An Interview With George Zodrow

by Billy Hamilton

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In this article, Hamilton interviews George Zodrow, a professor at Rice University and a respected authority on state, federal, and international tax matters. Zodrow discusses the Texas Legislature's likely debate next year on tax relief and says lawmakers will probably focus on the property tax and the margin tax -- two taxes he dislikes. He also offers his thoughts on the possibility of federal tax reform passing anytime soon.

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With a debate over tax relief looming in next year's legislative session here in Texas, it is a good time for some expert insight into the issues involved, as well as some other state tax matters. I talked to George Zodrow, an economics professor at Rice University and one of the country's most respected experts, not only in state and local finances but also on federal and international tax reform. Zodrow is also the editor of the *National Tax Journal* and holds appointments at Rice's Baker Institute for Public Policy and the Oxford University Centre for Business Taxation.

Texas, Zodrow said, has fared better financially than most states. "State tax revenues in Texas have benefited not only from the slow economic recovery since the 2008 financial crisis but also from the dramatic increases in shale oil and gas production attributable to technological advances in hydraulic fracturing -- fracking -- horizontal drilling, and three-dimensional seismic imaging, which have greatly expanded the size of recoverable reserves in the state," he said.

Texas will likely enter the 2015 legislative session with a surplus exceeding $6 billion, plus even more in its rainy day fund, which receives most of its income from oil and gas severance taxes. The state forecast projects that the rainy day fund balance will top $8 billion in 2015, with the total likely to grow when the state's official revenue estimates are released next January.

Given that situation, Zodrow said he thinks the Legislature will try to cut taxes next year. "There is, not surprisingly, pressure to use some of this revenue increase to cut taxes, and some tax reduction may be entirely appropriate," he said. But the state may also face pressures on the spending side. "Additional expenditures may be required to support the increase in economic activity in the state due to the expansion of the energy sector as well as population growth," Zodrow said. "Texas has historically been a relatively low expenditure state. Although this presumably reflects the taste of Texas residents, the political process in the state may result in some increases in real expenditures, including on education, infrastructure, and perhaps some social welfare programs."

Zodrow didn't offer any particular tax cut alternatives, but his past research might point toward a reduction in local property taxes, a popular idea in Texas but one that's at odds with some other experts in the public finance field. "There's a sense, especially among some academic economists, that the property tax is a relatively non-distortionary tax," he said. "Indeed, according to the 'benefit view' of the property tax, the tax is completely non-distortionary, as it merely represents a payment for public services received."

That's the theory, but things often don't work out that way in practice, Zodrow argued. The conditions required for the benefit view to work are "fairly stringent," he said. "Among other assumptions, either zoning has to be sufficiently restrictive that all residents of the taxing jurisdiction are paying the same amount of tax, or housing has to be fixed so that the tax is fully capitalized into housing prices," he said. "And even in the latter case, an increase in property taxes leads to capitalization effects with differential effects across houses of different values that are far from those consistent with the benefit tax view. Only after these capitalization effects occur does the property tax become a benefit tax," as he emphasized in recent research.[1] He argued that the tax can be highly distortionary, particularly in the longer run.

Zodrow listed three major problems associated with the tax. "First, it discourages the use of capital, both in housing and other activities, and thus tends to drive capital out of the taxing jurisdiction. Second, to the extent that local governments rely on a tax on mobile capital, they will tend to provide local public services at less than efficient levels. Finally, the property tax creates a tax bias against the production of capital-intensive goods, including housing, as well as reducing incentives for saving," he said.

Zodrow did, however, note one point in the property tax's favor. "There is one sense in which local use of the property tax is efficiency enhancing, although most non-economists wouldn't find this argument especially comforting," he said. "Specifically, because the federal income tax allows deductions for home mortgage interest, it tends to subsidize home purchases, resulting in a tax bias favoring owner-occupied housing that is offset to some extent by property taxes -- which of course are also tax deductible, which reduces their impact."

