing fixed dummies, and it incorporates several limits with a wide cross-section set. As a result, the question of loss of

freedom emerges. The REM that conveys time variation dummy factors is the intercept term. As a result, this model is appropriate for use when the regressors are uncorrelated with the intercept of each cross-sectional unit.

$$Cov(\epsilon_i, X_{i,t}) = 0$$

The equation for the REM is as follows:

$$Y_{it} = \alpha_0 + \alpha_1 X_{1it} + \alpha_2 X_{2it} + \dots + \alpha_k X_{kit} + \epsilon_i + u_{it}$$

Where, Y_{it} is a dependent variable, α_0 is intercept, X_{1it} is the first independent variable, X_{2it} is the second independent variable, ϵ_i is unobserved heterogeneity and u_{it} is the error term of the cross-sectional and time-series data. In REM, ϵ_i is a random country-specific error term. Individual unit intercept values are obtained from a much larger population having a constant mean in REM, with individual means treated as departures from the constant mean. Due to the problem of collinearity of these variables with the subject-specific intercept in FEM, time-variant regressors are achievable in REM but not in FEM.

4.2.4. Hausman Test:

To identify endogenous regressors (predictor variables), the Hausman test is applied. Variables whose values are affected by the values of other variables in a system are known as endogenous variables. One assumption of ordinary least squares estimation is that there is no connection between the error term and a predictor variable, ordinary least squares estimators would fail with the inclusion of endogenous regressors in a model. In this case, instrumental variable estimators can be utilized in place of conventional estimators. The best approach is to first evaluate if your predictor variables are endogenous before deciding which regression to apply. This is exactly what the Hausman test would do.

This test is also known as the enhanced regression test for endogeneity or the augmented regression test for endogeneity, in addition to the DWH test.

4.2.5. Choice among FEM and REM through “Hausman Test”:

Various criteria are presented in the literature for choosing between the FEM and the REM. This study, on the other hand, adheres to Hausman (1978), a statistical test for choosing between the two models. This statistical test outperforms all other judgment criteria.

The Hausman statistical test for determining "fixed-effect" and "random-effect" follows the paradigm shown below.

$$\omega = (\beta_{FEM} - \beta_{REM})[v(\beta_{FEM}) - v(\beta_{REM})]^{-1}(\beta_{FEM} - \beta_{REM}) \approx \chi^2$$

The above equation statistically compares two models to determine which one is superior. The selection criteria are based on the model, but with more consistent findings and a chi-square statistical technique.

4.3. Results and Discussion:

This part summarizes the statistics and correlation of the variables used in the study. The study aims to figure out the growth impact of tax expenditures on economic growth. Due to data limitations, we used panel data for seventeen countries and five variables. After checking the issues of heterogeneity and multicollinearity, we used the Hausman test. GDP growth is the dependent variable while labor force, investment, trade openness, tax expenditures, and government expenditures are the independent variables.

Table: 01

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|-----------|-------------|------------|-------------|--------|
| Intercept | 0.570113 | 1.069512 | 0.533059 | 0.5944 |
| INV | 0.093257 | 0.026236 | 3.554518 | 0.0004 |
| TE | -0.079009 | 0.036265 | -2.178640 | 0.0302 |
| LF | 0.038459 | 0.022459 | 1.712418 | 0.0879 |
| TRADE | 0.002736 | 0.003913 | 0.699385 | 0.4849 |
| GEXP | -0.145913 | 0.029804 | -4.895778 | 0.0000 |

P-value shows that trade openness and labor force have insignificant ($P\text{-value} > 0.05$) relationship while tax expenditures, government expenditures and investment have significant ($P\text{-value} < 0.05$) relationship. Coefficient shows that tax expenditures and government expenditures harm GDP growth while trade openness, investment, and labor force have a positive relationship with GDP growth.

According to Kim (2011), trade openness has a favorable influence on economic growth and real income in rich countries but a negative effect in developing countries. Furthermore, the true impact of trade is influenced by the amount of financial development and inflation. Trade openness has a detrimental influence on growth in nations with low financial development but does not affect those with high financial development. Trade openness promotes economic growth in low-inflation countries but has little effect on growth in high-inflation countries. According to Kim, Lin, and Suen (2012), trade enhances economic growth in high-income, low-inflation, non-agricultural countries but has a detrimental impact in countries with the opposite characteristics.

Lowering or raising income taxes might have a more subtle impact on the labor market. Lowering income tax rates may encourage people to work more hours because they will be able to keep more of their earnings. Similarly, extremely high-income tax rates may cause people to work less because their labor is so heavily taxed. People may desire to work less if their after-tax wages are lower, but they may work more to earn enough money to cover their expenses.

Government investment in infrastructure, such as schools, roads, and parks, has an impact on labor as well because these facilities can be as powerful as tax rates in selecting where businesses and people locate. These amenities also have an impact on labor force wages because people may be ready to work for less if they can live in an area that provides what they value.

According to the empirical findings, investment has a favorable impact on economic growth. According to the findings, investment is the main factor in driving growth.

Most developing country's economic growth has been impeded by government consumption spending. In these findings investment has a positive effect on growth, whereas government consumption expenditure harms growth. So, Government non-development spending should be

reduced since it contributes to the budget deficit by impeding economic growth and investment (Maqbool Hussain Sial, 2010).

In the case of the relationship between government expenditure and economic growth it appears that exploiting within-country variation by means of panel regressions, correcting for heteroscedasticity between countries, and addressing the issue of country selection, in fact permits a more robust conclusion. The results point to a robust negative relationship between government expenditure and growth in rich countries. When the rich country sample is extended to non-OECD countries both government expenditure and taxation are found to be negatively associated with economic growth (Fölster & Henrekson, 2001).

4.3.1. Causal Effect:

Using Granger's (1969) fundamental causality test, which assumes causal homogeneity across panels, was extended to panel data This is a common erroneous resumption.

Causation can be defined as "the cause preceded its impact, and a causal arrangement contained data about the impact that was unavailable in some other arrangement as per the contingent dissemination," according to Granger's definition of it (Poon & Granger, 2003) Because of this, a more precise assessment of impact can be made by looking at what causes it.

The following are the most important aspects of Granger Causality: For starters, if H0 is not rejected, X does not result in Y from a granger standpoint for any of the panel variables in consideration. Second, if H0 is rejected and N1 is equal to zero, then homogeneous causality exists for all units between x and y is the distance between them. To summarize, if H0 is rejected and 0N1/N1 is true, then there is heterogeneous causality; that is, the estimation and causality relations in all units may be different.

Table 02:

| Null Hypothesis: | Obs | F-Statistic | Prob. |
|----------------------------------|-----|-------------|--------|
| GEXP does not Granger Cause GDPG | 272 | 2.48102 | 0.0856 |
| GDPG does not Granger Cause GEXP | | 8.04197 | 0.0004 |
| INV does not Granger Cause GDPG | 272 | 1.58445 | 0.2070 |
| GDPG does not Granger Cause INV | | 5.01553 | 0.0073 |
| LF does not Granger Cause GDPG | 272 | 0.37332 | 0.6888 |

| | | | |
|-----------------------------------|-----|---------|--------|
| GDPG does not Granger Cause LF | | 0.21563 | 0.8062 |
| TE does not Granger Cause GDPG | 272 | 0.84637 | 0.4301 |
| GDPG does not Granger Cause TE | | 0.15619 | 0.8555 |
| TRADE does not Granger Cause GDPG | 272 | 1.91127 | 0.1499 |
| GDPG does not Granger Cause TRADE | | 7.98951 | 0.0004 |
| INV does not Granger Cause GEXP | 272 | 1.75533 | 0.1748 |
| GEXP does not Granger Cause INV | | 2.63276 | 0.0737 |
| LF does not Granger Cause GEXP | 272 | 0.49441 | 0.6105 |
| GEXP does not Granger Cause LF | | 1.42108 | 0.2433 |
| TE does not Granger Cause GEXP | 272 | 1.55142 | 0.2139 |
| GEXP does not Granger Cause TE | | 1.00273 | 0.3683 |
| TRADE does not Granger Cause GEXP | 272 | 1.24261 | 0.2903 |
| GEXP does not Granger Cause TRADE | | 0.29418 | 0.7454 |
| LF does not Granger Cause INV | 272 | 0.20802 | 0.8123 |
| INV does not Granger Cause LF | | 0.25626 | 0.7741 |
| TE does not Granger Cause INV | 272 | 4.63881 | 0.0105 |
| INV does not Granger Cause TE | | 0.48382 | 0.6170 |
| TRADE does not Granger Cause INV | 272 | 1.50575 | 0.2237 |
| INV does not Granger Cause TRADE | | 5.76061 | 0.0036 |
| TE does not Granger Cause LF | 272 | 0.83050 | 0.4370 |
| LF does not Granger Cause TE | | 0.61387 | 0.5420 |
| TRADE does not Granger Cause LF | 272 | 3.43637 | 0.0336 |
| LF does not Granger Cause TRADE | | 0.65288 | 0.5214 |
| TRADE does not Granger Cause TE | 272 | 1.47680 | 0.2302 |
| TE does not Granger Cause TRADE | | 3.02256 | 0.0503 |

GDP growth to investment and trade openness, investment with GEXP, TE, trade openness, and trade openness with LF and TE have the uni-directional causal effect. Among these economic factors, only GEXP and GDPG have bi-directional causality. But from the results, GDPG and TE don't have a causal effect, although from the previous table TE has a significant effect on GDP growth, it is not causing it. So, we can say that the relationship among them is not directly but indirectly.

