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Why Statutory Incidence Matters

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Abstract
Economists teach that tax incidence is invariant to statutory incidence. We offer two examples in which statutory incidence affected tax policy and argue that statutory incidence matters because politicians enact statutes and courts interpret them.

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I. Introduction

Economists frequently claim that the economic incidence of a tax is invariant to its statutory or legal incidence (Rosen and Gayer 2014, p. 303). That is, whether the tax authorities physically collect a tax from the buyer or the seller, the ultimate impact of the tax on prices, quantities, and the distributions of the gains from trade will be identical. The reason for this is that the party bearing the legal incidence of a tax may change his or her behavior in ways that cause some, or even all, of the tax burden to shift to other parties. For example, taxing the seller of an item may cause the seller to raise prices, thereby shifting part or all of the tax to buyers. The widely understood price-increasing consequences of cigarette taxes levied on tobacco firms or alcohol taxes levied on beer and spirits producers are examples of this phenomenon.

Suppose the state levied a 5 percent tax on a product or group of products and required the seller to remit the tax. Alternatively, suppose that the state levied a 5 percent tax on a product or group of products but required the buyer to remit the tax. Economics teaches that the true tax burden would be same in both cases. When the tax is levied on sellers, they pass some of the tax along to buyers in the form of higher prices When the tax is levied on buyers, the amount they are willing to pay decreases to offset some or all of the tax. In both cases, the result is the same: the ultimate sharing of the burden among these stakeholders depends on the relative elasticities of supply and demand in the market. Hence, for the purposes of economic incidence, the standard conclusion is that legal incidence does not matter.[1]

Economists' exposition of tax incidence is fine as far as it goes, and understanding that true tax incidence is independent of the tax's statutory imposition is an important concept. However, this standard treatment ignores the fact that tax policy is made by politicians and interpreted by courts. Consequently, what are mere words to economists—the party bearing the statutory burden of a tax even though the economic burden is invariant—do sometimes turn out to matter. In this paper, we illustrate this point with two examples.

II. Example 1: Ohio's Commercial Activity Tax

Most states choose not to tax groceries purchased for home consumption. At least one state, Ohio, has enshrined this policy choice in its state constitution. However, Ohio's constitutional prohibition on taxing groceries has been eroded by a court's reliance on statutory incidence rather than economic incidence.

On July 1, 2005, Ohio implemented a new tax of 0.26 percent (after ramping up over a phase-in period) on Ohio businesses. The new tax, called the Commercial Activities Tax (CAT), was levied on "gross receipts, which is defined as the total amount realized, without deduction for the cost of goods sold or other expenses incurred, from activities that contribute to the production of gross income" (Ohio Department of Taxation 2008, p. 19). Businesses with annual gross receipts of $150,000 or less were not subject to the CAT.

Gross receipts taxes are not new; Adam Smith ([1776] 1994) wrote of a version known as the alcavala, which operated from the fourteenth through the eighteenth centuries in Spain. In the first half of the twentieth century, many European countries relied on gross receipts or "turnover" taxes until later replacing them with value added taxes. In modern times, Ohio is not alone in levying a gross receipts tax. Malm (2014) reports that four other states, Delaware,

[1] Economists do recognize that there may be important differences between requiring the seller versus the buyer to remit a tax in terms of administration, compliance, and enforcement costs (Slemrod 2008). Such concerns are important for tax policy but do not alter the underlying point that economic incidence is indifferent to statutory incidence.

Texas, Virginia, and Washington, impose some form of gross receipts tax.

Our introductory discussion of tax incidence implies that there is no important economic distinction between sales and gross receipts taxes. A sales tax applies the tax from the perspective of the purchaser—a certain percentage is added to the amount that a person spends on taxable goods and services. Likewise, a gross receipts tax applies the tax to the revenue obtained by sellers from their sales of taxable goods and services. The taxes (if levied at the same rate) are economically equivalent because consumers' purchases and sellers' receipts are identical. The sensible conclusion, then, would be that the Ohio CAT, inasmuch as it is clearly a gross receipts tax, is in fact economically identical to a sales tax and would therefore run afoul of Ohio's constitutional ban on applying sales taxes to food. Therefore, it comes as no surprise that the Ohio Grocers Association (OGA), along with three food retailers and one food wholesaler, filed suit on February 17, 2006, against William Wilkins in his official capacity as Ohio's tax commissioner, arguing that the Ohio CAT violated the state's constitutional ban on taxing food.[2]

