P4___ Painting a Picture of the Public Purse

Introduction to Taxation in Idaho: Criteria for Evaluating Taxes[1]

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[1] Adapted from Circular 1306 Montana State University by V. W. House and M. E. Wolfe.

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Overview: The "P^4. . :" Series

Of all the money we spend, we seem to give it most grudgingly to pay taxes. Most of us have favorite public services, but no one seems to have a favorite tax. Disgruntled taxpayers often threaten to revolt, but they do not refuse to accept public services. Perhaps it is our distaste for paying taxes that has led us to construct an extremely complex system to determine who will pay how much and for what. The *P^4*...series of publications was written to help citizens gain a basic understanding of taxation so they can evaluate various tax alternatives. This series of four publications includes:

1. An Introduction to Taxation (AEES 92-4)
2. A Guide to Commonly Used State and Local Taxes (AEES 92-5)
3. Criteria for Evaluating Taxes (AEES 92-6)
4. A Tax Glossary (AEES 92-7)

Part III provides one explanation for the conflicts that go along with revising tax policy. The taxes we prefer (dislike least) depend somewhat on our viewpoint: "Where we are coming from." We describe how citizens, looking at taxes from four important vantage points of society (business, government, private individuals and members of society in general), might interpret the criteria by which we compare taxes and tax systems. Criteria are presented and interpreted.

Introduction

Tax and revenue policies seem to generate the most persistent public issues. Every legislative session, someone is asking for a change in the way taxes are collected, a reduction in their rates or some other change in the tax codes.

Tax issues seem to have two common characteristics. First, it is popular to plea for tax reform. Second, few people agree as to what tax reform is. Agreeing that "something must be done" is the easy part because, indeed, Idahoans face some difficult decisions about taxes, other revenues and public services. Finding ways to come to agreement is the hard part. Miscommunication is common. Tax law sounds like jargon to most of us and the non-tax revenues such as interest earned on trust funds often get confused with taxes. Interest groups seek to be heard regarding how to best solve the "money problems" of the day. Numerous ideas and suggestions are thrown into the political ring and it becomes the job of our elected governmental officials to "settle the dust" with sound fiscal decision making.

In this publication we try to answer three questions: 1) How can tax and revenue systems be compared? 2) Are there criteria that we can rely on? 3) Why do people have such different interpretations of the criteria?
Some important terms used to describe tax and revenue systems are presented first. Then, criteria that provide a basis for comparisons are described. Last, these criteria are examined from different perspectives or viewpoints to reveal much of the reason for conflicts about preferred tax policy.

This paper will make the tax issues more understandable, but the issues will remain difficult to resolve. Anyone who has tried to analyze taxes and revenues knows that there is much data available but that it is hard to put it in perspective. One needs some standards for comparison. As you read this paper, you will see that the criteria that are concise--for example, measures of taxes per capita or per $1,000 of personal income--tend to give only a partial view of the whole system. On the other hand, criteria that are broader tend to be abstract and philosophical. As you proceed, you will find yourself ranking the criteria offered here--some will seem much more important to you than others. What you think is equitable may seem quite unfair to someone else. Since viewpoints differ, we are likely to interpret the same criteria differently

Tax Bases and Tax Rates

Some Useful Definitions

A tax has two components; a tax base and a tax rate. The amount of revenue produced by a tax is simply the tax base multiplied by the tax rate. The tax base is the item or activity on which the tax is levied. The tax rate is the fraction of the base that is to be paid. The amount of the tax paid is the tax levy.

Taxes are based on what we earn (income), what we own (property or other wealth) and what we spend (consumption). However, there are innumerable variations. For example, the gasoline consumption tax is based on gallons rather than the retail value of the gasoline. In addition, most tax bases have exclusions and the income tax includes deductions to calculate taxable income. Thus, the exact base measures used to determine income, property or consumption vary from one tax to another and from one state to another, Examples of income commonly excluded from states' income taxes are all or parts of capital gains, retirement income, income earned abroad, dividends and interest, casualty losses, social security benefits, gifts and investment credit. Examples of deductions from income before the tax rate is applied are: depreciation, medical expenses, interest, business and federal tax paid.

