TALKING TAXES

Tax Principles: Building Blocks of A Sound Tax System

The fundamental purpose of taxation is to raise the revenue necessary to fund public services. But there are many ways to achieve this goal, and there is a widely agreed-upon set of principles according to which good (and bad) tax systems can be evaluated. This policy brief provides a basic overview of six commonly cited principles of sound tax policy: equity, adequacy, simplicity, exportability, efficiency, and balance.

Equity: Two Kinds of Tax Fairness

When people discuss tax "fairness," they're talking about equity. Tax equity can be looked at in two important ways: vertical equity and horizontal equity. **Vertical equity** addresses how a tax affects different families from the bottom of the income spectrum to the top—from poor to rich. Three terms are used in measuring vertical equity:

- *Regressive* tax systems require that low- and middle-income families pay a higher share of their income in taxes than upper-income families. Sales taxes, excise taxes and property taxes tend to be regressive.
- *Proportional* or *flat* tax systems take the same share of income from all families.
- *Progressive* tax systems require upper-income families to pay more of their incomes in taxes than those with lower incomes. Personal income taxes are usually progressive.

Most people accept the notion that, at a minimum, tax systems should not be regressive. Strategies for making state tax systems less regressive include:

- Introducing targeted low-income tax credits such as an Earned Income Tax Credit, a sales tax credit, or a property tax credit to make these taxes less regressive;
- Making personal income taxes more progressive by applying higher tax rates to the wealthiest taxpayers;
- Reducing sales taxes by cutting tax rates or exempting food and other necessities.

Horizontal equity is a measure of whether taxpayers in similar circumstances pay similar amounts of tax. For example, if one family pays much higher taxes than a similarly situated family next door, that violates the horizontal equity principle. Likewise, a tax that hits wage-earners harder than investors (as the federal income tax currently does) fails the test of horizontal equity. This sort of unjustified disparity undermines the public's support for the tax system and diminishes people's willingness to file honest tax returns.

Adequacy

An adequate tax system raises enough funds to sustain public services. Two dimensions of adequacy are stability and elasticity. A **stable** tax is one that grows at a predictable pace. Predictable growth makes it easier for lawmakers to put together budgets that match anticipated revenues to spending. But stability is not enough to achieve adequacy in the long run. For example, property taxes grow predictably—but tend to grow more slowly than the cost of the services that governments provide. **Elasticity** is a measure of whether the growth in tax revenues keeps up with the economy—an important consideration because the cost of providing public services usually grows at least as fast as the economy. An elastic tax system is one that grows faster than the economy during good times, and falls faster than the economy during bad times. Over the course of the business cycle, elastic taxes like the personal income tax are usually the most adequate revenue source.

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Simplicity

Simplicity is an important tax policy goal. Complicated tax rules make the tax system difficult for citizens to understand. Complexity also makes it harder for governments to monitor and enforce tax collections, and makes it easier for lawmakers to enact (and to conceal) targeted tax breaks benefitting particular groups. A tax system full of loopholes gives those who can afford clever accountants an advantage over those who must wade through the tax code on their own. Beware—tax changes described as "simplification" measures are often nothing of the kind. Anti-tax advocates frequently seek to "simplify" the income tax by eliminating the graduated rate structure and instituting a flat-rate tax. This is a red herring: a graduated tax system is no more complicated than a flat-rate tax. The better way to make income taxes simple is to eliminate tax loopholes, not to flatten the rates.

Exportability

The public services provided by state and local tax revenues are enjoyed by individuals from other states—including businesses that hire a state's college graduates and tourists who use a state's transportation infrastructure. Tax systems should be designed in part to make businesses and residents of other states pay their fair share of the state tax burden.

There are broadly three ways in which taxes can be exported: directly, by having non-residents pay the tax (sales taxes paid by tourists, for example); indirectly, by levying taxes on businesses which are then passed on to non-residents; and through interaction with the federal income tax (state and local income and property taxes can be written off on federal tax forms by those itemizing their federal income taxes, for more on this see ITEP Policy Brief #7). All taxes are at least partially paid by non-residents—and policy makers have the power to effectively adjust the percentage of taxes "exported" to residents of other states.

Neutrality

The principle of neutrality (sometimes called "efficiency") tells us that a tax system should stay out of the way of economic decisions. If individuals or businesses make their investment or spending decisions based on the tax code rather than basing them on what makes economic sense on its own, that's a violation of the neutrality principle. State and local governments should not use tax policy to create "winners and losers" by promoting one sector of the economy ahead of another or by favoring one type of income over another.

Balance

One final principle that can be used to evaluate state tax systems is to consider whether they strike an appropriate balance among the types of taxes they levy. States that rely too heavily on a single tax have an especially regressive tax structure. This is certainly true for the nine states that lack a broad based income tax. A state that relies too heavily on one form of taxation may also find itself in a precarious fiscal situation should economic factors disproprtionately affect that tax.

Conclusion

The tax principles outlined here are not the only criteria used by policymakers in enacting tax changes— and the principles can come into conflict with each other. But almost everyone would agree that advocates of tax reform should keep each of these principles in mind as they seek to improve their state's tax system.

To find out more about this issue, contact ITEP at (202) 299-1066