THE ROLE OF TAX POLICY IN THE ECONOMY

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ABSTRACT
This paper identifies tax policy that both speeds recovery from the current economic crisis and contributes to long-run growth. This is a challenge because short-term recovery requires increases in demand while long-term growth requires increases in supply.

Keywords: Tax Policy, Economic growth, Economic recovery, Project, Monetary

Introduction

To foster economic growth and development governments need sustainable sources of funding for social programs and public investments. Programs providing health, education, infrastructure and other services are important to achieve the common goal of a prosperous, functional and orderly society. And they require that governments raise revenues. Taxation not only pays for public goods and services; it is also a key ingredient in the social contract between citizens and the economy. How taxes are raised and spent can determine a government's very legitimacy.

Fiscal policy is the use of government spending and taxation to influence the economy [1-14]. Governments typically use fiscal policy to promote strong and sustainable growth and reduce poverty. The role and objectives of fiscal policy gained prominence during the recent global economic crisis, when governments stepped in to support financial systems, jump-start growth, and mitigate the impact of the crisis on vulnerable groups.

When policymakers seek to influence the economy, they have two main tools at their disposal—monetary policy and fiscal policy. Central banks indirectly target activity by influencing the money supply through adjustments to interest rates, bank reserve requirements, and the purchase and sale of government securities and foreign exchange. Governments influence the economy by changing the level and types of taxes, the extent and composition of spending, and the degree and form of borrowing [15-29].

The exact response ultimately depends on the fiscal space a government has available for new spending initiatives or tax cuts—that is, its access to additional financing at a reasonable cost or its ability to reorder its existing expenditures. Some governments were not in a position to respond with stimulus, because their potential creditors believed additional spending and borrowing would put too much pressure on inflation, foreign exchange reserves, or the exchange rate—or delay recovery by taking too many resources from the local private sector (also known as crowding out). Creditors may also have doubted some governments' ability to spend wisely, to reverse stimulus once put in place, or to address long-standing concerns with underlying structural weaknesses in public finances (such as chronically low tax revenues due to a poor tax structure or evasion, weak control over the finances of local governments or state-owned enterprises, or rising health costs and aging populations). For other governments, more severe financing constraints have necessitated spending cuts as revenues decline (stabilizers functioning). In countries with high inflation or external current account deficits, fiscal stimulus is likely to be ineffective, and even undesirable.

As for timing, it often takes a while to implement spending measures (program or project design, procurement, execution), and once in place, the measures may be in effect longer than needed. However, if the downturn is expected to be prolonged (as was the recent crisis), concerns over lags may be less pressing: some governments stressed the implementation of "shovel-ready" projects that were already vetted and ready to go. For all these reasons, stimulus measures should be timely, targeted, and temporary—quickly reversed once conditions improve [30-43].

Similarly, the responsiveness and scope of stabilizers can be enhanced—for instance, by a more progressive tax system that taxes high-income households at a higher rate than lower-income households. Transfer payments can also be explicitly linked to economic conditions (for instance, unemployment rates or other labor market triggers). In some countries, fiscal rules aim to limit the growth of spending during boom times, when revenue growth—particularly from natural resources—is high and constraints seem less binding. Elsewhere, formal review or expiration ("sunset") mechanisms for programs help to ensure that new initiatives do not outlive their initial purpose. Finally, medium-term frameworks with comprehensive coverage and assessment of revenues, expenditures, assets and liabilities, and risks help improve policymaking over the business cycle.

Businesses care about what they get for their taxes. Quality infrastructure is critical for the sound functioning of an economy because it plays such a central role in determining the location of economic activity and the kinds of sectors that can develop. A healthy workforce is vital to an economy's competitiveness and productivity—investing in the provision of health services is essential for both economic and moral reasons. Basic education increases the efficiency of each worker, and good-quality higher education and training allow economies to move up the value chain beyond simple production processes and products.

Compliance with tax laws is important to keep the system working for all and supporting the programs and services that improve lives. One way to encourage compliance is to keep the rules as clear and simple as possible. Overly complicated tax systems are associated with high tax evasion. High tax compliance costs are associated with larger informal sectors, more corruption and less investment. Economies with simple, well-designed tax systems are able to boost businesses activity and, ultimately, investment and employment.

Filing the tax return with the tax authority does not imply agreement on the final tax liability. Often, the ordeal of taxation starts after the tax return has been filed. Post filing processes—such as claiming a VAT refund, undergoing a tax audit or appealing a tax assessment—can be the most challenging interaction that a business has with a tax authority. Businesses might have to invest more time and effort into the processes occurring after filing of tax returns than into the regular tax compliance procedures.

In a risk-based approach the exact criteria used to capture noncompliant firms, however, should be concealed to prevent taxpayers from purposefully planning how to avoid detection and to allow for a degree of uncertainty to drive voluntary compliance.

The global financial and economic crisis revealed vulnerabilities of the European tax systems and the necessity to reform them in many cases. It also put governments in front of major tax policy challenges and dilemmas when searching for the recovery path. Most Member States needed to boost their revenue – in order to support the overall consolidation efforts – while at the same time needed to undertake actions to support recovery and restore sustained growth over the medium and long term. The situation

became even more complicated when considering the necessity to safeguard social equity. In this context, more than ever, new visionary and growth-friendly tax policy approaches are needed, as well as methods to assess their impact on the economy and on people.

Taxes are mandatory contributions levied on individuals or corporations by a government entity—whether local, regional, or national. Tax revenues finance government activities, including public works and services such as roads and schools, or programs such as Social Security and Medicare.

There are several very common types of taxes:

Income tax—a percentage of generated income that is relinquished to the state or federal government. The rate of taxation on the profit depends on the length of time for which the asset was held. Short-term capital gains (on assets sold one year or less after they were acquired) are taxed at the owner's ordinary income tax rate, whereas long-term gains on assets held for more than a year are taxed at a lower capital gains rate—based on the rationale that lower taxes will encourage high levels of capital investment.

Payroll tax—a percentage withheld from an employee's pay by an employer, who pays it to the government on the employee's behalf to fund Medicare and Social Security programs. Payroll taxes have both an employee portion and an employer portion. The employer remits both the employee portion, described above, and a duplicate amount for the employer portion. The employer rates are the same 6.2% for Social Security up to the wage base limit, and 1.45% for Medicare on all wages.

Corporate tax—a percentage of corporate profits taken as tax by the government to fund federal programs

Sales tax—taxes levied on certain goods and services; varies by jurisdiction. Sales taxes are charged at the point of sale when a customer executes the payment for a good or service. The business collects the sales tax from the customer and remits the funds to the government. Each state can implement its own sales taxes, meaning they vary depending on location. There's even room for cities and counties to use their own rates, provided that they abide by the taxing rules of their state.

Property tax—based on the value of land and property assets. Property tax rates vary considerably by jurisdiction and many states also tax tangible personal property, such as cars and boats.

Tariff—taxes on imported goods; imposed with the aim of strengthening domestic businesses. A tariff is a tax imposed by one country on the goods and services imported from another country. The purpose is to encourage domestic purchases by increasing the price of goods and services imported from other countries. There are two main types of tariffs: fixed fee tariffs, which are levied as a fixed cost based on the type of item, and ad valorem tariffs, which are assessed as a percentage of the item's value (like the real estate tax in the previous section).

Estate tax—rate applied to the fair market value (FMV) of property in a person's estate at the time of death; the total estate must exceed thresholds set by state and federal governments. Estate taxes are levied only on estates that exceed the exclusion limit set by law.

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