Trends in State Taxation: Consumption Tax Versus Income Tax

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Joe Eleniewski, James Trebby, and Doug Nagode describe an emerging trend in state tax legislation related to consumption tax and income tax.

Introduction

In recent years, a significant trend has emerged among the states regarding tax reform. Many states, including Georgia, Kansas, Oklahoma, Ohio, and North Carolina, among others, have introduced and/or passed legislation that reduces the state's income tax rate applicable to individuals, corporations, or both, while attempting to increase tax revenue from consumption taxes.[1] Generally, increased revenue from consumption taxes comes from an increase in the state's sales and use tax rate or an expansion of the sales/use tax base.

This article examines the drivers of this trend by identifying possible reasons for it and analyzing the costs and benefits of switching to a tax system primarily based on taxing consumption rather than income. It is important to note that when discussing income taxation, generally this article focuses on taxation of individuals and corporations only. Therefore, the complexities that accompany the taxation of gifts, trusts, estates, passthrough entities, tax-exempt taxpayers, *etc*. are outside the scope of our analysis.

First, we start by addressing the current tax regime, both at the federal level and generally at the state level. Next, we discuss the theory behind and issues created by both income tax and consumption tax systems. We then address the general state taxation climate and discuss specific states trending toward a system that increasingly taxes consumption. Finally, we address the consequences of such a trend and speculate regarding whether one type of taxing system may be better than another.

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Overview of Various Taxing Regimes

Different types of taxing regimes are utilized by tax authorities around the world. The system that people tend to be most familiar with is one that taxes income, which is used by the U.S. federal government and many state and local taxing authorities.[2] Under this system, a tax is imposed generally on income generated, both by individuals and corporations. For individuals, "income" is broadly defined, such that working wages are subject to tax, as is passive income, investment income, dividends and interest, *etc*. In the case of the United States, marginal tax rates reflecting a progressive approach to taxing income are imposed on individuals, resulting in a greater tax rate applicable to higher levels of income. This progressivity, at least in theory, should result in a tax system that relies on those who can afford to pay taxes bearing a greater share of the tax burden. More will be discussed on this point later.

Many states, including Georgia, Kansas, Oklahoma, Ohio, and North Carolina, among others, have introduced and/or passed legislation that reduces the state's income tax rate applicable to individuals, corporations, or both, while attempting to increase tax revenue from consumption taxes.

An important component of the income taxing system is the modification of income and/or expenses, such as exemptions, deductions, and credits. It is through these incentives that the government is able to influence behavior and to add balance and fairness to the taxing system. It is argued that fairness is also achieved through the progressive nature of the tax system.[3] The taxing authority's ability to influence behavior is a significant part of any taxing system.

Instead of an income tax system, some taxing authorities use a consumption tax system, while others implement a hybrid between the two. For instance, Nevada, Texas, and Wyoming have no individual or corporate income taxes, but do have a sales tax, which is a type of consumption tax.[4] Taxes on consumption are also referred to as "indirect taxes" or "transaction taxes," as opposed to "direct taxes" that are levied on income.[5] There are generally two types of consumption taxes. General consumption taxes are levied on a broad range of goods and services, such as a sales tax. Consumption taxes are also levied on a specific class of goods, such as excise duties on items like fuel, tobacco, and alcohol.[6] Typically, consumption taxes are imposed on the buyer, and paid to the seller, which acts as a collection agent on behalf of the taxing authority. Additionally, consumption taxes are generally required by the taxing jurisdiction regardless of whether the entity is profitable or not.

The primary difference between an income tax system and a pure consumption system is that a consumption tax (also known as a cash-flow tax, expenditure tax, or consumed income tax) is levied on goods and services that are consumed. For instance, if a taxpayer has gross wages of $100,000 in a given year and chooses to spend $80,000 and save $20,000, the taxpayer pays the consumption tax only on the $80,000, whereas the taxpayer is taxed on $100,000 in an income tax system that is based upon income that is earned from capital or labor.

