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Fiscal Excellence

Sound tax policy. Efficient spending. Accountable government.

Taxing Decisions Matter:
A Guide to Good Tax Policy

In every legislative session there is no shortage of ideas on how to improve our state and local tax system. Some recommendations are fundamental in nature, calling for sweeping overhaul of the system and greatly changing our reliance on certain types of taxation. Other recommendations are more targeted and revolve around tinkering or tweaking a specific tax. Any suggestion for changing tax rules—whether major or minor—raises the question of how to best analyze and compare proposals.

The fundamental purpose of any tax system is to raise revenue for government. Therefore, it's important to view tax proposals first through the lens of what makes a good public finance system. Over years of research and practical experience, the MCFE has advocated several concepts and principles to guide decision-makers and inform governments as to how to best tax their citizens.

It should be noted that "good tax policy" does not change during times of large budget deficits or healthy surpluses. Good tax systems can fall woefully short of creating adequate revenue during recessions, and poor tax systems can raise plenty of money (but they often are unsustainable). MCFE encourages policymakers and tax practitioners to focus on designing a system based on good tax principles first, and then assess how that system can best raise revenue adequate to meet public demands for service.

"Tax fairness" is the idea most people gravitate towards when thinking about good tax principles, but the emphasis placed on this issue is often so great it appears fairness is the only tax concept that matters. Of all the principles of good tax policy, fairness is the most challenging to put in place since it means different things to different people. It is also the tax principle that has made the most obvious leap from the world of economics into the rhetoric of politics, meaning policymakers are often comparing apples and oranges when they debate the fairness of competing tax proposals.

Fairness is indeed a very important and very influential tax policy principle, but it is just one of several other important concepts guiding good tax policy. Before policymakers become too attached to fairness, there are other tax policy principles that are no less important to a good state and local revenue system. Listed in the next section are those principles and some strategies to put each principle in place.

Six Tax Principles Which Deserve More Attention Than They Often Receive

1. ***Keep taxes simple, easy to comply with, and easy to collect*** — The more complex a tax, the greater the costs for the government to administer it and the greater the compliance costs for taxpayers to determine their liability and report it. Simplicity also breeds a sense of fairness among taxpayers due to greater understanding.

Implementation:

- Use broad bases with low rates, minimizing exemptions
- Use very clear statutory language (in other words, minimize rule making)
- Maximize conformity with federal tax code
- Seek to balance the cost of enforcement with the desired level of compliance

2. ***Make taxes transparent and visible*** — Taxpayers should know that a tax exists, why the tax is being levied, who's responsible for the tax, and how it's calculated and paid. As a matter of economics, when taxes are visible it allows citizens to make informed judgments about the relationship between their tax burden and the types and levels of government services provided to them. Ensuring that taxpayers “feel” their tax burdens helps ensure that government remains accountable to its citizens.

This principle is especially important in considering business taxation because economists agree that the “incidence” of business taxes– the final resting place of the tax burdens -- falls on people through higher prices, lower wages or lower returns on investment.

Implementation:

- Make taxpayers aware of linkages to spending (“truth in taxation”)
- Avoid automatic tax increases like indexed rates or triggers
- Report on tax incidence, especially taxes ultimately paid by people who are not directly levied (such as business taxes)

3. ***Encourage stability and predictability***— Both taxpayers and governments benefit from stability and predictability in tax systems. Taxpayers need stability in order to plan for payments. If they have no idea what level of tax they will be paying, they cannot plan their budgets well.

Governments benefit from tax stability because government spending is often driven by economic conditions. When revenue collections fall due to a weak economy, demands for certain government services may increase. When revenue collections rise during an economic expansion, decision-makers become tempted to support spending levels that are unsustainable during a downturn.

Stability in revenue collection can encourage more stable spending patterns. Since different types of taxes are affected differently by changes in the economy, stability is best achieved by avoiding an overreliance on any one revenue source.

Implementation:

- Use broad bases with low rates, minimizing exemptions
- Seek a balance among different types of taxes
- Use budget reserves and “rainy day funds” to respond to weak economies

4. ***Don’t distort decision-making –*** All taxes influence decision-making to some extent, but the effect of tax law on personal and business decisions should be kept to a minimum. As tempting as it is to try to encourage various social and economic outcomes through the tax code, markets normally allocate resources more effectively than government action.

There are exceptions to this policy -- “sin” taxes and revenues from pollution discharge fees are example -- but the use of these types of revenues should be limited to paying for the costs imposed on society by the activity in question, not for general revenue purposes.

Implementation:

- Use broad bases and low rates
- Use the revenue system to reflect costs imposed, not to influence social policy

5. ***Protect economic competitiveness —*** A tax system needs to reflect the realities of competing in a global economy. Information technologies and other advances are reducing the significance of "place" in the conduct of economic activity. No state can afford to ignore this by placing themselves at a distinct comparative disadvantage relative to other states. Tax systems should also be responsive to changing regulatory and competitive circumstances.

