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INCOME TAXES VS. SALES TAXES: A WELFARE COMPARISON

By Grant Casteel and Joseph Haslag

I. INTRODUCTION

Which tax structure — sales or income — is most preferred by the typical Missourian? For the purposes of this essay, the notion of "most preferred" is formalized as lifetime welfare. Both sales and income taxes are distortionary. In other words, changes in either type of tax rate will affect a price, which in turn will affect equilibrium quantities. In the case of a change in the income tax rate, prices change in the markets for labor capital, distorting equilibrium quantities. In the case of a change in the sales tax rate, prices change in the market for current consumer goods, distorting the equilibrium quantities of consumption goods. Because both types of taxes are distortionary, it is difficult to tell whether welfare is higher under the system relying more heavily on the income tax or under the system relying more heavily on the sales tax.

This essay uses quantitative methods built on logically consistent economic theory to compare welfare under the two alternative tax structures. The model economy we use here is built on three pillars. The first pillar is the technology that produces final goods and services — the composite consumer good — from physical and human capital. The second pillar is the welfare that people derive from consuming goods and services over time. The third pillar is the government budget constraint. With this model economy, we can offer some insights into the dynamic adjustments that arise because of changes in tax policy, while ensuring that the resources allocated to the government are held constant across the different policies. The main goal is to quantify the welfare effects over the short, medium, and long runs.

Our results are tied to our choice of the model economy. We will use the *AK* growth model, which shows the relationship between output (*Y*), capital stock (*K*), and a technology parameter (*A*) that measures output per unit of capital. This model has been criticized on a number of fronts. For one thing, the model does not allow for diminishing marginal return to capital, and critics argue that data contradict this assumption. However, defenders point out that this assumption is not necessarily inconsistent with the data when *K* is interpreted as a combination of human and physical capital. Both

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Our results are quite robust, finding that economic growth increases as the income tax rate declines.

are difficult to measure, and therefore no clear empirical evidence refutes the *AK* model.[1] In this model economy, the growth rate is inversely related to the income tax rate. Hence, movements in the state's income tax rate affect the state's economic growth rate. In contrast, in a model with diminishing marginal returns, a change in the income tax rate affects the state's long-run level of economic activity. In the absence of compelling evidence that the model economy's predictions are inconsistent with the data, we proceed with our quantitative analysis using the *AK* model.

Ultimately, our results sharpen the focus on a current policy issue. For several years, the Missouri legislature has considered bringing a constitutional amendment that would eliminate the state income tax and replace it with a broad-based sales tax on consumer items. When two alternative distortionary taxes are under consideration, there are tradeoffs between them. It is imperative, therefore, to bring quantitative analysis to bear; in other words, to help assess whether people would be generally happier under the current tax structure or under the proposed new tax structure. In this case, eliminating the state income tax would result in faster growth at the cost of less consumption initially. Is the increase in the state's economic growth rate worth it? That is the unanswered question.

Our results are easily summarized. Over the long run, welfare would be higher under the sales tax structure. Economists measure welfare in terms of "utils," which is a unit of utility. This is an ordinal measurement, so differences in numbers do not have comparative meaning. I can say that the difference between two policies is 10,000 utils and you can say the difference is 10 utils; but this is only a relative value statement, not a concrete value statement. In order to make comparisons, we need to convert the welfare measure into something tangible. The standard method for doing this is to examine a question with a tangible foundation. For instance: What percentage change in consumption must be provided to the typical person so that he or she is indifferent between the income tax policy and the sales tax policy? We find that, over the long run, a person would need an 8.7-percent increase in consumption under the income tax policy to maintain the same level of happiness as under the sales tax policy.

Our results are quite robust, finding that economic growth increases as the income tax rate declines. On the other hand, consumer spending declines in the face of an increase in the sales tax rate. Therein lies the basic tradeoff: foregoing some current consumption for faster growth. For most reasonable sets of model economy parameters, our findings indicate that people realize higher welfare when the income tax rate is lowered and a broad-based sales tax is implemented. However, we also show that if people value current consumption enough relative to future consumption, they prefer the income tax regime to the sales tax regime.

