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The use of stimulus in the tax system to affect behaviour

Summary

The Future-proof Tax Structure research stream

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Summary

Use of behavioural incentives in the tax system

The focus of the study is on how the tax system is used to achieve innovation, better health behaviour and a cleaner environment. In particular, we map interventions that seek to influence people on innovation, health and environmental matters through excise duties and taxes, and which (ideally) incorporate behavioural insights that help to achieve better results in terms of innovation, health and environmental goals. In addition, we examine what behavioural insights are built into the broader tax system (with the goal of improving tax compliance and collecting more tax revenue).

One conclusion of the study is that more behaviourally insightful solutions should be used in policy making. Using behaviourally smart solutions enables to direct the taxpayers without extra monetary incentives or strict prohibitions. To date, a number of solutions have been developed to make policies more insightful in terms of behaviour. One such solution is the EAST framework, which recommends that policies be based on four principles:

- **Easy** – the desired behaviour must be made as simple as possible for the person. In the context of taxation, this can mean that everyone understands the tax system and that it is easy to pay taxes.
  For example: Entrepreneur account developed by the bank of LHV, which allows for the automatic calculation and payment of taxes to the Tax and Customs Board.

- **Attractive** – policies should be designed to look attractive to users. In the case of taxes, attractiveness can be affected by emphasizing the benefit / value or by changing the taxes so that they are perceived as fair.
  For example: Taxing 80% of rental income instead of the previous 100% had a positive effect on apartment owners' sense of justice and increased tax revenue.

- **Social** – social norms can also be used to achieve the desired behaviour. Care should be taken when emphasizing negative norms.

For example: Estonians Tax and Customs Board tax behaviour ratings, which allows entrepreneurs to receive feedback on their tax behaviour.

- **Timely** – implement actions where people are most receptive to them.
  For example: Possibility to pay land tax as part of the income declaration process.

The EAST framework is easy to use and its principles should be followed not only in the development of health, innovation and environmental policy, but also in policy-making more generally. It is still worth maintaining a critical mind and taking the context into account when transposing best practices from other countries. Tax measures that are very efficient in developing countries may not have such a positive effect in the context of Estonia's high tax compliance **–** the base levels are different and the effect of the measure is expected to be different.

As main result of the study, we list tax instruments that have not been used in Estonia, but which are used or have been used elsewhere to promote health, environmental protection and innovation. The present study does not include an impact assessment of whether these measures are effective in the Estonian context – if there is a more serious intention to implement any them in Estonia, the effects should be assessed more thoroughly beforehand**.**

A selection of tax measures that have not been implemented in Estonia to promote health, environmental protection and innovation

Directing people towards healthier choices

Fat and sugar taxes. In Estonia (as elsewhere in the world) alcohol taxation is used, but there are no fat and sugar taxes. If we want to lessen the share of these components in food, then additional taxation of them could be one of the options. Several studies (such as estimates of the effects of taxing sugar in soft drinks in the UK) suggest that such interventions could have a positive effect. At the same time, it must be acknowledged that such instruments are not very widespread in other parts of the world. One reason may be that their implementation can have at first sight ambiguous consequences (the introduction of other unhealthy substances).

Not classifying health expenditures as fringe benefits. Some of the expenses spent by the employer on employees' health (training) are already not considered as a fringe benefit (in the amount of 100 € per quarter). At the same time, it could be considered not to regard spending on healthy food in the workplace or spending on sports equipment (e.g. bicycles) acquired by the employer as a fringe benefit.

Guiding companies towards more innovative products and services

Research and development (R&D) tax credit. The Estonian tax system does not differentiate expenditures for financing research and development from other expenditures. All expenses necessary for carrying out business activities are tax-free. On the one hand, this means that companies can decide for themselves which costs are most necessary for the successful conduct of their business. On the other, there are no state tax policy incentives that would direct companies to contribute more to R&D activities. In this way, it may be more practical for companies to invest in less innovative areas instead of risky development activities or to leave money in the account to wait for better times.

Therefore, the introduction of a R&D tax credit could be considered. When introducing a tax credit, four different ways of using the credit can be seen. The first of these would be to restore the taxation of companies' current profits, the liability of which could then be reduced by the R&D tax credit. Another option would be to allow the R&D tax credit to be deducted from dividend income tax within the existing system. As a third solution, the liability of other taxes (social tax, VAT) can be reduced at the expense of the R&D tax credit. The last option would be to introduce a separate R&D tax, which would finance, for example, state innovation policy measures aimed at companies and the liability of which could also be reduced by R&D expenditure.

All these solutions lower R&D costs compared to other costs. However, when implementing the measure, it must be borne in mind that the distinction between R&D expenditure and other expenditure is rather difficult in practice and offers opportunities for tax loopholes.

Shifting the tax burden from labour to capital. Labour costs form a significant part of R&D costs, which means that in innovative companies, taxation of labour costs is also taxation of R&D activities. This should be particularly detrimental to start-ups that do not yet have a strong cash flow from marketed products and services. As they do not have a profit either, the lack of income tax on the current profits of the companies in Estonia also does not give such companies significant advantages. If we want to see Estonia as a growth platform for start-up companies, we could consider lowering labour taxes and increasing corporate income tax accordingly (with the above-mentioned possibility to use the R&D tax credit).

Encouraging environmentally conscious behaviour

Car tax. A car tax is one of the tools for directing people towards more public transport as a greener transport solution. Estonia is also one of the few developed countries where this tax is not implemented. A car tax would have the potential to decrease the number of cars in towns and thus decrease the general environmental footprint of transport (e.g. less pressure for road construction, car production).

Congestion tax. The congestion tax also aims to reduce the number of cars driving in the city, but it is more targeted and focuses on reducing traffic in areas where the free movement of cars is significantly impeded. It also reduces incentives to own a car (making it more expensive to use a car in certain areas) and encourages people to use more public transport.

CO_2 tax. A CO_2 tax would help steer production companies towards solutions that emit less greenhouse gases. In order to limit the amount of CO_2 emissions, an emissions trading system is already in use at the level of the European Union, which, in simple terms, generates a constantly rising market price for CO_2 emissions in the long run. So far, however, the CO_2 trading system has not been comprehensive (focusing on larger producers) and some of the problems have been caused by state subsidies, which offset its effects. A CO_2 tax could be one way of patching emissions trading holes nationally. It also involves changing the coverage of emissions trading system (which is a matter of international agreements) and the carbon duties that are expected to be needed to protect European producers from climate-damaging competition from third countries.

Improving the packaging excise duty system. Consideration could be given to changing the principles for collecting packaging excise duty so that packaging excise duty is paid before packaging is placed on the market (i.e. excise duty is paid on all packaging put into circulation, not just the part that exceeds recovery standards). It is also recommended to review excise duty rates in order to motivate recycling. At the same time, the system could allow (based on the amount of recycled packaging) to recover part of the packaging excise duty paid – in summary, the aim is not to collect a higher amount of packaging excise duty, but a well-functioning circular economy.

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