Although Ohio pursued a number of arguments, its primary defense was that the Ohio "CAT is a franchise and privilege tax imposed on doing business in Ohio. It is not a transactional tax, which is the kind of tax prohibited in Section 3(C), Article XII, and Section 13, Article XII of the Constitution."[3] That is, the state argued that since the statutory incidence of the CAT falls on the seller and is calculated after the point of sale, the CAT is not a sales tax. Sales taxes, according to the state, assign statutory liability to the buyer (though they are remitted by the seller in most cases) and are calculated at the point of sale. This argument emphasizing the statutory liability of the tax and its administrative timing as being critical determinants of whether the tax is a sales tax is odd to say the least from the standpoint of standard public finance principles.

On August 24, 2007, the trial court ruled summarily in favor of the state, making explicit the importance of legal incidence and timing in the court's judgment:

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[2] *Ohio Grocers Assn. v. Wilkins*, Complaint for Declaratory and Injunctive Relief. Court of Common Pleas, Franklin County, Ohio. Case No. 06CVH-02-2278.

[3] *Ohio Grocers Assn. v. Wilkins*, Defendant's Memorandum Opposing Plaintiff's Motion for Summary Judgment and Cross-Motion for Summary Judgment. Court of Common Pleas, Franklin County, Ohio. Case No. 06CVH-02-2278.

> The Court further finds that the CAT is imposed directly on the business for the privilege of doing business in Ohio, and therefore the "incidence" of the tax rests upon the business not the consumer. While the tax may ultimately be passed on to the consumers in the form of higher prices, it cannot be directly billed to and paid by the purchaser. As such, the Court finds that the CAT is significantly different from a sales tax.[4]

The court also found the administrative timing of the tax's collection to be important:

> In addition, the Court finds that unlike a sales tax, the very terms of the CAT tie the obligation to pay the CAT to a time or date, not a specific transaction or sale.

Undeterred, the plaintiffs appealed the trial court's holding, and on September 2, 2008, the appellate court ruled in favor of the plaintiffs, echoing the economic logic presented above:

> Though appellee suggests the CAT is a franchise tax and is not equivalent to a sales or transactional tax, by its very operation when applied to gross receipts derived from the sales of food, a transactional tax is precisely what the CAT becomes. This is so because the tax is measured *solely* by gross receipts and is based on aggregate sales, including those from the sales of food. Because the CAT is not based on each transaction or each individual sale, appellee contends the CAT is constitutional. However, though not based on individual sales at the time they are made, the CAT is merely based on the aggregate of all sales within a specified time frame. If the legislature is prohibited from collecting a tax on the individual sale, it logically follows the legislature would be prohibited from collecting a tax on the aggregate of those same sales.[5]

The state of Ohio appealed the case to the Ohio Supreme Court, which ruled in September 2009.[6] The case was closely watched. Aside from the legal and economic issues at stake, if the state lost, it faced the daunting prospect of having to refund hundreds of millions of

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[4] *Ohio Grocers Assn. v. Wilkins*, Court of Common Pleas, Franklin County, Ohio. Case No. 06CVH02-2278.

[5] *Ohio Grocers Assn. v. Wilkins*, 178 Ohio App.3d 145, 2008-Ohio-4420.

[6] *Ohio Grocers Assn. v. Levin,* 123 Ohio St.3d 303, 2009-Ohio-4872. Note that the named defendant changed because there is a new tax commissioner in Ohio following the 2008 election.

collected tax dollars to food sellers. In the end, the Ohio Supreme Court, placing a high burden of proof on the plaintiffs, ruled that the CAT would be constitutional "if it may plausibly be interpreted as permissible." Then, notwithstanding the economic arguments made by the plaintiffs and the appellate court, the court merely accepted the state's assertion that the CAT was a tax on "the privilege of doing business" instead of an excise tax. Hence, the court effectively voided Ohio's constitutional prohibition on taxing food because it failed to acknowledge that the economic incidence of a gross receipts tax is identical to that of a traditional sales tax.