Chapter 5: Qualitative Analysis

This chapter is based on qualitative research methods which include the policy documents, analysis of acts and regulations, expert opinions and, interviews of officials from relevant and concerned ministerial departments.

5.1. Interviews of Officials from concerned ministerial departments:

Interviews were conducted with senior officials of the *Federal Board of Revenue* and the *Ministry of Finance* to better understand the framework, objectives, and pros and cons of tax expenditures. A questionnaire³ was designed to conduct these interviews. Below mentioned are the opinions and views of these officials⁴.

5.1.1 FBR Official:

The general perception that there is no policy framework for the tax expenditure was validated. The FBR official informed that *“As such no policy framework for tax expenditure exists. These exemptions and concessions are given through various schedules and acts of Income Tax Act 2001, Sales Tax Act 1990, and Customs Act 1969. Some exemptions are given through various SROs which are not mentioned by the acts but are needed to be done keeping in view the demands. FBR does not decide about tax expenditures, and these are decided by the government itself”*.

The revenue collection pressures make tax policy compromised. According to *FBR Tax Expenditure Report (2021)*, tax exemptions amounted to Rs. 1314.278 billion which was 32.88% of total tax collection. It means that one-third of potential tax revenue was lost to selected individuals and entities. FBR official informed that *“FBRs' main function is to raise revenue by the implementation of tax rates as per the government's decisions. Amount allocation decision is done by the government or finance division. It mainly depends upon the type of economic activity, keeping in view the income of the beneficiaries and societal benefits. For example, recently freelancing industry was given tax exemption to boost foreign exchange reserves, new business startups are tax exempted to generate economic activities and employment generation,*

³ Questionnaire is attached in appendix.

⁴ Names not to be disclosed.

philanthropic activities to help the lower-income or unemployed segments of the society, and imports of essential goods which are crucial to the health sector and daily use of general masses”.

A good expenditure program comes with fiduciary controls and post-implementation evaluations. But in the case of tax expenditures in Pakistan, it's absent. The FBR official informed that *“Performance evaluation of these exemptions or beneficiaries is not done by FBR as it is quite difficult to evaluate or audit due to its high cost both in terms of opportunity cost and monetary cost. Almost 70 % of these exemptions and concessions are time-bound and are backed by sunset clauses of acts. Some exemptions are given for the short-term, and some are long-term keeping in view the objectives and needs of the businesses or individuals”.* There is no framework for evaluation hence all the assessments are judgmental. FBR official informed that *“Theoretically, the positive impact of these expenditures is seen as they promote higher economic activities and social benefits to the larger segment of the society but practically it is quite difficult to assess the impacts as systematic and governance issues exist in the Pakistani economy”.*

It is generally assumed that tax-exempt sectors are more beneficial than zero-rated sectors. To clear this, the official said, *“Zero-rated sectors or items means any item, sector, or activity that is charged with 0% tax on their income(s), or profit(s). Zero-rated items or sectors benefit more as they pay 0% tax on final goods and services, and they can refund any tax amount paid on goods or services (taxes paid on raw material being used in the production of final goods and services). While tax-exempt sectors or items mean that income or profit generated is fully or partially exempt from taxation with no refund payment on the purchase of raw material for the production of that good or service. So, tax-exempt sectors or activities enjoy lesser benefits”.* Furthermore, different schedules of the Acts⁵ seem to be discriminatory among the taxpayers. FBR official answered that *“Different schedules have different purposes and different tax exemption categories. Some provide full tax exemption, some partial exemptions, and some provide reduced rates on taxable income”.*

⁵ Income Tax Act 2001, Sales Tax Act 1990 and Customs Act 1969.

A proposition that activities to be assisted by tax expenditures does not seem to be high on the national agenda. When asked, the official replied, *“Some activities which are assisted by the proposed tax expenditures are high on the national agenda such as pharmaceuticals, basic food items, new business startups, imports (raw materials), and exports. While some tax-exempt activities are due to certain constitutional, religious, cultural, and social agendas such as the income of higher judiciary and bureaucrats, trusts, shrines, and pensions”*.

The amount allocation or amount of tax exemption assisting the intended beneficiaries is not mentioned in acts. To which the official said, *“Assistance to be provided to beneficiaries with tax expenditure solely depends upon the income earned, type of economic activity, and the impact of that activity on society. For example, NGOs, Not-for-profit entities, public universities, the health sector, research institutes, and other philanthropic activities”*.

The assistance through taxation route is not the better way to serve intended purposes, instead, it should be done through direct budgetary allocation or expenditures. The FBR official said, *“A tax expenditure is not the better route to serve the intended purposes but instead, it creates distortions, discrimination among taxpayers, and tax evasion. Furthermore, it also leads to potential tax revenue loss. This potential tax revenue should be collected, and the intended social purposes are served through direct budgetary spending. Tax expenditures have both positive and negative impacts on the tax system as well as the economy. There is a significant negative impact in terms of financial revenue loss but a significant positive impact in terms of social benefits and public welfare”*.

There is a negative impact of the proposed tax expenditure on the equity of the tax system and these expenditures add a huge cost to tax administration in terms of putting pressure to increase revenue from other sectors and make the tax system more complex and irrational. But this is not the case as informed by the official, *“As stated earlier, these expenditures incur a huge cost from the finance side but if we look at social benefits there is no cost at all. After all, they contribute to society and lower-income households. Pakistan has the lowest cost of 0.47% to collect taxes. The government has approved funds of Rs. 28 billion to raise tax revenue of Rs. 6000 billion for current FY 2021-22”*.

Powerful elites, businesses, and trusts seem to be most benefitting from the tax exemptions and there are fewer social goals seen to be achieved through the concessionary regime. The FBR official said that *“Intended beneficiaries in specific and the general public in general benefit from these exemptions and concessions. They serve intended purposes/objectives to some extent practically, but these cannot be withdrawn keeping in view the interests of the general public and politically motivated system. Some expenditures do participate positively in the economic growth of Pakistan as they are utilized fully for the public interest and very least for the self-interests of beneficiaries”*.

It is easily understood that tax expenditures are misused, boost extravagance, and are used as a tool to evade/avoid taxes to the government. Furthermore, these are thought to be benefitting the lower segments of society through the trickle-down effect, but this does not happen. The official said, *“Tax expenditures can be misused, can encourage extravagance, and used as a device to evade taxes. It is quite difficult to say to what extent they lead to misuse, but issues do exist. Furthermore, the basic concept of the trickle-down effect has failed in developed as well as developing countries and we cannot justify these exemptions based on this theory. It does benefit the rich and elites of the society as they pass on the burden of their taxes on the final consumer or general public if tax exemptions are withdrawn. If these expenditures are kept intact, they do get benefits from these as well”*.

There has been much debate on statutory regulatory orders (SROs) as they are issued from time to time and without the approval of the legislative body. These are considered to be discriminatory and distortionary. When asked, the official replied, *“SRO-based expenditures are done in a time of need. These are mostly due to some natural disaster, calamities, to promote trade or some economic activity. Tax expenditure provisions seek to achieve social goals by easing the purchasing power of the individual(s) or entities in terms of food items, pharmaceuticals, education, employment generation, boosting industrial production, etc. Some of these activities attain social objectives beyond the gain and some do not. The cost cannot be justified on a large scale”*.

Tax expenditures are not well targeted at the activity that it intends to promote, and it is not structured as effectively as it could be. Modifications and well-structured policies are required to

make better use of these expenditures. The official also agreed to this and said, *“These expenditures are not well-targeted and not structured effectively at the activity it intends to promote. To make them more effective and viable, legislation through parliament and audits of beneficiaries are strongly needed. Tax expenditures are meant to provide income support to selected beneficiaries for providing special assistance and are justified by available Acts and schedules passed by the government. These assist only the targeted population, so discrimination does exist. Furthermore, issues also exist in duplication or overlapping. To overcome these issues, tax reforms are urgently needed to avoid duplication with modern technological advancements and a well-designed tax system”*.

5.1.2. Ministry of Finance Official:

To validate the perceptions related to tax expenditures in Pakistan, a ministry of finance (MoF) official was also interviewed, and similar questions were asked. The two departments differed in terms of their perceptions about tax expenditures.