This may sound similar to a sales tax but, in its purest form, a consumption tax will not become regressive as in the case of a pure sales tax. A pure sales tax often becomes regressive, as those with lower incomes spend a greater share of their income on taxes. As we will discuss in the following sections, critics often question the fairness of such a system. With that being said, many countries implementing a consumption tax, such as a Value-added Tax (VAT) system, have adopted two or more VAT rates, monthly rebates for individuals based on income level, or exempt certain items, such as food, clothing, and medicine, from the tax.[7] Similar measures may be implemented in order to create a progressive sales tax as well, though such a system could become complex and costly to administer.

In the United States, consumption taxes are levied primarily at the state and local level. The most common consumption taxes are sales and use taxes imposed by 45 states and the District of Columbia. The mechanics of the tax vary by state, as the tax base typically varies significantly from state to state. For instance, South Dakota imposes its sales tax on a broad range of services, while Wisconsin only taxes specified services.[8] In addition to state and local indirect taxes, the federal government imposes excise taxes on certain goods, such as cigarettes, alcohol, and fuel. Generally, consumption taxes in the U.S. are only imposed on retail sales—not on sales earlier in the distribution channel (*e.g.*, wholesale sales for resale), which would not be subject to sales or use taxes provided certain requirements are satisfied.

In contrast, the European Union imposes a broad-based consumption tax, or VAT, which is assessed on the value added to goods and services.[9] In fact, over 130 countries worldwide currently impose some form of VAT, and this form of taxation has spread faster than any other form of taxation in modern history.[10] It applies more or less to all goods and services that are bought and sold for use or consumption in the European Union. Thus, exports or services sold to customers outside of the EU are not subject to VAT.[11] The VAT is charged as a percentage of prices, and thus charged and collected at each stage of the production and distribution chain. Typically, businesses charge tax on their sales, and deduct the amount of VAT they paid to other persons on purchases for business activities. For illustration purposes, the following represents an example of how VAT is accounted for during the supply chain:

> A widget manufacturer procures raw materials from a local supplier. The local supplier charges and collects VAT at the applicable rate. Next, once the widget manufacturer sells the widgets to a retailer, the manufacturer charges and collects VAT on the gross value (also known as "Output VAT"). The manufacturer should enjoy an offsetting credit for the amount of VAT the manufacturer paid on the raw materials (Input VAT). In summary, the net VAT paid to the taxing authority is the difference between the Output VAT charged to the retailer and the Input VAT paid to the local supplier. Finally, when the retailer sells the widgets to the end-consumer, VAT is charged and collected on the retail sales amount. The retailer ultimately remits the VAT to the taxing authority on the difference between the VAT charged to the end-consumer and the Input VAT paid.

In some ways, the VAT may be simpler to implement, operate and enforce than income taxes, which are voluntarily remitted to taxing jurisdictions through filing returns (though some jurisdictions impose withholding requirements), or even indirect taxes imposed in the United States by many state and local taxing jurisdictions and other countries with a retail sales tax. For example, Puerto Rico has faced some challenges with enforcing compliance with its retail sales tax regime. Therefore, Puerto Rico recently enacted an "import tax" that acts as an up-front use tax on most imports to help ensure tax compliance.[12] It should be noted that this up-front use tax can be reclaimed once the imported goods are subsequently sold. The primary issue in the United States is determining if a sale is a retail sale and if a business has a sufficient enough relationship (contact) with a jurisdiction in order to collect sales tax on behalf of that jurisdiction.

While the VAT avoids these complications, some argue that it encourages economic and business inefficiencies. For instance, a company could potentially avoid paying and collecting VAT by vertically integrating its operations and shrinking the supply chain, which may not be an optimal choice economically. Additionally, an excessive consumption tax can affect an economy in two ways: 1) by discouraging consumer spending; and 2) by decreasing economic activity, both of which in turn can result in lower revenues for the taxing authority.

The graph below shows the revenue shares of taxes on consumption, as well as the portion of VAT and sales tax that make up total consumption tax revenue. Notably, the United States is at the bottom of the list of the Organization of Economic Cooperation and Development ("OECD") countries, with a little under 20 percent of its total revenue coming from consumption taxes.

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Income Tax System—Pros and Cons

Now that we've discussed an overview of the income and consumption tax systems, we turn our attention to the theory behind these systems by looking at the pros and cons of each, beginning with the income tax system. The U.S. federal government along with many states and localities impose an income tax on both individuals and corporations. In most cases, this income tax is a progressive system, which is the system that the analysis below contemplates.

