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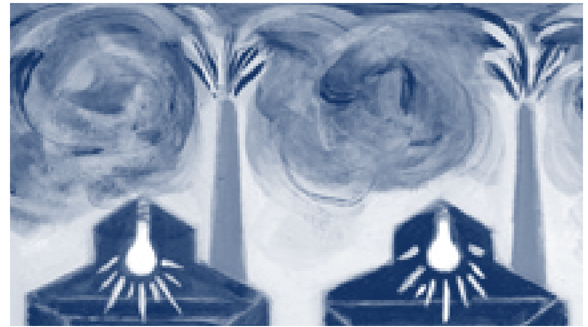

Tax Policy and the Principles Underlying a "Good Tax"

by Kenneth L. Nichols

A "good tax"—can there be such a thing? In this essay, Kenneth Nichols explores the principles for evaluating the strengths and weaknesses of taxes on income, consumption, and wealth. Contrary to common argument, Nichols points out, there is no "best" tax, but there are five interrelated criteria for evaluating taxes that, collectively, may be used to assess whether tax reform efforts are moving us closer to or further away from a better overall tax system for Maine.

A good tax? Can there be such a thing? Interest groups, the public, and Maine's state and local policymakers are investing much political energy exploring ways to achieve a sounder, fairer apportionment of the tax burden at the state and local levels. Many factors contribute to why Maine residents find themselves living in a state with high per capita taxes. The size of the overall tax burden is an issue that appears often in political speeches and in news stories. But how the general tax burden—whether heavy or light—is distributed among us all is a separate issue.

CATEGORIES OF TAXES

We can tax three things—income, consumption, and wealth—and we do. Each level of government has tax categories it favors and others it traditionally avoids. Federal and state governments favor *income taxes.* These include taxes on individual incomes and taxes on business profits. A few urban centers across the country—none of which are in Maine—assess a "commuter tax" or "service-center tax" on locally earned wages. Commuter taxes bolster core city infrastructure that suburban residents enjoy, but would otherwise not support through their own local taxes. Income taxes also encompass a family of taxes known as payroll or employment taxes—that is, specific taxes on wages and salaries that help to fund social security and unemployment compensation programs.

States are the biggest users of *consumption taxes.* These include retail sales taxes, special taxes on commodities such as petroleum products and a few luxury items, and "sin" taxes applied to products such as alcoholic beverages and tobacco. Some states permit an add-on of one percent or so to the state sales tax rate, then return that percentage to the locality where it was collected. Maine is not one of those states. The federal government has traditionally stayed away from retail sales taxes, though it does tax tobacco, alcohol, gasoline, and other products.

Localities are the heaviest users of *taxes on wealth,* although both federal and state governments assert wealth taxes in limited ways. The most prevalent tax on wealth is the property tax on real estate, but this tax category also includes taxes imposed on personal property, on estates left by decedents, and on large gifts.

Finding an equitable mix of these taxes is not easy. There is no single solution. Each possibility affects some people differently from others—which is where reasonableness, creativity, political will, and public pressure come into play.

…the five interrelated principles for creating a "good tax" are fairness, simplicity, neutrality, administrability, and sufficiency.

PRINCIPLES FOR EVALUATING A TAX

Each of the three basic categories of taxation—taxes on income, consumption, and wealth—has its strengths and weaknesses. That means there is no "best" tax, though we sometimes argue as if there were. Nonetheless, such arguments can be healthy public discourse when they are based on commonly accepted principles, characteristics, or criteria for evaluating what makes a tax bad or good. And it turns out that such criteria do exist: the five interrelated principles for creating a "good tax" are fairness, simplicity, neutrality, administrability, and sufficiency.

A *fair tax* is one that has approximately the same relative impact on all taxpayers. One facet of a fair tax is that it has "horizontal equity," which simply means that taxpayers in similar situations pay the same amount of tax. Given the diverse ways of arriving at the same bottom line (e.g., wage versus nonwage income, salary versus self-employment), this is tougher to achieve than it seems; consequently, a large part of any tax code is devoted to getting to that bottom line.

A second facet of a fair tax is "vertical equity," which means being mindful that taxpayers of lesser means will be harder hit by a given tax percentage than will taxpayers of greater means. Proportional and regressive taxes hurt poorer taxpayers the most, while progressive tax rates dampen that impact. For example, a 20 percent income tax would be more painful for a taxpayer earning only $20,000, who may have trouble meeting basic needs, than for a taxpayer earning $200,000. This leads to the concepts of progressive

and regressive taxation. Progressive taxes, such as our federal and state individual income tax rates, are graduated so that higher-income taxpayers pay higher tax rates than do lower-income taxpayers.

But many taxes tend to be regressive, disproportionately hitting taxpayers who are at the lower end of the economic spectrum. This is true for payroll taxes such as social security taxes, which stop once the worker has earned a certain amount of salary during the year. The cut-off amount is currently $90,000, which means someone earning $180,000 only pays social security taxes on the first half of her or his salary. Property and sales taxes also tend to be regressive unless they are tempered in ways that mitigate their impact on low-income taxpayers. Two methods Maine uses to mitigate property tax regressivity (i.e., improve vertical equity) are the homestead exemption and the circuit breaker exemption. The *homestead exemption* is an amount by which the value of a homeowner's principal dwelling is reduced when applying the tax rate (mill rate) against that home, effectively waiving property tax on the first several thousand dollars of value for that property. The *circuit breaker* exemption rebates a portion of the property tax to homeowners and renters with modest incomes whose property taxes or rents exceed a certain portion of their incomes. A version of the circuit breaker exemption not used in Maine holds the property's taxable value essentially constant until the property changes hands.

