The Evaluation of Tax Measures

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RÉSUMÉ

Les auteurs maintiennent que les mesures fiscales pourraient et devraient faire l'objet d'une évaluation suivant les mêmes principes d'évaluation auxquels sont assujettis les programmes gouvernementaux.

Les programmes gouvernementaux et les mesures fiscales sont essentiellement les mêmes quant à leurs objectifs et leur mise en oeuvre, donc sujets aux mêmes exigences et contraintes au regard de l'évaluation.

Cette étude se penche sur les caractéristiques des mesures fiscales, leurs ressemblances et leurs différences vis à vis les programmes gouvernementaux, et leur influence sur les possibilités d'évaluation. Une attention particulière est portée aux difficultés de définition des objectifs et de l'analyse coûts/bénéfices.

ABSTRACT

The authors contend that tax measures can and should be evaluated using the same principles as program evaluation. Funding programs and tax measures are viewed as essentially similar in their objectives and implementation, and therefore subject to similar imperatives and constraints in terms of evaluation. The authors examine some of the characteristics of tax measures, their similarities to, and differences from, funding programs, and how these affect their evaluability. Special attention is focussed on the special problems of defining objectives, and measuring costs and benefits.

Introduction

Most important elements of tax measures and government funding programs are quite similar. They both involve some type of expenditure by government, either as foregone revenue or as discretionary spending, to achieve certain desirable objectives. These similarities suggest that there should be some commonalities between evaluations of tax measures and other funding mechanisms. Whenever government expenditures are involved there is need for evaluation to deal with questions such as the desirability of the goals of the expenditures, effectiveness in achieving these goals and the intended and unintended results achieved. On an annual basis, program expenditures are reviewed through the Estimates cycle. There is no similar process of review for tax expenditures.

Program evaluation, while not providing all the answers, is a valuable decision-making tool. It provides information for resource allocation, delivery mechanism improvement and accountability. Federal government departments are required to evaluate their funding programs periodically, as one feedback mechanism for policy formulation. Principles and practices are set out in guidelines published by the Office of the Comptroller General. There is no similar requirement for the evaluation of tax measures. To some extent, Parliamentary and Senate Standing Committees perform this function. Inputs from sectoral departments, such as Agriculture Canada, and from the private sector are provided to the committees through written briefs and formal appearances. The Department of Finance also conducts tax measure studies in its ongoing taxation policy development. (Hartle, 1982)

The absence of any authoritative publications similar to those for program evaluation hampers efforts to achieve a coherent and consistent approach to the evaluation of tax measures. Because there are some differences between tax measures and funding programs, some conceptualization of relevant evaluation frameworks is required before substantive tax measure evaluation can be carried out. The discussion which follows highlights the similarities between tax measures and funding programs, but pays particular attention as well to the special nature of tax measures and the implications for their evaluation.

Certain terms have specific meanings when associated with taxes. A tax measure may be described as a differential tax treatment based on special circumstances applicable only to a particular group of taxpayers. (Department of Finance, 1985)

Tax provisions refer to the various sections and sub-sections of a statute that explain how certain taxation elements or categories are to be considered, determined or calculated. Tax provisions that induce a segment of society to undertake, or not, certain activities are tax incentives. The term tax expenditure is used in this paper to describe tax revenue foregone as a result of various tax measures. It is an expenditure because, were it not for the existence of the tax measure, the government would have the tax revenue to spend.

Considerations for Tax Measure Evaluation

Funding programs and tax measures are basically similar. Nevertheless, certain limitations in applying program evaluation principles result from the formulation, administrative and delivery differences between the two mechanisms, and because tax measures are part of an overall taxation system which has objectives other than the provision of tax incentives. Therefore, important considerations that distinguish tax measures from funding programs must be examined and incorporated into any suggested tax measure evaluation framework. In particular, such an examination should review the criteria important in tax policy analysis to determine their applicability to evaluation.

Functions of Taxation: Funds raised through the taxation system fulfill two fundamental functions, namely financing public expenditures for the overall good of all its citizens, and facilitating the distribution of income and wealth among individuals in society. Generally accepted principles are that individuals should contribute their wealth 'equitably' in the form of taxes for the overall good of society, and that the tax system should ''minimize interference with economic decisions in otherwise efficient markets'' (Economic Council of Canada, 1987).

The equity principle states that ''those who are essentially equal should be taxed equally'' (Samuelson and Scott, 1971). If equals are to be taxed equally, then some feel that unequals should be taxed unequally. In order to achieve the latter 'vertical equity', the government uses a progressive taxation system, i.e. higher incomes are taxed at a higher rate. Tax incentives will always put the equity criteria in disrepute because one group of the population will be favoured. A segment of Canadians who are in a position to, and do, undertake the activities deemed by government to be desirable, will receive a tax benefit, regardless of what economic position they are in. We must therefore question whether such measures can be evaluated on the horizontal equity, and in some instances, vertical equity criteria. Similarly, tax incentives will, in most cases, not be neutral, since they seek to affect investment and/or consumer behaviour, in line with their stated objectives. Tax measures directed at specific economic results cannot be evaluated on the basis of maintaining neutrality or not, since ''neutrality is deemed to be neither desirable nor undesirable'' (McCready, 1984).

