

EFFICIENCY AND EQUITY ISSUES IN SALES TAXES AND INDIVIDUAL INCOME TAXES



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URC's 2021 publication, "Fiscal and Economic Implications of Changes to the Sales Tax and Individual Income Tax in Mississippi," discusses how the state's general revenue and economy could be affected by various proposed changes to each tax (Miller and Collins). This publication builds on the previous analysis by discussing the characteristics of these taxes in terms of efficiency and equity and what factors policy makers should potentially consider when making changes.

As our previous publication outlined, the statewide sales tax and the individual income tax are the two largest sources of revenue for Mississippi's general fund. In state fiscal year 2023, together these two taxes accounted for over two thirds of general fund revenue (Robinson 2024). The following sections provide in-depth discussions of each tax.

Individual Income Tax

As of tax year 2024, the individual income tax in Mississippi consists of a single rate of 4.7% on taxable income above \$10,000 annually. For tax year 2025, this single rate will fall to 4.4%, and in tax year 2026 this rate will fall to 4.0%. Tax year 2026 will mark the final year of implementation of House Bill 531, the "Mississippi Tax Freedom Act of 2022," which became law in 2022. This legislation eliminated the 4.0% bracket on taxable income between \$5,000 and \$10,000 annually and reduced the 5.0% bracket on taxable income above \$10,000 annually to 4.0% as noted. URC previously analyzed the fiscal and economic impacts of this legislation¹. Therefore, beginning in 2016 with Senate Bill 2858, which eliminated the 3.0% tax bracket on the first \$5,000 of taxable income, over a span of ten years Mississippi will move from three tax brackets with increasing rates to a single rate.

Prior to 2016 the individual income tax structure in Mississippi was considered slightly progressive: the rate on the first \$5,000 of taxable income was 3%, the rate on the second \$5,000 of taxable income was 4%, and the rate on all taxable income above \$10,000 was 5% (Kaufman 2024). The revised rate structure noted above, viewed in isolation, might appear less progressive, if at all. However, the individual income tax rate is effectively 0% on taxable incomes of \$10,000 and below and, as of 2026, 4.0% on taxable incomes above \$10,000. Furthermore, as was the case prior to enactment of House Bill 531, the personal exemption is \$6,000 and the standard deduction for an individual is \$2,300. Therefore, beginning in 2026 an individual will pay a 4% rate on taxable income above \$18,300. While as of 2023 the individual income tax in Mississippi consists of a single bracket, the amount of taxable income on which no tax is paid nearly doubles compared to the period prior to the elimination of the 3% and 4% brackets.

We can calculate an effective tax rate for a given level of taxable income using the information on tax structure. We will assume an individual who has \$50,000 in earned income in 2024. After subtracting the standard deduction of \$2,300 and the personal exemption of \$6,000, and for simplicity assuming no other eligible deductions or credits, this individual has \$41,700 in taxable income. Therefore, in tax year 2024 the state will levy a tax rate of 4.7% on this individual's taxable income above \$10,000, which in this example equals \$31,700. Thus, this individual's total income tax paid in 2024 is approximately \$1,490. Dividing this amount by the individual's earned income of \$50,000 we determine the effective income tax rate in 2024 for a single individual with an income of \$50,000 is 3.0%.

¹ For more information see "Fiscal and Economic Analysis of HB 531," available at: http://www.mississippi.edu/urc/downloads/urc_analysis_hb_531.pdf.

Table I below lists the effective tax rates for selected levels of income by year. The first year, 2016, represents the last tax year that included the complete 3%, 4%, and 5% brackets. The remaining years, 2023 through 2026, represent the implementation years of House Bill 531. Most notably, the slightly progressive structure of Mississippi’s tax code is maintained each year across the income ranges included in Table I. Furthermore, all taxpayers with taxable incomes above \$10,000 annually pay less in taxes following the implementation of House Bill 531. For individuals with taxable incomes up to \$25,000 annually, after 2023 the subsequent reductions in taxes paid are relatively small. For individuals with annual taxable incomes above \$25,000 up to \$50,000, progressivity increases somewhat following the implementation of House Bill 531, as the effective tax rate rises more quickly. For annual taxable incomes above \$50,000, however, progressivity is essentially the same. The effective rates are basically shifted down for taxable incomes above \$50,000 annually.

Table I. Effective Mississippi individual income tax rates by taxable income, selected years.

