Standard Principles

and

Practice in Public Finance

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To put it simply, our tax system is unfair, inequitable, counterproductive, and all but incomprehensible. I've mentioned it before, and this is absolutely a fact, that even Albert Einstein had to write to the IRS for help with his Form 1040.

- Ronald Reagan

- **The Tax Reform Act of 1986 is perhaps the most notable modern example of how the principles that tax analysts use to evaluate a tax system can be applied.**
- **The Act is best known for lowering marginal tax rates, but it changed the tax code in a number of other important ways as well.** [1]
- **In addition to lowering marginal tax rates, the Act made thousands of changes to the federal code that simplified the code; made it more efficient and equitable; led to a more stable revenue system; and, many would argue, enhanced economic growth.**

[1] General Explanation of The Tax Reform Act of 1986, Joint Committee on Taxation, May 4, 1987.

Principles of Taxation

Tax economists judge the efficacy of a tax system by the standards of:

- ***Equity***
- ***Efficiency***
- ***Simplicity***
- ***Stability***
- ***and Economic Growth***

These five principles are interrelated and, when applied, may conflict with one another.

A Michigan Example:

Michigan has a 4.35% single rate income tax.

Example: A true flat tax -- one with no credits, deductions, or exemptions at a rate of 2% would replace the current income tax, and at 2.5%, an extra $1.8 billion.

- **It would be simple enough to file on a postcard.**
- **It would be much more stable than the current tax.**
- **It would promote growth because LLC's, etc., would get a tax break.**
- **At 2.3%, the 21.99% MBT surcharge and personal property taxes could be eliminated.**

Evaluating Equity (Fairness)

Everyone agrees that a tax should be "fair," -- but there is a great deal of controversy about what is or is not fair.

- ***Tax analysts use two concepts of fairness, or equity, to evaluate how fair a tax is: <u>vertical equity</u>, and <u>horizontal equity</u>. Both concepts deal with measures of the "incidence" of the tax.***

- ***Tax incidence refers to who ultimately pays the tax; even though a tax is collected from one taxpayer, the final burden of the tax may be shifted to a different taxpayer.***

Determining the incidence of a sales tax collected from a consumer who purchases a good or service is fairly straightforward.

Evaluating Equity (Fairness)

Determining tax incidence of business taxes, however, is more problematic because, in a very real sense, businesses don't pay taxes—people do.

- ***Economists have never been able to determine the final incidence of business taxes, but in the final analysis taxes must be borne by the consumer in the form of higher prices, the employee in the form of lower wages, the stockholder in the form of lower dividends or lower stock values, or the proprietor in the form of lower profits.*** [2]

[2] Advisory Commission on Intergovernmental Relations, The Michigan Single Business Tax: A Different Approach to State Business Taxation, March 1978, p. 38

Measuring Equity

- Vertical Equity is a measure of tax burden by income group
  - "Regressive" taxes levy a higher percent of tax relative to income for lower income groups than for higher income groups.
  - "Proportional," or flat, taxes levy the same percent of tax relative to income for all income groups.
  - "Progressive" taxes levy a higher percent of tax relative to income for higher income groups than for lower income groups.
  - The "effective" tax rate, which is the final tax liability after all credits and exemptions are taken as a percent of the tax base, measures vertical equity.
- Horizontal Equity is the measure of tax burden on taxpayers who have the same tax base. Perfect horizontal equity is equal tax treatment of taxpayers of equal means.

Simplicity

- A broad-based tax with one rate and no deductions or credits would be the simplest tax to pay and collect.
- Complex tax structures make compliance more costly. Provide more opportunities for both taxpayers and tax administrators to make errors. Afford more opportunity to avoid or evade tax liability.
- Simplicity in the tax code minimizes excess burden. The simplest tax is one that is broad-based and has a low rate.

Stability

- **Stable revenue sources are generally preferable to revenue sources that display erratic fluctuations because they minimize the necessity to make revisions to a budget. "A sharp decline in revenues in a state contributes to an uneven and inefficient delivery of public services." [3]**

- **Sources of revenue that have a broad base tend to be more stable. The long-run stability and predictability of a revenue source during business cycle peaks and troughs is also a consideration.**

[3] Ibid., p. 21.

