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Ideas for a More Prosperous Nation

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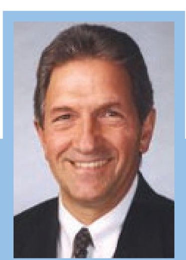
THE PERVERSE EFFECTS OF TAX MEASURES

With Quebec's new provincial budget coming soon, it is worth questioning the nature and effectiveness of tax measures applied by the government. As usual, the budget is sure to contain a series of new tax measures aimed at meeting various political goals. Our elected representatives may need reminding that intentions and results do not always coincide: caution is called for when government actions rely on tinkering with taxation.



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The simplest type of tax measure, obviously, is direct taxation aimed at generating income for the government. Sometimes it also seeks to deter certain forms of behaviour. Conversely, special treatment is often provided to particular groups of taxpayers for various reasons.[1] Since these exceptions leave the government with lower revenues than it might otherwise have collected, they are called "tax expenditures". They may take several forms: income not subject to taxation, tax exemptions, tax refunds, deductions from taxable income, tax credits and tax deferrals.

In 2006, the Quebec tax system contained more than 280 instances of tax expenditures, at a total cost of $18.6 billion.[2] Altogether, this represented 32% of the government's tax revenue (before tax expenditures). A substantial rise can be observed in the overall cost of tax expenditures over the last five years (see Figure 1). In fact, they went up 30% from 2003 to 2007, whereas the rise in the Quebec government's autonomous income (excluding federal transfers) was only 15%. The growing scope of this phenomenon demands that it receive special attention.

Many tax measures, even if well-intentioned, may cause "perverse effects". This term refers to unforeseen consequences that run counter to what was sought. We will look at three examples: a tax aimed at slashing tobacco consumption stimulates illicit production and may actually reduce income; subsidies and tax preferences provided to business in some resource regions harm economic development rather than helping it; and exemptions from the fuel tax for certain uses spur development of a black market. This Economic Note aims to give an overview of these examples and to suggest general lessons that can be drawn for a better assessment of the effectiveness of tax measures and their consequences for the economy.

The tobacco tax

Sometimes, when a taxation rate goes up beyond a certain level, revenues actually decline. People work less or consume less when the cost becomes too high. They are also likelier to turn to the black market. This phenomenon, called the "Laffer effect", may be considered a perverse effect. A measure meant to produce more income for the public treasury, if excessive, may have the opposite effect. Figure 2 shows the evolution of Quebec government revenues from the tobacco tax (federal tobacco revenues followed a similar trend). They went from a peak of $948

1. For example, to encourage retirement savings, to support economic development, to protect low-income households or to provide financial assistance to families.
2. Quebec Department of Finance, *Tax Expenditures – 2006 Edition*, October 2006, pp. 28-29, http://www.finances.gouv.qc.ca/documents/Autres/en/TaxExpenditures2006.pdf.

FIGURE 1
Change in the overall cost of tax expenditures by the Quebec government, by category of tax it is giving up (2003-2007)

Source: Quebec Department of Finance.

million in 1986-87 to $368 million in 1993-94, a 61% decline in seven years. This situation can be explained largely by an upsurge in smuggling. In February 1994, both levels of government were forced into a heavy reduction in tobacco taxes – by 80% in Quebec.

A few months later, the government resumed tax increases on tobacco, slowly at first and then more briskly. The Quebec tax now stands at $20.60, which is 15% more in constant dollars than at the peak in the early 1990s. From a peak of $948 million in 2002-03, provincial tobacco revenues began falling again (by 28% up to now).

The Quebec government admitted the problem in its 2006-07 budget: “Consumption tax revenue is adjusted downward by $113 million, mainly because of lower-than-anticipated revenue from the tax on tobacco products, stemming in part from the rise in smuggling.”[3] In recent years, budget forecasts related to revenues from the taxation of tobacco have often had to be revised.

The continuous rise in taxes on tobacco reduces the quantity purchased (beyond the reduction in demand caused by other factors), but it also leads to the emergence of an illegal cigarette trade that escapes taxation. It is less widespread than in the early 1990s, partly because controls and sanctions have been greatly strengthened, but it remains a factor. A recent investigation showed that 22% of cigarettes consumed in Quebec may come from illegal sales.[4] A carton purchased on the black market costs about $20, compared to $50 to $70 for a carton that is taxed.

Economic theory and historical experience both suggest that a prohibitive tax will necessarily trigger the rise of a black market which will end up hindering the collection of this tax. Even if the government’s aim was to eliminate tobacco consumption and thus to bring this source of revenue down to zero, it could not, except at huge cost, prevent tax evasion that would thwart its plans.