Zodrow said the least distortionary alternative to the property tax is the sales tax, although it too creates its share of economic problems. "Although a comprehensive tax on all retail sales is relatively efficient, in practice, state retail sales taxes exclude

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[1] Zodrow, "Intrajurisdictional Capitalization and the Incidence of the Property Tax," 45 *Regional Sci. and Urb. Econ.* 57-66 (2014).

many goods and services from the tax base, including many services as well as various socially desirable 'merit' goods, such as food, clothing, healthcare, and education." He said most sales taxes are only partly retail-level taxes, with some estimates suggesting that 40 percent of the sales tax base consists of business purchases, which in principle shouldn't be part of a retail sales tax base. "Thus, the typical state sales tax also creates distortions," he said.

Zodrow mentioned research he conducted with Athiphat Muthitacharoen in which they simulated the effects of equal-yield property and sales taxes, finding that the efficiency costs associated with the two taxes are roughly the same, although the property tax is slightly more distortionary.[2] "This suggests that the efficiency implications of replacing some property tax revenues with additional sales tax revenues wouldn't be huge, so that the choice between the two taxes should be decided primarily on other grounds, with the primary issues being the distribution of relative tax burdens and whether it's best to use a local revenue source to encourage local control of local services, or a state revenue source so that the levels of public services don't depend as much on the level of income or wealth of the residents of local jurisdictions," he said.

Zodrow said the swap of sales tax for property tax would make sense if the sales tax were effectively structured, an unlikely situation. "If the sales tax were in reality a comprehensive tax on retail sales, then a sales tax for property tax swap would be very likely to be efficiency enhancing," he said. "That would require dramatic reforms of the state sales tax structure in most states, with the elimination of the taxation of business purchases to the extent administratively feasible, coupled with increased taxation of consumer services and other goods currently not subject to tax."

The best that lawmakers can do is try to make the base as comprehensive as possible regarding both consumer services and tangible goods, Zodrow said. "A Texas state representative once asked me while I was testifying about state tax reform options how it would be possible, for example, to tax legal services provided to individuals but not to businesses -- and such treatment does appear to be unfair," he said. "But the point is that the legal services provided to the business will ultimately form part of the price of a good that is sold to consumers and will thus be taxed at that time. Taxing services provided by businesses to other businesses is highly undesirable because it results in tax cascading -- that is, multiple applications of the tax to a single consumer good."

Zodrow said numerous analyses have shown that the range of consumer services taxed under state sales taxes vary considerably across states. "For example, work by Michael Mazerov of the Center on Budget and Policy Priorities indicates that the five states that are the most aggressive in terms of taxing consumer services tax 38 of 40 potentially taxable services, while the U.S. average is less than half of that -- around 17 consumer services," he said. "Thus, expansion of the sales tax to additional consumer services is an attractive reform option, at least for the states that have not largely exhausted that option."

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[2] Zodrow and Muthitacharoen, "Revisiting the Excise Tax Effects of the Property Tax," 40 *Pub. Fin. Rev.* 555-583 (2012).

But what about the regressive effects of a broad-based sales tax with few consumer exemptions on low- and middle-income families? "Equity concerns should be addressed with means-tested income tax rebates -- or some other form of rebate in states without income taxes -- that offset the sales tax burden for low-income families," he said. "That's a much more targeted approach than applying zero or reduced sales tax rates to broad categories of goods that are purchased by both the poor and the rich." Any remaining tax regressivity can be offset by targeting expenditures to low- and middle-income families, he said.

Despite the drawbacks with state sales taxes, Zodrow said he generally favors the recent trend in several states to reduce personal income taxation and make up the revenues with expanded sales taxes. "I support reducing reliance on state income taxes and replacing the lost revenues with well-designed consumption-based taxes," he said. "I have always found compelling the arguments that the federal government should be primarily responsible for income redistribution while the states focus on resource allocation, and that consumption-based taxes are a more efficient source of revenues than state income taxes, especially since both capital and labor mobility are greater at the state level than at the national level."

