

CHAPTER TWO

BASIC PRINCIPLES AND TERMS

This chapter introduces some basic principles for evaluating your state’s tax system—and walks you through some of the “nuts and bolts” necessary for a basic understanding of tax policy issues. This chapter does not attempt to turn anyone into a tax attorney. Rather, our goal—here and throughout this guide—is to make the reader sufficiently knowledgeable about tax policy to effectively participate in important tax policy debates.

Tax Policy Principles: An Introduction

Tax fairness is a primary consideration in evaluating state and local tax systems. But there are other important criteria that must also be considered. This section explains five of the most commonly cited tax policy principles: equity, adequacy, simplicity, exportability, and neutrality.

Equity: Two Kinds of Tax Fairness

When people discuss tax “fairness,” they’re talking about equity. Tax equity can be looked at in two important ways: **vertical equity** and **horizontal equity**. Vertical equity addresses how

a tax affects different families from the bottom of the income spectrum to the top—from poor to rich. When we discussed regressive and progressive taxes in Chapter One, we were looking at vertical equity issues.

Horizontal equity is a measure of whether taxpayers in similar circumstances pay similar amounts of tax. For example, if one family pays higher taxes than a similar-income family next door, that violates “horizontal” fairness. This sort of unjustified disparity undermines public support for the tax system and diminishes people’s willingness to file honest tax returns. It would be hard to defend a tax system that intentionally taxed left-handed people at higher rates than right-handed people. Likewise, a tax that hits a wage-earner harder than an investor (as the federal income tax currently does), even if their total incomes are the same, fails the test of horizontal equity.

Adequacy

An adequate tax system raises enough funds to sustain the level of public services demanded by citizens and policymakers. At the end of the day, adequacy is what separates successful tax systems from unsuccessful tax systems. Of course, at any given time, the primary concern for state lawmakers is **short-term** adequacy—making sure there’s enough revenue to fund public services in the upcoming fiscal year. But it’s equally vital for good-government advocates and lawmakers to seek

Important Tax Policy Principles

- **Equity:** Does your tax system treat people at different income levels, and people at the same income level, fairly?
- **Adequacy:** Does the tax system raise enough money, in the short run and the long run, to finance public services?
- **Simplicity:** Does the tax system allow confusing tax loopholes? Is it easy to understand how your state’s taxes work?
- **Exportability:** Individuals and companies based in other states benefit from your state’s public services. Do they pay their fair share?
- **Neutrality:** Does the tax system interfere with the investment and spending decisions of businesses and workers?

strategies that will achieve *long-term* adequacy, balancing budgets not just this year and next, but five years and ten years down the road.

Two factors that contribute to the adequacy of a tax are its **stability** and its **elasticity**. A stable tax is one that grows at a predictable pace. Predictable growth makes it easier for lawmakers to put together budgets that match anticipated revenues to anticipated spending. But stability by itself is not enough to achieve adequacy in the long run. For example, property taxes grow predictably—but tend to

grow more slowly than the cost of the services that state and local governments provide. Elasticity is a measure of whether the growth in a specific tax keeps up with the economy—an important consideration because the cost of providing public services usually grows at least as fast as the economy. An elastic tax is one for which tax revenue grows faster than the economy over the long run.

There is some inherent tension between the goals of elasticity and stability. Elastic taxes, like the personal income tax, are more likely to ensure adequate revenues in the long run, but may fluctuate more from year to year. Academic research has shown that the long-term growth of the personal income tax is substantially greater than that of the sales tax, even though the income tax is more volatile in the short run.¹ This makes it vital for these taxes to be accompanied by prudent fiscal management to smooth out the ups and downs associated with normal economic cycles (for instance, by creating and maintaining a “rainy day fund”—see Chapter Nine for more details). Prudently managed, income taxes will likely provide a more sustainable funding source over the long run than is possible with sales or property taxes. Stable taxes, like the property tax, will grow predictably, but the slower growth rate of these taxes may mean that in the long run tax hikes will probably be necessary to fund services at the same level.

