The ITEP Guide to Fair State and Local Taxes

February 2005

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About this Report

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. Along with this report, ITEP has published a series of policy briefs providing additional information on specific topics discussed in the Guide. These briefs can be downloaded from the ITEP Internet site at www.itepnet.org.

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THE ITEP GUIDE TO FAIR STATE & LOCAL TAX POLICY

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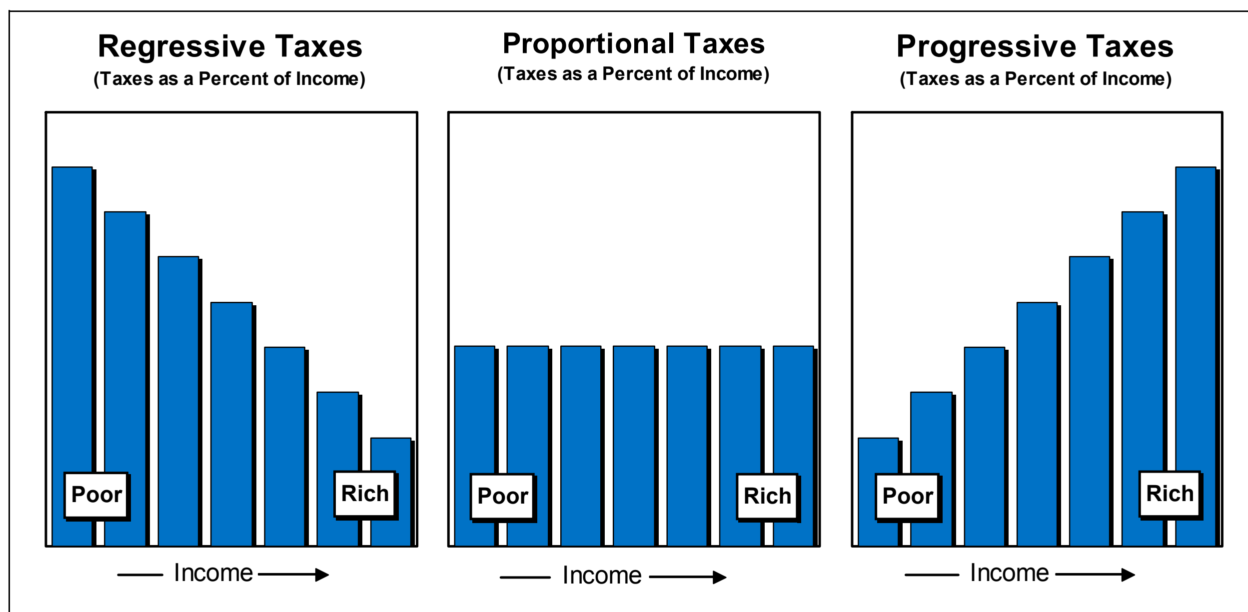
CHAPTER ONE

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.' "
>
> Adam Smith
> AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776)[1]

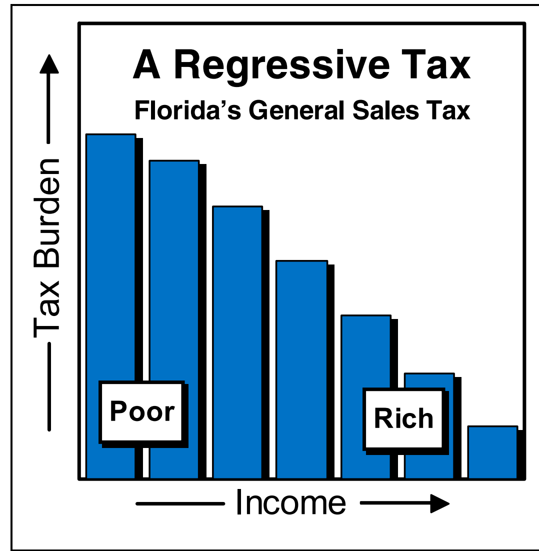
A fair tax system asks citizens to contribute to the cost of government services based on their **ability to pay**. This is a venerable idea, as old as the biblical notion that a few pennies from a poor woman's purse cost her more than many pieces of gold from a rich man's hoard. In discussing tax fairness,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

- 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.

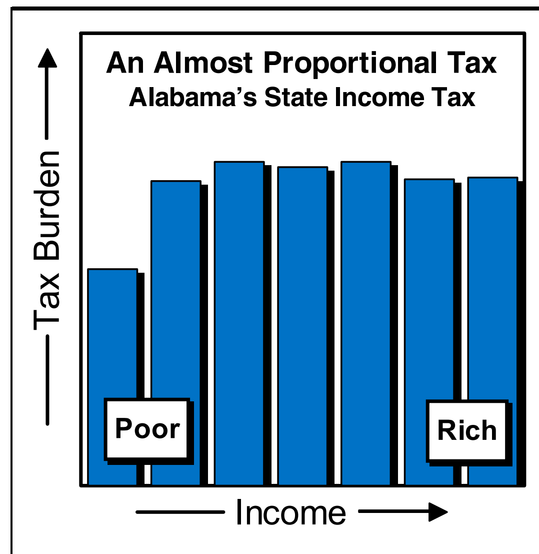


[1]Book V, Chapter II, part II, pp.777,779 (1937 ed.)

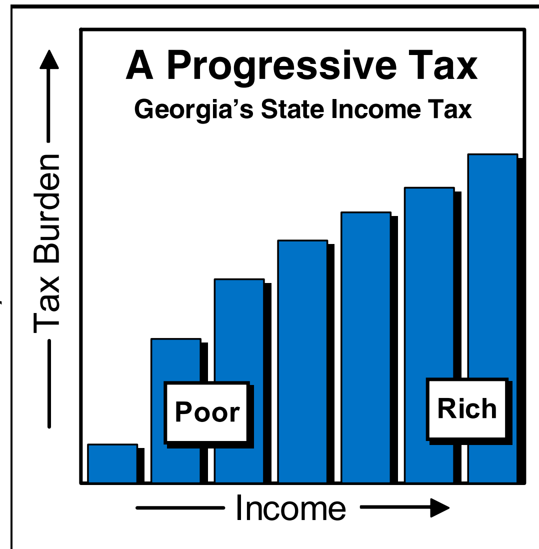
Few people would consider a tax system to be fair if the poorer you are, the more of your income you pay in taxes. But that's exactly what **regressive** taxes do. They reduce the standard of living of middle- and low-income families substantially, and have a much smaller impact on the wealthy. The sales tax is a regressive tax, as can be seen in the chart of Florida's sales tax. Excise taxes on cigarettes, gasoline and alcohol are also quite regressive, and property taxes are generally somewhat regressive.



