

Classification of tax expenditure by environmental impact

CHANNELLING PUBLIC FINANCES TOWARDS A GREEN ECONOMY

TAX EXPENDITURE BY ENVIRONMENTAL IMPACT: Tax benefits granted to economic activities that have observable or presumed impacts on environmental policy.

“As a country with clear goals to comply with the commitments under the Paris Agreement, it is critical to understand clearly: are our public finances promoting a decarbonized economy? Are our public finances consistent with our environmental policies?”

Climate Change Directorate, Ministry of Environment and Energy.

THE METHODOLOGY

Between 2020 and 2021, the Green Economy Transformation (GET) project of the German Development Cooperation (GIZ) supported the Costa Rican Government in developing a methodology for classifying tax expenditure by its environmental impact.

The methodology enables the identification of tax expenditure line-items based on a) the disaggregated analysis of the current regulatory framework, b) the application of internationally recognized statistical classification standards, and c) their incidence on six strategic environmental public policy areas. For each expenditure line-item, incidence factors are assigned per each public policy area, ultimately resulting in an overall incidence factor estimation that facilitates their qualification, i.e., positive, neutral, or negative.

It thus generates the necessary information for decision-making to align the country's fiscal policy with its environmental goals. Consequently, it is one additional tool for achieving the green tax reform, conceived as a response to the country's international environmental commitments and as a transversal axis of the National Decarbonization Plan 2018-2050.

The methodology's development was carried out jointly by the Ministry of Finance and the Ministry of Environment and Energy with the technical support of GIZ.

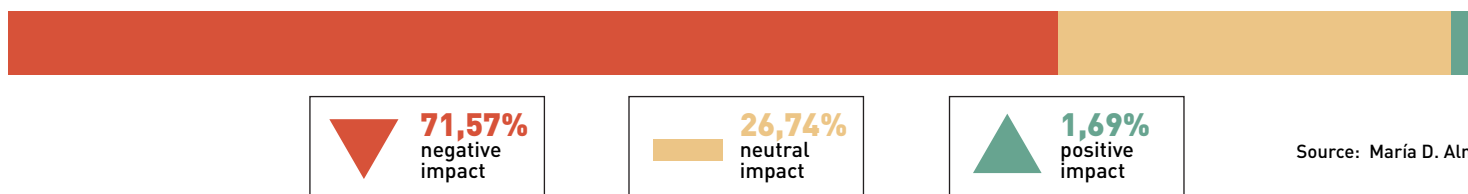
RESULTS

“This work built a bridge between the ministries of Finance and Environment. It marks a milestone for the country to address how to comply with the National Decarbonization Plan in a technical and dedicated way. From now on, we will see more upcoming processes of joint work between both entities”

**Fiscal Policy Division of the Directorate-General for Finance,
Ministry of Finance**

- The methodology for identifying the environmental impact of tax expenditure has been integrated into the Ministry of Finance's institutional framework.
- The methodological basis needed to analyze both the current tax expenditure and that which may be proposed in future bills has been institutionalized.
- Relevant information is being generated and used for decision-making based on evidence and transparency to align the country's public finances with its environmental goals.
- A new understanding has been developed between the financial and environmental authorities to allow future inter-institutional cooperation processes.

ENVIRONMENTAL IMPACT OF TAX EXPENDITURE IN COSTA RICA



Source: María D. Almeida

Note: these percentages refer to tax expenditure whose environmental impact has been identified, not overall tax expenditure

FOR MORE INFORMATION ABOUT THE DEVELOPMENT OF THE METHODOLOGY AND ITS TECHNICAL DETAILS, PLEASE CONSULT THE FOLLOWING RESOURCES:

[1. Classification of tax expenditure by environmental impact methodology](#)

[2. Methodology development process](#)

NEXT STEPS OF AN ONGOING PROCESS

The following actions are part of a roadmap to ensure continuity in the implementation of this methodology:

Ownership: to set up an inter-institutional working group to monitor and analyze new tax expenditure proposals and review previous analyses under new scientific knowledge or against new technologies.

Communication: to ensure access to information so that different public entities, the private sector, and the civil society can understand the scope of the data and utilize them per the country's international environmental goals and national policies.

Decision-making: to use the evidence to support reforms that encourage environmentally-positive tax expenditure and eliminate or scale back that with adverse environmental impact.

Just transition: to complement the environmental impact analysis with a comprehensive economic and social assessment to understand the transition actions impacts (intended and unintended) and devise the necessary compensation measures when social welfare is negatively affected.

“Decision-making is certainly a step that escapes this methodology and belongs to the political economy territory. However, just bringing this information to light and making it available for decision-making is of value in and of itself: it becomes a piece of information on which a position must be taken, and a well-founded decision must be made.”

**Secretariat of Environmental Sectoral Planning,
Ministry of Environment and Energy.**

LESSONS LEARNED

- The process for designing and applying a methodology for the classification of tax expenditure by its environmental impact requires a series of enabling conditions:
 1. Clearly defined environmental goals translated into public policies and instruments aimed at complying with environmental commitments;
 2. Robust institutions committed to the process, with existing technical capacities and a culture of transparency;
 3. The political will to align the fiscal policy with the national environmental goals.
- Technical knowledge in fiscal and environmental matters should be leveled between the participating ministries to enable them to “speak the same language” and seek solutions from a common conceptual approach.
- The environmental impact of each line-item of tax expenditure should be validated by environmental experts, both from the government and other (national or international) organizations.
- The technical teams and the authorities must be aligned so that the information generated feeds the decision-making processes.
- The environmental impact analysis of the tax expenditure and its resulting tax reform proposals should be complemented by an economic and social assessment (benefits and costs) that provides the authorities a sufficient basis to align the country's goals (economic, social, and environmental) from a just transition approach.
- The analyses should be communicated to all competent and interested stakeholders, aiming at a common understanding of the importance of the proposed reforms and how best to implement them.

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