

Ohio's Resource for Reliable Data & Analysis

**ETPI** 

***More  
Tax Foundation  
Nonsense!***



**William Driscoll and Howard Fleeter  
Education Tax Policy Institute**

**The Tax Foundation (TF) Special Report (August 2008) claims to offer a measurement of state-by-state tax burdens. It lists taxes allegedly paid by the residents of each state relative to each state's per capita income. It then ranks the states according to the percentage of personal income paid in taxes by each state's residents.**

Responsible tax policy organizations, such as the Federation of Tax Administrators, report the amount of taxes paid as defined directly by each state's tax collections and rank the states directly based on taxes collected in the state divided by personal income in the state. In contrast, the TF starts with tax collections and then makes a series of subjective determinations about tax "imports" and tax "exports" to arrive at an individual tax burden which it claims reflects a truer picture of each individual's actual tax payments. The TF computations also make adjustments to the definition of personal income so that it changes both the numerator and the denominator in the ratio of taxes to income. In the process, the TF separates its version of the "true" tax burden in any state from any effective control by that state.

Now each of the devices used by the TF to derive the "true" amount of taxes paid by each state's residents rests upon some discrete research outcome or some reasonable interpretation about how economic effects of taxation might play out. However, none of the research and none of the economic analyses upon which the TF relies actually validate the cumulative use of its various manipulations. With each "adjustment," the TF "data" wander further from reality.

The TF report amounts to the triumph of rationalism over empiricism. Rather than use actual data presented with a minimum of alteration and manipulation, the TF determined that its manipulated data presents a better picture of reality than the presentation of objective data. Historical precedents exist for attempts to rationalize an erroneous conception of reality. The TF's manipulation of tax data resembles the efforts of defenders of the Ptolemaic cosmology who introduced increasingly complicated and bizarre computations to "prove" that the earth is the center of the solar system. These adjustments were necessary to counter increasingly accurate measurements showing that the earth and other planets revolved around the sun.

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<sup>1</sup>While members of the TF undoubtedly will greet the notion of a sun-centered solar system with skepticism and dismay, we do not intend to list citations here. Along the same lines, TF researchers will *not* fall off the edge of the world if they sail to the horizon, however desirable such an outcome might be for the advancement of economic thought.

**Why should a person measure anything?** A measurement should provide a standardized description of some phenomenon in the real world. In the process, the measurement should increase the amount of knowledge about that phenomenon in an objective and efficient way. A ruler marked in inches or centimeters provides an efficient measurement of length with objective validity. If a book describes a window as 14 inches by 10 inches, the use of a common form of measurement works much better than “about as long as my somewhat shorter than average arms.”

Sometimes a particular form of measurement does not capture every nuance of a phenomenon. In such circumstances, some additional analysis may provide a desirable supplement to the measurement. However such circumstances do not justify the development of a new measurement based on the exception and the claim that such new measurements offer a more accurate description than actual data.

In contrast, the TF Report takes the actual amount of taxes collected in each state and changes the data. This is the key point about the TF methodology. It uses “rational” rules to change reality. The rules do not exist *a priori*. They involve a series of judgments by the TF about which rules provide a more accurate picture of reality than actual data. Evidence that the TF Report presents a subjective perspective comes from the TF's own technical notes in which the TF shows alternative measurements obtained by changing some of its assumptions. Such a system lacks objective validity because its results derive from subjective judgments. The TF Report does not report what is real, it reports its version of reality. Simple measurements may show that the earth revolves around the sun, but the same data can show that the sun still revolves around the earth *with the proper adjustments*.

The TF Report conceptually starts with the identification of an exception. The measurement of tax collections in the State of Alaska yields a high per capita tax burden. The TF correctly recognizes that this high burden does not really reflect the tax liability incurred by Alaskans. Most of the tax burden there takes the form of severance taxes on oil and other minerals. The burden of such taxes tends to fall on those who consume the petroleum and other products obtained from Alaska's geological bounty. Generally, these consumers do not live in Alaska. For that reason, tax policy analysis typically would footnote Alaska's extreme case in a description of a ranking of state and local tax collections per capita.

In contrast, the TF has devised an entire Rube Goldberg system of criss-crossing state and local tax imports and tax exports to create what it claims as a more accurate assessment of tax burdens.

This methodology has two fundamental problems.

1). It requires a large number of decisions about how to apportion tax collection data between residents and non-residents for each tax. No standard exists for making such apportionments. While the justification for each manipulation of the data has some origin in tax policy literature, the determinations of how to translate tax policy theory into the actual attribution of income to different states has no such objective basis. Essentially, the TF just makes them up.

2). Even if some analyses of each state's tax system can include a legitimate consideration of that state's ability to export some of its tax burden, the transformation of such individual analyses into a ranking system leads to perverse and meaningless results.

