The Illinois Budget Policy
TOOLBOX

Toolbox Fundamentals

Competing Goals of Budget Reforms

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Fixing the Illinois state budget requires more than simply balancing revenue and expenditures. Government budgeting also requires establishing the right mix of public goods and services in a way that is fair and efficient while minimizing interference in private markets. Understanding of these overarching social and economic goals is crucial for making budgeting choices. Indeed, the different goals may sometimes conflict with each other. This paper summarizes some basic principles that could support thoughtful taxing and public spending decisions.

This paper groups these many goals into just eight categories. The numbered ordering does not indicate their relative importance. A single reform rarely satisfies all eight goals, and policymakers therefore face tradeoffs among these goals as they develop a budget plan.

(1) Economic efficiency

By changing taxpayers' behavior away from their most-desired choices, taxes generally place burdens on taxpayers that are larger than the revenue received by government. For example, a higher tax on restaurant food than on grocery food encourages people to buy grocery food, even if they would rather have a restaurant meal in the absence of the higher tax. The full burden minus the revenue is a loss in economic efficiency called "excess burden." Thus, one goal of a good tax reform is to minimize this wastefulness for any given amount of revenue.

In a world with no taxes (or any other market failure, such as pollution), the private market can allocate resources to their most valuable use. People could work as hard as they want, at their most productive pursuits, to be able to pay for exactly the goods they want to buy. With taxes, however, people may change their labor supply or investments *away* from those most-productive pursuits, which must mean that labor and investments are *not* being used efficiently. Of course, we need taxes to pay for desired public goods like roads, schools, and police. But the goal would be to impose taxes that do the least to alter people's economic incentives.

In this respect, some revenue-raising methods are better than others. A general principle of minimizing inefficiency due to taxes is to use a broad base and low rates. If the state taxes virtually everything at the same low rate, then people cannot avoid the tax on one thing by doing something else instead. On the other hand, we might want to discourage certain activities for policy reasons, especially those that impose burdens on others, such as smoking or industrial pollution. In those cases, higher specific taxes may serve to reduce the behavior that leads to those external costs.

(2) Administrative efficiency

A tax is more administratively efficient to the extent that the cost of collecting it is lower. For a given amount of revenue, we want as little as possible going to pay for additional state bureaucracy to administer the tax, to audit taxpayers, or to enforce tax collection. Those administrative costs reduce the amount that can be used for valuable public goods and deficit reduction. Analogously, we want taxpayers to use as few resources as possible to figure out what they owe. For both spending programs and tax programs, bureaucracy can be wasteful. Some paperwork is necessary to determine eligibility and to avoid fraud, but we want as little paperwork as necessary.

For example, the Illinois income tax system piggybacks on the federal system. Taxpayers have already devoted time and money to fill out their own federal 1040 tax forms, and Illinois does not make them sink much *additional* time into their state tax forms. This piggybacking is administratively efficient. Adding any exemptions or deductions to Illinois income taxes may come at some cost of administrative efficiency.

(3) Vertical equity

Fairness or equity has multiple dimensions. A tax is vertically equitable to the extent that it is assesses the appropriate amount of tax to be paid by the rich, compared to the poor, and everybody in between. What is "appropriate" in this case is a matter of policy choice. Some believe that those who earn or have more money should pay a higher percentage in taxes. A graduated rate structure places higher relative burden on those who can most afford it. On the other hand, some prefer a flat income tax rate. Other tax policies also affect vertical equity, as discussed in other parts of the Illinois Budget Policy Toolbox.

The Illinois state income tax has a flat rate (currently 5 percent), but its exemption means that those with very little income pay no tax. Also, those with income slightly above the exemption have a ratio of tax paid to income that is less than 5 percent. That ratio rises for those with more income, so the system is somewhat progressive rather than strictly proportional. A sales tax is generally regarded as regressive because those with lower annual income spend a higher fraction of income on taxable goods. Policymakers may therefore want to exempt grocery food and not restaurant food, in order to place lower burden on low-income families – even if it reduces economic efficiency in our example above. Hence they may face tradeoffs between conflicting goals.

State spending programs obviously have distributional effects as well; some spending programs are specifically designed to help those less fortunate among us, and other programs tend to help those with more income. In fact, it may be only the combined effects of all taxes *and* spending programs that should be evaluated for vertical equity. Progressivity of income taxes may be offset by regressivity of sales tax burdens. And Medicaid and food stamps may help those with low income.

(4) Horizontal equity

A tax has horizontal equity if those with the same income or wealth are taxed the *same* amount. For many reasons, however, a tax may differently impact two families with the same income and the same circumstances – even living on the same block in the same size house. For example, state excise taxes on particular commodities like cigarettes or gasoline place greater burdens on those who buy more of the taxed goods, even among those with identical incomes. Illinois has gambling revenue that affects only some households and not others. The Illinois income tax exempts retirement income, which means that a retired person will pay less tax than a working person with the same income. Perhaps such differences achieve *other* state goals related to gasoline use or helping the elderly, but they do not achieve horizontal equity.