The “Benefits Principle” of Taxation

Not all taxes are based on ability to pay. Governments sometimes levy taxes and user fees designed to make people pay in accordance with the benefit they receive from certain public services. This idea is known as the benefits principle of taxation. For example, states raise money for highway maintenance by imposing a gasoline tax. Since the amount of gasoline a driver purchases is a reasonable proxy for the benefit that driver receives from publicly maintained roads, the gas tax follows the benefits principle of taxation.

But there are limits to the usefulness of the benefits principle. First, taxing according to the benefits principle can lead to a regressive result: gasoline taxes take a larger share of income from low-income taxpayers than from the wealthy. Second, for many of the most important functions performed by governments, such as education, health care and anti-poverty programs, and police and homeland security, it can be hard to quantify the benefits of these services for individual taxpayers. Third, many of the services provided by state governments are explicitly designed to redistribute resources to low-income taxpayers. Social welfare programs exist partially because low-income taxpayers cannot afford to pay for these programs themselves, so requiring these taxpayers to pay for the programs according to the benefits principle would defeat their purpose.

Simplicity

Simplicity is often touted as a goal for tax reform—and it’s an important one. Complicated tax rules make the tax system difficult for citizens to understand. Complexity also makes it harder for governments to monitor and enforce tax collections, and makes it easier for lawmakers to enact (and conceal) targeted tax breaks benefitting particular groups. A tax system full of loopholes gives those who can afford clever accountants an advantage over those who must wade through the tax code on their own.

But beware. Tax reform proposals described as “simplification” measures are often nothing of the kind. For example, anti-tax advocates frequently seek to “simplify” the income tax by eliminating the graduated rate structure and instituting a flat-rate tax. This is a red herring: a graduated tax system is no more complicated than a flat-rate tax, and generally doesn’t add even one extra line to your state income tax form. What makes filing taxes more complicated—and makes the tax forms longer and longer each year—is the proliferation of special tax breaks. The right way to make income taxes simple is to eliminate tax loopholes, not to flatten the rates.

Exportability

The public services provided by state tax revenues are enjoyed by individuals and businesses from other states—including businesses that hire a state's high school and college graduates and tourists who use a state's transportation infrastructure. This is why state tax systems are often designed to make multi-state businesses and residents of other states pay their fair share of the state's taxes. An **exportable** tax is one that is at least partially paid by these non-residents.

There are broadly three ways in which taxes can be exported: by having non-residents pay the tax directly (sales taxes on items purchased by tourists, for example); by levying taxes on businesses which are then passed on to non-residents; and through interaction with the federal income tax. (See "The Interaction of State and Local Taxes with Federal Income Taxes" on page 9.) All taxes are at least partially paid by non-residents—and policy makers have the power to effectively adjust the percentage of taxes "exported" to residents of other states.

Neutrality

The principle of neutrality (sometimes called "efficiency") tells us that a tax system should stay out of the way of economic decisions. Tax policies that systematically favor one kind of economic activity or another can lead to the misallocation of resources or, worse, to schemes whose sole aim is to exploit such preferential tax treatment. If individuals or businesses make their investment or spending decisions based on the tax code rather than basing them on their own preferences, that's a violation of the neutrality principle, and can lead to negative economic consequences in the long run. For example, the big tax breaks that the Reagan administration provided for commercial real estate in the early 1980s led to far too much office construction and the phenomenon of "see-through office buildings" that nobody wanted to rent. These wasteful investments came, of course, at the expense of more productive investments—and were paid for by all other taxpayers.

The tax principles outlined here are not the only criteria used by policymakers in evaluating tax changes—and these principles sometimes come into conflict. But almost everyone would agree that advocates of tax reform should keep each of these goals in mind as they seek to improve their state's tax system.

Nuts and Bolts: Basic Tax Policy Terms

The tax principles described so far are essential to a broad understanding of why one type of tax is preferable to another. But there is also a basic set of terms you'll need to understand in order to understand how each of these taxes work. This section explores the "nuts and bolts" of state and local tax policy.