The proposition about the nonexistence of tax expenditure framework, their benefits, decision-making authority, amount allocations, and time frame of these expenditures was inquired. To which MoF official said, *“There is no policy framework for tax exemptions in Pakistan, but procedures do exist in the form of Acts⁶. The basic purpose of tax exemption is to raise revenue by incentivizing the taxpayers to come under the taxation regime and promote economic activities which lead to employment generation, increase exports and human capital. The sole decision-making body of tax expenditures is FBR which on the directives of the federal government proposes the exemptions to be given to selected beneficiaries. FBR calculates the amount of exemption that it can forgo to achieve the specified objectives. The time frame for these exemptions is provided by sunset clauses of the Acts and performance-based criteria are also present. But FBR neither evaluates the performance of beneficiaries nor audits the entities or individuals”*.

The basic understanding regarding objectives of tax expenditures was discussed in detail and the official informed, *“The objectives of these expenditures should be to revive the industry to increase employment and exports, reduce imports, attract investment in industrial, educational,*

⁶ Income Tax Act 2001, Sales Tax Act 1990 and Customs Act 1969.

and health sectors, and not be used for spoon-feeding of individuals or entities. Performance and behavioral assessment should be done to promote economic activities. Low-performing individuals and entities should not be enjoying exemptions as it puts a gruesome burden on the national exchequer”.

Tax expenditure activities are seen as illogical and considered to benefit the powerful elites. The official agreed to this by saying, *“At present, most of the tax-exempt activities have no logic and are just being done to favor the elites and mafias who despite earning higher profits/incomes are avoiding and evading taxes. Some activities are high on the national agenda and doing their best to participate positively in economic growth. The tax route is not the better way to serve the intended purposes without performance evaluation. Instead, tax exemptions should be withdrawn and served through direct expenditures”.*

Tax expenditures harm the equity of the taxation system and put huge pressure on the national exchequer. The official further added, *“Proposed tax expenditures harm the tax system as potential tax revenue is lost and this loss is overcome by taking loans from international donors at higher interest rates which further puts the burden on the reserves of Pakistan. The issues of fiscal deficits and current account deficits arise, and the economy cannot perform better with these issues. Furthermore, IMF puts gruesome conditions on Pakistan which deteriorates the system. The cost is in the form of revenue loss which is done by the elites, businessmen, and bureaucrats but the general public pays taxes which creates discrimination and various other issues arise which make the tax system more complex and irrational”.*

The presumption that these expenditures are mostly done to favor the elites was validated by the official, to which he said, *“Most of these expenditures are done to favor the favorites so they hurt the economic growth. They are misused, encourage extravagance, and are used to evade or avoid taxes to a large extent”.*

The Statutory Regulatory Order (SRO) is the most commonly used weapon in Pakistan for obtaining advantages from the state in favor of a specific individual or group. SRO nation has a drastic influence on the Pakistani economy in terms of the rent-seeking, individuals, groups, and promotion of certain businesses. To this, MoF official commented, *“SRO-based expenditures are purely done to benefit the mafias and are politically motivated as their sole*

purpose is to earn higher profits/incomes and they do benefit the rich and elites and not the general population”.

Policymakers in general and the public in particular demands government intervention to provide for basic goods and services through lesser taxation. The official replied, *“Government intervention is not needed at all to achieve public policy goals through tax expenditures. In the short term, the tax expenditure led activities to generate social benefits beyond the gains but in the long run, they are just a waste of taxpayers’ money, so the benefits are not sufficient to justify the cost”.*

No justification for providing special assistance to the category of people receiving the tax exemption exists. Furthermore, it does not provide equal assistance to taxpayers in similar economic circumstances who meet the criteria instead these exemptions are discriminatory as middle and lower classes pay their full taxes to the government while the elite class enjoys the exemptions. The official commented that *“There is no justification for providing special assistance to the category of individuals or entities receiving the exemption and it does not provide equal assistance to taxpayers. It is effectively targeted to assist only the selected beneficiaries”.*

Tax expenditures are duplicated and overlapped with other provisions of the tax structure. There is no coordination seen among other legal provisions and exemption-related provisions. To this, the official replied that *“Tax expenditures duplicate and overlap with other tax provisions and are not coordinated with similar objectives. These exemptions should be withdrawn at the earliest, and if provided they should be evaluated and audited so they cannot be used to create distortions and discrimination in the economy”.*

5.1.3. Conclusion:

To summarize the above debate, it is quite clear that tax expenditures are done on the behest of the government to favor certain segments and favorite individuals. There is no concrete legal framework existing in Pakistan, but these expenditures are done through the various provisions of *Income Tax Act 2001, Sales Tax Act 1990, Customs Act 1969*, and various SROs which are issued from time to time. Most of the individuals, industries, entities, and trusts have become

habitual of spoon-feeding by these exemptions as they have been enjoying these perks over the last decade. Sunset clauses present in the acts are not implemented to withdraw these exemptions from favored beneficiaries. The government and FBR must strictly implement those clauses to increase potential tax revenue.

SROs are detrimental to economic growth and the overall economy. The system should get cleansed of the SRO culture, and decisions should be done with thorough investigation and thought. Policymaking should not be in the hands of individuals with entrenched interests, such as the FBR, whose primary goal is revenue raising. One method to transition from the present SRO structure to a more dynamic system is to provide tax breaks for new activities with a sunset clause and a baseline to judge success and failure by making them a law rather than a discretion. Second, to eliminate these SROs, overall or general tariff rates should be reduced.

5.2. Descriptive and Content Analysis:

Tax expenditures are governmental revenues that are foregone as a consequence of the preferential treatment of particular industries, regions, agents, or activities (Tyson, 2014). Allowances (tax deduction from the base), exemptions (omissions from the base), rate relief (lower rates), credits (obligation reductions), and tax deferrals (delaying expenditures).

In Pakistan, exemption and concessionary regimes have been in practice for many years in the form of allowances, tax credits, exemptions from total income, reduced rates and liabilities, and exemption on imports and exports. But FBR and the Government of Pakistan did not report or publish these estimates. Tax expenditure estimates were first reported in the Pakistan Economic Survey of 2006-07 under International Monetary Fund's conditionalities for its Stand-By Arrangement (SBA) of US\$ 7.6 billion. The global financial crisis's spillover effects, energy sector subsidies, and a current account deficit all affected the government's financial predicament. Global oil prices rose in 2007-08, but the government, frightened of economic instability, continued to aggressively subsidize the energy industry, transferring the burden to local consumers and raising the budget deficit to 7.4 percent of GDP. Despite this, rising oil imports increased overall imports, placing pressure on the country's depleting foreign exchange reserves. Remittances had dropped as a result of the global financial crisis. Rising imports and

lower remittances led to a 492 percent rise in the current account deficit from June to September 2007. To overcome this imbalance, the incoming Pakistan People's Party government negotiated a deal with the IMF for a US\$7.6 billion (\$10.44 billion at current currency rates) SBA package over 23 months. The IMF recommended that budgetary headroom be increased by increasing tax revenues and removing energy subsidies. To control inflation and encourage investment, the IMF recommended Pakistan's central bank tighten monetary policy and stop supporting the budget deficit.

Since then, tax expenditures have been on rising and further worsening the fiscal deficit. The crippling economy of Pakistan has been burdened by forgoing its potential revenues and to cover this gap, it has to take loans at higher interest rates. The below graphs show the trends of tax expenditures since FY 2006-07.

