# Faulty Foundations:

***State Structural Budget Problems and How to Fix Them***

Iris J. Lav
Elizabeth McNichol
Robert Zahradnik

CENTER ON BUDGET AND POLICY PRIORITIES

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Center on Budget & Policy Priorities
820 First Street, N.E., Suite 510
Washington, DC 20002
(202) 408-1080

E-mail: center@cbpp.org
Web: www.cbpp.org

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# I. Executive Summary

Many critical government services in this country rely on the ability of states and localities to raise sufficient revenues to provide them. Highways and public transportation, schools and universities, health care for children and elderly individuals, environmental protection, recreational facilities, and many more services depend on state and local funds, largely raised from taxes and fees.

Yet state revenues have an imperfect track record as a stable and reliable source of funding for services. Part of the problem is cyclical. State revenues decline when the economy experiences a downturn, and because most states are required to balance their budgets even during recessions, the decline in revenues often leads to cuts in public services. Also, while states sometimes raise taxes during downturns to reduce the severity of public service cuts, often they overcompensate for these tax increases after the economy recovers by cutting taxes below the level required to maintain services.

In addition to these cyclical issues, state revenues face a more enduring problem often called a *structural deficit,* or the chronic inability of state revenues to grow in tandem with economic growth and the cost of government. States have structural deficits largely because they have failed to modernize their revenue systems to reflect far-reaching changes in the economy. Several states have changed their revenue systems little since the 1930s or 1940s; others have revenue systems that are twenty or thirty years out of date. While tax reform can be a difficult undertaking, failure to modernize state revenue systems can cause substantial problems.

Structural deficits received significant attention from researchers and public finance practitioners in the early 1990s, and a number of states seemed poised to begin addressing the problem. But when the unusual economic boom of the mid-1990s began to swell state revenues, the need to fix structural deficits was soon forgotten.

The following are some of the main contributors to state structural deficits; the chapters of this report discuss each factor in greater detail. (See the appendix for a full review of the literature on the issue.)

- **The U.S. economy's shift from goods to services.** The increasing importance of the production and consumption of services has reduced the growth of state and local sales tax revenues, because in most states, sales taxes are levied largely on tangible goods and not on services. It also has constrained property tax revenue growth, because a service industry may have little property to tax compared to a comparably sized manufacturing industry.

- **The erosion of state corporate taxes.** Advances in transportation and communication have allowed corporations to operate anywhere in the country or even the world. This has largely rendered obsolete the manner in which many states tax corporations, and has made it extremely difficult for states to identify profits that should be taxable. Moreover, corporations have exploited their increasing mobility by demanding special tax breaks from states and localities as a condition of maintaining or establishing a location in a particular community.

- **The growth of interstate sales.** The rapid growth of the Internet and of online sales is beginning to reduce sales tax revenues significantly. Commerce over the Internet may also open up opportunities for avoiding state income taxes.

- **The aging of the population.** The baby boom generation will begin to turn 65 in 2011. Many states provide special income or property tax reductions based on age, often without regard to need; these tax breaks are likely to become prohibitively expensive over the next two decades. In addition, elderly people spend less than younger people — especially on taxable goods such as furniture, clothes, cars, and gasoline — so state sales tax collections will erode as the population ages.

- **The erosion of state income taxes.** State income tax structures are much flatter (that is, less progressive) than the federal income tax. They also have become flatter over time, as many states have failed to change their most basic tax laws in a half century or more. In addition, a number of states have reduced their top income tax rates, further reducing the growth of income tax collections relative to economic growth.

- **States' failure to maintain a mix of taxes that can grow with the cost of government.** States face a number of spending pressures. Medicaid — which makes up one-sixth of state budgets — and other health-related programs continue to grow much faster than the general rate of inflation. As the baby-boom generation ages, states will face escalating costs for prescription drugs (even after the new Medicare drug benefit takes effect) and long-term care. Also, many states are facing public demands for improved education. Yet a number of states have jeopardized their ability to handle these spending pressures by making

themselves more dependent on revenues from slower-growing tax sources such as sales and excise taxes, while weakening the faster-growing taxes such as the income tax and failing to maintain the estate tax.

