A Union of Professionals

AFT Public Employees

State Revenue Systems

Options for the current fiscal crisis

a resource guide

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2009

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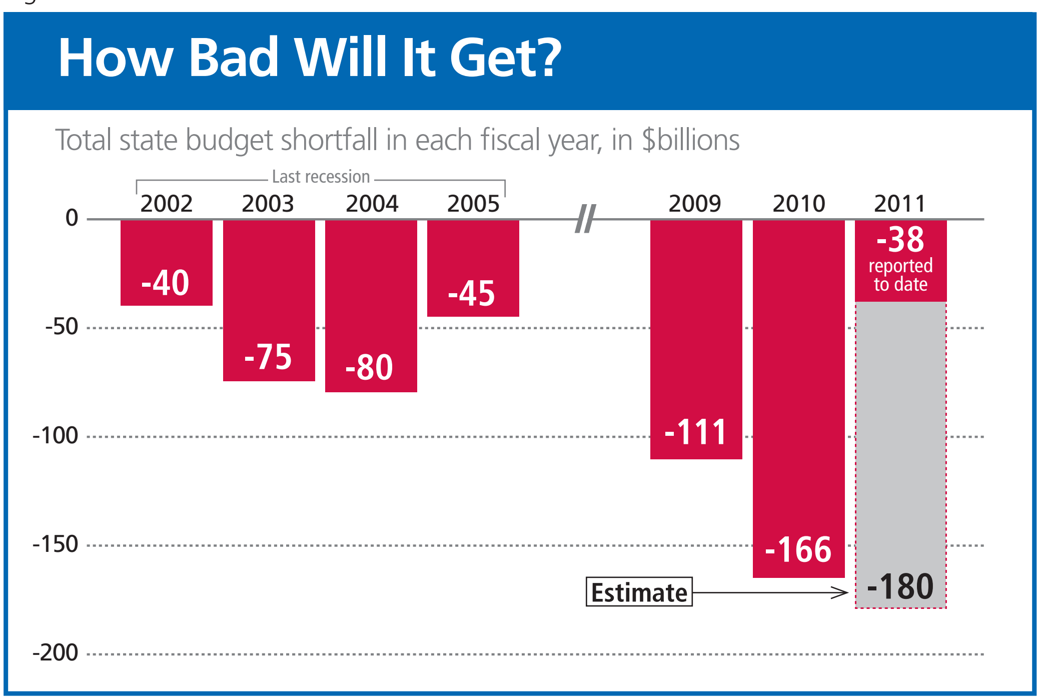
Introduction

FOLLOWING THE 2001 RECESSION, state governments experienced a previously unprecedented downturn in their fiscal condition. States faced aggregate shortfalls of $240 billion over the succeeding four years. Now, as a result of a deeper and longer recession, states are facing shortfalls that are more than twice the size of those in 2002-05. Dramatic revenue shortfalls are having a devastating effect on funding for public services at the state and local levels. The downturn, sometimes called the Great Recession, has limited our communities' ability to provide the healthcare, schools, colleges, public safety and transportation that people take for granted in good years but that they increasingly rely on in bad times. During a time when rising poverty and unemployment mean these services matter more than ever, state and local governments are looking to cut, rather than expand.

Figure 1



SOURCE: CENTER ON BUDGET AND POLICY PRIORITIES[1]

According to a recent report by the Center on Budget and Policy Priorities, no fewer than 48 states faced or face budget shortfalls for fiscal years 2009, 2010 and 2011. The estimated aggregate amount of these budget gaps is more than $450 billion.[2] States already have received

1 Iris J. Lav and Elizabeth McNichol. 2009. New Fiscal Year Brings No Relief from Unprecedented State Budget Problems. Updated Sept. 3, 2009. (www.cbpp.org/research/index.cfm?fa=topic&id=40).
2 Iris J. Lav and Elizabeth McNichol. 2009. New Fiscal Year Brings No Relief From Unprecedented State Budget Problems. Updated Sept. 3, 2009. (www.cbpp.org/research/index.cfm?fa=topic&id=40).

approximately $140 billion in needed federal assistance that can go toward closing these gaps. But the crisis is so large that states are left with no easy choices. They can draw down reserves, cut spending or increase revenues (mostly via taxes and fees). Almost all states facing budget gaps have exercised the first two options, including cuts to the vital services, such as education and healthcare, that AFT members provide.

At least 25 states have cut funding for K-12 education, 34 states have cut higher education, and 42 states have downsized their state workforce. Public health programs and programs for the elderly and the disabled have also felt the budget ax. Thousands of AFT members' jobs have been lost, either via attrition or layoff. And at this writing, the worst year of this crisis is still ahead of us.[3]

Given the circumstances, it is essential that AFT affiliates work in their states to minimize these cuts. This document, an AFT guide to state revenues and tax policy, is intended to give affiliates a road map to understand their state's fiscal issues and to provide suggestions for how to find revenues necessary to limit cuts to public services. Thirty states have taken action this year to raise revenues.[4] Some of these have been substantial. But with states facing another year of deficits even after accounting for these actions, more work will need to be done to stave off major budget cuts.

The goal of this report is to clearly explain how states raise revenue, examine the major policy questions concerning revenue systems, and offer some recommendations for reform.

The first section of this report provides an overview of the different types of funding that states receive, with a look at both taxes and federal assistance; the next section reviews elements of state tax systems; the third section suggests ways that states can increase their revenue collections. The appendices analyze topics in taxation such as the relationship between taxation and economic growth and between taxation and families' and businesses' location decisions.

3 Nicholas Johnson, Phil Oliff, and Jeremy Koulish. 2009. An Update on State Budget Cuts www.cbpp.org/cms/index.cfm?fa=view&id=1214.

4 Nicholas Johnson, Andrew C. Nicholas, and Steven Pennington, 2009. Tax Measures Help Balance State Budgets: A Common and Reasonable Response to Shortfalls. www.cbpp.org/files/5-13-09sfp.pdf.

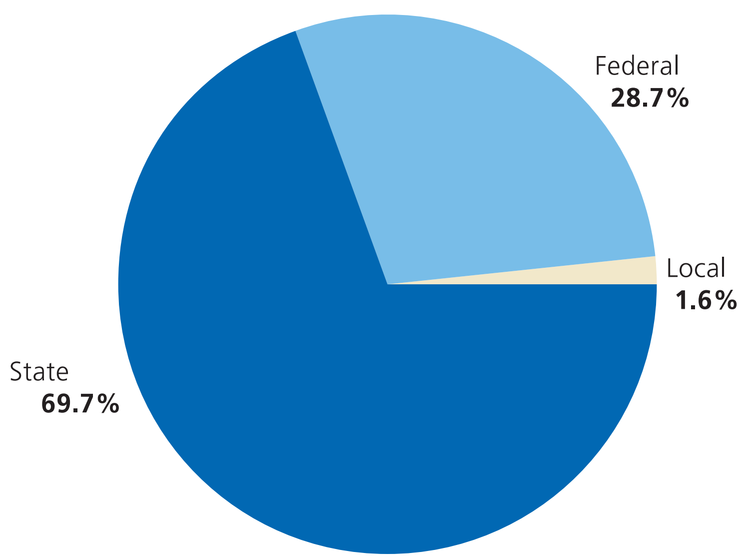
Overview of State Revenues

IN 2007, STATE GOVERNMENTS had general revenues totaling $1.45 trillion. That works out to $4,824 per capita.[1] Roughly two-thirds of this revenue (69.7 percent) came from states' own sources, while the remainder is transfers from the federal government (28.7 percent) or local government (1.6 percent) sources (i.e. intergovernmental revenue).

Figure 2

Sources of State General Revenue, 2007

SOURCE: U.S. CENSUS BUREAU



1 General revenue comprises about three-quarters of total state revenue. The remainder is almost entirely from "insurance trusts," including state pension funds and social assistance programs. In this section and the next, we will be discussing general revenue exclusively.

COMPOSITION OF STATE REVENUES

On average, about half of states' general revenue comes from taxes. These include taxes on income, sales taxes, excise taxes and license taxes. Almost 10 percent of states' revenue is from charges and fees. In 2006, about 54 percent of those fees came from higher education (e.g., tuition); another 23 percent were from state hospitals. The remainder is a combination of charges for services such as transportation, waste disposal and tolls. Finally, states get an average of 9 percent of their general revenue from miscellaneous sources. These include earned interest and the sale of assets such as public land or future revenue. For example, some states have considered selling their future lottery proceeds or settlement payments from tobacco litigation in exchange for immediate cash.

Each state differs somewhat in how much of its revenue comes from each source. Such differences are a result of policy choices, demographics and resource disparities. For instance, almost 19 percent of Utah's general revenues are from fees, while in Wyoming it is just 3 percent. More than half of Mississippi's general revenues are from intergovernmental transfers as compared with less than 20 percent in Virginia. Mississippi's relatively greater poverty and the state government's political choices mean that its tax system generates less revenue, making it more reliant on federal funds. Alaska, thanks to its royalties from oil production, receives 39 percent of its revenue from "miscellaneous sources."[2] No other state receives 20 percent of its revenue from this category. Alaska, not surprisingly, is the least reliant on taxes (and many of these are from additional oil taxes). Nevada is the most reliant on taxes to fund state services, with tourism driving sales taxes, hotel taxes and taxes on casino revenue.

2 See Alaska Department of Revenue. 2007. Revenue Source Book. www.tax.alaska.gov/programs/documentviewer/viewer.aspx?255.

Figure 3

General State Revenue per Capita, 2007

SOURCE: U.S. CENSUS BUREAU

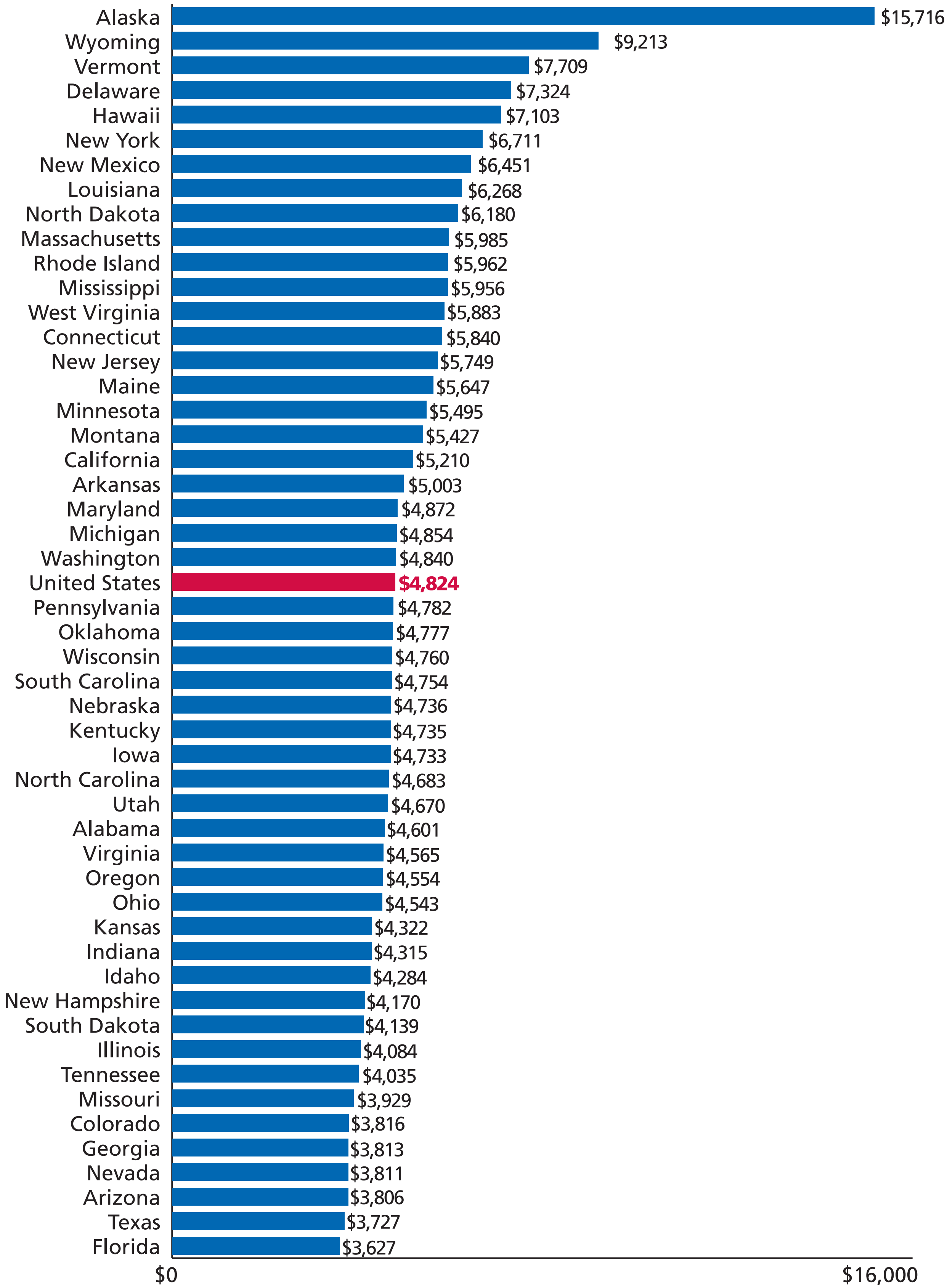
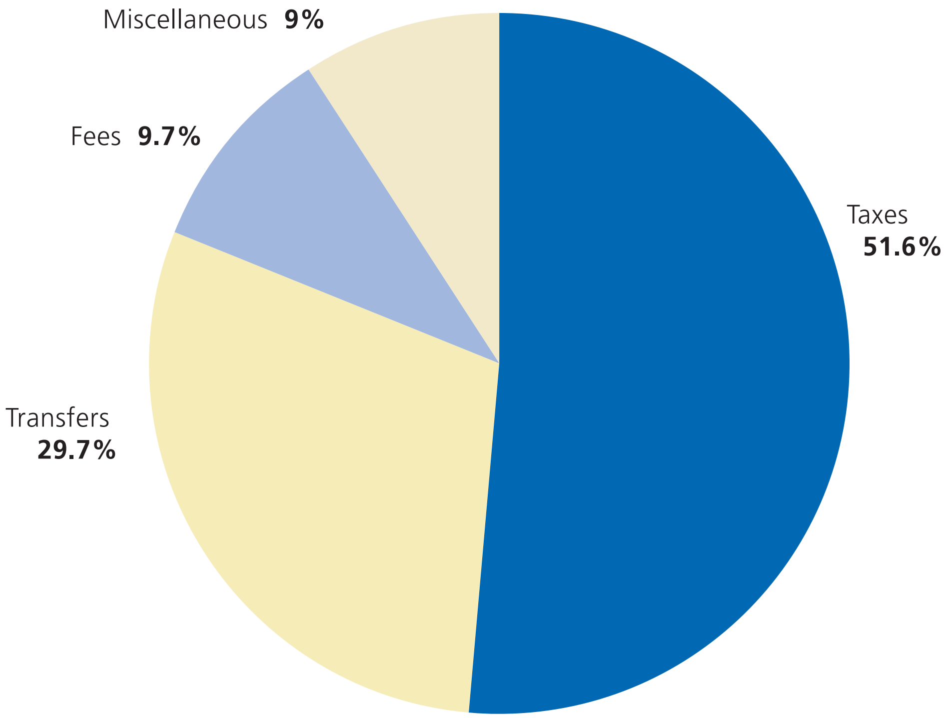


Figure 4

Types of State General Revenue, 2007

SOURCE: U.S. CENSUS BUREAU



In addition to differences between states in the sources of their revenue, there is also significant variation in how much they collect. For example Florida's revenues, from all sources, equal $3,627 per person (about 75 percent of the national average of $4,824). Alaska collects $15,176 per person (315 percent of the average). Again, Alaska's revenue comes primarily from its oil severance tax, which is paid by companies, so individuals pay much less and in fact often receive a dividend from a trust fund that the state uses to hold oil revenues. This is an example of how differences in state revenue collections can be the result of demographics, wealth or natural resources, choices about the burden placed on local government, or the political desire to invest in public services.

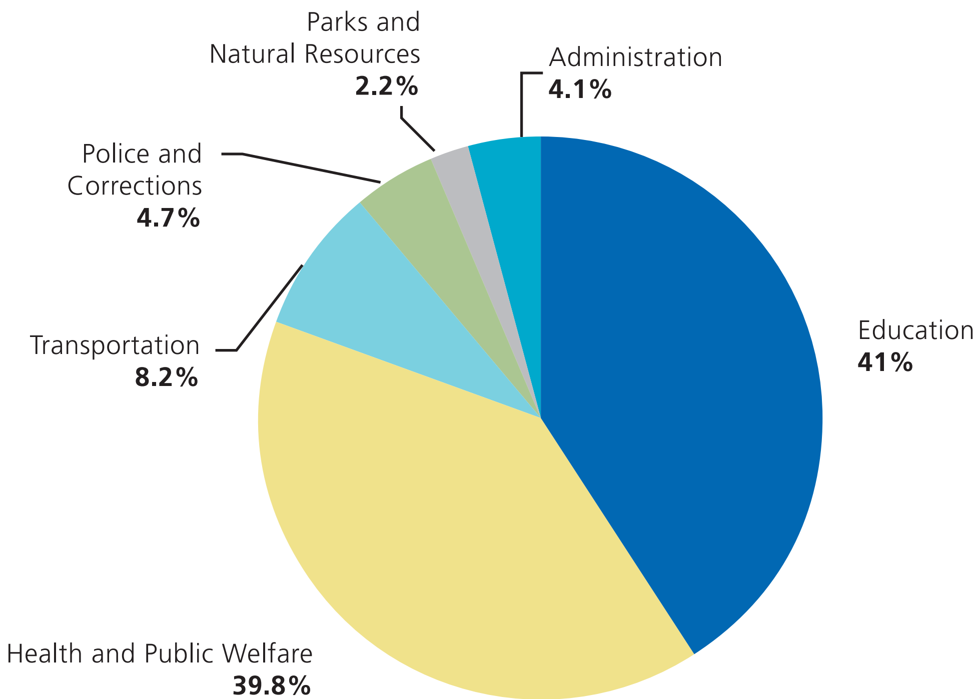
A NOTE ON STATE SPENDING

The purpose of this report is to focus on where states' revenue comes from and on ways to improve revenue systems. But a brief review of how states spend their money provides context for understanding the importance of this issue. Forty-one percent of state spending is for preK-12 and higher education. Another 40 percent is for social services that include healthcare and programs for the elderly and disadvantaged. Eight percent of spending is for highways and transportation, and 5 percent is for police and corrections. Only 4 percent is spent directly on state administrative matters. This includes the cost of running the state legislature, courts and the governor's office, as well as the cost of administering central offices and accounting functions, and maintaining state buildings.

Figure 5

State General Fund Spending, 2007

SOURCE: U.S. CENSUS BUREAU



Much of this money, particularly for K-12 education, is distributed in the form of grants to local governments. Other spending, particularly Medicaid, is reimbursement to providers who are directly supplying services. Only 13.1 percent of state government spending goes for direct state employee salaries and benefits. [3]

It is sometimes easy to forget that the purpose of the tax-reform debate should be to find ways to fund the services that people depend on and that improve the quality of life in our communities. A continued focus on the importance of services like environmental protection and education is necessary to advance efforts to improve the tax system.

3 U.S. Census. State and Local Government Finances: 2005-06. www.census.gov/govs/www/estimate06.html.

FEDERAL FUNDING

Roughly 30 percent of states' general revenue comes from outside the state, making external funding the second most important source of revenue after taxes. Almost all of this money is from the federal government. For some programs, the federal government provides matching funds, which means that federal aid varies by states' own commitments to these programs. This is the case for Medicaid, for instance. While this revenue is essential to funding public services, it must be used for the purpose the federal government intends, and often has significant requirements concerning implementation. For example, states need to follow a variety of rules to qualify for federal Medicaid payments, and school districts must do the same for Title I education funding.

Table 1

10 Largest Federal Grant Programs for States, FY 2008

Program	Amount ($ billions)
Medicaid Vendor Payments	194.7
Highway Obligation	41.2
Temporary Assistance to Needy Families	17.1
Section 8 Renter Assistance	16.4
Pell Grants	14.2
Child Nutrition	13.9
Title I	13.9
Special Education	10.9
Medicaid Administration	10.0
Mass Transit	7.8
Total (of programs above)	**340.1**
Percent of all Federal Grants	**76.3%**

SOURCE: FEDERAL FUNDS INFORMATION FOR STATES

Although there are more than 200 federal grant programs that provide payments to states, the 10 largest account for three-quarters of overall federal aid to states. By far, the largest grant is for payments to Medicaid vendors, which by itself accounts for 43.7 percent of total federal funds to state and local governments.[4]

4 Note that while Title I and Special Education funding for K-12 education are often treated as local programs since the state passes funds to school districts, states are the agents that apply for the funds; in federal accounting, they are counted for as part of state budgets and as transfers from the state to local school districts.

State Tax Structures

TAXES ARE THE SOURCE of 51.7 percent of state general revenue and account for 73.5 percent of the general revenue that comes from the state's own sources (i.e., not coming from federal sources). Taxes are the most important source of money for the services that states provide and the main lever they control for seeing that these services are adequately funded.

A good state tax system is built on four main principles. The first is adequacy. The tax system should produce revenues sufficient to meet a state's needs. The second is stability. State taxes should be able to provide revenues even when the economy is bad. A related principle is breadth. A state's tax base is the sum of everything that is subject to taxation. The broader the tax base, the more evenly spread the costs. A broader tax base also provides less distortion in how it treats different types of economic activity than a narrower base; in other words, it is more likely to treat all levels of the economy in the same manner. And a broader tax base has a better chance of providing stable revenue than a narrow one does. The final principle is progressivity, which is the concept that as a person's income rises, he or she will pay a greater share of that income in taxes, ensuring that the cost of paying for services will be shouldered according to one's ability to pay. Unfortunately, state tax systems generally do not sufficiently embody any of these principles. Instead, they are inadequate, volatile, narrow and regressive.