Sometimes a tax base is separated into several parts so that each part can be given different treatment. Idaho has several different classes of property and each class is taxed at a different rate. In theory, all property is to be taxed on its market value. In practice, farm land is taxed at one rate, mines at another, railroads at another. The property tax base (taxable value) is calculated by multiplying percentage rate times the market value to get the taxes due:

Likewise, income is classified into several brackets of taxable income. Each has a different rate of tax. When interpreting income tax rates, one cannot simply look at the published rate schedule; one must know something about deductions that narrow or reduce the income tax base. Obviously, deductions from income are more valuable to those with higher incomes; therefore, the stated income tax rate does not apply equally to everyone who has the same gross income.

Because exclusions and deductions vary, comparisons of tax rates alone are misleading. To make more accurate comparisons, an *effective tax rate* is calculated. An effective tax rate is merely the amount of tax paid divided by some standardized definition of the tax base. For example, an effective tax rate for the property tax would be determined by dividing the amount of taxes paid by the value of the property. Examining effective tax rates is the way to compare tax burdens of different people, different classes of property and taxes at different income levels. The use of effective tax rates also is necessary when making state-to-state comparisons.

The term "tax burden" implies the total amount of taxes paid by, for example, a family or a business. An individual tax or the "package" of all the different taxes may be proportional, progressive or regressive. A *proportional* tax means that the amount of tax paid varies proportionately with the base of the tax. As incomes increase, for example, taxes increase proportionately so that the effective tax rate is the same for every income level. A *progressive* tax structure means that effective tax rates are higher for people with high incomes, more property or consuming rates more than average.[1] A *regressive* tax levies a higher effective tax rate on people with less than the average tax base.

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[1]David N Hyman, Public Finance: A Contemporary Application of Theory to Policy, Chicago: The Dryden Press, 1983, pp. 363-364. Hyman points out that many people believe progressive

There are many ways of measuring the tax burden. Taxes paid per person and taxes paid per $1,000 of personal income are two common ways to express the total tax burden for comparisons across states. For comparisons over time, these data are deflated to adjust for changes in the purchasing power of the dollar (i.e.: to adjust for inflation).

Subtle but important factors determine who pays taxes levied against each of the three major tax bases. Earned income (salary) is subject to a tax in the state in which it is earned. Income from property, such as dividends and interest, is taxed in one's state of legal residence. Taxes on real property are paid by owners regardless of where they live. Finally, taxes on consumption, such as sales taxes, are paid in the state of purchase (or in the case of use taxes, are levied against items brought in from out of state). These factors affect how much of the tax burden can be "exported" to non-Idahoans.

In summation, tax base and tax rate are two fundamental parts of a tax; both should be scrutinized when evaluating a tax. The effective tax rate is commonly employed to make judgments about comparative tax burdens. But, beyond understanding these basic concepts, how can a tax or a tax system be evaluated? The following criteria can help.

Criteria for Evaluating Taxes

Many criteria can be used to evaluate taxes and systems of taxes. There is no one "best" criterion. The choice of criteria depends mostly on what one expects from the tax system, and expectations relate closely to whether one is looking at the tax from the viewpoint of the individual taxpayer, as a business person, as a public administrator or legislator, or as one concerned about what is best for society as a whole.

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taxes are "fairer" than others because they also believe that one's ability to pay increases more than proportionally with income.

The argument is heard that what is best for the individual or what is best for business is also best for society. If this were strictly true, there would be much less argument about policy. However, the whole is sometimes more and sometimes less than the sum of its parts. That is, sometimes viewpoints complement one another, but more often viewpoints complement each other only partially and often they compete. This is the genesis of much of the conflict about taxes.

In this paper four criteria are discussed: 1) equity, equality and fairness; 2) impact on economic growth or economic efficiency; 3) cyclical stability; and 4) economy of administration. More criteria could be added to this list, but these encompass the concerns most often expressed.

Equity, Equality and Fairness

It would be an unusual person who would argue for an unfair tax. But what is fairness? Is it the same as equity?

