

THE ITEP GUIDE TO

Fair State and Local Taxes

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Institute on Taxation and Economic Policy

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About the Guide

The ITEP Guide to Fair State and Local Taxes is designed to provide a basic overview of the most important issues in state and local tax policy, in simple and straightforward language.











The Guide is also available to read or download on ITEP's website at www.itepnet.org. The web version of the Guide includes a series of appendices for each chapter with regularly updated state-by-state data on selected state and local tax policies. Additionally, ITEP has published a series of policy briefs that provide supplementary information to the topics discussed in the Guide. These briefs are also available on ITEP's website.

The Guide is the result of the diligent work of many ITEP staffers. Those primarily responsible for the guide are Carl Davis, Kelly Davis, Matthew Gardner, Jeff McLynch, and Meg Wiehe. The Guide also benefitted from the valuable feedback of researchers and advocates around the nation. Special thanks to Michael Mazerov at the Center on Budget and Policy Priorities.

About ITEP

Founded in 1980, the Institute on Taxation and Economic Policy (ITEP) is a non-profit, non-partisan research organization, based in Washington, DC, that focuses on federal and state tax policy. ITEP's mission is to inform policymakers and the public of the effects of current and proposed tax policies on tax fairness, government budgets, and sound economic policy. Among its many publications on state and local tax policy is *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*

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CHAPTER ONE

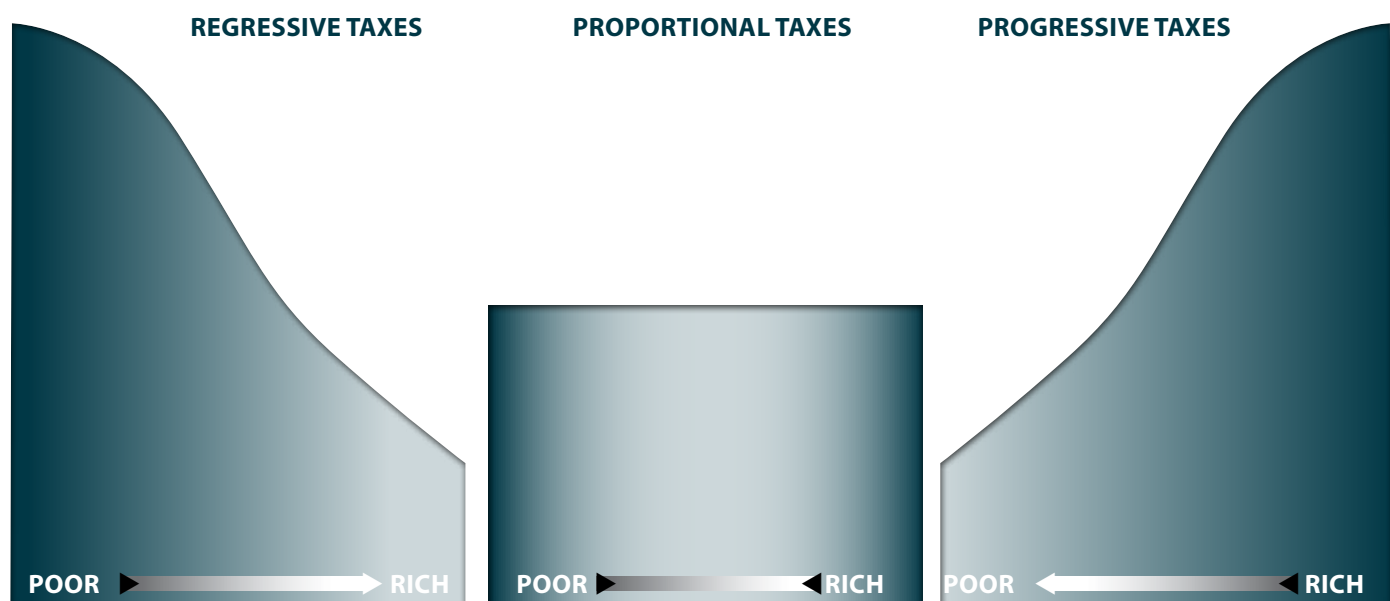
TAX FAIRNESS FUNDAMENTALS

“The subjects of every state ought to contribute toward the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state . . . [As Henry Home (Lord Kames) has written, a goal of taxation should be to] ‘remedy inequality of riches as much as possible, by relieving the poor and burdening the rich.’”¹

— Adam Smith, *An Inquiry Into The Nature and Causes of the Wealth of Nations* (1776)

A fair tax system asks citizens to contribute to the cost of government services based on their **ability to pay**. This is a venerable idea, as old as the biblical notion that a few pennies from a poor woman’s purse cost her more than many pieces of gold from a rich man’s hoard. In discussing tax fairness, we use the terms regressive, proportional and progressive. As the chart below illustrates:

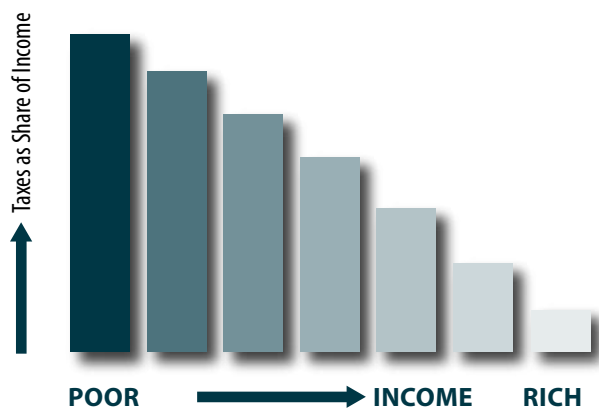
- A **regressive** tax makes middle- and low-income families pay a larger share of their incomes in taxes than the rich.
- A **proportional** tax takes the same percentage of income from everyone, regardless of how much or how little they earn.
- A **progressive** tax is one in which upper-income families pay a larger share of their incomes in tax than do those with lower incomes.



Few people would consider a tax system to be fair if the poorer you are, the more of your income you pay in taxes. But that's exactly what regressive taxes do. They require

A Regressive Tax

Florida's General Sales Tax

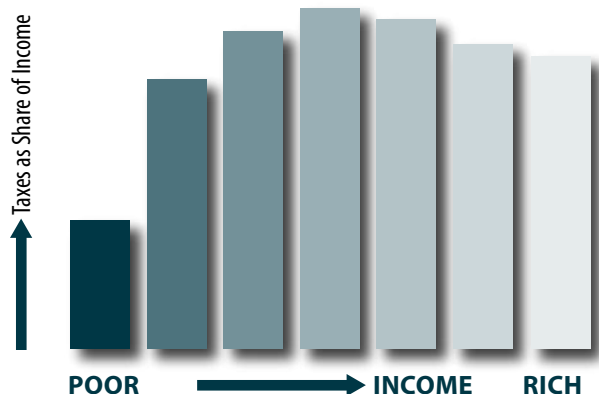


middle- and low-income families to pay a much greater share of their incomes in taxes than the wealthy. Fairness is, of course, in the eye of the beholder. Yet almost anyone would agree that the best-off families should pay at a tax rate at least equal to what low- and middle-income families pay. State and local taxes pay for the schools, safe neighborhoods, clean water and air, public transportation and other things that make for a better community and enhance quality of life. Because these investments benefit everyone, it is imperative that every household pay its fair share.

The sales tax is a regressive tax, as can be seen in the chart at left of Florida's sales tax. Because sales taxes are levied at a flat rate, and because low-income families spend more of their income on items subject to the sales tax than do wealthier taxpayers, sales taxes inevitably take a larger share of income from low- and middle-income families than they take from the wealthy. Excise taxes on cigarettes, gasoline and alcohol are also quite regressive, and property taxes are generally somewhat regressive.

An Almost Proportional Tax

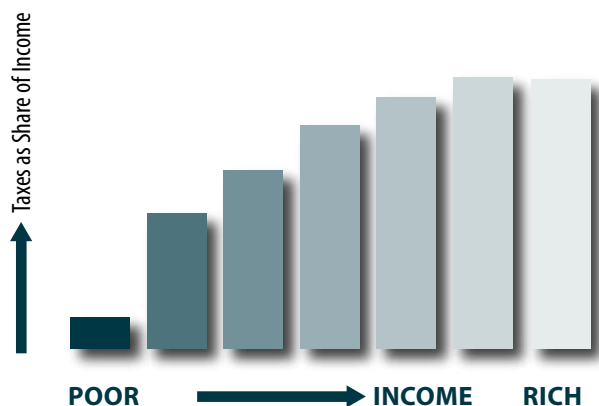
Alabama's State Income Tax



Some believe that a proportional, or "flat," tax structure is fair. They argue that if everyone pays the same share of income in taxes, then everyone is treated equitably. But this view ignores the fact that taking the same share of income from a middle- or low-income family as from a rich family has vastly different consequences for each. Low-income families must spend most (or all) of their income just to achieve the most basic level of comfort. Even middle income families spend most of what they earn to sustain only a modest standard of living. A tax on these families can cut directly into their ability to make ends meet. In contrast, the same tax will hardly affect the life style of the wealthiest families at all. An almost-flat personal income tax (like Alabama's, shown in the chart at left) is an example of a tax that can be proportional.²

A Progressive Tax

Georgia's State Income Tax



Progressive taxes are the fairest taxes. Personal income taxes are the only major tax that can easily be designed to be progressive. Low-income families can be exempted entirely and tax rates can be graduated, with higher tax rates applying to higher income levels, so that middle-income and rich families pay taxes fairly related to what they can afford. An example of a typically progressive income tax is Georgia's tax, shown in the chart at left: the poorest taxpayers pay the smallest amount as a share of income, and taxes increase with each income level.

Almost every state relies on some combination of regressive, proportional and progressive taxes. When you add these taxes together, the overall **progressivity** or **regressivity**

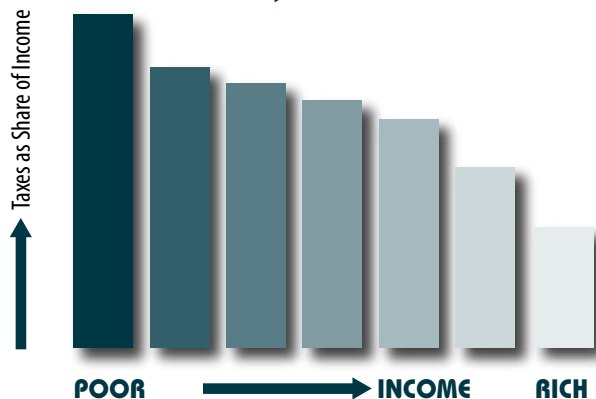
of a tax system is determined by (1) the degree of progressivity or regressivity of each tax within the system and (2) how heavily a state relies on each tax. Thus, a state that relies on regressive sales, excise and property taxes more heavily than its mildly progressive income tax will end up with a very regressive tax system overall. An example of a state like this is Illinois. At the other end of the spectrum, even the most progressive income taxes are only sufficient to make a state's tax system roughly proportional overall. An example of a state that achieves this result by relying more on its progressive income tax than on regressive sales, excise and property taxes is Vermont. The charts below illustrate Illinois and Vermont's tax systems.

Why Tax Fairness Matters

Tax fairness is an important goal for state policymakers, for several reasons. For one thing, a regressive tax system raises money from the people who have the least of it. This is

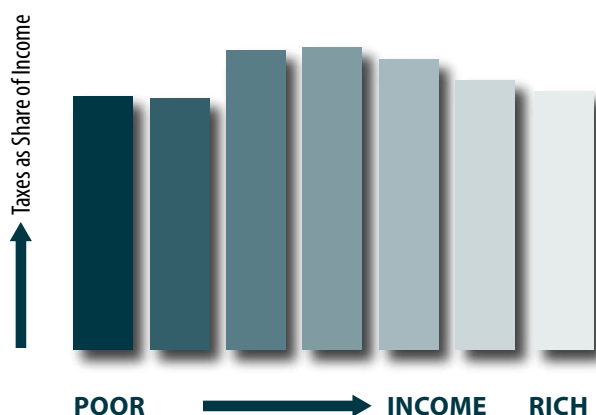
Illinois State & Local Taxes

As Shares of Family Income



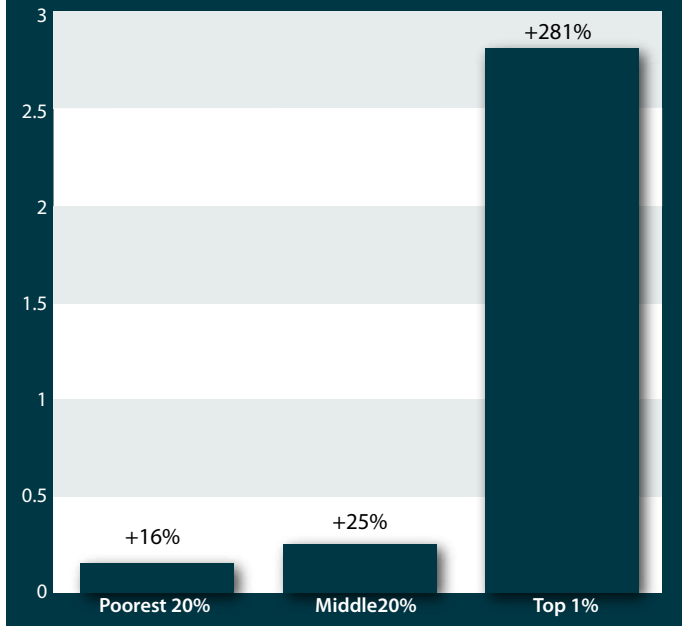
Vermont State & Local Taxes

As Shares of Family Income



Source: ITEP Microsimulation Model

The Rich Get Richer: Real Income Growth, 1979 - 2007



Source: Congressional Budget Office, "Data on the Average Federal Taxes by Income Group," June 2010.

illogical at best. The wealthiest one percent of Americans have more income than the poorest 40 percent put together. And the best-off 20 percent of Americans make more than the remaining 80 percent combined. Soaking the poor just doesn't yield much revenue compared to modest taxes on the rich. Fair taxes are essential to adequate funding of public services because they tax those who have the most to give.

This flaw in using a "soak the poor," regressive tax system for raising revenue has been compounded in recent years. The wealthiest Americans have gotten much richer, while just about everyone else has gotten squeezed. The richest one percent of families in the United States saw their average pre-tax income rise by 281 percent in the twenty-one years from 1979 to 2007—that's in "constant dollars" (meaning it's adjusted for inflation)! Meanwhile, middle-income earnings grew by 25 percent over this period, and the poorest twenty percent saw their real pretax incomes grow by just 16 percent.³

It's no wonder that so many states with regressive tax structures are facing long-term structural budget deficits. They're continually imposing higher taxes on people without much money—the very people who have experienced the most meager growth in income over the past thirty years. These states are largely bypassing—that is, by taxing at very low rates—the people whose incomes have grown the fastest: the rich. In the long run, progressive taxes like the income tax are a more dependable source of revenue for state and local governments precisely because they tax the wealthy state

Are Your State's Taxes Unfair?

*A November 2009 ITEP report, **Who Pays?**, measures the fairness of state and local taxes in each of the 50 states and the District of Columbia. The report finds that almost every state requires its poorest citizens to pay more of their income in taxes than any other income group—and allows the wealthiest taxpayers to pay the least. **Who Pays?** is available on ITEP's website at www.itepnet.org/whopays*

residents who have enjoyed the largest income gains in recent decades.

Fair taxes also help government in its relations with its citizens. The public accepts taxes because it values the services that government provides. When a tax system is unfair, however, there is a limit to the taxes the public will tolerate. It's one thing to ask people to pay taxes. It is another to ask them to pay more because others aren't paying their fair share. When states choose to balance their budgets by hiking taxes on the low- and middle-income families who are hit hardest by the current tax system, while giving the best-off families a free pass, this obvious unfairness undermines public support for revenue-raising tax reforms even when they are most desperately needed.


Finally, a fair tax system is important as a very real moral imperative. Taxes can amount to real money for any family. But for poorer families, it's money that could otherwise be used

for food, clothing, a trip to the doctor or some other necessity. When a state decides to tax the poor at a high rate, it is forcing these families to make choices that no family should have to make—choices that are far harder than those faced by upper-income families.

Federal Taxes Matter, Too

When we evaluate the fairness of a tax system, we should also consider overlapping tax systems that affect the same taxpayers. It is important, in particular, to consider state and local tax policy in the context of federal tax policy.

While the rich have seen their incomes go up substantially faster than others, federal taxes on the wealthy have gone way down—resulting in an overall tax system that is much less progressive. In 2009, the wealthiest 1 percent of Americans paid 30.8 percent of their income in combined federal, state and local taxes, down sharply from 37.1 percent before the George W. Bush administration. By comparison, the other 99 percent of Americans paid, on average, 28.2 percent of their income in total taxes—almost as much as the wealthiest taxpayers.

So as states determine which taxes to raise and on whom, they should consider that federal taxes have been getting significantly less progressive. A state that raises taxes on the rich will almost certainly still leave them better off than they were before their huge tax cuts on the federal level. Raising taxes on middle- and low-income taxpayers, however, will compound the injustice of the federal tax shift that has taken place in the past decade. 

¹ Smith, Adam. *An Inquiry into the Nature and Causes of the Wealth of Nations*. New York: Random House, 1937.

² Alabama's income tax has a nominally graduated rate structure, but the top income tax rate applies to all taxable income over \$6,000 for a married couples. As a result, 70 percent of Alabamans paid income tax at the top rate in 2009, making it an effectively flat income tax for most families.

³ Congressional Budget Office, "Average Federal Taxes by Income Group," June 2010. <http://www.cbo.gov/publications/collections/collections.cfm?collect=13>.

CHAPTER TWO

BASIC PRINCIPLES AND TERMS

This chapter introduces some basic principles for evaluating your state's tax system—and walks you through some of the “nuts and bolts” necessary for a basic understanding of tax policy issues. This chapter does not attempt to turn anyone into a tax attorney. Rather, our goal—here and throughout this guide—is to make the reader sufficiently knowledgeable about tax policy to effectively participate in important tax policy debates.

Tax Policy Principles: An Introduction

Tax fairness is a primary consideration in evaluating state and local tax systems. But there are other important criteria that must also be considered. This section explains five of the most commonly cited tax policy principles: equity, adequacy, simplicity, exportability, and neutrality.

Equity: Two Kinds of Tax Fairness

When people discuss tax “fairness,” they’re talking about equity. Tax equity can be looked at in two important ways: **vertical equity** and **horizontal equity**. Vertical equity addresses how

a tax affects different families from the bottom of the income spectrum to the top—from poor to rich. When we discussed regressive and progressive taxes in Chapter One, we were looking at vertical equity issues.

Horizontal equity is a measure of whether taxpayers in similar circumstances pay similar amounts of tax. For example, if one family pays higher taxes than a similar-income family next door, that violates “horizontal” fairness. This sort of unjustified disparity undermines public support for the tax system and diminishes people’s willingness to file honest tax returns. It would be hard to defend a tax system that intentionally taxed left-handed people at higher rates than right-handed people. Likewise, a tax that hits a wage-earner harder than an investor (as the federal income tax currently does), even if their total incomes are the same, fails the test of horizontal equity.

Adequacy

An adequate tax system raises enough funds to sustain the level of public services demanded by citizens and policymakers. At the end of the day, adequacy is what separates successful tax systems from unsuccessful tax systems. Of course, at any given time, the primary concern for state lawmakers is **short-term** adequacy—making sure there’s enough revenue to fund public services in the upcoming fiscal year. But it’s equally vital for good-government advocates and lawmakers to seek

Important Tax Policy Principles

- **Equity:** Does your tax system treat people at different income levels, and people at the same income level, fairly?
- **Adequacy:** Does the tax system raise enough money, in the short run and the long run, to finance public services?
- **Simplicity:** Does the tax system allow confusing tax loopholes? Is it easy to understand how your state’s taxes work?
- **Exportability:** Individuals and companies based in other states benefit from your state’s public services. Do they pay their fair share?
- **Neutrality:** Does the tax system interfere with the investment and spending decisions of businesses and workers?

strategies that will achieve **long-term** adequacy, balancing budgets not just this year and next, but five years and ten years down the road.

Two factors that contribute to the adequacy of a tax are its **stability** and its **elasticity**. A stable tax is one that grows at a predictable pace. Predictable growth makes it easier for lawmakers to put together budgets that match anticipated revenues to anticipated spending. But stability by itself is not enough to achieve adequacy in the long run. For example, property taxes grow predictably—but tend to

grow more slowly than the cost of the services that state and local governments provide. Elasticity is a measure of whether the growth in a specific tax keeps up with the economy—an important consideration because the cost of providing public services usually grows at least as fast as the economy. An elastic tax is one for which tax revenue grows faster than the economy over the long run.

There is some inherent tension between the goals of elasticity and stability. Elastic taxes, like the personal income tax, are more likely to ensure adequate revenues in the long run, but may fluctuate more from year to year. Academic research has shown that the long-term growth of the personal income tax is substantially greater than that of the sales tax, even though the income tax is more volatile in the short run.¹ This makes it vital for these taxes to be accompanied by prudent fiscal management to smooth out the ups and downs associated with normal economic cycles (for instance, by creating and maintaining a “rainy day fund”—see Chapter Nine for more details). Prudently managed, income taxes will likely provide a more sustainable funding source over the long run than is possible with sales or property taxes. Stable taxes, like the property tax, will grow predictably, but the slower growth rate of these taxes may mean that in the long run tax hikes will probably be necessary to fund services at the same level.

The “Benefits Principle” of Taxation

Not all taxes are based on ability to pay. Governments sometimes levy taxes and user fees designed to make people pay in accordance with the benefit they receive from certain public services. This idea is known as the benefits principle of taxation. For example, states raise money for highway maintenance by imposing a gasoline tax. Since the amount of gasoline a driver purchases is a reasonable proxy for the benefit that driver receives from publicly maintained roads, the gas tax follows the benefits principle of taxation.

But there are limits to the usefulness of the benefits principle. First, taxing according to the benefits principle can lead to a regressive result: gasoline taxes take a larger share of income from low-income taxpayers than from the wealthy. Second, for many of the most important functions performed by governments, such as education, health care and anti-poverty programs, and police and homeland security, it can be hard to quantify the benefits of these services for individual taxpayers. Third, many of the services provided by state governments are explicitly designed to redistribute resources to low-income taxpayers. Social welfare programs exist partially because low-income taxpayers cannot afford to pay for these programs themselves, so requiring these taxpayers to pay for the programs according to the benefits principle would defeat their purpose.

Simplicity

Simplicity is often touted as a goal for tax reform—and it’s an important one. Complicated tax rules make the tax system difficult for citizens to understand. Complexity also makes it harder for governments to monitor and enforce tax collections, and makes it easier for lawmakers to enact (and conceal) targeted tax breaks benefitting particular groups. A tax system full of loopholes gives those who can afford clever accountants an advantage over those who must wade through the tax code on their own.

But beware. Tax reform proposals described as “simplification” measures are often nothing of the kind. For example, anti-tax advocates frequently seek to “simplify” the income tax by eliminating the graduated rate structure and instituting a flat-rate tax. This is a red herring: a graduated tax system is no more complicated than a flat-rate tax, and generally doesn’t add even one extra line to your state income tax form. What makes filing taxes more complicated—and makes the tax forms longer and longer each year—is the proliferation of special tax breaks. The right way to make income taxes simple is to eliminate tax loopholes, not to flatten the rates.

Exportability

The public services provided by state tax revenues are enjoyed by individuals and businesses from other states—including businesses that hire a state's high school and college graduates and tourists who use a state's transportation infrastructure. This is why state tax systems are often designed to make multi-state businesses and residents of other states pay their fair share of the state's taxes. An **exportable** tax is one that is at least partially paid by these non-residents.

There are broadly three ways in which taxes can be exported: by having non-residents pay the tax directly (sales taxes on items purchased by tourists, for example); by levying taxes on businesses which are then passed on to non-residents; and through interaction with the federal income tax. (See "The Interaction of State and Local Taxes with Federal Income Taxes" on page 9.) All taxes are at least partially paid by non-residents—and policy makers have the power to effectively adjust the percentage of taxes "exported" to residents of other states.

Neutrality

The principle of neutrality (sometimes called "efficiency") tells us that a tax system should stay out of the way of economic decisions. Tax policies that systematically favor one kind of economic activity or another can lead to the misallocation of resources or, worse, to schemes whose sole aim is to exploit such preferential tax treatment. If individuals or businesses make their investment or spending decisions based on the tax code rather than basing them on their own preferences, that's a violation of the neutrality principle, and can lead to negative economic consequences in the long run. For example, the big tax breaks that the Reagan administration provided for commercial real estate in the early 1980s led to far too much office construction and the phenomenon of "see-through office buildings" that nobody wanted to rent. These wasteful investments came, of course, at the expense of more productive investments—and were paid for by all other taxpayers.

The tax principles outlined here are not the only criteria used by policymakers in evaluating tax changes—and these principles sometimes come into conflict. But almost everyone would agree that advocates of tax reform should keep each of these goals in mind as they seek to improve their state's tax system.

Nuts and Bolts: Basic Tax Policy Terms

The tax principles described so far are essential to a broad understanding of why one type of tax is preferable to another. But there is also a basic set of terms you'll need to understand in order to understand how each of these taxes work. This section explores the "nuts and bolts" of state and local tax policy.

The Tax Base

The **tax base** is all the items or activities subject to a tax. For any tax, it's worth distinguishing between the **potential** tax base—the set of items that would be taxed if there were no special exemptions—and the **actual** tax base used by a given state. The potential tax base of a general sales tax, for instance, is everything that a state's consumers purchase in a given year for their own personal use. But in every state levying a sales tax, the actual tax base is much smaller than that, because of exemptions for everything from groceries to haircuts.

Tax bases are usually measured as a dollar amount to which a tax rate is applied—for example, the total dollar amount of taxable income, in the case of the personal income tax, or the total dollar value of real estate, in the case of the real property tax. Taxes that are measured this way are called **ad valorem**, or value-based, taxes.

But not all taxes are calculated based on value: excise taxes on cigarettes, gasoline and beer are usually calculated on a per-unit basis. For these excise taxes, the amount of tax collected depends not on the value of the tax base, but on the number of items in the tax base. Cigarette taxes, for instance, typically are applied on a per-pack basis (the tax owed is a certain number of cents per pack of cigarettes sold). Thus, for a cigarette tax, the tax base is usually the number of packs sold. Taxes that are levied on a per-unit basis have one critical flaw—tax revenues only increase when the number of units sold goes up. By contrast, ad valorem taxes tend to grow with inflation even when the number of units sold is unchanged, because inflation drives the value of the base upwards.

Taxes are often described as having a broad base or a narrow base. A broad-based tax is one that taxes most of the potential tax base. For example, a broad-based sales tax is one that applies to almost all purchases of goods and services. A narrow-based tax applies to fewer items. A typical narrow-based sales tax applies only to goods, not services, and has exemptions for things like food, housing and medicine.

In general, broader tax bases are a good idea. At any given tax rate, a broad-based tax will raise more revenue than

a narrow-based tax—because more is taxed. The chart on this page illustrates this: Illinois taxes personal income at a flat 3 percent rate. (After this report was completed, the Illinois income tax rate was temporarily increased to 5 percent, but the tax breaks discussed in this section were not eliminated). If lawmakers repealed a special tax break for retirement income, the tax rate could have been lowered to 2.83 percent and still bring in the same amount of revenue. If lawmakers also repealed the state's property tax credit, a 2.69 percent rate would have raised the same amount of money as the current tax. This example illustrates an important tradeoff: the broader the tax base, the lower the tax rates can be. And the narrower the tax base, the higher the tax rate must be in order to fund a given level of public services.

A broader base also makes it more likely that the tax system will treat all economic activities the same, which helps ensure that the tax system will not discriminate in favor of some taxpayers and against others. For example, a state that collects sales tax on the purchase of goods from a store, but not on purchases made over the Internet, is choosing to favor one type of economic activity over another. Broadening the sales tax base to include Internet-based sales ensures that the neutrality principle is followed, and makes the sales tax rules less discriminatory.

But sometimes there are good reasons for having a narrower base. Excluding food from the sales tax, for example,

makes that tax less regressive. Many people argue that the benefit of making the tax less unfair outweighs the revenue loss from narrowing the sales tax base.

The Tax Rate (or Rates)

Multiplying the **tax rate** times the tax base gives the amount of tax collected. Usually, the tax rate is a percentage. For instance, if a state's sales tax rate is 4 percent on each taxable purchase and taxable purchases (the tax base) total \$1 billion, then the total amount of tax collected will be \$40 million (4 percent of \$1 billion).

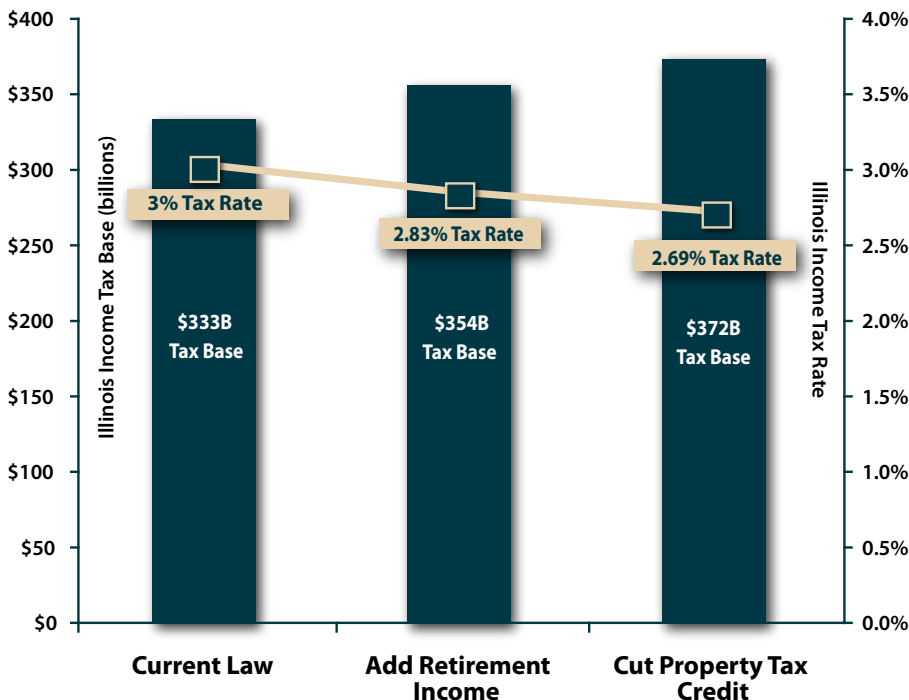
Income taxes typically have multiple rates—with different rates applying at different levels of income. This is called a “graduated” rate structure, using “marginal” rates. Chapter Five describes how such a rate system works.

Not all tax rates are percentages. A typical gasoline tax rate, for example, is expressed in per-gallon terms. So if a state has a gasoline tax rate of 10 cents per gallon and 100 million gallons of gasoline are sold, then the tax collected will be \$10 million (10 cents multiplied by 100 million).

Property tax rates are traditionally measured not in percentages but in mills. A mill represents a tenth of a percent. Mills tell us the tax for each thousand dollars in property value. Thus, a 20 mill rate applied to a house with a taxable value of \$100,000 yields a tax of \$2,000.

How Base Broadening Can Lower Tax Rates

The Illinois Income Tax



Effective Rates Versus Nominal Rates

So far, we have been describing **nominal tax rates**—the actual legal rate that is multiplied by the tax base to yield the amount of tax liability.

Though the nominal rate is used in the actual calculation of taxes, it's not the best measure for comparing taxes between states because it doesn't account for differences between tax bases. For example, suppose that two states, each with the same population and the same total amount of income, have sales taxes. The sales taxes have the same tax rate, 4 percent, but state A's sales tax applies to a narrow tax base, exempting groceries and many services, while state B's sales tax applies to a broader tax base. State B's sales

Effective Tax Rates and Nominal Tax Rates

	State A	State B
Nominal Sales Tax Rate	4%	4%
Tax Base	\$1 billion	\$1.5 billion
Sales Tax Collected	\$40 million	\$60 million
Statewide Personal Income	\$2 billion	\$2 billion
Effective sales tax rate	2.0%	3.0%

measure the tax compared to what the homeowner can afford? The owner of this home could be out of work—or could have just gotten a huge raise. Because we care about tax fairness, we need to measure the tax paid relative to ability to pay. Tax incidence tables—like the ones presented in ITEP’s “Who Pays” report and other ITEP analyses of tax fairness—are based on effective tax

tax (the total amount of statewide sales subject to the tax) applies to \$1.5 billion of retail sales, while state A’s sales tax applies to just \$1 billion in sales. State B’s sales tax is obviously much higher than State A’s tax—even though the legal rates are identical. To compare these two sales taxes solely on the basis of the legal rates would be misleading.