- **States' adoption of tax and expenditure limitations and supermajority requirements.** A number of states have rigid requirements in their state and local fiscal systems, such as constitutional restrictions on taxation and expenditures or supermajority requirements for increases in taxes. These restrictions make it difficult for policymakers to modernize tax codes and adjust to changing budgetary needs.

- **Federal policies that harm state revenues.** A number of federal laws prohibit states from taxing certain activities. The Internet Tax Freedom Act, for example, prohibits states from taxing the fees consumers pay for Internet access. As the ways in which the Internet is used for communications grow, this prohibition will increasingly undermine states' ability to modernize their tax systems. Moreover, the federal government has so far refused to address the problem of state sales taxation of electronic commerce, which it easily could do.

### *Structural Deficits*

When a state has a structural deficit, its normal growth of revenues is insufficient to finance the normal growth of expenditures year after year. As a result the state faces gaps between estimated revenues and expenditures.[1]

The term "normal growth of expenditures" generally refers to the amount it would cost the state to continue providing the existing level of programs and services. (This is often called a continuation budget or a current services budget.) Even if no programs or services are improved, costs generally rise from year to year because inflation pushes up the costs of purchased goods and services, because states must provide their employees with reasonable increases in wages and benefits in order compete with the private sector, and because the populations that require services may be growing. In addition to normal growth in spending, states sometimes face increased costs over which they have little control, such as natural disasters and new federal mandates.

Certainly states need not continue every program and service they currently provide, and it is healthy for a state to review its budget and determine what programs or services no longer are needed. On the other hand, new circumstances frequently arise that require an increase in expenditures, such as the popular pressure throughout the country for smaller public school classes. On balance, then, the concept of "normal growth of expenditures" remains a useful gauge of how well a state can meet its obligations.

[1] When a state faces a gap between estimated revenues and expenditures in any given budget year, the problem may be the result of both a structural deficit and a revenue adequacy problem. This paper focuses on structural deficits. For a discussion of the differences between a structural deficit and a revenue adequacy problem see box on page 42.

The term "normal growth of revenues" means the revenue level that would occur in the absence of any changes in tax rates or in what is taxable. For taxes such as income taxes and sales taxes, this means the normal change in such revenues that occurs as a result of economic growth. For other taxes and revenue sources, such as cigarette taxes or lottery revenues, it may reflect changes in population or per-capita consumption.

No research has definitively determined how many states have structural deficits, but it generally is thought that most states do have this problem to some degree. Over the last ten years, three studies have examined the structural balance of each of the 50 states. These studies were prepared by Hal Hovey, a state policy expert consulting with the National Education Association; Don Boyd of the Rockefeller Institute of SUNY, Albany; and economists at Boston University and the Department of Commerce. Though these studies differed in their assumptions, techniques, and results, all three found that more than two-thirds of the states face structural deficits.

Throughout this report, we identify ten factors that contribute to a state's propensity to face structural budget problems. These factors are:

- The extent to which services are taxed under the sales tax
- The strength of corporate income tax
- The amount of untaxed electronic commerce
- The extent of tax preferences for the elderly
- The degree of progressivity of personal income tax
- The growth of expenditure needs for residents
- Tax policy choices that worsen structural gaps
- The presence of process barriers such as tax and spending limits
- The failure to delink from federal tax changes that reduce state revenues
- The presence of structural gaps found by other studies

These factors are discussed in detail in the chapters of this report, along with discussions of policy responses.

The more of these issues that a state faces, the more likely it is that the state is currently experiencing — or is likely to experience — serious structural gaps in its budget. In order to assess the risk of structural problems faced by each state we developed a scale based on the measures discussed in this report.

