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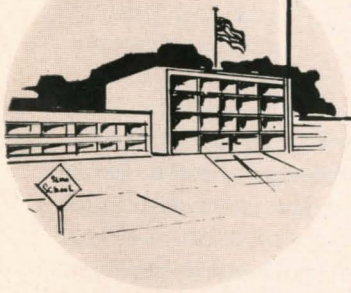
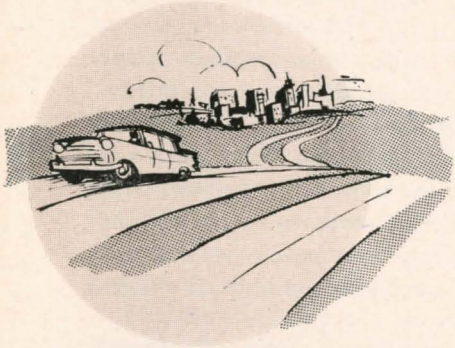


III

Basic Principles of Public Finance



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Issued November, 1962, 5000

Foreword

Nebraska citizens as individuals, as members of organizations, as business managers, as legislators, and as administrators of public institutions and agencies are concerned with important state and local public finance problems.

These problems are: demands for more and better public services; the numbers and types of local governmental units; the increasing costs of state and local government; and the continued reliance upon the property tax for revenue.

Many individuals and groups who recognize these problems have asked for additional information on the possibilities and limitations of alternative courses of action for solving these problems.

The objective of this series of four circulars on state and local public finance in Nebraska is to provide the citizens of the state with factual information on the expenditure and revenue systems of the state and local governments, on basic principles of public finance, and on the advantages and disadvantages of alternative methods of obtaining revenue for public purposes.

The following circulars are included in the series under the general heading *Let's Discuss Nebraska Taxes:*

EC 62-817A I.	Role of Government in Our Society
EC 62-817B II.	Public Services: Cost and Financing
EC 62-817C III.	Basic Principles of Public Finance
EC 62-817 D IV.	An Evaluation of Major Taxes

Let's Discuss:

NEBRASKA TAXES

III. Basic Principles of Public Finance

By Fred L. Olson, Agricultural Economist and
Jack D. Timmons, Graduate Assistant, Political Science

Introduction

Two questions basic to the study of public finance at any level of government are:

1. What should the level of government spending be?
2. How should the government obtain its revenue?

These two questions can be answered only within the framework of the broad economic and social objectives of society. These objectives in turn are the result of psychological factors and physical environment which will vary both from one community to another and from one generation to another. Each new generation must make itself aware of the requirements of the society and the economy and build upon and/or change the objectives of the past generation. Because our society is dynamic, there is a need for continual re-evaluation of objectives and the means of attaining those objectives.

Attitudes toward government spending in the United States today differ widely. One extreme attitude, derived from European feudalism before 1800, is expressed by: "One state may be good because of great expenditures and another bad because of small expenditures." On the other extreme, derived from 19th Century industrialism and the private enterprise creed, is: "The very best of all plans of public finance is to spend very little."

Out of this latter era have come three beliefs with regard to government finance.

The first is that government spending is a "necessary evil" and that the lowest level of spending is the best possible objective. The problem presented by this belief is in determining what the lowest level should be. Different groups in society have varying opinions of what the minimum services of government should be.

The "balanced budget" concept is the second major belief. The

problems of applying this concept to government services which are not primarily concerned with dollars and cents profit are many. Even business has revised its approach to the balanced budget in modern times by borrowing large sums for expansion during inflationary periods and accumulating savings during "tight money" periods. To stabilize the economy, some public finance experts propose that government attempt to offset this business practice by spending during depressions to put money into the economy and accumulating reserves or repaying debts during inflation to decrease the amount of money in the economy. Or, they say, the government should cut taxes during depressions to leave more money for consumer spending and investment and raise taxes during an inflationary period. With permissive legislation, changing the tax rates would be easier than changing the level of government spending for short periods of time.

The third belief, which started in the period of early capitalism, is that of "economic neutrality," which means that government should tax in such a manner as to affect existing economic relationships as little as possible. This concept would discourage any attempt by the government to curb the effects of the business cycle or to control consumption of certain items by means of a high tax (cigarettes, liquor, drugs, imports, etc.).