A better, more accurate measure for comparing these taxes is the **effective tax rate**. The idea of an effective rate is that instead of just saying “both state A and state B have four percent sales taxes,” we say that “state A’s sales tax takes 2.0 percent of the income of its residents while state B’s takes 3.0 percent of personal income.” This approach is better because it measures tax liability in a way that takes account of differences in the tax base. In this example, by comparing these effective rates we are able to see that, even though state A and state B have the same nominal rates, the tax is really higher in state B because state B has a broader base.

When we divide tax payments by personal income, as in the example above, we’re calculating the **effective tax rate** on income. Effective tax rates can be calculated in other ways, too. For example, the property tax on a home can be expressed as a percentage of its market value. But what if we want to

rates on income for families at different income levels because this approach is the most meaningful measure of tax fairness.

The Interaction of State and Local Taxes With Federal Income Taxes

State taxes often have a direct impact on your federal tax bill. People who itemize deductions on their federal tax returns can deduct the state and local personal income taxes and property taxes they pay in computing their federal taxable income. Sales and excise taxes, by contrast, are generally not deductible on federal tax forms, although federal legislation passed in 2004 allows a temporary, optional sales tax deduction for taxpayers who pay more sales tax than income tax (this mostly benefits those few itemizing taxpayers living in states that lack an income tax). This optional deduction has been temporarily extended on multiple occasions, most recently through the end of 2011. Thus, for every dollar in income or property taxes paid to a state or local government, taxpayers who itemize get a federal tax cut of as much as 35 cents (depending on what federal tax bracket they are in).

The chart on this page shows this effect graphically. Suppose an itemizing taxpayer in the 28 percent federal tax

How Increases in Federally Deductible Taxes Reduce Federal Taxes



bracket is subject to a \$1,000 state income tax hike. The value of her federal itemized deductions will increase by \$1,000. This means that \$1,000 less of this taxpayer's income will be subject to federal tax after the state tax increase. Since this last increment of income was originally taxed at 28 percent, this person's federal tax liability decreases by \$280 (28 percent of \$1,000). So the net tax hike for this taxpayer is actually \$720, not \$1,000. An analysis that looked only at the state impact of the proposal would show a tax hike of \$1,000, while an analysis that includes the offsetting federal change would show a tax hike of \$720.


This **"federal offset"** has clear implications for proposals to increase (or cut) state income and property taxes. When state income taxes go up, part of that tax hike will not come out of state residents' wallets at all, but instead will be paid by the federal government in the form of federal tax cuts for itemizers. Similarly, when state income taxes go down, federal income taxes paid by state residents will go up. And because the federal offset is most useful for wealthy taxpayers who are more likely to itemize and tend to pay at higher federal income tax rates, the best way to maximize the amount of a state income tax hike that will be offset by federal tax cuts is to target these tax hikes to the wealthiest state residents.

This benefit is not limited to income taxes paid by individuals. Corporations can export up to 35 percent of their state corporate income tax to the federal government. This means that when states enact corporate tax breaks for in-state businesses, up to 35 percent of these cuts may ultimately go not to the corporations for whom the tax breaks are intended, but to the federal government in the form of higher federal taxes.

The general inapplicability of the federal offset to sales and excise tax changes means that these regressive tax hikes are an especially bad deal for state residents, since virtually every dollar of a sales tax hike that is paid initially by state residents will ultimately come out of their pockets.

Conclusion

Now you've seen the basic conceptual building blocks of tax policy analysis. The next four chapters will take the concepts and terms you've learned here and apply them to each of the major types of taxes used by state and local governments.

We'll look at how each tax matches up against the principles of taxation described in this chapter, and at reforms that could help each tax remain a viable revenue source for the 21st century. We'll also look at some broader reforms that can help ensure accountability and fairness in all types of taxes. 

¹ Felix, R. Alison, "The Growth and Volatility of State Tax Revenue Sources in the Tenth District." Economic Review: Third Quarter, 2008. Federal Reserve Bank of Kansas City. <http://www.kc.frb.org/PUBLICAT/ECONREV/PDF/3q08Felix.pdf>

Felix surveys this literature and adds new findings showing that between 1965 and 2007, state income tax revenues had a long-term elasticity of 2.03, more than double the 0.97 elasticity of the sales tax.

CHAPTER THREE

SALES AND EXCISE TAXES

Sales and excise taxes, or consumption taxes, are an important revenue source, comprising close to half of all state tax revenues in 2010. But these taxes are inevitably regressive, falling far more heavily on low- and middle income taxpayers than on the wealthy. Consumption taxes also face structural problems that threaten their future viability. This chapter looks at how these taxes work, and outlines options for making consumption taxes somewhat less unfair and more sustainable.

How Sales Taxes Work

Sales taxes apply to items we purchase every day, including goods (such as furniture and automobiles) and services (such as car repairs and dry cleaning). To compute the sales tax on a taxable item, the cost of the item is multiplied by the tax rate. For example, in Michigan, where the sales tax rate is six percent, the sales tax on a \$10 book is sixty cents.¹ The cost of the book to the consumer, after tax, is \$10.60. The sales tax base is the total amount paid for all the goods and services subject to the tax. The sales tax is an example of an **ad valorem** tax—that is, a tax based on the price of the item sold.

In theory, the sales tax applies to all **retail transactions**—or sales to the final consumer—but most states tax only a fraction of household consumption. Some items that can be thought of as “essentials” are often exempted from the sales tax, including rent, medicine, utilities, and groceries. But not all sales tax exemptions apply to “essentials.” Politically powerful business groups often carve out exemptions for their products, and in many states, the tax base does not include personal services such as haircuts and car repairs. A large number of Internet transactions are also currently untaxed by the states.

States often have more than one sales tax rate. Some states apply lower tax rates to items such as groceries or utilities, as a means of providing low-income tax relief. Other states apply a higher tax rate to goods and services consumed primarily by tourists, such as hotels or rental cars,

with the goal of “exporting” part of the sales tax to residents of other states.

Many states also have **local sales taxes**. These usually (but not always) apply to the same items as the state sales tax. Thus, calculating the total state and local sales tax is generally simply a matter of adding the state rate to the local rate and multiplying it by the cost of taxable items.

Every state with a sales tax also has a **use tax**, which applies to items that are bought outside a state for use within a state. The use tax is designed to prevent state residents from avoiding the sales tax by purchasing goods in other states. Residents who purchase such goods are legally required to report and pay tax on those purchases, though that requirement is rarely enforced. Many states are now attempting to boost use tax compliance, both by passing so-called “Amazon laws” (discussed on page 19) and by allowing residents to pay the tax through their regular income tax forms—but enforcement remains a serious problem.

Most states have more than one type of sales tax. They have a **general sales tax** (which is what most people mean when they talk about their state’s “sales tax”), and **selective sales taxes** on particular goods or services. A typical selective sales tax—which may have a different rate than the general sales tax—is a tax on the purchase of alcohol, tobacco or gasoline, or a tax on utilities, such as electricity and telephone service. Selective sales taxes, also known as **excise taxes**, are discussed later in this chapter.

Sales Taxes and Fairness

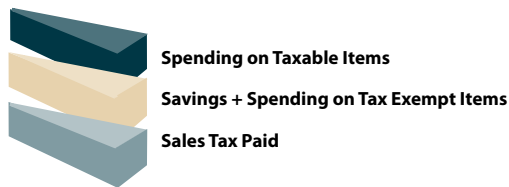
Sales taxes are inherently regressive because the lower a family's income, the more of its income the family must spend on things subject to the tax. According to estimates produced by ITEP based on Consumer Expenditure Survey data, low-income families typically spend three-quarters of their income on things subject to sales tax, middle-income families spend about half of their income on items subject to sales tax, and the richest families spend only about a sixth of their income on sales-taxable items. Put another way, a 6 percent sales tax is the equivalent of an income tax with a 4.5 percent rate for the poor (that's three-quarters of the 6 percent sales tax rate), a 3

percent rate on the middle-class (half of 6 percent) and a one-percent income tax rate for the rich (one-sixth of 6 percent). Obviously, no one could get away with proposing an income tax that looked like that. The only reason this pattern is tolerated in consumption taxes is that their regressive nature is hidden in a harmless looking single rate, and the amount families pay is hidden in many small purchases throughout the year.

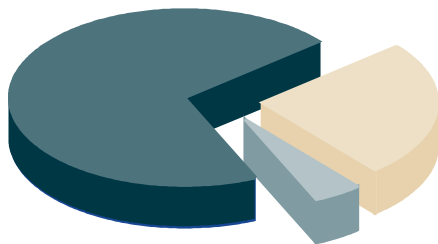
The sales tax violates the basic tax fairness principle of taxing according to one's ability to pay: low-income families are actually made to pay a larger share of their incomes in tax than their wealthier neighbors. Sales taxes also violate this principle in their insensitivity to fluctuations in taxpayer income: families will always need to spend money on sales taxable basic necessities, no matter how little they earn in a given year. A middle-income taxpayer who loses his job will still have to spend much of his income just to get by—and will still pay a substantial amount of sales tax even though his ability to pay these taxes has fallen dramatically.

The Impact of Sales Taxes at Different Income Levels

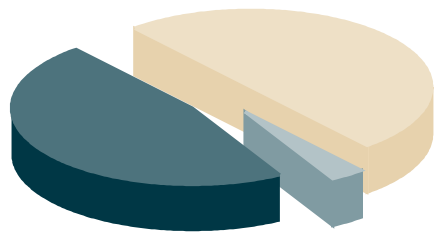
(shown as a share of income)



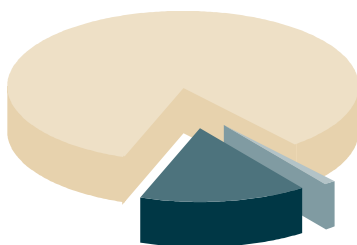
Low-Income Families



Middle-Income Families



Wealthiest Families



Source: Estimates by ITEP based on Consumer Expenditure Survey Data

The “Equal Tax on Equal Purchases” Fallacy

Despite the regressivity of the sales tax, some people claim that sales taxes are fair. After all, it is said, no one can completely avoid paying sales taxes since they apply to things that everyone—rich and poor alike—needs to buy. Supporters of this position argue that the sales tax affects everyone “equally,” since the tax on a tube of toothpaste, for example, is the same no matter who buys it.

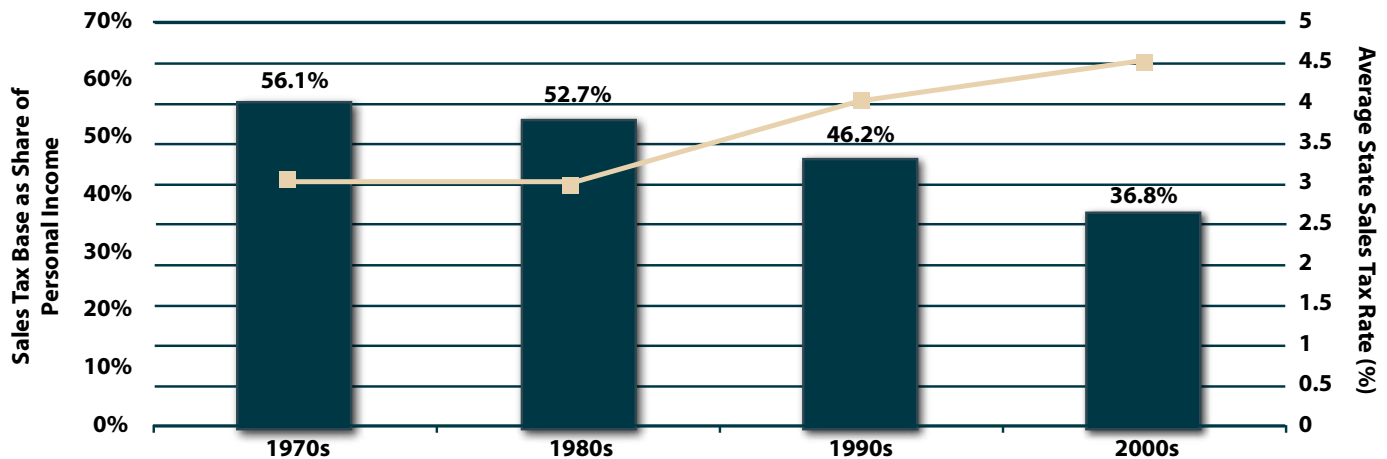
Is the Sales Tax “Voluntary”?

Occasionally, the argument is made that sales taxes possess a fairness advantage over other forms of taxation because they are “voluntary”—that is, they are only paid by people who choose to spend, rather than save their income.

In reality, however, many kinds of spending are far from voluntary. Clothing, toiletries, school supplies, and furniture are just a few examples of important everyday items usually subject to the sales tax. Individuals who purchase these items are rarely making a truly voluntary “choice” between saving and consuming their income.

The purpose of branding the sales tax as “voluntary” is to portray it as having some relationship to the taxpayer’s ability to pay the tax. But in fact, income taxes do a much better job of targeting tax liabilities in proportion to what individual taxpayers can afford to pay. Chapter Five examines the workings of state income taxes in detail.

The North Carolina Sales Tax: Shrinking Base, Rising Rate



Source: North Carolina General Assembly Fiscal Research Division

But this so-called “equality” is precisely why sales taxes *fail* the test of fairness. The cost of toothpaste, and therefore the sales tax on it, is the same for a rich person as for a poor person. But since the rich person has many times more income, the amount that he or she pays in tax on that tube of toothpaste is a much less significant expense—that is, a much smaller share of his or her income—than the same tax on a middle- or low-income family.

Of course, a rich family does consume more and thus pays more sales tax in dollars than does a less well-off family. But in terms of what those dollars mean to rich families—as a portion of their income and how it affects their standard of living—the sales tax has a much less significant effect on the rich than it does on middle- and low-income families.

Sales Taxes on Business—Who Pays?

Most state sales taxes are designed to exempt purchases made by businesses, on the theory that the sales tax is supposed to be a tax on final personal consumption. But the distinction between business and individual purchases is often difficult to make, and as a result every state applies its sales tax to some business purchases. These **business-input** sales taxes add to the cost of producing goods and services, and therefore mostly passed forward to consumers in the form of higher retail prices. In other words, taxing business inputs through the sales tax is generally akin to taxing the consumer more than once on the same retail sale. As a result, expanding the sales tax base to include business inputs will usually hurt low-income taxpayers.

Because some of the sales tax paid by businesses is **exported** to out-of-state consumers, lawmakers may find it politically appealing to apply the sales tax to business purchases. A manufacturer will likely be able to pass through most of the

sales tax it pays on its inputs to consumers in other states, which means only a little of the tax will hit state residents.

For more on the issues associated with sales taxes on businesses, see page 20.

Revenue and Stability

Sales taxes are a mainstay of state budgets nationwide. But during times of economic uncertainty, sales tax collections can be volatile. When the most recent economic recession began in 2008, for example, state sales tax collections were the first major revenue source to suffer. Sales tax revenues can also decline when people are simply afraid a downturn *may* be coming. If a family thinks it may face hard times soon, it may delay some spending in anticipation of the worst. Purchases of big-ticket

The “Fair Tax”: Anything But Fair

Some national and state-level policymakers have unfortunately become enamored with the idea of replacing existing sales, income and corporate taxes with a single high-rate sales tax on virtually everything we consume. This approach is referred to as the “Fair Tax” by its supporters. But its name is only one of the misleading features of this regressive plan.

For example, “fair tax” advocates generally give absurdly low estimates of the sales tax rate that would be necessary to replace existing state taxes. A plan considered in Missouri in 2009 would have created a “fair tax” at a 5.11 percent rate—but an ITEP analysis found that the rate would actually need to be more than twice as high to raise the advertised amount of revenue.

items like new cars are particularly likely to be postponed. As a result, sales tax revenues can fall during periods of economic uncertainty—even before a recession has set in.

Even in good economic times, the sales tax usually is not a fast-growing tax. In large part, this is due to the antiquated sales tax base used in most states. In 2007, services represented about 65 percent of individual spending nationally, and are currently the fastest-growing area of consumption.² But services remain largely untaxed by the vast majority of states, and sales tax collections have noticeably suffered as a result. Furthermore, failing to tax services also has the potential to increase the volatility of the sales tax, as the consumption of services is generally a more stable tax base than sales of big-ticket items, which make up a significant share of total sales taxes on goods.

The slow growth nature of sales tax revenues frequently forces lawmakers to increase the sales tax rate just to keep tax revenues growing with inflation over the long-term. The chart on the preceding page shows how North Carolina's declining sales tax base (fueled both by the increasing prominence of services and the addition of new exemptions for items like groceries) has resulted in a higher sales tax rate over time.

Federal Deductibility

Heavy reliance on sales taxes brings with it a big disadvantage for states: the uncertain future of the federal itemized deduction for sales taxes. Ever since the enactment of the Tax Reform Act of 1986, sales taxes, unlike income and property taxes, have not been available as an itemized deduction on federal tax forms. Federal legislation enacted in 2004 temporarily changed this fact for tax years 2004 and 2005, and since then the deduction has been repeatedly extended on a temporary basis. Because the structure of the deduction forces one to choose between deducting sales taxes and deducting income taxes, this break generally only benefits itemizers living in states that lack an income tax.

Unfortunately for states lacking an income tax, the sales tax deduction is not nearly as useful as the income tax deduction. As ITEP recently found in a report titled *Leaving Money on the Table*, the handful of states without an income tax could reduce their residents' federal tax bills by billions of dollars in the aggregate by shifting away from sales taxes and toward income taxes.³ This is because such a shift would raise taxes mostly on the high-income earners best able to take advantage of the federal deduction for state tax payments.

But as bad a deal as the sales tax deduction is today, states lacking an income tax could find themselves in an even worse

situation if the deduction is allowed to lapse entirely. As of this writing, the deduction has been temporarily extended through the end of 2011, though the bleakness of the federal budgetary outlook increases the possibility that the deduction may disappear at some point in the not-so-distant future. For more detail on the "federal offset" effect, see page 9.

Gross Receipts Taxes: Sales Taxes by Another Name

Before moving on to discuss the major issues confronting sales taxes, it is worth noting that some states levy a variation of the sales tax, known as a **gross receipts tax** (GRT). The main difference is that sales taxes apply (in theory, anyway) only to retail sales, while a GRT applies to the sales made by companies at every stage of the production process, including manufacturing companies, wholesalers, and retailers. In other words, a GRT is a sales tax that applies to more types of transactions. From the consumer's perspective, the major distinction between gross receipts taxes and retail sales taxes is that gross receipts taxes are not necessarily itemized on customers' bills—though they are nonetheless paid by customers in the form of higher prices.

The gross receipts taxes currently used by states typically only apply to the sales receipts from certain types of products, with utilities and insurance being the most common targets. In fiscal year 2008, state and local governments raised more than \$40 billion in gross receipts taxes on utilities and insurance—about twice as much as what the states raised from excise taxes on alcohol and tobacco.

When state policymakers propose a gross receipts tax as a proposal for comprehensive tax reform, what they usually have in mind is something very different from the single-item gross receipts taxes that most states currently use. These proposals typically would impose a very low tax rate on a very broad base of economic activity. For example, in 2005 Ohio enacted a "tax swap" that, among other things, replaced its corporate income tax with a gross receipts tax of 0.26 percent on all business revenues over \$150,000 a year.

This sort of gross receipts tax is quite rare on the state level. The most comprehensive current GRT is the Washington State Business and Occupation Tax, which taxes the gross receipts of most companies doing business in Washington at rates ranging from 0.47 percent to 1.8 percent.

There are three main problems with GRTs. First, like any sales tax, a GRT hits low-income taxpayers the hardest. Second, because GRTs are based on the amount that a business sells

rather than on its profit, a GRT is not sensitive to a business' ability to pay. In fact, some of the strongest opposition to Washington's GRT comes from businesses that engage in high-volume, low-profit-margin activities—and those that frequently don't turn a profit at all. And third, GRTs lead to severe pyramiding problems, because the tax applies not just to retail sales but to all stages of the production process. As a result of this last problem, it doesn't make much sense to compare the tax rate of a broad-based GRT to the tax rate of a general sales tax: a GRT is a multi-stage tax, whereas the sales tax is a single-stage tax. So, for example, if a GRT of 0.25 percent applies to four stages in the production of a product, that's roughly equivalent to a retail sales tax of one percent.

Perhaps worst of all, many lawmakers erroneously view GRTs as replacements for state corporate income taxes, simply because businesses are responsible for remitting these taxes to the state. But since GRTs are levied on sales, rather than profits, they are ultimately passed through to consumers like a sales tax, with all the same regressive effects.

Sales Tax Reform: Issues and Options

As lawmakers struggle to modernize the sales tax, they face two general problems: how to define the tax base, and how to make the sales tax less unfair. This section surveys a variety of specific issues falling under these two headings, with special emphasis on the solutions those issues demand.

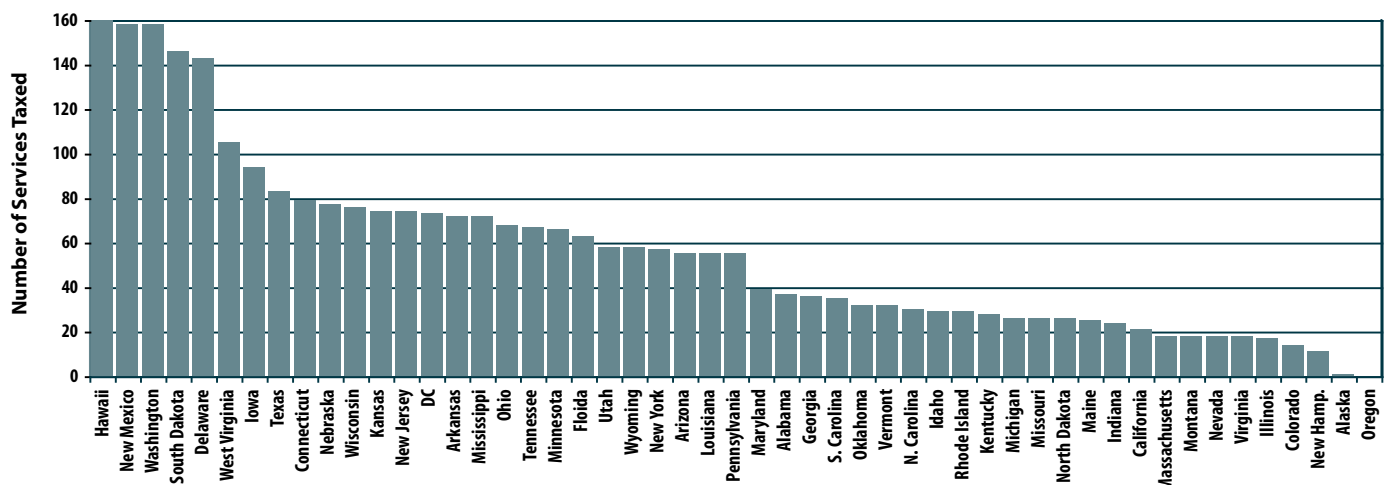
Applying the Sales Tax to Services

Most state sales taxes were enacted early in the twentieth century, at a time when most of the things people purchased were tangible goods like cars, furniture and books. But in the

past fifty years, American consumer purchases have changed dramatically, shifting toward consumption of services like gym memberships and cable television subscriptions. Few states have extended their sales tax to include services in their tax base. Only Hawaii, South Dakota, and New Mexico have a comprehensive service tax, and, according to a recent survey done by the Federation of Tax Administrators (FTA), a large majority of states still apply their sales tax to less than half of 168 potentially taxable services identified by the survey that are taxed in at least one state—such as rental services, repairs, installations, cleaning services, and a wide variety of entertainment options. Though it can be politically difficult to accomplish, there are sound tax policy reasons for seeking to modernize the sales tax base by expanding it to include some—but not all—services.

The basic rule of thumb for which services should be taxed is very similar to the way states seek to tax goods: services consumed by individuals should be taxed, while services consumed by businesses in the process of producing goods and services of their own should be exempt. Taxing business services may seem tempting to lawmakers because of the potentially high revenue yield—but doing so will actually make sales taxes more unfair in the long run, since business sales taxes are mostly passed through to consumers in the form of higher prices. Because these passed-through taxes are built into the prices of the goods we buy every day, the consumer doesn't see these hidden taxes, and the amount of this hidden tax that is included in any particular retail purchase will vary depending on the number of taxed stages in the production process for a given retail item. But consumers will, in general, be the ones most affected by efforts to impose sales taxes on business services.

Sales Taxation of Services, 2007



Source: Federation of Tax Administrators

Taxing personal services, in contrast, can make the sales tax more fair in two ways. First, taxing services helps ensure that the amount of sales tax anyone owes will depend primarily on how much they spend—not what they spend it on. There is nothing inherently better (or worse) for society in spending money on services as opposed to goods. Taxing goods but not services discriminates in favor of consumers who prefer services, and discriminates against those who prefer goods.

Second, if done carefully, expanding the tax base to include more services typically thought of as “luxuries” has the potential to make the sales tax less regressive. This is because these services tend to be purchased more frequently by higher-income households. Of course, the sales tax will still be regressive overall no matter how broad the tax base is made. But taxing services, in combination with the types of income tax credits discussed on page 39, could represent an important step towards tax fairness.

More fundamentally for state lawmakers facing long-term fiscal crises, taxing services will also increase the amount of sales tax revenue collected at any given tax rate—which makes it less likely that lawmakers will be forced to raise the sales tax rate to balance budgets. And broadening the tax base makes sales tax revenues more stable in the long run, because declines in one area of taxable consumption will be offset by gains in another.

Addressing Sales Tax Exemptions

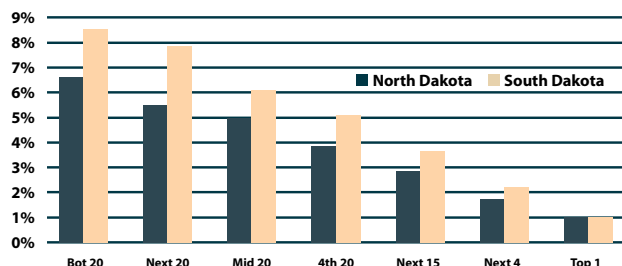
Every state’s sales tax allows targeted exemptions. These exemptions are usually intended to make the sales tax less unfair. Sales taxes can be made less regressive by taxing more of the things the wealthy consume the most and fewer of the things on which middle- and low-income families spend their money (e.g. taxing restaurant meals, but not groceries). Of course, every state and local general sales tax is regressive. But the degree of unfairness ranges substantially—from moderately regressive in states like Vermont to extremely regressive in states like Tennessee.

The most important factor affecting regressivity is whether groceries are taxed. Taxing food is extremely regressive because such a high portion of the income of poorer families goes to mere sustenance.

But there are reasons to be concerned about the long-term impact of sales tax exemptions. Economists generally argue that the sales tax base should be as broad as possible, for several reasons:

- Exemptions are **poorly targeted**. The poorest 40 percent of taxpayers typically receive about 25 percent of the benefit from exempting food. The rest goes to wealthier taxpayers.
- While exemptions can make the sales tax less regressive, they also create a new source of unfairness: **different treatment of taxpayers who earn similar amounts of income**. By exempting food while taxing other retail sales, lawmakers are discriminating against taxpayers who spend more of their money on things other than food.
- Exemptions **tend to make sales tax collections fluctuate more**, because changes in particular economic sectors can have a larger effect on tax collections. A broader tax base will allow tax revenues to be less sensitive to sudden swings in retail purchases of particular items since those swings will generally be offset by changes in purchases of other items.

Sales Taxes as a Share of Income in North Dakota and South Dakota



Source: ITEP Microsimulation Model

- Because they offer tax relief to everyone regardless of their individual need, exemptions are very **costly**. Exempting groceries, for example, has the potential to reduce the revenue yield of each penny of sales tax by nearly twenty percent. This requires that lawmakers increase tax rates in order to offset the reduction in the tax base.
- Exemptions are an **administrative challenge** to policymakers, tax administrators, and retailers because any exemption requires a way of distinguishing between taxable and exempt products. For example, in some states, a particular food item may be taxed based only on whether or not the seller provides eating utensils with the item. Exemptions require policymakers and tax administrators to make countless decisions of this sort, and retailers must be familiar with all of these rules.
- In states that allow local sales taxes, lawmakers **must decide whether exemptions should apply to**

local taxes as well. Doing so can be costly to local governments, but not doing so creates more complication for retailers and tax administrators.

In addition to each of these problems, many states offer a variety of poorly-conceived sales tax exemptions with no purpose other than to assist favored special interests. While the sales tax is well enough understood that special interest loopholes in the tax law tend to get noticed (especially compared to some of the more complex tax breaks that are sometimes hidden in the income tax), that doesn't mean that special interests don't work hard to win preferential sales tax treatment. In some cases, these exemptions cross into the absurd, such as the exemption for products made from trees infested by pine beetles in Colorado, or the Arkansas exemption for vehicles purchased by blind veterans.

With few exceptions, exemptions of personal consumption items from the sales tax are not necessary. At best, exemptions for necessities can be described as a second-best option to income tax credits for reducing regressivity. At worst, unwarranted exemptions can be described as expensive, wasteful, inefficient, unfair, and overly complex.

Sales Tax Holidays—Boon or Boondoggle?

In recent years, lawmakers in over a dozen states have sought to lessen the regressive impact of sales taxes by enacting “sales tax holidays.” These are temporary sales tax exemptions for clothing, computers, school supplies, and other “back to school” expenses. Most sales tax holidays last only a few days.

Virtually any sales tax cut will provide larger benefits, as a share of income, to low-income taxpayers than to the wealthy. But sales tax holidays are a problematic way of achieving low-income tax relief, for several reasons:

- A three day sales tax holiday for selected items still forces taxpayers to pay sales tax on these items during the other 362 days of the year, leaving a regressive tax system basically unchanged.
- Sales tax holidays are poorly targeted, providing tax breaks to both wealthy taxpayers and nonresidents.
- Sales tax holidays do not stimulate the economy. The increased consumption observed during such holidays has been shown to be primarily the result of consumers shifting the timing of their purchases.
- Many low-income taxpayers don't have the luxury of timing their purchases to coincide with brief sales tax holidays. By

contrast, wealthier taxpayers are likely to be able to time their purchases appropriately.

- Retailers know that consumers will shift their spending toward sales tax holidays to take advantage of the temporary tax exemption. Savvy retailers can take advantage of this shift by hiking prices during the holiday.
- Any sales tax exemption creates administrative difficulties for state governments, and for the retailers who must collect the tax. But a temporary exemption requires retailers and tax administrators to wade through a sheaf of red tape for an exemption that lasts only a few days.
- Perhaps most important for cash-strapped lawmakers, sales tax holidays are costly. Revenue lost through sales tax holidays will ultimately have to be made up somewhere else.

Sales tax holidays do have advantages, of course. The biggest beneficiaries from a sales tax cut are the low- and middle-income families affected most by sales taxes. And the heavily-publicized manner in which sales tax holidays are typically administered means that taxpayers will be very aware of the tax cut they receive—and will know that state lawmakers are responsible for it.

But in the long run, sales tax holidays are simply too insignificant to change the regressive nature of a state's tax system—and may lull lawmakers into believing that they have resolved the unfairness of sales taxes. Ultimately, sales tax holidays are much more political gimmick than reasoned tax policy.

Sales Tax Credits

Lawmakers seeking to make the sales tax less unfair without breaking the bank do have an increasingly popular alternative to broad-based exemptions of the “essentials”: targeted sales tax credits. Usually administered through the income tax, these credits generally provide a flat dollar amount for each member of a family, and are available only to taxpayers with income below a certain threshold. These credits are also usually refundable, meaning that the value of the credit does not depend on the amount of taxes a claimant pays (for more on refundability, see page 40). This approach offers several advantages over sales tax exemptions, among them: credits can be targeted to state residents only, and they can be designed to apply to whichever income groups are deemed to be in need of tax relief. The chart on the next page shows the details of one such program, the Kansas food sales tax refund. Low-income Kansas taxpayers over 55 years old, and non-elderly Kansans with children, can claim up to \$90 for each

family member. In 2010, Kansans with incomes up to \$31,900 were eligible for the credit.

The precise targeting of credits means that they are much less expensive than exemptions. Credits do not affect the sales tax base, so the long-term growth of sales tax revenues is more stable (credits do, however, reduce the yield of the income tax). And credits are easier for tax administrators to manage. Because of these advantages, state lawmakers have shown an increasing willingness to pair sales tax (and excise tax) increases with the creation or expansion of low-income credits.

