



Institute on Taxation and Economic Policy

1616 P Street, NW • Washington, DC 20036 • www.itepnet.org

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CONTACT:

Matthew Gardner 202.468.3722

New ITEP Report Offers Tax Reform Guidance to Cash-Strapped States

“ITEP Guide to Fair State and Local Taxes” Highlights Sensible State Tax Reform Options to Balance Budgets in a Fair and Sustainable Way

State governments face a budget crisis of historic proportions, and in recent months policymakers have responded with unpopular and often shortsighted spending cuts to close budget gaps. But as a new report from the Institute on Taxation and Economic Policy (ITEP) shows, policymakers in virtually every state have sensible tax policy tools at their disposal to help reform their underperforming tax systems in a sustainable way. With the scheduled end of temporary federal aid to state governments later this year, state lawmakers will face even more pressure to find real, long-term solutions to their tax systems’ woes. The report is designed to help policymakers approach both the short-term and long-term fiscal challenges they face.

Unwarranted Tax Loopholes Reduce Revenues From Every Major Tax

The *ITEP Guide to Fair State and Local Taxes*, released on March 3, takes a hard look at why state taxes have underperformed in the recent economic downturn, and recommends strategies for reforming these taxes to make them better able to fund needed public investments in the future. The report includes separate chapters discussing each of the major revenue sources on which state and local governments rely, including income, sales, property and corporate taxes. A common theme in ITEP’s analysis of each of these taxes is that unwarranted (and frequently unintentional) loopholes in the tax law make these taxes less fair and less sustainable than they should be. For example:

- Tax breaks for capital gains and retirement income make the personal income tax fall short of its full potential as a tool for enhancing tax fairness.
- Virtually every state’s sales tax exempts the services—ranging from haircuts to car repair—that make up a growing share of consumer spending. And the inability of states to effectively tax Internet-based sales makes the tax even more inequitable.
- Corporate income taxes are being decimated by clever corporate tax-avoidance techniques that lawmakers never sought to authorize.
- Property taxes are hampered by “tax caps” that reduce the ability of local governments to fund schools while failing to provide meaningful, targeted property tax relief to the fixed-income families and seniors who most need this help.

The report also recommends a variety of procedural tax reforms that would make it much easier for state policymakers to identify and evaluate these harmful tax giveaways in the future. These reforms include regularly publishing detailed “tax expenditure reports,” which list the cost and rationale for every tax break currently weighing down state tax codes, and “tax incidence analysis” to help measure the tax fairness impact of proposed tax changes.

Loophole-Closing Can Enhance Fairness While Raising Revenues

The loophole-closing tax reform strategies identified in ITEP's new report are valuable not only because they can raise needed revenues, but because these loopholes have a corrosive effect on tax fairness. "When state income taxes exempt capital gains while taxing workers' wages, sales taxes exempt haircuts while taxing scissors, and corporate taxes hit "mom and pop" companies while allowing multi-national corporations to pay zero or less, these inequities erode the public's confidence in the fairness of state tax systems," noted Matthew Gardner, ITEP's director. "Even for lawmakers who don't view tax increases as a necessary part of current budget battles, eliminating these unfair loopholes should be viewed as a vital strategy for building confidence in government."

Moreover, in the current political climate, these loophole-closing options are especially sensible because they allow lawmakers to raise needed revenues without increasing tax rates. "Even when new revenues are desperately needed, hiking tax rates can provoke political opposition," Gardner said. "But eliminating unwarranted tax giveaways allows states to collect more revenue from the same set of tax rates—and ensures that these revenues will be collected in a way that doesn't arbitrarily favor one set of taxpayers, consumers or businesses over others."

Every State Can Harness Tax Reform to Help Balance Its Budget

The variety of revenue-raising reforms outlined in ITEP's new report refutes the claim, espoused by elected officials recently in a number of states, that dramatic spending cuts are the only available option for balancing state budgets. "The growing refrain among many anti-tax lawmakers in state houses across the nation is 'we're broke.'" Gardner said. "But as this report demonstrates, these lawmakers are ignoring some pretty straightforward tax reform options. The structural problems facing state tax systems are eminently fixable, and addressing these problems could make state lawmakers' budget-balancing efforts a lot easier this spring."

The report is available on ITEP's website at http://www.itepnet.org/state_reports/guide2011.php