Equity requires that a tax system provide equal treatment of people with equal income, expenditure or wealth *(horizontal equity)* and fairness in the distribution of liabilities among people of unequal income, expenditure or wealth *(vertical equity).*

Horizontal equity is a measure of the equality of taxes paid by people in the same economic circumstance--the same income level, amount of assets or level of consumption spending, whichever is the tax base. Another way of stating it is that horizontal equity is equal treatment of equals. It indicates whether some people may take advantage of loopholes or deductions that aren't available to others.

Vertical equity measures whether people with a high level of income, property or consumption pay proportionally more taxes than people with low income, property or consumption levels. It is unequal treatment of unequals, accomplished systematically. Vertical equity implies a proportional system of taxes; or, if I make twice as much as you, I should pay twice as much tax as you. Or, if I consume twice as much as you, I should pay twice as much sales tax as you.

In general, an equitable tax system can be defined as one that provides the same tax treatment among individuals, businesses and industries. But considering the diversity of taxpayers, "sameness" or equality of treatment can also be unfair. Equity can be measured, but standards by which to judge fairness are less accepted. Thus, a progressive tax may be judged fair by a society even though it is not equal in treatment. The concept of fairness introduces an added dimension. Fairness requires a standard. Two standards for fairness are common: the principle of ability to pay and the benefits received rule.

The ability to pay principle requires taxpayers to support government services on the basis of their income, assets or consumption, whichever is the basis of the tax, to make an equal sacrifice. The use of this standard to determine fairness makes it the equivalent of horizontal and vertical equity. If this standard were simply applied, it would mean that those who have or consume more should pay more.

The principle does respond to social and economic objectives of redistributing tax burden or revenues. But applying the principle is difficult because it is hard to measure the tax capacity of groups with widely varying sources of income and wealth.

The benefits received rule recognizes that some people and businesses benefit more from a particular government service or activity than others. It suggests people and businesses should pay taxes for the benefits they receive. Simply put, those who receive the greatest benefits should pay the most taxes. For example, truckers receive the benefit of using public highways where railroads have to maintain their own rails and beds. Applying the benefits received rule would mean higher tax burdens for truckers than for railroad companies.

This principle is especially applicable to specific user fees, such as state motor fuel taxes or local garbage fees, which are priced to cover measurable costs. But the benefits received rule is not applicable to pure public goods, such as clean air or water, because such goods are not easily measured nor can they be denied to non-taxpayers. This principle also does not account for distributing income to achieve economic or social objectives.

The gasoline tax that is earmarked for highway construction and maintenance is an example of how benefits are tied to taxes. If the benefit rule were directly applied, the use of the highways would require that users pay fees for the provision of highway "services." This is what toll roads do. Although user fees are technically not taxes, they substitute directly for taxes in public enterprises. The gas tax accomplishes nearly the same thing indirectly by taxing the fuel required to run the vehicles that use a state's road system.

User fees, the direct application of the benefits received rule, are used extensively in most state and local revenue systems: school tuition, hospital charges, park entry fees, charges for parking automobiles in public lots, and sewer, water and sanitation charges are common examples. In addition, special improvement and other districts are formed for the specific purpose of tailoring tax burdens to those who benefit the most. Special Improvement Districts are formed for water and sewer systems, irrigation dams and canals, schools and other purposes.

Determining whether a tax conforms to standards of equity and fairness is difficult. Many "yardsticks" are possible. The previous discussion points, however, to three possible means for achieving tax equity and fairness. First, if the tax policy goals are equal treatment and proportional effective rates, those goals will be served by bringing about horizontal and vertical equity. Second, adherence to the ability to pay principle means that rich people would pay more than poor people. Third, if the benefit rule is to be used, taxes (or user fees) would have to be structured so as to balance the relationship between benefits and costs. Finally, any discussion of fairness and equity must clarify which set of criteria will be used. In this way, equity and fairness concerns and conflicts among participants in the tax system can be readily pinpointed.

Viewpoints Toward Fairness and Equity

As criteria, equity and fairness are widely accepted by businessmen, government officials, individuals and society in general. Ask anyone if they think the tax system should be equitable and fair and they will likely say "yes." Ask them what they mean by equity or fairness and you will likely get a variety of answers. Equity and fairness can mean different things to different segments of the population.

