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**The Definition of a Tax and the Treatment of Government Permits and Licenses**

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## The Definition of a Tax and the Treatment of Government Permits and Licenses

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### A. Introduction

1. The treatment of amounts paid for government permits and licences<sup>2</sup> in the SNA has been troublesome. There is no clear dividing line between treating the cost of a permit as the imposition of a tax or the sale of a service. Since the publication of the 1993 SNA, it has been suggested that the sale of a permit might also represent the sale of an asset or the permit itself might be an asset.<sup>3</sup>
2. It is asserted in this paper that much of the uncertainty about the treatment of permits results from a lack of clarity about the definition of a tax. This paper first reviews the definition of a tax and suggests improvements for the revised SNA. It then applies the improved definition of a tax to permits.

### B. Types of Definitions

3. Concepts can be defined by two general methods. First, a concept can be defined by listing a unique set of characteristics that identify the concept. Second, a concept can be defined by enumeration. With enumeration, the definition consists of a list of actual items. Any item on the list matches the concept; any item not on the list does not match the concept.
4. The current definition of a tax in the SNA is a mixture of the two general types. According to paragraph 7.48, “taxes are compulsory, unrequited payments, in cash or in kind, made by institutional units to government units.” This appears to be the first type of definition because three characteristics of taxes are listed: they are compulsory, they are unrequited, and they are received by government units. There exist, however, compulsory, unrequited payments to government units that are not taxes. Most important are social security contributions, but administrative fines and court judgments also qualify. The three characteristics included in the definition, therefore, are not sufficient to define a tax. The SNA definition is completed by enumerating the compulsory, unrequited payments to government units that are taxes. Unfortunately, this list is given partly in chapter 7 (taxes on production and on imports), partly in chapter 8 (current taxes on income, wealth, etc.), and partly in chapter 10 (capital taxes).
5. Conversations leading to the publication of *Government Finance Statistics Manual 2001* did not reveal additional characteristics that could be cited to distinguish taxes from other compulsory, unrequited payments to government units. ***The current definition of a tax should be retained, but the text immediately following the definition should state that not all compulsory,***

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<sup>2</sup> Permits and Licenses are considered interchangeable terms. Permits will be used hereafter.

<sup>3</sup> *ESA95 Manual on government deficit and debt* has a useful discussion (pages 159 to 176) of these and all other types of transactions analyzed in this paper. This manual is not an official interpretation of the SNA, but is intended to be consistent with the SNA.

*unrequited payments to government units are taxes. The text should then continue with both a list of the transactions that are not taxes and a complete classification of all taxes.*

### **C. Format of the Definition of a Tax**

6. The conclusion that the definition of a tax needs additional text to make its intended meaning clear is not unusual. The definition of an economic asset is provided in paragraph 10.2 of the SNA, but the following ten paragraphs provide additional information needed to interpret the definition. It is clear from the format of the presentation that the following paragraphs are an integral part of the definition of an economic asset. The same approach should be used in the revised SNA for the definition of a tax. ***The definition of a tax should be followed by several paragraphs elaborating on its interpretation in a way that makes it clear that the following paragraphs are an integral part of the formal definition.***

7. The observations recommended in section B would form the first of the explanatory paragraphs. The explanations currently in the SNA regarding the meaning of unrequited (paragraph 7.48) and the difference between the treatment of a permit as a tax or a service (paragraph 7.55) should also be retained, expanded, and placed directly after the definition. Additional information about the meaning of compulsory and unrequited should also be added (see sections D and E below).

### **D. Taxes as Compulsory Payments**

8. Most taxes can be described by a conditional statement with the following format: If event A happens, then an institutional unit must make a payment—the tax—to a government unit. Once the event A happens, the payment of a tax is compulsory. Conversely, if event A does not happen, the tax is not compulsory. The conditional nature of taxes implies there is some degree of choice on the part of the potential taxpayer whenever the taxpayer can control the occurrence or non-occurrence of event A.

9. Some taxes are effectively unavoidable, such as income, VAT, general sales, and property taxes. There is little analytical power gained by saying that if income is earned, then income tax must be paid. One simply speaks of the amount of income tax that will be paid. Even with income taxes, however, there is a degree of discretion as one can usually structure the type of income earned or choose to have more leisure and less income to reduce taxes.

10. Other taxes are more clearly avoidable if the potential taxpayer is willing to avoid the event that triggers the tax. For example, there may be a large excise tax on sales of private automobiles. A consumer decides whether to purchase an automobile based on the price including the excise tax, but any purchase is made with the knowledge that the government will receive the tax. Total sales are undoubtedly reduced by the existence of the tax, because some consumers choose not to purchase and thereby avoid the tax. Implicitly such consumers are deciding that the automobile does not provide sufficient utility to cover the cost of the tax.

