7. Government revenue and tax system: an introduction.[1]

Summary

This chapter is an introduction to different types of public revenue, it presents the main characteristics of a desirable tax system and the role of tax revenues in the pursuit of the goals of efficiency and equity.

The most important source of public revenue is tax revenue. *Taxes* are actual *unilateral* cash payments, coercive in nature and generally not earmarked to any kind of expenditures. *Social contributions*, are also mandatory cash contributions, distinguished from taxes just because, as a whole, they are earmarked to a certain type of expenditures (social benefits). Given the importance of these benefits they are administered by specific government departments. From the theoretical point of view e the way they are calculated they should be regarded as taxes. *Property revenues* are revenues generated by the ownership of financial assets or real estate of the state or other public body (deposit interest, rental income, dividends from public companies, or the proceeds from the sale of public assets). The *fees, licenses*, or "prices" are revenues as compensation for services rendered to individuals by public bodies or by the use of property in the public domain, or by removing legal obstacles to action by individuals. They should maintain a relationship of proportionality with the cost of service provided or the benefit received. *Fines and penalties* are unilateral coercive payments with the aim of a penalty or compensation for a breach of a regulation or a statute. Revenues from *borrowing*, through loans or the issue of bonds, have a different nature because they are *not effective* and give rise to future liabilities. As a result from the issue of debt, by the state or other public entity, in the future there will be the payment of interest and the repayment of the principal.

There are a number of desirable characteristics of a tax system, sometimes conflicting with each other. *Equity* - the distribution of tax burden should be equitable, that is not arbitrary, and in accordance with the principles of horizontal and vertical equity in that each must bear a fair share of the burden of public activity. *Efficiency* - taxes should minimize interference with efficient decisions of economic agents and should enhance efficiency by correcting negative externalities. *Flexibility* - the taxes should contribute to, automatically, have a stabilizing effect of the economic cycle, notably by promoting an expansionary effect on the product in a recession and *restritive* during periods of strong expansion (see Chapter 13). *Transparency* - taxes, tax benefits and other tax rules should be easily understandable to taxpayers and allow for accountability of governments when they take measures to amend the tax system. *Low cost* - the cost of tax compliance by taxpayers and tax administration by the Ministry of Finance should be as low as possible. *Financial Effectiveness* - tax revenues should be sufficient and adequate to meet the funding objectives of public expenditure and government budget policy.

In what concerns the characteristic of *efficiency* it can be said that the informed choices of economic agents, when they internalize all the marginal social costs of their decisions, are efficient. In general, taxes have distorting effects on the behavior of agents, since they reduce the consumption/production of the good taxed to minimize the burden of taxation. The inefficiency, or excess burden of tax, is roughly equal to the difference between the change in the welfare of consumers and producers and the income tax levied by the state. It is something that consumers and producers lose, but it is not an additional revenue to the state. It is measured by half the difference between the price to the consumer and the producer price (after tax) times the change in quantity. There are only three types of cases where taxes do not generate inefficiencies. One is a lump sum tax (e.g. a per capita tax). Another is the case when demand

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(or supply) are completely rigid, because in this case tax revenues equals the loss of well-being of consumers (or producers). Finally, there are intentionally distorting taxes, or Pigouvian taxes, which increase efficiency because they make market prices become efficient because they incorporate the marginal external costs associated with the production or consumption of certain goods (e.g. pollution).

As to *fairness* it is possible to establish various abstract principles to achieve this feature. The *horizontal equity* suggests that agents in similar situations should bear an equal burden of taxation. The *vertical equity* is a corollary of the above and states that if an agent is better off than another he/she should bear a higher burden of taxation. Both principles can be applied taking into account two other principles of taxation. According to equity under the *principle of ability to pay* the assessment of the situation of agents, similar or different, is determined by their ability to pay measured in terms of equivalent income (income adjusted for the existence of self-consumption, by possession of private housing, health spending and mandatory education expenditures, household composition, etc.).. Conversely, when equity is justified in terms of the *benefit principle*, it is considered that taxes should be related to the benefits derived from public spending.

From a practical standpoint, equity relates to the degree of progressive taxation. *Progressive taxes* are those where the average tax rate (ratio of tax yields in relation to income) increases with income level, while *regressive taxes* they decrase with income level. With *proportional taxation* everyone pays the same average tax rate. In the empirical analysis of equity it is also relevant to distinguish between the *legal and economic incidence of a tax.* The first relates to the taxable person, i.e. one who has the legal liability of its settlement with the tax revenue department. The second concerns who bears the tax burden following all adjustments in the various markets. For example, when a tax is imposed legally on the producer, but the economic burden is entirely on consumers, given the rigidity of demand, it is said that there is *full tax shifting forward of the tax*. There are other cases, when there is *no tax shifting*, which is the case when there is identity between the legal and economic incidence of tax. In general, the economic burden of the tax is higher on the agents whose behavior is more rigid, whether producers (supply) or consumers (demand). Therefore, the relative value of the elasticities of supply and demand (in module) is essential to study the incidence of a tax.