When a sales tax policy is implemented, consumer spending declines. Indeed, from a given identical starting point, consumer spending is lower under the sales tax policy than under the income tax policy. As such, welfare is adversely affected at first. However, over time, the absence of an income tax means

that economic growth increases when compared to the growth rate realized under the income tax policy. Faster growth means that, under the sales tax policy, consumption spending would eventually catch up and surpass the level of consumer spending under the income tax policy. Thus, the effects of the growth rate more than offset the effect that the sales tax policy would have on consumer spending.

We next consider several modified versions of this model economy in order to check whether our quantitative results are robust enough to withstand changes in the economic environment. The answers are consistent: After about a generation's worth of time, people are happier under the sales tax policy than under the income tax policy. We have abstracted away from cyclical fluctuations, concentrating instead on the trend rates of growth. One critical feature of our model economy is that the rate of growth depends on the income tax rate.

II. THE MODEL ECONOMY

Our model economy is a version of the *AK* model specified by Rebelo (1991). Ireland (1996) used a calibrated version of the *AK* model, conducting income tax policy experiments to assess the national long-run Laffer curve. Through this work, Ireland identified the minimum income tax rate that would support a government size that is a constant fraction of the national economy over time. Within its parameters, the federal government would be permitted to borrow, but could not run a Ponzi scheme.

Missouri faces a borrowing restriction for general revenue spending, so we have specified that the government budget constraint in our model economy allows for no government bonds. In other words, the government runs a balanced budget period by period. This further implies that our two policy experiments are set so that the level of government revenue is held constant. Tax rates, whether levied on income or sales, are held constant over time.

There are four key relationships in this model economy: 1) Agents must choose between consumption today and consumption in the future (i.e., the consumption-saving decision). 2) Production scales with capital accumulation. 3) In equilibrium, the rate of capital accumulation (that is, growth) depends on the income tax rate; a higher rate results in slower economic growth. 4) In equilibrium, consumer spending depends on the sales tax rate; higher rates lead to less consumption and greater saving.

We will not specify the entire model economy, but we will provide the six key equations that characterize its key equilibrium quantities, equations that encompass the tradeoffs listed in the preceding paragraph. Calibration is the process of specifying parameter values, choosing from the literature and from key observations that are realized in the Missouri economy. With the calibrated model, we can conduct our policy experiments.

Welfare is the centerpiece of our analysis, so we begin by specifying a person's utility function. Here, the objective is to maximize lifetime utility. For simplicity, we consider a case in which

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parents care about the welfare of their offspring, so that lifetime utility can be represented through summing period-by-period utility over an infinite horizon: That is:

$$U(\{c^t\}_{t=0}^{\infty}) = \sum_{t=\theta}^{\infty} \beta^t \frac{c_t^{1-\sigma}-1}{1-\sigma} \qquad (1)$$

where $0 < \beta < 1$ is the person's subjective time rate of preference.

This functional form, known as the constant elasticity of substitution (CES) function, tells us the rate at which a person substitutes consumption across two periods of time. Specifically, σ is the CES parameter that characterizes the rate 1/σ, which is the constant elasticity of substitution between consumption at date *t* and date *t+1*.

In each period of time in this model economy, people face a budget constraint. In general, people receive a flow of income from production and from the undepreciated value of the capital stock that they own. The government pays each person a lump-sum transfer payment. From this flow of income, people pay taxes, buy consumer goods and purchase new capital. Overall, this constraint tells us what the person can afford to purchase from the income they receive. With an income tax, the first-period budget constraint is represented as:

$$(1 - \tau_1)AK_0 + (1- \delta)K_0 + G_0 = C_0 + K_1 \qquad (2)$$

With the sales tax, it is represented as:

$$(1 - \tau_2)AK_0 + (1- \delta)K_0 + G_0 - \theta C_0 = C_0 + K_1 \qquad (3)$$

AK_0 denotes the consumer's output, τ the income tax rate, $(1- \delta)K_0$ the depreciated capital stock, G_0 a lump-sum transfer from the government, θ the sales tax rate, C_0 initial consumption, and K_1 the second-period capital. We consider an economy with separate federal and state income taxes. So, τ_2 is the federal income tax rate and τ_1 is the combined federal and state income tax rate. For each policy setting, we hold government revenues constant so that:

$$\tau_1 AK_0 = \theta C_0 + \tau_2 AK_0 \qquad (4)$$

Equations (1)–(3) are sufficient to derive the economy's equilibrium growth rate. Formally, this is represented as:

$$\gamma = \{\beta[(1-\tau)A + (1-\delta)]\}^{\frac{1}{\sigma}} \qquad (5)$$

The government budget constraint indicates that the revenues equal the lump-sum transfer per person. We represent this period-by-period constraint as:

$$G_0 = \tau_1 AK_0 \qquad (6)$$

These equations solve for welfare, government revenues, consumption, investment, output, and the economy's growth rate, taking the tax rates and initial capital stock as given. Once calibrated, we can use this model economy to assess the effects of different tax policies. We now turn to the calibration process.