11. Thus, there are two legitimate views of taxes. The government observes that certain events have taken place and, as a result of those events, certain taxes are compulsory. Taxpayers, on the other hand, are constantly deciding whether they wish to engage in certain actions knowing that taxes will be obligatory if they do engage in them. Before the event, they clearly have a choice between engaging in the event and paying a tax or avoiding the event and not paying a tax. In that sense, taxes are not compulsory.

**12. The definition of a tax should be stated as a compulsory payment. The explanatory paragraphs immediately following the formal definition should indicate that almost all taxes can be described as conditional events. They are compulsory only after an event that is not compulsory occurs. As such, it is quite possible to view a tax as voluntary without denying its compulsory nature.**

13. Payments for permits have the same conditionality as taxes. If a unit chooses to engage in a certain type of activity, then the purchase of a permit is compulsory. The unit has a choice, however, of engaging or not engaging in the activity. From the viewpoint of the potential purchaser of a permit, the purchase is voluntary. From the viewpoint of the government, the purchase is compulsory.

14. There is a slight difference between permits and other potential taxes in that if the taxpayer chooses to engage in the specified activity, then the payment must be made in advance of the event triggering the compulsory payment. Thus, the conditional statement is modified to: If one decides to engage in an activity, then a payment is compulsory before the activity can begin. Taxes other than from the sale of permits are compulsory only after the event has taken place.

15. Because a permit must be purchased in advance of the activity, it is clearer that the action is voluntary and that the permit will not be purchased unless the permission received is more valuable than the cost of the permit.<sup>4</sup> Thus, it appears as if the purchaser is acquiring something of value, the right to engage in the activity. In fact, however, the analysis is no different with ordinary taxes. A consumer will purchase an automobile only if the utility expected from ownership is sufficient to cover the excise tax as well as the price of the automobile itself. By paying the excise tax, the consumer is acquiring the right to the utility provided by the automobile. By purchasing the permit, the purchaser can engage in an activity that provides sufficient income or utility to be attractive when compared with the returns expected from other types of activity.

16. The importance of this distinction between the voluntary and compulsory aspects of taxes is important for the treatment of permits.

- A payment that clearly is voluntary from the viewpoint of the potential paying unit can be a tax.
- The establishment of a tax rate on the basis of how much taxpayers are willing to pay voluntarily does not prevent the payments from being a tax. It is quite sensible for a government to set the price of a permit to maximize the revenue it expects to receive.
- When setting the cost of a permit to maximize revenue, the government can use a market device, such as an auction, without preventing the permit from being treated as a tax.

**17. The explanatory paragraphs immediately following the formal definition of a tax should indicate that the amounts paid for permits can be taxes and that the amount for each permit can be set using market forces, including auctions.**

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<sup>4</sup> The value of the permission is not the same as the value of a more typical investment because the purchaser will not receive future income with a present value equal to or greater than the cost of the permit. It is more likely that the purchaser's income will be reduced by the cost of the permit but will still be sufficiently high to induce the purchaser to engage in the permitted activity.

## E. Taxes as Unrequited Payments

18. Paragraph 7.48 of the SNA includes the following statement about the general interpretation of taxes as unrequited payments: “They are described as unrequited because the government provides nothing in return to the individual unit making the payment, although governments may use the funds raised in taxes to provide goods or services to other units, either individually or collectively, or to the community as a whole.” ***This statement should be retained, possibly with some editing to improve its understanding.***

19. The optional aspect of taxes discussed in section D suggests that in some cases institutional units voluntarily engage in an event or activity because they perceive they will receive something in value that is greater than the amount that must be paid to the government because of that event or activity. Thus, it is possible to view the unit in question as receiving something of value in exchange for the payment to the government. Such an interpretation is especially likely with purchases of permits. With events other than the purchase of a permit, the most frequent circumstance will be two private units engaging in a transaction and the government imposing a compulsory payment as a result. The unit making the payment gains something of value from the other private unit but must share its gain with the government. With the purchase of a permit, there is no second private unit. The item of value gained is the permission granted by the government.<sup>5</sup> It is this aspect of permits that raises questions about the meaning of unrequited in the definition of a tax.

