Ideas in Action

Florida TaxWatch Inc.

1114 Thomasville Rd. ■ P.O. Box 10209 ■ Tallahassee, FL 32302 ■ Phone: (904) 222-5052 ■ FAX (904) 222-7476
Dominic M. Calabro, President and Chief Executive Officer

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TAX REFORM AND TAX FAIRNESS

By: Dr. Craig E. Reese, Professor of Taxation, University of South Florida

The traditional principles of good tax policy should be considered in any discussion of new taxes, tax increases and/or revenue-neutral tax reform. Four of these principles are over two centuries old, while the other four have evolved during the 20th century as federal, state, and local government expenditures grew to a level greater than one-third of the gross notional product.

In his treatise on political economy entitled *Wealth of Nations,* originally published in 1776, Adam Smith delineated four characteristics of a good tax: equity, convenience, certainty and economy. In addition four other characteristics of a good tax--productivity, neutrality, socioeconomic effects and political feasibility, apply today. For the body politic, the concept of equity is arguably the most important characteristic of a good tax because political debate over taxes generally focuses on the issue of fairness or equity.

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Adam Smith's notion of equity was limited to the equal treatment of taxpayers where such taxpayers are "similarly situated." Thus, if two individuals (taxpayers) each spend the same amount of money on goods during a year, each should incur the same general transaction (sales) tax on such goods. However, allowing various exemptions from the sales tax means that it is unlikely that any two similarly-situated taxpayers would pay the same sales tax on the money they spend on goods in one year.

Today, the concept of tax equity has been expanded to encompass progressivity in taxation. Adam Smith's tax equity may be referred to as "horizontal" equity, whereas the popular notion of equity, which is synonymous with progressive taxation, may be referred to as "vertical" equity. As applied to sales taxation, vertical equity exists where an individual (taxpayer) spending more on goods would pay *relatively* more annual sales tax than another individual (taxpayer) who spends less on goods. For this to occur, the sales tax rate would have to be higher for the former (higher-income) individual. Alternatively, exempting necessities (food and medicine) from sales taxation could result in a higher effective sales tax rate for the higher-income individual because a lower percentage of his/her spending would be on necessities exempted from sales taxation.

When vertical equity is considered in analyzing the political economy of financing government, one would compare the annual amount of any tax paid by each individual to each individual's (taxpayer's) personal income (ability-to-pay for government). The results of such a sales tax analysis would show it to be a vertically inequitable tax. Why? Because higher-income individuals pay a lower percentage of their annual personal income in sales tax than do those with a lower income. This occurs because higher-income individuals can afford to save more of their personal income and spend more of their income for services which are not subject to the sales tax.

Thus, it is said that the sales tax is regressive because as a person's annual personal income rises, the percentage paid in sales tax declines. That is, the *effective* rate of sales taxation declines as one's annual personal income increases. Therefore, a *technically* proportional (flat) rate of sales taxation translates to an *effective* rate of sales taxation which is regressive, even when life's necessities are exempted from sales taxation.

Insofar as the state relies heavily on the sales tax, Florida is said to have a regressive state tax system. Therefore, the tax system is inequitable because lower-income individuals pay relatively more (a higher percentage) of their income in sales tax than higher-income individuals do, notwithstanding the sales tax paid by tourists and part-time Florida residents. Assuming one ignores the other seven characteristics of a good tax (and thus, of a good tax system), what recommendations should the Taxation and Budget Reform Commission make to mitigate the inequity of sales taxation?

The choices are: fix the sales tax, substitute a more equitable tax for a portion of the sales tax, or to do both. These alternatives are independent of the decision to increase taxes to maintain or to increase state government expenditures. The major options apparently available to state are: expanding the scope of the sales tax to most exempt items and to encompass most services while lowering the sales tax rate; impose a personal income tax while lowering the sales tax rate; or taxing most exempt items and services, lowering the sales tax rate and imposing an income tax. It should be noted that restructuring the state tax system could be revenue-neutral if the lowered sales tax rate reduces revenue in an amount equal to the revenue increase incident to imposing a services tax, income tax or both.