None of these three beliefs has been applied with any degree of consistency in the United States. Although it is difficult to define the ethical values of a society at a particular time, three basic objectives of our society are generally accepted. These are:

1. Maximum individual freedom of choice.
2. Best possible standards of living, in terms of available resources, and consumer and resource-owner preferences.
3. Distribution of income in conformity with currently accepted standards of fairness.

These goals are quite general, but they provide a framework for use in considering government activities. Generally, the major conflicts occur over methods of reaching these goals rather than over the goals themselves.

Level of Government Spending

The level of government spending should be related closely to the basic economic rule that best possible levels of production are achieved only when social costs equal social benefits. The measures used by government to determine these conditions are often quite different from those used by private business. While businesses estimate their costs and benefits in terms of profit and capital gains, government must evaluate many of its activities in terms of community

benefits, which may be difficult to measure or predict. Often government is concerned with benefits derived over a much longer period of time than private business can afford.

Government activities are part of the national economy and provide goods and services, as does private business. We have a wide variety of needs such as food, clothing, shelter, and entertainment that we satisfy on an individual basis through the market mechanism or the family. Some of us also buy our education, health, and old-age security through private enterprise, family, or church; but most of us buy at least part of these services collectively through government. We buy most of our fire and police protection and all of our national security through government.

Since we buy security and education through government, we have to tell our wants in these areas to our elected representatives, be they school board members, county commissioners, city councilmen, state senators or the Governor. We do this by talking to our elected representatives and by forming lobbies with other individuals of similar interests to inform the responsible officials and legislators. Our views for or against any government expenditures can be brought out at public hearings.

At the state level, public hearings are held on matters that affect state spending. These hearings include such proposals as new highways, expansion or addition of parks and recreation areas, sale or purchase of land, and addition or reduction of taxes. These public hearings are extremely important. Here is where the legitimate interests of the people are threshed out. The general long-range plans for the subject under discussion should be clearly defined at these hearings. Some of the expenditures will be for buildings and roads which may be used 30 years or more. The more detailed, short-range plans that fit into the long-range plans should also be clearly defined.

The political responsibility for spending should be clearly established at these hearings. Procedures should be established for effectively evaluating the expenditures as they are being made. These procedures are especially important because the government does not have the profit gauge of private business for checking performance. Some of the safeguards necessary to protect society against political graft, favoritism, and uneconomic or unjustified expenditures include: auditing and special supervising methods, regulations on bidding, specification buying, and centralized purchasing, in addition to legislation and scrutiny by citizens. As government activities widen, these safeguards become more important.

Our elected representatives, in determining the level of spending, must gather and evaluate information, weigh conflicting views, and

determine whether or not the expenditures will do the job intended. It is easy to see that an expenditure is economic if it is self-liquidating, like a dormitory that pays for itself out of student room rent. Building a needed road may also be economic and increase the gasoline tax revenue. It is not so easy to determine whether an expenditure is economic when the service cannot be directly measured in terms of money. Government expenditures are economic if they directly or indirectly increase the productivity of the economy more than would the same expenditures in the private sector. This is hard to judge. Government expenditures for flood control, education, vocational training and roads can be classified as economic by this definition.

Besides the economic limit to government spending, upper limits are determined by the reactions of the individual, the market, and society. The individual usually thinks more about the taxes he has to pay than the benefits he receives from public services. There are some psychological limits, depending on the tax system and the rates, which produce strong reactions.

Each market also provides a limitation on government spending. For example, relief payments greater than the current wage rate would disrupt the labor market. There are, however, no set rules for these limits, which means again that subjective judgments must be made by our legislators. From the viewpoint of society, the level of government expenditures is limited in the long run if they are greater than taxes. This will either result in rationing and price-fixing, as occurred during World War II, or inflation.

Source of Revenue

Once the level of government spending has been determined, government activities have to be financed. Part of the finances come from non-tax sources, including licenses and permits, fees and fines. Licenses and permits are used both for revenue and for regulation and control. They include business and occupation licenses and permits, hunting and fishing licenses, motor vehicle registrations, and drivers' licenses. Individuals and firms obtaining a license or permit acquire certain rights and privileges or the right to participate in a public service. Fees are charges for services performed by public agencies. Examples are student fees at the University of Nebraska and the Teachers' Colleges, and fees for bonding, title transfers and recording deeds. Fines are the penalties for not conforming to law.