20. Despite the fact that the purchaser of a permit is gaining something with an expected value greater than the cost of the permit, it does not follow that the purchase is required. The purchase of a permit does not increase the purchaser’s expected future income relative to being able to engage in the same activity without a permit. In other words, if permits were not required, the purchaser would have a certain stream of expected income from engaging in the activity regulated by the permit. If the government were to give the permit to the prospective purchaser without a fee and the stream of expected future income does not change, then the unit receiving the permit did not receive anything of value. Purchasing the permit, therefore, is an unrequited transaction and the amount paid should be treated as a tax. In this case, the power to require the purchase of a permit is just one aspect of the power to tax. Amounts charged for permits that do not convey anything else of value are taxes.

21. An alternative way to view permits is to consider what would happen if the government were to engage in the activity permitted by the permit. What assets would it need to sustain its production process? Giving itself a permit would not change its production capacity or its expected future income; hence the permit adds no value.

22. ***There is a need for guidance in the SNA on how to determine if the purchase of a permit is a requited or unrequited transaction. Emphasis should be added to indicate that the receipt of permission to engage in an activity does not make a transaction requited.***

## F. Permits as Assets or Acquisitions of Assets

23. There is no guidance in the SNA on the purchase of an asset in connection with a permit, but there is guidance on leases of non-financial assets. Leases are applicable to permits that grant the use of a government-owned non-financial asset. It is unlikely that the sale of a permit would

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<sup>5</sup> It is assumed for this section that the permit only gives the purchaser the permission to engage in an activity and does not provide a service or the use of an asset to the purchaser.

also convey the legal and economic title to a non-financial asset, such as a fixed asset, inventories, a valuable, land, or another natural resource. In the unlikely case that such an asset is received together with the permit, the transaction should be recorded as the purchase of the relevant type of an asset. The permit is the legal document providing evidence of the transfer of ownership; by itself it is not an asset. If the amount paid for the permit is more than the value of the asset received, then the transaction should be partitioned and a separate determination is necessary to classify the remainder of the payment.

24. The purchaser of the permit might receive the use of an asset on the government's balance sheet by means of a lease. Such a lease typically refers to land and other natural resources, but it could refer to virtually any type of non-financial asset. All leases of government-owned assets should be treated according to the general rules adopted for leases. At present, it appears that all leases of non-financial assets will be treated as operating or financial leases. Operating leases of produced assets will be treated as rentals of those assets. The amounts payable under the lease will be classified as intermediate or final consumption by the purchaser of the permit. The amounts payable under operating leases of non-produced assets will be treated as rent, a type of property income.<sup>6</sup> If the lease is treated as a financial lease, then the purchaser of the permit is treated as acquiring the asset. In all cases, the permit itself is not an asset.

25. If the payment for a permit classified as a tax is paid for entirely at the beginning of its validity period and the permit is valid for more than one accounting period, then some portion of the initial payment will be applicable to later accounting periods. Normal accrual principles apply to this situation. The portion applicable to the current period should be recorded as a tax and the remainder as a financial asset for the purchaser of the permit and a liability for the government. Flexibility in practical implementation should be permitted. If a permit is valid for two years and roughly half of the permit holders purchase the permit each year, a reasonable simplification would be to treat all payments for the permits as taxes in the year received. If a financial asset and liability are recorded, it might be appropriate to impute interest on them. On the other hand, the amounts might be so small that the results would not be worth the effort.

26. Some permits treated as taxes might be tradable or the permit holder might be able to sell the unexpired portion back to the issuing government. Such permits clearly have a market value and are assets. If purchases of those permits are treated as taxes, then the secondary sale of the permit would be a negative tax for the seller and a positive tax for the purchaser.<sup>7</sup> If the permit is sold back to the government, the payment received should be treated as a tax refund.

27. Some permits treated as taxes might be valid in perpetuity. For example, a license to operate a taxi might be valid forever. There is no clear method for allocating the amount paid for these permits. The payment could be allocated over a plausible life span of the permit assuming that technology will eventually make it obsolete, or it could be treated as a tax in the year received.

28. "Leases and other transferable contracts" is one category in the SNA classification of assets. This provision has been interpreted as implying that a government permit could itself be an intangible non-produced asset representing the right to engage in an activity. It was concluded above that payments for permits that only grant the right to engage in an activity are taxes. It is proposed in the *ESA95 Manual on government deficit and debt* that if the permission is given

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<sup>6</sup> Leases of non-produced assets are not currently classified as operating or financial leases. It is assumed here that in the revised SNA, these or equivalent terms will be applied to such leases.

