Principles of Good Tax Policy

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Annette Nellen, CPA, CGMA, Esq.
Professor/Director – MST Program
San José State University
http://www.sjsu.edu/people/annette.nellen
http://www.21stcenturytaxation.com

What is tax policy?

Considerations involved in <u>design</u> of a tax system and its components.
  ◦ The appropriate type and mix of taxes.
  ◦ Tax base.
  ◦ Rate structures.
  ◦ Who is the taxpayer?
    ◦ Direct and indirect.
  ◦ Administrative and compliance structure.
  ◦ Intergovernmental considerations.

Must also consider legal constraints (constitutional, statutory, judicial) that might affect design.

Tax policy/design should lead to …

A "workable" tax system that …

◦ Taxpayers understand.

◦ Allows for effective and efficient funding of the desired level of government spending.

◦ Allows for reasonable predictability for creating government budgets.

◦ Support of the jurisdiction's economic, societal, and environmental goals (the tax system should not work in opposition to these goals).

Principles of Good Tax Policy

1. **Equity and Fairness.**
2. **Certainty.**
3. **Convenience of Payment.**
4. **Effective Tax Administration.**
5. **Information Security.**
6. **Simplicity.**

7. **Neutrality.**
8. **Economic Growth and Efficiency.**
9. **Transparency and Visibility.**
10. **Minimum Tax Gap.**
11. **Accountability to Taxpayers.**
12. **Appropriate Government Revenues.**

Principles of good tax policy

Help to:

1. achieve a "high-quality state revenue system." [NCSL]

2. guide tax reform by helping to:
   a. identify weaknesses in the existing tax system.
   b. adequately analyze any proposal for change.

3. allow for a more objective analysis approach.

Equity & Fairness

Similarly situated taxpayers should be taxed similarly.

Ties to *ability to pay* concept:
- *Horizontal equity* – those with similar abilities to pay should pay same amount of tax.
- *Vertical equity* – those with greater ability to pay should pay more tax.

"Fairness" – this term tends to be subjective, but can be helpful to know the public's perception of the fairness of a tax (can also indicate if public needs a better understanding of a tax).

Consider equity for each tax as well as the aggregate of the entire range of taxes a taxpayer is subject to both directly and indirectly.

Equity Examples

Age-based exemptions violate horizontal equity.
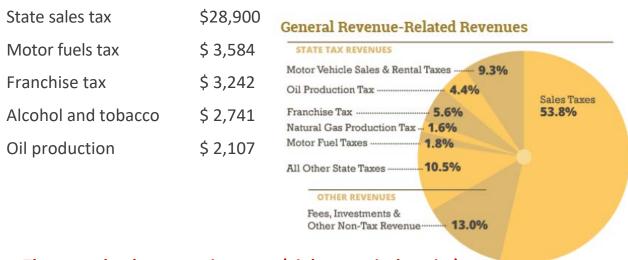
- Age has no bearing on ability to pay.

Consumption taxes and exemptions generally violate vertical equity.

- The tax paid represents a larger percentage of the lower income taxpayer's income relative to the higher income taxpayer.
  - Example: Two families both purchase 1000 gallons of gasoline during the year, and pay excise tax of $200.
    - Family A has income of $20,000
      - Gas tax is 1.0% of income.
    - Family B has income of $60,000
      - Gas tax is 0.33% of income.
  - See additional examples on next slides + "Suits Index" measure used in Comptroller report (https://comptroller.texas.gov/transparency/reports/tax-exemptions-and-incidence/2017/96-463.pdf).

Federal income tax generally meets vertical equity (both the graduated rate structure for individuals and the flat 21% rate for corporations).

State tax revenue types and amounts (000,000) (single year)

State sales tax	$28,900
Motor fuels tax	$ 3,584
Franchise tax	$ 3,242
Alcohol and tobacco	$ 2,741
Oil production	$ 2,107

General Revenue-Related Revenues

STATE TAX REVENUES

Motor Vehicle Sales & Rental Taxes ---- 9.3%
Oil Production Tax ---------------- 4.4%
Franchise Tax --------------- 5.6%
Natural Gas Production Tax --- 1.6%
Motor Fuel Taxes ------------ 1.8%
All Other State Taxes -------- 10.5%

Sales Taxes
53.8%

OTHER REVENUES

Fees, Investments &
Other Non-Tax Revenue -------- 13.0%

These tend to be regressive taxes (violate vertical equity).

