Tax Policy
Concept Statement 1

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

AICPA

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FOREWORD

This is the first in a series of tax policy concept statements issued by the AICPA Tax Division on tax policy matters. It is intended to aid in the development of federal tax legislation in directions that the AICPA believes are in the public interest.

Tax policy concept statements are approved by the Tax Executive Committee of the AICPA Tax Division after they are developed and approved by the division's Tax Legislation and Policy Committee. Other division committees and technical resource panels may develop tax policy concept statements if requested to do so.

This statement was developed by the Fundamental Tax Reform Task Force with input from the 1998-1999 Tax Policy and Simplification Committee and 1999-2000 Tax Legislation and Policy Committee. It was approved by the 2000-01 Tax Legislation and Policy Committee and the 2000-01 Tax Executive Committee. Members of the bodies that approved this statement tax policy concept statement are listed below.

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The AICPA Tax Division gratefully acknowledges the significant contributions of Annette Nellen in the development of the direction and the drafting of the statement.

Guiding Principles of Good Tax Policy:
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OVERVIEW

Purpose of This Tax Policy Concept Statement

Every year, discussions take place among politicians, economists, tax practitioners, and others about making changes to our federal and state tax systems. Some of the proposed changes are fundamental in that they would, for example, replace the federal *income* tax with a *consumption* tax. Other proposals call for varying degrees of change to the existing federal tax system, such as adding or expanding tax incentives to encourage savings, modernizing the international tax rules to better address today's global economy, or making procedural changes to improve compliance. In addition, the emergence of electronic commerce (e-commerce) as a new way of doing business has raised issues regarding the application of income, sales, and telecommunications taxes and generated suggestions for reforming state and federal tax rules.

Any suggestion for modifying tax rules–whether major or minor—raises the question of how to best analyze and compare proposals. Sponsors have reasons justifying their proposals, but sometimes, the same reasons are offered for what appear to be vastly different proposals. For example, the sponsors of both the flat tax and national retail sales tax state that the new system would be simpler than the current income tax and would promote savings. Similarly, a frequently cited beneficial feature of the flat tax is that it can be filed on a return the size of a postcard. Nevertheless, even today's complex income tax system could be filed by all taxpayers on a postcard-size tax return if no more than select elements of a taxpayer’s tax liability were reported. The size of the tax return does not measure the complexity of the calculations that go into each of the lines on the return. A framework based on appropriate tax policies is needed to effectively analyze proposals to change tax rules and tax systems.

This statement provides a framework to help answer the question: How should proposals to change existing tax rules be analyzed? This question is answered by providing ten principles, listed in the following section, that are commonly cited and used as indicators of good tax policy.

The Ten Guiding Principles of Good Tax Policy

The AICPA recommends that this ten-principle framework be used to analyze proposals to change a tax rule, as well as to change an entire tax system, such as by changing it from an income tax system to a consumption tax system, or to better address e-commerce transactions. Note that the ten guiding principles of good tax policy are equal in importance; the numbered order of the principles in this statement is for reference only and should not be taken as an indication of the order of importance of these principles.[1]

1. *Equity and Fairness*. Similarly situated taxpayers should be taxed similarly.

2. *Certainty.* The tax rules should clearly 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.

3. *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.

4. *Economy in Collection*. The costs to collect a tax should be kept to a minimum for both the government and taxpayers.

5. *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.

6. *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.

7. *Economic Growth and Efficiency*. The tax system should not impede or reduce the productive capacity of the economy.

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

9. *Minimum Tax Gap*. A tax should be structured to minimize noncompliance.

10. *Appropriate Government Revenues*. The tax system should enable the government to determine how much tax revenue will likely be collected and when.

A more detailed explanation of each of the ten principles is provided in the next section of this tax policy concept statement. This statement also notes some of the challenges that exist in following the ten principles. Despite the challenges, however, proposals for changes to the tax law should strive to incorporate all ten principles.

EXPLANATIONS OF THE TEN GUIDING PRINCIPLES OF GOOD TAX POLICY

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.

Economic Growth and Efficiency

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.

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 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.[2]

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

Various challenges exist to incorporating the ten guiding principles of good tax policy into our federal and state tax systems. 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 the Internal Revenue Service (IRS) and state tax agencies to issue guidance in a timely manner when there are hundreds of tax law changes every few years. The frequency of changes to the federal tax law has become overwhelming as described by the IRS National Taxpayer Advocate:

"In TRA 86, Congress made approximately 1,850 separate amendments to the Internal Revenue Code. … Since TRA 86 and ending in 1998, Congress made approximately 6,500 changes to Title 26 in 61 different pieces of legislation. In fact, the Taxpayer Relief Act of 1997 and RRA 98 alone made 1,260 changes to the tax code. The magnitude of the changes made by those two pieces of legislation resulted in revisions of at least 100 separate IRS forms."[3]

A key challenge is the reality that not all ten of the principles can always 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 ten 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 in order to best ensure an effective tax system based on good tax policy. The challenges that exist to incorporating the ten guiding principles of good tax policy are not insurmountable. It will take a concerted effort though, to consider these ten principles in any type of tax law change – both major and minor.

The AICPA encourages policymakers to work to improve our tax systems to better incorporate the principles outlined in this tax policy concept statement and will continue to offer its assistance in this important endeavor.

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[1] One framework that is frequently used to define good tax policy was laid out by economist Adam Smith in his 1776 work entitled *The Wealth of Nations.* (See *The Wealth of Nations*, edited by Edwin Cannan, New York, The Modern Library, 1994, pages 887 to 890). A review of tax systems at each level of government today shows the influence of Adam Smith's maxims of tax policy. The first four principles provided in this report are based on Smith's maxims. The remaining six principles have originated with state and federal legislators and administrators, as well as tax advisers and economists. The latter, more modern principles are considered an appropriate basis for good tax policy and are often used to justify changes to the tax laws. For example, see Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax* (JCS-18-95), June 5, 1995, pages 58 to 59.

[2] General Accounting Office (GAO), *Reducing the Tax Gap – Results of a GAO-Sponsored Symposium*, June 1995, GAO/GGD-95-157, page 13.

[3] Statement of the National Taxpayer Advocate in testimony before the Subcommittee on Oversight of the House Committee on Ways and Means, May 25, 1999.

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