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**THE GOVERNMENT PERFORMANCE PROJECT**

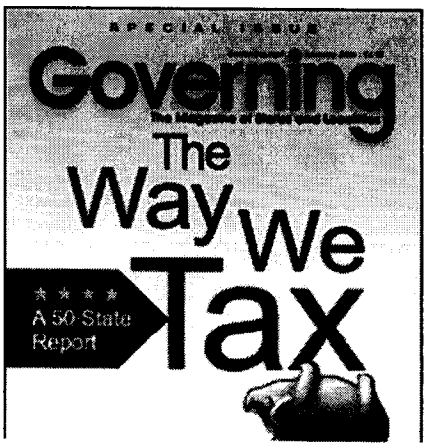
# The Way We Tax
## A 50-State Report

**By KATHERINE BARRETT & RICHARD GREENE, MICHELE MARIANI and ANYA SOSTEK**

The vast majority of state tax systems are inadequate for the task of funding a 21st-century government.

Most of those tax systems are also unfair. They break the golden rule of tax equity: collect the lowest possible rates on the widest possible base of taxpayers.

In addition, at a time when states are desperate to collect every dime they're owed, many are short-changing their tax-collection departments, cutting revenue agency budgets with a heavy hand.




These conclusions and others are the culmination of a year's effort by a team of *Governing* staffers researching the tax structures and tax management of the 50 states.

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**Coming soon: Supplementary reports on all 50 states**

Scores of reports, hundreds of interviews and thousands of hours of analysis went into this effort to evaluate the way each state raises its revenues.

Of course, the burden a tax system must carry varies from state to state. There is no such thing as a perfect structure, no template that all, or even most, of the states could use. One of the glories of the American system of governance is that states are free to offer different degrees of service to their citizens. The main commonality is that they must raise whatever revenue they need to meet their chosen level of service. Raising money to meet irresponsible spending doesn't make for a good tax system. But utilizing well-balanced streams of revenue and avoiding unsupportable tax cuts are critical, regardless of whether a state wants to have a Cadillac government or a Chevy.

Creating and maintaining a high-quality tax system — and balancing it against the demands of its citizenry — may be one of the most difficult tasks any state, or any government for that matter, faces. The two sides of the equation are often out of whack. Consider this: When Pennsylvanians were surveyed last summer, the majority favored higher prescription drug subsidies for the elderly, more money for public education and better funding for higher education. They also, however, opposed any increase in the state's sales tax or income tax. Gambling was the only new revenue source people favored.

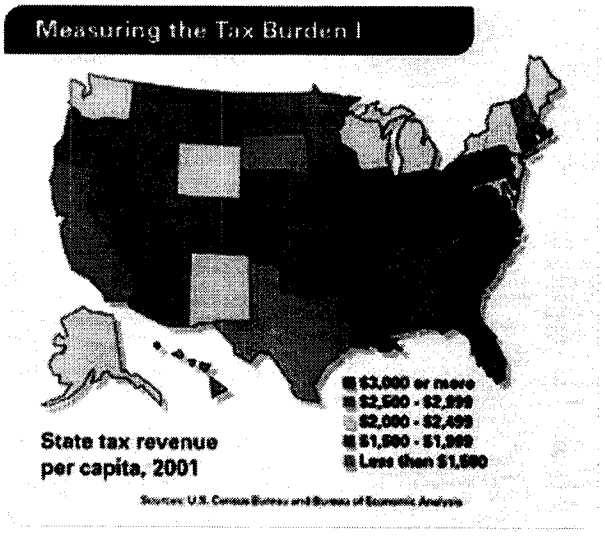
Of course, this is unrealistic. But it's the nature of the implausible and inscrutable world of state taxation, a world in which hyperbole is the native language and nitty-gritty politics trumps common sense. "It's the old classic," says Arkansas Governor Mike Huckabee. "Everyone wants to go to heaven, but nobody wants to die."

It's also a world of pliable statistics, where reality is a relative concept. "There are 50 states, 50 education governors, 50 bad states for taxes," says Randy Hodgins, who's on the staff of the Senate Ways and Means Committee in Washington State. "You can make statistics do whatever you want." Maine, for example, is 17th in its per-capita state tax burden. Mix in local taxes and the state has the 10th-highest per-capita tax burden. But look at taxes as a percentage of personal income, and the state zips up to third place.

