

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>