The single most significant advantage of the progressive income tax system, it is argued, is the fairness and equity of such a system.[13] In a system where those that have the most income pay the highest tax rates on that income, the system seems fair because those that have the means to pay taxes, pay the most taxes. On the other hand, those with little income end up paying very little, if any, in taxes. In theory, a person who makes $1 million a year has more ability to pay taxes and may be thought to have a social responsibility to contribute more to pay for the government services for which everyone receives benefit than a person who makes $20,000 a year. Of course, the "fairness" of such a position will be argued by the taxpayer that pays a higher percentage of their wealth in taxes.

Another advantage of the current income tax system is the ability to influence behavior. It is through the utilization of credits and deductions that the taxing authorities, and ultimately the political authorities, are able to influence behavior. For instance, by offering a tax credit to corporations that use equipment to control pollution, corporations have a very real economic incentive to act in an environmentally responsible way. In order to encourage individuals to own a home, which is generally beneficial for a number of reasons, the taxing authorities essentially help to subsidize the purchase and financing of a home through home purchase credits or though mortgage interest deductions. Similarly, in order to encourage individuals to purchase health insurance, the taxing authority may penalize those that do not have health insurance as of a particular date.

The single most significant economic advantage of a pure consumption system is that such a system encourages economic growth.

Another advantage of the progressive income tax system is that it is the current and accepted system. In other words, it is the "incumbent"; it is the system that people are familiar with and understand. Procedures are in place and have been in place for a number of years to withhold tax on income as it is earned. Then, after year end, a tax return is prepared, which ultimately calculates tax due and either payment of tax due is remitted or a tax overpayment is returned *via* (1) a refund, or (2) a carryforward credit. Based on the laws in place to administer this system, it is generally difficult to avoid having income taxes withheld on earned income at the time it is earned. Any change to such a system would be significant and would likely face resistance.

From a revenue-collection standpoint, federal income tax collection would seem to be less volatile than consumption-based taxes, which are tied exclusively to consumption. However, data has shown that revenue collection from income taxes is becoming increasingly more volatile as more and more tax revenue is attributable to capital gains income, which is dependent upon an active stock market.[14] Furthermore, the income tax revenue system has become more dependent on high income earners and more detached from larger macroeconomic trends.[15]

Moving to the disadvantages of the progressive income tax system, we first address the primary difference between an income tax system and a consumption tax system: the treatment of savings. Since an income tax system imposes tax on one's income, one's savings is ultimately being taxed. For instance, if a taxpayer earns $100,000, all of the earnings are subject to income tax, regardless of how much is saved and how much is spent. Thus, the income tax system provides very little incentive to save. The incentive to save, which ultimately leads to a greater ability to consume in the long run, is tied to economic growth.[16] Therefore, any income tax system ultimately hurts long-term economic growth by limiting the ability of persons to save and providing an incentive to consume in the short-run.

Additional arguments against a progressive income tax system are that such a system, by its nature, is inefficient because the system creates a disincentive to work high-paying jobs or to work additional hours.[17] For example, as a wage earner works more, a higher percentage of the earnings go to taxes as the taxpayer moves up the marginal rate tax brackets. From an economic perspective, a disincentive to work is created because the decreasing benefit received from additional work begins to be outweighed by the enjoyment from leisure activities that can be performed by not working.[18] Thus far, both disadvantages of the progressive income tax system discussed result in undesirable economic outcomes.

The progressive income tax may not accomplish what it is designed to: equity, at least in terms of "everyone paying their fair share," which is clearly subjective. However, the goal of a progressive tax system is to impose a greater economic tax burden on those who can afford it, while lessening the economic tax burden on those who earn less. In practice, it can be argued that the progressive income tax becomes more of a redistribution of wealth, which leads to less fairness and equity.

While many agree with the premise that those with the ability to pay taxes have a social responsibility to do so, this reasoning primarily contemplates government services such as national defense, roads, parks, *etc*. As the size of government continues to grow drastically, so do the services that government provides, including environmental protection, education, healthcare, increasing welfare and unemployment benefits, *etc*.[19] In such a system, it can be argued that not only do members of the lowest 40 percent income tax brackets not pay much in federal income taxes, many may receive payments from the federal government, which, it can be argued, essentially meets the definition of redistribution of wealth.[20] Some question the fairness and equity of a system that places a greater tax burden on one group of individuals and gives that money to a group that does not pay any tax at all.

