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Economic Efficiency of tax Incentives and Problems of Their Application

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Abstract

Background: Tax incentives are the main practical expression of the regulatory function of tax policy, but they reduce budget revenues, and the methods for evaluating their economic efficiency remain insufficiently developed. Aim: to clarify the theoretical foundations for evaluating the economic efficiency of tax incentives, to identify problems in their application in Uzbekistan, and to develop directions for improvement. Methods: general methods of scientific inquiry were applied within the tax expenditures concept, using the Tax Code of the Republic of Uzbekistan, regulatory documents, studies of international organizations (OECD, World Bank, IMF), and local and foreign scientific publications. Results: a system of five evaluation criteria (budgetary efficiency, economic efficiency, targeting, administrative and compliance costs, and fairness and neutrality) and a set of evaluation methods were systematized. Eight main problems in the application of incentives in Uzbekistan were identified, including insufficient accounting and monitoring, the multiplicity and fragmentation of incentives, weak targeting, and the risk of abuse. Conclusions: the efficiency of tax incentives depends on how well they are justified, targeted, and regularly evaluated. Eight proposals for evaluating and improving tax incentives are put forward.



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Introduction

In a modern economy, tax policy is one of the most important instruments through which the state influences economic processes. On the one hand, taxes serve to form the state budget (the fiscal function); on the other hand, they are used to regulate and stimulate economic activity (the regulatory function). Tax incentives are the main practical expression of the second function: through them the state supports particular sectors, regions, or categories of taxpayers [1].

However, tax incentives do not always produce the expected result. When an incentive is granted, the state budget forgoes part of the revenue it could otherwise have collected. For this reason, the question of whether the economic result of a given incentive exceeds the budgetary loss remains relevant for every incentive. In international practice, the debate on the effects of tax incentives has continued for many years: some researchers regard them as a necessary instrument for attracting investment and creating jobs, whereas others see them as a factor that complicates and distorts the tax system [2].

In Uzbekistan, the economic reforms launched in 2017, including the new Tax Code in force since 1 January 2020 have been aimed at reducing the tax burden, simplifying the tax system, and improving the business environment. At the same time, the incentives granted to a number of sectors and regions have a significant effect on budget revenues, which makes the assessment of their efficiency particularly important, both scientifically and practically [3].

The issue of tax incentives has developed alongside the theory of taxation in the history of economic thought. Adam Smith's principles of taxation (equity, certainty, convenience, and economy) [2] remain a relevant yardstick for assessing a system of incentives; in particular, incentives should not contradict the certainty and fairness of the tax system [4].

R. Musgrave in his theory of public finance, distinguished the distribution, stabilization, and resource allocation functions of taxes; tax incentives belong specifically to the directions of resource reallocation and economic stimulation.

S. Surrey put forward the concept of "tax expenditures" in the 1970s. According to this concept, a tax incentive has essentially the same economic effect as a direct subsidy from the budget, except that it is delivered through the tax system [5]. Incentives should therefore be recorded, controlled, and evaluated in the same way as budget expenditures. This approach is now the main methodological foundation for the recording and reporting of tax incentives in OECD countries.

Researchers such as H. Zee, J. Stotsky, and E. Ley who studied tax incentives for business in developing countries, noted that their effect on attracting investment is often limited and that factors such as political stability, infrastructure, and the quality of institutions play the main role in investment decisions [6]. The Mirrlees Review report "Tax by Design" noted that incentives and exemptions narrow the tax base, increase complexity, and create inequality among taxpayers [7].

In the studies of local scholars, tax incentives have been examined mainly in the context of the regulatory function of tax policy, support for small business, the operation of free economic zones, and export promotion. At the same time, the quantitative evaluation of the economic efficiency of incentives and their systematic monitoring have not been sufficiently covered, which determines the relevance of this article [8].

The aim of the study is to clarify the theoretical foundations for evaluating the economic efficiency of tax incentives, to identify problems in their application, and to develop directions for improvement.

The objectives of the study are:

- to define the essence, types, and functions of tax incentives;
- to systematize the criteria and methods for evaluating the efficiency of tax incentives;
- to identify the main problems in the practice of applying incentives;
- to study international experience and develop proposals for improvement.

Methods

The study used general methods of scientific inquiry: analysis and synthesis, induction and deduction, comparative analysis, a systems approach, and logical generalization. Approaches from tax theory, public finance, and institutional economics, together with the "tax expenditures" concept, were chosen as the theoretical basis. The study is analytical and qualitative in design: it is based on the analysis of legislation, regulatory documents, and published research.

The data sources were the Tax Code of the Republic of Uzbekistan other regulatory documents, studies by international organizations (OECD, the World Bank, and the IMF) and local and foreign scientific publications.

In this study, the efficiency of a tax incentive is understood as the ratio of the economic and social effect achieved as a result of the incentive to the budget losses. Efficiency is evaluated using the following system of criteria.