Efficiency

- **Tax analysts believe tax policy should be "efficient" in the sense that it should not encourage individuals or firms to make less than optimal economic and/or business decisions.**

- **According to this principle, to the extent possible, tax policy should minimize or have no influence on economic choices that consumers or businesses make.**

  Economists "believe that firms and individuals, aided by the signals given by market prices, are generally the best judges of what goods and services should be produced, and how resources should be allocated. In the interest of maximizing profits, firms will seek out those investments and opportunities that offer the highest reward, and pursue those opportunities using the most efficient techniques. For their part, individuals will spend, or save, their income the best they can to maximize their well-being according to their own preferences." [4]

- **One of the competing goals of producing "good" tax policy is to minimize distortions and incentives that cause a change in economic behavior.**

[4] Slemrod, Joel and Jon Bakija, Taxing Ourselves A Citizen's Guide to the Great Debate Over Tax Reform, 1998, p. 103.

Economic Growth

- Taxes and their effects on long-run economic growth are important. Tax policy at the national level plays an observable role in the economy. The sheer magnitude of the combined impact of federal fiscal and monetary policy can overwhelm the attempts of state policymakers to stimulate a state economy with tax policy.

- Because of state balanced-budget requirements that do not exist at the national level, a decrease in state tax levels must eventually result in an reduction in state spending levels.

- Reduced state spending in areas critical to sustained economic growth can have a negative economic impact on state economic growth, that offsets any positive impact a tax cut may have on state economic growth.

Other Considerations

- **Two other considerations often enter into the tax policy debate: <u>ability to pay</u> and <u>benefits received</u>.**

- **"The ability to pay concept reflects the idea that the taxpayers should contribute to the support of public goods and services in proportion to their financial capacity."[5] It suggests that taxpayers with higher income should pay proportionately more than taxpayers with less financial means.**

- **In the benefits received principle, taxes are treated as the price of government goods and services. In other words, taxpayers that benefit from public goods or services should pay the costs. User charges and fees are often justified under the benefits received principle.**

[5] Hy, Ronald John and William L. Waugh, Jr., <u>State and Local Tax Policies A Comparative Handbook</u>, 1995, p. 26.

Minimizing Administrative and Compliance Costs

- Administrative costs are the costs incurred by government agencies in order to collect tax revenues. Compliance costs are the costs incurred by households and businesses in order to obey the tax laws.

- The real burden of a tax system on society includes both administrative and compliance costs. Thus, all else being equal, a reasonable goal of a tax system is to minimize these costs.

- Excess burden: The burden to society that includes administrative and compliance costs.

Base Erosion

- There has been a significant increase in tax preferences in the form of exclusions, deductions, and credits in recent years. When a tax has special exemptions, deductions, exclusions, and credits, that tax suffers from base erosion.
- The net result of preferential treatment of certain taxpayers is to make the tax system substantially more complicated. Base erosion is therefore associated with high costs of administration and compliance.
- A simple, more uniform tax structure could raise the same amount of revenue for a lower total cost to society by reducing administration and compliance costs.

