Principles of Sound Tax Policy For Hawaii

Preamble

- All previous TRC reports have included a list of principles of sound tax policy. This one is a little different.
- "For Hawaii" is added to the heading, because the goal is to maximize economic well-being of Hawaii residents. This meant adding some things not usually included in a list of principles for sound tax policy.
- Also, an attempt is made to tie some of the principles (simplicity, stability, neutrality) to the size of the distortions they address.

The Basics

- The two main principles for sound tax policy are that taxes should be fair and they should be efficient.
- These two principles manage, at the same time, to complement and to conflict with each other.
- The principles complement each other, because unfair taxes breed tax resistance, which makes tax compliance hard to get. (We will see later how they conflict with each other.)

Fairness: Horizontal Equity

- Two standards are commonly used to determine if taxes are fair: horizontal equity and vertical equity.
- Horizontal equity requires that taxpayers in the same situation face the same taxes.
- Special tax breaks for selected businesses or groups of individuals violate horizontal equity.
- A "tax cliff," such as the sudden loss in the deduction for state income taxes in Hawaii's individual income tax, violates horizontal equity, because a dollar more in income can lead to hundreds of dollars more in tax.

Fairness: Vertical Equity

- Vertical equity usually is taken to mean that people with higher income should pay tax at a higher rate, to make the pain of taxes the same for everyone.
- The efficiency cost of the income tax rises with the tax rate – a higher tax rate has a higher efficiency cost per dollar of revenue. This causes the goal of vertical equity to conflict with the goal of efficient taxes.
- Vertical equity is hard to get with a sales or excise tax, but each individual tax doesn't have to meet the goal by itself – people just have to believe that overall the tax system is fair. The GET is regressive, but the individual income tax is progressive and has tax credits for lower-income taxpayers to help vertical equity.

Fairness: The Benefits Principle

- The benefits principle says those who get the benefits of a government service should pay for it.
- Most government services are in the public sector, instead of the private sector, either because you can't make all those who benefit pay (e.g., national defense), or because the beneficiaries can't afford them (e.g., public welfare). You can't apply the benefits principle in these cases.
- The benefits principle is useful for determining what public goods or services should be paid for with fees on users, instead of with taxes on everyone. This causes the users to take account of the cost of the services and discourages wasteful overuse. In other words, the benefits principle may be as much about tax efficiency (what should be included as a tax) as tax fairness.

Is Our Current Tax System Fair?

- No one can say with authority whether the current tax system is fair, but it is a product of our democratic system of government.
- The Legislature regularly tinkers with the individual income tax. This year it added the earned income tax credit and replaced the top tax brackets for high-income individuals. So it is hard to argue on *a priori* grounds that the system needs to be adjusted to make it more or less progressive.

Efficiency

- Tax efficiency usually means minimizing three costs of taxes:
  - A) The cost of administering and collecting taxes
  - B) The cost to taxpayers of complying with taxes
  - C) The cost of economic distortions imposed by taxes
- Costs of administering and collecting taxes usually are small. For example, the Tax Department administers and collects about 95% of the state's taxes at a cost of about one third of one percent of collections.
- Costs of tax compliance are much bigger than costs of administration. For example, for the federal individual income tax, compliance costs have been estimated to be about 6% of collections.
- Costs of economic distortions caused by taxes typically are much bigger than compliance costs. For example, costs of the disincentives to work and to save caused by the federal individual income tax have been estimated to be between 11% and 15% of collections.

Efficiency: Minimizing Costs of Tax Administration and Compliance

- Simplicity makes taxes easier to administer and easier to comply with. It also helps make them more transparent, which discourages mischief, such as tax breaks for special interests.
- Stability of the tax code makes business planning easier and also reduces costs of tax administration and compliance.
- Stability of collections is less clearly desirable, as it implies less stability in private budgets (As Mark Twain quipped – "When everybody has money they cut taxes, when they're broke they raise 'em. That's statesmanship of the highest order.") But the tax system should avoid relying too heavily on taxes with volatile collections.

Efficiency – Minimizing the Economic Distortions Caused by Taxes

- Tax neutrality is the most important principle for making taxes efficient. Tax neutrality is achieved by applying the tax uniformly to its base.
- Keeping the base broad helps keep the tax rate low. This is important, because a higher tax rate means a higher efficiency cost per dollar of revenue.
- Exempting part of the tax base and making up the revenue by imposing a higher rate on the remainder damages efficiency in two ways: it distorts choices between the taxed and untaxed parts of the base and it raises the efficiency cost per dollar of revenue.

Two Additional Things to Consider in Designing an Efficient Tax System

- Sometimes, part of the burden of a tax is exported. Tax exporting can be an important way to reduce the burden of taxes for residents.
- For example, recent estimates for the amount of "supernormal" profits in the corporate income tax base imply that the bulk of Hawaii's corporate income tax is exported to nonresidents. This would make income tax credits for corporations a particularly costly way to provide economic incentives.

Some Taxes Impose a Negative Excess Burden

- Instead of imposing an efficiency cost, some taxes provide an extra benefit by helping discourage negative externalities – adverse side effects of consumption or production that are not accounted for in the private market price, such as pollution and traffic congestion.
- For example, a carbon tax would discourage pollution.
- Such taxes are often called "Pigou" taxes after the British economist A.C. Pigou.

Other Principles of Sound Tax Policy

- Tax adequacy is a constraint that must be met by the tax system – taxes should be as fair and efficient as possible, subject to the constraint that they provide enough money to pay for needed government services. This limits choices, since the tax base has to be big enough to supply enough revenue. (Almost all states tax income, consumption or both.)
- Competitiveness is often listed as a goal of tax policy. Economists generally agree the best way to achieve this goal is by making taxes as efficient as possible, but the term is often used to support tax breaks for selected businesses.