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 quality of life. 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 right) is an example of a tax that can be proportional.[2]

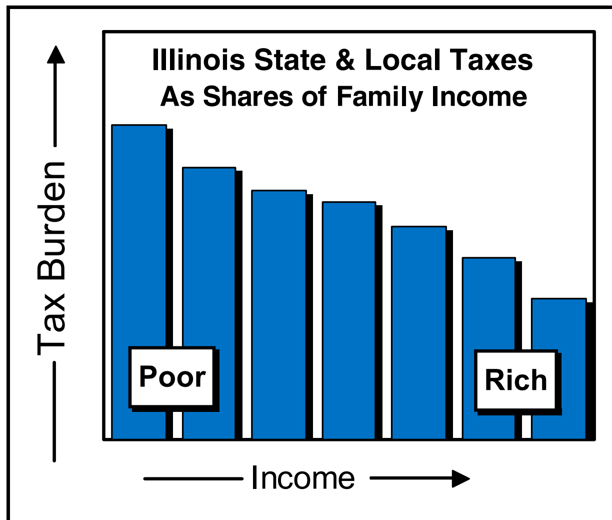


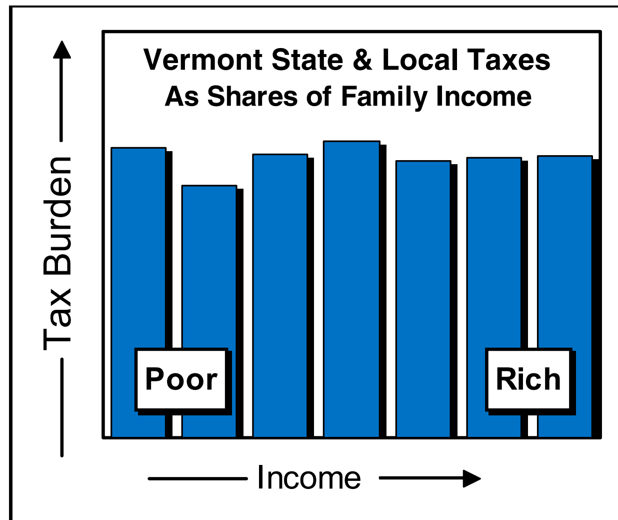
Progressive taxes are the fairest taxes. Personal income taxes are the only major tax that can easily be designed to be progressive. Low-income families can be exempted entirely and tax rates can be *graduated*, with higher tax rates applying to higher income levels, so that middle-income and rich families 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 right: 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

[2]Alabama's income tax has a graduated rate structure, but more than 75 percent of taxpayers pay at the top rate. So it operates as an effectively flat income tax for most Alabamians.



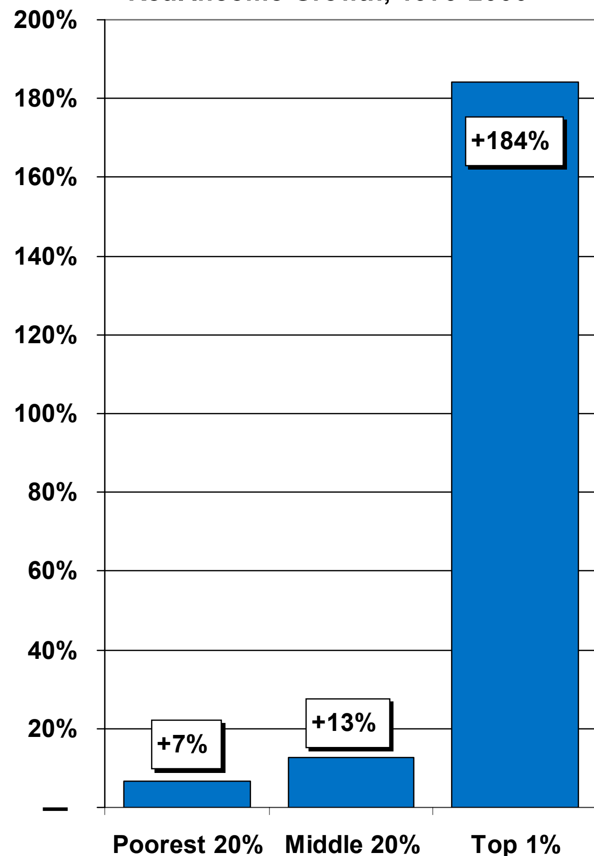


each tax. Thus, a state that relies on regressive sales, excise and property taxes more heavily than its mildly progressive income tax will end up with a very regressive tax system overall. An example of a state like this is Illinois. At the other end of the spectrum, even the most progressive income 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.

Why Tax Fairness Matters

Tax fairness is an important goal for state policymakers, for several reasons. For one thing, a regressive tax system tries to raise money from the people who have the least of it. This is 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 184 percent in the twenty-one years from 1979 to 2000—that's in "constant dollars" (meaning it's adjusted for inflation)! Meanwhile, middle-income



earnings grew by 13 percent over this period, and the poorest twenty percent saw their real pretax incomes grow by less than 7 percent.[3]

It's no wonder that so many states with regressive tax structures are falling short in revenue. 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 twenty 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 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 tax tolerance the public will show. 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. As Jean Baptiste Colbert, Louis XIV's controller general of finances reputedly said, "[t]he art of taxation consists in so plucking the goose as to get the most feathers with the least hissing." Fair taxes cause a lot less hissing.

Are Your State's Taxes Unfair?

A January 2003 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 tax 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.htm.

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 2004, the wealthiest 1 percent of Americans paid 32.8 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, 29.4 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 five years.

[3]Congressional Budget Office, *Effective Federal Tax Rates, 1997 to 2000.* August 2003.

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 be an effective advocate for progressive tax reform.

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.

> **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?

Adequacy

An adequate tax system raises enough funds, both in the short run and the long run, to sustain the level of public services demanded by citizens and policy makers. At the end of the day, adequacy is what separates successful tax systems from unsuccessful tax systems.

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 also require frequent tax increases and reductions to ensure that state revenues match the desired level of government services. (The use of "rainy day funds" can make these legislative changes unnecessary—see Chapter Ten.) 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 benefit 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. 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 tax burden. 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 10.) 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. Strategies for achieving this are outlined in later chapters of this guide.

Neutrality

The principle of neutrality (sometimes called "efficiency") tells us that a tax system should stay out of the way of economic decisions. 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.

Tax Incidence

When we look at tax burdens on families at different income levels, we're engaging in what's called **incidence analysis**. Tax incidence analysis is designed to answer basic questions about how the current tax system and various proposed alternatives affect families at different income levels. On this page is an example of an **incidence table**. It shows the total amount of state and local taxes paid nationwide, as a percentage of each group's income. For example, the table shows that the poorest twenty percent of Americans paid, on average, 7.8 percent of their income in sales and excise taxes, while the wealthiest taxpayers paid 1.1 percent of their income in these taxes.

The first step in incidence analysis is to divide a population into income groups. 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.)