Each state received points for the factors on this list that significantly affects its budget or tax system. (See Chapter 10 for a detailed description of the construction of this scale.) The overall results are summarized in Figure 1 below. Data for the District of Columbia are included in the tables throughout the report where it was available, but, the District does not appear in Figure 1 because information was not available on many of the measures used to compute the risk scores. No state received lower than a 3 on the scale, as all states have some structural problems in their fiscal systems. Over half the states (27 states) scored 7 or higher —

## Figure 1

### Number of Factors Contributing to Structural Gap

| 10 or 9 | 8 | 7 | 6 | 5 | 4 or 3 |
|---|---|---|---|---|---|
| Alaska | Alabama | Arizona | Connecticut | Kansas | Minnesota |
| Arkansas | Georgia | California | Delaware | Louisiana | Nebraska |
| Colorado | Kentucky | Hawaii | Illinois | Maine | New Jersey |
| Florida | Missouri | Idaho | Iowa | Maryland | North Dakota |
| Nevada | Rhode Island | Indiana | Massachusetts | New York | Vermont |
| New Mexico | South Dakota | Michigan | Montana | | Wisconsin |
| Pennsylvania | Washington | Mississippi | New Hampshire | | |
| South Carolina | | Oklahoma | North Carolina | | |
| Tennessee | | Virginia | Ohio | | |
| Texas | | | Oregon | | |
| Wyoming | | | Utah | | |
| | | | West Virginia | | |

**Most at Risk** ◄——————————————————► **Least at Risk**

reflecting the many structural problems facing most states. The states most at risk for structural deficits are Alaska, Arkansas, Colorado, Florida, Nevada, New Mexico, Pennsylvania, South Carolina, Tennessee, Texas and Wyoming.

The scores assigned to states are intended to summarize the degree of risk a state faces for structural problems that result in a gap between *the rate of growth* of revenues and expenditures. States also face gaps between revenues and expenditures that result from other factors such as the use of one-time measures to balance budgets or the use of temporary surpluses for permanent tax cuts or spending increases. As discussed in more detail in the box on page 42 the solutions to these problems differ from the solutions to the structural growth problems that are the focus of this paper.

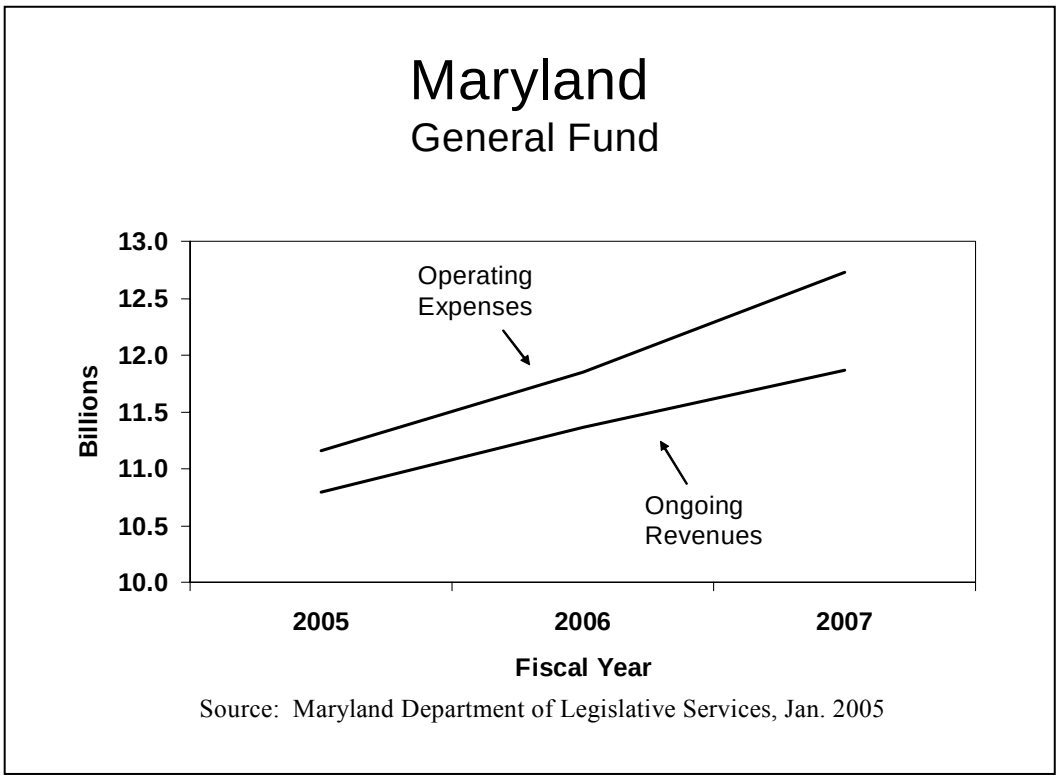
A number of studies in specific states have also documented structural deficits. The results of several of these studies are summarized in Appendix 2. For example:

- A long-term projection of Kentucky's spending and revenues by Professor William Fox of the University of Tennessee found that the state faces a gap equal to 12.5 percent of its budget by 2007.