The difference between this non-tax revenue and what the government spends must be made up by taxation, borrowing or spending of reserves. Thus the principle purpose of taxation is to obtain revenue to fulfill the policy objectives of government. Taxation sometimes is

used to achieve economic and social reforms. Trying to achieve these reforms by discouraging certain activities or consumption through high tax rates may increase the tax revenue (e.g. cigarette and liquor taxes) if the high rates are not effective in reducing consumption. Encouraging or promoting certain activities or consumption through low tax rates or exemptions usually lowers the amount of tax revenue. Exemptions and special low rates on certain items or tax categories will narrow the tax base and, consequently, increase the tax rate for those who do not fall within those special brackets. Taxation should be used for social reform only after careful consideration of its effects on the overall revenue system.

Taxes can be levied on property, expenditures, and income. Wealth (property) generally is a result of either the accumulation of production or deferred consumption. It may be bank savings, real estate, stocks and bonds or any other property which is a reserve of purchasing power. Property taxes and income taxes on dividends and interest are examples of taxes on wealth. Death, estate, inheritance, and gift taxes are taxes on the transfer of wealth. Taxes on consumption include the general retail sales tax, specific sales taxes on gasoline, liquor, tobacco and luxuries, use taxes, taxes on gross receipts, and tariffs on imports. Taxes on production include the income tax, grain and seed tax, and the severance tax on oil and gas. The head and poll taxes do not fit in any of these categories.

Evaluating a Tax System[1]

Any tax system should be evaluated from the viewpoint of the individual, the government, and society in general. These viewpoints occasionally will conflict and require careful study by the policy making bodies to determine whose interests should take precedence.

Individual Taxpayer

Most discussions of the principles of taxation include the famous tax canons stated in 1776 by Adam Smith in his book, *The Wealth of Nations*. These laws have withstood the changes of time quite well, particularly as they apply to the requirements of the individual. According to Smith, a tax should be: (1) equitable, (2) certain, (3) convenient, (4) economical.

Equity

Equity or fairness is probably the most important quality of a tax from the viewpoint of the individual. This means that taxes should

[1] The authors are indebted to E. B. Schmidt, University of Nebraska Department of Economics, for many of the ideas presented here.

be levied according to the common notions of justice—on the basis of either ability to pay or benefits received. In the words of Smith, "The subjects of every state ought to contribute toward the support of the government as nearly as possible in proportion to their respective abilities; that is, in proportion to the revenue they respectfully enjoy under the protection of the State."

Ownership of property is one index of ability-to-pay, but is not a perfect one because the productive (farm or business) or consumptive (home) use and the amount of indebtedness must be considered and because there are many sources of income other than property in modern society.

People with high incomes obviously have the ability to pay higher taxes than people with low incomes. In addition they can be considered able to pay a higher proportion of their income in taxes. This leads us to the need to define a progressive tax and a regressive tax. A progressive tax takes a larger proportion of income from people with high incomes than from those with low incomes and hence follows the ability-to-pay principle. The federal income tax is an example. A regressive tax takes a larger proportion of income from low income people and consequently does not meet the test of equity or justice. The general retail sales tax is regressive in effect.

The second concept of equity in taxation is based upon the idea that those who use government services should pay the cost of providing them. As government services have been extended into the fields of welfare, health, education and other social services, this concept becomes much more difficult to apply. When government was primarily concerned with keeping the peace, enforcing contracts, and maintaining internal and external security, property owners could be considered as the group benefiting most from government services and therefore paying most of the cost of government. In modern society government has expanded into the social welfare fields where people receiving large amounts of the benefits cannot pay for them. The burden then falls on society as a whole, which benefits indirectly from these programs. Several taxes are now used which are very rough measures of benefits received. Among these are the gasoline tax for highway construction, postal charges for mail service, student fees for part of public education costs, and specific property tax levies for irrigation, fire protection, drainage, and other similar functions.

Economy in Taxation

Adam Smith had this to say about economy: "Every tax ought to be so contrived as both to take out and keep out of the pockets of

the people as little as possible, over and above what it brings into the public treasury of the state." In other words, administering the tax should use up the smallest possible part of the total proceeds of the tax. Public finance economists generally agree that a tax which costs less than 3% for administration is an economical tax and meets this test.

