National Conference of State Legislatures

Principles of a High-Quality State Revenue System

1. A high-quality revenue system comprises elements that are complementary, including the finances of both state and local governments.
2. A high-quality revenue system produces revenue in a reliable manner. Reliability involves stability, certainty and sufficiency.
3. A high-quality revenue system relies on a balanced variety of revenue sources.
4. A high-quality revenue system treats individuals equitably. Minimum requirements of an equitable system are that it imposes similar tax burdens on people in similar circumstances, that it minimizes regressivity, and that it minimizes taxes on low-income individuals.
5. A high-quality revenue system facilitates taxpayer compliance. It is easy to understand and minimizes compliance costs.
6. A high-quality revenue system promotes fair, efficient and effective administration. It is as simple as possible to administer, raises revenue efficiently, is administered professionally, and is applied uniformly.
7. A high-quality revenue system is responsive to interstate and international economic competition.
8. A high-quality revenue system minimizes its involvement in spending decisions and makes any such involvement explicit.
9. A high-quality revenue system is accountable to taxpayers.

1. A high-quality revenue system comprises elements that are complementary, including the finances of both state and local governments.

The elements of a high-quality state revenue system are complementary rather than contradictory. Since state revenue systems have developed gradually and tax policy is used to address multiple objectives, state revenue systems are likely to include inconsistencies. However, a clear sense of the objectives of a revenue system can help to minimize these inconsistencies. Principles 2 through 9 look at specific objectives.

One especially important issue is the relationship of state and local governments. States can limit or expand the powers of local governments-cities, towns, counties, school districts and special districts; state mandates can create obligations that force local governments to raise revenue; and local resistance to property taxes can force higher state tax rates. The division of responsibilities between state and local governments differs greatly among the states and has a significant effect on the governments' revenue needs.

State and local governments often compete for tax bases. State policymakers should consider how state tax decisions affect local governments and vice versa. State lawmakers also should consider how state authority for local governments to levy sales, income or excise taxes affects taxpayers. For example, different rates and filing requirements across jurisdictions increase the costs of taxpayer compliance. State and local officials should cooperate to avoid a patchwork of rate structures across the state since a revenue system that minimizes complexity eases compliance costs (Principle 5) and improves the efficiency of revenue collections (Principle 6).

A high-quality state revenue system reflects the limitations and financial responsibilities that state government places upon local governments. For example, state policymakers should be explicitly aware of the costs that state mandates impose on local governments, and local governments should have the authority to raise sufficient revenues to meet these obligations. If local governments lack the revenue bases necessary to provide services mandated by state government, state policymakers should consider statewide solutions to avoid extreme inequalities. In some cases, state governments may subsidize local governments to reduce local tax burdens or increase service levels for governments that lack enough taxing capacity to meet some state standard of services. This approach needs to be weighed against the principle of local autonomy, in which local voters decide which services they want to receive and raise the money to pay for them.

State tax and expenditure limitations can undermine the ability of state and local governments to meet their responsibilities. Limitations can have different effects upon different governments, depending, for example, on a government's ability to charge for its services or find new revenue sources. Limitations may shift burdens or create new ones, and they can undermine the ability of local citizens to increase or reduce the level of services they are willing to fund.

2. A high-quality revenue system produces revenue in a reliable manner. Reliability involves stability, certainty and sufficiency.

Stability, certainty and sufficiency provide the framework for discussing reliability.

Stability. The amount of revenue collected should be relatively constant over time, not subject to unpredictable fluctuations. A high-quality state revenue system promotes stability by imposing a mix of taxes, with some responding less sharply to economic change. For example, taxes (such as progressive personal income taxes) whose revenue yield grows faster than personal income in good times but slower than personal income in bad times should be offset by taxes (such as broad-based sales taxes) whose yield tends to be more consistent over the business cycle. A diversified revenue structure with broad bases tends to be more stable than an undiversified structure with narrow bases (Principle 3). Some instability in state revenue systems is inevitable, however, because fluctuations in the business cycle affect all state revenue sources somewhat.

