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