

# The ITEP Guide to Fair State and Local Taxes

February 2005



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## **About this Report**

The ITEP Guide to Fair State and Local Taxes is designed to provide a basic overview of the most important issues in state and local tax policy, in simple and straightforward language. Along with this report, ITEP has published a series of policy briefs providing additional information on specific topics discussed in the Guide. These briefs can be downloaded from the ITEP Internet site at [www.itepnet.org](http://www.itepnet.org).

This report is the result of the diligent work of many ITEP staffers. Those primarily responsible for the report are Casey Cabalquinto, Norton Francis, Matt Gardner, Kelci Karl, Robert S. McIntyre, Kelly Ross and Melissa Threadgill. The report also benefitted from the valuable feedback of researchers and advocates around the nation. Special thanks to Michael Mazerov at the Center on Budget and Policy Priorities.

*This study was made possible by a grant from the Annie E. Casey Foundation.*

THE ITEP GUIDE TO FAIR STATE & LOCAL TAX POLICY  
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## CHAPTER ONE

# TAX FAIRNESS FUNDAMENTALS

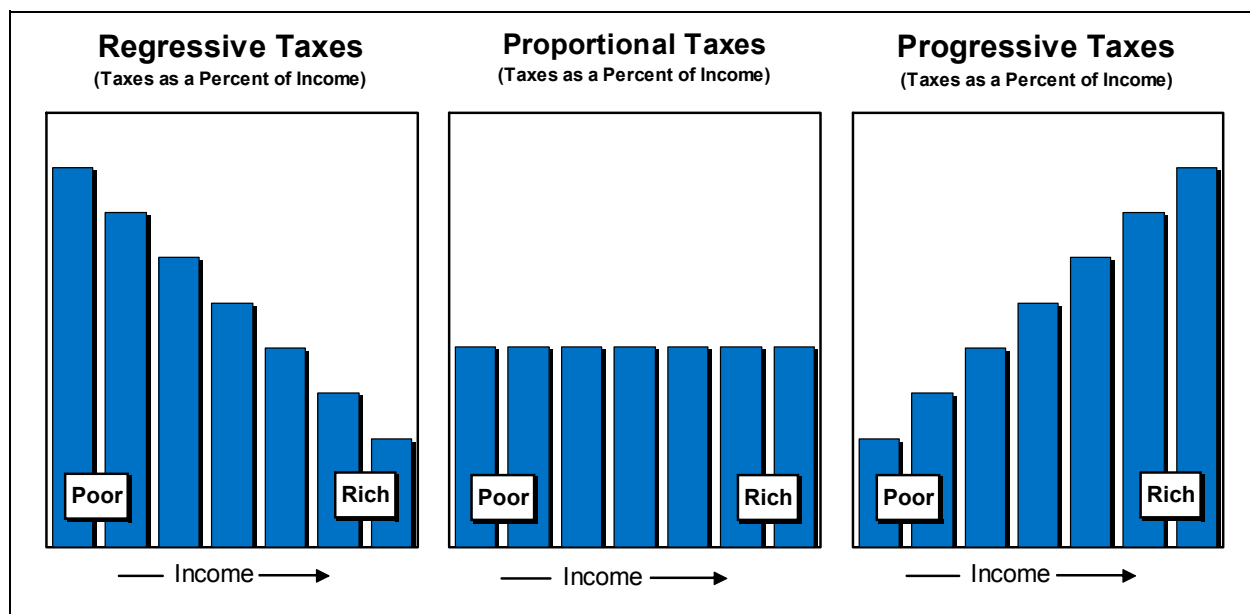
“The subjects of every state ought to contribute toward the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state . . . [As Henry Home (Lord Kames) has written, a goal of taxation should be to] ‘remedy inequality of riches as much as possible, by relieving the poor and burdening the rich.’ ”

Adam Smith

AN INQUIRY INTO THE NATURE AND CAUSES  
OF THE WEALTH OF NATIONS (1776)<sup>1</sup>

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

- A **regressive** tax makes middle- and low-income families pay a larger share of their incomes in taxes than the rich.
- A **proportional** tax takes the same percentage of income from everyone, regardless of how much or how little they earn.
- A **progressive** tax is one in which upper-income families pay a larger share of their incomes in tax than do those with lower incomes.



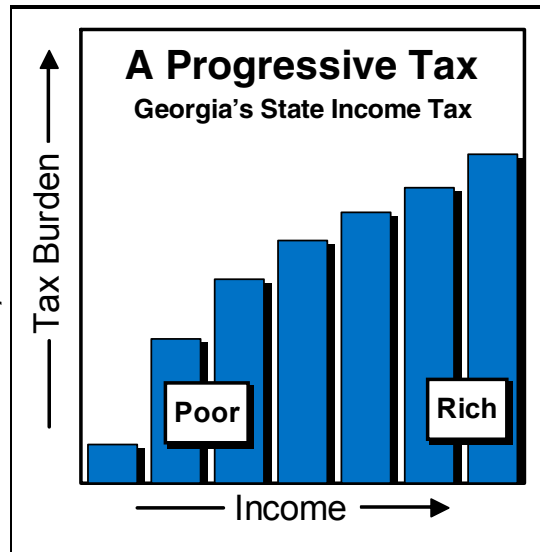
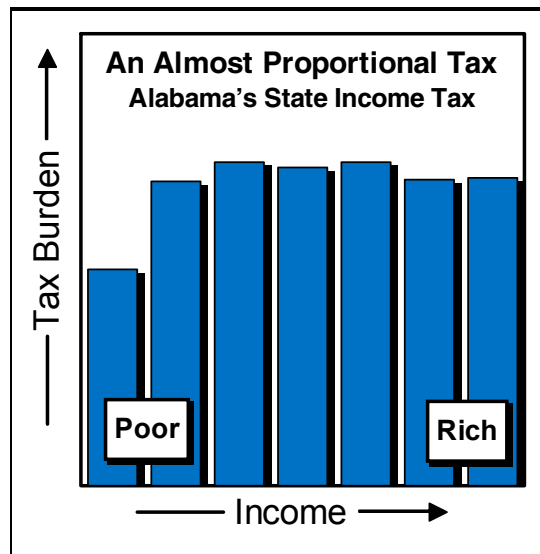
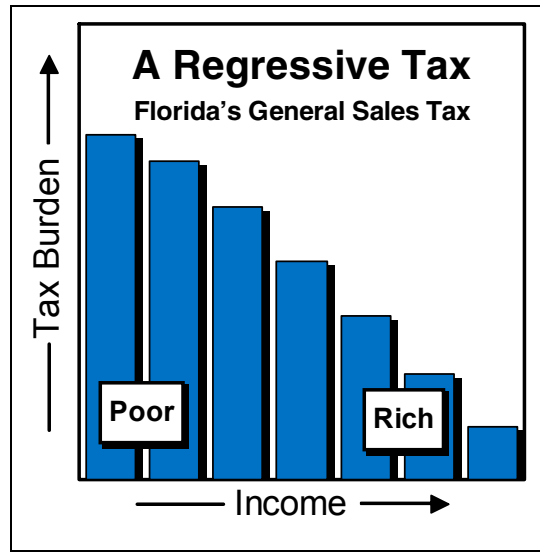
<sup>1</sup>Book V, Chapter II, part II, pp.777,779 (1937 ed.)

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

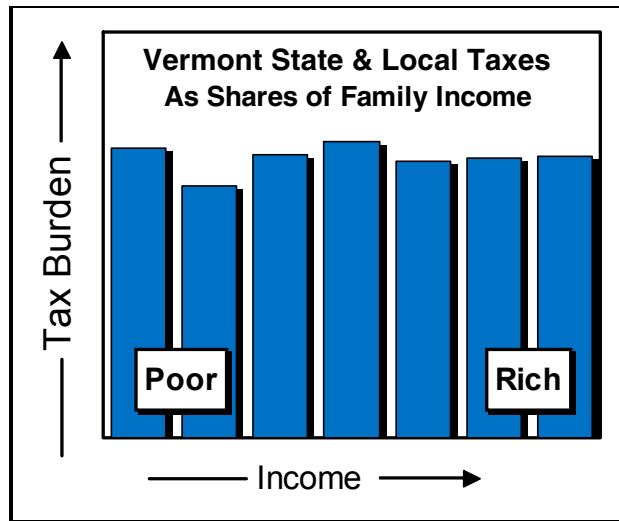
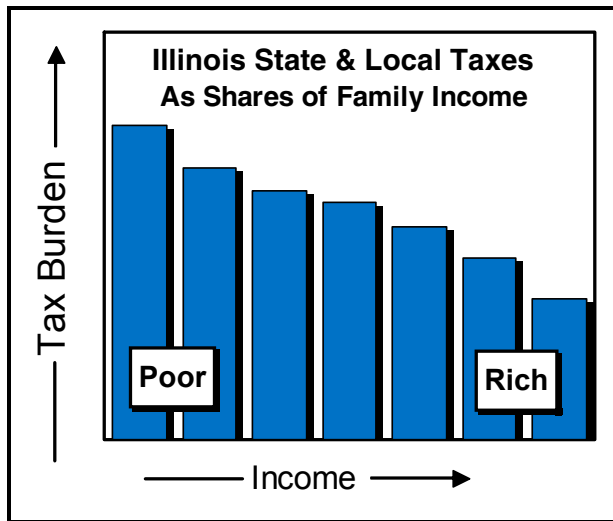
Some believe that a **proportional**, or "flat," tax structure is fair. They argue that if everyone pays the same share of income in taxes, then everyone is treated equitably. But this view ignores the fact that taking the same share of income from a middle- or low-income family as from a rich family has vastly different consequences for each. Low-income families must spend most (or all) of their income just to achieve the most basic level of comfort. Even middle-income families spend most of what they earn to sustain only a modest standard of living. A tax on these families can cut directly into their quality of life. In contrast, the same tax will hardly affect the life style of the wealthiest families at all. An almost-flat personal income tax (like Alabama's, shown in the chart at right) is an example of a tax that can be proportional.<sup>2</sup>

**Progressive** taxes are the fairest taxes. Personal income taxes are the only major tax that can easily be designed to be progressive. Low-income families can be exempted entirely and tax rates can be *graduated*, with higher tax rates applying to higher income levels, so that middle-income and rich families pay taxes fairly related to what they can afford. An example of a typically progressive income tax is Georgia's tax, shown in the chart at right: the poorest taxpayers pay the smallest amount as a share of income, and taxes increase with each income level.

Almost every state relies on some combination of regressive, proportional and progressive taxes. When you add these taxes together, the overall **progressivity** or **regressivity** of a tax system is determined by (1) the degree of progressivity or regressivity of each tax within the system and (2) how heavily a state relies on



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



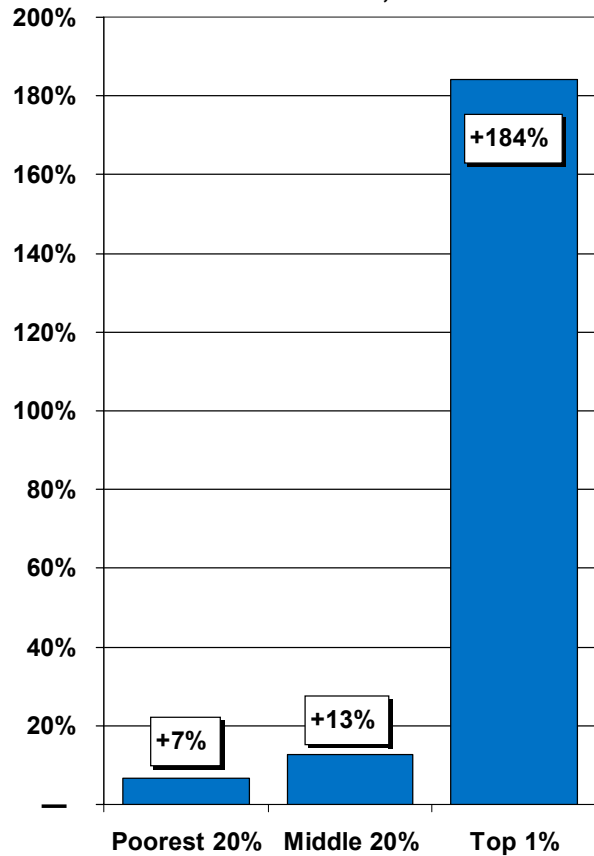
each tax. Thus, a state that relies on regressive sales, excise and property taxes more heavily than its mildly progressive income tax will end up with a very regressive tax system overall. An example of a state like this is Illinois. At the other end of the spectrum, even the most progressive income taxes are only sufficient to make a state's tax system roughly proportional overall. An example of a state that achieves this result by relying more on its progressive income tax than on regressive sales, excise and property taxes is Vermont.

### Why Tax Fairness Matters

Tax fairness is an important goal for state policymakers, for several reasons. For one thing, a regressive tax system tries to raise money from the people who have the least of it. This is illogical at best. The wealthiest one percent of Americans have more income than the poorest 40 percent put together. And the best-off 20 percent of Americans make more than the remaining 80 percent combined. Soaking the poor just doesn't yield much revenue compared to modest taxes on the rich. Fair taxes are essential to adequate funding of public services because they tax those who have the most to give.

This flaw in using a "soak the poor," regressive tax system for raising revenue has been compounded in recent years. The wealthiest Americans have gotten much richer, while just about everyone else has gotten squeezed. The richest one percent of families in the United States saw their average pre-tax income rise by 184 percent in the twenty-one years from 1979 to 2000—that's in "constant dollars" (meaning it's adjusted for inflation)! Meanwhile, middle-income

### The Rich Get Richer: Real Income Growth, 1979-2000



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

It's no wonder that so many states with regressive tax structures are falling short in revenue. They're continually imposing higher taxes on people without much money—the very people who have experienced the most meager growth in income over the past twenty years. These states are largely bypassing—that is, by taxing at very low rates—the people whose incomes have grown the fastest: the rich. In the long run, progressive taxes like the income tax are a more dependable source of revenue for state and local governments precisely because they tax the wealthy state residents who have enjoyed the largest income gains in recent decades.

Fair taxes also help government in its relations with its citizens. The public accepts taxes because it values the services that government provides. When a tax system is unfair, however, there is a limit to the tax tolerance the public will show. It's one thing to ask people to pay taxes. It is another to ask them to pay more because others aren't paying their fair share. As Jean Baptiste Colbert, Louis XIV's controller general of finances reputedly said, “[t]he art of taxation consists in so plucking the goose as to get the most feathers with the least hissing.” Fair taxes cause a lot less hissing.

Finally, a fair tax system is important as a very real moral imperative. Taxes can amount to real money for any family. But for poorer families, it's money that could otherwise be used for food, clothing, a trip to the doctor or some other necessity. When a state decides to tax the poor at a high rate, it is forcing these families to make choices that no family should have to make—choices that are far harder than those faced by upper-income families.

## Federal Taxes Matter, Too

When we evaluate the fairness of a tax system, we should also consider overlapping tax systems that affect the same taxpayers. It is important, in particular, to consider state and local tax policy in the context of federal tax policy.

While the rich have seen their incomes go up substantially faster than others, federal taxes on the wealthy have gone way down—resulting in an overall tax system that is much less progressive. In 2004, the wealthiest 1 percent of Americans paid 32.8 percent of their income in combined federal, state and local taxes, down sharply from 37.1 percent before the George W. Bush administration. By comparison, the other 99 percent of Americans paid, on average, 29.4 percent of their income in total taxes—almost as much as the wealthiest taxpayers.

So as states determine which taxes to raise and on whom, they should consider that *federal* taxes have been getting significantly less progressive. A state that raises taxes on the rich will almost certainly still leave them better off than they were before their huge tax cuts on the federal level. Raising taxes on middle- and low-income taxpayers, however, will compound the injustice of the federal tax shift that has taken place in the past five years.

### Are Your State's Taxes Unfair?

A January 2003 ITEP report, *Who Pays?*, measures the fairness of state and local taxes in each of the 50 states and the District of Columbia. The report finds that almost every state requires its poorest citizens to pay more of their income in tax than any other income group—and allows the wealthiest taxpayers to pay the least. *Who Pays?* is available on ITEP's website at [www.itepnet.org/whopays.htm](http://www.itepnet.org/whopays.htm).

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<sup>3</sup>Congressional Budget Office, *Effective Federal Tax Rates, 1997 to 2000*. August 2003.



# BASIC PRINCIPLES AND TERMS

This chapter introduces some basic principles for evaluating your state’s tax system—and walks you through some of the “nuts and bolts” necessary for a basic understanding of tax policy issues. This chapter does not attempt to turn anyone into a tax attorney. Rather, our goal—here and throughout this guide—is to make the reader sufficiently knowledgeable about tax policy to be an effective advocate for progressive tax reform.

### Tax Policy Principles: An Introduction

Tax fairness is a primary consideration in evaluating state and local tax systems. But there are other important criteria that must also be considered. This section explains five of the most commonly cited tax policy principles: equity, adequacy, simplicity, exportability, and neutrality.

#### Equity: Two Kinds of Tax Fairness

When people discuss tax “fairness,” they’re talking about equity. Tax equity can be looked at in two important ways: **vertical equity** and **horizontal equity**. Vertical equity addresses how a tax affects different families from the bottom of the income spectrum to the top—from poor to rich. When we discussed regressive and progressive taxes in Chapter One, we were looking at vertical equity issues.

Horizontal equity is a measure of whether taxpayers in similar circumstances pay similar amounts of tax. For example, if one family pays higher taxes than a similar-income family next door, that violates “horizontal” fairness. This sort of unjustified disparity undermines public support for the tax system and diminishes people’s willingness to file honest tax returns. It would be hard to defend a tax system that intentionally taxed left-handed people at higher rates than right-handed people. Likewise, a tax that hits a wage-earner harder than an investor (as the federal income tax currently does), even if their total incomes are the same, fails the test of horizontal equity.

#### Adequacy

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

Two factors that contribute to the adequacy of a tax are its **stability** and its **elasticity**. A stable tax is one that grows at a predictable pace. Predictable growth makes it easier for lawmakers to put together budgets that match anticipated revenues to anticipated spending. But stability by itself is not enough to achieve adequacy in the long run. For example, property taxes grow predictably—but tend to grow more slowly than the cost of the services that state and local governments provide. Elasticity is a measure of whether the growth in a specific tax keeps up with the

### Important Tax Policy Principles

- ☞ **Equity:** Does your tax system treat people at different income levels, and people at the same income level, fairly?
- ☞ **Adequacy:** Does the tax system raise enough money, in the short run and the long run, to finance public services?
- ☞ **Simplicity:** Does the tax system allow confusing tax loopholes? Is it easy to understand how your state’s taxes work?
- ☞ **Exportability:** Individuals and companies based in other states benefit from your state’s public services. Do they pay their fair share?
- ☞ **Neutrality:** Does the tax system interfere with the investment and spending decisions of businesses and workers?

economy—an important consideration because the cost of providing public services usually grows at least as fast as the economy. An elastic tax is one for which tax revenue grows faster than the economy over the long run.

There is some inherent tension between the goals of elasticity and stability. Elastic taxes, like the personal income tax, are more likely to ensure adequate revenues in the long run, but may also require frequent tax increases and reductions to ensure that state revenues match the desired level of government services. (The use of “rainy day funds” can make these legislative changes unnecessary—see Chapter Ten.) Stable taxes, like the property tax, will grow predictably, but the slower growth rate of these taxes may mean that in the long run tax hikes will probably be necessary to fund services at the same level.

### **Simplicity**

Simplicity is often touted as a goal for tax reform—and it’s an important one. Complicated tax rules make the tax system difficult for citizens to understand. Complexity also makes it harder for governments to monitor and enforce tax collections, and makes it easier for lawmakers to enact (and conceal) targeted tax breaks benefitting particular groups. A tax system full of loopholes gives those who can afford clever accountants an advantage over those who must wade through the tax code on their own.

But beware. Tax reform proposals described as “simplification” measures are often nothing of the kind. For example, anti-tax advocates frequently seek to “simplify” the income tax by eliminating the graduated rate structure and instituting a flat-rate tax. This is a red herring: a graduated tax system is no more complicated than a flat-rate tax. The right way to make income taxes simple is to eliminate tax loopholes, not to flatten the rates.

### **Exportability**

The public services provided by state tax revenues are enjoyed by individuals and businesses from other states—including businesses that hire a state’s high school and college graduates and tourists who use a state’s transportation infrastructure. This is why state tax systems are often designed to make multi-state businesses and residents of other states pay their fair share of the state tax burden. An **exportable** tax is one that is at least partially paid by these non-residents.

There are broadly three ways in which taxes can be exported: by having non-residents pay the tax directly (sales taxes on items purchased by tourists, for example); by levying taxes on businesses which are then passed on to non-residents; and through interaction with the federal income tax. (See “The Interaction of State and Local Taxes with Federal Income Taxes” on page 10.) All taxes are at least partially paid by non-residents—and policy makers have the power to effectively adjust the percentage of taxes “exported” to residents of other states. Strategies for achieving this are outlined in later chapters of this guide.

### **The “Benefits Principle” of Taxation**

Not all taxes are based on ability to pay. Governments sometimes levy taxes and user fees designed to make people pay in accordance with the benefit they receive from certain public services. This idea is known as the benefits principle of taxation. For example, states raise money for highway maintenance by imposing a gasoline tax. Since the amount of gasoline a driver purchases is a reasonable proxy for the benefit that driver receives from publicly maintained roads, the gas tax follows the benefits principle of taxation.

