Chris Atkins: Hi and welcome to another Tax Foundation Tax Policy Podcast. I'm Chris Atkins of the Tax Foundation.

I'm very pleased to be joined today by Dr. William Fox, a professor in the department of economics and director of the Center for Business and Economic Research at the University of Tennessee.

Dr. Fox has held appointments as a visiting scholar for the Federal Reserve Bank of Kansas City and as a visiting professor at the University of Hawaii. In addition, Dr. Fox has served as a consultant on finance, taxation and economic development in a number of states and developing countries.

Dr. Fox is also a member of the American Economic Association and a past president of the National Tax Association.

Dr. Fox, thank you very much for being here with us today.

Dr. William Fox: Chris, you're welcome. I appreciate you having me.

Chris Atkins: You're very welcome. Well, let's get right into it and I want to sort of go from the general to the more specifics today and focus mostly on sales taxes.

As you know, most economists generally think of state sales taxes as a "good tax," meaning they adhere to principles of good taxation. They're simple, they're transparent, they're neutral and they're pro-growth.

Could you please give our listeners just a short overview of how sales taxes generally work in the states, what kind of sales are subject to the tax and some of the merits and drawbacks of using sales taxes over other taxes?

Dr. William Fox: Sure. I believe in sales taxes. I think among the options available to us they're a good source of state tax revenues. States differ a lot though in their application. You find states like Hawaii where the tax base is so broad that it actually represents more than the economy.

On the other hand, you find some states like Illinois or New Jersey where the tax base is quite narrow. The difference in terms of what gets taxed comes down to a couple of areas.

First of all, services. Hawaii taxes services very broadly. Most other states do not. And what we're talking about is health care, legal services, construction services and so forth that are left out of most states' tax basis.

States also vary in terms of, do they tax food? Do they tax clothing? The use of tax holidays and so forth. And so they differ a lot. But if you were to generalize, what you'd say is states sales tax goods, they don't sales tax services.

Some of the strength of the sales tax: it grows a little more slowly than the economy. And so that's a good thing when you balance it with a state income tax because state income taxes will tend to grow too fast.

So to have something that's growing a little bit more slowly over the long term actually helps balance state systems and keeps their overall revenues from growing too fast. They tend, in many cases, to work well in terms of balancing across the recession with an income tax as well.

Now every tax slows in a recession. But in this most recent one, for example, the individual income tax plummeted. The sales tax was a bit more stable as consumers continued to spend and to spend and to spend.

There's also a sense among a lot of people that there's a certain degree of fairness, that taxing consumption is a more fair item than say taxing income. Now you get different views on that.

Some people are concerned about the regressiveness of the tax and frankly, that's not as big of an issue for me. I think trying to deal with regressiveness is not a very good target for state governments.

So the biggest downside to a sales tax that I hear from, particularly from my economist friends and myself, is that there's a strong tendency to tax business-to-business transactions.

What most states do is that they exempt a sale between one business and another if it's going to become a component part of what that second business, the buying business, is producing. So if it's steel going into an automobile, it's exempt.

On the other hand, a computer or a desk used at the factory is taxable. And the other thing is if you're buying something for reselling, like a grocery store buys a can of corn to resell, that's exempt.

But otherwise, business things are taxable, business purchases, and we end up finding that oh, 35 to 40 percent of the tax base is business-to-business transactions.

So it does give kind of perverse incentives for businesses. And it's one of the biggest business taxes in the country.

Chris Atkins: And, Dr. Fox, is the taxation of business-to-business transactions under the sales tax what accounts for the breadth of Hawaii's sales tax base? You mentioned that the sales tax base there was actually broader than the economy.

As you probably know, John Mikesell showed the same thing in a recent paper for us on gross receipts taxes in the state of Washington.

Dr. William Fox: Yes.

Chris Atkins: So is that what's causing the breadth of their sales tax base?

Dr. William Fox: Well there's two things going on in Hawaii. The first one is that they're taxing almost all services. And so that gets the base pretty well close to the economy anyway.

And then you add to it the taxation of business-to-business transactions and that's how you get that base bigger than the economy itself.

So you're right. In fact, Hawaii's sales tax is called the general excise tax. It's much closer to a gross receipts tax. Although it does have the exemptions I was talking about before on component parts and sales for resale.

