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# The Personal Income Tax as a Component of State Tax Structure

*William F. Fox\**

## I. INTRODUCTION

This Article evaluates the pros and cons of a state individual income tax from the perspective of an economist. The Article examines the income tax as one component of a tax structure that is best suited for raising a given level of revenues. The important assumption in the analysis is that the level of state public expenditures is determined by residents' demand for public services. This assumption does not preclude the tax structure from allowing greater or lesser expenditures than are demanded during any single year; rather, the assumption is that over time tax levels provide revenues that are in accord with consumer preferences for public services.

There are two basic implications to this assumption. First, it is unnecessary to consider how the revenues will be spent to determine whether an income tax is a desirable revenue generator. Second, based on this assumption, an income tax (or any tax) is most effectively evaluated relative to another tax because the existence of an income tax will result in either a direct replacement of or a decrease in another tax. All taxes are politically and economically disadvantageous when analyzed by themselves, so each tax is best judged relative to other taxes. At the state level, the income tax is best evaluated relative to the sales tax. Thus, the analysis below is frequently a comparison between the characteristics of an income and a sales tax. There are other taxes that could be compared with the income tax, but these levies generally would be limited revenue generators in comparison to sales and income taxes.

Part II of this Article is a brief overview of the current practice in state income taxation. Part III considers the pros and cons

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of using an income tax as a revenue generator, including analysis of the tax's potential as a revenue generator, the economic effects of the tax, the equity implications raised by the tax, and the administrative concerns in using the tax. Part IV draws together these pros and cons to reach a conclusion.

## II. INCOME TAX SUMMARY

Income taxes are the second largest source of state tax revenues, generating 30.0 percent of tax revenues in 1984.<sup>1</sup> Only the sales tax, which is responsible for 31.8 percent of revenues, contributes more.<sup>2</sup> Both taxes provided a greater share of revenues in 1984 than a decade earlier in 1974, but the income tax share has risen dramatically from the 23.0 percent share it provided in 1974.<sup>3</sup> Income tax revenues grow faster relative to economic conditions than most other state taxes, and this faster growth is likely to be the most important reason for the increase in its revenue contribution. The rapid growth means that the increase in the tax's share of revenues is likely to be widespread across those states that use an income tax, as opposed to being isolated in states that enacted rate increases. Professors Bowman and Mikesell reported that between 1971 and 1980 twenty-two states significantly increased the percentage of their revenues raised by an income tax.<sup>4</sup> On the other hand, Mikesell recently concluded that growth in the percentage of total taxes contributed by the sales tax is mostly the result of greater use of the tax by a small number of states.<sup>5</sup>

These statistics are useful for understanding average behavior, but they fail to reflect the diversity that exists across states. Forty-two states have income taxes, including Tennessee and New Hampshire, which tax only interest and dividend income.<sup>6</sup> Twenty states raise between 25 percent and 35 percent of their revenues

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1. UNITED STATES BUREAU OF THE CENSUS, STATE GOVERNMENT FINANCES IN 1984, Series GF84, No. 3, at 1 (1985).

2. *Id.*

3. UNITED STATES BUREAU OF THE CENSUS, STATE GOVERNMENT FINANCE IN 1974, Series GF74, No. 3, at 7 (1974).

4. Bowman & Mikesell, *State-Local Tax Structure Changes, 1971-1980*, 1981 PROC. OF THE SEVENTY-FOURTH ANN. CONF. OF TAX'N 202, 204.

5. Paper presented by John Mikesell at the Seventy-Eighth Annual Conference of Taxation, National Tax Association: Tax Institute of America (1985), to be published in 1985 PROC. OF THE SEVENTY-EIGHTH ANN. CONF. OF TAX'N.

