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ECONOMIC PERSPECTIVES

STATE AND LOCAL TAX POLICY

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As state tax systems grow increasingly complex, it helps to have a framework for evaluating their structure. States usually implement taxes that fall into one of three categories—income, property, and consumption—but there is substantial variation in how each of these taxes can be structured. When trying to balance the many competing goals for setting tax policy, state policymakers can use five main criteria to compare the benefits and drawbacks of potential tax instruments: economic efficiency, equity, transparency, collectability, and revenue production.[1]

The balancing of these criteria helps raise enough revenue to fund government services while minimizing the number of distortions to the economy. Some of the criteria can conflict with each other, and there are tradeoffs associated with prioritizing one criterion over another. For example, a tax that is easier to collect and produces more revenue relative to alternative methods may actually be very harmful for the economy. This summary provides a condensed overview of these nuances in setting tax policy and provides specific examples of the tools available to state policymakers.

ECONOMICALLY EFFICIENT TAXES PROMOTE GROWTH

A tax is considered more economically efficient the less it distorts decision-making. Taxes distort behavior when they cause individuals to make different choices than they would have made absent the tax. These distortions can manifest through the altering of choices in pricing, timing, location, or product quality. General guidelines that can help minimize the number of distortions in the economy include:

- *Lower tax rates.* Lower taxes place less of a burden on households and firms, leaving them more residual income to make purchases that optimize their own well-being.
- *Broader tax bases.* The most economically efficient taxes are generally those that fall on all like taxpayers evenly. Following this principle helps prevent the

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distortive effects caused by a tax system that introduces more deductions and itemization increases.

Research finds that higher state taxes are generally associated with lower economic performance.[2] There is somewhat weaker evidence[3] that state and local taxes can significantly reduce income growth within a state, particularly when the revenues raised are devoted to transfer payments.[4] More recent research corroborates this finding in relation to net investment and employment.[5] However, when additional tax revenue is used to improve the quality of public goods and services, economic growth may increase. When looking at business activity more broadly, more comprehensive reviews of the literature find higher taxes to be associated with less economic growth.[6] They also find this relationship to be stronger within metropolitan areas than across metropolitan areas,[7] which means that local taxes have a larger effect on economic growth when it is less costly for firms and taxpayers to relocate to avoid the tax.

A more economically efficient tax system can also greatly improve a state's competitiveness. States that increase their income tax rates more than their neighbors do have slower per capita income growth.[8] It should be noted that states with higher taxes also tend to have higher *levels* of economic activity. This does not suggest that the higher taxes lead to higher incomes. Rather, it suggests the inverse—states with higher income levels may feel that they have more room to raise taxes. Pursuing such policies, however, can greatly diminish a state's competitiveness. This is demonstrated by research that shows increases in state tax rates to be associated with a decline in in-migration.[9] Mercatus research corroborates this finding with evidence that higher state income taxes cause net out-migration at both the state and local levels.[10]

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When it comes to choosing between different tax instruments, consumption and property taxes tend to be relatively more economically efficient than income taxes. Research demonstrates that shifting from the reliance on income taxes to consumption or property taxes can lead to greater economic growth.[11] State policymakers interested in reaping the benefits of more economically efficient taxes should consider the following recommendations:

- *Income taxes should have more precise definitions of income.* Income taxes are more distortive when the

way income is defined becomes less precise. Imprecise definitions of income make it difficult for taxpayers to calculate their tax burden. This can distort the choice of how much income to generate since they will not know the marginal tax burden they face. Less distortive income taxes tend to define income as the taxpayer's purchase of goods and services plus the change in their net worth. This is considered a more precise measurement of the taxpayer's ability to pay, and any definitions that move away from this can cause economic efficiency to decline.[12]

- *Ensure comsumption taxes are general*. Consumption taxes can be a sound choice when they are general in nature and only applied to the final sale of a good. Selective consumption taxes, or taxes that target specific goods, are economically inefficient. These taxes are often created on paternalistic grounds, under the assumption that policymakers can make better consumption choices for citizens than citizens can make for themselves. Not only do these taxes often fail to meet their stated intentions,[13] but they lead to unproductive and defensive lobbying by the affected industries.[14] Additionally, consumption taxes that are applied at more than one stage of production can be distortive. Gross receipts taxes, for example, apply to business-to-business transactions as well as to the final sale of the good being produced. This type of tax incentivizes firms to consolidate or produce a good in-house rather than purchase it from outside the organization, even if contracting with another firm would be more efficient.[15] A general consumption tax—like the retail sales tax—may be preferable because it only applies to the final purchase of a good.