(5) Simplicity

A tax or public service program is simple if it is easy to understand. The state budget system should have as little complication as necessary to collect the tax, administer the program, and ensure eligibility. Simpler forms and eligibility requirements might also make it fairer by ensuring that those eligible can understand their eligibility. And it might also improve administrative efficiency, if it makes the program easier to implement or the tax easier to collect.

But two points about simplicity are different from other goals above. First, the system needs to be transparent and understandable in order to be *perceived* as fair, to be supported by voters, and to be accepted by taxpayers. People don't like taxes, and an unnecessarily complex system both annoys people and can make them suspicious of its fairness. Second, any system that is unnecessarily complex might effectively favor those who are best able to understand it and discriminate against those who are less able. For example, a highly complex system of deductions and credits in an income tax favors those who have the wherewithal to hire a tax specialist.

(6) Certainty

A tax is certain if people know it will not change significantly over time. Taxpayers continually make economic decisions about how much to work, what to buy, where to invest, and whether to own a home, and these choices have tax implications that ought to be known in advance. Just as investment is inhibited by an uncertain economic climate, productive investment is further inhibited by uncertain tax consequences. Moreover, certainty is necessary for fairness. What appear to be random increases or decreases in tax burdens can be seen as capricious and, therefore, unfair. Thus, the old saying: "an old tax is a good tax." Even if a tax is changed for good reasons, it will likely reduce taxes on some activities and increase taxes on others. Those taxes affect asset prices.

An investor will base a choice between two investments on the net-of-tax returns, and any tax reform could change the calculus of that decision after the fact. If two investments are expected to have the same net rate of return, for example, then a reform to collect more tax on one of them imposes a windfall capital loss arbitrarily on the person who happens to choose that investment instead of the other one. Thus the burden may feel capricious. Frequent reforms are also not conducive to efficient economic decision-making.

(7) Flexibility

A tax system is flexible if it allows the government to adapt to new circumstances. The state must be able to raise funds when needed, either to balance the budget or to undertake important investment opportunities. We don't want a tax system that can never be changed. Yet here is another tradeoff. While tax flexibility is valuable, all things being equal, such changes conflict with tax certainty.

An important question in this regard is the extent to which tax rules can be set by the revenue authorities, or by the legislature, as opposed to requiring a constitutional amendment. Tax rules embedded in the state's constitution are more difficult to change in the face of new circumstances. For example, the Illinois Constitution prohibits a graduated income tax rate structure. This provision assures certainty – but also less flexibility. It is another example of the tradeoffs among competing goals.

(8) Stability

A tax and budget system helps stability when it provides predictable and steady revenue that balances the budget over time. The Illinois economy naturally dips and surges along with the rest of the nation, through recessions and growth periods, and our state revenue naturally rises and falls along with that economic activity. Yet many of the state's expenditures are for infrastructure requirements that are constant across the business cycle (like the repayment of bonds for roads and bridges). Furthermore, many safety net and entitlement expenditures may rise exactly when revenue falls, as more people are in need just when taxable economic activity and thus revenue falls. All else equal, we might like state revenue and expenditures to move together, or at least to be mutually consistent with each other over the long run, a goal that can be facilitated by design features of the tax and budget system.

An example is that state income and sales tax revenue rises with the economy, while some safety net program expenses rise when the economy falls. This mismatch can be offset if the state can borrow more during bad times and pay off those loans during good times. The state also could defer costly projects if revenue falls temporarily.

Tradeoffs

As this discussion of the goals of tax and budget policy demonstrates, tradeoffs are inherent. Individually, each of these goals may sound perfectly reasonable, but they often conflict with each other. For example, tax flexibility is virtually the opposite of tax certainty.

One of the most important tradeoffs is between equity and economic efficiency. Vertical equity may suggest low or zero taxes on those least fortunate in our society, but that goal may require higher tax rates on others who are more fortunate – a tax rate differential that violates the efficiency principle of taxing all activities at the same low rate. Horizontal equity may suggest the same burdens on two people with the same income, but economic efficiency may instead require higher tax burdens on the person who buys more goods associated with negative externalities, like pollution or smoking.

No single tax or spending combination can achieve all these goals simultaneously, and so voters and policymakers face important choices. The "best" system is one that results from a process that recognizes all these goals and is aware of the tradeoffs, with conscious decisions about what is most important for the citizens of Illinois. •

Further Reading

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> Includes 518 pages with 200 different 3-page entries by 150 authors. Chapters include: "Budget Policy, State and Local," "Excess Burden," "Fairness in Taxation," "Horizontal Equity," "Tax Evasion," "Tax Transparency," and "Vertical Equity". View the index at http://www.urban.org/books/TTP/index.cfm

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