6. [1985] 46 ST. TAX REV. (CCH) No. 51, at 4. Connecticut, which is not included in the 42, also has a tax on interest and dividend income for taxpayers with more than \$50,000 in federal adjusted gross income. *Id.* at 9.

from the income tax, but at the extremes, some generate zero revenue and Oregon receives 65.8 percent of tax revenues from an income tax.<sup>7</sup>

Most states use progressive tax rates: thirty-three have their own progressive tax structure, and three levy the state tax as a percentage of the federal tax liability, thereby accepting federal progressivity.<sup>8</sup> The income level at which the highest marginal tax rate is reached often is low; thus, for many taxpayers, the tax may appear essentially proportional. Six states, including Tennessee and New Hampshire, have flat rate income taxes.<sup>9</sup> Minnesota has the highest marginal tax rate at 14.0 percent.<sup>10</sup>

Every state with an income tax, except for Tennessee and New Hampshire, allows withholding.<sup>11</sup> Fifteen states permit federal tax payments to be deductible in some form.<sup>12</sup> Forty of the forty-two states permit residents a credit for taxes paid in other states, but in some cases this credit is only given if reciprocity agreements exist.<sup>13</sup>

### III. THE PROS AND CONS OF AN INCOME TAX

This section addresses four main issues: the ability of the income tax to provide revenues, the equity implications of an income tax, the administrative and compliance implications of the tax, and the effects of an income tax on efficiently operating economic markets. This list of issues is not unique to the author, but is a standard set used by public finance economists for studying tax structures. The emphasis on topics within the list, however, may differ from what others would consider appropriate. The resulting conclusions provide mixed support for the income tax vis-a-vis a sales tax. To reach a conclusion about the degree to which a state income tax is an appropriate way to generate revenue for any particular state requires balancing the positive and negative aspects of the tax.

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7. UNITED STATES BUREAU OF THE CENSUS, STATE GOVERNMENT FINANCES IN 1984, Series GF84, No. 3, at 10-11 (1985).

8. [1985] 46 ST. TAX REV. (CCH), No. 51, at 8-19.

9. *Id.*

10. *Id.* at 14. Oklahoma has a 17.0% rate for people who choose to deduct their federal income tax when calculating their Oklahoma liability. *Id.* at 17.

11. *Id.* at 4.

12. *Id.*

13. *Id.* at 5.

### A. *Contribution of an Income Tax to Revenue Needs*

The assumption made at the Article's beginning implies that expenditure levels determine revenue needs for a state. Analysis of the tax structure's ability to provide for revenue needs can be divided into consideration of the tax's stability and the tax's adequacy. Revenue stability refers to the ability of the tax structure to provide sufficient revenues during each part of a business cycle. This concept differs from revenue adequacy, which is the ability of the tax structure to allow enough revenue growth to provide sufficient revenues over the long term. A revenue structure can be adequate in the sense that sufficient revenues are provided on average over a number of years and yet be unstable in that the revenue flow varies widely from year to year. The reverse also could be true. Unstable tax structures create the revenue shortfalls that cause deficits and impoundments during economic recessions. Inadequate revenues generate the need to raise tax rates because of an inability to finance desired services.

#### 1. Revenue Adequacy

Consider first the role that an income tax can play in achieving revenue adequacy. Given the assumption that demand for services sets long-term expenditure patterns, it follows that an adequate tax structure is one in which the income elasticity of revenues (revenue elasticity) is equal to the income elasticity of expenditures (expenditure elasticity). When these two elasticities are equal, states can maintain service levels without increasing tax rates. Some evidence on expenditure elasticities is available and would suggest that the elasticity for many services is likely to be in the range of one, or perhaps a little less.<sup>14</sup> Thus, the revenue elasticity over a large number of years should also be approaching one if the structure is to be adequate. Expenditure elasticities differ by state; so some difference in tax structure is appropriate.

The income elasticity of state income taxes (revenue elasticity) appears to be relatively high. McHugh estimates that the inflation elasticity (the elasticity from a nominal, but not real, increase in income) ranged from 1.6 to 2.2 for the six states he examined.<sup>15</sup> He

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14. See Inman, *The Fiscal Performance of Local Governments: An Interpretive Review*, in *CURRENT ISSUES IN URBAN ECONOMICS* 270 (1979) (reviewing local government expenditure elasticities).

15. McHugh, *Income Tax Indexation in the States: A Quantitative Appraisal of Partial Indexation*, 34 *NAT'L TAX J.* 193, 197 (1981).

indicated that indexing the taxes for inflation would allow revenue elasticities in most of the six states to be in the range of one.<sup>16</sup> In practice, however, indexing is not used in all states. Inman estimates that the revenue elasticity for local government income taxation is 1.2.<sup>17</sup> Both Wasylenko and Greytak and Thursby found the New York income tax to have an elasticity of approximately 1.3.<sup>18</sup> A reasonable conclusion is that in most cases a state using an income tax to generate all of its revenues would have a revenue elasticity that would exceed the expenditure elasticity.