Certainty. Certainty provides that the number and types of tax changes will be kept to a minimum. Individuals and businesses should not be subject to frequent changes in tax rates and bases because frequent changes interfere with their economic choices and their ability to make long-term financial plans and decisions. This concept reinforces the need for stability because an unstable revenue stream is more likely to require continual tax changes.

Sufficiency. Sufficiency requires that revenue be adequate to balance the state budget in the short run and change at approximately the same rate as desired state spending, whatever that may be. A high-quality revenue system produces enough revenue to finance the level of services that the state chooses to provide (as determined by what the voters and elected officials are willing to fund). The level will vary according to the political, cultural, social and economic characteristics of the state. Developing a revenue system that is capable of producing the desired level of revenue will help lawmakers avoid frequent tax increases or spending cuts.

Further, a high-quality revenue system minimizes the use of tax earmarking, the practice of designating a particular revenue source for a specific expenditure. State programs may be placed in jeopardy if they are funded solely by earmarked revenues because there is no guarantee of a consistent revenue stream (stability) nor of adequate ongoing revenue (sufficiency). Further, earmarking often imposes rigidities into the budgeting system that do not permit flexible allocations of general revenue among competing uses. When earmarking is used, there should be a direct link between the recipient of the funds and the earmarked revenue source (e.g., the highway department receiving gasoline tax revenues). This use is justified on the grounds that all or a portion of the earmarked revenue source is supporting the benefit received. Generally, earmarking should not be used for general expenditures.

3. A high-quality revenue system relies on a balanced variety of revenue sources.

A high-quality revenue system relies on a diverse and balanced range of sources. All taxes have their advantages and disadvantages, but reliance on a diverse assortment can cancel out their biases. One of the goals of a revenue system is economic neutrality to prevent the distortion of individual and business behavior. If reliance is divided among numerous sources and their bases are broad, rates can be made low in order to minimize the impact on behavior. A broad base itself helps meet the goal of diversification since it spreads the burden of the tax among more payers than a narrow basis does. And the low rates that broad bases make possible can improve a state's competitive position relative to other states.

There is merit in the notion that states and local governments should balance their tax systems through reliance on the "three-legged stool" of income, sales and property taxes in roughly equal proportions, with excise taxes, business taxes, gaming taxes, severance taxes and user charges playing an important supplemental role.

Special economic circumstances or policy decisions have led some states to develop revenue systems that do not rely on a broad range of revenue sources. States with extensive mineral resources (such as Wyoming), unique tourist attractions

(such as Florida), or particular concern for decentralization (such as New Hampshire) rely on more narrowly based tax systems than most states. Some state policymakers defend taxes with narrow bases on the ground that rates have to be raised substantially to increase revenue very much. They feel that, because it is politically difficult to increase rates sharply, narrow tax bases help to limit the growth of government spending. Although such states may not modify their present systems extensively, they should attempt to avoid excessive reliance on any single revenue system.

Ultimately, whatever the mix, the revenue system should reflect the state's attempt to reach its fiscal policy objectives. The reasons for selecting one set of revenue instruments over another should be clear. State policymakers should be encouraged to evaluate new revenue systems, especially if they can be shown to be more equitable (such as fees that pass a portion of the service cost to users), but revenue decisions should comply with the state's fiscal policy objectives.

4. A high-quality revenue system treats individuals equitably. Minimum requirements of an equitable system are that it imposes similar tax burdens on people in similar circumstances, that it minimizes regressivity, and that it minimizes taxes on low-income individuals.

Equity traditionally has been measured in terms of individuals' ability to pay taxes and has two main components-horizontal equity and vertical equity. Horizontal equity requires that people in similar circumstances have similar tax burdens. Vertical equity refers to the distribution of tax burdens among people in different circumstances.