Inadequacy. Various studies have found that states generally do not have revenue systems that can be expected to generate adequate funding for their needs. A 2002 analysis by the Rockefeller Institute of the State University of New York found that 44 states have structural deficits, meaning that their revenue systems simply couldn't be expected to adequately cover their future spending requirements. Other research from the Center on Budget and Policy Priorities found that most states' fiscal systems had at least seven elements that could lead to a structural deficit. The simple fact that states like Indiana and Pennsylvania were examining proposals to sell assets even during so called "good years" earlier this decade is a sign of inadequacy. When a revenue system that is inadequate or barely adequate in the good years meets with a recession, the results are devastating.

Volatility. From the third quarter of 2008 to the second quarter of 2009, the U.S. economy shrank by approximately 3.1 percent.[1] At the same time, state tax collections in the first quarter of 2009 were 12.6 percent lower than in the first quarter of 2008.[2] In other words, the rate of tax decline was four times greater than the decline in the economy overall. We are living through an example of the dangers of volatility. The most progressive taxes, especially income taxes on the wealthiest and the corporate income tax, are quite volatile. Yet these taxes are essential to creating a progressive revenue system. Volatility from any one tax can be offset by policies such as the appropriate use of rainy-day funds or the creation of a broad tax base, which provide smoothing over time and across different sorts of taxes.

1 Derived from the Bureau of Economic Analysis National Income and Product Account data. Table 1.1.1. Percent Change from Preceding Period in Real Gross Domestic Product Seasonally Adjusted at Annual Rates." (www.bea.gov/national/nipaweb/SelectTable.asp?Popular=Y).

2 Lucy Dadayan and Donald Boyd. 2009. "Personal Income Tax Revenue Declined Sharply in the First Quarter." *State Revenue Flash Report.* www.rockinst.org/pdf/government_finance/2009-05-13-state_revenue_flash_report_personal_income_tax_revenue_decline.pdf.

Narrowness. Two main dynamics influence the narrowing of a tax base. The first is the changing nature of our economy. For example, the sales tax is largely a tax on durable goods such as cars and household electronics. As households consume more services, which often are not covered by the sales tax, the sales tax covers a smaller share of overall household spending. As our society ages, pensions will provide a greater share of individual income. These benefits traditionally are not taxed or are taxed at a lower rate than payroll income, which narrows the income tax base. The second dynamic is politics; political decisions have further narrowed the tax base. Some of these decisions, such as to exempt food from the sales tax, are laudable because they add progressivity.[3] Other decisions, such as tax exemptions given to lure investment from other states are often less so.

Regressivity. According to the Institute on Taxation and Economic Policy (ITEP), the wealthier taxpayers in our community generally pay a smaller share of their income in state and local taxes than do the middle class and those living in poverty. Using 2002 incomes, ITEP found that the poorest 20 percent of families—those earning less than $15,000 per year—paid about 11 percent of their income in state and local taxes, as opposed to a rate of 7 percent for the richest 1 percent of families who all earned more than $304,000 per year.[4] Having a tax system that doesn't take a greater share of the income of working families than it does the rich is an issue of basic fairness that should undergird state policy reforms.[5]

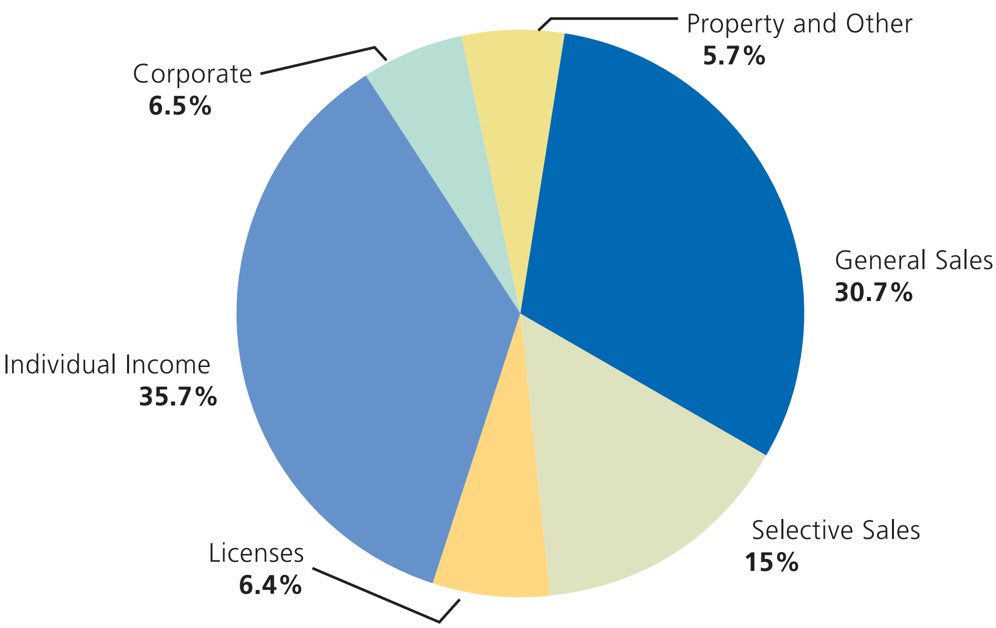
THE NUTS AND BOLTS OF STATE TAX SYSTEMS

There are several basic components to state tax systems. The most important of these are taxes on sales and income. Income taxes come from the earnings of individuals and corporations. The general sales tax and additional selective sales taxes are applied to the purchase of goods and some services. License taxes are the other mainstay of the system. In addition, states derive some revenue from property taxes, severance taxes and estate taxes.

Figure 6

State Tax Collections by Type, 2008

SOURCE: U.S. CENSUS BUREAU



3 Federation of Tax Administrators. State Sales Tax Rates. www.taxadmin.org/FTA/rate/sales.html.

4 Robert McIntyre, et al. 2003. Who Pays? A Distributional Analysis of the Tax Systems in All 50 States (Second Edition). Institute on Taxation and Economic Policy. www.itepnet.org/whopays.htm.

5 A deeper look at progressivity and regressivity is provided in Appendix II.

Although states collected a total of $750 billion in taxes in 2007, the amount collected varied considerably by state. Larger states, like California, naturally collect more taxes overall than smaller states, but there is great variation even when controlling for population differences.

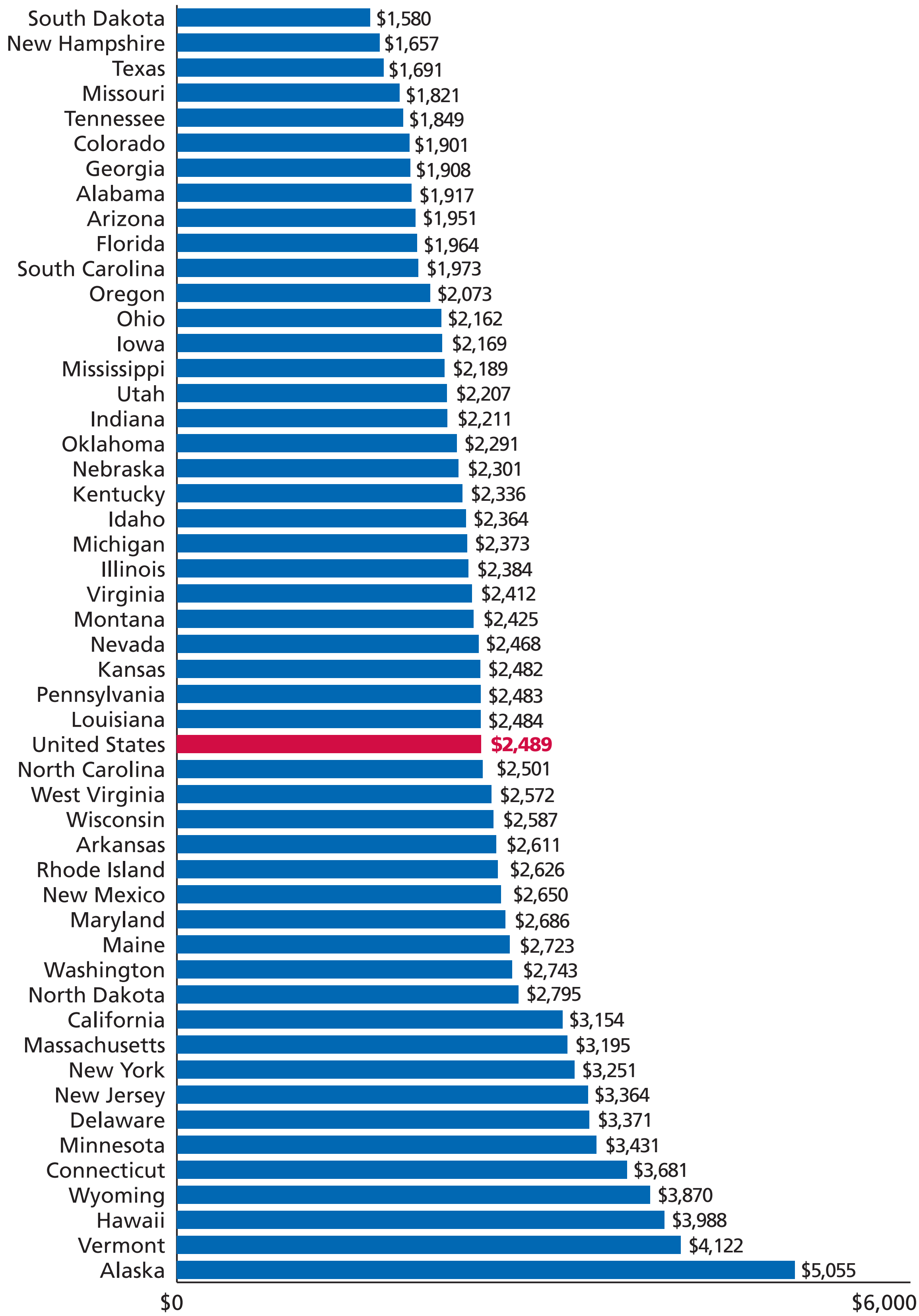
Figure 7 provides a breakdown of the amount of taxes paid per capita in each state in 2007. South Dakota has the lowest per capita taxes and Alaska, thanks to its oil revenue, has the highest—more than twice the national average.

This variation among states is directly a function of wealth and tax effort. For example, New York and Oklahoma each collected per capita state taxes in 2007 that were equal to 6.76 percent of personal income. They have similar overall tax effort, but New York's wealth meant it collected $3,251 per capita as compared with $2,291 in Oklahoma.

Figure 7

Per Capita State Taxes Collected, 2007

SOURCE: U.S. CENSUS BUREAU



INDIVIDUAL INCOME TAX

Taxes on individual (or personal) income, which were first imposed during the latter half of the 19th century, have played an increasingly important role in financing state governments over the past 50 years. In 1950, income taxes represented only about 10 percent of state revenue, while in 2007, they accounted for about 25 percent of states' own general revenue. Income taxes include levies on wages, capital gains, interest and dividends.

Forty-one states and the District of Columbia collect personal income taxes. Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not. New Hampshire and Tennessee tax some capital gains, interest and dividends, but not wages. Eight states—Arkansas, Hawaii, Montana, New Mexico, North Dakota, South Carolina, Vermont and Wisconsin—give preferential treatment to capital gains, valuing capital more than labor and making their tax systems more regressive. Six states receive more than half of their total tax revenue from personal income taxes, including more than two-thirds in Oregon. The U.S. average is 35.9 percent.

The income tax, more than any other tax, grows in direct proportion to economic growth. Because many states collect higher income taxes on people with higher incomes and because almost all states exempt some portion of income up to a certain amount, this is the most progressive tax.

Figure 8

Individual Income Tax Collections as a Percentage of States' Total Tax Collections, 2008

SOURCE: U.S. CENSUS BUREAU

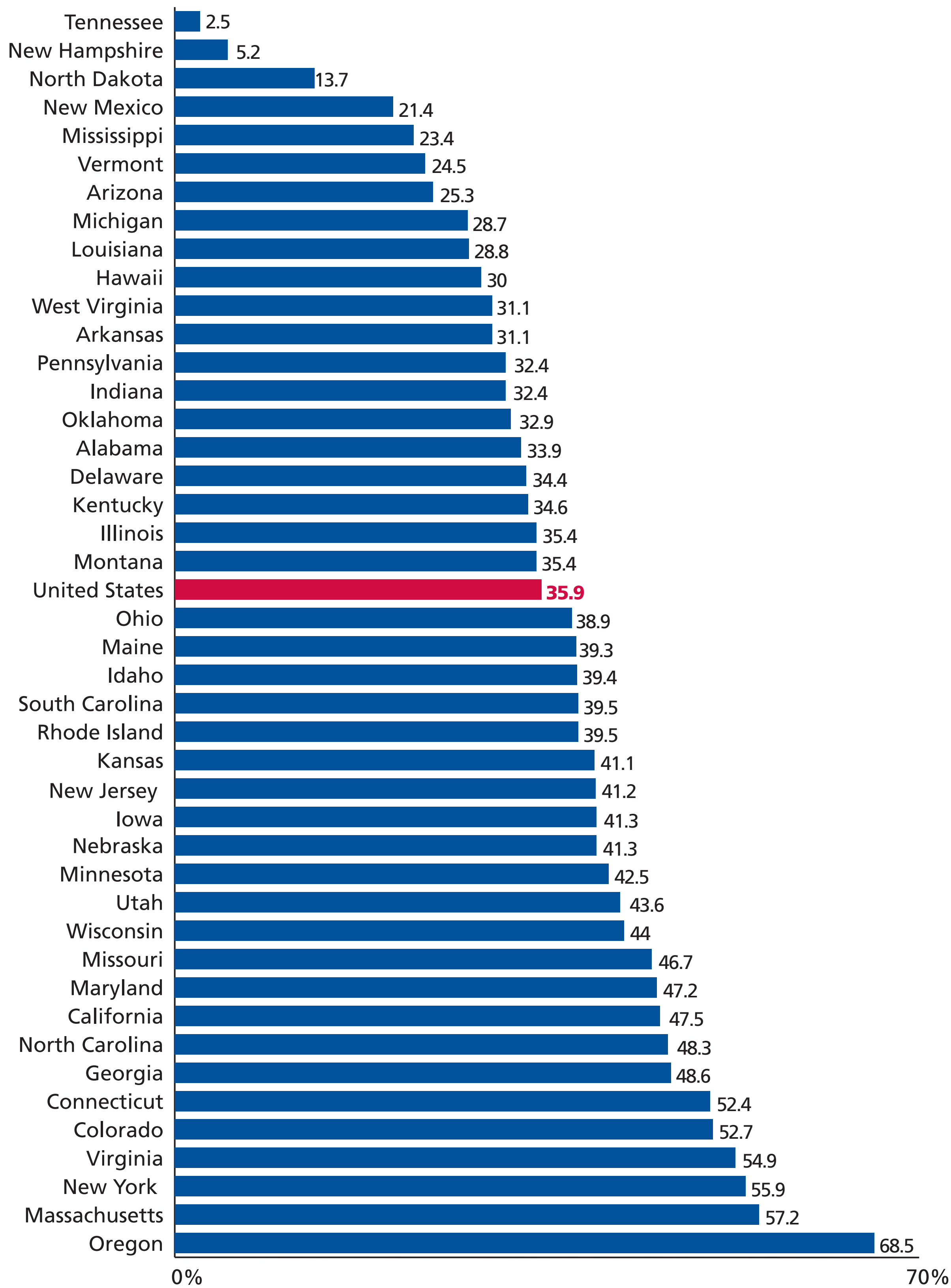


Table 2

Top Individual Income Tax Rates and Brackets, 2009

State	Top Rate %	Top Income Bracket ($)	State	Top Rate%	Top Income Bracket ($)
Alabama	5.0%	$3,000	Missouri	6.0%	$9,000
Arizona	4.54	150,000	Montana	6.9	16,600
Arkansas	7.0	31,000	Nebraska	6.84	27,000
California	10.6	1,000,000	New Hampshire	5.0	Dividends/int. only
Colorado	4.63	Flat rate	New Jersey	10.75	1,000,000
Connecticut	6.5	1,000,000	New Mexico	4.9	16,000
Delaware	6.95	60,000	New York	8.97	300,000
Georgia	6.0	7,000	North Carolina	7.75	60,000
Hawaii	11.0	400,000	North Dakota	5.54	357,700
Idaho	7.8	24,736	Ohio	5.925	200,000
Illinois	3.0	Flat rate	Oklahoma	5.5	8,700
Indiana	3.4	Flat rate	Oregon	11.0	500,000
Iowa	8.98	63,315	Pennsylvania	3.07	Flat rate
Kansas	6.45	30,000	Rhode Island	9.9	357,700
Kentucky	6.0	75,000	South Carolina	7.0	13,150
Louisiana	6.0	50,000	Tennessee	6.0	Dividends/int. only
Maine	6.9	250,000	Utah	5.0	Flat rate
Maryland	6.25	1,000,000	Vermont	9.5	357,700
Massachusetts	5.3	Flat rate	Virginia	5.75	17,000
Michigan	4.35	Flat rate	West Virginia	6.5	60,000
Minnesota	7.85	74,650	Wisconsin	7.75	300,000
Mississippi	5.0	10,000			

Notes: States that do not have an income tax are excluded from this table. This table reports income levels for married couples. Individual income levels are often lower. The top rates in California, Hawaii, Maryland, New Jersey, New York and Oregon are temporary.

SOURCES: FEDERATION OF TAX ADMINISTRATORS; CENTER ON BUDGET AND POLICY PRIORITIES

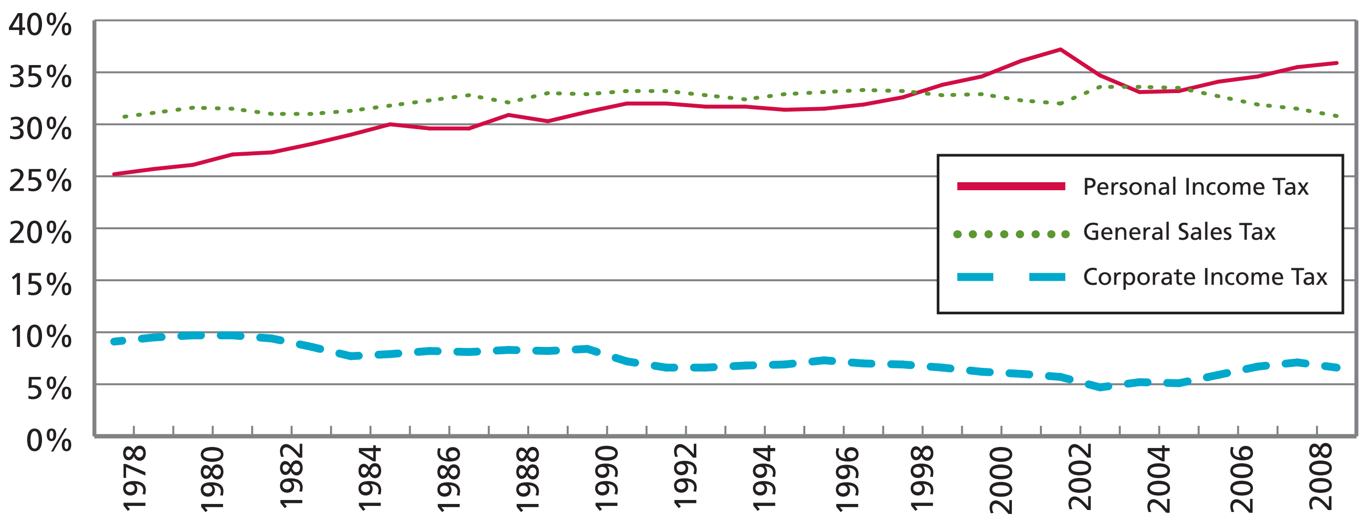
The tax also adds considerably to the breadth of the state tax base, generating revenue across all industries, capturing wages, rental income and capital gains. Personal income taxes from wages are a generally stable revenue source, and are relatively resilient even in times of economic hardship. However, taxes on earnings derived from bonuses and investment income are much more volatile. State personal income taxes have widespread public acceptance; polls indicate that most people acknowledge the need for states to tax income. This contrasts with their reaction to other types of tax, most notably the property tax.

While the income tax has merits, its usefulness could be improved. Seven states do not have an income tax, and two states apply the tax only to dividends and interest income. Seven states have a flat rate that limits the tax's progressivity and prevents it from tracking with recent trends in economic growth. And 12 states apply their top rate at income levels of $30,000 or below. Such rate structures might have made sense in decades past, but they offer little in the way of real progressivity now.

Figure 9

Trend in Tax Revenue as a Percent of Total Tax Revenue, 1997-2008

SOURCE: U.S. CENSUS BUREAU



CORPORATE INCOME TAX

Corporate income taxes are levied on the profits of businesses (revenue minus expenses), and they are an important tool for increasing the fairness of state taxes. On average, states derive 6.6 percent of their tax revenue from corporate income taxes, with New Hampshire (27.3 percent) and Alaska (11.7 percent) topping the list. Neither state taxes individual income, which increases the relative importance of their other taxes. Nevada, Texas, Washington and Wyoming are the only states that do not have corporate income tax.