The Economic Development Strategy for Resource Regions

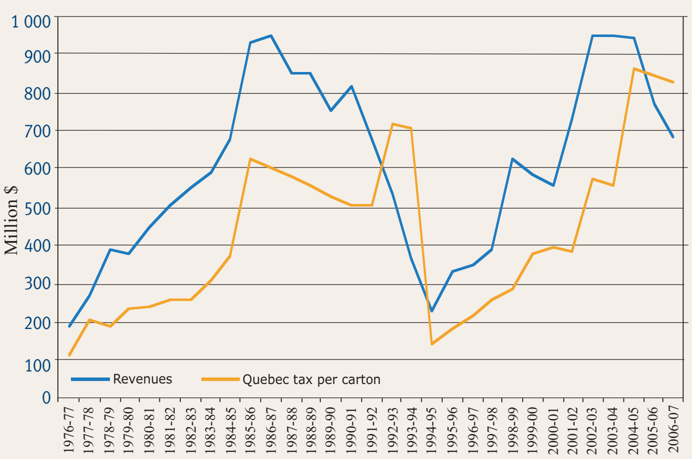
Another type of perverse effect comes from subsidies to businesses, especially those connected to regional development policies. Unlike similar programs, the Economic Development Strategy for Resource Regions, instituted under the 2001-02 Quebec budget, was not seriously questioned during the change of government in 2003. This program (known by its French acronym SDERR) was influenced by new economy schemes and by existing regional programs. It aimed to turn government assistance to traditional production activities in seven resource regions into a general program available to many businesses. The Liberal Party government did, however, reduce some advantages under the program, especially in its last two budgets.

The two main measures remaining in force are: 1) a refundable tax credit, in other words a subsidy, equal to 30% of the wages of new employees in processing activities; 2) for small and medium-sized businesses in the manufacturing sector, a 75% tax holiday on income tax, capital tax and employer contributions to the Health Services Fund. The first measure is supposed to end on December 31, 2009, and the second one at the end of 2010.[5]

Economic theory and historical experience both suggest that a prohibitive tax will necessarily trigger the rise of a black market which will end up hindering the collection of this tax.

3. Quebec Department of Finance, *Budget 2006-2007 – Budget Plan*, March 2006, section 2, p. 6.
4. Imperial Tobacco Canada, *Collateral damage – Illicit tobacco trade takes on phenomenal proportions*, press release, October 14, 2006.
5. The seven privileged regions are the Lower St. Lawrence, the Saguenay–Lac-Saint-Jean, part of the St. Maurice Valley, the Abitibi-Témiscamingue, the Côte-Nord, Northern Quebec, and the Gaspé Peninsula–Magdalen Islands. One regional county municipality in the Laurentians and two in the Outaouais are also covered. In addition to the seven “resource regions”, Quebec has seven “central regions” (the Eastern Townships, the Outaouais, the Chaudière-Appalaches, Lanaudière, the Laurentians, and Central Quebec) as well as three metropolitan areas (Quebec City, Montreal and Laval).

Figure 2
Revenues from the taxation of tobacco in Quebec from 1976 to 2007 (in constant 2006 dollars)



Sources: Quebec Department of Finance and Statistics Canada.

This assistance to businesses in resource regions spurred numerous attacks from economic bodies and elected representatives in regions where businesses do not benefit from these tax preferences and see themselves as victims of tax discrimination that creates unfair competition.[6] Protesters spoke of "the perverse effects of the end of a free market".[7]

The February 2007 budget reacted to these criticisms by reducing the level of the tax holiday in the last two years of the program (2008 and 2009). At the same time, the government announced the creation of a task force "to thoroughly examine the impact that the end of the tax measures for businesses in resource regions and the new economy will have on Quebec companies."[8]

The economic activity that was prevented would have been more efficient than what replaced it because it could be justified economically and could finance itself on the market without subsidies or discriminatory tax preferences.

The problems caused by this type of regional discrimination go well beyond a simple displacement of economic activity from non-subsidized regions to subsidized regions. It is clear that such a displacement is occurring: lower tax costs for businesses (more than $100 million in 2006) will attract some that would otherwise have stayed or been created in regions that do not benefit from the tax preferences at issue here. Businesses that create jobs in certain regions do so at the expense of economic activity that $100 million in taxpayers' pockets would have produced elsewhere. But it goes beyond a simple transfer: the economic activity that was prevented would have been more efficient than what replaced it because it could be justified economically and could finance itself on the market without subsidies or discriminatory tax preferences. The result is a net destruction of value and wealth potential. The perverse effects of the SDERR program result in a net loss for the economy.

In addition to loss of economic efficiency, the program has other undesirable effects. It is hard to end because the client base that benefits from it will fight kicking and screaming to hang onto its privileges. It also creates a culture of dependency on government in the regions favoured by these policies along with an indefinite delay in adaptations and changes.

