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

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Challenges

Various challenges exist to incorporating all of the guiding principles of good tax policy into any tax system. A number of these challenges stem from the 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, practitioners, and government tax administrators have in understanding the tax consequences of transactions. Also, it becomes more difficult for tax agencies to issue guidance in a timely manner when there are hundreds of tax law changes every few years.

A key challenge is the reality that achievement of all of the principles is not possible 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 guiding principles to achieve an optimal law.

Purpose

The legislative process is unpredictable. Every year, as part of the budget process, our state lawmakers typically consider 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) can help. The PICPA recommends these 12 points – The Guiding Principles of Good Tax Policy – for analyzing tax change proposals. 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 demonstrates how proposals to change existing tax rules should be analyzed through the aid of the following principles, commonly cited and used as indicators of good tax policy. Note that the Guiding Principles of Good Tax Policy are equal in importance; the numbered order in this document is for reference only and should not be taken as an indication of order of importance.

The PICPA represents more than 20,000 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.
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 to pay is a common topic of debate 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 tax systems.

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, consideration of a fair income tax system might arise 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 is 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. Yet, as explained in the JCT and GAO reports, various measures exist to examine equity including distributional analyses of annual taxes, lifetime taxes, and more.

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

Certainty

The 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, of a person’s tax liability is vital. The tax rules should specify the amount of the payment, when the tax is due, and how payment is made. 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 have the ability 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 attained. On the other hand, if the tax base is dependent on subjective valuations or transactions that are difficult to categorize, attaining the principle of certainty might not happen. In addition, spelling out how the taxes are paid and when the taxes are due in the applicable laws, as well as in the tax forms and instructions, is essential.

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 is compromised.
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. For example, assessment of tax upon the purchase of goods should occur at the time of purchase when the person still has the choice as to whether 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 payment will not happen. 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 as well as the equity of collection from all taxpayers. Also, consideration of appropriate use of secure technology is important.

Effective Tax Administration
Costs to collect a tax should be kept to a minimum for both the government and taxpayers. Minimizing administrative and compliance costs is critical. These costs include the administrative cost to the government that is influenced by the number of revenue officers necessary to administer the tax. Consideration of taxpayer compliance costs is also a must. This principle is closely related to the principle of simplicity. The more complex a tax, the greater the costs of government administration and the greater the compliance costs for taxpayers to determine and report their tax liability. Consideration of appropriate use of secure technology is also necessary. The benefits of any reform should outweigh the costs of adoption, including transitional and implementation costs.

Information Security
Tax administration must protect taxpayer information from all forms of unintended and improper disclosure. This includes, but is not limited to, adequate “firewalls” for security of the tax agency’s internal system, safeguards necessary to prevent degradation of the system via fraudulent claims resulting from identity theft, as well as sufficient controls to ensure that taxpayer information is only disclosed to the appropriate parties as permitted by law. A tax administration’s responsibility for information security should extend to its employees, representatives, agents, and any contracted or affiliated party. This protection must extend throughout the period the information is held, and must accommodate changes in technology and threats against the information. Failure to provide adequate security ultimately results in erosion of the principles of equity and fairness, effective tax administration, and appropriate government revenues.

Simplicity
Simple tax laws are necessary 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 tax administrators. 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
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. Minimizing the effect of the tax law on business and personal decisions is appropriate. The primary purpose of a tax is to raise revenue for governmental activities, rather than to influence business and personal decisions.
Economic Growth and Efficiency

The tax system should not unduly impede or reduce the productive capacity of the economy. All taxes reduce economic efficiency and create distortions, but good tax policy minimizes these effects. The tax system should not hinder a jurisdiction’s economic goals, such as economic growth, capital formation, and international competitiveness. The principle of economic growth and efficiency is maximized by a tax system that is aligned with the economic principles and goals of the jurisdiction imposing the tax. For example, a jurisdiction’s tax rules should not pose competitive disadvantages for firms resident in that jurisdiction relative to non-resident 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. Such action 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. Evaluating a potential tax structure with respect to neutrality between different forms of business activities to ensure that the enactment would not result in discrimination in favor or against particular ways of doing business is vital.

Minimum Tax Gap

Structuring tax laws to minimize noncompliance is essential. 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, and omission of transactions) and unintentional errors (math mistakes and lack of understanding of the rules). Complex tax provisions can lead to noncompliance due to errors caused by confusion and uncertainty. Procedural rules are generally required for all tax systems 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.5

Appropriate enforcement efforts are necessary to prevent non-compliance by both filers and nonfilers. Insufficient efforts to keep the tax gap to a minimum result in inequities and inefficiencies due to the need to offset the revenue loss with other sources.


Transparency and Visibility

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 is easily retained or raised with little, if any, awareness among taxpayers about how the tax affects them.

Accountability to Taxpayers

Accessibility and visibility of information on tax laws and their development, modification and purpose are necessary for taxpayers. Public awareness of tax reform activities, as well as an understanding of proposed changes, enables broader and more well-informed debate. Taxpayers should readily have access to information for understanding sources and uses of tax revenues. Transparency in the lawmaking and guidance process helps promote an improved understanding and respect for the system. Evaluating multiple alternatives before deciding on any particular change is necessary. Taxpayers should have opportunities through government reports and hearings to gain an understanding of the jurisdiction’s tax and budget situation.
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. A dynamic and flexible tax system is necessary in order to adapt to changing needs and technological and commercial developments. It is important that a tax system is flexible to meet the current revenue needs of the government while adapting to changing needs on an ongoing basis. Thus, it is necessary to review tax systems regularly to ensure they are supportive of the jurisdiction’s goals (or not hindering their attainment), appropriate for new business models, and capable of generating appropriate revenues.

Further, the complementary nature of a tax system among relevant jurisdictions is important. That is, giving consideration to how tax bases are determined within the national or global economy and the effect that changes in a tax system have on other tax systems is important. Consideration of fairness among jurisdictions is important, including revenue generation for the appropriate government for activities that involve multiple jurisdictions.

In order for required spending to occur, governments need assurance that tax revenues are available and stable. Tax revenues need to support general government spending needs, thus for example, earmarking tax revenues for a specific purpose warrants express justification. Regarding stable revenues, typically, a mix of taxes provides a more stable and flexible tax base because different types of taxes are affected differently by changes in the economy. 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 if the effect will not occur as quickly, government revenues in total are less adversely affected than if the government relied solely on an income tax.

Conclusion

A framework of appropriate tax principles is needed to analyze proposals to change tax rules and tax systems in order to best ensure an effective tax system based on good tax policy. The challenges that exist to incorporating the guiding principles of good tax policy are not insurmountable. It takes a concerted effort to consider these principles in any type of tax law change – both major and minor.

The 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.

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- Educating lawmakers and public officials about issues concerning the CPA profession
- Monitoring state legislation and regulatory actions to determine their effect on the CPA profession
- Communicating regulatory and legislative updates to members
- Advocating on behalf of PICPA

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