AN EQUITABLE TAX SYSTEM IS A FAIR SYSTEM

A tax is considered equitable when similarly situated individuals or businesses face the same tax obligations. States have many taxes that violate this criterion because of how they disproportionately benefit some individuals and businesses at the expense of the general public. Policymakers interested in an equitable system should pursue taxes that have both horizontal equity and vertical equity.

- *Horizontal equity* occurs when two similarly situated taxpayers also face the same tax obligations. For example, a tax lacks horizontal equity when two consumers purchase the same amount of goods or services but pay a different amount in sales taxes.

- *Vertical equity* occurs when two taxpayers who have the same income face the same tax obligations. A tax lacks vertical equity when the amount of the tax does not change with the taxpayer's ability to pay. A progressive tax is when the tax bill faced by a taxpayer rises as the ability to pay increases. The opposite scenario, when the total tax burden rises as the ability to pay declines, is called a regressive tax.

The potential benefits of a more equitable tax structure have been demonstrated using data from Nebraska, where there is evidence that eliminating tax privileges and simultaneously lowering tax rates could save an average Nebraskan family more than $3,200 per year if the benefits of tax reform are evenly distributed.[16]

As tax obligations begin to fall unevenly on the population, the separation between the taxpayers and the citizens who actually benefit from the tax spending begins to widen. Research demonstrates that this inequity can lead to higher government debt and greater entitlement spending.[17]

State policymakers interested in improving the equity of their tax systems should pursue the following recommendations:

- *Flatten income taxes.* Most state income taxes are relatively progressive, with tax obligations rising as income rises. This is often pursued as a method to address income inequality, but research has demonstrated that despite state policymakers' efforts, progressive taxation does little to affect income inequality.[18] The many deductions and credits present in state income taxes also raise concern about horizontal equity. For instance, two individuals with similar incomes purchasing similarly priced houses can face different tax burdens depending on whether they finance the purchase with a mortgage or pay for it from savings.[19] Moving toward flatter tax rates, removing the number of exemptions, and modifying the range of tax brackets can help address these equity concerns.

- *Consumption taxes should be general.* Consumption taxes perform slightly better than income taxes from an equity standpoint; however, they have the potential to be highly regressive when they target specific types of goods.[20] Selective consumption taxes are often created with benevolent-sounding intentions, such as curbing consumption of harmful goods, but they are borne disproportionately by low-income households.[21] For example, the taxation of purchases at fast-food restaurants is more burdensome for low-income households because larger fractions of their budgets are spent on these goods relative to higher-income households.

- *Improve property reassessment processes.* The reassessment process that determines the property tax base lends itself to inequities because of the difficulty of uniformly assessing property at market values. Research shows that property taxes can be regressive in that high-valued properties receive proportionally smaller assessments than low-valued properties.[22]

TRANSPARENCY LEADS TO MORE INFORMED VOTERS

More transparent tax systems make it easier for citizens to understand the true cost of the government services they receive. A tax that is transparent is clear in how it is calculated and how much revenue it should produce. This allows citizens to predict the tax implications of any

choice they make, and it alleviates concerns of corruption in the administration of tax policy.

Complex tax systems are often the result of increased political pressure. Politicians face the incentive to minimize how costly their spending projects appear in order to improve election prospects. This can lead them to employ tax "gimmicks" that conceal the size of the tax burden.[23] When a tax is more hidden, it allows politicians to more easily direct funds to special interests.

A specific example of a less-transparent tax practice is when politicians dedicate portions of tax revenue to specific expenditure categories. There is evidence that this practice, also known as earmarking, increases total government size, while having little effect on the programs that are supposed to be funded with these dedicated tax revenues.[24] Other tax collection practices that decrease transparency include income tax withholding and employer-paid taxes.

State policymakers interested in improving the transparency of their taxes can do so through:

- *A simpler tax structure*. More complex tax structures can mislead taxpayers to support new spending projects that they wouldn't approve of if they had a more complete picture of the costs.[25] A simpler tax structure allows citizens to make more informed choices.

- *Citizen education*. Improving citizen knowledge of the tax burden includes providing information on the scope, benefits and costs, and financing of government services. States can educate taxpayers through taxpayer receipts that display how much of a citizen's taxes fund each government program.[26] States can also provide websites that display budget information in an easily accessible manner.[27]

More specific changes that policymakers can make to their tax instruments in order to improve transparency include:

- *Flatter income taxes*. States have reported issues with tax preparation software—caused primarily by the many itemizations, deductions, exemptions, and credits that differ tremendously across the states and federal government.[28] Moving toward an income tax with fewer exemptions could alleviate this problem.