- The New Mexico Legislative Finance Committee projects a gap equal to 3.5 percent of the states' budget by 2007.

State studies have found sizeable structural gaps even in states with a moderate number of risk factors.

**Figure 2**




Source: Maryland Department of Legislative Services, Jan. 2005

- As of February, 2005, New York State's Division of the Budget projected that the state's budget would be out of balance by $5.8 billion (13 percent) by 2007 unless taxes are raised or spending is cut.

- A study of New Hampshire's budget by the New Hampshire Center for Public Policy Studies projects a gap equal to 8.0 percent of the state's budget by 2007.

Figure 2 which shows the results of a structural deficit study in Maryland demonstrates how structural problems result in a gap between revenues and spending that widens over time.

In many states, structural deficits generally remain hidden from public attention. States manage to cover them up in a variety of ways. Some states use periodic tax increases: the substantial erosion of the sales tax base over the past few decades, for example, has been offset by increases in the sales tax rate. Between 1970 and 2003, states raised sales tax rates 72 times and lowered them only a few times. In other states, structural deficits are masked by a gradual decline of programs and services, as program benefit levels and/or payments to service providers (such as day care centers or hospitals) erode over time.

Many of the ways that states cope with structural deficits tend to reduce public confidence in government. When taxes must be increased simply to maintain current services rather than provide new ones, or when taxes remain constant but services deteriorate, the public may conclude that government is being wasteful. Thus, rather than take ad hoc measures to hide structural deficits, states would be much better off modernizing their tax systems so they appropriately reflect economic and population growth.

There are a number of changes to state tax systems that can reduce structural gaps and improve fiscal stability. These options are summarized below and discussed in more detail in the report:

- **Expanding the sales tax base to include more services.** State sales tax bases could be expanded to include more services in order to account for the shift in the U.S. economy from manufacturing to services.

- **Closing corporate tax loopholes.** States can adopt "combined reporting" under which all related corporations that are operated as a single business enterprise are treated as one taxpayer for apportionment purposes thereby preventing the shifting of profits to low- or no-tax jurisdictions. In the absence of combined reporting, states could close a specific loophole that is common to most states that allows certain types of profit-shifting. States also could enact a rule to ensure that profits earned in a state in which a corporation may not be subject to an income tax are taxed instead by its home state. Finally, they could amend the definition of apportionable "business income" to include some types of income that now go untaxed.

- **Streamlining sales tax provisions among states.** Forty of the 45 states with a sales tax have embarked on a project to simplify the design, administration, and compliance requirements of their sales tax. That would make it easier for companies to collect sales taxes on online purchases by out-of-state residents which should encourage Congress to pass legislation allowing states to require remote sellers to collect sales and use taxes. As of early 2005, twenty states had adopted legislation to implement the sales tax streamlining arrangement. Additional states could adopt the arrangement and could work to persuade Congress to pass the legislation.

- **Reducing or eliminating tax breaks based on age.** States and local governments cannot change some of the impacts that the aging of the population has on tax collections, but they can scale back or eliminate the age-related tax exemptions they enacted over the years in their property taxes and personal income taxes. One way these exemptions could be reduced is by replacing them with exemptions targeted by income as well as age.

- **Updating state income taxes.** States can periodically revisit and update their income tax rates and brackets to avoid a flattening of the tax structure over time.

- **Adopting a state value-added tax.** A value-added tax with a low rate can be used as a backstop to the corporate income tax; it would tax the business activity of companies that are not subject to the corporate income tax, as well as service companies whose products are not subject to the traditional sales tax. Such a tax could be designed in such a way that no company would have to pay both the corporate income tax and a value-added tax.