But there are limits to the usefulness of the benefits principle. First, taxing according to the benefits principle can lead to a regressive result: gasoline taxes take a larger share of income from low-income taxpayers than from the wealthy. Second, for many of the most important functions performed by governments, such as education, health care and anti-poverty programs, and police and homeland security, it can be hard to quantify the benefits of these services for individual taxpayers. Third, many of the services provided by state governments are explicitly designed to redistribute resources to low-income taxpayers. Social welfare programs exist partially because low-income taxpayers cannot afford to pay for these programs themselves, so requiring these taxpayers to pay for the programs according to the benefit principle would defeat their purpose.

## Neutrality

The principle of neutrality (sometimes called “efficiency”) tells us that a tax system should stay out of the way of economic decisions. If individuals or businesses make their investment or spending decisions based on the tax code rather than basing them on their own preferences, that’s a violation of the neutrality principle, and can lead to negative economic consequences in the long run. For example, the big tax breaks that the Reagan administration provided for commercial real estate in the early 1980s led to far too much office construction and the phenomenon of “see-through office buildings” that nobody wanted to rent. These wasteful investments came, of course, at the expense of more productive investments—and were paid for by all other taxpayers.

The tax principles outlined here are not the only criteria used by policymakers in evaluating tax changes—and these principles sometimes come into conflict. But almost everyone would agree that advocates of tax reform should keep each of these goals in mind as they seek to improve their state’s tax system.

## Nuts and Bolts: Basic Tax Policy Terms

The tax principles described so far are essential to a broad understanding of why one type of tax is preferable to another. But there is also a basic set of terms you’ll need to understand in order to understand how each of these taxes work. This section explores the “nuts and bolts” of state and local tax policy.

### Tax Incidence

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

The first step in incidence analysis is to divide a population into income groups. ITEP’s analyses usually divide the population into five groups based on income—ranging from the poorest 20 percent to the richest 20 percent. Each of these groups is called an “income quintile.” (“Quintile” simply means one fifth, or 20 percent, of the population.)

ITEP’s analyses also split the richest 20 percent into three subgroups: the lowest-income 15 percent of the quintile, the next 4 percent and the richest one percent. This is done because families in the top 20 percent have more than half of all personal income nationally. Within this quintile, there are substantial differences in income levels and tax burdens between the “poorest”

## Total State & Local Taxes in 2002 As Shares of Income for Non-Elderly Taxpayers

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

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

members and the richest members. Incomes in this group range from what might be called upper-middle class, to the richest families in the country. From a tax policy standpoint, relatively lower-income families in this group should not be treated the same as the richest families because they have very different abilities to pay. This is why our incidence tables show them separately.

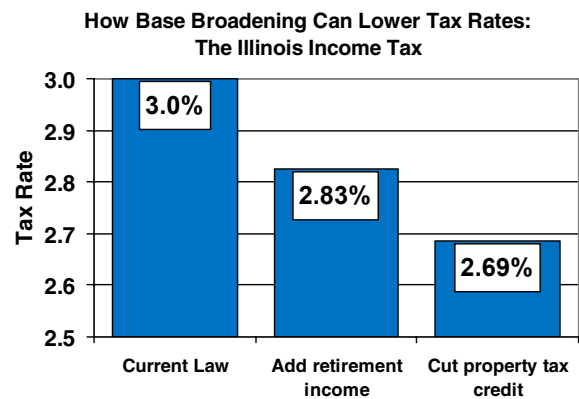
### The Tax Base

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

Tax bases are usually measured as a dollar amount to which a tax rate is applied—for example, the total dollar amount of taxable income, in the case of the personal income tax, or the total dollar value of real estate, in the case of the real property tax. Taxes that are measured this way are called *ad valorem*, or value-based, taxes. But not all taxes are calculated this way: excise taxes on cigarettes, gasoline and beer are often calculated on a per-unit basis. The amount of tax collected depends not on the value of the tax base, but on the number of items in the tax base. Cigarette taxes, for instance, typically are applied on a per-pack basis (the tax owed is a certain number of cents per pack of cigarettes sold). Thus, for a cigarette tax, the tax base is usually the number of packs sold. Taxes that are sold on a per-unit basis have one critical flaw—tax revenues only increase when the number of units sold goes up. By contrast, ad valorem taxes tend to grow with personal income even when the number of units sold is unchanged.

Taxes are often described as having a **broad base** or a **narrow base**. A broad-based tax is one that taxes most of the potential tax base. For example, a broad-based sales tax is one that applies to almost all purchases of goods and services. A narrow-based tax applies to fewer items. A typical narrow-based sales tax applies only to goods, not services, and has exemptions for things like food, housing and medicine.

In general, broader tax bases are a good idea. At any given tax rate, a broad-based tax will raise more revenue than a narrow-based tax—because more is taxed. The chart at right illustrates this: Illinois taxes personal income at a flat 3 percent rate. If lawmakers repealed a special tax break for retirement income, the tax rate could be lowered to 2.83 percent and still bring in the same amount of revenue. If lawmakers also repealed the state's property tax credit, a 2.69 percent rate would raise the same amount of money as the current tax. This example illustrates an important tradeoff: the broader the tax base, the lower the tax rates can be. And the narrower the tax base, the higher the tax rate must be in order to fund public services.



A broader base also makes it more likely that the tax system will treat all economic activities the same, which helps ensure that the tax system will not discriminate in favor of some taxpayers and against others. So a broad tax base helps achieve the goal of neutrality described above.

But sometimes there are good reasons for having a narrower base. Excluding food from the sales tax, for example, makes that tax less regressive. Some people argue that the benefit of making the tax less unfair outweighs the revenue loss from narrowing the sales tax base.

### The Tax Rate (or Rates)

Multiplying the tax rate times the tax base gives the amount of tax collected. Usually, the tax rate is a percentage. For instance, if a state's sales tax rate is 4 percent on each taxable purchase and

taxable purchases (the tax base) total \$1 billion, then the total amount of tax collected will be \$40 million (4 percent of \$1 billion).

Income taxes typically have multiple rates—with different rates applying at different levels of income. This is called a “graduated” rate structure, using “marginal” rates. Chapter Five describes how such a rate system works.

Not all tax rates are percentages. A typical gasoline tax rate, for example, is expressed in per-gallon terms. So if a state has a gasoline tax rate of 10 cents per gallon and 100 million gallons of gasoline are sold, then the tax collected will be \$10 million (10 cents multiplied by 100 million).

Property tax rates are traditionally measured not in percentages but in **mills**. A mill represents a tenth of a percent. Mills tell us the tax for each thousand dollars in property value. Thus, a 20 mil rate applied to a house with a taxable value of \$100,000 yields a tax of \$2,000.

### Effective Rates Versus Nominal Rates

So far, we have been describing **nominal tax rates**—the actual legal rate that is multiplied by the tax base to yield the amount of tax liability.

Though the nominal rate is used in the actual calculation of taxes, it’s not the best measure for comparing taxes between states because it doesn’t account for differences between tax bases. For example, suppose that two states, each with the same population and the same total amount of income, have sales taxes. The sales taxes have the same tax rate, 4 percent, but state A’s sales tax applies to a narrow tax base, exempting groceries and many services, while state B’s sales tax applies to a broader tax base. State B’s sales tax (the total amount of statewide sales subject to the tax) applies to \$1.5 billion of retail sales, while state A’s sales tax applies to just \$1 billion in sales. State B’s sales tax is obviously much higher than State A’s tax—even though the legal rates are identical. To compare these two sales taxes solely on the basis of the legal rates would be misleading.

A better, more accurate measure for comparing these taxes is the **effective tax rate**. The idea of an effective rate is that instead of just saying “both state A and state B have four

Effective Tax Rates and Nominal Tax Rates		
	State A	State B
Sales Tax Rate	4%	4%
Tax Base	\$1 billion	\$1.5 billion
Sales Tax Collected	\$40 million	\$60 million
Statewide Personal Income	\$2 billion	\$2 billion
<b>Effective Sales Tax Rate</b>	<b>2.0%</b>	<b>3.0%</b>

percent sales taxes,” we say that “state A’s sales tax takes 2.0 percent of the income of its residents while state B’s takes 3.0 percent of personal income.” This approach is better because it measures tax liability in a way that takes account of differences in the tax base. In this example, by comparing these effective rates we are able to see that, even though state A and state B have the same nominal rates, the tax is really higher in state B because state B has a broader base.

When we divide tax payments by personal income, as in the example above, we’re calculating the **effective tax rate on income**, and this is the way taxes are usually measured in ITEP’s incidence analyses. Effective tax rates can be calculated in other ways, too. For example, the property tax on a home can be expressed as a percentage of its market value. But what if we want to measure the tax compared to what the homeowner can afford? The owner of this home could be out of work—or could have just gotten a huge raise. Because we care about tax fairness, we need to measure the tax paid relative to ability to pay. Tax incidence tables—like the one presented in this chapter—are based on effective tax rates on income for families at different income levels because these tables are designed to determine the fairness of taxes. A fair tax takes more from those with a greater ability to pay, so the effective rate on income is higher on those with greater income. A regressive tax has lower effective rates on income for the rich than for middle- and low-income families.

## The Interaction of State and Local Taxes With Federal Income Taxes

State taxes often have a direct impact on your federal tax bill. People who itemize deductions on their federal tax returns can deduct the state and local personal income taxes and property taxes they pay in computing their federal taxable income. Sales and excise taxes, by contrast, are generally not deductible on federal tax forms, although federal legislation passed in 2004 allows a temporary, optional sales tax deduction for taxpayers (mostly living in states without an income tax) who pay more sales tax than income tax. This optional deduction is only available in 2004 and 2005.) Thus, for every dollar in income or property taxes paid to a state or local government, taxpayers who itemize get a federal tax cut of as much as 35 cents (depending on what federal tax bracket they are in). The chart on this page shows this effect graphically. Suppose an itemizing taxpayer in the 28 percent federal tax bracket is subject to a \$1,000 state income tax hike. The value of her federal itemized deductions will increase by \$1,000. This means that \$1,000 less of this taxpayer's income will be subject to federal tax after the state tax increase. Since this last increment of income was originally taxed at 28 percent, this person's federal tax liability decreases by \$280 (28 percent of \$1,000). So the net tax hike for this taxpayer is actually \$720, not \$1,000. An analysis that looked only at the *state* impact of the proposal would show a tax hike of \$1,000, while an analysis that includes the offsetting federal change would show a tax hike of \$720.

This "federal offset" has clear implications for proposals to increase (or cut) state income and property taxes. When state income taxes go up, part of that tax hike will not come out of state residents' wallets at all, but instead will be paid by the federal government in the form of federal tax cuts for itemizers. Similarly, when state income taxes go down, federal income taxes paid by state residents will go up. And because the federal offset is most useful for wealthy taxpayers who are more likely to itemize and tend to pay at higher federal income

tax rates, the best way to maximize the amount of a state income tax hike that will be offset by federal tax cuts is to target these tax hikes to the wealthiest state residents.

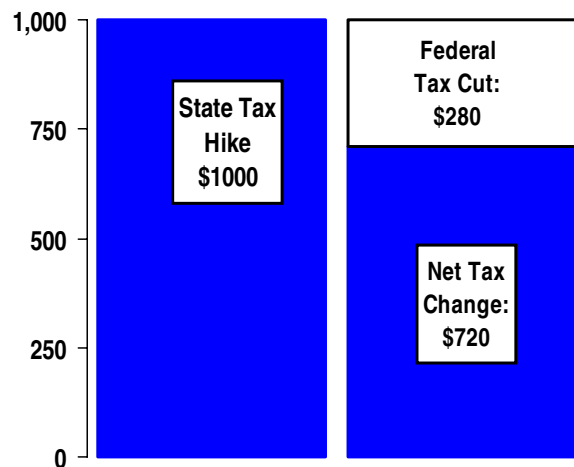
This benefit is not limited to income taxes paid by individuals. Corporations can export up to 35 percent of their state corporate income tax to the federal government. This means that when states enact corporate tax breaks for in-state businesses, up to 35 percent of these cuts may ultimately go not to the corporations for whom the tax breaks are intended, but to the federal government in the form of higher federal taxes.

The general inapplicability of the federal offset to sales and excise tax changes means that these regressive tax hikes are an especially bad deal for state residents, since virtually every dollar of a sales tax hike that is paid initially by state residents will ultimately come out of their pockets.

## Conclusion

Now you've seen the basic conceptual building blocks of tax policy analysis. The next four chapters will take the concepts and terms you've learned here and apply them to each of the major types of taxes that state and local governments rely on. We'll look at how each tax matches up against the principles of taxation described in this chapter, and will look at reforms that could help each tax remain a viable revenue source for the 21<sup>st</sup> century. We'll also look at some broader reforms that can help ensure accountability and fairness in all types of taxes.

How Increases in Federally Deductible Taxes Reduce Federal Tax Burdens



## CHAPTER THREE

# SALES AND EXCISE TAXES

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Sales and excise taxes, or consumption taxes, are an important revenue source, comprising close to half of all state tax revenues in 2004. But these taxes are regressive, falling far more heavily on low- and middle income taxpayers than on the wealthy. Consumption taxes also face structural problems that threaten their future viability. This chapter looks at how these taxes work, and outlines options for making consumption taxes less unfair and more sustainable.

### How Sales Taxes Work

Sales taxes apply to items we purchase every day, including goods (such as furniture and automobiles) and services (such as haircuts and car repairs). To compute the sales tax on a taxable item, the cost of the item is multiplied by the tax rate. For example, in Michigan, where the sales tax rate is six percent, the sales tax on a \$10 book is sixty cents. The cost of the book to the consumer, after tax, is \$10.60. The sales tax base is the total amount paid for all the goods and services subject to the tax. The sales tax is an example of an **ad valorem** tax—that is, a tax based on the price of the item sold.

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

States often have more than one sales tax rate. Some states apply lower tax rates to items such as groceries or utilities, as a means of providing low-income tax relief. Other states apply a higher tax rate to goods and services consumed primarily by tourists, such as hotels or rental cars. This is done to ensure that non-resident visitors pay their fair share of the sales tax.

Many states also have **local sales taxes**. These usually (but not always) apply to the same items as the state sales tax. Thus, calculating the total state and local sales tax is generally simply a matter of adding the state rate to the local rate and multiplying it by the cost of taxable items.

Every state with a sales tax also has a **use tax**, which applies to items that are bought outside a state for use within a state. The use tax is designed to prevent state residents from avoiding the sales tax by purchasing goods in other states. However, the use tax is rarely enforced.

Most states have more than one type of sales tax. They have a **general sales tax** (which is what most people mean when they talk about their state’s “sales tax”), and **selective sales taxes** on particular goods or services. A typical selective sales tax—which may have a different rate than the general sales tax—is a tax on the purchase of alcohol, tobacco or gasoline, or a tax on utilities, such as electricity and telephone service. Selective sales taxes, also known as **excise taxes**, are discussed later in this chapter.

### Sales Taxes Are Regressive

Sales taxes are inherently regressive because the lower a family’s income, the more of its income the family must spend on things subject to the tax. Typically, low-income families spend three-quarters of their income on things subject to sales tax, middle-income families spend about half of their income on items subject to sales tax, and the richest families spend only about a sixth of their income on sales-taxable items. Thus, about three-quarters of the income of a low-income family, half of a middle-income family’s income and just one-sixth of the income of a rich

family is typically subject to sales tax. Put another way, a 6 percent sales tax is the equivalent of an income tax with a 4.5 percent rate for the poor (that's three-quarters of the 6 percent sales tax rate), a 3 percent rate on the middle-class (half of 6 percent) and a one-percent income tax rate for the rich (one-sixth of 6 percent). Obviously, no one could get away with proposing an income tax that looked like that. The only reason this pattern is tolerated in consumption taxes is that their regressive nature is hidden in a harmless looking single rate, and the amount families pay is hidden in many small purchases throughout the year.

The sales tax violates the basic tax fairness principle of taxing according to one's ability to pay: the highest burdens are shouldered by those low-income taxpayers with the least ability to pay them. Sales taxes also violate this principle in their insensitivity to fluctuations in taxpayer income: families will always need to spend money on sales taxable items such as food, clothing and utilities no matter how little they earn in a given year. A middle-income taxpayer who loses his job will still have to spend much of his income just to get by—and will still pay a substantial amount of sales tax even though his ability to pay these taxes has fallen dramatically.

### The “Equal Tax on Equal Purchases” Fallacy

**D**espite the regressivity of the sales tax, some people claim that sales taxes are fair. After all, it is said, no one can completely avoid paying sales taxes since they apply to things that everyone—rich and poor alike—needs to buy. The sales tax hits everyone “equally,” goes this argument; the tax is the same on, say, a tube of toothpaste, no matter who buys it.

But this so-called “equality” is precisely why sales taxes *fail* the test of fairness. The cost of toothpaste, and therefore the sales tax on it, is the same for a rich person as for a poor person. But the rich person has many times more income. So the amount that the rich person pays in tax on that tube of toothpaste is a much smaller share of his or her income than the same tax on a middle- or low-income family.

Of course, a rich family does consume more and thus pays more sales tax in dollars than does a less well-off family. But in terms of what those dollars mean to rich families—as a portion of their income and how it affects their standard of living—the sales tax is much less of a burden on the rich than it is on middle- and low-income families.

### Sales Taxes on Business—Who Pays?

**M**ost state sales taxes are designed to exempt purchases made by businesses, on the theory that the sales tax is supposed to be a tax on final personal consumption. But the distinction between business and individual purchases is often difficult to make, and as a result every state applies its sales tax to some business purchases. These **business-input** sales taxes add to the cost of producing goods and services, and therefore they are mostly passed forward to consumers in the form of higher retail prices. In other words, taxing business inputs through the sales tax is generally akin to taxing the consumer more than once on the same retail sale. As a result, expanding the sales tax base to include business services will usually hurt low-income taxpayers.

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

### A Volatile, Slow-Growth Tax

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



downturn and when people are afraid a downturn is coming. If a family thinks it may face hard times soon, it may delay some spending in anticipation of the worst. Purchases of big-ticket items like new cars are particularly likely to be postponed. As a result, sales tax revenues can fall during periods of economic uncertainty—even before a recession has set in.

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

## No Federal Deductibility

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

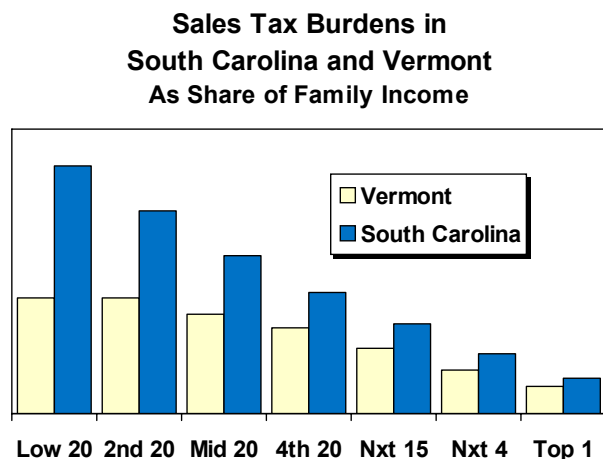
## Sales Tax Reform: Issues and Options

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

### Broadening the Sales Tax Base

Every state's sales tax allows targeted exemptions. These exemptions are usually intended to make the sales tax less unfair. Sales taxes can be made less regressive by taxing more of the things the wealthy consume the most and fewer of the things on which middle- and low-income families spend their money. Of course, every state and local general sales tax is regressive. But the degree of unfairness ranges substantially—from moderately regressive in states like Vermont to extremely regressive in states like South Carolina. The most important factor affecting regressivity is whether groceries are taxed. Taxing food is extremely regressive because such a high portion of the income of poorer families goes to mere sustenance.

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



- Exemptions are very costly. Exempting groceries can reduce the revenue yield of each penny of sales tax by up to twenty percent. This puts pressure on lawmakers to increase tax rates.
- Exemptions are poorly targeted. The poorest 40 percent of taxpayers typically receive about 25 percent of the benefit from exempting food. The rest goes to wealthier taxpayers.
- Exemptions tend to make sales tax collections fluctuate more, because changes in particular economic sectors can affect tax collections. The broader the tax base, the less sensitive tax revenues will be to sudden swings in retail purchases of particular items.
- In states that allow local sales taxes, lawmakers must decide whether exemptions should apply to local taxes as well. Doing so can be costly to local governments, but not doing so creates more complication for retailers and tax administrators.
- While exemptions can make the sales tax less regressive, they also create a new source of unfairness: different treatment of taxpayers at a given income level. By exempting food while taxing other retail sales, lawmakers are discriminating against taxpayers who spend more of their money on things other than food.
- Exemptions are an administrative challenge to policy makers because any exemption requires a way of distinguishing between taxable and exempt products. For example, New York taxes marshmallows as snack food, but exempts mini-marshmallows as groceries. Exemptions require tax administrators to make countless decisions of this sort, and retailers must be familiar with all of these rules.

### Sales Tax Credits

Lawmakers seeking to make the sales tax less unfair without breaking the bank do have an alternative to broad-based exemptions: targeted **sales tax credits**. These credits generally give a flat dollar amount for each member of a family, and are available only to taxpayers with income below a certain threshold. These credits are usually refundable, meaning that the value of the credit does not depend on the amount of taxes a claimant pays. This approach offers several advantages over sales tax exemptions: credits can be targeted to state residents only, and they can be designed to apply to whichever income groups are deemed worthy of tax relief. The box at right shows the details of one such program, the Kansas food sales tax refund. Low-income Kansas taxpayers over 55 years old, and non-elderly Kansans with children, can claim up to \$72 for each family member. In 2004, Kansans with incomes up to \$26,900 were eligible for the credit.

