Policy Approach to Analyzing Tax Systems

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Overview: This analysis is based on testimony presented by Professor Nellen on 4/21/03 to the Commission on Tax Policy in the New Economy,[1] at the California State Capitol Building in Sacramento, CA. It is based on the AICPA Tax Policy Concept Statement 1 – *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*, first issued in 2001 and modernized in 2017. The 12 principles laid out in that statement are compared to frameworks used by other groups including government agencies and tax reform panels. The comparison list has subsequently been expanded. The purpose is to illustrate that there is a core set of tax principles that can effectively be used to evaluate tax proposals and existing tax systems. At the state and local level, additional principles may be included such as the possible effect on interstate competition.

Tax Policy Perspectives: Analyses of tax systems almost always looks at tax principles as criteria for understanding and critiquing tax systems. The principles are typically the same although terminology, emphasis and sequencing may differ. Listed below are some examples of tax system analyses that have applied principles of good tax policy and effective tax systems.

American Institute of Certified Public Accountants (AICPA) – Tax Policy Concept Statement 1 – *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals* - http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/tax-policy-concept-statement-no-1-global.pdf.

This report, issued in 2001 and updated in 2017,[2] lays out 12 principles of good tax policy that had been used by lawmakers and others for decades, if not centuries (two were added in the 2017 version). The purpose of the statement is to provide a tool for policymakers to evaluate existing tax rules or systems, as well as reform proposals to determine where improvements were needed to make the rule or system more effective. The ten principles are summarized below.

- **Equity and Fairness -** Similarly situated taxpayers should be taxed similarly.
- **Certainty -** The tax rules should clearly specify how the amount of payment is determined, when payment of the tax should occur, and how payment is made.
- **Convenience of Payment** – Facilitating a required tax payment at a time or in a manner that is most likely convenient for the taxpayer is important.
- **Effective Tax Administration -** Costs to collect a tax should be kept to a minimum for both the government and taxpayers.[3]

[1] The Commission used the AICPA version of the principles in their final report; http://www.library.ca.gov/crb/catax/.
[2] The author of this report (Annette Nellen) was the lead author for both the AICPA (2001 and 2017) and Joint Venture documents noted here. The two principles added to the AICPA document in 2017 are information security and accountability to taxpayers.
[3] Originally referred to as "economy in collection" in the 2001 AICPA document and by Adam Smith.

- **Information Security** – Tax administration must protect taxpayer information from all forms of unintended and improper disclosure.
- **Simplicity -** Simple tax laws are necessary so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.
- **Neutrality** – Minimizing the effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction is important.
- **Economic Growth and Efficiency -** The tax system should not unduly impede or reduce the productive capacity of the economy.
- **Transparency and Visibility -** Taxpayers should know that a tax exists and how and when it is imposed upon them and others.
- **Minimum Tax Gap** – Structuring tax laws to minimize non-compliance is essential.
- **Accountability to Taxpayers** – Accessibility and visibility of information on tax laws and their development, modification and purpose, are necessary for taxpayers.
- **Appropriate Government Revenues** – Tax systems should have appropriate levels of predictability, stability and reliability to enable the government to determine the timing and amount of tax collections.

Joint Venture: Silicon Valley Network - In 2001, the Tax Policy Group of Joint Venture: Silicon Valley Network turned the AICPA's 10 principles (now 12) into a workbook to help elected officials and others in applying the 10 principles to analyze tax proposals. In doing so, they reorganized the principles into three categories as follows:

- Fairness
    - Equity and Fairness
    - Transparency
- Operability
    - Certainty
    - Convenience of Payment
    - Economy of Collection
    - Simplicity
    - Minimum Tax Gap
    - Appropriate Government Revenues
- Appropriate Purpose and Goals
    - Neutrality
    - Economic Growth and Efficiency

Joint Committee on Taxation – *Description and Analysis of Proposals To Replace the Federal Income Tax*, JCS-18-95, 6/5/95, pages 58 – 59. https://www.jct.gov/publications.html?func=startdown&id=2481

Excerpt:

> "Analysts generally judge tax systems in term so how well the tax system answers four different questions.
>
> - First, does the tax system promote or hinder economic efficiency. That is, to what extent does the tax system distort taxpayer behavior? Does the tax system create a bias against the

domestic production of goods and services? To what extent does it promote economic growth?