There is no general agreement on what vertical equity means in practice. Vertical equity raises complicated questions about how much (and whether) taxes should increase as income increases. Reliance upon sales, excise and property taxes tends to make state and local revenue systems regressive, that is, low-income people pay a larger proportion of their income in taxes than higher income people do. Although some might argue that a high-quality revenue system should be proportional (where taxes account for the same proportion of income as income rises or progressive (where taxes account for a higher proportion of income as income rises), at the very least a high-quality revenue system minimizes regressivity. The progressivity or regressivity of the entire system is more important than that of any particular tax.

An equitable revenue system minimizes taxes on low-income households. As part of the Tax Reform Act of 1986, the federal government exempted those with poverty-level income from taxation. Since that time, a number of states also have exempted very poor households from income taxes, and some provide for reimbursement of a portion of sales and property taxes to low-income taxpayers. State earned income tax credits offered in 15 states supplement the federal earned income tax credit and provide tax reductions and wage supplements for low- and moderate-income working families. The basis for such policies is the concept of the ability to pay; such policies also help preserve the economic independence of the working poor.

5. A high-quality revenue system facilitates taxpayer compliance. It is easy to understand and minimizes compliance costs.

A high-quality revenue system facilitates taxpayer compliance by avoiding a maze of taxes, forms and filing requirements. This reduction in complexity helps taxpayers better understand the system and reduces the costs of compliance.

Reducing complexity also helps taxpayers confirm that taxes are being applied fairly and uniformly. Because tax compliance is largely voluntary, it is important that taxpayers feel the system is fair.

Some complexity is inevitable, however. As stated in Principle 1, a state revenue system pursues multiple policy objectives that lead to some complexity. For example, some states have created sales tax credits for low-income households to reduce the regressivity of the sales tax. Applying for the credits becomes more complex and burdensome for eligible individuals, but the benefits of low-income tax relief are considered to outweigh the trouble of applying. Compliance is facilitated by certainty (future tax obligations are predictable), consistency (tax bases are identical throughout a state), simplicity (taxpayer costs are reduced), and stability of revenue collections (changes in the rates and bases of the taxes are minimized).

Although compliance costs should be minimized for all types of taxpayers, policymakers should be aware of special compliance burdens that primarily affect businesses. In particular, businesses may be subject to numerous rates and requirements if they operate in multiple jurisdictions. States can reduce this burden by working with local governments to

coordinate business tax policy and administration (Principle 1), consolidating industry-specific taxes into general forms, and coordinating business tax policy with other states and the federal government.

6. A high-quality revenue system promotes fair, efficient and effective administration. It is as simple as possible to administer, raises revenue efficiently, is administered professionally, and is applied uniformly.

Tax administration involves assessing and collecting taxes. A tax system that is easy to administer reduces the likelihood of errors and facilitates fairness. Professional and uniform tax administration-both throughout the state and within individual jurisdictions-enhances the effectiveness of the system by improving taxpayer compliance. Poor tax administration will mean that tax burdens are distributed among taxpayers in ways the law did not intend. If the tax system is administered fairly, individuals and businesses are more likely to pay their rightful share of the tax burden.
Also, an easily managed system increases the efficiency of revenue collections, since a smaller proportion of revenue is used to pay for tax administration.

7. A high-quality revenue system is responsive to interstate and international economic competition.

Interstate and international economic competition has intensified in the past decade, increasing pressures on policymakers to use revenue systems as a tool of economic development.
Benefits have to be measured against costs when state revenue systems are used as a tool of economic development policy. Interstate tax competition can deplete state resources without significantly enhancing job creation, and concessions in the form of tax breaks can erode tax bases. In evaluating its competitive position, a state should be aware that tax policy is only one consideration in business location decisions; service levels are also important.
But tax levels matter. Any state that imposes a tax burden far different from that of its neighboring states runs the risk of hurting its economy. This does not mean it must match every tax advantage of its neighbors. Levels of public services, energy and labor costs, access to markets, and availability of capital are some of the other factors affecting economic development. The total package is the measure of a state's competitiveness. Taxes should help in providing similar treatment for all industries and all firms within a given industry within a state.

8. A high-quality revenue system minimizes its involvement in spending decisions and makes any such involvement explicit.