Interventionism seems generally ineffective in promoting regional development. A recent Quebec government report[9] was highly critical: "Regional development policies traditionally focused on the most disadvantaged regions. Observations of results in this regard have been rather disappointing…." The report speaks of "distortions in markets", of "a culture of dependence", of policies that "in many cases have harmed chances for development in the regions concerned", and of "efforts that end up leading only to useless and heavy spending". A study from CIRANO, an interuniversity research centre, took a similar stance: "Despite the variety of approaches and the intensity of government involvement at both the federal and provincial levels, we must acknowledge the paucity of tangible results from regional development policies."[10] This observation could also apply to the recent fashions of "industrial clusters" or "innovating regions", both of which have similar principles.

6. Conférence régionale des élus de la Capitale-Nationale *et al*, *Cadre de réflexion et recommandations pour une fiscalité équitable des sociétés québécoises*, brief presented to the Quebec government, November 2006, http://www.sosregionscentrales.com/Fichiers/Communique-de-presse/24-01-2007-cre-ca-cadre-de-reflexion.pdf.
7. *Ibid*., p. 45.
8. Quebec Department of Finance, *Budget 2007-2008 – Budget Plan*, February 2007, p. E.31, http://www.budget.finances.gouv.qc.ca/budget/2007-2008/en/pdf/BudgetPlan.pdf.
9. Department of Economic Development, Innovation and Exports, *Synthèse et comparaison des politiques de développement économique régional aux États-Unis et en Europe*, 2006, pp. 14-15, http://www.mdeie.gouv.qc.ca/mdercontent/000021780000/upload/publications/pdf/developpement_regional/fr/general/synthese_dev.pdf.
10. Marcelin Joanis and Fernand Martin, *La dimension territoriale des politiques de développement économique au Québec : enjeux contemporains*, CIRANO, 2005, p. 3.

Exoneration of the tax on dyed fuel oil

Among examples of tax measures that cause "perverse" but foreseeable side effects, we should mention the exemption from the provincial tax on fuel oil aiding those who use it for particular purposes: domestic heating, farm machinery, commercial boats, fishing vessels, etc. Other users, such as truckers or the owners of cars with diesel engines, must use dyed fuel, which is otherwise the same product but carries a tax of 16.2 cents a litre.[11] Or to take a truly odd example, a City of Montreal motorized snow-blower can use undyed fuel only for the engine that drives the rotor; for the engine propelling the machine, dyed fuel must be used![12]

This tax discrimination causes a price distortion based on use and creates a black market requiring continuous checks by fuel inspectors. In 2005-06, inspectors issued 280 infraction notices and imposed $264,000 in fines.[13] Press releases from Revenue Quebec mention numerous convictions for using dyed fuel oil for illegal purposes (by trucking companies, for instance) or for selling it to illegal users (the sellers are often gas stations or distributors). Revenue Quebec, while condemning the black market to which this discriminatory taxation gives rise, possesses no studies assessing its extent.

Implications for the evaluation of public policy

The perverse effects that turn up in various countries or which persist over long periods cannot be seriously regarded as unexpected. Intervention in the delicate economic mechanism of market re-balancing generally leads to complex consequences that are spread over time and often hard to forecast. These impacts arise in many contexts where the establishment of institutions and bodies intended to solve a short-term problem ends up creating permanent problems that are increasingly onerous for society (permanent subsidies, price controls[14], and so on).

Governments have got into the habit of announcing new taxes in each budget along with exemptions targeted more or less transparently at particular groups. Few of these measures will be abrogated except to be substituted by more generous ones. The costs of these measures are too often assessed superficially (for example, during debate on the budget), and their perverse effects are ignored or swept under the carpet.

The government should, when introducing or renewing any tax measure, make public the analyses it has conducted dealing with possible perverse effects.

Greater transparency is a must. A step in the right direction was taken recently when the Department of Finance confirmed a commitment it made to publish an annual report on the government's tax expenditures. But this is just a start. To enable the pertinence of a tax measure to be grasped, the government should, when introducing any new tax measure or renewing existing measures, make public the analyses it has conducted dealing with their possible perverse effects (or to conduct such analyses if this has not been done). Elected representatives should not hesitate to ask detailed questions on the results of these measures, as they would for any more visible spending of taxpayers' money. This is a necessary condition for good governance in public affairs.

11. Revenue Quebec, *Fuel tax rates and exemptions*, http://www.revenu.gouv.qc.ca/eng/entreprise/taxes/carburants/taux.asp.
12. Paul Roy, "Des gars qui aiment la neige", *La Presse*, December 14, 1994, p. A1.
13. Revenue Quebec, *L'inspection du carburant*, http://www.revenu.gouv.qc.ca/documents/fr/publications/com/com-251(2006-07).pdf.
14. See an earlier Economic Note from the Montreal Economic Institute prepared by Valentin Petkantchin, *The pernicious effects of price controls,* April 2006, http://www.iedm.org/main/show_publications_en.php?publications_id=134.

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