Interestingly, as the chart below shows, when all federal income taxes are considered, the majority of people do pay federal taxes, and the taxes end up being progressive in nature and do not look to be a redistribution of wealth.

Consumption Tax System—Pros and Cons

The advantages and disadvantages of a pure consumption tax system are generally the opposite of the pros and cons of an income tax system. The single most significant economic advantage of a pure consumption system is that such a system encourages economic growth. By allowing individuals and businesses to save money, especially in the short run, such a system encourages future spending and immediate investment that becomes a catalyst for economic growth in the short run.[21]

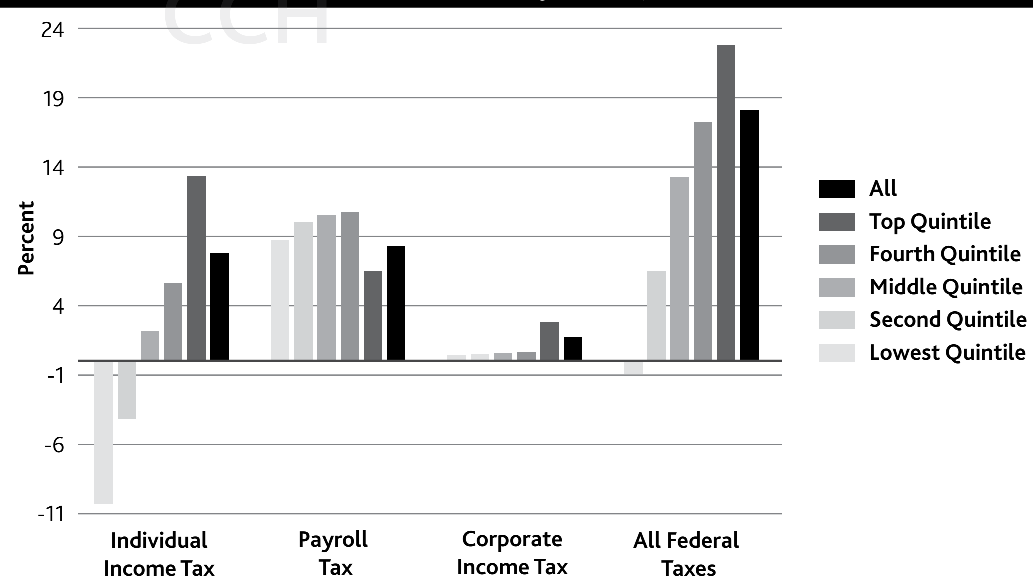
The second major economic advantage of a purely consumption-based tax system is that such a system is more efficient economically, as workers receive a real and increasing benefit to working more.[22] This is because the amount of additional income earned is not taxed unless spent (ignoring payroll taxes), and as workers receive increased overtime wages, or simple additional wages, they tend to be more willing to work because the incentive to engage in additional labor is sufficient to justify the loss of leisure.[23]

It can also be argued that the consumption tax system is fundamentally more equitable than an income tax system because everyone must pay some sort of tax based on the amount they consume. Furthermore, if the consumption tax system is designed similarly to the sales tax that many states impose, such a system achieves equality by not taxing basic necessities, such as shelter, groceries, and in some cases, clothing. By doing so, those in the lowest income tax brackets would not pay tax on basic purchases necessary to survive, but everyone would pay tax on their consumption of nonessential goods and possibly services. More will be discussed about an optimal system later in this analysis.

A true consumption tax can be difficult to increase to excessive or punitive levels. In fact, many countries with a VAT regime have increased tax rates close to 25 percent, apparently without discouraging investment. This tax is naturally limited, in terms of imposing a higher rate, because it will ultimately discourage economic activity when it becomes too high. An excessive consumption tax affects an economy in three ways: 1) by discouraging consumer spending; 2) by decreasing business revenues; and 3) by lowering the amount of tax that can be collected when economic activity decreases.