ITEP's analyses also split the 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 nationally. Within this quintile, there are substantial differences in income levels and tax burdens between the "poorest"

Total State & Local Taxes in 2002

As Shares of Income for Non-Elderly Taxpayers

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	TOP 1%
Average Income in Group	$9,900	$22,000	$36,100	$57,900	$98,100	$204,100	$950,000
Sales & Excise Taxes	7.8%	6.4%	5.1%	4.1%	3.1%	2.0%	1.1%
Property Taxes	3.1%	2.3%	2.5%	2.6%	2.6%	2.3%	1.4%
Income Taxes	0.6%	1.6%	2.3%	2.7%	3.2%	3.8%	4.8%
TOTAL TAXES	11.4%	10.4%	9.9%	9.4%	8.9%	8.1%	7.3%
Federal Deduction Offset	–0.0%	–0.1%	–0.3%	–0.6%	–1.2%	–1.6%	–2.0%
TOTAL AFTER OFFSET	11.4%	10.3%	9.6%	8.8%	7.7%	6.5%	5.2%

Source: ITEP, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* (2003)

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. From a tax policy standpoint, relatively lower-income families in this group should not be treated the same as the richest families because they have very different abilities to pay. This is why our incidence tables show them separately.

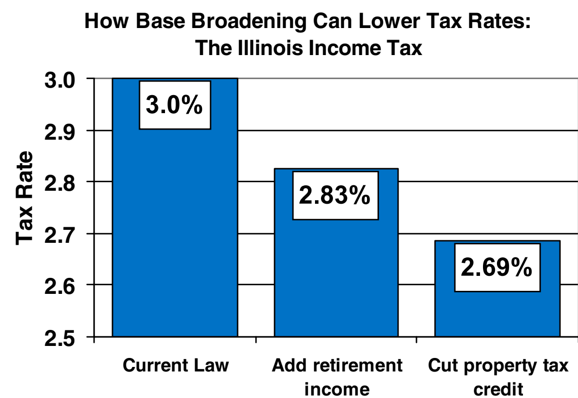
The Tax Base

The **tax base** is all the items or activities subject to a tax. The tax base of a sales tax, for instance, is the amount paid for all the items that are subject to the tax. So, if the total amount a state's consumers paid in a year for taxable items is $2 billion, then the state's sales tax base is $2 billion.

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 this way: excise taxes on cigarettes, gasoline and beer are often calculated on a per-unit basis. 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 sold 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 personal income even when the number of units sold is unchanged.

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 at right illustrates this: Illinois taxes personal income at a flat 3 percent rate. If lawmakers repealed a special tax break for retirement income, the tax rate could be 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 raise 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 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. So a broad tax base helps achieve the goal of neutrality described above.

But sometimes there are good reasons for having a narrower base. Excluding food from the sales tax, for example, makes that tax less regressive. Some 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 mil rate applied to a house with a taxable value of $100,000 yields a tax of $2,000.

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 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.

Effective Tax Rates and Nominal Tax Rates

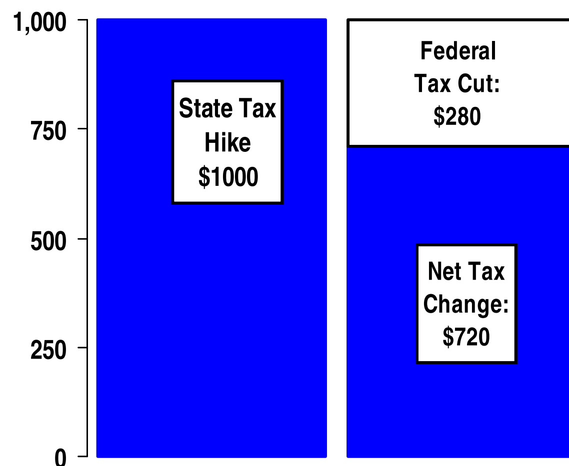
	State A	State B
Sales Tax Rate	4%	4%
Tax Base	$1 billion	$1.5 billion
Sales Tax Collected	$40 million	$60 million
Statewide Personal Income	$2 billion	$2 billion
Effective Sales Tax Rate	**2.0%**	**3.0%**

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**, and this is the way taxes are usually measured in ITEP's incidence analyses. 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 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 one presented in this chapter—are based on effective tax rates on income for families at different income levels because these tables are designed to determine the fairness of taxes. A fair tax takes more from those with a greater ability to pay, so the effective rate on income is higher on those with greater income. A regressive tax has lower effective rates on income for the rich than for middle- and low-income families.

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 (mostly living in states without an income tax) who pay more sales tax than income tax. This optional deduction is only available in 2004 and 2005.) 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 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 that state and local governments rely on. We'll look at how each tax matches up against the principles of taxation described in this chapter, and will look 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.

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 2004. But these taxes are 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 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 haircuts and car repairs). 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. 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**—that is, sales to the final consumer. But every state allows some special exemptions. Almost all states exempt some items that can be thought of as "essentials"—rent and health care expenses are almost never taxed, for example. More than half of the states exempt groceries. Some states also exempt residential utilities such as electricity and natural gas, and a few states exempt sales of clothing. And in most states, the tax base does not include personal services such as haircuts.

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. This is done to ensure that non-resident visitors pay their fair share of the sales tax.

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. However, the use tax is rarely enforced.

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 Are Regressive

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. Typically, low-income families 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. Thus, about three-quarters of the income of a low-income family, half of a middle-income family's income and just one-sixth of the income of a rich

family is typically subject to sales tax. 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: the highest burdens are shouldered by those low-income taxpayers with the least ability to pay them. Sales taxes also violate this principle in their insensitivity to fluctuations in taxpayer income: families will always need to spend money on sales taxable items such as food, clothing and utilities 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 "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. The sales tax hits everyone "equally," goes this argument; the tax is the same on, say, a tube of toothpaste, no matter who buys it.

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 the rich person has many times more income. So the amount that the rich person pays in tax on that tube of toothpaste 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 is much less of a burden on the rich than it is 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 they are 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 services will usually hurt low-income taxpayers.

Some of the sales tax paid by businesses is **exported** to out-of-state consumers. For example, Mississippi taxes industrial electrical use at a 1.5 percent rate. A Mississippi-based manufacturer that sells primarily to consumers in other states will likely be able to pass through most of the tax it pays on electricity to consumers in Texas, California, Massachusetts, and elsewhere. In this case, only a little of the tax hits Mississippi's middle- and low-income families.

A Volatile, Slow-Growth Tax

Sales taxes are a mainstay of state budgets nationwide. But during times of economic uncertainty, sales tax collections can be volatile. They can fall both when there is an economic

downturn and when people are afraid a downturn is 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 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. The main reason for this is that sales taxes only reflect the income you spend. (By contrast, income taxes depend on the total amount of income you earn.) Sales taxes also grow more slowly than the economy for reasons that have to do with the antiquated tax base in many states: the fastest-growing area of personal consumption is services, which are currently not taxed by most states. The slow growth of sales taxes frequently forces lawmakers to increase the sales tax rate just to keep tax revenues growing with inflation.