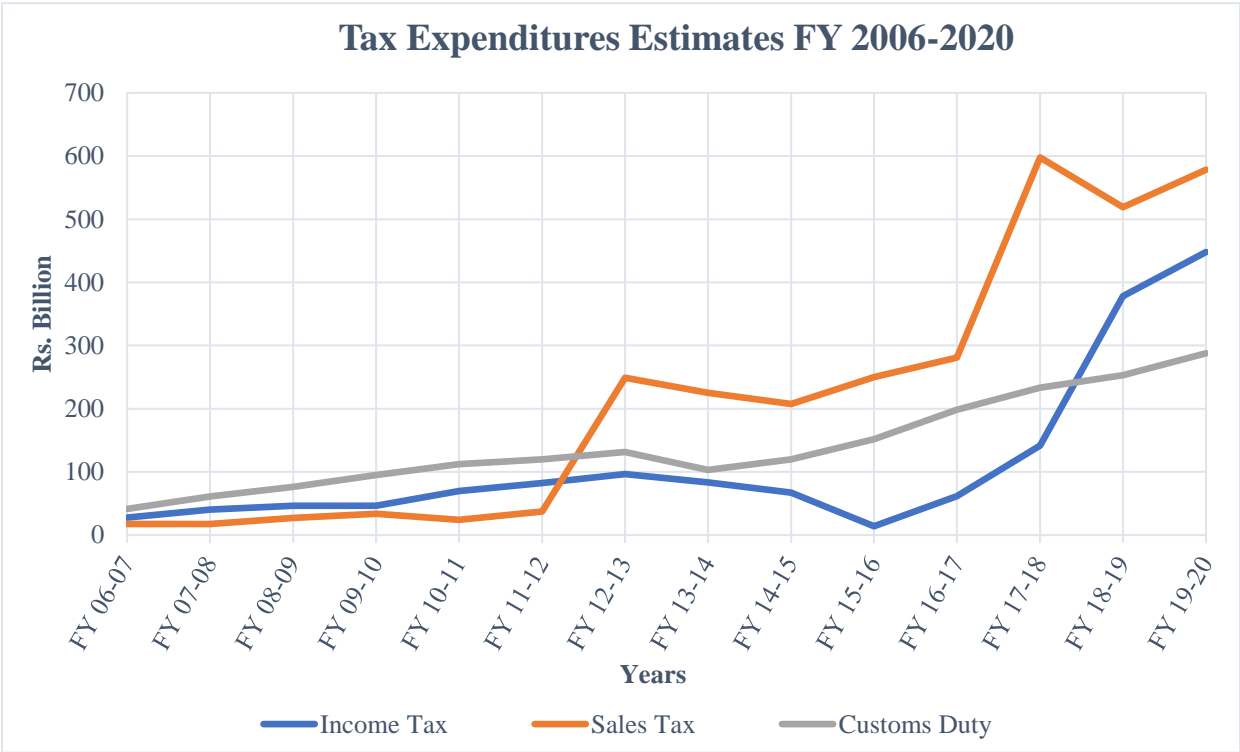


Figure 01: Source: Author's calculations

Different methodologies and judgments of what constitutes a tax expenditure confound tax expenditure comparisons, but the practice is widespread, and tax expenditures in Pakistan have increased over time.

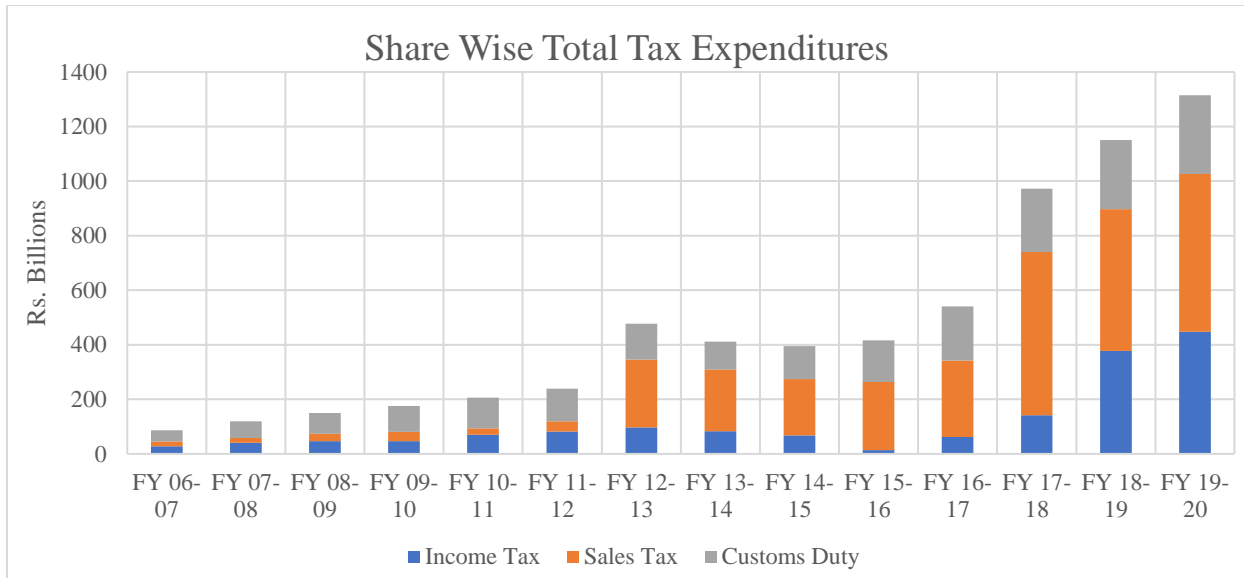


Figure 02: Source: Author's calculations

It is evident that customs duty exemptions were the highest among all three during the initial years but since FY 2012-13, sales tax exemptions took the lead followed by income tax exemptions. Details of these expenditures are discussed below:

5.2.1. Sales Tax Expenditures:

Sales tax expenditures are given through various schedules of the *Sales Tax Act 1990*. Sales tax expenditures cost Rs. 578.456 billion (44% of total TEs) worth of tax loss to the national exchequer out of which exemptions (under different schedules) amounted to Rs. 342.829 billion (59.26% of ST expenditures). According to the *Sales Tax Act 1990*, sales tax exemptions are granted in three broad categories i.e., Zero-Rated, Exemptions (on imports and local supplies), and Reduced Rates.

The graph below shows the trends of these exemptions for the last seven years, which are further explained in detail as well.

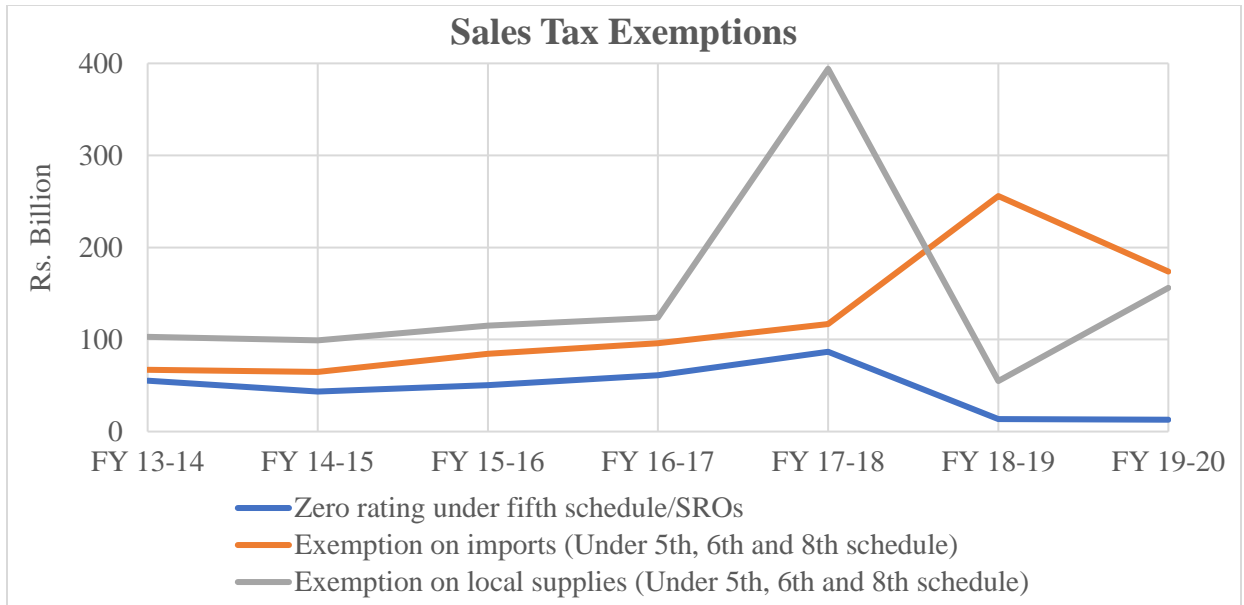


Figure 03: Source: Author's calculations

5.2.2. Zero Rated:

Under section 4 of the Sales Tax Act 1990, goods exported, or items defined in the 5th schedule; including exports of goods for national security, natural disaster, food security in emergencies, and implementation of bilateral and multilateral agreements are charged to tax at the rate of zero percent. Zero-rated items get the most benefits in sales tax exemptions, as the tax paid on the raw material used for the production of goods or services is refunded by the tax authority.

In the last fiscal year 2019-2020, 27 items were granted tax concessions at zero-rate worth Rs. 12.887 billion. Food items of infants were exempted by Rs. 8.202 billion, followed by industrial inputs (manufacturing) Rs. 2.102 billion and educational items (stationery) Rs. 1.297 billion. Industrial inputs (general population) cost Rs. 1.284 billion while diplomatic supplies cost Rs. 3 million.