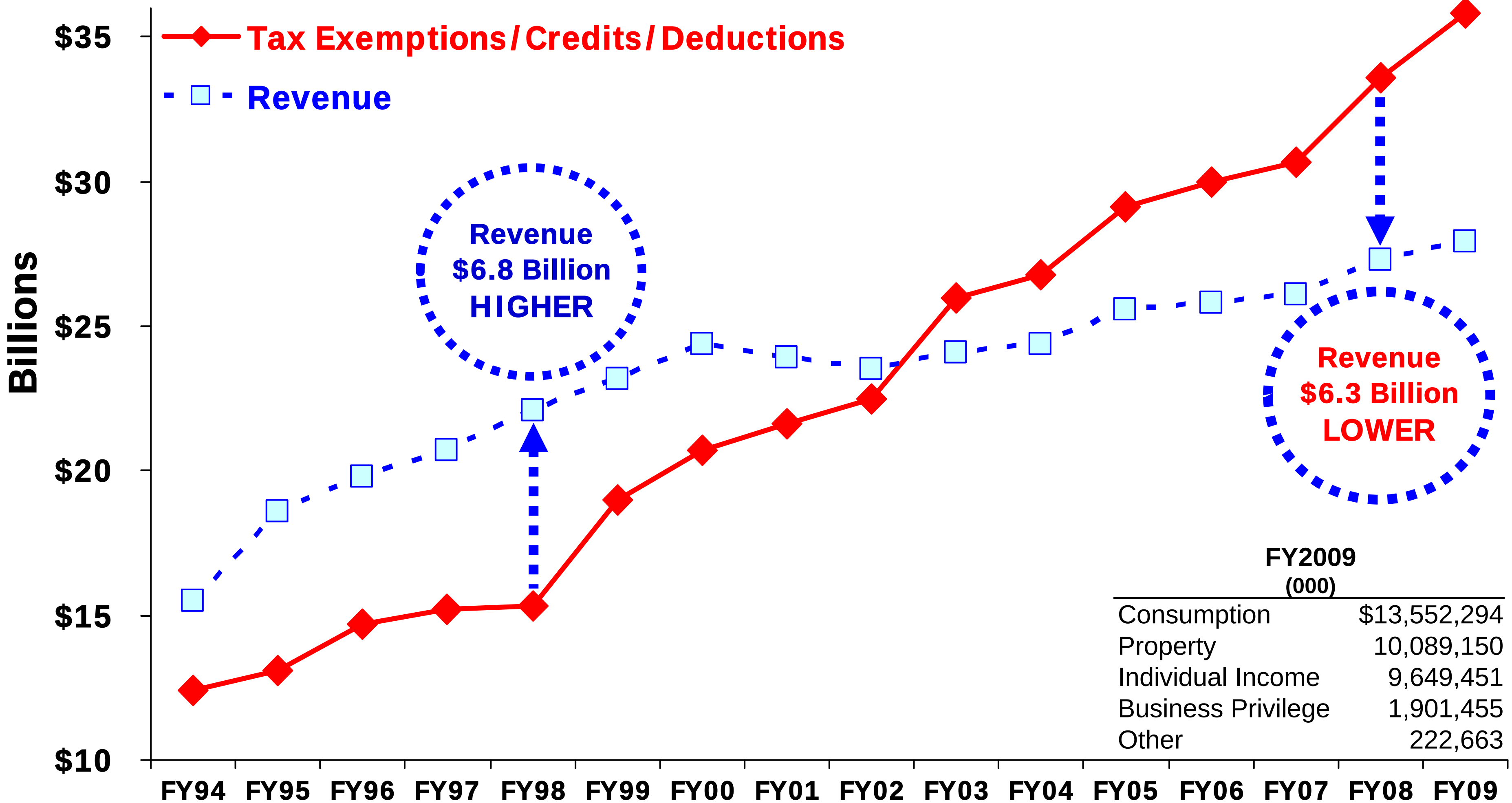
The Impact of Tax Expenditures

Why consider tax expenditures?

- **Tax expenditures are an <u>alternative</u> to direct spending.**
- **They can be used to effectively continue to spend tax dollars on policy initiatives while the budget is being reduced.**
- **They're "off-budget" for all practical purposes.**
- **Transparency and government accountability demand they be reported and evaluated.**

EXAMPLES FROM MICHIGAN

Impact of Tax Exemptions/Credits Deductions



	FY2009 (000)
Consumption	$13,552,294
Property	10,089,150
Individual Income	9,649,451
Business Privilege	1,901,455
Other	222,663

Impact of Recent Tax Cuts on Future Revenues

	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
Reducing Michigan Income Tax Rate	$0.0	$0.0	$0.0	($150.0)	($329.0)	($522.5)
Alternative Energy Credits - Income Tax	($16.0)	($46.0)	($47.0)	($42.0)	$0.0	$0.0
Michigan EITC	($140.0)	($325.0)	($338.0)	($358.3)	($379.8)	($402.6)
Eliminating MBT Surcharge			Eliminated in Tax Year 2017			
MBT Battery Credits (Assumes Maximum Used)	$0.0	$0.0	$0.0	($40.0)	($268.0)	($278.0)
MBT Film Production Credit	($37.5)	($100.0)	($125.0)	($125.0)	($125.0)	($125.0)
Photovoltaic Technology - Facility & Manufacturing	$0.0	($0.8)	($9.8)	($12.5)	($12.5)	($15.0)
Polycrystalline Manufacturing Credit	$0.0	$0.0	$0.0	$0.0	($25.0)	($25.0)
MBT Gross Receipt Changes	($115.8)	($80.5)	($93.4)	($117.8)	($129.9)	($132.7)
Decouple Bonus Depreciation/Production Activities	$172.5	$23.4	$19.2	$45.3	$52.3	$60.0
Historic Preservation Credits	$0.0	$0.0	($5.0)	($8.6)	($9.6)	($10.6)
Promise Zones - SET	$0.0	($1.0)	($4.0)	($10.0)	($15.0)	($20.0)
IFT Exemption for Commercial Real Land	$0.0	($2.0)	($2.0)	($2.0)	($2.0)	($2.0)
Use Tax Bad Debt Deduction Change (Court Case)	($2.0)	($25.5)	($16.6)	($17.1)	($17.7)	($18.4)
Exempt Supplies for Cobo Center	$0.0	$0.0	($2.5)	($2.5)	($3.5)	($1.5)
Totals in Millions	**($138.8)**	**($557.4)**	**($624.1)**	**($840.5)**	**($1,264.7)**	**($1,493.3)**