Notwithstanding the conventional wisdom that a progressive income tax is the most equitable tax base, evidence indicates that the body politic does not understand progressive taxation. For example, the results of an early 1950s study entitled, *The Uneasy Case for Progressive Taxation*, by University of Chicago professors Blum and Kalven indicate that the average person has difficulty distinguishing progressive income tax rates from proportional income tax rates insofar as higher-income individuals pay more taxes than lower-income individuals under both regimes. Three decades later (1982) Blum revisited the case for progressive taxation in an article published in the periodical *Taxes* and concluded that the case for such taxation was no more supportable by the public 30 years later.

The 1986 Tax Reform Act lowered the highest marginal income tax rate on personal employment and business income from 50 percent to 28 percent, although the highest rate was raised to 31 percent by 1991. Finally, respondents to the Advisory Council on Intergovernmental Relations' (ACIR's) annual survey of the public's attitudes toward taxes and government services, which has been published since the mid-1970s, indicate each year that the federal income tax is the least fair tax followed by the local property tax, state sales tax and the state income tax. Therefore, the ACIR poll rates the state income tax "least" of the worst and the federal income tax the absolute "worst." This apparent paradox is not easily explained without considering the other seven characteristics of a good tax.

The federal income tax (FIT) does not fare well when one considers all the characteristics of a good tax. Although the FIT is very productive, i.e., it raises hundreds of billions in revenue, it is not: ▪ Certain, because the law is complicated to apply, although the tax is visible either as an amount withheld or payable at the time of filing a tax return; economical, insofar as the government's administration cost and the taxpayers cost of compliance amounts to tens of billions; ▪ Neutral, for it affects the structure of many business and investment transactions; and ▪ Politically feasible, inasmuch as its complexity precludes any rate increases without simplification of the law.

After the tax reforms of 1981 and 1986, the FIT is more horizontally equitable but perhaps less vertically equitable. Inasmuch as most taxpayers are employees, the FIT is relatively convenient because the employer withholds and pays it. The FIT's socioeconomic effects, i.e., the use of the FIT law to complement federal public policy, are fewer and less distorting than before the dramatic base-broadening provisions were enacted in the 1986 Tax Reform Act, which also lowered progressive income tax rates.

If the FIT is the most unpopular tax, why is the state income tax (SIT) the least unpopular tax? Before analyzing this paradox, one must understand the various SIT systems. Most of the state personal income tax systems rely on the federal taxable income amount which usually is adjusted per SIT law, including an exemption and sometimes a deduction for FIT liability. Either a proportional rate or a mildly progressive rate structure is applied to the SIT base to determine the SIT liability. The other common SIT system is one wherein a proportional rate is applied to the FIT liability to determine the SIT liability.

Whether the SIT is a proportional or progressive tax is of little importance to those individuals (taxpayers) who itemize deductions for FIT purposes because state income taxes are deductible in determining federal taxable income. Therefore, the SIT could be considered a regressive tax for higher-income individuals who are able to reduce the cost of the SIT insofar as most of them itemize deductions in determining federal taxable income; lower-income individuals (few of whom itemize) are not able to offset part of their SIT with a lower FIT. Thus, the SIT imposed at a proportional or mildly progressive rate is not vertically equitable and consequently its "popularity" must be explained on other grounds.

The SIT generally fares better than the FIT when evaluated on the basis of the other seven characteristics of a good tax. The SIT is productive, certain, and economical insofar as it would be "piggybacked" on the FIT. It would be convenient if employers were required to withhold and pay the tax on behalf of employees. Assuming the state would not enact additional adjustments to the federal taxable income in determining state taxable income, the SIT would be neutral although the FIT is non-neutral in its impact on business and investment decisions.

If an adequate exemption amount or credit for lower-income individuals and families (dependents) were enacted as part of the SIT, the tax would complement the state public policy objective of limiting the general tax burden, and cost of government for lower-income individuals and families, thereby mitigating a major socioeconomic effect without affecting the SIT's neutrality. Such an exemption would also improve the SIT's equity. Although a constitutional prohibition renders political feasibility problematic in Florida--as it was in Connecticut, this characteristic is not at issue in the 41 states with an SIT, where political controversy would be limited primarily to proposals to raise the income tax rate or to enact progressive rates where the rate has been proportional.