- Second, is the tax system fair? Does the tax system treat similarly situated individuals similarly? Does the tax system account for individuals' different capacities to bear the burden of taxation?
- Third, is the tax system simple? Is it costly for taxpayers to determine their tax liability and file their taxes?
- Fourth, can the tax system be easily administered by the government and can it induce compliance by all individuals? Is enforcement costly? Can some individuals successfully avoid their legal liabilities?

The design of a tax system involves tradeoffs between these different goals. Measures designed to ensure compliance may increase the complexity of taxation for individual filers. Measures designed to promote simplicity may create distortions in individual choice of investments. Measures designed to promote growth may alter the distribution of the tax burden."

Government Accountability Office (GAO) – *Understanding the Tax Reform Debate: Background, Criteria and Questions*, GAO-05-1009SP (9/05); http://www.gao.gov/new.items/d051009sp.pdf.

Excerpt:
"Long-standing" criteria for evaluating tax policy:

1. Equity – including principles of:
    a. Ability to pay
        i. Horizontal equity
        ii. Vertical equity
    b. Benefits received
2. Economic Efficiency
    a. Efficiency costs include (1) taxes owed, (2) "efficiency cost" (costs that reduce well-being – effect of taxes on decisions to do or not to do something), and (3) compliance costs.
3. Combination of simplicity, transparency, and administrability
    a. Simplicity:
        i. Compliance burden
    b. Transparency of
        i. Tax calculations
        ii. Logic behind the rules
        iii. Tax burden
        iv. Compliance
    c. Administrability
        i. Processing returns
        ii. Enforcing the law
        iii. Providing taxpayer assistance

National Conference of State Legislatures (NCSL) – A set of nine principles were developed by a bipartisan group of legislators, staff and others from both the public and private sectors in 1991.[4]

These principles of a "high-quality state revenue system" are:[5]

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[4] Scott Mackey, *Tax Policy Handbook for State Legislators*, NCSL, 12/97, pg. 7.

"Principles of a High-Quality State Revenue System:

1. A high-quality revenue system comprises elements that are complementary, including the finances of both state and local governments.
2. A high-quality revenue system produces revenue in a reliable manner. Reliability involves stability, certainty and sufficiency.
3. A high-quality revenue system relies on a balanced variety of revenue sources.
4. A high-quality revenue system treats individuals equitably. Minimum requirements of an equitable system are that it imposes similar tax burdens on people in similar circumstances, that it minimizes regressivity, and that it minimizes taxes on low-income individuals.
5. A high-quality revenue system facilitates taxpayer compliance. It is easy to understand and minimizes compliance costs.
6. A high-quality revenue system promotes fair, efficient and effective administration. It is as simple as possible to administer, raises revenue efficiently, is administered professionally, and is applied uniformly.
7. A high-quality revenue system is responsive to interstate and international economic competition.
8. A high-quality revenue system minimizes its involvement in spending decisions and makes any such involvement explicit.
9. A high-quality revenue system is accountable to taxpayers."

California Legislative Analyst's Office – *The 2003-04 Budget Bill: Perspectives and Issues – The Governor's Tax Proposal: Evaluation and Alternatives*, February 2003, http://www.lao.ca.gov/analysis_2003/2003_pandi/pi_part_5a_taxes_anl03.html.

"Excerpt (Figure 2)

Essential Criteria for Evaluating The Governor's Tax Proposals:

- *Growth Performance*—Will the new tax revenues grow along with the economy and/or the program responsibilities they are expected to fund?
- *Reliability and Volatility*—Are new revenues raised by the taxes relatively stable over time or are they excessively volatile and difficult to predict?
- *Distributional Effects*—Is the additional burden or "incidence" from the increased taxes distributed among taxpayers in a manner that the Legislature believes is appropriate?
- *Tax Administration*—Are the new taxes simple to collect and administer or do they add additional complexity to the existing administrative structure?
- *Federal Interaction*—Would the increased taxes be deductible for federal purposes, allowing the state to "shift" some of the additional tax burden to the federal government?
- *Economic Climate*—What effects are the proposed tax increases likely to have on the business climate and overall economic activity?"

Washington State Tax Structure Study Committee – *Tax Alternatives for Washington State: A Report to the Legislature*, November 2002, Chapter 2 http://dor.wa.gov/Content/AboutUs/StatisticsAndReports/WAtaxstudy/wataxstudy.htm.