Zodrow said that even if a state wanted to redistribute income more than what now occurs at the national level, it could be accomplished with "pro-poor expenditure policy and by providing tax rebates to the poor." He added that "if a state wanted a personal tax system with progressive marginal rates, that could be accomplished with one of the individual-based consumption-based tax systems that have been debated at length -- but never adopted -- at the federal level, such as the progressive consumption tax option discussed by the 2005 President's Advisory Panel on Federal Tax Reform."

That led the teacher to feed his student -- me -- a question I hadn't considered asking. "Suppose a state reformed its sales tax along the lines I've outlined -- a comprehensive tax on consumption, with a rebate for the poor to address equity concerns at the bottom of the income distribution," he said. "Wouldn't such a system be subject to the same criticism often levied against the value added tax or VAT -- that it would be a 'money machine,' leading to an undesirable overexpansion of public services?"

My guess was yes, but I was only partly right. "The money machine argument certainly has some currency," he said. "It was one of the main reasons that the president's tax reform panel recommended against introducing a value added tax at the federal level. However, I don't find the money machine argument particularly compelling. Even if there's a correlation between the use of broad-based consumption taxes and the level of public services, it's important to note that one would expect that using such a tax would lower the cost of raising revenue, relative to other less efficient options such as a gross receipts tax -- which the VATs replaced in many cases when they were enacted in Europe -- or an income tax."

Zodrow said that if the cost of public funds declines because of the replacement of a highly inefficient tax with a less inefficient tax, the implication is that the optimal level of public services increases to some extent. "Thus, the money machine argument is relevant only if the increase in public services is greater than that associated with a reduction in the cost of public funds, and it's far from clear that this has been the case," he said. "Instead, it seems more likely that countries with a relatively high demand for public services choose to finance those public services with a relatively efficient tax, such as the consumption-based value added tax. Moreover, in the U.S., any tendency toward overexpansion of public services will be mitigated by political pressures to keep tax rates low -- a very powerful force in most if not all states."

Returning to the topic of possible tax cuts in Texas, another tax likely to attract legislative attention next year is the business franchise tax, commonly known as the margin tax. Enacted in 2006 and first imposed in 2008, it is a form of modified gross receipts tax on most businesses that has proved extremely unpopular, particularly among business taxpayers that didn't pay the old corporate tax. One major problem with the tax is that it is extremely complicated, with multiple possible tax bases among which taxpayers are allowed to choose. The tax also varies in many of its definitions from federal tax law, which complicates the task for taxpayers.

I asked Zodrow about the tax. "I'm not a fan of the margin tax," he said. "My concern is not about the relatively large number of businesses subject to the tax. The primary rationale for a business tax is that it acts as a rough approximation to a user charge for the benefits that all businesses -- not just corporations -- receive from public services. Under this view, a comprehensive low-rate business tax is entirely appropriate.[3] However, the margin tax falls far short of this standard. It has some of the features of a classic gross receipts tax, widely perceived by economists as an exceedingly poor tax that is characterized by pervasive tax cascading."

Zodrow said the three alternative margin tax bases imply that the tax burden varies across different types of businesses, creating all sorts of investment distortions. "The margin tax also creates obvious incentives for businesses to specialize in activities that benefit from one form of the tax, while outsourcing activities that benefit from the other forms of the tax -- a phenomenon that is presumably at least partially responsible for the persistent revenue shortfalls under the tax," he said.

That's not all. "Because the tax base is defined so haphazardly, consisting of neither an approximation to income nor an approximation to consumption or production, differential rates are imposed under the tax and seem likely to proliferate," Zodrow said. "The result is an inequitable, inefficient, and complex tax system." He said John Mikesell of Indiana University has described the margin tax as a "badly designed business profits tax . . . combin[ing] all the problems of minimum income taxation in general -- excess compliance and administrative cost, penalization of the unsuccessful business, undesirable incentive impacts, doubtful equity basis -- with those of taxation according to gross receipts." Zodrow couldn't agree more. "The Texas margin tax is ripe for reform or elimination," he said.

