

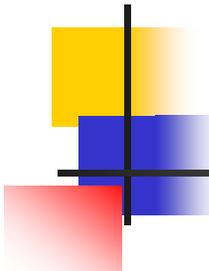
The Economics of State Taxation

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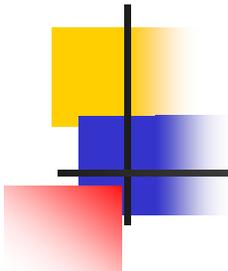
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Outline

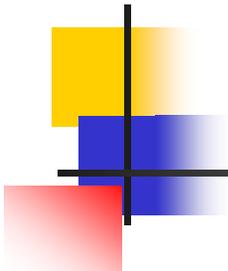
- What are implications of economic theory and empirical research for state tax policy?
 - Basic principles
 - Qualifications
- In general, “common sense” prescriptions based on standard theories
- But must always consider additional implications of three essential factors affecting state tax policy

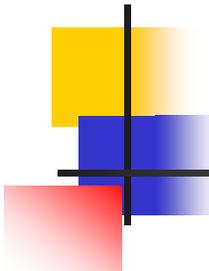


- Mobility

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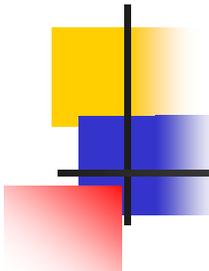
- Mobility

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



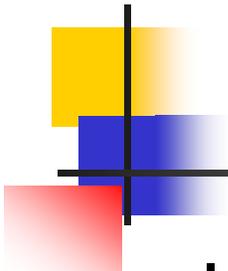
Economic Research and State Tax Policy

- 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?



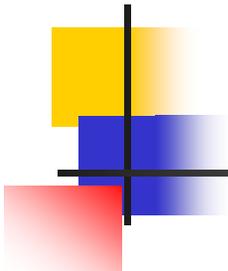
Should States Tax Consumption or Income?

- 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



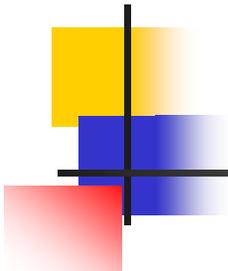
■ Implications

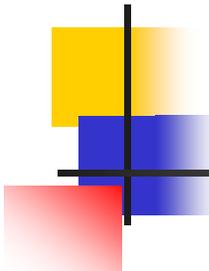
- State retail sales taxes in theory are a consumption-based tax, so would be desirable
- Only broad-based consumption tax in U.S. (no VAT), so even more likely to be desirable on efficiency grounds
- Alternative of income tax exacerbates distortions of federal income tax, with large efficiency costs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



- BUT,

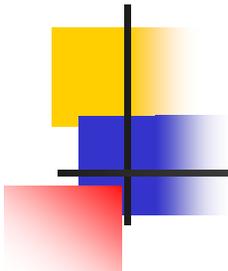
- State sales taxes not true taxes on consumption
- Typically include many business purchases – roughly 40% of base on average
- Implies tax is haphazard tax on income
- Violates “production efficiency theorem” – under certain circumstances, avoid taxes on inputs entirely, using only appropriate set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

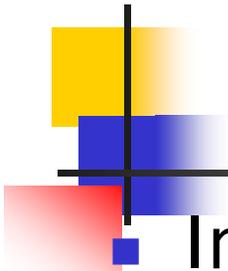
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- Results in tax pyramiding – multiple layers of tax prior to retail stage
 - Distorts decisions regarding investment across inputs and across sectors
 - Distorts consumption decisions
 - Encourages vertical integration
 - Creates tax bias against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



Should A Consumption Tax Be Uniform?

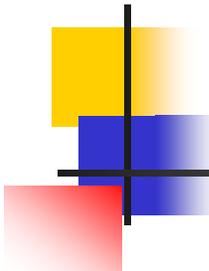
- On efficiency grounds, not necessarily – want to tax at higher rates goods that are not price sensitive to minimize distortions
- BUT
 - Such goods are necessities, so want to tax at lower rates for equity reasons – effects cancel?
 - Administrative concerns argue for neutrality
 - Political concerns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

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- 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



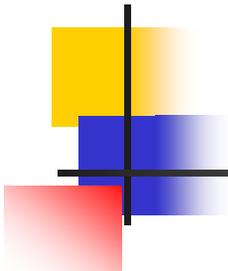
■ Implications for state tax policy

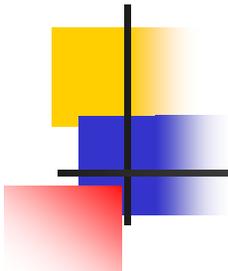
- Use broad-based tax, low-rate on consumption
- Mobility problems: cross border sales, remote (Internet and mail order) sales – only solution is remote vendor tax collection, so SSTP crucial
- Achieve equity goals with income tax adjustments or rebates (not poorly targeted preferential rates or exemptions 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

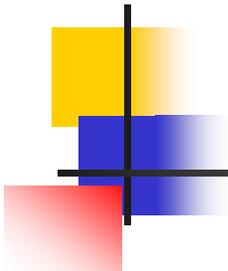


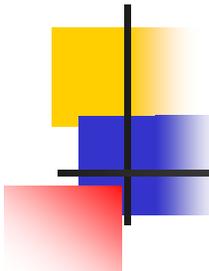
Should Businesses Be Taxed?

- 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?

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- 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

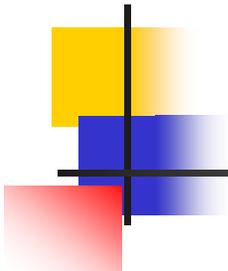
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- Most recent empirical work suggests investment responsive to tax differentials, mobility increasing
 - Main qualifications to argument
 - Need corporate tax backstop to personal income tax
 - Want to tax economic rents, at least immobile location-specific 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?

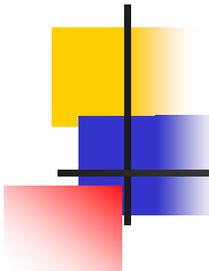
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- Implications for state business tax policy
 - Utilize benefit taxes, or reasonable proxies for benefit taxes
 - Avoid business taxes in excess of benefit tax levels
 - Use mineral production taxes (or cash flow taxes) to capture resource rents
 -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



Should States Use Progressive Income Taxes?

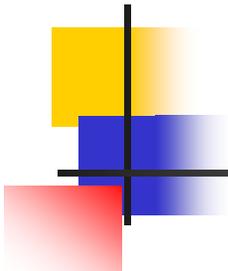
- Same “small open economy” argument applies to skilled labor, if such labor is perfectly mobile
- Feldstein-Wrobel empirical evidence argues mobility sufficient to make redistribution impossible, and adjustment is fast (but results controversial)
- State tax progressivity muted by federal tax deductibility,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

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- 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

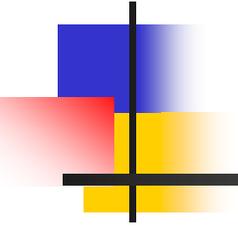
- If use state corporate tax, must apportion income of multi-state corporations
- Formula apportionment converts CIT to tax on factors in formula – labor, property, sales
 - Just tax these factors directly
 - To avoid driving out mobile labor and property, many states increase sales tax weight
 - But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

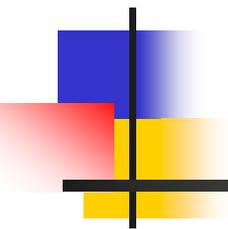


- Implications for state tax policy

- 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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