No Federal Deductibility

Heavy reliance on sales taxes carries one big disadvantage for states: sales taxes are generally not deductible by itemizers in computing their federal taxable income. (2004 federal tax legislation allows residents of states without income taxes to temporarily deduct their sales taxes, but this tax break is only available in 2004 and 2005—and taxpayers must choose between deducting sales taxes and deducting income taxes, so this tax break will generally only benefit itemizers living in non-income tax states.) Because these taxes generally can't be written off on federal tax forms, every dollar of sales tax that is paid initially by state residents ultimately comes out of their pockets—and every dollar of a sales tax cut that goes to state residents remains in their pockets. In this sense, income and property taxes offer a much greater "bang for the buck" than sales and excise taxes—an important point as lawmakers decide which taxes to increase or cut.

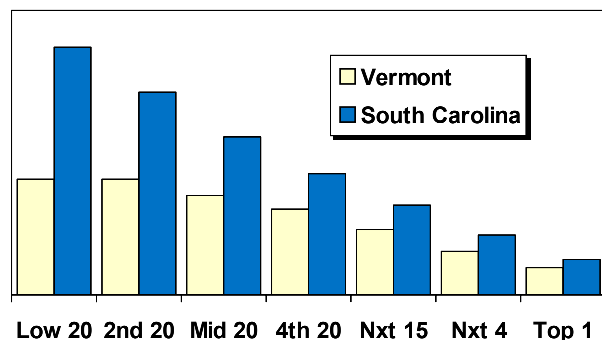
Sales Tax Reform: Issues and Options

As lawmakers struggle to bring the sales tax into the twenty-first century, they face difficult decisions ranging from the age-old question of how broad the sales tax base should be, to newly evolving concerns such as the wisdom of taxing services and of taxing Internet-based transactions. This section surveys problems facing the future of the sales tax.

Broadening the Sales Tax Base

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. 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 South Carolina. 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.

Sales Tax Burdens in South Carolina and Vermont
As Share of Family Income



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

- Exemptions are very costly. Exempting groceries can reduce the revenue yield of each penny of sales tax by up to twenty percent. This puts pressure on lawmakers to increase tax rates.
- 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.
- Exemptions tend to make sales tax collections fluctuate more, because changes in particular economic sectors can affect tax collections. The broader the tax base, the less sensitive tax revenues will be to sudden swings in retail purchases of particular items.
- 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.
- While exemptions can make the sales tax less regressive, they also create a new source of unfairness: different treatment of taxpayers at a given income level. 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 are an administrative challenge to policy makers because any exemption requires a way of distinguishing between taxable and exempt products. For example, New York taxes marshmallows as snack food, but exempts mini-marshmallows as groceries. Exemptions require tax administrators to make countless decisions of this sort, and retailers must be familiar with all of these rules.

Sales Tax Credits

Lawmakers seeking to make the sales tax less unfair without breaking the bank do have an alternative to broad-based exemptions: targeted **sales tax credits**. These credits generally give 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 usually refundable, meaning that the value of the credit does not depend on the amount of taxes a claimant pays. This approach offers several advantages over sales tax exemptions: credits can be targeted to state residents only, and they can be designed to apply to whichever income groups are deemed worthy of tax relief. The box at right 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 $72 for each family member. In 2004, Kansans with incomes up to $26,900 were eligible for the credit.

The Kansas Food Sales Tax Refund

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

Income Level	Refund
$0 to $13,450	$72 per person
$13,451 to $26,900	$36 per person
$26,901 or more	no refund

The precise targeting of credits means that they are much less expensive—and much better targeted—than exemptions. Credits do not affect the sales tax base, so the long-term growth of sales tax revenues is more stable. And credits are easier for tax administrators to manage.

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.

It is also important to recognize that sales tax credits will never be able to eliminate the regressivity of sales taxes. The Kansas sales tax remains quite regressive, even after the food sales tax refund. It would take a very large tax credit to eliminate the extra sales tax burden on low-income taxpayers. And while a state may be able to relieve the sales tax burden 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 low- and middle-income families bear most of the burden of the sales tax, a sales tax and rebate system that ended up 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 entirely solve the problem of sales tax regressivity.

Business Sales Tax "Loopholes?"

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, however, that special interests don't work hard to get preferential sales tax treatment. Indeed, when states consider expanding their sales tax bases, lobbyists for such potential targets as lawyers, accountants, dry cleaners, advertising agencies, country clubs and others will fight tooth and nail for their exemptions.

On the other hand, one type of supposed "business loophole" in the sales tax—the tax exemption given for many purchases by businesses—is not simply the result of effective lobbying, but also is often based on sound economic principles. 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 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. But another 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.

An oddity created by 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.

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. These examples illustrate that supposed "business loopholes" in the sales tax must be analyzed to see if they are sensible rules or undeserved tax breaks.

Sales Tax Holidays—Boon or Boondoggle?

In recent years, lawmakers in more than a dozen states have sought to relieve the burden 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 one-week sales tax holiday for selected items still forces taxpayers to pay sales tax on these items in the other fifty-one weeks of the year, leaving a regressive tax system basically unchanged.
- 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.
- Sales tax holidays are poorly targeted, providing tax breaks to both wealthy taxpayers and nonresidents.
- Many low-income taxpayers don't have the luxury of timing their purchases to coincide with week-long 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.
- 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 for whom these taxes are most burdensome. 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.

Should Sales Tax Apply 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 haircuts and car repairs. But 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 the Federation of Tax Administrators, a majority of states still apply their sales tax to less than one-third of the 164 service categories that are potentially taxable. Though it can be politically difficult to accomplish, there are sound tax policy reasons for seeking to expand the sales tax base 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 (usually) 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, feel the pain from efforts to impose sales taxes on business services.

Taxing personal services 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

- For those companies that have nexus with a state, the state must next divide each company's taxable income into a "business income" component and a "non-business income" component. This distinction matters because business income is typically divided up between the states depending on the location of the firm's business operations, while non-business income is typically assigned exclusively to the state in which the assets generating the income are managed—usually the state in which a company is headquartered.
- Finally, the state uses a process called **apportionment** to divide a company's business income into an "in-state" portion (which is taxable) and an "out-of-state" portion (which is not).

These additional steps are required by federal law to ensure that each state can tax only its "fair share" of the corporate profits earned by companies doing business in the United States. If these rules didn't exist, any given state would be able to tax the profits of corporations that had no activities whatsoever in the state—and every dollar of corporate income could, in theory, be taxed multiple times by multiple states. The amount of in-state activity that a business must engage in before achieving nexus with a state for corporate income tax purposes is defined by a federal law known as Public Law 86-272. This law says that states cannot apply their corporate income tax to businesses whose only connection to the state is soliciting orders in and/or shipping goods into the state.