States with unbalanced tax systems are particularly ripe for misinformation and misconception. In Texas, sales and property taxes are high because there is no income tax. Even though Texas ranks near the bottom in tax burden — per capita or otherwise — its citizens "think of themselves as overtaxed," reports Judith Stallmann, a professor at the University of Missouri.

This kind of veracity vertigo wouldn't be such a bad thing if complaining about high taxes were like complaining about the weather. But politicians who want to stay in office regularly disregard their better instincts and follow their citizens on a path to misbegotten policies. Tennessee's tax structure, with its over-reliance on high sales taxes, is, for instance, famously dysfunctional

and inadequate to state needs. Well-informed observers have long argued in favor of adding a state income tax to the mix. "Many in the legislature believed the income tax was the right approach to funding government," says Bill Fox, a nationally known tax expert and professor at the University of Tennessee. "But the percentage who was willing to vote for it was different."



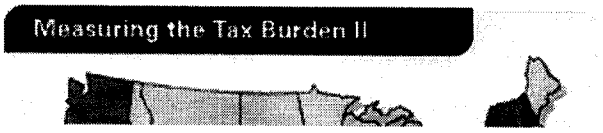

Over the past couple of years, the states have found themselves beset by so many financial problems that the word "fiscal" appeared to be married to the word "woes." The National Governors' Association dubs the current crisis "the most dire fiscal situation since World War II." In the months following the 2002 elections, many states discovered their fiscal problems were even worse than anticipated and headed into the January legislative sessions facing huge budget shortfalls.

Of course, most states will first look to cutting expenses in order to make their books balance. But it's inevitable that over the next few months, many legislatures are going to be forced to make hard decisions about new revenue streams. They will have to take a close look at their tax systems — as well they should.

Truth is, many states' current maladies are rooted in long-diseased tax systems. And although some state leaders are still living in denial, today's problems were nothing if not predictable. In July 1999, while money was rolling into state coffers, the late Hal Hovey, one of the most perspicacious observers of state finances, wrote, "While spending for current services will grow at about the same pace as personal income, state and local revenues from existing taxes will not do so." The result, he noted, would be a shortfall in state and local budgets "that is almost entirely attributable to the characteristics of state and local tax systems."

## THE FRONT FOUR

States rely on some combination of four major taxes to support their services. Of course, there are a host of smaller revenue streams that are important in various states. But it's sales taxes, personal income taxes, property taxes and, to a lesser extent, corporate taxes that provide the bulk of revenues in most states.




Property taxes, of course, are primarily collected at the local

level. But the distinction between local and state taxes is often fuzzy. After all, when property taxes get too high, states often cap that source of revenue and then subsidize localities with money from income or sales taxes.

When states play Scrooge with local aid, as happens in New York, state taxes remain relatively unpressured but local taxes feel the effects. State taxes in New York are, believe it or not, ranked 27th as a percentage of personal income. Add in taxes assessed by local governments — where property taxes are escalating — and taxpayers who live in New York State are No. 1: They carry the highest tax burden of all.

Generally speaking, property taxes are incredibly unpopular — largely because they tend to be paid in big, noticeable lumps. And if they're not well administered — if appraisals are conducted infrequently, for instance — they can be very unfair. That said, property taxes are a sound way for governments to bring in revenue. They tend to be stable and their problems — they may unreasonably hurt fixed-income elderly whose houses have escalated in value — can be alleviated through a variety of simple measures.

A balance between the four sources of revenue is ideal. Income taxes tend to move more dramatically than the economy. Property taxes are much slower to oscillate. Sales taxes tend to fall somewhere in between. "A diversified revenue structure is important," says Don Boyd, director of the fiscal studies program at the Nelson A. Rockefeller Institute of Government. It brings some stability and a shot at a more constant revenue stream. "Look at Alaska," Boyd says, noting a case in point. "You see that their revenues swing wildly because they rely on one or two revenue sources."