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III. QUANTITATIVE RESULTS

We begin our quantitative analyses by choosing some key parameter values. The average marginal federal tax rate is 20 percent.[2] The Missouri individual income

tax is 6 percent on all taxable income greater than $9,000. We set τ_1 equal to the sum of these two values. If the state's individual income tax were eliminated, the resulting total, τ_2, would be set at 20 percent.

Values for the preference parameters are set at standard levels from economic literature. Each period is treated as if it is one year, and the size of the economy is determined by the size of the initial capital stock. For our purposes, we assume that the state's initial capital stock is 1. Changing this value will only change the scale of the economy, so we can scale up or down the Missouri economy without changing our key results. Thus, to recap, we start with:

$$\tau_1 = 0.26,\ \tau_2 = 0.2,\ \delta = 0.1,\ \sigma = 1.5,\ \beta = 0.96,\ K_0 = 1 \qquad (7)$$

To solve for the value of the technology parameter, *A*, we use Equation (5) with $\delta = 0.10$ and $\gamma = 1.006$. With the values specified in Equation (7), we find that A = 0.2041.

With the parameters set in Equation (7), Equations (1)–(6) can be solved and evaluated. Now, we can use Equation (6) to find the size of the combined federal and state government. The model economy, under the income tax structure, has a growth rate of 1.006. This should not be surprising, because it is an artifact of our calibration. Missouri's capital stock grows at the same rate as the state economy, so $K_0 = 1.006$. We solve Equation (2) for consumption in the first period (date 0), and find that consumption is 48.1 percent of gross domestic product (GDP).

Next, we consider a change to this economy so that the new tax rate is 20 percent, reflecting only the federal income tax. With the state individual income tax eliminated, the income tax rate falls from 26 percent to 20 percent. Note that the state's growth rate changes when the income tax rate declines. With the other parameter values constant, we recomputed Equation (5) with $\tau_2 = 0.20$. Using the lower individual income tax rate, we find that $\gamma = 1.014$. In other words, the state's net growth rate increases from 0.6 percent to 1.4 percent.

Equation (4) is the expression that dictates revenue neutrality in the first period. We solve Equation (4) for the sales tax rate that will keep state (and federal) revenues constant from date 0 to date 1. We find that $\theta = 0.119$. So, the sales tax rate would need to rise to 11.9 percent in order to keep state revenue constant. With the new state sales tax policy, consumption is 44.9 percent of GDP. So, the tradeoff is clear: Consumption falls initially when a broad-based sales tax is applied, but the economy experiences faster economic growth.

To see the impact, we compute the utility level (welfare) for each period under the two alternative policy regimes. We use Equation (1) to compute period-by-period welfare. Using the consumption at date 1, we know that consumption growth is equal to 0.6 percent in the economy with state individual income taxes, and growth is equal to 1.4 percent in the economy with a sales tax replacing the individual income tax. Figure 1 plots the utility level for both economies. Initially, we see that our model person prefers the income tax to the sales tax, because utility is higher. Over time, however, the faster growth means that both consumption and accumulated welfare in the sales tax regime surpass the

Initially, we see that our model person prefers the income tax to the sales tax, because utility is higher. Over time, however, the faster growth means that both consumption and accumulated welfare in the sales tax regime surpass the levels of consumption and accumulated welfare in the income tax regime.

levels of consumption and accumulated welfare in the income tax regime. Although our analysis indicates that it takes only nine periods for consumption under the sales tax to exceed consumption under the income tax, it takes about a generation for the relative levels of welfare to switch.[3]

Figure 2 plots the same utility functions as Figure 1, but extends from period 1 to past period 270. The graph shows that welfare approaches parallel asymptotes, leveling off to a constant difference of about six utils. Although the measure of six utils has no concrete value — it is only a relative ordinal measurement, as mentioned earlier — the fact that it is invariant at the outer limits of our data set implies that the utility levels will never cross again. Therefore, the welfare under the sales tax regime is lower than welfare under the income tax regime initially, but over time accumulated welfare is consistently higher under the sales tax regime than under the income tax regime.