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[3] Elisabeth Gugl and Zodrow, "Tax Competition, Local Infrastructure, and Business Taxation: A Comparison of Different Tax Instruments," *Nat'l Tax J.*, forthcoming.

What originally made me contact Zodrow was state tax reform and how tax studies fit into reform efforts. He was involved in the Louisiana tax study I wrote about recently, mainly reviewing some of the early analysis prepared for the study.[4] Because his role was limited to reviewing a preliminary analysis of Louisiana's tax system, he didn't want to comment on the ongoing study, particularly this early in the process. He did, however, offer several points about state tax studies generally.

"One of the most important things a good state tax study can do is simply remind policymakers that there's a widely accepted set of tax principles that should be used to evaluate any proposed state tax reforms, regardless of whether the immediate political goal is to lower taxes, raise revenues, reform existing taxes, or change the state tax mix," he said. "There are good and bad ways to achieve any particular political goal, and a well-executed study should play an important role in distinguishing between the two."

He also said that state tax studies should encourage policymakers to focus on, or at least consider, the long-term implications of their policy choices rather than just focusing on the current issue that led to the reform debate. "State tax reform discussions often initially have a very narrow perspective," he said. "A good state tax study should broaden the perspective to include a wide variety of potential reforms that might achieve the same goals that were the focus of the initial discussion but in a way that's more consistent with the principles of good policy from a public finance perspective."

Zodrow said that much of the current discussion regarding state tax reform focuses on tax rates. "State tax studies should remind policymakers that equally if not more important issues are the definitions of the tax base and the mix of taxes utilized," he said. "In fact, these issues should be largely resolved before the critical issue of tax rates is addressed -- with the important benefit that the efficiency costs associated with any pattern of tax rates should be lower if the base is designed well and a desirable mix of taxes is chosen." A comprehensive state tax study can provide a deeper understanding of current and past thinking on what works -- and what doesn't -- in state taxation.

He said that the literature on the effects of state taxes, which lies at the heart of many recent debates over tax cuts and tax swaps, is constantly changing. A comprehensive state tax study can provide an analysis of recent developments, as well as a deeper understanding of current and past thinking on what works -- and what doesn't -- in state taxation. "A good example is the ongoing discussion regarding the relative merits of retail sales taxes as they are actually implemented in the states, relative to gross receipts taxes, which have always had an exceedingly bad reputation in the academic community," he said.

"A good state tax study can provide an unbiased yet critical review of the literature relevant to the reforms being discussed," he said. "For example, there is considerable controversy regarding the effects of taxes on capital income on the levels of investment

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[4] Hamilton, "Louisiana Tax Study Takes on the 'Whole Ball of Wax,'" *State Tax Notes*, Oct. 7, 2014, p. 41.

and the size of the state capital stock. Some of these studies don't control adequately for the mix of expenditures financed with these revenues, including the levels of services provided to business. In my view, these studies should be weighed much less than alternative studies that thoroughly consider the mix of public services that accompany any given level of capital income taxation."

He said other issues that should be covered by a comprehensive study include "the effects of taxes on economic growth, tax competition among states, the implications of mobility of capital and labor across states, the extent to which a state has benefited from the recent increase in domestic production of energy resources, and recent changes in the income distribution, both nationally and within the state in question."

Gathered in one place and presented clearly, that information can be valuable to policymakers, particularly given recent changes in tax policies in many states, Zodrow said. "There's evidence that state tax policies are not only affected by tax competition -- the tendency to reduce taxes on capital income, and to a smaller extent on high labor incomes, to avoid losing capital and high-income individuals to other states -- but also by 'yardstick competition' under which changes in state policies are related to similar policy changes in neighboring states," he said.

To wrap up, I asked Zodrow about federal tax reform, another major focus of his research since the 1980s when, as a visiting economist for the U.S. Treasury, he worked on what's come to be known as Treasury I, the precursor to the Tax Reform Act of 1986.

