TAX POLICY

Pierre Cliche, Visiting professor
École nationale d'administration publique
pierre.cliche@enap.ca

The term "tax policy" refers to all the decisions and main directions that determine the characteristics of a tax system and make it possible to finance public spending and support economic activity. The word tax comes from the Latin *taxare*, meaning to evaluate, estimate, assess or charge. It has eventually come to mean the process whereby the government collects from taxpayers all the funds it needs to run its operations.

As for the term "tax legislation," it refers to the legal and regulatory framework that defines the terms and conditions governing the collection of taxes, while the broader term "tax system" denotes the mix of administrative, legal, social and economic features that characterize the tax measures implemented by a government.

Purpose of tax policy

The main function served by tax policy is to determine how the funds required to finance government spending will be collected so as to ensure a stable and sufficient supply of revenues. However, there are a number of additional functions pertaining to the role to be played by the government in the economy – pertaining, namely, to economic regulation, income redistribution and resource allocation (Musgrave, 1959).

The weight of public budgets in the economy is such that governments can influence economic activity by varying taxation levels. Tax policy becomes a regulatory tool when its aim is to stimulate or slow economic activity by lowering or raising income tax and other taxes and the various contributions that affect individuals' disposable income and ultimately their consumption. Likewise, tax policy can, through tax incentives, influence resource allocation. Tax rules can encourage or discourage certain decisions by individuals and businesses and thus foster certain behaviours and financial flows. Lastly, the funds collected by a government can be redirected towards certain categories of citizens to compensate for or offset the disparities inherent in market economies. Similarly, by taking the economic situation of individual taxpayers into account, the tax system can modulate their tax burden.

Essential components of tax policy

Drawing up or adjusting a tax policy must take into account certain optimality criteria, as well as principles for deciding what public taxes will be levied and what form they will take. These criteria and principles are effectiveness, equity, simplicity and neutrality (Tremblay, 1998; Ministère de

l'Industrie, de l'Économie et de l'Emploi, 2008) and, because they occasionally conflict with one another, it takes compromise and negotiation in order to implement them.

To be effective, a tax policy must reduce the negative impact of taxes on the decisions of economic actors. Tax measures create distortions whose effects have to be mitigated. Economic studies show that certain characteristics make tax policy more effective. For example, low-rate, broad-based taxes have a more limited impact on behaviours than high-rate, narrowly based taxes. In addition, the more demand for a particular good or service is price-sensitive, the more the impact of taxes on economic activity and employment will be negative.

To be equitable, a tax system must take into account the situation of certain categories of taxpayers by ensuring that they do not have to shoulder an overly heavy tax burden. The system must involve both vertical equity – i.e., the redistribution of resources to low-income taxpayers thanks to the progressive nature of certain taxes – and horizontal equity – i.e., solidarity towards those (such as families) who have certain expenses to defray or those (such as retirees or disabled people) for whom certain risks materialize.

To be neutral, a tax system must strive to treat the activities of all economic actors in the same way. Specifically, it must seek to avoid creating distortions in production structures as the result of favouring certain actors or adding to the cumulative tax burden. The value-added tax (VAT) is the classic example of a neutral tax in that it avoids the cascade effect of a sales tax levied at each stage of production and distribution.

Lastly, to be simple, a tax system must avoid the kind of complexity that entails a cost for taxpayers and the government: where a system becomes less legible or understandable, it also becomes harder to explain and justify. A number of features can be used to measure the simplicity of a tax system, including the number of taxes applicable to a particular activity, the number of exemptions allowed, and the instability of tax legislation over time.

It is not easy to reconcile these principles and criteria, making for a situation that requires a capacity for give and take among stakeholders. While effectiveness and equity are not necessarily contradictory, they are not immediately compatible either. For example, taxing both capital and labour can prompt an exodus or drain among a society's most mobile elements, while lowering taxes on unskilled labour can stimulate employment. Similarly, the decision to prioritize effectiveness and neutrality ultimately means not using taxes for stimulus purposes or refraining from channelling scarce resources toward collectively defined priority targets.

Tax policy instruments

Tax systems use different categories of taxes, with each corresponding to an area in which the government exercises its power of financial coercion over citizens. The three main categories are direct taxes, indirect taxes and payroll taxes.

Direct taxes are tied to the creation and possession of wealth and the revenues derived from the factors of production represented by labour and capital. They are borne directly by the taxpayers (individuals and corporations) to whom they are charged. The most common types of direct taxes are income tax, corporate tax and property tax. Indirect taxes target transactions and apply to production and consumption activities. However, they are not borne directly by the individuals, manufacturers and merchants who collect them, but are rolled into the final price paid by consumers. They include, for example, value-added taxes, excise taxes and customs duties. As for payroll taxes, they are generally based on the total wage bill, are paid by employees and employers, and are designed to fund the various programs that provide replacement income in the event that certain risks materialize (e.g., work accident, disability, retirement, unemployment, etc.).