To further illustrate this, we present the path for consumer spending in the two regimes. Figure 3 plots aggregate consumption over time. Initially, people consume more in the income tax regime than in the sales tax regime. As the sales tax rate is increased, consumer spending declines. However, the slope of the consumer spending line in the sales tax regime is steeper than the slope of consumer spending in the income tax regime. The slope of this line conveys the economy's growth rate. By the 10th period, consumer spending in the sales tax regime has caught up and surpassed consumer spending in the income tax regime. So, the tradeoff between the two tax regimes boils down to whether the person is willing to accept lower initial consumption for higher future consumption. Our quantitative analysis indicates that for the baseline parameter settings, the typical person is patient enough to accept lower current consumption for higher future consumption.

To focus on the long-run implications, we follow economic tradition by asking how much extra consumption the typical person would need in order to be indifferent between the sales tax regime and the income tax regime. Long-run welfare is lower in the income tax regime, so people living in this economy would need to be compensated — that is, receive extra units of consumption — to be just as happy as the same person would be living in the sales tax regime. For a person living in the income tax regime, we find that per-period consumption would need to be increased by 8.7 percent for that person to be indifferent to the sales tax regime.

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Robustness

Clearly, our results depend on the tradeoff between consumer spending and economic growth, and several parameters in the model economy affect this tradeoff. We use parameter values that are fairly standard in the economics literature. There is, however, uncertainty about the exact values of these parameters. Accordingly, we will systematically consider changing these parameter values to see how much they affect the results.

To recap, the tradeoff between consumer spending and economic growth owes chiefly to the relationship between the income tax rate and the equilibrium economic growth rate. If a state government lowers the income tax rate, the state benefits from faster

economic growth. If the foregone income tax revenues are replaced by a higher sales tax rate, consumer spending is immediately and adversely affected. So, our basic question is: Would the typical person benefit enough from the faster growth to be willing to suffer the immediate loss of consumer spending?

In our model economy, the economic growth rate depends on the after-tax rate of return. One of the factors affecting the equilibrium growth rate is the technology parameter, *A,* along with the income tax rate. As the income tax rate permanently decreases, the equilibrium growth rate permanently increases.

The after-tax rate is a multiplicative function of the technology parameter and the income tax rate, so the size of the tax rate effect depends on the size of the technology parameter. Indeed, the smaller the technology parameter becomes, the smaller the effect that a tax reduction will have on the equilibrium growth rate. Put another way, our analysis could be overstating the technology parameter, which — holding everything else constant — would also mean overstating the size of the growth rate effect. With a smaller increase in the economic growth rate, the sales tax regime becomes relatively less attractive.

We cannot simply reduce *A* in an effort to correct for this, because that would change the calibration that matches Missouri's actual economic growth rate. We could, however, lower the initial individual income tax rate. Suppose that we treat 20 percent as the average marginal income tax rate for the combined federal and state income tax burdens. The rationale for using this figure is that combined federal, state, and local taxes account for about 20 percent of national GDP. This approach is not a marginal concept, but an average.With $\tau_1 = 0.20$, we redo our calibration. We set $A = 0.1888$ for the value of the technology parameter that matches Missouri's average annual growth rate of 0.6 percent. We also reduce the value of the change in the individual income tax rate. Instead of falling 6 percentage points, suppose the decline is only four percentage points. In other words, let $\tau_2 = 0.16$. The smaller the change in the tax rate, the smaller will be the impact on the state's economic growth rate. Using these parameter settings, we find that the equilibrium growth rate increases to 1.2 percent. With a smaller decline in the individual income tax proceeds accompanying this parameterization (see Equation (5)), the sales tax rate that keeps revenue neutral in the initial period is also lower. We compute the revenue-neutral sales tax rate to be 10.9 percent.

For these settings, it takes a little longer for welfare under the sales tax regime to catch up to the welfare under the income tax regime. After a generation and a half (39 periods), we find that the faster economic growth results in higher accumulated welfare under the sales tax regime than under the income tax regime. With slower growth, it takes 11 periods for consumer spending in the sales tax regime to surpass consumer spending in the income tax regime. However, the person in this model economy is patient enough, preferring the faster growth rate that comes with the sales tax regime. Our welfare analysis indicates that the person is willing to bear reduced consumption spending to realize faster growth. In the long run, a person in the income

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By replacing the income tax with a revenue-neutral sales tax, the state economy realizes faster economic growth.

tax economy would require 3.8 percent higher consumption to be indifferent to the long-run welfare achieved under the sales tax regime. Thus, although the welfare gain is smaller under the revised parameterizations, we continue to see that the benefits of faster economic growth more than offset the distortionary effects that exist in the sales tax regime.