The Tax Base

The **tax base** is all the items or activities subject to a tax. For any tax, it's worth distinguishing between the **potential** tax base—the set of items that would be taxed if there were no special exemptions—and the **actual** tax base used by a given state. The potential tax base of a general sales tax, for instance, is everything that a state's consumers purchase in a given year for their own personal use. But in every state levying a sales tax, the actual tax base is much smaller than that, because of exemptions for everything from groceries to haircuts.

Tax bases are usually measured as a dollar amount to which a tax rate is applied—for example, the total dollar amount of taxable income, in the case of the personal income tax, or the total dollar value of real estate, in the case of the real property tax. Taxes that are measured this way are called **ad valorem**, or value-based, taxes.

But not all taxes are calculated based on value: excise taxes on cigarettes, gasoline and beer are usually calculated on a per-unit basis. For these excise taxes, the amount of tax collected depends not on the value of the tax base, but on the number of items in the tax base. Cigarette taxes, for instance, typically are applied on a per-pack basis (the tax owed is a certain number of cents per pack of cigarettes sold). Thus, for a cigarette tax, the tax base is usually the number of packs sold. Taxes that are levied on a per-unit basis have one critical flaw—tax revenues only increase when the number of units sold goes up. By contrast, ad valorem taxes tend to grow with inflation even when the number of units sold is unchanged, because inflation drives the value of the base upwards.

Taxes are often described as having a broad base or a narrow base. A broad-based tax is one that taxes most of the potential tax base. For example, a broad-based sales tax is one that applies to almost all purchases of goods and services. A narrow-based tax applies to fewer items. A typical narrow-based sales tax applies only to goods, not services, and has exemptions for things like food, housing and medicine.

In general, broader tax bases are a good idea. At any given tax rate, a broad-based tax will raise more revenue than

a narrow-based tax—because more is taxed. The chart on this page illustrates this: Illinois taxes personal income at a flat 3 percent rate. (After this report was completed, the Illinois income tax rate was temporarily increased to 5 percent, but the tax breaks discussed in this section were not eliminated). If lawmakers repealed a special tax break for retirement income, the tax rate could have been lowered to 2.83 percent and still bring in the same amount of revenue. If lawmakers also repealed the state’s property tax credit, a 2.69 percent rate would have raised the same amount of money as the current tax. This example illustrates an important tradeoff: the broader the tax base, the lower the tax rates can be. And the narrower the tax base, the higher the tax rate must be in order to fund a given level of public services.

A broader base also makes it more likely that the tax system will treat all economic activities the same, which helps ensure that the tax system will not discriminate in favor of some taxpayers and against others. For example, a state that collects sales tax on the purchase of goods from a store, but not on purchases made over the Internet, is choosing to favor one type of economic activity over another. Broadening the sales tax base to include Internet-based sales ensures that the neutrality principle is followed, and makes the sales tax rules less discriminatory.

But sometimes there are good reasons for having a narrower base. Excluding food from the sales tax, for example,

makes that tax less regressive. Many people argue that the benefit of making the tax less unfair outweighs the revenue loss from narrowing the sales tax base.

