

Chapter 2: Tax Principles

Principles for a Well-Designed Tax System

In ESSB 6153, the Committee was directed to evaluate the existing state tax system and to develop multiple alternatives guided by several principles or criteria for a well-designed tax system. The Committee used the following commonly-accepted working definitions for these principles in its determinations.

Commonly-Accepted Definitions

Adequacy/Stability/Elasticity. A good tax system is expected to generate sufficient revenue to pay for established public services without the need for continuous or drastic changes in tax rates or in the tax base.

- *Adequacy* is the ability of the tax system to provide for growth in revenue adequate to fund normal growth in public services as the state's population and economy expand. *Long-run elasticity* (LRE) is a measure of that adequacy. A tax system that has an LRE equal to 1.0 generates revenue growth commensurate with the growth rate of the overall economy. If a tax system has an LRE that is significantly less than 1.0, revenue will grow at a lower rate than the overall economy, posing adequacy problems.
- *Stability* is the ability of the tax system to provide the revenue necessary to maintain public services notwithstanding fluctuations in economic activity over the business cycle. The *short-run elasticity* (SRE) is a measure of the stability of the tax system. A tax system of normal stability has an SRE equal to 1.0 and generates short-run fluctuations in revenue comparable in magnitude to contemporaneous fluctuations in economic activity. A more stable tax system has an SRE that is less than 1.0 and will generate fluctuations in revenue that are smaller than contemporaneous fluctuations in economic activity. The converse is true for a less stable tax system with an SRE greater than 1.0.

Equity/Fairness. A good tax system should distribute the tax burden across taxpayers in a manner that is consistent with the accepted norms of fairness and equity. These norms typically define fairness according to the relationship between the amount of taxes paid (or borne) by taxpayers and their respective abilities to pay the tax, or to the benefits received by them from government programs. Three widely-accepted norms of fairness considered by the Committee are:

- *Vertical Equity.* This principle of fairness requires that the amount of tax paid by taxpayers with different income levels should reflect their respective abilities to

pay the tax. Specifically, taxes paid as a percentage of income should not unduly burden taxpayers with limited ability to pay the tax. Some would view this principle as satisfied by a proportional tax burden, where taxes paid are the same percentage of income for taxpayers at all income levels. Others believe that the principle requires that taxes paid as a percentage of income should be higher for taxpayers with more income than those with less income (a progressive tax burden). To our knowledge, almost no one believes that taxes paid should be a higher percentage of income for less affluent taxpayers than for those with more income (a regressive tax burden).

- *Benefits Received.* A tax may be considered fair if the taxes paid are matched by benefits received by a taxpayer from the government. This principle is most relevant when a tax is levied specifically for the purpose of providing a particular government service to a specific group of taxpayers. Such “benefit taxes” are impractical for much of government spending because the “benefits” received cannot be determined for each taxpayer. Therefore, this principle is relevant mainly for certain types of selective excise taxes which act like user fees, such as the motor vehicle fuel tax. It also applies to taxes that have much in common with insurance premiums, such as employment security and industrial insurance taxes.
- *Horizontal Equity.* According to this principle, taxpayers with similar abilities to pay a tax should pay comparable amounts of the tax. More generally, the principle of horizontal equity enjoins the government from levying taxes that have arbitrary and peculiar distributions of tax burdens across taxpayers or from levying dissimilar tax burdens on taxpayers that are not justified by differences in their ability to pay or by distinctions in the benefits they receive from government programs.

Economic Vitality and Harmony with Other States. A good tax system should not place business enterprises located within the state at a competitive disadvantage relative to similar enterprises located in other states. At a minimum, this requires the following:

- The state tax system should not unduly burden enterprises located or considering locating within the state of Washington relative to the business tax systems of other states that offer a comparable non-tax business environment.
- The state tax system should be harmonized with those of other states in order to prevent, or provide relief from, double or multiple levels of taxation on the same economic activity. Similarly, the tax system should minimize the opportunities for selective tax avoidance that would allow some firms to shift their taxable activity out of the state and thereby raise the tax burdens on other firms within the state.

- The state tax system should support a stable economic infrastructure conducive to a vital and growing economy. It should not subject the state economy to fiscal crises that create a climate of fiscal and economic uncertainty.

Economic Neutrality and Efficiency. A good tax system should not distort economic decisions. Distortions cause a measurable loss in the economic value of production and consumption, which increases the tax burden on the residents of the state. There are two important methods for minimizing the burden on state residents of raising a given amount of state tax revenue:

- Different production and consumption activities should be subject to the same effective rate of tax. Such a *neutral* tax system is efficient when taxpayers make decisions based on economic advantages rather than tax advantages.
- The state should minimize the tax burden on state taxpayers by choosing a tax system that maximizes the extent to which taxes can be *exported* (paid by nonresidents). An example of exporting is facilitating Washington taxpayers' abilities to take full advantage of deducting state and local taxes on their federal income tax returns. This deductibility allows the taxpayers to shift part of their state and local tax burden to the federal government by reducing federal taxes paid.