Next, we consider a change in people's preferences. Here, a person's patience is captured by two different parameters. The discount factor, β, reflects a person's global patience, while the value of σ measures local patience. Put another way, a person with a lower discount factor has a lower preference for all future periods. Alternatively, a person with a higher elasticity of substitution must receive more of the *next period's* consumption when facing a given reduction in today's consumption.[4]

We consider a case in which $\beta = 0.94$. For this parameter setting, the tax rate changes from 0.2 to 0.16. With $\tau = 0.2$, then $A = 0.2165$, which will match the annual average growth rate. We find here that lifetime welfare is higher under the sales tax regime than under the income tax regime, and the state economy's growth rate increases from 0.6 percent to 1.1 percent. People in this example care less about future consumption, however, so they only need to be compensated by 0.9 percent of consumption spending to be equally as well off in the income tax regime as they are under the sales tax regime.

Lastly, we consider a case in which $\sigma = 2.5$. If we reduce the marginal income tax rate from 0.20 to 0.16, then $A = 0.196703$. For these parameter settings, the equilibrium growth rate increases from 0.6 percent to 0.9 percent. Moreover, future consumption is not as highly valued under larger values of σ. With these parameter values, we find that long-run lifetime utility is lower under the sales tax regime compared with the income tax regime. Thus, the increase in the growth rate combined with the increased curvature of the utility function means that, given these parameters, welfare declines under policy in which a broad-based sales tax is used to finance state government.[5]

Our model economy produces a revenue-neutral sales tax rate. We find that the rate is quite high principally because consumer spending is about 50 percent of GDP. In the actual economy, consumer spending is approximately two thirds of GDP. With a larger base, the revenue-neutral tax rate would be smaller. It is not clear whether the proportion of consumer spending to GDP is a significant detriment to our analysis. In practice, some forms of consumer spending would be exempted.

Are Some Parameter Values More Reasonable Than Others?

There is some justification for choosing varying parameter values for the elasticity of substitution. In the economic literature on business cycle fluctuations, researchers tend to use $\sigma = 1$. The elasticity of the substitution parameter is obtained from econometric studies that use micro data; that is, the estimates are obtained from observations on individual behavior. Typically, the values for σ are taken between 1 and 2, though values ranging from 1 to 4 are considered "reasonable." Thus, the values considered in our quantitative analyses are both reasonable in the economic literature.[6]

There is one troublesome aspect to the lack of robustness observed in our quantitative analysis. Namely, one can argue that our results depend on preferences. It matters whether the typical person likes growth more or less relative to the initial decline in consumer spending. Whenever one relies on unknown preferences in order to assess welfare comparisons, the outcome is inherently uncertain.

IV. SUMMARY

The purpose of this essay is to quantify the welfare effects of two different distortionary taxes. We consider a welfare comparison between an income tax regime and a sales tax regime, and calibrate our model economy to observed settings in the Missouri economy.

Our main finding is simple. By replacing the income tax with a revenue-neutral sales tax, the state economy realizes faster economic growth. With a higher sales tax rate, to replace lost revenues from the income tax, the immediate effect is a reduction in consumer spending. Consumer spending grows at a faster rate, however, so consumption catches up and eventually surpasses the consumer spending in the income tax regime.

In the long run, people would be need to be compensated in order to have the same welfare level in the income tax regime as they obtain in the sales tax regime. Our quantitative results indicate that a representative person would need an 8.7-percent increase in consumer spending in the income tax regime to be as well off as they are under the sales tax regime.

We do find that our results are sensitive. Specifically, we find that if the representative person has a low-enough elasticity of intertemporal substitution, they will prefer the state income tax regime to a broad-based sales tax regime. In other words, our results indicate that the more a person values current consumption relative to next year's consumption, the income-tax policy yields higher welfare than the sales-tax policy. Despite realizing faster economic growth, people with that set of preferences in our model economy simply do not value future consumption enough to suffer the initial reduction suffered by consumers when the sales tax is implemented.