When considering the disadvantages of a consumption tax system, the most prominent disadvantage is the lack of progressivity. Because all taxpayers pay the same amount of tax on the goods and services subject to tax, the percentage of total income/budget comprised of tax

AVERAGE EFFECTIVE TAX RATE BY SOURCE AND INCOME QUINTILE, 2009



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0509-2).

will be less for wealthier individuals than for lower-income families. Indeed, because tax is only paid on consumption, a situation could arise in which wealthier individuals and families pay virtually no tax if these taxpayers choose to save all of their income, while lower-income taxpayers have no choice but to spend their earnings in order to survive. However, a consumption tax can be structured so as to be progressive in application.

Similarly, because only consumption is taxed, it is possible that revenue from tax collections could become increasingly volatile and wealthy taxpayers could essentially choose not to pay tax by choosing, to the extent possible, not to spend. It is unclear whether such a scenario would occur, but is worth noting as, under such a system, taxpayers have greater control in the amount of tax they pay.

Finally, political and government officials, at least on the surface, may have a more difficult time encouraging desired behaviors and discouraging other behaviors through a consumption tax system. While certain goods and services may be excluded or exempt from tax, such as food and basic clothing, it would be very difficult to try and alleviate the burden of specific, lower-income taxpayers, unless a rebate-type system is implemented. The more significant issue would be discouraging undesirable behavior. For instance, the federal government already imposes an excise tax on cigarettes and alcohol to discourage the consumption of these products. If instead many goods and services become subject to a consumption tax, absent a higher tax rate or another method, it would be difficult to discourage the purchase of these types of products.

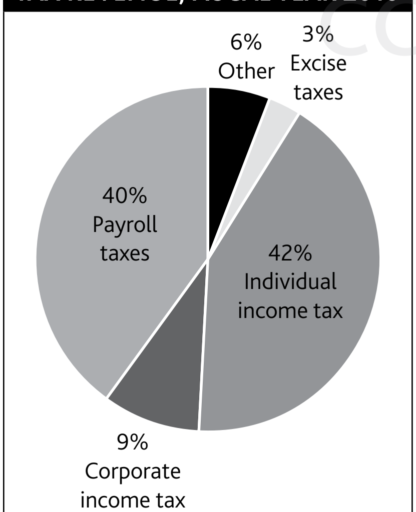
Federal Versus State Taxing Regimes

Now that we have given an overview of the types of taxing regimes and an analysis of the advantages and disadvantages of a purely income-tax-based system and a purely consumption-based taxing system, we will discuss the differences between the taxing regimes of the U.S. federal government versus the taxing regimes of individual states followed by a discussion of the trends in state taxation.

Generally speaking, tax revenue collected from the federal government is primarily composed of payroll taxes and income taxes. Figure 1 shows the sources of federal tax revenue for the Federal Government's fiscal year 2010. Individual and corporate income tax make up 51 percent of total federal tax revenue, while consumption taxes (excise taxes) make up three percent of total revenue collections. Figure 2 demonstrates that while income tax collections as a percentage of total revenue have decreased over time, they have remained the dominant source of revenue collections. While payroll taxes are a significant revenue source at 40 percent of total revenue collections, our analysis is primarily concerned with comparing direct income taxes to direct consumption taxes.

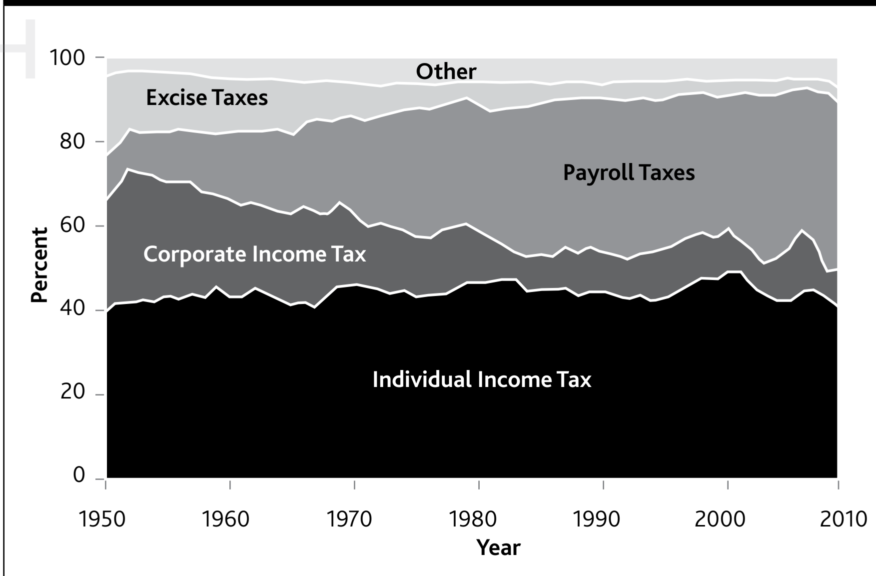
In contrast to tax revenue collected by the federal government, when looking at tax revenue collected by the 50 states and the District of Columbia, approximately