First, budgetary efficiency. The balance is determined between the reduction in budget revenues resulting from the incentive (the tax expenditure) and the additional tax revenues generated owing to the incentive (through expanded activity, new jobs, and new taxpayers). If the additional revenues do not offset the losses, the incentive is considered inefficient from the budgetary standpoint, although it may still be justified by social or strategic objectives.

Second, economic efficiency. It is assessed how much the incentive has influenced the growth of investment, production, exports, employment, and labor productivity. The key question here is the counterfactual one: "Would this activity have been carried out in the absence of the incentive?" If the investor would have implemented the project without the incentive, the incentive merely creates a windfall gain and is considered inefficient.

Third, targeting. It is verified whether the incentive is actually used by the intended category of taxpayers and whether it serves its intended purpose.

Fourth, administrative and control costs. The costs of granting, recording, and controlling the incentive, as well as taxpayers' compliance costs, also affect efficiency.

Fifth, fairness and neutrality. An incentive should not distort the competitive environment and should ensure equal treatment of entities in similar circumstances.

The evaluation methods include cost-benefit analysis; the calculation of tax expenditures (the revenue forgone, outlay equivalent, and revenue gain approaches); analysis of effective tax rates; economic-mathematical modeling; and econometric analyses comparing entities that have and have not received an

incentive (for example, the "difference-in-differences" method).

Results

A tax incentive is an advantage established by legislation that allows certain categories of taxpayers to reduce their tax liability, or to be completely exempted from it, relative to the general regime. Incentives are regarded as a departure from the general rule of the tax system; for this reason, each of them must be economically justified [9].

Tax incentives can be divided into the following main forms:

- tax exemption (not taxing a particular object or operation);
- reduction of the tax rate (preferential or zero rates);
- reduction of the tax base (deductions, accelerated depreciation, and enhanced deduction of expenses);
- tax credits (a direct deduction from the calculated amount of tax);
- tax deferral or payment in installments (changing tax payment deadlines);
- special tax regimes (free economic zones, small industrial zones, and turnover tax).

The economic functions of incentives are to attract investment, stimulate innovation, create jobs, expand exports, support socially vulnerable groups, and develop lagging regions. At the same time, incentives may lead to a decline in budget revenues, a narrowing of the tax base, and a more complex tax system. Incentives therefore have a "dual" character: their positive effect appears only if they are properly designed and controlled [10].

In the Republic of Uzbekistan, tax incentives are regulated by the Tax Code and other regulatory documents. In practice, incentives are applied in several directions:

- attracting investment: profit tax and property tax incentives for projects that meet specified investment volumes and conditions;
- free economic zones and small industrial zones: tax and customs incentives for entities operating in these territories;
- small business and entrepreneurship: turnover tax and other simplified regimes, and stimulating rules for newly established entities;
- agriculture: special tax regimes and incentives for agricultural producers;
- social sphere: incentives for education, health care, persons with disabilities, and other socially important areas;
- export promotion: a zero VAT rate for export operations and other support measures.

In recent years, measures have been taken to review and reduce the system of incentives: many incentives are being abolished or more narrowly targeted, tax rates are being reduced, and the tax base is being broadened. This corresponds to the "broad base, low rate" principle of world practice. Nevertheless, the system of incentives remains rather fragmented, and a single, open, and regularly updated system for assessing their economic effect has not yet been formed [11].

The analysis identified the following problems in the application of tax incentives.

1. Insufficient accounting and monitoring of incentives. Information on how much revenue the budget

loses as a result of incentives is not published fully, transparently, and regularly. If tax expenditures are not recorded, it is difficult to assess an incentive as a state budget expenditure and to compare its efficiency.

2. Multiplicity and fragmentation of incentives. Incentives granted by various resolutions and decrees outside the Tax Code complicate the tax system, create uncertainty for taxpayers, and make control difficult. This contradicts Adam Smith's principles of certainty and convenience.

3. Lack of economic justification. Many incentives may be introduced without prior cost-benefit analysis, under lobbying influence or for temporary political purposes. As a result, incentives do not serve their purpose and merely reduce the tax burden of certain entities [12].

4. Open-ended duration and absence of review. Incentives are often granted without a specific period of validity (a sunset clause) and without a system of regular evaluation. As a result, they remain in force even when they lose their significance over time.

5. Abuse of incentives and the risk of tax planning. To gain access to a preferential regime, methods such as artificially re-registering an activity, transferring income to a preferential entity, and transfer pricing may be used. This leads to erosion of the tax base.

6. Distortion of the competitive environment. Uneven competition arises between entities that have received incentives and those that have not. Incentives may push more efficient but non-incentivized entities out of the market.

7. Weak targeting. Incentives are often used not by the neediest entities or those that would produce the greatest effect, but by large and well-established companies that are better able to obtain them.

8. Administrative complexity and staff capacity. Verifying the conditions for applying incentives requires high qualifications and reliable information systems on the part of tax authorities. Shortcomings in this area lead to the incorrect application of incentives.

3.4. International Experience

Several successful approaches to managing tax incentives exist in international practice. In most OECD countries, the tax expenditure report is prepared as an annual document together with the state budget and submitted to parliament which ensures public and legislative oversight of incentives.