Each state uses a formula to determine which corporations are taxed. Corporations need not actually be headquartered within a state to be taxed by that state, but have to meet some threshold of business activity. The formula for this typically takes into account some combination of the amount of a corporation's property located in a state, the volume of business it does there and the amount of payroll paid to residents. A corporation that is subject to tax under these rules is deemed to have "nexus." Nexus is one of the most hotly contested issues in tax policy. For example, a growing trend is for states to determine nexus entirely or disproportionately on the basis of sales rather than on physical presence. This change, known as the "single sales factor" is one of the more heavily debated issues in state taxation.[6]

A primary argument against corporate incomes taxes is that they, in one way or another, ultimately are paid by consumers in the form of higher prices for goods and services that businesses provide. This is true at least to the extent that companies choose to pass on these costs rather than lower their profit margins. Were it not for the corporate income tax, much of the income of the wealthiest individuals would be untaxed, because they simply would shelter their assets in corporations. Corporations also directly and indirectly use many of the state's services, such as roads, schools, police, environmental protection and courts. Corporate taxation is one way to ensure that out-of-state entities profiting from these services pay their share of the costs.

Corporate tax collections as a share of states' revenues have been decreasing for some time. Most observers believe that this trend is likely to continue, and some talk of the death of the corporate income tax.[7] Part of this decline is due to purposeful avoidance strategies on the part of corporations. An analysis of 252 Fortune 500 companies over three years (2001-03), for example, compared the state taxes paid to profits as they were reported to shareholders. The report found that the corporations' state tax payments were about one-third of what one would expect if one simply applied the states' corporate tax rate to those profits as stated in the companies' annual reports.[8]

This is the case in part because many companies are using increasingly sophisticated strategies to avoid paying state taxes. Creating offshore subsidiaries to hold profits, for example, is becoming a more common way of avoiding both state and federal taxes. Companies also traditionally seek to use loopholes in one state's laws to shelter revenue from other states' tax systems.

Another tax-avoidance tactic consists of simple efforts to create or take advantage of existing tax credits and subsidies that states offer to corporations to promote economic development. The presence of this system of incentives also turns the corporate tax rate into a relatively meaningless indicator of how high corporate taxes are, since many companies pay nothing and many more pay much less than the stated rate. Actual tax collections are the best way to provide an apples-to-apples comparison across states.

6 For arguments on the problems caused by the single sales factor, see Mazerov, Michael. 2001. The "Single Sales Factor" Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway? http://www.cbpp.org/files/3-27-01sfp.pdf. In effect, the single sales factor provides a tax benefit to large in-state companies with facilities in the state. This has a greater revenue effect than the higher taxes that out-of-state companies, and mom-and-pop companies that totally operate in a state would pay as a result of the change. See also Forsberg, Mary. 2001. "Single Factor: Double Trouble." New Jersey Policy Perspective. www.njpp.org/rpt_singlefactor.html#foot2 and Citizens for Tax Justice. 2001. "Alternatives to the Proposed Illinois Budget Cuts" www.ctj.org/itep/ctba.pdf. Illinois' single sales factor cost $95 million in its first year.

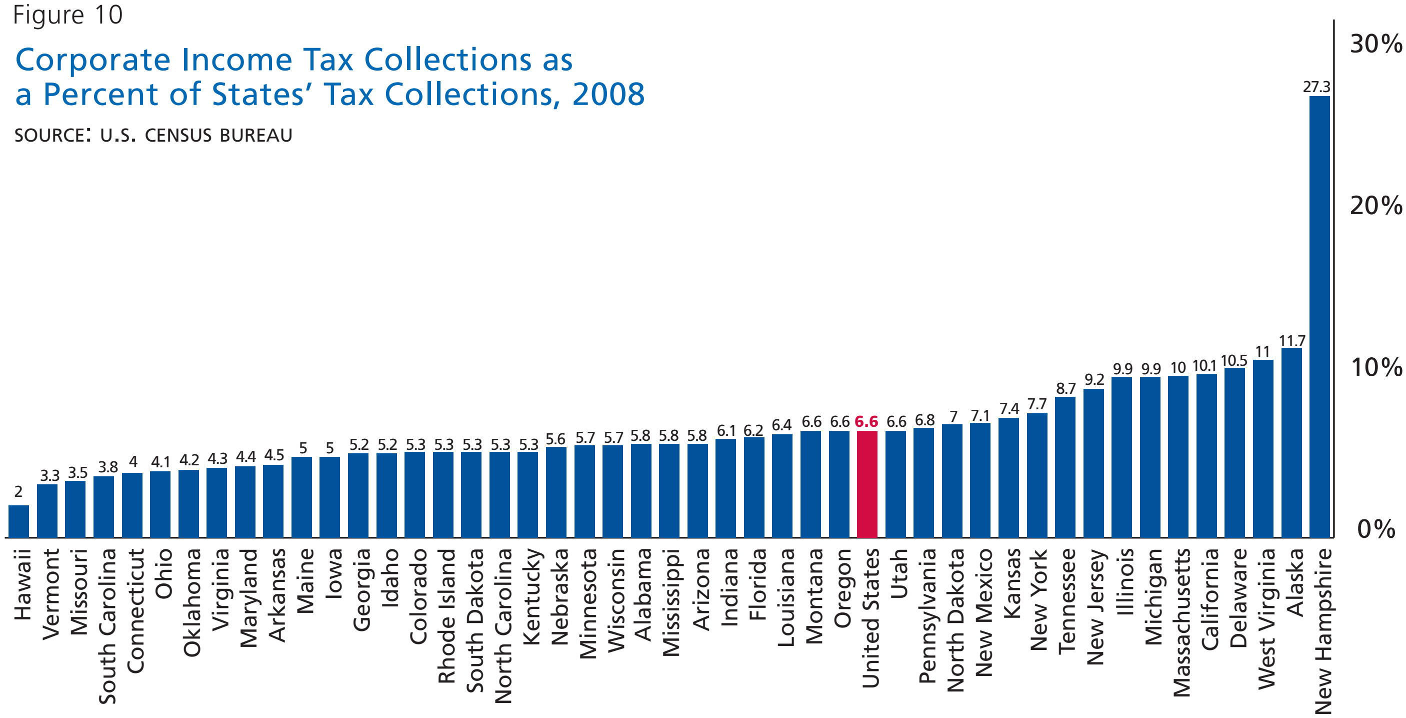
7 David Brunori. 2002. State Tax Policy: A Political Perspective. Urban Institute Press.

8 Robert McIntyre and T.D. Coo Nguyen. 2005. State Corporate Income Taxes: 2001-03. Citizens for Tax Justice. www.ctj.org/pdf/corp0205an.pdf.

Figure 10

Corporate Income Tax Collections as a Percent of States' Tax Collections, 2008

SOURCE: U.S. CENSUS BUREAU



A final reason for shrinking revenues from corporate income taxes is a number of tax changes that the federal government passes down to state governments. In their tax codes, states typically use a variety of federal definitions. This is a commonsense policy and makes it easier for corporations to comply with law. But when the federal government makes changes to the federal code related to how income is calculated, or for depreciation of assets, for example, it can affect the states. (See "Decouple From Harmful Federal Tax Changes" on page 32.)

To summarize, the benefits of the corporate income tax include its progressivity, its ability to broaden the tax base, and its role in seeing that out-of-state businesses that benefit from public services pay their fair share. On the negative side, the tax is volatile, declining dramatically in recession, and it is easily gamed.

SALES TAXES

General Sales Tax

The general sales tax is imposed on everyday retail purchases at a flat percentage rate (making it what is called an ad valorem tax). It represents, on average, 30.8 percent of states' tax revenues. The tax typically is applied to goods (such as food or stereos) as well as, but less frequently, to services (from accounting to hair salons to computer services). State-level sales taxes are often accompanied by county or municipal sales taxes. Forty-five states and the District of Columbia impose a general sales tax. Alaska, Delaware, Montana, New Hampshire and Oregon do not, although Alaska does allow localities to charge the tax.

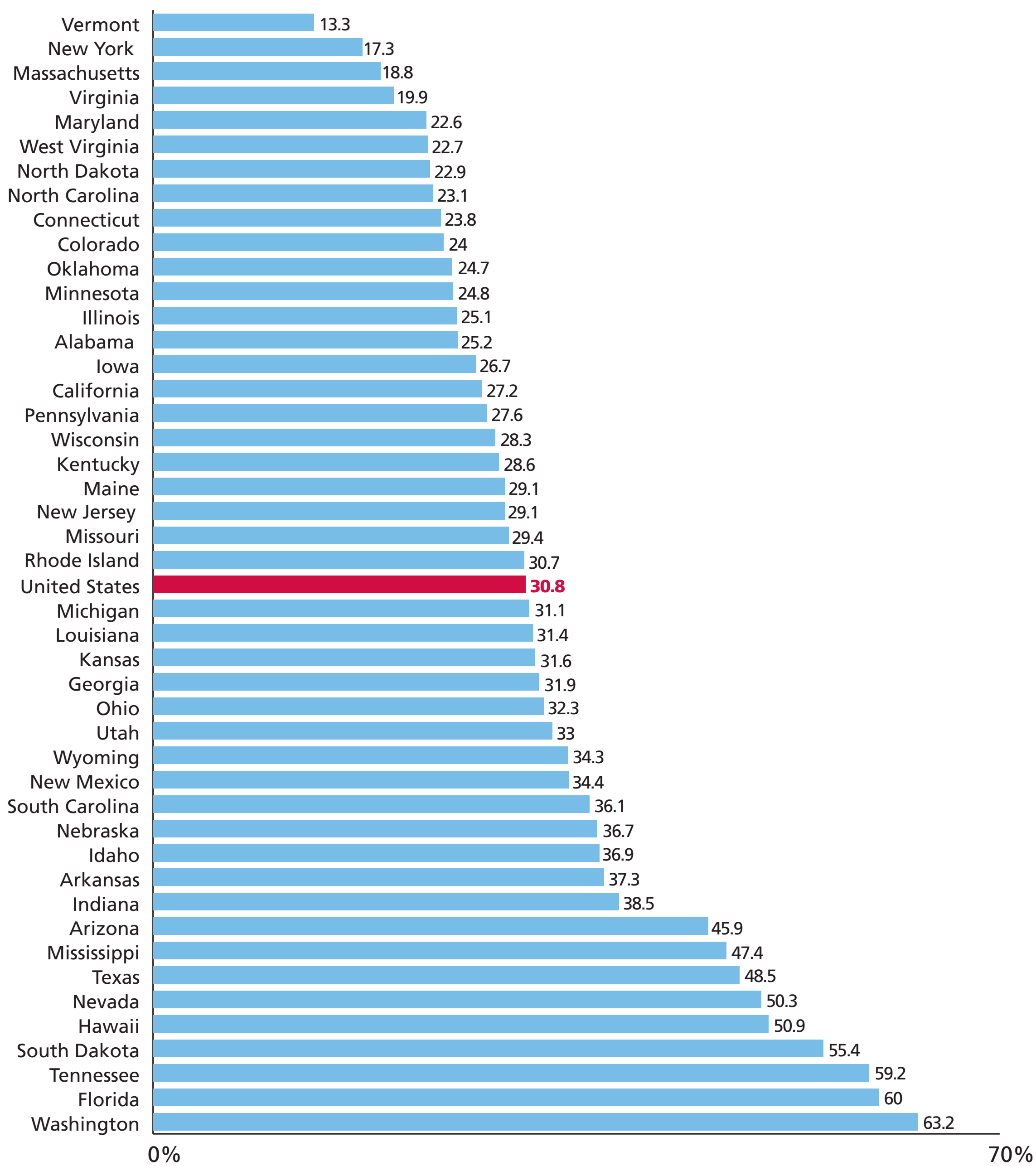
In contrast with personal income, the share of revenue coming from general sales taxes has been slowly declining over the past 20 years. This is a result of various legal, political, economic and technological developments. Nevertheless, six states depend on general sales tax for more than half of their tax revenue, including Washington and Florida at more than 60 percent.

Sales taxes are supported (or at least not opposed) by the public in part because they are seen as fair. Since they are only imposed when people choose to buy things, they often are considered a somewhat voluntary tax. And unlike income and property taxes, sales taxes usually are paid in very small increments, which prevents them from being viewed cumulatively. This explains

Figure 11

General Sales Tax Collections as a Percent of States' Tax Collections, 2008

SOURCE: U.S. CENSUS BUREAU



why proposals to raise the sales tax instead of income or property tax are often the first political response to the need to raise revenue.

However, general sales taxes are quite regressive. On average, low-income families spend 75 percent of their income on purchases subject to sales tax (both general and selective, which is discussed below), middle-income families spend half, and high-income families spend about one-sixth. As a result, the 20 percent of families having the lowest incomes pay about 3.6 percent of that income to general sales tax, the middle 20 percent pay roughly 2.7 percent, while the richest 1 percent pay only 0.5 percent.[9]

Sales tax revenues are also somewhat unstable, declining in times of economic downturn, when people buy less. Part of this effect is psychological, and sales tax revenues are tied to consumer confidence. Even the fear of a downturn can depress sales of high-price (and therefore high-revenue) items such as cars. As the sales tax base narrows, such that a greater share of it is derived from sales of electronics and major appliances, the tax may grow more volatile.

The sales tax base is also too narrow, and tends to get narrower every year. The tax is applied mainly to consumer goods and to a smaller section of services. As the economy becomes more service-based, the tax is missing a growing share of the purchases that families make. Adding to this problem are state decisions to create sales tax holidays for back-to-school periods, or to exempt clothing from the sales tax. This is not to say that exemptions are uniformly without merit. For example, 32 states exempt food for personal home consumption from the sales tax, which eases the regressivity of the tax because lower-income families pay a far larger percentage of their income to buy food than wealthier families do. But, overall, the narrowing of the sales tax base is a major concern.

Table 3

General Sales Tax Rates by State, 2010

Rate	States
8%	California
7%	Mississippi, New Jersey, Rhode Island, Tennessee
Between 6% and 7%	Illinois, Massachusetts, Minnesota, Nevada, Texas, Washington
6%	Arkansas, Connecticut, Florida, Idaho, Indiana, Kentucky, Maryland, Michigan, Pennsylvania, South Carolina, Vermont, West Virginia
Between 5% and 6%	Arizona, District of Columbia, Kansas, Nebraska, Ohio
5%	Iowa, Maine, New Mexico, North Dakota, Virginia, Wisconsin
Between 4% and 5%	Missouri, North Carolina, Oklahoma, Utah
4%	Alabama, Georgia, Hawaii, Louisiana, New York, South Dakota, Wyoming
Up to 4%	Colorado
None	Alaska, Delaware, Montana, New Hampshire, Oregon

SOURCES: FEDERATION OF TAX ADMINISTRATORS; CENTER ON BUDGET AND POLICY PRIORITIES

9 Robert McIntyre, et al. 2003. Who Pays? A Distributional Analysis of the Tax Systems in All 50 States. Second Edition. Institute on Taxation and Economic Policy. www.itepnet.org/whopays.htm.

The inability of states to collect sales and use taxes on many Internet purchases also contributes to the narrowing of the tax base.[10] Federal court rulings from the 1960s have set the standard that one cannot compel a retailer that ships goods throughout the country to keep track of the state and local tax rates in every jurisdiction. Remote sellers can be expected to collect sales taxes only if they have a real physical presence in a locality, which is how nexus is defined for sales tax collections. This ruling—created for catalog companies before there was an Internet—is sadly out of date. As online purchasing becomes increasingly popular, states are losing larger amounts of revenue. States lost an estimated $7 billion in revenue in 2009 from uncollected taxes on electronic commerce, with billions more lost on catalog sales.[11]

Overall, general sales taxes remain a strong source of state revenue, and politically they are relatively viable. However, they are also inherently regressive and unstable. States that receive a disproportionately high share of revenue from sales tax, such as Florida and Nevada, are likely to be hit harder during economic downturns.

Selective Sales Tax

Selective sales taxes are imposed on specific goods such as insurance premiums, tobacco and motor fuel. They are also known as excise or special taxes. Prior to the 20th century, excise taxes were the top source of revenue for states. In 2008, however, only 14.8 percent of states' tax revenue came from this source. As with all other taxes, states vary in how dependent they are on excise taxes, from 3.3 percent of total state tax revenue in Alaska to 35.2 percent in New Hampshire.

States also vary in terms of which goods are subject to excise taxes. These typically include taxes on utilities, fuel and alcohol. One item that is taxed in all states, albeit at varying rates, is cigarettes. Tobacco taxes account for 13.9 percent of selective sales tax revenue.

10 Every state with a sales tax also has a use tax. Use taxes are imposed on good purchased out-of-state but used within the state. The tax is supposed to prevent people from buying things in other states with lower tax rates. However, the use tax is rarely enforced, and states with higher sales tax rates may be losing a great deal of revenue as a result.

11 Donald Bruce, William Fox, William Stokely, and LeAnn Luna. 2009. State and Local Government Sales Tax Revenue Losses from Electronic Commerce. University of Tennessee. www.streamlinedsalestax.org/Executive%20Committee/Previous_meetings/4_13_09/SSTP%20e-commerce%202009%20REV041309.pdf.