"I doubt that anything will be done on fundamental tax reform until after the next presidential election -- if then," he said. "Tax reform is an extremely contentious issue, and it's hard to believe that the current highly polarized Congress will be able to deal with it, especially once the debate turns to the details." He said the lukewarm reception given to the comprehensive reform proposal issued as a discussion draft by House Ways and Means Committee Chair Dave Camp, R-Mich., is "a pretty clear indication of the current state of affairs."

TRA 1986 faced similar obstacles. "The situation was in some ways similar in 1986 with a split Congress and a reform process that was clearly headed toward making the tax system significantly worse," he said. "In that case the congressional leadership reversed course and ultimately passed the landmark Tax Reform Act of 1986, with a vote in the Senate of 97-3. Still, it's exceedingly hard to imagine that happening in the current environment. Moreover, given that the current U.S. corporate income tax rate is the highest in the industrialized world, it won't be possible to apply the 'grease to the wheels of reform' that was so effective in 1986: an 8 percent tax cut for all individual income groups, financed with an increase in corporate taxes -- all magically achieved within the context of what was widely described as a 'revenue-neutral' tax reform."

He said that if any reform is enacted, it's likely to be a stand-alone corporate income tax reform plan. "Existing proposals from both parties recommend a standard base-broadening, rate-reducing approach, funding a cut in the statutory corporate rate with the elimination of a wide variety of tax preferences or business 'tax expenditures,'" he said. "Such a corporate rate reduction would be especially beneficial to the extent it reduces incentives for income shifting to take advantage of relatively low statutory tax rates abroad and encourages U.S.-based production of very profitable products that utilize highly mobile intangible capital."

Nothing will come easily, though. "Once the specifics of corporate tax reform are known, there will be fierce opposition from those whose industry-specific preferences are being eliminated, coupled with a reluctance to eliminate general investment incentives such as accelerated depreciation," Zodrow said. He painted a picture reminiscent of the "showdown at Gucci Gulch," the fight among lobbyists over the provisions of TRA 1986 that was famously recounted in Jeffrey Birnbaum and Alan Murray's 1987 book by that name.[5]

It was quite a battle. When the Treasury I plan was presented late in 1984, it was, as *The New York Times* later reported, "a singularly pure intellectual exercise."[6] The plan eliminated almost every tax preference, including the investment tax credit and personal deductions for state and local taxes, and limited deductions for charitable contributions -- although the deduction for home mortgage interest was left intact. Not surprisingly, it caused an instant uproar. Then-Treasury Secretary Donald Regan responded that the plan had been composed on a word processor and could be amended on the same device.

Considerable compromise went into the next version, Treasury II, which appeared in 1985. Numerous tax preferences were retained, including those that favored oil and gas production, so that the proposal was considerably less "pure" -- although significantly more politically feasible -- than Treasury I.[7] More to the point, it started a legislative process that ended on October 22, 1986 --almost exactly 28 years ago -- when President Reagan signed the widely heralded Tax Reform Act of 1986 into law on the South Lawn of the White House.

That may be the most important lesson Zodrow has to offer from his long experience. Often the most popular aspects of any tax system also distort it and contribute to its inefficiency. Redesigning tax systems, whether in a state capital or in Washington, will never be perfect, but the process works better when policymakers understand the effects of various tax policies, rather than just how they're presented in lobbyists' talking points. If policymakers pay attention to the experts, they'll better understand what's at stake, and that can help them find a balance between the clean lines of economic theory and the messy patchwork that characterizes most tax systems today.

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[5] Birnbaum and Murray, *Showdown at Gucci Gulch*, New York: Vintage Books, 1987.

[6] Robert Lekachman, "And They Said It Couldn't Be Done," *The New York Times*, July 5, 1987.

[7] In fact, Zodrow and coauthor Charles McLure wrote an article at the time comparing the actual law enacted with the original Treasury I proposal. *See* McLure and Zodrow, "Treasury I and the Tax Reform Act of 1986: The Economics and Politics of Tax Reform," 1 *J. of Econ. Persp.* 37-58 (1987).