However, sales tax credits have one important disadvantage: they must be applied for. All of the states that allow sales tax credits require taxpayers to fill out a form every year. Taxpayers who do not know about the credit—or who do not have to file income tax forms—may not claim the credit even if they are eligible. This means that an effective outreach program must be a central part of any effort to provide sales tax credits. By contrast, exemptions are given automatically at the cash register—so consumers don't need to apply or even to know about them.

Many states interested in mitigating the regressive effects of the sales tax have decided to rely on a state Earned Income Tax Credit (EITC) in lieu of a formal sales tax credit. While this approach offers state lawmakers less flexibility in deciding on the credit's eligibility criteria and amount, it is preferable from a tax simplicity perspective and can potentially enhance the ease with which taxpayers can claim the credit. For more on state EITCs, see page 40.

It is also important to recognize that sales tax credits (or state EITCs) will never be able to eliminate the regressivity of sales taxes. As the chart on this page shows, the Kansas sales tax remains quite regressive, even after the food sales tax refund is taken into account. It would take a very large tax credit to eliminate the disproportionate effect that the sales tax has on low-income taxpayers. And while a state may technically be able to relieve the sales tax load on low-income families through a credit, there is no practical way to make sales taxes on middle-income families equal to the light sales taxes borne by the wealthy. Since a substantial share of sales tax revenue currently comes from low- and middle-income families, a sales tax and rebate system that ended up

The Kansas Food Sales Tax Refund (2010)

Only taxpayers over 55, taxpayers with children under 18, and disabled taxpayers are eligible.

INCOME LEVEL	REFUND
\$0 to \$15,950	\$90 per person
\$15,951 to \$31,900	\$45 per person
\$31,901 or more	no refund

taxing the middle class at the same low rate as the rich wouldn't be worth the trouble of collecting (and rebating).

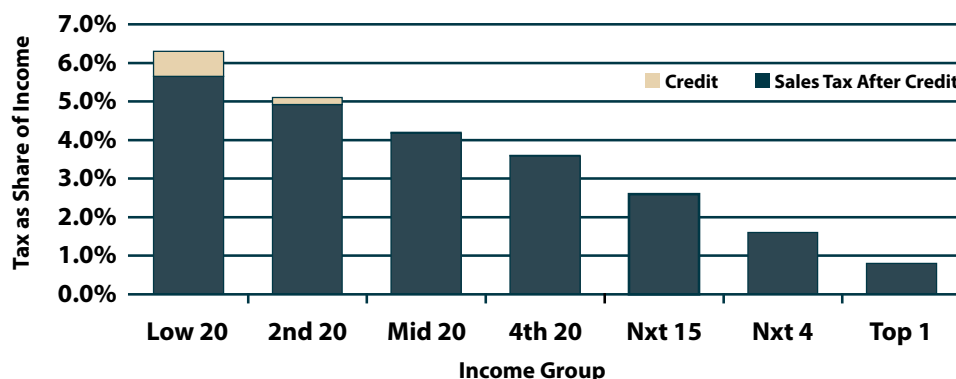
To be sure, rebates or credits can be valuable to poor families. But no one should think that they can solve the problem of sales tax regressivity entirely.

Applying the Sales Tax to Internet Transactions

A large and growing share of retail purchases are now being made on the Internet—and a substantial portion of these are not being taxed by states.⁴ This is not a totally unfamiliar problem, as states have long struggled with how to tax “remote sales” (e.g. catalog, telephone, and internet sales). With the growth of the Internet, however, this once marginal issue has evolved into a serious problem. The most commonly cited estimate of the revenue loss associated with Internet transactions, by researchers at the University of Tennessee, is that state and local governments lost \$8.6 billion in sales tax revenue in 2010, and will lose as much as \$11.4 billion in 2012.⁵ If expanded to include mail and telephone orders, these figures would be significantly larger. Left unchecked, this revenue loss will sap the vitality of state sales taxes.

From a tax fairness perspective, Internet-based transactions should be treated in the same manner as other retail

Still Regressive: How the Kansas Food Tax Credit Affects the Overall Sales Tax Distribution



transactions. That is, retail transactions that are taxable when sold by conventional “bricks and mortar” retailers should also be taxable when sold over the Internet, for several reasons:

- Exempting e-commerce transactions is unfair to “bricks and mortar” retailers. Retailers who choose to sell their wares primarily in a “brick and mortar” setting rather than making sales over the Internet are unfairly disadvantaged by a policy that exempts e-commerce.
- Exempting e-commerce transactions is also unfair to consumers. Consumers who are unable to access the Internet are unfairly disadvantaged by having to pay sales taxes on their purchases. Exempting Internet retail sales has the potential to increase the regressivity of sales taxes as better-off taxpayers are able to avoid these taxes through Internet purchases.
- In addition to being unfair, allowing internet transactions to go on tax-free also violates the principle of ‘neutrality’, discussed in Chapter Two. A sales tax that treats Internet sales differently from “bricks and mortar” sales creates an inefficient economic incentive for consumers to shop online, and for retailers to accommodate that demand with an increased online presence. This results in an overabundance of online transactions, relative to what the market would normally allow.
- Exempting e-commerce transactions will become increasingly costly in terms of lost state and local revenues as the importance of the Internet continues to grow.

Unfortunately, a series of U.S. Supreme Court decisions, most recently *Quill Corp. v. North Dakota*,⁶ have found that states cannot require retailers to collect sales taxes on items purchased from remote sellers (that is, sellers based in other states). As a rationale for this decision, the Court cited the complexity of state and local sales tax systems. The Court argued that with so many states, counties, and municipalities levying different taxes at different rates with different tax bases, forcing retailers to figure out the appropriate tax to collect on sales to each jurisdiction would impose an unacceptable administrative burden on these sellers.

However, the Court also indicated that this problem could be solved, noting that there are good reasons to try to collect taxes on remote sales: even businesses that engage only in mail-order or Internet sales in a state still benefit from the public services that make these transactions possible—and should help to pay the cost of providing these services. The Court also

noted that Congress could pass legislation allowing states to require sales tax collection on remote sales, and hinted that Congress would be more likely to pass such legislation if state lawmakers took immediate steps to simplify the current maze of tax bases and tax rates.

States have responded to the Supreme Court’s suggestion by cooperating to simplify their sales tax rules. The Streamlined Sales Tax Project (SSTP) was formed in April of 2000 by representatives of most states to develop a plan to simplify sales tax structures. In 2002, these representatives agreed on model legislation, called the Streamlined Sales and Use Tax Agreement (SSUTA), designed to be enacted by each state legislature. The agreement became legally binding (in states enacting it) in 2005. As of 2010, twenty states are full members of the agreement, and three states have associate member status. However, the states remain largely powerless to require the collection of sales taxes on remote sales until Congress acts to enable them. Bills have recently been introduced in Congress that would

A New Method for Taxing Internet Sales?

A number of states, led by New York, are refusing to wait for permission from Congress to tax internet sales, and have taken some controversial steps to expand the number of internet retailers subject to its sales tax.

Under legislation enacted in New York in early 2008, internet retailers based in other states are required to collect sales tax on purchases made by New Yorkers if those internet retailers use the services of advertisers located in New York. This is an important change to existing law, and has the potential to increase the state’s sales tax revenue significantly, especially in the long-term.

Major internet retailers such as Amazon and Overstock have filed lawsuits challenging the law, claiming that the companies New York is attempting to tax are in fact untaxable “remote sellers”, despite any agreements made with New York advertisers.

Arkansas, Connecticut, Illinois, North Carolina and Rhode Island have followed New York’s lead in expanding their authority to tax internet sales in this manner, and legislation containing similar provisions has been introduced in over a dozen other states. If New York’s law is upheld in court, more states can be expected to follow suit.⁷

allow states to collect sales tax on remote sales, but these bills have failed to advance due to the anti-tax attitudes of many in Congress, as well as a more general apathy toward this uniquely state-level problem.

Tax Treatment of Sales Made to Businesses

Unlike the special exemptions enjoyed on sales made by internet retailers, the service sector, and various other favored businesses, the exemption from the sales tax of most purchases made by businesses is actually good policy. For example, nobody thinks that retailers should pay sales tax when they buy goods at wholesale. If they did, the goods would be taxed twice—once at the wholesale transaction and once at the retail sale—with the ultimate consumer bearing much of the burden of this double-taxation.

But the same principle applies when, for example, furniture-

making companies buy wood to make into tables and chairs. If they must pay sales tax on the wood, then the wood will, in effect, be taxed twice—once when it is bought by the manufacturer, and again when it is bought by the consumer as part of the furniture. When sales taxes from earlier stages of the production process pile up on the final consumer, economists call it “**pyramiding**” or “**cascading**”.

Cascading sales taxes can create serious economic problems. For example, suppose one furniture manufacturer chops down trees, does all the wood machining, shaping and assembly itself, and runs its own retail stores. In contrast, a second furniture manufacturer buys semi-finished wood from a lumber company, which in turn bought it from a timber company. And suppose that the second manufacturer sells its furniture at wholesale to unrelated retail stores. Only the final retail furniture sales of the first, integrated manufacturer will be taxed, since until then, the furniture and its components never change ownership. But under a “cascading” sales tax system, the products of the second manufacturer would be taxed four times: first when the wood is purchased by the lumber company, second when purchased by the furniture manufacturer, third when bought by retailers, and finally when sold to consumers at retail. Such a strange tax system would give the products of the integrated company a huge competitive advantage over those of the second manufacturer—even though the multi-company approach to furniture making and sale might be just as economically efficient. As with many of the sales tax issues discussed in this section, this is a clear violation of the “neutrality” principle, discussed in Chapter Two.

Taxing business inputs can also undermine the methods used to make the sales tax less unfair. For example, if grocery stores pay sales tax on the smocks they buy for their clerks or the fees they pay their lawyers, and these taxes are passed on to their customers in the form of higher retail food prices, the benefit of exempting food from the sales tax is partially undermined.

One often overlooked result of taxing business inputs is that the effective sales tax rate on income (that is, sales taxes as a percentage of income) may actually end up higher than the nominal sales tax rate. In other words, a state can have a 5 percent sales tax rate but there may be families that have 6 percent of their income going to sales taxes. This is caused by two related phenomena. First, families pay a higher price for a product because the tax on the purchases by businesses increases the cost of making, wholesaling and retailing the product. Second, the retail sales tax applies to this added increment in the price, compounding the problem.

What is the Role For The “Benefits Principle”?

In general, the appropriate measure for evaluating the fairness of any tax policy is its adherence to the “ability-to-pay” principle, described on page 1. In some limited instances, however, it may make sense to also consider the “benefits principle” in evaluating tax fairness. Under the benefits principle, the tax one pays should be linked to the benefit one receives from relevant government services. This principle is most commonly applied to user fees, discussed on page 3, but can also be expanded to include the gasoline tax.

Unlike a public education system, which produces enormous “spillover” benefits and should therefore be funded by society as a whole, the benefits gained from an efficient transportation system are often more localized. For this reason, relying on gasoline taxes to fund transportation can actually improve tax fairness by ensuring that those individuals who do not own cars, or who only drive very short distances, do not have to subsidize the behavior of long-distance commuters and other road-trippers. Of course, since gasoline taxes are still regressive, additional progressivity should be built into the tax system in other ways—such as through the use of low-income credits—in order to avoid disproportionately affecting low-income families.

With only a few minor exceptions, a sales tax on business inputs is no more fair than any other kind of regressive sales tax, with the added drawback that it distorts the economy.

How Excise Taxes Work

Excise taxes are sales taxes that apply to particular products. Compared to income, property, and general sales taxes, excise taxes constitute a fairly small portion of state revenues. This is because excise taxes lack a broad base, and are instead levied on only a few specific products—typically tobacco, fuel, and alcohol. In part because of its narrow base, the tobacco tax in particular has become a popular source of revenue even among politicians that are generally opposed to raising taxes—though health concerns have also contributed to this popularity.

Unlike general sales taxes, excise taxes are usually applied on a per-unit basis instead of as a percentage of the purchase price. For instance, cigarette excise taxes are calculated in cents per pack. And most gasoline excise taxes are imposed in cents per gallon. As is explained in the next section, this structure contributes to the extreme regressivity of excise taxes.

Because excise taxes are generally not itemized on consumer receipts, they tend to be invisible to the taxpayer. Nonetheless, while most states levy general sales taxes, *every* state levies excise taxes on tobacco, alcohol, and gasoline.

Excise Taxes and Fairness

Like sales taxes, excise taxes as a share of personal income fall more heavily on middle- and low-income families than on the rich, and thus violate the principle of “vertical equity,” explained on page 5. In fact, excise taxes tend to be even more regressive than general sales taxes. This is because excise taxes are unrelated to the price of the item purchased. Under a typical sales tax, a wealthy person purchasing an expensive Mercedes would pay more—in dollars—than a middle-income family purchasing a less expensive Chevrolet. But excise taxes do not work this way because of their per-unit basis. The excise tax paid on premium wine, beer, and cigarettes is the same as that paid on less expensive brands.

The regressivity of cigarette excise taxes is especially pronounced due to an additional factor: lower-income individuals are far more likely to smoke than are wealthy individuals. Unlike most categories of products and services—where wealthier individuals tend to spend more than lower- and middle-income families—cigarette consumption is actually concentrated among the less wealthy members of society. Taxes on cigarettes, therefore, are particularly regressive.

Why Levy Excise Taxes?

In addition to violating the principle of “vertical equity,” excise taxes on their face also appear to violate the principle of “horizontal equity” (explained on page 5) by singling out those taxpayers who chose to spend a portion of their income on items subject to excise taxes. In reality, however, the rationale for levying most excise taxes is that consumers of these products are in some way *not* similar to other consumers, and are thus deserving of differential treatment under the tax law. The following three reasons for levying excise taxes are each based on this assumption.

Levying “Sin Taxes” to Discourage Consumption

Excise taxes are commonly referred to as “sin taxes” because they are applied to items whose consumption is deemed to be detrimental to society (e.g. alcohol, tobacco, and gasoline). By singling out these products for excise taxation, their price can be increased in order to discourage both their consumption and the societal ills associated with such consumption—including drunk-driving, second-hand smoke, vehicle emission pollution, etc. Extending this idea further, proposals to impose excise taxes on soda in order to reduce obesity, and its associated strain on the nation’s health care system, have recently received attention at both the state and federal levels.

While pursuing social policy goals such as these through the tax code can be controversial, this strategy has proven effective in some circumstances. Cigarette taxes, for example, have been shown to have a meaningful impact on reducing smoking, especially among younger people.⁸ But even under a cigarette tax levied at a high rate, the vast majority of smokers will simply pay the higher tax and continue in their habit. This is even more true of gasoline taxes, which at current levels have been shown to be relatively ineffective at reducing consumption.⁹

Levying “Sin Taxes” to Pay for Societal Costs

Because some individuals will always continue to consume certain products despite the presence of “sin taxes,” such taxes can also provide revenues with which to compensate society for the burdens imposed by these goods. A smoker whose second-hand smoke affects the health of current or future Medicare recipients, for example, is necessitating higher spending on the part of government due to her decision to smoke.¹⁰ A similar argument can be made regarding the plethora of environmental costs associated with gasoline consumption—and in fact, a

number of states dedicate a portion of their gasoline tax revenue to funding environmental cleanups of gasoline spills and leaks. Excise taxes can ensure that consumers of these products help pay for the full range of costs associated with their use.

Levying Gas Taxes as a User Fee Proxy

The most important rationale for levying a gasoline excise tax differs from the two reasons discussed above. Gasoline taxes are usually dedicated to funding the maintenance and expansion of a state's transportation infrastructure, and are therefore widely understood as an approximation of a "user fee" on drivers for their enjoyment of the nation's roadways. Those who drive the furthest distances (or the heaviest vehicles) produce more wear-and-tear on the roads, and therefore generally pay more in gasoline taxes.

As the discussion of user fees on page 53 makes clear, however, gasoline taxes are not quite a true user fee. Moreover, with new fuel-efficient technologies allowing some drivers to purchase significantly less gasoline while deriving the same benefit from the nation's roads (and producing the same wear-and-tear on those roads), the usefulness of this tax as an even-handed user charge has been diminished. Until other methods, such as tolls or "vehicle miles traveled taxes" become more widespread, however, the gas tax remains the most realistic method for charging users in rough proportion to the benefit they receive from the nation's transportation infrastructure.

Revenue and Stability

Excise tax revenues tend to grow very slowly, which makes them an inadequate source of revenue over the long run. Nonetheless, states have increasingly turned to excise taxes—particularly the cigarette tax—in recent years as a more politically expedient alternative than broad-based tax increases for shoring up their budgets. As a result, the slow-growth, unsustainable nature of these taxes is likely to be an issue of importance for years to come.

Unprepared for Inflation's Inevitable Effect

The unsustainable nature of excise taxes results primarily from their per-unit rate. Because of their per-unit structure, excise tax revenue grows only when the volume of sales subject to the tax grows. General sales tax revenue, by contrast, also grows when the price of the products subject to tax rises as a result of inflation.

Under a general sales tax, for example, if the price of a product increases by 3 percent as a result of inflation, tax

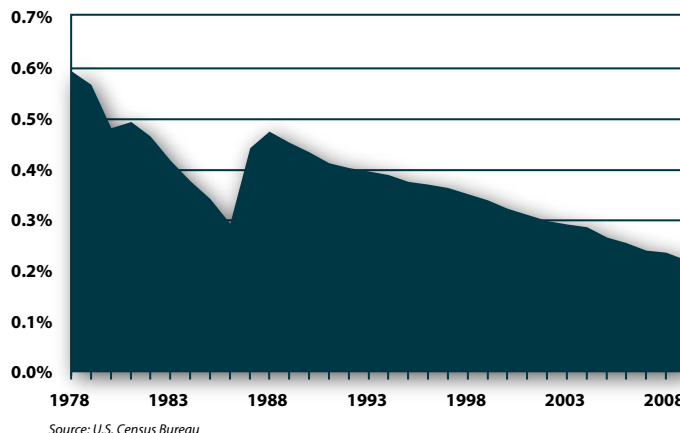
revenues from the sale of that product (all else being equal) will increase by 3 percent as well. Of course, this isn't a real gain in revenue for the government, since those extra revenues will simply go to paying the higher, inflation-adjusted prices associated with providing government services. This "gain" is instead a bare minimum requirement for keeping government running at a stable level over time.

But excise taxes fail to live up to this bare minimum requirement. Under a gasoline excise tax of twenty cents per gallon, the government will always receive twenty cents on each gallon sold, regardless of what happens to the price of gasoline and the price of government services over time. As inflation erodes the value of that twenty cents, government's ability to provide a consistent level of services will suffer.

Virginia provides one example of a state suffering from this flawed arrangement. Though Virginia has collected 17.5 cents on each gallon of gasoline sold within its borders since 1987, the real value of its gasoline excise tax has declined considerably as a result of inflation. The 17.5 cent tax Virginians pay on each gallon purchased today is, in inflation-adjusted terms, really about 16 cents lower than what they paid when the rate was set at that level in 1987. Put another way, 17.5 cents today has the same purchasing power that 33.5 cents had in 1987. Inflation has effectively provided Virginians with an unintended, 16 cent per-gallon tax cut which has, in turn, had a stark effect on state revenues—as well as on the (already limited) ability of the gas tax to deter consumption.

That effect on revenues can be seen by looking at Virginia's gas tax revenues as a share of its economy over time. As seen in the graph on this page, the spike in revenues that occurred in 1987 is the result of the legislature's action to increase the per-gallon excise tax rate from 11 to 17.5 cents per gallon. Before

Effect of Inflation on Excise Taxes: Virginia Gasoline Tax Revenues as a Share of Virginia Gross State Product



and after that spike, however, are predictable revenue declines brought about by inflation's effects on the real tax rate. A similar story could be told in most states around the country.

Declining Consumption of Goods Subject to Excise Taxes

In some cases, the slow-growth of excise tax revenues can also be attributed to changes in the demand for products subject to excise taxes. Cigarette consumption, for instance, has been steadily declining as a result of increased awareness of tobacco's negative health effects, as well as the higher prices created by cigarette excise taxes. This decline has already had a marked effect on state cigarette tax revenues. In time, gasoline consumption will decline as well as alternative energy sources and more fuel-efficient technologies continue to improve.

Inevitably, if excise taxes succeed in deterring consumption, they will fail to produce sustainable revenue growth. These two goals of excise taxation are completely incompatible.

Federal Deductibility

Unlike income taxes and property taxes (and, at least temporarily, general sales taxes), excise taxes are not deductible in computing federal taxable income. As a result, every dollar in excise tax paid is a dollar out of that taxpayer's pockets. There is no offsetting reduction in federal income taxes for those who itemize deductions. For a more detailed discussion of the "federal offset" effect, see page 9.

Excise Tax Reform: Issues and Options

Though there are persuasive reasons for levying excise taxes, their regressive and unsustainable nature demands careful attention from policymakers. This section surveys the options available for remedying these problems associated with excise taxes.

Reducing Regressivity

As explained earlier, excise taxes are more regressive than general, percentage based sales taxes. One obvious way of reducing this regressivity is to levy excise taxes in a manner more akin to how general sales taxes are levied. Unlike a flat, per-gallon tax on premium and regular liquors, a percentage based tax would take account of the difference in price between these two products, and would collect more tax from those consumers able to afford premium brands. This method would reduce, but by no means eliminate the regressivity of excise taxes.

But levying an excise tax in this manner does have its problems. Expensive and inexpensive brands of liquor, for example, are equally capable of producing societal ills, and should therefore be treated equally by an excise tax aimed at discouraging their consumption or to offsetting their social costs. Moreover, with gasoline in particular, tying excise tax revenues to the often wild and unpredictable price of gasoline can have unfortunate implications for state revenues.

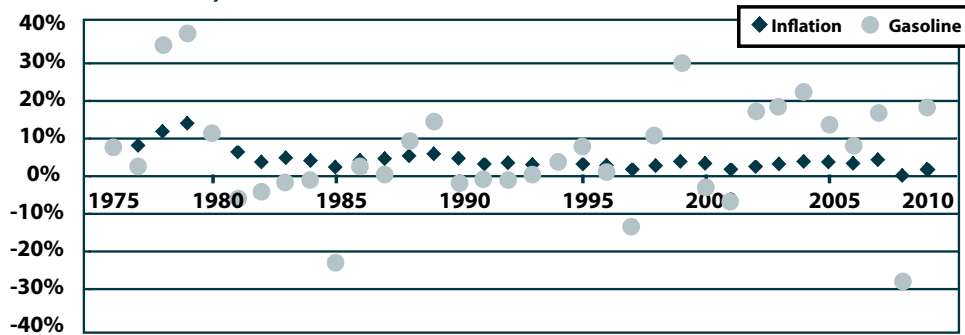
Rather than altering the structure of the tax itself, a more targeted approach with fewer side-effects is to rely on low-income credits to offset the effects of excise taxes on those individuals least able to afford them. This could be accomplished by bolstering the types of sales tax credits discussed on page 17, or by enhancing (or enacting) a state Earned Income Tax Credit (EITC). In 2009, Minnesota temporarily offered a refundable tax credit—dubbed the "lower income motor fuels tax credit"—specifically as a means of offsetting a recent increase in the state's gasoline excise tax.

Improving Revenue Growth

Aside from regressivity, the other principal disadvantage of excise taxes is the unsustainable nature of the revenue they produce, as explained on page 22. Fortunately, options do exist for mitigating this disadvantage—though it is neither possible nor desirable to eliminate it entirely. Indeed, as is noted above, poor revenue growth is an inevitable side-effect of any excise tax that is effective in deterring consumption.

Levying excise taxes as a percentage of the item's sales price, rather than at a flat per-unit rate, can result in additional revenue growth over time as inflation raises the item's sales price. Some state gasoline and alcohol excise taxes are already levied in this manner. But while this strategy may result in additional revenue over the long-term, it does somewhat reduce the predictability of the revenues generated by the tax, since variations in the item's price can have significant effects on the amount of revenue collected. In the case of tobacco and alcohol—products with prices that are not particularly volatile—this is a fairly minor issue, and a strong case can in fact be made for levying these taxes in this way. With gasoline taxes, on the other hand, tying the state's revenues too closely to the product's price can cause a serious problem. As the graph on the preceding page shows, gasoline prices over the past three decades have been quite variable, sometimes changing by 30 or 40 percent in a single year. This aspect of gasoline prices is especially troubling because gas tax revenues, rather than being intermingled with other types of revenue in a state's general

Annual Percentage Change in the Price of Gasoline, and in the Overall Inflation Rate




fund, are often dedicated to a separate transportation trust fund. Needless to say, when gas prices plummet, a trust fund reliant on a percentage-of-price gas tax can be expected to suffer as a result. Many states that previously levied their gasoline taxes in a percentage-based manner have since abandoned this method precisely because of this threat.

So if a percentage-of-price levy is not a good fit for the gasoline tax, what is? The most obvious answer is to index the per-unit rate based on the economy's overall rate of inflation. As the above graph shows, inflation provides a much more stable and predictable measure than the price of gasoline itself. Maine and Florida currently index their gas tax rates to the general inflation rate, and the idea has been discussed in many other states.

For states not interested in indexing, there is one other alternative. Nebraska regularly adjusts its gasoline tax rate based on a number of factors, including most notably the budget

the best option available for avoiding unforeseen shortfalls in the transportation budget, though it can create a reluctance among lawmakers to spend adequately on transportation since their spending decisions translate directly into sometimes politically unpopular gas tax increases.

Conclusion

Despite all their flaws, sales and excise taxes are an important component of state and local tax systems. Sales and excise tax reform should focus both on improving the sustainability of the revenues generated by these taxes, as well as on reducing the inevitable regressivity associated with these forms of taxation. But while much can be done to improve sales and excise taxes in these respects, policymakers must recognize that neither of these characteristics is the strong suit of these taxes, and for that reason, no state tax system should ever come to rely too heavily upon them. 

the legislature has authorized for the Department of Roads. When the legislature decides that the Department needs additional funding to adequately maintain Nebraska's roads, this linkage provides a straightforward way for securing the necessary revenue without having to reduce spending on education, public safety, or other priorities. This is arguably

¹ In many states, a small portion of this tax is actually pocketed by retailers through programs known as "vendor discounts." These "discounts" are ostensibly designed to compensate retailers for the costs associated with collecting and remitting sales tax payments, though in many states the compensation provided arguably exceeds the actual costs to retailers. For more information see: Good Jobs First, "Skimming the Sales Tax." November 2008. <http://www.goodjobsfirst.org/pdf/skimming.pdf>

² This figure represents household consumption expenditures for services as a share of personal consumption expenditures, as found in the Bureau of Economic Analysis' National Income and Product Account Tables (NIPA), available at: <http://www.bea.gov/national/nipaweb/index.asp>

³ "Leaving Money on the Table: 'Federal Offset' Provides Incentive for States to Rely on Progressive Income Taxes." Institute on Taxation and Economic Policy, April 2010. <http://www.itepnet.org/pdf/leavingmoney.pdf>

⁴ This is not to be confused with taxing internet access itself, which the Internet Tax Freedom Act (ITFA) prohibits in most states through 2014 based on the dubious claim that exempting internet access encourages more households to purchase high-speed internet service.

⁵ Bruce, Donald, William Fox, and LeAnn Luna, "State and Local Government Sales Tax Revenue Losses from Electronic Commerce." Center for Business and Economic Research, The University of Tennessee, April 13, 2009. <http://cber.utk.edu/ecom/ecom0409.pdf>

⁶ Quill Corp. v. North Dakota (91-0194), 504 U.S. 298 (1992). <http://www.law.cornell.edu/supct/html/91-0194.ZO.html> (1992)

⁷ For more information see Michael Mazerov, Amazon's Arguments Against Collecting Sales Taxes Do Not Withstand Scrutiny." Center on Budget and Policy Priorities, November 2010. <http://www.cbpp.org/cms/index.cfm?fa=view&id=2990>

⁸ This has been shown in numerous studies, including: Carpenter, Christopher and Philip J. Cook, "Cigarette Taxes and Youth Smoking: New Evidence from National, State, and Local Youth Risk Behavior Surveys." Journal of Health Economics, Vol. 27(2), March 2008.

⁹ Hughes, Johnathan E., Christopher R. Knittel, and Daniel Sperling, "Evidence of a Shift in the Short-Run Price Elasticity of Gasoline Demand." The Energy Journal, Vol. 29(1), January 2008.

¹⁰ Lindblom, Eric, "Toll of Tobacco in the United States of America." Campaign for Tobacco Free Kids, June 2008.

CHAPTER FOUR

PROPERTY TAXES

The property tax is the oldest major revenue source for state and local governments. At the beginning of the twentieth century, property taxes represented more than eighty percent of state and local tax revenue. While this share has diminished over time as states have introduced sales and income taxes, the property tax remains an important mechanism for funding education and other local services. But property taxes are regressive, and because these taxes are usually collected at the local level, the unequal distribution of wealth between rich and poor school districts can lead to inequitable school funding.

The challenge facing state lawmakers today is to preserve this important revenue source while at the same time offsetting its regressivity and reducing the disparities in school funding between rich and poor districts. This task has been made much more difficult by a decline in the popularity of the property tax—in part a result of the disconnect that exists between property tax bills and one's ability to afford those bills. As this chapter shows, however, relatively simple means exist for remedying this unpopular problem. This chapter surveys the basic workings of the property tax, its weaknesses and strengths, and numerous options for providing responsible, fair property tax relief.

Why Tax Property?

Although the personal income tax is best suited to fulfill the “ability-to-pay principle,” the property tax can also provide an important contribution toward this end. By taxing those families with large quantities of wealth more heavily than those without such reserves, the property tax can help differentiate between families of very different means (though

this could be improved upon further if the property tax were applied to the intangible and other properties often owned by the wealthiest families). As things currently stand, however, the impact that property taxes can have on low-income families, and particularly the elderly, makes clear that the linkage of the property tax to the ability-to-pay principle is far from perfect.

The property tax is also commonly understood as being

rooted in the “benefits principle” of taxation, discussed on page 6. Under this view, the property tax essentially functions as a user-charge on local residents for the benefits they receive from the local policies funded by property taxes. These policies benefit local residents both directly, and indirectly in the form of increased housing values.

Finally, the stability and enforceability of the property tax make it among the best options available for providing local governments with a predictable revenue stream that can be used to fund indispensable services like schools, roads, and public safety.

Despite the very good reasons that exist for levying property taxes, however, it is important to keep

How Property Taxes Work

$$\begin{array}{r}
 \text{Market Value} \\
 \times \\
 \text{Assessment Ratio (between 0\% \& 100\%)} \\
 = \\
 \text{Assessed Value} \\
 - \\
 \text{Exemptions} \\
 = \\
 \text{Taxable Value} \\
 \times \\
 \text{Sum of All Relevant Millage (Tax) Rates} \\
 = \\
 \text{Property Tax Before Credits} \\
 - \\
 \text{Homestead Credits and Circuit Breakers} \\
 = \\
 \text{Property Tax Owed}
 \end{array}$$

in mind that property taxes are regressive, and that targeted property tax relief must be provided as a result.

How Property Taxes Work

Historically, property taxes applied to two kinds of property: **real property**, which includes land and buildings, and **personal property**, which includes moveable items such as cars, boats and the value of stocks and bonds. Most states have moved away from taxing personal property and now impose taxes primarily on real property. In its simplest form, the real property tax is calculated by multiplying the value of land and buildings by the tax rate. Property tax rates are normally expressed in **mills**. A mill is one-tenth of one percent. In the most basic system, an owner of a property worth \$100,000 that is subject to a 25 mill (that is, 2.5 percent) tax rate would pay \$2,500 in property taxes.

In reality, however, property taxes are often more complicated than this. The first step in the property tax process is determining a property's value for tax purposes. In most cases, this means estimating the property's **market value**, the amount the property would likely sell for.

The second step is determining the property's **assessed value**, its value for tax purposes. This is done by multiplying the property's market value by an **assessment ratio**, which is a percentage ranging from zero to one hundred. Many states base their taxes upon actual market value—in other words, these states use a 100 percent assessment ratio.

A large number of states, however, assess property at only a fraction of its actual value. New Mexico assesses homes at 33.3 percent of their market value, and Arkansas uses a 20 percent assessment ratio. Some states place a cap on increases in a home's assessed value in any given year, which in many cases can lead to vastly different assessment ratios among similarly valued homes (see page 34 for more on this issue). And even when the law says properties should be assessed at 100 percent of their value, local assessors at times systematically under-assess property, reporting assessed values that are substantially less than the real market value of the property.

After the assessment ratio has been factored in, many states reduce a property's assessed value further by allowing **exemptions**. For example, Ohio allows an exemption for the first \$25,000 of home value. Subtracting all exemptions yields the **taxable value** of a property.