- **Strengthening property taxes.** States could improve the administration of the property tax — that is, the process of identifying, locating, and valuing taxable property as well as levying the tax. Also, states could carefully examine the types of property that are exempted from the tax with an eye to eliminating some exemptions.

- **Resisting new tax and spending limits or modifying existing ones.** States that do not have tax and spending limits, super-majority requirements, or property tax limits in place should avoid these measures, which act as barriers to addressing structural deficits. States already subject to such limits could consider modifying them to allow policymakers more flexibility to adapt to changing conditions.

- **Adopting state laws to increase sales tax collections on remote sales.** Without waiting for Congressional action, states can proceed on their own to address the problem of taxation of sales through the Internet and catalogs. States can expand their definition of when a company has presence in their state, require that the state do business only with companies that collect sales tax on purchases from state residents, and collect the tax on these purchases directly from consumers through the income tax.

- **Improving budget transparency.** State policymakers need longer-term projections of current services spending and revenues to help them understand the implications of their decisions for the state's structural balance. This information is also critical to building support for policies that will improve the state's fiscal stability over the long term.

- **Other ideas.** Additional ways to bolster state revenue growth include greater interstate cooperation in business taxation and other areas, preventing federal preemption of state and local taxes, and pursuing federal restrictions on the use of state and local tax preferences for interstate competition.

No single policy will work in every state, of course, and many of the options considered here will not be easy to implement. Yet states' future growth and the well-being of their residents depend on the ability of state policymakers to ensure that their tax and budget decisions enhance the state's long-term fiscal stability.

## II. The Service Economy

There is little question that production and consumption in the U.S. economy have been shifting from goods to services. Consumption of services has risen from 44 percent of total consumption in 1969 to 59 percent in 2004. Over the same period, consumption of nondurable goods (like clothing and light bulbs) has declined from 42 percent to 29 percent of consumption, and consumption of durable goods (like cars and computers) has declined slightly.[2]

This shift has major implications for state and local taxes. The most striking effect is on sales tax revenues, but property tax collections are also affected.

Despite this shift, only a few states impose sales taxes on a broad array of services; sales of goods generate the vast majority of state sales tax receipts. According to the Federation of Tax Administrators, an association of state revenue department officials, most states apply their sales tax to less than one-third of the potentially taxable service categories, and eight states apply their sales tax to less than one-eighth of those categories.

States' failure to tax services, as well as their propensity to create other types of sales tax exemptions, is likely the biggest reason why sales tax revenues have not kept pace with economic growth. The sale tax base — that is, the amount of goods and services that are subject to tax each year — has fallen from about 51.4 percent of personal income (a standard measure of the economy) in the average state in 1979 to 41.5 percent in 2001.[3] This reduction has occurred even though total personal consumption expenditures have risen as a share of personal income from 77 percent in 1979 to 81 percent in 2001.

As sales tax bases have declined, states have raised sales tax *rates* in order to continue generating adequate revenue from a declining base. In 1970, the average sales tax rate was 3.5

[2] U.S. Department of Commerce, Bureau of Economic Analysis. http://www.bea.gov/bea/dn/nipaweb/TableView.asp#Mid

[3] William F. Fox, "Three Characteristics of Tax Structures Have Contributed to the Current State Fiscal Crisis," State Tax Notes, August 4, 2003, available at www.urban.org/WilliamFFox.

percent; in 2003, it was 5.2 percent, an increase of 49 percent. Yet because of the shrinking sales tax base, this 49 percent increase in sales tax rates produced only a 20 percent gain in sales tax revenues as a share of personal income.

The research of John Mikesell of Indiana University, shown in **Table 1** illustrates the erosion of the sales tax base over time. In 1990, just over half of all sales were subject to the sales tax in the median state. By 2003, 43.3 percent were. In nine states — Arizona, Georgia, Nevada, New Mexico, North Carolina, Oklahoma, South Dakota, Virginia and Washington — the sales tax base declined by more than 15 percentage points. It should be noted, however, that the breadth of the sales tax base remained well above average in two of these states — New Mexico and South Dakota — despite this decline.