Also - https://comptroller.texas.gov/transparency/revenue/docs/96-1774.pdf

Tax incidence by household income quintile

How big is the slice for taxes?

Income pie

Household income:	1 < $35, 108	2 $35,108-61,522	3 $61,522-95,635	4 $95,635-146,699	5 > $146,699
Sales/use tax	6.7	3.7	3.2	2.8	1.5
Franchise tax	0.5	0.3	0.3	0.3	0.2
Motor vehicle sales/use tax	0.9	0.5	0.6	0.5	0.3
Gasoline tax	0.7	0.4	0.4	0.3	0.1
School property tax*	7.5	3.7	2.9	2.9	2.1

(Row label, vertical: Tax as a percent of total income)

*Represents about half of total property tax assessments. Comptroller report only includes school property tax incidence.
https://comptroller.texas.gov/transparency/reports/tax-exemptions-and-incidence/2017/96-463.pdf

Certain sales tax exemptions provide greater value to higher income individuals (despite flat tax rate)

Examples:
◦ Back to school sales tax holiday
◦ Sales tax exemption for food consumed at home and services

Income quintile:	Lowest	Second	Third	Fourth	Highest
Food at home	$2,502	$3,112	$3,697	$4,738	$6,193
Sales tax savings (6.25%)	$156	$195	$231	$296	$387
Household personal services	$150	$170	$228	$456	$1,282
Sales tax savings (6.25%)	$9	$11	$14	$29	$80

Bureau Labor Statistics (BLS), Quintiles of income before taxes (average – Table 1101; 2016 data)
https://www.bls.gov/cex/tables.htm

Certainty

Tax rules should clearly specify how the amount of payment is determined, when payment of the tax should occur, and how payment is made.

Certainty, rather than ambiguity.

Ability to determine tax base and rate.

Basically, the level of confidence that exists that the tax is being calculated correctly.

Example: Not knowing if movie is tangible personal property – relevant for sales tax and margin tax (TPP gets cost of sales deduction (*AMC* case – is movie a product or intangible / service?)

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Convenience of Payment

Facilitating a required tax payment at a time or in a manner that is most likely convenient for the taxpayer is important.

Helps ensure compliance.

Appropriate payment mechanism depends on amount of liability and ease of collection.

Consider use of technology, such as system to easily enable hotel tax to be paid by Airbnb users at the time they collect payment from customers.

Example: Gas tax is easier to pay at pump than at year end.

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Effective Tax Administration

Costs to collect a tax should be kept to a minimum for both the government and taxpayers.

Calls for efficient, uniform and fair administration of the tax.

Closely related to simplicity principle (simple rules are simpler to administer, less chance of errors by taxpayers).

Consider use of technology, such as allowing consumers to report and pay use tax online rather than paper form to be mailed in.

Examples: Use of existing records rather than ones created solely for tax purposes. Penalties and interest set appropriately to encourage compliance and deter non-compliance.

Example – Discounts, penalties and interest

What encourages compliance?

Example: Hotel Occupancy Tax Rules
- ❖ 1% discount of tax due if file and pay by due date.
- ❖ $50 penalty if file after due date.
- ❖ 5% penalty if tax paid 1 to 30 days late.
- ❖ 10% penalty if tax paid over 30 days late.
- ❖ Interest charge once 61 days late in paying.

Once 31 days late, incentive exists to wait another 30 days to pay.

Query: Why both a discount (carrot) and penalty (stick)?

Technology Query: Why not have tax automatically paid electronically when customer pays hotel bill and avoid need to file returns?

https://comptroller.texas.gov/taxes/hotel/ (similar system for sales tax)

Information Security

Tax administration must protect taxpayer information from all forms of unintended and improper disclosure.

Digital security and safeguards.

No inappropriate disclosure regardless of format of information.

Needs to withstand changes in technology.

Example: Avoid rules that require disclosure of taxpayer ID to others where possible (example, taxpayer needing to report info on who they paid in order to get a deduction or credit).

Simplicity

Simple tax laws are necessary so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.

Reduces the amount of errors (intentional and unintentional).

Increases respect for the system (and therefore higher compliance).

Enables taxpayers to understand tax consequences of their transactions.

Example: Strive for having few exemptions to the tax base (special rules require definitions which can be difficult to draft, understand and apply).

Neutrality

Minimizing the effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction is important.

