Guiding Principles of Good Tax Policy:
A Framework for Evaluating Tax Proposals
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**Purpose**

Every year, as part of the state budget process, many discussions focus on making changes to Pennsylvania’s tax systems. Any suggestion for modifying tax rules – whether major or minor – raises the question of how to best analyze and compare proposals.

The Pennsylvania Institute of Certified Public Accountants (PICPA) recommends 10 principles that can be used to analyze tax change proposals. Note that the 10 guiding principles of good tax policy are equal in importance; the numbered order of the principles in this document is for reference only and should not be taken as an indication of order of importance.

The principles herein were developed by the American Institute of Certified Public Accountants’ Fundamental Tax Reform Task Force, with input from its Tax Policy and Simplification Committee and Tax Legislation and Policy Committee.

This framework helps answer the question: How should proposals to change existing tax rules be analyzed? This question is answered by the following principles, which are commonly cited and used as indicators of good tax policy.

PICPA represents more than 22,000 CPAs in business and industry, public accounting, government, and education. Our members provide auditing and accounting services to individuals, not-for-profit organizations, and employers of all sizes; advise clients on state, federal, and international tax matters; and prepare income and other tax returns for an extensive number of state taxpayers.
10 Guiding Principles of Good Tax Policy

1 Equity and Fairness

Similarly situated taxpayers should be taxed similarly.

The principle of taxing similar taxpayers similarly is typically described in terms of equity. The concept of horizontal equity provides that two taxpayers with equal abilities to pay should pay the same amount of tax. If a taxpayer has a greater ability to pay than another taxpayer, the concept of vertical equity comes into play, which means that the person with the greater ability to pay should pay more tax. Of course, how much more tax should be paid has been a topic of debate under our current income tax system and, over the decades, has resulted in a variety of ranges of graduated tax rates and exemption amounts leading to varying levels of progressivity of the system.

The principle of equity is often viewed as a fairness principle. That is, many people view a tax as fair if taxpayers with the greatest ability to pay have the highest tax burdens. Nevertheless, the term fair tends to have different meanings to different people. For example, with respect to an income tax, an income tax system might be considered fair if—

1. All taxpayers are taxed at the same tax rate (a flat tax) because those with higher incomes will pay more than taxpayers with lower incomes.

2. Taxpayers with higher incomes pay tax at higher rates than lower income taxpayers (a progressive tax).

3. Many different types of income are taxed the same (meaning, for instance, that few or no types of income are excluded from taxation).

4. It combines the elements of items 1 and 3 above.

5. It combines the elements of items 2 and 3 above.

Therefore, use of the word fair in describing a tax might be better used in the context of whether a tax system is perceived as fair. This approach acknowledges some of the subjectiveness of the term fair.

Generally, in evaluating the principle of equity, consideration should be given to the entire range of taxes a taxpayer is subject to, rather than to just one type of tax.
Certainty

The tax rules should specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.

A person’s tax liability should be certain rather than ambiguous. The tax rules should specify when the tax is to be paid, how it is to be paid, and the amount to be paid. A tax system’s rules must enable taxpayers to determine what is subject to tax (the tax base) and at what tax rate(s). Taxpayers should be able to determine their tax liabilities with reasonable certainty based on the nature of their transactions. If the transactions subject to tax are easy to identify and value, the principle of certainty is more likely to be attained. On the other hand, if the tax base is dependent on subjective valuations or transactions that are difficult to categorize, the principle of certainty might not be attained. In addition, how the taxes are paid and when the taxes are due should be spelled out in the applicable laws, as well as in the tax forms and instructions.

Certainty is important to a tax system because it helps to improve compliance with the rules and to increase respect for the system. Certainty generally comes from clear statutes as well as timely and understandable administrative guidance that is readily available to taxpayers.

The principle of certainty is closely related to the principle of simplicity. The more complex the tax rules and system, the greater likelihood that the certainty principle will be compromised.
Convenience of Payment

A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.

A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer. A tax should be payable when it is most likely to be convenient for the taxpayer. For example, a tax upon the purchase of goods should be assessed at the time of purchase when the person still has the choice as to whether or not to buy the goods and pay the tax. Convenience of payment is important in helping to ensure compliance with the tax system. The more difficult a tax is to pay the more likely that it will not be paid. Typical payment mechanisms include withholding (such as the withholding of income taxes from employee paychecks) and periodic payments of estimated tax liability. The appropriate payment mechanism should depend on the amount of the liability and ease of collection.

Economy of Collection

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

The costs to collect a tax should be kept to a minimum. These costs include the administrative cost to the government that is influenced by the number of revenue officers necessary to administer the tax. There are also compliance costs incurred by taxpayers to consider. This principle is also closely related to the principle of simplicity. The more complex a tax, the greater the costs for the government to administer it and the greater the compliance costs for taxpayers to determine their tax liability and report it.
Simplicity

The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.