Sales taxes are likely to have much lower revenue elasticities.<sup>19</sup> Fox and Campbell found the long-term elasticity of the sales tax in Tennessee to be 0.59.<sup>20</sup> The elasticity for many of the selective sales taxes, such as those on cigarettes and alcoholic beverages, are likely to be even lower. Thus, a state that relies on consumption taxes to generate most of its revenue is likely to have an inadequate tax structure. In Tennessee, which generates about seventy-five percent of its revenues from consumption taxes and only two percent from an income tax, the legislature has been forced to enact five major tax rate increases (corporate and sales taxes) since 1971 to keep state tax revenues nearly constant as a percent of personal income. Kentucky, which uses a more balanced tax structure, has had no major rate increases during the same time period.

The discussion of tax adequacy indicates that a tax structure based substantially on either income or consumption is likely to be inadequate unless the demand for public services is either highly elastic or highly inelastic (the expenditure elasticity is either very high or very low). The income-tax-dominated state could generate too much revenue, prompting efforts to reduce rates, as occurred through Propositions 13 and 4 in California during the 1970s. The consumption-tax-dominated state could generate too little revenue, requiring frequent rate increases as in the Tennessee experience.

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The income tax elasticity will depend on the characteristics of the tax's structure, such as the degree of progressiveness and the size of the personal exemptions.

16. *Id.*

17. Inman, *supra* note 14, at 290.

18. Greytak & Thursby, *Functional Form in State Income Tax Elasticity Estimation*, 32 NAT'L TAX J. 195, 197 (1979); Wasylenko, *Estimating the Elasticity of State Personal Income Taxes*, 28 NAT'L TAX J. 139, 142 (1975).

19. The income and sales tax bases are probably similar in size for many states because many business purchases are taxed under state sales taxes. The different revenue elasticities mean that the income base will become increasingly larger.

20. Fox & Campbell, *Stability of the State Sales Tax Income Elasticity*, 37 NAT'L TAX J. 201, 207 (1984).

Only a state that balances its tax structure with both consumption and income taxes is likely to achieve an adequate tax structure. This balance permits states to keep services at desired levels without the politically difficult actions associated with frequent tax rate changes. A state with somewhat higher tastes for government services may need to rely more on an income tax, and a state with somewhat lower demands may need to rely more on a sales tax, but significant use of both taxes will be necessary in most states.<sup>21</sup> A state that can tax particularly unique resources, such as oil (in past years) or tourism, provides an exception to this finding. These few states may not need the balanced tax structure to achieve adequacy.

## 2. Revenue Stability

Revenue stability is the other issue to be considered when evaluating the role that an income tax would play in providing for revenue needs. The tax elasticity described above represents the relationship between revenue growth and income growth over a number of years. In practice, however, the elasticity varies across business cycles, and this variation is the important issue for examining the tax's stability. A stable tax can be defined as one in which the short-term (year-to-year) elasticity varies in a countercyclical manner. Stability is thus defined in terms of the dynamics of revenue growth rather than in a static sense, which would define stability as the collection of a constant amount of revenue. The definition means that the elasticity would rise in a recession and fall in an expansion and the changing elasticity would have the effect of reducing the swings in revenue *growth* rates across business cycles. A truly stable tax by this definition probably does not exist, yet the concept is most useful in a comparative sense.

Little study has been done on the stability of the income tax, but an income tax that had a proportional tax rate and taxed all sources of income would have an elasticity exactly equal to one at all points across the business cycle. Progressive tax rates, large personal exemptions, and significant exclusions from taxable income would make the tax elasticity vary in a procyclical fashion. That is, the elasticity probably rises in expansions and falls in recessions,

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21. More rapid revenue growth for income taxes means that states will become more income tax oriented over time and this trend would require infrequent adjustments in the structure.

