
Principles of Sound State Tax Policy

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Purpose of a Tax Policy Framework

1. To achieve a “high-quality state revenue system.”
2. To guide tax reform by helping to:
 - a. Identify weaknesses in the existing tax system.
 - b. To adequately analyze any proposal for change.

The Principles

1. Equity
2. Certainty
3. Convenience of payment
4. Economy of collection
5. Simplicity
6. Neutrality & efficiency
7. Economic growth and efficiency
8. Transparency, visibility & accountability
9. Minimum tax gap
10. Appropriate government revenues

Presentation of principles based on AICPA and NCSL principles of good tax policy and a high-quality revenue system.

Equity

**Similarly situated taxpayers
should be taxed similarly.**

- aka “horizontal equity.”
- Vertical equity:
 - Minimize regressivity.
 - Minimize taxes on low-income individuals.
- “Fairness” (or really, the *perception* of fairness).

Additional equity considerations

- Consider:
 - Entire range of taxes a taxpayer is subject to.
 - Ability to pay.
 - Benefits received.
- Query: What does “similarly situated mean”?
 - How to factor in age, health, regional differences in cost-of-living, family size, nature of income or assets, etc.?
- Query: How to tie concept to tax mix decisions?
 - EX – income tax versus consumption tax, polluter-pays taxes versus other taxes.

Certainty

Tax rules should specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.

- Certainty, rather than ambiguity.
- Ability to determine tax base, rate and taxpayer.
- Basically, the level of confidence that exists that the tax is being calculated correctly.
- Keep changes to a minimum.
- Ties to *stability* because greater certainty in the tax system means fewer changes needed.
- Ties to *economy in collection* because uncertain system is costly to comply with.

Convenience of Payment

A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.

- Helps ensure compliance.
- Appropriate payment mechanism depends on amount of liability and ease of collection.
- Also consider at which level to collect tax in the chain of parties (for example, distributor versus final consumer).

Economy of Collection

The costs to collect a tax should be kept to a minimum for both the government and taxpayers.

- What is administrative cost as percent of tax generated annually? Will agency need to hire more employees?
- Will costs be so high as to deter people from entering a particular industry?
- Calls for efficient, uniform and fair administration of the tax.
- Closely related to *simplicity* principle.

Simplicity

The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.

Simplicity:

- Reduces the amount of errors.
- Increases respect for the system.
- Enables taxpayers to understand tax consequences of their transactions.
- Should exist in both the law and compliance process.

Neutrality & Efficiency

The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.

- Primary purpose of tax system is to raise revenue.
- Taxpayers should not be unduly encouraged or discouraged from engaging in certain activities due to the tax law.
- Tax break for some taxpayers means higher taxes for others.
- When non-neutrality approach is used, purpose should be explicit.
- Special rules should be reviewed regularly to determine if still needed or if changes are warranted.

Economic Growth & Efficiency

The tax system should not impede or reduce the productive capacity of the economy.

- Tax system should be aligned with the economic goals of the jurisdiction imposing the tax.
 - Should be aligned with state's goals for economic growth, capital formation and interstate and int'l competitiveness.
 - Consider broad bases that keep rates low to improve competitive position to other states.
 - Should not favor one industry or type of investment at the expense of others.

Transparency, Visibility & Accountability

Taxpayers should know that a tax exists and how and when it is imposed upon them and others; system should be accountable to taxpayers.

- Taxpayers should be able to see the true cost of transactions.
- Taxpayers should know when tax is being assessed or paid and to whom.
- Requires regular review of tax expenditures, special tax rules, and earmarked funds.

In a Transparent Tax System ...

Taxpayers:

- can easily calculate liabilities
- grasp logic behind tax laws and rates
- know their own tax burden and that of others
- are aware of extent of compliance by others

[GAO, *Understanding the Tax Reform Debate: Background, Criteria and Questions*, GAO-05-1009SP (2005), pages 47-48;
<http://www.gao.gov/new.items/d051009sp.pdf>]

Minimum Tax Gap

A tax should be structured to minimize noncompliance.