The businessperson is concerned that competitors, especially those in the same business, not be given exemptions, deductions and exclusions that are not available to all. But although people of this perspective openly advocate a fair and equitable tax structure, there are obvious existing exceptions to these standards among the business community itself. For example, partnerships, chapter S corporations, sole proprietors and the standard corporation are sometimes treated differently for income tax purposes. And, in some cases, some types of business enterprises benefit from loopholes that are not available to others.

Idaho's property tax law is an example of the dilemma we face in trying to define equity and fairness. There are different classes of property. Horizontal equity asks for equality among taxpayers in the same economic circumstance. Are our property owners so diverse that different classes are needed? Or, is this preferential treatment for some?

Another specific example in Idaho property taxation is the treatment of rural land being held for subdivision. Should this land be taxed as agricultural or residential land? Owners of such land will probably pay less tax if the benefits received rule is applied instead of basing their taxes on ability to pay. Vacant lands do not require as many public services as developed subdivisions (although they do increase local government costs for road maintenance and weed control). On the other hand, the owners argue that when the lots are not selling, they do not have the ability to pay. (In the case of timber, coal and other resources, cash flow problems are handled by severance or "balloon" payments when the resource is sold.)

Existing businesses occasionally express concern that it is unfair for government to give tax concessions to entice new businesses to locate in a state or community. The use of government-backed revenue bonds also has been criticized on grounds of fairness.

Appointed government officials have little opportunity to affect equity or fairness, although they endure much criticism. They must simply take and implement the law as given. It is the *elected officials* who must balance equity and fairness against other criteria. Constituents either ask for programs, subsidies or preferential tax treatment. These requests often run counter to equity or fairness and priority may be given to some other criterion.

Individual citizens also advocate horizontal and vertical equity of taxes. Criticisms of the income tax are most familiar. Deductions from income provide greater benefit to people in high-income tax brackets, for example, for they lower their effective tax rates more than those of middle-income wage earners. The perception is that high income citizens and businesses can use the tax system to their advantage to defer or avoid taxation while amassing wealth. Based on this perception, lower- and middle-income wage earners advocate the "ability to pay" criterion to achieve a fairer distribution of the tax burden and tax benefit.

The viewpoint of *society* in general can be significant. First, society frequently tries to use the tax system as a means of achieving social reform. Examples are the so-called "sin taxes." Taxes on tobacco and alcohol are a way to raise revenue and perhaps they curb consumption in the process. Supporters of these taxes may invoke arguments that anyone who smokes or drinks creates social problems that require public services--the benefits received rule. (In this case, it could be called the "costs imposed" rule.)

Tax reductions for homeowners 65 years and older are one example supported by a fairness argument: that ability to pay is diminished after retirement and society should avoid pushing the elderly out of their homes. This is an example of tax law that says it is unfair to base taxes on wealth because it may not accurately indicate an ability to pay.

Special treatments resulting from tax law exemptions, exclusions and deductions often conflict with society's desire for tax equity and fairness. They also conflict with the criterion, economic efficiency (more will be said about this under economic development). If such special treatments exist, then those individuals and groups that stand to benefit are likely to adjust their behavior to take advantage of the non-tax benefits. Such behavior changes encouraged by the tax system may distort the economy of a state in ways that are not necessarily in the best interests of society at large.

Characteristics of Equitable and Fair Tax Systems

If a tax system is to be fair and equitable, what characteristics should it have? While opinions on this vary, the West Virginia Tax Study Commission[2] summed it up as follows:

> Individual [tax] proposals should satisfy either the benefits received or ability to pay principle or both. The overall tax system should achieve a balance in progressivity and regressivity that meets social and economic goals of citizens and revenue-generating needs of government, both in the mix of revenues and

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[2]William R. Dodge, "Structuring State and Local Tax Reform Commissions," Monograph 86-2, Lincoln Institute of Land Policy, 26 Trowbridge Street, Cambridge, Mass. 02138, pp. 39-45.

in their administration (such as by standardizing assessment criteria and minimizing tax evasion, tax avoidance and tax delinquency).

