State and Local Tax Principles and Vocabulary

I. Purpose of state and local taxation

The fundamental purpose of any tax system is to raise revenue adequately to meet public demand for services and for the operation of state and local government.

The principles of good taxation were formulated many years ago. In *The Wealth of Nations* (1776), Adam Smith argued that taxation should follow the four principles of

- fairness,
- certainty,
- convenience and
- efficiency.

Fairness, in that taxation, should be compatible with taxpayers' conditions, including their ability to pay in line with personal and family needs.

Certainty should mean that taxpayers are clearly informed about why and how taxes are levied.

Convenience relates to ease of compliance and efficiency relates to administration of tax collection.

Efficiency relates to the collection of taxes. Collection should not negatively affect the allocation and use of resources in the economy and should not cost more than the taxes themselves.

II. Basic types of taxation

- Individual income taxes
- State & Local sales & use taxes
- Local property taxes
- Corporate income & franchise taxes

Other government income may come from user fees or charges.

Each type of tax has advantages and disadvantages. The advantages and disadvantages can be adjusted by the setting of tax rates and administrative characteristics and by balancing the advantages and disadvantages.

 Produced by the LWVNC Tax Policy Review Committee, January 2024

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III. Criteria for a fair and equitable tax system

Horizontal equity means that taxpayers who are similarly situated pay the same amount.

Vertical equity means that those who have more income (or property) pay more in taxes because they are better able to pay. (*Tax Division of the American Institute of Certified Public Accountants)*

Five criteria to evaluate tax systems are:

1. Equity
2. Adequacy
3. Collectability
4. Economic Effects
5. Transparency

Equity refers to the fairness of the tax system. Measurement is based on benefits received vs ability to pay.

Adequacy refers to the ability of taxes to raise enough revenue to fund public goods and services. Measurement is based on revenue stability vs Responsiveness.

Collectability refers to the ease of administering and enforcing the tax system. Measurement is based on administration costs vs compliance costs.

Economic Effects refers to the ability of taxes to raise revenue with minimal distortion to economic behavior. Measurement is based on distortions in economic activity.

Transparency refers to the openness and accessibility of tax information. Measurement is based on adoption, administration, compliance requirements and payment amount.

Gauging tax structure equity:

- Regressive
- Proportional
- Progressive

A regressive tax takes a larger percentage of income from low-income groups than from high-income groups.

A proportional tax takes the same percentage of income from all income groups.

A progressive tax takes a larger percentage of income from high-income groups than from low-income groups

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IV. Tax principles and considerations: advantages vs disadvantages

(as outlined by Ken Klase at 2023 LWVNC Convention)

Tax evaluation criteria applied: <u>Income Tax</u>

- <u>Equity</u> --High vertical equity if progressive rate structure used (+)
- <u>Adequacy</u> -- High on Responsiveness but low on Stability (+/-)
- <u>Collectability</u> -- Modest Admin Costs but substantial Compliance Costs (+/-)
- <u>Economic Effects</u>– Modest potential effects (+)
- <u>Transparency</u>– Complicated and unclear provisions (-)

Tax evaluation criteria applied: <u>Sales Tax</u>

- <u>Equity</u> –Regressive lacks vertical equity (-)
- <u>Adequacy</u> -- Moderate on Responsiveness and Stability (+/-)
- <u>Collectability</u> -- Low Admin Costs but Compliance Costs for retailers (+/-)
- <u>Economic Effects</u>– Modest potential effects (+/-)
- <u>Transparency</u>– Visible and transparent (+)

Tax evaluation criteria applied: <u>Property tax</u>

- <u>Equity</u> – Traditionally considered regressive (-)
- <u>Adequacy</u> -- Low Responsiveness but relatively Stable (-/+)
- <u>Collectability</u> -- High Admin Costs but low Compliance Costs (-/+)
- <u>Economic Effects</u>– Distorts economic decisions on location of home ownership and business investment (-)
- <u>Transparency</u>– Highly visible tax. Often target of taxpayer frustration (+/-)

Tax evaluation criteria applied: <u>User charges or fees</u>

- <u>Equity</u> –Benefits Received criteria could apply, but generally considered Regressive (+/-)
- <u>Adequacy</u> -- Relatively Stable but may be responsive to economic downturns (+/-)
- <u>Collectability</u> -- Moderate Admin Costs but low Compliance Costs (+/-)
- <u>Economic Effects</u>– Distorts economic decisions about utilization of public facilities and services (-)
- <u>Transparency</u>– Not always visible or transparent (-)