The next step in the process is applying a property tax rate, also known as a **millage rate**, to the property's taxable value. The millage rate is usually the sum of several tax rates applied by several different jurisdictions: for example, one property might be

subject to a municipal tax, a county tax, and a school district tax. This calculation yields the property tax owed.

Many states allow **property tax credits** that either directly reduce the property tax bill, or that reimburse part of the property tax bill separately when taxpayers apply for them. Subtracting these credits is the final step in calculating one's property tax bill—though taxpayers are often required to pay the pre-credit property tax amount, only to later have the amount of the credit refunded to them. These “property tax relief” mechanisms are described later in this chapter.

Before moving on, it is worth noting one potentially confusing result created by the complicated process described above. The tax rate most property owners are familiar with is known as the “nominal rate”—that is, the actual millage rate used in calculating your bill. But when comparing property taxes across districts or across states, analysts generally find the “effective” property tax rate to be much more useful. This rate is usually calculated by expressing the property tax as a share of market value. Expressing property taxes this way gives us a better sense of the true rate being paid per dollar of property owned, without the confusions associated with the wide variety of exemptions, assessment ratios, and credits utilized in each state. For example, the owner of a \$100,000 home subject to a 25 mill (or 2.5 percent) nominal tax rate will almost always owe less than 2.5 percent of that home's value in tax. An 80 percent assessment ratio and \$10,000 homestead exemption, for instance, would drop the home's effective tax rate to just 1.75%.

Property Taxes and Fairness

Although sales and excise taxes are the most regressive taxes, they are rarely as maligned as the property tax. The “sticker shock” effect of the property tax is partly to blame for this: it's a large, very noticeable payment that is made once or twice a year, while sales taxes are spread throughout the year on hundreds of purchases. Homeowners with mortgages are often less shocked than other homeowners, since their property tax payments are usually lumped into their mortgage payments, but once their homes are paid off these bills become harder to overlook. For these homeowners, the property tax can seem more oppressive and more unfair than it actually is, simply because it's more visible.

That said, there is no denying that the property tax is generally regressive. Nationwide, low-income families paid 3.7 percent of their income in property taxes in 2007, while middle-income families paid 2.9 percent of their income and the wealthiest taxpayers paid just 1.4 percent.¹

The chief reason that property taxes are regressive is that they are based on home values rather than on income levels—and home values do not always vary directly with income levels. Home values represent a much larger share of income for middle- and lower-income families than for the wealthy. It is common for a middle-income family to own a home valued at two or three times their annual income, for example, while wealthier taxpayers are less likely to own homes worth as much relative to their income levels. The box on this page uses two hypothetical examples to illustrate the effects of this discrepancy.

Moreover, property taxes are not responsive to variations in taxpayers' income: someone who suddenly loses his job will find that his property tax bill is generally unchanged, even though his ability to pay it has drastically fallen. (By contrast, income tax bills depend on the level of earned income, so income taxes are much more sensitive to taxpayers' ability to pay—an important consideration in times of economic hardship.) A similar problem is very common among elderly taxpayers at the end of their working careers who find themselves "property rich" but "cash poor."

When the United States was an agrarian society, the property tax was a relatively fair form of taxation. The value of a citizen's land and buildings was an excellent measure of his wealth. But today, rich families have most of their wealth in other forms of property—stocks, bonds, etc. These forms of

property are usually not taxed until they are sold. According to the Survey of Consumer Finances (SCF), in 2007 real estate represented less than nineteen percent of the assets of the richest one percent of wealth-holders.

Low- and middle-income families, however, still have most of their limited wealth invested in their homes. Because the wealthy have relatively little of their wealth invested in property subject to the real property tax, while the most valuable thing a middle-income family owns is its house, much more of a middle-income family's wealth is subject to the property tax.

Business Property Taxes

Of course, homeowners don't pay all of the property tax. Businesses pay it as well. Property taxes on business are mostly borne by business owners. (The special case of residential rental property is discussed below.) This makes the property tax less regressive since business owners tend to be wealthier than average. Also, some of the business property tax is exported to property owners living in other communities and other states. The business property tax is an important part of ensuring that the businesses that make use of local government services pay their fair share.

Though business property is frequently ineligible for many of the residential "property tax relief" programs described on page 29, it is nonetheless often granted large and expensive tax breaks by state and local lawmakers worried about attracting jobs. One such tax break, Tax Increment Financing (TIF), is described in the "Economic Development" chapter on page 60.

In many cases, lawmakers will strike deals directly with individual businesses in an attempt to encourage them to relocate or expand within the lawmakers' state or district. These types of cuts can have serious consequences for local revenues, thereby necessitating higher tax rates on all other properties, or fewer government services. Their true ability to change companies' location decisions is also a matter of serious question.

Property Taxes and Non-Profit Entities

Non-profit entities are generally exempt from state and local property taxes. While these exemptions can make it easier for these organizations to pursue their missions, localities in which a large amount of property is held by non-profit entities can find it hard to raise enough revenue via the property tax to adequately fund local services. This problem arises most frequently in areas with large non-profit hospitals and/or universities.

In some instances, a payment in lieu of taxes (PILOT) is negotiated in order to partially or fully compensate the

Who is Affected Most by Property Taxes?

Jerry Seinfeld

Annual Income	\$85,000,000
Taxable Value of Home	\$32,000,000
Home Value as a % of Income	38%

Tax as a % of Income 0.5%

Susan Anybody: Hypothetical Middle-Income Homeowner

Annual Income	\$55,000
Taxable Value of Home	\$150,00
Home Value as a % of Income	273%

Tax as a % of Income 3.8%

Created based on data from the American Housing Survey, U.S. Census Bureau

government for the revenue loss associated with a non-profit organization's tax exempt status. Because PILOTs are usually voluntary, however, non-profit organizations often have little incentive to sit down with government officials to negotiate such agreements. As a result, PILOTs are typically negotiated only when the organization in question needs the local government's help in some matter (such as amending a zoning law), or if the organization simply wishes to see the quality of public services in the area improve.

In order to improve the quality of PILOT negotiations that do take place, the Institute for Wisconsin's Future (IWF) recommends that localities take care to update available data on the value of tax-exempt properties.² IWF also recommends that states develop systematic and enforceable criteria for determining which entities are truly deserving of tax exempt status.

Residential Rental Property

While the public's attention to property taxes is usually focused on the taxes paid by homeowners, the property tax also affects taxpayers who rent, rather than own, their home. Who ultimately pays the property taxes levied on residential rental properties is disputed. Some economists believe that it is mostly borne by the landlords who own these rental properties. Others argue that it is mostly passed through to tenants in the form of higher rents. It is generally agreed that the answer partially depends on the rental market. When residential rental property is in short supply, landlords are more likely to pass their property taxes on to renters in the form of higher rents. But if rental property is abundant, landlords may find this more difficult.

Of course, most rental markets are not purely dominated by either tenants or landlords—so the answer probably is somewhere in between. And the matter is confused further because many rental markets cross municipal boundaries so that taxes vary on rental units in different parts of the market. Absent significant differences in the local government services renters care most about, landlords in higher tax jurisdictions can't simply raise rents to pay their property taxes if they have to compete with apartments in nearby, lower tax jurisdictions.

Two things are certain about property taxes on rental property. First, lawmakers consistently neglect renters in designing property tax relief, despite the fact that renters are paying some share of the property taxes levied on rental property. Second, data from the U.S. Census indicates that renters generally have incomes about half the size of their homeowner neighbors. "Property tax relief" paid directly to renters is therefore progressive in nature. The discussion of "circuit-breakers" on page 30 looks at

how one can go about distributing tax relief to a group that only indirectly pays property taxes.

Personal Property Taxes

Personal property is all property other than real estate. Personal property taxes usually apply to **tangible** property such as individually-owned cars and trucks or business equipment. The tax can also apply to **intangible** property such as stocks and bonds.

Taxing tangible personal property is relatively straightforward, in theory. In the case of cars and trucks, the tax is usually a percentage of the "blue book" value of the vehicle. Since people have to register their vehicles, it's hard to avoid the tax. And business equipment can be assessed based on income tax return data for depreciation deductions.

The most common type of state personal property tax is on individually-owned cars and trucks. Although at first glance this tax may appear to be progressive (rich people have more expensive cars), it is not. Personal property taxes on automobiles are regressive for the same reason residential property taxes are regressive: the value of a person's car (or home), as a share of their income, is higher for low-income people than for the wealthy. Personal property taxes on vehicles are, however, generally preferable to most "vehicle registration fees," which are sometimes proposed as substitutes to the car tax. While some states like to brag that they lack a car tax, these registration fees can be equally as burdensome to low-income families. Unlike a flat-amount vehicle registration fee, the property tax paid on a middle-income individual's \$20,000 Chevrolet is actually less than what is paid by a wealthier individual on his \$50,000 Mercedes (though as a share of income, the tax on the middle-income person will still often be higher). Though this isn't enough to make the tax progressive, it is preferable to a flat fee. Making matters worse, these fees cannot be taken as an itemized deduction when computing one's federal tax bill, so even upper-income taxpayers—who are more likely to itemize their returns—may not benefit as much as one would expect (see page 37 for more on this point).

On the other hand, business personal property taxes and, especially, intangible property taxes on stocks and bonds are progressive because the wealthy own far more business property and intangible assets than do middle- and low-income people. It's also easy to exempt low- and middle-income people from an intangible property tax by providing generous exemptions.

But as a result of difficulties many states had with enforcing the intangible property tax, no state levies such a tax at this time.

In 2007, Florida became the last state to repeal its intangibles tax. Unfortunately, the movement against the intangibles tax proved to be short-sighted. The rise of the digital age and other advances in technology have greatly improved the potential for states to enforce an intangibles tax. Any state bold enough to reinstate its intangibles tax has a lot to gain, not only in terms of improved tax progressivity, but also in the form of a substantial revenue boost. Before reducing the intangibles tax rate shortly before its repeal, Florida brought in as much as \$1 billion annually from the tax.

Revenue and Stability

Property taxes are generally more stable over time than the income or sales tax. This is because property tax revenue depends on property values, not income. When personal income grows rapidly, property taxes will generally not grow as fast (the recent housing bubble being the obvious exception)—and slower personal income growth is not always reflected in slow property tax growth. If property values are inflated prior to a recession, they will tend to fall once a recession starts. If an area is particularly hard hit by an economic downturn—if a town loses its leading industry, for example—property values also probably will fall. On the other hand, where property values were not inflated and a downturn is not catastrophic, it is not uncommon for property values to hold relatively steady during a recession.

Most localities also have at least some ability to further stabilize property tax revenues by adjusting the tax rate to offset changes in property values. This is an important benefit of relying on property taxes to finance local governments, as it allows for a stable level of local police, fire, and education services even during periods of great volatility in the housing market.

Unfortunately, property tax stability also means that people who are hardest hit during a recession—people who lose their jobs—don't get any relief. Property taxes are insensitive to variations in taxpayers' income: a taxpayer who suddenly becomes unemployed will find that her property tax bill is unchanged, even though her ability to pay it has fallen. By contrast, income taxes vary with income, so income taxes are more sensitive to taxpayers' ability to pay. Adding an income test to the calculation of property tax bills, such as the "circuit-breaker" credit described on page 30, can somewhat alleviate this problem.

Federal Deductibility

Property taxes, like state and local income taxes, are deductible in calculating federal taxable income for those who itemize their returns.³ This means, in effect, that a portion of some

My Federal Tax Bill Did WHAT?

Federal deductibility can be a confusing concept. In 1998, Utah decided to repeal its car tax and replace it with a vehicle registration fee. Soon thereafter, lawmakers were surprised to learn that their constituents would be facing a \$12 million federal income tax hike, as well as a \$3 million state income tax hike, because vehicle fees cannot be taken as an itemized deduction unless they are related to the price of the vehicle. The editorial pages of some of the state's largest newspapers sensibly criticized lawmakers for this embarrassing oversight.

state residents' property tax bills is "exported" to the federal government in the form of reduced federal income taxes for itemizers, and never comes out of those residents' pockets. For a more detailed discussion of this "federal offset" effect, see page 9.

Because property taxes are much more regressive than income taxes, however, a substantial share of property taxes is paid by low- and middle-income taxpayers who are much less likely to itemize than their wealthier neighbors. This means that property taxes offer a lower "bang for the buck" than income taxes in terms of reducing taxpayers' federal tax bills.

Interestingly, vehicle property taxes are deductible, but only when they are calculated as a percentage of the car's value. Car taxes that are based on a flat dollar amount cannot be deducted. This is an important distinction because almost all states levy flat-dollar car "registration fees" that cannot be deducted. Doing away with such fees and replacing the lost revenue with a property tax on car value would result in federal tax cuts for many car owners.

Property Tax Relief Options

As states have moved away from heavy reliance on property taxes, a variety of different mechanisms have been introduced for providing residential tax "relief". These mechanisms vary significantly in their methods, as well as in their quality. Unfortunately, the trend in many states has been in favor of blunt, poorly targeted tax relief, rather than towards more carefully targeted policies that can help those in need without requiring large cuts in government services. The implementation of poorly targeted relief programs have in many cases given the greatest benefits to the wealthy, and have often created grave inequities between neighbors' property tax bills as well. In this way, poorly designed property tax relief programs have frequently violated both the vertical and horizontal equity principles discussed on page 5.

This section surveys each of the major property tax relief mechanisms available to the states. The first three discussed here can actually make the tax less regressive in a well-targeted and fiscally responsible manner. These options include homestead exemptions, circuit-breakers, and deferral programs.

In contrast, split-roll property taxes, income tax breaks (especially deductions), and property tax caps have reduced property tax revenues substantially, while doing little to help those who need it most. Lawmakers have at times used imagery of residents being “taxed out of their homes” as reason to enact broad cuts that are by no means targeted to those vulnerable individuals for whom this possibility is most real. State policymakers and voters should not be swayed by this empty rhetoric.

Homestead Exemptions

More than forty states now allow some form of a **homestead exemption**, which reduces property taxes for homeowners by sheltering a certain amount of a home’s value from tax. Homestead exemptions are a progressive approach to property tax relief, providing the largest tax cuts as a share of income to lower- and middle-income taxpayers. These exemptions are usually funded by local governments, so their cost is often made up through higher property tax rates than would otherwise be the case.

There are two broad types of homestead exemptions: flat dollar and percentage exemptions. The more common type, flat dollar exemptions, are calculated by exempting a specified dollar amount from the value of a home before a property tax rate is applied. A flat dollar exemption is especially beneficial to low-income homeowners because it represents a larger share of property taxes (and of income) for low-income taxpayers. Percentage exemptions give the same percentage tax cut to all income levels. This form of exemption is much less effective at targeting relief to those in need than are flat exemptions.

If neglected by lawmakers, flat dollar exemptions can become less valuable to homeowners over time if home values rise while the homestead exemption amount remains constant. A flat dollar homestead exemption that is not regularly updated will gradually become less able to protect a portion of a home’s value from taxation, and property taxes will effectively increase as a result. Indexing the exemption (that is, automatically increasing it with inflation every year), is a simple way to avoid this unintentional tax hike.

While homestead exemptions are a progressive approach to property tax relief, even indexed exemptions have two important flaws: first, they provide no tax relief to renters, even though

renters are generally agreed to pay some property tax indirectly in the form of higher rents. Second, exemptions are poorly targeted and costly. Because most homestead exemptions are not targeted to low- and middle-income taxpayers, but are available to even the wealthiest homeowners, they are especially costly—and provide little “bang for the buck” to low-income taxpayers.

Expanding homestead exemptions to include rental properties would in most cases be prohibitively costly to local governments. And for lawmakers interested in providing targeted property tax relief to those in need, there are much more effective tools than a means-tested homestead exemption. For these reasons, a modest, broad-based, flat dollar homestead exemption that is available to homeowners of all ages and income levels can provide a good base of property tax relief upon which to build with a circuit breaker program, discussed next.

Circuit Breakers

The property tax **circuit breaker** is a less expensive, more targeted approach to tax relief. Its name reflects its design: circuit breakers protect low-income residents from a property tax “overload”, just like an electric circuit breaker. When a property tax bill exceeds a certain percentage of a taxpayer’s income, the circuit breaker offsets property taxes in excess of this “overload” level. Circuit breakers are usually funded by state, rather than local governments, so their existence rarely puts any upward pressure on local property tax rates.

Circuit breakers usually give homeowners (and oftentimes renters as well) a credit equal to the amount by which their property tax bill exceeds a certain percentage of their income, though sometimes only a fixed percentage of that amount is given, and there is usually a cap limiting the total amount of credit allowed. Circuit breakers are usually made available only to low-income taxpayers, on the premise that this group is most in need of “relief.” Limiting circuit breaker eligibility based on income is far preferable to limiting it based on age—as many states do in restricting their programs to elderly taxpayers—because low-income taxpayers of very different ages can be equally in need of relief.

Because it is generally agreed that renters pay property tax indirectly in the form of higher rents, many states now extend their circuit breaker credit to renters as well. The calculation is the same as for a homeowner, except that some percentage of the rent you pay is assumed to be the property tax paid. Renters in Michigan, for instance, use 20 percent of their rent as their assumed property tax in calculating their circuit breaker credit.

The ability to target circuit breakers to those taxpayers most in need means that virtually none of the property tax relief from a circuit breaker credit will be offset by federal income tax hikes for itemizers. By contrast, when a homestead exemption reduces the property tax paid by a wealthy homeowner, that homeowner will have less property tax to claim as an itemized deduction on his federal tax return—which means that his federal taxes will go up.

Like the homestead exemption, circuit breakers must be indexed for inflation in order to preserve the value of this tax break for low-income taxpayers. For example, if the Illinois circuit breaker's maximum income level for eligibility and the maximum credit amount had been indexed for inflation since it was first introduced in 1972, the income threshold would have been \$52,000 in tax year 2010—more than double the current value for unmarried taxpayers—and the maximum value of the credit would have been about five times its current value.

The main drawback of circuit breakers is that, in general, they only are given to taxpayers who apply for them. (By contrast, homestead exemptions are usually given automatically to eligible taxpayers.) Eligible taxpayers will only apply for tax credits if they are aware of their existence. This means that an essential component of a circuit breaker program must be an educational outreach effort designed to inform state taxpayers of the credit. In addition, one way of making it easier for eligible taxpayers to claim the circuit breaker is to make it possible to claim the credit either on income tax forms or on a separate circuit breaker form (for those who do not have to file income tax forms).

Deferral Programs

A number of states allow some homeowners to delay paying their property tax bills by making use of **deferral programs**. The vast majority of these programs are restricted to taxpayers above a certain age. Deferrals can apply to all or part of a homeowners' tax bill in a given year, and the maximum amount that can be deferred over time is often limited to a specific percentage of the property's value. Some deferral programs resemble circuit breakers in that the taxpayer can only defer the portion of their tax bill exceeding a certain percentage of their income. Interest is generally owed on the amount of tax deferred, and payment of the deferred taxes is often made when the home is sold.

Because the state and/or locality eventually receives the amount of property taxes deferred, deferrals cost the government less than any other form of property tax relief. The cost of deferrals is further limited by the fact that they are often not widely used. At least two factors contribute to the relative

Property Tax “Relief” for Renters

Distributing property tax relief to renters is critical on fairness grounds. It is widely assumed that some portion of property taxes are usually passed on to renters in the form of higher rents, and depriving this group of relief from those taxes is unfair not only on horizontal equity grounds, but on vertical equity grounds as well (since renters as a class are generally poorer than homeowners).

unpopularity of deferrals among taxpayers. First, many taxpayers are likely unaware of deferral programs, in part because states often do a poor job advertising their existence. Second, because deferred taxes must be paid back with interest, only those taxpayers in genuine need are likely to take advantage of these programs. In this way, deferrals are an extremely targeted form of property tax relief.

Split Roll

A fourth way to provide property tax relief is a split roll, also known as a “classified property tax.” Unlike a regular property tax, which taxes the value of all real property at the same rate, a split roll property tax applies different effective tax rates to different types of property. One approach to a split roll property tax is taken by the District of Columbia, which taxes homes at a lower rate than business properties. This shifts some of the property tax load from homeowners to businesses.

A second approach is to assess homeowners at a lower percentage of their value than other types of property. For example, Utah assesses all residential properties at 55 percent of their value, and assesses all other types of property at 100 percent of their value. A single tax rate is then applied to all properties of all types within each taxing district. This approach has exactly the same impact on tax fairness as the District of Columbia approach of using different tax rates.

While split roll taxation is sometimes favored by those seeking to ensure that businesses pay their fair share, it has three main shortcomings that severely limit its usefulness. First, it's poorly targeted. Every homeowner pays a lower tax rate because of the split roll, from the very poorest to the very wealthiest. And the lower rate is available to anyone who owns a property—even those whose principal residence is in another state. Because of these flaws, a split roll system is less targeted than either a circuit breaker or a flat dollar homestead exemption. This latter point is illustrated in the chart below, which demonstrates how more expensive homes can benefit disproportionately from a split

Property Taxes and Age

Many property tax relief programs, including homestead exemptions, circuit breakers, deferrals, and even some assessment limitations are available only to people above a certain age. This is because elderly people are oftentimes among those most likely to be “property rich” and “cash poor.” Put another way, while many elderly people own homes that they purchased earlier in life, a significant percentage of those people lack the level of retirement income needed to afford the property tax bills owed on those homes. Ensuring that low- and moderate-income elderly individuals are not taxed beyond their ability to pay is therefore an important goal.

But although the elderly are among those most likely to be in need of relief, this does not mean that such relief should be restricted based on age. After all, a given taxpayer’s income, not their age, is what determines whether they can afford to pay their property tax bill. Well targeted relief, such as a circuit breaker, should not be reserved exclusively for the elderly.

roll system. Second, reducing the property tax on one class of property inevitably means shifting a greater share of the tax onto other groups. Unless lawmakers ensure that the “residential” property tax owner includes renters as well as homeowners, split roll taxation can actually make the property tax less fair by shifting the property tax load from homeowners to low-income renters.⁴ Third, the split roll makes property tax administration more complicated, because it requires tax administrators to determine not just the value of each property, but also its use.

Homestead Exemption vs. Split Roll: Who Benefits?		
	Home #1	Home #2
Assessed Home Value	\$100,000	\$500,000
Homestead Exemption (HSE)	\$25,000	\$25,000
New Taxable Value	\$75,000	\$475,000
Tax with HSE and 2 mill (2%) rate	\$1,500	\$9,500
Split Roll	1.5%	1.5%
Tax under split roll system	\$1,500	\$7,500

Income Tax Breaks for Property Taxes

Most states provide property tax relief through their state income tax forms. This is done in two ways: **itemized deductions** and **income tax credits**. More than thirty states allow itemizers to deduct their property tax payments from their taxable income. Since these deductions are usually only available to state itemizers—and can only be claimed by those who pay state income taxes—this approach to property tax relief excludes many of the low-income homeowners for whom property taxes are most burdensome.

A few states provide other forms of income-tax-based property tax relief. Illinois, for example, allows taxpayers to claim a non-refundable income tax credit equal to 5 percent of the property taxes paid on their home. Credits are usually a more progressive approach to tax relief—but when these credits are non-refundable, those who don’t pay enough income tax to claim the full credit receive less relief, despite the fact that these “income-poor, property-wealthy” taxpayers are often less able to pay property taxes than most.

Most income tax breaks for property taxes are restricted to homeowners, and overlook the fact that renters’ monthly payments include some amount of built-in property tax. Circuit breakers, which are often administered via the income tax as well, are the exception.

Property Tax Caps

In response to what anti-tax advocates have branded as “out of control” property taxes, a number of states have decided to make use of blunt caps to restrict the growth of the property tax. California’s infamous Proposition 13, approved in 1978, was instrumental in inspiring numerous other states to enact similarly ill-conceived **property tax caps**. These caps can come in many forms, but all are poorly-targeted and costly. In most cases, these caps amount to a state-mandated restriction on the ability of local governments to raise revenue. While state lawmakers get to take credit for cutting taxes, local lawmakers are the ones forced to make difficult decisions regarding which services to cut. Among the types of property tax caps in use around the country are:

- **Caps on property tax rates:** Property tax rate caps limit the size of a property’s tax bill to a specific percentage of its value. California and Indiana, for example, each restrict homestead property tax bills to 1 percent of the home’s value. Massachusetts imposes its rate cap in a slightly different manner, prohibiting total property tax revenues in each municipality from exceeding 2.5 percent of total

assessed property value. Rate caps reduce both the revenue generating potential of the property tax, and the ability of local lawmakers to stabilize property tax collections through periodic adjustments in the tax rate. Both of these flaws cause rate caps to erode local governments' ability to provide a consistent and adequate level of services.

■ **Caps on increases in a property's assessed value:**

This type of cap prevents the taxable assessed value of a homeowner's residence from rising faster than a pre-determined rate. In California, Proposition 13 limits increases in a homeowners' assessed value to 2 percent per year, or the overall rate of inflation, whichever is lower. In Florida, the "Save Our Homes" amendment limits assessed value increases to the lower of 3 percent or inflation. In addition to being poorly targeted and costly, these caps also result in bizarre and unfair differences in the tax bills paid by neighbors with similarly valued homes. Since a home's taxable assessed value is reset upon changing ownership to reflect its actual value, residents who have recently moved into a home are required to pay significantly more in property taxes than their long-term neighbors who have seen increases in their home's taxable value capped for many years. This same phenomenon has also resulted in some homeowners feeling trapped in their current homes, due to the fact that they would have to pay much higher taxes if they were to change residences. Florida recently sought to address this issue by allowing homeowners to essentially carry over their tax cap savings to a new residence upon moving. While some long-term homeowners have been helped by this change, it has also been an enormously costly change that has made Florida's property system much more complicated, and has done nothing to help first-time homebuyers.

- **Caps on increases in overall revenue collected:** The most restrictive type of property tax caps prevent localities from increasing overall property tax collections beyond a certain annual amount. In Massachusetts, for example, municipalities are prohibited (absent specific approval from voters) from collecting more than 2.5 percent in additional property tax revenue beyond what they collected in the previous year. As is oftentimes the case with caps, there are some exceptions. Towns, for example, are allowed to tax new growth within their borders, which does provide a significant amount of revenue. Nonetheless, since the cost of providing a stable level of local government services has traditionally risen at more than 2.5 percent per year, this cap has

noticeably diminished the quality of public services in many localities. New Jersey recently chose to follow Massachusetts' lead with a similar 2 percent cap on revenue increases.

Property Tax Reform: Issues and Options

Property taxes are the most venerable revenue source for state and local governments—but there is some concern that these taxes are unsuitable for the needs of the modern state. This section looks at two such areas of concern: the impact of regional inequities in property wealth on the quality of public education in poor districts, and the quality of property tax assessment.

Property Taxes and Education Financing

The primary purpose of local property taxes is to fund schools. But property wealth is usually distributed unequally between taxing districts. As a result, property-poor districts are not able to fund education as easily as property-wealthy districts. For example, in 2000 the Lake View school district in Arkansas raised only \$827 per student in local revenue—just over a quarter of the \$3,200 per student raised by the much wealthier Little Rock school district in that year. Left to their own devices, low-wealth districts typically have to tax homeowners at a much higher rate—and still don't raise as much revenue per-pupil as a wealthier district can. This sort of inequity between poor and wealthy districts has been the basis for a series of court cases challenging the constitutionality of school funding systems in various states.

Even property-wealthy districts can find it difficult to raise enough money to fund schools adequately using property taxes. As a result, almost every state has enacted a program of state aid to local school districts, designed to provide a guaranteed minimum amount of education spending per pupil while minimizing the gaps in spending between poor and wealthy districts.

What can go wrong with a school funding system that works in this way? First, the baseline amount of spending per pupil may be well short of the amount required to achieve an adequate education—that is, states can achieve equity without achieving adequacy. Second, property-wealthy districts can usually raise more than this state-sponsored amount per pupil without relying on state help—which means that the amount spent on education will differ between poor and wealthy districts, even after taking account of state aid. Some argue that as long as these differences between poor and wealthy districts remain, equity will not have been achieved.

One tax reform option for the growing number of states that are now confronting court mandates to fund schools adequately

and equitably is to preserve the role of property taxes in funding schools by replacing some of their current local property taxes with a statewide property tax levied at a uniform rate. The statewide property tax requires the same level of effort from all taxing districts in a state, and reallocates some of the resulting tax revenue between wealthy and poor districts in a way that, if done properly, can equalize the revenue-raising ability of all districts.

Assessment Practices

The most important step in the property tax process is assessing the value of a property. After all, under the property tax, home value is the basis for measuring a homeowner's ability to pay—so the property tax will only be as fair as the assessment process. Unfortunately, many jurisdictions don't assess property fairly. Some states don't require regular reassessment of property. In other states, there can be significant variation in assessed values between properties that are actually very similar. When assessment practices are poor, two families with identical homes and the same income level could face different property tax bills. This undermines people's faith in the fairness of the tax system and erodes public support for the taxes needed to pay for government services.

Local assessors routinely assess properties at less than what the law prescribes. For example, a typical state might require that residential properties be assessed at 100 percent of their market value, but assessors might actually assess these properties at an average of 90 percent of their market value. From a tax collector's point of view, this approach has two virtues. First, it gives taxpayers the illusion that government is giving them a good deal by taxing only part of their home values. This is an illusion because the underassessment, by necessity, is offset by a higher property tax rate. Second, underassessment reduces the likelihood of legal challenges to assessments. Unless homeowners compare their assessments with those of other homeowners, even large and unfair discrepancies will not be detected.

When property is under-assessed not because of poor-quality assessments but because of legal rules requiring low assessment ratios, fairness can be undermined as well. If


assessments are at full value, inaccurate assessments stand out. But if property is legally assessed at (for example) 20 percent of its true value, it becomes much harder to detect variations in assessment quality because the assessed value is hard to compare to a homeowner's sense of the home's true value. Thus, underassessment makes unfair or corrupt assessment practices more difficult to detect.

Poor or infrequent assessment can also make it difficult for lawmakers to equalize differences between poor and wealthy districts' ability to fund schools. Most state school-aid programs are based on the property wealth of each district—and poor-quality assessments make it hard to know which districts are truly poor and which are simply under-reporting their assessed value. For this reason, reform of local property assessment practices must usually be done before school finance reform can be accomplished at the state level.

Finally, infrequent assessments make it difficult for taxpayers to plan for their financial future, since large changes in a home's property tax bill can occur when a property is finally reassessed after many years. This can also lead to "sticker shock"—which erodes support for the property tax—as well as to an increase in time-consuming legal challenges to assessments, regardless of whether or not those challenges are justified.

Important steps lawmakers can take to ensure accuracy and transparency in the property assessment process include hiring and training professional assessors, making assessed valuation information publicly available, assessing property at its full market value so taxpayers can understand how they are being taxed, and frequently reassessing all properties.⁵

Conclusion

Property taxes are generally regressive, and relying on local property taxes to fund education can create unfair disparities between poor and wealthy districts. But despite these shortcomings, the property tax is truly indispensable in financing essential local services. Progressive tax reform can help make the tax a more sustainable—and less unfair—revenue source for the twenty-first century. 

¹ "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States." Institute on Taxation and Economic Policy, November 2009. <http://www.itepnet.org/whopays3.pdf>

² "Hospitable Taxes: How Non-profit Hospitals Profit from Wisconsin's Outdated Tax System." Institute for Wisconsin's Future, May 2008. http://www.wisconsinfuture.org/publications_pdfs/tax/hospital_taxes_5_08.pdf

³ Sales taxes have also been deductible since 2004, though this deduction is only temporary through tax year 2011. See page 9 for more on the deductibility of sales taxes.

⁴ This was originally true of the D.C. split roll system. Until fairly recently, homeowners paid a tax rate of 0.96 percent and rental properties paid 1.54 percent. But tax changes enacted in 1999 reduced the property tax rate on residential rental real estate to equal the homeowner rate.

⁵ States and localities that lack the resources to frequently reassess all properties can, as a second-best solution, also consider adjusting assessments on an annual basis to reflect changes in the assessed values of a sampling of nearby properties.

CHAPTER FIVE

PERSONAL INCOME TAXES

The personal income tax can be—and usually is—the fairest of the main revenue sources relied on by state and local governments. When properly structured, it ensures that wealthier taxpayers pay their fair share, provides lower tax rates on middle-income families, completely exempts the poor and allows “refundable” low-income tax credits that can be used to offset the sales, excise and property taxes that fall most heavily on low-income families. In this way, the income tax can provide an important counterbalance to these other regressive taxes.

But in many states, the income tax fails to live up to its potential. Some states have flat-rate taxes, which apply the same tax rate to the wealthiest CEO as it does to middle-class workers. Other states tax the income of families living in poverty. Many states allow expensive tax breaks that favor wealthier taxpayers. And, of course, some states don’t currently levy an income tax at all. This chapter explains the basic workings of the income tax and discusses important issues that should be addressed in order to ensure the continued fairness and sustainability of this tax.