Figure 12

Selective Sales Tax Collections as a Percent of States' Tax Collections, 2008

SOURCE: U.S. CENSUS BUREAU

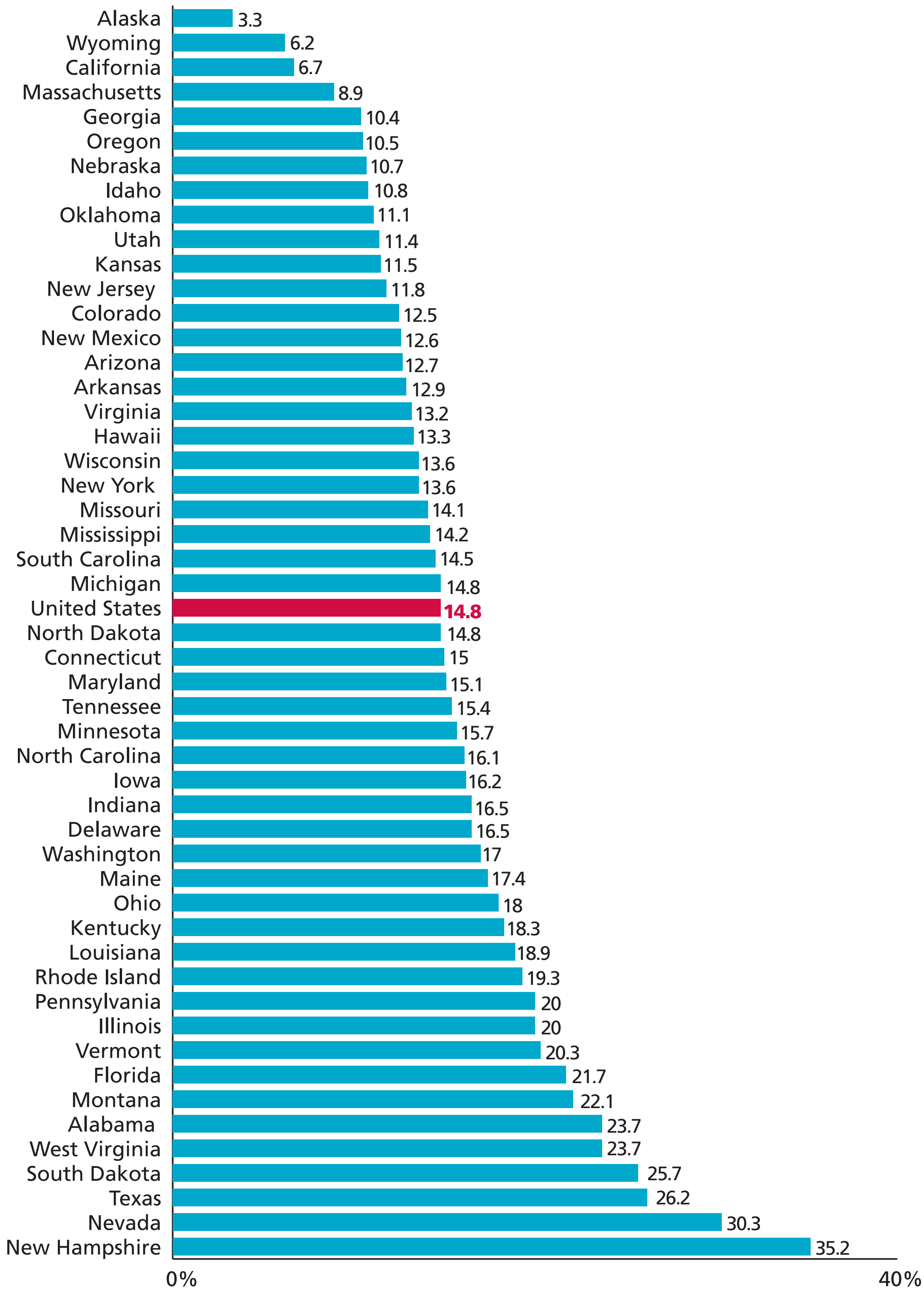


Figure 13

Sources of State Selective Sales Tax Collections, by Product Type, 2008

SOURCE: U.S. CENSUS BUREAU

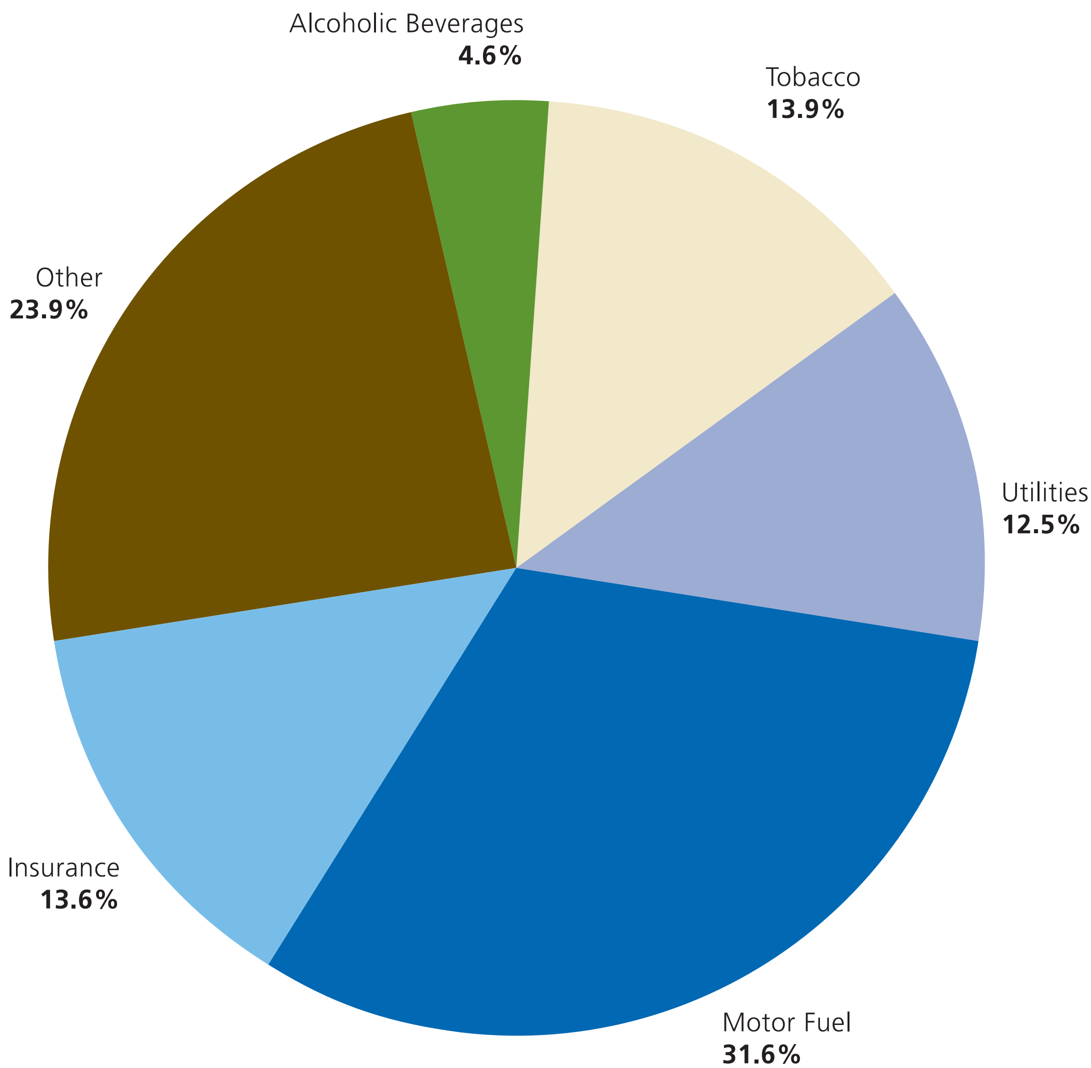


Table 4

State Cigarette Taxes (per 20 pack) by State, July 2009

Alabama	$0.43	Montana	$1.70
Alaska	2.00	Nebraska	0.64
Arizona	2.00	Nevada	0.80
Arkansas	1.15	New Hampshire	1.78
California	0.87	New Jersey	2.70
Colorado	0.84	New Mexico	0.91
Connecticut	2.00	New York	2.75
Delaware	1.60	North Carolina	0.35
Florida	1.34	North Dakota	0.44
Georgia	0.37	Ohio	1.25
Hawaii	2.02	Oklahoma	1.03
Idaho	0.57	Oregon	1.18
Illinois	0.98	Pennsylvania	1.35
Indiana	1.00	Rhode Island	3.46
Iowa	1.36	South Carolina	0.07
Kansas	0.79	South Dakota	1.53
Kentucky	0.60	Tennessee	0.62
Louisiana	0.36	Texas	1.41
Maine	2.00	Utah	0.70
Maryland	2.00	Vermont	2.24
Massachusetts	2.51	Virginia	0.30
Michigan	2.00	Washington	2.03
Minnesota	1.50	West Virginia	0.55
Mississippi	0.68	Wisconsin	2.52
Missouri	0.17	Wyoming	0.60
		Washington D.C	2.00

Note: Rounded to the nearest cent.

SOURCES: FEDERATION OF TAX ADMINISTRATORS; CENTER ON BUDGET AND POLICY PRIORITIES.

Motor fuel is also universally taxed (31.6 percent of excise revenue) as are alcoholic beverages (4.6 percent), even though rates vary among different products within these categories (e.g., cigarettes versus pipe tobacco, unleaded versus diesel fuel).

Like general sales taxes, excise taxes are perceived as fair because individuals can “opt out” of paying by not consuming the good subject to the tax. Taxes on products like tobacco and alcohol, often referred to as “sin taxes,” may also be viewed as deterrents to unhealthy behavior, just as taxes on motor fuel are sometimes seen as good for the environment in that they discourage driving and help pay for mass transit. This logic can be extended beyond environmental and health concerns. For example, in 2004 Utah passed legislation imposing a 10 percent tax on the adult entertainment industry.

It is considered by some to be a principle of good taxation to dedicate excise tax revenues to purposes related to their subject. For example, 12 states use their cigarette taxes to fund anti-smoking programs, while gasoline taxes are often used to finance road construction and repair. This targeting increases public acceptance of the tax.

Excise taxes are paid to the government directly by the vendors, making the administrative costs relatively low and often invisible to consumers. Most people do not know how much of their spending on alcohol or fuel is taxation.

Unlike general sales taxes, which increase as the price of the particular product increases, excise taxes are typically imposed on a per-unit basis, for example, on a pack of cigarettes or a gallon of fuel. This means that the tax is the same if you are buying an expensive or cheap bottle of wine, or a premium or low-grade fuel. As a result, selective sales taxes are even more regressive than general sales taxes because the “premium” versions of products that rich people buy are subject to the same amount of tax as the less expensive variants. This feature also means that excise taxes don’t keep pace with inflation or with economic growth. The per-unit basis, however, is not an inherent feature of excise taxes.

Selective sales taxes share many of the advantages and disadvantages with general sales taxes. Both are strong revenue sources that arouse little political opposition, yet both are also highly regressive and relatively unstable.

One of the latest developments in tax policy is the question of instituting excise taxes on particular foods that are high in sugar or fat. Such taxes will, to the extent that lower-income families are more likely to buy processed foods and to suffer from obesity, be quite regressive. Because these proposals combine taxation with a direct effort by the state to create disincentives for eating certain kinds of foods, they move the debate from “how to fund services” to “how much should Massachusetts dictate what people eat.” The added political controversy may work against efforts to fund public services. Linking such a tax to physical education in schools or to childrens’ health generally might help in this regard because it transforms the tax from an instrument of state intervention in people’s choices into more of a logical way to fund services needed to offset the harm that overconsumption of such foods can cause. But even such steps will not change the concerns related to regressivity.

OTHER TAXES

Severance Tax

Severance taxes are a special kind of excise tax that are imposed on the extraction of nonrenewable resources from the earth, such as oil, gas and coal. They are usually set at a flat rate per unit of measure (per barrel for oil, per ton for coal, etc.). Only 16 states derive more than 1 percent of their total tax revenue from severances, while 15 states impose no severance taxes at all. These include at least one state, California, that has substantial mineral extractions. At this writing, it also includes New York and Pennsylvania, where substantial natural gas deposits may soon be tapped.

For those states with abundant nonrenewable natural resources, severance tax revenue can be quite important. Alaska draws just under 83 percent of its tax revenue from severances—mostly on oil and gas. These collections have more than doubled since 2004. Collections have increased substantially for all states with significant severance tax revenues.

The logic behind the severance tax is twofold. First, extraction of natural resources can be seen as the depletion of a state's common inheritance, and it is proper that companies profiting from the extraction share the benefits. Second, the extraction itself can create public costs. Portions of severance taxes are often devoted to conservation, reclamation and remediation of lands. Because the natural resources are considered to be finite, it is considered good policy to place the proceeds of severance taxes in a trust fund. The idea is that the principal of the trust will be a permanent monetary resource to replace the natural resource that was extracted. A substantial share of public education funding in New Mexico, for example, comes from trust fund revenue.

Severance tax collections often enable states to eliminate other types of taxes. The two largest revenue states (Alaska and Wyoming) have no personal income tax, and the former also imposes no sales tax.

Table 5

State Severance Tax Collections, 2008

State	2008 Collections ($thousands)	% Total Tax Revenue
United States	$18,259,644	2.3%
Alaska	6,939,040	82.4
Wyoming	883,786	40.8
North Dakota	791,692	34.2
New Mexico	1,089,836	19.2
Montana	347,221	14.1
Oklahoma	1,184,765	14.0
Louisiana	1,035,695	9.4
Texas	4,131,185	9.2
West Virginia	347,592	7.1
Kentucky	293,334	2.9
Kansas	168,696	2.4
Alabama	197,581	2.2
Mississippi	135,248	2.0
Utah	106,060	1.8
Colorado	151,474	1.6
Nevada	74,130	1.2

The other 34 states either have no severance taxes (15) or have severance taxes whose collections are less than 1 percent of total state tax collections (19).

SOURCE: U.S. CENSUS BUREAU: STATE TAX COLLECTIONS 2008

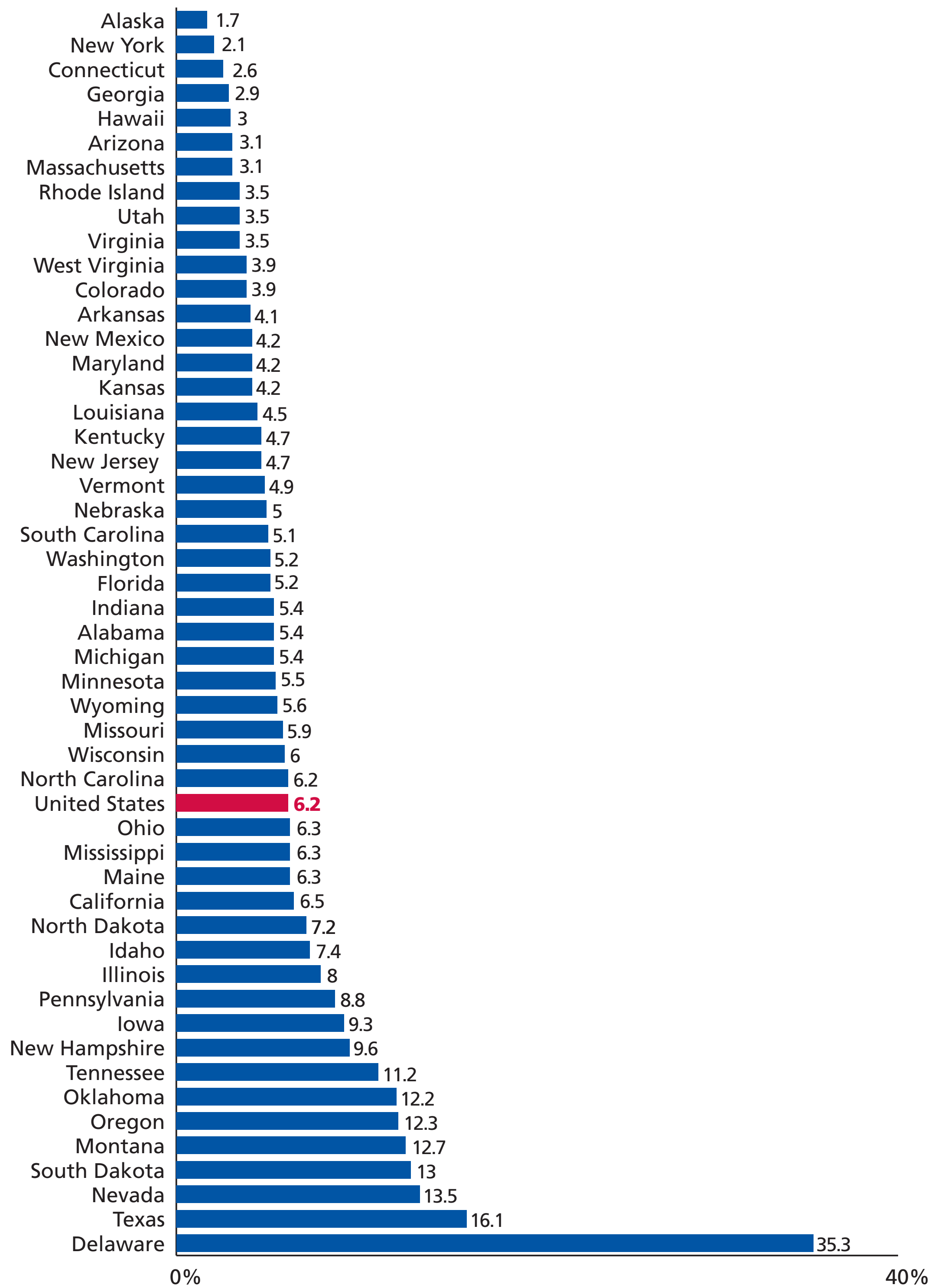
License Tax

License taxes, which account for 6.2 percent of states' own general revenue, are imposed when people apply for licenses to do things like drive a car, hunt, fish or operate a business. They are similar to fees in this respect.

Figure 14

License Tax Collections as a Percent of States' Tax Collections, 2008

SOURCE: U.S. CENSUS BUREAU



Many states use the proceeds from license taxes for programs related to the activity being licensed. For example, hunting license taxes often are used to fund wildlife management departments and parks. States issue hundreds of different licenses, such as those for beauticians, street vendors, and even bounty hunters.

License taxes are not progressive because they do not vary with income. For example, hunters and drivers pay the same tax regardless of how much they earn. Some license taxes provide stable revenue (e.g., driver's licenses), while others are highly volatile. While some states can receive significant tax revenues from license taxes, with Texas (16.1 percent) and Delaware (35.3 percent) being the most dependent, these are generally not a major source of revenues.

Property Tax

Property taxes are the oldest significant source of revenue for state and local governments, and represented more than 80 percent of state revenue at the beginning of the 20th century.[12]

Today, property taxes are overwhelmingly a local tax; in 2002, about 45 percent of local governments' own revenue came from property taxation. States, on the other hand, receive a relatively small proportion of their revenue from property taxes (about 1 percent). Seven states do depend on these taxes for more than 5 percent of their revenue. Of these, Vermont is an outlier, receiving 26 percent of its general state revenue from property taxes.

Even in states where property tax revenue is a minor part of state revenue, the state plays a role in policies related to local property taxation. For example, state-level policy in many cases sets limits on local property taxes or provides for targeted reductions in property taxes for certain corporations, or for low-income or elderly families. State policy in areas like education funding also can drive local property tax policy by setting standards that require greater investment.

The three components in determining how much property tax is levied are the types of property that are taxed, the value of that property and the tax rate. States typically allow for the taxation of real property (both private and commercial buildings and land) and personal property (including automobiles). The value of the property is determined by an assessment; the degree to which assessments match the actual value of a property can vary. Assessments may become out of date, for example, and local politics can affect the environment in which assessors operate. The way that rates are applied to property varies considerably among states as well. Rates typically are expressed as "mills" or thousandths of a dollar. If a tax rate is 10 mills, property is being taxed at one cent per dollar of taxable assessed value.

The property tax is unpopular with the public. It is often paid in a lump sum, and so is far more visible than sales tax. It has a misleading reputation among some as a progressive tax because lower-income renters often seem spared from it, although they do carry the cost in their rents. Also, middle-income families are more likely to pay a greater share of their wealth in property taxes than are wealthier families, making the tax regressive. One method of providing some progressive relief is the homestead exemption, which decreases by a set amount the assessed value of homes for purposes of taxation. Most states have an even more progressive system of "circuit breakers" that limit the amount of tax that lower-income property owners will pay. Although such measures add progressivity, they limit the revenue the tax generates. States that pass homestead exemptions and circuit breakers can act to hold local government services like schools harmless by replacing lost funds.

12 ITEP (2005).

State Lotteries

Forty-three states and the District of Columbia have lotteries, up from 37 in 1998. The gross revenue from these programs was $75.9 billion in 2007. This means that Americans spend, on average, $252 each on lottery tickets. This number has almost doubled over the past 10 years.

After prize awards and administration, the net revenue was $17.7 billion, about 1.7 percent of states' own total general revenue. However, fives states depend on lotteries for more than 5 percent of their own general revenue: Oregon (5.3 percent); South Dakota (5.9 percent); Delaware (6.1 percent); Rhode Island (7.6 percent); and West Virginia (9.2 percent).

A state lottery is a legal form of gambling; although not a tax per se, it is still a de facto form of excise tax because the winnings paid out are less than the net revenue. Lotteries are regressive because lower-income players spend a higher percentage of their earnings on each ticket than higher-income players do. Studies show that poorer individuals are more likely to play the lottery, and are more likely to play often, which adds to the tax's regressivity. [13]

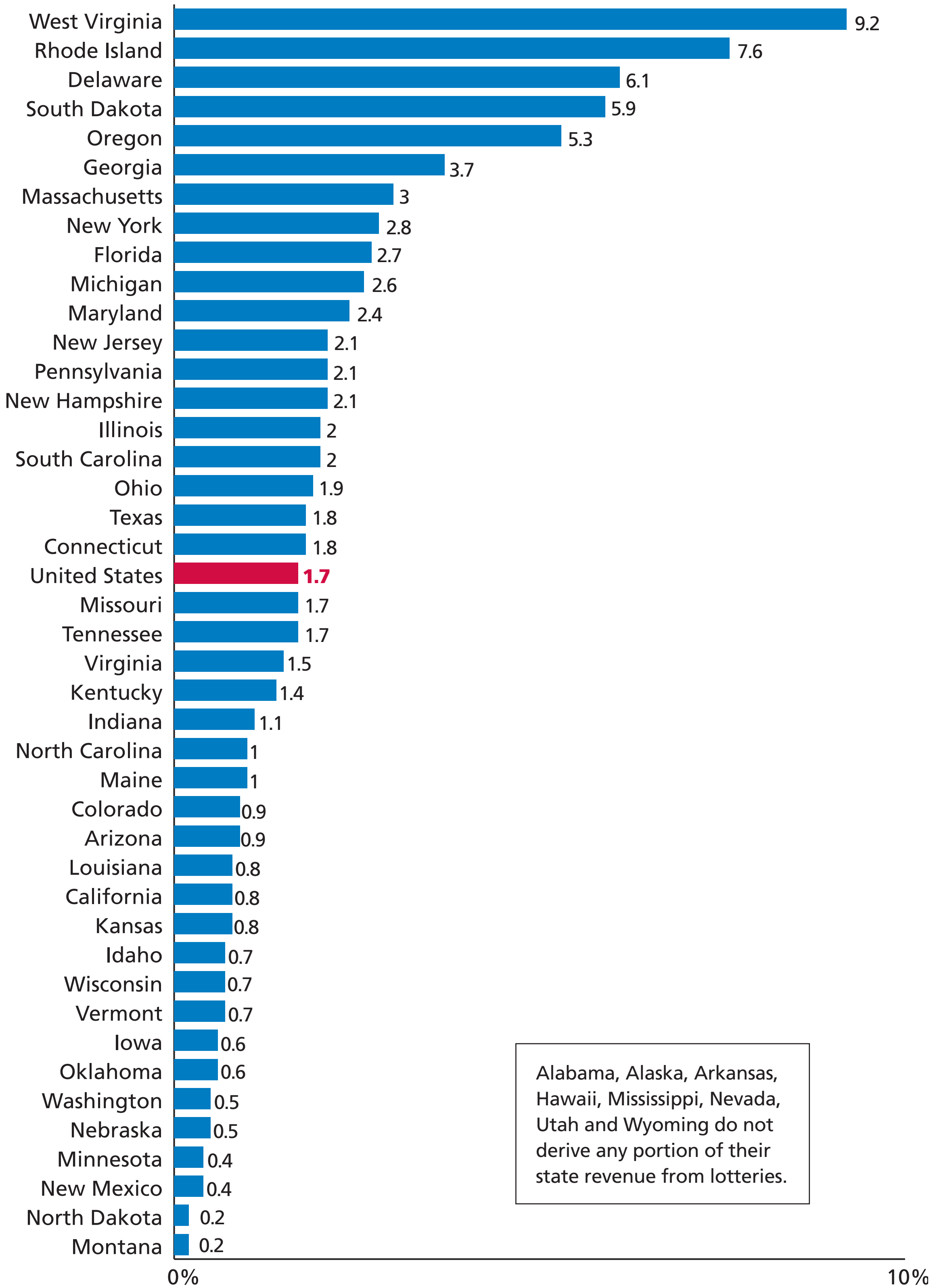
Many states address the opposition to lotteries (for example, on moral grounds or because they are regressive) by using part of the proceeds for popular programs, such as education. There is reason to be concerned, however, that lottery funds simply end up supplanting other revenues.

13 Ann Hansen. The Tax Incidence of the Colorado State Lottery Instant Game. Public Finance Review, Vol. 23, No. 3, 385-398 (1995). (http://pfr.sagepub.com/cgi/content/abstract/23/3/385); Donald I. Price and E. Shawn Novak. The Income Redistribution Effects of Texas State Lottery Games. Public Finance Review, Vol. 28, No. 1, 82-92 (2000). (http://pfr.sagepub.com/cgi/content/abstract/28/1/82); and Ann Hansen, Anthony D. Miyazaki, and David E. Sprott. The Tax Incidence of Lotteries: Evidence from Five States, Journal of Consumer Affairs, Vol. 34, Issue 2, 182-203 (March 3, 2005). www3.interscience.wiley.com/journal/119035834/abstract?CRETRY=1&SRETRY=0.

