Issues in Comparing State Taxes

Aggregate Tax Comparisons

Debates over state tax policy often lead to comparisons among the states. Policy analysts use a variety of methods to make these comparisons. The most commonly used measures include:

- Taxes per capita.
- Taxes per $1,000 personal income.
- Top tax rates.

Before discussing some flaws in the specific tax measures noted above, there are some generic problems inherent in any overall measure of tax competitiveness. The primary problem revolves around a state's ability to export taxes.

- First, states rich in economically sensitive natural resources, such as petroleum, coal, natural gas and lumber, can impose severance taxes upon removal of these resources which are primarily paid by the ultimate consumers of these products. To the extent these consumers are located in other states, the tax is exported. For this reason alone, most aggregate comparisons fail to be completely informative.

- Second, states with significant tourist industries, like Hawaii, Florida, California and New York, can export a portion of their sales tax base (and certain selected excise taxes) to nonresident visitors. For example, Hawaii has a very high sales tax rate which results in significant revenue generated from nonresident tourists.

- Third, states with significant economic migration of workers may have the opportunity to shift taxes to nonresidents who work in the state.

- Fourth, some state and local tax sources are deductible from federal taxes. To the degree a state and local tax structure is weighted to federally deductible tax sources, a part of the tax cost is exported to the federal government. These factors are not recognized in aggregate tax comparisons.

- Fifth, it is extremely difficult to incorporate tax burdens into overall tax capacity measures. While business taxes are allocated to states based on formula apportionment, the question of who actually pays the tax and where they are located is difficult to determine. This is a specific instance of the more generic problem in the overall tax burden of determining the underlying incidence of a tax structure.

Per Capita Taxes

Per capita taxes are the dollar amount of total tax collections divided by the population of a state. Measuring state tax burdens by using per capita tax collections can seriously mislead the reader. This measure does not reflect ability to pay tax or the demographic composition of taxpayers. Also, as already mentioned, it does not indicate the amount of state tax paid by nonresident workers and consumers, or exported to the federal government through deductibility (i.e., tax incidence, or "who pays the tax").

Tax to Income Ratio

Taxes per $1,000 of personal income are the dollar amount of total collections divided by the personal income of the state's residents in thousands of dollars. Dividing state tax collections by personal income provides a better indicator because it provides some measure of taxpayers' ability to pay. However, like per capita measures, it does not show who actually pays state taxes.

This measure of tax burden is necessarily imprecise as not all residents pay tax particularly corporate and certain selective sales taxes). Again, it also includes taxes paid by nonresidents, but not the income they earn. In New York State, nonresidents and part-year residents currently account for approximately 9 and 15 percent, respectively, of all personal income tax taxpayers and tax liability. Moreover, New York's population is under 7 percent of the national total, but the State accounts for almost 8 percent of total personal income.

A further problem with this measure is that it does not provide control for wealth differences across states. For example, if all states had identical tax structures composed only of a progressive personal income tax, then states with higher per capita incomes would appear as higher tax states. Additionally, as already discussed, this measure does not correct for the deductibility of certain taxes from federal taxes. Federal deductibility allows state taxpayers to shift a portion of the cost of the personal income tax to the federal government.

The U.S. Commerce Department's definition of personal income does not include capital gains or nonresident income, each of which may go toward paying a particular state's income taxes and corporate taxes. In the case of New York State, nonresidents and part-year residents are liable for tax on taxable income derived from sources within New York. Additionally, New York State residents pay tax on capital gains realizations. As a result, the tax-to-income ratio is biased in an upward direction because it includes tax but excludes the associated income. New York residents realize a substantial fraction of national capital gains. This means the upward bias in the tax-to-income ratio is even greater for New York. Tax-to-personal income is, however, a more useful interstate comparison than taxes per capita, because it partially adjusts for the relative wealth or poverty of different states.

Top Rates

Top tax rates are usually represented by the state's top marginal tax rate for corporate and personal income taxes. Comparing state tax *rates* can prove especially misleading because state tax *bases* differ widely, particularly for personal income and sales taxes. For example, states with high graduated income tax rates often have more deductions, exclusions and credits than states with lower, less-graduated rate structures. Also, states tax similar bases differently.

Other Factors

More generally, tax collection patterns can vary from state to state, and fluctuate from year to year. Such factors as law changes, audit activities, withholding rules, and the relationship between tax and fiscal years can skew apparent collections in any given period.

Moreover, caution is warranted when comparing U.S. Census Bureau data to State tax collections data provided by individual states (including New York). The Census Bureau includes various license revenues in tax amounts even though particular states may not report these revenues in their tax collections data.

Furthermore, the U.S. Census Bureau's classification scheme does not always capture ways states may chose to impose taxes on similar entities. For example, the State of Washington does not have a corporation income tax, but it collects about one billion dollars from a tax on business receipts, in addition to a retail sales tax. These differences in classification can hide the fact that the states often elect different approaches to taxing similar entities or activities.

Using the standard measure of tax burden – collections per capita or as a share of personal income – has less meaning for business tax burden than for other taxes. Whereas personal income and sales taxes are at least, in part, paid by individuals out of their personal income, business tax incidence is far less straightforward. Although individuals, as workers, consumers and shareholders, ultimately pay business taxes with their income, where they live may bear little relationship to where the business ultimately pays tax. Also, per-capita and share-of-income burden measures provide little insight on different businesses' ability to pay tax.