How Personal Income Taxes Work

In most states, the income tax base—that is, the types of income that are subject to the tax—looks a lot like the federal income tax base. There’s a straightforward reason for this: because the income tax is the one major tax levied both by the states and by the federal government, it provides a unique opportunity for states to reduce the cost of tax compliance, both for taxpayers and tax administrators, by “piggybacking” on the income definitions used in federal law.

In practice, this means that income taxpayers can calculate their federal taxes first, and then simply copy their total income from the federal tax forms to their state form. Most states link to federal **adjusted gross income** (AGI), which is income before exemptions and deductions, and then allow their own special exemptions and deductions. A few states link instead to federal **taxable income**, which means that these states adopt the generous federal exemptions and deductions, and then apply

their own tax rates. A few states do not link to the federal tax base at all.

Which Income Is Taxed—and Which Is Exempt?

The federal income tax and most state income taxes apply to most, but not all, types of money income.¹ But different types of income are, in some systems, taxed differently:

- The **wages and salaries** that form the bulk of income for most middle-income families are almost always fully taxed. However, all states follow the federal practice of excluding the “fringe benefits” that are a growing share of workers’ pay packages. For example, the value of employer-paid health insurance is usually tax-exempt. This is problematic because two workers with the same total pay can have different income tax bills depending on whether their pay all takes the form of salary (in which case it will all be taxed) or it includes substantial fringe benefits (in which case much of it will not be taxed).
- **Interest** from bank accounts and bonds is generally taxed. A few states, however, exempt some interest from tax, usually for senior citizens only. Interest from government bonds usually gets preferential treatment: interest from federal treasury bonds is exempt from state taxation, and interest from state and municipal bonds is exempt from the federal tax. States usually exempt interest on their own bonds, while taxing other states’ bonds.

- Some **business income** is reported on individual tax forms. In particular, businesses that are unincorporated include their taxable profit (or loss) in personal income. (Incorporated businesses are taxed under the corporate income tax.) For example, if a self-employed craftsman, known as a “sole proprietor,” makes and sells furniture, she reports her gross proceeds from selling the furniture minus any deductible expenses such as the cost of wood, tools and advertising. (Farm profits are reported in the same way.) If a craftsman worked jointly with another craftsman in a multi-member unincorporated business called a “partnership,” each member would report her share of taxable partnership profit. In each case, when these businesses report losses rather than profits, most or all of the loss is allowed to offset other positive income sources on income tax forms.
- **Rental income** from real estate is also part of the personal income tax base. As with other business income, gross rents are allowed to be reduced by various expenses. One “expense” that is commonly used to reduce taxable rental income is “depreciation.” For tax purposes, rental real estate is assumed to gradually lose its value, or depreciate, over time. (Of course, this is usually a fiction—rental real estate typically becomes more valuable over time.) For some real estate professionals (broadly defined), depreciation expenses can be used to reduce not just rental income, but other income as well. But for most people, depreciation can only reduce taxable rental income.
- **Capital gains** are profits from the sale of assets such as stocks, bonds and real estate. Income tax on a capital gain is paid only when the asset is sold. Thus, a stockholder who owns a stock over many years doesn’t pay any tax as it increases in value each year. He or she pays tax only when the stock is sold. At that time, the capital gain is calculated by taking the difference between the original buying price and the selling price. Special rules apply to homes that were a family’s primary residence for at least two of the last five years, for which the first \$250,000 of home value gains are exempt from tax (\$500,000 for a married couple). In addition, a valuable capital gains tax break called “stepped-up basis” means that people who inherit property don’t have to pay any tax on capital gains that accrued during the original owner’s life.² The federal government now taxes capital gains at a far lower rate than wages. A few states also provide capital-gains tax breaks. State capital-gains tax breaks are discussed on page 41.
- Dividends are the part of a corporation’s earnings that are distributed to its shareholders. Most dividend income **flows to upper-income** families: in 2009, the poorest 60 percent of Americans enjoyed about 10 percent of all dividend income, and the best-off 1 percent received more than a third of all dividend income. Notwithstanding this, about half a dozen states misguidedly allow taxpayers (usually senior citizens) to exclude some of their dividend income from tax.
- Transfer payments from governments to individuals are subject to a variety of different rules. Payments from the Temporary Assistance to Needy Families (TANF) program are fully exempt; unemployment compensation is generally fully taxed, and the federal income tax taxes a fraction of Social Security benefits above certain income levels. States always follow the federal lead on TANF benefits, but most states have chosen to not follow the federal rule on Social Security benefits and instead completely exempt these benefits.
- Pension income is generally taxable at the federal level, with an offset for already-taxed employee contributions to pension plans. But many states depart from the federal rule by excluding all or some pension income from taxation. All too often, these tax breaks are given even to the best-off taxpayers, but some states provide targeted pension tax relief that is available only to lower-income taxpayers.

“Adjustments” and Adjusted Gross Income

Once all of a taxpayer’s potentially-taxable income is added up, **adjustments to income** are applied. Many adjustments originate on federal tax forms—and most states following federal rules will include these adjustments, too. For example, health insurance payments by self-employed people and alimony are subtracted from total income as an adjustment on federal forms, and most states have chosen to conform to federal rules by allowing the same tax breaks. On federal forms, adjusted gross income is the income that is subject to tax after subtracting adjustments.

Of course, states always have the option of “decoupling” from these federal adjustments, and sometimes do so. For example, when Congress enacted a temporary subtraction for the first \$2,400 in unemployment benefits in 2009, lawmakers in Oklahoma and several other states decided not to conform to this tax break—so Oklahoma tax forms for 2009 require anyone who benefitted from this federal tax break to add it back to Oklahoma income.

In addition to these federal adjustments, most states diverge from the federal starting point to allow special tax breaks of their own invention. These tax breaks are the difference between the federal starting point (usually federal AGI) and a state's own adjusted gross income. These include:

- Exemptions for capital gains or dividends;
- Tax breaks for pensions or Social Security;
- Deductions for federal income taxes paid.

Computing Taxable Income

Taxable income is the amount of income that is subject to tax after subtracting all deductions and exemptions from AGI. This is the amount of your income to which the tax rates are actually applied.

In computing their taxable income, federal taxpayers have a choice of subtracting either a basic standard deduction or special "itemized" deductions—whichever is larger. Many (but not all) states give their taxpayers the same options.

Standard Deduction

Most low-income families, and many middle-income taxpayers, claim the **standard deduction**. This is a basic "no-tax floor", designed to ensure that all families should have a certain amount of income that should not be subject to tax.

On federal tax returns, the standard deduction is set at \$11,400 for couples, \$8,400 for unmarried parents and \$5,700 for single filers in 2010. (These amounts are increased every year to allow for inflation.) Twelve states allow the same standard deductions as the federal amounts; three allow larger amounts; and the rest either have smaller standard deductions or don't allow one at all.

Itemized Deductions

Itemized deductions are the collective name for a motley group of about a dozen separate tax deductions available as an alternative to the basic standard deduction. Generally, better-off families are more likely than lower-income families to have enough deductions to make itemizing worthwhile. Deductions related to homeownership are often what makes a family's itemized deductions exceed its standard deduction.

In general, the rationale for each itemized deduction is to take account of large or unusual personal expenditures that affect a taxpayer's ability to pay. Itemized deductions are also offered as a way of encouraging certain types of behavior. For example, on the federal income tax return:

- Charitable contributions are deductible to encourage charitable giving, and because people who give income to charities have less money left over with which to pay income taxes.
- Mortgage interest paid by homeowners is deductible to encourage home ownership, and because interest paid on mortgages is one of the main costs associated with owning a home.
- State and local income and property taxes are federally deductible because families that pay a lot in those taxes

How the Personal Income Tax Works

$$\begin{array}{r}
 \text{Total Income} \\
 - \\
 \text{Items Not Included in Gross Income} \\
 = \\
 \text{Gross Income} \\
 + / - \\
 \text{Adjustments} \\
 = \\
 \text{Federal Adjusted Gross Income} \\
 + / - \\
 \text{State Adjustments} \\
 = \\
 \text{State Adjusted Gross Income} \\
 - \\
 \text{Exemptions, Standard and} \\
 \text{Itemized Deductions} \\
 = \\
 \text{Taxable Income} \\
 \times \\
 \text{Tax Rates} \\
 = \\
 \text{Tax Before Credits} \\
 - \\
 \text{Tax Credits} \\
 = \\
 \text{Net Tax Liability}
 \end{array}$$

have less ability to pay federal income taxes than those who pay little. Sales and excise taxes are generally not deductible, however, because Congress found that (a) they don't affect ability to pay very much for those who itemize, (b) they are difficult for taxpayers to compute and hard for tax agencies to audit, and (c) since they are regressive, states shouldn't be encouraged to rely too heavily on them.³

- Very large medical expenses are deductible to reflect taxpayers' reduced ability to pay taxes under adverse medical circumstances. At the federal level and in most states, medical expenses that exceed 7.5 percent of a taxpayer's adjusted gross income are deductible.

Each of these tax breaks are frequently defended as an important means of offsetting large household expenses that reduce a family's ability to pay taxes. But because they are structured as deductions, they typically provide much larger tax breaks to the best-off families than to middle-income taxpayers. This is because the tax cut you get from an itemized deduction depends on your income tax rate: imagine two Kansas families, each of which has \$10,000 in mortgage interest payments that they include in their itemized deductions. If the first family is a middle-income family paying at the 15 percent federal tax rate, the most they can expect is a \$1,500 federal tax cut from this deduction (\$10,000 times 15 percent). But if the second family is much wealthier and pays at the 35 percent top rate, they could expect a tax cut of up to \$3,500.

Because state income taxes are less graduated than the federal income tax, the inequity of itemized deductions is generally less extreme at the state level. But these deductions remain an upside-down tax subsidy that is entirely unavailable to low-income families. No lawmaker would ever seriously propose a direct spending program designed to make homeownership more affordable that started by excluding low-income families entirely, while reserving the most assistance to the richest families. Yet that is precisely how the itemized deduction for mortgage interest works.

Personal Exemptions

The final step in arriving at taxable income—the tax base to which income tax rates are applied—is to subtract **personal exemptions**.

At the federal level, the personal exemption is currently \$3,650 for each taxpayer and dependent (indexed each year for inflation). Thus, in 2010 a family of four gets a total of \$14,600

in federal exemptions. State personal exemptions vary greatly, but are usually less generous than the federal amounts. Some states provide additional exemptions for the elderly, disabled or veterans.

A Graduated Rate Schedule	
Taxable Income Bracket	Marginal Rate
0-\$25,000	2%
\$25,001-\$40,000	4%
\$40,001-\$100,000	6%
Over \$100,000	8%

The theory behind exemptions is that at any income level, a taxpayer's ability to pay declines as family size increases: the more mouths to feed, the less money is left over to pay taxes. So if two families each make \$40,000 and family A has no children while family B has two, then family A has greater ability to pay. To adjust for this, family B gets two more exemptions than family A.

Some states tie their exemptions to the federal amount. Because federal exemptions grow each year with inflation, this is an administratively easy way to ensure that exemptions will not lose their value over time. The many states that fail to adjust their exemptions for inflation end up imposing a hidden tax hike on their citizens over time. For instance, when the Illinois income tax was adopted in 1969, the state's personal exemption was set at \$1,000—and was subsequently left unchanged for thirty years. 1998 legislation doubled the exemption to \$2,000—but if the exemption had been kept up with inflation since 1969, it would have been worth \$5,800 in 2009. In other words, the Illinois personal exemption is worth \$3,800 less than it originally was. As a result, Illinois taxpayers paid almost \$1.5 billion more in income taxes in 2009 than they would have if the exemptions had been adjusted to preserve their 1969 value.

Tax Rates

The single most important policy choice in determining the fairness of a state's income tax is the way its tax rates work. Most states use graduated tax rate schedules where higher tax rates are applied at higher income levels. The table at right shows an example of a graduated rate system in which the first \$25,000 of a family's taxable income is taxed at 2 percent, income from \$25,000 to \$40,000 is taxed at 4 percent, income from \$40,000 to \$100,000 is taxed at 6 percent and income over \$100,000 is taxed at 8 percent.

But not all graduated income taxes are created equal. The overall progressivity of a state's rate structure depends on two factors: the difference between the top and bottom tax rates, and the width of the tax brackets.

Truly progressive income taxes, like California's, use broad income tax brackets to ensure that relatively few taxpayers are subject to the top rate and also have a fairly wide range between the lowest and top income tax rates. Some states fall short of this approach by having relatively low top rates. For example, Arizona's top income tax bracket only applies to married couples with taxable income over \$300,000, but the top rate is just 4.54 percent. Other states use higher tax rates, but apply them to a much broader swath of the population. For example, Oregon's 9 percent marginal rate applies to married couples with taxable incomes over \$15,200.

Still other states don't use graduated rates at all, usually because the state's constitution forbids it. Seven states (Colorado, Illinois, Indiana, Massachusetts, Michigan, Pennsylvania and Utah) have flat rate systems that tax all taxable income at the same rate, with rates ranging from 3.07 percent in Pennsylvania to 5.3 percent in Massachusetts.

Graduated rates are an important step toward tax fairness because they allow states to apply higher tax rates very precisely to whichever group they view as "upper-income" taxpayers.

Understanding Marginal Tax Rates

Tax policy debates sometimes confuse the distinction between effective tax rates, which tell us what fraction of a taxpayer's income goes to income tax overall, and marginal tax rates, which tell us the tax rate that applied to the last dollar of income. Anti-income-tax advocates are only too happy to foster this confusion—which is why it's important for clear-eyed observers to understand this important distinction. What confuses some people is that they look at a tax table like the one on the preceding page, know that they earn \$45,000 per year, for example, and conclude that they must have to pay 6 percent of their income in tax. But that isn't the way it works at all.

First, the tax rate table is based on taxable income, not total income. Thus, someone making \$45,000 per year probably has taxable income under \$40,000 after deductions and exemptions are subtracted—and taxable income is what determines your tax rate. So this person is

probably only paying tax at the 4 percent rate.

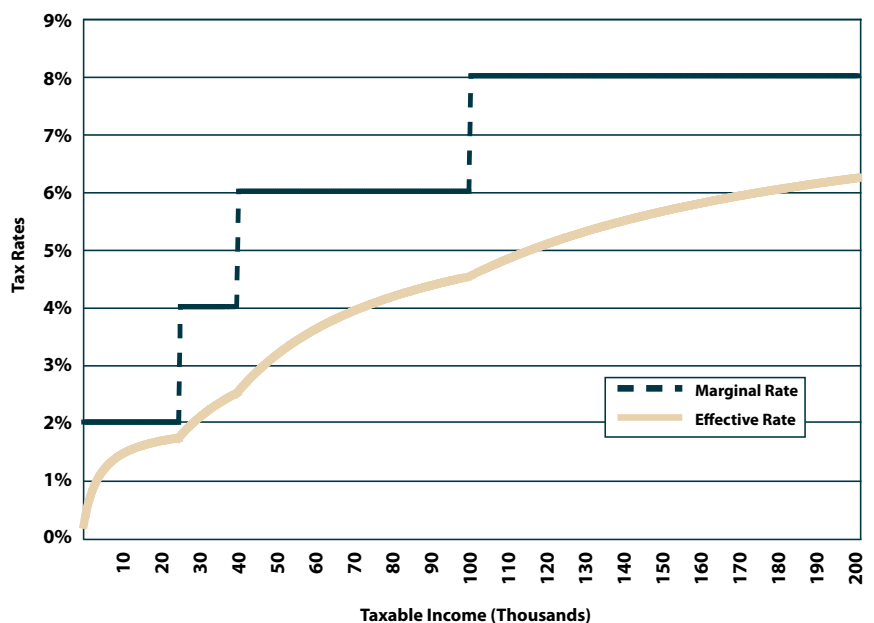
Second, because these tax rates are marginal tax rates, even if a family does have taxable income of \$45,000, only the last \$5,000 of that will be taxed at 6 percent. Marginal rates apply only to taxable income over the amount where the tax bracket starts. This means that the effective tax rate paid at any income level (that is, the percentage of your total income you pay in tax) will always be lower than the top marginal rate. The chart on this page shows how the effective tax rate on a married couple with no children compares to the marginal tax rate at each income level, assuming the state allows a \$2,000 personal exemption and no other deductions. The first \$25,000 of taxable income is taxed at 2 percent, so the effective tax rate starts at zero and gradually approaches 2 percent as taxable income approaches \$25,000.⁴ As the marginal rate increases, the effective rate increases too—but it always remains well below the top marginal rate.

Credits

After computing the amount of income tax based on the applicable tax rates, **credits** (if any) are subtracted. Credits are taken directly off the tax amount that would otherwise be owed, as opposed to deductions, which are subtracted from the amount of income that is subject to tax.

Low-income credits are commonly used at both the federal and state levels to reduce income taxes on those least able to pay. Other credits are designed to provide relief from other taxes. For example, low-income sales tax rebates and property

Marginal Versus Effective Rates: An Example



tax circuit breakers are often administered as credits against the personal income tax.

However, not all low-income tax credits are created equal. The hallmark of a truly effective low-income credit is that it is **refundable**. This means that if the amount of the credit exceeds the amount of personal income tax you would otherwise owe, you actually get money back. The best-known refundable credit is the federal earned-income tax credit (EITC), which allows low-income working families with children to get a direct payment from the government if the amount of the credit exceeds the income taxes they otherwise would owe. In 2011, 25 states (including the District of Columbia) allowed earned income tax credits modeled after the federal credit.

Refundability is a vital feature in low-income credits simply because for most fixed-income families, sales and property taxes take a much bigger bite out of their wallets than does the personal income tax. Refundable credits on income tax forms are the most cost-effective mechanism for partially offsetting the effects of these other regressive taxes on low-income families.

Local Income Taxes

In most states, local taxes are much less diverse than state taxes: local governments tend to rely mostly on property taxes to fund needed services. But more than a dozen states, seeking a fairer and more diversified revenue structure, now allow local-option income taxes. States allowing these taxes usually do it in one of two ways: by granting authority to every taxing district of a particular kind in a state, or by granting authority to specific

metropolitan areas. One example of the broader approach is Maryland, where each county government levies a “piggyback” tax that applies to the same tax base as the state income tax.

In states that already levy state income taxes, these local taxes can be administered and collected by state tax administrators on state tax forms, requiring no new paperwork.

Revenue and Stability

Advocates for a “flat tax” sometimes make the case that progressive personal income taxes are excessively volatile, growing too rapidly during good times and collapsing during economic downturns in a way that makes budgeting more difficult for state policymakers. It’s certainly true that progressive income taxes are much more responsive to economic growth than the other taxes levied by state and local governments, as California found out during the last economic boom years in the Golden State (see text box on this page).

Academic economists have shown that while income taxes are sometimes more volatile over the short run than sales taxes, that’s not always the case. And in the long run, virtually any income tax, whether flat or graduated, will outperform sales taxes in keeping pace with the cost of funding public investments. In fact, the more progressive the income tax, the more it grows. Why? Because virtually all income growth over the past decade has been concentrated in the top of the income scale. Thus, a state that has high rates on the wealthy captures this growth better than a state with low rates on the well-to-do. Progressive income taxes will usually grow faster than personal income over time. This is important because the cost of providing public services often grows faster than income as well.

Of course, in a severe recession, personal income tax collections will decline as taxpayers’ income declines. But in the long run, the personal income tax is the most reliable source of revenue to fund public services.

Federal Deductibility

A final step in the calculation of state income taxes doesn’t even appear on your state tax form: part of what people pay in state and local income taxes is offset by the deduction itemizers get in computing their federal taxable income. On average, every dollar that a state collects in income tax ends up costing its residents only about 80 cents, because about 20 percent of the cost of these state taxes is offset by federal tax cuts for itemizers. And, from the point of view of many high-income taxpayers, every dollar paid in state income tax costs only 65 cents. For a more detailed discussion of this “federal offset” effect, see page 9.

The Best of Times...

In early 2006, California newspaper headlines trumpeted “Google’s April surprise,” referring to the fact that the state’s income tax revenue had grown from \$7 billion to \$11.3 billion in just one year, in part due to Google millionaires cashing in their stock options.

The flip side of this explosive growth is that it can’t happen all the time. When investors hit hard times and choose not to cash in capital gains income, progressive income tax collections will decline. But over the business cycle, progressive income taxes simply do a better job of keeping pace with overall income growth than any other major tax levied by state governments.

Simplicity and the Personal Income Tax

Every special state tax break has to be subtracted from income—which means it takes at least one line on your state’s tax form. The main reason why state income tax forms—and instructions—are so complicated is because taxpayers must wade through these special tax breaks.

When these tax breaks discriminate between taxpayers who have a similar ability to pay, such unfair distinctions can make the tax system seem more arbitrary—and can undermine public confidence in the system. These tax breaks also make it harder to understand the overall effect of a tax system on people at different income levels.

Personal Income Tax Reform: Issues and Options

A personal income tax can be designed to be as fair as lawmakers want it to be. Almost every income tax is at least slightly progressive. A progressive personal income tax is the key to a fair overall tax system: without it, a tax system is doomed to being highly regressive. With a sufficiently progressive personal income tax, the whole tax system can be made to be at least slightly progressive even if the system includes regressive sales, excise and property taxes.

But in practice, virtually no states have achieved this. Only a handful of states require their wealthiest taxpayers to pay as much of their income in overall state and local taxes as the poorest state residents. By this measure, very few tax systems can even be described as “flat.” This section looks at the policy choices that can either enhance or limit income tax fairness.

Graduated Rate Structures

The easiest way to make an income tax adequately progressive is through graduated rates. The higher the rates are on wealthier taxpayers, the lower the rates can be on everyone else to raise the same amount of revenue. But many states fall short of this goal, for a variety of reasons:

- Seven states don’t apply graduated rate structures at all, but use a flat tax rate that applies to all taxable income. These states are Colorado, Illinois, Indiana, Massachusetts, Michigan, Pennsylvania and Utah.
- Some states use nominally graduated rate structures that don’t mean much in practice. For example, Alabama’s top income tax rate begins at just \$6,000 of taxable income. As a result, about 75 percent of Alabama families pay at the top rate. In states (like Alabama) that do not index their

income tax brackets for inflation, this problem grows worse every year.

- Other states use much wider income brackets, but apply relatively low rates. For example, Arizona’s top tax rate takes effect for married couples earning over \$300,000—but these taxpayers pay a marginal rate of just 4.54 percent. The relatively small difference between the bottom tax rate and the top tax rate makes the Arizona income tax less progressive.

Tax Breaks for Middle- and Low-Income Families

Policymakers can also make income taxes fairer without adjusting the tax rates. Large standard deductions and exemptions provide relief to all income groups, but are more significant to middle- and low-income families than to the well off. For instance, \$10,000 worth of exemptions amounts to 25 percent of income for a family earning \$40,000. But the same exemption offsets only 2 percent of income for a family making \$500,000. For this reason, providing a generous no-tax floor will generally be a more progressive move than simply reducing income tax rates “across the board.”

Targeted tax credits like the Earned Income Tax Credit are an even more effective (and less costly) way of making income taxes progressive. Because the benefits of these credits can be designed to phase out above a specified income level, these credits can be targeted to the low-income families who need them most, and the cost of the credit can be kept to a minimum. As previously noted, making these credits refundable is probably the single most effective step policymakers can take towards achieving a fairer tax system.

Capital Gains Tax Breaks

The progressive reforms outlined above can be undermined when a state allows major tax shelters for a state’s wealthiest residents. The federal income tax provides a special tax break from dividends and capital gains income, and a number of states have followed in this misguided path. Since most dividend and capital gains income goes to a small group of the very wealthiest Americans, these tax breaks mainly benefit the wealthy while offering only a pittance to middle- and low-income families.

Capital gains tax breaks have not been shown to encourage additional investment on the federal level—and this linkage is even more tenuous at the state level.⁵ A general state capital gains tax break is highly unlikely to benefit a state’s

The Impact of Indexing Income Taxes for Inflation

Many features of the personal income tax are defined by fixed dollar amounts. For instance, income taxes usually have various rates starting at different income levels. If these fixed income levels aren't adjusted periodically, taxes can go up substantially simply because of inflation. This hidden tax hike is known as "bracket creep."

Take, for example, a state that taxes the first \$20,000 of income at 2 percent and all income above \$20,000 at 4 percent. A person who makes \$19,500 will only pay tax at the 2 percent tax rate. But over time, if this person's salary grows at the rate of inflation, she will find herself paying at a higher rate—even though she's not any richer in real terms. Suppose the rate of inflation is five percent a year and the person gets salary raises that are exactly enough to keep up with inflation. After four years, that means a raise to \$23,702. Now part of this person's income will be in the higher 4 percent bracket—even though, in terms of the cost of living, her income hasn't gone up at all.

The way the federal personal income tax and some states deal with this problem is by "indexing" tax brackets for inflation. In the example above, indexing would mean that the \$20,000 cutoff for the 4 percent bracket would be automatically increased every year by the amount of inflation. If inflation is five percent, the cutoff would increase to \$21,000 after one

year. After four years (of five percent inflation), the 4 percent bracket would start at \$24,310. So, when the person in our example makes \$23,702 after four years, he or she would still be in the 2 percent tax bracket.

Inflation has just the same impact on other features of income taxes, including standard deductions, exemptions, and targeted low-income tax credits. Unless these progressive tax breaks are indexed, they will gradually become less valuable over time—imposing a hidden tax hike on the low- and middle-income taxpayers for whom they are most valuable.

Of course, the flip side of indexing income taxes is that it reduces the growth of income tax revenues. Lawmakers discussing indexation should be aware that the fairness gains from indexing income taxes do come at a cost.

"Hidden Tax Hikes": An Example		
	Year 1	Year 5
Actual Income	\$19,500	\$23,702
Taxed at 2%	\$19,500	\$20,000
Taxed at 4%	\$0	\$3,702
Inflation-Adjusted Income	\$19,500	\$19,500

economy, since any investment encouraged by the capital gains break could take place anywhere in the United States or the world.

In addition, a substantial part of any state capital gains tax break will never find its way to the pockets of state residents. Because state income taxes can be written off on federal tax forms by those taxpayers who itemize their federal income taxes, as much as 35 percent of any reduction in state capital gains taxes will be directly offset by an increase in federal income tax liability.

And capital gains tax cut promoters ignore the significant advantages capital gains already receive. First of all, the federal income tax applies a special lower top tax rate on capital gains than it applies to other income (15 percent versus 35 percent—so the top rate on capital gains is less than half the top rate on wages). Second, income tax is only paid on capital gains when the asset is sold. This is the equivalent of only paying tax on interest earned in a bank account when it is withdrawn. And,

of course, not a dime of income tax is ever paid on capital gains that are inherited. Thus, a significant amount of capital gains (the amount held at the time of death) are never taxed at all.

Tax Breaks for Senior Citizens

Virtually every state's income tax allows some form of special tax break for senior citizens. The most sensible approach to doing so, followed by more than thirty states, is allowing a larger personal exemption or standard deduction to seniors. For example, some states follow the federal government's example and add \$1,250 to a married couple's standard deduction if one or both spouse is over 65.

But many states have taken a less sensible, and less inclusive, approach to exempting senior citizens' income, allowing tax breaks only for specific types of senior income. For example, New York's income tax now exempts the first \$20,000 of private pension benefits from tax. This type of exemption creates two glaring tax fairness problems: first, it provides a tax

of the wealthiest executive receive the same treatment as the benefits of the lowest-paid worker. Second, it provides special treatment for non-working taxpayers, with no comparable break for the earned income of otherwise identical seniors. Over-65 workers whose earnings are based on salaries rather than pensions are completely excluded from this generous tax break. Since elderly taxpayers who work tend to be poor, this tax preference for non-wage income is hard to justify.

Limiting senior tax breaks to low- and middle-income retirees—or replacing the pension tax break with a more general elderly exemption that applies to both earned income and unearned income—are two approaches to tax reform that would improve the perceived fairness of state income taxes.

Itemized Deductions

Thirty one states and the District of Columbia allow itemized deductions patterned after federal rules which are costly, “upside-down” subsidies for the best-off taxpayers, offering little or no benefit for many low- and middle-income families. Most states have taken steps to make their itemized deductions somewhat less unfair by limiting the ability of upper-income taxpayers to claim them. This has typically been done by piggybacking on a federal law that phased out up to 80 percent of the benefit of certain itemized deductions for individuals with incomes above \$166,000 (in 2009). But as of 2010, the Bush tax cuts repealed this phaseout—so itemized deductions are now more of an “upside-down” tax subsidy that at any time in the past decade. Unless this federal law is reintroduced for 2011, most states’ laws will have no mechanism for making itemized deductions less unfair.

A few states have reduced the unfairness of itemized deductions in their own ways, either by capping the allowable deduction, phasing out deductions for the best-off taxpayers or by changing them to a tax credit. For example, Vermont caps the itemized deduction for real property taxes at \$10,000 and New York has an additional phaseout above and beyond


the federal rules which begins for taxpayers with AGI greater than \$475,000. Wisconsin allows taxpayers to claim a credit for 5 percent of their federal itemized deductions. This is a straightforward way of ensuring that the value of the credit is the same for middle-income families as for upper-income taxpayers—and can go a long way towards reducing the cost of these tax breaks.

The most comprehensive reform approach available to states is simply to repeal all itemized deductions and ensure that most middle- and low-income families are held harmless by simultaneously increasing the basic standard deduction available to all families, a step taken by Rhode Island in 2010.⁶

Deduction of Federal Income Taxes from State Taxable Income

Another pitfall for state income taxes is the deduction for federal income taxes paid.⁷ Since the federal personal income tax is progressive, this deduction significantly reduces the state income taxes paid by the wealthy in the seven states that allow it. In fact, for people in the top federal bracket, the state deduction for federal income taxes effectively lowers a state’s top marginal tax rate by about a third. For low- and middle-income taxpayers, on the other hand, this tax break offers little or no relief.

Conclusion

State governments rely on three main sources of revenue—income, sales and property taxes. Of these, only the income tax is progressive. For this reason, an effective income tax, with graduated rates and a minimum of regressive tax loopholes, is the cornerstone of any fair state tax system. But many states have undermined the effectiveness of their income taxes in a variety of ways described in this chapter. The result, as noted in Chapter One, is that even the most progressive income taxes are usually insufficient to offset the unfairness of sales and property taxes. But a progressive income tax makes the difference between extreme and mild tax unfairness at the state level. 

¹ New Hampshire and Tennessee tax only interest and dividend income, and local governments in half a dozen states have income taxes that apply only to wages.

² Here’s how it works: if Sally Jones buys stock in 2000 worth \$1,000, then dies in 2011 with it having a value of \$10,000, no income tax is ever paid on the \$9,000 of gain from 2000 to 2010. If her heirs sell the stock in 2014 for \$12,000, the heirs pay tax on only the \$2,000 gain from 2011 (the date of inheritance) to 2014.

³ Federal legislation enacted in 2004 allows an optional, temporary deduction for sales taxes paid, but taxpayers claiming the deduction cannot write off their state and local income taxes—which means that this temporary deduction will generally only be useful—very modestly—for residents of non-income tax states.

⁴ Even when taxable income is exactly \$25,000, however, the effective tax rate remains less than 2 percent in this example. This is because the \$2,000-per-person exemption means that this family’s total income is \$29,000, not \$25,000. Not all of the family’s income is subject to the 2 percent tax.

⁵ For more information see “A Capital Idea.” Institute on Taxation and Economic Policy, August 2010. <http://www.itepnet.org/pdf/capitalidea0111.pdf>

⁶ To find out more about options for making state itemized deductions less unfair, see “Writing Off Tax Giveaways: How States Can Help Balance Their Budgets by Reforming or Repealing Itemized Deductions.” Institute on Taxation and Economic Policy, August 2010. <http://www.itepnet.org/pdf/itemize0810.pdf>

⁷ For more information see “Topsy-Turvy: State Income Tax Deductions for Federal Income Taxes Turn Tax Fairness on its Head.” Institute on Taxation and Economic Policy, March 2011. http://www.itepnet.org/pdf/topsyturvy_0311.pdf

CHAPTER SIX

CORPORATE INCOME TAXES

A robust corporate income tax is an important tax fairness tool. It ensures that the large and profitable corporations that benefit from public services pay their fair share towards the maintenance of those services, just as working people do. The corporate tax is also one of the few progressive taxes available to state policymakers.

More than forty states currently levy a corporate income tax, but a variety of forces have combined to weaken the tax over the past quarter century. This decline is troubling for at least two reasons. First, rather than arising solely from the conscious design of elected officials, it appears to be at least partially the result of tax avoidance strategies by multi-state corporations. Second, the less that profitable corporations pay in taxes, the more working people must pay to shore up their states' tax systems.