Figure 15

Net State Lottery Revenue as a Percent of States' Own General Revenue, 2007

SOURCE: U.S. CENSUS BUREAU



Options for Increasing Revenues in the States

THE FIRST SECTION of this report presented an overview of state revenue systems. The goal was to provide context and background for AFT leaders and staff to inform their advocacy on these issues. This section of the report reviews a series of proposals to improve the adequacy of state revenues and the overall effectiveness of the state revenue system in this time of fiscal crisis.

IMPROVE TAX ENFORCEMENT AND THE COLLECTION OF EXISTING TAXES

One way for states to generate new revenue from their tax systems is to better enforce existing laws. The federal tax gap, which is the difference between taxes owed and collected, was estimated at $353 billion in 2001. That's equal to 16 percent of total taxes owed.[1] There is no comprehensive estimate of the total tax gap at the state level, but it is certainly in the tens of billions of dollars. State-specific studies that have been done are summarized in the table below.

Table 6

State Tax Gap Analyses

State	Year	Type of Tax Studied	Gap	Gap as % of Total Collected Tax Revenues
Minnesota	1999-2000	Sales and PIT	$1.05 billion	7.8%
New York	2002	PIT	2.3 billion	5.3
California	2005	PIT, CIT and Sales	8 billion	8.1
Montana	2005	PIT and CIT	178 million	9.4
Oregon	2006	PIT	1.2 billion	15.8

PIT = personal income tax; CIT = corporate income tax. SOURCES: VARIOUS STATE REVENUE AGENCIES

Tax avoidance narrows the tax base, which puts more of a burden on law-abiding citizens. Research at the federal level also indicates that income tax evasion adds to regressivity. Upper-income earners fail to report 21 percent of their earnings as compared with 7 percent for middle-

1 Max B. Sawicky. Do-it-yourself tax cuts: The crisis in U.S. tax enforcement. EPI Briefing Paper #160, April 12, 2005. (http://www.epi.org/publications/entry/bp160/).

class families.[2] And widespread corruption can undermine the legtimacy of the entire system. Moreover, the tax gap comprises a substantial part of the shortfalls that states are facing this year.

Here are some steps that states should consider for improving tax enforcement:

- **Protect auditors and enforcement staff from personnel reductions.** Budget cuts can affect the performance of any department, but when the jobs of auditors and tax enforcement personnel are cut, it can make the overall budget crisis worse. For example, news reports estimate that layoffs of 208 tax auditors in Arizona will cost the state $178 million.[3] California is similarly applying across-the-board cuts to its revenue department.[4] That agency estimates that every dollar cut from its budget leads, on average, to a $9 reduction in tax collections.

- **Analyze the tax gap.** Only a handful of states have systematically examined the compliance rate for any part of their tax system. Even fewer have looked at the system overall. Understanding the issues relating to tax delinquency is a first step toward figuring out how to improve collections.

- **Invest in tax enforcement.** Minnesota was one of the first states to study its tax gap. In response to that analysis, it expanded investment in auditing and enforcement. For each dollar invested in this program, $7 in previously uncollected taxes were recovered.[5] Such modernization includes both technology and staffing; and it focuses not just on the auditing of filed returns but also on identifying nonfilers and unreported economic activity. This year, Wisconsin placed $11.8 million in the budget to hire 31 additional auditors, which the state estimates will garner $70 million in additional revenues.

- **Increase penalties for enforcement.** Increasing penalties can be an effective way to improve enforcement, particularly when coupled with amnesties. But states also can take steps short of fines and prosecutions. Connecticut, for example, posts on its Web site a list of the 100 top state tax delinquents.[6] In the first two years of this program, the state collected $52 million in additional revenues. California, Illinois, Louisiana and Wisconsin have similar programs.

- **Enact a tax amnesty.** States that adopt tax amnesties will, during a specified period of time, waive civil and criminal penalties to encourage delinquent taxpayers to pay their outstanding taxes. In the last 10 years, 27 states have had at least one amnesty program.[7] One benefit of amnesties is that they can add new taxpayers to the rolls. Amnesties work best when they are not offered regularly and when they are coupled with the prospect of increased enforcement and penalties. New Jersey's 2002 amnesty netted $277 million; nevertheless, the effect of an amnesty is always uncertain. For example, Massachusetts' 2003 amnesty garnered just $11.2 million. Overly frequent amnesties, particularly when they are not coupled with increased penalties, can undermine public confidence in the fairness of the state tax system and promote the idea that tax avoidance is broadly acceptable.

- **Analyze tax expenditures.** Each state tax code contains numerous exemptions, credits and deductions. Each of these represents a decision not to collect revenue and is typically based on the presumption that the commerce being exempted or the activity that triggers the tax break is somehow providing a community benefit. These tax breaks are a form of off-budget spending. Forty-one states and the District of Columbia compile a "tax expenditure budget"

2 Andrew Johns and Joel Slemrod. The Distribution of Income Tax Noncompliance. Sept. 12, 2008. www.bus.umich.edu/OTPR/DITN%20091308.pdf.

3 Craig Harris. Layoff of Tax Collectors, Auditors May Cost Arizona. The Arizona Republic. April 2, 2009. www.azcentral.com/news/articles/2009/04/02/20090402biz-nocollections0402.html.

4 Marc Lifsher. State Tax Collectors Denied Exemption from Furloughs. Los Angeles Times. July 29, 2009. http://articles.latimes.com/2009/jul/29/business/fi-furloughs29.

5 Investing in Revenue. How Wisconsin Can Profit by Using the Minnesota Model for Closing the Tax Gap. Institute for Wisconsin's Future. January 2009. www.wisconsinsfuture.org/publications_pdfs/tax/investinginrevenue.pdf.

6 100 of the Top Delinquent Income Taxpayer Accounts. State of Connecticut Department of Revenue Services. Mid-September 2009. www.ct.gov/DRs/cwp/view.asp?a=1453&q=296114.

7 State Tax Amnesty Programs. Nov. 22, 1982. www.taxadmin.org/fta/rate/amnesty1.html.

that allows taxpayers to see the true cost of these choices. Alabama, Alaska, Georgia, Indiana, Nevada, New Jersey, New Mexico, South Dakota and Wyoming do not. Of those that do have a tax expenditure budget, Arkansas, Colorado, Iowa, New Hampshire, North Dakota, South Carolina, Utah and Virginia all leave out major tax expenditures. Arkansas, Maryland, New Hampshire and South Carolina all fail to post this part of their budget online.[8]

DECOUPLE FROM HARMFUL FEDERAL TAX CHANGES

State tax systems typically are built around the structure of the federal tax code. States do this to keep the system simpler for taxpayers. Among the features of the federal tax code that states typically rely on are definitions of income and schedules for depreciation of assets. As a result, changes in federal tax law affect state taxes, and federal tax cuts often will reduce state revenues. The main areas of taxation where federal action is currently having an adverse effect on states relate to the treatment of debt income, the domestic production deduction, and the estate tax. In each instance, states can avoid harmful effects by decoupling from the federal tax change.

- **Cancellation of debt income.** An obscure business tax break in the federal stimulus package enacted in February 2009 provides a tax incentive for companies to purchase their own debt. The provision, know as CODI (cancellation of debt income), allows companies to defer tax payments on the income generated as a result of such purchases; those payments will begin in 2014. Because most state tax codes use the same definitions of income as the federal government in this particular sector of tax policy, 43 states and the District of Columbia will have tax collections on this income deferred until 2014. Those collections are estimated to be worth $5.5 billion from 2009-11. Given that states lack the federal government's capacity to borrow during tough times, deferral of payments can mean job losses and service cuts. The only states that are not affected by this provision are Nevada, Texas, Washington and Wyoming.[8]
- **Corporate domestic production deduction.** In 2004 the federal government created a new tax break that allows corporations a deduction if they can show profits from certain types of activities, ranging from manufacturing to filmmaking to oil and gas production. The "domestic production deduction" (also known as the "qualified production activities income deduction" or QPAI) will fully phase in next year. The goal of the credit is to create an incentive for domestic production employment. Because state corporate tax codes frequently use federal definitions, 47 states have been affected by this change. Since 2004, some 20 states and the District of Columbia have taken action to disallow the deduction. The rest stand to lose a combined $728 million a year once the change fully phases in. (These states are Alabama, Alaska, Arizona, Colorado, Connecticut, Delaware, Florida, Idaho, Illinois, Iowa, Kansas, Kentucky, Louisiana, Michigan, Missouri, Montana, Nebraska, New Jersey, New Mexico, Ohio, Oklahoma, Pennsylvania, Rhode Island, Utah, Virginia, Vermont and Wisconsin.)[9]
- **The estate tax.** Prior to 2001, the federal estate tax included a credit for payment of state estate taxes. The credit gave every state government the opportunity to share in estate tax revenue without adding to the overall cost of the tax. This prevented states from engaging in a macabre competition to attract millionaires at the end of their lives and as such was good tax policy. Most states had their estate tax directly linked to this federal provision. These linked estate taxes are known as "pick-up taxes." When the federal government phased out its estate tax as part of George W. Bush's tax cuts, it had the effect of repealing the pick-up taxes. Only the handful of states with their own estate tax were unaffected.

8 Michael Mazerov. Obscure Tax Provision of Federal Recovery Package Could Widen State Budget Gaps – States Can Avoid Revenue Loss by "Decoupling." Center on Budget and Policy Priorities. May 19, 2009. www.cbpp.org/cms/index.cfm?fa=view&id=2820.

9 Jason Levitis, Nicholas Johnson and Katherine Lira. States Can Opt Out of the Costly and Ineffective "Domestic Production Deduction" Corporate Tax Break. Center on Budget and Policy Priorities. July 29. 2008. www.cbpp.org/files/7-29-08sfp.pdf.

More disinformation has been spread about the estate tax than probably any other. Opponents call it the "death tax" and claim for example that it forces the sale of family farms because the tax burden prevents farmers from passing their businesses on to their heirs. Such claims are patently false. In fact, the Congressional Budget Office estimated in 2005 that there were only 300 estates with family farms of sufficient size to owe any estate tax at all, let alone enough to put the farm out of business.[10] Instead, the estate tax is a vehicle for fairness that only touches the very richest among us. For example, in 2009 the federal estate tax exempted the first $3.5 million that an individual chose to bequeath. In 2006, only seven out of every 1,000 estates paid any estate tax at all.[11]

As of this writing, eight states have a stand-alone estate tax and 14 others, as well as the District of Columbia, have retained their pick-up tax. These 22 states collect $4.5 billion a year from these taxes. Of these states, Oklahoma and Kansas have estate taxes that are scheduled to expire in 2010 unless action is taken to renew them. The rest also would need to take some action in order to recover this revenue.[12] Those states are Alabama, Alaska, Arizona, Arkansas, California, Colorado, Delaware, Florida, Georgia, Hawaii, Idaho, Louisiana, Michigan, Mississippi, Missouri, Montana, Nevada, New Hampshire, New Mexico, North Dakota, South Carolina, South Dakota, Texas, Utah, Virginia, West Virginia, Wisconsin and Wyoming. Note that Alabama, California, Florida and Nebraska would need to alter their state constitutions to implement this change.

TAKE ACTION TO COLLECT TAXES ON REMOTE SALES

A state typically is unable to collect sales and use tax on most items that are purchased via catalogs or the Internet. These sales are referred to as remote sales, and like any other sales, the purchaser is in fact legally obligated to pay the relevant tax. The difference is that the state is unable to compel retailers to actually collect the tax on remote sales. This is the result of a set of court rulings going back to 1967 relating to catalogs and mail orders.[13] These rulings found, in part because understanding the different state and local sales codes was too complex a task, that administering the tax placed an undue burden on catalog companies. Only in places where those companies have nexus, through the presence of retail outlets or distribution centers, could it be required that the tax be collected. That is why, for example, Amazon.com collects sales tax on sales in Washington state but is not likely to do so elsewhere.

The failure to collect taxes on remote transactions adds to regressivity because wealthier people are more likely to shop online.[14] The policy also distorts the market, giving remote sellers a competitive advantage over traditional retailers who also generate local property and income taxes. The counterargument from companies like Amazon is that this remains an undue burden on business. States' recent efforts to simplify their tax codes and the availability of better technology undermine that argument.[15] For funding public services, the key issue is that the loss of tax revenue from remote sales has expanded dramatically since the days when catalogs were responsible for the bulk of remote sales.

10 David Cay Johnston. Few Wealthy Farmers Owe Estate Taxes, Report Says. New York Times. July 10, 2005. www.nytimes.com/2005/07/10/politics/10tax.htm.

11 Steve Wamhoff. Latest State-by-State Data Show Why Obama Should Scale Back His Proposal to Cut the Federal Estate Tax. Citizens for Tax Justice. Dec. 3, 2008. www.ctj.org/pdf/estatetax20081203.pdf.

12 Elizabeth McNichol. State Taxes on Inherited Wealth Remain Common: 22 States Levy an Estate or Inheritance Tax. Center on Budget and Policy Priorities. April 10, 2009. www.cbpp.org/cms/index.cfm?fa=view&id=337.

13 These rulings are National Bellas Hess Inc. v. Department of Revenue of Illinois and Quill v. North Dakota.

14 For example, as of 2003 there was still a substantial digital divide. Children of families in poverty and from households with lower education levels generally have less access to home computers than do children from higher-income families. See Jennifer Cheeseman Day, Alex Janus and Jessica Davis. 2005. Computer and Internet Use in the United States. www.census.gov/prod/2005pubs/p23-208.pdf.

15 Reed Hastings is the chief executive of Netflix. After reading about Amazon's tax avoidance efforts, he sent an e-mail to the New York Times technology blog: "As a point of reference, we collect and provide to each of the states the correct sales tax. There are vendors that specialize in this (we use Vertex). It's not very hard." http://bits.blogs.nytimes.com/2008/02/13/amazon-plays-dumb-in-internet-sales-tax-debate/.

Table 7

Estimated Annual State Revenue Loss for E-Commerce

2009	$ 6.95 billion
2010	$ 8.62 billion
2011	$10.14 billion
2012	$11.39 billion

SOURCE: UNIVERSITY OF TENNESSEE

The most comprehensive way to address this issue would be either for the courts to rule or Congress to mandate that companies must collect these taxes. In an effort to smooth the way for this, a number of states are working together to standardize their sales tax codes. The goal of this Streamlined Sales Tax Project is to reduce the burden on remote sellers for collecting the sales tax. States that are not members of the project are Alabama, Arizona, California, Colorado, Connecticut, Florida, Georgia, Hawaii, Louisiana, Massachusetts, Maine, Maryland, Mississippi, New Mexico, New York, South Carolina, Texas, Virginia and the District of Columbia.[16] This is a long-term project that, while laudable, will not immediately affect revenue collections. Congress has not acted on this, but it should. In the immediate future, there are a number of steps that states can take to increase collections of remote sales.

- **Make it easier for people to volunteer to pay their use tax.** Twenty-two states that have an income tax provide a method for taxpayers to report their sales and use tax obligation on their tax return. Compliance rates are low, with less than 2 percent of taxpayers actually reporting purchases. California, for example collected $5.4 million in 2006.[17] A smaller number of states also provide a table to help taxpayers estimate their liability for this tax, which leads to higher collections.[18] Only Kansas, Maine, Massachusetts, Michigan, New Jersey, New York, North Carolina, Oklahoma and Vermont have both look-up tables and a line in their tax returns. Arizona, Georgia, Hawaii, Illinois, Iowa, Maryland, Mississippi and New Mexico have neither a look-up table nor a line in their income tax returns. Arkansas, Colorado, Minnesota, Missouri, Nebraska, North Dakota, Pennsylvania and West Virginia provide relevant information on use tax obligation, but do not provide a line in the tax return, making it harder for taxpayers to comply. Alabama, California, Connecticut, Idaho, Indiana, Kentucky, Louisiana, Ohio, Rhode Island, South Carolina, Utah, Virginia and Wisconsin have a line in the tax return but do not supply a table to help estimate the tax liability.
- **Appropriately define nexus.** In 2008, New York state defined nexus so that Internet retailers who sell on the Web pages of residents, such as through Amazon's Associate's program, would be defined as having nexus. In effect, New York is treating people who use their own Web pages to sell Amazon's goods as a sales force. New York estimates that it will collect $73 million per year as a result. A state court has upheld this law, and such programs may well comply with the U.S. Supreme Court's nexus requirements for both in-state physical presence and presence of a sales representative. North Carolina and Rhode Island have passed similar legislation, and the governors of California and Hawaii have vetoed bills in those states.[19]

16 Governing Board States SST State Status Map. Streamlined Sales Tax Governing Board Inc. www.streamlinedsalestax.org/govbrdstates.htm.

17 Annette Nellen. Sales and Use Tax Weakness & Possible Remedies: Use Tax Collection Challenges. California's Tax System. Report #2b. July 2007. www.cob.sjsu.edu/nellen_a/TaxReform/Report2bSUTUseTax.pdf.

18 Nina Manzi. Use Tax Collection on Income Tax Returns in Other States. Policy Brief. Minnesota House of Representatives Research Department. Updated November 2007. www.house.leg.state.mn.us/hrd/pubs/usetax.pdf.

19 Michael Mazerov. New York's "Amazon Law": An Important Tool for Collecting Taxes Owed on Internet Purchases. Center on Budget and Policy Priorities. July 23, 2009. www.cbpp.org/cms/index.cfm?fa=view&id=2876. Overstock.com, putting tax avoidance above civic responsibility, has eliminated its associates programs in states that pass these laws. Amazon has done the same in Rhode Island, but not in New York. See Bill Radke. States Find 'Amazon Tax' Has Pitfalls. Marketplace from American Public Media. July 23, 2009. http://marketplace.publicradio.org/display/web/2009/07/23/am_amazon_tax/.

While this is a useful step, it is possible to further assert nexus based on a broad range of activities conducted by in-state businesses on behalf of out-of-state businesses that arguably help the latter to "establish and maintain a market." These include but go beyond what is covered in the Amazon law. In addition to acting as a sales agent, performing warranty repair, maintenance, installation, assembly, billing or training could count as defining nexus.[20]

- **Prevent use of subsidiaries to avoid nexus.** A number of companies that have retail stores in multiple states and that sell over the Internet organize these operations as separate subsidiaries. The parent corporation can then claim that the Internet subsidiary lacks nexus. Many major retailers like Wal-Mart do not use this avoidance method, but some do. There are two strategies for limiting this practice. The first is to define the stores as creating nexus for the Internet subsidiary if they sell gift certificates redeemable on the Web, take returns from the Web site, have co-branded credit cards, advertise the Web site or have any contact wherein the physical store is acting as an agent for the Internet subsidiary. Or, a state could assert that common ownership of similar entities is de facto nexus. This is a simpler solution, but it has yet to be tested in the courts. [21]

- **Treat all goods and services purchased on the Internet the same way as those purchased in stores.** A number of state tax codes do not apply the sales tax to movies, books, music or computer programs that are purchased online even though a sales tax would apply to the purchase or rental of these goods if the transaction were made in a store. States that do not tax downloaded computer programs even though they tax programs sold on disks are: Arkansas, California, Colorado, Florida, Georgia, Iowa, Maryland, Missouri, Nevada, North Carolina, Oklahoma, South Carolina and Virginia. States that do not tax downloaded music, videos, games, books, even though they tax them in stores are: Arkansas, California, Florida, Georgia, Iowa, Illinois, Kansas, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Nevada, New York, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Vermont, Virginia and Wisconsin. Connecticut taxes both of these downloads at a rate of only 1 percent. Note that making this change only helps if the state already has nexus to collect the tax. It does not actually help with the underlying issues of establishing nexus.[22]

TAKE OTHER ACTIONS TO MODERNIZE THE SALES TAX

As our economy has changed over the last three decades, the sales tax base has narrowed. The shift to a service economy, in particular, means that a larger percentage of what consumers buy each year is not subject to sales taxes because states typically do not apply their sales tax to services. Many states also have chosen to create "sales tax holidays" for items like clothes and computers, often scheduled during the back-to-school shopping period. The goal may be laudable, but such "holidays" further erode the tax base, while providing inefficient relief to the very families policymakers want to assist. The administration of the sales tax itself could be modernized in a number of states as well.

- **Broaden the sales tax base to include more services.** The Federation of Tax Administrators tracks whether states apply their sales tax to 168 different services. These range from utilities to tailoring and from healthcare to legal services. Delaware, Hawaii, New Mexico, South Dakota and Washington are the only states to apply the sales tax to 85 percent of these services. And 28 states apply the tax to less than one-third of these services.[23] Applying the tax to more services will better match the tax to the shape of the economy, providing for stability.

20 See Michael Mazerov, Michael. Chipping Away at the Problem of Untaxed Internet Sales. SFAI Conference Nov. 20, 2008.
21 See Michael Mazerov. Chipping Away at the Problem of Untaxed Internet Sales SFAI Conference. Nov. 20, 2008.
22 See Michael Mazerov. Chipping Away at the Problem of Untaxed Internet Sales. SFAI Conference. Nov. 20, 2008.
23 Number of Services Taxed by Category and State. FTA Survey of Services Taxation. July 2007. www.taxadmin.org/fta/pub/services/btn/0708.html#table.