Transparency and Administrative Simplicity. People should know when they pay taxes and how much they pay. A good tax system is designed to ensure that the tax burdens on residents are clear and evident. The rules, record-keeping and computation requirements should be simple enough that the tax system can be administered at low cost by the tax collection agency without imposing an undue compliance burden on the taxpayer.

Home Ownership. The tax system should facilitate, or at least not impede, the ability of individuals and families to purchase and maintain a home consistent with their standard of living.

Interaction of Principles

The Committee recognized that in certain instances the advancement of some principles may conflict with the maintenance or advancement of others. In other cases, the advancement of several principles may be complementary. The possibilities of conflict include:

- Exempting necessities from taxation may increase fairness but reduce neutrality. For example, the exemption for groceries under the retail sales tax (RST) reduces the neutrality of the tax and induces households to purchase more of the exempted categories of goods. However, because low-income households spend disproportionately more on necessities, these exemptions reduce the regressivity of the RST, and therefore serve to advance vertical equity.

- A tax that collects regular amounts of revenue regardless of fluctuations in economic activity increases fiscal stability but imposes a steady burden on taxpayers at times when they are less able to bear them. Such taxes are also procyclical (i.e., they exacerbate the state business cycle). On the other hand, a tax for which revenue fluctuates more than economic activity increases the chance of a fiscal crisis, yet it is counter-cyclical and acts as an economic stabilizer.
- The vertical equity principle may conflict with the benefit principle of fairness, such as in the case of motor fuel and cigarette excise taxes. Although such excise taxes may be justified by the transportation and health benefits received by the taxpayer, they increase the regressivity of the tax system and burden lower-income people disproportionately.
- Actively promoting home ownership requires a non-neutral tax structure. Whereas a neutral tax structure treats all forms of consumption alike, including housing services (whether rented or owned), promoting home ownership would require a preferential treatment for expenditures on owner-occupied housing.

Given the potential conflicts among the principles, the Committee sought tax structure alternatives that could balance competing objectives and, where possible, take advantage of complementarities among the principles. The primary areas where the Committee found complementarities are as follows:

- Broad-based, uniform taxes with fewer exemptions can advance the principles of adequacy, stability, neutrality, and horizontal equity. The broader the tax base, the greater the tendency for revenue to grow and fluctuate in concurrence with overall economic activity. Also, a uniform tax rate structure treats different taxpayers even-handedly while minimizing the distorting impact of taxation on taxpayer decisions.
- A more transparent tax structure may be complementary to increased competitiveness. A major cause of non-transparency occurs when taxes levied on businesses are passed on to consumers in the form of higher prices—the so-called “hidden” taxes. When business taxes cannot be passed on, competitiveness is reduced. Increasing the fraction of taxes levied on households relative to taxes levied on businesses makes the tax system both more transparent and more competitive.

Taxpayer Perceptions and Considerations

Although the principles defined above represent a consensus of most tax experts about good tax system design, the perceptions of ordinary taxpayers as revealed by surveys and by studies conducted by behavioral scientists may operate in addition to, or in some instances in opposition to, these principles.

In this regard, two questions especially concerned the Committee.

- In addition to the principles enunciated above, what factors might influence taxpayer perceptions as to the fairness of a particular tax relative to another?
- What factors influence taxpayer perceptions as to how burdensome a tax is relative to the objective burden as measured by the revenue collected?

In the Committee's investigation of these matters, the following observations were made:

- Taxpayers seem to be unusually averse to "lumpy" taxes (a tax paid all at once is "lumpy"). Unexpected lumpy taxes are the least popular.
- Taxpayers may be more resistant to taxes that are transparent than to taxes that are hidden in the prices of the goods they buy. Thus, the principle of transparency may conflict with the political feasibility of certain tax reforms because the replacement of hidden taxes with transparent taxes may be perceived as an overall tax increase.
- Taxpayers prefer taxes they think they can control through their own actions, such as taxes on discretionary purchases. This preference conflicts with the principle of neutrality, which ranks as superior a tax system that minimizes such taxpayer control.
- Surveys in other states have found that many taxpayers list the retail sales tax as the "most fair" because everyone pays the same rate of tax. However, sales taxes are regressive because low-income taxpayers spend a larger portion of their incomes than do high-income taxpayers. Thus a tax that is perceived as fair in one respect is considered unfair according to the principle of vertical equity.
- People dislike taxes to which they are not accustomed.
- Taxpayers have a sense of "reciprocity." Hence, they are less resistant to earmarked taxes where they perceive the benefit of a tied government service. Another example of reciprocity is that people are more likely to comply with a tax when they perceive that other taxpayers comply.

While taxpayer perceptions should not take priority over the accepted principles of good tax system design, it is wise to take note of them when evaluating the existing tax system and any potential alternatives. The operative principle here was best expressed by Abraham Lincoln who said, "A universal feeling, whether well or ill-founded, cannot be safely disregarded." Also, discrepancies between taxpayer perceptions and the principles of good tax design identify issues on which it is particularly important to inform and educate voters about the objectives of proposed reforms.