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[5] NCSL, *Principles of a High-Quality State Revenue System*, updated 6/07; http://www.ncsl.org/research/fiscal-policy/principles-of-a-high-quality-state-revenue-system.aspx.

The charge of the committee was to study Washington's existing tax structure and recommend alternatives to improve the system. The extensive report issued in 2002 begins with an explanation of tax principles for a "well-designed tax system." It also explains the existing structure and where it does and does not meet the tax principles. The study also explains various constraints to change that exist in the U.S. and state constitutions and local government funding limitations. Such constraints are important in reform efforts as they are limitations that likely can't be changed.

Various proposals are analyzed including major ones such as replacing a portion of the tax structure with some type of value-added tax or adding a state income tax (currently, Washington imposes no income tax). Incremental proposals such as continuing to impose an estate tax even after repeal of the federal tax, are also made. Additional proposals include extending the sales tax to consumer services, compensating vendors for collecting the sales tax, periodically reviewing exemptions and business incentives, and exempting construction labor from the sales tax. Each proposal made is analyzed in terms of it would allow the system to better meet the tax principles and what problems it might create in terms of not completely meeting particular tax principles.

The tax principles used to guide the committee's work were as follows.[6]

- Adequacy/stability/elasticity
- Equity/fairness
- Economic vitality and harmony with other states
- Economic neutrality and efficiency
- Transparency and administrative simplicity
- Home ownership

Hawaii 2010-2013 Tax Review Commission – *Report*, 2012, http://tax.hawaii.gov/stats/a9_2trc/.[7]

The Commission uses a set of principles for "sound tax policy" provided by the National Conference of State Legislatures (NCSL) that were compiled in 1988 with input from lawmakers and academics. The five principles are:

1) Raising adequate revenues (focuses on sufficiency, stability and certainty of revenues produced).
2) Neutrality.
3) Fairness.
4) Ease of administration and compliance.
5) Accountability (including regular review of the law, fair and efficient administration, transparent policies).

Note: The NCSL list was expanded to nine principles by 2007 (see earlier description and chart below).

Georgia 2010 Special Council on Tax Fairness for Georgians[8] **–** *Final Report*, 2011

This Georgia Council was formed in 2010 via legislation. Its final report was released in January 2011. The Council established seven principles to guide its work:

[6] The principles were provided to the committee in ESSB 6153 (likely some type of legislative directive).

[7] Hawaii's Tax Review Commission, 2005-2007 used the following principles: fairness, efficiency, simplicity, transparency and accountability, adequacy and stability, and competitiveness; http://tax.hawaii.gov/stats/a9_2trc/.

[8] The Council was created through legislation in 2010 (HB 1405; http://www.legis.ga.gov/Legislation/20092010/106078.pdf).

1) Growth Enhancing – "Tax policy should foster strong economic growth, job creation, and a rising standard of living for all Georgians."
2) Efficient – "Tax structures should minimize distortions of both household economic choices and of capital and labor allocations by business."
3) Stable – "The system of taxation should be stable such that changes in state revenue occur in line with changes in the general level of economic activity so that frequent changes in tax rates and severe changes in the delivery of government services are avoided."
4) Clear – "Tax structures should be simple, understandable, and predictable."
5) Fair and Equitable – "Tax burdens should recognize the ability to pay or benefits received. Similarly situated taxpayers should pay approximately the same amount of tax."
6) Properly Developed – "The Tax Reform Council should conduct its business openly and should develop its recommendations based on an analysis of the issues and options."
7) An Avenue for Resolution – "The system of taxation should include an avenue for resolving tax disputes that is unbiased, transparent, cost-effective for all parties, and easily accessible."

Vermont Blue Ribbon Tax Structure Commission

- Created in 2009 by legislation (Act 1, Sec. H. 56) with three members.
- Final report issued in January 2011 - http://www.leg.state.vt.us/jfo/blue_ribbon_tax.aspx.
- The Commission evaluated the NCSL principles. There was also a presentation made recommending use of the AICPA tax principles. The final report states that the Commission "coalesced" around these principles (pages 15 – 17):
    1. "Fairness, Actual and Perceived
    2. Economic Competitiveness
    3. Simplicity
    4. Transparency
    5. Tax Neutrality
    6. Sustainability
    7. Executive and Legislative Accountability to Tax Payers
    8. Revenue Neutrality and Interoperability"
- Fairness was further defined to include three key elements:
    1. "Broad Base and Low Rate: Policymakers should avoid enacting targeted deductions, credits, and exclusions. If such tax preferences are few, substantial revenue can be raised with low tax rates.
    2. Progressive: Taxes ought to be based on the capacity to pay, treating individuals and businesses equitably within their tax classes.
    3. Ubiquity: Everyone, regardless of income or assets, should pay something to feel vested in the system that serves them."

