

Ten Principles of Good Tax Policy

There are many different ways that any particular tax, such as an income tax or a sales tax, can be structured. There are also many ways that a “tax system” for a government can be structured. Tax system” means the set of taxes that are used by a government, such as the U.S. government or the City of San Jose. Over the course of several hundred years, a set of principles for designing tax systems has evolved. In 2001, the American Institute of Certified Public Accountants (AICPA) published a report outlining a set of ten principles to be followed in designing workable and fair tax systems. It is this set of principles which is described below and which we’ll use in class to both design tax solutions to environmental problems and to evaluate existing environmental taxes or proposals.

The ten principles:

1. Equity and fairness
2. Certainty
3. Convenience of payment
4. Economy in collection
5. Simplicity
6. Neutrality
7. Economic growth and efficiency
8. Transparency and visibility
9. Minimum tax gap
10. Appropriate government revenues

These principles are explained below.

Equity and Fairness

“Similarly situated taxpayers should be taxed similarly.” (AICPA, 2001) For example, two individuals with equal income should pay equal income taxes. The challenge posed by the principle of equity and fairness is in defining “similarly situated.” Are two individuals similarly situated under an income tax if one has high medical expenses and the other has high private school tuition for their 8th grade child? The federal government says “no” because only the medical expenses (some portion of them) are deductible, not the K-12 tuition.

Certainty

“The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.” (AICPA, 2001) Certainly helps to improve understanding and hopefully, compliance with the tax. Certainly can also be viewed as the level of confidence a taxpayer will have that he or she is computing the tax correctly.

Convenience of Payment

“A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.” (AICPA, 2001) Employees have federal and state income taxes withheld from their employer who remits the withheld tax to the government. The purpose of withholding is to make it more convenient for the employee to pay the income taxes. Withholding causes the tax to be paid before it ever gets into the hands of the employee who might use it for something else. Another example of convenience of payment would be for a tax to be due along with some other existing payment. For example, assume the federal government creates a tax to be paid by car owners based on the miles-per-gallon (mpg) of their car. The tax is to be collected by the motor vehicle department in each state (the DMV in California) who would then remit it to the federal government, keeping 2% of the tax to cover its costs. Compared to having individuals completing a form on their own to pay the tax, this collection (payment) method is convenient because it uses an existing collection point (the annual car registration fee notice) and there is no additional work to be done by the taxpayer.

Economy in Collection

“The costs to collect a tax should be kept to a minimum for both the government and taxpayers.” (AICPA, 2001) If the government will need to hire more revenue agents and collection officers to enforce the tax, this principle might not be met. If there are millions of collection points, the costs to collect will be higher than if there were only hundreds or thousands of collection points. For example, the costs of collecting the gasoline excise tax which is imposed on producers rather than on gasoline stations or consumers is lower than if the tax were imposed directly on either the retailers or consumers. If taxpayers have to institute new recordkeeping systems (such as tracking how many miles they drive every year), or hire an accountant to compute a new tax, this principle might not be met.

Simplicity

“The tax law should be simple so that taxpayers can understand the rule and comply with them correctly and in a cost-efficient manner.” (AICPA, 2001) Simplicity helps build and maintain respect for the tax system, which leads to improved compliance. Our federal income tax is a good example of a system that violates the simplicity principle, despite efforts to simplify it. Some examples of this complexity include:

- § The National Taxpayer Advocate (who reports to the IRS Commissioner) lists “the confounding complexity of the tax code” as the most serious problem facing taxpayers today. (National Taxpayer Advocate 2004)
- § The instruction booklet for the 2004 Form 1040EZ is 36 pages. The 1040A has 72 pages of instructions. The IRS estimates that it will take 10 hours and 25 minutes to prepare Form 1040A, not including the schedules. (2004 Instructions to Form 1040A, page 57)
- § Most taxpayers do not prepare their federal income tax returns themselves. In 2003, 56% of individuals and over 85% of businesses hired someone to prepare their tax returns. For taxpayers claiming the earned income tax credit (EITC) over 70% used a paid preparer. Yes, the EITC is for low-income wage earners. (National Taxpayer Advocate 2004, pages 4 - 5)

Neutrality

“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 should be kept to a minimum.” (AICPA, 2001) The purpose of taxes is to raise revenue for government operations. However, taxes are an economic tool in that they can be used to influence human behavior and policymakers often use taxes in a non-neutral way. For example, to encourage companies to conduct R&D in the U.S., a tax credit is offered under the federal income tax. Policymakers must weigh the lack of neutrality in such an incentive with the ease and sometimes appropriateness of using the tax law for a specific economic reason (such as to raise the level of domestic R&D activity by companies).