	2016	2023	2024	2025	2026
\$10,000	0%	0%	0%	0%	0%
\$25,000	2.7%	1.3%	1.3%	1.2%	1.1%
\$50,000	3.9%	3.2%	3.0%	2.8%	2.5%
\$75,000	4.2%	3.8%	3.6%	3.3%	3.0%
\$100,000	4.4%	4.1%	3.8%	3.6%	3.3%

Sources: Kaufman (2024) and Mississippi House Bill 531. URC calculations.

By replicating the calculations for Mississippi for the other forty-nine states, we can compare the effective tax rate for an individual with \$50,000 in earned income in 2024. After making these calculations, we determine that the 3.0% effective tax rate in Mississippi is tied with Indiana and Missouri for twenty-eighth among all states. Among surrounding states, the effective tax rate in Louisiana is slightly lower at 2.8%, which ranks thirty-third among all states. Tennessee, which has no income tax, is tied for forty-first among all states with an effective rate of 0.0%. Arkansas has an effective rate of 3.9%, which is tied for thirteenth among all states. Finally, Alabama has an effective rate of 4.5%, which is tied for sixth among all states. The effective tax rates on \$50,000 in earned income in 2024 vary across Mississippi and surrounding states. The rankings of these effective rates will change in future years, as Mississippi lowers its single tax rate to 4.0% in 2026 and other states are likely to make changes to their tax rates as well.

We can also examine how the effective tax rate in Mississippi changes at different income levels. For example, if we assume an individual earns \$100,000 in income in 2024, the effective tax rate increases to 3.8%. This rate is tied with Utah and Colorado for thirtieth among all states. If we assume an individual earns \$25,000 in income in 2024, the effective tax rate falls to 1.3%. This rate is tied with Missouri for twenty-seventh among all states. Thus, we can see from evaluating different levels of earned income that the individual income tax structure in Mississippi remains slightly progressive, even after effectively shifting to a single rate. The personal exemption and standard deduction partially offset the elimination of multiple rates. Furthermore, we find that as of 2024 the relative ranking among all states of the effective income tax rate in Mississippi changes little at different levels of income.

Features of the Income Tax

As numerous researchers have discussed, multiple aspects of the individual income tax affect its use as a revenue source for states. This section examines the most important characteristics of the individual income tax.

As we note in our previous publication, “the growth potential of individual income tax revenues is considerably greater than sales tax revenues in the short run, but only moderately better over the long term” (Miller and Collins 2021). Individual income tax revenues are subject to vary more with upturns and downturns in the economy compared to sales tax revenues, particularly the sales tax in Mississippi that currently has very few exemptions. We previously found that the average annual change in Mississippi individual income tax revenues between 1980 and 2020 was an increase of 5.9%, which compares to an average annual change in Mississippi sales tax revenues of an increase of 1.5% over the same period. This conclusion is consistent with the findings of Brunori (2022), who notes that individual income tax revenue was 19% of total state tax revenue in 1970 and 36.5% of state tax revenue by 2013; at that point the individual income tax became the largest source of revenue for state governments.

Researchers, including Brunori and Eleniewski, Trebby, and Nagode (2014), state that one of the important attributes of the individual income tax is its perceived fairness by the public at large. Brunori (2022) states, “Opinion polls have routinely indicated that the public rates the [income] tax as the most acceptable form of taxation.” Similarly, Eleniewski, Trebby, and Nagode (2014) assert, “The single most significant advantage of the progressive income tax system, it is argued, is the fairness and equity of such a system.” These conclusions are reached chiefly because under most state income tax systems, individuals with larger incomes pay more in income taxes in both absolute and relative terms than individuals with smaller incomes. However, Brunori (2022) notes that the public’s view about *state* income taxes “contrasts sharply” compared to how it views *federal* income taxes. He affirms, “Like the sales tax, the state income tax also does not generally produce dissatisfaction, because of the relatively low rates imposed by the states.”

Both Brunori and Eleniewski, Trebby, and Nagode (2014) note the individual income tax system is generally widely accepted by the public, as most people are familiar with income taxes and how these taxes work. Brunori (2022) cites the examples of several states in the last fifteen years where residents either voted against eliminating the individual income tax or voted in favor of increasing the income tax rates on the highest earners, typically to provide more funds for education.