- Tax gap = amount owed less amount collected.
- Procedural rules needed to attain compliance.
- Generally, is a need to strike a balance between:
 - (a) desired level of compliance, and
 - (b) costs of enforcement and the level of intrusiveness of the tax system.
- [General Accounting Office (GAO), *Reducing the Tax Gap – Results of a GAO-Sponsored Symposium*, June 1995, GAO/GGD-95-157, page 13]

Techniques to reduce the tax gap

- Information reporting.
- Sharing of information between various government agencies and with federal government.
- Tax education to reduce unintentional mistakes and help people see the cost to them of the non-compliance of others.

Appropriate Government Revenues

The tax system should enable the government to determine how much tax revenue will likely be collected and when.

- Predictability, sufficiency, reliability, stability.
- Better stability with a mix of taxes.
- Should support healthy budget process:
 - Minimize use of earmarked taxes.
 - Have mechanism for occasional windfall revenues (e.g. Rainy Day Fund).
- Consider local and federal relationships:
 - Is state tax deductible for federal individual income tax purposes?
 - What federal rules and proposals support or harm state revenues?
 - Monitor federal tax rules and proposals and be involved.
 - State tax policy should not impede local tax policy.

Additional policy/design considerations

1. Strategic planning

- Identify state's economic, societal and environmental goals and how tax system can support it and where current rules work against the goals.

2. Modernization

- Check regularly to consider changes in ways of doing business and living, improved technology
- Plan ahead
 - EX – Oregon's 2001 task force on alternatives to gas tax

Additional policy/design considerations

3. Transition in major changes

- ❑ Phase-in or phase-out.
- ❑ Allow taxpayers sufficient time to get ready to deal with a new tax.
 - Successful example – Ohio CAT
 - Unsuccessful example – Michigan expansion of sales tax to selected services effective in 2 months

4. Pursue public education on taxes

- ❑ Low understanding of taxes:
 - Impedes ability to make changes or leads to voters enacting less than ideal rules.
 - Increases tax gap (example – use tax).

Challenges

- Too easy to overlook principles in dealing with budget shortfalls and short time frames.
- Lack of unified support or awareness of benefits of considering principles of good tax policy.
- Desire to use the tax law for more than raising revenue.
- Frequent changes to the federal tax laws.
- Not all principles can be achieved to same degree for all proposed changes - need to strike a balance.

Tax Policy Quick Check

Will the tax liability of one type of taxpayer go up or down more than the liability of another type of taxpayer relative to their incomes? [Equity]	<input type="checkbox"/> Yes <input type="checkbox"/> No
Will most taxpayers be unaware of the change? [Transparency]	<input type="checkbox"/> Yes <input type="checkbox"/> No
Will taxpayers find it more challenging to determine how much they owe, when the tax is due or how to pay it? [Certainty, Convenience of Payment]	<input type="checkbox"/> Yes <input type="checkbox"/> No
Will costs of tax collection increase? [Economy in Collection]	<input type="checkbox"/> Yes <input type="checkbox"/> No
Will new or longer tax forms be needed or new recordkeeping procedures needed? [Simplicity]	<input type="checkbox"/> Yes <input type="checkbox"/> No
Will affected taxpayers be more likely to hire a tax practitioner to determine their tax liability? [Simplicity]	<input type="checkbox"/> Yes <input type="checkbox"/> No
Will it be easier for taxpayers to evade the tax? Will more taxpayers be likely to try to evade the tax? [Minimum Tax Gap]	<input type="checkbox"/> Yes <input type="checkbox"/> No
Will the government budget estimators have difficulty predicting the amount of the tax to be collected annually? Will the change affect the stability or reliability of the tax? Will the change exacerbate flaws that already exist with the tax? [Appropriate Gov't Revenues]	<input type="checkbox"/> Yes <input type="checkbox"/> No
Will some taxpayers be inclined to change their behavior or decisions because of the tax change? [Neutrality]	<input type="checkbox"/> Yes <input type="checkbox"/> No
Will some people perceive the change to be detrimental to the business climate or to economic growth? [Economic Growth and Efficiency]	<input type="checkbox"/> Yes <input type="checkbox"/> No

“Yes” answers indicate problem areas.