Simplicity in the tax system is important both to taxpayers and to those who administer the various taxes. Complex rules lead to errors and disrespect for the system that can reduce compliance. Simplicity is important both to improve the compliance process and to enable taxpayers to better understand the tax consequences of transactions in which they engage in or plan to engage.

Neutrality

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 should be kept to a minimum. The effect of the tax law on business and personal decisions should be kept to a minimum.

That is, taxpayers should not be unduly encouraged or discouraged from engaging in certain activities or taking certain courses of action primarily due to the effect of the tax law on the activity or action. The primary purpose of a tax is to raise revenue for governmental activities, rather than to influence business and personal decisions.
The tax system should not impede or reduce the productive capacity of the economy.

The tax system should neither discourage nor hinder national economic goals, such as economic growth, capital formation, and international competitiveness. The principle of economic growth and efficiency is achieved by a tax system that is aligned with the economic principles and goals of the jurisdiction imposing the tax. For example, U.S. tax rules should not pose competitive disadvantages for U.S. firms relative to foreign firms. Economic growth and efficiency is impeded by tax rules that favor a particular industry or investment thereby causing capital and labor to flow to such areas for reasons not supported by economic factors which can potentially harm other industries and investments, as well as the economy as a whole.

The principle of economic growth and efficiency is related to the principle of neutrality in that tax rules that distort taxpayer behavior may hinder economic efficiency.

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

Visibility enables individuals and businesses to know the true cost of transactions. It also enables them to see what their total tax liability is and to which level of government it is being paid. When a tax is not visible, it can be easily retained or raised with little, if any, awareness among taxpayers about how the tax affects them.
Minimum Tax Gap

A tax should be structured to minimize noncompliance.

The tax gap is the difference between taxes that are owed and taxes that are voluntarily paid. A tax gap exists with any tax for a variety of reasons, such as intentional errors (non-filing, underreporting of income, overstating of deductions, omission of transactions) and unintentional errors (math mistakes and lack of understanding of the rules). A number of tax provisions may encourage noncompliance because the provision is too complex to understand or to comply with. Procedural rules are generally required for all tax systems in order to encourage compliance. Rules to encourage compliance might include mandatory withholding of taxes at the source and penalties for noncompliance. Generally, compliance measures need to strike a balance between the desired level of compliance against the costs of enforcement and the level of intrusiveness of the tax system.

Appropriate Government Revenues

The tax system should enable the government to determine how much tax revenue will likely be collected and when.

Tax systems should have some level of predictability and reliability to enable the government to determine how much tax revenue is likely be collected and when. This is particularly important to state governments, most of which operate under a balanced budget requirement. Typically, a mix of taxes provides a more stable tax base because different types of taxes are affected differently by changes in the economy.

Governments need some assurance that tax revenues will be stable so that required spending can occur. For example, in an economic downturn causing unemployment, income tax revenues will decline. If the government is collecting other types of taxes that are less affected by decreased employment or the effect will not occur as quickly, government revenues in total will be less adversely affected than if the government relied solely on an income tax.
Challenges

Incorporating the 10 guiding principles of good tax policy into our state tax system can be difficult. A number of challenges stem from a desire to use the tax law for more than raising revenue – for instance, to implement social or economic policies (such as by limiting certain deductions and credits to individuals with income below specified amounts). In addition, frequent changes to the tax law challenge the principles of certainty and simplicity. The more changes that are made, the greater the difficulty taxpayers, tax practitioners, and government tax administrators have in understanding the tax consequences of transactions.

The reality is that not all of these principles can be achieved to the same degree for all proposed tax changes. For example, to exclude a particular type of economic benefit from taxation may satisfy the simplicity principle, but not the equity or neutrality principles. Thus, lawmakers must carefully balance the 10 principles to achieve an optimal law.

Conclusion

A framework of appropriate tax principles is needed to analyze proposals to change tax rules and tax systems and to best ensure an effective tax system based on good tax policy. The challenges that exist to incorporating the 10 guiding principles of good tax policy are not insurmountable, but it will take a concerted effort to consider these principles in any type of tax law change.

PICPA looks forward to working with the members of the Pennsylvania General Assembly and other interested stakeholders to improve our tax system to better incorporate the principles outlined in this tax policy concept statement, and we will continue to offer our assistance in this important endeavor.
Government Relations Office
500 N. 3rd Street, Ste. 600A
Harrisburg, PA 17101

(717) 232-1821
fax (717) 232-7708
governmentrelations@picpa.org

www.picpa.org/govt