## IRRATIONAL EXUBERANCE

Diversification, however, is no guarantee that a state can slide through economically stressful times. In fact, states that lack a broad-based income tax, such as New Hampshire, have ridden through the current recession with less pain than those with income taxes. Income taxes are vulnerable to economic swings and have been particularly volatile in the past couple of years — artificially buoyed as they were by the stock market boom. While the stock market — and the states' revenue bubble from it — soared for seven years, the highs couldn't go on forever. Still, many states — Arizona, Idaho, Maryland, Massachusetts and Virginia, among them — seemed to think they could. They cut taxes steeply and paid their annual bills with stock market-based money. Overall, net state tax reductions amounted to $35.7 billion between 1995 and 2001, but state tax receipts still grew at an annualized rate of 6.4 percent.

While the numbers looked good, the approach broke two of the most fundamental rules of basic finance: Do not pay for ongoing expenses with one-time revenues. Do not cut tax rates in response to a transitory surge in revenues.

To their credit, many states used part of the windfall to fill their rainy day funds. But that is money that can be used only once — spend it and it's gone — to stop the pain of a budget wound. The erosion of the income tax base, however, can hurt indefinitely. "I've always said, 'Once you giveth you cannot taketh away,' " says R. Gary Clark, Rhode Island's tax administrator. "I've seldom been proven wrong."

Nonetheless, the political pressures to cut income taxes and make political capital out of the windfalls are intense when there's a lot of money flooding the coffers. According to one prominent budget official, budget directors were telling their governors throughout the boom years that the good times wouldn't last, that the windfall had to be used for one-time spending. "Even if they proposed one-time only uses, the legislators would have rejected it," he explains. "You get it from both sides. People from left of center say you have to spend more, and people right of center say we have to have tax cuts. You're talking about incredible political pressure. Everybody treated the new money as recurring revenues."

## A PROBLEM PRODUCER

The other major source of state revenues — the sales tax — has its own problems. Relying on the sales tax is "like riding a horse that is rapidly dying," according to James Hite, an expert on such matters at Clemson University.

**Sales Tax Sticklers**

The five states most reliant on sales tax for revenue

| STATE | % OF TOTAL COLLECTION |
|---|---|
| Washington | 63.6 |
| Florida | 59.0 |
| Tennessee | 57.3 |
| Nevada | 53.5 |
| South Dakota | 52.7 |
| 50-state average | 32.1 |

Source: U.S. Census Bureau, 2001

With a total take of more than $170 billion in 2001, broad-based sales taxes are collected in 45 states and account for about one-third of total state budgets. Given the strength — so far — in consumer spending during the current economic downturn, sales tax receipts have not been hit nearly as hard as income tax revenues. But the problem with the sales tax is that its base has not moved forward with the times. "Nearly every state has a defective sales tax in terms of dealing with the economy of the 21st century," says John Mikesell, professor of public finance at the University of Indiana. "We're still pretty close to the taxes that were developed in the 1930s Depression."

What Mikesell is talking about are numbers such as these: In 1960, 41 percent of U.S. consumption dollars were spent on services provided by attorneys, accountants, landscapers, pool-cleaners and the like. By 2000, this percentage had risen to 58 percent. And yet, only three states — Hawaii, New Mexico and South Dakota — get a significant portion of revenues from services. Instead, sales taxes are largely collected on tangible goods, and those goods account for an ever-dwindling share of the total economy.

Why don't states just start taxing more services? There are two good reasons and one bad one. The first good reason is that it could put them at a competitive disadvantage. If Illinois, say, taxed sales

of accounting services, there would likely be a sudden boom in CPAs doing business in nearby Indiana.

The second good reason is that when some services are taxed, there's a likelihood of double and triple taxation. If, for example, you hired an attorney and he, in turn, brought in an accountant to help with the case, the sales tax on the accounting fees would be built into the legal fee and you'd pay a sales tax on that. "It's not a good idea to tax items that are used by business," says Andrew Reschovsky, professor of public affairs and applied economics at the University of Wisconsin-Madison. "And if you look at legal services, for example, most of them are provided to businesses."