Of course, "tempering" has a way of reducing a tax's simplicity, the second characteristic of a good tax. A *simple tax* is one that is easy to understand and to comply with. A straight retail sales tax is probably the simplest tax around. The legislature could choose to impose a broad-based six (or five or four) percent sales tax on *every* product sold within the state, in which case each dollar someone spends at a local grocery store or pharmacy would cost six (or five or four) cents extra in sales tax. Simple—but regressive. That box of cereal, carton of milk, or bottle of cough syrup would cost more, making it more difficult for folks at the poverty level to buy food or medicine. However, as soon as the legislature passed measures to temper the regressivity of the sales tax—say, by exempting medicines and certain food items from sales tax or by setting up a rebate program for low-income residents—simplicity would begin to erode. So, unfortunately, fairness and simplicity often are at odds when designing a good tax.

One approach for dealing with the fairness-simplicity dilemma is what former Internal Revenue Commissioner Fred Goldberg has referred to as "rough justice": paying attention to areas that affect the most people and the people most in need (fair but not so simple) while recognizing that other injustices will not be addressed (simple but not so fair). For example, exempting prescription medications and medical products from taxation would help many people, but not those who rely on over-the-counter medications. If all medications were considered exempt, determining the line between medication and health food, nutrition supplements, and even some candies would become complicated.

Neutrality is the third principle. A *neutral tax* is one that does not influence whether parties will prefer one type of exchange over another. (This is not the same as a similar-sounding tax term, "revenue neutral," which means a new mixture of taxes calculated to yield the same overall tax revenue.) Here, too, sales taxes provide a clear example. Take widgets, the universal gadget. I want one, and it costs $99.95, plus sales tax, at my local store. It also costs $99.95 through a catalog or over the Internet, but there I pay no sales tax and happen to be offered free shipping. I'm a frugal consumer in no hurry, so which widget will I prefer? Probably the untaxed catalog item. Outside forces can affect neutrality, compromising the principle when social goals become compelling. For instance, heavy taxes help to discourage the use of products such as alcohol and tobacco, while tax breaks encourage certain business practices, individual homeownership, and charitable giving, among other behaviors.

The fourth principle is to establish an *administrable tax,* a tax that is workable to implement and maintain. If the government cannot enforce a tax effectively, establishing that tax is probably a bad idea. Simpler taxes are typically easier to administer than are complicated taxes. Collection at source—as with a retail sales tax, for example, or with income tax withholding on wages—is more effective than after-the-fact compliance. Staying with the widget purchase example,

let's say I buy a widget in May through an out-of-state catalog company. The seller collects no sales tax, yet the law says that I, as a taxpaying resident, owe that tax. Unless I keep a record of that transaction, the details will be a challenge for me after the end of the year, when I prepare my next state tax return. It will likewise be a challenge for state tax collectors since, without subpoenaing my credit card records, they will not know about the transaction either, making interstate transactions a difficult sales tax to administer. What our state and many others do, instead, is to establish an add-on "use tax" to the state income tax return, wherein taxpayers look up an estimated tax amount based on their income. More rough justice.

The fifth principle, a *sufficient tax,* is one that raises sufficient revenue to address the need for which it is imposed. Some types of taxes have more potential than others for generating tax revenue. An obvious key factor is the tax rate. Not quite as obvious but possibly more important is the base to which the tax is applied. The broader the base is the more revenue-generating potential that tax has. For that reason, a small tax on all retail sales would generate far more money for the state treasury than an enormous tax imposed on a high-cost luxury item. But determining the appropriate base raises potential conflicts among the principles of fairness, simplicity, and sufficiency—if not among all five principles.

HELPFUL, NECESSARY, AND TOUGH

In the real world, consequently, coming up with a good tax is tough. Maine's effort to make the property tax burden more equitable underscores these challenges, both technical and political. The good news is that, although these principles generally apply to a specific type of tax, they readily apply to a mixture of taxes designed to offset the structural weaknesses of one type of tax with the strengths of another. It is hoped that the mixture itself would be orchestrated because, just as a healthy diet draws from a variety of food groups, sound tax policy relies on a balance among categories of taxes. Striking that balance is difficult given the needs of the many stakeholders involved and the evolving dynamic of any state's economy.

"Taxes are what we pay for civilized society," as Supreme Court Justice Oliver Wendell Holmes reminded us long ago. Finding ways of optimizing each of these five principles is an essential battle in determining what, for all Mainers, will be a good tax.

Kenneth L. Nichols is an associate professor of public administration at The University of Maine, where he has taught since 1996. He holds a Doctor of Public Administration (D.P.A.) in change and innovation from George Mason University. In his prior career with the Internal Revenue Service, he held administrative positions in legislative affairs, information processing, and planning, finance, and research.

ENDNOTE

1. An abbreviated version of this paper appeared as an op-ed piece in the *Bangor Daily News* (p. 10) on January 6, 2005.

FOR FURTHER EXPLORATION

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