Researchers differ on their assessment of the individual income tax in terms of generating revenue. Eleniewski, Trebby, and Nagode (2014) argue more reliance on sales taxes by states is preferable because the revenue from this source is less variable than revenue from income taxes, particularly in periods of economic downturns. Conversely, Brunori (2022) contends individual income tax revenues have consistently performed over time in terms of growth. He cites how nearly every state reduced individual income taxes in the late 1990s when economic growth was relatively strong, yet revenues continued to grow in the early 2000s when economic growth was comparatively weaker.

Another important aspect of the individual income tax is the treatment of savings. Under an individual income tax, all of a person’s income is taxed, regardless if he or she spends or saves it. The income tax therefore creates an incentive for an individual, in the short run at least, to consume and a disincentive to save. Eleniewski, Trebby, and Nagode (2014) argue that because saving results in an increased ability to consume in the long run, “any income tax system ultimately hurts long-term economic growth.” Similarly, Ehrbar (2008) argues the individual income tax creates a “tax wedge,”

which is equal to the difference between what an individual is paid by his or her employer and what his or her after-tax income is. He also notes that because of the tax wedge people will consume more currently and less in the long run. The reduction in consumption in the future results from both the additional current consumption and the absence of gains that could have occurred from more saving at market interest rates. Ehrbar, like Eleniewski, Trebby, and Nagode (2014), notes the reduction in saving ultimately leads to slower economic growth in the long run.

Sales Tax

In our previous publication, we noted the current statewide sales tax rate in Mississippi is 7.00%; this rate has been in effect for more than thirty years. Some municipalities in the state impose an additional sales tax within their jurisdictions up to a maximum of 1.00%. The Mississippi legislature must approve any municipality's request to levy an additional sales tax and to date only a handful of cities are permitted to impose an additional sales tax. According to the Tax Foundation, the effective average statewide sales tax rate in Mississippi incorporating local sales tax rates is 7.06%, only slightly higher than the overall state rate (Walczak 2024a). The sales tax in Mississippi is subject to only a limited number of exemptions. Groceries or unprepared foods are not exempt from the sales tax, in contrast to more than thirty states. An analysis by the Tax Foundation in 2021 found sales tax revenue as a percentage of personal income in Mississippi was 3.50%, which ranked third among all states (Walczak 2024b). The relatively low level of personal income in the state, along with a lack of exemptions to the sales tax, contribute to this ranking.

Economists consider ordinary sales taxes to be regressive because an individual's average tax rate decreases as his or her income increases (Marples 2023). Or, said differently, the amount paid in taxes becomes a smaller share of an individual's income as that income increases. For example, using Mississippi's sales tax rate of 7.00%, suppose two individuals purchase \$1,000 of goods subject to the sales tax. Both individuals will pay a total of \$70 in sales taxes. Assume the first individual has a total income of \$5,000 and the second individual has a total income of \$10,000. In this example, the first individual pays an average of 1.4% of his or her income in sales taxes, while the second individual pays an average of 0.7% of his or her income in sales taxes—thus meeting the definition of a regressive tax. Other taxes classified as regressive include excise taxes (such as taxes on gasoline and tobacco), payroll taxes, and, to some degree, property taxes. In one sense property taxes are regressive because the tax is based on the value of the property, which if two separately owned properties in the same jurisdiction have equal value, then each owner pays the same amount in property taxes regardless of his or her income. However, at the same time property taxes cannot be considered completely regressive because those individuals with smaller incomes tend to own lower-valued properties.

Ways to Mitigate Regressive Sales Taxes

One of the most common methods states use to diminish the regressive effects of sales taxes is exemptions. Exempting groceries from sales taxes, as mentioned previously, mitigates some of the regressivity of sales taxes because lower income residents spend a larger portion of their income on food. However, the trade off from exempting food or any other commodity is a reduction in the efficiency of the sales tax, as the base is narrowed as a result. Furthermore, because essentially everyone must purchase food regardless of the condition of the economy, sales tax revenues become more variable when a grocery tax exemption is in place. Some researchers are quite critical of exemptions; Mikesell and Kioko (2018) note, "Taking household consumption out of the tax base contributes to ...

base narrowing, makes the tax more complicated for administration and compliance, and discriminates according to household preferences.”

Another option that falls short of a complete exemption is levying a reduced rate on certain categories. For example, as of 2024, of the eleven states that impose a sales tax on food items, five levy a reduced rate. Neighboring Alabama is in the process of phasing in a reduction in the sales tax on groceries from 4% to 2%. Neighboring Arkansas taxes groceries at a rate of 0.125%, which is the lowest rate among the states that tax food items. The tax on groceries in neighboring Tennessee is 4%, less than the statewide rate for all items of 7%. While most states either do not tax groceries or tax groceries at a reduced rate, in some states local jurisdictions may still levy a tax on food items, often at a relatively high rate. For example, in Montgomery, Alabama, combined state and local taxes result in a 9% tax rate on groceries.