The bad reason? It's a political pariah. In 1986, Florida passed a sales tax on most services. The new tax included advertising. That turned out to be deadly. "The advertisers killed it in enlightened self-interest," says Larry Fuchs, former revenue director of Florida. "They just kept hammering at it. In the end, Governor Bob Martinez was willing to compromise and cut the advertisers out. But it was too late. It was doomed." So, by the way, was Martinez, who was voted out of office three years later.

This is the kind of thing that isn't quickly forgotten by other politicians. Fifteen years later, most states are still just nibbling at the edges of service taxation. Arkansas, for example, taxes armored car services, auto parking and fur storage. Generally sales taxes fall on services that don't have vocal or powerful constituencies. The fur-storage lobby has never been known as a powerhouse in Little Rock. Meanwhile, the big-ticket items — legal services, accounting and advertising — have the organization, wherewithal and clout to escape unscathed.

## FOOD FOR THOUGHT

The erosion of the sales tax is also due to the exclusion of more and more tangible goods from the taxable base. States have a propensity to exempt a hodge-podge of items. Sometimes this is done in an effort to bring greater fairness to a system. About 30 states have either reduced the sales tax rate on groceries or eliminated the tax altogether to make the sales tax fairer to poor people. Sometimes exclusions are done to please a special interest group. In either case, the overall effect of such legislative decisions to exclude items is to narrow the sales tax base and thereby make it less productive.

A quick look at the list of things freed from the sales tax is downright funny. In New York, Kool-Aid is taxable, but Ovaltine is exempt. Candied apples are taxable, as are Jordan almonds, but Clamato Juice Cocktail and pretzels are not. That is, of course, provided the pretzels are not candy- or sugar-coated. Or sold hot.

**Income Addiction**

The five states most reliant on individual income taxes

| STATE | % OF TOTAL COLLECTION |
|---|---|
| Oregon | 74.4 |
| New York | 59.0 |
| Massachusetts | 57.5 |
| Virginia | 55.2 |
| Colorado | 51.5 |
| 50-state average | [illegible] |

Source: U.S. Census Bureau, 2001

Ohio Tax Commissioner Tom Zaino keeps

two bottles of Snapple on his desk as an illustration of just how absurd some exemptions can be. One bottle is iced tea; the other, fruit punch. Ohio law says that fruit juice is not a food, so it's taxable. But iced tea is defined as food, so it's not taxable. The tricky part, Zaino says, is that food is only exempt if the purchaser carries it out of the store. If it's consumed in the place of purchase, it is taxable. Which means the checkout clerk has to figure out whether the customer is bringing the Snapple iced tea home or not.

Ultimately, however, the states are far less concerned about the vagaries of their own tax systems than they are about the possibilities of losing tax dollars when citizens make remote purchases. With the Internet and its potential to turn every wired living room into a department store, everyone is worried and with good reason. Nobody knows precisely how much money is being lost to states from online transactions, but estimates range to $14 billion — and the number is sure to grow.

Right now, not only are the logistics of taxing Internet transactions wildly complicated, states aren't even allowed to require retailers to collect. A U.S. Supreme Court decision ruled that it was simply too burdensome to do so and that only the U.S. Congress could give the states the go-ahead to make the tax collectable. Recognizing that they needed to streamline the tax in order to persuade Congress to help them, a majority of states have been working on a multi-state agreement to establish a uniform system to administer and collect sales taxes. Legislators of individual states will now have to decide whether to approve the agreement that, among other things, reduces the number of sales tax rates and provides uniform definitions of goods and services.

Whether or not a critical mass of states will jump on the bandwagon is an open question. What's clear, however, is that as long as they can't tax Internet or mail-order transactions, the state sales tax base is going to be disappearing as quickly as a database with a bad virus.

## ESCAPE ARTISTS

If the sales tax base is a shrinking resource, corporate income taxes belong on the endangered species list. Corporations still contribute significantly to state and local revenues through property taxes and sales taxes. But, according to a report by Nicholas Jenny of the Rockefeller Institute, their contribution through corporate income taxes has wasted away: In the early and mid-1990s, corporate income taxes contributed about 8 percent of total tax revenue to the states; recently, they stood at less than 4 percent. And that may be the good news. Most tax experts think the corporate income tax will continue to fall as a percentage of total tax revenue.