FIGURE 1. SOURCES OF FEDERAL TAX REVENUE, FISCAL YEAR 2010



Source: Budget of the United States Government, Fiscal Year 2012, Historical Tables: Table 2.1; http://www.whitehouse.gov/omb/budget/Historicals

FIGURE 2. SOURCES OF FEDERAL REVENUE, FISCAL 1950–2010



Source: Budget of the United States Government, Fiscal Year 2012, Historical Tables: Table 2.1; http://www.whitehouse.gov/omb/budget/Historicals

41 percent of total tax revenue collections are related to individual and corporate income taxes, while roughly 30 percent of collections are related to consumption taxes in the form of sales and use tax collections.[24] Most states impose a sales/use tax, an individual income tax, and a corporate income tax; there are four states that do not impose an individual or corporate income tax and five states that do not impose a sales tax. However, every state imposes at least one type of tax in order to derive revenue.[25]

Based on the facts in the preceding paragraph, from a state perspective, a change from a consumption-based tax system to an income-based tax system, or vice versa, would not be as dramatic as it would be at the federal level, since most states already impose both types of taxes. As a result, the debate emerges as to which system, or which mix of the two systems, will provide an optimal result and help any given state meet its taxing objectives. This debate has become increasingly important as taxpayers, both individuals and businesses operate in a multistate and international environment. Each state attempts to ensure that its interests are protected and that taxpayers pay tax if those taxpayers are receiving benefits from operating within the state.

Current Trends in State Tax

Many states are currently discussing their existing tax regimes and considering ways to raise additional revenue from tax collections, especially from out-of-state taxpayers. For instance, in terms of apportioning business income among the states for purposes of imposing corporate income tax on businesses with multistate operations, many states have moved to an apportionment method that emphasizes sales rather than property or payroll when calculating the apportionment factor, which may result in a benefit for many in-state businesses at the expense of many out-of-state businesses.

Another change many states are considering is reducing or eliminating the state's individual and corporate income tax while raising the state's sales and use tax rates.[26] Such states include Georgia, Kansas, Louisiana, Missouri, Nebraska, and North Carolina.[27] We begin by looking at two bills introduced (or re-introduced) in the Georgia legislature. One plan, alternatively known as the Fair Taxation Act of 2014, would repeal all income taxes imposed by the state and would extend the sales tax base to include all services as well as changing the sales tax rate, which would be set by the General Assembly.[28] Another bill seeks to accomplish a similar goal by mandating no increase in the sales tax rate occurs unless it is accompanied with a reduction in state income tax collections.[29] Opponents of such a measure argue that this type of legislation shifts the tax burden to lower and middle income families and really does not constitute tax reform.[30] Furthermore, because the state collects roughly 53 percent of its tax revenue from income taxes, and its average state and local combined sales tax rate is already 7.0 percent, some question how much higher the sales tax rate would need to be to achieve revenue neutrality. It is estimated that the sales tax rate would need to rise to a combined rate of 14.5 percent, which would raise the tax burden on households making less than $85,000 a year.[31] While a 14.5 percent sales tax rate may seem unusually high, by comparison global VAT rates today approach 25-percent as previously noted.

From a state government perspective, such tax reform is appealing because tax revenue from sales tax collections has become increasingly more stable when compared to the growing volatility of income tax collections, especially as the business cycle has been rocky as of late.