Providing sales tax credits or rebates represents one other measure to mitigate the regressive effects of sales taxes. Mikesell and Kioko, referenced above, argue a system of sales tax credits or rebates, similar to an earned income tax credit program, would be more efficient and equitable and result in less revenue lost than an exemption for groceries. Similarly, Frieden and Lindholm (2020) recommend “providing refundable income tax credits for sales taxes paid by lower income households” to mitigate the regressive effects of consumption taxes. While this measure is less commonly used than exemptions and reduced rates, some states do employ rebates. Idaho, which taxes groceries at the full 6% state sales tax rate, provides a grocery tax credit that averages \$120 for most residents of the state. Similarly, while Hawaii does not have a sales tax on groceries, the state does impose an excise tax that effectively applies to groceries. Individual residents with annual adjusted gross incomes less than \$40,000 in the most recent tax year could obtain a refundable income tax credit that offsets the food excise tax. However, according to the Hawaii Department of Taxation, many eligible low-income residents do not claim the credit, often because they fail to file a state income tax return.

Features of the Sales Tax

Much like the individual income tax, multiple characteristics of the sales tax affect its use as a revenue source for states. This section discusses the most important characteristics of the sales tax.

Brunori (2022) notes, “The practical advantages of the sales tax include public acceptance and efficient administration.” He also cites its stability and predictability. Indeed, the findings in our previous publication regarding sales tax revenue variability support this latter conclusion. URC estimates that the short run and long run income elasticity values of sales tax revenues in Mississippi are approximately 0.8 and 0.9, respectively. Both values indicate that sales tax revenues in Mississippi are slightly income elastic, which means a 1% change in income results in a slightly smaller change in sales tax revenues. These values imply sales tax revenues remain relatively stable, even during downturns in the economy. The tradeoff is sales tax revenues have a limited potential for growth relative to other taxes such as income taxes. Furthermore, as noted previously, increasing the number of exemptions to the sales tax, such as for groceries, decreases this relative stability by narrowing the base—even while reducing the regressivity of the sales tax.

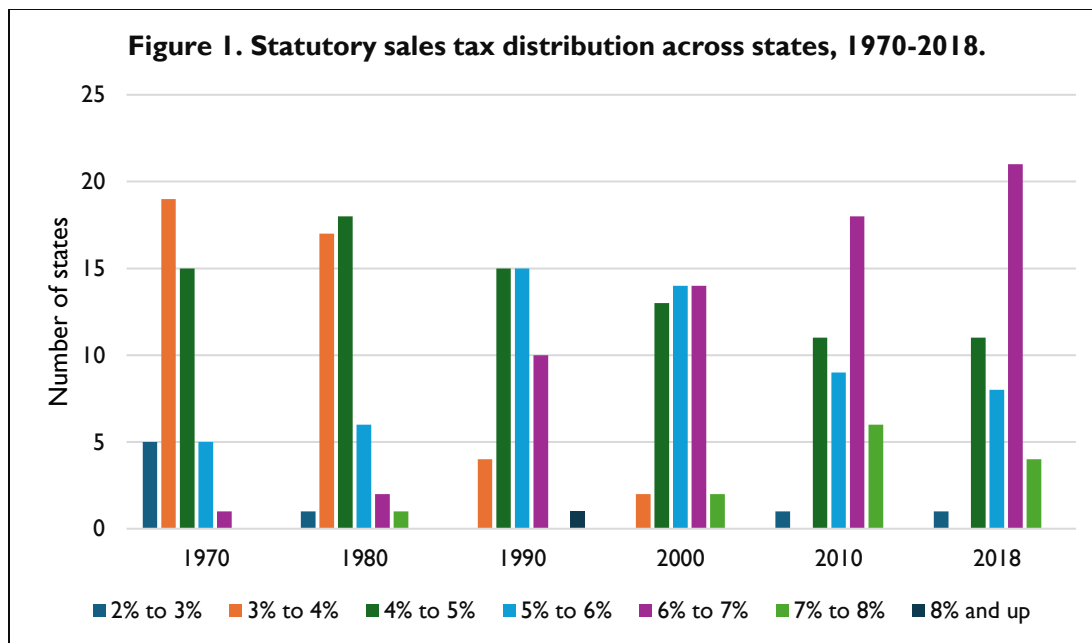
As Viard (2010) states, “Economic analysis generally supports the efficiency of consumption taxation, which avoids the penalty on saving and investment imposed by income taxes.” In the previous discussion of the individual income tax, we noted this tax creates a disincentive to save. As a form of a consumption tax, a well-designed sales tax, by taxing spending, should encourage saving and investment. By not taxing saving and investment, consumption taxes should, in theory, promote the accumulation of