It also will add breadth. Depending on the service mix, it can add progressivity and can help raise revenues. This is good tax policy, but even though many proposals have been made to broaden bases, there has been little movement on this front. In at least one case, where Maryland passed legislation to apply the tax to computer services, that industry was able to lobby for the law's repeal.[24] If the goal is to find revenues for the coming year rather than to create a long-term tax modification strategy, this may not be the policy to pursue. Even so, in 2009 Tennessee broadened its base to cover software services. Maine extended its base to cover amusement parks, dry cleaning and other services.[25]

- **Replace sales tax holidays with programs designed to assist families that need help.** This year, 17 states scheduled times when certain purchases would not be subject to sales taxes. These "tax holidays" are seen as a way of encouraging commerce and providing incentives for the kinds of purchases the state believes should be encouraged. Louisiana has a tax holiday in September for the purchase of firearms. Other tax holidays are more prosaic: Louisiana also has one at the start of hurricane season for the purchase of hurricane supplies. Fifteen states have one for clothing and school supplies in the back-to-school season. Seven states have them for the purchase of energy-efficient appliances.[26]

  Tax holidays are poorly calibrated to assist lower-income taxpayers. These families are less able to plan their purchasing to coincide with tax holidays, while families with more disposable income, including those from neighboring states, are better able to do so. Retailers also can use the holiday to bump up prices, increasing their profit margin. One study found that up to 20 percent of families' potential savings from a Florida sales tax holiday instead were turned into profit for retailers.[27] If the goal of the tax holiday is to increase the purchasing power of low-income families, policies like a refundable income tax credit for purchases of a certain type would more directly accomplish it. For example, Kansas, which is among the handful of states that applies the sales tax to food, offers a credit of up to $80 a year for people making less than $15,150 a year to offset the tax they pay on food.[28]

- **Cap administrative subsidies for sales tax collection.** Twenty-six states provide retailers with a subsidy to offset their costs in collecting sales tax, allowing stores to keep up to 5 percent of their sales tax collections. In half of these states, that compensation is capped at a certain amount. The caps range from $360 per store in Florida to $240,000 per corporation in Michigan. Altogether, it is estimated that just over $1 billion in revenues is returned to corporations nationwide every year as a result of this subsidy, with the vast majority occurring in places where there is no cap. Given that technology has greatly aided the administration of sales taxes, there is little justification for an uncapped subsidy. Illinois pays $126 million a year in these subsidies, making it the leader. Other states with uncapped subsidy programs include Colorado, Georgia, Indiana, Louisiana, Missouri, Nevada, Ohio, Pennsylvania, Texas, Virginia and Utah.[29] Colorado took action in 2009 to temporarily reduce its subsidy, and Wisconsin permanently reduced its subsidy.[30]

- **Improve enforcement of the Jenkins Act.** This 1949 law mandates that anyone who ships cigarettes nationally must file reports with state tax collectors indicating who received the cigarettes. This allows states to ensure that the appropriate cigarette excise taxes are paid. Thanks to the rise of the Internet, this law is more relevant now than ever. However,

24 Gadi Dechter. A Tech Lobby Is Born. Baltimore Sun. April 7, 2008. http://mcsassoc.org/MSCA_sunarticle.pdf.
25 Nicholas Johnson, Andrew Nicholas and Steven Pennington. Tax Measures Help Balance State Budgets: A Common and Reasonable Response to Shortfalls. Center on Budget and Policy Priorities. Updated July 9, 2009. www.cbpp.org/cms/index.cfm?fa=view&id=2815.
26 2009 State Sales Tax Holidays. Federation of Tax Administrators. Updated Sept. 2, 2009. www.taxadmin.org/fta/rate/sales_holiday.html.
27 Sales Tax Holidays: Boon or Boondoggle? Institute on Taxation and Economic Policy. Policy Brief #17. 2005. www.itepnet.org/pb17hol.pdf.
28 Options for Progressive Sales Tax Relief. Institute on Taxation and Economic Policy. Policy Brief #14. 2009. www.itepnet.org/pb14crex.pdf.
29 Philip Mattera with Leigh McIlvaine. Skimming the Sales Tax: How Wal-Mart and other Big Retailers (Legally) Keep a Cut of the Taxes We Pay on Everyday Purchases. November 2008. www.goodjobsfirst.org/pdf/skimming.pdf.
30 Nicholas Johnson, Andrew Nicholas, and Steven Pennington. Tax Measures Help Balance State Budgets: A Common and Reasonable Response to Shortfalls. Center on Budget and Policy Priorities. Updated July 9, 2009. www.cbpp.org/cms/index.cfm?fa=view&id=2815.

it too often is honored in the breach. The U.S. Government Accountability Office (GAO) reviewed 147 cigarette vendors' Web sites and found that at least 114 indicated noncompliance with the act. Most Internet vendors do not comply with the act, and GAO reported that estimates of lost revenue are as high as $1.4 billion per year. In 2002, Washington state sued an Internet cigarette vendor over noncompliance of the Jenkins Act. The state calculated that consumers had evaded approximately $6 million in owed taxes since the company refused to comply with the law. A few other states have followed Washington's lead and sued for lists of taxpayers who have purchased cigarettes over the Internet. However, the revenues gained have been relatively small, and this effort has not sparked greater compliance overall.

Federal legislation to increase penalties and improve enforcement of the act is needed to ensure that cigarette taxes are paid. Until then, states should search for ways to identify nexus and force Internet retailers to collect appropriate taxes.

MODERNIZE THE CORPORATE INCOME TAX

The corporate income tax has been described as the last charitable contribution that major American businesses choose to make each year. That's because companies with the resources to hire lobbyists and lawyers are able to minimize or eliminate their corporate tax liability.

One of the main strategies companies use to shelter their income from taxation is to play states' tax codes against each other. This is done by creating subsidiaries in a state with a friendly tax system. The subsidiary's role is to provide services to other parts of the company. The resulting transactions move taxable income from a state where it is subject to taxation to a state where it is not subject to taxation or is taxed at a lower rate. These strategies are estimated to cost state governments more than $7 billion annually.[31]

For example, many companies use subsidiaries incorporated in Delaware to hold their trademarks and patents. Their main business then pays the subsidiary for their use. Under Delaware law, income from the sale of intangible items such as patents and trademarks is not taxable. By having the subsidiary that does the main business in a state make a payment to the Delaware subsidiary, which claims the profit, the corporation is able to lower its tax liability. In effect, the company has gotten a tax break for moving its wallet from one pocket to another. A real estate investment trust (REIT) is one of the newest forms of this game. A company creates a REIT to hold its property and it pays the REIT rent. The REIT then pays another subsidiary of the company a dividend. The rent paid is a business expense that is not taxed. The dividend is either not taxed or is taxed at a lower rate. There are ways to combat these tax-avoidance strategies.

- **Require combined reporting of corporate income.** At this writing, 23 states mandate combined reporting, which requires that all of a corporation's components operated as a single business enterprise be taxed as one entity. By treating the subsidiaries as one entity, states no longer allow companies to gain tax benefits by transferring funds from one of their entities to another. Some states have chosen to attack individual loopholes, but as they do, corporate tax lawyers think of other ways, like REITs, to game the system. And any effort to close a single loophole could be subject to legal challenge. The courts already have upheld combined reporting, and it ends the across-state tax-avoidance game. Despite the protests of corporate lobbyists, implementation of combined reporting does not lead to a decline in jobs.[32] Wisconsin, which passed legislation on combined reporting

31 Combined Reporting of State Corporate Income Taxes: A Primer. Institute on Taxation and Economic Policy. Policy Brief #24. 2009 www.itepnet.org/pb24comb.pdf.

32 Michael Mazerov. A Majority of States Have Now Adopted a Key Corporate Tax Reform—"Combined Reporting." Center on Budget and Policy Priorities. Revised April 3, 2009. www.cbpp.org/cms/index.cfm?fa=view&id=246.

in 2009, is expected to recoup an estimated $75 million per year.[33] States that should enact combined reporting include Alabama, Arkansas, Connecticut, Delaware, Florida, Georgia, Indiana, Iowa, Kentucky, Louisiana, Maryland, Mississippi, Missouri, New Jersey, New Mexico, North Carolina, Oklahoma, Pennsylvania, South Carolina, Tennessee, Virginia, Vermont and the District of Columbia.

- **Limit offshore sheltering of corporate profits.** Corporations are increasingly using offshore tax shelters to hide profits. The Multistate Tax Commission estimated that in 2001 state governments lost $5.3 billion in revenue because of the use of offshore tax shelters.[34] One step states can take is to refuse to do business or offer incentives or subsidies to companies that use such tax-avoidance schemes.[35] However, the most effective step states can take is to force companies to report the income of all subsidiaries, domestic and foreign, as a single entity. This takes the concept of combined reporting beyond the water's edge. Of the states with combined reporting, only Massachusetts, Montana and West Virginia do this in even a limited fashion. They require reporting both for U.S. subsidiaries and for subsidiaries located in known offshore tax shelter locations, such as Bermuda and the Cayman Islands.[36]

- **Enact a minimum corporate tax.** The Institute on Taxation and Economic Policy studied 253 Fortune 500 companies' annual reports for the years 2001-03. It found 71 firms that paid no state corporate income tax at all in at least one year. In those years, these same companies reported $86 billion in profits.[37] Less-gigantic companies are equally adept at tax avoidance. Two-thirds of companies covered by the corporate tax in Pennsylvania paid no taxes in 1999.[38] And 73 percent of companies doing business in California paid only the state's minimum tax in 2001.[39] In 2002, more than half (58 percent) of Arkansas corporations paid no corporate income taxes.[40] One solution to this problem is to enact a strong minimum corporate tax. Oregon had been the lowest at $10, but in 2009 the state raised it to $150. Fourteen states have a flat rate minimum tax that varies from $20 in Idaho to $800 in California. In Arizona, Idaho, Montana and the District of Columbia, the tax is $100 or less. No other state charges less than $250. In addition, eight states (Alaska, California, Florida, Iowa, Maine, Minnesota, New Jersey and New York) have an alternative minimum tax that establishes a higher floor than a simple flat rate.[41]

- **Eliminate retroactive deductibility for losses.** Nineteen states allow companies with an unprofitable year to apply losses to their prior year tax returns and generate refunds. This tax break, known as "the net operating loss carryback" deduction (NOL) hurts states particularly in tough times because they divert scarce funding for public services to other purposes. Alaska, Delaware, Georgia, Hawaii, Idaho, Indiana, Iowa, Louisiana, Maryland, Michigan, Mississippi, Missouri, Montana, New York, Ohio, Oklahoma, Utah, Virginia and West Virginia can adopt this reform.[42]

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33 Dennis Collier, Jack Norman, and Jon Peacock. November 2008. Catalog of Tax Reform Options for Wisconsin. www.wccf.org/pdf/catalog_wi_tax_reform_1108.pdf.

34 Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections. Multistate Tax Commission. July 15, 2003. www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Resources/Studies_and_Reports/Corporate_Tax_Sheltering/Tax%20Shelter%20Report.pdf.

35 North Carolina and California have provisions to accomplish this. See "Hynes Leads Fight Against Corporate Foreign Tax Havens." Office of State Comptroller Daniel W. Hynes. Feb. 19, 2004. www.ioc.state.il.us/news/ViewNewsRelease.cfm?ID=2070837158.

36 Michael Mazerov. State Corporate Tax Shelters and the Need for "Combined Reporting." Center on Budget and Policy Priorities. Oct. 26, 2007. www.cbpp.org/files/10-26-07sfp.pdf.

37 Robert S. McIntyre and T.D. Coo Nguyen. State Corporate Income Taxes 2001-2003. February 2005. www.ctj.org/pdf/corp0205an.pdf.

38 David Bradley. 2003. "The Truth About Business Taxes in Pennsylvania." Keystone Policy Institute. www.keystoneresearch.org/sites/keystoneresearch.org/files/krc_uneven_bus_taxes.pdf

39 Jean Ross. 2004. "All Gain, No Pain: California's 'No Tax" Corporations. California Budget Project.

40 Arkansas Advocates for Children and Families. 2004. The Vanishing Arkansas Corporate Income Tax. In Paycheck and Politics, April 2004.

41 Montana Legislature. State Corporate Income Taxes: Rates, Minimum Tax, Reporting, Apportionment. January 1, 2004. http://leg.mt.gov/content/committees/interim/2003_2004/rev_trans/corptaxcomp_excel_1.pdf. See also Michael Mazerov. Many States Could Avoid an Unnecessary Revenue Loss During the Current Fiscal Crisis by Disallowing Business Operating Loss Carrybacks. Center on Budget and Policy Priorities. May 20, 2003. www.cbpp.org/cms/index.cfm?fa=view&id=1900.

42 Michael Mazerov. Minority of States Still Granting Net Operating Loss "Carryback" Deductions Should Eliminate Them Now. Center on Budget and Policy Priorities. Revised May 11, 2009. www.cbpp.org/files/2-21-08sfp3.pdf.

- **Require withholding for partnerships and S corporations.** Under federal law, the profits of partnerships and S corporations are treated solely as the income of the shareholders or partners for purposes of taxation. (The "s" refers to the subchapter of federal tax code that allows for this treatment.) This means that shareholders and partners pay via the personal income tax, and no corporate tax is generated. Unfortunately, many partnerships and S corporations never pay the taxes on income generated in the state by partners or shareholders who don't reside in the state. By requiring that partnerships and S corporations withhold tax on nonresident partners, a state can make nonresidents with tax liability pay their fair share. Montana requires this withholding now. The Colorado Fiscal Policy Institute estimates that Colorado could gain $49 million in revenues annually by requiring withholding of income tax due by nonresidents.[43]

- **Cap deductibility for excess compensation.** The federal government allows corporations to deduct up to $1 million in annual salary per employee from their taxes. Additional compensation has to be performance-based in order for it to be deductible. Almost every state with a corporate tax uses this federal definition. Deductibility at this level is an incentive for higher executive compensation, and as such is a statement of our values about the allocation of public resources. But states do not have to follow this practice. Texas' corporate tax disallows any deduction for wages and other compensation that is in excess of $300,000 per employee. Decoupling from the federal tax code in this way is different from efforts to directly cap CEO pay. Corporations are still free to provide the compensation they would like. It simply removes a public subsidy. The Colorado Fiscal Policy Institute estimates that if Colorado limited its corporate deduction to salaries up to $250,000, it would allow the state to create $184 million in new revenue annually.[44]

REFORM ECONOMIC DEVELOPMENT SUBSIDIES

The average state has more than 30 different programs to subsidize corporations in the name of job creation and retention. Estimates indicate that these programs cost states and cities $50 billion every year.[45] Most of these subsidies come in the form of property and corporate income tax breaks. There is a large body of evidence—from nonprofit watchdogs, state auditors, investigative journalists and academics—that such programs are tremendously inefficient, creating few good jobs and too often simply moving an existing job from one state to another.

When bad jobs are created with subsidies, taxpayers end up paying twice. One study found that the families of Wal-Mart employees in California are not only more likely to rely on public health and income assistance than other retail workers but also that their children are more likely to need and receive extra support in school, such as subsidized lunch and academic interventions to help low-income children. Taxpayers at all levels of government spent more than $80 million a year providing assistance to Wal-Mart employees and their families in California, yet Wal-Mart receives major subsidies for construction of its facilities.[46]

43 Colorado Fiscal Policy Institute. Revenue Options: The Other Side of the Ledger. August 2009. http://www.cclponline.org/pubfiles/RevOptionsFactSheet091409_FINAL.pdf

44 Colorado Fiscal Policy Institute. Revenue Options: The Other Side of the Ledger. August 2009. http://www.cclponline.org/pubfiles/RevOptionsFactSheet091409_FINAL.pdf.

45 Greg LeRoy. 2005. The Great American Job Scam (Berrett-Koehler) and Peter Fisher and Alan Peters. 2004. "The Failures of Economic Development Incentives." Journal of the American Planning Association.

46 Arindrajit Dube and Ken Jacobs. Hidden Cost of Wal-Mart Jobs—Use of Safety Net Programs by Wal-Mart Workers in California. UC Berkeley Labor Center Briefing Paper Series. Aug. 2, 2004. http://laborcenter.berkeley.edu/retail/walmart.pdf and Philip Mattera and Anna Purinton. Shopping for Subsidies: How Wal-Mart Uses Taxpayer Money to Finance Its Never-Ending Growth. May 2004. www.goodjobsfirst.org/pdf/wmtstudy.pdf.

Simply eliminating these subsidies would eliminate distortions in the tax code, add breadth and make new revenues available for public services. Job creation, particularly in a period of high unemployment, is a proper goal for state government. And creating good private sector jobs adds to the tax base and reduces working families' need to receive supports from the state. In that spirit, systematic review and reform of economic development subsidies to make them more efficient is an essential component of sound budgeting, particularly in times of economic stress. Here are several steps that states should take.

- **Disclosure.** States should require annual, company-specific, deal-specific online reporting of costs and benefits from subsidy programs, including jobs created, wages paid and healthcare benefits provided. Most states do not know just how inefficient their subsidy programs are because they do not collect good data.[47] Illinois' subsidy disclosure Web site is a model because it includes reporting on the number of jobs and wage levels that each subsidy creates. States that have some of these features: Connecticut, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Minnesota, Missouri, Montana, Nebraska, Nevada, New Jersey, New York, North Carolina, North Dakota, Ohio, Pennsylvania, South Dakota, Texas, Utah, Vermont, Washington, West Virginia and Wisconsin. However, many of these disclosure Web sites are incomplete, and too many fail to track outcomes over time.
- **"Clawbacks."** When companies fail to meet promised goals (such as jobs or capital investment), a clawback allows the public sector to recapture part or all of the subsidy. This reform turns a subsidy into a contract with accountability for good job creation. Arizona, Colorado, Connecticut, Georgia, Illinois, Iowa, Maine, Missouri, Michigan, Minnesota, Nebraska, Nevada, North Carolina , North Dakota, Ohio, Oklahoma, South Carolina, Vermont, Virginia and West Virginia have clawbacks for some of their programs, but only a smaller subgroup (Connecticut, Illinois, Iowa and Minnesota) covers most or all of the subsidy deals.[48]
- **Job quality standards.** States can require subsidized companies to create full-time jobs with healthcare and wages at least as good as those of nearby competing firms, with a living-wage floor for service-sector jobs. Otherwise, job subsidies will incur hidden taxpayer costs. Project labor agreements in construction are a good example of a way to ensure job quality standards.
- **Allow school boards to protect their own tax base.** All too often, when city councils or county boards give property tax abatements or tax increment financing (which diverts property taxes) to developers, they give away the school increment as well, with little or no input from the school board. States can pass a law to give school districts control over whether their share of the tax base will be included in any given deal. States that do this: Kansas, Minnesota, Ohio, Pennsylvania and Texas.[49]
- **Eliminate subsidies that don't make sense.** Many programs have been on the books for decades even though the economy has changed greatly, and not all deals are worth subsidizing. For example, subsidies to simply lure jobs from other states (or from urban centers to suburbs) have no real social value. Subsidies to create low-paying jobs, such as those for most retail projects, that do not lift families out of poverty are also a poor investment. Subsidies that primarily create economic activity outside the state are yet another poor investment.

47 Reform #1: Require Disclosure of Subsidy Spending and Company Compliance. www.goodjobsfirst.org/accountable_development/reform1.cfm.

48 Examples of Clawback Provisions in State Subsidy Programs. Good Jobs First. Updated September 2005. www.goodjobsfirst.org/pdf/clawbacks_chart.pdf.

49 Protecting Public Education from Tax Giveaways to Corporations. Property Tax Abatements, Tax Increment Financing, and Funding for Schools. NEA Research Working Paper. January 2003. www.goodjobsfirst.org/pdf/edu.pdf.

For example, a growing number of states are creating extremely generous corporate income tax credits to lure film and television productions. A study of Connecticut's program found that of the $113 million in subsidies awarded, 89 percent of the spending that was credited actually occurred out of state. Of the 11 percent that was spent inside the state, one-quarter was simply for lodging. The credit generated $1 of in-state economic activity for every $5 the state paid out, and no progress was made toward creating a viable industry. This credit and credits like it should be eliminated.[50] Kansas temporarily suspended its film credit in 2009.

REFORM THE INCOME TAX

The individual income tax is the cornerstone of a fair state tax system, bringing breadth, progressivity and 36 percent of overall state tax revenues. Making changes to the income tax is the fairest way to add substantial new revenues for state services. Changes that calibrate the income tax to assess the rich at a higher rate than middle- and lower-income families are among the most progressive ways to raise new revenues and put the focus on those who can most afford to pay.

Such reforms also match the tax to the shape of the economy we live in today. Between 1975 and 2005, incomes for middle-income families grew by 21 percent, about 1 percent a year. Lower-income families' incomes grew by 6 percent overall, about one-third of 1 percent per year. During the same period, the income for the richest 1 percent of Americans tripled.[51] As a result, in 2005, the richest 20 percent of Americans earned more than half the income produced in the nation. The richest 1 percent earned 16 percent of all income.

These taxes also have the smallest relative effect on the economy overall. As discussed in Appendix IV, this is because the richest taxpayers are better able to save or spend money out of state than other taxpayers are.

Among the changes that states can consider:

- **End preferential treatment of capital gains.** A handful of states tax capital gains at a lower rate than other income. This distorts the economy by giving the earnings of investors a tax advantage over the earnings of wage earners. In 2009, Rhode Island passed legislation to treat capital gains like ordinary income, and Vermont and Wisconsin limited the advantages they give to capital gains. Colorado ended deductibility of capital gains as well. Other states that could do this are Arkansas, Hawaii, Montana, New Mexico, North Dakota and South Carolina.[52]
- **Institute a graduated income tax.** Of the 42 states (the District of Columbia is included here) that have an income tax, 35 have a graduated system of rates. This system taxes higher-income families at a greater rate than lower-income families. It does so by applying a higher rate to any income earned above a certain level. Thus, a family in Connecticut pays 3 percent on all income under $20,000 and 5 percent on all income up to $1 million.[53] Colorado, Illinois, Indiana, Massachusetts, Michigan, Pennsylvania and Utah could make this change.

50 Shelley Geballe. Fiddling While Rome Burns: Connecticut's Multi-Million Dollar, Money-Losing Subsidy to the Entertainment Industry. Connecticut Voices for Children. June 2009. www.ctkidslink.org/publications/bud09filmtax.pdf.

51 Jared Bernstein. 2007. Updated CBO data reveal unprecedented increase in inequality. Economic Policy Institute Issue Brief #239. www.epi.org/publications/entry/ib239/.