These different taxes take different forms depending on the decisions made regarding the parameters used to define them: tax base, tax rate, taxation unit and taxation period. The tax base indicates the basis or object on which the taxes are collected; for example, employment income, business income, investment income and capital gains. In each case, the tax base corresponds to the sum of taxable income and benefits. The tax rate is the proportion of the tax base that must be collected from applicable taxpayers. As a rule, it varies according to income bracket, such that the contribution expected from each taxpayer is not the same. Tax unit refers to the taxpayer concerned. In the case of income tax, for instance, it is generally a natural person or an individual, although it can sometimes be a household or a dependant. In the case of corporate tax, it is the legal entity that has its own personality as well as the authority to make commitments and fulfil obligations. As for the taxation period, it is the calendar year for individuals and the fiscal year for corporations. That said, corporations can carry such things as losses and credits over from one year to the next.

However, there is another tool that governments may use to achieve their fiscal objectives – namely, tax expenditures (ministère des Finances, 2003; Godbout, 2006). Briefly, these expenditures are measures (e.g., exemptions, deductions, rebates, deferrals and credits) that reduce revenues and thus constitute a cost. They are designed to influence certain behaviours or activities and to help certain categories of taxpayers in specific situations. They are thus preferential or discretionary measures that modify the basic tax system and enable governments to reach specific goals. Consequently, they can have a positive or negative effect on the neutrality, equity and simplicity of a tax system.

Tax policy challenges

Tax policies change as their environment changes. They must constantly adapt to new internal or external conditions and the constraints these conditions impose (OECD, 2004). And, in today's world, these policies must adapt rapidly if they are to meet their financial and economic objectives.

Globalization has been accompanied by increased mobility of capital and skilled labour. Multinationals undergo reengineering and engage in offshoring, concentrating certain activities in countries where they were previously little present if at all. While manufacturers are increasingly in search of cheap labour, financial flows between subsidiaries are often dependent as well on the location of intangible assets (e.g., trademarks and patents), a factor in turn largely dependent on the presence of a favourable tax environment. Research and development activities are also affected by taxation and, albeit to a lesser extent than before, the availability of skilled labour on the local market.

Therefore, countries engage in tax competition in an effort to curtail the trend toward offshoring and to re-build the capacity to attract new investment. This competition has had a direct impact not only on emerging countries but also on their industrialized neighbours. When location factors (e.g., productivity and cost of labour, accessibility of outlet markets, legal security, etc.) are very similar, tax levels can make the difference, with the result that countries adjust their tax rules in regard to capital and labour.

Furthermore, high tax rates are likely to erode tax bases and thus reduce revenues. As tax pressure rises, so does tax avoidance behaviour. Such avoidance comes in two forms: tax evasion and fraud. In the first case, citizens obtain, for example, non-taxable benefits (e.g., travel, insurance, equipment, hours worked, etc.) quite legally, while in the second, they illegally avoid paying taxes, particularly by underreporting their income or falsifying financial documents.

Taxation authorities are struggling to adapt to the current electronic era of lightning speed transactions, many of which occur cross-border. How can they ensure that online transactions obey

the same tax rules as traditional commercial transactions? How can they recover funds payable by businesses that have no legal existence in creditor countries? And lastly, how can they avoid hampering the development of e-commerce and yet remain neutral toward traditional competitors? Today's new transaction methods pose formidable challenges to taxation authorities, if only because of the way they allow traditional tax registration to be circumvented.

Population ageing is another factor that tax policy must take into account, since existing social protection programs depend largely on contributions by employees and employers. In the coming decades, the non-working population (unemployed people and retirees) will exceed the working population (people who pay taxes), which may lead to a review of the way these programs are funded. This could in turn make the cost of labour exorbitant and affect not only job creation but also the level of economic activity.

Current tax policy trends

In an effort to adapt to the changing environment, the governments of industrialized countries have made major adjustments to their tax policies since the end of the last century. Even though the pace and objectives these adjustments are not always the same, some common trends have emerged and have been steadily taking root (OECD, 2004; European Commission, 2000).

A first example of these changes is the decrease in taxes on mobile factors of production. Capital and skilled labour are treated in such a way as to protect countries' comparative economic advantages. As a result, corporations have witnessed a decrease in tax rates and an increase in various exemptions and deductions (e.g., accelerated depreciation, interest deductions, capital gains and dividend exemptions, deficit carry-over, etc.). As for individuals, they have seen their disposable income rise as a result of measures like the lowering of high-income thresholds and tax rates or the granting of deductions (e.g., higher pension plan contribution ceilings, investment expenses and eligible investment losses, etc.).