capital and economic growth. Eleniewski, Trebby, and Nagode (2014) similarly explain that this is because “The incentive to save, which ultimately leads to a greater ability to consume in the long run, is tied to economic growth.” They describe this benefit as the greatest advantage of a “pure consumption system.”

Another feature of consumption taxes and, by extension, the sales tax, is economic efficiency. As Eleniewski, Trebby, and Nagode note, an individual who decides to work more hours has no disincentive to do so under a sales tax because he or she keeps all money earned and incurs no sales tax until he or she chooses to spend this money. We will note that the individual income tax in Mississippi, because it is comparatively low, likely creates a relatively small disincentive for additional work. This characteristic is particularly true at the lowest income levels because, as we noted in the discussion of the previous section, a Mississippi resident incurs no individual income tax liability below annual taxable incomes of \$18,300.

The preceding paragraphs referred to a “well-designed” sales tax and used the qualifier, “in theory.” While economists generally laud several features of consumption taxes, many of them are pointedly critical of how sales taxes are applied by individual U.S. states. Economists’ critiques of sales taxes fall into three basic categories: 1) the diminishing base of sales taxes; 2) the taxation of business inputs; and 3) the exclusion of services.

Diminishing base of sales taxes. One of the issues that has threatened the sustainability of the sales tax as a revenue source for states is how the base has become narrower over time. This change has occurred gradually due to multiple factors, including changes in technology. Mikesell, Mullins, and Kioko (2021) argue that the diminishment of the sales tax base was not inevitable but resulted from both the actions and inaction of state-level officials. The sales tax was borne out of the Great Depression at a time when individual states were struggling to raise revenue. While the sales tax became an unqualified success at generating revenue for states, it was designed to levy taxes on tangible personal property. At the time most states adopted a sales tax, the services component of the economy was relatively small. Over the ensuing decades, however, services became a much larger share of overall individual consumption. In most cases, the sales tax base became narrower because states did not adjust the base to capture the increase in services activity—a generally difficult task politically. Secondly, in many states the number of products exempted from sales tax has steadily increased over time as well. Mikesell, Mullins, and Kioko note that the number of states exempting or imposing a reduced sales tax rate on the following goods increased between 1970 and 2018: food for at-home consumption, clothing, prescription medicine, gasoline, residential electricity, residential gas, and residential water. Furthermore, they note that in 1970 no state conducted a state sales tax holiday for any type of product. As of 2018, however, twenty-two states held at least one sales tax holiday; seven states held multiple sales tax holidays. Mikesell, Mullins, and Kioko contend that a credit/rebate system is far superior to exemptions and that such a system would address most of the negative effects of exemptions, including “high revenue loss.” Despite the narrowing of the base, the sales tax has maintained its preeminence among revenue sources for states over the years. Mikesell and Kioko (2018) note the sales tax has maintained its position because states have continually increased the statutory rate. Figure 1 below is adapted from Mikesell and Kioko and depicts the “rate creep” that has occurred across states since 1970.



Source: J.L. Mikesell and S.N. Kioko, 2018, “The Retail Sales Tax in a New Economy.”

The graph clearly shows the increase in sales tax rates over the last five decades. In 1970, of the forty-five states that levied sales taxes, twenty-four states imposed a rate below 4%. By 2018, twenty-six states imposed a rate above 6%. Mikesell and Kioko assert that, with no other changes to sales tax structure, states will need to continue to raise rates to maintain revenues from sales taxes. However, they also warn, based on a consensus from researchers, “that retail sales tax rates much above 10 percent are likely to produce compliance issues so difficult that the tax becomes almost impossible to administer.” The imposition of additional sales taxes by cities and counties only intensifies the concern.