52 Institute for Taxation and Economic Policy. 2009. A Capital Idea: Repealing State Tax Breaks for Capital Gains Would Ease Budget Woes and Improve Tax Fairness www.itepnet.org/A_Capital_Idea.pdf. And Nicholas Johnson, Andrew Nicholas and Steven Pennington. Tax Measures Help Balance State Budgets: A Common and Reasonable Response to Shortfalls. Center on Budget and Policy Priorities. Updated July 9. 2009. www.cbpp.org/cms/index.cfm?fa=view&id=2815.

53 Wisconsin Legislative Fiscal Bureau. January 2009. Individual Income Tax Provisions in the States. Informational Paper 4. www.legis.state.wi.us/lfb/Informationalpapers/4_individual%20income%20tax%20provisions%20in%20the%20states.pdf.

If this can't be done, because of state constitutional barriers for example, it is possible to raise the tax rate on everyone while giving lower-income households relief through increasing the amount of income that is exempt from being taxed. Each of these states, except Colorado and Pennsylvania, exempts a set amount from the tax. In Illinois, it is $4,000 per married couple. Exemptions cover a greater share of the earnings of lower-income families, so they provide progressivity. The higher the exemption, the more progressive the tax.

- **Increase the tax on upper-income earners.** For states that already have a graduated income tax, this is an effective way to raise revenue. Many states apply their top rate at a very low level of income, which minimizes the progressive effect of a graduated system. The District of Columbia and 25 states apply their top rate to families filing joint returns with combined incomes below $100,000 per year. Only 11 states (Arizona, Connecticut, Hawaii, Maryland, New Jersey, New York, North Dakota, Ohio, Oregon, Vermont and Wisconsin) apply their top rate at an income level above $100,000 a year. Among the states making changes in 2009:

  - **Oregon** created a new top rate of 11 percent on income over $250,000 a year. The previous top rate had been 9 percent on income above $7,300 per year. This change will add more than $200 million in new revenues that can be used to minimize the effect of budget cuts in the next two years.

  - **Wisconsin** enacted a new 7.75 percent tax bracket on income over $300,000 for a married couple and $225,000 for individuals and heads of households. This change is expected to generate about $164 million in fiscal 2010.

  - **New York** has taken similar measures, making a temporary set of new brackets for families with income over $300,000 and over $500,000. These measures are expected to raise $4 billion over three years.[54]

54 Elizabeth McNichol, Andrew Nicholas, and Jon Shure. Updated Sept. 30, 2009. Raising State Income Taxes on High-Income Taxpayers. Center on Budget and Policy Priorities. www.cbpp.org/cms/index.cfm?fa=view&id=2792.

Appendices

APPENDIX I

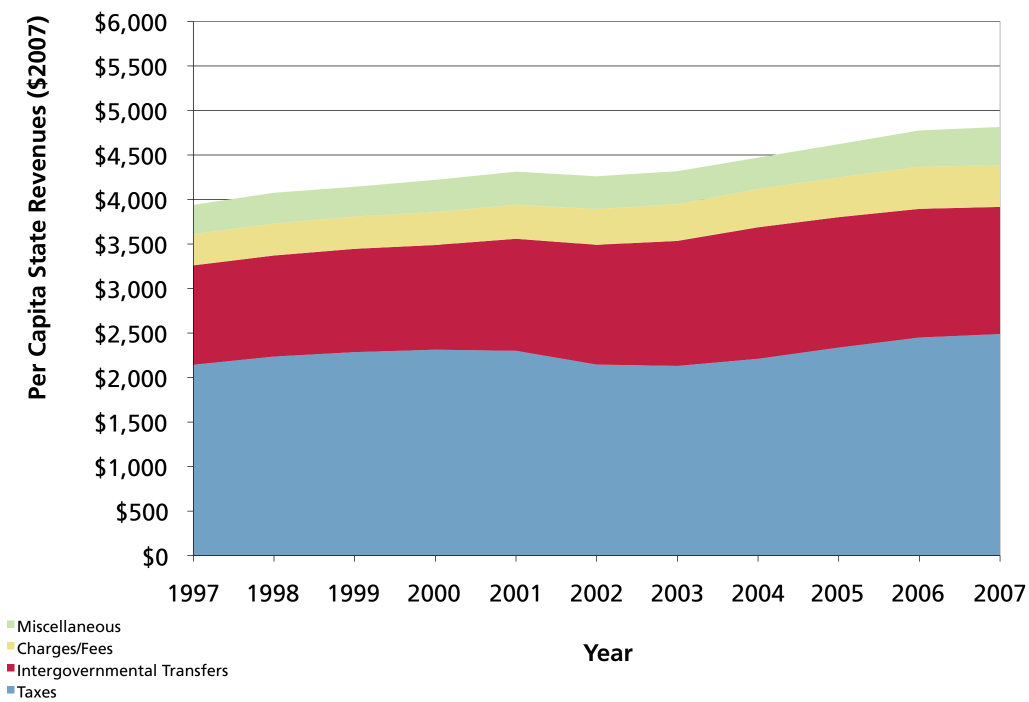
Have Taxes Increased During the Last Decade?

IN 1997, STATES HAD just over $1 trillion in general fund revenues. By 2007, this revenue had grown by 45 percent.[1] At first glance, this appears to be a substantial increase in the size of state government. However, the growth was driven largely by trends in population and economic growth. On a per capita basis, state revenue grew by 22 percent, from $3,939 per capita in 1997 to $4,824 in 2007. At the same time, personal income grew by 16 percent. As a share of personal income, state revenues have grown from 11.8 percent per capita in 1997 to 12.4 percent in 2007.

Figure 16

Changes in Real Per Capita State Revenues 1997-2007

SOURCE: U.S. CENSUS BUREAU

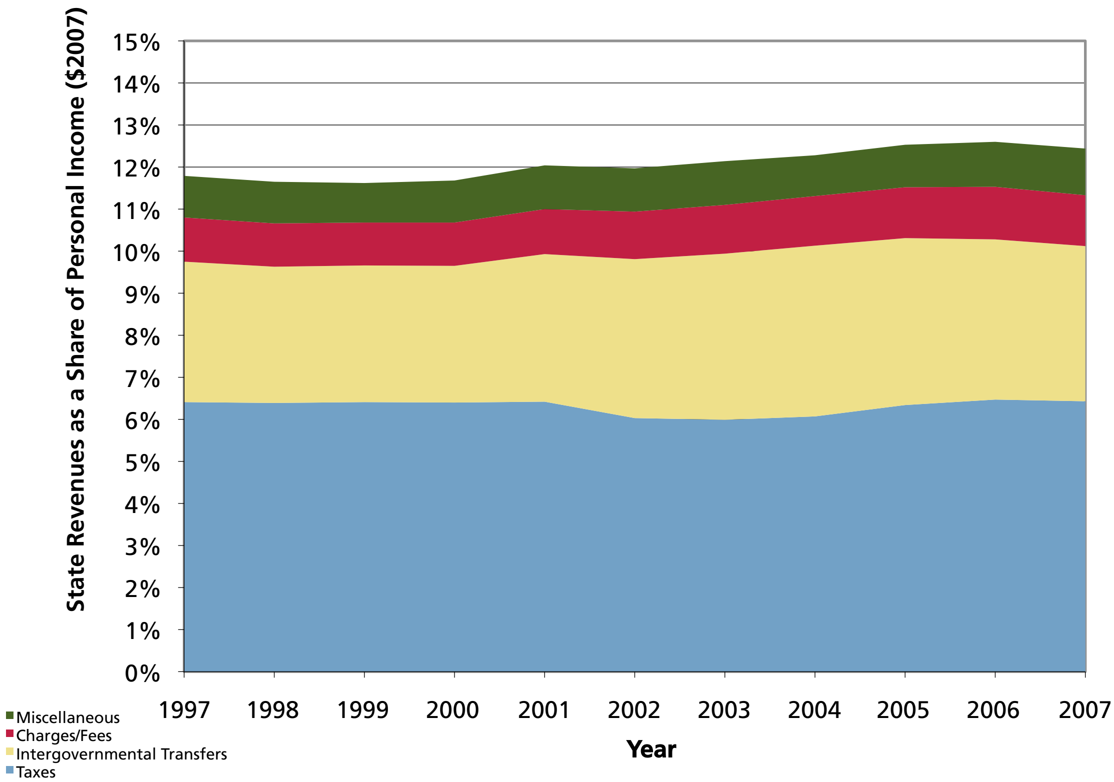


[1] This is expressed in 2007 dollars as adjusted by the Consumer Price Index. In 1997, states collected $814 billion. Between 1997 and 2007, the CPI rose by 29.2 percent; the $1 billion figure comes from this adjustment. As will be discussed, while the CPI is the most commonly used measure of inflation, it may not be the best.

Figure 17

Real Changes in State Revenue as a Share of Personal Income

SOURCE: U.S. CENSUS BUREAU



Interestingly, this expansion is largely from growth in transfers, fees and miscellaneous revenues. Taxes have remained relatively stable as a share of personal income.

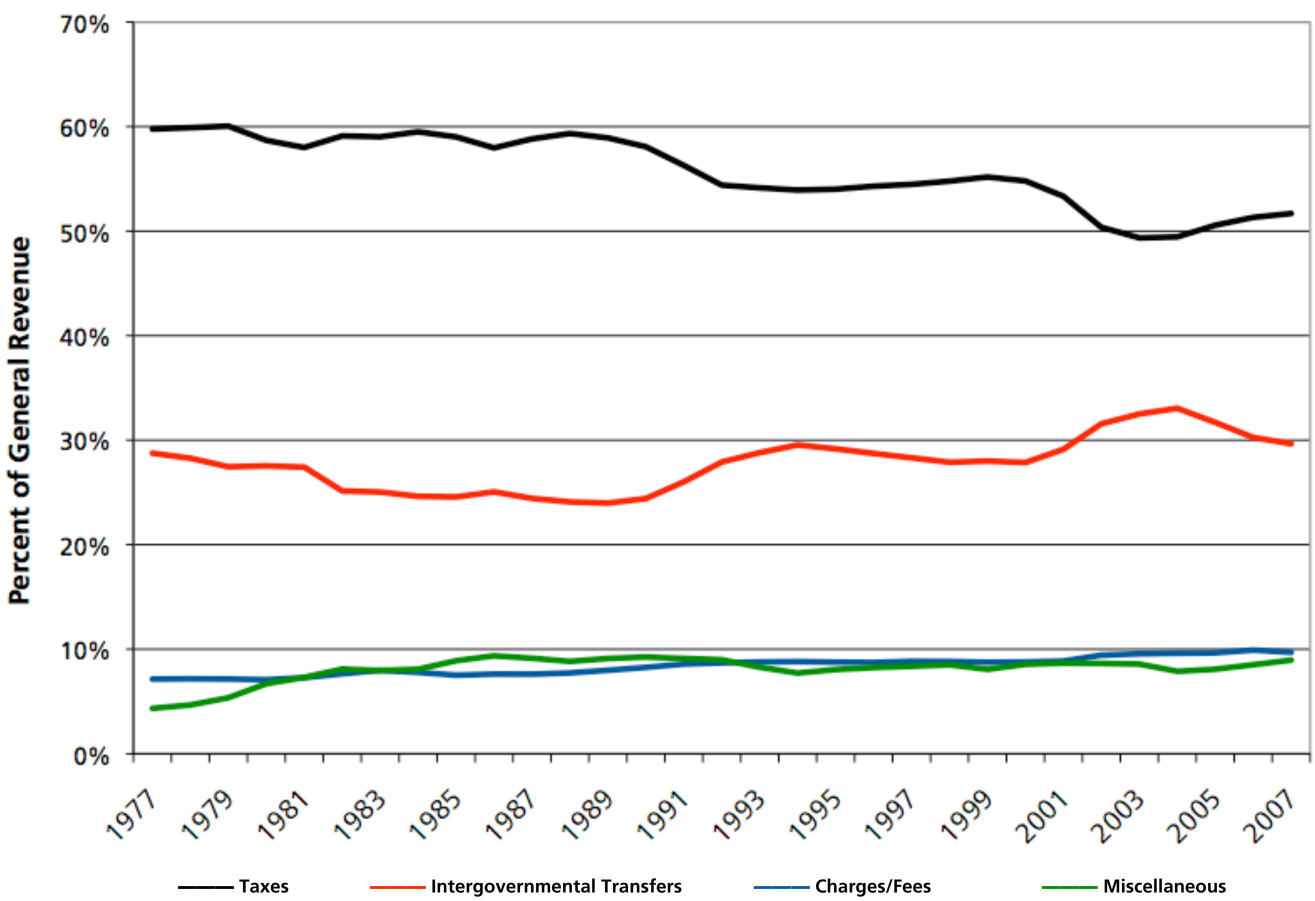
And there is reason to believe that this overall funding increase was necessary to keep up with the actual cost of public services. When economists make adjustments for inflation, they are attempting to compare the buying power of a dollar at two different points in time. As prices rise, the buying power of that dollar diminishes. Analysts typically use the Consumer Price Index (CPI) to make these adjustments. That's because the data are easily available and widely understood. The CPI, however, is carefully put together to measure how prices change in a specific set of household goods and services. To the extent that we want to examine how changes in taxation over time affect taxpayers, this is a perfectly appropriate measure. But the set of goods that state and local governments buy is different, and its prices tend to rise at a greater rate. For example, state governments purchase fewer consumer electronics and spend more on wages and healthcare. In the private sector as well as in the public, the costs of services typically grow faster than the costs of consumer goods. Unfortunately, this means that the real growth in government revenues reflected here is to some extent a result of the real growth in the cost of government rather than an expansion of services.[2]

Taking a longer view, over the last 30 years the trend has been for states to rely to a slightly greater extent on miscellaneous revenues and fees. The share of state revenue that comes from taxes has decreased.

Figure 18

Trends in Sources of State General Revenue, 1977-2007

SOURCE: U.S. CENSUS BUREAU



For transfers, this trend began to reverse between 2004 and 2007. The reversal partially reflects the natural results of the Bush administration's budgetary policy, and in particular the tax cuts and growing defense spending. The result of these policies was a squeeze on federal aid to states.[3]

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2 See Richard Rothstein with Karen Hawley Miles. 1995. Where's the Money Gone? Changes in the Level and Composition of Education Spending. Economic Policy Institute. http://epi.3cdn.net/9f9803682f88680e77_06m6iixw2.pdf.

3 Some conservative analysts, looking to justify the Bush era budget policy used the phrase "starve the beast," meaning that the high deficits and tax cuts would combine to eventually force government to lower domestic spending. Figure 18 indicates the first results of that policy.

The increase in the share of revenue coming from charges and miscellaneous sources is of some concern. Growth in charges will, over time, lead to a more regressive revenue system overall. Reliance on miscellaneous revenues, particularly from the sales of finite assets, also can have harmful long-term consequences, especially when states are using such measures to make up for a longer-term gap between their spending needs and their more stable sources of income. Although economic circumstances will change from year to year, the eventual consequence of such policies is the creation of a structural deficit wherein the state's revenue system is, over time, inadequate to meet its spending requirements.

Overall, the size of state government as a share of the economy has expanded slightly in the last decade leading up to the current Great Recession. These changes were a result of an expansion of miscellaneous revenues and transfers, and, given the rising cost of services generally, they do not represent an expansion of services.

APPENDIX II

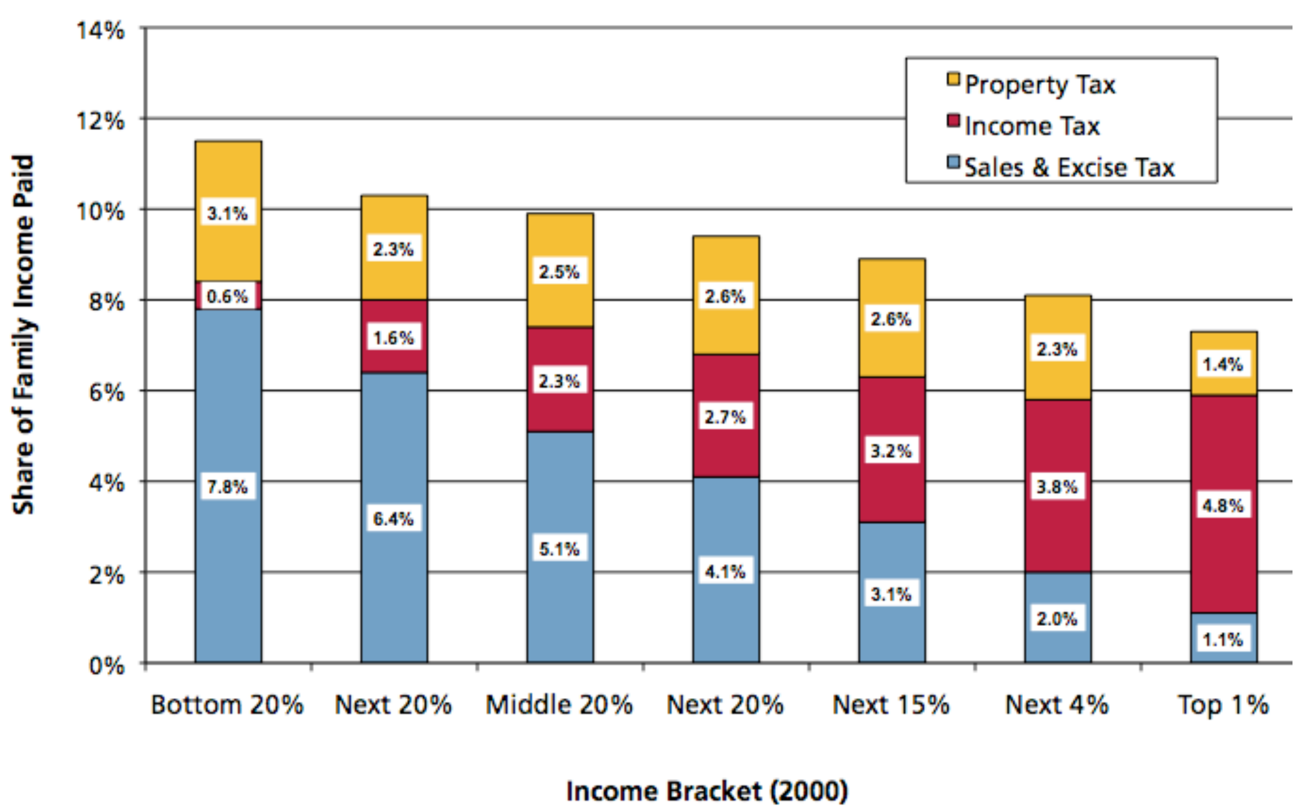
State Tax Systems Are Unfairly Regressive

IN GENERAL, RICHER AMERICANS pay a smaller share of their income in state and local taxes than do lower-income Americans. The primary sources of this regressivity are a reliance on sales and excise taxes. In 2002, the poorest Americans paid 7.8 percent of their income as sales tax, compared with only 1.1 percent paid by the highest-income families. Property taxes add slightly to the overall regressivity. That's in part because lower-income families typically stretch their budgets to get the best housing possible, while housing costs are a smaller share of the income for wealthier families. In contrast, income taxes (personal and corporate) are generally progressive, with the poorest families paying 0.6 percent of their income and the wealthiest paying 4.8 percent. But this is not enough to offset the overall regressivity of the rest of the tax structure.

