



Thinking of Tax Policy as a Portfolio

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Introduction

One function of government is to provide goods and services that citizens need and want but which are not provided effectively by the private sector (police, courts, education, roads, economic security, etc). In order to provide these services, the government must impose taxes to pay for them. Tax policy is an important dimension of economic development policy for two reasons. First, investors are more likely to invest, and employees are more likely to take jobs, in states and localities where taxes are perceived to be lower (Bartik 1994, Wasylenko 1997). Second, investors are more likely to invest, and employees are more likely to take jobs in states and localities where public services are perceived to be higher quality and more accessible. Obviously better services are generally more costly so the most attractive states and localities are those that carefully strike a balance between, and choose the right mix of, taxes and public services. Thus the right mix of taxes, and tax reform to obtain that mix, can be a direct, immediate and long-term strategy for economic development.

This report summarizes the criteria used by economists to evaluate state tax systems and then applies the criteria to Missouri state and local taxes to indicate how various income groups fare under Missouri's tax system. It concludes with recommendations about how the system could be revised, without necessarily increasing the overall level of state and local taxes.

Criteria for Evaluating Tax Systems

A state can tax virtually anything that it chooses but the objective is to develop taxes and a tax system that serve the broad needs of society in an efficient, fair and supportive way. Taxes may be evaluated according to their economic efficiency, the extent to which they keep the state competitive, as well as their administrative simplicity, revenue adequacy and fairness. Using these criteria it is clear that there is no single best tax and that relying on a single tax exposes the state to shortcomings on many of the criteria. Of particular concern at the moment is an adequate and stable revenue stream for state government. A portfolio of taxes, similar to a portfolio of investments, allows the balancing of the negative aspect of one tax with positive aspects of another tax. Consequently, selecting taxes and designing a tax system for state and local revenues is a process of trade-off and compromise between the following desirable features:

Administrative simplicity - Is the tax easy to comply with and to administer or do the administrative costs use a large proportion of the revenues collected?

Competitiveness - Does the tax encourage business or individuals to leave Missouri or limit the state's ability to attract business?

Efficiency - Does the tax interfere with efficient allocation of resources and consumer choices?

Revenue adequacy - Does the tax allow the state to meet the needs of its citizens in good times and bad?

Equity - Is the tax fair? Equity refers to the principle of ability to pay. A progressive tax charges a higher percentage to wealthier taxpayers while a regressive tax does the opposite. Most people accept the proposition that a regressive tax, one that imposes a greater proportional burden on those with lower incomes, is not equitable.

Administrative simplicity and cost effectiveness:

A simple tax system is one that is easy for the taxpayer to understand and one that is both easy and inexpensive for the public sector to administer. Research finds that personal and corporate income taxes and the property tax have higher administrative costs than other types of taxes in the current state tax portfolio. Because the property tax is assessed locally, the state has almost no administrative costs for this tax, while some of the costs of sales tax administration are borne by the private sector that must collect the tax and forward it to the state. Tying state income taxes to the federal tax, as Missouri does, lowers the state's administrative costs.

Economic competitiveness: A competitive tax system does not handicap the ability of firms to compete with those located outside the state and does not limit the state's ability to attract new business. In 2007, Missouri ranked in the bottom ten states in the nation in terms of overall taxes per capita and per \$1,000.00 of income (Cox, Morris and Leatherman, 2010). This suggests that in general, Missouri should be competitive for business.

- Missouri's effective corporate income tax is low in comparison with other states. The combined corporate income tax and franchise license/tax per capita and per \$1,000.00 of income rank in the lowest 10 states.
- Missouri also ranks among the lowest ten states on personal income tax per capita and per \$1,000.00 of income.
- Missouri ranks in the bottom 20 states on both property taxes per capita and per \$1,000.00 of income. Thus the state should be competitive for all types of firms, including capital intensive firms.
- Missouri ranks in the bottom 20 states on sales taxes per capita and in the middle 10 states in sales taxes per \$1,000.00 of income. This is the tax on which Missouri ranks the highest. Missouri's two major cities are located on state borders. Because the neighboring states have higher sales tax rates

than Missouri, it is likely that significant sales are made to residents of Illinois and Kansas.

- Some states maintain a relatively low tax rate, but increase licenses, fees, and miscellaneous taxes and charges. Missouri ranks in the bottom 10 states on licenses fees and miscellaneous taxes per capita and in the bottom 20 per \$1,000.00 of income.

Missouri ranks among the lowest states in overall taxes. It also ranks low on the individual taxes. Its highest rank on an individual tax is in the middle 10 states on sales taxes per \$1,000.00 of income. If tax rates alone determined the rate of economic development, Missouri would have one of the most robust economies in the country.

Economic efficiency: An efficient tax system does not interfere with the efficient allocation of resources or consumer choices, that is, it does not encourage businesses and/or individuals to make economic decisions based upon their tax consequences.

- A broad-based tax is more efficient than the same tax with a narrow base, in part because it is more difficult to avoid the tax. Because a broad-based tax is difficult to avoid, firms and individuals will not make decisions just to avoid the tax.

* A broad-based sales tax would tax all goods and services, including internet sales. The authors estimate that the state may have lost approximately \$26 million in internet sales tax revenues in 2009. Services are the fastest growing part of the national economy and generally are not subject to sales tax (Tannenwald, 2001). A broader base provides the same revenue at a lower tax rate.

* A broad-based personal or corporate income tax would have few exemptions, deductions and tax credits.