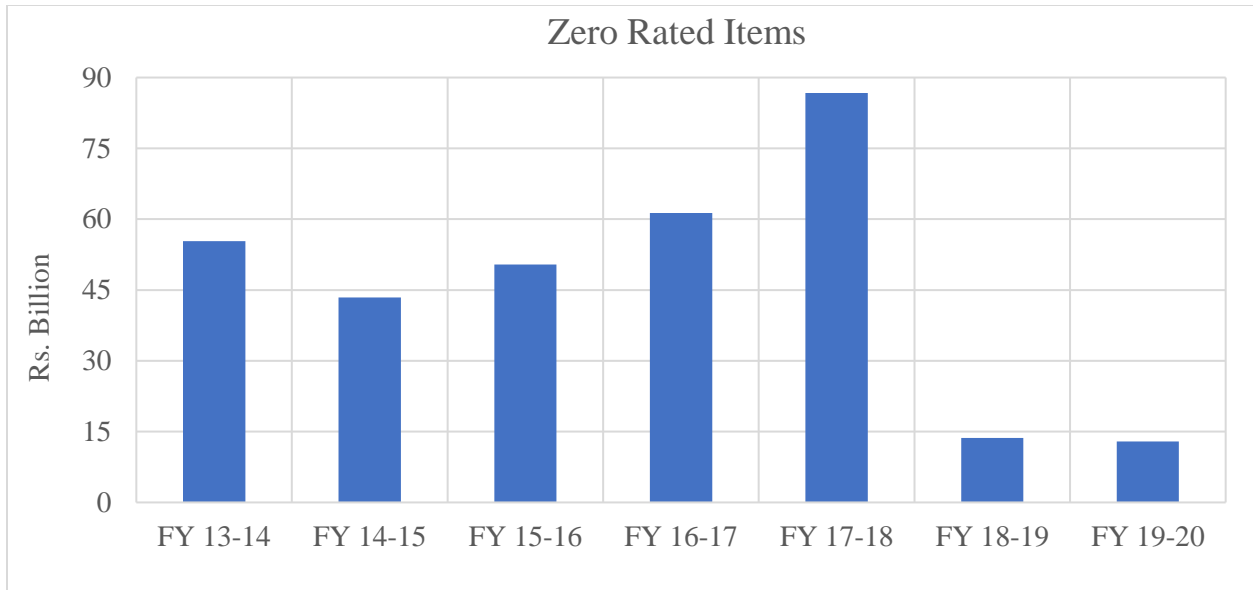


Figure 04: Author's calculations

5.2.3. Exemptions:

Section 13 of the *Sales Tax Act of 1990*, states that the local supply of products or import of items mentioned in the Sixth Schedule is exempt from taxation. Exemptions may be granted for any supply produced or imports of any products or class of commodities from the entire or a portion of the tax imposed by the Act.

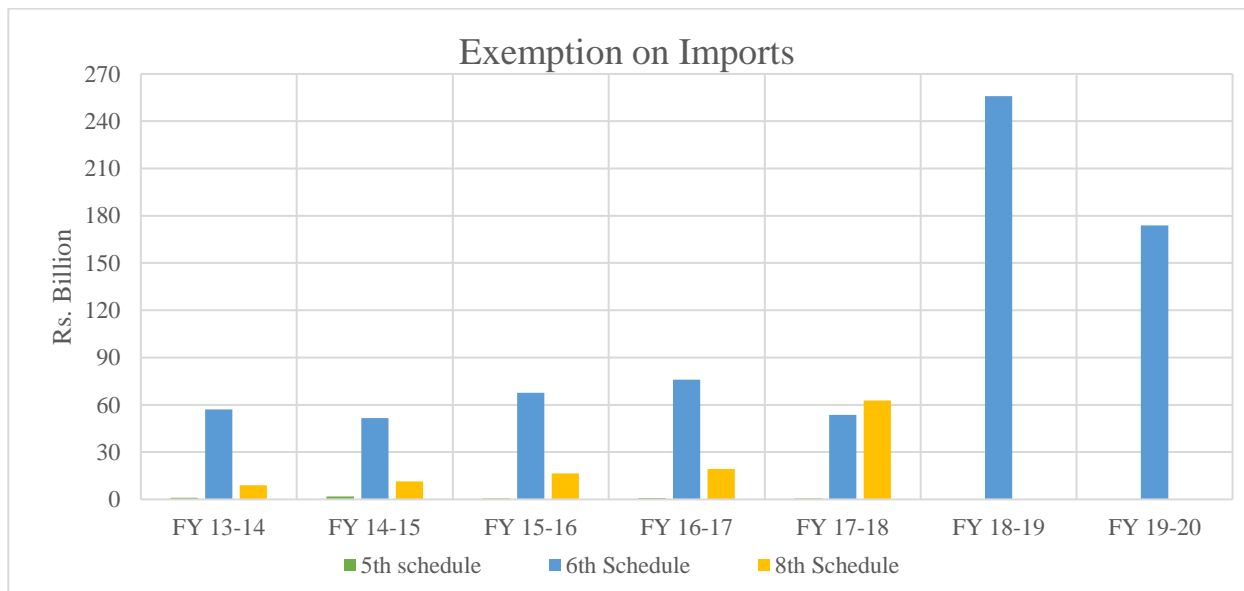


Figure 05: Author's calculations

202 types of exemptions on import of goods under the 6th schedule were granted worth Rs. 316.015 billion during FY 2019-20. Exemptions relevant to food items were Rs. 90.375 billion, health/ pharmaceutical Rs. 45.407 billion, agricultural-related goods/machinery Rs. 6.165 billion, exported goods Rs. 1.079 billion while the rest of the goods were industrial inputs benefitting the general masses. 45% of these exemptions were adjusted on account of local supplies.

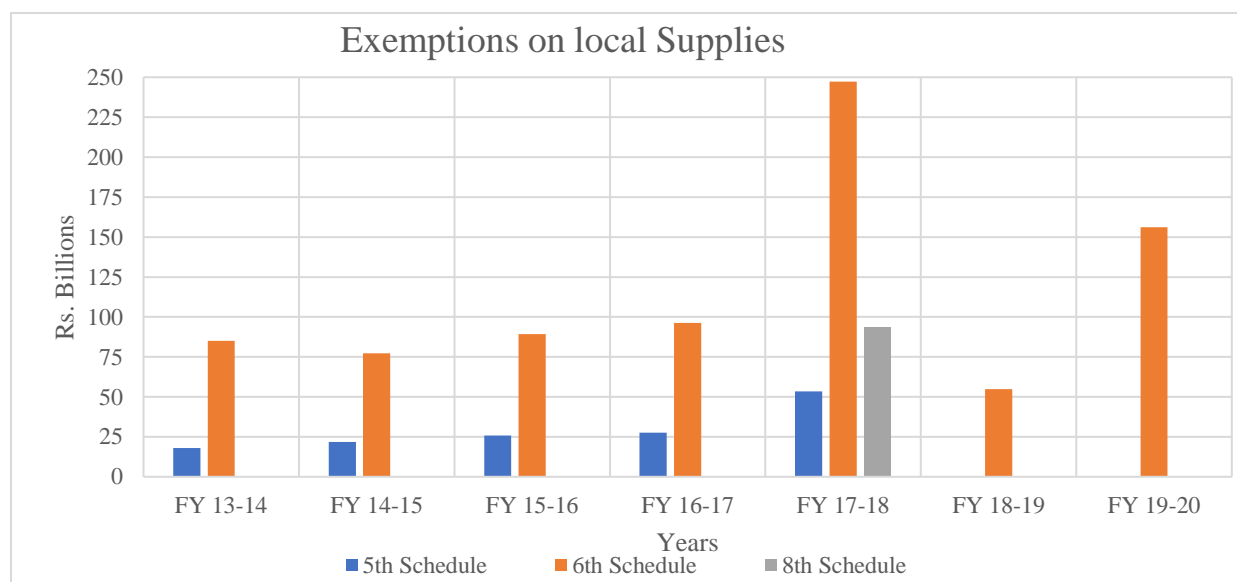


Figure 06: Authors calculations

Under the 6th schedule of the *Sales Tax Act 1990*, 213 locally manufactured items were exempted from sales tax during FY 2019-20 which amounted to Rs. 283.88 billion but 45% of these exemptions were reversed on account of taxable activities. Food products cost Rs. 53.619 billion, health-related products Rs. 117.069 billion, agricultural products Rs. 21.27 billion, products related to general population Rs. 53.992 billion, educational items Rs. 772 million while the remaining were the manufacturing of industrial equipment.

5.2.4. Reduced Rates:

Section 3(2)(b) of the *Sales Tax Act 1990*, empowers the federal government to declare that, in respect of any taxable goods, the tax shall be charged, collected, and paid in such manner and at such higher or lower rate or rates as may be specified, subject to such conditions and restrictions as it may impose, by notification in the Official Gazette.