A number of countries apply the principle of time-limiting incentives (a sunset clause): an incentive is automatically abolished when the set period expires, and to extend it, its economic efficiency must be evaluated and it must be justified anew. Estonia's tax system is distinguished by a minimal number of incentives and simple rules: the tax base is broad and the rates are neutral, so there is little need for separate incentives. Singapore's experience is notable for applying incentives in a clearly targeted manner (for example, to research, innovation, and strategic sectors) and conditionally (granted when specific results are achieved). Reforms to reduce incentives and to record tax expenditures are also being carried out in Kazakhstan and other CIS countries [13].

Discussion

The results show that the system of incentives in Uzbekistan is moving in the direction that international experience and the literature regard as appropriate: reducing the number of incentives, lowering rates, and broadening the tax base. However, the institutional mechanisms needed to evaluate incentives are still lacking [14].

Most of the identified problems can be explained by the absence of the tax expenditure approach. Where tax expenditures are not recorded and reported (problem 1), incentives cannot be treated as budget expenditures; this makes it impossible to compare their efficiency and hides the cost of introducing incentives without cost-benefit analysis (problem 3) and of maintaining them indefinitely (problem 4). The counterfactual criterion shows why weak targeting (problem 7) is costly: if the beneficiaries would have undertaken the activity without the incentive, the incentive generates only a windfall gain.

Fragmentation (problem 2) conflicts with Smith's principles of certainty and convenience while the distortion of competition (problem 6) and the risk of abuse (problem 5) are consistent with the Mirrlees Review's observation that incentives and exemptions narrow the tax base, increase complexity, and create inequality among taxpayers. The limited effect of incentives on investment noted by Zee et al. strengthens the argument for evaluating incentives before they are introduced: because political stability, infrastructure, and institutional quality often determine investment decisions, an incentive cannot be assumed to be effective merely because it has been granted.

Two main conclusions can be drawn from the international experience described above. First, an efficient tax system is determined not by an abundance of incentives but by a broad tax base and stable, predictable rules. Second, regardless of when and to whom incentives are granted, their regular evaluation and transparency must be ensured. These lessons underlie the proposals presented below.

Based on the results of the study, the following proposals are put forward to increase the economic efficiency of tax incentives:

1. Introduce a tax expenditure report. Publish annually, together with the state budget, a report containing the revenues lost owing to all incentives, the number of incentive users, and data by sector.
2. Create a mandatory system for evaluating incentives. Require cost-benefit analysis and regulatory impact assessment (RIA) before each new incentive is introduced.
3. Set a validity period for incentives. Introduce a specific term for incentives (usually 3–5 years) and a mechanism for extending them after the results have been evaluated.
4. Consolidate incentives in the Tax Code. Increase the certainty and transparency of the tax system by codifying in a single place the incentives contained in various regulatory documents.
5. Link incentives to results. Tie the granting of an incentive to specific indicators such as investment volume, the number of jobs created, and export volume, and introduce a mechanism for withdrawing the incentive if they are not met.
6. Target incentives. Move from general incentives to conditional incentives directed at specific sectors, regions, and types of activity.
7. Strengthen digital control systems. Prevent abuse by automating the verification of the use of incentives, applying a risk-based approach to risk analysis, and integrating databases.
8. Improve the qualifications of tax officials. Develop staff capacity in incentive evaluation, economic analysis, and control.

Proposals 1–3 respond to the lack of accounting, justification, and review (problems 1, 3, and 4); proposal 4 responds to fragmentation (problem 2); proposals 5 and 6 respond to weak targeting and the distortion of competition (problems 6 and 7); proposal 7 responds to the risk of abuse (problem 5); and

proposal 8 responds to the shortage of administrative capacity (problem 8).

This study is analytical and qualitative. It does not provide quantitative estimates of the revenue forgone owing to incentives, the number of preferential entities, or the counterfactual effect of specific incentives. Such estimates require data from the State Tax Committee and the Statistics Agency on the structure of tax revenues, the revenue lost because of incentives, and the number of beneficiaries [15]. Future research should therefore apply the cost-benefit and econometric methods described in Section 2.3 (for example, difference-in-differences) to such data.

Conclusion

The results of the study show that tax incentives can be an important tool for stimulating the economy, but their efficiency depends on how well an incentive is justified, how well it is targeted, and whether it is regularly evaluated. Because an incentive is in essence a hidden subsidy from the budget, it must, like other budget expenditures, meet the requirements of transparency, accountability, and performance.

In the practice of applying tax incentives in Uzbekistan, problems persist such as insufficient accounting and monitoring, fragmentation, open-ended duration, lack of economic justification, and the risk of abuse. To eliminate them, it is necessary to keep a tax expenditure report, make cost-benefit analysis mandatory, set validity periods for incentives, link incentives to results, and strengthen digital control. Implementing the proposed measures will make it possible to ensure the fairness and stability of the tax system, protect budget revenues, and retain the incentives that have a real impact on economic growth.

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