State Income, Sales and Consumption Taxes

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Principles of efficient and effective state taxation.

- Efficient taxes raise revenue effectively and with the least associated economic distortions.
- Given the competitive positions and small sizes of American states, the most efficient taxes are those on relatively immobile bases:
  - Land and other real property
  - Personal expenditures
- The least efficient taxes are those on activities whose levels respond most to taxation:
  - Business income, property, and activity
  - Personal income, including capital income
- The international evidence is that historically smaller countries have relied much less on business and personal income taxes, and more on expenditure taxes, than did larger countries (though the gap may be closing).
- The reason is that business and personal income taxes rapidly become very inefficient when imposed by small jurisdictions. Economic activity flees, and tax bases erode.

How then can California increase the efficiency of its tax system?

- The obvious answer is to tax land and other real property at higher rates.
- The next most obvious answer is to rely more on expenditure taxation and less on business and personal income taxation. This can be accomplished not only by increasing sales tax rates but also by expanding the sales tax base, itself an efficiency-enhancing gesture.
- It is possible to maintain tax progressivity by combining higher sales taxation with progressive adjustments to the income tax. Such a reform conceives of the sales tax as the primary producer of additional revenue, the income tax adjustments being designed to achieve appropriate distribution of final tax burdens.

How can states tax expenditures?

- General sales taxes serve this function, but typically have numerous exemptions that create inefficient distortions and erode revenue bases.
- Excise taxes on things like gasoline, tobacco, and alcohol are forms of expenditure taxation that can be tailored to discourage undesired activities, and have significant revenue potential, albeit at the expense of creating incentives for noncompliance.
- It is very difficult for states to try to tax expenditures indirectly by imposing a value-added tax (VAT), as Michigan's experience illustrates.

The Michigan experience with a form of value-added taxation.

- Michigan introduced its Business Activities Tax (BAT) in 1953.
  - This was a type of origin-based subtraction-method income VAT (how's that for tax jargon?) The tax applied to incorporated and unincorporated businesses.
  - Firms paid tax equal to 0.75% of: (sales to any destination minus purchases from other firms minus depreciation on real property): no deduction for labor expenses, and no depreciation deductions for equipment expenditures, on the theory that the equipment might move to other states.
  - Michigan dropped the BAT in 1967, replacing it with a corporate income tax as part of a general movement to introduce income taxation at the personal and corporate level.

Corporate income taxation in Michigan.

- Michigan had a corporate income tax from 1968-1975, with rates of 5.6% (1968-1970) and 7.8% 1971-1975).
- Economic cycles produced large annual fluctuations in state corporate tax revenue, as is so often the case:
  - 1969: $ 210m ($ 1047m in 2001 dollars)
  - 1971: $ 151m ($ 649m in 2001 dollars)
  - 1973: $ 358m ($ 1,347m in 2001 dollars)
  - 1975: $ 236m ($ 783m in 2001 dollars)
- Michigan replaced its corporate income tax (and 6 other business taxes) with the Single Business Tax in 1976.

The Michigan Single Business Tax (SBT), 1976-2007.

- This looked more like a value-added tax than its predecessor, the BAT.
- All firms paid tax equal to 2.35% of: (nonfinancial income minus purchases from other firms, including capital expenses). There were also some adjustments.
- Expenses for structures in Michigan were fully deductible; multistate firms deducted a portion of their total U.S. equipment expenditures, based on the Michigan fraction of their employment and tangible capital.

The SBT over time.

- There were several challenges in Michigan (!) courts over the constitutionality of the SBT treatment of investment expenditures, which the state narrowly won each time on appeal.
- In 1999 the deduction for investment expenses was replaced by an investment credit at a low (0.85%) rate for real investments in Michigan and for an apportioned fraction of total U.S. equipment investment of multistate firms.
- The 1999 legislation phased the SBT out of existence by 2021; in 2002 the elimination date was advanced to 2009, and in 2006 the elimination date became the end of 2007.
- The current Michigan Business Tax (2008-present) taxes both income (at 4.95%) and modified gross receipts (at 0.8%); there is a temporary 22% surcharge.

Pros and cons of the Single Business Tax.

- Why Michigan adopted the SBT in 1975.
  - The new tax structure could be designed to cover the revenue shortfall that year.
  - The SBT was a more stable revenue source.
  - The SBT permitted firms to deduct capital expenses, so did not discourage investment.
  - The SBT treated incorporated and unincorporated businesses the same.
- Why Michigan abandoned the SBT in 2006.
  - Firms had to pay the SBT even when making losses.
  - The legislature was unwilling to give generous treatment to investment expenditures made in other states.
  - The SBT tax burden was heavy.
  - Oh, and there was a looming statewide referendum calling for repeal.

Value-added taxation in one state.

- The problem of treating multistate businesses is formidable, given allocation formulas (which states use) rather than separate accounting (which is used internationally).
- Tax burdens in Michigan were high: to reproduce the SBT revenues with a corporate income tax between 1977-1998, the corporate tax rate would need to have been 14.3%, by far the highest in the country.
- The use of an origin-basis tax reduces the likelihood that tax burdens are passed on to consumers, so local business activity, local employment, and local wages are reduced instead.
- The flip side of creating stable state tax revenues is that taxpayers face tax burdens that do not decline as much as their incomes do during economic downturns.

The future of state tax revenues.

- The world is moving strongly in the direction of expenditure taxation and away from business and personal income taxation; the United States has been slow to join this trend.
- More than 134 countries have adopted national value-added taxes, including 29 of the 30 richest countries (the United States being the exception).
- Since it is problematic for states to use VATs, their sales and excise taxes offer the best opportunity to raise revenue by taxing expenditures. Obtaining significant revenue from other sources is difficult due to the mobility of income and economic activity.
- It is not really a question of whether, but when, states will increase their reliance on expenditure tax bases, since the alternatives become increasingly costly as barriers to mobility fall.