This chapter discusses the rationale for taxing corporations; explains the basic workings of the corporate tax; details the downward trend in the tax over the last thirty years; explores some of the factors that have contributed to that decline; and reviews some of the reforms—at both the federal and the state level—necessary for revitalizing this important revenue source.

Why Tax Corporations?

Corporations are legally considered “persons,” eligible for many of the same rights and protections as ordinary men and women. Corporations are also granted certain privileges—such as limited liability and perpetual life—that everyday people do not enjoy. And just as working families and individuals benefit from the services that state and local governments provide, so too do corporations. Corporations rely on a state's education system to provide a trained workforce, use a state's transportation system to move their

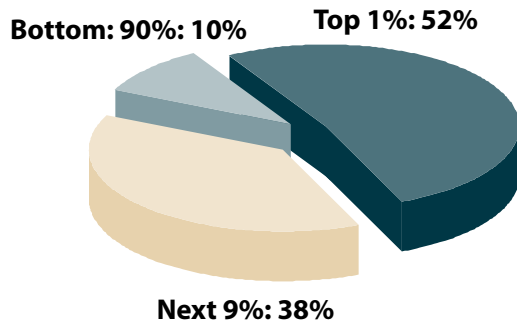
products from one place to another, and depend on the state's court system and police to protect their property and business transactions. Consequently, corporations should contribute to funding these services just as working people do. While corporations—like individuals—may pay taxes on the purchases they make or on the property they own, they should also pay taxes on the profits they realize, much in the way that people earning a living in the state pay taxes on their income.

Just as working families and individuals benefit from the services that state and local governments provide, so too do corporations.

Of course, while a corporation may be treated as a single legal person, it exists in reality as a collection of individuals—the shareholders that own it; the executives and staff that work for it; and the consumers that buy its products. As a result, any tax levied on a corporation ultimately falls on one of these groups. Economic research generally indicates that for the most part, it tends to be borne by corporate shareholders.

From a fairness perspective, the corporate tax has three important attributes:

Corporate Stock Ownership, 2007



Source: Kennickell, Arthur B. "Ponds and Streams: Wealth and Income in the US 1989-2007."

- **The corporate income tax is one of the most progressive taxes a state can levy.** Since stock ownership is concentrated among the very wealthiest taxpayers, the corporate income tax falls primarily on the most affluent residents of a state. As the chart on this page shows, the wealthiest one percent of Americans held just over half of all corporate stock in 2007, while the poorest ninety percent of Americans owned just 10 percent of the total.
- **The corporate income tax is, in part, exported to other states.** Because most multi-state corporations have shareholders around the country and around the world, the bulk of a state's corporate income tax will ultimately fall on residents of other states and countries. The ability to export some portion of the corporate income tax may hold great appeal for state policymakers, since it may be their only option for taxing those out-of-state shareholders who benefit indirectly from the services provided to in-state corporations.
- **The corporate income tax serves as an essential backstop to the personal income tax.** Without the corporate tax, much of the income of wealthier Americans would go entirely untaxed, as individuals could easily shelter their personal income by putting it in a corporate form.

How Corporate Income Taxes Work

In its simplest form, the corporate income tax is a tax on corporate profits—that is, receipts minus expenses. Like the personal income tax, the corporate tax is based on the "ability to pay" principle: just as someone who does not have any income in a given year usually does not owe any personal income tax, a corporation that does not realize a profit in any one year generally does not owe any corporate income tax that year.

Here's an overview of how the state corporate income tax is calculated:

- **Determining who can be taxed.** A given company must determine whether it has nexus in a given state—that is, the company must determine whether it engages in a sufficient level of activity in the state to be subject to tax. The amount of in-state activity in which a company must engage before achieving nexus with a state for corporate income tax purposes is defined by a little-known federal law known as Public Law 86-272, which says that a state cannot apply its corporate income tax to companies whose only connection to the state is the solicitation of orders from, or the shipment of goods to, the residents of the state. In recent years, an increasing number of states have determined that physical presence is not necessary to establish substantial nexus. They have successfully argued in court that out of state businesses selling services to state residents (such as banking or accounting) should be subject to the corporate income tax because they have an "economic presence" in the state and are benefitting from state provided public services to conduct their business activities. As will be discussed later in this chapter, companies are well aware of nexus requirements and may structure their operations so that they avoid "crossing the nexus threshold"—and, by extension, the corporate income tax—in some of the states in which they do business.
- **Measuring profits.** Potentially taxable companies must calculate the net income, or profit, that it earned over the course of the year. To do this, most states "piggyback" on the federal corporate income tax, using the federal definition of taxable income as a starting point. While this dependence on federal tax law leaves states vulnerable to potential revenue losses in the event the law changes—as has been the case with accelerated depreciation rules or the deduction for "qualified production activities income" (QPAI) enacted in recent years—it makes tax administration easier both for states and for taxpayers.
- **Splitting income into "business" and "non-business" components.** The next step is to divide a company's taxable income into a "business income" component and a "non-business income" component. Business income is typically considered to be the profits a company earns from its day-to-day business operations (and therefore must be distributed among the states in which it operates). Non-business income arises from certain irregular

transactions such as the sale of an asset no longer used in day to day operations and is allocated in full to the state in which such a sale occurs or to the state in which the part of the company generating such income is situated (usually the state in which a company is headquartered).

- **Apportionment, or determining each state's share of corporate "business" income.** For obvious reasons, a given state is not allowed to simply tax all of the profits of any company that has nexus in the state. If states could do this, the profits of companies that operate in multiple states might be taxed many times over.

Instead, states are required to levy their corporate income taxes in such a way that the whole of a company's profits are subject to tax just once.¹

States conform with this requirement by dividing their business income into an "in-state" portion (which is taxable in a given state) and an "out-of-state" portion (which is not). Each state uses what is known as an apportionment formula to accomplish this step.

In the 1950s, legal reformers worked to set up a fair, uniform way of distributing profits among states, so that the profits of companies operating in multiple states were taxed exactly once. The result was a model piece of legislation—the Uniform Division of Income for Tax Purposes Act or UDITPA—that is today part of about twenty states' tax codes. UDITPA recommends relying on three factors to determine the share of a company's profits that can be taxed by a state. These factors are:

- The percentage of a corporation's nationwide **property** that is located in a state.
- The percentage of a corporation's nationwide **sales** made to residents of a state.
- The percentage of a corporation's nationwide **payroll** paid to residents of a state.

The main rationale for using these three factors is that it is impossible to determine with any accuracy the specific parts of a company that generate a given dollar of profit, let alone the states in which those parts may be located. These three factors are viewed as reasonable approximations of the share of a company's profit that arises from doing business in a state, based on both the demand for company output in the state (the sales factor) and the production activity in which it engages in that state (the property and payroll factors), since profits are a function of both demand and supply.

UDITPA's recommendation was to assign each of these three factors an equal weight in distributing a company's business income among the states in which it operates. In other words, the percentage of a company's business income that can be considered "in-state" is the average of these three percentages. If one supposes that the Acme Corporation operates in three states—each of which uses an equally-weighted three factor apportionment formula, as UDITPA recommends—40 percent of its business income will be apportioned to State A, 25 percent to State B, and 35 percent to State C. In each case, these percentages are the averages of Acme's sales, property, and payroll factors in each state. For instance, Acme has 50 percent of its total sales, 20 percent of its property, and 50 percent of its payroll in State A. The average of these factors is 40 percent; accordingly, 40 percent of Acme's business income will be apportioned to State A.

- **Calculating tax:** Having determined the share of its total taxable income that is attributable to a given state (including the amount of business income that can be apportioned to the state and the amount of non-business income that is allocated to the state), the resulting sum is multiplied by the state's corporate tax rates to yield a tax amount.
- **Subtracting credits.** Many states now allow targeted tax credits (for example, credits for research or investment activities) that companies can subtract directly from their pre-credit liability.
- **Pay the Minimum.** Most states now require that even technically unprofitable corporations must pay some minimal amount of income tax. As is discussed at greater length later in this chapter, states' minimum taxes vary from very modest flat dollar amounts to more substantial sums based on a company's net worth.

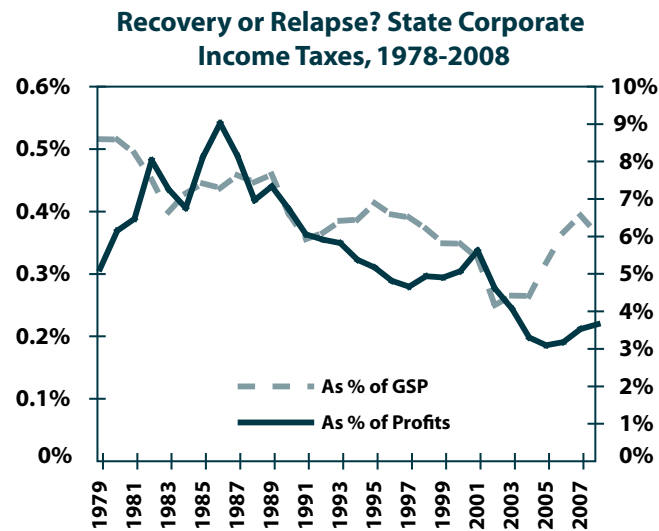
Federal Deductibility

In considering how corporate income taxes are determined, it is worth noting one final similarity between personal and corporate state income taxes – both are deductible in determining federal income tax liability. Thus, since the federal corporate income tax rate is 35 percent, as much as 35 percent of a state's corporate income tax ultimately will be paid, not by the businesses operating in that state, but by the federal government in the form of reduced federal corporate income tax collections. This interaction also means that any state corporate income tax increase is subsidized by the federal

government—and that part of any state corporate income tax cut will never be received by in-state businesses, but will flow instead into the federal treasury. For a more detailed discussion of this “federal offset” effect, see page 9.

Revenue and Stability

Few state tax trends are as striking as the rapid decline of state corporate income tax revenues. As recently as 1986, state corporate income taxes equaled almost 9 percent of nationwide corporate profits, and 0.5 percent of nationwide Gross State Product (a measure of nationwide economic activity). But by each of these measures, the state corporate tax has declined noticeably in the past two decades.



Source: US Census Bureau, Bureau of Economic Analysis

- As a share of nationwide GSP, state corporate taxes reached a low of 0.25 percent of GSP in 2002 before rebounding in the past several years.
- The post-2002 rebound in taxes as a share of the economy conceals a more worrisome trend: nationwide taxes as a share of corporate profits have remained at historical low levels since 2002. Measured this way, state corporate taxes were just over a third of their 1986 level in fiscal year 2008.

Some of the fluctuation in the corporate tax is due to legitimate year-to-year fluctuations in the tax base: the corporate income tax is affected by the state of the economy because the tax is based on corporate profits, which usually fall significantly during economic downturns. State corporate income taxes are also facing downward pressure because they are linked to the federal tax code: the proliferation of tax loopholes at the federal level is being passed through, in many cases, to state governments. Another reason for declining

corporate income tax revenues is that many companies have become better at taking advantage of loopholes that Congress (and state legislatures) never intended to create.

Corporate Income Tax Reform: Issues and Options

The decline of the state corporate income tax has been so dramatic in recent years that a few anti-tax advocates have suggested repealing the tax entirely, arguing that the limited yield of the corporate tax makes it not worth the trouble of collecting. A robust corporate income tax can—and should—be part of each state’s tax system. State policymakers only need understand the sources of this problem and the solutions that are available to them. Indeed, a number of easily administrable, economically sound reforms could help to revitalize this important revenue source.

An Eroding Federal Tax Base

One of the factors that has contributed to the decline of state corporate income taxes is the erosion of the federal corporate income tax. As noted earlier in this chapter, for many companies, the starting point in determining their state corporate income tax liabilities is the income they report for federal tax purposes. Consequently, changes in law that shrink the size of the federal corporate income tax base, in many instances, result in smaller state bases as well. Similarly, both federal corporate income taxes, relative to gross domestic product, and state corporate income taxes, relative to gross state product, have both grown over the last several years, principally because corporate profits have come to comprise a larger share of the economy. Again, whatever affects the federal base—whether due to policy or from fundamental changes in the economy—affects the state base as well.

Two changes in federal tax law are illustrative. In 2002, Congress and the Bush Administration enacted a federal corporate tax break known as “bonus depreciation” that enabled companies to write off capital investments much more rapidly than they had been able to do previously. At the time the change was made, it was expected to lead to a federal revenue loss of \$97 billion; since that break affected federal taxable income, it was also expected to suppress state corporate income tax revenue by as much as \$14 billion².

In 2004, Congress and the President extended another giveaway to profitable multinational corporations. Known as the “qualified production activities income” (QPAI) deduction, this tax cut was originally envisioned as a means to

Tax Credits and the Incentive Illusion

Many states give businesses numerous tax credits that significantly reduce (or even eliminate) their tax liability. These include credits supposedly intended to create jobs or encourage investment. Unfortunately, these credits usually just reward businesses for doing things they would have done anyway—or, even worse, make a state's economy more inefficient by shifting investment into areas that do not make the most economic sense.

compensate manufacturers for the loss of an export subsidy that violated World Trade Organization rules, but grew well beyond that purpose on its way to enactment. At the time that it became law, this new deduction was projected to reduce federal tax revenue by \$77 billion over 10 years. States were also expected to sustain significant revenue losses from the change.

States are not powerless in the face of such changes, however. They do not have to stand idly by and accept such unwelcome inheritances from the federal government. They can—and have—selectively severed the connections between the federal tax code and their own tax laws that convey such tax cuts from one level of government. This process, known as “decoupling,” allows states to preserve most of the administrative ease of linking to federal rules while also preserving their revenue stream. Indeed, at least twenty states have decoupled from the “bonus depreciation” tax break, while just under half have chosen to decouple from the QPAI deduction.

Manipulating Apportionment Rules in the Name of Economic Development?

In determining what portion of a multistate company's profit is taxable in a given state, most states use the three-factor, payroll-property-sales apportionment formula method described on page 46. In recent years, however, many states have deviated from this basic three-factor approach by increasing the importance of the “sales factor.” For example, Florida allows companies to count the sales factor twice. (In the example on page 46, this means that instead of taxing 70 percent of a company's business income (the average of

90, 30 and 90), Florida can only tax 60 percent of that income (the average of 90, 30, 30 and 90). This “double weighting” approach reduces the tax paid by corporations that sell most of their products in other states—for example, manufacturing corporations. Nine states still use the unweighted UDITPA formula.

Many states have gone even further, increasing the weight of the sales factor to one hundred percent—eliminating the payroll and property factors entirely. This is known as the “single sales factor,” or SSF. Under SSF, the sole determinant of a corporation's state tax is how much of its sales are made to in-state customers. Advocates of increasing the sales factor claim that it encourages exporting businesses to locate in a state, since it favors companies with greater payroll and assets in a state than sales. But claims that an increased sales factor attracts corporate investment are dubious. Indeed, in some cases, it might actually discourage investment in a state.

If a company, for instance, only ships products into a state, it may not have nexus with the state. But in a state with an increased sales factor, if such a company makes even a small investment in a state, it will immediately have much of its income apportioned to the state because the sales factor counts so heavily. And a company with only a small amount of

Claims that the single sales factor attracts corporate investment are dubious. Indeed, in some cases, this tax break can actually discourage investment in a state.

property or payroll in a sales factor state can reduce its in-state corporate taxes to zero by moving this property and payroll out of the state. Thus, increasing the sales factor can actually have exactly the opposite effect of what its proponents intend: discouraging in-state investment.

In addition, increasing the sales factor discriminates between companies in a way that is hard to defend. Increasing the sales factor will reduce taxes for some companies, but will increase taxes for others. For each corporation that benefits from SSF because most of its sales take place in other states, there are also corporations that will be punished by SSF rules because their sales are mostly in-state. Smaller corporations that tend to make most or all of their sales within the state in which they are located generally get little if any tax savings

under the SSF approach. In short, adoption of the single sales factor ultimately benefits some corporations while punishing others in an arbitrary way.

These arbitrary distinctions reduce the confidence of the public—and of corporations—in the fairness of state tax administration. When profitable companies benefit from a state's services—as the manufacturing companies that typically benefit from the single sales factor clearly do—they should pay their fair share of the corporate tax. When these corporations are allowed to reduce or eliminate their tax liability, that lost revenue must be made up by other competing companies—and by individual taxpayers.

Separate Accounting & Transfer Pricing

A further inconsistency in state corporate taxes stems from the fact that some states permit companies to determine their in-state taxable income using separate accounting for each of their related subsidiaries. Separate accounting is a bookkeeping procedure that determines each company's taxable income by having companies keep separate accounts for their in-state and out-of-state business segments. Every transaction between the legally distinct subsidiaries of a company is supposed to have a transfer price (that is, the "sales price" at which these companies are essentially selling products to themselves) attached to it, which is supposed to be carefully scrutinized by auditors.

Not surprisingly, separate accounting is subject to abuse by large, multistate companies. In fact, it's an open highway for corporate tax avoidance. A large multistate company can use separate accounting to shift taxable profits to low-tax jurisdictions. Here's how it works:

Consider a multistate company that has two subsidiaries, one in State A that permits separate accounting and one in State B, which has no corporate income tax. To reduce its taxable profits, the subsidiary in State A might say that it "pays" high transfer prices for the items it "buys" from the State B subsidiary. This shifts income out of State A (where it would be taxed) and into State B (where it's not).

For example, a furniture company might machine the metal parts for its furniture (handles, knobs, etc.) in State B, but assemble the furniture in State A. The company will, on paper, charge very high prices to its State A subsidiary for the metal parts. This makes the State B subsidiary look like it has very high profits (which are not taxed) and the State A subsidiary look like it has very low (taxable) profits.

Of course, except for tax considerations it doesn't matter to

ExxonMobil to Maine: Sayonara

Maine is among the states that have recently enacted a "single sales factor" with the hope of improving the state's business climate. But the hit-or-miss nature of SSF became immediately apparent when ExxonMobil announced in July of 2008³ that they planned to stop doing business with Maine airports—and cited likely tax hikes from the new single sales factor as one reason for their decision.

the parent company if its State B subsidiary has 80 percent of the total profits and its State A subsidiary has only 20 percent. Either way, the parent company gets 100 percent of the profits.

Another example of transfer pricing that has gotten more attention in recent years is the passive investment company (PIC) approach. In this variation on the transfer pricing scheme, a multi-state company will set up a subsidiary in a state that does not tax certain types of intangible income like royalties and interest—and make sure that this subsidiary receives all of the company's royalty income. The most infamous example of this practice is the Toys R Us corporation, which created a subsidiary in Delaware called Geoffrey, Inc. The subsidiary owns the Toys R Us trademark, and Toys R Us stores around the nation pay royalty fees to the Delaware subsidiary for their use of the trademark. This reduces the taxable profit of Toys R Us in two ways: stores based in other states get to deduct their royalty payments as a cost of doing business, which reduces their taxable profit, and the Delaware subsidiary pays no tax on their royalty income because Delaware does not tax such income.

Trying to assure accurate transfer pricing under separate accounting creates huge enforcement problems. It is a time-consuming, complicated and often impossible job for state auditors to determine whether separate accounting methods accurately reflect a company's net business income in the state. The federal government, which tries to apply the same approach to multinational corporations, has had the same kinds of difficulties.

States seeking to prevent these income-shifting strategies have two options. They can close down these loopholes one at a time—as some states have done in response to the PIC problem by enacting legislation that prevents the use of PICs—or they can adopt a comprehensive solution known as combined reporting. Combined reporting requires a multi-

Separate accounting is an open highway for corporate tax avoidance by big multi-state companies—but “combined reporting” can help clamp down on tax-avoidance schemes.

state corporation to determine its apportionable income by adding together the profits of all its subsidiaries into one total. Since the income of subsidiaries in the various states is added together in one sum, there is no tax advantage to income shifting between these subsidiaries under a combined reporting regime. While anti-PIC legislation can close down one particular path to tax avoidance, combined reporting is a better, more comprehensive approach to loophole-closing because it simply removes the incentive to shift income from high-tax to low-tax jurisdictions.

Combined reporting is intuitively more fair than separate accounting because it ensures that a company's tax should not change just because its organizational structure changes. It also creates a level playing field between smaller and larger companies: small companies doing business in only one state can't use separate accounting to reduce their tax because they have no business units in other states to shift their income to. Large, multi-state corporations will find it easier to avoid paying taxes using separate accounting because they have business units in multiple states. The fact that small businesses can benefit from combined reporting may help explain the growing popularity of this needed reform: seven states and DC have enacted combined reporting since 2004.

“Nowhere Income” and the Throwback Rule

Every state with a corporate income tax uses the location of the corporation's sales as a factor in apportioning business income between states. The “sales factor” for a given corporation in a given state is calculated by assigning each individual sale a company makes to exactly one state, and then calculating what percentage of total nationwide sales are in each state. In general, the rule states use to decide which states a given sale should be assigned to is the “destination rule,” which says that a sale should be assigned to the state to which the product sold is being sent.

Sometimes, however, sales allocated to other states using the destination rule end up not being taxed at all because the destination state lacks the authority to tax the seller. When

this happens, it's because the seller doesn't have nexus in the destination state.

Unless states take action, this “**nowhere income**” will not be taxed anywhere at the state level. The best remedy for the problem of nowhere income is enacting a **throwback rule**, which simply says that any sales to other states that are not taxable will be thrown back into the state in which the sale originated for tax purposes. The throwback rule was among the tax rules adopted by the UDITPA in the 1950s, but many states still have not enacted it. The lack of throwback rules poses a major threat to state corporate income tax revenues in almost twenty states.

Splitting Hairs? Exploiting the Business/Nonbusiness Income Distinction

As previously noted, every company must divide its potentially taxable income into two categories: a “business income” component and a “nonbusiness income” component. Business income is apportioned (divided) between the states in which a company does business, while non-business income generally is taxed entirely by the one state in which the asset generating that income is managed. But each state must set its own legal dividing line between business- and non-business income—and the way in which states do this has important implications for corporate tax fairness.

The appropriate dividing line between these two types of income has been the topic of frequent litigation in the states. In many states, business income is defined as any income that arises from the regular transactions that a company typically engages in—which means that any income that can be characterized as “irregular” may be considered non-business (and therefore non-apportionable) income. Businesses sometimes try to take advantage of this poorly defined distinction between business and non-business income by misleadingly classifying some business income as irregular non-business income, then allocating this non-business income entirely to a low-tax state in which they are nominally headquartered. A 1992 U.S. Supreme Court case, *Allied-Signal v. Director, Division of Taxation, New Jersey*⁴, made it clear that many states currently falling prey to these tax-minimization strategies are not taxing all the corporate income they could legally tax.

States with corporate income taxes have responded to these corporate tax-minimization efforts using two strategies:

- Seven states define business income as everything they can legally apportion under the U.S. Constitution—which

means that non-business income is whatever is left over. This approach is recommended by corporate tax experts as the best way of fairly taxing multi-state corporations' income.⁵

- Eleven states define all income as business income. This approach allows states to tax some of the "irregular" income that companies seek to classify as non-business income, but prevents states from taxing some non-business income that they are entitled to tax. For example, if a company is based in state A, and generates \$100 million of non-business income in state A, the state should be entitled to tax the entire amount as non-business income (since non-business income is not apportioned between states). But when states make no distinction between business and non-business income, all of a company's income is apportioned—which means that state A can only tax a percentage of this income.

Every state with a corporate income tax (except for the six states that currently define business income in accordance with the U.S. Constitution's limits), could enact statutory changes that would allow them to prevent the nonbusiness income loophole from eroding their tax base.

Corporate Minimum Taxes

All states with corporate income taxes use corporate profits to define the tax base. This ensures that the corporate tax reflects a business' ability to pay the tax: if a corporation loses money in any year, they don't pay the tax. But the growing use of tax avoidance strategies means that many profitable corporations are now able to report artificially low (or negative) profits for tax purposes even when they've done quite well financially. These tax avoidance strategies have created the specter of profitable "zero-tax corporations." Federal tax reform legislation in 1986 created an "alternative minimum tax" (AMT) to ensure that all profitable corporations would pay some tax no matter how many tax breaks they might otherwise claim.

States seeking to follow the federal government's lead have taken one of three strategies: imposing an AMT based on the federal tax, imposing a flat-dollar minimum tax, or using a non-profit-based measure of business activity as a backstop to the corporate profits tax.

A few states use an AMT based on the federal tax. Like the regular corporate income tax, the AMT usually is defined as a percentage of corporate profits—but the AMT typically applies a lower tax rate to a much broader definition of corporate

There is a growing consensus among many tax experts that state and local tax breaks for business are being used in a way that is actually unconstitutional, by subverting the regular flow of interstate commerce. Congress can take steps to stop the bleeding.

taxable income. This approach has become much less useful because the federal AMT has been seriously watered-down over time by Congress—but a state AMT based on the older federal AMT rules could still help prevent the excessive use of tax loopholes.

A growing number of states rely on a simpler, lower form of minimum tax: a flat-dollar amount that all corporations must pay. This amount ranges widely, from \$50 in Ohio to a maximum of \$1,500 in New York. As more and more corporations rely on tax avoidance strategies, the fixed-dollar minimum tax has become more important in these states: in New York, for example, more than sixty percent of all C-corporations paid only the fixed-dollar minimum tax in tax year 2006.⁶ More than 70 percent of Utah C-corporations paid only the minimum in tax 2008 including 27 percent of profitable corporations.⁷

About half of the states now levy a "corporate franchise tax" in addition to a corporate income tax. In general, these taxes are based on a company's net worth. Some states also use a tax on gross receipts. Gross receipts taxes are described in Chapter Three.

Should States Repeal Their Corporate Taxes?

A few states, including Ohio and Texas, have recently enacted alternative businesses taxes that are designed not as a backstop to the profits tax, but as a replacement. Learn more about the shortcomings of this approach to "tax reform" in Chapter Three.

Each of these options can help eliminate the “zero-tax corporation” problem—and (in some cases) can also help states to get around the problem of corporate nexus described above. Some nexus rules only apply to taxes that are based on profit. So a company that does business in a state, but doesn’t have enough physical presence in the state to satisfy the nexus rule, cannot be reached by a profits-based tax, but can be reached by a fixed-dollar minimum tax.

Corporate Disclosure: An Important Tool for Tax Fairness


Tax fairness is important. The perception that state and local taxes treat individuals and corporations fairly is a cornerstone of public support for the tax system. The fairness of corporate taxes at the federal level can be evaluated on a company-by-company basis, with some difficulty: publicly available Securities and Exchange Commission (SEC) filings allow analysts to determine how much the nation’s largest corporations have paid in federal taxes and compare this to their profits. In a series of reports, ITEP has shown that many profitable corporations pay little or no federal income tax. A September 2004 ITEP report surveyed 275 of the most profitable corporations, and found that almost a third of these companies paid zero (or less) in federal taxes in at least one year between 2001 and 2003.⁸

Unfortunately, the fairness of each state’s corporate tax cannot be evaluated in the same way, because neither the SEC

nor most state governments require corporations to release detailed information on their state corporate tax payments. A few states have now implemented some form of corporate tax disclosure. For example, Massachusetts now requires very limited anonymous disclosure of basic information about profits, taxes paid and tax credits received. But nearly all states still have no such requirements. Greater state corporate tax disclosure is the best means available to ensure that each corporation is treated fairly—and that corporations as a group pay their fair share of taxes.

Corporate disclosure can also help states to prevent the accounting hijinks described above. For example, some companies will report certain income as “non-business income” in one state and “business income” in another to minimize their tax liability. More open reporting of this information could allow states to check for consistency in income reporting between states.

Conclusion

State corporate profits taxes have been a mainstay of state tax systems for almost a century. And despite the worrisome recent drop in the yield of these taxes, virtually every state now has available a straightforward set of tax reform policies that could not only end the erosion of their corporate tax base, but could help these taxes regain their former health. 

¹ This is required by a patchwork of federal case law – most notably, the Supreme Court’s decision in *Container Corporation of America v. California Franchise Tax Board*.

² Johnson, Nicholas, “States Can Avoid Substantial Revenue Loss by Decoupling from New Federal Tax Provision.” Center on Budget and Policy Priorities, April 20, 2002. <http://www.cbpp.org/archiveSite/3-20-02sfp.pdf>. The change was retroactive to September 2001 and was set to expire in September 2004, but has been extended several times, most recently as part of the 2009 American Recovery and Reinvestment Act.

³ Robbins, Toni-Lynn, “Jet fuel supplier cites state taxes for decision to pull out of BIA.” All Business. July 3, 2008. <http://www.allbusiness.com/government/government-bodies-offices-regional-local/14685900-1.html>

⁴ *Allied-Signal, Inc. v. Director, Division of Taxation* (91-615), 504 U.S. 768 (1992). <http://www.law.cornell.edu/supct/html/91-615.ZS.html>

⁵ Mazerov, Michael, “Closing Three Common Corporate Tax Loopholes Could Raise Additional Revenue for Many States.” Center on Budget and Policy Priorities, May 23, 2003. <http://www.cbpp.org/cms/index.cfm?fa=view&id=1868>

⁶ New York State Department of Taxation and Finance, “2006 New York State Corporate Tax Statistical Report.” April, 2010. http://www.tax.state.ny.us/pdf/stats/stat_corp/corp_stat/2006_new_york_state_corporate_tax_statistical_report.pdf

⁷ Lund, Matthew, “Utah State Tax Commission Corporate Statistics: Tax Year 2008.” Utah State Tax Commission, 2010. <http://www.tax.utah.gov/esu/income/corp08/corp2008.pdf>

⁸ McIntyre, Robert and T.D. Co Nguyen, “Corporate Income Taxes in the Bush Years.” Citizens for Tax Justice and Institute on Taxation and Economic Policy, September 2004. <http://www.ctj.org/corpfed04an.pdf>

CHAPTER SEVEN

OTHER REVENUE SOURCES

The vast majority of state and local own-source revenue comes from the “big three” types of taxes (personal income, consumption, and property taxes). But smaller taxes, and non-tax revenue such as user fees, are an important part of the picture in many states. This chapter takes a closer look at some minor revenue sources that have traditionally formed a small part of the state tax pie: user fees, the estate tax, gambling revenues and borrowing, and discusses the appropriate uses of each.

“User Fees”: What’s In a Name?

The most literal policy response to perceived anti-tax sentiment is to simply replace taxes with revenue sources that can’t be called a tax. Since California’s Proposition 13 tax caps gave this approach widespread notoriety, virtually every state has increased its use of a category of non-tax revenues called “user fees” as an alternative to hiking taxes. What makes user fees different from conventional taxes is that they take the form of a direct payment to government for a specific service rendered to a specific taxpayer by the state—and the payment is usually made at the same time that the service is rendered. Common examples of user fees include:

- Highway tolls (you pay each time you use a section of tolled highway);
- Car registration and driver’s license fees (you pay each time you register your car);
- Tuition at public universities (you pay when you enroll at a public university).

In each case, no one has to pay the fee unless they actually use the service. If you don’t drive a car or go to school, you don’t pay a dime in the user fees mentioned above.

By contrast, conventional taxes are collected in a way that is almost never linked to a specific personal service taxpayers get in return. For example, personal income taxes usually go into a state’s general fund to pay for a wide variety of public services; it’s impossible to draw a direct connection between the tax you pay in and a specific service you get in return. And while gasoline

taxes may seem like user fees, they’re not: even when gas taxes are earmarked for transportation funding, the \$5 in gas taxes you paid at the pump on Monday won’t give you a tangible benefit that day, that week or even that year—you’re simply helping to fund transportation in general.

In 1962, user fees were just over 15 percent of local governments’ own-source revenue; in fiscal year 2008, that number had risen to more than a quarter of the local government revenue pie¹. State governments have also increased their reliance on user fees somewhat, but the user fee remains primarily a local government tool.

Fairness and User Fees: Two Views

Are user fees fair? There are two competing views of fiscal fairness that tell very different stories about the underlying fairness of user fees. Most Americans subscribe to the “ability to pay” school of tax fairness; by this view, user fees almost always fail the fairness test. A \$20 fee to use a state campground, or a \$50 fee for registering a car, hits low-income families much more heavily than upper-income families, simply because \$20 is a much larger share of their annual income.

But there is a second, competing view of fiscal fairness, called the “benefits principle,” which says that what taxpayers put into the public coffers should depend directly on what they get in return from the state. According to this view, user fees are unambiguously the fairest way of raising revenue.

These two views of fairness are obviously at loggerheads. Relying more heavily on user fees creates a more direct connection

between the taxpayer and the benefits she receives, but almost certainly will make state revenue systems more regressive—an important concern because almost every state’s tax system is quite unfair to begin with.²

When Should Governments Rely on User Fees?