Reduced rate exemptions were first given in FY 2018-19 at rate of 2%, 5%, and 10% but in FY 2019-20, rates at 1%, 7%, 8% and 12% were added under reduced rates. Below table shows the detail of these exemptions:

Table 03:

| Reduced rates under 8 th Schedule | FY 2018-19 (Rs. Billion) | FY 2019-20 (Rs. Billion) |
|--|-----------------------------|-----------------------------|
| 1% | 0 | 0.33 |
| 2% | 74.008 | 90.288 |
| 5% | 8.677 | 27.108 |
| 7% | 0 | 0.496 |
| 8% | 0 | 1.396 |
| 10% | 35.452 | 69.592 |
| 12% | 0 | 19.21 |

Now, these above-mentioned sales tax exemptions require a deep analysis in terms of goods that are exempted from tax. Necessary goods which are beneficial to the lower-income households in terms of food items, health-related products, and agriculture need not be reversed. Furthermore, these items need to be defined in terms of purpose i.e., household consumption, business, or investment before any meaningful reform in TE through sales tax can be carried out.

5.2.5. Nature of Concessions and Exemptions:

Sales tax concessions and exemptions are divided into four major categories according to the *FBR Tax Expenditure Report 2020-21*:

1. Concessions based on goods:

Under some circumstances, concessions based on manufactured goods are allowed under the sales tax statute; for example, in the case of grocery and food items, some products have reduced rates, and some are exempt from sales tax. It may become complicated if these exemptions have rules inside rules. Ready-to-eat food products and prepared foods may be exempted or charged at a reduced rate, although the identical things sold under a brand name may not be exempted or charged at a reduced rate.

2. Concessions based on use:

Certain items designed for in-house consumption, for use by a single organization, are exempt from taxation under the Act. Typically, this is where the end customer is not subject to taxation or is designed to receive a tax break.

3. Concessions based on buyers:

Sales tax is frequently waived for diplomatic missions, diplomats, diplomatic officialdoms, non-profit firms, and government activities. These international and national organizations benefit from this concession, which takes the form of a zero rating or exemption.

4. Concessions based on economic activity:

Certain tax breaks are allowed under the statute for a certain economic activity. For example, export promotion or specific operations in export processing zones. Exemptions in the former Federally Administered Tribal Areas (FATA) is a one-of-a-kind example in Pakistan, where exemptions are allowed for geographic mainstreaming.

5.3.2. Income Tax Exemptions:

Commercial taxpayers, individuals and association of persons (AOPs) are qualified for numerous tax expenditures under a variety of sections of the Second Schedule of the *Income Tax Act of 2001*. Deductible allowances, a zero-rated income tax bracket, concessions, tax credits, some withholding taxes, special provisions and exemptions are examples of these. The Second Schedule of the Income Tax Ordinance 2001 has a lengthy list of exemptions and tax breaks that fills about ninety pages in the Income Tax Manual.

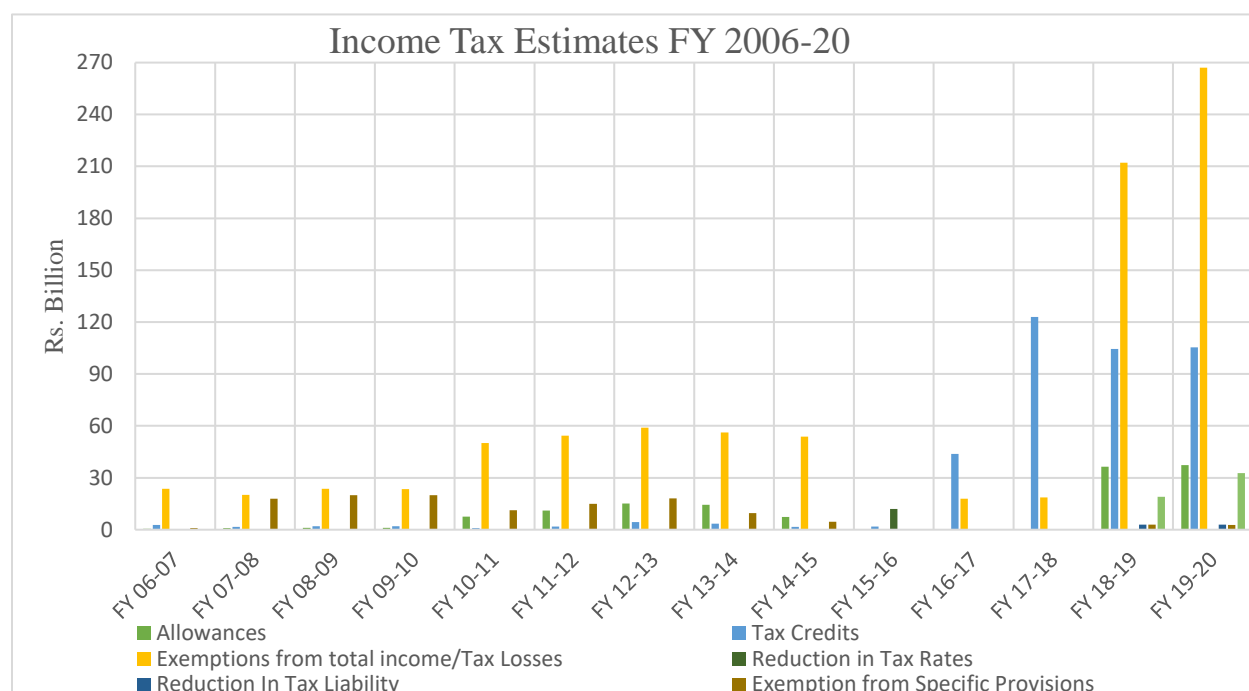


Figure 07: Authors calculations

5.3.2.1. Categorization of Income Tax Estimates:

Income tax expenditures are given to the following thirteen categories according to the *Tax Expenditure Report 2020-21*.

- 1) National Operations.
- 2) Social Security.
- 3) Employment generation.
- 4) Donations, Charities and Non-Profit Organizations.

- 5) Science, Technology, & Innovation.
- 6) Education, Health, Sports, & Culture.
- 7) Business & Industry – Agribusiness.
- 8) Business & Industry – Energy and Mining.
- 9) Business & Industry – General.
- 10) Financial Sector.
- 11) Investment and savings.
- 12) Non-resident internationals.
- 13) Others (Government income etc.)

This collection of exemptions and concessions serves to make loopholes in the income tax base for both individuals and AOPs. Exemptions include, in general, the following:

- ❖ Privileges including rental and recreational allowances for certain persons such as the Prime Minister, the President, federal/provincial cabinets and ministries, high ranking officials of armed forces, Governors, judges of Supreme and High Court.
- ❖ Pensions, annuity payments, and extreme benefits granted to workers of transportation firms, schools, hospitals, hotels, and restaurants, as well as revenue earned from owning federal securities.
- ❖ Income generated by mutual funds, venture capital firms, or investment firms.
- ❖ Income earned by vocational or technical institutes, educational universities, textbook boards, and organizations promoting games.
- ❖ Income from philanthropic organizations, nonprofit organizations, foundations, or institutions.
- ❖ Income given as a gift to certain institutions, funds, foundations, societies, boards, and trusts.
- ❖ Income generated by businesses in Export Processing Zones and Industrial Zones.
- ❖ IPPs generated income.
- ❖ Earnings from the export of IT services.

Favorable tax rates for certain groups of taxpayers are also included in the *Second Schedule*. Income from building contracts and services delivered outside of Pakistan is taxed at a lower rate

of 2.5%. A significant range of withholding taxes are levied at varying concessional rates in the case of local supply of commodities, import, distributors of cigarette, advertising agencies, re-rollers and steel melters, pharmaceutical products, and shipping industry. Certain types of dividends are also exempt from taxation. The specifics of these concessional rates are discussed further under the term withholding taxes.

Part III of the Second Schedule reduces the tax burden of some individuals or groups of individuals. The following categories, in particular, benefit from a reduction in tax liability:

- ❖ Tax reduction liability of 50% for senior citizens.
- ❖ Tax reduction liability of 75% for teachers and researchers.
- ❖ Distributors of pharmaceutical supplies, cigarettes, and fertilizers, rice mills, dealers, and wheat mills pay 80% of the minimum tax burden, while the poultry business pays 50%.

A large assortment of tax benefits further reduces the size of the income tax base. These tax breaks occur in a variety of forms:

- ❖ A tax credit for philanthropic contributions to organizations that promote sports, religion, culture, welfare, medicine, and technology. The amount of the tax credit is regulated by a formula that increases the ratio of tax liability to taxable income by a tax credit coefficient equal to the lesser of the contribution amount or 30% of taxable income for a person or AOP.
- ❖ A tax break for investing in fresh stocks (IPOs). The credit is again restricted for individuals, but not for corporations, by the product of tax obligation to taxable income and a tax credit coefficient equal to the lesser of the cost of share acquisition, 15% of taxable income, or Rs.500,000. If the shares are sold within a year of acquisition, the credit value is returned to taxable income.
- ❖ Contributions to an authorized pension fund are tax deductible. In this case, the typical formula is the product of tax obligation to taxable income plus a tax credit coefficient equal to the lesser of the premium paid or 20% of taxable income.
- ❖ A tax credit for any profit, share of rent, or share of appreciation on a residence purchased with a loan from a registered lending institution. This de facto mortgage

interest credit is again capped by the tax liability to taxable income ratio multiplied by the lesser of total interest paid, 50% of taxable income, or Rs.750, 000.