Proponents of such a change argue that such tax reform drives economic growth and encourages businesses to operate or relocate within Georgia. However, some benefits from the tax reform that are often overlooked are the decreased volatility of sales and use tax collections and the difficulty of avoiding the payment of sales/use tax (as it is generally collected at the time of the transaction), relative to income tax. Studies have generally shown that retail sales and gross receipts taxes are less volatile than both individual and corporate income tax collections.[32] This is in large part due to the fact that an income tax generates attributes that individuals and taxpayers may use going forward, most notably the net operating loss carryforward. Thus, if a corporation loses money in one year, it may be able to reduce future taxable income with the prior-year loss. However, there is no such equivalent for sales and use taxes. As such, taxpayers will always pay sales tax on taxable goods and services based on the amount of consumption. This practice generally smooths out tax payments and makes tax collections less volatile while also reducing the ability of many taxpayers to avoid paying tax. Typically it is more difficult to reduce or even eliminate a sales tax liability when compared with an income tax liability. It is easy to see why politicians and governments see some benefit to this proposed tax reform, even if lower- and middle-income taxpayers will see a tax increase.

In North Carolina, legislation has recently been passed that will enact a tax that is similar to a flat tax. The new law introduces a single, lower income tax rate for individuals (5.75 percent in 2015) and corporations (five percent in 2015, possibly as low as three percent after).[33] At this point, no modifications have been enacted to the state's sales tax rate or base, though some would like to see the sales tax base increased to compensate for the lost income tax revenue. Legislators believe the reduced revenue from the law change will be more than offset by increased economic activity within the state. Opponents of the law change fear that such a revenue reduction will cause the state to reduce or eliminate state services to maintain budget neutrality. This point is an interesting one as it represents a significant hurdle to major tax reform: the risk that the new tax structure will result in less tax revenue that will need to be made up through budgetary cuts.

In Louisiana, Governor Bobby Jindal has developed a plan to eliminate all personal and corporate income taxes while raising sales tax revenue to remain budget neutral in an effort to simplify the state's tax code.[34] It is unclear if the additional sales tax revenue would come from an increase in the sales tax rate or an increase in the sales tax base. However, the governor's plan has not moved forward due to a lack of support from the state legislature to pass such tax reform, especially if the plan would require raising the sales tax rate. Louisiana is also attempting to conform to its neighboring states such as Texas, which already does not impose an individual income tax and has a much higher sales tax than Louisiana, Oklahoma, and Kansas.

In Kansas, Governor Brownback signed legislation into law one year ago that flattened and simplified the tax code, cutting personal income tax rates for most earners from 6.45 percent to 4.9 percent and eliminating small business income taxes.[35] The state now wants to make permanent a temporary increase in the sales tax rate to further reduce the income tax rate as the initial results of the plan have been very positive.[36] In Kansas, the state economy has grown significantly as unemployment has shrunk, population has increased, the state has developed a surplus, and businesses have moved into the state. Most notably, the Kansas portion of the Kansas City Metro area has seen job growth and economic growth, while the Missouri side, without the tax reform, has not seen the job/economic growth.[37] Missouri had introduced similar tax policy, but the bill was initially vetoed by Governor Nixon.[38] This provides a very interesting case study that shows the benefits of reducing/eliminating income taxes, though this tax reform did not directly accompany the increase in sales taxes, which had occurred previously.

On May 6, 2014, the Missouri legislature overrode Governor Nixon's veto, thus adopting the senate bill into law.[39] Effective for tax years on or after January 1, 2017, Missouri law provides a phase-in of personal income tax rate reductions and other policies that look to reduce the personal income tax burden on taxpayers within the state.

Finally, in Nebraska, Governor Dave Heineman has argued in favor of legislation that will either eliminate or lower both individual and corporate income taxes, while eliminating sales tax exemptions, thus widening the sales tax base.[40] The governor points to a number of indicators that portray Nebraska's business tax climate poorly. The governor believes that tax reform is necessary in order for Nebraska to be competitive and to drive economic growth. Currently, Nebraska has not passed or enacted any such legislation. The state has, however, enacted legislation to encourage businesses to operate in Nebraska and to promote economic development, which have produced mixed results.[41]

The common theme in all of these states is that state residents traditionally vote for leaders who generally value economic growth and reduce taxes to promote a positive climate to do business, an approach viewed by some as ultimately benefitting all citizens of the state by raising the standard of living. Others, however, may oppose these tax reforms because the tax burden can and often does shift from wealthier businesses and individuals to lower- and middle-income taxpayers. From a state government perspective, such tax reform is appealing because tax revenue from sales tax collections has become increasingly more stable when compared to the growing volatility of income tax collections, especially as the business cycle has been rocky as of late.