We submit that tax measures, like other programs, are government expenditures, and as such should be looked at from the perspective of their effectiveness and efficiency in achieving their intended objectives. It is given that tax incentives disrupt the equity and neutrality equilibria. Once Parliament has indicated that equity and neutrality are to be set aside for a particular purpose, what is important is to determine whether the means chosen efficiently produce results, whether these results are desirable, and whether other more equitable measures could produce similar results.

Discretion and Results: With most spending programs, the government can make final approval decisions to ensure that participants' activities meet the criteria of a program with some expectation of achieving its goals. Spending programs can be altered through the annual Estimates cycle with less fanfare than is implied in the budget speech and subsequent alterations to the Tax Act. To some extent, political pressure can be exerted to maintain many universal social programs and changes in spending policy can be introduced in the more publicized budget speech. Once a tax measure is in effect, however, the government has very little discretionary authority, except to repeal or amend it. If a taxpayer undertakes activities which meet the conditions defined in the statutes, s/he will receive the tax benefit. It is therefore possible that, while the taxpayer adheres to the letter and the spirit of the law, the undertaking itself will have little or none of the impact intended by the tax measure. This may also lead to unintended results.

Budgetary Control: It is also very difficult for the government to control the actual expenditure for most tax measures. Unlike spending programs for which the government can plan, allocate and control expenditures, it cannot put any limitation on the total tax expenditure of a given tax measure. It can only put an upper limit on each taxpayer's credit or deduction. Tax expenditure is dependent on the taxpayer's discretion. It is therefore possible that unexpected and unbudgeted drains of the federal treasury may occur. Feedback concerning the levels of expenditures is also faster for funding programs. Parliament must await the filing of tax returns before it can even attempt to assess the effective expenditure of a given tax measure.

Delivery: Some aspects of the delivery of a tax measure will have an impact on related expenditures, efficiency and effects. They are:

Simplicity	— Are the rules easy to understand? Is their application simple?
Avoidance	— Is the ambit of the rule difficult to avoid and evade?
Administrative Authority	— Do the legislative, judicial or executive bodies delegated to administer the measures have the appropriate authority to do so?
Compliance costs	— Is the rule convenient and inexpensive for taxpayers to abide by? Is it fashioned so that it can be enforced without any undue invasion of privacy?
Predictability	— Does the application of the rules depend upon readily verifiable facts? Is its application relatively certain?

These issues are the direct and immediate functions of Revenue Canada and Finance. Other departments, which are more concerned with their impact on their own social or economic sectors, should consider such delivery issues primarily in those terms.

Incremental Difficulties in Tax Measure Evaluation

Program evaluation is not an easy task in itself and the interdepartmental, interdisciplinary and generally complex nature of tax measures presents special difficulties for evaluation. Several factors need consideration.

Objectives Identification: Ideally, funding programs have stated objectives in program submission and approval documents. Such documents should provide a definition of objectives and justifications, in addition to other program information including considerations of eligibility, program administration and control. Descriptions of tax measures are less explicit and structured. Typically, the intent of major new or revised tax measures is introduced in a budget speech in very broad terms. Recently, in the case of major tax measures, discussion papers, hearings by Parliamentary or Senate committees and various reports are considered before their introduction as tax policy.

Important factors in the lack of documentation are the secrecy which surrounds the preparation of a budget speech, and the time contraints the Department of Finance must operate within. However, such problems would be alleviated to a great extent if discussion papers were prepared and circulated on an on-going basis between budget speeches, so that the questions of objectives and intended and unintended impacts could be addressed fully by all concerned parties and departments before tax measures were adopted. Because objectives are broadly defined and seldom explicit, assessing the relevance of a tax measure and its achievement of objectives is more difficult than for a funding program. One has to know what the objective of the measure was when it was introduced before one can answer the questions of whether the tax measure still makes sense given today's environment, and whether it has achieved what was originally intended. This difficulty is quite similar to that faced when one is evaluating funding programs with non-specific and implicit objectives. There are disagreements now for instance as to the purpose of the basic exemption for a taxpayer, spouse and their dependents.

To have a good understanding of what is the intended objective of a tax measure, an analyst may have to go through discussion papers, committee reports, budget speech documents and Hansards. Through careful reading of background information and legislative history, useful insight can be gained into the reasons behind the existence, continuation, and modifications of tax measures and other inter-related factors. It is possible that the objective of a measure introduced years ago may no longer be relevant to current socio-economic realities. The identification of the intended objective is especially important in measures where the unintended effect is so paramount that it can be viewed by some as being the intended objective. Indeed, situations may arise where the unintended but popularly perceived objective of a tax measure is assessed rather than the intended objective. Although assessment of the popularly perceived objective in itself may be a useful exercise, directing the analytical focus on the unintended objective would leave unanswered one of the fundamental and important evaluation questions, namely; ''Is the objective of the measure still relevant?''