Figure 19

Shares of Family Income for Nonelderly Taxpayers Going to State and Local Taxes, by Type of Tax

SOURCE: INSTITUTE ON TAXATION AND ECONOMIC POLICY

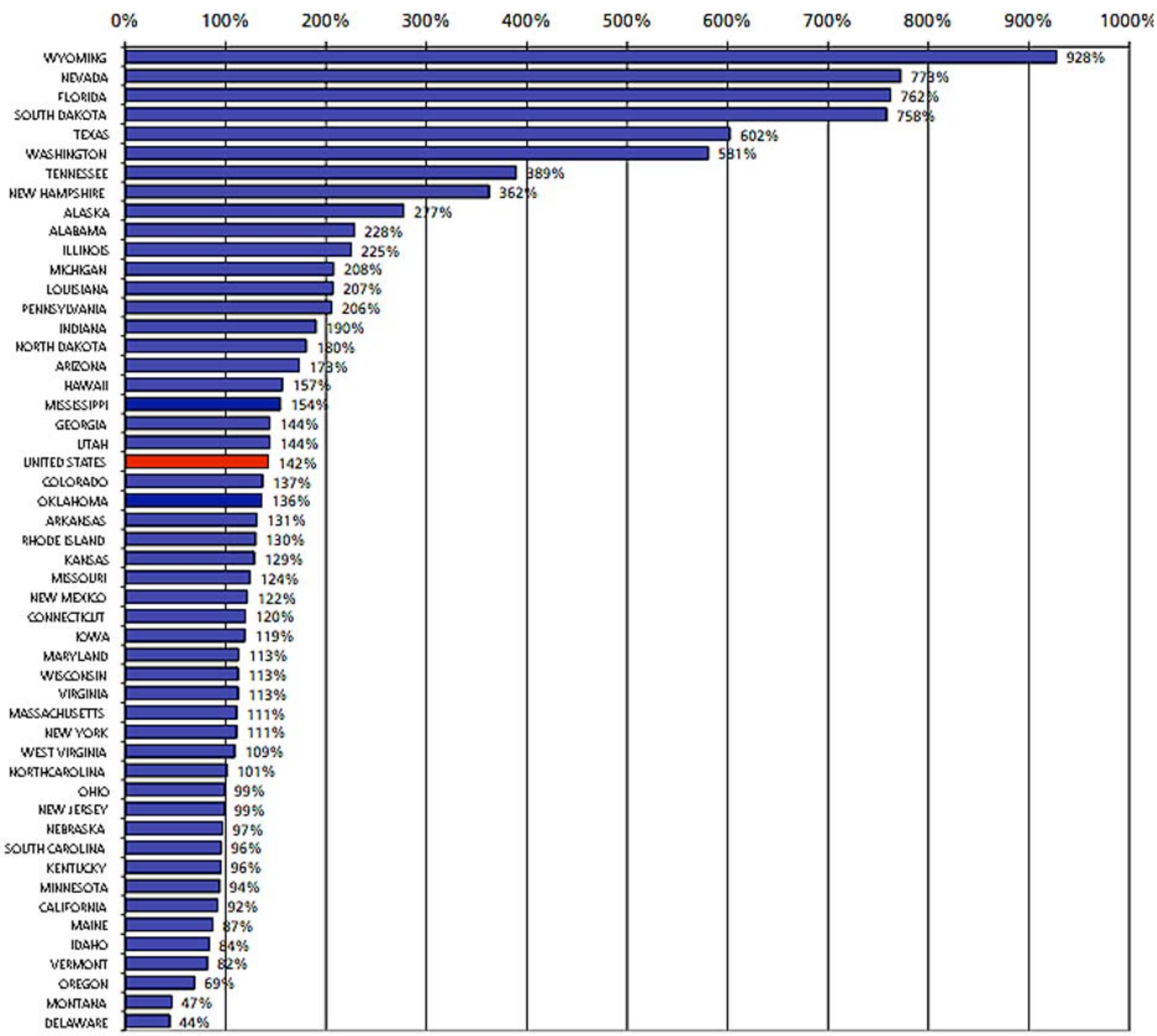


While state and local tax systems on average are regressive, that regressivity varies, and there are a handful of that manage to have a progressive tax system. One simple way to compare states is to look at the total tax burden (percent of family income paid) between the lowest-income (bottom 20 percent) and highest-income (top 1 percent) families. Although there is variance among states, on average the poorest 20 percent of families in the United States earned $18,725 or less in 2008.[4] The richest 1 percent each earned $601,906 or more. In the figure below, we present this ratio by state, looking only at the income and sales tax (excluding property tax). Doing so provides a relatively accurate picture of state tax burdens proper, since property tax provides the vast majority of revenue to local governments, and relatively little to states.[5]

Figure 20

Ratio of Bottom 20 Percent to Top 1 Percent of Non-Elderly Taxpayers: Percent of Family Income Paid to Sales and Income Tax, by State

Note: Based on 2002 sales tax rates and 2000 income tax rates.
SOURCE: INSTITUTE ON TAXATION AND ECONOMIC POLICY



4 U.S. Census. 2007. Historical Income Tables—Households. http://www.census.gov/hhes/www/income/histinc/h01AR.html.

5 Given that state decisions on support for local government generally, and school districts in particular, create the preconditions for the implementation of relatively regressive property taxes, the lack of progressivity of the state system is an even more disturbing phenomenon. States should be seeking, through their revenue systems, to offset the regressivity of local taxes.

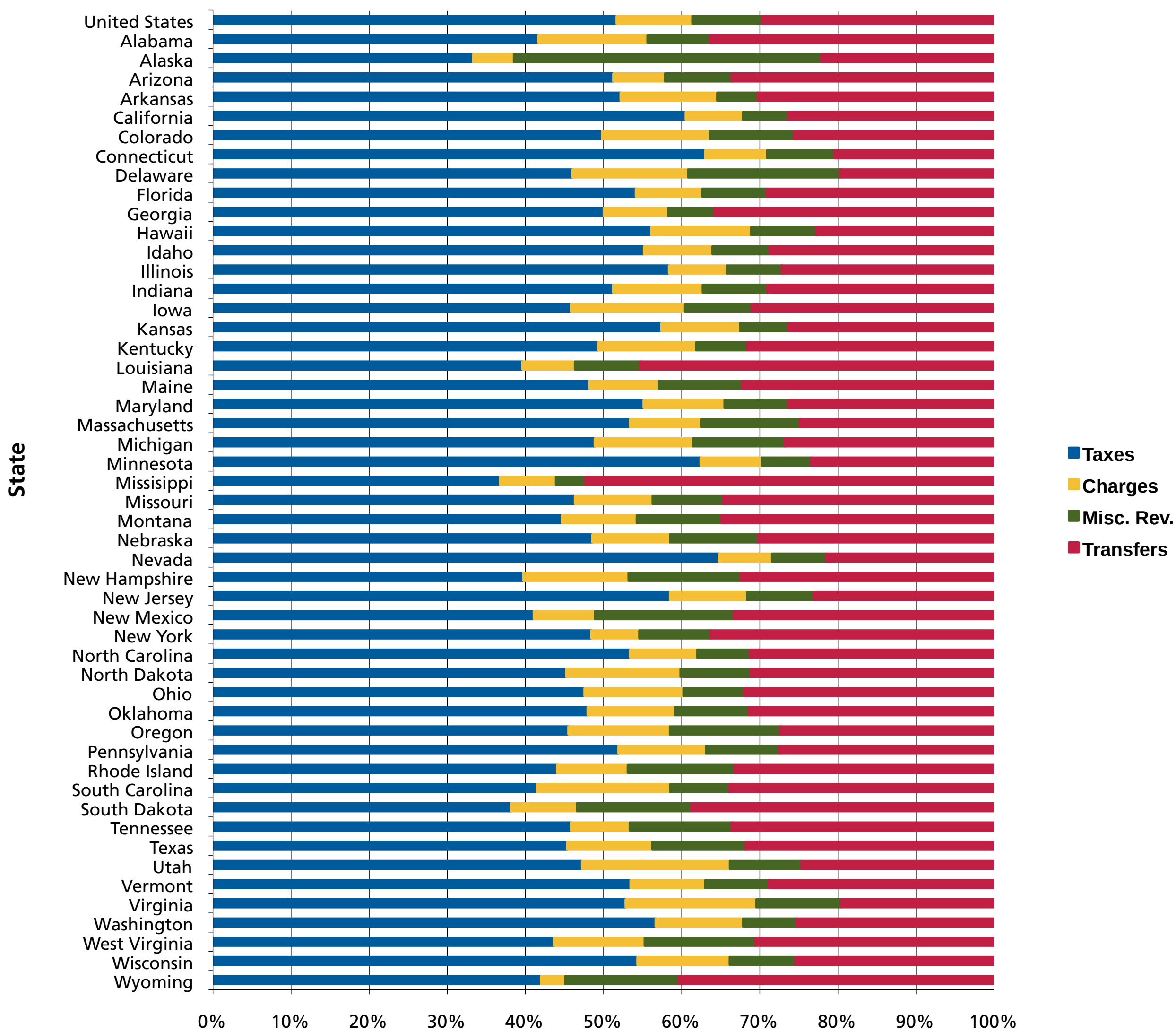
On average, the poor pay a 42 percent greater share of their income to sales and income tax compared with the very rich (top 1 percent). In six states, the poor pay at least a five times greater share. The most regressive state tax system is Wyoming's, where the poorest families pay a share of their income in these taxes that is nine times greater than that paid by the wealthiest. In another eight states, the poor pay at least twice as great a share of their income in these taxes as do the rich.

Just as surprising is the fact that there are only 13 states in which the wealthiest 1 percent pay a higher percentage of their income than the poorest residents, and in seven of these states, the ratio is within 10 percent of equality. Montana and Delaware are the most progressive states in terms of sales and income tax; in both, the rich pay about twice as great a share of their income as do the poor.

Figure 21

Sources of States' General Revenue, by State, 2007

SOURCE: U.S. CENSUS BUREAU



APPENDIX III

The Effect of the Stimulus on State Revenues

The American Recovery and Reinvestment Act (ARRA) has temporarily altered the revenue structure of states, and makes the federal government a significantly larger contributor for the 2009, 2010 and 2011 fiscal years. The act provides $787 billion in much-needed economic stimulus. That includes $140 billion in federal grants to the states for 2009-11, which can be offset against the $450 billion in budget gaps that states are facing, with additional money provided directly to school districts and for other purposes.

The logic behind this aid to state government is threefold. First, state governments have a variety of balanced budget requirements that limit their ability to run deficits. The federal government is uniquely suited to borrow money to cover state budget gaps when states cannot. Second, state budget cuts have the potential to add momentum to the economic downturn. Public sector job losses add to the unemployment rolls just as those in the private sector do. Moreover, cuts to assistance programs like Medicaid would similarly pull dollars out of the economy leading to job loss and further economic contraction. In fact, spending on state and local government services is an effective way to stimulate the economy and offset the effects of rising unemployment. Finally, state and local government services are uniquely suited to counteract the social harms caused by the economic downturn. This includes growth in the number of children on the wrong side of the achievement gap, increased numbers of uninsured and more workers who need to retool their skills while waiting for the opportunity to find a job.

The two main vehicles in the ARRA for helping state budgets are increased payments to Medicaid and a new program, the State Fiscal Stabilization Fund. The stabilization fund has $48.6 billion that states can use directly to prevent budget cuts. A majority of this funding is for public K-12 and higher education, with the rest placed in a discretionary fund.

Taken together, the federal government has provided state governments with about 30 percent of the revenues they will need to close the budget gaps that they are facing from 2009-11 (compared with the $20 billion in federal assistance that was provided during the 2001-05 fiscal crisis). As a result, thousands of jobs have been saved.[6]

The ARRA, while vitally important, only closes a portion of the gaps that states face, and the stimulus spending is largely frontloaded in 2009 and 2010. For example, all of the Medicaid funding contained in the federal stimulus will need to be obligated by December 2010. And, in education, states have obligated approximately 87 percent of their fiscal stabilization fund revenues for the 2009 and 2010 years, leaving just 13 percent for 2011. Barring further federal action, states are going to be left largely to their own devices for the 2010-11 budget year.

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6 See Phil Oliff, Jon Shure, and Nicholas Johnson. Updated June 29, 2009. Federal Fiscal Relief For States Is Working as Intended. Center on Budget and Policy Priorities. http://www.cbpp.org/files/5-26-09sfp.pdf; and Recovery Act: States' And Localities' Current and Planned Uses of Funds While Facing Fiscal Stresses. Gene L. Dodaro. 2009. Testimony Before the Committee on Oversight and Government Reform, House of Representatives. http://www.gao.gov/new.items/d09831t.pdf.

Table 8

Largest ARRA State Grants

Program	Amount ($billions)
Medicaid (FMAP)	$80.1
State Fiscal Stabilization Fund	53.6
Highways[1]	19.3
Food Stamps (SNAP)	19.0
Title I	13.0
Special Education	12.20
Total (of programs above)	**197.1**
Percent of all ARRA State Grants	**65.5%**

[1] Original grant is $27.5 million, but 30 percent goes to local governments, leaving $19.3 billion with states.

SOURCE: FEDERAL FUNDS INFORMATION FOR STATES

APPENDIX IV

Tax Increases and Job Creation

All spending, public and private, has a "ripple effect" on the size of the overall economy. The size of that ripple will vary depending on how money is distributed. Those who argue that raising taxes has an economic cost because it takes money out of the economy are quite correct. But debate on this issue too often ignores two key elements. First, some tax increases have a greater economic cost than others. Second, the spending of tax dollars by state and local governments also has an economic effect. Comparing these effects, one must conclude that a tax increase is not the worst thing to do in a recession. Budget cuts that lead to job losses are worse, sometimes far worse.

This analysis is based on a 2008 paper by Mark Zandi of Moody's Economy.com. Zandi assessed the value of different federal stimulus proposals. He estimated that state and local government spending will stimulate the economy by a factor of 1.36.[7] In other words, for every dollar a state or local government spends, there is a total of $1.36 in new economic growth. This is in addition to any investment effect from the services themselves. For example, education builds human capital for the future. Nor does the calculation consider the social or moral dimension to providing services such as healthcare and public safety. It just considers the direct economic effect of the spending. This effect comes simply from the efficiency with which state and local services put dollars to work across communities in the state. And, just as state government spending has a stimulative effect; budget cutting has the opposite effect, contracting the economy by the same rate. Budget cuts can accelerate an economic crisis.

Zandi's analysis shows that tax changes vary in their effect. A change in payroll taxes or implementation of an earned income tax credit, for example, has greater economic effect than a change for upper-income earners. Again, this is not a moral judgment. It is a conclusion from economic research and based on the fact that the working poor typically spend every penny, but upper-income earners are more likely both to save extra income and to spend their money overseas.[8]

In his research, Zandi found that the multiplier effects for taxes on business and upper-income families range from 0.29 to 0.48. The effect of tax cuts focused on families with lower incomes ranged from 1.20 to 1.29. Again, the effect of spending on state and local services is 1.36. Each of the tax changes that Zandi looked at had an economic benefit or cost that was smaller than that of state and local spending. We can draw the following conclusion: An increase in taxes, particularly on the wealthiest households, is less harmful to the economy than the effect of an equal amount of budget cuts.

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7 Zandi, Mark M. 2008. "Assessing the Macro Economic Impact of Fiscal Stimulus 2008." West Chester, Pa.: Moody's Economy.com. http://www.economy.com/mark-zandi/documents/assissing-the-impact-of-the-fiscal-stimulus.pdf .

8 Zandi's analysis is conducted at the federal level. To the extent that wealthier residents are more likely to spend money out of state, the underlying trends should be even stronger at the state level.

The Center for Economic Policy Research (CEPR) uses Zandi's findings to quantify the harmful effect of budget cuts.[9] Under its model, if a state facing a billion-dollar shortfall were simply to cut its budget by that amount, a total of $1.36 billion (1 billion x 1.36) would be taken out of the economy. If it were to cut a half billion, it would take $680 million out of the economy.

In either case, an inevitable consequence is job losses in both the public and private sectors. CEPR's modeling projects job losses by estimating an average "price" of just under $100,000 for each job in the economy overall. In the example above, a $1 billion budget cut would lead to 13,671 jobs lost.[10] Note also that some of the initial jobs lost would be in the private sector, with vendors and contractors. Jobs created as a result of the multiplier effect, as money is spent, would also tend to be in the private sector. The Economic Policy Institute estimates that half the job creation from state and local government spending is in the private sector.[11]

Taking CEPR's logic to the next step, a $1 billion tax increase targeted at those who pay the federal Alternative Minimum Tax (i.e., the upper middle class and the wealthiest among us) would take $480 million out of the economy and cost 4,825 jobs. When coupled with the benefits from state spending outlined above, the net effect would be to preserve $880 million more and 8,846 more jobs, public and private, than there would be if the state simply cut the budget. A tax focused even more tightly on higher earners would have an even greater net effect. This economic argument was first articulated by Nobel Prize winner Joseph Stiglitz and Peter Orszag for the Center on Budget and Policy Priorities during the last economic downturn.[12]

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9 Matthew Sherman. 2008. "Will Workers Survive State Budget Belt-Tightening?" Washington, D.C.: Center for Economic and Policy Research. http://www.cepr.net/documents/publications/2008-12-Will-Workers-Survive-State-Budget-Belt-Tightening.pdf .

10 The actual cost per job is estimated to be $99,481. This is based on a comparison of employment to gross domestic product (GDP). On average, for every $99,481 in economic activity there is one job. A $1 billion budget cut has a $1.36 billion effect on the economy. 1.3 billion divided by 99,481 is 13,671. This assumes that jobs actually are created at the average rate that economic investment has created them overall. A more focused effort on job creation or preservation may well be more efficient.

11 Larry Mishel. "Introductory Remarks." Delivered at "Generating a Robust Recovery." Economic Policy Institute Forum, September 30, 2009.

12 Peter Orszag and Joseph Stiglitz. 2001. Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession? Center on Budget and Policy Priorities. http://www.cbpp.org/cms/index.cfm?fa=view&id=1346.

Table 9

One-Year Change in Real Gross Domestic Product (GDP) from a Given Dollar Reduction in Federal Taxes or Increase in Federal Spending

Policy Changes	GDP Multiplier
Tax Rebates	
Nonrefundable Lump Sum Rebate	1.02
Refundable Lump Sum Rebate	1.26
Temporary Tax Cuts	
Payroll Tax Holiday	1.29
Across-the-Board Tax Cut	1.03
Accelerated Depreciation	0.27
Permanent Tax Cuts	
Extend Alternative Minimum Tax Patch	0.48
Extend Bush Administration Income Tax Cuts	0.29
Extend Dividend and Capital Gains Tax Cuts	0.37
Cut the Corporate Tax Rate	0.30
Spending Increases	
Extending Unemployment Insurance Benefits	1.64
Increase in Food Stamps	1.73
General Aid to State Governments	1.36
Increased Infrastructure Spending	1.59

SOURCE: MOODY'S ECONOMY.COM

APPENDIX V

Will Taxing the Rich Cause Them To Leave?

Policymakers often fear that increased taxes will affect the behavior of workers and investors. A first concern is that the richest workers will decide to work less because their incentives have lessened. This is the logic behind supply side economics as practiced, for example, by the Reagan administration. There is an empirical basis for such concerns. When the top federal tax rate was above 90 percent, for example, there was some reason to think this was true. But the empirical evidence for this theory is seen only at tax rates of 80 percent or higher.[13] With the top federal tax rate at 35 percent, this logic simply does not apply to the current debate.

The second concern is the specter of people moving out of a state in order to avoid paying taxes. For example, radio host Rush Limbaugh threatened to move from New York following the income tax increase there. A recent study from Princeton University did find that a New Jersey state tax increase on families making above $500,000 had resulted in an out-migration of just 67 households a year to other states and that in-migration of families had dropped by 287 per year. But these numbers are so small as to be insignificant. To put this in perspective, at the time the tax was enacted in 2004, New Jersey had 26,000 households that qualified for the tax. Last year, it had 44,000 such households.[14] Research in California found that the number of upper-income earners in the state similarly increased following the passage of upper-bracket income tax increases.[15] Limbaugh aside, there is simply no reason to believe that a moderate income tax increase will lead to substantial out-migration.

13 See for example: Michael Ettlinger and John Irons. 2008. Take a Walk on the Supply Side: Tax Cuts on Profits, Savings and the Wealthy Fail to Spur Economic Growth. Economic Policy Institute and Center for American Progress. http://epi.3cdn.net/41cd8594dac5cf8e29_5pm6bjhu3.pdf.

14 Cristobal Young, Charles Varner, and Douglas S. Massey. "Trends in New Jersey Migration: Housing, Employment and Taxation." Princeton University. http://www.princeton.edu/prior/PRIOReconomy-Final-(2).pdf.

15 The California Budget Project. "The Number of High-Income Taxpayers Increased Significantly During a Period With 10 Percent and 11 Percent Tax Rates on High-Income Earners," August 2008.

APPENDIX VI

Tax Definitions of Interest to Public Employees

Ad valorem: A tax that is applied at a set rate to the value of a good. The general sales tax is an ad valorem tax. An alcohol tax that charges 25 cents per drink, no matter the drink's cost, is not.

Apportionment: The process by which business income is assigned to a particular state for purposes of taxation. States use a variety of formulas to determine what share of a corporation's revenue should be subject to a state's tax.

Combined reporting: A requirement that a corporation report the income of its subsidiary corporations in a single statement for tax purposes.

Corporate tax: A levy placed on the profit of a firm; different rates are used for different levels of profits.

Decoupling: The process of changing a state tax code so that changes in the federal tax code do not apply.

Fee: A monetary charge for making use of a particular state service. Fees often are treated as separate from taxes but in many ways are akin to license taxes or selective sales taxes. As such, fees are regressive.

Jenkins Act: Federal law mandating that a business that ships cigarettes nationally must file monthly reports with each state tax agency listing "the name and address of the person to whom the shipment was made, the brand and the quantity thereof."

Licensing tax: A tax applied to the procurement of a permit or license. It is akin to a fee and is a regressive tax.

Millionaires tax: An increase in the income tax that is applied only to high-income tax filers. The original concept was a tax on income above $1 million, but some people apply the term to tax increases on the wealthiest taxpayers generally.

Motor fuel tax: Tax imposed per gallon of motor fuel. Gasoline may be subject to a different rate than diesel.

Nexus: The standard of business activity that makes a corporation subject to the tax code.

Progressive tax: A tax that takes a larger percentage from the earnings of high-income people than it does from low-income people.

Quill decision: *Quill v. North Dakota* is a 1992 U.S. Supreme Court decision. The court ruled that remote sellers, such as an Internet retailer, are not required to collect sales and use taxes for sales made to buyers located in states in which the seller does not have a physical presence. The Quill decision has led to a situation that enables large Internet retailers not to collect sales taxes, while traditional brick-and-mortar stores are required to collect sales taxes on all sales.

S corporation: A corporation whose profits are treated for tax purposes as the wage income of its shareholders.

Sales tax holiday: A temporary period during which purchases of certain items are exempt from the jurisdiction's sales and use taxes.

Selective sales tax: A tax that applies a particular rate to a particular good. Sin taxes are generally a subset of selective sales taxes.

Severance tax: A tax imposed by a state on the extraction of natural resources, such as oil, coal or gas that will be used in other states.

Sin tax: A state-sponsored tax that is added to products or services, such as alcohol, tobacco and gambling that some would see as vices.

Streamlined Sales Tax Project: A project of a growing number of state governments to simplify, standardize and modernize sales and use tax definitions and policies. First began in 2000. The goal is to make it easier for remote sellers such as Amazon.com to collect sales taxes, hopefully smoothing the way for political or judicial action to require such collection.

Tax gap: The difference between the amount of tax that taxpayers should pay/owe and the amount that is paid voluntarily and on time. The tax gap can also be thought of as the sum of noncompliance with the tax law.

Use tax: Use taxes are imposed on goods purchased out of state but used within a state. In effect, it extends the obligation to pay sales tax on goods purchased out of state.

Water's edge: In corporate taxation, "water's edge" requirements refer to whether a company will have to report on economic activity and income from subsidiaries that are incorporated outside the United States (i.e., "beyond the water's edge").

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