Another example is the development of consumption taxes. On the whole, economic studies have shown that consumption taxes and fees for public services are less damaging for the economy than income tax or production taxes. Tax bases should be defined on the basis of real consumer spending rather than theoretical spending capacity, for such an approach is thought to encourage savings and investment. Therefore, a growing number of governments have been imposing general consumption taxes and, in particular, taxes on added value, which follows dynamic flows in circuits of production and distribution.

A third example is the emergence of environmental and behavioural taxes. There is a growing trend toward “ecotaxation” or “green taxation,” as shown by the introduction of carbon taxes, fossil fuel taxes and royalties on wastewater treatment and drinking water, or the granting of tax deductions for the use of public transit. This is also illustrated by the adoption of certain taxes aimed at preventing risky behaviour with a view to promoting public health – for instance, taxes on tobacco and alcohol or so-called nutritional taxes on products that can make people obese if eaten in overly large quantities (e.g., sweet drinks, sweet or salty snacks, etc.).

A fourth example is the reduction of multiple taxation. Cumulative taxes can lead to high tax rates. For instance, charging payroll taxes on top of corporate tax along with capital income tax imposes a heavy tax burden on businesses. Similarly, requiring individuals to pay wealth taxes or gift taxes and estate duties amounts to taxing the same income several times over. In this regard, a number of tax reforms in OECD countries in recent years have been aimed at limiting or eliminating multiple taxation.

Taxation is closely tied to national sovereignty, for if a government is deprived of financial resources it can no longer implement its policies. Taxation is also an economic regulation tool that

can influence consumption, enhance saving or influence the form of business organization adopted by companies. Tax policy is thus of great importance for all governments.

In the realm of taxation, the art of governing consists in not crossing the psychological limit for the tax burden that taxpayers are prepared to bear, while also ensuring a degree of equity among the different categories of taxpayers (Cliche, 2009). Resistance to taxes is universal. Usually, older taxes are contested less than more recent ones of the same type because they have been adjusted over time. However, the most readily accepted taxes are those that are least visible. Tax evasion and fraud are fairly common, but they tend to increase when tax rates rise, such that higher tax rates do not generate a proportional increase in tax revenues. All in all, tax systems that have gradually been put in place seem complex because of all the tax breaks and exemptions incorporated into them and that ultimately amount to tax expenditures because they deprive the government of revenue. On the other hand, it is this complexity that may, paradoxically, be one of the features that makes a tax system acceptable, because it provides many citizens with what they perceive as a personal benefit or compensation tailored at least in part to their specific situation.

Bibliography

Cliche, P. (2009). *Gestion budgétaire et dépenses publiques : description comparée des processus, évolutions et enjeux budgétaires du Québec*, Québec, Presses de l'Université du Québec.

European Commission (2000). *Tax policy in the European Union*, http://ec.europa.eu/publications/booklets/move/17/txt_en.pdf (last retrieved in May 2010).

Godbout, L. (2006). *L'intervention gouvernementale par la politique fiscale : le rôle des dépenses fiscales*, Paris, Economica.

Ministère de l'Industrie, de l'Économie et de l'Emploi (2008). *Document d'orientations sur les évolutions de la politique fiscale*, www.minefe.gouv.fr/directions_services/sircom/impot_fiscalite/080724_rgpo.pdf (last retrieved in May 2010).

Ministère des Finances (2003). *Dépenses fiscales*, Québec, Gouvernement du Québec.

Musgrave, R. A. (1959). *The Theory of Public Finance: A Study in Public Economy*, New York, McGraw-Hill.

OECD (2004). *Recent Tax Policy Trends and Reforms in OECD Countries*, Paris, OCDE.

Online Etymology Dictionary. www.etymonline.com/index.php?l=t&p=5 (last retrieved in August 2011).

Tremblay, P. (1998). *La politique fiscale à la recherche du compromis*, Québec City, Presses de l'Université du Québec.

REPRODUCTION Reproduction in whole or part of the definitions contained in the *Encyclopedic Dictionary of Public Administration* is authorized, provided the source is acknowledged.

HOW TO CITE Cliche, P. (2012). "Tax Policy," in L. Côté and J.-F. Savard (eds.), *Encyclopedic Dictionary of Public Administration*, [online], www.dictionnaire.enap.ca

INFORMATION For further information, please visit www.dictionnaire.enap.ca

LEGAL DEPOSIT Library and Archives Canada, 2012 | ISBN 978-2-923008-70-7 (Online)