Overall, the model economy stresses the role played by the relationship between the income tax rate and economic growth in determining lifetime welfare. Through compounding, faster growth overcomes the immediate detrimental effect that a sales tax produces on consumer spending. In this sense, a person's patience, or lack thereof, determines which state tax regime is preferable. It is not under dispute that replacing the state income tax with a revenue-neutral sales tax increase would result in faster economic growth, but the policy switch would mean that people have to wait a bit for consumer spending to rise above their current levels.

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Figure 1 — Utility Levels for an Income Tax Model Economy and a Sales Tax Model Economy

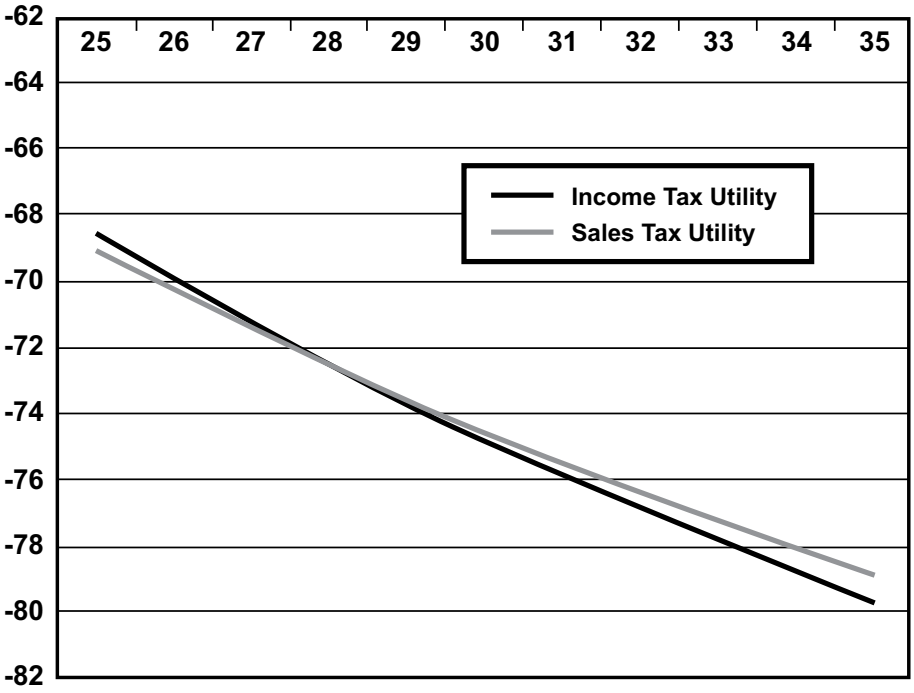


Figure 2 — Extended Utility Levels for an Income Tax Model Economy and a Sales Tax Model Economy

