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Perspective

All Taxes Are Not Created Equal

Advantages of Consumption Tax Versus Business Tax

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Texas policymakers are once again dealing with the most difficult of all policy areas: taxes. Taxes are necessary because government has to be financed, but no one wants to pay taxes. To the extent possible, all are happy to let someone else bear the financial burden of government. Anyone who has managed to avoid that burden understandably seeks to protect the privilege.

Tax avoidance demonstrates that taxes are an economic negative even where there is a benefit from the financing of government. Some level of government is necessary and beneficial. The proper level of government is not considered here but if there is to be a net benefit from taxation, it makes sense that policymakers should maximize it. This means the tax system should have as little negative effect on the economy as possible.

Consumption Tax Advantages Over Business Taxes

- Simplicity
  - Lower cost of compliance
  - Better for small business
- Transparency
  - Discourage government growth
  - Distribute burden equally to everyone
- Do not directly penalize investment, innovation, work effort, and job creation
- Texas already has the seventh highest business tax burden in the nation

Tax Choices Before Texans

Policymakers have clearly already decided property taxes are too high. The accepted wisdom is that there is some tax alternative less damaging to the state's economy than the current level of property taxation. Some continue calling for an income tax in Texas despite the income tax's demonstrable bad economic effects.[i] The real choice we face is between a business tax of some sort and expansion of Texas' sales (consumption) tax.

So, the simple question is, "Which kind of tax—consumption or business—has the least negative effect on an economy?" This relevant question is not easy to answer. Using models and statistical analyses, some economists seem to have mostly confused themselves about the effects of various taxes. However, incentives are not really that hard to understand, and taxes are all about incentives.

Taxes Are Incentives

Economists see the economy as a big circle. Money flows from businesses to households to pay for resources since households ultimately own everything. Money also flows from households to businesses to

[i] Vedder, Richard, *Taxing Texans Part I: The Worst Tax for Texas?* Texas Public Policy Foundation, February 28, 2002, http://www.texaspolicy.com/pdf/2002-02-28-tax-taxingtexans1.pdf.

pay for goods and services because businesses produce everything. The two streams of money ultimately have to be equal and a diversion of money from one stream reduces the size of the other stream by the same amount.

Because of the circular nature of money flows in an economy and because households (people) ultimately pay all taxes since they own everything, some economists conclude that it makes little difference what type of tax government depends on. The money is all dipped out of the same money stream anyway, the reasoning goes, so what difference does it make where in the stream government dips it out?

But taxes do affect behavior, sometimes in amazingly perverse ways. Suppose we taxed shoes heavily but not socks. Pretty soon, "socks" fashioned with heavy soles would become acceptable workplace attire. Actual shoes would only be for high fashion and inclement weather. On the other hand, if we taxed socks heavily and not shoes, sandals would likely become the rage and shoe interiors would probably be fashioned with soft, removable inserts that do not meet the tax man's definition of socks.

The types of taxes do make a difference. Taxes do affect peoples' behavior. Taxes' most profound effects, however, only manifest themselves in the long run—over many years. Unfortunately, partly due to lack of data and because so many different circumstances with many different effects can change in the long run, analysis is difficult. The long run does not lend itself well to economic modeling or even to statistical analysis. Still, it is only in the long run that the truly big differences between consumption taxes and business taxes will be witnessed.

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Consumption Versus Business Taxes

Such is the case with business and consumption taxes. Business taxes take many forms but the main issue is that the *producers* of goods and services *directly* pay them. Consumption taxes, on the other hand, are paid directly by *everyone* because we are all *purchasers* of goods and services. The two taxes are *not* equal. They produce very different incentive effects.

The best way to illustrate how business and consumption taxes produce different results is to resort to a thought experiment. Suppose two nations, Nation A and Nation B, are exactly alike in every respect—government, size, geographic circumstance, culture, ethnicity, religious and cultural traditions, and so on. At exactly the same time, the two countries enact a new tax. However, Nation A's tax is a business tax. Nation B's tax is a consumption tax. The two taxes look the same in their effects on national income accounts. They have the same effect on total personal income. Governments in each country spend the money in the same way. And each tax provides the same amount of funds to government—initially.