Taxpayers should not be unduly encouraged or discouraged from engaging in certain activities due to tax rules.

Primary purpose of tax system is to raise revenue, not change behavior.

When non-neutrality approach is used, purpose should be explicit.
◦ Special rules should be reviewed regularly to determine if still needed or if changes are warranted; consider temporary enactment.

Earmarking generally to be avoided.

Example: No sales tax on clothing or backpacks for three days in August violates neutrality (encourages purchases these days and not others).

Economic Growth & Efficiency

The tax system should not unduly impede or reduce the productive capacity of the economy.

Tax system should be aligned with the economic goals of the jurisdiction imposing the tax.
◦ For example, should be aligned with jurisdiction's goals for economic growth, number and types of jobs, capital formation, and competitiveness.
◦ Should not favor one industry or type of investment at the expense of others.

Examples: Violated by exemptions that favor some industries over others. Tends to be met by taxes with broad base and low rate (few exceptions and special rules).

Transparency & Visibility

Taxpayers should know that a tax exists and how and when it is imposed upon them and others.

Enables taxpayers to know the true cost of transactions.

Enables taxpayers to know when a tax is being assessed or paid and to whom.

Aided by regular review and disclosure of tax expenditures, special tax rules, and earmarked funds.

Examples: Many consumers don't know: (1) they owe use tax when they purchase taxable items from out-of-state vendors (should know at time of purchase decision); (2) that they pay taxes indirectly such as via part of rent on apartment unit (includes portion of property tax paid by owner (without any homestead exemption)).

Minimum Tax Gap

Structuring tax laws to minimize noncompliance is essential.

Tax gap = amount owed less amount collected.

Procedural rules needed to attain compliance.

Generally, is a need to strike a balance between (a) desired level of compliance and (b) costs of enforcement and the level of intrusiveness of the tax system.

Example: Consumers and some businesses not self-assessing use tax when applicable. (see next slide)

Issue - Use tax gap

Mainly due to e-commerce and other sales where seller has no physical presence in Texas.

NCSL estimate for Texas (2012) - $1.8 billion
  ◦ http://www.ncsl.org/research/fiscal-policy/collecting-ecommerce-taxes-an-interactive-map.aspx

Marketplace Fairness Act estimated to bring in $1 billion in state and local sale tax for Texas.
  ◦ https://www.dallasnews.com/business/retail/2017/05/24/getting-e-commerce-sites-collect-sales-taxes-still-issue-congress-courts-resolve

Watch for U.S. Supreme Court decision in *South Dakota v. Wayfair, Inc*. re-examining the physical presence nexus standard for sales/use tax from the 1992 *Quill* decision. Oral argument is April 17, 2018.

Actions of USSC and Congress can reduce the use tax gap, but won't completely eliminate it due to likely de minimis rule, purchases from outside of the U.S., and non-compliance.

Accountability to Taxpayers

Accessibility and visibility of information on tax laws and their development, modification and purpose, are necessary for taxpayers.

Public awareness and basic understanding of current system and changes.

Access to information that is complete, clear and timely.

Examples:

  ◦ Explain rationale and operation of proposed tax changes.

  ◦ Information is complete, readily available and explained (see next slide for a good example).

  ◦ Knowing true tax rate when vendor or hotel gets discount for timely compliance.

Transparency

Texas state government is an enormously complex undertaking, including everything from road construction to professional licensing, from prisons to university research. It's a more than $110 billion-a-year enterprise that relies on funding from a variety of sources, including about $50 billion annually that the Texas Comptroller's office collects from more than 60 separate taxes, fees and assessments.

Where the Money Goes
Tools to search the state check register, track state spending and see your tax dollars at work.

https://comptroller.texas.gov/transparency/

Appropriate Government Revenues

Tax systems should have appropriate levels of predictability, stability and reliability to enable the government to determine the timing and amount of tax collections.

Need to have some level of predictability, stability, sufficiency and reliability to enable governments to know how much will be collected and when.

Periodic review helps to measure tax system against trends, state goals, what other states do.

Earmarking generally to be avoided.

◦ Different from *benefits principle* based tax such as gas tax.

Generally, government realizes better stability with a mix of taxes.

Considers relationship with local and federal tax rules, finances and goals.

Example: To help meet, regularly review tax rules and trends (see next slides).

Texas revenue sources for public education

PUBLIC EDUCATION FUNDS (2018-19)

State taxes	37%
Local taxes	52%
Federal	9%
Other	2%

Stable?