the inverse of revenue stability. Overall, however, an income tax would not appear to be as unstable as a sales tax unless it were very progressive with large personal exemptions. In a study of Tennessee's sales tax, Fox and Campbell demonstrated that the sales tax is highly unstable: between 1975 and 1982 it had short-term income elasticities as low as 0.16 and as high as 0.92.<sup>22</sup> The highest elasticities were found to occur in expansion years and the lowest during recession years.<sup>23</sup> The instability arises because of differences in the items that are purchased across the business cycle. It should be noted that sales taxes with very broad bases will be the least unstable; attempts to improve sales tax equity by eliminating food from the base, therefore, have the effect of making the sales tax more unstable. The instability and inadequacy of sales taxes compound at the end of a recession. Sales tax revenue growth during a recession generally has been very slow, and the elasticities coming into an expansion are too low to offset the effects of the recession.

In conclusion, a more stable tax structure can be achieved with greater use of an income tax. This conclusion is not accepted by all students of public finance and, in fact, runs counter to the current conventional wisdom.<sup>24</sup> Even if the income tax were unstable, the high elasticities in an expansion generally are sufficient to overcome the slow revenue growth that occurs during a recession. With a sales tax, the elasticities in an expansion are not high enough to overcome the weak revenue growth in a recession.

### B. *Economic Effects of an Income Tax*

This section examines three types of economic effects of taxes: first, the distortions in behavior that arise when taxes affect the decisions that people make; second, the effects that taxes have along the border of a state; and third, the effects that taxes have on employment growth.

#### 1. Tax Effects on Decisions

Every tax that state governments impose will create some distortions in behavior by influencing some individuals to change their decisions. Income taxes will distort the choice between earn-

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22. Fox & Campbell, *supra* note 20, at 209.

23. *Id.* at 208-09. The effects of other factors, like changes in the inflation rate, are held constant in the Fox and Campbell analysis.

24. See C. PENNIMAN, STATE INCOME TAXATION 11 (1980).

ing income and taking leisure because only labor is taxed. Income taxes also distort the choice between present and future consumption because the return earned by deferring consumption (interest) is taxed. A consumption tax (general sales) also will distort the choice between earning income and taking leisure because the spending of income will be taxed, but leisure will not. Furthermore, a general consumption tax will distort the choice of what goods are consumed because even a general sales tax fails to tax all consumption.

These distortions are well known to economists. One frequent use of this information is to design the tax structure to encourage a particular public policy objective by taxing in a way that encourages desirable behavior or discourages undesirable behavior. State economies, however, are very open, meaning it may be difficult for states to achieve significant policy objectives through choice of a tax structure. Furthermore, state government taxes often will create smaller incentives for behavior than federal taxes. The ability to create incentives is particularly limited in the case of the income tax simply because the state's tax structures are lower. Thus, the use of tax structures to promote policy objectives probably is better achieved at the federal level. Despite this drawback, Penniman notes that all states have used the income tax to achieve various social purposes.<sup>25</sup> Nevertheless, at the state level the best approach is to be aware of the distorting effects of tax alternatives and to choose the alternatives that create the smallest distortions. These distortions should be minimized because well-being is always reduced when taxes change behavior. Again, this argument implies that a balanced tax structure is most suitable for state governments because it would keep the tax rates low and, therefore, the distortionary effects for each tax at a minimum.

## 2. Border Effects

One set of economic effects that arise because of different state tax structures, but that is much less important at the federal level, is the border tax effects. These occur along state borders because of differences in the tax structure across state lines. Examples of border effects are when lower taxes on tobacco or alcohol products or lower general sales tax rates induce people to cross state lines to make purchases. Avoidance of taxes through these mechanisms may be illegal, but enforcement is very difficult. An-

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25. *Id.* at 65.

other example is when professionals choose to live and operate their businesses in a state without an income tax and still serve clients from across the state's borders. This strategy permits the professionals to avoid paying the state income tax.

A recent study examined the importance of these border effects for sales taxes.<sup>26</sup> The study concluded that in two Tennessee metropolitan areas one percent of sales was lost for every one percent increase in the state sales tax rate.<sup>27</sup> In the Clarksville-Hopkinsville metropolitan area, where the tax differentials are the greatest, the loss estimate was nearly four percent for every one percent increase in the sales tax rate.<sup>28</sup> Tennessee does not have a general income tax and imposes much higher sales tax rates (state and local rates combined) than most of its neighbors; so the border effects can be large. Tennessee also has higher selective sales tax rates than many of its neighbors.

