

Independent, principled state policy fostering limited and responsible government, free enterprise, and a robust civil society.

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The Why and How of Sound Tax Policy - Summary*

Introduction

The tax on windows in buildings, imposed by King William III of England in 1696, illustrates the folly of not following sound tax policy. The consequences of that “clever” tax, intended to make the rich pay more, since they had larger houses with more windows, included:

- Removal of windows in tenement buildings for tax avoidance,
- The lowering of the window-count threshold below which a building owner was relieved of the tax,
- Removal of windows in private houses,
- Windowless housing resulting in ill-health, contributing to the spread of typhus and cholera, and
- The poor suffering most, being least able to afford housing with windows.

Sound tax policy should be a priority, regardless of ideology, because:

- 1 Taxation is inevitable,
- 2 Unsound tax policy contributes to fiscal and economic waste, especially enforcement costs, and
- 3 Much government spending is likely to become trite and unproductive.

Four Essential Tax Principles

Since the days of Adam Smith and then John Stuart Mill, there has been a remarkable amount of consensus among economists about what principles should determine tax policy.

Neutrality

A tax system should impact organic, market-based decisions based on actual costs and true tastes and preferences as little as possible. Taxes should not distort relative prices. This allows the economy to operate efficiently and make the most of always-scarce resources.

Transparency

Taxes should be apparent to the citizenry in order to result in:

- 1 The right size and functions of government by knowing and understanding its true cost,
- 2 Justice - ensuring that government is truly consented to by free people.

Simplicity

With simpler taxes, enforcement is less costly for government and less frustrating for taxpayers. Economically, complex taxes:

- 1 Cause government to grow and become needlessly more costly just to enforce taxes,
- 2 Cause a waste of resources by the private sector in excessive compliance costs, and
- 3 Redirect resources into skills and enterprises focused only on tax compliance.

Broader taxes with fewer special provisions for allowing some to avoid taxes tend to be simpler.

Predictability

Citizens should pay taxes in a predictable way, at predictable times, and in predictable amounts. Taxes should target sources that can be expected to produce steady revenue. This makes government service provision more predictable, reducing risk. It also reduces the risk of doing business and complying with tax law.

Interplay Between Principles

Pursuit of all four principles at once, along with other desirable benefits, results in:

- 1 Greater compliance since taxpayers and enforcement understand the system and regard it as fair, and
- 2 Little corruption, since it is relatively easy to identify cheating and difficult to hide it.

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Conclusion

When government in the U.S. was smaller, the importance of sound tax policy was less obvious because taxes played such a minor role in every day decision making. The large size of government today increases the urgency and necessity of applying sound principles to tax policy.

TABLE 1	Common State-Imposed Taxes and Whether They Follow the Four Tax Principles			
	Neutral	Simple	Transparent	Predictable
Value-	✗	✓	✗	✓
Payroll	✓	✓	✗	✗
Personal Income	✗	✗*	✓	✗
Corporate Income	✗	✗	✗	✗
Sales	✓	✓	✓	✓
Property	✓	✓	✓	✓

*While an income tax can be made simple, such as a flat tax, this evaluates the current system.
Source: Author's judgment