Impact on Economy

Idahoans are asking a lot of questions about the effects of taxes on income and employment. Indeed, the questions are broader than just taxes; they include non-tax revenues and public spending, too. Research indicates that taxes are one factor that affects business activity, especially if one traces the effect over a few years and compares tax burdens among "competing" states.

Much of the political language would have us believe that either a) high taxes are the reason that Idaho's economy has weakened; or b) taxes are such a small part of business expenses that they do not dominate business decisions. Taxes are neither irrelevant nor the sole cause of changes in Idaho's economic picture. What would happen to the economy if taxes were lowered? Obviously, individuals and businesses would keep a larger percent of what they earn. But, to estimate the impacts on the economy, we would have to look at the effects the taxes have on individuals and businesses and at how their funds are spent. In addition, we would have to be aware that some business taxes are passed on to customers.

It is important to recognize that some public spending is for infrastructure--roads and airports are examples--that reduce the cost of doing business. Some is for services that help attract employees. Some is for research and dissemination of new technology and the education of managers and employees. These types of public spending support economic activity. Rarely are they directly supplied by business except in "company town" situations.

As a criterion for evaluating taxes, impact on the economy has many dimensions. The West Virginia study mentioned earlier summarized these dimensions using three key ideas: *neutrality, non-shiftability and effectiveness of tax expenditures.*

1) Neutrality requires that [taxation] be as neutral as possible in economic effect, avoiding any undue distortions of economic choices or preferences between producers and consumers. [Taxation] should not control the economy or influence decisions by individuals or businesses as to whether to work or not, how to price their output or how to allocate resources.

2) Non-shiftability similarly requires that [taxes] not be shifted from their intended target to unintended ones. This is especially difficult to measure when the targets of [taxation] are not those who bear the burden, such as businesses that serve as a conduit between tax-collecting governments and burden-bearing citizens.

3) Effectiveness of Tax Expenditures. In practice, however, [taxes] have intended and unintended impacts on the economy by encouraging positive economic efforts (such as capital plant investment credits) or restraining undesirable ones (such as deductions for pollution control equipment) or exporting the burden to out-of-state taxpayers. In addition, [taxes] have an impact on locational decisions of individuals and businesses within the state or those considering locating in the state. Many of these incentives or restraints are built into the tax system in the form of exclusions, exemptions, credits, refunds or discounts or, in general, as tax expenditures....[3]

Viewpoints about Impacts on the Economy

Every tax affects businesses, industry and individuals directly or indirectly Even higher individual income taxes in comparison with other states mean that firms must pay more to attract and hold labor. Thus, viewpoints toward taxes and development are justifiably varied.

Business people depend on increases in total income and population for their business climate. They encourage growth. Therefore, it is logical that they might advocate low taxes on people and assets associated with the service sectors because

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[3]Ibid., pp. 39-45.

growth is in the service activities. Business people often express concern about possible negative effects of taxation on profits and their ability to compete. Corporate taxes, property taxes and taxes that come due regardless of cash flow are regular targets for their policy agenda.

Different types of taxes do alter business operations. High property taxes relative to other types of taxes give businessmen an incentive to skimp on capital and use it intensively. Numerous other tax features also can produce unique incentives affecting how businesses are operated. For example, studies have shown that the ability to deduct interest and depreciation from income taxes has a large effect on the investments that people choose.

The location of economic activity may be affected by taxes. Suburbanization is encouraged if taxes are low outside city boundaries, for example. Industries will tend to locate where their overall tax burden is low if every other competitive aspect of the location is the same as alternative locations.[4] Furthermore, capital-intensive industries that are mobile will tend to pick locations with low property taxes. On the other hand, labor-intensive industries that are mobile will tend to gravitate to sites with low individual income taxes and a low overall cost of living in order to minimize their wage bill.

Society appears to have many viewpoints about taxation and the economy. Intelligent life from a visiting spaceship would not have to view us long to see that we want jobs, profits and good schools but with low taxes, solitude and a clean environment. The conflicts within this list are not a surprise, of course. They are just part of the agenda that our policy makers have to balance.

