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 – 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
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 a 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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