Tax Structure Design--Economic Principles

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Why should the tax structure matter?

- The revenue burden is not the only aspect of taxation that matters
- different tax structures have different “hidden” burdens

Tax structures can differ in four important ways

- different economic incentives and disincentives
- different distributions of the tax burden
- different responses to growth and fluctuations in economic activity
- different “running” costs of administration and compliance

Non-economic considerations may also be important

- timing of tax payments (lumped or spread out)
- visibility (transparency) of the tax burde
- legal issues such as *nexus*
- predictability by the taxpayer
- privacy and intrusiveness

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Tax rates may vary from one economic activity to another

- Higher than average *effective* tax rates (due to statutory rates or *pyramiding)* discourage activities
- Lower than average *effective* rates (reflecting statutory rates, exemptions, deferrals or credits) encourage activities
- *Uniform* tax rates neither favor nor disfavor one activity over another--such a tax structure is said to be *neutral*

A tax structures that imposes a low *excess burden* is desirable

- excess burden is caused when economic decisions reflect tax differences rather than economic values
- excess burden is a hidden burden due to lost economic efficiency
- high and differential tax rates create the largest excess burdens
- A broad-based uniform tax structure imposes a lower excess burden

Examples of tax differentials in WA structure

- exemptions of groceries and many services under the RST
- tax pyramiding under RST and B&O
- different property tax rates by use
- different local sales and use tax rates (may be offset by benefits)
- "tax-free" internet, catalogue and out-of-state shopping

Tax rate differences and user fees can increase economic efficiency

- high rates on goods and services that exhibit low price responsiveness
- high taxes on external-cost (e.g., pollution-causing) activities
- User fees for government goods and services that have high “privateness”
- congestion and impact fees

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Distributions may differ in *fairness*, *tax-exporting* and *competitiveness*

- distributions over WA households determine *fairness*
- distributions over residents and non-residents determine *tax-exporting*
- distributions over households and enterprises determine *competitiveness*

Several (sometimes conflicting) concepts of fairness exist

- *ability-to-pay principle*--taxpayers' burdens should reflect ability to pay tax.
- *benefit principle*--taxpayers' burdens should reflect benefits received
- *horizontal fairness*--"equal" taxpayers should bear equal tax burdens
- *vertical fairness*--"unequal" taxpayers should bear appropriately unequal tax burdens

A tax structure that is less regressive is desirable

- one study finds taxes are 17% of incom for lowest quintile vs 7% for highest
- all sales taxes are regressive because spending/income ratio falls with income
- regressivity of RST reduced by exempting more "necessities"
- Such exemptions make tax less uniform hence less "efficient"

Benefit principle explains some features of the tax structure

- benefit principle may limit resistance to some regressive taxes
- earmarking used to connect tax revenues to benefits
- decline in share of MV fuel tax linked to decline in state spending on roads
- user fees considered fair if benefits focused narrowly on payer

Non-residents lack “standing”, so *tax-exporting* is desirable

- states are legally restricted in ability to directly tax non-residents
- most obvious form of direct tax-exporting is tourism taxes
- some taxes levied on residents may be “shifted” to non-residents
- main means of tax exporting is federal deduction offset

S&L taxes deductible from federal taxable income can be exported

- a fraction of property tax and business-paid RST and B&O is exported in WA
- additional exporting possible by switching from sales to income tax
- BP figure is \$5.8 b. x .6 x .75 x .25 x .9 = \$640 m.
- initiatives abolishing MVET and limiting property tax reduce tax-exporting

Business-household tax "balance" affects *competitiveness*

- ultimately, all business taxes are shifted to households
- businesses limited in ability to shift taxes by interstate commerce
- tax burdens higher than in other states discourage firms from locating in WA

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A tax structure that provides more stable revenue is desirable

- WA is obligated to balance state budget
- stabilization (rainy day) funds prove difficult to conserve
- an unstable revenue stream can cause state fiscal crisis
- budget balance by means of expenditure changes aggravates state business cycle

Tax structures differ in their cyclical revenue variability

- corporate income tax among the most variable
- property tax among the least variable
- no clear advantage of income tax over sales tax on cyclical variability
- variability of sales tax increased by exempting necessities and services

Studies show that WA has one of the more variable tax structures

- measured by *short-run* elasticity of revenue to state personal income
- average elasticity for WA is 2.15 over 1972-93 period
- comparable figure for Oregon was 1.04
- same study does not find WA RST as source of variability

A tax structure that provides suffic-ient revenue growth is desirable

- government spending grows with population, income and inflation
- revenue growth insufficient if *long-run* revenue elasticity less than 1
- LR elasticity in WA estimated at 1.25
- growth in tax-exempt services and internet shopping poses problem for sales tax systems

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A tax structure that has low "running cost" is desirable

- running cost = administration, monitoring, enforcement and private compliance costs
- running cost of income tax minimized if federal system imitated
- running cost increases exponentially with tax rate and complexity
- simple, broad-base, low-rate tax structures have lower running cost