We, as a society, often try to use tax policy to affect business. Whether we should or should not do this is a matter for public debate, but the fact is that we do. For example, we might try to reduce smokestack emissions or sediment in runoff by

[4]Examples of competitive features are natural resources, geographic advantage, climate, quantity and quality of labor, management, technology and essential government services.

imposing a tax on business. Some people support taxes on alcohol and tobacco to shrink the market for these products. Society often uses tax incentives for social goals. The use of tax preferences at the state level in an attempt to foster economic development is common. More frequently, other types of inducements substitute for state tax incentives because tax preferences result in revenue losses in order to induce change at the margin.

Government officials want to create a business climate for economic development. The power to bargain with relocating industries on a caseby-case basis is much more attractive than offering generalized tax preferences. Generalized tax preferences, frequently enacted to satisfy special interest groups, invite criticism of government officials by those who cannot take advantage of the preferences.

Government depends on the economy to generate its revenue. It creates and administers the rules that guide the conduct of business. It licenses businesses and enforces the laws. Government also hires employees, buys goods and contracts for services. Thus, government can have a substantial impact on the economies in which its activities are located. So, government can impact economies by where and how it takes money out of the economy and where and how it spends that money. Sometimes the impact is intentional, but sometimes the impact is a by-product of socking other objectives. Government's perspective is that the economy is the source of revenue.

Government officials favor taxes that produce increases in revenues in response to population and economic growth. Without taxes that can adjust to economic growth, government officials must continually raise tax rates to make up the difference between demands for governmental services, as population increases, and the inadequate revenues produced by a less-than-efficient system.

Individuals want an abundance of employment and income opportunities. They want the values of their homes and businesses to improve. Economic development frequently is supported for those reasons. We want access to a variety of goods and services at competitive prices. Individual citizens, especially the established residents, desire a tax system that responds quickly to population growth. They want assurances that new and emerging businesses and industries and their employees will pay their share of the increased cost of governmental services. At the same time, they also expect the uninterrupted flow of familiar services.

Cyclical Stability of Revenue

A revenue system that is cyclically stable would provide revenues that are predictable and relatively stable throughout economic cycles. A cyclically stable system prevents the "boom and bust" revenue cycles that plague many states today.

Kids knock on the schoolhouse door in bad times and good. The demand for services continues in the downtrend of business cycles, so there is a concern for a tax system that includes *inelastic* taxes. In times of economic growth, new families move in and their kids line up at the schoolhouse door with the others. Demand for public services increases, so there is a concern that a tax system include *elastic* revenue sources.

Elastic revenue sources grow with and are proportional to population and the economy (such as income taxes) but can also fall as quickly during recession.

Inelastic revenue sources (such as cigarette taxes and liquor profits) remain relatively stable regardless of the economy.

The overall tax system should include both elastic and inelastic revenue sources to provide for growth in revenues during periods of economic expansion and stability during recessions.[5]

For example, taxes on the production of raw materials and processing are especially vulnerable to wide swings in the demand for raw materials. This can

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[5] Ibid., p. 6.

produce wide variations in tax revenues. Under such circumstances, relatively small cutbacks in inventories at each of the retail, wholesale and processing stages in the marketing system mount up to very wide changes in quantities of raw materials demanded.

At the other extreme, sales taxes levied against luxury items also are subject to wide swings in revenues due to business cycles. Declines in consumers' incomes in recessions result in sharp curtailments in purchases of luxury items. The result is declining sales tax revenues if the tax base is defined in terms of those items.

Finally, revenues from a use tax (a modified sales tax) levied against manufacturing equipment and machinery brought into a state also are subject to cyclical swings. This can be explained by the fact that investment is closely tied to the business cycle and tends to be concentrated in good years.

A cyclically stable tax would be less vulnerable to changes in demand and variability in the business cycle. It would, instead, provide relatively predictable levels of revenue over time.

Viewpoints Toward Cyclical Stability

Developing a tax that is cyclically stable can create conflicts among the various members of society.

Business people likely would prefer a tax that varies with their net income. One example, the property tax, can provide a clear illustration of why business people would prefer tax variability.