Border tax effects will arise along state borders, and these effects cannot be easily eliminated by administrative means (enforcement, for example). Naturally, each state maintains the prerogative to tax by the means it deems appropriate, but undesirable border effects can be created by that choice. The best way for a state to minimize border effects is to make its tax structure similar to its neighbors', both in terms of the tax sources used and the rates that are levied.

### 3. Employment Effects

The final issue for economic effects is how taxes influence employment growth in a state. The influence of a tax on employment is not a completely separate issue from the border effects, but the focus here is on the entire state rather than the narrow area along the border. A recent study by Wasylenko and McGuire provided some limited information suggesting that high income taxes can discourage employment growth in the wholesale and retail trade and finance industries.<sup>29</sup> In particular, their research indicates that high tax rates for the highest income (over fifty thousand dollars)

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26. W. Fox, D. Ploch, P. Price & S. Bott, *The Effect of Differential Tax Rates on Consumption Behavior and Government Revenues* (June 1985) (copies may be obtained from the Center for Business and Economic Research, The University of Tennessee, Knoxville).

27. *Id.* at 28.

28. *Id.* at 15.

29. See Wasylenko & McGuire, *Jobs and Taxes: The Effect of Business Climate on States' Employment Growth Rates*, 38 NAT'L TAX J. 497 (1985).

residents can discourage employment in these industries.<sup>30</sup> The authors also suggest that the sales tax rate can discourage wholesale trade employment.<sup>31</sup> On the other hand, the findings reveal that the expenditure of tax revenues on education can increase employment.<sup>32</sup> Overall, there is very little evidence to support an assertion that a low rate income tax would cause greater employment losses than the alternative tax that would be used. In fact, judicious expenditure of the tax revenues could increase employment.

### *C. Equity Implications of an Income Tax*

The income tax must be evaluated relative to two concepts of equity—horizontal and vertical. Horizontal equity usually is interpreted to mean that people with the same taxpaying capacity should pay the same taxes. Vertical equity means that people with different taxpaying capacity should pay different taxes. The degree to which these people should pay different taxes depends on one's view of whether progressive, regressive, or proportional taxes are desirable.

#### 1. Horizontal Equity

As currently used, both sales and income taxes suffer from horizontal equity problems. People with the same taxpaying capacity (frequently measured by income) can pay very different income taxes depending on how they earn their income. For example, in some cases it is possible to earn interest from municipal, state, or federal securities without paying taxes on the income. Earning income through fringe benefits is another way to avoid income taxes. The same holds true of sales taxes because people with the same taxpaying capacity will pay different taxes depending on how they spend their income. The most effective way to eliminate the horizontal equity problem is to insure that the tax base is as broad as possible. This principle is often violated when efforts are made to exempt items from taxation to improve vertical equity.

#### 2. Vertical Equity

Vertical equity can be defined by an economist, and taxes can be categorized according to their vertical equity characteristics, but a decision on which tax is preferable is a value judgment about

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30. *Id.* at 505-08.

31. *Id.*

32. *Id.* at 506.

whether progressive, regressive, or proportional taxation is desired. None of these vertical equity concepts is inherently better. Income taxes usually are structured as either proportional or progressive depending on the choice of rates, use of personal exemptions, and breadth of the tax base. Sales taxes are regressive in essentially every case, although they become less regressive when food and other "necessities" are excluded from the base.

The individual taxes should not be considered in a vacuum. The choice of a sales tax, an income tax, or some combination on vertical equity grounds should be made with consideration of the entire tax structure. Many of the smaller selective sales taxes and fees that states impose are likely to be regressive in their incidence. Thus, substantial reliance on an income tax would likely make the overall state tax structure proportional to slightly progressive. By contrast, reliance on a sales tax to provide most state revenues almost certainly will mean that the whole tax structure is regressive. A slightly regressive to proportional tax structure can be obtained by balancing sales and income taxes. Overall, Musgrave and Musgrave estimate that the existing state and local tax structure is proportional,<sup>33</sup> while Phares concludes the structure is regressive to about ten thousand dollars income and roughly proportional above that level.<sup>34</sup>

In a recent public opinion poll by the United States Advisory Commission on Intergovernmental Relations, those sampled were asked to identify the most *unfair* tax. The federal income tax with thirty-eight percent was chosen by the most respondents, followed by the local property tax with twenty-four percent, the state sales tax with sixteen percent, and the state income tax with ten percent.<sup>35</sup> The percentage choosing the state income tax was one percentage point lower than the finding of a similar poll a decade earlier.<sup>36</sup> These polls suggest that the state income tax is not as unpopular as the other major taxes, but this lack of unpopularity probably has more to do with levels of the tax and other features than with the perceived equity of the tax.

