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Policy Brief

June 2010

Principles of a Good Revenue System

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Every state has a revenue system, which consists of the sources tapped to fund state and local public services. Ideally, public policy should be concerned with the design of the system as a whole, rather than focusing on one particular tax at a time. At the heart of the revenue system is the tax code, but states also rely on non-tax revenues to fund many important activities and programs. So fees and charges, licenses and permits, are part of the revenue system.

Every revenue source has positive and negative attributes. Some are more stable than others, or create fewer distortions in household and business decisions. Some are more costly to collect than others. Some are hidden, others highly visible. Some have broad bases, others narrower bases. Certain kinds of taxes are useful for encouraging "good" actions (like education) or discouraging "bad" actions (like drinking alcohol). Other taxes or fees may be designed to create a fairer distribution of the tax burden.

Two of the most important qualities of a tax (or a fee) are efficiency and equity. Efficiency means many things. It may mean minimizing the (negative) impact on household decisions about where to shop, where to live, how hard to work, whether to save and invest. It may mean encouraging (or discouraging) business location in the country or state or county, or encouraging investment and job creation in general. Efficiency may also means minimizing the cost of collection and compliance, or annoyance to taxpayers.

In general, a higher tax rate causes more changes in decisions. A high sales tax encourages internet and cross-border shopping. A high income tax rate may encourage high-income households to leave the state, and discourage others from moving in. High property tax rates discourage construction and improvements. So an important aspect of efficiency is to rely on several broad-based taxes with relatively low rates, rather than fewer kinds of taxes at higher rates. Most states rely on income, sales and property taxes to fund state and local governments, supplemented by excise taxes, licenses, fees and charges. States that have no income taxes (like Tennessee) tend to have sales and property tax rates, and the handful of states with no sales tax tend to have higher income and property tax rates.

Equity means fairness in distribution of the tax burden among households and firms. There is some general agreement among economists that the tax system should be at least proportional, so that it takes about the same share of everyone's income. There is less consensus about the idea that it should perhaps be even moderately progressive, taking a larger share of the income of wealthier households.

Equity is at least as important as efficiency, sometimes more so to policymakers, in designing and reforming tax systems. Every change in the tax base, the tax rate(s), or the tax rules alters the distribution of the tax burden between taxpayers. Substantial lobbying effort is expended on tax breaks for particular firms, individuals, or activities. Efforts to redistribute the burden, whether in the interests of greater equity or in response to lobbying by particular interests, are the source of much of the complexity in the tax system, especially the income tax.

The most widely used criterion for tax fairness is called ability to pay. Ability to pay as a determinant of one's tax burden implies that those who have more resources than others can and should make a larger contribution toward the cost of government and public services. How is ability to pay measured? The simplest measure is income—the amount of revenue flowing through the household in a month or a year. A second measure is consumption or spending, and a third measure is assets or property owned. These three measures are the bases for the principal tax revenue sources in the U.S. economy and most other places as well—the income tax, some form of sales or consumption tax, and the property tax.

Some of these measures of ability to pay are more accessible to the tax collector than others. Consumption is the easiest measure to track because it involves transactions in the marketplace that can be tapped at the point of sale. Some income, particularly wage and salary income, is easy to track through payroll records, but other forms of income—self-employment earnings, interest and dividends, profits from proprietary businesses, capital gains—are much harder to uncover. Assets are the most challenging tax base of all. Few tax systems attempt to be broadly inclusive of all assets (household furnishings, stocks, bonds, jewelry, works of art, etc.) and just focus on certain kinds of property, such as real estate, automobiles and boats.

Another way to design taxes or fees is to apply the benefit principle. Unlike ability to pay, the benefit principle links the tax obligation to the value of the services received in exchange. The property tax is to some degree a benefit tax. Most local services (except for education) are fairly directly related to property. Police protection, fire protection, roads, streetlights, and garbage pickup are the most obvious examples. A case could be made that the value of those services to property rises with the value of the property being served or protected. The best-known example of a benefit tax is the tax on gasoline, which is earmarked for highway construction and maintenance. Those who purchase more gasoline either drive more miles or drive heavier, less fuel-efficient cars, but in either case they cause more wear and tear on the roads. Those who drive little do not have to subsidize those who drive a lot, and those who drive smaller, more fuel-efficient cars do not have to subsidize those who drive gas guzzlers. Fees and charges ranging from impact fees for new development to recreation charges to dog licenses and hunting and fishing licenses also embody the benefit principle.

How do we measure equity? We start with describing the distribution of the tax burden. The measure used is to compute this burden as a percentage of income paid in taxes (and fees). Taxes and tax/revenue systems are then classified as regressive, proportional, or progressive according to whether that percentage decreases, remains the same, or increases as income rises. A regressive tax takes a smaller percentage of income as income rises. Some excise taxes are regressive, while others are not, depending on how consumption patterns for cigarettes, gasoline, alcohol, and other items subject to excise taxes vary with income. A proportional tax takes a constant fraction of income as income rises. Some states, such as Illinois, have simple, flat income taxes that take a constant percentage of all income (not just payroll or wage and salary) without any deductions or exemptions. A progressive tax takes an increasing percentage of income as income rises. The federal income tax and most state income taxes are moderately progressive. For states, the ideal system would be between proportional and mildly progressive. Individual taxes or fees may be progressive, proportional, or regressive, but it is the distribution of the burden as a whole that is the important measure.