Reliable?

https://tea.texas.gov/WorkArea/DownloadAsset.aspx?id=51539620147; slide 7.

Sales tax – What is taxed versus what is not taxed?

Sales tax collection for 2017　　　　　　**$28,900 million**

Value of tax expenditures for sales tax*　　**$41,993 million****

Note: Several of the untaxed items are subject to excise tax, or represent business purchases.

*Items removed from the tax base by law (exemptions, exclusions, discounts).

** Includes:

Auto repair	$ 385.5
Barber/beauty	$ 99.4
Car washes	$ 41.0
Clothing/backpack holiday	$ 67.3
Other sales tax holidays	$ 9.3
Food for home	$2,972.8
Newspapers	$ 44.8
Over counter drugs	$ 257.3
Sales to nonprofits	$ 37.3
Utilities, residential	$ 836.9
Veterinary services	$ 101.8
Water	$ 383.3
Timely filer & prepayment discounts	$ 264.0

Trend concern: What's not taxed is expected to grow faster than what's taxed.

Projected change in sales tax collections (biennial):
2016-17 $56,832
2018-19 $57,262 **(0.8% increase)**
https://comptroller.texas.gov/transparency/reports/biennial-revenue-estimate/2018-19/docs/96-402.pdf (p 12)

Projected growth of tax expenditures for sales tax:
2017 to 2018 = **6.2% increase**
2018 to 2019 = **5.3% increase**
https://comptroller.texas.gov/transparency/reports/tax-exemptions-and-incidence/2017/96-463.pdf   (p 3)

Table 1
Value of Sales Tax Exemptions, Exclusions and Discounts
Fiscal 2017 to 2022 (in millions of dollars)

Item	2017	2018	2019	2020	2021	2022
Exemptions	$34,590.0	$36,791.7	$38,753.5	$40,840.9	$42,715.1	$44,884.0
Exclusions	7,139.5	7,512.8	7,890.8	8,290.7	8,705.7	9,143.8
Discounts	264.0	278.5	291.5	304.6	318.3	332.6
Total	$41,993.4	$44,583.0	$46,935.8	$49,436.3	$51,739.1	$54,360.4

Note: Totals may not sum due to rounding.

Tax expectation changes

Changes in technology, ways of living and
doing business can affect tax bases.

Tax	Change/concern
Sales tax on tangible personal property	Digitization – iTunes, e-books, streaming movies, software downloads. **Seems to be addressed already.** Increasing consumption of personal services and untaxed items (see prior slide).
Sales tax collected by vendor only if has physical presence in the state	E-commerce – easy to have sales to Texans without having a physical presence in Texas; increased reliance on Texans self-assessing and paying use tax.
Gas tax based on cents per gallon	More fuel efficient cars including those that don't use gasoline.
Age exemptions (such as for school property tax)	Not all seniors need an age-based tax break today.
Cigarette taxes	Emergence and growth of vapor / e-cigarette products.

Tax Policy Challenges

Desire to use the tax law for more than raising revenue.

Not considering all aspects of the system together
- All types of taxes used
- What is exempt from tax (tax expenditures)
  - Consider effect on different income levels of taxpayers.
- Direct and indirect tax effects (tax incidence)
  - Example, who really pays the margin tax and the sales tax on business purchases?

Public's understanding of taxes and the effects to them and others, tends to be low.

Not all 12 principles can be achieved to same degree for all proposed changes - need to strike a balance though.

Resources / References

AICPA - Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals (2001, 2017)
- https://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/tax-policy-concept-statement-no-1-global.pdf
- May 2017 article
  - http://www.journalofaccountancy.com/issues/2017/may/tax-principles-for-digital-age.html

Other presentation forms of principles of good tax policy including the National Conference of State Legislatures (NCSL)
- http://www.sjsu.edu/people/annette.nellen/website/PolicyApproachAnalyzingTaxSystems.pdf

Tax Foundation – lots of data and policy analysis
- https://taxfoundation.org/center/state-tax-policy/

Federation of Tax Administrators – state tax rate comparisons and more
- https://www.taxadmin.org/

Hegar, *Tax Exemptions & Tax Incidence*, Feb 2017 – pages 43-46 and others (tax incidence, ability to pay, benefits principle, and more)
- https://comptroller.texas.gov/transparency/reports/tax-exemptions-and-incidence/2017/96-463.pdf