#### The Kansas Food Sales Tax Refund

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

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

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

However, sales tax credits have one important disadvantage: they must be applied for. All of the states that allow sales tax credits require taxpayers to fill out a form every year. Taxpayers who do not know about the credit—or who do not have to file income tax forms—may not claim the credit even if they are eligible. This means that an effective outreach program must be a central part of any effort to provide sales tax credits. By contrast, exemptions are given automatically at the cash register—so consumers don't need to apply or even to know about them.

It is also important to recognize that sales tax credits will never be able to eliminate the regressivity of sales taxes. The Kansas sales tax remains quite regressive, even after the food sales tax refund. It would take a very large tax credit to eliminate the extra sales tax burden on low-income taxpayers. And while a state may be able to relieve the sales tax burden on low-income families through a credit, there is no practical way to make sales taxes on middle-income families

equal to the light sales taxes borne by the wealthy. Since low- and middle-income families bear most of the burden of the sales tax, a sales tax and rebate system that ended up taxing the middle class at the same low rate as the rich wouldn't be worth the trouble of collecting (and rebating).

To be sure, rebates or credits can be valuable to poor families. But no one should think that they can entirely solve the problem of sales tax regressivity.

### **Business Sales Tax “Loopholes?”**

The sales tax is well enough understood that special interest loopholes in the tax law tend to get noticed, especially compared to some of the more complex tax breaks that are sometimes hidden in the income tax. That doesn't mean, however, that special interests don't work hard to get preferential sales tax treatment. Indeed, when states consider expanding their sales tax bases, lobbyists for such potential targets as lawyers, accountants, dry cleaners, advertising agencies, country clubs and others will fight tooth and nail for their exemptions.

On the other hand, one type of supposed “business loophole” in the sales tax—the tax exemption given for many purchases by businesses—is not simply the result of effective lobbying, but also is often based on sound economic principles. For example, nobody thinks that retailers should pay sales tax when they buy goods at wholesale. If they did, the goods would be taxed twice—once at the wholesale transaction and once at the retail sale—with the ultimate consumer bearing the burden of this double-taxation.

But the same principle applies when, for example, furniture-making companies buy wood to make into tables and chairs. If they must pay sales tax on the wood, then the wood will, in effect, be taxed twice—once when it is bought by the manufacturer, and again when it is bought by the consumer as part of the furniture. When sales taxes from earlier stages of the production process pile up on the final consumer, economists call it **pyramiding** or **cascading**.

Cascading sales taxes can create serious economic problems. For example, suppose one furniture manufacturer chops down trees, does all the wood machining, shaping and assembly itself, and runs its own retail stores. But another furniture manufacturer buys semi-finished wood from a lumber company, which in turn bought it from a timber company. And suppose that the second manufacturer sells its furniture at wholesale to unrelated retail stores. Only the final retail furniture sales of the first, integrated manufacturer will be taxed, since until then, the furniture and its components never change ownership. But under a “cascading” sales tax system, the products of the second manufacturer would be taxed four times: first when the wood is purchased by the lumber company, second when purchased by the furniture manufacturer, third when bought by retailers, and finally when sold to consumers at retail. Such a strange tax system would give the products of the integrated company a huge competitive advantage over those of the second manufacturer—even though the multi-company approach to furniture making and sale might be just as economically efficient.

An oddity created by taxing business inputs is that the effective sales tax rate on income (that is, sales taxes as a percentage of income) may actually end up higher than the nominal sales tax rate. In other words, a state can have a 5 percent sales tax rate but there may be families that have 6 percent of their income going to sales taxes. This is caused by two related phenomena. First, families pay a higher price for a product because the tax on the purchases by businesses increases the cost of making, wholesaling and retailing the product. Second, the retail sales tax applies to this added increment in the price, compounding the problem.

Taxing business inputs can also undermine the methods used to make the sales tax less unfair. For example, if grocery stores pay sales tax on the smocks they buy for their clerks or the fees they pay their lawyers, and these taxes are passed on to their customers in the form of higher retail food prices, the benefit of exempting food from the sales tax is partially undermined. These examples illustrate that supposed “business loopholes” in the sales tax must be analyzed to see if they are sensible rules or undeserved tax breaks.

## **Sales Tax Holidays—Boon or Boondoggle?**

In recent years, lawmakers in more than a dozen states have sought to relieve the burden of sales taxes by enacting “sales tax holidays.” These are temporary sales tax exemptions for clothing, computers, school supplies, and other “back to school” expenses. Most sales tax holidays last only a few days.

Virtually any sales tax cut will provide larger benefits, as a share of income, to low-income taxpayers than to the wealthy. But sales tax holidays are a problematic way of achieving low-income tax relief, for several reasons:

- A one-week sales tax holiday for selected items still forces taxpayers to pay sales tax on these items in the other fifty-one weeks of the year, leaving a regressive tax system basically unchanged.
- Any sales tax exemption creates administrative difficulties for state governments, and for the retailers who must collect the tax. But a temporary exemption requires retailers and tax administrators to wade through a sheaf of red tape for an exemption that lasts only a few days.
- Sales tax holidays are poorly targeted, providing tax breaks to both wealthy taxpayers and nonresidents.
- Many low-income taxpayers don’t have the luxury of timing their purchases to coincide with week-long sales tax holidays. By contrast, wealthier taxpayers are likely to be able to time their purchases appropriately.
- Retailers know that consumers will shift their spending toward sales tax holidays to take advantage of the temporary tax exemption. Savvy retailers can take advantage of this shift by hiking prices during the holiday.
- Perhaps most important for cash-strapped lawmakers, sales tax holidays are costly. Revenue lost through sales tax holidays will ultimately have to be made up somewhere else.

Sales tax holidays do have advantages, of course. The biggest beneficiaries from a sales tax cut are the low- and middle-income families for whom these taxes are most burdensome. And the heavily-publicized manner in which sales tax holidays are typically administered means that taxpayers will be very aware of the tax cut they receive—and will know that state lawmakers are responsible for it.

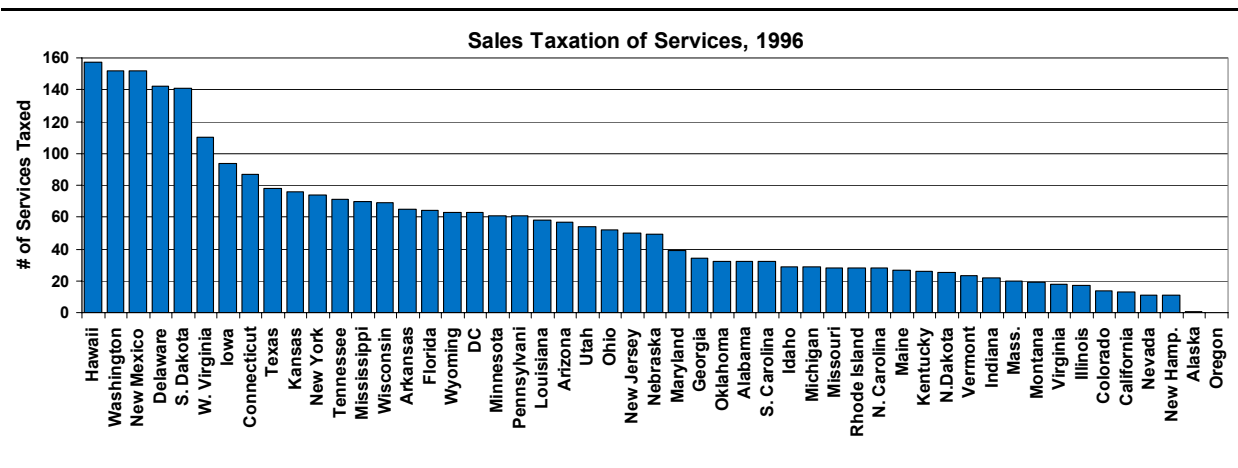
But in the long run, sales tax holidays are simply too insignificant to change the regressive nature of a state’s tax system—and may lull lawmakers into believing that they have resolved the unfairness of sales taxes.

## **Should Sales Tax Apply to Services?**

Most state sales taxes were enacted early in the twentieth century, at a time when most of the things people purchased were tangible goods like cars, furniture and books. But in the past fifty years, American consumer purchases have changed dramatically, shifting toward consumption of services like haircuts and car repairs. But few states have extended their sales tax to include services in their tax base. Only Hawaii, South Dakota, and New Mexico have a comprehensive service tax, and, according to the Federation of Tax Administrators, a majority of states still apply their sales tax to less than one-third of the 164 service categories that are potentially taxable. Though it can be politically difficult to accomplish, there are sound tax policy reasons for seeking to expand the sales tax base to include some—but not all—services.

The basic rule of thumb for which services should be taxed is very similar to the way states seek to tax goods: services consumed by individuals should be taxed, while services consumed by businesses in the process of producing goods and services of their own should be exempt. Taxing business services may seem tempting to lawmakers because of the potentially high revenue yield—but doing so will actually make sales taxes more unfair in the long run, since business sales taxes are (usually) passed through to consumers in the form of higher prices. Because these passed-through taxes are built into the prices of the goods we buy every day, the consumer doesn’t see these hidden taxes—and the amount of this hidden tax that is included in any particular retail purchase will vary depending on the number of taxed stages in the production process for a given retail item. But consumers will, in general, feel the pain from efforts to impose sales taxes on business services.

Taxing personal services can make the sales tax more fair in two ways. First, taxing services helps ensure that the amount of sales tax anyone owes will depend primarily on how much they



spend—not what they spend it on. There is nothing inherently better (or worse) for society in spending money on services as opposed to goods. Taxing goods but not services discriminates in favor of consumers who prefer services, and discriminates against those who prefer goods.

Expanding the sales tax base also makes the tax less regressive, because higher-income households spend more of their money on services while lower-income families primarily purchase goods. Of course, the sales tax will still be regressive overall no matter how broad the tax base is made. But taxing services can be an important step toward reducing sales tax regressivity.

Taxing services will also increase the amount of sales tax revenue collected at any given tax rate—which makes it less likely that lawmakers will be forced to raise the sales tax rate to balance budgets. And broadening the tax base makes sales tax revenues more stable in the long run, because declines in one area of taxable consumption will be offset by gains in another.

### Should Internet transactions be taxed?

A growing share of retail purchases are now being made on the Internet—and are not being taxed by states. According to a recent study, the total state and local revenue loss from “e-commerce” was \$15.5 billion in 2003.<sup>4</sup> The study projected that this revenue loss will reach \$21.5 billion by 2008. Left unchecked, this revenue loss will sap the vitality of state sales taxes.

From a tax fairness perspective, Internet-based transactions should be treated in the same manner as other retail transactions. That is, retail transactions that are taxable when sold by Main Street retailers should also be taxable when sold over the Internet, for several reasons:

- Exempting e-commerce transactions is unfair to Main Street retailers. Retailers who choose to sell their wares primarily in a “bricks and mortar” setting rather than making sales over the Internet are unfairly disadvantaged by a policy that exempts e-commerce.
- Exempting e-commerce transactions is also unfair to consumers. Consumers who are unable to access the Internet are unfairly disadvantaged by having to pay sales taxes on their purchases. Exempting Internet retail sales probably increases the regressivity of sales taxes as better-off taxpayers are able to avoid these taxes through Internet purchases.

However, states are currently powerless to remedy this source of unfairness. A series of U.S. Supreme Court decisions, most recently *Quill v. North Dakota* (1992), have found that states cannot require retailers to collect sales taxes on items purchased from remote sellers (that is, sellers based in other states). As a rationale for this decision, the Court cited the complexity of state and local sales tax systems. The Court argued that with so many states, counties, and municipalities

<sup>4</sup>Donald Bruce and William Fox, “State and Local Sales Tax Revenue Losses from E-Commerce: Estimates as of July 2004” Center for Business and Economic Research, (Knoxville: Univ. of Tennessee ) July 2004.

levying different taxes at different rates with different tax bases, forcing retailers to figure out the appropriate tax to collect on sales to each jurisdiction would impose an unacceptable administrative burden on these sellers.

However, the Court also indicated that this problem could be resolved, noting that there are good reasons to try to collect taxes on remote sales: even businesses that engage only in mail-order or Internet sales in a state still benefit from the public services that make these transactions possible—and should help to pay the cost of providing these services. The Court also noted that Congress could pass legislation allowing states to require sales tax collection on remote sales, and hinted that Congress would be more likely to pass such legislation if state lawmakers took immediate steps to simplify the current maze of tax bases and tax rates.

In recent years, states have responded to the Supreme Court's suggestion by cooperating to simplify their sales tax rules. The Streamlined Sales Tax Project (SSTP) was formed in April of 2000 by representatives of most states to develop a plan to simplify sales tax structures. In 2002, these representatives agreed on model legislation, called the Streamlined Sales and Use Tax Agreement (SSUTA), designed to be enacted by each state legislature. This legislation will become legally binding (in states enacting it) when 10 states representing 20 percent of the U.S. population enact it. However, even after this happens, the states will still be powerless to require the collection of sales taxes on remote sales until Congress acts to enable them. Although bills have recently been introduced in Congress that would allow states to collect sales tax on remote sales, these bills have so far failed to advance.

## How Excise Taxes Work

**E**xcise taxes are sales taxes that apply to particular products. Compared to sales, income and property taxes, excise taxes do not raise very much revenue. This is primarily because excise taxes lack a broad base, focusing instead on a narrow base of a few products—typically tobacco, fuel, and alcohol. Unlike general sales taxes, excise taxes usually are applied on a per-unit basis instead of as a percentage of the price. For instance, cigarette excise taxes are calculated in cents per pack. And most gasoline excise taxes are imposed in cents per gallon.

Because excise taxes are generally not itemized on consumer receipts, they tend to be invisible to the taxpayer. In the case of gasoline taxes, some states have one tax when fuel enters the state and another that is applied at the pump. New York, for example, has what appears to be one of the lowest state gasoline tax rates at only 8 cents per gallon. But after adding in the Petroleum Testing Fee, the Petroleum Business Tax, the Supplemental Business Tax and the Oil Spill Cleanup and Removal Tax, however, the New York tax that shows up in the pump price is around 32 cents per gallon. Consumers don't see these taxes in the price—but they're still there.

## Excise Taxes Are Regressive

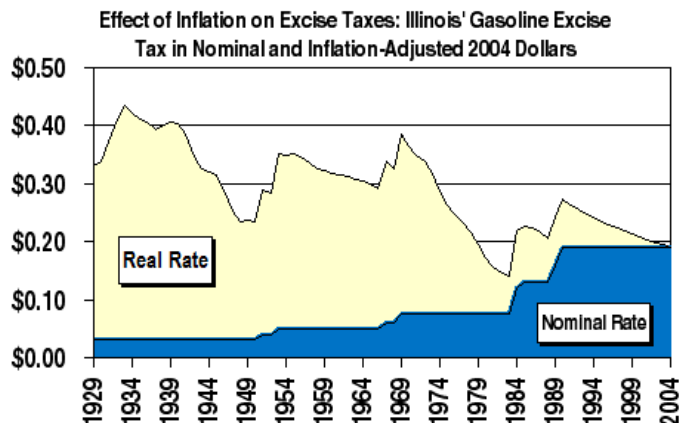
**L**ike sales taxes, excise taxes apply to purchases that take more of the income of middle- and low-income families than of the rich. But excise taxes are usually even more regressive than general sales taxes.

With a sales tax, the tax is at least related to the price of the thing purchased. So the sales tax paid on a wealthy person's Mercedes is more—in dollars—than the tax on a middle-income family's Chevrolet. But because excise taxes are usually calculated on a per-unit basis, it doesn't matter that rich people often buy more expensive things. The tax is the same on premium wine and beer as on less expensive brands. Moreover, there are natural limits on what can be spent on most items subject to excise taxes. Rich people typically don't drive more in a year than do middle-income families, so their gasoline tax bills are almost the same in absolute dollars. As a result, the share of income spent by the wealthy on excise taxes is particularly low.

## A Slow-growth Tax

Excise tax revenues tend to grow very slowly, which makes them an inadequate source of revenue over the long run. The per-unit base of excise taxes means that these taxes inherently grow more slowly than the economy.

Excise tax revenue grows only when the volume of the commodity sold grows, and does not respond to changes in prices. In an inflationary environment, this means that states must continually raise the rates of excise taxes just to keep revenues up with inflation. The chart at right shows the legal rate and the inflation-adjusted rate of Illinois' gasoline excise tax over time.



## No Federal Deductibility

Excise taxes are not deductible in computing federal taxable income. As a result, every dollar paid by residents of a state in excise taxes is a dollar out of their pockets. There is no offsetting reduction in federal income taxes for those who itemize deductions.

## “Sin” Taxes

A sin tax is a tax (almost always an excise tax) levied on a good or service that is deemed to be in some way detrimental to society—typically products such as alcohol, cigarettes, and gasoline. Proponents of sin taxes argue that these taxes are good because they discourage a particular behavior—smoking, for example, or driving gas-guzzling cars—by raising the price of the product. If the tax is imposed *for the express purpose* of affecting behavior rather than raising revenue, the tax may be successful. However, many policy makers cloak their desire for a revenue generator with these arguments, and as a revenue generator, a sin tax is inherently flawed.

Most revenue sources are expected to grow with inflation and an increasing population; most sin taxes, however, are a naturally *decreasing* source of funding. As the tax increases, consumption—and revenues—will decrease. Many states are using these revenues to support programs, such as education or health programs, that have a naturally increasing need for funding. The result is that, while sin taxes may bring in enough revenue to support the designated program for a few years, in the long run a deficit will inevitably appear unless the taxes are raised yet again.

## Excise Tax Issues

Excise taxes are inherently regressive. In some cases, however, a slight improvement can be made by making an excise tax apply to the value of the goods taxed instead of basing it on the number of units purchased. For instance, having a 4 percent tax on the value of liquor is somewhat less regressive than a 60 cents per-bottle tax. With the 4 percent tax, the amount due would be 40 cents on a \$10 bottle of liquor and \$1.20 on a \$30 bottle. Thus, those who can afford more expensive brands will pay more, in dollar terms. Of course, as a share of income the tax will still be very regressive—but less so than if the tax is a flat amount per bottle.

Some states have tried to improve upon the gasoline excise tax by enacting a variable tax rate, indexing the rate for inflation. Wisconsin, for example, adjusts its gas tax rate every April based on the U.S. Consumer Price Index. Six other states also tax gasoline on a variable basis.

## CHAPTER FOUR

# PROPERTY TAXES

The property tax is the oldest major revenue source for state and local governments. At the beginning of the twentieth century, property taxes represented more than eighty percent of state and local tax revenue. While this share has diminished over time as states have introduced sales and income taxes, the property tax remains an important mechanism for funding education. But property taxes are regressive, and because these taxes are usually collected at the local level, the unequal distribution of wealth between rich and poor school districts can lead to inequitable school funding. The challenge facing state lawmakers today is to preserve this important revenue source while making the tax less regressive, and reducing the disparities in school funding between rich and poor districts. This chapter surveys the basic workings of the property tax, and assesses its weaknesses and strengths.

### The Property Tax: How it Works

Historically, property taxes applied to two kind of property: **real property**, which includes land and buildings, and **personal property**, which includes moveable items such as cars, boats and the value of stocks and bonds. Most states have moved away from taxing personal property and now impose tax primarily on real property. In its simplest form, the real property tax is calculated by multiplying the value of land and buildings by the tax rate. Property tax rates are normally expressed in **mills**. A mill is one-tenth of one percent. In the most basic system, an owner of a property worth \$100,000 that is subject to a 25 mill (that is, 2.5 percent) tax rate would pay \$2,500 in property taxes.

In reality, however, property taxes are often more complicated than this. The first step in the property tax process is determining a property's value for tax purposes. This means estimating the property's **market value**, the amount the property would likely sell for. The second step is determining the property's **assessed value**, its value for tax purposes. This is done by multiplying the property's market value by an **assessment ratio**, which is a percentage ranging from zero to one hundred. Many states base their taxes upon actual market value—in other words, these states use a 100 percent assessment ratio.

But many states assess property at only a fraction of its actual value. New Mexico assesses homes at 33.3 percent of their market value, and Arkansas uses a 20 percent assessment ratio. And even when the law says properties should be assessed at 100 percent of their value, local assessors often systematically under-assess property, reporting assessed values that are substantially less than the real market value of the property.

#### Effective versus Nominal Rates—An Example

Here's an example of why it's important to look at effective tax rates instead of nominal rates. Property tax assessments vary greatly between localities, with some places assessing property at only a fraction of its real value. So some localities are applying their tax to a broader base than others.

By only comparing nominal rates, one might conclude from the example below that Town A has higher property taxes than Town B. But by looking at effective tax rates we see that the property tax burdens are, in fact, equal. Effective rates take into account the different assessment practices in Town A and Town B. (Town A assesses at 50 percent of market value, Town B at 100 percent).

Calculation of Property Tax	Town A	Town B
1. Nominal Tax Rate	3%	1.5%
2. Real Market Value	\$100,000	\$100,000
3. Assessed Value	\$50,000	\$100,000
4. Tax (line 3 times line 1)	\$1,500	\$1,500
5. Effective Rate on Market Value (line 4 divided by line 2)	1.5%	1.5%



Many states reduce a property's assessed value further by allowing exemptions. For example, Florida allows an exemption for the first \$25,000 of home value. Subtracting all exemptions yields the **taxable value** of a property.