Potential GF/GP Base Revenue
(millions)

	Consensus FY 2011	FY 2012	FY 2013	FY 2014
Baseline Revenue * Assume 3% Growth	$6,968.4	$7,177.5	$7,392.8	$7,614.6
Adjust for Tax Change Not Built Into FY 2011	N/A	($194.4)	($591.5)	($789.1)
Net GF/GP Revenue	N/A	$6,983.1	$6,801.3	$6,825.5
Percent Change from Prior Year	N/A	0.2%	(2.6%)	0.4%

* Note: 3% baseline growth has not been achieved since 2000.

Senior Tax Preferences

- **Income Tax**
  - **Fully exempts social security, military, federal, state and local government pension/retirement income**
  - **Exempts private pensions up to $45,120 single/$90,240 joint (TY 2009); indexed to inflation**
    - **Annual cost all pension income exemption = $725 million**
  - **Deduction for senior investment income $10,058 single/$20,115 joint; indexed to inflation**
    - **Annual cost = $40 - $50 million**

Senior Tax Preferences

- Income Tax
  - Additional Personal Exemption $2,300 single/$4,600 joint (TY 2009)
  - Annual cost = $55 million

- Property Tax
  - Homestead Property Tax Credit
    - Under age 65 – credit is 60% of the amount by which property taxes exceed 3.5% of household income, up to a maximum of $1,200
    - 65 and older – credit is 100% of the difference Annual cost = $320 million

Demographics

- Michigan's population is aging
  - 2000 – 12.3% pop age 65+
  - 2010 – 12.8% pop age 65+
  - 2020 – 16.0% pop age 65+
  - 2030 – 19.5% pop age 65+
- Senior tax preferences will get more expensive

Impact of Shrinking Tax Base

	Income Tax Rate	Collections as Percent of State Personal Income
FY 2000	**4.0%**	**2.6%**
FY 2010	**4.35%**	**1.5%**
Revenue Impact of Declining Base (In Millions of Dollars)		**$3,653.50**

	Sales and Use Tax Rate	Collections as Percent of State Personal Income
FY 2000	**6.0%**	**2.8%**
FY 2010	**6.0%**	**2.1%**
Revenue Impact of Declining Base (In Millions of Dollars)		**$2,511.60**

Fewer People Pay Income Tax

	2000	2008
Tax Liability < $0	19.5%	25.6%
Tax Liability = $0	8.0%	8.0%
Tax Liability < $100	33.6%	38.6%

Refundable Credits on the Michigan Income Tax

- **Homestead Property Tax Credit ($987.5 million in FY2009-10)**
- **Earned Income tax Credit ($333.0 million in FY2009-10)**
- **Alternative Energy/Qualified Home Improvement Credit ($46.0 million in FY2009-10)**
- **Adoption Credit ($1.0 million in FY2009-10)**
- **Stillbirth Credit ($41,000 in FY2009-10)**

Indexed Provisions of the Michigan Income Tax

- Personal Exemption
- Special Exemptions for Seniors and/or Disabled Individuals
- Special Exemption for Qualified Disabled Veterans
- Income Threshold for Pension Income Deduction
- Income Threshold for Deduction of Interest and Capital Gains Earned by Seniors
- Home Heating Credit
- Stillbirth Credit

Earmarking

- An important trend in recent years in Michigan has been an increase in earmarking. Several of the tax changes in Proposal A involved substantial earmarking. Rate reductions in the individual income tax also involve earmarking. Recent increase in the tobacco taxes produced additional earmarking.

- Earmarking often leads to the perception that certain discretionary programs have become entitlements and may make it more difficult for state government to respond to changing fiscal circumstances and priorities.

Summary

- **The type of tax system that policymakers typically seek is fair, efficient, simple, stable and pro-growth. These principles are interrelated and, when applied, may conflict with one another. Policymakers may conclude that a *simple* tax structure, for example, is not as *equitable* as it should be or that a more *equitable* system is not as pro-*economic growth* as it should be. Conflicts often arise because views differ as to which principal is more important.**

- **The type of system most likely to reflect these principles is one that includes a diverse set of taxes that are as broad-based as possible and have rates that are as low as possible.**

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