In conclusion, restructuring the tax system would not insulate the state from revenue declines during economic recessions, although it could mitigate the volatility of state tax receipts. A mandated "rainy day" fund with specific, non-discretionary criteria for its accumulation and expenditure could, along with restructuring, effectively insulate the state from much of the revenue variation incident to the business cycle.

Please Note: The information contained in this article represents the opinion of the author, but does not necessarily express the views of Florida TaxWatch.

HOW CORRECT IS POLITICALLY CORRECT?

By: Dr. Neil S. Crispo, Director of Research, Florida TaxWatch

Citizen confidence in government is encouraged by the delivery of services in an effective and efficient manner. Other encouraging factors are the existence or appearance of fairness and justice in government's actions. Americans can even tolerate dissidence between two commonly accepted values when they are in conflict, such as the disputes beteen property rights and the rights of individuals. But when government condones, encourages or fails to censure behavior that is contrary to the basic value system of fairness, even if the behavior in question is occuring in order to enhance the ultimate good or to redress a wrong, antagonism, distrust and rejection ensue. The pursuit of political correctness in higher education may well foster such distrust if it is induldged in by state universities supported by taxpayers' dollars. Those charged with the responsibility of directing our state university system should be mindful of this.

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The term "politically correct" has received considerable press attention lately, much of it appropriately negative. It refers to a movement on many of the nation's university campuses to dictate the kinds of reading, course work or even thoughts that are deemed acceptable. Too often, the trend has been introduced as a way of exposing students to other cultures and points of view at the expense of Western civilization. Proponents insist that as America becomes increasingly multi-cultural students will be more comfortable, competitive and adaptable in the world business arena if they are given some insight on how the other race or gender lives. But some critics of this movement fear that its motivating premise is far

more insidious than mere cross culturization. Its immediate goal, they charge, is to vilify Western culture--a culture they find to be largely racist, sexist and oppressive. Its ultimate objective then is to sufficiently exacerbate old social grievances to promote compensatory entitlements.

On the campuses where this trend is becoming prevalent, mostly the traditionally liberal Ivy League schools, the movement is beginning to transform what used to be stimulating and enlightening education into a vicious political struggle to defeat any idea that is thought to be oppressive. Critics charge that although radical politics may have perished after the sixties, they are very much alive on many college campuses. They view this trend as an attempt by the more radical enclaves of the faculty to use their instructive role as an extension of political activism.

The result can be an increase in demands for intellectual conformity that is eerily reminiscent of the disgraceful McCarthy "witch hunts" of the 1950s or the pre-perestroika Soviet Union. Many campuses report unmistakable pressure tactics aimed at forcing students and even faculty to "watch what they say." Some students have reportedly been punished for deviating from the politically correct point of view.

According to a recent issue of *New York* magazine, campuses where this movement has taken hold treat previously instructive courses as philosophy as metaphors for everything patriarchal and elitist. *Newsweek* reported that in some circles Shakespeare's "Tempest" is said to reflect the "imperialist rape of the Third World." Emily Dickinson's poetic references to flowers are "encoded messages of feminist rage . . . to protest the prison of patriarchal sex roles."

Will the liberal arts education of the future consist solely of anti-Western, anticapitalist viewpoints? Are we seeing an American acceptance of the Marxist belief that education is a vehicle of indoctrination and not of enlightenment? By allowing the encroachment, however slight, of things ethnically acceptable, are we opening the door to the extremism being experienced elsewhere? Post secondary educators, like it or not, can and do influence the opinions and thought processes of the students they instruct and counsel. By imprinting their beliefs on students, who are tomorrow's business and civic leaders, universities can in effect shape the governance of the future.

Currently, the politically correct movement does not seem to represent a prevailing trend on Florida's campuses. But often ideological and philosophical inclinations, which ultimately can become the universal norm, are first experienced among a handful of influential American colleges. Truth and intellectual honesty are supposed to be the foundation of a university education. Political correctness, when taken to an extreme, tolerates neither truth nor empirical evidence and tends to ignore historically established facts. Taxpayers should be aware of these kinds of curriculum changes and monitor them carefully. This kind of vigilance can prevent today's seemingly beneficial course requirement, ostensibly meant to broaden and enhance students' acceptance of other cultures, from becoming a means of demanding conformity of thought.

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