Once states have determined the total amount of taxable business income for businesses that pass the nexus test, they divide each company's nationwide taxable business income into an "in-state" portion and an "out-of-state" portion. Each state uses its own **apportionment formula** to achieve this. In the 1950s, legal reformers worked to set up a fair, uniform way of allocating income between states that would result in multi-state businesses' profits being taxed exactly once. The result was the Uniform Division of Income for Tax Purposes Act (UDITPA). The UDITPA model legislation prescribed relying equally on three different factors in determining the share of a corporation's profits that can be taxed by a state. These factors are:

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

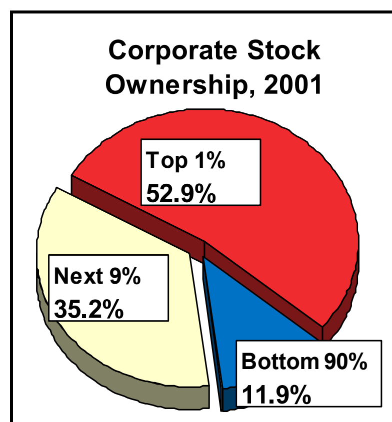
The main rationale for using these three factors to determine taxable income was that companies benefit from a state's public services in a variety of ways, including owning property in a state, making sales within a state, and having an in-state employee base. The three-factor formula ensures that corporate tax liability reflects the benefits received by each type of corporation.

The UDITPA three-factor approach prescribes assigning each of these three factors an equal weight in determining a corporation's taxable income. In other words, the percentage of a corporation's taxable income that can be considered "in-state" is calculated as a simple average of these three percentages. So, for example, suppose that the Acme Corporation has located 90 percent of its property, 30 percent of its total sales, and 90 percent of its payroll in one state. Under the three-factor formula, that state could tax 70 percent (the average of 90, 30, and 90) of Acme's apportionable business income.

For each company, the total amount of taxable income in a state is determined by adding together the amount of business income that can be apportioned to the state, plus the amount of non-business income that is attributable to the state. (As noted above, non-business income is generally allocated entirely to the state in which the assets generating that income are managed.) Taxable income is multiplied by a set of tax rates to yield a pre-credit tax amount. Most states provide special tax credits for research or investment activities which are then subtracted to yield net tax liability.

Fairness

Corporate income taxes are paid by businesses. But as with any business tax, the corporate tax is ultimately paid by individuals. Corporate income taxes are usually passed through to shareholders. Since stock ownership is concentrated among the very wealthiest taxpayers, the corporate income tax is one of the most progressive taxes a state can levy. As the chart at right shows, the wealthiest one percent of Americans held 52.9 percent of all corporate stock in 2001, while the poorest ninety percent of Americans owned just 11.9 percent of the total. Also, because most multi-state corporations have shareholders around the nation, the burden of any state's corporate tax is largely distributed to the other states in which shareholders live. The ability to export part of the corporate income tax is important because out-of-state shareholders benefit indirectly from the public services provided to in-state corporations.



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 loopholes 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.

More than a dozen states now 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 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 corporations now pay only the minimum tax. In New Jersey, 30 of the state's 50 largest corporations paid only the $200 minimum tax in 2002.

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

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 taxed, but can be reached by a fixed-dollar minimum tax.

How "Decoupling" State Corporate Taxes From Federal Rules Can Help Shore Up Your State's Tax Base

Many of the tax breaks that reduce state tax collections are inherited from federal tax law. Since state corporate income taxes are based on federal rules, federal corporate tax breaks will usually be automatically passed on to the state level. States do, however, occasionally "decouple" from specific federal tax giveaways: a substantial majority of states decoupled from the Bush Administration's "bonus depreciation" giveaways in 2001-2003. Decoupling allows states to avoid revenue losses from certain federal tax breaks while keeping their corporate tax rules simple by continuing to link to federal tax definitions in most other areas.

Now states face a new federal tax break enacted in 2004 for manufacturers—the so-called "qualified production activities income" deduction. This new deduction was enacted to compensate manufacturers for the loss of an unjustified and illegal (under World Trade Organization law) export subsidy. Decoupling from this new tax break makes sense because this manufacturers' tax break is in no way tied to the creation of manufacturing jobs in any particular state. Massachusetts has already decoupled from this new federal tax break, and the other states with corporate income taxes can do so as well.

Deductible in Computing Federal Income Tax

Like the personal income tax, corporate income taxes are deductible for federal corporate income taxpayers. Since the federal corporate income tax rate is 35 percent, this means that up to 35 percent of the state corporate income tax paid by businesses in your state will be ultimately paid for not by these businesses but by the federal government, in the form of reduced federal tax collections. This interaction also means that state corporate income tax increases are 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 go instead to federal tax coffers.

Revenue and Stability

Corporate income taxes can raise significant revenues—but they are also quite volatile. Corporate tax collections have declined in recent years, in part due to the slow economy. 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 never intended to create.

Corporate Income Tax Issues

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. But this pessimistic outlook ignores a set of easily administrable, sound reforms that could help revitalize the state corporate tax. This section looks at problems facing the state corporate income tax, and suggests possible reforms.

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 shift investment into areas that do not make the most economic sense.

The **investment tax credit** (ITC) is one example. Under the ITC, when a firm makes a qualifying investment, a percentage of the investment is allowed as a dollar for dollar reduction in the firm's tax liability. The theory is that companies will invest more if they are rewarded with tax breaks.

In practice, however, if an investment makes business sense, the company will generally make it whether there's a tax credit or not. Thus, the ITC largely rewards companies for what they would have done anyway and therefore does not serve as an economic growth stimulus at all.

Ironically, to the limited extent that businesses do make investments because of the tax credit, it's bad for the national economy. The country is better served by investments based on sound business grounds than those based on the tax code.

The ITC is also very expensive, and the majority of its benefits typically go to only a few very large firms. In fact, three-fourths of the federal investment tax credits from 1981 to 1986 went to firms with over $250 million in assets—the top one-tenth of one percent of companies. Similarly, in New York in 1985, five companies, each with over one billion dollars in net profits, got 44 percent of the state's total investment tax credits—more than $100 million worth. As a result, at least one of these billion-dollar companies paid only the $250 minimum New York corporate tax.

The question for policymakers is whether they want to support a program that:

- gives a large amount of scarce government funds to huge corporations;
- doesn't cause companies to significantly change their overall investment levels; and
- to the extent companies do change their investment patterns, is usually bad for the nation's economy.

The federal government abandoned its own investment tax credit in 1986 after Congress and President Reagan concluded that it was ineffective in stimulating investment.

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 37. In recent years, however, many states have deviated from this basic three-factor approach by increasing the importance of the "sales factor." For example, Arizona allows companies to count the sales factor twice. (In the example on page 37, this means that instead of taxing 70 percent of a company's business income (the average of 90, 30 and 90), Arizona 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. A dozen states still use the unweighted UDITPA formula.

Several 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 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 burden. 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 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-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 tax using separate accounting because they have business units in multiple states.

"Nowhere Income" and the Throwback/Throwout 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 of origin 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 twenty states.

Splitting Hairs? Exploiting the Business/Nonbusiness Income Distinction

The first step in calculating state corporate taxes is dividing a company's income into 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 distinc-

tion 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. New Jersey*, 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:

- Six 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.[10]
- Thirteen 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 depleting their tax base.

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. Corporate tax fairness at the federal level can be evaluated, 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.

Unfortunately, the fairness of state corporate taxes 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.

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[10] Michael Mazerov, *Closing Three Common Corporate Tax Loopholes Could Raise Additional Revenue for Many States* (Center on Budget and Policy Priorities, 2003).