*Why Tax Services?*

For decades, public finance economists and other tax experts have been urging states to include more services in the sales tax base. Such a step meets all of the criteria by which state tax policy options are normally evaluated.

- **It can generate substantial new revenue. Table 2** indicates that a 5 percent tax on all services purchased by households except health care, education, housing, and a few others would yield roughly $57 billion each year. The new revenue from taxing household services would be less than this, since most states do tax services to some extent. The estimates shown in Table 2 do suggest, however, that states that do not tax services to any significant degree at present — such as California, Illinois, Michigan, and Virginia — probably could increase their sales tax revenue by 25 to 30 percent if they taxed a wide range of services.

- **It may reduce the year-to-year volatility of sales tax collections.** Sales tax bases are dominated by purchases of "big-ticket" durable goods such as cars, appliances, and furniture; such purchases often decline sharply during economic downturns. Expanding the base to include more services could moderate slightly the volatility of sales tax revenues over the course of the business cycle.

- **It would make the sales tax fairer.** Since the sales tax is intended to be a general tax on consumption, there is little reason to tax the consumption of goods and not tax the consumption of services, which in fact can be substitutes for one another. For example, it is not equitable — it violates the principle of "horizontal equity" — to tax the person who buys a lawnmower but not the person who hires a lawn care service.

  Sales taxes are regressive; that is, they absorb a larger proportion of the income of lower-income taxpayers than of higher-income taxpayers. Therefore, expanding the sales tax to services could make a state's overall tax system somewhat less equitable if it lowers the proportion of state revenue that is derived from more progressive revenue sources, such as personal and corporate income taxes. States

## Table 1: Sales Tax Base is Declining

| | Percent of Sales Subject to Tax, 1990 | Percent of Sales Subject to Tax, 2003 | Point Change in Breadth of Sales Tax Base |
|---|---|---|---|
| Alabama | 47.8% | 40.0% | -7.8% |
| Alaska | No General Sales Tax | | |
| Arizona | 68.3% | 51.1% | -17.2% |
| Arkansas | 67.6% | 57.5% | -10.1% |
| California | 48.1% | 34.7% | -13.4% |
| Colorado | 47.2% | 40.5% | -6.7% |
| Connecticut | 38.2% | 34.0% | -4.2% |
| Delaware | No General Sales Tax | | |
| District of Columbia | N/A | N/A | N/A |
| Florida | 61.1% | 48.5% | -12.6% |
| Georgia | 63.6% | 46.3% | -17.3% |
| Hawaii | 121.4% | 109.8% | -11.6% |
| Idaho | 55.1% | 47.6% | -7.5% |
| Illinois | 34.0% | 24.8% | -9.2% |
| Indiana | 49.0% | 39.3% | -9.7% |
| Iowa | 53.6% | 40.4% | -13.2% |
| Kansas | 49.5% | 43.7% | -5.8% |
| Kentucky | 50.3% | 43.5% | -6.8% |
| Louisiana | 55.8% | 59.2% | 3.4% |
| Maine | 51.3% | 45.6% | -5.7% |
| Maryland | 38.8% | 33.6% | -5.2% |
| Massachusetts | 29.8% | 29.0% | -0.8% |
| Michigan | 49.3% | 41.6% | -7.7% |
| Minnesota | 46.1% | 43.3% | -2.8% |
| Mississippi | 59.0% | 52.1% | -6.9% |
| Missouri | 53.5% | 40.0% | -13.5% |
| Montana | No General Sales Tax | | |
| Nebraska | 50.7% | 48.3% | -2.4% |
| Nevada | 65.2% | 48.1% | -17.1% |
| New Hampshire | No General Sales Tax | | |
| New Jersey | 29.8% | 28.3% | -1.5% |
| New Mexico | 92.8% | 62.3% | -30.5% |
| New York | 39.7% | 30.3% | -9.4% |
| North Carolina | 59.2% | 37.4% | -21.8% |
| North Dakota | 52.5% | 46.5% | -6.0% |
| Ohio | 40.2% | 39.5% | -0.7% |
| Oklahoma | 52.0% | 35.7% | -16.3% |
| Oregon | No General Sales Tax | | |
| Pennsylvania | 33.9% | 31.8% | -2.1% |
| Rhode Island | 37.0% | 34.0% | -3.0% |
| South Carolina | 60.9% | 47.5% | -13.4% |
| South Dakota | 69.7% | 54.1% | -15.6% |
| Tennessee | 58.7% | 46.5% | -12.2% |
| Texas | 54.4% | 42.9% | -11.5% |
| Utah | 62.6% | 53.3% | -9.3% |
| Vermont | 44.3% | 33.3% | -11.0% |
| Virginia | 40.6% | 25.5% | -15.1% |
| Washington | 61.1% | 45.2% | -15.9% |
| West Virginia | 49.3% | 43.0% | -6.3% |
| Wisconsin | 49.6% | 44.3% | -5.3% |
| Wyoming | 78.8% | 64.6% | -14.2% |
| | | | |
| US Median | 51.3% | 43.3% | -8.0% |

