

## Written Testimony:

Thank you for inviting Dr. Hendrickson and me here today and allowing us to serve the taxpayers of Mississippi by speaking to you all about our analysis of the proposed change to the tax structure. My written testimony aims to provide context as to how we think about the economic effects of a tax system and provide an overview of our study.

Tax systems create distortions in behavior that reduce economic activity. An ideal tax policy raises sufficient revenue, given government objectives, while minimizing these distortions. Revenue-neutral tax reform can only positively affect economic activity by eliminating or reducing distortions relative to the current tax system. A more efficient tax system can create more economic activity without sacrificing revenue.

In general, consumption taxation, or a sales tax, creates smaller distortions than income taxation. Income taxes tax both labor and savings income. Due to the nature of compound interest, the effective tax rate on a dollar set aside today is larger for a longer duration of savings. Savings provide additional future consumption. The income tax on savings is equivalent to taxing future consumption at higher and higher rates the more distant that consumption takes place.

A tax system with both consumption and income taxation results in double taxation. Worker income is taxed, reducing the after-tax wage. Households either save or spend their after-tax income. Consumption is then taxed separately. Taxing both labor income and consumption further reduces the effective after-tax wage of the worker. Any additional income from savings is also taxed. In principle, the proposed tax reform could provide macroeconomic benefits by eliminating the double taxation of income and consumption taxes and taxes on income from savings, creating a more efficient tax system for Mississippi.

Our report asks a single question: Will the proposed tax reform provide macroeconomic benefits by creating a more efficient tax system without sacrificing tax revenue? We aim to answer this question transparently using a model of the Mississippi economy and publically available data. We find that the proposal is approximately revenue-neutral. Furthermore, we find that the proposal would increase Mississippi's gross domestic product (GDP) by \$371 million per year in 2019 dollars.

The elimination of the income tax eliminates the distortion in the economy caused by taxing income from savings. Eliminating the income tax incentivizes households to save more and leads to more investment. More investment leads to increased demand for workers. Increased demand for workers raises wages in the economy.

What are the effects of the proposal on tax distortions in the labor market? Eliminating the income tax reduces this distortion while raising the sales tax has the opposite effect. For the proposed tax changes, the relative effects of the income tax cut and sales tax increase on the labor market distortion are essentially the same. Tax distortions in the labor market are unaffected by the proposed tax reform.

In summary, our analysis shows that eliminating the distortion caused by taxing income from savings drives the increase in Mississippi GDP. Eliminating the income tax leads to more investment and higher labor income across the state. Our analysis demonstrates that the economic benefits from eliminating the income tax more than offset the costs of a higher sales tax. As evidence of this point, aggregate consumption increases even though there is a higher sales tax.

Our estimates are conservative in the sense that they only consider the net benefits of a more efficient tax system. We assume the tax reform only affects the level of economic activity, not the growth rate. To the extent that tax reform affects the growth rate, the benefits could be substantially larger due to the nature of compounding. We also do not consider migration in the model. If the elimination of the income tax attracts additional people to Mississippi, the benefits would also be larger than our model suggests.

How do we perform our analysis? We consider a model of the Mississippi economy in which households consume, save, and work. At the same time, firms produce, and the government spends money. We do not model the use of government spending. To the extent that policy changes are revenue-neutral, this is irrelevant. However, this implies we understate the economic impact of any sizeable revenue losses.

We model three types of taxes: sales, individual income, and corporate income. Sales, individual income, and corporate income taxes are all proportional taxes that distort the decision-making of households and firms in the model by altering relative prices. For instance, a sales tax raises the effective price of goods in the economy. These taxes represent 93% of total tax revenue in Mississippi in the fiscal year 2019. Our tax collections data comes from the U.S. Census Bureau Annual Survey of State Government Tax Collections.

Our quantitative exercise starts by considering the model-consistent economy of Mississippi in 2019. We set GDP in the model to \$115.4 billion, or GDP in Mississippi in 2019 net of government expenditures backed by the taxes we do not consider in the model. Consumption is 83% of GDP, and the three taxes considered are equivalent to approximately 7% of GDP. This data is publicly available from the Federal Reserve Economic Database managed by the Federal Reserve Bank of St. Louis. We also set the relative shares of the three tax types to match the revenue shares from each tax in 2019. These targets imply effective or average tax rates for taxable items within the economy. For instance, we compute an effective sales tax rate of 5.4% in 2019.

Given this initial setting, we consider the effects of the proposed tax change on the economy. We cut the income tax rate to 0 and raise the economy's effective sales tax by the proposed proportion (7.07 to 9.57 = 35.4%). The effective sales tax rate rises from approximately 5.4% to about 7.4%. This exercise is essentially revenue-neutral and generates the \$371 million annual increase in Mississippi GDP aforementioned.

For comparison, we report the effects of only eliminating the income tax. Doing so reduces tax revenue by 24%. Although our model shows this may still boost GDP, we do not model any potential costs to reducing government spending due to the lack of revenue. This revenue loss is non-trivial, and we view it as a note of caution to solely eliminate the income tax without increasing the sales tax as proposed.

To close, we once again appreciate your time and consideration of our analysis in this important discussion about tax structure and potential reform in the state of Mississippi. We look forward to your questions regarding our report.