CHAPTER SEVEN

OTHER REVENUE SOURCES

State tax systems are constantly in flux, as new revenue sources develop and old ones wither away. This chapter looks at two revenue sources that have traditionally formed a small part of the state tax pie: the estate tax and gambling revenues.

Estate and Inheritance Taxes

Since the federal government enacted an estate tax in 1916 to "break up the swollen fortunes of the rich," every state has enacted a similar tax of its own. While these taxes typically represent only a small part of overall state tax collections, estate taxes 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 2001, the wealthiest 1 percent of Americans owned 32.7 percent of the wealth nationwide—more than the poorest 90 percent put together. [11] The estate tax was designed to apply only to the very wealthiest Americans—and that's exactly what it does. Nationwide, less than two percent of decedents typically owe any federal estate tax.

Recent federal tax changes, however, threaten the future of the estate tax at the state level. Since 1926, the federal estate tax has 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 the pickup tax.

Federal tax cuts enacted in 2001 are scheduled to repeal the federal estate tax over ten years —and, more importantly for the states, to phase out the federal credit allowed for state estate taxes between 2002 and 2005. The federal credit declined by 25 percent in 2002, 50 percent in 2003, 75 percent in 2004, and ceases to exist in 2005. In many of the states that base their tax on the federal credit, this means that the state's estate tax will also cease to exist in 2005 unless states take action to prevent this from happening.

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. A number of states have made this simple administrative change already.

Gambling Revenues

Like tax policy, gambling policy is made in a decentralized way: each state's lawmakers can choose which 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 racing and greyhound racing.

[11] Arthur Kennickell, "A Rolling Tide: Changes in the Distribution of Wealth in the US, 1989-2001", November 2003. Levy Economics Institute Working Paper No. 393.

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** will eventually make state-sponsored gambling less profitable—and will ultimately put the burden of this tax primarily on state residents rather than tourists from other states. Increased competition also means that the **yield of the tax will likely decline over time**.
- 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.
- **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 total 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.
- 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.
- 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.

The slow economic growth of the past several years has forced policymakers across the nation to make painful fiscal policy decisions. It is understandable that lawmakers have sought every opportunity to avoid general tax increases while continuing to provide public services. But policymakers in many states have moved away from the estate tax, which affects only a small number of the wealthiest Americans, and have increased their reliance on regressive gambling revenues, which are far more burdensome to low- and middle-income taxpayers. And the unpredictable yield of gambling revenues means that lawmakers using lotteries as a "quick fix" to avoid politically difficult structural tax reforms in the short run will likely be forced to confront the same difficult tax policy decisions in the future.

CHAPTER EIGHT

THINKING OUTSIDE THE BOX: OTHER TAXES

Most of this report's chapters have focused on ways of reforming the major taxes currently levied by state and local governments. But some states use unusual revenue sources that other states don't—and these taxes are occasionally proposed as options for comprehensive tax reform. This chapter looks at two such proposals: the value-added tax and the gross receipts tax.

Value-Added Taxes (VATs)

In recent years, lawmakers in a number of states have suggested that a particular type of sales tax, called the value-added tax or VAT, might be a cure-all for state budgetary problems. Although Michigan is the only state that currently relies on a VAT as a major revenue source, several other states have recently considered implementing this type of tax.

The value-added tax is exactly what its name implies. It is a tax on the *value added* at each stage of the production of goods and services. For any firm paying the VAT, the "value added" for a particular item is the amount by which the sales price of the product exceeds the cost of all the products purchased to make that item. Because the tax is paid at each level of production, and is often not itemized on the final bill to consumers, some try to characterize the VAT as a tax on business. But most analysts agree that "the value-added tax is essentially a sales tax on consumer purchases that businesses collect in stages."[12] From a tax fairness perspective, in other words, a VAT is just like a sales tax—it's regressive, requiring low-income consumers to pay more of their income in tax than wealthier taxpayers must pay.

How a Value-Added Tax Works

	Price	Value Added	Tax at 5%
Raw materials	$40	$40	$2
Manufactured product	140	$100	5
Wholesale sale	200	$60	3
Retail sale	300	$100	5
Total		**$300**	**$ 15**

The following example shows how a VAT would apply to the production and sale of a chair:

- First, a supplier sells raw materials (for example, wood) to a manufacturer for use in producing the chair. If the raw materials are sold for $40, the materials supplier pays tax on the whole $40. A five percent tax rate on the $40 of value added equals a $2 tax.
- Second, the manufacturer builds the chair and sells it to a wholesaler for $140. The manufacturer pays a VAT only on the value it has added to the chair. Since the manufacturer has taken raw materials worth $40 and made a chair worth $140, the manufacturer's value added is $100. A five percent tax on the $100 value added is $5.
- Third, the wholesaler sells the chair to a retailer for $200. The wholesaler bought the chair for $140 and sells it for $200, so the wholesaler's value added is $60. The five percent tax is $3.
- And finally, the retailer sells the chair for $300. Since the retailer bought the chair for $200 and sold it for $300, the retailer's value added is $100—and the five percent tax is $5.

At the end of this process, the outcome from the consumer's perspective is just the same as if the state had imposed a retail sales tax on the $300 price. The main difference is that the VAT is collected a little bit at a time at each stage of the production process, rather than being collected in one lump sum at the time of the final retail sale.

[12]Congressional Budget Office, *The Economic Effects of Comprehensive Tax Reform*, 1997

Why Adopt a VAT?

Policymakers seeking to impose a state VAT usually have one of two tax policy goals in mind, depending on which existing tax they want to replace. European VATs were created to eliminate structural problems in existing sales taxes. In particular, European sales taxes often applied not only to retail purchases but to "business to business" transactions which should be exempt. When sales taxes apply to these business inputs, the tax is typically passed through to consumers in the form of higher retail prices. In other words, taxing business inputs amounts to taxing consumers multiple times on the same retail purchase. This problem, known as "pyramiding," is discussed in more detail in Chapter Three. Pyramiding is both regressive and unpredictable (because the number of times the tax is paid depends on the number of stages of production), and encourages businesses to "vertically integrate" to avoid paying taxes on inputs to the production process. VATs are especially well designed to avoid taxing business inputs, since each component of a retail product's value added is taxed exactly once. In other words, European countries replaced their poorly structured sales taxes with a better-functioning sales tax.

In Michigan, the rationale for adopting a VAT was quite different: their VAT was adopted to replace the corporate income tax, not the sales tax. Corporate income taxes tend to fluctuate widely over the business cycle because they are based on corporate profits, which vary dramatically during periods of economic growth and downturns. Michigan's corporate tax was especially volatile due to the importance of auto sales to its economy. A VAT is an inherently more stable and predictable revenue source than a corporate profits tax, because the tax base is a firm's total amount of economic activity rather than its profits. In other words, Michigan replaced its corporate profits tax with what amounts to a second sales tax, choosing revenue stability as a primary goal of its "Single Business Tax."

