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Principles of Taxation

PAD 642

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Principles of Taxation

- Tax base & tax rate: What is taxed, and at what rate?
  - Tax revenue = tax rate × tax base

- Adequacy of revenue source: Generates sufficient and stable revenue to fund services.
- Equity consideration: Distributes tax burdens fairly.
- Economic efficiency: Minimizes distortions to work, saving, spending, and investment.
- Cost of Administration: Simple to collect and comply with at low cost.

Principle 1: Adequacy of revenue source

- Will that tax generate adequate revenue to fund the services provided by the government?
- The ability to grow with income and wealth
  - (Roughly) Individual income tax > corporate income tax > property tax > sales tax > motor-fuels tax > tobacco tax
- Stability to economic fluctuation
  - (Roughly) Corporate income tax < sales tax < individual income tax < property tax

Principle 2: Equity consideration

- Who should pay the tax and at what level in a fairly way?
- Equity 1: The ability to pay
  - Taxpayers with greater ability to pay should contribute more.
  - Horizontal equity: People with similar ability to pay should pay similar taxes.
  - Vertical equity: People with greater ability to pay should pay more than those with less.

- Example of tax revenues that follow this equity principle?

Effective tax rate

- Effective tax rate = tax paid / personal income

- Progressive: effective tax rates are higher for higher income taxpayers;
- Proportional (flat rates): effective tax rates are the same across income categories;
- Regressive: effective tax rates are higher for lower income taxpayers.

Effective tax rate examples

Progressive tax system

Taxpayer income	Tax paid	Effective tax rate
20,000	1,200	1,200/20,000 = 6%
80,000	8,800	8,800/80,000 = 11%

Proportional tax system

Taxpayer income	Tax paid	Effective tax rate
20,000	2,000	2,000/20,000 = 10%
80,000	8,000	8,000/80,000 = 10%

Regressive tax system

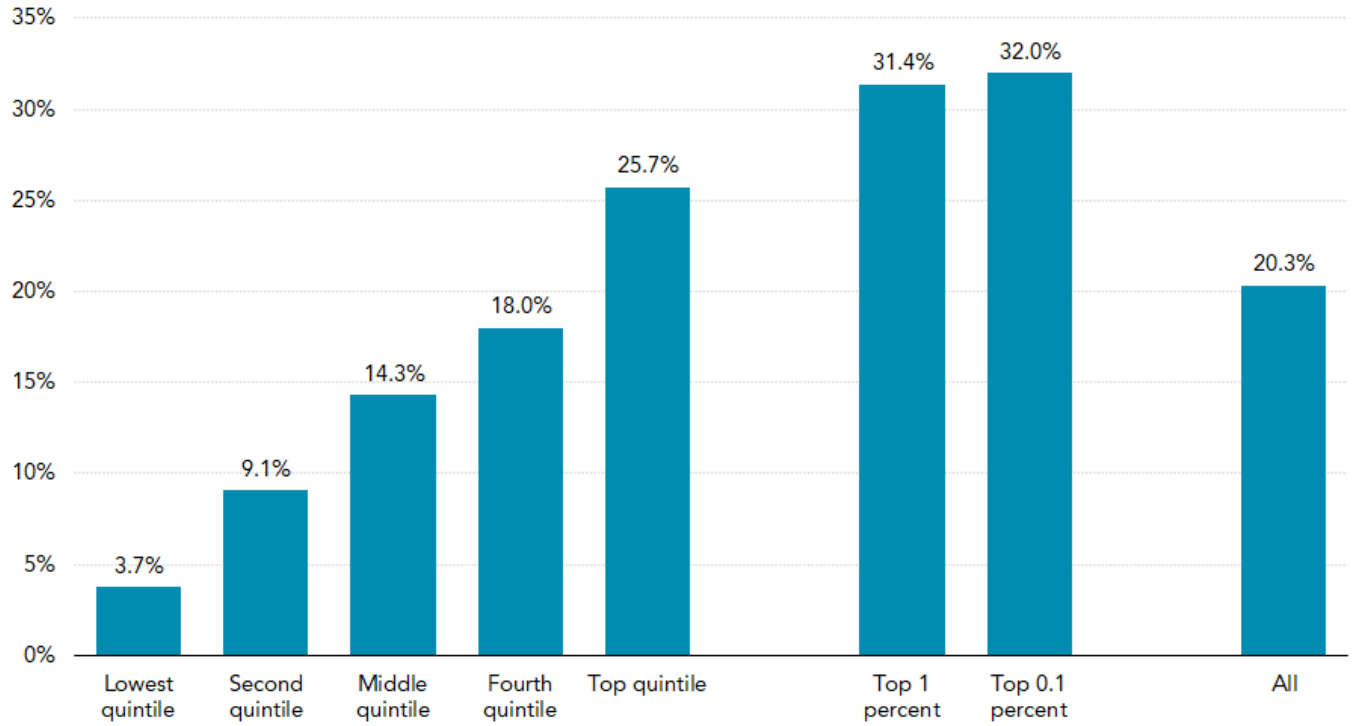
Taxpayer income	Tax paid	Effective tax rate
20,000	3,000	3,000/20,000 = 15%
80,000	7,000	7,000/80,000 = 8.75%