Too often, state and local governments have taken to enacting user fees simply because they fear the political repercussions from enacting higher-visibility tax increases. But a case can be made that under certain circumstances, user fees are the right thing to do, not just the politically expedient thing to do.

In particular, when state or local governments provide a type of service that clearly benefits one taxpayer and has no direct benefit for anyone else, it can be argued that the beneficiary should pay for that service. Parking your car at a downtown parking meter provides a narrowly targeted service to you as a car owner—therefore, your use of the parking space should be paid for by you personally as a driver rather than the entire population of a city or state.

But many of the most important services provided by state and local governments provide both personal and social benefits. A quality high-school education certainly confers benefits on the student receiving it, but also helps to build a state’s supply of human capital by creating a better educated work force. For this reason, a strong argument can be made that public education should be funded primarily through general taxes, not user fees.

There is, of course, an even more fundamental objection to relying on user fees to fund important public services. There is broad agreement that government should ensure basic human rights to even the poorest families and children—even those who lack the resources to fully pay for these rights. For this reason, almost every state has enshrined in its constitution the right to an adequate public education—and these constitutional protections are generally understood to mean that the quality of a child’s education shouldn’t depend on whether their parents can afford to pay for it. Relying on user fees to pay for education or other vital services such as health care and public safety directly violate the notion that states should guarantee basic human rights.

Many of the most vital services provided by state and local governments provide benefits not just to isolated individuals, but to society—and should be paid for with taxes, not user fees.

Estate and Inheritance Taxes

Until 2001, levying a tax on the transfer of wealth from one generation to the next was one of the few things all fifty states could agree on. After the federal government enacted an estate tax in 1916 to “break up the swollen fortunes of the rich,” every state enacted a similar tax of its own. While these taxes typically represent only a small part of overall state tax collections, estate taxes (which are paid by taxable estates upon death) and inheritance taxes (which are paid by those individuals who receive gifts from estates) play an important role in reducing the transmission of concentrated wealth from one generation to the next. This function is now more important than ever: in 2007, the wealthiest 1 percent of Americans owned 33.8 percent of the wealth nationwide—more than the poorest 90 percent put together.³ The estate tax was designed to apply only to the very wealthiest Americans—and that’s exactly what it does. Nationwide, less than one percent of decedents owed federal estate tax in 2008.⁴ This is primarily because the federal tax exempted the first \$3.5 million of an estate’s value from tax in 2009. (Of course, due to temporary tax changes enacted by the Bush administration, the federal tax disappeared entirely, for a single year, in 2010.)

Recent federal tax changes, however, threaten the future of the estate tax at the state level. Since 1926, the federal estate tax allowed a dollar-for-dollar tax credit against the estate taxes levied by states, up to a certain maximum amount. The credit gave states an incentive to levy an estate tax at least as large as this credit: in the states levying a “pickup tax”—that is, a tax calculated to be exactly equal to the maximum federal tax credit—the state’s estate tax amounted only to a transfer of estate tax revenues from the federal government to the states. In other words, the pickup tax did not change the amount of estate tax paid—it just meant that part of the federal estate tax liability was being shared with, or “picked up” by, state governments. Every state took advantage of this incentive to enact an estate tax at least as big as the pickup tax.

Federal tax cuts enacted in 2001 gradually repealed the federal estate tax over ten years—and, more importantly for the states, phased out the federal credit allowed for state estate taxes between 2002 and 2005. In many of the states that base their tax on the federal credit, this meant that the state’s estate tax also ceased to exist in 2005, although a number of states took steps to prevent this accidental tax repeal.

The “pickup tax” credit was scheduled to come back to life along with the federal estate tax in 2011, but Congress acted to permanently replace the credit with a deduction. States seeking to preserve this important progressive revenue source have an

easy way of doing so: “decoupling” from the federal tax repeal. The easiest way to achieve this is by defining the state estate tax to equal the federal credit as it existed in 2001—before the passage of the Bush administration’s estate tax cuts. States taking this step will effectively have a tax with a rate of 16 percent on estate value in excess of \$1 million. Importantly, states taking this step can “piggyback” on special federal provisions that help to ensure that small businesses and family farms won’t be hit by the estate tax, including a provision that assessing farmland according to its agricultural value, not its market value, an extra exemption above the basic amount, and a 14-year grace period to pay any estate taxes owed.⁴

A number of states have made this simple administrative change already. Half a dozen other states are at least partially unaffected by the federal estate tax repeal because they levy separate inheritance taxes, which are paid individually by those receiving transfers from an estate (by contrast, the estate tax is levied on the value of an entire estate, generally without regard to the way taxable estate value is split up between beneficiaries). Each of these options could be enacted by close to half of the states as a means of shoring up state revenues and restoring tax fairness.⁵

Gambling Revenues

Like tax policy, gambling policy is made in a decentralized way: each state’s lawmakers can choose which (if any) forms of legalized gambling to allow. As a result, the states now have very different approaches to allowing gambling activities. Some form of government-sanctioned gambling is now allowed in all but two states (Utah and Hawaii). By far the most popular forms of legalized gambling are lotteries and casinos: 37 states and the District of Columbia have state lotteries, and more than half of the states have some form of casino gambling. Many states also allow “pari-mutuel” gaming, wagering on live events such as horse and greyhound racing.

Advocates of state-sponsored gambling typically see it as a painless, voluntary tax—and one that is at least partially paid by residents of other states. At a time when lawmakers’ willingness to increase politically unpopular taxes is especially low, a tax paid by non-residents may seem especially palatable. It is also argued that in the absence of legal gambling, many state residents will either gamble illegally or travel to other gambling-friendly states—with no benefit to the state. But opponents raise a host of troubling objections to states’ use of legalized gambling.

- Even if gambling boosts state revenues in the short run, competition from other states means that the **yield of the**

tax will likely decline over time—and will ultimately shift the cost of this tax primarily to state residents rather than tourists from other states.

- Instead of increasing the total amount of revenue available to fund public services, **gambling may simply shift money from one tax to another** with no net gain to the state.

When consumers spend more money on gambling, they will spend less money on other items. Since these other types of purchases are usually subject to state sales taxes, any increase in state gambling revenue usually means a decrease in state sales tax revenue.

- Rather than simply capitalizing on existing illegal gambling activities, legalized gambling may **encourage consumers to gamble more** than they otherwise would. When states use gambling as a revenue source, they depend on the continued flow of this revenue to fund services. This often leads to state-sponsored advertising that actively encourages citizens to gamble more. In this respect, gambling is very different from “sin taxes” on alcohol and cigarettes, which are often enacted not to raise money but to discourage behavior that is deemed socially harmful.

- Gambling may introduce a variety of **social costs**, including increased crime rates, decreased private savings, increased debt, and job losses. These social costs can result in increased social welfare spending by state governments in the long run.

- Low-income and poorly-educated taxpayers are far more likely to participate in lotteries and other forms of gambling than are wealthier, better-educated taxpayers. As a result, state-sponsored gambling can be considered a **regressive tax**.

- Like other “sin taxes,” gambling is **not always a truly voluntary tax**. Compulsive gambling has been recognized as an addictive disease. Relying on compulsive gamblers to fund public services amounts to taking advantage of these gamblers’ addictions. And because state gambling administrators tend to downplay the poor odds of winning, gamblers are usually given incomplete information about these odds—which means, in a sense, that gamblers are being tricked into these “voluntary” spending decisions.

- **Promises of additional spending for specific public services may be illusory**. Advocates of state-sponsored gambling often seek to earmark gambling revenues for specific purposes, usually to help fund education. These advocates often promise that state spending on education will increase as a result of the new gambling revenues. But it is just as likely that lawmakers will use gambling revenues

to replace other revenues that have been shifted from education to other areas—leaving the total amount of spending on education unchanged.

Borrowing From the Future: Debt and Other Strategies

The imbalance between federal spending and federal revenues that resulted from huge federal tax cuts enacted in the past decade has prompted growing concern over our national debt. Yet state and local policymakers continue to blithely pass on the cost of funding current services to future generations, using borrowing as a substitute for tax reform. When is this practice appropriate—and when is it simply stealing from our grandchildren?

Borrowing is an important—and, at times, entirely appropriate—strategy for funding public investments in every state. When state or local policymakers choose to invest in infrastructure spending that will benefit not just current taxpayers but future generations, such as roads, bridges and hospitals, it makes sense to spread the cost of paying for these investments across the years of their use. This is done by issuing bonds, which are purchased by individual and business investors. In the short run, investors' bond purchases pay for needed public investments, and the investors are repaid, with interest, over time. The government pays investors back with revenues from taxes collected each year, effectively spreading the cost of funding these infrastructure investments over the life of the bonds, and ensuring that tomorrow's taxpayers will pay some of the costs of the long-term infrastructure improvements they enjoy.


In part because federal lawmakers recognized the importance of bonding as a state and local tool for funding capital improvements, income from state and local bond issues is generally exempt from federal income tax. This is meant to make it easier for state and local governments to attract investors in their infrastructure projects.

Borrowing becomes problematic, however, when governments use it to balance their current budgets. For example, Arizona's legislature recently sold a variety of state-

owned buildings to private investors—and then promptly leased many of the same properties back from their new owners for a long period. The result—a short-term infusion of funds followed by a much larger long-term stream of state spending—was proudly described by one of its legislative advocates as the equivalent of “taking out a mortgage.”⁷ In the very short run, lawmakers are able to balance their budget—but even a year later, this “solution” ends up making budget deficits even worse.

A variant on the same approach is leasing out state infrastructure in a way that is designed to outsource the provision of the infrastructure to private companies. The most notorious example of this strategy is in Indiana, where the state government recently leased a highway to a private consortium. In exchange for a short-term infusion of cash valued at nearly \$4 billion, the consortium is allowed to maintain (and charge drivers for use of) the highway for the next 75 years. While this approach is more ideologically motivated than conventional bonding (since it places state resources in the hands of private entities), its impact on state finances can be broadly similar, and it is, after all, designed to pay for capital improvements that will benefit future generations. The main concern with this approach is that it can be difficult to ensure that state and local governments get a good deal out of these exchanges. The consortium running Indiana's toll road may realize long-term profits far exceeding the short-term benefit to Indiana government.

Conclusion

When policymakers perceive (correctly or otherwise) that their constituents have anti-tax views, they often reach for revenue-raising strategies that help balance budgets in the short run but do long-term harm. Inappropriate bonding practices amount to an indirect tax increase on future generations, while gambling revenues and user fees too often shift the cost of funding public investments onto the backs of the low-income families who are already hit hardest by regressive state and local taxes. By contrast, minor revenue sources such as estate and inheritance taxes can be a vital backstop to the main taxes levied by states, and should be preserved. 

¹ State and Local Government Finance Data.” U.S. Census Bureau. <http://www.census.gov/govs/www/financegen.html>

² Who Pays? A Distributional Analysis of the Tax Systems in All 50 States.” Institute on Taxation and Economic Policy, November 2009. <http://www.itepnet.org/whopays3.pdf>

³ Kennickell, Arthur B. “Ponds and Streams: Wealth and Income in the US 1989–2007.” Finance and Economics Discussion Series 2009–13, Washington DC: Board of Governors of the Federal Reserve System, January 7, 2009. <http://www.federalreserve.gov/pubs/feds/2009/200913/200913pap.pdf>

⁴ “Congress About to Give Away the Farm: Even Worries about the Deficit Don't Stop Lawmakers from Helping the Uber-Rich.” Citizens for Tax Justice, September 2010. <http://ctj.org/pdf/etfarms2010.pdf>

⁵ For more information see: McNichol, Elizabeth, “State Taxes On Inherited Wealth Remain Common : 21 States Levy An Estate or Inheritance Tax.” Center on Budget and Policy Priorities, May 20, 2010. <http://www.cbpp.org/cms/index.cfm?fa=view&id=337>

⁶ “State-by-State Estate Tax Figures: Number of Deaths Resulting in Estate Tax Liability Continues to Drop.” Citizens for Tax Justice, October 2010. <http://www.ctj.org/pdf/estatetax2010.pdf>

⁷ Eaton, Leslie, “Pinched States Wrestle With More Cuts.” The Wall Street Journal, July 30, 2009. <http://online.wsj.com/article/SB124891089628491887.html>

CHAPTER EIGHT

TAXES AND ECONOMIC DEVELOPMENT

One of the main concerns of state policymakers is how to lure jobs to their state—and too often, policymakers assume that tax cuts make the best bait. It's not hard to understand why they might believe this: tax-cut advocates frequently assert that cutting tax rates will spur economic growth by attracting more jobs and employers to the state, and businesses are constantly threatening to relocate to other jurisdictions if state governments won't pony up lavish tax breaks. But there is growing evidence that tax cuts and incentives are not an effective growth strategy for states—and that investing in public infrastructure such as schools, roads and hospitals can be a better approach to encouraging economic development. This chapter discusses the relationship between state fiscal policies and a state's economic climate.

Assessing Claims that Taxes Affect State Economies

When state policymakers discuss proposed tax increases, the debate inevitably turns to the impact of these proposals on the state's business climate. Business lobbyists usually argue that tax increases will hurt a state's business climate and drive away industries and jobs. And if tax increases aren't on a state's agenda, the same lobbyists will push for special tax breaks to encourage new business investment—or to prevent a company from leaving the state—and will tell apocalyptic tales about what will happen if these business demands are not met.

But there is little hard evidence to support the assertions of those who see tax cuts as a panacea for a state's economy. A comprehensive survey of the literature on the relationship between taxes and economic development by economist Robert Lynch found little evidence that state and local taxes are important factors in determining business location decisions or in affecting state economic growth.¹

Lynch's survey suggests that there is a wide variation in the quality of the "research" used to support these anti-tax arguments, and suggests that the studies that do claim a strong relationship between tax levels and economic growth usually have design flaws that invalidate their conclusions. Here's a quick review of some important questions to ask in evaluating these studies:

- **Does the study assume that tax changes have no effect on public spending?** One of the most frequent errors made by these studies is to simply ignore the linkage between taxes and public spending. This is equivalent to saying that when taxes are hiked, the resulting revenues will simply be thrown away rather than being used to fund education and other public services—and that when taxes are cut, there will be no reduction in the state's ability to fund these services. In the real world, of course, tax cuts must be paid for—and that usually means spending cuts. In contrast, when taxes are increased, the new revenue is used to preserve state services that are important to residents, as well as businesses and the economy.

Studies that ignore this basic linkage and look only at the impact of tax cuts are merely stating the obvious: state economies would be stronger if they could maintain the current package of public services while paying less for them. In the best of all possible worlds, state and local governments would provide all of our public services for free. Of course, that's unrealistic—but that's the implication of studies that don't factor in the impact of tax cuts on public services.

- **Does the study measure the impact of any other possible explanations for economic growth?** There are many plausible explanations for the difference between

fast-growing and slow-growing state economies. These differences could result from tax law changes, government spending behavior, regional and national economic changes, demographic changes, or even the weather. The simplest “studies” often measure the linkage between only one explanation—tax levels—and an economic outcome. But if the study doesn’t at least try to test for the impact of these other factors, its findings shouldn’t be taken seriously.

- **Does the study measure tax levels correctly?** Anti-tax advocates frequently resort to manipulating data in arcane ways to back up their assertions. For example, some studies use the “per capita” measure of tax levels—that is, the total amount of taxes collected in a state divided by the state’s population—to identify high-tax states. The problem with this is that “per capita” tax measures tell us more about how rich a state is than how high its taxes are.

For example, in 2007 Virginia collected \$1,330 per capita in personal income tax, while Wisconsin collected \$1,131. Yet the Virginia income tax has lower tax rates than Wisconsin’s income tax. Virtually anyone moving from Wisconsin to Virginia (and keeping the same salary) would, in fact, see their income taxes go down. Simply put, tax collections are higher overall because Virginia has more wealthy taxpayers, not higher taxes. This approach to measuring tax levels is simply misleading—but anti-tax advocates rely on it simply because the average taxpayer won’t know the inherent flaws in per capita measures.

Other data manipulation tricks to watch for include:

- Making assertions about how total taxes affect growth—but backing these assertions up using only state tax data. State tax hikes are often enacted to reduce local taxes, so it is important to use combined state and local tax data in evaluating these assertions.
- Using legal or nominal tax rates as a measure of true tax levels. This trick is frequently used in states that combine high income tax rates with generous deductions, exemptions and other tax breaks. Effective tax rates—that is, taxes as a share of income—are a far more accurate approach to measuring tax levels.
- Using aggregate tax collection data to measure state tax levels instead of measuring the incidence of these taxes on state residents. Aggregate measures based on total tax collections tell us little about whether specific groups of taxpayers experience the state as a high-tax or low-tax place

to live. Some nominally “high-tax” states rely heavily on taxes paid by large multi-state businesses or non-residents, which may not apply to state residents.

- Not factoring in the deductibility of state and local income and property taxes when comparing tax levels across states. The ability to write off these taxes means that the difference in tax levels between “high tax” and “low tax” states is never as large as it may seem. For the wealthiest taxpayers (and for profitable corporations), up to 35 percent of the difference between any two states’ tax levels will disappear once federal deductibility is taken into account.

Much of the research that is commonly cited by anti-tax advocates is based on research methods that are dubious at best—and the tricks outlined above tend to get recycled in different states by anti-tax lobbyists and researchers. So whenever lawmakers or the media are presented with a study purporting to show that high taxes hurt economic development, it’s a good idea to ask these basic questions about the design of the studies.

Low-Tax Strategies Aren’t Effective

So why is it that there’s no observable relationship between tax levels and economic growth? One sensible reason is that taxes are levied for a very important purpose: to help fund the public services that make a state more attractive to businesses. Good roads and bridges, a well-educated workforce and other government services are essential to business productivity and profitability. And on the other side of the coin, low taxes generally lead to low-quality public services. Moreover, compared to other costs of doing business, state and local taxes are rather insignificant: Lynch’s 2004 survey estimated that the state and local taxes paid by businesses represented just 0.8 percent of the costs they face. Usually the decision on where to locate is based on more important economic factors than taxes, such as proximity to suppliers and markets, and the availability of skilled workers. That’s why heads of major corporations will candidly admit that taxes are not very important in their location decisions.

As Paul O’Neill, a former executive at Alcoa and President George W. Bush’s Treasury Secretary put it: “I never made an investment decision based on the tax code...If you are giving money away I will take it. If you want to give me inducements for something I am going to do anyway, I will take it. But good business people do not do things because of inducements.”²

Other corporate leaders have echoed these thoughts. Oklahoma billionaire George Kaiser recently testified to the ineffectiveness of tax incentives in that state by noting that “the tax rebates

we are considering cause almost no wells to be drilled in Oklahoma that would not otherwise be drilled. As an oil and gas producer myself... I can say unequivocally that the rebates in this legislation have never influenced our decision to drill or rework or restore any well in this state or the many other states in which we operate. And the reason isn't that we do not understand the benefit from the rebate; we are happy to file for and receive the gift, and we do."³

Similarly, long-time business leader Michael Bloomberg has bluntly said that "any company that makes a decision as to where

they are going to be based on the tax rate is a company that won't be around very long. If you're down to that incremental margin you don't have a business."⁴

The Corporation for Enterprise Development (CFED) has issued a series of reports grading states on the characteristics that are likely to attract high-wage, high-value-added industry—and these reports' findings echo the explanations of these corporate leaders. Level of taxation has consistently been found to be of little significance. The factors that businesses look for include the quality of life in the community, a good supply of highly skilled and educated men and women to fill demanding technical and management positions, good roads and adequate transportation, public safety, and the quality of health care.

When corporations raise the "business climate" issue, it's often just a ruse to try to keep their taxes low. For example, research from New Jersey Policy Perspective and Good Jobs New York found that Citigroup regularly plays New York, New Jersey, Kentucky and Texas against each other by threatening to move their operations from one state to another.⁵ The study found that "Citigroup appears to have taken advantage of rivalry among states, exploiting the 'prisoners' dilemma' dynamic to mislead one government that it is competing against another, when no rival offers actually have been made." Between 1989 and 2007, Citigroup received nearly \$286 million in state and local economic development subsidies.

It's also worth noting that the few businesses that might actually be attracted by low taxes are likely to be low-paying industries with little loyalty to the community and its long-term well-being.

Finally, it's important to remember that tax breaks don't buy loyalty from companies. Many states and communities have given huge tax breaks to large companies for years, only to have the company shut down the local plant for reasons unrelated to taxes. Massachusetts lawmakers enacted a special corporate income tax break largely in response to threats from the Raytheon Corporation that it would reduce its employment in the state unless this break was enacted—and after they got their way, the company cut thousands of Massachusetts jobs.

The Millionaire Migration Myth

Some anti-tax advocates and lawmakers have recently generated a lot of publicity by attacking state income tax increases targeted at high-income earners—so-called "millionaires' taxes." One of the most obviously false claims made about these types of tax increases is that they inevitably lead to a mass exodus of high-income earners from the states that enact them.

Claims of this sort overlook the fact that high-income earners, like all Americans, care about a lot more than their tax bill when deciding where to put down their roots, and whether or not to move. These claims also often overlook—or even distort—available empirical evidence.

In 2009 and 2010, for example, anti-tax groups in Maryland repeatedly referenced data from the Maryland Comptroller's office indicating that the number of individuals with over a million dollars in income had recently declined. These groups enthusiastically cited this finding as evidence of a "millionaire migration." A more careful analysis of the data by ITEP, however, showed that the decline was in fact a result of wealthy Marylanders seeing their incomes decline in the wake of the 2008-2010 recession.^a

These same groups also pointed toward New Jersey as an example of a state where an income tax increase caused high-income individuals to flee the state. In order to make this claim, anti-tax groups were forced to ignore a contrary study from Princeton University, and to instead distort the findings of a study out of Boston College with no real relevance to Maryland's situation.^b

Ultimately, the erroneous claims by anti-taxers in Maryland played a key role in the state's decision not to extend the temporary income tax increase on Maryland's millionaires. Other states debating the creation or continuation of a "millionaires' tax" should expect to confront similar, misleading arguments.

Types of Tax Breaks Offered

The types of tax breaks offered to companies under the guise of economic development vary widely, but they can be categorized into three groups:

■ Broad changes in tax rates or apportionment rules.

Some states choose to pursue general reductions in corporate taxes, either by cutting the legal tax rate on all

[a] "Where Have All of Maryland's Millionaires Gone?" Institute on Taxation and Economic Policy, May 2009. http://www.itepnet.org/pdf/MD_Millionaires.pdf

[b] "Maryland's Millionaire Migration Debate: Understanding the Relevance of the New Jersey Migration Studies." Institute on Taxation and Economic Policy, March 2010. http://www.itepnet.org/pdf/md_migrationstudies_0310.pdf

corporations or by providing special apportionment rules, such as the “single sales factor,” that will provide benefits to large groups of companies (although, as noted in Chapter Six, such rules may create as many losers as they create winners).

■ **Abatements, credits, exemptions, and TIFs.** States also offer tax breaks that apply to specific companies, or companies doing business in a specific area. One example of this approach is **tax increment financing** or TIF.⁶ TIF districts are usually established in areas that are considered to be blighted. When property values rise because of development in a TIF district, a portion of the property taxes generated are set aside from their normal use (usually funding schools) and instead are used to improve infrastructure used by businesses in the district. TIFs deserve greater scrutiny because many of the areas designated as TIF districts aren’t actually blighted, and because studies have shown that development in many of these areas would likely have happened even without the use of TIFs.⁷

■ **Tax packages offered by states to lure investment.** States and local governments often put together entire packages of tax subsidies including a mix of exemptions and credits designed to reduced taxes. For example, North Carolina gave away almost \$300 million in tax incentives to Dell in 2004 to lure it to build a manufacturing plant in the state while the closest competitor state offered only \$30 million. The company promised to invest at least \$100 million in the plant and create at least 1,500 jobs by 2010. But instead, after only four years in operation, Dell announced plans to shut its North Carolina plant in 2010. While most of the incentives were never paid out to Dell, the company left more than 900 people in an economically distressed area without work and its actions raise doubts about the role of tax incentives to spur economic development. Incentive packages of this kind too often result in bidding wars between the states—and these costly and ambitious tax breaks bring no guarantees that a company will remain in the state over the long term.

Ensuring Accountability in Economic Development

Even if there is little evidence that tax policy affects economic growth, state lawmakers continue to pursue potentially damaging tax breaks in an effort to spur economic growth in their state. How can lawmakers limit the damage of these tax breaks and ensure that companies receiving these breaks won’t take them to the cleaners? The Washington-based

nonprofit watchdog group Good Jobs First focuses on issues of economic development accountability, and has recommended a variety of best practices for lawmakers enacting tax breaks, including:

- **Disclosure** of how much tax breaks cost state and local governments and what public benefits resulted from the tax breaks. For example, lawmakers and the public should be able to determine how many jobs were created as a result of the tax breaks and whether the jobs created are “good jobs” in terms of the wages and benefits provided. This information should be made publicly available online and frequently updated. For example, according to Good Job First’s The State of State Disclosure report, Iowa’s Department of Economic Development releases annual disclosure reports on a variety of state business development programs that detail the number of jobs produced and the wages paid. The reports are searchable and available online.⁸
- **Strict job quality standards** should be applied to any tax break designed to increase in-state employment. Requiring these new jobs to provide a basic “living wage” along with health care benefits helps to avoid imposing hidden taxpayer costs on state government. If a tax break results in a company hiring employees who are paid so little that they qualify for food stamps, Medicaid, or other taxpayer-funded safety nets, the cost of the tax break may exceed its benefits to the state. For example, in Montana companies receiving federal Workforce Investment Act training monies must pay wages and benefits of at least 110 percent of the state’s median wage.
- **Money-back guarantees** that companies receiving tax breaks to create new jobs will actually create these jobs—and that the jobs will remain in the state for some specified period of time. These guarantees, known as “clawbacks,” are now used in at least twenty states to ensure that lawmakers get enough “bang for the buck” for the tax breaks they offer. For example, Minnesota’s clawback statute states that if a company receiving benefits doesn’t fulfill the subsidy’s requirements, the company is banned from getting more aid for five years or until they have repaid the subsidy amount.
- **Location-efficient incentives** should encourage economic development in areas that are accessible to public transportation. This creates more opportunity for low-income families who cannot afford cars, and reduces traffic congestion.
- **Automatic review of giveaways** should be mandatory. Corporate tax breaks are often given without regard for

how long the tax break will remain on the books. Regularly reviewing tax breaks is essential to ensuring that subsidies that aren't working are removed from state law. For example, a 2006 Washington State law requires regular review of tax preferences with the goal of evaluating their effectiveness and making reform recommendations to the state legislature.⁹

- **Establishing an economic development policy** that outlines goals, objectives, and strategies for state economic development is one way to ensure that reasonable and responsible questions about tax incentive packages are asked. A coherent policy can ensure that each decision on tax incentives will be analyzed in terms of how the incentive package helps to achieve larger economic development goals.

Businesses Are a Vital Partner in Tax Fairness Efforts

Business owners and fair tax advocates fully understand the importance of a healthy economic climate for jobs and incomes. Good roads and bridges, a well-educated workforce and other government services are essential to both business productivity and community prosperity. There is a clear linkage between taxes and a state's ability to provide important public services. Governments must have the resources to provide the education, the roads, the sewer systems and other services that allow businesses to prosper.

Unless those with the most ability to pay contribute their fair share, it will be virtually impossible for governments to provide essential programs. Precisely for this reason, not all corporations fight against progressive tax changes. Especially in states with low taxes, businesses may support progressive tax increases in order to improve the quality of government services. When Virginia lawmakers passed a billion-dollar tax hike in 2004, for example, it was with the blessing of the state Chamber of

Commerce. In 2005 many Colorado business owners came out in favor of a five year time-out from a restrictive spending cap called TABOR (the Taxpayers Bill of Rights) because of the horrific impact that state spending caps had on the state's schools, infrastructure, and even businesses' own ability to function.

There are some sectors of the business community that favor progressive tax reform. Often the organized business lobby is dominated by a few large corporations that may have very different interests than do small- and medium-sized businesses. Small businesses typically are left holding the bag when larger multi-state corporations carve out special tax breaks for themselves, and for this reason small businesses can be an essential partner to progressive coalitions seeking to achieve tax reform. The importance of working in coalition with businesses is discussed more in Chapter Ten.

Conclusion

Improving living and working conditions for residents and businesses is among the most basic tasks facing state policymakers. But all too often, the simple economic development recommendations made by anti-tax advocates can actively work against these goals by starving the ability of state governments to adequately fund needed infrastructure, and when these advocates present "research" purporting to prove that low taxes encourage economic growth, it's important to ask the basic research design questions outlined in this chapter. When policymakers do decide to provide targeted tax incentives to businesses, it's imperative that the breaks come with sufficient strings to rein in companies who aren't hiring well-paid workers or fulfilling the requirements for receiving special treatment. After all, business owners and nonbusiness owners alike thrive when communities prosper and government is able to provide adequate infrastructure and a healthy, educated workforce. 

¹ Lynch, Robert G., *Rethinking Growth Strategies: How State and Local Taxes Affect Economic Development*. Washington, DC: Economic Policy Institute, March 2004.

² O'Neill, Paul. Statement to the U.S. Senate Finance Committee. Confirmation of the US Treasury Secretary, Hearing, January 17, 2001.

³ Kaiser, George. Statement to Oklahoma's House Appropriations and Budget Committee. Oil and Gas Tax Rebates, Hearing, January 22, 2009. http://www.gkff.org/userfiles/file/1_22_09%20Oklahoma%20oil%20and%20gas%20rebate%20hearing.pdf

⁴ Tierney, John, "The Big City: An Outsider Comes Inside to Run Things." *The New York Times*, November 8, 2001. http://www.nytimes.com/2001/11/08/nyregion/the-big-city-an-outsider-comes-inside-to-run-things.html?ref=michael_r_bloomberg

⁵ Stecker, Sarah and Dan Steinman, "Pay or We (Might) Go: How Citigroup Games the State and Cities." *New Jersey Policy Perspective and Good Jobs New York*, June 2007. http://www.njpp.org/rpt_games.html

⁶ For more on tax increment financing, visit Good Jobs First at www.goodjobsfirst.org

⁷ Dye, Richard and David Merriman, "Tax Increment Financing: A Tool for Local Economic Development." *Land Lines*: Vol. 18, Number 1. The Lincoln Land Institute, January 2006.

⁸ See Mattera, Phillip, Karla Walter, Julie Farb Bain and Michelle Lee, "The State of State Disclosure: An Evaluation of Online Public Information About Economic Development Subsidies, Procurement Contracts and Lobbying Activities." *Good Jobs First*, November 2007. <http://www.goodjobsfirst.org/news/article.cfm?id=375> and The Iowa Department of Economic Development's Legal and Compliance Project Portfolio- Searchable database: <http://www.iowalifechanging.com/AnnualReport/2009/asp/search.aspx>

⁹ Washington State House of Representatives, Final Bill Report EHB 1069, <http://www.leg.wa.gov/pub/billinfo/2005-06/Pdf/Bill%20Reports/House%20Final/1069.FBR.pdf>

CHAPTER NINE

OTHER STEPS TOWARD (OR AWAY FROM) FAIR TAXES

Tax reform is not just about making taxes fairer and more sustainable. It's also about making procedural improvements in the way policymakers evaluate their tax system. Lawmakers around the nation have enacted procedural changes in the way tax breaks and proposed tax changes are reported and evaluated, as well as rules governing the way taxes are collected and rebated. This chapter looks at several such efforts and discusses their impact on the quality of state and local tax systems.

Tax Expenditure Reports

Lawmakers often provide targeted tax cuts to particular groups of individuals or businesses. These special tax breaks are called “tax expenditures” because they are essentially government spending programs that happen to be administered through the tax code. However, tax expenditures are usually less visible than other types of public spending—which makes it harder for policymakers and the public to evaluate these hidden tax breaks.

The main difference between tax expenditures and regular government spending is that under the tax expenditure approach, instead of the government sending out a check to the recipient, the recipient pays less in tax. For example, a government could create a direct spending program to subsidize windmill construction. Or, instead, it could offer a tax expenditure that lets companies building windmills reduce their taxes by exactly the same amount. In theory, it doesn't matter whether a government uses direct spending or a tax expenditure to achieve a policy goal. In either case, the windmill subsidy program will (in theory) have to compete with other government spending priorities when the government makes its budget decision.

In practice, however, tax expenditures differ from direct spending in several important ways:

- Unlike most spending programs, tax expenditures are usually open-ended; they have no built-in budget

limits, and generally there is no annual appropriations or oversight process. Anyone who meets the statutory criteria for eligibility can get the subsidy.