The next step in the process is applying a property tax rate, also known as a **millage rate**, to the property's taxable value. The millage rate is usually the sum of several tax rates applied by several different jurisdictions: for example, one property might be subject to a municipal tax, a county tax, and a school district tax. This calculation yields the property tax owed.

The rate most property owners are familiar with is the nominal rate—the actual tax rate used in calculating your bill. But when comparing property taxes across districts or across states, analysts will often look at effective property tax rates, which are usually calculated by expressing the property tax as a share of market value. Expressing property taxes this way gives us a better sense of how all exemptions and assessment ratios affect the tax paid.

Many states allow property tax credits that either directly reduce the property tax bill, or that reimburse part of the property tax bill separately when taxpayers apply for them. These property tax relief mechanisms are described later in this chapter.

## A Regressive Tax

**A**lthough sales and excise taxes are the most regressive taxes, they are rarely as maligned as the property tax. The “sticker shock” effect of the property tax is partly to blame for this: it's a large, very noticeable payment that is made once or twice a year, while sales taxes are spread throughout the year on hundreds of purchases. So the property tax often seems more oppressive and more unfair than it actually is, simply because it's more visible.

That said, there is no denying that the property tax is generally regressive. Nationwide, low-income families paid 3.0 percent of their income in property taxes in 2002, while middle-income families paid 2.4 percent of their income and the wealthiest taxpayers paid just 0.8 percent.

The chief reason that property taxes are regressive is that they are based on home values rather than on income levels—and home values do not always vary directly with income levels. Home values represent a much larger share of income for middle- and lower-income families than for the wealthy. For example, it is common for a middle-income family to own a home valued at two or three times their annual income, but wealthier taxpayers are less likely to own homes worth as much relative to their income levels.

Moreover, property taxes are not responsive to variations in taxpayers' income: someone who suddenly loses his job will find that his property tax bill is unchanged, even though his ability to pay it has drastically fallen. (By contrast, income tax bills depend on the level of earned income, so income taxes are much more sensitive to taxpayers' ability to pay—an important consideration in times of economic hardship.) And the property tax can be especially burdensome for elderly taxpayers at the end of their working careers who find themselves “property rich” but “cash poor.”

### Who Bears the Brunt of Taxes on Homes?

*Is it...*

#### Warren Buffett, of Omaha, Nebraska--One of the 400 Richest Americans?\*

Net Worth	\$36 billion
Taxable Value of Home	\$690,300
Home Value as % of Net Worth	0.002%
<b>Tax as % of Net Worth</b>	<b>0.00004%</b>

\*"400 Richest in America," Forbes, 2003; Omaha World Herald, 8/22/03

*Or is it...*

#### Susan Anybody, a Hypothetical Middle-Income Homeowner?

Net Worth:	\$80,000
Taxable Value of Home	\$50,000
Home Value as % of Net Worth	62.5%
<b>Tax as % of Net Worth</b>	<b>1.3%</b>

When the United States was an agrarian society, the property tax was a fair form of taxation. The value of a citizen's land and buildings was an excellent measure of her wealth. But today, rich families have most of their wealth in other forms of property—stocks, bonds, etc. These forms of property are usually not taxed. According to one recent study, in 2001 real estate represented less than twenty percent of the assets of the richest 0.5 percent of wealth-holders.<sup>5</sup>

Low- and middle-income families, however, still have most of their limited wealth invested in their homes. Because the wealthy have relatively little of their wealth invested in property subject to the real property tax, while the most valuable thing a middle-income family owns is its house, much more of a middle-income family's wealth is subject to the property tax.

## Business Property Taxes

Of course, homeowners don't pay all of the property tax. Businesses pay it as well. Property taxes on business are mostly borne by business owners. (The special case of residential rental property is discussed below.) This makes the property tax less regressive since business owners tend to be wealthier than average. Also, some of the business property tax is exported to property owners living in other communities and other states. The business property tax is important because without it, many businesses that use local government services would go largely untaxed.

## Residential Rental Property

While the public's attention to property taxes is usually focused on the taxes paid by homeowners, the property tax also affects taxpayers who rent, rather than own, their home. Who ultimately pays the property taxes on residential rental real properties is disputed. Some economists believe that it is mostly borne by the landlords who own these rental properties. Others argue that it is mostly passed through to tenants in the form of higher rents. It is generally agreed that the answer partially depends on the rental market. When residential rental property is in short supply, landlords are more likely to pass their property taxes on to renters in the form of higher rents. But if rental property is abundant, landlords may find this more difficult.

Of course, most rental markets are not purely dominated by either tenants or landlords—so the answer probably is somewhere in between. And the matter is confused further because many rental markets cross municipal boundaries so that taxes vary on rental units in different parts of the market. Landlords in higher tax jurisdictions can't simply raise rents to pay their property taxes if they have to compete with apartments in nearby, lower tax jurisdictions.

Two things are certain about property taxes on rental property. First, owners lobby against property tax hikes as if they think owners pay the tax, but when they try to raise rents they tell their tenants that tenants have to pay it. Second, because renters as a class are poorer than homeowners, "property tax relief" (discussed below) paid directly to renters is progressive regardless of whether the relief really is related to tenants' actual property tax burdens.

## Personal Property Taxes

Personal property is all property other than real estate. Personal property taxes usually apply to **tangible** property such as individually-owned cars and trucks or business equipment. The tax can also apply to **intangible** property such as stocks and bonds.

Taxing tangible personal property is relatively straightforward, in theory. In the case of cars and trucks, the tax is usually a percentage of the "blue book" value of the vehicle. Since people

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<sup>5</sup>Arthur Kennickell, "A Rolling Tide: Changes in the Distribution of Wealth in the US, 1989-2001", November 2003. Levy Economics Institute Working Paper No. 393.

have to register their vehicles, it's hard to avoid the tax. And business equipment can be assessed based on income tax return data for depreciation deductions.

The most common type of state personal property tax is on individually-owned cars and trucks. Although at first glance this tax may appear to be progressive (rich people have more expensive cars), it is not. Personal property taxes on automobiles are regressive for the same reason residential property taxes are regressive: the value of a person's car (or home), as a share of their income, is higher for low-income people than for the wealthy.

On the other hand, business personal property taxes and, especially, intangible property taxes on stocks and bonds are progressive because the wealthy own far more business property and intangible assets than do middle- and low-income people. It's also easy to exempt low- and middle-income people from an intangible property tax by providing generous exemptions.

Unfortunately, taxation of intangibles is hard to enforce because of the difficulty in valuing many taxable stocks and bonds and the ease of hiding many intangible assets. If these problems can be solved, however, an intangibles tax is extremely progressive, and can be a substantial revenue raiser, even with very low rates.

Florida raised \$717 million in 2001 from its intangibles tax. Enforcement is, however, largely confined to intangibles for which income is reported on the federal income tax. It is widely believed that there is a significant compliance problem in Florida—with much of the intangible wealth of rich Floridians escaping taxation.

## Revenue and Stability

Property taxes are generally more stable over time than the income or sales tax. This is because property tax revenue depends on property values, not income. When personal income grows rapidly, property taxes will generally not grow as fast—and slower personal income growth is not always reflected in slow property tax growth. If property values are inflated prior to a recession, they will tend to fall once a recession starts. If an area is particularly hard hit by an economic downturn—if a town loses its leading industry, for example—property values also probably will fall. On the other hand, where property values were not inflated and a downturn is not catastrophic, it is not uncommon for property values to hold relatively steady during a recession.

Unfortunately, property tax stability also means that people who are hardest hit during a recession—people who lose their jobs—don't get any relief. Property taxes are insensitive to variations in taxpayers' income: a taxpayer who suddenly becomes unemployed will find that her property tax bill is unchanged, even though her ability to pay it has fallen. By contrast, income taxes vary with income, so income taxes are more sensitive to taxpayers' ability to pay.

## Deductible in Computing Federal Income Tax

Property taxes, like state and local income taxes, are deductible in calculating federal taxable income (for those who itemize their returns.) This means, in effect, that a portion of a state resident's property tax bill is "exported" to the federal government in the form of reduced federal income tax for itemizers, and never comes out of the pocket of state residents.

Because property taxes are much more regressive than income taxes, the lion's share of these taxes are paid by low- and middle-income taxpayers who are less likely to itemize. This means that property taxes offer a lower "bang for the buck" than income taxes in terms of the federal offset.

Car taxes are deductible, but only when they are calculated as a percentage of the car's value. Car taxes that are based on a flat dollar amount cannot be deducted. This is an important consideration because almost all states levy flat-dollar car "registration fees" that cannot be deducted.

## Property Tax Relief Options

As states have moved away from heavy reliance on property taxes, a variety of different mechanisms have been introduced for providing residential tax relief. This section surveys various approaches to property tax relief, including general exemptions, targeted low-income tax credits, “split roll” taxes and income tax-based deductions and credits.

### Homestead Exemptions

More than forty states now allow some form of a **homestead exemption**, which reduces property taxes for all homeowners by sheltering a certain amount of a home’s value from tax. Homestead exemptions are a progressive approach to property tax relief, providing the largest tax cuts as a share of income to lower- and middle-income taxpayers.

There are two broad types of homestead exemptions: flat dollar and percentage exemptions. Flat dollar exemptions are calculated by exempting a specified dollar amount from the value of a home before a property tax rate is applied. A flat dollar exemption is especially beneficial to low-income homeowners, because it represents a larger share of property taxes (and of income) for low-income taxpayers. Percentage exemptions give the same percentage tax cut to all income levels. This form of exemption is also progressive—but is less effective at targeting relief to poor taxpayers than are flat exemptions.

The table at right illustrates this point using two examples. If the state allows a flat exemption for the first \$15,000 of home value, a home worth \$60,000 will see a 25 percent property tax cut. A home worth \$500,000, however, will only see a 3 percent property tax cut. By contrast, a percent exemption will give each taxpayer the same percentage cut.

Fixed dollar exemptions tend to become less valuable over time. In Florida, for example, the average home value jumped from \$88,000 in 1998 to \$140,000 in 2003—a 59 percent increase in

only five years. But during that time, the value of Florida’s homestead exemption remained at \$25,000. So for most Florida homeowners, the exemption is now a much smaller portion of their home value than it was in 1998. Indexing exemptions (that is, automatically increasing the exemption every year to take account of the rising cost of living) can avoid this unintentional tax hike.

While homestead exemptions are a progressive approach to property tax relief, they have two important flaws: first, they provide no tax relief to renters, even though renters are generally agreed to pay some property tax indirectly in the form of higher rents. Second, exemptions are poorly targeted and costly. Because most homestead exemptions are not targeted to low- and middle-income taxpayers, but are available to even the wealthiest homeowners, they are especially costly—and provide little “bang for the buck” to low-income taxpayers.

### Circuit Breakers

The property tax **circuit breaker** is a less expensive, more targeted approach to tax relief. Its name reflects its design. Because it protects low-income residents from a property tax “overload” just like an electric circuit breaker: when a property tax bill exceeds a certain percentage of a taxpayer’s income, the circuit breaker reduces property taxes in excess of this “overload” level.

Circuit breakers usually give homeowners a credit equal to the amount by which their property tax bill exceeds a certain percentage of their income, though there is usually a cap

Flat Dollar versus Percentage Exemptions: Who Benefits? [Calculation Assumes 20 Mil (2 percent) Rate]		
Assessed Home Value	\$60,000	\$500,000
Tax Without Exemption	\$1,200	\$10,000
<b>Flat \$ Exemption</b>	\$15,000	\$15,000
New Taxable Value	\$45,000	\$485,000
Tax With \$ Exemption	\$900	\$9,700
<b>Tax Cut</b>	<b>25%</b>	<b>3%</b>
<b>Percent Exemption</b>	15%	15%
Exemption in \$	\$9,000	\$75,000
New Taxable Value	\$51,000	\$425,000
Tax With % Exemption	\$1,020	\$8,500
<b>Tax Cut</b>	<b>15%</b>	<b>15%</b>

limiting the total amount of credit allowed. Circuit breakers are usually made available only to low-income taxpayers, on the theory that property taxes are most burdensome for the least wealthy homeowners. Because it is generally agreed that renters pay property tax indirectly in the form of higher rents, many states now extend their circuit breaker credit to renters as well. The calculation is the same as for a homeowner, except that some percentage of the rent you pay is assumed to be the property tax paid. Renters in Michigan, for instance, use 20 percent of their rent as their assumed property tax in calculating their circuit breaker credit.

The ability to target circuit breakers to those taxpayers most in need means that virtually none of the property tax relief from a circuit breaker credit will be offset by federal income tax hikes for itemizers. By contrast, when a homestead exemption reduces the property tax paid by a wealthy homeowner, that homeowner will have less property tax to claim as an itemized deduction on his federal tax return—which means that his federal taxes will go up.

Like the homestead exemption, circuit breakers must be indexed for inflation in order to preserve the value of this tax break for low-income taxpayers. For example, if the Illinois circuit breaker’s maximum income level for eligibility and the maximum credit amount had been indexed for inflation since it was first introduced in 1972, the income threshold would have been \$45,000 in tax year 2004—more than double the current value for unmarried taxpayers—and the maximum value of the credit would have been more than four times its current value.

The main drawback of circuit breakers is that, in general, they only are given to taxpayers who apply for them. (By contrast, homestead exemptions are usually given automatically to eligible taxpayers.) Eligible taxpayers will only apply for tax credits if they are aware of their existence. This means that an essential component of a circuit breaker program must be an educational outreach effort designed to inform state taxpayers of the credit. In addition, one way of making it easier for eligible taxpayers to claim the circuit breaker is to make it possible to claim the credit either on income tax forms or on a separate circuit breaker form (for those who do not have to file income tax forms).

### Split Roll

A third way to provide progressive property tax relief is a split roll, also known as a “classified property tax.” Unlike a regular property tax, which taxes the value of all real property at the same rate, a split roll property tax applies different effective tax rates to different types of property. One approach to a split roll property tax is taken by the District of Columbia, which taxes homes at a lower rate than business properties. This shifts some of the property tax burden from homeowners to businesses. The chart on this page shows the current tax rates in the District of Columbia.

District of Columbia Split Roll Property Tax Rates, 2004		
Class	Tax Rate (in Mills)	Description
I	9.6	Residential
II	18.5	Commercial
III	50	Vacant

A second approach is to assess homeowners at a lower percentage of their value than other types of property. For example, Utah assesses all residential properties at 55 percent of their value, and assesses all other types of property at 100 percent of their value. A single tax rate is then applied to all properties of all types within each taxing district. This approach has exactly the same impact on tax fairness as the District of Columbia approach of using different tax rates.

Split roll taxation has three main shortcomings. First, it’s poorly targeted. Every homeowner pays a lower tax rate because of the split roll, from the very poorest to the very wealthiest. And the lower rate is available to anyone who owns a property—even those whose principal residence is in another state. A better-targeted approach would provide tax cuts only for the low- and middle-income homeowners for whom these taxes are most burdensome. Second, reducing the property tax on one class of property inevitably means shifting a greater share of the tax onto other groups. Unless lawmakers ensure that the “residential” property tax owner includes renters

as well as homeowners, split roll taxation can actually make the property tax less fair by shifting the property tax burden from homeowners to low-income renters.<sup>6</sup> Third, the split roll makes property tax administration more complicated, because it requires tax administrators to determine not just the value of each property, but also its use.

### **Income Tax Breaks for Property Taxes**

Most states provide property tax relief through their income tax forms. This is done in two ways: itemized deductions and income tax credits. More than thirty states allow itemizers to deduct their property tax payments from their taxable income. Since these deductions are usually only available to state itemizers—and can only be claimed by those who pay state income taxes—this approach to property tax relief excludes many of the low-income homeowners for whom property taxes are most burdensome.

A few states provide other forms of income-tax-based property tax relief. Illinois, for example, allows taxpayers to claim a non-refundable income tax credit equal to 5 percent of the property taxes paid on their home. Credits are usually a more progressive approach to tax relief—but when these credits are non-refundable, those who don't pay enough income tax to claim the full credit receive less relief, despite the fact that these “income-poor, property-wealthy” taxpayers are often less able to pay property taxes than most.

### **Property Tax Issues**

Property taxes are the most venerable revenue source for state and local governments—but there is some concern that these taxes are unsuitable for the needs of the modern state. This section looks at two such areas of concern: the impact of regional inequities in property wealth on the quality of public education in poor districts, and the quality of property tax assessment.

#### **Property Taxes and Education Financing**

The primary purpose of local property taxes is to fund schools. But property wealth is usually distributed unequally between taxing districts. As a result, property-poor districts are not able to fund education as easily as property-wealthy districts. For example, in 2000 the Lake View school district in Arkansas raised only \$827 per student in local revenue—just over a quarter of the \$3,200 per student raised by the much wealthier Little Rock school district in that year. Left to their own devices, low-wealth districts typically have to tax homeowners at a much higher rate—and still don't raise as much revenue per-pupil as a wealthier district can. This sort of inequity between poor and wealthy districts has been the basis for a series of court cases challenging the constitutionality of school funding systems in various states.

Even property-wealthy districts can find it difficult to raise enough money to fund schools adequately using property taxes. As a result, almost every state has enacted a program of state aid to local school districts, designed to provide a guaranteed minimum amount of education spending per pupil while minimizing the gaps in spending between poor and wealthy districts.

What can go wrong with a school funding system that works in this way? First, the baseline amount of spending per pupil may be well short of the amount required to achieve an adequate education—that is, states can achieve equity without achieving adequacy. Second, property-wealthy districts can usually raise *more* than this state-sponsored amount per pupil without relying on state help—which means that the amount spent on education will differ between poor and wealthy districts, even after taking account of state aid. Some argue that as long as these differences between poor and wealthy districts remain, equity will not have been achieved.

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<sup>6</sup>This was originally true of the D.C. split roll system. Until quite recently, homeowners paid a tax rate of 0.96 percent and rental properties paid 1.54 percent. But tax changes enacted in 1999 reduced the property tax rate on residential rental real estate to equal the homeowner rate.

One tax reform option for the growing number of states that are now confronting court mandates to fund schools adequately and equitably is to preserve the role of property taxes in funding schools by replacing some of their current local property taxes with a statewide property tax levied at a uniform rate. The statewide property tax requires the same level of effort from all taxing districts in a state, and reallocates some of the resulting tax revenue between wealthy and poor districts in a way that equalizes the revenue-raising ability of all districts.

### Assessment Practices

The most important step in the property tax process is assessing the value of a property. After all, home value is the basis for measuring a homeowner's ability to pay—so the property tax will only be as fair as the assessment process. Unfortunately, many jurisdictions don't assess property fairly. Some states don't require regular reassessment of property. In other states, there can be significant variation in assessed values between properties that are actually very similar. When assessment practices are poor, two families with identical homes and the same income level could face different property tax bills. This undermines people's faith in the fairness of the tax system and erodes public support for the taxes needed to pay for government services.

Local assessors routinely assess properties at less than what the law prescribes. For example, a typical state might require that residential properties be assessed at 100 percent of their market value, but assessors might actually assess these properties at an average of 90 percent of their market value. From a tax collector's point of view, this approach has two virtues. First, it gives taxpayers the illusion that government is giving them a good deal by taxing only part of their home values. This is an illusion because the underassessment, by necessity, is offset by a higher property tax rate. Second, underassessment reduces the likelihood of legal challenges to assessments. Unless homeowners compare their assessments with those of other homeowners, even large and unfair discrepancies will not be detected.

When property is under-assessed not because of poor-quality assessments but because of legal rules requiring low assessment ratios, fairness can be undermined as well. If assessments are at full value, inaccurate assessments stand out. But if property is legally assessed at (for example) 20 percent of its true value, it becomes much harder to detect variations in assessment quality because the assessed value is hard to compare to a homeowner's sense of the home's true value. Thus, underassessment makes unfair or corrupt assessment practices more difficult to detect.

Poor or infrequent assessment can also make it difficult for lawmakers to equalize differences between poor and wealthy districts' ability to fund schools. Most state school-aid programs are based on the property wealth of each district—and poor-quality assessments make it hard to know which districts are truly poor and which are simply under-reporting their assessed value. For this reason, reform of local property assessment practices must usually be done before school finance reform can be accomplished at the state level.

Important steps lawmakers can take to ensure transparency in the property assessment process include:

- Hiring and training professional assessors;
- Making assessed valuation information publicly available;
- Assessing property at its full value so taxpayers can understand how they are being taxed.

### Conclusion

Property taxes are generally regressive, and relying on local property taxes to fund education can create unfair disparities between poor and wealthy districts. But the property tax plays an important role in funding public services, and progressive tax reform can help make the tax a sustainable—and less unfair—revenue source for the twenty-first century.

# PERSONAL INCOME TAXES

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**T**he personal income tax can be—and usually is—the fairest tax. When properly structured, it makes wealthier taxpayers pay their fair share, eases the tax load somewhat on middle-income families and completely exempts the poor. Because the personal income tax is the only major progressive tax levied by states, it provides an important counterbalance to regressive sales, excise and property taxes.

But in many states, the income tax fails to live up to its potential. Some states have flat tax rates, while others tax at least some of the income of families living in poverty. And many states allow expensive, poorly targeted tax breaks that favor wealthier taxpayers. This chapter explains the basic workings of the income tax and discusses important issues that should be addressed in order to ensure the continued fairness and adequacy of this tax.

### How It Works

**A**lmost all states with personal income taxes tie their income tax base to federal tax rules. This means that income taxpayers can do their federal income taxes and then copy their total income from the federal tax forms to their state tax form. This time-saving step makes income taxes easier to file—and makes it easier for tax administrators to monitor compliance. Most states link to federal adjusted gross income (AGI), which is income before exemptions and deductions, and then allow their own special exemptions and deductions. A few states link to federal taxable income, which already includes the generous federal exemptions and deductions, and then apply their own tax rates. A few states do not link to the federal tax base at all.

