The Economics of State Taxation

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Outline

- What are implications of economic theory and empirical research for state tax policy?
  - Basic principles
  - Qualifications
- In general, “common sense” prescriptions based on standard theories
- But must always consider additional implications of three essential factors affecting state tax policy

- Mobility
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- Mobility

- Mobility – of capital
- Mobility – of labor, especially higher skilled labor
- Mobility – of consumers in making purchases

Economic Research and State Tax Policy

- Should States Tax Consumption or Income?
- Should A Consumption Tax Be Uniform?
- Should Businesses be Taxed?
- Should States Use Progressive Income Taxes?
- How to Tax Multi-State Corporations?

Should States Tax Consumption or Income?

- Consumption-based taxation is focus of many efforts at federal tax reform
- Many argue that consumption is superior base
  - Efficiency: Reduce or eliminate distortions of savings decisions, promote growth
  - Equity: Fairer over lifetime (no tax penalties for savers) and can have progressive rates
  - Simplicity: Consumption flows easier to measure than accruing income
- Empirical/simulation evidence: Potential large gains, but depends on nature of plan and transition rules

- Implications
  - State retails sales taxes in theory are a consumption-based tax, so would be desirable
  - Only broad-based consumption tax in U.S. (no VAT), so even more likely to be desirable on efficiency grounds
  - Alternative of income tax exacerbates distortions of federal income tax, with large efficiency costs at margin even at low state tax rates
  - (But assumes sufficient progressivity with federal tax, as state consumption tax not progressive)

- BUT,
  - State sales taxes not true taxes on consumption
  - Typically include many business purchases – roughly 40% of base on average
  - Implies tax is haphazard tax on income
  - Violates “production efficiency theorem” – under certain circumstances, avoid taxes on inputs entirely, using only appropriate set of taxes on consumption goods

- Results in tax pyramiding – multiple layers of tax prior to retail stage
  - Distorts decisions regarding investment across inputs and across sectors
  - Distorts consumption decisions
  - Encourages vertical integration
  - Creates tax bias against small firms
  - Creates tax bias against exporters
  - Effective rates greater than nominal rates

Should A Consumption Tax Be Uniform?

- On efficiency grounds, not necessarily – want to tax at higher rates goods that are not price sensitive to minimize distortions
- BUT
  - Such goods are necessities, so want to tax at lower rates for equity reasons – effects cancel?
  - Administrative concerns argue for neutrality
  - Political concerns argue for neutrality

- And (Atkinson-Stiglitz theorem), if income tax set appropriately to achieve equity goals, do not need commodity tax differentials (under certain circumstances)
- So, for consumption taxes, economic efficiency reasonably approximated by economic neutrality
- Empirical evidence suggests that rate differentials do distort consumption decisions, and moves toward uniform rate structure increase efficiency

- Implications for state tax policy
  - Use broad-based tax, low-rate on consumption
  - Mobility problems: cross border sales, remote (Internet and mail order) sales – only solution is remote vendor tax collection, so SSTP crucial
  - Achieve equity goals with income tax adjustments or rebates (not poorly targeted preferential rates or exemptions for goods purchased by poor)
  - Avoid taxes on business inputs, tax pyramiding (unless offset missing C-taxes, e.g., services), but monitor closely to limit avoidance

Should Businesses Be Taxed?

- Benefit taxes are efficient and equitable as payment for services received – highly desirable if difficult to implement
- Proxy benefit taxes are reasonable approximation, but must determine what benefits are most closely linked to – e.g., production, property, (not income), …
- Are taxes beyond benefit tax levels desirable?

- States are “small open economies” – facing fixed prices of capital (and tradable goods)
- Implies production-based taxes on capital are counter-productive, from resident perspective
  - Drive out mobile capital, until after-tax rate of return equals national (or international) return
  - Immobile local factors – land and labor, at least relatively immobile labor – bear whole tax burden, plus efficiency costs
  - Might as well tax labor, consumers directly

- Most recent empirical work suggests investment responsive to tax differentials, mobility increasing
- Main qualifications to argument
  - Need corporate tax backstop to personal income tax
  - Want to tax economic rents, at least immobile location-specific rents (assumed taxed in production efficiency theorem)
    - But resource rents can be taxed separately, e.g., with mineral production taxes
    - Are other location-specific rents significant, can they be measured and taxes?

- Implications for state business tax policy
  - Utilize benefit taxes, or reasonable proxies for benefit taxes
  - Avoid business taxes in excess of benefit tax levels
  - Use mineral production taxes (or cash flow taxes) to capture resource rents
  - Attempt to capture location-specific rents?
  - Potential for exportation of state taxes (business and consumption) very limited

Should States Use Progressive Income Taxes?

- Same "small open economy" argument applies to skilled labor, if such labor is perfectly mobile
- Feldstein-Wrobel empirical evidence argues mobility sufficient to make redistribution impossible, and adjustment is fast (but results controversial)
- State tax progressivity muted by federal tax deductibility, to extent available (only sales or income tax deductible, AMT)

- Implications for state tax policy
  - Redistribution accomplished much more effectively at national level – not essential that personal income taxes at all levels be progressive
  - State expenditure policy typically redistributive
  - State personal income tax should at most be moderately progressive

How to Tax Multi-State Corporations

- If use state corporate tax, must apportion income of multi-state corporations
- Formula apportionment converts CIT to tax on factors in formula – labor, property, sales
  - Just tax these factors directly
  - To avoid driving out mobile labor and property, many states increase sales tax weight
  - But sales tax component is effectively true gross receipts tax – maximizes pyramiding

- Implications for state tax policy
  - Another argument for avoiding corporate income tax, a production-based tax on highly mobile capital
  - Note: Formula apportionment issues must be resolved in many of the recently enacted and proposed tax reforms to be discussed today, including state origin-based value-added taxes used as benefit taxes

The End

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