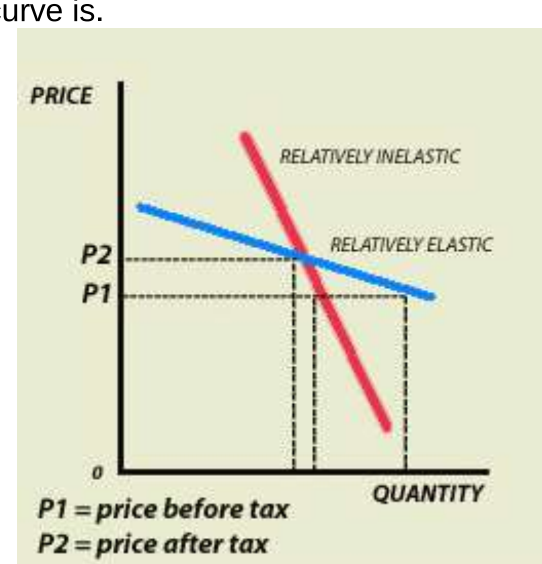
Price Elasticity and Tax Reform

By Audrey D. Kline

The start of 2018 has seen a wave of teacher protests spreading from West Virginia, to Oklahoma, to Kentucky, and Arizona where teachers are protesting to their state legislators over several pay and funding-related issues, including wage increases, pensions, sick days, per pupil funding, and more. The desired changes don't come cheap, and in many cases the state budgets are already cash – strapped. Kentucky, for example, has long known that the state pension system, which pays a pension to public school teachers in the state, is underwater. The current session of the legislature passed a surprise pension reform bill at the end of March, proposing to move incoming teachers to a 401k plan, among other modifications. This led to a walkout on March 30, the Friday before spring break in many counties, and shut down remaining school districts not on spring break on Monday April 2. According to the Tax Foundation, Kentucky ranks among the worst in the country for its pension system, and as a result, it is searching for ways to raise revenue. In a surprise move, a proposal to change the state tax code was introduced on the morning of April 2, moved quickly through the Kentucky House and Senate, and found its way to the Governor's desk that same day, where he has until April 13 to approve or veto the bill.

While entities such as the Tax Foundation find that the proposed reforms are enhancing to the business climate in the state, those closer to the ground are understandably concerned about the impact on low-income residents. The proposal calls for a move to a flat income and corporate tax rate, moving both to 5%. This is a significant increase for the lowest income individuals, who can face as little as a 2% income tax rate presently. For the wealthy and for corporations, the flat tax would be a tax break. The Tax Foundation estimates this move will change Kentucky's ranking on the State Business Tax Climate Index from 33rd to 18th overall, which is a significant increase.

So, how will the state pay for its pension system in the face of the flat tax proposal? By widening the tax base for the sales tax. Microeconomic principles show that imposing a tax to be passed on to consumers works best if the tax is imposed on goods and services that have a relatively (price) inelastic demand, meaning such goods and services are relatively insensitive to a price increase so consumption does not drop off with the imposition of the tax. The illustration below illustrates the much smaller reduction in the quantity purchased the less elastic the demand curve is.



Kentucky currently has a 6% sales tax, and seeks to expand the sales tax to several services not currently taxed. Additionally, the proposal aims to increase the cigarette tax by 50 cents, moving it to $1.10 a pack and will also move to a 15% tax on e-cigs, which are currently taxed at the 6% sales tax rate since they are not classified as a tobacco product. While many in the state called for a cigarette tax increase of $1 a pack, the legislators cut that in half. That was probably a smart move. Though the demand for cigarettes is highly inelastic, such a large increase could cause consumers to quit smoking or find a less expensive substitute. While this is not a bad thing from a health perspective, a significant decline in smoking would not help generate the tax revenue that the state needs. As such, a tax increase that is half the desired amount will still generate significant additional revenue because it will be less likely to cause people to significantly cut back or quit smoking.

While the cigarette tax is an obvious low-hanging fruit scenario for generating revenue, the surprise for Kentuckians came with the added services that are in line for being subject to the state sales tax. The state is proposing to begin taxing the following services at the current 6% sales tax rate: labor and services related to personal property (automobiles), pollution control facilities, landscaping services, janitorial services, small animal veterinary services, pet grooming and boarding, fitness and recreational sports centers, industrial and laundry services, golf courses and country clubs, limousine services, dry cleaning and non-coin operated laundry service, linen supply (excluding charitable hospitals), non-medical diet and weight loss centers, overnight trailer campgrounds, personal care services, bowling centers, and extended warranties. It is certainly an interesting list! Moreover, some personal and corporate tax credits and deductions will be eliminated.

The current plan will keep funding for the teacher pension system, but it lowers the income tax exclusion by $10,000. Overall estimates of the proposed tax reform bill point to a revenue increase of $487 million over the next biennium from the proposed tax reform, with increased cigarette taxes accounting for just over $100 million, and the sales tax expansion expected to bring in nearly $250 million. Concurrently, the move to the flat income tax is expected to reduce tax revenue by about the same amount as the cigarette tax revenue increase.

In essence, the plan shifts some of the burden away from income and toward a consumption tax. What is true about most of the services listed above that will be taxed under the new plan? Will consumers stop taking care of their pets, using their country clubs, getting their dry cleaning done, or getting their cars repaired? Probably not, because all of these services have a relatively inelastic demand, meaning few consumers will decrease their consumption of these services as a result of the new tax (and resulting higher price). Admittedly, there are a few things on the list that don't seem to fall into the category of inelastic demand—like bowling alleys—but overall, most of the services are not likely to see a significant decline in consumption. To that end, the plan might be smart from the perspective of raising revenue by seeking to tax goods and services that have a relatively inelastic demand.

Critics are urging the Governor to veto the plan, saying it benefits the wealthy and corporations at the expense of the middle class and working poor. The Governor has expressed concerns that the plan might not be fiscally responsible, leaving the door open for some changes to the bill before the legislative session closes. It seems likely, however, that the expanded sales tax on some relatively inelastic goods and services will not find themselves struck by the veto pen. It remains to be seen if other states will follow a similar approach to raising revenue by significantly modifying its tax code.

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