### Which Income is Taxed—and Which Is Exempt?

The federal income tax and most state income taxes apply to most, but not all, types of money income.<sup>7</sup> But different types of income are, in some systems, taxed differently:

- **Wages and salaries** are almost always taxed. However, “fringe benefits” such as employer-paid health insurance are usually tax-exempt, and taxes on employer contributions to pension plans are deferred until the money is paid out at retirement.
- **Interest** from bank accounts and bonds is generally taxed. A few states, however, exempt some interest. For example, Massachusetts excludes the first \$100 (\$200 for a married couple) of interest received from Massachusetts banks. Interest from government bonds usually gets preferential treatment: interest from federal treasury bonds is exempt from state taxation, and interest from state and municipal bonds is exempt from the federal tax. States often exempt interest on their own bonds, while taxing other states’ bonds.
- **Business income or loss** for individuals is the taxable profit (or loss) from unincorporated businesses. People who are self-employed report their taxable business results on Schedule C. For example, if someone makes and sells furniture, he or she reports the gross proceeds from selling the furniture minus deductible expenses such as the cost of wood, tools and advertising. Partnership income is reported similarly: each partner reports his or her share of taxable partnership profit or loss on Schedule E. Farm profits and losses are reported on Schedule F. Because of a variety of special tax concessions for farming, most people filing farm tax returns claim “losses” rather than profits for tax purposes.

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<sup>7</sup>New Hampshire and Tennessee tax only interest and dividend income, and half a dozen states have local income taxes that apply only to wages.



From 1988 to 2002, taxable farm profits reported to the IRS were \$138 billion, but tax-deductible losses totaled \$223 billion.

- **Rental income** is reported on a separate form on federal tax returns. Gross rents are offset by various expenses. One “expense” that is commonly used to reduce taxable rental income is “depreciation.” For tax purposes, rental real estate is assumed to gradually lose its value, or depreciate, over time. (Of course, this is usually a fiction—rental real estate typically becomes more valuable over time.) For some real estate professionals (broadly defined), depreciation expenses can be used to reduce not just rental income but other income as well. But for most people, depreciation can only reduce taxable rental income. This makes it less attractive for people to invest in real estate solely as a tax shelter—a widespread tax-avoidance scheme before 1986 federal legislation narrowed this loophole.
- **Capital gains** are profits from the sale of assets such as stocks, bonds and real estate. Income tax on a capital gain is paid only when the asset is sold. Thus, a stockholder who owns a stock over many years doesn’t pay any tax as it increases in value each year. He or she pays tax only when the stock is sold. At that time, the capital gain is calculated by taking the difference between the original buying price and the selling price.<sup>8</sup> The federal government now taxes capital gains at a far lower rate than wages. A few states also provide capital-gains tax breaks. State capital-gains tax breaks are discussed on page 34.
- **Dividends** are the part of a corporation’s earnings that are distributed to its shareholders. Until 1986, the first \$100 (\$200 for married couples) of dividends was exempt from the federal personal income tax. From 1986 to 2002, dividends were taxed as regular income. The 2003 Bush tax cuts created a special set of lower tax rates for dividend income. A few states allow special dividend exclusions of their own.
- **Transfer payments**, such as welfare benefits, unemployment compensation and Social Security benefits are subject to a variety of different rules. The federal income tax exempts welfare, treats unemployment compensation the same as wages and taxes a fraction of Social Security benefits above certain income levels. A few states follow the federal rule and tax some Social Security benefits, but most states completely exempt Social Security.
- **Pension income** is generally taxable at the federal level, with an offset for already-taxed employee contributions to pension plans. Many states exclude all or some government pension income from taxation, and some even exempt private pension income. Some states provide targeted pension tax relief, available only to lower-income taxpayers.

### “Adjustments” and Adjusted Gross Income

Once all of a taxpayer’s taxable income is added up, **adjustments to income** are subtracted. Some adjustments appear on federal tax forms—and most states following federal rules will include these adjustments, too. For example, contributions to retirement accounts by self-employed people are subtracted from total income as an adjustment on federal forms, and most states have chosen to conform to federal rules by allowing the same tax break. Other examples of typical adjustments are alimony and health insurance payments by the self-employed. On federal forms, **adjusted gross income** is the income that is subject to tax after subtracting these adjustments.

In addition to these federal adjustments, most states diverge from the federal starting point to allow at least one special deduction or targeted tax break of their own invention. These special

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<sup>8</sup>People who inherit property don’t pay income tax on capital gains that accrued during the original owner’s life. If Sally Jones buys stock in 1990 worth \$1,000, then dies in 2000 with it having a value of \$10,000, no income tax is ever paid on the \$9,000 of gain from 1990 to 2000. If her heirs sell the stock in 2002 for \$12,000, the heirs pay tax on only the \$2,000 gain from 2000 (the date of inheritance) to 2002.

breaks are the difference between the federal starting point (usually federal AGI) and a state's own adjusted gross income. Among the tax breaks commonly granted by states are:

- Exemptions for capital gains or dividends;
- Tax shelters for pension or Social Security benefits;
- Deductions for federal income taxes paid.

Every special state tax break has to be subtracted from income—which means it takes at least one line on your state's tax form. The main reason why state income tax forms—and instructions—are so complicated is because taxpayers must wade through these special tax breaks.

When these tax breaks discriminate between taxpayers who have a similar ability to pay, such unfair distinctions can make the tax system seem more arbitrary—and can undermine public confidence in the system. These tax breaks also make it harder to understand the overall effect of a tax system on people at different income levels.

### Computing Taxable Income

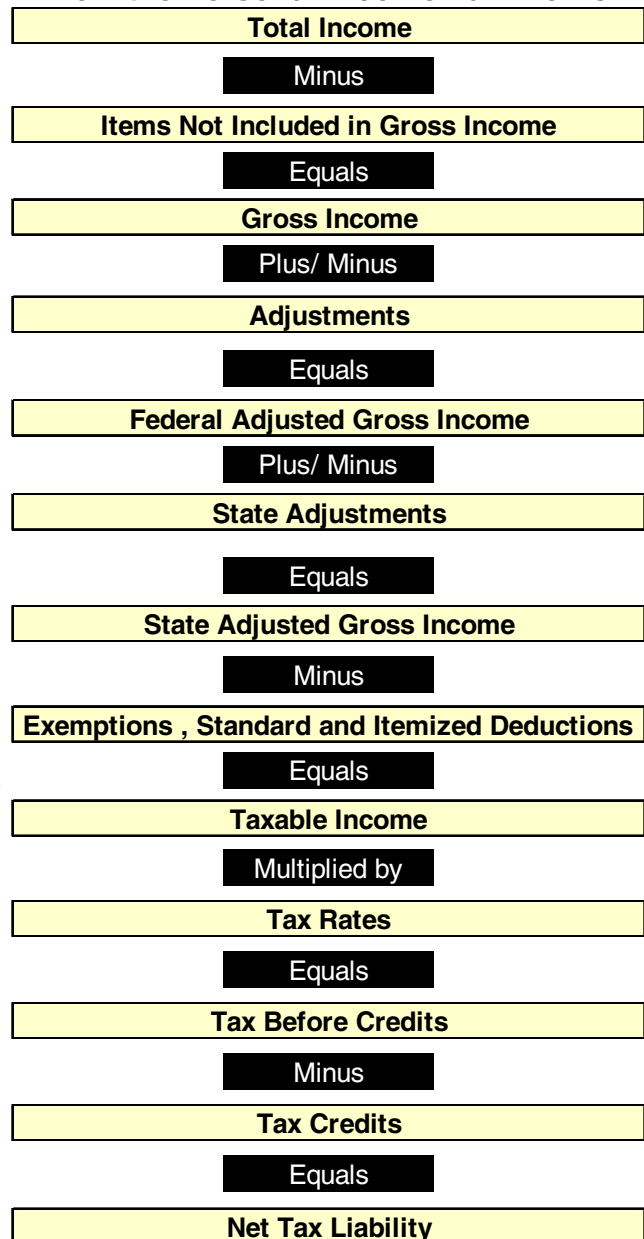
**Taxable income** is the amount of income that is subject to tax after subtracting deductions and exemptions from AGI. This is the amount to which the income tax rate(s) are applied.

In computing their taxable income, taxpayers usually have a choice of subtracting from AGI either a standard deduction or their total itemized deductions—whichever is larger. Generally, better-off families are more likely than lower-income families to have enough deductions to make itemizing worthwhile. Deductions related to homeownership are often what makes a family's itemized deductions exceed its standard deduction.

**Itemized deductions** are allowed for two main reasons. Usually the primary reason is to take account of large or unusual personal expenditures that affect a taxpayer's ability to pay. Itemized deductions are also offered as a way of encouraging certain types of behavior. For example, on the federal income tax return:

- Charitable contributions are deductible to encourage charitable giving, and because people who give income to charities have less money left over with which to pay income taxes.
- Mortgage interest paid by homeowners is deductible to encourage home ownership, and because the interest paid on mortgages is one of the principal costs associated with owning a home.
- State and local income and property taxes are deductible on the federal level because families that pay a lot in those taxes have less ability to pay federal income taxes than those who pay little. (By con-

### How the Personal Income Tax Works



trast, most states don't allow a deduction for their own income taxes, but do allow a deduction for property taxes.) Sales and excise taxes are generally not deductible, however, because Congress found that (a) they don't affect ability to pay very much for those who itemize, (b) they are difficult for taxpayers to compute and hard for tax agencies to audit, and (c) since they are regressive, states shouldn't be encouraged to rely too heavily on them. (Federal legislation in 2004 allows an optional, temporary deduction for sales taxes paid on 2004 and 2005 federal tax forms, but taxpayers claiming the deduction cannot write off their state and local income taxes—which means that this temporary deduction will generally only be useful—very modestly—for residents of non-income tax states.)

- Very large medical expenses are deductible to reflect taxpayers' reduced ability to pay taxes under adverse medical circumstances. At the federal level and in most states, medical expenses that exceed 7.5 percent of a taxpayer's adjusted gross income are deductible.

A **standard deduction** is a basic zero-tax amount, used by people whose itemized deductions total less than the standard deduction amount. The theory behind a standard deduction is that even those who do not have significant itemized deductions have a certain amount of income that should not be subject to tax.

On federal returns, the standard deduction is set at \$9,700 for couples, \$7,150 for unmarried parents and \$4,850 for single filers in 2004. (These amounts are increased every year to allow for inflation.) Twelve states allow the same standard deductions as the federal amounts; three allow larger amounts; and the rest have smaller standard deductions or don't allow one at all.

The final step in arriving at taxable income—the tax base to which income tax rates are applied—is to subtract **personal exemptions**.

At the federal level, the personal exemption is currently \$3,100 for each taxpayer and dependent (indexed each year for inflation). Thus, in 2004 a family of four gets a total of \$12,400 in federal exemptions. State personal exemptions vary greatly, but are usually less generous than the federal amounts. Some states provide additional exemptions for the elderly, disabled or veterans.

The theory behind exemptions is that at any income level, a taxpayer's ability to pay declines as family size increases: the more mouths to feed, the less money is left over to pay taxes. So if two families each make \$40,000 and family A has no children while family B has two, then family A has greater ability to pay. To adjust for this, family B gets two more exemptions than family A.

Some states tie their exemptions to the federal amount. Because federal exemptions grow each year with inflation, this is an administratively easy way to ensure that exemptions will not lose their value over time. States that fail to adjust their exemptions for inflation will end up imposing a hidden tax hike on their citizens over time. For instance, when the Illinois income tax was adopted in 1969, the state's personal exemption was set at \$1,000—and was subsequently left unchanged for thirty years. 1998 legislation doubled the exemption to \$2,000—but if the exemption had been kept up with inflation since 1969, it would currently be worth \$5,100. In other words, the Illinois personal exemption is worth \$3,100 less than it originally was. As a result, Illinois taxpayers paid \$900 million more in income taxes in 2004 than they would have if the exemptions had been adjusted to preserve their 1969 value.

## Tax Rates

Most states use **graduated rate** schedules where the **marginal tax rates** are higher as taxable income increases. In a graduated tax rate system, different marginal rates are assigned to different taxable income brackets. The table at right shows an example in which the first \$25,000 of taxable income is taxed at 2 percent, income from \$25,000 to \$40,000 is taxed at 4 percent, income from \$40,000 to \$100,000 is taxed at 6 percent and income over \$100,000 is taxed at 8 percent.

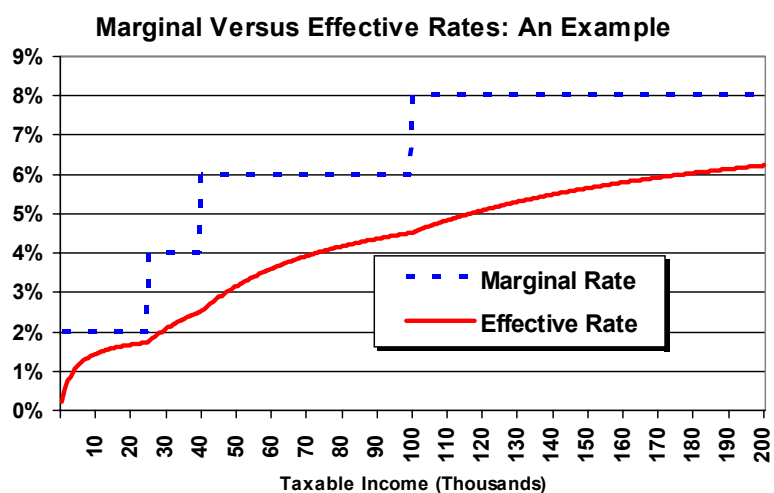
A Graduated Rate Schedule	
Taxable Income Bracket	Marginal Rate
0 - \$25,000	2%
\$25,000 - \$40,000	4%
\$40,000 - \$100,000	6%
Over \$100,000	8%

What confuses some people is that they look at a tax table like this, know that they earn \$45,000 per year, for example, and conclude that they must have to pay 6 percent of their income in tax. But that isn't the way it works at all.

First, the tax rate table is based on taxable income, not total income. Thus, someone making \$45,000 per year probably has *taxable* income under \$40,000 after deductions and exemptions are subtracted—and taxable income is what determines your tax rate. So this person is probably only paying tax at the 2 percent rate.

Second, because these tax rates are *marginal* tax rates, even if a family does have taxable income of \$45,000, only the last \$5,000 of that will be taxed at 6 percent. Marginal rates apply only to taxable income *over* the amount where the tax bracket starts. This means that the effective tax rate paid at any income level (that is, the percentage of your total income you pay in tax) will always be lower than the top marginal rate. The chart on this page shows how the effective tax rate on a married couple with no children compares to the marginal tax rate at each income level, assuming the state allows a \$2,000 personal exemption and no other deductions. The first \$25,000 of taxable income is taxed at 2 percent, so the effective tax rate starts at zero and gradually approaches 2 percent as taxable income approaches \$25,000.<sup>9</sup> As the marginal rate increases, the effective rate increases too—but it always remains well below the top marginal rate.

Some states have **flat rate** systems that tax all taxable income at the same rate. For example, Illinois has a flat rate of 3 percent that applies to all taxable income.



## Credits

After computing the amount of income tax based on the applicable tax rates, **credits** (if any) are subtracted. Credits are taken directly off the *tax* amount that would otherwise be owed, as opposed to deductions, which are subtracted from the amount of *income* that is subject to tax.

Low-income credits are commonly used at both the federal and state levels to reduce income taxes on those least able to pay. Other credits are designed to provide relief from other taxes. For example, low-income sales tax rebates and property tax circuit breakers are often administered as credits against the personal income tax.

Some credits are **refundable**. This means that if the amount of the credit exceeds the amount of tax otherwise calculated, a filer actually gets money back. The reason for making a credit refundable is to assure that deserving families get the full benefit of the credit, even if they don't owe much in income taxes. The best-known refundable credit is the federal earned-income tax credit (EITC), which allows low-income working families with children to get a direct payment from the government if the amount of the credit exceeds the income taxes they otherwise would owe. In 2004, 18 states allow earned income tax credits modeled after the federal credit.

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<sup>9</sup>Even when taxable income is exactly \$25,000, however, the effective tax rate remains less than 2 percent in this example. This is because the \$2,000-per-person exemption means that this family's total income is \$29,000, not \$25,000. Not all of the family's income is subject to the 2 percent tax.

## Local Income Taxes

In most states, local taxes are much less diverse than state taxes. But more than a dozen states, seeking to move away from the property taxes that have historically dominated local revenues, now allow local-option income taxes. States allowing these taxes usually do it in one of two ways: by granting authority to every taxing district of a particular kind in a state or by granting authority to specific named districts. One example of the broader approach is Maryland, where each county government levies a “piggyback” tax that applies to the same tax base as the state income tax.

In states that already levy state income taxes, these local taxes can be administered and collected by state tax administrators on state tax forms, requiring no new paperwork. An optional local income tax helps to achieve tax diversity, fairness and adequacy for local governments.

## Revenue and Stability

Because of its direct link with growth in personal income, revenue from an income tax grows with a state’s economy. In fact, the more progressive the income tax, the more it grows. Why? Because virtually all income growth over the past decade has been concentrated in the top of the income scale. Thus, a state that has high rates on the wealthy captures this growth better than a state with low rates on the well-to-do. Progressive income taxes will usually grow faster than personal income over time. This is important because the cost of providing public services often grows faster than income as well.

Of course, in a severe recession, personal income tax collections will decline. But in the long run, the personal income tax is the most reliable source of revenue to fund public services.

## Deductible in Computing Federal Income Tax

A final step in the calculation of state income taxes doesn’t even appear on your state tax form: A part of what people pay in state and local income taxes is offset by the deduction itemizers get in computing their federal taxable income. On average, every dollar that a state collects in income tax ends up costing its residents only about 80 cents, because about 20 percent of the cost of these state taxes is offset by federal tax cuts for itemizers. And, from the point of view of high-income taxpayers, every dollar paid in state income tax costs only 65 cents.

## How Fair Is Your Income Tax?

A personal income tax can be designed to be as fair as lawmakers want it to be. Almost every income tax is at least slightly progressive. A progressive personal income tax is the key to a fair overall tax system: without it, a tax system is doomed to being highly regressive. With a sufficiently progressive personal income tax, the whole tax system can be made to be at least slightly progressive even if the system includes regressive sales, excise and property taxes.

But in practice, very few states have achieved this. Only a handful of states require their wealthiest taxpayers to pay as much of their income in state and local taxes as the poorest state residents. By this measure, very few tax systems can even be described as “flat.” This section looks at the common pitfalls that limit income tax progressivity at the state level.

### Graduated Rate Structures

The easiest way to make an income tax adequately progressive is through graduated rates. The higher the rates are on wealthier taxpayers, the lower the rates can be on everyone else to raise the same amount of revenue. But many states fall short of this goal, for a variety of reasons:

- Six states don’t apply graduated rate structures at all, but use a flat tax rate that applies to all taxable income. These states are Colorado, Illinois, Indiana, Massachusetts, Michigan and Pennsylvania. Most of these states do this because constitutional rules require it.

- Some states use nominally graduated rate structures that don't mean much in practice. For example, Maryland's top income tax rate begins at just \$3,000 of taxable income. As a result, 79 percent of Maryland families pay at the top rate. In states (like Maryland) that do not index their income tax brackets for inflation, this problem grows worse every year. (See the text box on the next page for more information on indexation.)
- Other states use much wider income brackets, but apply relatively low rates. For example, Arizona's top tax rate takes effect for married couples earning over \$300,000—but these taxpayers pay a marginal rate of just 5.04 percent. The relatively small difference between the bottom tax rate and the top tax rate makes the Arizona income tax less progressive.

### **Capital Gains Tax Breaks**

High nominal tax rates on the rich are indeed the simplest way to make the wealthy pay their fair share. But high rates don't do much good if there are major tax shelters for the wealthy in the tax law. The federal income tax provides a special tax break from dividends and capital gains income. Since most dividend and capital gains income goes to the wealthiest Americans, this tax break mainly benefits the wealthy while offering only a pittance to middle- and low-income families.

Capital gains tax breaks have not been shown to encourage additional investment on the federal level—and this linkage is even more tenuous at the state level. A general state capital gains tax break is highly unlikely to benefit a state's economy, since any investment encouraged by the capital gains break could take place anywhere in the United States or the world.

In addition, a substantial part of any state capital gains tax break will never find its way to the pockets of state residents. Because state income taxes can be written off on federal tax forms by those taxpayers who itemize their federal income taxes, as much as 35 percent of any reduction in state capital gains taxes will be directly offset by an increase in federal income tax liability.

And capital gains tax cut promoters ignore the significant advantages capital gains already receive. First of all, the federal income tax applies a special lower top tax rate on capital gains than it applies to other income (15 percent versus 35 percent—so the top rate on capital gains is less than half the top rate on wages). Second, income tax is only paid on capital gains when the asset is sold. This is the equivalent of only paying tax on interest earned in a bank account when it is withdrawn. Also, no income tax is ever paid on capital gains that are inherited. Thus, a significant amount of capital gains (the amount held at the time of death) are never taxed at all.

Most states currently do not have a tax break for capital gains. The federal government, however, has the mentioned lower top rate and proposals for cutting it further frequently surface.

