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Qualities of a Desirable Tax System

by
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The current fiscal situation facing state and local governments across the U.S. has elevated the public debate about our local government tax to the forefront of public discussion. To address the current budgetary shortfalls the debate has centered on whether expenditures should be reduced or taxes increased or new revenue mechanisms put in place. Clearly a balance must be struck between expenditure reductions and revenue enhancements. During these important public discussions, it is imperative that we stop and think about the qualities we want on both sides of the tax and spend equation. This issue of *Community Economics* we discuss the qualities of a good tax system. These attributes include: (1) revenue potential, (2) efficiency, (3) equity, and (4) accountability. While these attributes do not lend insight into the question of whether or not local taxes are too high, they provide some guidelines for thinking about the issue of how local tax policy should be formulated.

Revenue Potential All other attributes aside, a good tax must be able to generate enough revenue for the purpose it is imposed. User fees, for example, may be fair because they are directly tied to the use of a particular service, but generally fail to generate significant revenue volume. For example, some communities charge a nominal fee for the right to utilize the community public swimming pool. While a ten or even twenty-dollar fee for a pool pass helps defer the costs of provide the services represented by the pool, this fee structure will not generate sufficient revenues to pay for all the costs associated with operating and maintaining a public pool. Further, revenue from the tax should grow in proportion to the growth of the local economy. As a community grows the revenue base must be able to keep pace with increased demand for government services. Finally, the revenue flowing from the tax should be as resistant to economic downturns as possible. The sales tax, for example, may be able to generate significant revenues, grow in proportion to the community, but falls off with downturns in the economy. Thus, the tax must not only reflect the growth of the economy but also affords local officials with some degree of stability for budgeting and planning purposes.

Tax Efficiency When local decision-makers consider how a particular tax might affect economic activity they are considering tax efficiency. Taxes that disturb market decisions the least are more efficient taxes. This attribute is at the center of the taxation and economic growth and development debate. The commonly held perception that governments are inherently wasteful (inefficient) driving taxes unnecessarily higher which in terms harms the local economy. This view is too simplistic. In the broadest sense, in diverting resources to the public sector, taxes of different sorts impose varying degrees of distortions on the economy. Unfortunately, there is no completely efficient tax, since all taxes distort the economy to some extent.

A second dimension to tax efficiency concerns the costs associated with administering and enforcing the tax. Clearly, imposing and collecting a tax places an administrative cost on government and compliance costs imposed on the taxpayer. An efficient tax is one that minimizes those costs.

Tax Equity Tax equity asks "What is fair?" While fairness is "in the eye of the beholder" there are some guidelines to help think through tax equity. Tax equity is often judged on the

basis of the *benefit principal* and the *ability-to-pay principal*. The benefits principal suggests that who benefits most from a government good or service should bear most of the tax burden. A user-fee, such as a toll road, is an example of a tax that follows the benefits principal because the users of the road system are directly paying for it, as long as revenues from the toll are devoted to the road system.

Many public goods and services, such as police protection, cannot be readily supported by a user-fee type tax because there is no reliable or efficient way to measure the benefits each resident receives. Many people believe that individuals with more income, or more property and other wealth, can afford to pay more to support government services and therefore should pay higher taxes. This concept of tax equity is known as the ability-to-pay principal. For example, a person with a large home with many improvements, it is argued, receives more benefits from police and fire protection than a person with a modest home. Based on the benefit principal the homeowner should pay more in support of those protective services.

Two generally accepted notions of equity associated with the ability-to-pay principal are *horizontal equity* and *vertical equity*. Horizontal equity essential means that equals should be treated equally. That is, if two people have the same level of well-being before the tax they have the equal well-being after the tax. In practice this translates into individuals with equal income should have equivalent tax burdens. Vertical equity means that people with different levels of welfare should be treated differently. In order to judge the degree to which a tax system is vertically equitable, one must be prepared to make a judgment about the appropriate way to treat people at different levels of well-being. In practice this is a particularly difficult concept to apply; while the idea of equal is clear, the notion of being treated differently is not as clear and requires subjective judgment. Should an individual with twice the welfare of another pay exactly twice the taxes, or one-third more, or five times as much?

The concept of vertical equity can be reflected in progressive, proportional or regressive taxes. A progressive tax is one that takes a higher percentage of income in taxes at each level of income. The federal income tax system is progressive by the construction of increasing marginal taxation rates. With a proportional tax, the same percentage of income is paid in taxes for all income levels. Finally, a regressive tax is the least defensible on the basis of ability-to-pay or benefits principals. A tax is regressive if the percentage of income taken in tax declines with higher income levels. Fixed dollar fees, such as licenses and some user fees, are regressive.

Accountability A tax should be visible with a clear link between the taxing unit and the services provided. That is, people should known when they are paying taxes and how much they are paying. If local residents become separated from the public policy process, they may become unaware of how local tax dollars are raised and spent. This sometimes called *fiscal illusion* and is not a difficult scenario to imagine in light of the many special districts for certain purposes, the array of public charges for services, the state collection and redistribution of revenues (state aids to local governments and special districts), and the many boards involved in the decision-making process and their unclear relationship to one another.

In some instances taxes become excessively cumbersome and complex. Here individuals may become confused about what they are being taxed on and at what level. Income tax systems that treat different types of income differently, for example wage and interest income, or offer a variety of special tax credits or deductions, can distort the market. The tax code may be altered to encourage, or discourage, certain types of activity and people become confused about how they are being taxed. At the local level tax incentives used in the name of economic development may not only fail the notion of horizontal equity and benefits principal, but also create unintended distortions in the market (i.e., efficiency).

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