Data Source:

John L. Mikesell, "State Retail Sales Taxes, 1999-2001: The Recession Hits," State Tax Notes, February 10, 2003;
John L. Mikesell, "State Retail Sales Tax Burdens, Reliance, and Breadth," State Tax Notes, July 12, 2004.

## Table 2: Estimated Sales Tax Revenue Yield from Taxing All "Readily-Taxable" Services ($millions)

| | *Share of 2001 National Personal Income* | *Estimated Purchases of "Readily-taxable" Services* | *July 1 2001 Sales Tax Rate* | *Revenue from Taxing Services* | *FY 01 State General Sales Tax Revenue* | *Revenue from Services as Percent of Current Revenue* |
|---|---|---|---|---|---|---|
| United States | 100.00% | 1,148,000 | 5.000% | 57,400 | 184,315 | 31.1% |
| Alabama | 1.26% | 14,521 | 4.000% | 581 | 1,823 | 31.9% |
| Alaska | 0.23% | 2,598 | 0.000% | 0 | 0 | 0.0% |
| Arizona | 1.58% | 18,164 | 5.600% | 1,017 | 3,757 | 27.1% |
| Arkansas | 0.71% | 8,150 | 5.125% | 418 | 1,772 | 23.6% |
| California | 13.00% | 149,251 | 5.750% | 8,582 | 24,298 | 35.3% |
| Colorado | 1.70% | 19,560 | 2.900% | 567 | 1,970 | 28.8% |
| Connecticut | 1.67% | 19,226 | 6.000% | 1,154 | 3,475 | 33.2% |
| Delaware | 0.30% | 3,420 | 0.000% | 0 | 0 | 0.0% |
| Dist. of Columbia | 0.26% | 3,037 | 5.750% | 175 | 682 | 25.6% |
| Florida | 5.47% | 62,786 | 6.000% | 3,767 | 14,862 | 25.3% |
| Georgia | 2.78% | 31,867 | 4.000% | 1,275 | 4,874 | 26.2% |
| Hawaii | 0.41% | 4,697 | 4.000% | 188 | 1,560 | 12.0% |
| Idaho | 0.37% | 4,303 | 5.000% | 215 | 782 | 27.5% |
| Illinois | 4.75% | 54,528 | 6.250% | 3,408 | 6,565 | 51.9% |
| Indiana | 1.96% | 22,473 | 5.000% | 1,124 | 3,606 | 31.2% |
| Iowa | 0.92% | 10,569 | 5.000% | 528 | 1,756 | 30.1% |
| Kansas | 0.89% | 10,182 | 4.900% | 499 | 1,745 | 28.6% |
| Kentucky | 1.17% | 13,404 | 6.000% | 804 | 2,656 | 30.3% |
| Louisiana | 1.26% | 14,493 | 4.000% | 580 | 2,665 | 21.8% |
| Maine | 0.40% | 4,548 | 5.000% | 227 | 818 | 27.8% |
| Maryland | 2.18% | 25,021 | 5.000% | 1,251 | 3,326 | 37.6% |
| Massachusetts | 2.86% | 32,833 | 5.000% | 1,642 | 3,756 | 43.7% |
| Michigan | 3.43% | 39,369 | 6.000% | 2,362 | 7,686 | 30.7% |
| Minnesota | 1.90% | 21,773 | 6.500% | 1,415 | 4,768 | 29.7% |
| Mississippi | 0.72% | 8,223 | 7.000% | 576 | 2,330 | 24.7% |
| Missouri | 1.83% | 21,021 | 4.225% | 888 | 2,805 | 31.7% |
| Montana | 0.25% | 2,867 | 0.000% | 0 | 0 | 0.0% |
| Nebraska | 0.57% | 6,547 | 5.000% | 327 | 1,017 | 32.2% |
| Nevada | 0.73% | 8,329 | 6.500% | 541 | 2,049 | 26.4% |
| New Hampshire | 0.50% | 5,686 | 0.000% | 0 | 0 | 0.0% |
| New Jersey | 3.76% | 43,220 | 6.000% | 2,593 | 5,759 | 45.0% |
| New Mexico | 0.49% | 5,603 | 5.000% | 280 | 1,731 | 16.2% |
| New York | 7.89% | 90,585 | 4.000% | 3,623 | 8,449 | 42.9% |