### **Pension Tax Breaks**

Many states provide much more generous tax breaks for pension benefits than for other income sources. For example, New York exempts the first \$20,000 of private pension benefits from tax. This type of exemption creates two glaring problems of tax equity: first, it provides a tax break to taxpayers at all income levels. The benefits of the wealthiest executive receive the same treatment as the benefits of the lowest-paid worker. Second, it provides special treatment for non-working taxpayers, with no comparable break for the earned income of otherwise identical seniors. Over-65 workers whose earnings are based on salaries rather than pensions are completely excluded from this generous tax break. Since elderly taxpayers who work tend to be poor, this tax preference for unearned income is hard to justify.

Limiting pension tax breaks to low- and middle-income retirees—or replacing the pension tax break with a more general elderly exemption that applies to both earned income and unearned income—are two approaches to tax reform that would improve the perceived fairness of state income taxes.

## The Importance of Indexing Income Taxes for Inflation

Many features of the personal income tax are defined by fixed dollar amounts. For instance, income taxes usually have various rates starting at different income levels. If these fixed income levels aren't adjusted periodically, taxes can go up substantially simply because of inflation. This hidden tax hike is known as "bracket creep."

Take, for example, a state that taxes the first \$20,000 of income at 2 percent and all income above \$20,000 at 4 percent. A person who makes \$19,500 will only pay tax at the 2 percent tax rate. But over time, if this person's salary grows at the rate of inflation, she will find herself paying at a higher rate—even though she's not any richer in real terms. Suppose the rate of inflation is five percent a year and the person gets salary raises that are exactly enough to keep up with inflation. After four years, that means a raise to \$23,702. Now part of this person's income will be in the higher 4 percent bracket—even though, in terms of the cost of living, her income hasn't gone up at all.

### "Hidden Tax Hikes:" An Example

	Year 1	Year 5
Actual Income	\$19,500	23,702
Taxed at 2%	\$19,500	\$20,000
Taxed at 4%	\$0	\$3,702
<b>Inflation-Adjusted Income</b>	<b>\$19,500</b>	<b>19,500</b>

The way the federal personal income tax and some states deal with this problem is by "indexing" tax brackets for inflation. In the example above, indexing would mean that the \$20,000 cutoff for the 4 percent bracket would be automatically increased every year by the amount of inflation. If inflation is five percent, the cutoff would increase to \$21,000 after one year. After four years (of five percent inflation), the 4 percent bracket would start at \$24,310. So, when the person in our example makes \$23,702 after four years, he or she would still be in the 2 percent tax bracket.

Inflation has just the same impact on other features of income taxes, including standard deductions, exemptions, and targeted low-income tax credits. Unless these progressive tax breaks are indexed, they will gradually become less valuable over time—imposing a hidden tax hike on the low- and middle-income taxpayers for whom they are most valuable.

## Deduction of Federal Income Taxes from State Taxable Income

Another pitfall for state income taxes is the deduction for federal income taxes paid. Since the federal personal income tax is progressive, this deduction significantly reduces the state income taxes paid by the wealthy in the nine states that allow it. In fact, for people in the top federal bracket, the state deduction for federal income taxes effectively lowers a state's top marginal tax rate by about a third. For low- and middle-income taxpayers, on the other hand, this tax break offers little or no relief.

## Tax Breaks for Middle- and Low-Income Families

There are a number of ways, other than low tax rates, to keep income taxes affordable for middle- and low-income families. Large standard deductions and exemptions provide relief to all income groups, but are more significant to middle- and low-income families than to the well off. For instance, \$10,000 worth of exemptions amounts to 25 percent of income for a family earning \$40,000. But the same exemption offsets only 2 percent of income for a family making \$500,000.

Targeted tax credits like the Earned Income Tax Credit are an even more effective (and less costly) way of making income taxes progressive. Because the benefits of these credits can be designed to phase out above a specified income level, these credits can be targeted to the low-income families who need them most, and the cost of the credit can be kept to a minimum.

## Conclusion

State governments rely on three main sources of revenue—income, sales and property taxes. Of these, only the income tax is progressive. For this reason, an effective income tax, with graduated rates and a minimum of regressive tax loopholes, is the cornerstone of a fair state tax system. As noted in Chapter One, even the most progressive income taxes are usually insufficient to offset the unfairness of sales and property taxes. But a progressive income tax makes the difference between extreme and mild tax unfairness at the state level.

## CHAPTER SIX

# CORPORATE INCOME TAXES

Corporate taxes are an important tool for state tax fairness. In the 46 states that levy one, the corporate income tax helps to offset the regressivity of property and sales taxes. But corporate income taxes are declining as a revenue source nationwide. This decline is troublesome for two reasons: first, it appears to be at least partially the result of tax avoidance strategies by corporations rather than the conscious design of federal and state lawmakers. Second, the decline of the corporate tax means that individuals must pay a bigger share of the tax pie. This chapter surveys the basic workings of the corporate tax and looks at potential reforms.

### Why Tax Corporations?

In the end, all taxes on business are paid by individuals. It may be a company's shareholders that bear the tax, or its employees, or consumers buying its products—but ultimately, these business taxes fall on individuals. So why should corporations be taxed at all?

The most commonly cited reason for taxing corporations is that they derive benefits from the public services a state provides. Corporations rely on a state's education system to provide a trained workforce, use a state's transportation system to move their products from one place to another, and depend on the state's court system and police to protect their property and business transactions.

Another reason is that corporations have special privileges—limited liability and unlimited life, for example—that individuals do not have.

The corporate income tax also acts as an important backstop to the personal income tax. Without the corporate tax, much of the income of wealthier Americans would go entirely untaxed, because individuals could easily shelter their personal income by putting it in a corporate form.

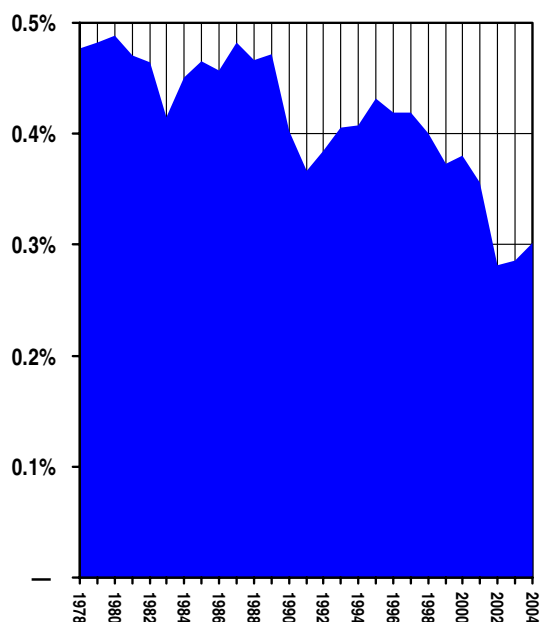
In addition, states find corporate taxes attractive because they often are the only option available for taxing residents of other states. Many of the shareholders of a corporation doing business in a state likely live in other states. States seeking to tax these non-residents on the benefits their company receives from public services have no other means of doing so than the corporate tax.

### How it Works

Like personal income taxes, state corporate income taxes are usually based on the “ability to pay” principle. The tax applies to corporate profits—that is, income minus business expenses. Most states “piggyback” on the federal corporate income tax, using federal taxable income as a starting point in determining each corporation's state taxable income. But states must take several additional steps in determining how much (if any) of a corporation's profit they can tax.

- First, the state must determine whether a corporation has **nexus** in a state—that is, whether the company engages in a sufficient level of activity in the state to be taxable by the state.

State & Local Corporate Income Taxes  
As a % of GDP — Fiscal 1978-2004





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

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

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

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

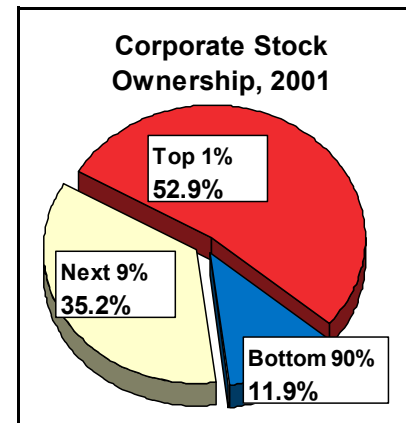
The main rationale for using these three factors to determine taxable income was that companies benefit from a state's public services in a variety of ways, including owning property in a state, making sales within a state, and having an in-state employee base. The three-factor formula ensures that corporate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

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

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

## Fairness

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



## Corporate Minimum Taxes

All states with corporate income taxes use corporate profits to define the tax base. This ensures that the corporate tax reflects a business' ability to pay the tax: if a corporation loses money in any year, they don't pay the tax. But the growing use of tax avoidance strategies means that many profitable corporations are now able to report artificially low (or negative) profits for tax purposes even when they've done quite well financially. These tax avoidance strategies have created the specter of profitable "zero-tax corporations." Federal tax reform legislation in 1986 created an "alternative minimum tax" (AMT) to ensure that all profitable corporations would pay some tax no matter how many loopholes they might otherwise claim.

States seeking to follow the federal government's lead have taken one of three strategies: imposing an AMT based on the federal tax, imposing a flat-dollar minimum tax, or using a non-profit-based measure of business activity as a backstop to the corporate profits tax.

More than a dozen states now use an AMT based on the federal tax. Like the regular corporate income tax, the AMT usually is defined as a percentage of corporate profits—but the AMT typically applies a lower tax rate to a much broader definition of corporate taxable income. This approach has become much less useful because the federal AMT has been seriously watered-down over time by Congress—but a state AMT based on the older federal AMT rules could still help prevent the excessive use of tax loopholes.

A growing number of states rely on a simpler, lower form of minimum tax: a flat-dollar amount that all corporations must pay. This amount ranges widely, from \$50 in Ohio to a maximum of \$1,500 in New York. As more and more corporations rely on tax avoidance strategies, the fixed-dollar minimum tax has become more important in these states: in New York, for example, more than sixty percent of all corporations now pay only the minimum tax. In New Jersey, 30 of the state's 50 largest corporations paid only the \$200 minimum tax in 2002.

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

Each of these options can help eliminate the "zero-tax corporation" problem—and (in some cases) can also help states to get around the problem of corporate nexus described above. Some nexus rules only apply to taxes that are based on profit. So a company that does business in a state, but doesn't have enough physical presence in the state to satisfy the nexus rule, cannot be reached by a profits-based tax, but can be reached by a fixed-dollar minimum tax.

### How “Decoupling” State Corporate Taxes From Federal Rules Can Help Shore Up Your State’s Tax Base

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

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

## Deductible in Computing Federal Income Tax

Like the personal income tax, corporate income taxes are deductible for federal corporate income taxpayers. Since the federal corporate income tax rate is 35 percent, this means that up to 35 percent of the state corporate income tax paid by businesses in your state will be ultimately paid for not by these businesses but by the federal government, in the form of reduced federal tax collections. This interaction also means that state corporate income tax increases are subsidized by the federal government—and that part of any state corporate income tax cut will never be received by in-state businesses, but will go instead to federal tax coffers.

## Revenue and Stability

Corporate income taxes can raise significant revenues—but they are also quite volatile. Corporate tax collections have declined in recent years, in part due to the slow economy. The corporate income tax is affected by the state of the economy because the tax is based on corporate profits, which usually fall significantly during economic downturns. State corporate income taxes are also facing downward pressure because they are linked to the federal tax code: the proliferation of tax loopholes at the federal level is being passed through, in many cases, to state governments. Another reason for declining corporate income tax revenues is that many companies have become better at taking advantage of loopholes that Congress never intended to create.

## Corporate Income Tax Issues

The decline of the state corporate income tax has been so dramatic in recent years that a few anti-tax advocates have suggested repealing the tax entirely, arguing that the limited yield of the corporate tax makes it not worth the trouble of collecting. But this pessimistic outlook ignores a set of easily administrable, sound reforms that could help revitalize the state corporate tax. This section looks at problems facing the state corporate income tax, and suggests possible reforms.

### Tax Credits and the Incentive Illusion

Many states give businesses numerous **tax credits** that significantly reduce (or even eliminate) their tax liability. These include credits supposedly intended to create jobs or encourage investment. Unfortunately, these credits usually just reward businesses for doing things they would have done anyway—or shift investment into areas that do not make the most economic sense.

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

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

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

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

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

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

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

### **Manipulating Apportionment Rules in the Name of Economic Development?**

In determining what portion of a multistate company's profit is taxable in a given state, most states use the three-factor, payroll-property-sales apportionment formula method described on page 37. In recent years, however, many states have deviated from this basic three-factor approach by increasing the importance of the "sales factor." For example, Arizona allows companies to count the sales factor twice. (In the example on page 37, this means that instead of taxing 70 percent of a company's business income (the average of 90, 30 and 90), Arizona can only tax 60 percent of that income (the average of 90, 30, 30 and 90). This "double weighting" approach reduces the tax paid by corporations that sell most of their products in other states—for example, manufacturing corporations. A dozen states still use the unweighted UDITPA formula.

Several states have gone even further, increasing the weight of the sales factor to one hundred percent—eliminating the payroll and property factors entirely. This is known as the "single sales factor," or SSF. Under SSF, the sole determinant of a corporation's state tax is how much of its sales are made to in-state customers. Advocates of increasing the sales factor claim that it encourages exporting businesses to locate in a state, since it favors companies with greater payroll and assets in a state than sales. But claims that an increased sales factor attracts corporate investment are dubious. Indeed, in some cases, it might actually *discourage* investment in a state.

If a company, for instance, only ships products into a state, it may not have nexus with the state. But in a state with an increased sales factor, if such a company makes even a small investment in a state, it will immediately have much of its income apportioned to the state because the sales factor counts so heavily. And a company with only a small amount of property or payroll in a sales factor state can reduce its in-state corporate taxes to zero by moving this property and payroll out of the state. Thus, increasing the sales factor can actually have exactly the opposite effect of what its proponents intend: discouraging in-state investment.

In addition, increasing the sales factor discriminates between companies in a way that is hard to defend. Increasing the sales factor will reduce taxes for some companies, but will increase taxes for others. For each corporation that benefits from SSF because most of its sales take place in other states, there are also corporations that will be punished by SSF rules because their sales are

mostly *in-state*. Smaller corporations that tend to make most or all of their sales within the state in which they are located generally get little if any tax savings under the SSF approach. In short, adoption of the single sales factor ultimately benefits some corporations while punishing others in an arbitrary way.

These arbitrary distinctions reduce the confidence of the public—and of corporations—in the fairness of state tax administration. When profitable companies benefit from a state’s services—as the manufacturing companies that typically benefit from the single sales factor clearly do—they should pay their fair share of the corporate tax burden. When these corporations are allowed to reduce or eliminate their tax liability, that lost revenue must be made up by other competing companies—and by individual taxpayers.

### **Separate Accounting & Transfer Pricing**

A further inconsistency in state corporate taxes stems from the fact that some states permit companies to determine their in-state taxable income using **separate accounting** for each of their related subsidiaries. Separate accounting is a bookkeeping procedure that determines each company’s taxable income by having companies keep separate accounts for their in-state and out-of-state business segments. Every transaction between the legally distinct subsidiaries of a company is supposed to have a **transfer price** (that is, the “sales price” at which these companies are essentially selling products to themselves) attached to it, which is supposed to be carefully scrutinized by auditors.

Not surprisingly, separate accounting is subject to abuse by large, multistate companies. In fact, it’s an open highway for corporate tax avoidance. A large multistate company can use separate accounting to shift taxable profits to low-tax jurisdictions. Here’s how it works:

Consider a multistate company that has two subsidiaries, one in State A that permits separate accounting and one in State B, which has no corporate income tax. To reduce its taxable profits, the subsidiary in State A might say that it “pays” high transfer prices for the items it “buys” from the State B subsidiary. This shifts income out of State A (where it would be taxed) and into State B (where it’s not).

For example, a furniture company might machine the metal parts for its furniture (handles, knobs, etc.) in State B, but assemble the furniture in State A. The company will, on paper, charge very high prices to its State A subsidiary for the metal parts. This makes the State B subsidiary look like it has very high profits (which are not taxed) and the State A subsidiary look like it has very low (taxable) profits.

Of course, except for tax considerations it doesn’t matter to the parent company if its State B subsidiary has 80 percent of the total profits and its State A subsidiary has only 20 percent. Either way, the parent company gets 100 percent of the profits.

Another example of transfer pricing that has gotten more attention in recent years is the passive investment company (PIC) approach. In this variation on the transfer pricing scheme, a multi-state company will set up a subsidiary in a state that does not tax certain types of intangible income like royalties and interest—and make sure that this subsidiary receives all of the company’s royalty income. The most infamous example of this practice is the Toys R Us corporation, which created a subsidiary in Delaware called Geoffrey, Inc. The subsidiary owns the Toys R Us trademark, and Toys R Us stores around the nation pay royalty fees to the Delaware subsidiary for their use of the trademark. This reduces the taxable profit of Toys R Us in two ways: stores based in other states get to deduct their royalty payments as a cost of doing business, which reduces their taxable profit, and the Delaware subsidiary pays no tax on their royalty income because Delaware does not tax such income.

Trying to assure accurate transfer pricing under separate accounting creates huge enforcement problems. It is a time-consuming, complicated and often impossible job for state auditors to

determine whether separate accounting methods accurately reflect a company's net business income in the state. The federal government, which tries to apply the same approach to multi-national corporations, has had the same kinds of difficulties.

States seeking to prevent these income-shifting strategies have two options. They can close down these loopholes one at a time—as some states have done in response to the PIC problem by enacting legislation that prevents the use of PICs—or they can adopt a comprehensive solution known as **combined reporting**. Combined reporting requires a multi-state corporation to determine its apportionable income by adding together the profits of all its subsidiaries into one total. Since the income of subsidiaries in the various states is added together in one sum, there is no tax advantage to income shifting between these subsidiaries under a combined reporting regime. While anti-PIC legislation can close down one particular path to tax avoidance, combined reporting is a better, more comprehensive approach to loophole-closing because it simply removes the incentive to shift income from high-tax to low-tax jurisdictions.

Combined reporting is intuitively more fair than separate accounting because it ensures that a company's tax should not change just because its organizational structure changes. It also creates a level playing field between smaller and larger companies. Small companies doing business in only one state can't use separate accounting to reduce their tax because they have no business units in other states to shift their income to. Large, multi-state corporations will find it easier to avoid tax using separate accounting because they have business units in multiple states.

### **“Nowhere Income” and the Throwback/Throwout Rule**

Every state with a corporate income tax uses the location of the corporation's sales as a factor in apportioning business income between states. The “sales factor” for a given corporation in a given state is calculated by assigning each individual sale a company makes to exactly one state, and then calculating what percentage of total nationwide sales are in each state. In general, the rule states use to decide which states a given sale should be assigned to is the “destination rule,” which says that a sale should be assigned to the state to which the product sold is being sent.

Sometimes, however, sales allocated to other states using the destination rule end up not being taxed at all because the destination state lacks the authority to tax the seller. When this happens, it's because the seller doesn't have *nexus* in the destination state.

Unless states take action, this “**nowhere income**” will not be taxed anywhere at the state level. The best remedy for the problem of nowhere income is enacting a **throwback rule**, which simply says that any sales to other states that are not taxable will be thrown back into the state of origin for tax purposes. The throwback rule was among the tax rules adopted by the UDITPA in the 1950s, but many states still have not enacted it. The lack of throwback rules poses a major threat to state corporate income tax revenues in twenty states.

### **Splitting Hairs? Exploiting the Business/Nonbusiness Income Distinction**

The first step in calculating state corporate taxes is dividing a company's income into a “business income” component and a “nonbusiness income” component. Business income is apportioned (divided) between the states in which a company does business, while non-business income generally is taxed entirely by the one state in which the asset generating that income is managed. But each state must set its own legal dividing line between business- and non-business income—and the way in which states do this has important implications for corporate tax fairness.

The appropriate dividing line between these two types of income has been the topic of frequent litigation in the states. In many states, business income is defined as any income that arises from the regular transactions that a company typically engages in—which means that any income that can be characterized as “irregular” may be considered non-business (and therefore non-apportionable) income. Businesses sometimes try to take advantage of this poorly defined distinc-

tion between business and non-business income by misleadingly classifying some business income as irregular non-business income, then allocating this non-business income entirely to a low-tax state in which they are nominally headquartered. A 1992 U.S. Supreme Court case, *Allied Signal v. New Jersey*, made it clear that many states currently falling prey to these tax-minimization strategies are not taxing all the corporate income they could legally tax.

States with corporate income taxes have responded to these corporate tax-minimization efforts using two strategies:

- Six states define business income as everything they can legally apportion under the U.S. Constitution—which means that non-business income is whatever is left over. This approach is recommended by corporate tax experts as the best way of fairly taxing multi-state corporations' income.<sup>10</sup>
- Thirteen states define all income as business income. This approach allows states to tax some of the “irregular” income that companies seek to classify as non-business income, but prevents states from taxing some non-business income that they are entitled to tax. For example, if a company is based in state A, and generates \$100 million of non-business income in state A, the state should be entitled to tax the entire amount as non-business income (since non-business income is not apportioned between states). But when states make no distinction between business and non-business income, all of a company's income is apportioned—which means that state A can only tax a percentage of this income.

Every state with a corporate income tax (except for the six states that currently define business income in accordance with the U.S. Constitution's limits), could enact statutory changes that would allow them to prevent the nonbusiness income loophole from depleting their tax base.

