How Would Leading Federal Tax Reform Options Affect State and Local Governments?

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Reform options

- Individual income tax base-broadening and statutory tax rate reduction
- Corporate income tax base-broadening and statutory tax rate reduction
- Reduce corporate taxes, raise shareholder taxes (possible accrual taxation of gains)
- Partial replacement of income tax with VAT
- Full replacement of income tax with X tax

Possible effects of reforms

- Administrative and conformity effects
- Real economic effects – change in incentives to use state government to produce output, redistribute
  - Federal tax treatment of state government production
  - Federal tax treatment of state transfers
  - Use example to analyze economic effects for three of the reform options

Administrative and Conformity Effects

Individual and corporate base broadening

- Limited administrative effects
- For states that conform to federal base, revenue would rise at unchanged tax rates

Shareholder taxation

- Limited administrative effects if federal government still taxes realized gains
- If federal government taxes accrued gains, difficult for states to still tax realized gains – if states conform to accrual taxation, revenue would rise at unchanged tax rates

Partial-replacement VAT

- States may find it administratively convenient to replace sales taxes with conforming VATs – state VATs would need to be apportioned
- If federal income tax narrowed to apply to only high-income taxpayers, difficult for states to maintain mass income tax

X tax

- With federal business cash flow tax, difficult for states to maintain traditional corporate income tax
  - States might conform, but could turn to gross receipts (margin) taxes
  - Need to apportion state cash flow taxes
- With federal individual tax only on wages, difficult for states to tax capital income

Federal Tax Treatment of State Government Production

Simple example

- Immobile labor, no capital
- State imposes wage tax to finance public park – hires some employees and some independent contractors
- Compare combined federal tax burden to corresponding burden on production of private recreation facility

Current-law treatment

- Wage tax partially deductible
  - Deducted against income tax by non-AMT itemizers
  - Not deducted against payroll tax
- Employees' wages subject to income tax, maybe payroll tax – contractors' wages subject to income and payroll taxes

Current law favors public park

- Deduction for state taxes, but not for charges paid to private recreation facility
- Possible payroll tax exemption for state employees, but not for private employees
- May be valid policy arguments for differential treatment

Individual base broadening

- Any curtailment of state-tax deduction would raise federal tax burden
- No net change in employees' and contractors' taxes
- Treatment less favorable than current law
- But, still more favorable than treatment of private facility (payroll-tax exemption, any lingering state-tax deduction)

Key VAT policy choice

- Does state government pay VAT on wages paid to its employees?
- Many VAT (and sales tax) proposals include such a provision – FairTax, Cruz, Paul
- Provision has been criticized (largely due to misunderstanding of the economics)

VAT in isolation

- Imposing VAT on state wages causes public park to be treated same as private facility
- Not imposing VAT on state wages treats public park more favorably, but only for employees (not contractors)
  - Artificial incentive to hire in-house
  - Incentive could be removed by zero-rating payments to contractors

Partial-replacement VAT

- Scaling back income tax reduces value of its state-tax deduction
- Scaling back income tax and adopting VAT with tax on state wages clearly reduces relative tax advantage of public park
- Scaling back income tax and adopting VAT without tax on state wages has ambiguous effect

X tax

- Little change if household X tax allows state-tax deduction on similar terms as current income tax
  - Employees clearly will pay household tax on their wages
- Tax advantage for public park reduced if state-tax deduction curtailed or eliminated

Federal Tax Treatment of State Transfers

Simple example

- Immobile labor, no capital
- State imposes wage tax – makes “social welfare” transfer payment
- Current-law federal income tax favors transfer payment
  - Deduction for wage tax
  - Exclusion of transfer payment

Individual base broadening

- May reduce current-law favoritism by curtailing state-tax deduction or taxing transfer payment

Partial-replacement VAT

- In isolation, VAT provides no favorable treatment for transfer
- Scaling back income tax reduces current-law favoritism

X tax

- No change if household component of X tax provides similar treatment of state taxes and transfers
- Transfers likely to remain excludable, but state-tax deduction may be curtailed or eliminated

Extensions

- Consider other state taxes, with different federal tax treatments
  - State employer payroll taxes are (implicitly) fully deductible against federal income and payroll taxes
  - User fees are not deductible
- Allow labor mobility, capital

Extensions (continued)

- Generalize type of state output
- In some cases (inputs into private production, health care, etc.), private counterparts receive federal tax relief
- In those cases, federal tax system may not treat state output more favorably than private output