Chris Atkins: You mentioned some of the business inputs that are exempt, things that themselves become component parts or that are resold. Economists, some economists, I think, would tend to say that anything a business buys should be exempt from the sales tax because of the pyramiding problems and those types of things. Do you agree with that assessment?

Dr. William Fox: I do agree with that assessment with the sales tax. I think we should exempt all business-to-business transactions. Now we're talking theoretically here for the moment, that I think it is definitely the right thing to do.

And to the extent we can continue to get the business-to-business transactions out, I think the economy would work better. We wouldn't have so much pyramiding. We wouldn't have perverse incentives.

I've done some work on business location decisions and helping set in lieu tax agreements and so forth with big plants. And one of the big automobile manufacturers, when we first were involved with them, were focused on the property tax.

And then when they came back a few years later, they said, "Wait a minute. We realize this sales tax on business-to-business transactions is a big issue. We need to start thinking about how we're being affected by that. It begins to affect business decisions and we'd like to get that out."

Now having said all that, we need to recognize that if what we were to say is that every business-to-business transaction is exempt, then you and I would have an incentive to form our own companies and buy everything through our company and act like it was our business.

And so the biggest challenge with a sales tax is knowing how to do this, this exemption. And the biggest advantage of a value-added tax is that it prevents this problem.

So both taxes have their strengths, but that's the biggest weakness of the sales tax is being able to administer a tax that exempts all business-to-business transactions. But we could go further than we go.

And you know, as I talk to legislators on these issues, it's hard for legislators, in my experience, to get this concept that businesses don't consume, they produce. And what I try to emphasize is that we're trying to tax consumption; therefore nothing that a business buys ought to be taxable and we only ought to tax people on everything that they buy.

And yet it doesn't seem to click with many of the legislators that I've talked with.

Chris Atkins: Those are great thoughts.

You mentioned property taxes. Let's shift a little bit to the interplay between sales taxes and property taxes. As you know, a recent Tax Foundation analysis of state sales tax rates revealed that few states have made changes to their rates.

A recent trend we're seeing is lawmakers proposing to reduce property taxes at the local level and pay for those reductions through higher state sales tax rates. What do you make of this trend?

Dr. William Fox: Yes, I mean it's surprising. And I think it is a bit of a reaction to the run-up in housing prices that took place a few years ago. It's not stalled and I think the politics is just catching up with what was happening to housing prices.

By and large, I would like to see states continue to use the property tax; and particularly because I like to see each level of government responsible for generating most of the revenue that it's going to spend.

And if you what you're going to do is move from a local property tax to a state sales tax, then you're going to end up with more inter-governmental transfers between the state and the local level.

Now in the case of education, you know there probably needs to be a big state role, particularly because many constitutions require that. But otherwise, I want local governments to be responsible for financing the services that they provide. And so that's my biggest concern in that particular direction.

Chris Atkins: And I think, just to explore that a little bit further, property taxes make a lot of sense for local governments. I mean it's really the only immovable source of revenues that they have.

And I would think, though I haven't really seen any studies that bear this out—maybe you could share with us if you've seen it—that the tax competition problem at the local level would become nearly insurmountable if you required them to rely on local sales or income taxes.

It'd just be too easy to move to different locations and pay, or go to different locations and buy products or live in a different locality and have a lower income tax. Do you see that being a problem with moving away from the property tax at the local level?

Dr. William Fox: No, absolutely. I think you're right on target. I've seen a little bit of research on the individual income tax, I believe in the Philadelphia area where they have a pretty stiff local wage tax.

And you know, the research suggested that it really pushed workers out of Philadelphia to avoid this tax of three or four percent. I've forgotten the exact rate. Pretty stiff tax. And you know, you just locate right across the border and you miss it.

Wel,l it is true that within a metropolitan area the research indicates that firms do respond to property tax differences. In fact, that was my dissertation a long time ago. But there's been some other work in the meantime supporting this same finding.

So property tax has some influences on location too, but the sales tax is very, very easy to pay differently. You just cross the border, you know? You drive a quarter of a mile down the street and you've got a different tax rate. And in that environment, a very difficult tax to impose.

And so we absolutely agree that the property tax, particularly to the extent it's on land, you know you can't avoid that. You can't move the land. And so I do believe that the property tax is the best source for local governments. And I would hate to see that eroding.