Today, Oregon raises more money from its lottery than its corporate income tax. In Nebraska, the corporate tax has become so minimal that legislators have jokingly speculated that the only reason to keep it on the books is so they'll have a tax to give back when they want to attract new companies to the state.

The corporate-tax problems are manifold. For one thing, a number of states have changed the formulas that govern the income base on which corporations can be taxed. Some are shifting to tax formulas that are heavily based on the portion of a company's sales that take place in their state. About one-fifth of the 46 states that tax corporate income have gone so far as to use sales as the only factor in determining income tax liability for all or some of their corporate taxpayers.

What's the problem with that? Consider a firm with its headquarters and all its factories in Iowa. It sells products in all 50 states and only has 10 percent of its sales in Iowa. Under this system, which tax accountants call "single sales factor apportionment," it would be required to pay taxes on only 10 percent of its profits to Iowa.

**Corporate Collectors**

The five states most reliant on some form of corporate income taxes

| STATE | % OF TOTAL COLLECTION |
|---|---|
| Alaska | 28.0 |
| New Hampshire | 19.7 |
| Illinois | 9.6 |
| Delaware | 9.5 |
| Michigan | 9.4 |
| 50-state average | 5.7 |

Source: U.S. Census Bureau, 2001

The problems just start there. States often don't tax firms that have incorporated under a whole variety of structures, including as limited liability partnerships. Should anyone be surprised that more and more companies have chosen to take that route? Then there are the growing number of companies that have chosen to set up holding companies in their home state, an organizational change that shifts income to subsidiaries in other states or even other countries where the tax burden is low or nonexistent. While this problem can be controlled by tightening up tax laws in the home state — as New Jersey and a growing number of other states are doing — that requires real political willpower.

Deregulation also leads to less income from corporate taxes. Power and phone companies that are no longer regulated are demanding and getting lower tax rates.

Apportionment formulas, the holding-company option and other variations in corporate tax laws give corporate accountants a plethora of opportunities for "planning," one of the most transparent euphemisms in the dictionary of state taxation and one which accounts for the many ways in which corporations have been able to elude state taxes. After all, when you pit a handful of officials in a state revenue office against the squadrons of tax accountants that can be employed by a giant corporation, it's an unequal battle.

Beyond tax avoidance, there's a genuinely reasonable argument to be made about whether corporate income taxes make sense to begin with. A lot of academics think corporate income should not be taxed. They argue that a state can't effectively tax corporate income because of interstate competition and the political power of corporations. If it can't be done effectively, fairly and efficiently, they say, it shouldn't be done at all.

Other tax experts see things differently: Corporations receive services, and they should pay a share for them as they have in the

past. The corporate income tax should be restructured, they argue, so that it is broad based and as low as possible.

Even faced with the current budget shortfalls, only nine states boosted corporate taxes for 2003, while eight states actually cut them, for a net increase of $1 billion. That number is not very dramatic since $900 million of it came from New Jersey. There, Governor James McGreevey waged a post-election war in the press that portrayed his state's corporations as reverse Robin Hoods who take from the poor and give to the rich.

Pressed for revenues, other states may soon be following New Jersey's path. In Missouri, Governor Bob Holden has continued to call on public support for his plan to close a series of business-tax loopholes, evoking images of education-deprived children and vulnerable elderly. And in Texas, both Governor Rick Perry and state Comptroller Carole Keeton Strayhorn have leveled blasts at businesses that tax-plan their way out of paying their share.

Many continue to give away corporate revenue — including that which comes from property and sales taxes — by waging vigorous tax wars with their neighbors for economic development. A 1997 survey conducted for the Council of State Governments showed that all states had greatly increased the level and variety of business tax and financial incentives during the previous 20 years, with 38 states accelerating the give-aways in the last five years of the period.

States argue that these incentives are increasingly vital to their ability to attract corporations. The shift to a service economy has meant that businesses are far more mobile than they used to be. You can't stick a Pennsylvania steel mill in the back of a few U-Hauls and move to Nevada. But you can do something pretty close to that with a computer-software outfit.

