

# Tax Policy is Economic Policy

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# Outline

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- Goals of tax policy
- California's goals and options



# A good tax system is:

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- Equitable
- Minimally volatile
- Administratively simple
- Adequate to cover spending
- Predictable by taxpayers
  
- Efficient



# What does “efficient” mean?

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- Minimizes distortions to free-market outcomes
  - Free market usually supposed to be right
- Does not cause households or businesses to change behaviors, such as:
  - What households buy
  - Whether businesses hire
  - How much households save
  - Where businesses locate
  - How much employees work
- Also called “neutrality”



# Simple tax illustration

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- Prior to tax, market sells 100 bottles of wine, \$10 each
- Impose \$1 tax on buyers
  - Fewer buyers for \$10 bottles
  - Pre-tax price falls somewhat
- Hypothetical outcome:
  - Bottle sells for \$9.50, buyer pays \$10.50
  - 90 bottles sold
- Where's the “distortion”?
  - Tax means 10 bottles unsold – mutually advantageous wine sales don't happen



# Taxes and efficiency

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- Distortion depends on:
  - Square of tax rate
  - “Elasticity”: sensitivity of behavior to prices
- Neutrality implies we want to:
  - Use *broad-based* taxes with *low rates*
  - Tax what or who is least responsive



# Which behaviors are elastic?

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- More elastic = more sensitive to price
- Behaviors more elastic if possible to substitute across:
  - Products (e.g. home-cooked vs. restaurant meals)
  - Time (e.g. buying TV this year or next)
  - Space (e.g. moving back-office functions to Nevada)



# Example: responses to gas prices

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- Short run
  - Transit
  - Carpool
  - Telecommute
- Medium run
  - Switch to more fuel-efficient car
  - Move closer to work or activities
- Long run
  - Denser housing construction
  - Industry-wide fuel-efficiency



# The efficiency-equity tradeoff

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- Minimizing distortions favors:
  - Taxing necessities more than luxuries
  - Taxing immobile factors rather than mobile factors
    - E.g. land
  - Lump-sum taxes
  - Broad base with low rates
- But low-distortion taxes tend to be more regressive



# Can taxes have economic benefits?

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- Externalities, imperfect information, etc.
- Taxes can “correct” market outcomes
  - “Sin” taxes
  - Environmental taxes
  - Subsidies for charitable giving
- BUT: tradeoff between revenue and changing behavior
  - More revenue if behavior changes little
  - Less revenue if behavior changes a lot



# The challenge states face

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- Easier to shift activity across states than countries
  - Where households live (personal income tax)
  - Where households shop (sales tax)
  - Where businesses locate (corporation tax)
- Mobility greater among:
  - Rich than poor
  - Tradables than non-tradable industries
  - Labor and capital than land



# Main points so far

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- Taxes discourage the taxed behavior
- Tax systems should be efficient (i.e. minimize distortions), but:
  - Tradeoff between equity and efficiency
  - Some taxes correct distortions



# Outline

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- Goals of tax policy
- California's taxes and policy goals



# Selected California taxes

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- Personal income tax
- Sales and use tax
- Corporation tax
- Vehicle license fee
- Carbon or gas tax
- Mortgage interest deduction



# Potential California policy goals

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- Minimizing economic distortions, and:
  - Economic stimulus
  - Improving the business climate
  - Lowering carbon emissions (AB 32, SB 375)



# Personal income tax

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- Broad-based
- Disincentive to work and to save
  - Important in long-run, perhaps less in recession
  - Encourages sheltering income or changing sources
- Effect on spending varies
- Mobility could limit tax rate, especially for rich



# Sales and use tax

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- Moderately broad-based; services excluded
- Taxing sales discourages new purchases
  - Lowering sales tax would be economic stimulus
  - Yet higher sales tax might encourage saving
- Temporary changes could shift purchases over time
- Some cross-state shopping



# Corporation tax

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- How responsive are businesses?
  - Very little actual business relocation
  - Need to look at all sources of job change
- One element of business climate
  - California ranks poorly on indices
  - But economic performance strong relative to U.S.
    - Open question how much tax differentials matter
    - Taxes might buy productivity advantages



# Vehicle license fee

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- Short-run, little distortion: tax falls primarily on past purchases
- Longer-run: encourages cheaper or no car purchase
- Could work for or against environmental goals
  - Large vehicles less fuel-efficient and more expensive
  - Delays purchases of newer cars



# Carbon or gas tax

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- Clearest example of correcting a free-market distortion
  - Pollution is classic negative externality
- Helps meet environmental and revenue goals
- Downsides:
  - Are high-energy-using businesses mobile?
  - Not broad-based: falls heavily on some industries or users



# Mortgage interest deduction

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- Tax system encourages homeownership
  - Mortgage interest deduction without taxing imputed rent
  - Capital gains exclusions
- Reducing state mortgage interest deduction would:
  - Raise revenue while correcting distortion
  - Reduce inequity
  - Fall heavily on construction industry and slow house-price recovery



# Wrap-up

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- Every revenue option can be assessed by:
  - Extent of economic distortion
  - Likely behavioral response
- Taxation-induced behaviors could work for or against broader policy goals
  - Economic stimulus
  - Business climate
  - Lowering carbon emissions