In fact, I'm concerned both by this notion of shifting to a sales tax and also the limits that some governments have put on the property tax. Maryland, for example, being one of them that has really severely limited the change in assessment values which will ultimately make it difficult to use the property tax as a revenue source that people can be comfortable with.

Chris Atkins: And of course, the catch 22 for state lawmakers though is that unless they cap something, either the assessments or the rates, the local property tax, then what people end up with is usually a higher local property tax and then a higher state sales tax to boot.

Dr. William Fox: Well, that certainly could happen. You know it is, in my view, incumbent upon people at the local level to throw the bums out if they let the property tax get out of line with where it ought to be. You know I'm not sure that state legislators will do that much better job of controlling taxes than local people will. Both of them we need to hold accountable for taxes.

Taxes are a necessity of life but they need to be kept at the right levels. And so I'm certainly in no way advocating rampant growth in tax revenues.

But I am saying that trying to limit the growth rates, along the line of the Prop. 13 in California, does end up with a lot perverse effects on how the economy operates. You know could ultimately create some difficulties in the ability to use the property tax as a funding source.

And instead, of course, my theoretical thought is I'd like to hold our legislators and our local political leaders accountable for what they're doing. And to the extent we can do that, I think that's the best way.

If not, maybe states need to get involved or we need to find some other ways to put limits on it.

Chris Atkins: A couple of other trends I think that we're seeing in the sales tax base arena are sales tax holidays and grocery or food tax cuts. Let's start with the first; sales tax holidays. You mentioned these during your introductory remarks.

As you know, these are just basically time periods or weekends or weeks where the state says on certain purchases of goods and services the sales tax will not apply. What's your opinion of these proposals and do you see this continuing or are some lawmakers starting to see the light here?

Dr. William Fox: I see it continuing. I have not bumped into an area where I think I see more conflict between what makes political sense and what makes good economic sense in the case of tax holidays.

I mean what is better than a holiday from a tax, you know? This is nirvana for us all. And so I think the political benefits of giving them are really, really strong. I think they just don't achieve anything useful at all.

The good news part of it is, of course, that when revenues get bad, you know you're in a time like 2001, 2003, which was the worst time in modern history for states from a revenue perspective, you can always back off on the holidays and collect the revenues.

So that's kind of the strength of them. You probably can let them come and go. And some states did that. But I don't see them doing anything useful.

In fact, I'm a tennis player, maybe not a very good one – don't ask my opponents. But when we had our last tax holiday, I went to the store and bought a bunch of pairs of tennis shoes because I could buy them under the tax holiday.

Now surely this is not what we think of as good revenue policy. I went ahead and took advantage of it because they offered me the chance. But it doesn't, to me, make a lot of sense. And so I think holidays are not the way to go.

What I believe we ought to do is get the tax rate down. If we're collecting too much money, get the rate down. Don't do these kind of gimmicky things that don't change the economy. They just influence the timing of when I buy.

I would have bought those tennis shoes anyway; I just would have bought them over the course of the year.

Chris Atkins: How about the movement to either cut the tax rate on groceries or exempt food or groceries from the sales tax base altogether?

Dr. William Fox: Right. Well that's a discussion we're having here in Tennessee right now. And there's a lot of people who are proponents of eliminating the sales tax on food.

We've already reduced the rate from our standard state seven percent rate to six. I oppose it. I think what we need is broad bases and low rates. That is the best policy for any kind of tax. It has the least influences on behavior if you do that.

And you get a lot of really perverse outcomes from taking the sales tax off food. You do things like encourage me to eat at home rather than eat at a restaurant.

Now it's just that the tax shouldn't decide that for me. I ought to make that judgment based on whether I like to cook and so forth, not because a tax influences my behavior.

So you get those kind of influences on how I behave. You get influences on how taxes are performed across the business cycle because, in a recession, the most stable part of the sales tax is the sales tax on food.

And of course what happens is you now make this tax more unstable and you have states responding even more to offset their revenue declines in those particular time periods. So it's bad from that perspective. It's not even particularly any more fair.

The sales tax, if you compare it with people's income this year, is a regressive tax. But it's not just because food's in the base; everything essentially that people buy is regressive in consumption. That is people spend a lower share of their income on almost everything as their income rises.