Comparing Sets of Tax Principles

As noted above, reports of governments and various tax organizations and committees have used a set of tax principles to analyze tax structures and tax proposals. A logical question arises from looking at all of this – is there a common set of principles? The answer is yes. While terminology and layout may vary, the concepts are the same. Some reports either ignored a principle that others used or did not find it to be as important, perhaps, in its particular analysis. The following chart helps to illustrate the similarities among the principles utilized.

<table>
<tr><th>AICPA</th><th>Joint Committee on Taxation</th><th>GAO</th><th>NCSL</th><th>CA Legislative Analyst's Office</th><th>Washington</th><th>Hawaii</th><th>Georgia</th><th>Vermont</th></tr>
<tr><td>Equity and fairness</td><td>(2) Is the tax system fair?</td><td>Equity</td><td>(4) Treat individuals equitably; minimizes regressivity and taxes on low-income individuals</td><td>Distributional effects</td><td>Equity/fairness</td><td>Fairness</td><td>Fair and Equitable</td><td>Fairness, actual and perceived</td></tr>
<tr><td>Certainty</td><td rowspan="3">(4) Can the tax system be easily administered?</td><td></td><td>(2) Certainty; number and types of changes kept to minimum.</td><td></td><td></td><td rowspan="4">Ease of administration and compliance</td><td>Clear</td><td></td></tr>
<tr><td>Convenience of payment</td><td></td><td></td><td></td><td rowspan="3">Transparency and administrative simplicity</td><td></td><td></td></tr>
<tr><td>Effective tax administration</td><td>Administrability</td><td>(6) Promotes fair, efficient and effective and professional administration</td><td rowspan="2">Tax administration</td><td>Clear
An Avenue for Resolution</td><td></td></tr>
<tr><td>Simplicity</td><td>(3) Is the tax system simple?</td><td>Simplicity</td><td>(5) Easy to understand and minimizes compliance costs</td><td>Clear</td><td>Simplicity
Sustainability</td></tr>
<tr><td>Neutrality</td><td>(1) Does the tax system promote or hinder</td><td></td><td>(8) Minimizes effect on spending decisions; any influences are</td><td></td><td>Economic vitality and harmony with</td><td>Neutrality</td><td>Efficient</td><td>Tax neutrality</td></tr>
</table>

	economic efficiency?		explicit		other states Economic neutrality and efficiency Home ownership[9]			
Economic growth and efficiency		Economic efficiency	(7) Responsive to interstate and international competition (3) Broad bases and balanced variety (mix) of revenue sources to improve competitive relative to other states	Growth performance Economic climate			Growth Enhancing	Economic competitiveness Executive and legislative accountability to taxpayers
Transparency and visibility		Transparency	(9) Accountable to taxpayers; information on proposals publicized and debated.		Transparency and administrative simplicity	Accountability	Clear	Transparency
Minimum tax gap	(4) Can the tax system be easily administered?					Ease of administration and compliance	Clear	
Appropriate government revenues			(2) (3) Stability of revenues with mix of taxes. (2) Sufficiency so budget is balanced. (1) Complementary elements including finances of both state and local governments	Reliability and volatility Federal interaction	Adequacy/stability/elasticity	Adequate revenues	Stable	Sustainability Executive and legislative accountability to taxpayers Revenue neutrality and interoperability

[9] This principle is an unusual one in that it is so specific or narrow. It appears that the state has made this such an important goal that it is something to be followed in the design of their tax system to help ensure that individuals are able to “purchase and maintain a home consistent with their standard of living” (page 5).

Accountability to taxpayers								
Information security								
AICPA	**JCT**	**GAO**	**NCSL**	**CA LAO**	**Washington**	**Hawaii**	**Georgia**	**Vermont**

Note: The 2017 AICPA principles document includes a table comparing its 12 principles to those laid out by the OECD, JCT and GAO.