A debate has raged for years about the utility of tax incentives. Economic development officials in states such as Alabama, South Carolina and Tennessee proudly point to new plants and new jobs in their states that they attribute to tax breaks. On the other hand, there is a question as to whether companies are simply pitting one state against another to get the best deal they can — and then settling in the state they would have in the first place. "The research we've done has been inconclusive on tax incentives," says Washington State's Randy Hodgins.

## A CHANCE FOR CHANGE

With tax systems in such deteriorating disarray, discussion of reform has been making headway in state capitals. Nevada, South Carolina, Washington and many other states have set up task forces or commissions to try to come up with better approaches to raising revenue. In the past, many of these same states have convened similar panels.

The problem is that virtually every tax reform means shifting burdens. As former Minnesota Governor Jesse Ventura pointed out in his 1999 State of the State address, "One taxpayer's fix becomes

another taxpayer's problem."

What's more, there's a widespread belief on the part of many voters that any change is going to hurt them. A little more than a decade ago, that was precisely the situation in Connecticut, which did not have an income tax but did have high taxes on all sales, corporate profits, utilities and estates. There were recommendations to acquire an income tax, but governors Ella Grasso and William A. O'Neill both took "the pledge" to make sure that such a thing would never sully the liberty-loving citizens of the Nutmeg State. Residents who would have clearly benefited from the new tax dreaded it, believing those who predicted that once it was installed, it would just be raised and raised again until it didn't pay to get out of bed and go to work in Connecticut.

As existing taxes skyrocketed, Governor Lowell Weicker pushed for the new tax. He was burned in effigy, but he and a courageous group of legislators worked to bring the new income stream into existence in 1991. And, despite all the dire predictions, the income tax seems to have given Connecticut a balanced tax system for the first time. "In 1990, we had a sign on the door, don't invest here, don't form a corporation here and don't retire here," says Connecticut state Senator William Nickerson, the ranking member of the Finance, Revenue and Bonding Committee. "Tax reform took away significant disincentives."

Today, Florida, Tennessee and Texas are all facing serious financial problems. They don't have an income tax. And leaders in these states have taken "the pledge" to make sure they don't get one.

Complicating matters still more, it's very difficult for states to be genuine pioneers in tax legislation. Even the most elegant and fair tax idea won't wash if no one else is doing it. Consider the Single Business Tax in Michigan. The state was a national leader when it established it in the 1970s. At the time, this modified value-added tax was heralded by many academics and public finance scholars as good tax policy. But because the tax is so different from anything levied by other states, it complicated life for interstate businesses. An effort to keep businesses happy resulted in a proliferation of credits, thus hurting the revenue-raising benefits of the effort and compromising fairness. The tax is now being phased out.

There is probably no other field in which the distance between academic theory and what really happens on the street is so enormous. Experts criticize the idea of sales tax holidays, for instance, as gimmicks that don't work. Nonetheless, states are lined up to do them. Three years ago, only three states had tax holidays. This year, nine did.

Over the past couple of years, almost no states engaged in anything that could be genuinely defined as wide-scale structural reform. In fiscal year 2002, 16 states raised taxes to help close 2003 budget gaps and another 10 raised fees. Of the $6.7 billion in tax increases, $2.9 billion came from cigarette and tobacco tax increases; most of the rest came from relatively small changes.

Many in state government will quickly tell you that there's a major alternative to tax reform: spending reform. And many state leaders are still sticking to the notion that the current emergency can be solved by cutting back on government services — or making the services they currently provide more efficient. In some states, they certainly have a point. Wisconsin, for example, was overspending its budgets even when the state revenues were running ahead of estimates on a yearly basis. It's difficult to discount the need for budgetary restraint.

But is there enough fat in most state budgets to re-balance them? No. Will citizens likely sit still as they lose services they think are important? No. In any case, even when spending less is an important part of the solution, that's no reason to ignore the problematic nature of the tax systems being used in state government in 2003. Why deal with one without fixing the other as well?

"Everybody's in crisis management right now, needing to do something," says the NGA's Ray Scheppach. "If we ever have an opportunity in the next eight years, that time is now."

## More introductory information:

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