Economic Growth and Efficiency

“The tax system should not impede or reduce the productive capacity of the economy.” (AICPA, 2001)

This principle might seem at first to be contrary to the neutrality principle explained earlier. However, this principle serves to remind policymakers that since taxes involve use of money, there are financial implications of taxes. For example, in measuring business income in computing the corporate income tax, one of the permissible deductions is for depreciation. Depreciation represents the wearing out of fixed assets such as buildings and equipment. If a piece of equipment costs \$100,000 and is allowed a 5 year life for depreciation, put simply, the owner is allowed a \$20,000 depreciation deduction each year. If instead, the law provided a 30-year life for the equipment, the depreciation deduction would be much

smaller and the business would pay more taxes in the early years of owning the asset than it would if it had a 5 year life. Thus, the decision on how to measure depreciation to compute taxable income does have economic consequences for companies and affects the economy.

Transparency and Visibility

“Taxpayers should know that a tax exists and how and when it is imposed upon them and others.” (AICPA, 2001) An income tax is very visible because people have to file their own tax return and pay the tax themselves. On the other hand, a gasoline excise tax is not very visible because it is actually imposed on the producer but usually passed along in the price charged to the consumer. But, most individuals do not know how much of the price of a gallon of gas includes federal and state excise taxes. A transparent tax is important so that payers know when the tax will be imposed on them and how much it will be.

Minimum Tax Gap

“A tax should be structured to minimize non-compliance.” (AICPA, 2001) Any tax proposal should be analyzed to determine the likelihood and ability of taxpayers to avoid the tax. Such avoidance might be purposeful (evasion, which is illegal) or unintentional (such as can happen when a tax is complicated and taxpayers make mistakes in computing how much tax is owed). When a transaction tax is imposed in one jurisdiction (such as a state), but not in neighboring jurisdictions, consideration must also be given to how to prevent citizens of the taxing jurisdiction to go across the border and complete the transaction in the non-taxing jurisdiction. For example, assume that California imposes a tax of \$2 on each incandescent light bulb and no tax on the purchase of a fluorescent bulb. In contrast, in Nevada there are no taxes on any light bulb purchases. How will California prevent its residents from avoiding the tax by going to Nevada to buy incandescent light bulbs, bringing them back to California to use?

Appropriate Government Revenues

“The tax system should enable the government to determine how much tax revenue will likely be collected and when.” (AICPA, 2001) The primary purpose of taxes is to raise revenue for government operations. In order to create a meaningful budget, the government needs to have a good sense of its revenues. Governments also strive to reduce volatility (change) in their tax revenues. For example, if there was a downturn in the economy and people were being laid off, there would be a decline in income tax collections. If that were the only type of tax a state had, it would be in trouble. This is why most states have a combination of taxes that are affected in different ways or on different time frames when there is a change in economic conditions. Another aspect of the principle of appropriate government revenues is the preciseness under which governments can estimate how much revenue a particular tax will produce. Many state governments have requirements for balanced budgets and so much know how much they likely have to spend and thus need fairly predictable tax systems.

Application of the 10 Principles of Good Tax Policy

The principles can be applied to an existing tax or a tax proposal. Application of the principles helps point out problem areas in an existing tax and for a proposal, where it may need changes to better meet the ten principles. Following is a proposal to increase the gasoline excise tax by 12 cents per gallon. That proposal is from the Congressional Budget Office for the benefit of Congress should they be looking for ways to increase revenues (it is not the only proposal the CBO provided).

APPLICATION OF THE GUIDING PRINCIPLES OF GOOD TAX POLICY: INCREASE EXCISE TAXES ON MOTOR FUEL BY 12¢ PER GALLON

Background

The federal gasoline excise tax was created in 1932. At that time, it was 1¢/gallon which represented about 6% of the cost of a gallon of gas (CBO 2002, page viii). Today, the excise tax rate is 18.3¢/gallon which, in July 2005 in San Jose, represents about 9% of the cost of a gallon of gas (based on a price of \$2.52/gallon less federal and state excise taxes as well as state sales tax).

When first created, the funds from the excise tax went into the general fund. In 1956, the Highway Trust Fund was created and the excise tax is deposited into that fund. The fund is used for highways and mass transit. The tax is imposed on producers, but passed through to retailers, and ultimately, consumers. Imposing the tax on producers reduces the number of collection points.