The following example shows how such perverse results can occur. In the "ranking" for 2008, California ranks 6<sup>th</sup> and Ohio ranks 7<sup>th</sup>. If Ohio cut certain business taxes by \$100 per capita, California cut residential property taxes by \$75 per capita, and all other variables between the two states remained constant, Ohio's rank would change to 6<sup>th</sup> and California would fall to 7<sup>th</sup>. Corporate income and personal property tax burdens are allocated by the TF methodology according a formula with 50% distributed according to: "share of capital income" and 50% according to the "share of total net earnings" attributable to each state.

Since the TF report describes generally what these terms mean but it provides no actual data, an assumption is made for purposes of this thought experiment that the apportionment, at least as between Ohio and California, would occur roughly proportionally to the population of each state. The TF report is unclear, but owner occupied real property taxes appear to be allocated 100% within the State where levied.

The table on page 5 shows the result of the hypothetical changes suggested by this example.

### Hypothetical Effect of a \$100 Per Capita Reduction in Ohio Business Taxes and a \$75 Per Capita Reduction in California Residential Property Taxes on the Relative Rank of California and Ohio According to an Approximate Application of the TF Method

Year	State	Total State & Local Tax Collections Per Capita	Tax Paid By Non-Residents Per Capita	Tax Paid to Other States Per Capita	Net Tax Burden Per Capita	TF Defined Per Capita Income	Net Tax As a % Of Income
2008	CA	4,752	1,069	1,345	5,028	47,706	10.54%
2008	OH	4,084	1,147	1,112	4,049	38,925	10.40%
2009	CA	4,677	1,069	1,341	4,949	47,706	10.37%
2009	OH	3,984	1,051	1,112	4,045	38,925	10.39%

The amounts shown for California and Ohio in the two rows applicable to 2008 mirror the amounts shown in the TF August Special Report.

The rows showing estimates for 2009 assume that all of the amounts shown for 2008 remain unchanged, except Ohio reduces business property or income taxes by \$100 per capita or by a total of about \$1.1 billion. (Presumably the CAT would be an "income" tax for purposes of this table.) And, the table also assumes a \$75 per capita reduction in owner occupied residential property taxes in California.

- 1) California tax collections go down by \$75 per capita due to reductions on owner occupied real property.
- 2) Ohio tax collections go down by \$100 per capita.
- 3) Taxes paid by non-residents to California do not change.
- 4) Taxes paid by non-residents to Ohio go down by \$96.24 per capita. The reason is that the allocation of Ohio business taxes to other states means that about 96.24% of the \$100 per capita Ohio tax collection reduction is spread among the other states. Since Ohio's population equals 3.76% of the US population, one minus 3.76% or 96.24% equals the share of Ohio business taxes attributed to residents of other states. (Again, in the absence of precise data, the example uses population percentage as proxy for income and earnings percentages.)
- 5) Taxes paid by Californians to other states go down by \$4 per capita. Californians pay less to other states because the amount of Ohio business taxes allocated to California goes down by roughly 11.99% times 1.1 billion. On a per capita basis relative to California's 36 million population, this equals about \$4 per capita.
- 6) Ohioans' taxes paid to other states do not change. The adjustment in California

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taxes is neutral with respect to Ohioans because it applies only to owner occupied housing.

7) California's net tax burden goes down by about \$79 per capita although its tax collections decrease by only \$75 per capita.

8) Ohio's net tax burden as implied by the TF methodology drops by about \$4 even though the State's tax collections fell by \$100 per capita.

9) The last column shows that Ohio's tax burden declined by 0.01% when it reduced corporate taxes by \$100 per capita, but California's burden fell by 0.17% when it reduced residential real estate taxes by \$75 per capita. The final outcome means that Ohio climbs up one place in the ranking relative to California and California falls below Ohio. Moreover, putting aside California's hypothetical reduction in real property taxes, the reduction in the Ohio taxes attributed to California matches the reduction in Ohio taxes attributed to Ohio. Both states receive a net reduction of \$4 per capita when Ohio reduces corporate taxes by \$100 per capita.

To put it another way, if the TF system of allocating tax liability had any validity, it would mean that for every \$100 in per capita tax reductions granted by the legislature when it enacted business tax reforms in H.B. 66, Ohioans only received the benefit of \$4 per capita. Furthermore, the example makes clear that the Tax Foundation's methodology creates outcomes where a state's tax ranking can be influenced more heavily by the tax policy decisions of other states than by the decisions in their own states. Such a perspective not only creates essentially meaningless rankings but also contributes nothing to understanding tax policy in the State because it produces a result without any meaningful insight into what the State's tax policy should be.

Whatever limitations may result from the direct measurement of tax collections, such measures have one overriding advantage – they do not require an enormous number of subjective judgments about how to adjust the direct measure in a way that does not introduce more distortion than the original measure includes. Thus, it makes much more sense to make a direct measurement of tax collections illuminated by some discussion of its limitations than to introduce a whole series of arbitrary, subjective adjustments to that direct measure.

**Science really began its advance when its practitioners realized the advantages of empiricism over rationalism. It is unfortunate that the TF never got the message.**