- ❖ A tax credit of 10% of the amount invested in the acquisition of plant and machinery for basic metabolic rate (BMR).
- ❖ A tax credit of 2.5 percent of the tax payable for a tax year for people registered under the Sales Tax Act of 1990 if ninety percent of sales are to sales tax registered persons.
- ❖ A tax credit of 15% of the tax due for stock exchange enlisting.
- ❖ A tax credit of 100% of the tax payable for new industrial undertakings.
- ❖ A wealthy or high-income person who can claim all of these credits in a single tax year would have no problem decreasing his or her income tax payments to zero.

5.2.1.3. Customs Duty Estimates:

Tax expenditures under the Customs Act of 1969 take different forms, including exclusions, concessions, and items subject to a certain tariff rate. Customs exemptions and concessions are roughly classified as follows:

- ❖ Raw materials not produced locally.
- ❖ Raw materials, subcomponents, components, assemblies, and sub-assemblies.
- ❖ Vehicle production or assembly.
- ❖ The equipment, machinery and plant.
- ❖ Privileges for prosperous individuals and companies.
- ❖ Concessional arrangements are available through several bilateral and regional agreements.

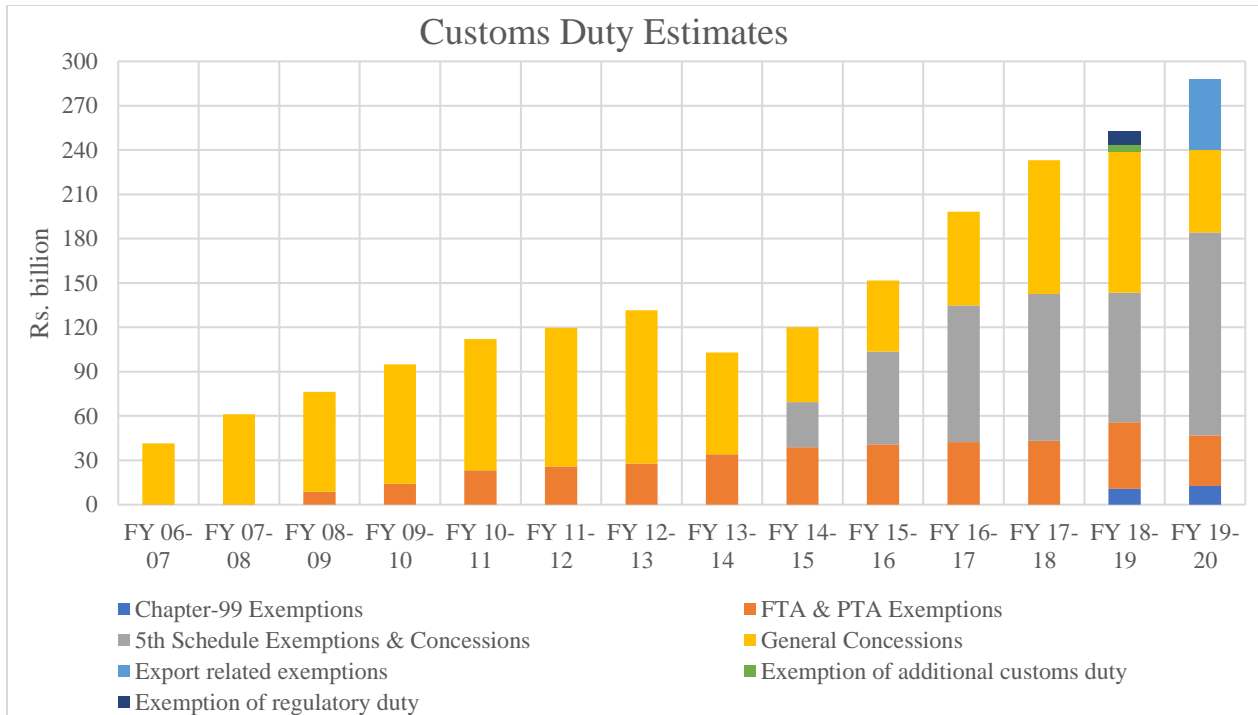


Figure 08: Authors Calculations

Concessions and exemptions are given by different SROs, special categorization in Chapter 99, and the use of unique tariff rates.

Most of the exemptions/concessions are granted by a number of significant SROs. Section 19 of the Customs Act of 1969 allows for customs tax exemptions on imports from foreign nations. These are accomplished via the use of Free Trade Agreements (FTAs) and Preferential Trade Agreements (PTAs).

SRO 280 (I)/2014 (D) and *SRO 280 (I)/2014 (Table 1 and 2)* permit a bilateral Free Trade Agreement (FTA) between Pakistan and Sri Lanka. Trade concessions totaled Rs. 2.8 billion for fiscal year 2019-20. *SRO 659 (I)/2007 (Tables 1 and 2)* and *SRO 1640 (I)/2019* exempted the Pakistan-China free trade agreement under FTA, which amounted to Rs. 24.457 billion.

SRO 567(I)/2006, dated May 6, 2006, enables certain items to be subject to a reduced duty rate. Agriculture products, poultry industry inputs, chemicals, gold, silver, pearls, precious stones, ships, aircrafts, defense stores, agriculture tractors, printing machinery, gas operating generators, audio & cinema equipment, certain types of trucks, active pharmaceutical ingredients, and packing material are all exempt from customs duty.

SRO 565 (I)/2006 dated May 6, 2006, allows for reduced duty rates on raw materials used in the manufacture of specified industrial items. 157 broad categories of such industrial items have been notified, including raw materials in the millions of rupees at concessionary rates of 5% and 10%.

Another concessionary SRO is *575(I)/2006*, dated May 6, 2006, which exempts plant and mechanical equipment and apparatus, as well as capital goods. This concessionary package includes practically all types of plant and machinery imported into Pakistan at a cost of 0-5 percent. Agriculture, plant protection, irrigation, dairy, livestock, poultry, fishing, and agro-based sector machinery and equipment are all included. This agreement also includes concessions for CNG, hospital & medical, hotel, mineral exploration, construction, power production, oil refinery, renewable energy, and navigation equipment.

SRO 655 (I)/2006 and 656(I)/2006, both dated June 22, 2006, are intended for the auto sector and provide concessionary rates for raw materials and components that are not made locally, as well as components imported in kit form for automobiles under Chapter 87.

The underlying design of SROs has a number of overlapping clauses and distortions. FBR attempted to limit the number of SROs in the year 2000, and as part of that reform effort, numerous SROs were grouped together, mostly in these three SROs. Regrettably, the work of changing the exemption rule could not be completed. Exemptions are often provided to various imported commodities based on their tariff headings; however, this system is complicated by the fact that there are hundreds of tariff heads in a single SRO and that one specific heading exists in many SROs. There is an urgent need to rationalize and simplify the general exemption scheme so that it is easily understandable, straightforward, and transparent.

Furthermore, unique categorization requirements in Chapter 99 of the Pakistan Customs Tariff identify some types of commodities for exemption. This includes items brought in by diplomats, the United Nations (UN), government agencies, export processing zones (EPZs), and philanthropic and nonprofit organizations. Under this rule, ships, spares, containers, currency notes, medical equipment, pharmaceutical raw materials, gold, and jewelry are also free from customs duty. Furthermore, some specialized sectors have been granted concessions by being

subject to a specified rate of duty rather than ad valorem, such as betel leaves, culinary oils, animal or vegetable fats, and cellular mobile phones.

5.3. Issues related to Tax Expenditures:

Tax expenditures can have a significant impact on the fairness, complexity, efficiency, and effectiveness of not only the tax system but also the wider fiscal system, because they frequently fulfill ends that might (or are) pursued through public spending.

5.3.1. Tax expenditures can compromise fairness:

Tax expenditures can be a poor way of achieving equity goals: in a progressive tax system, for example, any policy that reduces taxable income will benefit those in the highest marginal tax bracket the most and provide no benefit to those outside the tax system, which could be a reason to use tax credits (or spending measures) instead. Tax expenditures linked with lower income tax rates in Pakistan, for example, boost progressivity—but much of the gain will go to the better affluent, implying that the same equitable goals may likely be achieved at a lower cost through social spending.

5.3.2. Tax expenditures can be inefficient and poorly targeted:

Tax expenditures can cause unanticipated or undesirable distortions: for example, the present charitable donation deduction may have been reasonable when imputed income from owner-occupation was effectively taxable, but it currently encourages tax fraud.

5.3.3. Tax expenditures are vulnerable to lobbying:

It may be simpler for special interest groups to argue for tax advantages than for explicit budget assistance. Tax expenditures sometimes escape the scrutiny afforded to ordinary budget spending and may not require yearly renewal in the budgeting process—this lack of transparency may explain part of their attraction to policymakers.