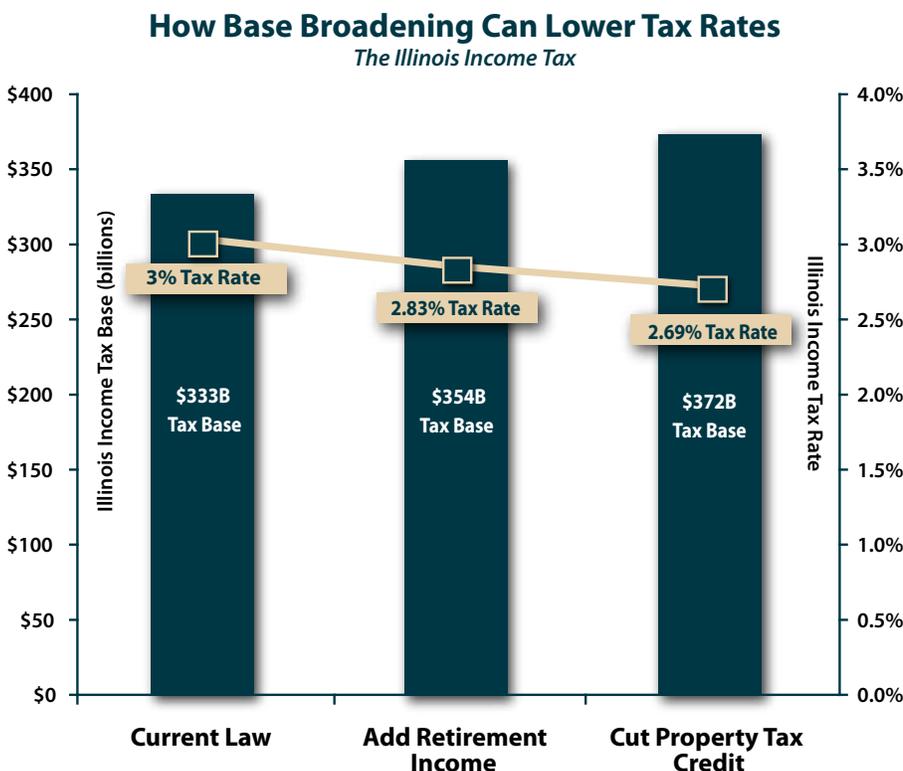
The Tax Rate (or Rates)

Multiplying the **tax rate** times the tax base gives the amount of tax collected. Usually, the tax rate is a percentage. For instance, if a state’s sales tax rate is 4 percent on each taxable purchase and taxable purchases (the tax base) total \$1 billion, then the total amount of tax collected will be \$40 million (4 percent of \$1 billion).

Income taxes typically have multiple rates—with different rates applying at different levels of income. This is called a “graduated” rate structure, using “marginal” rates. Chapter Five describes how such a rate system works.

Not all tax rates are percentages. A typical gasoline tax rate, for example, is expressed in per-gallon terms. So if a state has a gasoline tax rate of 10 cents per gallon and 100 million gallons of gasoline are sold, then the tax collected will be \$10 million (10 cents multiplied by 100 million).

Property tax rates are traditionally measured not in percentages but in mills. A mill represents a tenth of a percent. Mills tell us the tax for each thousand dollars in property value. Thus, a 20 mill rate applied to a house with a taxable value of \$100,000 yields a tax of \$2,000.



Effective Rates Versus Nominal Rates

So far, we have been describing **nominal tax rates**—the actual legal rate that is multiplied by the tax base to yield the amount of tax liability.

Though the nominal rate is used in the actual calculation of taxes, it’s not the best measure for comparing taxes between states because it doesn’t account for differences between tax bases. For example, suppose that two states, each with the same population and the same total amount of income, have sales taxes. The sales taxes have the same tax rate, 4 percent, but state A’s sales tax applies to a narrow tax base, exempting groceries and many services, while state B’s sales tax applies to a broader tax base. State B’s sales

Effective Tax Rates and Nominal Tax Rates

	State A	State B
Nominal Sales Tax Rate	4%	4%
Tax Base	\$1 billion	\$1.5 billion
Sales Tax Collected	\$40 million	\$60 million
Statewide Personal Income	\$2 billion	\$2 billion
Effective sales tax rate	2.0%	3.0%

measure the tax compared to what the homeowner can afford? The owner of this home could be out of work—or could have just gotten a huge raise. Because we care about tax fairness, we need to measure the tax paid relative to ability to pay. Tax incidence tables—like the ones presented in ITEP’s “Who Pays” report and other ITEP analyses of tax fairness—are based on effective tax

tax (the total amount of statewide sales subject to the tax) applies to \$1.5 billion of retail sales, while state A’s sales tax applies to just \$1 billion in sales. State B’s sales tax is obviously much higher than State A’s tax—even though the legal rates are identical. To compare these two sales taxes solely on the basis of the legal rates would be misleading.

