

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 be an effective advocate for progressive tax reform.

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, both in the short run and the long run, to sustain the level of public services demanded by citizens and policy makers. At the end of the day, adequacy is what separates successful tax systems from unsuccessful tax systems.

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

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?

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 also require frequent tax increases and reductions to ensure that state revenues match the desired level of government services. (The use of “rainy day funds” can make these legislative changes unnecessary—see Chapter Ten.) 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.

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. 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 tax burden. 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 10.) 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. Strategies for achieving this are outlined in later chapters of this guide.

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 benefit principle would defeat their purpose.

Neutrality

The principle of neutrality (sometimes called “efficiency”) tells us that a tax system should stay out of the way of economic decisions. 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.

Tax Incidence

When we look at tax burdens on families at different income levels, we’re engaging in what’s called **incidence analysis**. Tax incidence analysis is designed to answer basic questions about how the current tax system and various proposed alternatives affect families at different income levels. On this page is an example of an **incidence table**. It shows the total amount of state and local taxes paid nationwide, as a percentage of each group’s income. For example, the table shows that the poorest twenty percent of Americans paid, on average, 7.8 percent of their income in sales and excise taxes, while the wealthiest taxpayers paid 1.1 percent of their income in these taxes.

The first step in incidence analysis is to divide a population into income groups. ITEP’s analyses usually divide the population into five groups based on income—ranging from the poorest 20 percent to the richest 20 percent. Each of these groups is called an “income quintile.” (“Quintile” simply means one fifth, or 20 percent, of the population.)

ITEP’s analyses also split the richest 20 percent into three subgroups: the lowest-income 15 percent of the quintile, the next 4 percent and the richest one percent. This is done because families in the top 20 percent have more than half of all personal income nationally. Within this quintile, there are substantial differences in income levels and tax burdens between the “poorest”

Total State & Local Taxes in 2002 As Shares of Income for Non-Elderly Taxpayers

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	TOP 1%
Average Income in Group	\$9,900	\$22,000	\$36,100	\$57,900	\$98,100	\$204,100	\$950,000
Sales & Excise Taxes	7.8%	6.4%	5.1%	4.1%	3.1%	2.0%	1.1%
Property Taxes	3.1%	2.3%	2.5%	2.6%	2.6%	2.3%	1.4%
Income Taxes	0.6%	1.6%	2.3%	2.7%	3.2%	3.8%	4.8%
TOTAL TAXES	11.4%	10.4%	9.9%	9.4%	8.9%	8.1%	7.3%
Federal Deduction Offset	-0.0%	-0.1%	-0.3%	-0.6%	-1.2%	-1.6%	-2.0%
TOTAL AFTER OFFSET	11.4%	10.3%	9.6%	8.8%	7.7%	6.5%	5.2%

Source: ITEP, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* (2003)

members and the richest members. Incomes in this group range from what might be called upper-middle class, to the richest families in the country. From a tax policy standpoint, relatively lower-income families in this group should not be treated the same as the richest families because they have very different abilities to pay. This is why our incidence tables show them separately.

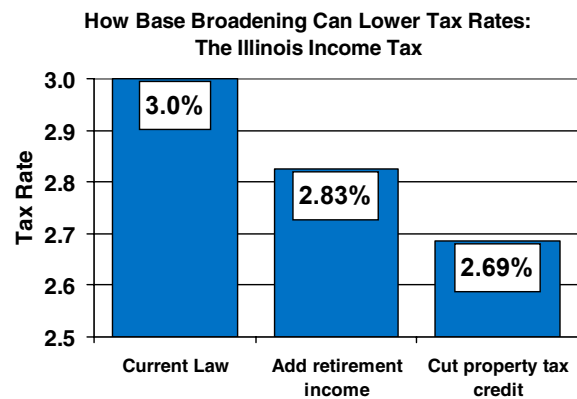
The Tax Base

The **tax base** is all the items or activities subject to a tax. The tax base of a sales tax, for instance, is the amount paid for all the items that are subject to the tax. So, if the total amount a state's consumers paid in a year for taxable items is \$2 billion, then the state's sales tax base is \$2 billion.

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 this way: excise taxes on cigarettes, gasoline and beer are often calculated on a per-unit basis. 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 sold 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 personal income even when the number of units sold is unchanged.

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 at right illustrates this: Illinois taxes personal income at a flat 3 percent rate. If lawmakers repealed a special tax break for retirement income, the tax rate could be 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 raise 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 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. So a broad tax base helps achieve the goal of neutrality described above.

But sometimes there are good reasons for having a narrower base. Excluding food from the sales tax, for example, makes that tax less regressive. Some 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 mil 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 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

Effective Tax Rates and Nominal Tax Rates		
	State A	State B
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%

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**, and this is the way taxes are usually measured in ITEP’s incidence analyses. 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 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 one presented in this chapter—are based on effective tax rates on income for families at different income levels because these tables are designed to determine the fairness of taxes. A fair tax takes more from those with a greater ability to pay, so the effective rate on income is higher on those with greater income. A regressive tax has lower effective rates on income for the rich than for middle- and low-income families.

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 (mostly living in states without an income tax) who pay more sales tax than income tax. This optional deduction is only available in 2004 and 2005.) 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 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 that state and local governments rely on. We'll look at how each tax matches up against the principles of taxation described in this chapter, and will look 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.

How Increases in Federally Deductible Taxes Reduce Federal Tax Burdens