A property tax is a lump sum that may be levied against the value of property, regardless of the profitability of the assets at that time. Property taxes, such as those on agricultural land, may be fixed, though profits derived from the use of that property may vary from year to year. In such cases, the property tax is regressive in relation to income. During periods of recession, a property tax may weigh heavily upon some businesses at a time when a tax levy is most onerous.

Society in general demands continuity in governmental services. When cyclical stability does not exist for example, in a period of cyclical crisis deep cuts may be made in governmental services. Such cuts can impose burdens on society that appear to have been arbitrarily determined. Cyclically stable taxes would correct for such problems and assure greater stability in the provision of services.

Individual consumers also have a large stake in cyclically stable revenue sources. First, they expect continuity of government services. Second, taxes that produce stable revenues across business cycles must be levied against sources that are stable through business cycles,

The most stable tax base in periods of business cycles is consumer spending for necessities. A broad tax base that includes the necessities of life may, therefore, be less vulnerable to cyclical changes, but it may conflict with other individual and societal values. In particular, it may conflict with society's concept of fairness if necessities are taxed.

Some states attempt to counteract this tendency by enacting circuit breakers on the sales tax, that give rebates and refunds of sales taxes to low income people and thereby reduce their regressivity. There are two pressing reasons for concern about cyclical stability. They are: *1) Balancing the relative needs of state and local government* requires that the tax system recognize the respective responsibilities of governments, now and into the foreseeable future, by providing tax authorities commensurate with those responsibilities"; and 2) *Adequacy of revenues* requires that the revenues generated by the tax system be sufficient to cover expenditures, be reliable on a year-to-year basis and be flexible to accommodate changes in the population or economy."[6]

[6] Ibid., p. 42.

Characteristics of a Cyclically Stable Tax Levy

It was previously mentioned that a stable tax system would include both inelastic and elastic sources of revenue. The following list is more specific about the characteristics that contribute to stability.

- A broad tax base.
- A tax base that includes the necessities of life.
- Inclusion of "services" in the tax base, since they are less affected by economic cycles than other types of businesses, and are some of the fastest growing sectors in the economy.
- Inclusion of property in the tax base, since property taxes may be levied despite the profitability of a business or the income of individuals.

Economy of Administration

Another criterion to consider when evaluating a tax (or a tax system) is its *economy of administration.* This criterion refers to a tax that can be administered efficiently It suggests a tax where operational and compliance costs for both taxpayers and governments would be low compared to the net revenue yield per tax dollar.

Taxes that are easy to understand and administer in a consistent manner reduce the costs of collection, enforcement and compliance for everyone. Foremost, the measure of the tax base should be simple, subject to easy measurement and a prominent feature of businesses' and individuals' lives. Complexity would introduce a chance for tax manipulation and evasion, increasing the costs of enforcing the tax, hence, reducing its yield. Finally, penalties for non-payment of levies, tax avoidance and tax evasion increase compliance and, thus, tend to reduce the costs of enforcement to governments.

Viewpoints on Economy of Administration

Each segment of the community may stress different features of tax administration, depending on its point of view.

Business people want a minimum amount of record keeping. Keeping two sets of books-one for tax purposes and one for business decisions, for example-is expensive for business people. Furthermore, business managers do not want to bear the cost of collection and enforcement of a tax. From their perspective this would mean that tax administration costs were delegated to them as a part of tax law. Furthermore, the use of an excessive variety of business taxes has the effect of increasing the compliance costs.

Government officials also desire economy of administration from the perspective of their budget and expenditures. However, they may shift the burden of collection and enforcement over to businesses, creating the illusion that enforcement costs are low. Another example of shifting enforcement costs is illustrated by states whose income taxes are a simple percentage of the federal income tax. Such taxes minimize enforcement costs for the state government (and make it easier for us taxpayers to calculate our state tax liability) but link state income tax revenues to the relative efficiency or inefficiency of federal tax collection and enforcement.

Finally, government administrators may be put in the untenable position of administering an unenforceable tax levy. Certain inventory taxes are an example where government depends on businesses for establishing the value of the inventory, but businesses can take evasive action to minimize the value of inventories in numerous (and legal) ways.