### **Corporate Disclosure: An Important Tool for Tax Fairness**

Tax fairness is important. The perception that state and local taxes treat individuals and corporations fairly is a cornerstone of public support for the tax system. Corporate tax fairness at the federal level can be evaluated, with some difficulty. Publicly available Securities and Exchange Commission (SEC) filings allow analysts to determine how much the nation's largest corporations have paid in federal taxes and compare this to their profits. In a series of reports, ITEP has shown that many profitable corporations pay little or no federal income tax. A September 2004 ITEP report surveyed 275 of the most profitable corporations, and found that almost a third of these companies paid zero (or less) in federal taxes in at least one year between 2001 and 2003.

Unfortunately, the fairness of state corporate taxes cannot be evaluated in the same way, because neither the SEC nor most state governments require corporations to release detailed information on their state corporate tax payments. A few states have now implemented some form of corporate tax disclosure. For example, Massachusetts now requires very limited anonymous disclosure of basic information about profits, taxes paid and tax credits received. But nearly all states still have no such requirements. Greater state corporate tax disclosure is the best means available to ensure that each corporation is treated fairly—and that corporations as a group pay their fair share of taxes.

Corporate disclosure can also help states to prevent the accounting hijinks described above. For example, some companies will report certain income as “non-business income” in one state and “business income” in another to minimize their tax liability. More open reporting of this information could allow states to check for consistency in income reporting between states.

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

# OTHER REVENUE SOURCES

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

### Estate and Inheritance Taxes

Since the federal government enacted an estate tax in 1916 to “break up the swollen fortunes of the rich,” every state has enacted a similar tax of its own. While these taxes typically represent only a small part of overall state tax collections, estate taxes play an important role in reducing the transmission of concentrated wealth from one generation to the next. This function is now more important than ever: in 2001, the wealthiest 1 percent of Americans owned 32.7 percent of the wealth nationwide—more than the poorest 90 percent put together.<sup>11</sup> The estate tax was designed to apply only to the very wealthiest Americans—and that’s exactly what it does. Nationwide, less than two percent of decedents typically owe any federal estate tax.

Recent federal tax changes, however, threaten the future of the estate tax at the state level. Since 1926, the federal estate tax has allowed a dollar-for-dollar tax credit against the estate taxes levied by states, up to a certain maximum amount. The credit gave states an incentive to levy an estate tax at least as large as this credit: in the states levying a “pickup tax”—that is, a tax calculated to be exactly equal to the maximum federal tax credit—the state’s estate tax amounted only to a transfer of estate tax revenues from the federal government to the states. In other words, the pickup tax did not change the amount of estate tax paid—it just meant that part of the federal estate tax liability was being shared with, or “picked up” by, state governments. Every state took advantage of this incentive to enact the pickup tax.

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

States seeking to preserve this important progressive revenue source have an easy way of doing so: “decoupling” from the federal tax repeal. The easiest way to achieve this is by defining the state estate tax to equal the federal credit as it existed in 2001—before the passage of the Bush administration’s estate tax cuts. A number of states have made this simple administrative change already.

### Gambling Revenues

Like tax policy, gambling policy is made in a decentralized way: each state’s lawmakers can choose which forms of legalized gambling to allow. As a result, the states now have very different approaches to allowing gambling activities. Some form of government-sanctioned gambling is now allowed in all but two states (Utah and Hawaii). By far the most popular forms of legalized gambling are lotteries and casinos: 37 states and the District of Columbia have state lotteries, and more than half of the states have some form of casino gambling. Many states also allow “pari-mutuel” gaming, wagering on live events such as horse racing and greyhound racing.

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<sup>11</sup>Arthur Kennickell, “A Rolling Tide: Changes in the Distribution of Wealth in the US, 1989-2001”, November 2003. Levy Economics Institute Working Paper No. 393.



Advocates of state-sponsored gambling typically see it as a painless, voluntary tax—and one that is at least partially paid by residents of other states. At a time when lawmakers' willingness to increase politically unpopular taxes is especially low, a tax paid by non-residents may seem especially palatable. It is also argued that in the absence of legal gambling, many state residents will either gamble illegally or travel to other gambling-friendly states—with no benefit to the state. But opponents raise a host of troubling objections to states' use of legalized gambling.

- Even if gambling boosts state revenues in the short run, **competition from other states** will eventually make state-sponsored gambling less profitable—and will ultimately put the burden of this tax primarily on state residents rather than tourists from other states. Increased competition also means that the **yield of the tax will likely decline over time**.
- Instead of increasing the total amount of revenue available to fund public services, **gambling may simply shift money from one tax to another** with no net gain to the state. When consumers spend more money on gambling, they will spend less money on other items. Since these other types of purchases are usually subject to state sales taxes, any increase in state gambling revenue usually means a decrease in state sales tax revenue.
- Rather than simply capitalizing on existing illegal gambling activities, legalized gambling may **encourage consumers to gamble more** than they otherwise would. When states use gambling as a revenue source, they depend on the continued flow of this revenue to fund services. This often leads to state-sponsored advertising that actively encourages citizens to gamble more. In this respect, gambling is very different from “sin taxes” on alcohol and cigarettes, which are often enacted not to raise money but to discourage behavior that is deemed socially harmful.
- **Promises of additional spending for specific public services may be illusory**. Advocates of state-sponsored gambling often seek to earmark gambling revenues for specific purposes, usually to help fund education. These advocates often promise that total state spending on education will increase as a result of the new gambling revenues. But it is just as likely that lawmakers will use gambling revenues to replace other revenues that have been shifted from education to other areas—leaving the total amount of spending on education unchanged.
- Low-income and poorly-educated taxpayers are far more likely to participate in lotteries and other forms of gambling than are wealthier, better-educated taxpayers. As a result, state-sponsored gambling can be considered a **regressive tax**.
- Like other “sin taxes,” gambling is **not always a truly voluntary tax**. Compulsive gambling has been recognized as an addictive disease. Relying on compulsive gamblers to fund public services amounts to taking advantage of these gamblers' addictions. And because state gambling administrators tend to downplay the poor odds of winning, gamblers are usually given incomplete information about these odds—which means, in a sense, that gamblers are being tricked into these “voluntary” spending decisions.
- Gambling may introduce a variety of **social costs**, including increased crime rates, decreased private savings, increased debt, and job losses. These social costs can result in increased social welfare spending by state governments in the long run.

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

## THINKING OUTSIDE THE BOX: OTHER TAXES

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

### Value-Added Taxes (VATs)

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

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

How a Value-Added Tax Works			
	Price	Value Added	Tax at 5%
Raw materials	\$40	\$40	\$2
Manufactured product	140	\$100	5
Wholesale sale	200	\$60	3
Retail sale	300	\$100	5
<b>Total</b>		<b>\$300</b>	<b>\$ 15</b>

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

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

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

<sup>12</sup>Congressional Budget Office, *The Economic Effects of Comprehensive Tax Reform*, 1997

## Why Adopt a VAT?

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

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

## Problems with a VAT

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

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

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

## Gross Receipts Taxes

A **gross receipts tax (GRT)** is still another type of sales tax. The main difference between a retail sales tax and a GRT is that sales taxes apply (in theory, anyway) only to retail sales, while a GRT applies to the sales made by companies at every stage of the production process, including manufacturing companies, wholesalers, and retailers. In other words, a GRT is a sales tax that applies to more types of transactions. From the consumer's perspective, the major distinction between gross receipts taxes and retail sales taxes is that gross receipts taxes are not necessarily itemized on customers' bills.

The gross receipts taxes currently used by states typically only apply to the sales receipts from certain types of products, with utilities and insurance being the most common targets. In fiscal year 2002, state and local governments raised more than \$30 billion in gross receipts taxes on utilities and insurance—twice as much as what the states raised from excise taxes on alcohol and tobacco.

When state policymakers propose a gross receipts tax as a proposal for comprehensive tax reform, however, what they usually have in mind is something very different from the single-item gross receipts taxes that most states currently use. These proposals typically would impose a very low tax rate on a very broad base of economic activity. For example, a Nevada tax reform commission recently proposed a gross receipts tax of 0.25 percent on all business revenues over \$450,000 a year.

This sort of gross receipts tax is quite rare on the state level. The most comprehensive current GRT is the Washington State Business and Occupation Tax, which taxes different types of companies at different rates ranging from 0.138 percent to 1.5 percent.

There are three main problems with GRTs. First, like any sales tax, a GRT hits low-income taxpayers the hardest. Second, because GRTs are based on the amount that a business sells rather than on its profit, a GRT is not sensitive to a business' ability to pay. Third, GRTs lead to severe pyramiding problems, because the tax applies not just to retail sales but to all stages of the production process.

The first two of these problems are basically identical to those faced by value added taxes (see above); the third, however, separates GRTs from VATs. VATs are explicitly designed to get around the problem of tax pyramiding, while GRTs have no mechanism for avoiding it. As a result, it doesn't make much sense to compare the tax rate of a broad-based GRT to the tax rate of a general sales tax: a GRT is a multi-stage tax, whereas the sales tax is a single-stage tax. So, for example, if a GRT of 0.25 percent applies to four stages in the production of a product, that's roughly equivalent to a retail sales tax of one percent.

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

# TAXES AND ECONOMIC DEVELOPMENT

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One of the main concerns of state policymakers is how to lure jobs to their state—and too often, policymakers assume that tax cuts make the best bait. It’s not hard to understand why they might believe this: tax-cut advocates frequently assert that cutting tax rates will spur economic growth by bringing more jobs and employers to the state, and footloose businesses are constantly threatening to relocate to other lower-tax jurisdictions if state governments won’t pony up lavish tax breaks. But there is growing evidence that tax cuts and incentives are not an effective growth strategy for states—and that investing in public infrastructure such as schools, roads and hospitals can be a better approach to encouraging economic development. This chapter discusses the relationship between state fiscal policies and a state’s economic climate.

## How Taxes Affect State Economies

When state policymakers discuss proposed tax increases, the debate inevitably turns to the impact of these proposals on the state’s business climate. Business lobbyists usually argue that tax increases will hurt a state’s business climate and drive away industries and jobs. And if tax increases aren’t on a state’s agenda, the same lobbyists will push for special tax breaks to encourage new business investment—or to prevent a company from leaving the state—and will tell apocalyptic tales about what will happen if these business demands are not met.

But there is very little hard evidence to support the assertions of those who see tax cuts as a panacea for a state’s economy. A recent comprehensive survey of the economic literature on the relationship between taxes and economic development by economist Robert Lynch found little evidence that state and local taxes are important factors in determining business location decisions or in affecting state economic growth.<sup>13</sup>

Lynch’s survey suggests that there is wide variation in the quality of the “research” used to support these anti-tax arguments, and suggests that the studies that do show strong relationships between tax levels and economic development often have design flaws that invalidate their conclusions. But for the average advocate, who does not have an advanced degree in economics, it can be difficult to tell the difference between high-quality and low-quality research. Fortunately, these poor-quality studies tend to share the same design flaws. Here’s a quick overview of some important questions to ask in evaluating these studies:

**Does the study assume that tax changes have no effect on public spending?** One of the most frequent errors made by these studies is to simply ignore the linkage between taxes and public spending. This is equivalent to saying that when taxes are hiked, the resulting revenues will simply be thrown away rather than being used to fund education and other public services—and that when taxes are cut, there will be no reduction in the state’s ability to fund these services. Of course, the world doesn’t work this way. In the real world, tax cuts must be paid for—and that usually means spending cuts. And when strapped lawmakers pass politically unpopular tax increases, the new revenue is used to preserve important state services.

Studies that ignore this basic linkage and look only at the impact of tax cuts are merely stating the obvious: state economies would be stronger if they could maintain the current package of public services while paying less for them. In the best of all possible worlds, state and local governments would provide all of our public services for free. Of course, that’s unrealistic—but that’s the implication of studies that don’t factor in the impact of tax cuts in public services.

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<sup>13</sup>Lynch, Robert G., *Rethinking Growth Strategies: How State and Local Taxes Affect Economic Development*, Economic Policy Institute, March 2004.

**Does the study measure the impact of any other possible explanations for economic growth?** There are many plausible explanations for the difference between fast-growing and slow-growing state economies. These differences could result from tax law changes, government spending behavior, regional and national economic changes, demographic changes, or even the weather. The simplest “studies” often measure the linkage between only one explanation—tax levels—and an economic outcome. But if the study doesn’t at least try to measure the impact of these other factors, its findings shouldn’t be taken seriously.

**Does the study measure tax burdens correctly?** Anti-tax advocates frequently resort to manipulating data in arcane ways to back up their assertions. For example, some studies use the “per capita” tax burden—that is, the

total amount of taxes collected in a state divided by the state’s population—to identify high-tax states. The problem with this is that “per capita” tax measures tell us more about how rich a state is than how high its taxes are. For example, Connecticut collects \$1,065 per capita in personal income tax, while Maine collects \$829. Yet Connecticut’s income tax has lower

<b>Comparing State and Local Taxes: Connecticut and Maine</b>		
	<b>Connecticut</b>	<b>Maine</b>
<b>Income Taxes Per Capita</b>	\$ 1,065	\$ 829
Rank	6	16
<b>Personal Income Per Capita</b>	\$ 43,173	\$ 28,831
Rank	2	33
<b>Income Tax as % of Income</b>	2.5%	3.0%
Rank	20	12
<b>Source: Census Bureau, Bureau of Economic Analysis</b>		

tax rates and higher exemptions than Maine’s income tax. Virtually anyone moving from Maine to Connecticut would, in fact, see their income taxes go down. This approach to measuring tax burdens is simply misleading—but anti-tax advocates rely on it simply because the average reader won’t know this. Other data manipulation tricks that these advocates frequently use include:

- Making assertions about how total taxes affect growth—but backing these assertions up using only state tax data. State tax hikes are often enacted to reduce local taxes, so it is important to use the combined state and local tax burden in evaluating these assertions.
- Using legal tax rates as a measure of true tax burdens. This trick is frequently used in states that combine high income tax rates with generous deductions, exemptions and other tax breaks. Effective tax rates—that is, taxes as a share of income (or profits, in the case of businesses) are a far more accurate approach to measuring tax burdens.
- Using aggregate tax collections data to measure state tax burdens instead of measuring the incidence of these taxes on state residents. Aggregate measures based on total tax collections tell us little about whether specific groups of taxpayers experience the state as a high-tax or low-tax place to live. Some nominally “high-tax” states rely heavily on taxes paid by businesses or non-residents, which don’t apply to state residents.
- Not factoring in the deductibility of state and local income and property taxes when comparing tax burdens across states. The ability to write off these taxes means that the difference in tax levels between “high tax” and “low tax” states is never as large as it may seem. For the wealthiest taxpayers (and for profitable corporations), up to 35 percent of the difference between any two states’ tax burden will disappear once federal deductibility is taken into account.

Much of the “research” that is commonly cited by anti-tax advocates is based on research methods that are dubious at best—and the tricks outlined above tend to get recycled in different states by anti-tax lobbyists. So whenever lawmakers or the media are presented with a study purporting to show that high taxes hurt economic development, it’s a good idea to ask these basic questions about the design of these studies.

## Why Low-Tax Strategies Don't Work

So why is it that the doomsday scenarios of corporate lobbyists fail to materialize when taxes are increased? No doubt, all things being equal, businesses would prefer low taxes to high taxes. But in fact, all things are *not* equal. Taxes are levied for a very important purpose: to help fund the public services that make a state more attractive to businesses. Good roads and bridges, a well-educated workforce and other government services are essential to business productivity and profitability. And there is a clear linkage between raising taxes and a state's ability to provide these important public services.

And on the other side of the coin, low taxes generally lead to low-quality public services. Providing businesses with a low-tax, low-service environment is not likely to be a winning strategy for attracting significant new investment. Moreover, compared to other costs of doing business, state and local taxes are rather insignificant. That's why heads of major corporations will candidly admit that taxes are not very important in their location decisions.

As Paul O'Neill, a former executive at Alcoa put it: "I never made an investment decision based on the tax code...If you are giving money away I will take it. If you want to give me inducements for something I am going to do anyway, I will take it. But good business people do not do things because of inducements."<sup>14</sup>

Other corporate leaders have echoed these thoughts. For example, long-time business leader Michael Bloomberg told the *New York Times* that "any company that makes a decision as to where they are going to be based on the tax rate is a company that won't be around very long. If you're down to that incremental margin you don't have a business."<sup>15</sup>

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

The Corporation for Enterprise Development (CFED) has issued a series of reports grading states on the characteristics that are likely to attract high-wage, high-value-added industry. Level of taxation has consistently been found to be of little significance. The factors that really drive location decisions include the quality of life in the community, a good supply of highly skilled and educated men and women to fill demanding technical and management positions, good roads and adequate transportation, public safety, and the quality of health care.

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

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<sup>14</sup>Testimony before the United States Senate Finance Committee, January 18, 2001.

<sup>15</sup>*New York Times*, November 8, 2001.

<sup>16</sup>*Washington Post*, March 22, 1992, p.A22

Finally, it's important to remember that tax breaks don't buy loyalty from companies. Many states and communities have given huge tax breaks to large companies for years, only to have the company shut down the local plant for reasons unrelated to taxes.

## Ensuring Accountability in Economic Development Strategies

Even if there is little evidence that tax policy affects economic growth, state lawmakers will continue to pursue potentially damaging tax breaks in an effort to spur economic growth in their state. How can lawmakers achieve the greatest “bang for the buck” from these tax breaks, while ensuring that the footloose corporations receiving these breaks won't take them to the cleaners? The Washington-based nonprofit watchdog group Good Jobs First focuses on issues of economic development accountability, and has recommended a variety of best practices for lawmakers enacting tax breaks, including:

- **Disclosure**, for each company receiving tax breaks, of how much the tax breaks cost and what public benefits resulted from the tax breaks. For example, lawmakers should be able to determine how many jobs were created as a result of the tax breaks and whether the jobs created are “good jobs” in terms of the wage and benefit structure. This information should be made publicly available and frequently updated.
- **Strict job quality standards** should be applied to any tax breaks designed to increase in-state employment. Requiring these new jobs to provide a basic “living wage” along with health care benefits helps to avoid imposing hidden taxpayer costs on state government. If a tax break results in a company hiring employees who are paid so little that they qualify for food stamps, Medicaid, or other taxpayer-funded social supports, the cost of the tax break may exceed its benefits to the state.
- **Money-back guarantees** that companies receiving tax breaks to create new jobs will actually create these jobs—and that the jobs will remain in the state for some specified period of time. These guarantees, known as “clawbacks,” are now used by almost twenty states to ensure that lawmakers get enough “bang for the buck” out of these tax breaks.
- **Location-efficient incentives.** Tax incentives should encourage economic development in areas that are accessible to public transportation. This creates more opportunity for low-income families who cannot afford cars, and reduces traffic congestion.

## Is Business the Enemy? (No)

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

Precisely for this reason, not all corporations fight against progressive tax changes. Especially in states with low taxes, businesses may support progressive tax increases in order to improve the quality of government services. When Virginia lawmakers passed a billion-dollar tax hike in 2004, for example, it was with the blessing of the state Chamber of Commerce.

Even in states where many companies, and perhaps even the organized corporate lobby, oppose fair taxes, there may be some sectors of the business community that favor progressive tax reform. Often the organized business lobby is dominated by a few large corporations that may have very different interests than do small- and medium-sized businesses. These corporations can be an essential partner in progressive coalitions seeking to achieve tax adequacy and fairness. These partnerships are discussed in more detail in Chapter Eleven.



## OTHER STEPS TOWARD (OR AWAY FROM) FAIR TAXES

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**T**ax reform is not just about changing the base and the rates of particular taxes. Lawmakers around the nation have enacted procedural changes in the way tax breaks and proposed tax changes are reported and evaluated, as well as rules governing the way taxes are collected and rebated. This chapter looks at several such reforms and discusses their impact on the quality of state and local tax systems.

### Tax Expenditure Reports

**L**awmakers often provide targeted tax cuts to particular groups of individuals or corporations. These special tax breaks are called “tax expenditures” because they are essentially government spending programs that happen to be administered through the tax code. However, tax expenditures are usually less visible than other types of public spending—which makes it harder for policymakers and the public to evaluate these hidden tax breaks.

The main difference between tax expenditures and regular government spending is that under the tax expenditure approach, instead of the government sending out a check to the recipient, the recipient pays less in tax. For example, a government could create a direct spending program to subsidize windmill construction. Or, instead, it could offer a tax expenditure that lets companies building windmills reduce their taxes by exactly the same amount. In theory, it doesn’t matter whether a government uses direct spending or a tax expenditure to achieve a policy goal.

In practice, however, tax expenditures differ from direct spending in several important ways.

- Unlike most spending programs, tax expenditures are usually open-ended; they have no built-in budget limits, and generally there is no annual appropriations or oversight process.
- Tax agencies typically have little incentive to ensure that tax-expenditure programs are working as they were hoped to. By contrast, government agencies tend to look closely at the effectiveness of their direct spending initiatives.
- Basic facts about who benefits from tax expenditures are often hidden behind the cloak of tax return secrecy, unlike the beneficiaries of conventional spending programs.

As a result, tax expenditures often turn out to be very expensive programs for which there is little oversight. Once a tax expenditure is put into the law, it usually stays there indefinitely. And typically little is known about what the government is getting—if anything—for its money.

In most states, lawmakers don’t know how much is being spent on tax expenditures. Of course, tax collections are lower than they otherwise would be. But how much lower is a mystery.

In recognition of this problem, many states (and the federal government) now publish **tax expenditure budgets**. These are simply a listing of tax breaks and how much they cost.