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33. R. MUSGRAVE & P. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 257 (1984).

34. D. PHARES, *WHO PAYS STATE AND LOCAL TAXES?* 90-91 (1980).

35. STATE POLICY RESEARCH, *STATE POLICY REPORTS*, Vol. 3, No. 24, at 16 (Dec. 1985).

36. *Id.*

### D. Administration and Compliance

The last set of issues concerns achieving a tax structure that is administratively efficient and has low compliance costs. Administration and compliance costs are a deadweight loss to the economy since they are lost to the taxpayer and unavailable for public spending. Thus, efficiency in the revenue structure is essential. Administrative efficiency can be defined as collecting the taxes at the lowest possible cost per dollar of revenues. Compliance efficiency occurs when a tax is understandable and requires relatively little effort on the part of the taxpayer to file. Again, the administration and compliance implications of an income tax must be compared with the alternative tax instrument that could be used, because costs are involved in collecting all taxes. A brief discussion of the implications from federal tax reform also is included here.

#### 1. Administrative Efficiency

This Article is not the proper setting for an in-depth analysis of the administrative issues raised by the income tax. A broad discussion of administration is available elsewhere.<sup>37</sup>

Relatively little information exists in the economics literature on the costs of collecting taxes per dollar raised. In a recent survey Stan Chervin of the Tennessee Department of Revenue found that the income tax costs between 0.2 and 1.5 cents per dollar to collect across the twenty-six states that responded.<sup>38</sup> In a separate analysis Chervin estimated that the Tennessee sales tax costs 0.8 cents per dollar to collect.<sup>39</sup> Data of this type is indicative of the low collection costs for both the income and sales taxes. Further, the results evidence that collection costs are similar for income and sales taxes. States appear to lose between 1.0 percent and 2.5 percent of their collections for both sales and income taxes because of difficulties in enforcement.<sup>40</sup>

A number of options are available for state governments to limit the administrative costs of collecting the income tax. First, a state government can opt to have the federal government collect the tax as a piggyback tax on the federal income tax.<sup>41</sup> Second, if

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37. See generally C. PENNIMAN, *supra* note 24.

38. Unpublished survey conducted by Stan Chervin, Tennessee Department of Revenue, Nashville, Tennessee.

39. Unpublished working document by Stan Chervin, Tennessee Department of Revenue, Nashville, Tennessee.

40. See C. PENNIMAN, *supra* note 24, at 268.

41. See generally Kurtz, *Federal Collection of State Individual Income Taxes*, 1977

the state adopts a tax base that is similar to the federal government's, IRS tapes can be purchased and used to provide much of the data necessary to audit the returns.

To make a decision about whether an income tax, a sales tax, or a combination of the two is desirable on administrative grounds would require much more information than is generally available. Such decisions must be based on judgments about the relationship between administrative costs and collections. First, there are probably some economies of scale to collecting an individual tax, whether sales or income, because of large fixed costs in administration; therefore, as higher rates produce higher collections, the tax becomes less costly to administer per dollar of revenues. On the other hand, it seems likely that at some point the costs of administering a tax will rise with rates because the incentives to avoid the tax rise with the rates. Thus, as sales tax rates rise, it becomes more advantageous to cross state lines to avoid the tax, and greater resources must be used to administer the tax. Similarly, incentives to avoid income taxes will increase as the rates rise.

An overall judgment is that it would cost more to administer both a sales and an income tax than to administer just one, but probably not significantly more as a share of revenues. Multiple tax bases will, however, reduce the incentives to cheat or avoid the taxes.