III. Example 2: The Affordable Care Act's Tax on Expensive Health Insurance Plans

The 2010 Affordable Care Act (ACA) contains a provision that levies a tax on expensive employer-provided medical insurance plans beginning in 2018. According to health economist Jonathan Gruber, who, as a paid consultant to the Obama administration, contributed to the design of the ACA, this tax on so-called "Cadillac plans" was crafted with a clear understanding of the difference between statutory and economic incidence. Tapper (2014) reports on Gruber's 2011 comments to a Boston think tank:

> "Economists have called for 40 years to get rid of the regressive, inefficient and expensive tax subsidy provided for employer provider health insurance," Gruber said at the Pioneer Institute for public policy research in Boston. The subsidy is "terrible policy," Gruber said.
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> "It turns out politically it's really hard to get rid of," Gruber said. "And the only way we could get rid of it was first by mislabeling it, calling it a tax on insurance plans rather than a tax on people when we all know it's a tax on people who hold those insurance plans."

In other words, Gruber says that it was politically infeasible to levy the tax directly on insurance premiums or to explicitly revoke the tax exemption of employer provided medical insurance. Instead, Gruber says that taxing insurance plans yields the same result because insurance companies will pass along the tax in the form of higher premiums. Fundamental in doing so, says Gruber, was the drafters' "exploitation of the lack of economic understanding of the American voter." Hence, we see that the policymakers' clear understanding of economic incidence led them to find a politically palatable way to chisel away at the tax exemption for employer provided medical insurance. Here again, the key insight is that the ACA can achieve the same result by applying the tax to sellers (insurance companies) as it could by imposing the levy on policy purchasers. Policyholders still bear the tax, as it is rolled into the price they pay for insurance. The ultimate burden is the same either way, depending, as usual, on the elasticities of supply and demand.

While the structuring of the ACA's Cadillac tax is a recent example of statutory incidence being used to disguise economic incidence, history offers other examples. Social Security's division of statutory responsibility of its payroll tax equally between employers and employees disguises the fact that the tax's true incidence is thought to fall almost entirely on employees in the form of lower wages (Rosen and Gayer 2014, p. 307). Likewise, governments sometimes mandate that employers provide certain benefits to their employees. For example, the states of California, Connecticut, and Massachusetts require employers to provide their workers with paid sick leave. While the statutory incidence of such benefits falls on employers, employees likely absorb some or all of their cost in reduced pay.

IV. Conclusion: Tax Incidence without the Romance

The foregoing examples suggest that economists' view that a tax is a tax is a tax ignores the important matter that politicians design laws and courts interpret them.

Many states exempt food from taxation. Presumably, such exemptions are based on the premise that food is a basic necessity of life and that taxing food would therefore be fundamentally unfair. Of course, not all food is alike—it's hard to defend exempting steak and caviar from taxation because they are necessities of life—and one might also apply the "necessities" rationale to other goods and services, such as clothing, shelter, and medical care. There are also reasonable arguments for including groceries in the tax base; for example, Sobel and Holcombe (1996) find that state tax revenue shows less cyclical volatility if the state's sales tax base includes groceries. Groceries might also be a tempting target for taxation by politicians trying to increase revenue to fund additional spending (most states are prohibited from deficit spending). Whether food should or should not be taxed is a debate beyond the scope of this paper. The important point for our purposes is that courts can treat two taxes with an identical economic incidence differently because they have a different statutory incidence. Such behavior by courts opens the door to cynical policymaking, in which a state's ban on taxing food can be circumvented.

We have no idea if the designers of Ohio's CAT had such cynical motives, but, as Gruber's remarks make clear, the same cannot be said of the ACA's drafters. Gruber is hardly alone among economists in thinking that the tax exemption of employer-provided medical insurance is economically distortionary, but politicians have shown little interest in repealing the exemption because of its political popularity. Instead, the ACA's architects relied on the economics of tax incidence to concoct a plan that, over time, effectively repeals the exemption of employer-provided medical insurance.[7] That politicians might use an understanding of economic incidence to shape tax policy to accomplish politically unpopular ends raises an important point. Economic teaching that tax incidence is invariant to statutory incidence is necessary but not sufficient for understanding public policy. A complete understanding of public policy also requires understanding fundamental principles of public choice as explained by Buchanan, Tullock, and others.

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[7] Although the "Cadillac tax" will apply to fewer than 10 percent of employer-provided medical insurance plans when it goes into effect in 2018, the percentage of plans will grow because of how the tax threshold's indexation is based on CPI inflation instead of the faster-growing rate of medical inflation. Says Gruber (quoted in Tapper 2014): "What that means is the tax that starts out hitting only 8% of the insurance plans essentially amounts over the next 20 years [to] essentially getting rid of the exclusion for employer sponsored plans."