4

Tax Policy Analysis: Concepts and Critiques

This section reviews key concepts that guide tax policy analysis. As stated previously, tax policy is at the heart of the political debate as to the level of public services that should be provided and who should pay for them. To engage in this debate from the perspective of gender equality in taxation, it is important to understand the concepts that are used, as well their limitations.

Tax policy analysis seeks to identify the impact of tax policy options on individuals, households, businesses, and economic growth and development, so that government decision-makers and the public can make informed policy decisions. Gender analysis of tax policy seeks to identify the differential impact on women and men of tax alternatives, to the extent that their social and economic roles and responsibilities are different, in order to ensure gender equity. In developing countries, most people – and especially most women – are poor, so the analysis of both income and gender equity is central to tax policy analysis.

4.1 The Behavioural Response to Taxation

The most basic concept in tax policy on which there is general agreement is that there is a behavioural response by individuals and businesses to changes in income and changes in relative prices. Taxation, with very few exceptions, alters both disposable income and the relative prices of both inputs to production and consumer goods, and thus affects a wide range of socio-economic decisions.[14] For example, decisions by men and women about the time they spend in formal, informal and unpaid work are influenced by the impact of taxation on wages and disposable income. Decisions about savings, consumption and investment are also affected by taxes.

The direction of the behavioural change depends on many factors and is open to debate, but there is agreement that behavioural responses must be carefully evaluated if tax policy is to attain the desired goal – whether in expected revenue or in the desired impact on targeted groups or activities[15] – with minimal unintended consequences.

Unintended consequences of tax policy are difficult to anticipate but must be considered. An example of unintended consequences from a revenue-raising measure used in India – although it was not a tax – is shown in the following box.

In developed countries with sophisticated data systems, revenue and impact analysis is performed by governments and academics according to various socio-economic and demographic characteristics, such as income class, ethnic group, geographical area, household type (married or single) and business sector/size. Attention to tax impacts by gender has begun only recently.

Box 4.1: Example of Unintended Consequences – Alcohol Licence Fees as a Source of Revenue in India

India inherited from the British a revenue mechanism entailing the auction of licences to sell alcohol. In the 1980s, in the state of Andhra Pradesh, a populist regime came to power with promises of '2 rupees a kg. of rice' to be funded by revenue from the auction of alcohol licences. This coincided with a shift in the type of alcohol sold from higher end and more expensive liquor to a cheaper drink, arrak, also called 'the drink of the poor'.

To increase revenue from alcohol licences, the state government actively promoted the extension of licensing and the distribution of arrak throughout the state, and revenues from liquor licences increased by over 400 per cent in five years. The pervasive increased consumption of arrak, especially among poor men, increased rates of alcoholism and had a negative impact on household budgets and on family and social life in communities, including a rise in domestic violence.

In 1992, a group of women in Andhra Pradesh joined together to demand a ban on arrak sales in their village. The anti-arrak campaign soon spread to other districts and across the entire state, and the state government was forced to concede to the demand for prohibition. However, due to the need for revenues, and the absence of other tax mechanisms, state governments eventually reintroduced the alcohol licences.

Note: The Andhra Pradesh anti-arrak campaign is documented in the film *When Women Unite: The Story of an Uprising* by Nata Duvvury and Shabnam Virmani.

The following sections discuss three public finance concepts used in tax policy analysis: equity, efficiency and ease of administration. The first two, as discussed below, depend on underlying assumptions and normative values and there is no unanimity regarding their practical application, but they are important terms in tax analysis.

4.2 Equity

Equity in taxation expresses the idea that taxes should be 'fair', and is a concept used in all tax policy analysis. However, it should be noted that equity/fairness is a normative, value-based, concept and its interpretation differs across individuals, countries, cultures and time. Since it depends on one's particular perspective, as well as the specific circumstances being considered, the concept is difficult to apply in practice.

Tax equity is commonly discussed according to four definitions of 'fairness'. These definitions are also normative, and sometimes conflict, so they too are difficult to apply in practice. However, they are a common reference point for discussion.

Horizontal equity posits that taxpayers who are equally economically situated should be treated equally for tax purposes. *Vertical equity* posits that taxpayers who are *not* identical from an economic standpoint, but are differently situated, should be treated differently for tax purposes.

The limits in application of these principles are seen in the following examples:

Horizontal Equity: Two households both earning 60,000 rupees per month would be considered to be the same for tax purposes. But if one household earns this income through the labour of one wage earner and the other from two wage earners, are they 'the same'?

Vertical Equity: Of two individuals with an income of 50,000 pesos, one saves part of her income for retirement, while the other spends all of her income on consumption. The former will pay more taxes as she earns interest on her savings, while the latter may consume more government services since she is without private retirement savings. Is this 'fair'?

One measure for evaluating equity or fairness is the *ability-to-pay* principle, whereby those with a higher income should bear a larger share of the tax burden than those with a lower income. An alternative measure commonly used for user charges and local taxation is that of *benefits-received*, according to which it is fair to assess taxpayers in proportion to the benefits they receive from public services. From this perspective, those receiving the same benefits should pay the same, and those receiving higher or lower levels of benefits should pay more or less.

The limits of usefulness of these two principles in tax policy practice are seen in the following question: What is a 'fair' tax policy if a poor person, or an entire poor population, needs a great deal of public benefits yet has no ability to pay? The most commonly accepted idea of fairness in taxation is that taxes should be *progressive* – those with lower incomes should bear a lower share of the tax burden than those with higher incomes. But again the problem is in the application: what is the measure of who has a 'lower' income, and relative to whom? And how much less should they pay?