American tax system

FIGURE 1

Average Effective Federal Tax Rates by Income Percentile

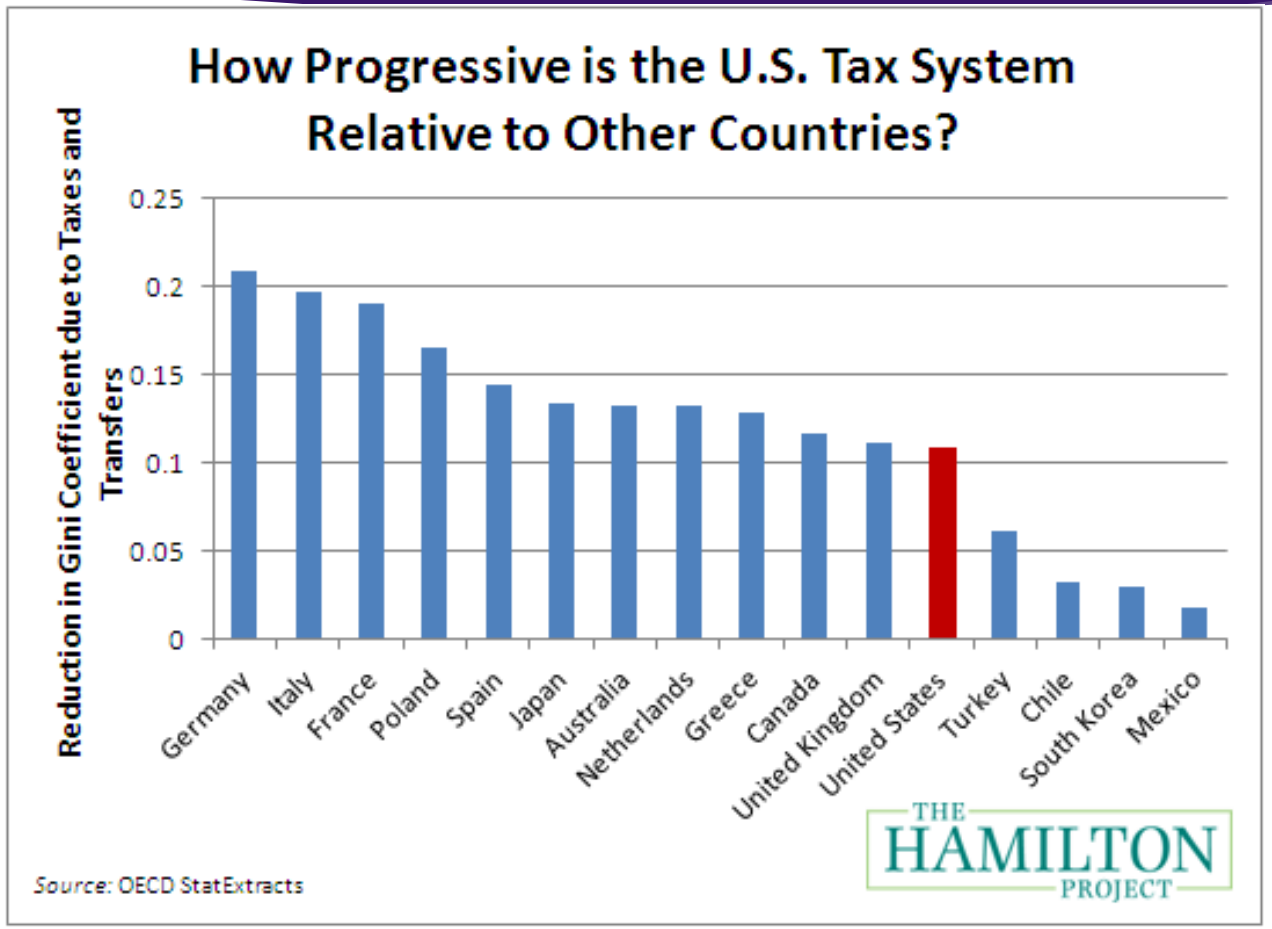
All federal taxes, 2023[a]



Source: Urban-Brookings Tax Policy Center. T22-0076. "Effective Federal Tax Rates—All Tax Units, by Expanded Cash Income Percentile, 2023."
Notes: (a) Individual income, payroll, corporate income, estate, and excises taxes are included.
(b) The average effective federal tax rate is the sum of individual and corporate income tax, payroll taxes for Social Security and Medicare, the estate tax, and excise taxes as a percentage of expanded cash income. For a description of expanded cash income, see Urban-Brookings Tax Policy Center. "Income Measure Used in Distributional Analyses by the Tax Policy Center."