Other important qualities of a tax system are adequacy, visibility, sensitivity to growth (versus stability), and administrative and collection cost. A revenue system has to generate adequate funds to pay for the desired level of public services. Some kinds of revenue systems could generate too much revenue. Legislators awash in funds are rarely without pet projects to fund, and will respond to a revenue windfall with additional spending, although sometimes they do respond to rapid revenue growth with tax cuts. At other times, revenue can fall short of the amount needed to fund basic services at the desired level. State governments had nearly a decade of steady revenue growth in the 1990s, a fiscal crisis at the end of the dot.com boom in the early 2000s, another period of revenue growth until 2008, and then a sharp drop in revenue starting in late 2008 and expected to continue for at least four years because of the financial crisis and high unemployment. In general, revenue needs to grow at least as fast as the increase in population and in the costs of inputs into providing public goods as well as public services (administration, regulation, etc.). It may need to also keep pace with real income growth, because demand for public services as a complement to private consumption can be expected to increase as the standard of living rises.

Ensuring and defending adequacy means that legislators must be sensitive to the dangers of eroding the tax base. Adding exemptions to the sales tax, increasing deductions on the income tax, or using corporate income tax breaks to lure industry all exact a cost in terms of not just current revenue adequacy but also future revenue flows.

Some of the revenue sources in the overall system need to offer a cushion of stability, particularly for state and local governments that must balance their budgets annually through recessions as well as periods of prosperity. Stability means that the revenue flow is not unduly sensitive to fluctuations in economic activity. For local governments, an important positive attribute of the property tax is its stability. The two major state taxes, income and sales, are responsive to growth in personal income (which also reflects population and inflation), but tend to fluctuate more than income during recessions and expansions. Stability has been a serious challenge for state governments in the last two decades. However, the long-term tendency of revenue from income and sales taxes to reflect growth in income, population, and inflation has a plus side. As the population grows, revenue needs to grow in order to finance the additional services required by a growing population. Because taxable sales grow more slowly than income over the long haul, states that rely primarily on sales taxes have more difficulty keeping pace with the cost of services than those that have an income tax.

Visibility means that taxpayers are aware of what they are paying. Is visibility desirable? Those who think that government is too large prefer that taxes be highly visible so that the pain of paying taxes will be weighed carefully against the benefits from government services. Others argue that, because many government services are low visibility, taxes should be equally low in visibility. In practice, there is a mix of taxes and revenue sources in the system that range from highly visible (property taxes) to moderately visible (sales taxes, payroll taxes) to low visibility (excise taxes included in the price). Likewise, government services range from high visibility (road repairs, trash pickup, schools) to moderately visible (national defense, parks, prisons) to low visibility (building inspection, financial administration).

Taxes can be made more visible in a variety of ways. Referenda, usually on bond issues for schools and other capital expenses, give taxpayers a chance to directly weigh an increase in taxes against an increase in services. Stating the retail sales tax separately from the price, a practice in most states with retail sales taxes, makes it more visible. Posting the excise tax on the pump at gas stations is another way to try to make consumers more aware of how much of what they pay is for the product itself and how much is tax.

Collecting taxes is not free. Bureaucracies must be created to interpret the tax laws and ensure that taxes are collected. The cost of printing forms, processing and auditing returns, and assessing tax liabilities is the collection cost. Taxpayers also incur costs. They have to keep records, fill out forms, go through audits, and pay tax accountants to make sure that they are in compliance. These costs that fall on the taxpayers are called compliance costs. Some taxes are costly to administer but not to comply with, like the property tax, while others are burdensome on both the tax collector and the taxpayer, like the individual income tax. In some cases, compliance costs fall on third parties—employers who must keep the records and file the returns for Social Security taxes or retailers who must collect and remit the retail sales tax. While compliance costs for property taxes are low, these taxes are quite expensive to administer because of the need to assess the market value of a variety of assets, and to handle disputes and appeals over the values assigned. Being the property tax assessor is one of the more frustrating tasks in local government!

There are a few rules of thumb that provide some guidance in reducing these costs. As a general rule, it is cheaper in terms of collection costs to administer a tax centrally than locally, because each local government will need its own staff. There are substantial economies of scale in tax administration that result in counties collecting property taxes on behalf of municipalities and states collecting and distributing local sales taxes on behalf of their cities and counties. It is also less expensive to administer a broad-based income tax than one with many exemptions, exclusions, adjustments and deductions. For retail sales taxes, it is less costly to administer and to comply with a tax that is broad-based in terms of tangible goods, because neither the tax collector nor the retailer has to worry much about separating taxable from nontaxable sales. On the other hand, expanding the tax to include services could increase the cost of both collection and compliance because of the large number of very small firms that would have to be included in the process.

So the perfect tax, or the perfect revenue system, would include several broad-based taxes (income, sales, property) at relatively low rates as well as a variety of specialized taxes, fees that assign costs to those who benefit from specific services. It would offer a stable base of revenue that grows with the state's population and income, and would be collected at minimum cost and inconvenience to the government and the taxpayer, and its burden would be distributed fairly between business firms and households, old and young, rich and poor. That's a daunting challenge facing every legislator and public official as the state goes through the annual process of budgeting for public services and finding the money to pay for them.

These tax policy briefs describe a number of contemporary tax issues in South Carolina that will be facing policy makers in the next few years. We hope this is helpful in evaluating the options that you will be facing.

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