The primary purpose of a revenue system is to raise money. One of the goals of a revenue system is to be economically neutral (Principle 3), a goal that is inconsistent with the use of tax policy to make budget decisions or to influence behavior. Revenue systems can affect budgets in two main ways-through deductions, exemptions and credits intended to foster certain activities and through the use of earmarking.
A high-quality revenue system may include such devices. But policymakers should be certain that these measures not only would do what is expected of them, but also reach their goal at a reasonable cost. Tax deductions, credits and exemptions shift tax burdens from a favored set of taxpayers to less favored taxpayers. For this reason, the costs should be explicit and should be reviewed annually. Earmarked taxes also may fail in the long run to perform as efficiently as originally expected, providing a different amount of revenue for services or programs than policymakers would allocate if it were a matter of appropriation. All these devices tend to remain on the law books without regular consideration of their impact and possibly after the need for them is gone.
On the other hand, these measures have many uses, and they will continue to be part of state revenue systems. They should be used carefully with full consideration given to the tax shifting that may be involved and to the long-term costs and benefits. Since the budget process makes expenditures explicit, the revenue system ideally should leave expenditures to the budgetary system.

9. A high-quality revenue system is accountable to taxpayers.

The essence of accountability is that tax laws should be explicit, not hidden. Proposals for changes should be well publicized to stimulate debate. Local governments, in particular, may suffer from media and voter inattention and may need to devote special efforts to alert voters to proposed changes. Truth-in-taxation policies that require clearly written notices to taxpayers and hearings on tax increases are simple methods of providing accountability. For state governments, tax expenditure budgets are ways of enhancing accountability. A tax expenditure budget shows the costs, expressed in lost tax revenue, of a tax credit or exemption that is intended to benefit some group of taxpayers or encourage a public policy goal. It shows revenue losses just as a regular budget shows expenditures. For example, states may exempt a portion of retirement income from personal income taxes or provide deductions for business subsidies for child care. In addition to identifying the revenue loss from such tax preferences, tax expenditures also provide data that can be used to evaluate the effectiveness and efficiency of these policies.

Accountability in a larger sense means that policymakers must examine the costs and benefits of using revenue measures as tools to put nonfiscal policies into effect. Since tax policy inevitably will be used to reach other policy objectives, lawmakers have a responsibility to ensure that the policy produces the intended effect and does so at a reasonable cost. Earmarked funds, tax expenditures and all other special tax preferences should be reviewed regularly to assess their efficiency and effectiveness as policy measures.

Appendix 1. Sources of State and Local Governments' Revenue, 1971, 1990, 1998 and 2005

Revenue Sources	FY 1971	FY 1990	FY 1998	FY 2005
Taxes as a Percentage of Total Revenue	**65.5%**	**59.1%**	**56.6%**	**53.3%**
Property taxes	26.1	18.3	16.8	16.6
Individual income tax	8.2	12.6	12.9	11.9
Corporate income tax	2.4	2.6	2.5	2.1
General sales tax	12.3	14.3	13.8	13.0
Excise taxes	10.6	6.7	7.4	6.0
Other taxes	5.9	4.6	3.2	3.6
Nontax Revenues as a Percentage of Total Revenue	**34.4%**	**40.9%**	**43.4%**	**46.6**
Charges and miscellaneous	14.1	17.9	19.9	21.2
Interest	2.3	6.9	4.8	3.7
Federal aid	18.0	16.1	18.7	21.7
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**

General revenue includes all sources of government income as defined by the federal government, except for the income of publicly owned utilities and liquor stores and the income of public insurance trusts-that is, unemployment compensation, workers' compensation and public employee retirement funds.