Producers file Form 720 to pay the excise tax on gasoline, due quarterly.

All states and the District of Columbia impose gasoline excise taxes as well. Many also impose sales tax on gasoline. In 2001, the average state gasoline and sales tax amount was 22.6¢/gallon (CBO 2002, page 4).

Analysis

Principle	Application and Analysis	Rating
<p>Equity and Fairness Similarly situated taxpayers should be taxed similarly.</p>	<p>An excise tax is typically viewed as regressive. That is, it represents a higher portion of a lower-income taxpayer relative to a higher-income taxpayer. For example, assume two individuals each drive the same number of miles each year. One individual has income of \$10,000 and the other \$100,000. If each incurs gasoline excise tax of \$100, that amount represents 1% of the lower-income individual's income, but only .1% of the higher income individual's income. Using regressivity as a measure of equity and fairness, an increase in the gasoline tax would be viewed as "unfair."</p> <p>However, others may view the gasoline excise tax as fair because everyone pays the same rate for each gallon of gasoline. Assuming that gallons purchased equate to miles driven and wear and tear on the road, the tax could, however be viewed as fair. However, not all vehicles get the same miles per gallon. An owner of a vehicle that gets 8 MPG who drives as much as someone owning a vehicle that gets 25 MPG will pay more gasoline excise tax. While that might seem fair if the tax were being used to help abate air pollution, when it is being used to build highways, it would seem unfair.</p>	<p>+/- depends on how the tax is viewed</p>
<p>Certainty The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.</p>	<p>There would be no change to the collection and filing procedures for producers, there would just be more tax owed, which would be clear.</p>	<p>+</p>
<p>Convenience of Payment A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.</p>	<p>The tax is owed by the producer which is easier than having each consumer track the number of gallons of gas they used and paying the tax to the federal government. A producer knows of the tax before it begins producing.</p>	<p>+</p>

<p>Economy in Collection The costs to collect a tax should be kept to a minimum for both the government and taxpayers.</p>	<p>The rate increase will not change the costs to the taxpayers or IRS in collecting the tax.</p>	<p>+</p>
<p>Simplicity The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.</p>	<p>Even if the existing tax is complicated, it will not become any more complicated with a rate changes. The forms will remain the same, the tax rate will just increase.</p>	<p>+</p>
<p>Neutrality 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 should be kept to a minimum.</p>	<p>The tax increase may have some impact on the amount of gasoline produced and consumed. Generally, it is better if a tax does not impact decision-making, but the government may determine that a tax, such as a gasoline excise tax, is a way to reach a necessary goal, such as reducing gasoline consumption. Thus, while a proposal to raise the gasoline excise tax will get a negative rating, that may be ok given the purpose of the proposal.</p>	<p>-</p>
<p>Economic Growth and Efficiency The tax system should not impede or reduce the productive capacity of the economy.</p>	<p>An increase in the gasoline tax may have direct effects of reducing gasoline consumption. However, it can have some indirect effects as well. For example, individuals may reduce their vacation travel which will hurt the travel industry, perhaps even leading to loss of jobs. Gasoline producers may have drops in sales. If the tax also applies to gasoline used in the trucking industry, items delivered by truck may increase in price. It is not clear what the impact of a 12¢/gallon increase will be.</p>	<p>-</p>
<p>Transparency and Visibility Taxpayers should know that a tax exists and how and when it is imposed upon them and others.</p>	<p>While producers will know of the tax increase because they pay the tax directly to the federal government. However, unless the producer and retailer highlight the increased tax for consumers, they are unlikely to know whether the cost of gasoline went up due to a tax increase versus a price increase.</p>	<p>-</p>
<p>Minimum Tax Gap A tax should be structured to minimize non-compliance.”</p>	<p>It is unlikely that producers' compliance rate will change with the tax increase.</p>	<p>+</p>
<p>Appropriate Government Revenues The tax system should enable the government to determine how much tax revenue will likely be collected and when.</p>	<p>The government has a record of gasoline consumption patterns year by year and how producers and consumers respond to price increases. Thus, the government should be able to easily determine the tax to be collected from the higher gas excise tax.</p>	<p>+</p>

References

AICPA (2001). *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals* (Report No. 1). New York: American Institute of Certified Public Accountants.

Congressional Budget Office, *Reducing Gasoline Consumption: Three Policy Options*. November 2002.

National Taxpayer Advocate report to Congress for 2004; available at <http://www.irs.gov/pub/irs-utl/ntafy2004annualreport.pdf>.