## 2. Compliance Costs

Compliance costs arise when taxpayers file tax returns and make payments. Income taxes impose compliance costs on employers when withholding is used and on taxpayers when tax forms are filed. The costs may consist of out-of-pocket expenditures or opportunity costs in terms of time. Compliance costs for an income tax probably are greater than for a sales tax because more people must file returns. The compliance costs, however, can be reduced substantially if a state adopts simple forms that are based on information already prepared as part of the taxpayer's federal income tax return. States often reduce sales tax compliance costs by making a payment to vendors in proportion to tax collections. The payment is compensation for the compliance costs. This payment, however, only shifts the burden from the taxpayer to the state; it does not *eliminate* the costs. Again, compliance costs appear higher for a balanced tax structure using both income and sales

taxes than for a tax structure with only one major source.

### 3. Federal Tax Reform

A final topic to be considered is the effect that federal tax reform will have on the use of state income taxes. The impact depends on the shape federal tax reform actually takes. One possibility is that state income taxes, but not sales taxes, will remain deductible. This result would likely induce states to use income taxes more intensely and sales taxes less so. Another possibility is that no state taxes will remain deductible. Sales and income taxes would still be the largest sources of state revenue with this scenario. In this case, however, states would partially substitute fees and charges on government services rendered for taxes on sales and income. Also, in some states income taxes probably would be restructured to be less progressive. The reason this restructuring would occur is that the main beneficiaries of the current deductibility are higher income taxpayers who are paying the highest marginal rates on state income taxes; thus, elimination of deductibility would raise their taxes most, causing them to seek lower state rates.

## IV. CONCLUSION

There is no uniform tax structure that should be employed by every state, nor is there an inviolate rule that says every state should have an income tax. The tax structure for each state must be set after consideration of the issues raised above and in light of the economic characteristics, history, political climate, and demand for government services that exists in the particular state. Still, it is possible to reach some general conclusions about whether an income tax is appropriate.

The previous section included a discussion of four broad issues that are involved in the decision whether a personal income tax is a desirable revenue raising instrument for a state. Revenue stability and revenue adequacy were examined under the general topic of meeting revenue needs. In the absence of an income tax, a state probably will have both inadequate and unstable revenue flows, making this a strong argument in favor of an income tax.

Keeping rates low is one way to minimize economic effects from taxes. States can keep tax rates lower with a balanced structure than with a concentrated structure. This balanced structure generally will limit the distorting effects of taxes on people's decisions, on economic activity along the border, and on economic development. States also should keep their tax structure (including

revenue sources and rates) in line with neighboring states'. States can reduce the distortions of economic behavior along state borders by using similar tax structures. Both of these arguments indicate that an income tax usually is desirable.

Issues regarding the administration of and compliance with taxes argue for a simple structure that relies on a relatively limited number of tax instruments, each of which raises significant revenues. Whether it would be less expensive to administer an income tax, a sales tax, or a combination probably depends on the size of each tax and on a number of other considerations such as how the taxes are designed. In the case of a state tax system that is designed to achieve efficient administration, there is no reason why it should be significantly more expensive to administer both taxes. Compliance costs also likely would be somewhat higher with a balanced structure than with a concentrated structure.

Definitive statements cannot be made about whether an income tax is desirable on equity grounds. Horizontal equity problems arise with both sales and income taxes, and defending either as being strongly preferable would be difficult. Vertical equity differences are clear: the sales tax is regressive and the income tax is proportional to progressive. There is, however, nothing inherently preferable about either progressive, proportional, or regressive taxation. The choice is one of value judgments.

Overall, the income tax as one part of the tax structure is desirable on the basis of economic effects and revenue needs. The arguments are relatively neutral on the basis of administration and compliance. Whether an income tax improves or harms tax equity must be judged independently according to each person's values. In my estimation, the first two reasons are sufficient justification for having an income tax as part of the tax structure. If residents of the state prefer a regressive tax structure on equity grounds, it is possible to design the combined income tax and sales tax structure to allow the system to remain regressive.

The choice of the particular characteristics of the income tax depends on the state. A state with high demands for public services will need higher rates and a more progressive pattern of rates. States that desire more progressivity in the structure also will want progressive rates. In states with different preferences, fiat and lower income tax rates may be preferable with more concentration within the tax system on the sales tax. For all states the income definition for taxation should be as close to the federal definition as is acceptable to ease administration and compliance.

