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POLICY BRIEF

Guiding Principles of a Fair and Effective Tax System

Prepared for the
Washington State Tax Structure Committee
by Washington Policy Center

January 2002

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<u>Introduction</u>

The proper function of taxation is to raise money for government. This is true regardless of whether government is big or small, and this is true for lawmakers at all levels of government. Taxation always will impose some damage on an economy's performance, but that harm can be minimized if policymakers resist the temptation to use the tax code for social engineering, class warfare and other extraneous purposes. A simple and fair tax system is an ideal way for advancing Washington's economic interests and promoting prosperity for its residents.

The fundamental principles discussed in this paper provide guidance for a fair and effective tax system; one that raises needed revenue for government, while minimizing the burden on citizens.

Today, Washington is the fifth most highly taxed state, measured per capita, in the nation. The people of Washington pay more to meet their tax obligation than they do for food, clothing and transportation combined. We also have one of the latest "Tax Freedom Days," the date each year on which citizens have earned enough to pay their tax obligation, of any state. Basic to the concept of a fair tax system is that the state should take no more from citizens than it needs to pay for the essential functions of government. This consideration goes beyond the need to balance the budget; it is a matter of fundamental respect and trust between citizens and their government.

Unfortunately, short-term political considerations usually drive tax policy. Many states have so-called highly "progressive" tax regimes, which punish those who add more wealth to an economy. Many lawmakers think of the tax code as a way to penalize "bad" behaviors and reward "good" ones. They have sought incessantly to guide, micromanage and steer the economy by manipulating the tax laws.

The federal government is the biggest culprit, but the tax policies of state governments often add to the problem. The result is less prosperity, tax systems that stifle entrepreneurship and hinder productive behavior. The only winners in a complex “progressive” tax system are the lawyers, accountants and entrenched interests who benefit from manipulating the system.

State tax policy has an added dimension, jurisdictional competition. It is relatively easy for individuals and businesses to move from one state to another. As a result, states that maintain onerous tax regimes almost certainly will lose jobs and growth to competing states. Competition also exists at the international level – which is why America is so prosperous compared to Europe, but state lawmakers are even more likely to reap quick rewards if they implement pro-growth, pro-opportunity tax policy.

Below are fundamental principles that should guide the development of a fair and effective tax system, one that raises needed money for government while minimizing harmful impacts on our economy.

Guiding Principles

Simplicity – The tax code should be easy for the average citizen to understand, and it should minimize the cost of complying with the tax laws. Tax complexity adds cost to the taxpayer, but does not increase public revenue. For governments, the tax system should be easy to administer, and should help promote efficient, low-cost administration.

Accountability – Tax systems should be accountable to citizens. Taxes and tax policy should be visible and not hidden from taxpayers. Changes in tax policy should be highly publicized and open to public debate.

Economic Neutrality – The purpose of the tax system is to raise needed revenue for the government, not control the lives of citizens. The tax system should exert minimal impact on the spending and business decisions of individuals and businesses.

Equity and Fairness – Fairness means all taxpayers should be treated the same. The government should not use the tax system to pick winners and losers in society, or unfairly shift the tax burden onto one class of citizens. The tax system should not be used to punish success or to “soak the rich.”

Complementary – The tax code should help maintain a healthy relationship between the state and local governments. The state should always be mindful of how its tax decisions affect local governments so they are not working against each other – with the taxpayer caught in the middle.

Competitiveness – A low tax burden can be a tool for Washington's economic development by retaining and attracting productive business activity. A high quality revenue system will be responsive to competition from other states.

Balance – An effective tax system should be broad-based, without relying too heavily on a few sources of revenue. For the same reason, a tax system should avoid special exemptions, preferring a low overall tax rate with few loopholes.

Reliability – A high quality tax system should be stable, providing certainty in taxation and in revenue flows. It should provide certainty of financial planning for individuals and businesses.

While these guiding principles are important, there are inherent problems with any system of taxation. Basically, taxation reduces spending on private sector goods and services traded in the free market. The benefits of free exchange – to both the purchaser and seller – are reduced when trade is restrained by taxation. The way that taxes restrain private trade varies. Income and property taxes reduce incomes to taxpayers, lowering their demand for goods and services. Sales and excise taxes increase costs to suppliers, reducing their willingness to provide goods at any given prices. In any case, taxes reduce private trade.

Benefits of a low tax burden

Since taxes lower the economic welfare of citizens, policymakers should try to minimize the economic and social problems that taxation imposes. Citizens then directly gain the benefits of a low tax burden.

Faster economic growth – A tax system that allows citizens to keep more of what they earn spurs increased work, saving and investment. A low tax burden will mean a competitive advantage for Washington over states with high-rate, overly progressive tax systems.

Greater wealth creation – low taxes significantly boost the value of all income-producing assets and help citizens maximize their fullest economic potential, thereby broadening the tax base.

End micromanagement and political favoritism – a complex, high-rate tax system favors interests that are able to exert influence in Olympia, and who can negotiate narrow exemptions and tax benefits. "A fair field and no favors" is a good motto for a strong tax system.

Increased civic involvement – A complex, high-rate tax systems makes it nearly impossible for the average citizen to understand why and how money is being taken by the state. Citizens become cynical and alienated from their government. At some point, most citizens come to feel the state government no longer represents their interests. A simplified, broad-based, low-rate system encourages citizens to become re-engaged with government and to seek greater civic involvement.

The people of Washington work hard for what they earn. Money paid in taxes is by definition not available to meet the other needs of life. Naturally residents require and expect basic government services and taxes must pay for these services, but government revenue should be limited to real public needs, so that the tax system itself does not becomes part of the burden. For that reason a fair and efficient tax system is a matter of having respect for the citizens of our state.

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