Now there's a few exceptions. I think life insurance and private schools, but we're not sales taxing those anyway. Of the things that we're sales taxing, you know they're all pretty much regressive in consumption.

So you're not going to make this tax progressive or proportional, if that's your goal, by taking the sales tax off food. So it's not making the tax more fair. It's pushing the rate up for any given amount of revenue.

So you don't get fairness from the perspective of those worried about it. You get more perverse effects from the tax. It's more complicated to administer. Bad tax policy to take the sales tax off food.

Chris Atkins: Fascinating. I was going to follow up about the issue of reactivity, but I think you already answered that one. This has been a great interview. I've only got one more question for you.

Of course, this is a pretty big question and one that I think is going to be a part of our tax debate at the state and federal level for quite a while. As you know, there's a vocal movement in the country to repeal the income tax and move to a consumption-based tax such as the national retail sales tax. Is this feasible and you know, in your opinion would it represent an improvement over the current system?

Dr. William Fox: That is a challenging issue. Most of the rest of the world has looked at this issue and they've gone with a value-added tax instead. There's going to be a tough sell in the U.S. with the value-added tax. It's a new tax. I think that's a tough sell.

My concern with it, with the value-added tax as it happens around the rest of the world, it there's been this tendency for the rate to move up. And I'm afraid that if we went the VAT route, there'd be an increased chance that government grows.

And so you know—and by the way, I should note that VATs have not proven to be as wonderful of tax instruments as people have often asserted. They always get talked about in a theoretical context.

But there's beginning to be a lot of literature in Europe about how easy it is to evade these taxes and how much evasion is taking place. You know with a VAT, there's some rebating of revenue that takes place.

And whenever the government is ready to pass money out to people, folks stand in line, maybe even illegally, to get some of that money. And that's what's beginning to happen in Europe and they're beginning to notice this.

So the VAT is the option most of the rest of the world has adopted; 125 countries. And I'm not saying we shouldn't ever consider going that route, but I think we need to go cautiously in that direction.

Now the alternative of course, to try to achieve this same goal, is a national retail sales tax. And I'd be okay with having a retail sales tax at the national level. Just as we talked about before, every state has a different tax structure here.

So if we're going to try to line the national and state governments up, we're going to have to have reform in every state to somehow reach an agreement on what we're going to tax because these are very different tax bases. And so that's a pretty big concern of mine.

There's also been some worry that if you were to get tax rates at the level that would be necessary with a tax only on sales at the national level, you'd have rates, when you put the state and federal together, that are getting very, very high.

And whether you can really administer taxes let's say in the 30 percent or more range when you put federal and state together, that gets really pretty questionable on a lot of kinds of cash-based transactions, restaurants and so forth where there is a fair amount of evasion at the state level today.

And so the use of a sales tax, I'm okay with. To replace the income tax entirely with it, I'm not a proponent of that.

Chris Atkins: Wel,l you mentioned the combined state and federal rate; that might be particularly tough sale in a state like Tennessee where you work where you have combined state and local rates already approaching ten percent.

Dr. William Fox: No, that's right. And one of the things that tends to get ignored in the discussion about the national retail sales tax is—I've done some work on the rates and I believe that the rates would need to be higher than those that have usually been talked about.

And part of what's forgotten there is that in order to get the rates even as low as I might think they could be, you're actually having the federal government tax the states. That is the state activities is a part of the base except for education; state and local in fact.

I've forgotten the details, but it's something like state and local governments would have to pay $300 billion to the federal government. Well somehow they're going to have to get $300 billion.

So not only do they have to have the rates that they do today, but they then have to have a rate or cut spending enough to pay the money to the federal government.

And if you align the bases so that the state's, the federal government taxes state activity, the states might say well, then we ought to be able to tax federal activity. And then you've have to generate the revenue at the federal level to go to the states. The interplay here of how this tax works is it's a tricky one.

So again, the notion of taxing consumption is something that by and large I'm comfortable with. Would I go 100 percent that direction? Probably not.

Chris Atkins: Well Dr. Fox, thank you very much for taking time to be with us today. This is a fascinating interview. I know our listeners are going to learn a lot when they listen to it. And we thank you again for joining us.

Dr. William Fox: Chris, you're welcome very much and have a great day.

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