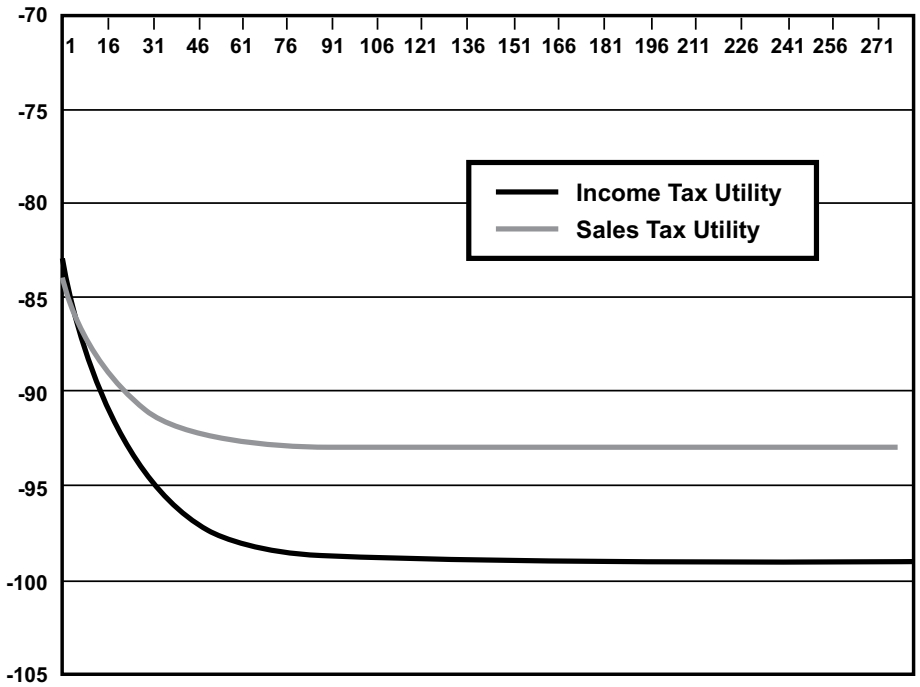
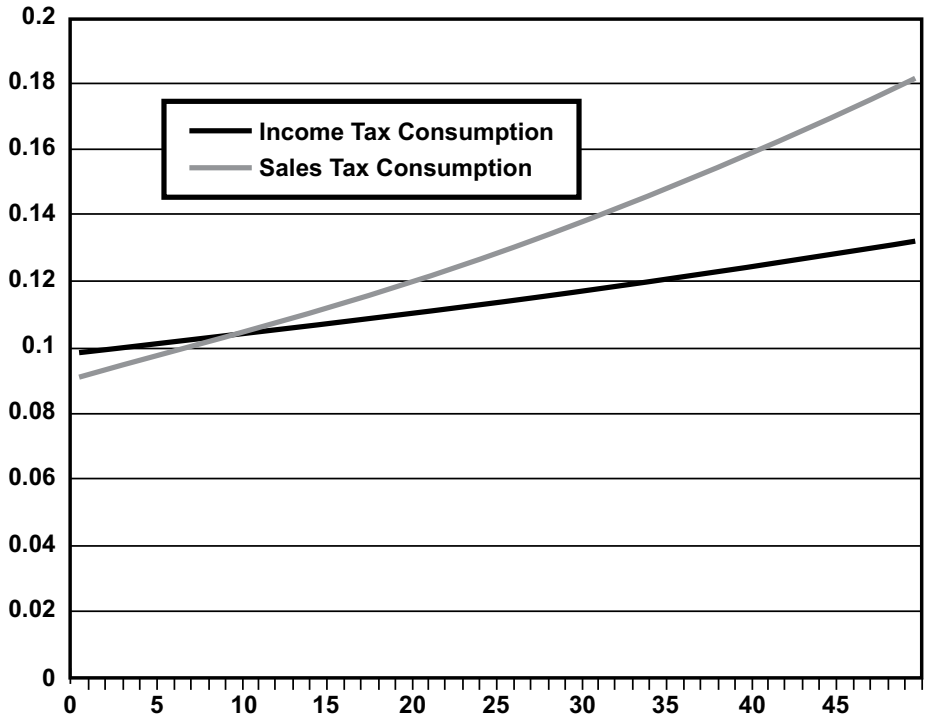


Figure 3 — Aggregate Consumption Over Time



NOTES

1 McGrattan, Ellen R., "A Defense of AK Growth Models," Federal Reserve Bank of Minneapolis *Quarterly Review*, 22(4), 1998, pp. 13–27.

2 See: Barro, Robert J., and C. Sahasakul, "Measuring the average marginal tax rate from the individual income tax," *Journal of Business*, 56(4), October 1983, pp. 419–52.

3 The results indicate that it takes 29 periods for accumulated welfare in the sales tax regime to be greater than accumulated welfare in the income tax regime.

4 The parameter σ in our analysis captures the rate at which a person values current consumption relative to future consumption. Formally, the higher is σ, the less a person receives utility from a given future level of consumption. Put another way, suppose a person gives up one unit of current consumption. With a higher value of σ, that person would have to be compensated with more future consumption to be equally as well off while a person with a lower value of σ would not need as much of an increase in future consumption to be equally as well off.

5 In our model economy, a credible, permanent decrease in the income tax rate results in an immediate change to the new equilibrium growth rate. In other model economies, the adjustment to the long-run growth rate takes time. This would be another interesting experiment that future researchers could investigate. With a slower adjustment to the equilibrium growth rate, for cases in which welfare is higher under the sales tax regime compared with the income tax regime, one could see smaller welfare gains. Indeed, smaller growth rate increases could yield the opposite results.

6 See: Rupert, Peter, and Paul Gomme, "Theory, Measurement and Calibration of Macroeconomic Models," *Journal of Monetary Economics*, 54(2), March 2007, pp. 460–97.

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