Now look at the long run—say 20 years. Nation A and Nation B will be very different. After two decades of taxing business enterprise Nation A will see significantly less investment than Nation B. Entrepreneurs and business managers see the business tax as a penalty on investment, enterprise, and hard work. People still want to get rich, but with the rewards so apparently reduced through taxation, work effort of all types is reduced. Many businesses will relocate to other countries to avoid the tax.

Nation B, on the other hand, is penalizing consumption. This encourages individuals to shift their earnings into investment. While an initial commercial slowdown occurs, economic growth persists due to investment activity and Nation B soon enjoys a much higher rate of economic growth than Nation A. Some in Nation B will try to buy elsewhere in order to avoid the consumption tax but most purchasing occurs near where people live and the jobs do more to keep them at home than anything else.

After 20 years, despite the consumption taxes, Nation B's citizens are enjoying a higher standard of living than Nation A. The reality is that so-called business taxes are not really business taxes at all. They are just another form of taxation on people—one that particularly discourages work effort, thrift, and innovation. Jobs will be less plentiful with the business tax than with the consumption tax.

The two countries will differ in other ways as well. Business taxes are more complex than consumption taxes. Therefore, Nation A sees the emergence of a large tax compliance industry in both the legal and accounting professions. Nation B's consumption tax tends to be simpler and encourages less of these industries, thereby encouraging innovative people to engage in profitable efforts that actually benefit others through product and technological development.

One of the manifestations of Nation B's greater dynamic potential will be burgeoning small businesses. Business tax complexity favors big businesses over small businesses because big businesses enjoy economies of scale in tax preparation and compliance. Small businesses suffer a comparative disadvantage. Nation A's workers especially suffer because small business is generally the dominant source of job growth in dynamic economies.

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Nation A also sees the emergence of a large tax lobby. Complexity breeds special privilege and the desire by those without privileges to get them. As time goes on, rules and statutes surrounding the business tax grow more lengthy and complex loopholes are created, discovered, closed, and opened again. The business tax rate will likely increase as tax avoidance schemes become increasingly sophisticated.

Taxes in Nation A are likely to increase more rapidly than in Nation B for another reason. Business taxes are not nearly as visible as consumption taxes. Everyone consumes so everyone knows about consumption taxes. Relatively few own businesses and pay their bills, so fewer realize how costly government actually is. Hidden taxes are much easier to increase than are transparent taxes.

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No doubt, Nation B's consumption tax will see its share of tax avoidance, both legal and illegal as well. Nevertheless, consumption taxes are generally simpler to enforce than are business taxes.

With constant rule and statutory changes, businesses in Nation A will have to live with more uncertainty. A tax practice legal today might be illegal tomorrow and this is more likely to occur with business taxes than with consumption taxes. Uncertainty discourages business expansion. A similar phenomenon already occurs with the federal income tax in the United States.[ii]

Lessons for Texas

The many vagaries of tax law and definitions make it difficult to measure business and consumption taxes' relative effects across states and over time. It is much less difficult to discover the negative effects of income taxes which have done so much to grow government and damage economies in other states. Nevertheless, economic reasoning and common sense can serve as guides.

Business taxes take many forms and virtually all of them have been proposed in Texas recently. These include: a business activity tax and its close cousin the value-added tax, the gross receipts tax, a payroll tax, a dedicated commercial property tax, various excise taxes, and most recently something currently termed the "alternative margins tax." Regardless, they all have the effects described above, not the least of which is a cottage industry of lobbyists seeking tax

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[ii] Edwards, Chris, *Simplifying Federal Taxes: The Advantages of Consumption-Based Taxation*, Policy Analysis No. 416, Cato Institute, October 17, 2001.

privileges that destroy any neutrality such taxes might have had claim to at one time.

On the other hand, Texas' sales tax has never been fully applied. The sales tax can be broadened. The rate can be adjusted as well. It is far more visible and has far more desirable long-term incentives associated with it. It would be a shame for Texas policy-makers to trade short-term political advantage for long-term economic health, but that is the only reason for choosing a business tax over consumption taxes in a property tax swap.

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Texas' business tax burden is already the seventh highest in the nation. Part of that burden is in the property tax, but a property tax reduction would only partially accrue to the business sector. A new or increased business tax would entirely accrue to the business sector.

So-called business taxes are not really business taxes at all. The fact is that only people pay them through lost wages, profits, and investment income. Business taxes pack a one-two punch—particularly when they discourage economic growth and hurt the wealth of a nation or, for that matter, a state.

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