From the vantage point of *society* in general, economy of administration simply means an efficient governmental system that tends to get the highest yield from a tax levy with the least amount of anxiety and influence on the economy. Compliance rates are an indicator of the efficiency of the system,

The individual citizen very likely has the same concerns as the person in business. Like the business sector, the individual would want a tax that demands a minimal amount of record keeping and compliance costs per dollar of taxes billed. As Adam Smith put it in the *Wealth of Nations:* ". . Every tax ought to be so contrived as both to take out and 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 ... the time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor and to every person.

Characteristics of Easily Administered Tax Levies

The foregoing discussion suggests several characteristics that would help to create economy of administration in a tax.

- A readily and easily measured tax base.
- a simple and understandable tax law.
- A levy with few possibilities for avoidance and evasion.
- Enforcement dependent upon government, with provisions for stiff penalties.

Summary

In this publication we try to answer three questions: 1) How can tax and revenue systems compared? 2) Are there criteria that we can rely on? 3) Why do people have such different interpretations of the criteria?

To help answer the first question, some useful definitions were reviewed: A tax has two components: a tax base and a tax rate. The amount of revenue produced by a tax is simply the tax base multiplied by the tax rate. The tax base is the item or activity upon which the tax is levied. The tax rate is the fraction of the base that is to be paid. The amount of the tax paid is the tax levied. Taxes are based on what we earn (income), what we own (property, or other wealth) and what we spend (consumption). Effective tax rates provide standardized comparisons of the tax burdens of different groups.

In answer to the second question, four criteria were used: 1) equity, equality and fairness, 2) impact on economy, 3) cyclical stability, and 4) economy of administration.

Equity,, equality and fairness. Equity requires that a tax system provide equal treatment of people with equal income, spending or wealth; and fairness in the distribution of tax liabilities among people of unequal income, spending or wealth. Equal treatment of equals and unequal treatment of unequals are also called horizontal and vertical equity Fairness is measured against two standards which give very different results: ability to pay and benefits received. Much of the conflict over tax policy is actually over which standard will be applied to whom.

Impact on economy. Taxes, other methods of gathering state and local revenue and public spending all affect the economy. Some of this is intentional; some is a by-product of other activities. Viewpoints about preferred tax policy vary sharply among business people, individuals, government and the whole of society. If the intent is for tax policy to have minimal impact on the economy, the tax (system) should be neutral so as not to distort economic choices, "non-shiftable" from their intended target and effective. In practice, much tax policy is to provide some incentive for economic growth through exclusions and deductions.

Cyclical stability of revenue recognizes that "kids knock on the school house door in bad times and good." If public services are to be provided in recessions, then the tax system needs to include some taxes that are inelastic. If public services are to be provided when and where the economy booms, then the system needs to include some elastic taxes that will grow in proportion with service demands. Also, individual taxes-for example, a general retail sales tax can be designed to be elastic by levying it only against luxury items that would be subject to business cycles. Or, it could be inelastic by levying it against essential goods and services. Obviously, viewpoints on this vary, too.

The fourth criterion, economy of administration, refers to a tax or a tax system that can be administered efficiently. This criterion will be easier to achieve if the system is simple, certain, acceptable and a small percent of the revenue is used up by the collection process.

These four criteria provide "tools" that make it a little easier for us to compare taxes and tax systems. The criteria are not concise, unfortunately. We have gone far beyond the simple criterion offered by Colbert: "The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing." Even so, much is left to subjective judgment.

Why is there so much conflict about tax policy? The different viewpoints of each of the criteria portray the diversity of social values and identify some conflicts that come to the surface when legislators try to redesign tax policy. By looking at each criterion from the respective viewpoints of individuals, business people and government (both elected officials and civil servants) as well as from society's perspective as a whole, reasons for conflicts become more apparent. For readers who don't enjoy politics, especially the politics of taxation, we suggest that anyone who hopes to influence tax policy does not have to enjoy politics but does have to understand it.

Public discussions over tax policy provide input to those charged with balancing all citizen preferences; concord, conflicts, and all. It is the hope of the authors of this publication that the definitions and concepts herein will make it easier for citizens to participate in the construction of the tax system that is best for them and for Idaho.

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