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.