Costs: The budgeted and actual costs of a funding program are usually available in program files and budgetary control and reporting documents. Hidden costs, such as opportunities foregone, can be estimated, given sufficient resources and incentive, but are usually ignored. Actual tax expenditures of a given measure (in terms of foregone revenue) are not yet readily obtainable. Some work has been done by Smith (1979) and, separately, by the Department of Finance to determine the values of tax foregone for certain measures, for which data is available, through various modelling techniques. There are still some important measures whose values are not provided because the available data is not sufficient (Department of Finance, 1985). More elaborate research methods are necessary to derive data from unpublished material. Estimates of impact tied to population are easier to obtain, as opposed to those related to corporate actions, which can be more difficult to pin down. While it would be relatively inexpensive for the tax forms to be amended to collect detailed cost data concerning the implementation of tax measures from taxpayers, the cost to those taxpayers of collecting the data can be prohibitive and a significant 'paper burden'.

In the absence of published data, sample surveys, combined with simulation techniques, could provide estimates of costs. Regardless of how crude estimated values might be, they would provide very fundamental and essential information for tax measure evaluation, and to decision-makers for budgetary and policy formulation purposes.

Benefits: It is often difficult to quantify the benefits derived from a government program, especially when the impact is in non-monetary terms. Nevertheless, some techniques have been used in the evaluation of funding programs, that might also be applicable, with slight variations, to tax measure evaluation. For example, some government research programs have been evaluated using the opinions of the industrial user community as to the usefulness, appropriateness and eventual impact of specific research projects and programs. In the same vein, evaluators of tax measures could use surveys of samples of individuals who claimed specific deductions to identify the implementation of practices, use of assets or job creation that might have been intended by a particular tax measure. Mishan (1971) also outines principles and practices for quantifying benefits and costs related to social and economic funding programs. Such methods can be applied to the evaluation of tax measures.

Classifications of tax measures: The task of tax measure evaluation can be made easier if measures are conceptually compartmentalized by similar elements. If similarities between various measures can be found, then evaluation criteria or methods may also be similar. At the very least, similar measures may have like objectives and effects, and the data gathered in the course of one evaluation might be used for another.

Proposed System

The Economic Council of Canada, and other economists, have proposed various methods for evaluating tax systems. Such schemes are usually based on some combination of equity, neutrality and other factors and are most suited to a study of entire systems of tax measures. On the other hand, we submit that individual tax measures cannot be evaluated on the same basis as a tax system, and that they can in fact be evaluated in a manner similar to funding programs. Integrating the concept of evaluation to tax measures is essential in our opinion to renewing the credibility of the system. We suggest the following process as a basis for further development.

- Recognition of a social or economic problem or need.
- Development by the concerned department(s) of alternative strategies (i.e. programs and tax measures).
- Proposals for tax measures to include:
  —statement of objectives
  —profile (similar to component profile)
  —evaluation framework
- Consultations and impact studies.
- Recommendations for action.
- If implemented, review/evaluation on a cyclical basis.

The evaluation process itself could be modelled on that of the Office of the Comptroller General, and would stress five elements, i.e. rationale, impact, achievement of objectives, alternatives and delivery. In other words, the tax measure in its entirety would be reviewed, in order to justify its existence, verify its performance, weigh other means of achieving the same ends, and judge the efficiency of its delivery mechanisms. The latter point is usually the responsibility of central agencies. Both spending programs and tax measures should evaluate the costs to individuals as well as to government.

Sectoral departments should restrict themselves to providing any indirect findings that they might have observed during the evaluation, focusing on the effect this issue has on sectoral development. The evaluation of tax measures would thus not be the sole responsibility of a central agency, but would be within the sphere of any department whose mandate is touched by a particular tax measure. For example, tax measures dealing with farm machinery might implicate Agriculture Canada, Regional Industrial Expansion and its regional off-shoots, and Consumer and Corporate Affairs. Each would have had a particular result in mind during the creation of the measure, and each would therefore be best situated to judge its effectiveness in that particular instance. Truly complex situations, involving many interlocking departments and agencies, may well demand evaluations conducted by a central agency, but with advisory committees composed of representatives of all concerned parties. The central agency should not be the Department of Finance, since it plays such a primary role in the development and introduction of the tax measures to be evaluated. The Office of the Comptroller General, however, already has considerable expertise in the practice of program evaluation, and would seem suited to take on this additional role.

Conclusion

We have attemped to demonstrate the feasibility of using program evaluation principles and practices to evaluate tax measures. The two delivery mechanisms differ primarily in the way they are introduced and monitored. As a result, much more information is available on the objectives and results of funding programs. Until the planning and justification of tax measures are undertaken in a systematic manner similar to funding programs, there will continue to be problems. However, with some retrospective fact-finding and analysis, it should be possible to produce evaluation assessments for a few well-defined tax measures, in order to further explore the role of evaluation in the development of tax policies and of the efficiency and relevance of specific tax measures.

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