

October 2004

Comments on tax revenue, uncollectible tax and tax credits” by
Jean-Pierre Dupuis, July 2004, presented at the
TFHPSA September 2004 meeting

OTHER PARTS OF THE TAX CREDIT SECTION

Treatment of payable tax credits. -- I very much agree that a tax credit should be recorded as an expenditure to the extent that it exceeds the amount of tax otherwise due. This treatment has a good conceptual basis, because it follows from the definition of “tax”. The payable part of a tax credit does not reduce the compulsory payments made by the institutional units to government units and therefore is not an offset to the amount of tax.

Terminology: payable tax credits or non-wastable tax credits. – I prefer the UK term “payable tax credit” to the term “non-wastable tax credit”. The UK term describes the credit more simply and directly and is easier to understand.

Definition of “tax credit”. – The UK definition is an improvement, because it separates the definition of “tax credit” from the criteria used to assess whether or not a transaction is embedded in the tax system. (This is aside from questions about which criteria are used.)

The definition would be more precise if it included the word “liability” as follows: “a reduction of tax liability” rather than “a reduction of tax”.

CRITERIA TO ASSESS WHETHER A TAX CREDIT IS EMBEDDED IN THE TAX SYSTEM

I believe the criteria in the UK Treasury alternative are more appropriate than those in the September paper for identifying which tax credits are embedded in the tax system. (Both sets of criteria would record any payable part of a tax credit as an expenditure, and nothing more needs to be said about that subject here.)

Criteria in September 2004 Paper:

The September paper states some general criteria (such as “part of the tax law”) and also proposed two more specific criteria:

- Amounts should be deducted from tax otherwise due only if they “are calculated on the same base as the tax (usually the income), and over the same period of time.” The July paper, footnote 8, explains what this means. A tax credit should be recorded as an expenditure, instead of a reduction in tax, if it is “determined arbitrarily or in fixed amount (e.g. allowances per child), but not as a function (percentage) of the underlying tax base (for example taxable income).”
- Some social benefits and subsidies should not be recorded as tax credits. I am not certain from the paper whether this is intended to be a separate criterion in some way. However, the

category of “social benefits and subsidies” appears to have some role in assessing whether a tax credit is embedded in the tax system, because otherwise it would not be singled out. I shall therefore consider it a separate criterion in my last three comments below.

I agree with the UK Treasury paper that these criteria do not divide tax credits between those that are embedded in the tax system and those that are not.

1. The way in which a tax credit is calculated – whether it is a fixed amount, or is a function of the underlying tax base – does not seem related to whether it is embedded in the tax system. All tax credits are intended to redistribute income and/or influence the allocation of resources in specific directions. A tax credit performs these functions regardless of whether it is determined as a fixed amount or as a function of the underlying tax base. Moreover, the tax law, the tax statement, and so forth can readily be written for a tax credit regardless of whether it is determined as a fixed amount or as a function of the underlying tax base.

In the US, there is a tendency for tax credits that provide social benefits, such as the child credit, to phase-out as income is higher, so that the benefit is limited to people with lower or middle incomes; and there is a tendency for tax credits that provide corporate subsidies to be in fixed amounts not related to the tax base, so that corporations of all sizes have an incentive to allocate resources toward designated objectives such as increasing research. Whether or not the tax credit phases-out may be rationally related to the purpose of the tax credit, but it is not related to whether the tax credit is embedded in the tax system.

2. Tax credits and other types of tax expenditure can substitute for one another to achieve the same objective. For example, the US has a tax credit equal to 20 percent of qualified research expenditures in excess of a base amount. It is not a function of the underlying tax base and therefore would be considered “not embedded” according to the first criterion above. However, a roughly similar impact could be obtained by an allowance equal to 60 percent of qualified research expenditures in excess of a base amount. If the tax credit for increasing research is defined as “not embedded” in the tax system, according to the first criterion, it would seem that an equivalent allowance should also be defined as “not embedded”. However, allowances have not been questioned.
3. Tax credits that provide social benefits and subsidies should not be singled out for different treatment from tax credits provided for other purposes. The social or economic purpose of a tax credit does not seem related to whether it is embedded in the tax system.
4. All tax expenditures are intended to redistribute income and/or influence the allocation of resources in specific directions. If one were to say that tax credits for social benefits and subsidies are not embedded in the tax system, because these purposes are not legitimate functions of the tax system, one should say the same thing about other types of tax expenditure that provide social benefits or subsidies: allowances, exclusions (exemptions), deferrals, and preferential rates. Chris Heady said that non-payable tax credits are a very small proportion of social expenditure made through the tax system. (The US is a good example, for non-payable tax credits are less than one-tenth of total tax expenditures.)
5. The two criteria listed above are not necessarily consistent with each other.
 - For example, the second criterion says that subsidies to corporations for hiring specific categories of workers should not be recorded as tax credits. However, the first criterion would allow a tax credit designed for this purpose to be recorded as a reduction in tax if it was related to the tax base by being phased-out at higher income

levels. This could happen if the government wanted to limit the incentive to small businesses.

- As another example, the second criterion says that some social benefits should not be recorded as tax credits. The US tax code has a tax credit to lower income workers that phases-out as their income is higher. This surely is like social benefits. Nevertheless, the first criterion would allow it to be recorded as a tax credit (to the extent it reduced the tax otherwise due), because it is determined as a function of the underlying tax base.

For these reasons, I do not believe the criteria in the September paper are satisfactory for assessing whether a tax credit is embedded in the tax system. (I would say the same thing about the criterion in the July paper that was not included in the September paper.)

Alternative Criteria Proposed by the UK Treasury:

The September paper does, however, say several things that point the way toward better criteria. Most notably, it says that “the tax credit measure must appear as part of the tax law, the tax code and on tax statements”.

The alternative proposals made by the UK Treasury take this approach but develop it much further by listing several specific indicators. I believe they are right that judgement is needed, because institutional arrangements may differ widely in ways that cannot be foreseen or captured by a single rule. I also believe they are right that a group of indicators is needed, because the indicators provide specific guidance that can be applied to actual situations and that tighten up the meaning of the general guidance. With one exception, I think their general guidance and specific criteria are good indicators to assess whether a tax credit is embedded in the tax system and ought to be adopted.

That exception is their third indicator: “That the value of the reduction in tax depends on the marginal rate of tax”. Let me illustrate why I do not think it works. Suppose a tax credit is \$500 and the amount of tax otherwise due is \$1,000. The reduction of tax is \$500 regardless of the marginal rate of tax. Alternatively, suppose a non-payable tax credit is \$1,700 and the amount of tax otherwise due is \$1,000. In this case, the reduction of tax is \$1,000 regardless of the marginal rate of tax. As these cases illustrate, the reduction in tax is the same regardless of the marginal tax rate. The marginal rate of tax is relevant only as one of the factors determining the amount of tax otherwise due. Because the marginal rate of tax is always one factor in determining the amount of tax otherwise due, this does not say anything particular about the nature of the tax credit. Unless I have misunderstood what was intended, I would suggest that this indicator not be used. If I did misunderstand, perhaps it could be clarified.

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