A growing number of state governments have followed the federal government’s lead by publishing tax expenditure reports of variable quality. The best reports include the following:

- A **complete list of all exemptions** from taxes levied by a state—including tax breaks (like exemptions of services from state sales taxes) that are not explicitly written in the tax code.
- **Estimates of the state and local revenue loss** from each tax expenditure, including estimates of how much the tax break is likely to cost in the future.
- Many state tax expenditures are inherited indirectly by state linkage to federal tax codes. Separately **itemizing these indirect federal tax breaks** will give policy makers a clearer understanding of the extent to which the federal linkage reduces state revenues.
- A written **evaluation of the effectiveness of each tax expenditure** will help policy makers to understand why each tax break was enacted—and how well it achieves its stated goals.

- A **regular publishing schedule** that coincides with the state budgeting process. State policy makers should be able to evaluate tax expenditure side-by-side with conventional spending.

## Tax Incidence Analysis

**T**ax fairness is an important policy goal—and lawmakers frequently make bold claims about the impact of tax reform proposals on tax fairness. However, most states do not currently have the analytical capability to evaluate these claims—so the media, the public and even lawmakers are often left in the dark about the true impact of tax reform proposals. The best tool for evaluating the fairness of state taxes is tax incidence analysis, which measures the impact of various taxes on residents at different income levels. Only three states—Maine, Minnesota, and Texas—have legal requirements mandating the regular use of tax incidence analyses, although other states are currently developing a limited tax incidence analysis capability.

By developing a regularly-used tax incidence model capable of evaluating all of the major taxes levied at the state and local level, state lawmakers can increase the public’s understanding of tax policy issues—and can help build public trust in elected officials. But until a regular tax incidence analysis capability is introduced, policymakers and the public will have no easily available basis for evaluating the fairness of important tax policy decisions. This increases the likelihood that lawmakers will be persuaded by false claims about the fairness of various proposals—and also makes it less likely that tax fairness will be a factor in tax policy decisions.

## Rainy Day Funds

**I**n the long run, states with progressive personal income taxes will enjoy the most reliable growth in tax revenues. But the recent decline of income taxes in many states has left policy makers jittery about the role of the tax in funding services. Some lawmakers have advocated making income taxes less progressive to help ensure the long-term adequacy of state revenues.

This is, however, a red herring. The real culprit in states suffering from income-tax shortfalls in recent years is the unwillingness of states to save sufficient revenue in good years to devote to shoring up revenues in lean years. Almost all states now have some form of “Rainy Day Fund” designed to achieve this—but the recent economic slowdown has exposed the design flaws of many states’ funds. The box at right shows some of the most important factors differentiating effective and ineffective rainy day funds. Important questions to ask about your state’s rainy fund include:

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| <ul style="list-style-type: none"> <li>■ Under what circumstances must lawmakers deposit revenues into the fund? Requiring annual deposits when revenue growth exceeds a certain threshold is a good approach.</li> <li>■ Is there a limit on the size of the fund? Many states limit their rainy day fund to five percent of annual expenditures or less—a figure that most now agree is too low.</li> <li>■ How hard is it to withdraw funds? Excessive constraints on withdrawals make the rainy day fund less flexible as a fiscal policy tool.</li> <li>■ How quickly must the fund be replenished after a withdrawal? The faster the replenishment rule, the less flexible rainy day funds are in dealing with fiscal shortfalls.</li> </ul> | <div style="background-color: #0000FF; color: white; padding: 2px;"><b>Important Features of Rainy Day Funds</b></div> <ul style="list-style-type: none"> <li>✓ Rules for deposits</li> <li>✓ Size limits</li> <li>✓ Rules for withdrawals</li> <li>✓ Rules for replenishing funds</li> </ul> |
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Rainy day funds are a necessary component of a responsible state budget for a simple reason: taxes and public spending operate on different cycles. When the economy slows down, tax revenues slow down too. Declining income means declining income taxes and declining sales taxes as families make fewer purchases. But the need for important public services such as education and transportation does not diminish when the economy declines: declining income

actually *increases* the need for many areas of public spending, such as health care and low-income tax relief. Rainy day funds are an important way of allowing states to match up taxes and spending needs over the business cycle. Almost every state has recognized this reality by enacting a rainy day fund—but few states have created a fund that is truly adequate to bridge fiscal shortfalls.

## Tax and Expenditure Limits (TEs)

A growing number of states now limit revenue growth by placing strict limits on the annual growth of state or local tax revenues or spending. These limits are collectively known as tax and expenditure limits, or TEs. One example of these limits is Colorado’s Taxpayer Bill of Rights (TABOR). Colorado’s TABOR limits the annual growth in state revenues to the sum of inflation and population growth. So if Colorado’s population grows by 1 percent and inflation grows by 2 percent in a given year, Colorado government revenues are allowed to grow by no more than 3 percent in that year. “Surplus” revenues over that limit are rebated directly to taxpayers. So what’s wrong with a TABOR-style limit on state revenues and spending?

- When states collect revenue above the limit, this so-called “surplus” must be rebated to taxpayers. This makes it harder to replenish rainy day funds—which means that when the economy tanks, these states may have to enact painful spending cuts to make ends meet.
- Imposing a spending limit assumes that states are already adequately funding public services. Few state lawmakers would assert with a straight face that their public service needs have all been met—but that’s one implication of strictly capping the growth rate of a state’s spending.
- Spending limits assume that the cost of providing existing services will grow no faster than the limits allow. But many state spending needs grow faster than population and inflation, as any state lawmaker confronting skyrocketing Medicaid enrollment and education expenses can attest. And some public sector spending—spending on corrections facilities, for instance—can grow faster than spending limits for reasons that are beyond the control of lawmakers.
- Spending limits also assume that no new and unanticipated spending needs will emerge. The states’ recent experience with homeland security expenditures attest to the constantly changing mix of spending priorities at the state level.

TABOR limits are often described by their proponents as a good-government tool. But state bond rating agencies, arguably the best arbiter of state fiscal health, reject this argument. In 2002, Standard and Poor’s downgraded Colorado’s bond rating, citing the TABOR spending limits as a reason for this punishment. And Colorado policymakers are now engaged in a heated debate over whether their TABOR limit should be modified or repealed entirely.

Across the nation, state lawmakers are facing painful decisions between further spending cuts and unpopular tax increases. TABOR-style spending caps restrict the ability of lawmakers to make the bread-and-butter decisions about government activities that should be their primary function, forcing the elimination of needed public services at the very time when they are most needed.

## Good Choices, Bad Choices

Some of the structural reforms outlined in this chapter can have a positive impact on the ability of lawmakers to make reasoned, fully informed decisions about tax fairness and adequacy. Tax expenditure reports are an important tool to help citizens evaluate targeted tax breaks that would otherwise be hidden from public view. Tax incidence analysis makes it possible to accurately judge the fairness of tax reform proposals. And an adequate rainy day fund can allow states to weather the storm of economic recessions without cutting public services to the bone. But the arbitrary tax and spending limits collectively known as TEs actually add a new layer of complexity to the already difficult decision-making process facing legislators, making it much harder for policy makers to provide the services demanded by their constituents.

# FIGHTING THE FIGHT

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Progressive tax reform may seem like a daunting task. After all, successful tax reform can take years—and progressives often are too busy fending off the unfair “tax deform” strategies of anti-tax organizations and lawmakers to embark on their own constructive agendas. But the good news is that the road to a fairer tax system is clearly marked. This chapter looks at important strategies and information sources for progressive tax advocates seeking to follow this road.

### Strategies for Progressive Tax Reform

The first step in achieving state tax reform is to **understand what’s wrong with your state’s tax system**. This report has described in general language the structural flaws that plague almost all states’ taxes—such as narrow sales tax bases and corporate tax loopholes. But there is no substitute for a good understanding of exactly which provisions of your state’s tax laws prevent the state from achieving a fair and adequate tax system. The resources described later in this chapter can help you to learn more about the specific flaws in your state’s tax structure.

In describing your proposals for tax reforms to fix these structural flaws, it’s important to **be specific about what your plan does and how it affects people**. If your plan includes a vaguely stated proposal to raise income taxes on the rich, tax reform opponents will claim that by “rich” you mean anyone with a job. But if you make it clear that (for example) your plan would raise the tax rate on those with incomes over \$200,000 by 5 percent in order to pay for a tax cut for those earning under \$50,000, and would result in a tax cut for 60 percent of your state’s residents, you’ll have the kind of clearly stated proposal that will be difficult for the other side to distort.

Unfortunately, even clearly-defined tax reform plans can be smeared by scare tactics. So it’s important to **be prepared to respond to misleading arguments** against your plan. For example, opponents of tax reform frequently claim that raising taxes on the wealthy or corporations will drive businesses away from a state and cost jobs. Or they will falsely claim that tax reform would increase taxes on middle-income families. These arguments are usually based on conjecture rather than research, and when there is “research” to back these claims up, it is often poorly designed. (See Chapter Nine for more on how to evaluate these anti-tax claims.) The goal of these scare tactics is not to inform voters—it’s to make tax issues seem harder to understand than they really are, and to create confusion about what a reform proposal really does. So it’s important to recognize and debunk specious arguments against progressive tax reform.

For example, it’s important to remember that tax fairness means asking people to pay according to their ability and that incidence tables are the best measure of what is fair. Of course, your opponents will try to undermine incidence analyses. They might claim, for instance, that the top fifth of the population pays some high percentage of the total tax burden and that it wouldn’t be “fair” to make them pay more. But this argument is nothing but a smoke screen. What really matters is the share of income paid in tax by taxpayers at different income levels—and by this basic measure of fairness, the wealthiest residents in most states pay substantially less than lower- and middle-income taxpayers.

It’s also important to **highlight the linkage between the taxes you want to reform and the public services that are provided by these taxes**. If you ask most people whether they favor raising the state income tax, they’ll probably say no. But if you ask people whether they favor raising the income tax to help fund education or health care, they will be much more supportive. Most people understand intuitively that the public services they value can only be provided if the tax system raises adequate revenues to pay for them—so it’s important to remind people that the ultimate purpose of tax reform is to ensure the continued provision of these services.

Successful tax reform campaigns should **include organizations from many sectors of the community**. Unions, religious groups, public interest organizations, business groups and others should all be part of the campaign. Certainly, with more groups, there will be more conflict over the campaign's goals and tactics. But without broad participation, it is very difficult to overcome the power of those who oppose reform.

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

When these strategies are followed, successful tax reform efforts can be the result. For example, in recent years Alabama Arise and the Virginia Organizing Project each helped to build broad-based coalitions in their states. These groups developed plans for progressive tax reform, publicized which income groups would see increases or cuts in taxes as a result of their proposals, and worked with legislators and the media to help these groups understand the basic tax policy principles underlying their proposals. They also helped to lay the groundwork for public acceptance of tax reform by holding public workshops to explain basic tax fairness issues. This ongoing work helped to establish these groups as a credible source of accurate incidence, and made these coalitions a respected voice in state tax policy debates. The work of these coalitions also helped to increase the visibility of tax fairness issues in both states.

## Resources for Further Investigation

There are many sources of information on state taxes. A good place to start is with the reports issued by ITEP and **Citizens for Tax Justice (CTJ)**. ITEP analyzes the fairness of state and local taxes in dozens of states annually. ITEP's *Who Pays?* report (2003) provides a baseline for measuring the fairness of taxes in all fifty states. CTJ monitors the fairness of federal tax reform proposals; CTJ's analyses of the Bush tax cuts were the most widely cited measuring-stick for evaluating the unfairness of these cuts. CTJ and ITEP also have published a series of analyses of corporate tax avoidance, most recently *Corporate Income Taxes in the Bush Years* (2004).

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

Other good sources for information on state taxes include:

- **State revenue and tax departments.** Many states publish reports that provide valuable information about the state's tax structure. Usually, the best place to start is with your state tax agency's annual report—but be sure to check out a complete list of available publications. Tax departments also often have a great deal of unpublished information. If there's something you need but can't find in an agency's publications, give the agency a call and ask for it. You can access the websites of these agencies on ITEP's website at [www.itepnet.org/linkileg.htm](http://www.itepnet.org/linkileg.htm).
- **State advocacy and research groups** are an essential component to any successful movement for tax fairness. These groups can be found in most states. ITEP maintains a list of these groups, organized by state, on our website at [www.itepnet.org/linkistg.htm](http://www.itepnet.org/linkistg.htm).
- The **U.S. Census Bureau** publishes *Government Finances*, a helpful source of data for comparing your state's tax system to other states. Census reports are available at [www.census.gov](http://www.census.gov).
- The **Center on Budget and Policy Priorities** publishes a wealth of information on tax and spending programs as they affect low-income taxpayers. Their website is [www.cbpp.org](http://www.cbpp.org).

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

## Final Thoughts

The need for progressive tax reform is now greater than ever. Even before the recent economic slowdown began, state and local taxes in almost every state were regressive. And most of the states that have managed to push through revenue-raising measures to respond to recent budget deficits have done so in a way that makes their tax systems even less fair—hiking regressive sales and excise taxes much more frequently than progressive income taxes. Meanwhile, as this report has documented, the structural flaws that have reduced the yield of these taxes remain unresolved:

- State and local sales tax bases are too narrow: few states have expanded their tax base to include services, the fastest-growing area of consumption. And many states have a host of poorly-targeted exemptions for the sales of various goods that reduce the yield of each penny of tax. Collectively, these tax breaks put added pressure on lawmakers to increase the sales tax rate on the remaining items of consumer spending.
- Personal income taxes, ostensibly the most progressive tax levied by states, are being eroded away—and made less progressive—by a proliferation of poorly targeted tax breaks for capital gains, retirement income and other income sources. And many states use income tax brackets that require a large percentage of taxpayers to pay at the top rate, rather than subjecting only the wealthiest taxpayers to the highest rates. These structural flaws mean that most state income taxes are not living up to their potential as a progressive offset for the regressive sales and property taxes that states rely on most.
- Corporate income taxes continue to decline, as federal and state tax breaks and clever accounting tricks by the corporations themselves make the tax base ever narrower.
- Property taxes remain an important, but unfair revenue source for state and local governments. Many states have enacted overly restrictive tax limits designed to reduce the use of these taxes, but relatively few have enacted well-targeted exemptions or credits designed to reduce the property tax on the low-income taxpayers for whom these taxes are most burdensome. And many states have not yet dealt with the inequities between low-wealth and higher-wealth taxing districts that the local property tax usually creates.

Events at the federal level have compounded these inequities: in the last four years alone, the wealthiest taxpayers have seen their effective tax rate decline substantially, while lower- and middle-income taxpayers have failed to reap similar gains. And corporate income taxes are nearing an all-time low. These unaffordable federal tax cuts have had the predictable impact of forcing cuts in important federal services, and cutting aid to state and local governments.

With the political paralysis and the knee-jerk fear of taxes so often found in Congress and state houses throughout the country, the task of igniting tax reform falls on tax activists. We do have one important thing going for us: most people *want* fair and adequate taxation. The key is showing the public, elected officials and the media what fair tax policy is and how it can benefit the people of our nation. We hope this primer provides you with enough tax policy knowledge to start that process.

## GLOSSARY

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**Adjusted gross income (AGI).** On an personal income tax form, the amount of income that is subject to tax after all adjustments have been taken, but before subtracting deductions or exemptions. (Chapter 5)

**Adjustments.** Income tax breaks that reduce the amount of taxable income. For example, on federal income tax forms moving expenses, some teaching supplies, and contributions made to certain retirement plans are subtracted from income. Most states allow the same adjustments that are allowed on federal forms, and many allow their own unique adjustments. These adjustments are often enacted with good intentions, but tend to make the income tax more complicated than it needs to be. (Chapter 5)

**Ad valorem tax.** A tax based on the value of the thing being taxed. Sales taxes are based on the sales price of items taxed, so they are ad valorem taxes. Cigarette taxes are not ad valorem taxes, because they are levied on a per-pack basis, so tax collections do not vary with the price of a pack of cigarettes.(Chapter 3)

**Apportionment formula.** The formula states use to divide up the profit of a multi-state corporation into an “in-state” portion and an “out-of-state” portion. In theory, apportionment rules should divide a corporation’s income between the states in which it earns profits in such a way that all of its profit is taxed exactly once, but special apportionment rules mean that some profits are never taxed at all. (Chapter 6)

**Assessed Value.** The official value of a property for tax purposes, as determined by property tax officials. A property’s assessed value can be equal to its market value, or less than market value, depending on the legal assessment ratio used by the state and the quality of assessments. (Chapter 4)

**Bracket Creep.** When income tax brackets are not adjusted frequently to account for the impact of inflation, taxpayers can see income tax hikes over time even if their real income doesn’t grow. These inflationary tax hikes can affect any income tax variable that is defined as a fixed dollar amount, including exemptions and credits, and can also reduce the value of property tax breaks. (Chapters 4, 5)

**Business Input Sales.** The sale of items purchased by businesses to create their products. For example, a baker purchases flour to make bread. The baker’s purchase of flour is a business input sale. Retail sales taxes should not apply to such sales—but most state sales taxes do so to some extent. (Chapter 3)

**Circuit Breakers.** A form of targeted property tax credit. Typically, states give homeowners a credit equal to the amount by which their property tax exceeds a certain percentage of their income. Most states target their circuit breakers to elderly homeowners, but an increasing number of states use them to deliver tax relief to non-elderly taxpayers and to renters. (Chapter 4)

**Consumption Tax.** A tax that applies to purchases of goods and/or services by individuals and businesses. These taxes include general sales taxes, which apply to retail sales, and special excise taxes on alcohol, cigarettes, and gasoline. (Chapter 3)

**Credit.** A dollar amount subtracted from tax liability. (By contrast, deductions and exemptions are subtracted from taxable income.) Tax credits are used primarily to reduce income and property tax liability, but are occasionally used to partially offset the regressivity of sales taxes. In general, credits are a more progressive approach to tax relief than are exemptions. (Chapters 3, 4, 5)

**Effective Tax Rate.** The tax burden as a share of the potentially taxable base. For example, the effective income tax rate is the income tax paid expressed as a share of total personal income. (Chapter 2)

**Excise Tax.** Sales taxes that apply to particular products. For example, many states levy excise taxes on alcohol, cigarettes and gasoline. Excise taxes are especially regressive because the tax is levied on a per-unit basis (so the tax on a bottle of cheap wine is the same as the tax on an expensive wine). (Chapter 3)

**Exemptions.** A special rule that provides a tax shelter for some economic activity. Exemptions reduce the amount of taxes owed. Income taxes usually allow exemptions for each taxpayer, and property taxes often allow part of a home’s value to be exempted from tax. Sales taxes frequently exempt all sales of certain items such as food, utilities and rent. (Chapters 3, 4, 5)

**Exported Tax.** The amount of a tax paid by out-of-state residents. Some part of almost every state tax is paid by residents of other states. This helps ensure that non-resident individuals and businesses that use a state’s services pay their fair share of the cost of providing these services. (Chapter 2)

**Graduated Tax.** A graduated tax applies higher tax rates to higher income levels. Most income taxes use graduated rate structures. By contrast, a flat-rate tax applies the same rate to all incomes. (Chapters 1, 5)

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

**Incidence Analysis.** A tool for measuring the fairness of state and local taxes and tax changes. (Chapter 2)

**Intangible Property.** Property that has no physical substance, but may have financial value. Examples of intangible property include stocks, bonds, and retirement plans. (Chapter 4)

**Marginal rate.** Income tax rates that apply only to the taxable income over the amount where the tax bracket starts. (Chapter 5)

**Nexus.** The minimum level of contact that a business must have with a state in order for its activities to be taxable in that state. (Chapters 3, 6)

**Progressive.** A progressive tax is one in which upper-income families pay more of their income in tax than do those with lower incomes. (Chapter 1)

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

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

**Regressive.** A regressive tax requires low- and middle-income families to pay more of their income in tax than wealthier families must pay. (Chapter 1)

**Remote Sales.** Purchases of items from companies based in other states. Every state with a sales tax also levies a use tax designed to tax these remote sales. (Chapter 3)

**Retail sale.** A sale made to the final consumer of a product. When we buy a new refrigerator for personal use, that's a retail sale. By contrast, when a business buys lumber for use in building a house, that's not a retail sale but an *intermediate transaction*, because the goods purchased are used in the process of making something else. In theory, states should tax all retail sales and exempt all intermediate transactions, but almost all states fall short of both of these goals. (Chapter 3)

**Tangible Property.** Property that has physical substance and can be touched. This includes real property such as homes and apartments, and personal property such as cars and furniture. (Chapter 4)

**Tax Base.** The amount subject to tax. If all the consumers in a state purchase \$1,000,000 in coffee each year, then the tax base for a coffee sales tax would be \$1,000,000. However, the tax base does not have to be expressed in terms of money. If coffee was taxed by the pound, then the tax base would be the number of pounds of coffee sold. (Chapter 2)

**Tax Expenditure.** A special tax break targeted to particular groups of individuals or businesses. These tax breaks have the same impact as a direct government spending program giving cash grants to these groups, but implementing them through the tax system makes these grants less visible—and makes lawmakers less accountable for explaining why these breaks are a good idea. (Chapter 10)

**Uniform Division of Income for Tax Purposes Act (UDITPA).** Model legislation adopted in the 1950s by legal reformers seeking to achieve fairness and uniformity in state corporate tax practices. Most states initially adopted at least some of the UDITPA recommendations, but many have moved away from UDITPA recommendations by changing apportionment factors and other rules. (Chapter 6)

**Use Tax.** A sales tax which applies to goods that are purchased from out-of-state retailers. (Chapter 3)

**Vertical equity.** The measure of tax fairness that describes how a tax system treats people at different income levels. When we describe a tax as regressive, proportional or progressive, we're making a statement about vertical equity. (Chapter 2)