Implementation:

- Use broad bases with low rates, minimizing exemptions
- Reduce reliance on taxing mobile factors of production (labor, capital and tangible property)
- Ensure business taxes are directed toward public investments that stimulate growth and job creation in the private sector

6. ***When possible and appropriate, base taxes on benefits received --*** Policy makers should always strive to enact fees or taxes that are directly related to the costs of the benefits provided to the people paying them. Of course, most government services are more general in nature and broadly beneficial to society as a whole, which means they can’t readily be tied to identifiable taxpayers or groups of taxpayers. Consequently, most government services require general taxation and the consideration of other tax principles.

Implementation***:***

- Use fees rather than general taxes wherever they can be justified:
  1) where public services can be reasonably apportioned among beneficiaries;
  2) where beneficiaries have some degree of flexibility over their level of consumption; and most importantly
  3) where "spillovers" are minimal (non payers do not benefit in some way from payers')
- Base fees on full costs of providing government services

The Two Dimensions of Tax Fairness

Good tax policy should promote fairness. One way to strive for fairness in a tax system is to "treat equals equally." In other words two taxpayers with equal ability to pay should pay the same amount of tax. This perspective on tax fairness, known as horizontal equity, is quite intuitive.

However, ability to pay often differs significantly among taxpayers. In that case, a second principle of tax fairness arises called vertical equity. In most policy discussions, evaluating vertical equity requires a look at progressivity and regressivity.

- In a **progressive** tax system, the tax burden as a percentage of income ***rises*** as income rises
- In a **regressive** tax system, tax burden as a percentage of income ***falls*** as incomes rises
- In a **proportional** tax system, tax burden as a percentage of income remains ***constant*** across all income levels

Individual taxes have different degrees of progressivity or regressivity based on how they are structured. When examining tax fairness, it is important to consider the progressivity and regressivity of the <u>entire</u> tax system as a whole, rather than its individual pieces. Since most taxes are regressive in nature, progressivity in any tax system is achieved principally through imposition of the income tax on individuals.

Although the progressivity principle is accepted by many – the higher the income, the more you should pay -- a specific degree of progressivity cannot be defended by any objective standards of economic theory. There is no measure for "optimal progressivity."

An alternative approach to promote tax fairness is to reduce the inherently regressive nature of other taxes, rather than allowing excessive income tax rates. This approach focuses on the use of an array of mechanisms such as exemptions, rebates, and credits to reduce the burden on lower-income households.

Strategies:

- Assess system-wide tax incidence, not the impact of individual taxes
- Shield subsistence income from taxation
- Use refunds, rebates, and credits to achieve some desired level of system progressivity

Thoughts for Putting Good Tax Policy into Practice

- ***There is no such thing as ignoring tax principles***

Every tax policy decision inevitably has an impact on all tax principles, even if certain principles are not a conscious consideration in the decision-making process. It is much better to evaluate the possible implications beforehand than to be surprised by consequences after the fact. If you don't think about good tax principles when developing a tax proposal, the chances are pretty good you will end up with "Bad Tax Policy."

- ***Tradeoffs are a fact of tax policy***

Tax principles are often in conflict with each other. For example, the price of improving fairness often comes at the expense of simplicity by introducing much more complexity into the tax code. Placing too great an emphasis on any single tax principle may result in significantly weakening the integrity of the revenue system as a whole.

- ***Principles that are the least interesting to constituents are often the most relevant to sound public finance.***

If asked, most citizens would likely say that "fairness" or "ability to pay" is the most important consideration in developing tax policy. As important as this concept may be, other principles such as simplicity of administration, stability, and transparency are more crucial to the quality and reliability of public finance systems. Placing too much emphasis on politically popular principles to the exclusion of others may have harmful long term repercussions for budgets and revenue systems.

- ***Care should be exercised in attempting to export taxes***

Legendary U.S. Senator and tax expert Russell Long once described the definition of tax reform as, 'Don't tax you, don't tax me. Tax that fellow behind the tree.' Exporting state and local taxes to non-residents has considerable political and public appeal. It also aligns with good tax principles when non-resident activities impose public service burdens or create public costs. But in many cases, market forces will simply not accommodate large exportation of tax burdens without harming demand for the product or service being taxed. More fundamentally, most efforts to export tax burdens are ineffective and counterproductive because the incidence of business taxation rests with individuals.

- ***Some goals are best met through federal tax policy***

For many households, the state and local tax burden is smaller than the federal burden. In evaluating tax policy, it is important to understand the interactive effects with federal tax policy and the implications for household and business decision-making. This is especially true for redistributive goals, which economists recognize are best left to the federal system. State borders are very open and significant redistributive efforts can result in people and businesses leaving the state for more welcoming environments (or not coming here in the first place.). People are less likely to move out of the US than they would be to move from one state to another state in search of a more favorable balance between public benefits and resulting tax levels (or public costs more generally).

For more information on tax principles and good tax policy, contact the MCFE at (651) 224-7477.