Progressive taxes are designed so that those with a lower income pay a lower percentage of their income in taxes than those with a higher income. Taxes that take a greater proportion of income from the poor than from the rich are said to be *regressive*. Income taxes can be made progressive by a structure of increasing marginal tax rates applied to higher brackets of income and/or through allowable credits and deductions and no-tax thresholds, which reduce the tax burdens of the poor. Consumption taxes are generally regressive, since the poor spend more of their income on consumption than the rich. Consumption taxes can be made less regressive through targeted exemptions, or lower rates for goods purchased primarily by the poor, and/or through special taxes or higher rates on luxury consumption items purchased mostly by the rich.

Gender equity in tax policy can be examined from several perspectives. First, according to the principles of horizontal and vertical equity, to the extent that women as a group or on average are situated similarly to men in terms of economic roles, behaviour or income, they should be treated similarly by the tax system; to the extent that they are situated differently, they should be treated differently. It is important to recognise that since gender interacts with race, ethnicity and geography, the concept of horizontal gender equity should be further extended along these lines. Secondly, since the vast majority of women in the developing world are poor, tax policies that address vertical equity and ability to pay will also improve tax equity for most women.

4.3 Efficiency

Taxes cost individuals and businesses through the loss of income which is transferred to government. If the income is 'recouped' by the same individual/business through public services, there is no net cost to the individual.

However, neo-classical public finance theory holds that, with the exception of lump-sum taxes, taxation imposes an 'efficiency cost' on society because individuals and businesses change what would otherwise have been 'optimal decisions' about labour, investment and production, and this deviation from optimality results in reduced overall economic output and growth. According to this theory, when taxes reduce social welfare – whether directly or indirectly – by more than the amount of revenues they produce, they are considered to be 'inefficient'. The loss to society constitutes a 'deadweight loss', also referred to as the 'excess burden' of taxation. Thus, good tax policy should produce the desired revenue and/or social goals of redistribution, environmental protection, etc., while minimising distortions to the economic decisions of individuals and businesses, and therefore minimising the cost to society.

It goes without saying that everyone wants the maximum social welfare possible – but again, the problem is in the application. Who defines social welfare? What is included in this concept? How is it measured?

The neo-classical calculation of efficiency assumes that there is a social welfare function that can be used as a benchmark for optimal output and production, against which the degree of inefficiency caused by taxation can be measured. Both mainstream and feminist economists have critiqued various aspects of this social welfare function:

- The underlying assumption that individual utility can be measured, compared and summed for society;
- The assumption that non-market time is leisure;
- The omission of non-market and reproductive activities with social value, in which women are heavily engaged;

- The omission of economic and productive value from public services;
- The omission of the possibility that taxation, through its redistributive mechanisms or through the public services it supports, can improve social and gender equity.

Feminist economists have especially criticised the neo-classical notion of efficiency. Diane Elson (1999), for instance, argues that efficiency is too often conceptualised and measured in ways that focus only on market-oriented production and ignore unpaid processes of social reproduction. This notion of efficiency can lead to policy actions which simply shift costs from the paid (public and private) economy to the unpaid economy of the household and community, with no genuine increase in efficiency in the sense of attaining maximum social welfare.

Taxation may also cause unrecognised economic inefficiencies if differential gender impacts are not included in the analysis. To the extent that women's economic roles place them in different positions than men, the impact of taxation on relative prices will be different for women than for men, and their decisions regarding labour supply, consumption, production and investment will be differently impacted. Specific examples of this are discussed in Section 5.

4.4 Ease of Tax Administration

The third 'E' of tax policy, in addition to equity and efficiency, is that taxation should be easy to administer. Administration of a tax system must be funded from public revenue, reducing the amount of revenue available for other public services. In developed countries, the cost of collecting taxes has been estimated at 1 per cent of tax revenues, and in developing counties at possibly twice this. There may also be compliance costs to taxpayers in time and effort. To reduce the overall cost, the structure of the tax system should take into account the conditions of the country and its ability to administer and enforce the tax code. For many developing countries with conditions of low literacy, poor infrastructure and a weak civil service, consideration of the ease of administration is a particularly important factor in the design of tax policy.

4.5 The So-called 'Efficiency/Equity Trade-off'

Traditional public finance theory suggests that practitioners and policymakers should design taxes to raise needed revenues while addressing equity concerns and minimising economic inefficiency. Since equity and efficiency are in themselves normative principles, and often require a normative decision to determine the primacy of one over the other, the 'trade-off' between the two is a political decision to be decided by public debate.

This so-called trade-off between equity and efficiency is at the heart of many fiscal policy discussions. First, there is disagreement about the definitions of equity and

efficiency. Second, there is disagreement about the size or very existence of the trade-off. In the economic growth literature, an emerging body of work suggests that inequality in the distribution of income and assets constrains economic growth and that a wider array of efficiency-enhancing redistributions exist in the policymakers' tool-box than have been recognised (Bardhan, Bowles and Gintis, 1998; Bénabou, 1996). Third, what is the relative value of a decrease in equity compared to a decrease in efficiency, and can this be determined?

Public finance theory may suggest that tax policy analysis should be guided by basic principles of equity and efficiency, but each country must determine through its political processes and within its own social and economic context how it defines these terms and their relative priority. And regardless of the answers, each country faces difficult tax policy decisions in seeking to raise revenues to support public services. The government can reduce the amount of targeted revenue in order to keep the tax burden low, but this in turn reduces the level and quality of public services that can be provided. An alternative is to collect the needed revenues by imposing a higher burden on wealthier taxpayers and/or on businesses, but this risks political opposition or the loss of the high-income tax base due to relocation, especially in conditions of liberalised open markets. A third alternative is to increase tax rates on all taxpayers, including those with low income, but this leads to an increased burden on the poor.

The role of good tax policy is to make sure that political decision-makers and the public have full information about these crucial decisions, so that they can be made in a democratic and transparent manner.