Washington Research Council

Policy Brief
June 14, 2012 PB 12-14

Five Keys to Evaluating a Tax System

Briefly

Economic neutrality, administrative simplicity, stability, transparency and fairness are the five principles that the Research Council uses to evaluate tax systems.

The Washington Research Council has long advocated that tax policy be evaluated against five principles of a good tax system: economic neutrality, administrative simplicity, stability, transparency and fairness. These five principles were cited in the 2001 legislation (ESSB 6153) establishing the Washington State Tax Structure Study Committee (commonly known as the Gates Committee).

Since the five principles don't always align, the design of a tax system necessarily involves trade-offs between them.

Economic Neutrality

A tax system should be designed to minimize tax-based distortions in decision making and to promote the efficient use of resources.

In *The Wealth of Nations*, Adam Smith put it this way:

> Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state. A tax may … obstruct the industry the people, and discourage them from applying to certain branches of business which might give maintenance and unemployment to great multitudes. While it obliges the people to pay, it may thus diminish, or perhaps destroy, some of the funds which might enable them more easily to do so.

Economists call such tax-induced losses in efficiency *excess burdens*—costs to taxpayers in excess of the monies paid to government.

With respect to state-level taxes, economic neutrality is often framed in terms of economic competitiveness. The Tax Structure Study Committee, for example, stated that "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."

Washington ranks relatively high in the share of state and local government revenue raised through taxes on businesses (E&Y 2011). A recent study done for the Tax Foundation by KPMG shows that Washington's attractiveness as business location, from a tax standpoint, varies dramatically by industry. For example, the state ranks 16th (best) for a mature capital-intensive manufacturer, 29th for a mature labor-intensive manufacturer, 41st for a newly-established capital-intensive manufacturer and 48th for a newly-established labor-intensive manufacturer (Tax Foundation 2012).

Administrative Simplicity

A tax system should not be excessively expensive for the state to administer. Similarly, a tax system should be easy for taxpayers to understand and should not impose undue record-keeping and reporting expenses on them.

Taxpayer compliance costs are another form of excess burden.

When state and local governments impose the same tax, there should be a common set of definitions and a common collection system. State and local auditing of taxpayers should likewise be integrated.

The 1982 Tax Advisory Council cited relatively low state-administrative and taxpayer-compliance costs as positive features of Washington's tax system. Tax liabilities are simple to calculate, and individuals need not file income tax forms with the state (Washington State 1983).

Stability

The revenue of a tax system should not fluctuate wildly with the condition of the economy. Similarly, the system itself should be stable. Taxpayers should be able to accurately forecast what their future tax obligations will be.

Over time, all tax structures will show revenues fluctuating relative to the economy. Highly progressive income taxes tend to produce windfall revenues during times of rapid growth, but plummet when the economy falters. Washington showed remarkable stability during the recession of the early 2000s, as consumer spending remained steady during the decline.

The Tax Structure Study Committee concluded:

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Although Washington's tax system is volatile overall, it has a number of stable elements, and during certain business cycles it is not as volatile as some other state tax systems. The property tax, on which Washington is more reliant than most states, is more stable than either a sales or income tax. Also, the sales tax, although volatile, is less volatile than a graduated personal income tax. There is no evidence that a flat rate personal income tax in Washington would be less volatile than the sales tax. The B&O tax is not as volatile as a corporate income tax (WSTSSC 2002)

Transparency

A tax system should be designed so that the costs of government are clear to citizens.

Economists distinguish between a tax's statutory incidence and its economic incidence. The former identifies the person who is legally obligated to pay the tax; the latter identifies who ultimately pays it, after accounting for all of the changes in market prices the tax induces. The basic lesson of the theory of tax incidence is that statutory and economic tax burdens are not necessarily related. This "means that taxes on capital may be borne by workers, that investment incentives may be injurious to capitalists, that taxation of foreigners may simply represent indirect domestic taxation, and that generations alive many decades in the future may be supporting those currently alive" (Kotlikoff and Summers 1987).

Because of this shifting, it is not transparent to most individuals how much tax they actually pay. To promote political accountability, many economists believe that those taxes where the statutory and economic incidences coincide are better than taxes where the statutory and economic incidences differ wildly.

As noted above, a relatively high share of state revenue comes from taxes on businesses. Much of this burden is shifted either forward onto customers or backwards onto workers. Because of this, Washington's tax system ranks relatively low on transparency.

Fairness

The burden of taxation should be equitably spread among the citizens.

Few would disagree with the preceding statement. There is, however, less agreement on what it means for the burden to be "equitably spread."

There are two dimensions of equity: Horizontal equity concerns the distribution of burden across persons who are the same in all relevant aspects. Vertical equity concerns the distribution of burden across persons who differ in income or wealth.

The 1982 Tax Advisory Council defined fairness with this quote from *The Wealth of Nations*:

> The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.

A tax system where all taxpayers contribute at the same rate relative to their ability to pay is said to be proportional. A system where the rate of contribution rises with ability to pay is said to be progressive, while a system where the rate of contribution falls with ability to pay is said to be regressive.

A widely cited study by the Institute on Taxation and Economic Policy (ITEP) finds the average state tax system to be regressive and Washington's tax system to be the most regressive. However, as we have noted elsewhere, the ITEP study is biased against states lacking income taxes because it examines tax burdens at a single point in time rather than over the full lifecycle of the taxpayer and biased against Washington because of way the study treats our unique business and occupation tax (WRC 2010).

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