- Taxing goods which have deleterious consequences increases efficiency. Pollution is an example. Taxing polluting goods (such as gasoline), or the pollution itself, will reduce their use, resulting in lower costs to others and increased efficiency.
- Taxing goods with lower sensitivity to price changes (inelastic supply or demand) will create a smaller inefficiency than taxing other goods. Examples include:

* Land: The supply of land does not change as price goes up or down. The supply of real estate in the short run is also relatively inelastic.

- * Food: The overall demand for food does not change as much with price as the demand for other consumer goods

Taxing goods based on their elasticity would result in different tax rates for different goods. This is an example of where there would likely be a trade-off between efficiency and administrative costs. But the result would be overall lower tax rates and greater economic efficiency.

Revenue adequacy: An adequate tax system is able to generate sufficient revenue to meet public needs as population, incomes and the economy grow or decline. Each tax has its own response to an economic cycle. This is the idea behind portfolio management of private investments - a balanced portfolio provides a trade-off between risk and short run and long run revenues. Applied to taxes it means that a portfolio of taxes, rather than a reliance on a single tax, will provide more stable revenue performance.

A recent article published by the Kansas City Federal Reserve (Felix 2008) shows that among the states in the Tenth District, Missouri has the most volatile tax revenues.

- For Missouri the corporate income tax revenues are the most volatile.
- Personal income tax revenues are the second most volatile. Capital gains, particularly from stocks, contribute to the volatility of income tax revenues.
- The general sales tax revenues are the next most volatile. Diversifying the sales tax base by including services may reduce volatility.
- Selective sales tax revenues—alcohol, cigarettes and gasoline - are the least volatile. The quantities

consumed grow less slowly than income, but also do not decline much in a downturn.

- Generally the property tax is the most stable revenue source, although during the current housing crisis they have fallen significantly in some states, particularly on both coasts (Felix, 2008).

Equity or fairness: The equity of taxes is typically evaluated by looking at the distribution of the tax relative to the taxpayer's ability to pay. However, it is not clear how much of a difference in income constitutes a different ability to pay, nor what tax rates are equitable at different income levels.

Data assessing the equity of Missouri's tax system are presented in the table below.

- The property tax (mainly a local tax) is regressive because it is passed on to renters in their rent and because their home is the major asset of middle class families.
- Taken collectively, state sales and excise taxes are regressive.
- The state income taxes and corporate income taxes are progressive. In addition to the lower tax rate on the first \$9,000.00 of income, other provisions of the law contribute to the tax being progressive. Examples of these provisions include the property tax circuit breaker for low income households and deductions of a percentage of public pensions and social security income for those with incomes below a particular threshold.
- While there is a mix of regressive and progressive taxes, overall the state and local tax system of Missouri is regressive.

Percentage of income paid in state and local taxes by income group

Income Group	Lowest 20%	Second 20%	Third 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	Top 1%
Income Range	Less than \$17,000	\$17,000 to \$31,000	\$31,000 to \$50,000	\$50,000 to \$81,000	\$81,000 to \$156,000	\$156,000 to \$412,000	\$412,000 or more
Average Income in Group	\$10,000	\$24,200	\$40,400	\$64,300	\$107,300	\$226,900	\$1,170,600
Sales& Excise Taxes	6.00%	5.30%	4.30%	3.70%	2.70%	1.80%	0.90%
Property Taxes	2.80%	2.30%	2.40%	2.40%	2.40%	2.20%	1.30%
Income Taxes	0.80%	2.10%	2.80%	3.30%	3.70%	4.00%	4.40%
Corporate Income Tax	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.10%
TOTAL TAXES	9.60%	9.60%	9.50%	9.40%	8.90%	8.00%	6.60%
Federal Deduction	-0.0%	-0.1%	-0.3%	-0.6%	-1.2%	-1.2%	-1.2%
TOTAL TAXES AFTER OFFSET	9.60%	9.50%	9.20%	8.80%	7.60%	6.70%	5.40%

Note: Table shows 2007 tax law updated to reflect permanent changes in law enacted through October, 2009

Source: Institute on Taxation and Economic Policy. "Who pays state and local taxes?" 3rd edition. 2009.

<http://www.itepnet.org/whopays3.pdf>

Recommendations

Tax policy is always a contentious political issue. The criteria outlined here provide tools that can be used to assess the merits of a given proposal, as well as existing state tax policies. Although easily expressed, it is difficult for states to craft and maintain tax structures that balance these criteria, so no portfolio will be perfect. In addition, economies change continuously while tax systems change very little.

Based on the principles above, we suggest that the economy of the state would be stimulated by a series of revenue-neutral tax reforms that include:

1. Broadening the sales tax base to include services and internet sales;
2. Reducing exemptions, deductions, credits and incentives in the corporate and personal income taxes;
3. Minimizing the administrative costs for citizens and the state by simplifying compliance procedures;
4. Increasing relative dependence on excise and pollution taxes; and
5. Increasing relative dependence on land taxes.
6. Reducing the dependence on general sales taxes;
7. More reliance on progressive taxes, such as the income tax, to assure that the tax system at a minimum is not regressive.

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Suggested Citation

Stallmann, Judith I., and Thomas G. Johnson. (2011). "Thinking of Tax Policy as a Portfolio" Report 14-2011. Retrieved [Month Day, Year], from University of Missouri Columbia, Institute of Public Policy Web site: <http://ipp.missouri.edu>