Problems with a VAT

Each of these rationales has some merit: replacing a sales tax with a VAT will improve the horizontal equity of the sales tax (by ensuring that each retail transaction is taxed the same way), and replacing a corporate profits tax with a VAT will make revenues more stable. But implementation of either approach at the state level is problematic, for several reasons:

- What works on a national level in Europe may not work on the state level in America. If one state adopts a VAT while neighboring states do not, the inability of states to tax purchases from some out-of-state sellers will mean that some value added won't be taxed, and sales made to other states will create the same problem. Put another way, a VAT can't easily work in one state without a lot of help from other states.
- Unlike a retail sales tax, a VAT often isn't itemized on retail receipts (although it can be). Thus, consumers may be less aware that they are paying a VAT. Invisible taxes make it harder for consumers to see how much they are really paying.
- People don't understand how VATs work. Calling a VAT a "Single Business Tax" may fool people into thinking that a VAT falls on business rather than consumers.
- Abandoning a corporate profits tax for a VAT makes the tax system less responsive to a business' ability to pay taxes. This is part of the reason why Michigan's VAT is currently slated to be repealed by 2009: the VAT is especially painful for businesses not turning a profit.
- Because a VAT is passed through to consumers like a sales tax, replacing a corporate profits tax with a VAT will make already-unfair state tax systems even more regressive.

Value added taxes have been enacted internationally to address important concerns about structural flaws in sales taxes. But as a replacement for corporate profits taxes on the state level, the main impact of a VAT will be a more regressive tax system—and a host of angry businesses.

Gross Receipts Taxes

A **gross receipts tax** (GRT) is still another type of sales tax. The main difference between a retail sales tax and a GRT 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.

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 2002, state and local governments raised more than $30 billion in gross receipts taxes on utilities and insurance—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, however, 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, a Nevada tax reform commission recently proposed a gross receipts tax of 0.25 percent on all business revenues over $450,000 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 different types of companies at different rates ranging from 0.138 percent to 1.5 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. Third, GRTs lead to severe pyramiding problems, because the tax applies not just to retail sales but to all stages of the production process.

The first two of these problems are basically identical to those faced by value added taxes (see above); the third, however, separates GRTs from VATs. VATs are explicitly designed to get around the problem of tax pyramiding, while GRTs have no mechanism for avoiding it. As a result, 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.

As in Michigan, some of the strongest opposition to Washington's GRT comes from businesses. The firms that tend to dislike the Washington state tax most are those that engage in high-volume, low-profit-margin activities—and those that frequently don't turn a profit at all.

CHAPTER NINE
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 bringing more jobs and employers to the state, and footloose businesses are constantly threatening to relocate to other lower-tax 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.

How 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 very little hard evidence to support the assertions of those who see tax cuts as a panacea for a state's economy. A recent comprehensive survey of the economic 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.[13]

Lynch's survey suggests that there is wide variation in the quality of the "research" used to support these anti-tax arguments, and suggests that the studies that do show strong relationships between tax levels and economic development often have design flaws that invalidate their conclusions. But for the average advocate, who does not have an advanced degree in economics, it can be difficult to tell the difference between high-quality and low-quality research. Fortunately, these poor-quality studies tend to share the same design flaws. Here's a quick overview 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. Of course, the world doesn't work this way. In the real world, tax cuts must be paid for—and that usually means spending cuts. And when strapped lawmakers pass politically unpopular tax increases, the new revenue is used to preserve important state services.

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 in public services.

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[13]Lynch, Robert G., *Rethinking Growth Strategies: How State and Local Taxes Affect Economic Development*, Economic Policy Institute, March 2004.

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 measure the impact of these other factors, its findings shouldn't be taken seriously.

Does the study measure tax burdens 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" tax burden—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, Connecticut collects $1,065 per capita in personal income tax, while Maine collects $829. Yet Connecticut's income tax has lower tax rates and higher exemptions than Maine's income tax. Virtually anyone moving from Maine to Connecticut would, in fact, see their income taxes go down. This approach to measuring tax burdens is simply misleading—but anti-tax advocates rely on it simply because the average reader won't know this. Other data manipulation tricks that these advocates frequently use include:

Comparing State and Local Taxes: Connecticut and Maine

	Connecticut	Maine
Income Taxes Per Capita	$ 1,065	$ 829
Rank	6	16
Personal Income Per Capita	$ 43,173	$ 28,831
Rank	2	33
Income Tax as % of Income	2.5%	3.0%
Rank	20	12

Source: Census Bureau, Bureau of Economic Analysis

- 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 the combined state and local tax burden in evaluating these assertions.
- Using legal tax rates as a measure of true tax burdens. 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 (or profits, in the case of businesses) are a far more accurate approach to measuring tax burdens.
- Using aggregate tax collections data to measure state tax burdens 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 businesses or non-residents, which don't apply to state residents.
- Not factoring in the deductibility of state and local income and property taxes when comparing tax burdens 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 burden 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. 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 these studies.

Why Low-Tax Strategies Don't Work

So why is it that the doomsday scenarios of corporate lobbyists fail to materialize when taxes are increased? No doubt, all things being equal, businesses would prefer low taxes to high taxes. But in fact, all things are *not* equal. 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 there is a clear linkage between raising taxes and a state's ability to provide these important public services.

And on the other side of the coin, low taxes generally lead to low-quality public services. Providing businesses with a low-tax, low-service environment is not likely to be a winning strategy for attracting significant new investment. Moreover, compared to other costs of doing business, state and local taxes are rather insignificant. 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 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. "[14]

Other corporate leaders have echoed these thoughts. For example, long-time business leader Michael Bloomberg told the New York Times 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."[15]

Likewise, John Tyson, of Tyson Foods, a $4 billion a year business, noted that tax breaks had nothing to do with his company's decision to locate a plant in Pine Bluff, Arkansas, rather than out of state. "It [the location decision] was based purely on geography. Pine Bluff was in the right place. The tax credits didn't make any difference."[16]

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. Level of taxation has consistently been found to be of little significance. The factors that really drive location decisions 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 usually nothing but a ruse to try to keep their taxes low. For example, a corporation might negotiate with two states over where to locate a facility in hopes of starting a bidding war, with each state offering more tax breaks than the other. Finally, after the corporation has been promised the tax breaks it wants (or more) from each of the states, it will locate in one state or the other. The location decision, however, very likely will have actually been made long before the bidding started. The company just plays the states off each other, promising jobs and economic growth to the lowest tax bidder. But the decision on where to locate is based on more important economic factors than taxes, such as distance from suppliers and markets, and the availability of skilled workers. It's also worth remembering that the few businesses that might actually be attracted by low taxes are likely to be low-paying, low-employment industries with little loyalty to the community and its long-term well-being.

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[14]Testimony before the United States Senate Finance Committee, January 18, 2001.

[15]*New York Times*, November 8, 2001.

[16]*Washington Post*, March 22, 1992, p.A22

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.