Convenience

Again Adam Smith writes: "Every tax should be levied at a time, or in a manner in which it is most likely to be convenient for the taxpayer to pay it."

The federal withholding tax on wages and salaries and the timing of property tax due dates in Nebraska are examples of attempts to make tax paying convenient.

Certainty

This criterion includes the requirement that the taxpayer should clearly understand the amount of tax required and how and when it should be paid. Simplicity is an important virtue when dealing with the masses of people involved in taxation but it is not easily realized. Each new law that provides special requirements and exemptions adds confusion and complexity to the problem. Special treatment of dividends, capital gains, retirement income, etc., tends to complicate the income tax. Exempting food, clothing and other items from the sales tax is intended to remove inequities, but causes serious problems of definition. To quote Smith again: "The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor and to every person."

Governmental Tax Requirements

The tax requirements of governmental units coincide in some respects with those of the individual but conflict in other ways. The executive and legislative branches of government are most concerned that a tax system should be: (1) adequate, (2) flexible, (3) stable, and (4) easy to administer.

Adequacy

An adequate tax system provides enough money during a fiscal period to enable administrative officials to carry out their responsibilities. If the tax revenues are not large enough to finance the quantity

and quality of services desired, the appropriate legislative and administrative authorities have two alternative courses of action:

1. Raising rates of existing taxes or imposing new ones.
2. Restricting the scope and/or reducing the quality of services offered.

Flexibility

A flexible source of revenue is one that can be changed easily to meet changing governmental needs. A non-flexible tax system would result in surpluses at times and deficits at other times (if deficits are permitted). The property tax is flexible because a governmental unit can meet changes in revenue needs by raising or lowering the mill levy. The sales tax is relatively inflexible because the rate is usually set by law and can be changed only by changing the law.

Stability

The stability of taxes refers to the effect changes in economic conditions have upon revenue yields. The Great Plains States, with wide fluctuations in annual rainfall and other weather and price hazards, may experience substantial year-to-year variations in economic conditions. Progressive income taxes are much more sensitive to changes in economic conditions than are sales taxes, and sales tax yields respond to changing economic yields more readily than property tax yields. This criterion for a tax system conflicts with the needs of the individual, since a stable tax such as the property tax in times of low income burdens the individual with a fixed cost at a time when other economic pressures are also great.

Ease of Administration

The less complicated the administration of a tax system the lower the administrative cost. Effective administration also is important from the standpoint of equity. No matter how equitable a tax structure appears in form, it is not actually equitable if there is substantial evasion or avoidance of the tax. Generally, the cost of enforcement should not exceed the additional revenue it obtains. This is not a hard and fast rule, however, because strict enforcement not only obtains more revenue from persons trying to evade or avoid the tax but also insures more complete compliance and respect from the rest of the taxpayers. Most people pay their taxes more willingly if they feel they are being enforced equally upon everyone.

Ease of administration varies with the level of government involved in a particular tax. The property tax is comparatively easy to admin-

ister at the local level, while sales and income taxes are generally difficult to administer at that level. Administration of the income tax is difficult and expensive even at the state level unless it can be tied to the federal income tax. Ease of administration, however desirable, should not override the other criteria.

Society

From the point of view of society in general, a tax system should be considered in light of its: (1) effect on economic growth, (2) impartiality, (3) impact, shifting, and incidence, and (4) use for social reform. These criteria also are important to the individual and government.

Economic Growth

Economic growth is the increase in the nation's production of goods and services. Our population is growing and economic growth is needed just to keep our level of living constant. With an increasing population and no economic growth our level of living would decline. However, in the past century our economy has grown faster than the population and, as a result, our level of living has increased. The economic growth that results in an increase in income or level of living is associated with larger and larger investments per worker. These investments may be private or public investments in facilities and equipment, but they also include public and private investments in the education and vocational training of labor.

Taxation should help desirable economic growth. This means that the revenue should be large enough to provide necessary education and training and also should encourage private investment either through various other services or by tax incentives. The impact of taxes upon economic growth varies with the type of tax, the tax rate, and the type of industry. One type of tax may favor one industry while it retards the development of another.

