What Drives Tax Policy? Political, Institutional, and Economic Determinants of State Tax Policy

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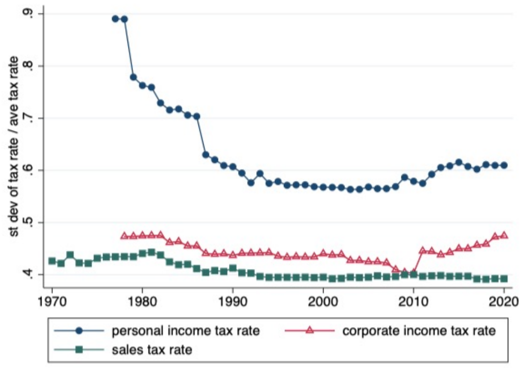
- **Goal:** Explain how states set their tax rates
- Important because state taxes affect revenues, business cycles, and welfare
- Also, for policy analysis – are tax changes exogenous?

- **What we do:** Focus on 6 tax rates from 1980-2020 (≈80% of tax revenue)
  - Top personal income, top corporate, sales, gasoline, cigarette, and alcohol
- Study long-term trends for signs of competition, Tiebout sorting, polarization
- Quantify to what extent political, institutional, and economic factors can explain the timing and magnitude of tax changes

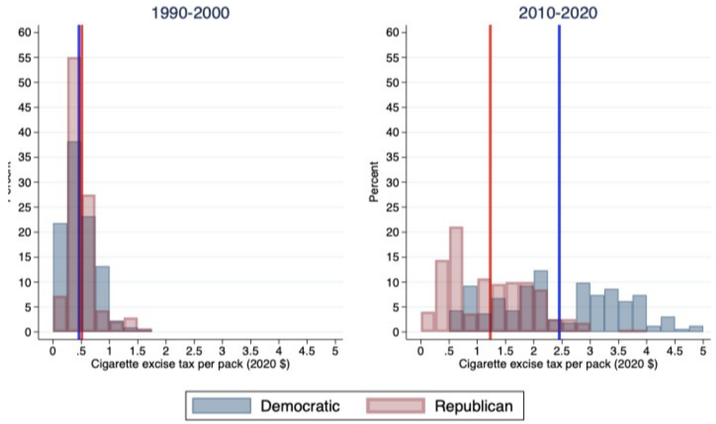
Finding 1

Little convergence/divergence of tax rates over time
Inconsistent with Tiebout sorting and race-to-the-bottom competition



Finding 2

Increasing polarization of tax levels between Democratic & Republican states since 2000
But no convergence within Dem/Rep states



Finding 3

Timing and magnitude of tax changes hard to predict
Determinants from literature explain <20% of total variation, even when using machine learning

- Tax policy in neighboring states
- State recessions
- Unfunded federal mandates for spending
- Political cycles & changes
- Institutional rules (e.g., # of legislators, balanced budget rules)
- Federal tax policy

- **Discussion:** Tax setting processes are complicated and are not easily explained by economic, political, or institutional factors
- Politics matter, but provide far from a full explanation
- The models we consider, even combined, do not explain tax policy very well
- Tax policy may be idiosyncratic due to gridlock; or, other factors matter more (e.g., lobbying or political contributions)