Principles of a good tax system

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Tax Principles

The proper function of taxation is to raise money for core functions of government, not to direct the behavior of citizens. This is true regardless of whether government is big or small, and this is true for lawmakers at all levels of government. 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.

Tax Principles

Taxation will always 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.

Tax Principles

The following fundamental tax principles provide guidance for a fair and effective tax system; one that raises needed revenue for core functions of government, while minimizing the burden on citizens:

- Simplicity
- Accountability
- Economic Neutrality
- Equity and Fairness
- Complementary
- Competitiveness
- Balance and Reliability

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 core functions of 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 and Reliability

An effective tax system should be broad-based, avoid special exemptions, and utilize a low overall tax rate with few loopholes. 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.

Benefits of a Low Tax Burden

- Faster economic growth
- Greater wealth creation
- End micromanagement and political favoritism
- Increased civic involvement

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 would 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 the state capitol, 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 system makes it nearly impossible for the average citizen to understand how and why the state is collecting money. 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.

Tax Transparency

Another important principle for elected officials to embrace is tax transparency. Individuals and business owners should be able to quickly and easily learn about how much officials in each taxing district add to their total tax burden. This is especially true when considering there are nearly 1,800 taxing districts in the state.

Tax Transparency

To improve tax transparency an online searchable database of all tax rates in the state should be created and modeled after the state's searchable budget website (fiscal.wa.gov). The online tax database should be set up to allow users to find their state and local tax rates (such as property and sales taxes) by entering their zip code, street address, or by clicking on a map showing individual tax district boundaries. An online calculator should also be included to allow citizens to calculate what their potential total tax burden is and know which of their elected officials are responsible for which parts of it.

– SB 6105: Concerning transparency in state and local taxation (2009)

Tax Structures and Volatility

A 2010 study by the St. Louis Federal Reserve Bank (State Tax Revenue Growth and Volatility) found that Washington's tax structure resulted in the 4th least volatile tax revenues. The study covered tax collections between 1995-2009.

The reason for this is Washington's three major tax sources (sales, gross receipts, and property) are among the least volatile taxes. Progressive income and capital gain taxes, however, are the most volatile taxes.

http://research.stlouisfed.org/publications/red/2010/01/Cornia.pdf

St. Louis Federal Reserve Bank

"As mentioned, the retail sales and gross receipts tax is a very significant revenue source for state and local governments. As shown in Figures 6A and 6B, it grows moderately relative to other tax revenues and is also reasonably stable. It does have a couple of very negative growth quarters. The mean for this category is probably influenced by a series of three quarters of significantly large declines."

"The property tax is mainly used to finance local government. Its combination of high growth and low volatility make it a very attractive revenue source. Its high growth rate is undoubtedly related to the real estate bubble that existed during the early part of this century. If real estate prices continue to decline, however, the growth rate of the property tax could decline commensurately."

St. Louis Federal Reserve Bank

“The corporate income tax is especially problematic in state budgeting because of its high volatility. Interestingly, its high volatility is not associated with a high growth rate. From a similar point of view used to analyze financial markets, this is a high-risk revenue source without compensation provided by higher expected growth.”

“As mentioned, individual income taxes also constitute a very important source of revenue for state and local governments. Their growth rate exceeds that of the retail sales and gross receipts taxes. It is also much more volatile. This volatility is undoubtedly the source of many of the current budgeting challenges faced by state and local governments. Notice the large number of outliers, which correspond to negative rates of growth during the current recession. The significant number of positive deviations possibly encouraged state and local governments to increase their government expenditures and base budgets.”

S&P Bond Rating

The relative stability of Washington's tax structure has also been noted by Standard & Poor's. From S&P's July 2013 bond rating for the state:

"Sales tax-based revenue structure that exhibits sensitivity to economic cycles but to a lesser degree than those of states that rely primarily on personal and corporate income taxes."

"The state's reliance on retail sales and business and occupation (gross receipts) taxes for a combined 69% of general fund tax revenues (on a budgetary basis) typically affords more revenue stability than other states enjoy because many of them rely on personal income tax revenues."

http://www.tre.wa.gov/documents/SnPBonds__2014A,2014B,2014T.pdf

No magic tax bullet for budgets

There is no such thing as a recession-proof tax structure. For budget peace of mind when the economy recovers, states need to use a “three-legged stool” of sound budgeting:

- Meaningful spending limit to avoid overextending in the good times;

- Protected 10% reserve account (so you don’t have to resort to tax increases or deep spending cuts in the bad times); and

- Limiting base expenditures to core functions within the revenue forecast when in the good times.

Questions?

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