Taxation of business inputs. One of the areas of strongest agreement among economists regarding the application of sales taxes is the treatment of business inputs. Economists argue that for a sales tax to be a true consumption tax, it should tax only final consumption and not intermediate goods. Business inputs, because they represent materials and products used in the production of consumer goods (and in some cases, services), are considered intermediate goods. A good is at least double-taxed when a business pays sales tax on a purchased input used to produce the final product sold to a consumer at retail, who also pays a sales tax on that final product. This multiple taxation is referred to by economists as “cascading” or “pyramiding,” and causes multiple problems in the economy. Philips and Ibaid (2019) find that pyramiding “may constitute additional business costs, which may then be reflected in higher consumer prices and reduced state economic activity, including reduced employment and lower wages.” Similarly, Frieden and Lindholm (2020) describe pyramiding as economically inefficient. They note that pyramiding “affects business choices of location of jobs and investment, input purchases, and organization of business structures.” Perhaps economists are most critical of the taxation of business inputs in the application of the sales tax because such taxation weakens what is likely the best attribute of the sales tax, which Frieden and Lindholm describe as its ability to “raise substantial revenues with the least impact on business and economic growth.” In their analysis of state and local sales taxes, Philips and Ibaid (2019) found that in 2017, approximately 42% of total revenue from sales taxes in the U.S. was derived from business inputs. The share of sales tax revenue derived from business inputs across states was as high as 60% in New Mexico and as low as 32% in Indiana and Idaho. The analysis found 36% of

sales tax revenue in Mississippi in 2017 was derived from business inputs, which was tied with Hawaii, Rhode Island, and Michigan for fortieth among the forty-five states that levied sales taxes. Given that taxation of business inputs accounts on average for more than 40% of a state's sales tax revenue, how can a state make up that lost revenue? That question leads into the discussion of the final critique of the sales tax by economists, the exclusion of services.

Exclusion of services. The previous discussion mentioned that one of the important principles of the efficiency of the sales tax is that it taxes final consumption. The exclusion of services from the sales tax base violates that principle. Nevertheless, the sales tax bases of many states remain largely if not exclusively limited to goods, and despite frequent debates, capturing services has often proven politically difficult. Most sales tax states, in addition to taxing goods, levy a sales tax only on a limited number of services. Mikesell, Mullins, and Kioko (2021) cite only four states as of 2018 “that generally tax purchases of tangible personal property and services on a roughly equivalent basis.” The authors argue that most states make the mistake of applying the sales tax to finished goods rather than *final*—typically household—consumption of goods and services. They also find that the typical sales tax base of a state was 20% smaller in 2016 than in 1970.

Changes in technology, as alluded to previously, can also impact if a good or service is subject to a state's sales tax. For example, cloud-based computing is a potentially nebulous area for sales tax purposes. Purchases of digital products such as books and videos are frequently taxed by states, although Mikesell, Mullins, and Kioko note that as of 2021, nearly half of states did not. They argue that such products should be subject to a state's sales tax, as the value or utility provided to consumers by these goods is indistinguishable from that provided by their physical counterparts. The authors also note Mississippi was one of only a few states at the time of writing that taxes custom software. Services provided through cloud computing are a separate concern. Data processing services from the cloud at present are more likely to be purchased by businesses than households. However, as technologies continue to evolve, individuals may purchase more computing services via the cloud. Because of how rapidly technologies can change, Mikesell, Mullins, and Kioko contend that rather than trying to keep up with every breakthrough, state sales tax laws should apply the same standard to the consumption of electronic services as to the consumption of other services. That is, only the final consumption of a cloud-based computing service should be subject to the sales tax. If the cloud-based computing service is a business input, then it should be excluded. Given the limited number of exemptions in Mississippi's sales tax code, the state appears well positioned to handle most digital products. However, because of their intangibility, cloud-based computing services remain subject to the same issues as other services.

Summary and Conclusions

Mississippi is reducing its individual income tax rates and, in the process, becoming more reliant on its sales tax for general fund revenue. This report highlights several issues and features of both the individual income tax and the sales tax that policymakers should potentially consider, regardless of any additional changes that might be made to the individual income tax. These issues include the progressivity and regressivity associated with both taxes, along with related equity issues; the growth potential of both taxes; the relative efficiency of both taxes; and economists' three primary critiques of most state sales taxes. These three critiques are: 1) the diminishing base of sales taxes; 2) the taxation of business inputs; and 3) the exclusion of services. By considering and addressing these issues, policymakers can further develop a state tax system for Mississippi that maintains long-term viability in terms of generating revenue, increase the efficiency of the state's tax system, and provide equity in taxation across varying levels of income.

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