- Direct spending usually requires a government agency to weigh the worthiness of an application from any potential beneficiary. In contrast, most tax expenditures require no action other than the filing of a tax return—which means that the benefits of these tax breaks may inadvertently be extended to beneficiaries who might otherwise be deemed unworthy or ineligible.
- Tax agencies typically have little incentive to ensure that tax-expenditure programs are working as they were hoped to. By contrast, government agencies tend to look closely at the effectiveness of their direct spending initiatives.
- Basic facts about who benefits from tax expenditures are often hidden behind the cloak of tax return secrecy, unlike the beneficiaries of conventional spending programs who are usually easy to identify.

As a result of these flaws, tax expenditures often turn out to be very expensive programs for which there is little oversight and review. Once a tax expenditure is put into the law, it usually stays there indefinitely. And typically little is known about what the government is getting—if anything—for its money.

In most states, lawmakers don't know how much is being spent on tax expenditures. Of course, tax collections are lower than they otherwise would be. But how much lower is a mystery.

In recognition of this problem, many states (and the federal government) now publish tax expenditure reports. These are simply a listing of tax breaks and how much they cost. In recent years a growing number of state governments have followed the federal government's lead by publishing tax expenditure reports of variable quality. The best reports include the following:

- A **complete list of all exemptions** from taxes (and tax credits) levied by a state. This means looking not just at the income and sales tax base but at smaller taxes as well. It also means identifying exemptions that are not explicitly written into the tax code. For example, most states exempt personal services (such as haircuts and car repairs) from their sales tax unless they are specifically taxed. These implicit exemptions cost states hundreds of millions of dollars annually—but are usually not visible in the tax code. A good tax expenditure report will identify all such implicit exemptions.
- **Estimates of the annual state and local revenue loss** from each tax expenditure, including estimates of how much the tax break has cost in recent years and how much it is projected to cost in the future. The impact (if any) on local tax revenues should be estimated as well.
- Many state tax expenditures are inherited indirectly by state linkage to federal tax codes. Separately **itemizing these indirect federal tax breaks** will give policymakers a clearer understanding of the extent to which the federal linkage reduces state revenues.
- A written **evaluation of the effectiveness of each tax expenditure** will help policymakers to understand why each tax break was enacted—and how well it achieves its stated goals.
- A **regular publishing schedule** that coincides with the state budgeting process. State policymakers should be able to evaluate tax expenditures side-by-side with conventional spending—and this requires, good, current estimates of how much each tax break costs. For example, tax expenditure reports that are published every five or ten years are likely to be insufficient as a source for updated cost estimates.

The important insight provided by the tax expenditure concept is that a law that lowers a citizen's tax liability has no different effect than a law that requires a direct payment to the citizen. And if a tax break is designed to accomplish a public

policy goal other than the equitable collection of tax revenues, then it should be evaluated according to the standards by which we evaluate spending laws, not the standards by which we evaluate tax laws.

Tax Incidence Analysis

Tax fairness is an important policy goal—and lawmakers frequently make bold claims about the impact of tax reform proposals on tax fairness. However, most states do not currently have the analytical capability to evaluate these claims—so the media, the public and even lawmakers are often left in the dark about the true impact of tax reform proposals. The best tool for evaluating the fairness of state taxes is tax incidence analysis, which measures the impact of various taxes on residents at different income levels. Only three states—Maine, Minnesota, and Texas—have legal requirements mandating the regular use of tax incidence analyses, although other states are currently developing a limited tax incidence analyses capability.

By developing a regularly-used tax incidence model capable of evaluating all of the major taxes levied at the state and local level, state lawmakers can increase the public's understanding of tax policy issues—and can help build public trust in elected officials. But until a regular tax incidence analysis capability is introduced, policymakers and the public will have no easily available basis for evaluating the fairness of important tax policy decisions. This increases the likelihood that lawmakers will be persuaded by false claims about the fairness of various proposals—and also makes it less likely that tax fairness will be a factor in tax policy decisions.

The Institute on Taxation and Economic Policy (ITEP) maintains a sophisticated microsimulation tax model that provides policymakers and advocates with incidence analysis. ITEP's analyses usually divide the population into five groups based on income—ranging from the poorest 20 percent to the richest 20 percent. Each of these groups is called an "income quintile." ("Quintile" simply means one fifth, or 20 percent, of the population.)

The ITEP Model is capable of estimating the impact, both on tax fairness and on overall tax revenues, of virtually any change to the major taxes relied upon by state and local governments. ITEP maintains an up-to-date database of all state and local tax laws. Each year ITEP works with lawmakers and nonprofit groups in over 40 states to help them evaluate the impact of regressive tax plans—and to help them develop their own progressive tax reform plans.

ITEP's analyses also split the very richest 20 percent into three subgroups: the lowest-income 15 percent of the quintile, the next 4 percent and the richest one percent. This is done because families in the top 20 percent have more than half of all personal income in most states. Within this quintile, there are substantial differences in income levels and tax levels between the "poorest" members and the richest members. Incomes in this group range from what might be called upper-middle class, to the richest families in the country.

These analyses have been instrumental in recent state tax policy debates. For example, when residents of Washington State recently evaluated a ballot measure that would have enacted a limited personal income tax, applicable only to upper-income families, ITEP's analysis of the plan's fairness and revenue yield was the most widely cited analysis of the plan's effects, and helped to galvanize progressive support for the plan. And in Missouri, state lawmakers came perilously close to enacting a so-called "Fair Tax" in 2010—a tax plan that would replace the state's income and corporate taxes with a sales tax on virtually everything consumers buy—despite having little concrete information about how the plan would affect tax fairness or even what the required "Fair Tax" rate would be. ITEP's analysis of these questions clarified the public debate over the plan, and helped to ensure that lawmakers had accurate information on the plan's impact at their fingertips when they voted on this issue. Astonishingly, in each of these cases, if ITEP had not conducted these pro bono analyses, there simply would not have been any such information available to policymakers and the public to help them evaluate these plans.

Rainy Day Funds

In the long run, states with progressive personal income taxes will enjoy the most reliable growth in tax revenues. But the recent decline of income taxes in many states has left policymakers jittery about the role of the tax in funding services. Some lawmakers have advocated making allegedly volatile income taxes less progressive to help ensure the long-term adequacy of state revenues. But this is misguided policy.

The real culprit in states suffering from income-tax shortfalls in recent years is the unwillingness of states to save sufficient

revenue in good years in order to shore up revenues in lean years. Almost all states now have some form of **"Rainy Day Fund"** designed to achieve this—but the recent economic slowdown has exposed the design flaws of many states' funds. The box on this page shows some of the most important factors differentiating effective and ineffective rainy day funds. Important questions to ask about your state's rainy fund include:

- Under what circumstances must lawmakers deposit revenues into the fund? Requiring annual deposits when revenue growth exceeds a certain threshold is a good approach.
- Is there a limit on the size of the fund? Many states limit their rainy day fund to five percent of annual expenditures or less—a figure that most now agree is too low.
- How hard is it to withdraw funds? Excessive constraints on withdrawals make the rainy day fund less flexible as a fiscal policy tool.
- How quickly must the fund be replenished after a withdrawal? The faster the replenishment rule, the less flexible rainy day funds are in dealing with fiscal shortfalls.

Rainy day funds are a necessary component of a responsible state budget for a simple reason: taxes and public spending operate on different cycles. When the economy slows down, tax revenues slow down too. Declining income means declining income taxes and declining sales taxes as families make fewer purchases. But the need for important public services such as education and transportation does not diminish when the economy declines: declining income actually increases the need for many areas of public spending, such as health care, education, and disability services. Rainy day funds are an important way of allowing states to match up taxes and spending needs over the business cycle. Almost every state has recognized this reality by enacting a rainy day fund—but few states have created a fund that is truly adequate to bridge fiscal shortfalls.

Important Features of Rainy Day Funds

- ✓ Rules for deposit
- ✓ Size limits
- ✓ Rules for withdrawals
- ✓ Rules for replenishing funds

Tax and Expenditure Limits (TELS)

A growing number of states are considering proposals to limit revenue growth by placing strict limits on the annual growth of state or local tax revenues or spending. These limits are collectively known as **tax and expenditure limits**, or **TELS**. TELS take many forms and no two are entirely alike. They include limits on revenue or spending increases tied to some

type of index such as population, inflation, or personal income. A few states tie their appropriations to their revenue forecast. More than half the states have some type of TEL in place.¹ In the majority of states that have TELs the spending or revenue limit is embedded in the state's constitution, which makes it difficult to lift these restrictive limits. TELs remove decision-making authority from elected officials, frequently forcing damaging automatic cuts in tax revenue and public infrastructure when both are vitally needed.

One of the most controversial TELs is Colorado's Taxpayer Bill of Rights (TABOR). Colorado's TABOR limits the annual growth in state revenues to the sum of inflation and population growth. So if Colorado's population grows by 1 percent and inflation grows by 2 percent in a given year, Colorado government revenues are allowed to grow by no more than 3 percent in that year. "Surplus" revenues over that limit are rebated directly to taxpayers.

So what's wrong with a TABOR-style limit on state revenues and spending?


- When states collect revenue above the limit, this so-called "surplus" must be rebated to taxpayers. This makes it harder to replenish rainy day funds—which means that when the economy tanks, these states have to enact painful spending cuts to make ends meet.
- Imposing a spending limit assumes that states are already adequately funding public services. Few state lawmakers would assert with a straight face that their public service needs have all been met—but that's one implication of strictly capping the growth rate of a state's spending.
- Spending limits assume that the cost of providing existing services will grow no faster than the limits allow. But many state spending needs grow faster than population and inflation, as any state lawmaker confronting skyrocketing Medicaid enrollment and education expenses can attest. And some public sector spending—spending on corrections facilities, for instance—can grow faster than spending limits for reasons that are beyond the control of lawmakers.
- Spending limits also assume that no new and unanticipated spending needs will emerge. The upcoming expansion of Medicaid, funded in part by

states, attests to the constantly changing mix of spending priorities at the state level.

TABOR limits are often described by their proponents as a good-government tool. But state bond rating agencies, arguably the best arbiter of state fiscal health, reject this argument. In 2002, Standard and Poor's downgraded Colorado's bond rating, citing the TABOR spending limits as a reason for this punishment. Moreover, there is evidence that the TABOR limits had unintended consequences far beyond the intentions of its supporters. The Bell Policy Center has shown that under TABOR, health care fees increased, state investment in higher education fell dramatically, and tuition for higher education increased.² In a victory for tax justice advocates, in 2005 Colorado voters approved a referendum designed to temporarily suspend the TABOR revenue limit for five years. Coloradans continue to debate whether TABOR should be allowed to expire permanently.

Across the nation, state lawmakers are facing painful choices between further spending cuts and unpopular tax increases. TABOR-style spending caps restrict the ability of lawmakers to make the bread-and-butter decisions about government activities that should be their primary function, forcing the elimination of needed public services at the very time when they are most needed.

Conclusion

Some of the structural reforms outlined in this chapter can have a positive impact on the ability of lawmakers to make reasoned, fully informed decisions about tax fairness and adequacy. Tax expenditure reports are an important tool to help citizens evaluate targeted tax breaks that would otherwise be hidden from public view. Tax incidence analysis makes it possible to accurately judge the fairness of tax reform proposals. And an adequate rainy day fund can allow states to weather the storm of economic recessions without cutting public services to the bone. But the arbitrary tax and spending limits collectively known as TELs actually add a new layer of complexity to the already difficult decision-making process facing legislators, making it much harder for policy makers to provide the services demanded by their constituents. 

¹ Waisanen, Bert, "Tax and Expenditure Limits 2008." National Conference of State Legislatures. <http://www.ncsl.org/Default.aspx?TabId=12633#typesoflimts>

² "Ten Years of TABOR." The Bell Policy Center, 2003. <http://bellpolicy.org/node/3440>

CHAPTER TEN

ACHIEVING TAX REFORM: NEXT STEPS

Tax reform may seem like a daunting task. After all, successful tax reform can take years—and tax justice advocates often are too busy fending off the unfair “tax deform” strategies of anti-tax organizations and lawmakers to embark on their own constructive agendas. But the good news is that the road to a fairer tax system is clearly marked. This chapter looks at important strategies and information sources for progressive tax advocates seeking to follow this road.

Why Tax Reform is Necessary

The need for tax reform is now greater than ever. State and local taxes in almost every state are regressive. And many of the states that have managed to push through revenue-raising measures to respond to recent budget deficits have done so in a way that makes their tax systems even less fair—hiking regressive sales and excise taxes much more frequently than progressive income taxes. Meanwhile, as this report has documented, the structural flaws that have reduced the yield of these taxes remain unresolved:

- State and local sales tax bases are too narrow: few states have expanded their tax base to include services, the fastest-growing area of consumption. And many states have a host of poorly-targeted exemptions for the sales of various goods that reduce the yield of each penny of tax. Collectively, these tax breaks put added pressure on lawmakers to increase the sales tax rate on the remaining items of consumer spending.
- Personal income taxes, ostensibly the most progressive tax levied by states, are being eroded away—and made less progressive—by a proliferation of poorly targeted tax breaks for capital gains, retirement income and other income sources. And many states use income tax brackets that require a large percentage of taxpayers to pay at the top rate, rather than subjecting only the wealthiest

taxpayers to the highest rates. These structural flaws mean that most state income taxes are not living up to their potential as a progressive offset for the regressive sales and property taxes that states rely on most.

- Corporate income taxes continue to decline, as federal and state tax breaks and clever accounting tricks by the corporations themselves make the tax base ever narrower.
- Property taxes remain an important, but unfair revenue source for state and local governments. Many states have enacted overly restrictive tax limits designed to reduce the use of these taxes, but relatively few have enacted well-targeted exemptions or credits designed to reduce the property tax on the low-income taxpayers for whom these taxes are most burdensome. And many states have not yet dealt with the inequities between low-wealth and higher-wealth taxing districts that the local property tax usually creates.

Events at the federal level have compounded these inequities. With the political paralysis and the knee-jerk fear of taxes so often found in Congress and state houses throughout the country, the task of igniting tax reform falls on tax activists. The key is showing the public, elected officials and the media what fair tax policy is and how it can benefit people. We hope this primer provides you with enough tax policy knowledge to start that process.

Strategies for Tax Reform

The first step in achieving tax reform is to **understand what's wrong with your state's tax system**. This report has described in general language the structural flaws that plague almost all states' taxes—such as narrow sales tax bases and corporate tax loopholes. But there is no substitute for a good understanding of exactly which provisions of your state's tax laws prevent the state from achieving a fair and adequate tax system. If your state doesn't have a tax expenditure report (see p. 62), a rainy day fund (see p. 64), or accountable economic development strategies in place, these are good first goals to put on a tax reform agenda because these tools will make the shortcomings of your tax system more obvious.

Successful tax reform campaigns usually **include organizations from many sectors of the community**. Unions, religious groups, public interest organizations, business groups and others should all be part of the campaign. Certainly, with more groups, there will be more conflict over the campaign's goals and tactics. But without broad participation, it is very difficult to overcome the power of those who oppose reform. Depending on the coalition's goals, economic climate and political realities it may be important for the coalition to come together and support one specific tax reform plan. On the other hand, simply agreeing that new revenues are necessary may be the best strategy.

If advocates decide to support a specific plan, they should **be specific about what their plan does and how it affects people**. If the plan includes a vaguely stated proposal to raise income taxes on the rich, tax reform opponents will claim that by "rich" you mean anyone with a job. But if you make it clear that (for example) your plan would raise the tax rate on those with incomes over \$200,000 by 1 percent in order to pay for a tax cut for those earning under \$50,000, and would result in a tax cut for 60 percent of your state's residents, you'll have the kind of clearly stated proposal that will be more difficult for the other side to distort.

Coalition strategies and tactics will vary depending on the politics in the states, but it is important to **remember the vital role the media can play**. Coalition members can work with the media in a variety of ways including: writing op-eds, encouraging letters to the editor, issuing press releases, holding press conferences, and participating in editorial board meetings. Coalition members may find it valuable to purchase space in newspapers or websites and potentially produce television or radio commercials. There is also value in utilizing

the Internet and building a website that utilizes social media like Facebook and Twitter.

Political strategies for advocates **should look for opportunities to engage policymakers and the general public**. If a Tax Commission is meeting or a relevant legislative hearing is taking place, coalition members may want to testify at these events. Coalition members will likely want to participate in individual meetings with legislators or key staff to understand their views on tax reform.

In order to engage the general public, most coalitions have an educational component too. Educational materials should be presented in a simple and straightforward way. Public workshops on tax reform can be a critical component in building public awareness of—and support for—tax reform.

Unfortunately, tax reform plans can be smeared by scare tactics. So it's important to **be prepared to respond to misleading arguments** against your plan. For example, opponents of tax reform frequently claim that raising taxes on the wealthy or corporations will drive businesses away from a state and cost jobs. Or they will falsely claim that tax reform would increase taxes on middle-income families. These arguments are usually based on conjecture rather than research, and when there is "research" to back these claims up, it is often poorly designed. (See Chapter Eight for more on how to evaluate these anti-tax claims.) The goal of these scare tactics is not to inform voters—it's to make tax issues seem harder to understand than they really are, and to create confusion about what a reform proposal really does. So it's important to recognize and debunk specious arguments against progressive tax reform.

For example, it's important to remember that tax fairness means asking people to pay according to their ability and that incidence tables are the best measure of what is fair. Of course, your opponents will try to undermine incidence analyses. They might claim, for instance, that the top fifth of the population pays some high percentage of the total taxes and that it wouldn't be "fair" to make them pay more. But this argument is nothing but a smoke screen. What really matters is the share of income paid in tax by taxpayers at different income levels—and by this basic measure of fairness, the wealthiest residents in most states pay substantially less than lower- and middle-income taxpayers.

It may also be important to **highlight the linkage between the taxes you want to reform and the public services that are provided by these taxes**. If you ask most

Taxing Services

Despite near-universal agreement among economists on the wisdom of taxing personal services, multiple states have recently lost hard-fought battles to expand their sales tax bases in this manner. These failures raise some obvious questions about the politics involved in bringing this huge share of the economy within the reach of the sales tax.

In Maryland, an effort to tax about half-a-dozen personal services was gradually whittled down to include only one (computer services) as a result of intense efforts by business industry lobbyists. By focusing on such a small group of services, Maryland left itself vulnerable to charges that it was unfairly singling out specific businesses for new taxes (despite the fact that the consumers, not businesses, would be paying the taxes), and that dozens of other services not being considered were equally worthy of being taxed. Simply put, Maryland's piecemeal approach to taxing services missed an opportunity to focus the debate on the principle of taxing all consumption equally. In doing so, this left the door open for the business lobby to claim (with no apparent sense of irony) that marginal improvements to Maryland's already discriminatory sales tax would somehow worsen its unfairness. Ultimately, these flaws with Maryland's approach proved to be fatal to the cause of services taxation, and even the tax on computer services was eventually repealed.

It appears that Maryland's "baby steps" approach to modernizing its sales tax base was too incremental, and too vulnerable to the efforts of well-organized business lobbies. The taxation of personal services is an issue that must be addressed comprehensively, so that meaningful, principled support can be rallied to the cause. Of course, this approach does not guarantee success, but by addressing the issue more broadly, it has the potential to draw in enough stakeholders that the ability of narrow business interests to monopolize the debate can be curtailed.


people whether they favor raising the state income tax, they'll probably say no. But if you ask people whether they favor raising the income tax to help fund education or health care, they will be much more supportive. Most people understand intuitively that the public services they value can only be provided if the tax system raises adequate revenues to pay for them—so it's important to remind people that the ultimate purpose of tax reform is to ensure the continued provision of these services.

When people work together, successful tax reform efforts can be the result. For example, in recent years Oregon Center for Public Policy and Kentuckians for the Commonwealth each helped to build broad-based coalitions in their states. These groups developed plans for tax reform, publicized which income groups would see increases or cuts in taxes as a result of their proposals, and worked with legislators and the media to help the general public understand the basic tax policy principles underlying their proposals. This ongoing work helped to establish these groups as a credible source of accurate information and made these coalitions a respected voice in state tax policy debates. The work of these coalitions also helped to increase the visibility of tax fairness issues in both states.

Resources for Further Investigation

There are many sources of information on state taxes. A good place to start is with the reports issued by **ITEP** and **Citizens for Tax Justice** (CTJ). ITEP analyzes the fairness of state and local taxes in dozens of states annually. ITEP's **Who Pays?** report (2009) provides a baseline for measuring the fairness of taxes in all fifty states. CTJ monitors the fairness of federal tax reform proposals; CTJ's analyses of the Bush tax cuts were the most widely cited measuring stick for evaluating the unfairness of these cuts. **Just Taxes**, our quarterly newsletter, and our weekly **Tax Justice Digest** keeps readers informed on the latest developments in tax policy and advocacy, and lists new publications of note by CTJ, ITEP and other organizations (you can sign up for the Tax Justice Digest at http://www.ctj.org/digest_signup.php).

Other good sources for information on state taxes include:

- **State revenue and tax departments.** Many states publish reports that provide valuable information about the state's tax structure. Usually, the best place to start is with your state tax agency's annual report—but be sure to check out a complete list of available publications. Tax departments also often have a great deal of unpublished information. If there's something you need but can't find in an agency's publications, give the agency a call and ask for it. ITEP's website features a state-by-state tax policy hub which includes links to resources published by state revenue and tax departments. Visit www.itepnet.org and click on a state to access the policy hubs.
- The **U.S. Census Bureau** (www.census.gov/govs/) publishes *Government Finances*, a helpful source of data for comparing your state's tax system to other states.
- The **Center on Budget and Policy Priorities** (www.cbpp.org) publishes a wealth of information on tax and spending programs as they affect low-income taxpayers.
- The **Demos Center for the Public Sector** (www.demos.org) is an organization dedicated to helping people understand the important role that government structures play.
- **Economic Policy Institute** (www.epi.org) publishes helpful reports that offer information on the relationship between economic policy and working families.
- **Good Jobs First** (www.goodjobsfirst.org) is an excellent resource for advocates interested in learning about accountable development in their state.
- The **Lincoln Institute of Land Policy** (www.lincolnst.edu) maintains a comprehensive online database of property tax features in all 50 states plus the District of Columbia.
- **The National Conference of State Legislatures** (www.ncsl.org) has a number of publications evaluating state taxes, including their annual report *State Budget and Tax Actions*.
- The **Rockefeller Institute** (www.rockinst.org) regularly analyzes trends in the health of state tax systems, and follows trends in state spending as well.
- State advocacy and research groups are an essential component to any successful movement for tax fairness. These groups can be found in most states. ITEP maintains a list of these groups, organized by state, on our website.
- **Networks of state groups.** Many state groups stay connected and function as part of a larger series of networks. These networks include: the **Economic Analysis and Research Network** (www.earncentral.org), the **State Fiscal Analysis Initiative** (www.statefiscal.org), the **Progressive States Network** (www.progressivestates.org), and the **Tax Fairness Organizing Collaborative** (www.faireconomy.org/tfoc). These networks partner with state and local advocates and policymakers across the country as well as national groups. 

APPENDIX I: GLOSSARY

Adjusted gross income (AGI). On a personal income tax form, the amount of income that is subject to tax after all adjustments have been taken, but before subtracting deductions or exemptions. (Chapter 5)

Adjustments. Income tax breaks that reduce the amount of taxable income. For example, on federal income tax forms moving expenses, some teaching supplies, and contributions made to certain retirement plans are subtracted from income. Most states allow the same adjustments that are allowed on federal forms, and many allow their own unique adjustments. These adjustments are often enacted with good intentions, but tend to make the income tax more complicated than it needs to be. (Chapter 5)

Ad valorem tax. A tax based on the value of the thing being taxed. Sales taxes are based on the sales price of items taxed, so they are ad valorem taxes. Cigarette taxes are not ad valorem taxes, because they are levied on a per-pack basis, so tax collections do not vary with the price of a pack of cigarettes. (Chapter 3)

Apportionment formula. The formula states use to divide up the profit of a multi-state corporation into an “in-state” portion and an “out-of-state” portion. In theory, apportionment rules should divide a corporation’s income between the states in which it earns profits in such a way that all of its profit is taxed exactly once, but special apportionment rules mean that some profits are never taxed at all. (Chapter 6)

Assessed Value. The official value of a property for tax purposes, as determined by property tax officials. A property’s assessed value can be equal to its market value, or less than market value, depending on the legal assessment ratio used by the state and the quality of assessments. (Chapter 4)

Benefits Principle. A principle of taxation in which taxes are based on the benefits received from the public services funded by the tax. (Chapter 2)

Bracket Creep. When income tax brackets are not adjusted frequently to account for the impact of inflation, taxpayers can see income tax hikes over time even if their real income

doesn’t grow. These inflationary tax hikes can affect any income tax variable that is defined as a fixed dollar amount, including exemptions and credits, and can also reduce the value of property tax breaks. (Chapter 5)

Business Input Sales. The sale of items purchased by businesses to create their products. For example, a baker purchases flour to make bread. The baker’s purchase of flour is a business input sale. Retail sales taxes should not apply to such sales—but most state sales taxes do so to some extent. (Chapter 3)

Circuit Breakers. A targeted property tax credit. Typically, states give homeowners a credit equal to the amount by which their property tax exceeds a certain percentage of their income. Most states target their circuit breakers to elderly homeowners, but an increasing number of states use them to deliver tax relief to non-elderly homeowners and renters. (Chapter 4)

Consumption Tax. A tax that applies to purchases of goods and/or services by individuals and businesses. These taxes include general sales taxes, which apply to retail sales, and special excise taxes on alcohol, cigarettes, and gasoline. (Chapter 3)

Credit. A dollar amount subtracted from tax liability. (By contrast, deductions and exemptions are subtracted from taxable income.) Tax credits are used primarily to reduce income and property tax liability, but are occasionally used to partially offset the regressivity of sales taxes. In general, credits are a more progressive approach to tax relief than are exemptions. (Chapters 3, 4, 5)

Deferral Program. A special rule that allows some homeowners, usually the elderly, to delay paying their property taxes for some period of time. Interest is often owed on the deferred taxes, and the final payment is usually due when either the homeowner dies or the property is sold. (Chapter 4)

Effective Tax Rate. The tax paid as a share of the potentially taxable base. For example, the effective income tax rate is the income tax paid expressed as a share of total personal income. (Chapter 2)

Elasticity. A measure of tax adequacy that describes whether or a tax produces revenue growth faster or slower than the economy. (Chapter 2)

Excise Tax. Sales taxes that apply to particular products. For example, many states levy excise taxes on alcohol, cigarettes and gasoline. Excise taxes are especially regressive because the tax is levied on a per-unit basis (so the tax on a bottle of cheap wine is the same as the tax on an expensive wine). (Chapter 3)

Exemptions. A special rule that provides a tax shelter for some economic activity. Exemptions reduce the amount of taxes owed. Income taxes usually allow exemptions for each taxpayer, and property taxes often allow part of a home's value to be exempted from tax. Sales taxes frequently exempt all sales of certain items such as food, utilities and rent. (Chapters 3, 4, 5)

Exported Tax. The amount of a tax paid by out-of-state residents. Some part of almost every state tax is paid by residents of other states. This helps ensure that non-resident individuals and businesses that use a state's services pay their fair share of the cost of providing these services. (Chapter 2)

Federal Offset. The ability to deduct certain state taxes on federal income tax forms. For taxpayers this can result in state taxes being offset by lower federal income taxes. (Chapter 2)

Graduated Tax. A graduated tax applies higher tax rates to higher income levels. Most income taxes use graduated rate structures. By contrast, a flat-rate tax applies the same rate to all incomes. (Chapters 1, 5)

Gross Receipts Tax (GRT). A tax on the total gross revenues of a company, regardless of their source. A gross receipts tax is similar to a sales tax, but it is levied on the seller of goods or services rather than the consumer. Applies to the sales made by companies at every stage of the production process, including manufacturing companies, wholesalers, and retailers. (Chapter 3)

Homestead Exemption. A tax break enjoyed by owner-occupied homes in many states that shelters a portion of the home's value from tax. (Chapter 4)

Horizontal Equity. The measure of tax fairness that describes how a tax system treats taxpayers in similar circumstances. (Chapter 2).

Incidence Analysis. A tool for measuring the fairness of state and local taxes and tax changes. (Chapter 2)

Intangible Property. Property that has no physical substance, but may have financial value. Examples of intangible property include stocks, bonds, and retirement plans. (Chapter 4)

Marginal rate. Income tax rates that apply only to the taxable income over the amount where the tax bracket starts. (Chapter 5)

Microsimulation Tax Model. A tool for calculating revenue yield and incidence (current and proposed), by income group, of federal, state and local taxes. The model starts with a sample of income tax returns representative of the tax-filing population of interest rather than aggregate data. (Chapter 9)

Nexus. The minimum level of contact that a business must have with a state in order for its activities to be taxable in that state. (Chapter 6)

Nominal tax rate. The legal rate that is multiplied by the tax base to yield the amount of tax liability. (Chapter 2)

Progressive. A progressive tax is one in which upper-income families pay more of their income in tax than do those with lower incomes. (Chapter 1)

Proportional. A proportional tax is one in which all taxpayers pay the same share of their income in tax. (Chapter 1)

Public Law 86-272. A federal law restricting the ability of states to tax the income of multi-state businesses under their corporate income tax. PL 86-272 holds that states cannot tax the income of businesses whose only connection to the state is shipping products into it. (Chapter 6)

Pyramiding. Pyramiding occurs when an input is subject to sales tax when purchased by a business and then, effectively, a second time when the business passes the cost of the input into the selling price of a good or service that is also subject to sales tax. (Chapter 3)

Rainy Day Fund. Term used to describe a reserved amount of money to be used in times when regular income is disrupted or decreased in order for typical operations to continue. (Chapter 9)

Regressive. A regressive tax requires low- and middle-income families to pay more of their income in tax than wealthier families must pay. (Chapter 1)

Remote Sales. Purchases of items from companies based in other states. Every state with a sales tax also levies a use tax designed to tax these remote sales. (Chapter 3)

Retail sale. A sale made to the final consumer of a product. When we buy a new refrigerator for personal use, that's a retail sale. By contrast, when a business buys lumber for use in building a house, that's not a retail sale but an intermediate transaction, because the goods purchased are used in the process of making something else. In theory, states should tax all retail sales and exempt all intermediate transactions, but almost all states fall short of both of these goals. (Chapter 3)

Split Roll. A property tax system that applies different tax rates, or different assessment ratios, to different categories of properties. Split roll systems often favor residential property over commercial property. (Chapter 4)

Stability. A measure of tax adequacy that describes whether or not a tax grows at a predictable pace. (Chapter 2)

TABOR (Taxpayer Bill of Rights). A constitutional amendment that limits the annual growth in state revenues and expenditures to the sum of the inflation rate and the percentage change in the state's population. (Chapter 9)

Tangible Property. Property that has physical substance and can be touched. This includes real property such as homes and apartments, and personal property such as cars and furniture. (Chapter 4)

Tax Base. The amount subject to tax. If all the consumers in a state purchase \$1,000,000 in coffee each year, then the tax base for a coffee sales tax would be \$1,000,000. However, the tax base does not have to be expressed in terms of money. If coffee was taxed by the pound, then the tax base would be the number of pounds of coffee sold. (Chapter 2)

Tax and Expenditure Limits (TEs). Designed to curb growth in government spending by placing constitutional or statutory restrictions on the amount a government entity can spend or tax its citizens. (Chapter 9)

Tax Expenditure. A special tax break targeted to particular groups of individuals or businesses. These tax breaks have the same impact as a direct government spending program giving cash grants to these groups, but implementing them through the tax system makes these grants less visible—and makes lawmakers less accountable for explaining why these breaks are a good idea. (Chapter 10)

Tax Incidence Analysis. A measure of the impact of various taxes on residents at different income levels. (Chapter 9)

Tax Increment Financing (TIF). A public financing method which uses future gains in taxes to finance current improvements. (Chapter 8)

Uniform Division of Income for Tax Purposes Act (UDITPA). Model legislation adopted in the 1950s by legal reformers seeking to achieve fairness and uniformity in state corporate tax practices. Most states initially adopted at least some of the UDITPA recommendations, but many have moved away from UDITPA recommendations by changing apportionment factors and other rules. (Chapter 6)

Use Tax. A sales tax which applies to goods that are purchased from out-of-state retailers. (Chapter 3)

User Fee. A fee charged by government for a specific service rendered to a specific taxpayer by the government. The payment is usually made at the same time that the service is rendered and the amount of the fee is usually related to the cost of the good or service provided. (Chapter 7)

Vertical equity. The measure of tax fairness that describes how a tax system treats people at different income levels. When we describe a tax as regressive, proportional or progressive, we're making a statement about vertical equity. (Chapter 2)

THE **ITEP** GUIDE TO **Fair State and Local Taxes**

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