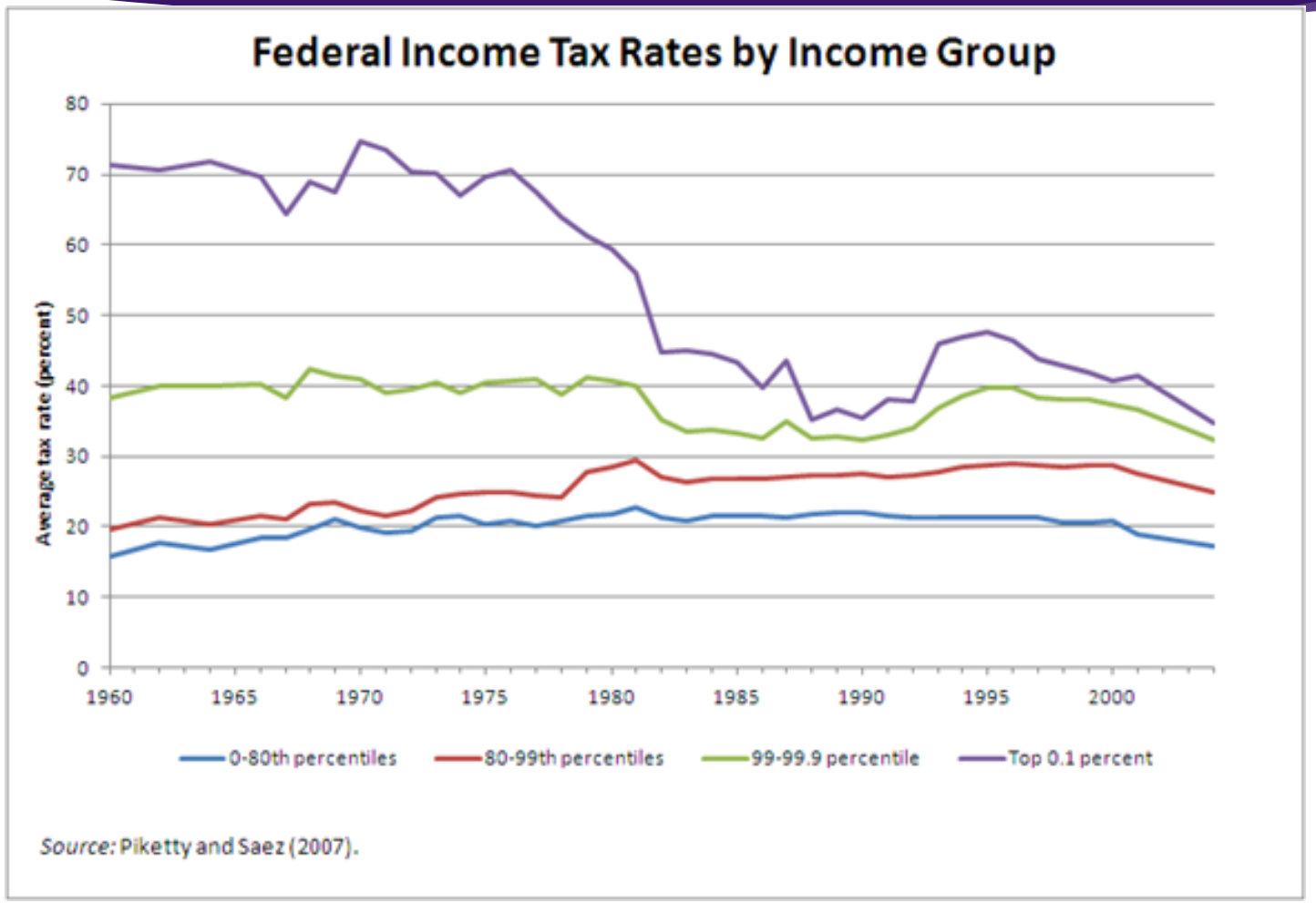
Tax Policy Center, 2024

How Progressive Is the U.S. Tax Code



Brookings Institute 2012

How Progressive Is the U.S. Tax Code



Brookings Institute 2012

Principle 2: Equity consideration

- Equity 2: Benefit received
  - Those who benefit from a service should pay more
- Examples:
  - Motor fuel taxes help fund highway construction and maintenance.
  - Airline ticket taxes/fees help fund airports and aviation infrastructure.
  - User charges/fees: state parks, public transit fares, water & sewer bills, garbage/trash collection fees, parking fees/garages, etc.

Principle 3: Economic efficiency

- An efficient tax is one that does not significantly change how people and businesses allocate resources in the private sector.
- Examples: Taxes on alcohol and tobacco, incentives like retirement tax deductions, and progressive income taxes can change individual and business behavior.
- The key issue is whether those behavior changes are desirable (e.g., improving health) or costly (e.g., discouraging work or investment).
- There can be tensions between economic efficiency and other goals such as equity and regulatory/public health purposes.

Principle 4: Cost of administration

- Costs of administration
  - Compliance costs: time and money to file, report, and document (e.g., income tax)
  - Upfront collection costs: setup/valuation systems needed to levy the tax (e.g., property assessment)
  - Enforcement costs: monitoring, auditing, and collecting unpaid taxes