Source: U.S. Department of Commerce, Bureau of the Census. (http://www.census.gov/govs)

Appendix 2. Taxes on People and Taxes on Business

In any state and local revenue system, one of the toughest issues to decide is the fair distribution of taxes between individuals and businesses. If individuals and businesses were separate entities, things would be simpler, but the

relationships are complex. A partnership, for example, may be subject to taxation more like that of a single person than that of a corporation, even though a partnership and a corporation may be alternative forms of organization for some kinds of operations. The definitions of equity and ability-to-pay that apply to individuals do not necessarily apply to corporations. Because there are not hard and fast rules, a fair division of tax obligations between individuals and corporations in practice has to be worked out as a matter of public policy.

Individuals are taxed because they possess wealth and receive incomes in their own right. Individuals' wealth and incomes are used as keys to their tax liabilities. Corporations are superficially similar, but the analogy breaks down. Corporations are associations of individuals designed to hold property and carry out ventures jointly. Corporations' income passes to owners and workers in the form of dividends, interest, salaries, bonuses, and so on. As just one example of the problem this creates for fair tax policy, there is a long-standing disagreement about the taxation of corporate dividends. These are taxed in the form of corporate income and then taxed again as personal income when collected as dividends by stockholders. There will never be a national consensus on the fairness of this procedure.

There are a number of reasons for taxing businesses. One is the benefit principle: public services like police and fire protection, education and highways are benefits received by businesses, and taxes are the cost of them. This argument requires all businesses to pay taxes regardless of their profit levels. Taxes levied solely on profits do not meet this rationale of business taxation, but other taxes do, such as taxes based upon capital (like the franchise tax in some states), a gross receipts tax (like that of Delaware) or a value-added tax (like Michigan's single business tax). Such taxes address the issue of equity between business enterprises and individuals, particularly as they may pass some of the cost of providing state services to nonresident customers and owners of a business who otherwise might not be reached by a state tax system. Another rationale is administrative efficiency. Business firms are intermediaries in economic processes from which it is administratively convenient to collect taxes. Businesses provide a large, accessible revenue stream, so that taxes on business help meet the need for revenue sufficiency.

Suggestions for Further Reading

- Bonnett, Thomas W. *Is the New Global Economy Leaving State-Local Tax Structures Behind?* Washington, D.C.: National League of Cities, 1998.

  A collaboration of the National Conference of State Legislatures, the National Governors' Association and the National League of Cities that examines challenges to state-local revenue systems.

- District of Columbia Tax Revision Commission. *Taxing Simply, Taxing Fairly.* Washington, D.C.: 1998. Available electronically at www.dctrc.org.

  This study of the District of Columbia's economy and revenue systems includes 17 research papers and studies on subjects ranging from property taxes to telecommunications and utility taxes.

- Ebel, Robert D., ed. *A Fiscal Agenda for Nevada: Revenue Options for State and Local Governments in 1990.* Reno & Las Vegas, Nev.: The University of Nevada Press, 1990.

  The book's subject is much broader than its title indicates. Its articles provide clear and thorough discussions of how various state taxes work and how they are connected to a state economy.

- Gold, Steven D. *The State Fiscal Agenda for the 1990s.* Denver: National Conference of State Legislatures, 1990.

  A readable summary of the tax law changes and new controls on state expenditures that the economy of the 1900s will require.

- Gold, Steven D., ed. *The Unfinished Agenda for State Tax Reform.* Denver: National Conference of State Legislatures, 1988.

  Leading national authorities on state taxes discuss the specific changes in state tax law needed to bring state tax systems into conformity with the first set of *Principles of a High-Quality State Revenue System.*

- Mackey, Scott. *Tax Policy Handbook for State Legislators*, first edition. Denver: National Conference of State Legislatures, 1997. The second edition is currently available.
  A handbook that evaluates state taxes on equity, efficiency, and other criteria in this report.
- Musgrave, Richard A., and Peggy B. Musgrave. *Public Finance in Theory and Practice.* New York: McGraw-Hill Book Company, various editions.
  A standard textbook on public fiscal policy and taxation.
- Snell, Ronald K., ed. *Financing State Government in the 1990s*. Denver: National Conference of State Legislatures and National Governors' Association, 1993.
  This report examines major challenges facing state/local tax systems because of demographics, structural changes in the economy, and the actions of state and local policymakers.

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