<sup>7</sup> This treatment would apply only to the portion treated as a tax in the current period. The portion treated as a financial asset would be the sale of that asset.

to only one unit or to a restricted number of units, then the exclusion of other units may give rise to an intangible non-produced asset.<sup>8</sup> The rationale for this decision is not clear. It is true that by restricting the permits sold to a number less than would be sold otherwise, the amount of value received by each purchaser is increased. But this increase in value is produced by creating a monopolistic market. The same analysis as in section E is valid in this situation. Once the monopoly is created by restricting entry, the permit does not provide any additional value; it merely determines who receives the monopoly profits created by the restricted entry. ***All permits that only grant permission to engage in an activity should be treated as taxes, even if the number of permits is restricted to create a monopolistic market.***

## G. Permits as Sales of Services

29. The discussion in section E about taxes as unrequited payments did not analyze the distinction between treating the payment for a permit as a tax or as the purchase of a service. The only guidance in the current SNA is in paragraph 7.55: “One of the regulatory functions of governments is to forbid the ownership or use of certain goods or the pursuit of certain activities, unless specific permission is granted by issuing a licence or other certificate for which a fee is demanded. If the issue of such licences involves little or no work on the part of government, the licences being granted automatically on payment of the amounts due, it is likely that they are simply a device to raise taxes, even though the government may provide some kind of certificate, or authorization, in return. However, if the government uses the issue of licences to exercise some proper regulatory function -- for example, checking the competence, or qualifications, of the person concerned, checking the efficient and safe functioning of the equipment in question, or carrying out some other form of control which it would otherwise not be obliged to do -- the payments made should be treated as purchases of services from government rather than payments of taxes, unless the payments are clearly out of all proportion to the costs of providing the services. The borderline between taxes and payments of fees for services rendered is not always clear cut in practice, however.”

30. This choice is never a pure decision because the government issuing the permit always has to engage in some productive activity to issue the permit. The thrust of paragraph 7.55 is that in some cases, the amount of productive activity is slight compared to the price of the permit and in some cases it is roughly equivalent to the price. It is normally impossible to divide the total payment into a tax element and a service element. Moreover, it may not be desirable because the service element should refer only to a service provided to the purchaser of the permit and not the ordinary administrative costs that are present with the collection of any taxes.

31. One way to elaborate on the guidance in paragraph 7.55 is to ask if the service element has a reasonable public policy purpose and whether the provision of the service could be separated from the government agency establishing the policy. That is, the government may have a legitimate policy purpose for establishing the requirement for the provision of a service, such as sanitation inspections of restaurants and verification of the professional credentials of doctors, lawyers, accountants, and others. The policy requirement is only that an independent certification be obtained. The certification could be carried out by a third party or an independent agency of the government as well as by the agency requiring the certification. If such a separation of the certification from the policy is possible, then the payment for the permit could be treated as the purchase of a service. The provision of such a service is not of obvious value to the purchaser as it may only increase its cost of production without affecting the quality of its output. It is

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<sup>8</sup> Page 165.

generally recognized, however, that customers place a value on this type of information, but are not able to acquire it individually at a reasonable cost. Therefore, it is most efficient for a government to require the information to be produced and made public so that customers can purchase with confidence.

32. Once it is established that a service is being provided to the purchaser of a permit, it then must be determined whether the price of the service reasonably related to the cost of producing it. The test in paragraph 7.55 is whether the price is out of all proportion to the cost. Such a test can only be judgmental; it is not possible to establish more precise guidance except by imposing some arbitrary limits, such as requiring the price to be at least 75 percent of the cost but no more than 150 percent.

## **H. Conclusions and Recommendations**

33. The current definition of a tax in SNA paragraph 7.48 should be retained, but the text immediately following the definition should state that not all compulsory, unrequited payments to government units are taxes. The text should then continue with both a list of the transactions that are not taxes and a complete classification of all taxes.

34. The definition of a tax should be followed by several paragraphs elaborating on its interpretation in a way that makes it clear that the following paragraphs are an integral part of the definition.

35. The definition of a tax should be stated as a compulsory payment. The explanatory paragraphs immediately following the formal definition should indicate that almost all taxes can be described as conditional events. They are compulsory only after an event that is not compulsory occurs. As such, it is quite possible to view a tax as voluntary without denying its compulsory nature.

36. The explanatory paragraphs immediately following the formal definition of a tax should indicate that the amounts paid for permits can be taxes and that the amount for each permit can be set using market forces, including auctions.

37. The general statement in SNA paragraph 7.48 about the unrequited nature of taxes should be retained, possibly with some editing to improve its understanding. There is, however, a need for additional guidance on how to determine if the purchase of a permit is a required or unrequited transaction. Emphasis should be added to indicate that the receipt of permission to engage in an activity does not in itself make a transaction required, and all permits that only grant permission to engage in an activity should be treated as taxes, even if the number of permits is restricted to create a monopolistic market.

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