Chapter 6: Conclusion and Recommendations

6.1. Conclusion:

This research intended to analyze the economic impact of tax expenditures in Pakistan. Tax expenditures are important fiscal policy tools that are used widely all over the world to achieve certain social and economic goals.

Tax expenditures are a potential revenue loss as a result of preferential treatment of tax, such as reduced tax rates and exemptions. Though worldwide assessments are confounded by varied methodology and interpretations of what constitutes a tax expenditure. Tax expenditures in Pakistan are definitely increased. Even though certain types of tax support may be justifiable, tax expenditures are frequently an inadequate means of advancing policy goals, generate biases, and avoid public scrutiny. Instead, government assistance provided through tax expenditures, particularly lower rates and exemptions, should be assessed on a regular basis in the budget process alongside normal spending. A streamlined tax structure that minimizes administrative expenses and improves compliance would be an extra advantage.

The main purpose of tax expenditures is to help individuals invest in human capital, business startups, employment generation, and industrial revival. But, in Pakistan tax expenditures do more harm than good. Taxes are essential revenue tools in developing economies that help governments to run their affairs in the best possible way. This revenue is then utilized in infrastructural development, health, education, law and order, and other functions of the state. Over the years, tax expenditures have been on rising almost one-third of this potential revenue is lost in favoring a few individuals or entities.

In Pakistan, this revenue loss in the form of tax exemptions leads to fiscal deficits which are then covered by taking loans from IMF with tough conditionalities. These conditions not only burden the poor or low-income population but puts state institutions at stake. Inflation spikes up which further deteriorates the economy of Pakistan. Furthermore, econometric estimation also shows the negative impact of tax expenditures on economic growth.

The government should rethink such policies which only benefit the few at the behest of potential taxpayers. It also leads to discrimination and distortion in the economy. A substantial number of tax exemptions is a major focus. It is vital to perform a thorough evaluation of the

indicated tax expenditures, particularly in income tax, where tax expenditure could not be computed due to a lack of data on exempt individuals, an association of persons (AOPs), and businesses. The methods utilized in this study might be used to assess tax expenditure to present a complete image of revenue lost due to concessions and exemptions provided under various pieces of legislation.

A tax expenditure limitation plan is urgently needed, and as a first step, as a part of the government's yearly budget statement, a tax expenditure report should be released. Tax spending management, of which reporting, and costing are two significant components, should be incorporated into the government's budgeting process. Tax expenditure management necessitates the creation of a system for identifying, quantifying, and critically evaluating the benefits of specific tax expenditures before they are passed. Tax expenditure analysis should be updated regularly to account for social and legal changes throughout time. The government should analyze the cost and explanation for its main tax expenditures in detail and regularly justify it on a distributional, efficient, or cost-effective basis.

6.2. Policy Recommendations

The government suffers a considerable revenue loss as a result of tax expenditures. Given the significant amount of money lost as a result of tax expenditures, it is preferable to pay special consideration to tax expenditures. Efforts to increase revenue should be adopted in the short run. The government should address tax distortions to improve transparency, accountability, and efficiency in the tax system in the long run. The following are certain long-term and short-term recommendations for the government:

i. Withdrawing sales tax exemptions:

In Pakistan, 17% GST is applied on each consumable item irrespective of the income of the consumer. Lower-income households suffer badly as they have to pay GST on the consumption of each necessary good while higher-income households do not suffer as such if there are discriminations through various exemptions and reduced rates. The latter enjoy the perks of tax exemptions which is discriminatory for the poor. Producers do not pass on the benefit of reduced taxes as compared to the pass-through for increased taxes onto the lower-income masses. Instead of giving tax concessions to the upper/privileged class, the government should lower the GST

and it should apply to each segment of the population equitably. e.g., if 17% GST is decreased to 12% for all and tax exemptions to privileged are reversed, it could benefit the economy of Pakistan more.

ii. Uniform Income tax rate:

Schedule 1 of the *Income Tax Act, 2001* provides the varying income tax rates. These are categorized by different income slabs. Annual income of Rs. 600,000 is nontaxable, while income above this threshold level is taxed at progressive rates. This discriminates the taxpayers which further leads to economic distortions, tax evasion and paying less taxes. Tax exemptions to powerful lobbies further deteriorate the tax system. Withdrawing these exemptions and applying a uniform rate of 15% on all income levels may bring fruitful results.

iii. Rationalize exemptions to charitable organizations:

There is no FBR-affiliated welfare, cultural, religious, nonprofit, charitable, or medical and technology-encouraging organizations on record. More than 2000 such groups have been registered with the Income Tax Department. They are required to be audited, although no audit has ever occurred. Most of these organizations are also commercially active. All such organizations/trusts must register in Pakistan under the *Companies Ordinance 1984*, the *Trust Act 1882*, the *Societies Registration Act 1860*, or the *Voluntary Social Welfare Organization Ordinance 1961*. The FBR can consider creating a policy in partnership with all of these agencies to keep a consolidated record of all such entities, auditing these groupings at least once every five years, and bringing commercial operations into the tax net, in the short- to long term.

iv. Income tax exemptions should be withdrawn (Second Schedule):

The Second Schedule contains far too numerous and far too generous exemptions and concessions. Income gained by exporting IT services, IPPs, decreasing minimum tax liability to pharmaceutical and cigarette distributors, and in the short run, the tax benefit (credits) for individuals who register for sales tax may be abolished.

v. Justification of pension income exemption:

Pensions are frequently taxed favorably, although not to the same extent as pensions in Pakistan. For income tax reasons, pensions are normally taxed in one of two ways. Pension payments are either non-deductible and the resultant benefits are not taxed, or pension contributions are deductible, and the benefits received are taxed. Due to the tax deferral provided by both sources, pension income is given preferential consideration over other forms of income.

vi. Withdraw SRO-based customs duty exemptions:

More than 50% of imports are either tax-exempted or subject to preferential treatment. Exemptions and concessions received by particular items in several SROs must be thoroughly investigated. High tariffs have shielded the car industry. However, car assemblers are excluded from CKD imports. The plant has been in operation for a long time, and the infant industry justification is no longer valid. The tariff system in this industry must be simplified. Tariff concessions granted under various preferential trade agreements must also be investigated. Partner nations' benefits in terms of market access for Pakistan's export products should be commensurate to Pakistan's concessions under these agreements.

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Appendix-1

Qualitative Analysis (Questionnaire)

1. What is the policy framework for tax expenditures in Pakistan?
 - i. Who decides the tax expenditures? FBR or ministries?
 - ii. Decision of amount allocation? How much? To whom?
 - iii. Decision of time frame for these exemptions?
 - iv. How FBR evaluates the performance of beneficiaries?
 - v. Objectives of these expenditures?
 - a. Is the activity to be assisted by the proposed tax expenditure high on the national agenda?
2. How much assistance are the proposed tax expenditures expected to provide?
3. Is the tax route the better way of serving the intended purpose?
4. Can it be that the intended purpose may be served better through the direct budget?
5. What kind of impact would the proposed tax expenditure have on the equity of the tax system?
6. How much cost these expenditures added to tax administration in terms of putting pressure to increase revenue from other sectors and made tax system more complex and irrational?
7. Who benefits the most from these expenditures?
8. Whether these are helpful in achieving the intended objectives or not?
9. Whether these specific expenditures are doing their best to participate positively or negatively for economic growth in Pakistan?

10. Have these tax expenditures been misused? If yes, to what extent and how?
11. Have these encouraged extravagance or waste? If yes, to what extent?
12. Have these been used as a device to evade or avoid taxes?
13. Under Constitution and PFM Act, 2019 are not legal. Why SROs based expenditures to benefit the rich and elites?
14. No trickledown effect seen. Why?
15. What public policy goal does the tax expenditure provision seek to achieve? Is there a need for government intervention at all?
16. If the tax expenditure is meant to promote more of some activity, does the activity generate any societal benefit beyond the gain to direct consumers of the good or service? If so, are the benefits sufficient to justify the cost?
17. Is it well targeted at the activity that it intends to promote and is it structured as effectively as it could be? If not, how could it be modified to make it more effective in achieving its objectives?
18. If the tax expenditure is meant to provide income support to selected beneficiaries, is there a justification for providing special assistance to the category of people receiving the tax exemption? Does it provide equal assistance to taxpayers in similar economic circumstances who meet the criteria? Is it effectively targeted to assist only the intended beneficiaries?
19. Does the tax expenditure duplicate or conflict with other tax provisions? Is it coordinated with spending programs with similar objectives? What changes can be made to avoid either wasteful duplication or incomplete coverage?
20. Are the provision's objectives best achieving by a tax expenditure or would be it be more effective and transparent to have a direct spending program instead? Is IRS the best agency to administer the provision?