Missouri Legislative Academy

Evaluating Tax Systems

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Introduction

One function of government is to provide the goods and services (police, courts, education, roads, economic security, etc) that individuals need and want but are unable to obtain from the private sector. In order to provide these services, the government must impose taxes to pay for them. A state can tax virtually anything that it chooses but the objective is to develop taxes and a tax system that serve the broad needs of society in an efficient, fair and impartial way. Several attributes of taxes are widely accepted as criteria for evaluating the impacts of taxes on society and the economy. These criteria are: economic efficiency, economic competitiveness, administrative simplicity, adequacy, and equity. No tax is ideal with respect to all these criteria and each citizen views the taxes differently based on the taxes they pay and the benefits they receive. Consequently, selecting taxes and designing a tax system for state and local revenues is a process of trade-off and compromise.

Criteria for evaluating tax systems

Taxes may be assessed according to their economic efficiency, the extent to which they keep the state competitive, as well as their administrative simplicity, adequacy, and fairness (see box below). Although easily expressed, it is very difficult for states to craft and maintain tax structures that maximize these criteria because, in many cases, the maximizing of one criterion negatively impacts others.

Efficiency – Does the tax interfere with efficient allocation of resources and consumer choices?
Competitiveness – Does the tax encourage business or individuals leave Missouri or limit the state's ability to attract business?
Administrative simplicity – Is the tax easy to comply with and to administer?
Adequacy – Does the tax allow the state to meet the needs of its citizens in good times and bad?
Equity – Is the tax fair?[2]

1. Judith I. Stallmann is a Professor of Agricultural Economics and Rural Sociology at the University of Missouri – Columbia.
2. Equity refers to the principle of ability to pay. A progressive tax charges a higher percentage to wealthier taxpayers while a regressive tax does the opposite. Most scholars accept the proposition that a regressive tax, one that imposes a greater proportional burden on those with smaller incomes, is not equitable. For another view see Richard J. Joseph, 1996, "Why Progressive Taxation?" Tax Notes (January 15), 313-318.

1. Economic efficiency: An efficient tax system does not interfere with the efficient allocation of resources or consumer choices and does not encourage businesses and/or individuals to make economic decisions based upon their tax consequences. A broad-based tax is more efficient than the same tax with a narrow base, in part because it is more difficult to avoid the tax.

2. Economic competitiveness: A competitive tax system does not handicap the ability of firms to compete with those located outside the state and does not limit the state's ability to attract new business.

3. Administrative simplicity and cost effectiveness: A simple tax system is one that is easy for the taxpayer to understand, one that is easy to comply with, and one that is both easy and inexpensive for the public sector to administer.

4. Adequacy: An adequate tax system is able to generate sufficient revenue to meet public needs as the population and economy grow or decline.

5. Equity or fairness: The equity of taxes is typically evaluated by looking at the distribution of the tax relative to the taxpayer's ability to pay. If persons of lower incomes pay a higher percentage of their incomes in taxes than do persons with higher incomes, the tax is *regressive*. If persons of increasingly higher incomes pay an increasingly higher percentage of their incomes in taxes, the tax is *progressive*. If persons of all income levels pay the same percentage of their incomes in taxes, the tax is *proportional*. This equity criterion does not give guidance about how large a difference in income is considered a different ability to pay, nor on how different the percentages should be between income levels.

Equity in state tax systems

It is possible to measure all five criteria. For example, data assessing the equity of tax systems in all 50 states are presented in the Table 1 below. These data, based upon taxes collected in 2002, presents five levels of family income. These data indicate that, taken collectively, state sales and excise taxes are regressive while state income taxes are progressive except for the wealthiest 20% of income tax payers.

Conclusion

The criteria outlined here do not address the broad political questions that surround tax policy, including whether tax revenue is sufficient to meet the needs of the citizens of Missouri. But they do provide tools that individuals and policymakers can use to assess the merits of any given proposal as well as existing state tax policies.

Table 1

Percentage of Income Paid in State Taxes by Family Income Level[3]

Family Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%
Income Range	Less than $15,000	$15,000-25,000	$25,000-40,000	$40,000-69,000	$69,000 or more
Average Income in Group	$9,300	$19,700	$31,900	$52,500	$165,925
Total Sales & Excise Taxes	7.8	6.4	5.1	4.1	2.8
General Sales—Individuals	3.6	3.3	2.7	2.3	1.6
Other Sales & Excise—Ind.	1.9	1.3	0.9	0.7	0.4
Sales & Excise on Business	2.3	1.9	1.4	1.1	0.7
Total Income Taxes	0.6	1.5	1.9	2.2	2.1
Personal Income Tax	0.5	1.6	2.2	2.7	3.4
Federal Deduction Offset*	0	-0.1	-0.3	-0.5	-1.3
Total State Taxes	8.4	7.9	7.0	6.3	4.9

* Taxpayers can deduct, from their income, the amount that they paid in federal income taxes for that year.

Source: Adapted from McIntyre, Robert S., Robert Denk, Norton Francis, Matthew Gardner, Will Gomaa, Fiona Hsu, and Richard Sims. “Who Pays? A Distributional Analysis of the Tax System in All 50 States.” Washington, D.C.: Institute on Taxation and Economic Policy. January, 2003. www.itepnet.org

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3. For all 50 states.