- *Straightforward consumption taxes*. Consumption taxes become less transparent with more exemptions. The gross receipts tax, which does poorly on economic efficiency grounds, also does poorly in this area. Since it applies to each transaction in the production process, it creates a tax pyramiding effect that renders it difficult for tax-collecting businesses to inform taxpayers what share of the price is caused by taxes.[29] The value-added tax and the retail sales tax, in contrast, are more straightforward for the taxpayer to calculate.

- *Clearer calculation of the property tax*. Policymakers at the local level have been

shown to take advantage of the complicated nature of property reassessments in order to generate extra revenue.[30] When property values rise, this decreases the visibility of the tax burden and allows policymakers to raise additional revenues without the transparency of a rate hike. States can reduce this problem by clarifying how property taxes are calculated through the reassessment process and by lowering property tax rates to adjust for extra revenue following property value increases. Despite issues with the reassessment process, property taxes are in general more transparent than income and consumption taxes.

COLLECTABILITY REDUCES COSTS

Taxes that require relatively few resources to administer and enforce are considered highly collectable. When the collection responsibility and the supply of information for computing the tax base and tax rate fall on the taxpayers—as with sales taxes—the tax is taxpayer active. In contrast, when the responsibility falls entirely on government agencies, as with property taxes, the tax is taxpayer passive.

State policymakers interested in improving the collectability of their taxes should consider the following recommendations:

- *Enforce income taxes.* The income tax is considered a collectable tax because increases in tax rates have very modest effects on taxable income.[31] The three main types of enforcement problems that inhibit collectability are non-filing, underreporting, and underpaying of tax bills. The largest issues for state governments include inaccurate reporting from the self-employed and wealthy taxpayers who have multiple residences. The good news is that state governments are able to benefit from federal enforcement efforts because data from audits are shared.

- *Simplify consumption taxes.* Since consumption taxes are taxpayer active, the collection costs fall largely on the businesses collecting them. More complex taxes increase the cost of doing business by making it more difficult for businesses to calculate the taxability of their goods. This becomes especially challenging when it comes to interstate transactions and the taxation of online services. An "origin-based" sourcing rule—where states would tax all sales inside their borders equally, regardless of the buyer's residence or the ultimate location of consumption—is a potential solution to the burdensome collection costs facing businesses.[32]

- *Collect property taxes in a timely manner*. Property taxes are highly collectable because the tax is levied against the property rather than the person who owns it, making the taxes difficult to avoid. The main hindrance to their collectability is when local governments do not actively pursue tax seizures upon unpaid liabilities. This is because the legal process for collecting long overdue property taxes can be very costly for local authorities.[33]

REVENUE PRODUCTION

Raising revenue is the primary purpose of most taxes, but the amount of revenue a particular tax raises does not always justify its undertaking. This is because a tax's revenue production is limited by pressures such as what tax rates are considered socially acceptable, the size of the taxable base, and the responsiveness of the tax base to the amount of the rate.

State policymakers interested in improving the productivity of their tax systems should pursue the following:

- *Competitive income taxes.* The ability of the income tax to produce revenue is limited by the collectability challenges mentioned above as well as how responsive citizens are to the tax. The economics literature finds that income taxes are revenue-enhancing, which means that for any marginal increase in the tax rate, revenue also increases.[34] However, this does not mean that legislators can increase income tax rates indefinitely. Increases in tax rates are constrained by the mobility of taxpayers, especially for local governments. If policymakers increase the income tax rate, citizens may be incentivized to relocate to nearby areas with lower rates.

- *General consumption taxes with broad bases.* Although they are less popular with the general public, consumption taxes can raise revenue without punishing savings, especially when they have broad bases.[35] State policymakers should be cautious about narrowing the bases of their consumption taxes, as this can decrease their revenue production and adversely impact the state's budget.

- *Property taxes.* Property taxes are the largest proportion of local revenues and are also a relatively stable revenue source.[36] The productivity of property taxes is greatly diminished when states impose limits on local property tax revenue growth. These limits can substantively lower the level of property tax revenue.[37] Restricting property taxes can bring financial hardship on cities that can cause policymakers to search for additional revenue sources that are often more distortionary, such as sales or income taxes and other fees.

LINKS

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