A better, more accurate measure for comparing these taxes is the **effective tax rate**. The idea of an effective rate is that instead of just saying “both state A and state B have four percent sales taxes,” we say that “state A’s sales tax takes 2.0 percent of the income of its residents while state B’s takes 3.0 percent of personal income.” This approach is better because it measures tax liability in a way that takes account of differences in the tax base. In this example, by comparing these effective rates we are able to see that, even though state A and state B have the same nominal rates, the tax is really higher in state B because state B has a broader base.

When we divide tax payments by personal income, as in the example above, we’re calculating the **effective tax rate** on income. Effective tax rates can be calculated in other ways, too. For example, the property tax on a home can be expressed as a percentage of its market value. But what if we want to

rates on income for families at different income levels because this approach is the most meaningful measure of tax fairness.

The Interaction of State and Local Taxes With Federal Income Taxes

State taxes often have a direct impact on your federal tax bill. People who itemize deductions on their federal tax returns can deduct the state and local personal income taxes and property taxes they pay in computing their federal taxable income. Sales and excise taxes, by contrast, are generally not deductible on federal tax forms, although federal legislation passed in 2004 allows a temporary, optional sales tax deduction for taxpayers who pay more sales tax than income tax (this mostly benefits those few itemizing taxpayers living in states that lack an income tax). This optional deduction has been temporarily extended on multiple occasions, most recently through the end of 2011. Thus, for every dollar in income or property taxes paid to a state or local government, taxpayers who itemize get a federal tax cut of as much as 35 cents (depending on what federal tax bracket they are in).

The chart on this page shows this effect graphically. Suppose an itemizing taxpayer in the 28 percent federal tax

How Increases in Federally Deductible Taxes Reduce Federal Taxes



bracket is subject to a \$1,000 state income tax hike. The value of her federal itemized deductions will increase by \$1,000. This means that \$1,000 less of this taxpayer's income will be subject to federal tax after the state tax increase. Since this last increment of income was originally taxed at 28 percent, this person's federal tax liability decreases by \$280 (28 percent of \$1,000). So the net tax hike for this taxpayer is actually \$720, not \$1,000. An analysis that looked only at the state impact of the proposal would show a tax hike of \$1,000, while an analysis that includes the offsetting federal change would show a tax hike of \$720.

This **"federal offset"** has clear implications for proposals to increase (or cut) state income and property taxes. When state income taxes go up, part of that tax hike will not come out of state residents' wallets at all, but instead will be paid by the federal government in the form of federal tax cuts for itemizers. Similarly, when state income taxes go down, federal income taxes paid by state residents will go up. And because the federal offset is most useful for wealthy taxpayers who are more likely to itemize and tend to pay at higher federal income tax rates, the best way to maximize the amount of a state income tax hike that will be offset by federal tax cuts is to target these tax hikes to the wealthiest state residents.

This benefit is not limited to income taxes paid by individuals. Corporations can export up to 35 percent of their state corporate income tax to the federal government. This means that when states enact corporate tax breaks for in-state businesses, up to 35 percent of these cuts may ultimately go not to the corporations for whom the tax breaks are intended, but to the federal government in the form of higher federal taxes.

The general inapplicability of the federal offset to sales and excise tax changes means that these regressive tax hikes are an especially bad deal for state residents, since virtually every dollar of a sales tax hike that is paid initially by state residents will ultimately come out of their pockets.

Conclusion

Now you've seen the basic conceptual building blocks of tax policy analysis. The next four chapters will take the concepts and terms you've learned here and apply them to each of the major types of taxes used by state and local governments.

We'll look at how each tax matches up against the principles of taxation described in this chapter, and at reforms that could help each tax remain a viable revenue source for the 21st century. We'll also look at some broader reforms that can help ensure accountability and fairness in all types of taxes. 

¹ Felix, R. Alison, "The Growth and Volatility of State Tax Revenue Sources in the Tenth District." Economic Review: Third Quarter, 2008. Federal Reserve Bank of Kansas City. <http://www.kc.frb.org/PUBLICAT/ECONREV/PDF/3q08Felix.pdf>

Felix surveys this literature and adds new findings showing that between 1965 and 2007, state income tax revenues had a long-term elasticity of 2.03, more than double the 0.97 elasticity of the sales tax.