John F. Due has reported a summary of studies of state-local tax influences on the location of industry in the June, 1961 issue of the *National Tax Journal.*[2]

> "Out of this review came three general conclusions:
>
> 1. . . . It is obvious that relatively high business tax levels do not have the disastrous effects often claimed for them. While the statistical analysis and study of location factors are by no means conclusive, they suggest very strongly that the tax effect cannot be of major importance.
> 2. However, without doubt, in some instances the tax element plays the deciding role in determining the optimum location, since other factors

[2] Due, John F., "Studies of State-Local Tax Influences on Location of Industy," *National Tax Journal* (1961), XIV, p. 171.

balance. This is most likely to be the case in the selection of the precise site in a metropolitan area (property taxes being the ones of chief concern), or when a suitable area for site location straddles a state border. But state and local taxes represent such a small percentage of total costs that the cases in which they are controlling cannot be very significant.

3. The tax climate factor, as one element in the general business reputation or climate of the state, without doubt influences some location decision making, by causing firms to exclude certain states or urban areas from consideration. Again, these cases are probably not a significant portion of the total.

"To the extent that firms are influenced by tax factors, a species of Gresham's Law operates: these firms will tend to gravitate to the low tax cost areas. If these low taxes arise from actual economies in the provision of public services, the tax factor reflects a real economic factor and its influence does not distort location from the sites which are most economic. But if this is not the case, tax influences do exercise an undesirable influence, by leading firms to locate in places other than those which involve maximum efficiency in the use of resources. If, for example, the business firm does not take into consideration, or regards as unimportant, or from a community decision that equity requires placing a higher portion of the over-all tax burden on business, the location of the taxes does distort the location pattern from the optimum.

"More serious is the effect on the development of tax structures of the belief of state legislative bodies about the influence of taxation on location. The endless propaganda on the subject and the strategy-inspired announcements of business firms when tax changes are being considered lead many legislators to exaggerate the influence of the taxes beyond any effect which they may have. The result is a potential danger of state cutthroat competition, and more seriously in fact, a major obstacle to reform of tax structures. In terror of 'driving business out' legislatures become unwilling to adjust taxes to levels necessary to meet equity in taxation. States which have made the adjustments seldom retreat from the changes, and find that losses in business activity are not great enough to be noticeable. But efforts of other states to improve their tax structures are seriously impeded. Not infrequently two adjacent states are both in urgent need of tax reform but in each the main obstacle is the fear that industries will be lost to the other."

Impartiality of Treatment

Taxes generally should be neutral with respect to individuals and industries, but the economic situations (income, debt, assets) among these are often entirely different. Some industries, like ware-housing and farming, require a high investment per worker and have a slow capital turnover (one to three years). These industries may be hit hard by a property tax unless the tax can be shifted. Other businesses like grocery and variety stores have a rapid turnover (15 to 30 days) and a very low profit per sale, so they object to gross receipts taxes. Still other occupations, like commission firms, insurance, and personal service, have a very small investment per worker (excluding education) and comparatively large income per sale. People in such occupations are likely to object to an income tax.

It is almost impossible for a tax to be neutral in every respect. The head or poll tax gives the same treatment to taxpayers who are essentially different because of wealth or income and is an example of a non-neutral tax. The property tax with a high rate on tangible and a low rate on intangible property may give unequal treatment to two taxpayers who are essentially similar as to income and wealth, but one of whom has his wealth invested in tangible property and the other in intangible property. This is also an example of a non-neutral tax.

Although none of our present taxes are completely neutral, certain standards have been established for making distinctions between groups and classes of property or income. Most of all, the tax differentiation must be relevant. There should not be a classification for example, which, applies a higher tax to one man because he is taller or because his name is Johnson instead of Williams. The Constitutional requirement that taxes shall be uniform has been interpreted by the courts to mean that all persons or property within a certain class, such as those having the same income or obtaining income from stocks and bonds, shall pay equal tax rates. In the case of identical incomes the classification is reasonable, but the classification between investment in real property or intangible property is somewhat more doubtful.