Ensuring Accountability in Economic Development Strategies

Even if there is little evidence that tax policy affects economic growth, state lawmakers will continue to pursue potentially damaging tax breaks in an effort to spur economic growth in their state. How can lawmakers achieve the greatest "bang for the buck" from these tax breaks, while ensuring that the footloose corporations 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**, for each company receiving tax breaks, of how much the tax breaks cost and what public benefits resulted from the tax breaks. For example, lawmakers 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 wage and benefit structure. This information should be made publicly available and frequently updated.
- **Strict job quality standards** should be applied to any tax breaks 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 social supports, the cost of the tax break may exceed its benefits to the state.
- **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 by almost twenty states to ensure that lawmakers get enough "bang for the buck" out of these tax breaks.
- **Location-efficient incentives.** Tax 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.

Is Business the Enemy? (No)

Believing that companies and their shareholders should pay their fair share of taxes doesn't make one "anti-business." On the contrary, fair tax advocates fully understand the importance of a healthy economic climate for jobs and incomes. But governments must have the resources to provide the education, the roads, the sewer systems and other services that allow the economy to prosper. And unless those with the most ability to pay contribute their fair share, it will be virtually impossible for governments to provide these 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.

Even in states where many companies, and perhaps even the organized corporate lobby, oppose fair taxes, there may be 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. These corporations can be an essential partner in progressive coalitions seeking to achieve tax adequacy and fairness. These partnerships are discussed in more detail in Chapter Eleven.

CHAPTER TEN
OTHER STEPS TOWARD (OR AWAY FROM) FAIR TAXES

Tax reform is not just about changing the base and the rates of particular taxes. 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 reforms 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 corporations. 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 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.
- 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.

As a result, tax expenditures often turn out to be very expensive programs for which there is little oversight. 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 budgets**. These are simply a listing of tax breaks and how much they cost.

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 levied by a state—including tax breaks (like exemptions of services from state sales taxes) that are not explicitly written in the tax code.
- **Estimates of the state and local revenue loss** from each tax expenditure, including estimates of how much the tax break is likely to cost in the future.
- Many state tax expenditures are inherited indirectly by state linkage to federal tax codes. Separately **itemizing these indirect federal tax breaks** will give policy makers 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 policy makers 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 policy makers should be able to evaluate tax expenditure side-by-side with conventional spending.

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 analysis 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.

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 policy makers jittery about the role of the tax in funding services. Some lawmakers have advocated making income taxes less progressive to help ensure the long-term adequacy of state revenues.

This is, however, a red herring. 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 to devote to shoring 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 at right 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.

Important Features of Rainy Day Funds

- ✔ **Rules for deposits**
- ✔ **Size limits**
- ✔ **Rules for withdrawals**
- ✔ **Rules for replenishing funds**

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 and low-income tax relief. 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.

Tax and Expenditure Limits (TELs)

A growing number of states now 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. One example of these limits 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 may 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 states' recent experience with homeland security expenditures attest 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. And Colorado policymakers are now engaged in a heated debate over whether their TABOR limit should be modified or repealed entirely.

Across the nation, state lawmakers are facing painful decisions 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.

Good Choices, Bad Choices

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.

CHAPTER ELEVEN
FIGHTING THE FIGHT

Progressive tax reform may seem like a daunting task. After all, successful tax reform can take years—and progressives 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.

Strategies for Progressive Tax Reform

The first step in achieving state 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. The resources described later in this chapter can help you to learn more about the specific flaws in your state's tax structure.

In describing your proposals for tax reforms to fix these structural flaws, it's important to **be specific about what your plan does and how it affects people**. If your 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 5 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 difficult for the other side to distort.

Unfortunately, even clearly-defined 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 Nine 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 tax burden 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's also 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 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.

Successful tax reform campaigns should **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.

A winning tax reform agenda must also have an **educational component**—and these educational efforts must use simple, easily understandable language. State tax fairness and adequacy are important goals—but are also too complicated for most members of the media, state legislatures, and the public to understand intuitively. State tax advocates must make an effort to explain tax fairness issues to newspaper editorial boards, reporters, and lawmakers of all stripes. Equally important is presenting basic information on tax reform to the general public. Public workshops on tax reform can be a critical component in building public awareness of—and support for—progressive tax reform.

When these strategies are followed, successful tax reform efforts can be the result. For example, in recent years Alabama Arise and the Virginia Organizing Project each helped to build broad-based coalitions in their states. These groups developed plans for progressive 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 these groups understand the basic tax policy principles underlying their proposals. They also helped to lay the groundwork for public acceptance of tax reform by holding public workshops to explain basic tax fairness issues. This ongoing work helped to establish these groups as a credible source of accurate incidence, 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 (2003) 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. CTJ and ITEP also have published a series of analyses of corporate tax avoidance, most recently ***Corporate Income Taxes in the Bush Years*** (2004).

Just Taxes, our quarterly newsletter, keeps readers informed on the latest developments in tax policy and advocacy, and lists new publications of note by CTJ, ITEP and other organizations.

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. You can access the websites of these agencies on ITEP's website at www.itepnet.org/linkileg.htm.
- **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 at www.itepnet.org/linkistg.htm.
- The **U.S. Census Bureau** publishes *Government Finances*, a helpful source of data for comparing your state's tax system to other states. Census reports are available at www.census.gov.
- The **Center on Budget and Policy Priorities** publishes a wealth of information on tax and spending programs as they affect low-income taxpayers. Their website is www.cbpp.org.

- The **National Conference of State Legislatures** has a number of publications evaluating state taxes, including their annual ***State Budget and Tax Actions***. Their website is www.ncsl.org.
- The **Rockefeller Institute** regularly analyzes trends in the health of state tax systems, and follows trends in state spending as well. Their website is www.rockinst.org.

Final Thoughts

The need for progressive tax reform is now greater than ever. Even before the recent economic slowdown began, state and local taxes in almost every state were regressive. And most 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: in the last four years alone, the wealthiest taxpayers have seen their effective tax rate decline substantially, while lower- and middle-income taxpayers have failed to reap similar gains. And corporate income taxes are nearing an all-time low. These unaffordable federal tax cuts have had the predictable impact of forcing cuts in important federal services, and cutting aid to state and local governments.

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. We do have one important thing going for us: most people *want* fair and adequate taxation. The key is showing the public, elected officials and the media what fair tax policy is and how it can benefit the people of our nation. We hope this primer provides you with enough tax policy knowledge to start that process.

GLOSSARY

Adjusted gross income (AGI). On an 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)

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. (Chapters 4, 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 form of 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 taxpayers and to 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)

Effective Tax Rate. The tax burden 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)

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)

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)

Homestead Exemption. A tax break used to shelter a certain amount of a homeowner's property from the property tax. (Chapter 4)

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)

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. (Chapters 3, 6)

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)

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

Pyramiding. Sales taxes are supposed to apply only to consumer purchases. When these taxes also apply to business-to-business transactions during the production process for a retail product, that sales tax is usually built into the final purchase price of the product. Since this built-in sales tax is itself subject to the retail sales tax, taxing early stages of the production process has a "pyramiding" or "cascading" effect on the total amount of sales tax we pay on any retail purchase. (Chapter 3)

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)

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 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)

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)

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)