Conclusion: Is a Consumption-based Tax System Better than an Income Tax System?

Throughout this article, we have discussed various aspects of a taxing system that is based on consumption taxes (*i.e.*, sales and use tax, excise tax) as compared to a taxing system that is based on income tax collections. We have looked at the theory behind each system and how each system operates and affects both individuals and businesses. We also evaluated these systems at both the federal and state level, and discussed the current trend in many states of moving to a system that is based more on consumption taxes as opposed to income taxes. We focused our analysis on state tax portfolios rather than federal taxes imposed.

There is an argument to be made—often by many economists—suggesting that a consumption-based system drives economic growth and creates a friendlier climate to attract businesses and others to move to a particular state. However, these attributes must also be balanced with the potential for shifting the tax burden to lower- and middle-income taxpayers. It can be argued that this outcome can be avoided if certain steps are taken when designing a consumption-based tax system. For instance, many states exempt sales tax on groceries and unprepared food as well as shelter. States could look to enact exemptions on other basic living necessities as well. Alternatively, states could offer rebates of sales and use tax paid by lower- and middle-income families. By doing so, those taxpayers would not be unfairly burdened by such tax. Thus, they would only pay tax on items other than basic necessities, or on discretionary purchases. However, each time an exemption or rebate is added, more complexity can be introduced into the administration of the tax system. Additionally, if a state government sets a goal of collecting a certain amount of revenue, these added exemptions can result in a higher tax rate on fewer transactions than otherwise anticipated by policymakers.

While the focus of this article is on state efforts, we see at the federal level that a consumption tax can be a hard sell politically. Democrats often worry that rebates and exemptions may not be enough to address their concerns about regressivity resulting in a tax that may unfairly burden lower- and middle-income taxpayers.[42] Republicans, on the other hand, contend that consumption taxes, particularly VATs, are "money machines" and fear that rates will continually ratchet up to fund increased federal government expenditures.[43] In an example of how politically unpopular a proposed VAT could be, the U.S. Senate voted 85-13 in 2010 to approve a resolution against implementing a U.S. VAT.[44]

In the end, there is not one optimal tax structure that should be implemented in every state. Therefore, each state needs to carefully consider its own economic conditions when formulating tax policy and should implement legislation that will create a tax portfolio that limits negative effects of the business cycle on its fiscal health. In the end, not considering the aforementioned tax reform may result in the continued budget shortfall crisis faced today. States with volatile economies may want a tax portfolio primarily consisting of sales tax collections as these collections tend to be more stable, whereas a state with more stable economic conditions might want to implement a more aggressive tax policy weighted heavily on income tax collections.

ENDNOTES

* This article does not constitute tax, legal, or other advice from the authors or their respective firm or organization, which assume no responsibility with respect to assessing or advising the reader as to tax, legal, or other consequences arising from the reader's particular situation. This article has multiple authors with varying opinions that do not necessarily represent, and may differ from, the opinions of the other authors.

1 Richard W. Stevenson, *Governors Push Bigger Reliance on Sales Taxes*, New York Times, January 24, 2013. (Link: *www.nytimes.com/2013/01/25/us/politics/republican-governors-push-taxes-on-sales-not-income.html?pagewanted=all*).

2 United State Internal Revenue Service, "Publication 17—Your Federal Income Tax," *IRS.gov*, January 31, 2013. (Link:*www.irs.gov/pub/irs-pdf/p17.pdf*).

3 Peter Diamond and Emmanuel Saez, *The Case for a Progressive Tax: From Basic Research to Policy Recommendations*," Journal of Economic Perspectives, Vol. 25, No. 4, Fall 2011.

4 The Texas Franchise Tax (referred to by some as the "Margin Tax") is imposed on corporations, limited liability companies, partnerships, and other taxable entities. The tax is considered to be an income tax for ASC740 purposes given the significant amount of deductions from gross receipts, although the State of Texas does not consider the tax to be an income tax.

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