Distinguishing strict neutrality, unintentional departure from neutrality, and departure from neutrality *in the public interest* is difficult. This is best summed up in the following statement by John R. Commons in his book *Institutional Economics.*

> "Taxation, then, is the most pervasive and privileged exercise of the police power . . . Even when not consciously intended to be regulative, taxes nevertheless regulate, for they, like the protective tariff, determine the directions in which people may become wealthy by determining the directions in which they may not become wealthy. They say to the business man: Here is profit, there is loss. It is impossible to escape the police power of taxation, therefore impossible to look upon taxes of any kind whatever as merely a means of obtaining revenue according to any principle of equality, or ability to pay, or accumulation of wealth or any standard that looks solely to the acquisition of the past."[3]

Impact, Shifting and Incidence

The tax **impact** is on the first person or firm to pay the tax. But the person or firm liable for the tax may be able to **shift** the tax to someone else.

Incidence is the final resting place of a tax. This final resting place in practically all cases is on people, even though the original tax may

[3] John R. Commons, *Institutional Economics* (New York: MacMillan Co., 1934), p. 820.

be on business. Shifting of the tax to someone else may be done legally by avoiding the tax or illegally by evading the tax. In either of these cases the tax is shifted to other taxpayers by narrowing the tax base.

Most of a tax on a business may be shifted to the consumer by reducing the quantity of goods available and charging more if the consumer is local and relatively captive and the demand is less elastic than the supply. Most of the tax may be shifted to the supplier by paying lower prices for purchased items if the demand is more elastic than the supply. Moving to areas that have a low tax rate is another way of avoiding a tax. This is seen in the flight to the suburbs to avoid city taxes. The possibility of avoiding state and local taxes by moving depends on the tax rates and would be eliminated if all the state and local tax rates were the same.

Individual circumstances may affect the ability of investment and labor to avoid a tax by moving out of a taxing district. Present investments in building and improvements generally will not be movable because of the losses involved. People established in a community who own a home and are trained and skilled in a profession can move, but find it difficult. Young people just out of school are quite movable to those areas that give the best opportunities for jobs, wage rates, and cost of living (including taxes).

Taxes are also shifted illegally by evasion. This involves either not filing a return or incomplete or under-reporting of income or personal tangible and intangible property. Harold M. Groves, an authority on public finance in Wisconsin, writing in the first issue of the *National Tax Journal* said that a tax system will lose respect rapidly if evasion reaches the 20% level.[4]

The **incidence** of a tax describes who finally pays the tax after all the tax shifting has been completed. In some cases the tax cannot be shifted. Then, the impact and the incidence would be on the same individual. Some people or industries cannot shift a state or local tax—homeowners, for example, or agriculture and other industries which compete in a national market and cannot effectively reduce the quantity of goods available for sale.

Taxes levied on corporations or other types of business firms and professional and service groups are nearly always passed on. In a highly competitive market most of the corporate income taxes may be passed on to the owners or stockholders. In a market where the firm may be one of the few sellers (e.g. grocery stores) facing many buyers (consumers), most of the business taxes are shifted to the con-

[4] Harold M. Groves, "Neutrality in Taxation", *National Tax Journal* (1948), I, p. 22.

sumers. In a market where the firm is one of few buyers (such as a grain elevator or meat packer) facing many sellers (farmers and ranchers), most of the business taxes are shifted back to the producer. If a tax makes an investment or a potential investment unprofitable, some of the tax is shifted to the employees or potential employees. The incidence of any tax should be known as nearly as can be determined; otherwise the tax may fall on persons or industries which cannot afford it and thus cause damage to economic growth and the interests of the society.

Social Reform

Taxes are sometimes used for social reform by applying low rates and exemptions to encourage certain activities and applying high rates to discourage others. This has always been a controversial subject. Those who oppose this system claim that the tax problem is complicated enough for obtaining revenue without the added confusion of non-revenue purposes. Those who favor such uses of the taxing power claim that this is often the only way the reform can be brought about and that many reforms can be designed so as not to interfere with the revenue system.

Any tax for social reform which seriously interferes with the process of obtaining revenue should be carefully scrutinized. Several taxes which were originally enacted to bring about social reform and have developed into lucrative sources of revenue, cigarette and liquor taxes are cases in point. Again, as with the administrative cost factor, social reform must be secondary to other criteria for a good tax system. If the tax for social reform purposes is likely to produce confusion and interfere with the revenue raising purpose of a tax system, then other methods of accomplishing social reform should be used.

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