| North Carolina | 2.60% | 29,795 | 4.000% | 1,192 | 3,430 | 34.7% |
| North Dakota | 0.19% | 2,174 | 5.000% | 109 | 403 | 27.0% |
| Ohio | 3.78% | 43,356 | 5.000% | 2,168 | 6,288 | 34.5% |
| Oklahoma | 1.00% | 11,476 | 4.500% | 516 | 1,550 | 33.3% |
| Oregon | 1.13% | 12,939 | 0.000% | 0 | 0 | 0.0% |
| Pennsylvania | 4.35% | 49,932 | 6.000% | 2,996 | 7,238 | 41.4% |
| Rhode Island | 0.37% | 4,233 | 7.000% | 296 | 699 | 42.4% |
| South Carolina | 1.17% | 13,375 | 5.000% | 669 | 2,507 | 26.7% |
| South Dakota | 0.23% | 2,669 | 4.000% | 107 | 464 | 23.0% |
| Tennessee | 1.79% | 20,492 | 6.000% | 1,230 | 4,483 | 27.4% |
| Texas | 7.02% | 80,626 | 6.250% | 5,039 | 17,903 | 28.1% |
| Utah | 0.63% | 7,260 | 4.750% | 345 | 1,480 | 23.3% |
| Vermont | 0.20% | 2,319 | 5.000% | 116 | 356 | 32.6% |
| Virginia | 2.69% | 30,836 | 3.500% | 1,079 | 2,992 | 36.1% |
| Washington | 2.21% | 25,367 | 6.500% | 1,649 | 6,078 | 27.1% |
| West Virginia | 0.48% | 5,454 | 6.000% | 327 | 1,086 | 30.1% |
| Wisconsin | 1.82% | 20,916 | 5.000% | 1,046 | 3,613 | 28.9% |
| Wyoming | 0.17% | 1,924 | 4.000% | 77 | 406 | 19.0% |

Data Source: Center on Budget and Policy Priorities

Note: Readily taxable services refer to all services purchased by households except health care, education, housing and a few others.

could avert this outcome by balancing the sales tax expansion with other changes, such as lowering the sales tax rate, cutting the personal income tax, or establishing low-income tax credits.

- **It can improve the allocation of economic resources.** Taxing most goods but not most services subtly distorts resource allocation throughout the economy by creating an artificial incentive to purchase services rather than goods.

## Policy Responses – Sales Tax

If policymakers do decide to expand the services subject to taxation, when they contemplate which services to tax, it could be useful to think of services as falling into three categories: those primarily purchased by businesses (such as payroll processing and television advertising), those primarily purchased by households (such as diaper service and cable TV), and those purchased by both groups (such as landscaping and pest control).

Economists generally counsel states to avoid taxing the first category, so-called "business-to-business" sales. They point out that taxing the goods and services that businesses buy in order to produce other goods and services often leads to "tax pyramiding," where an input is taxed when purchased and then effectively taxed again when the good or service it was used to make is sold.

Taxation of business inputs also tends to complicate sales tax administration. For example, rules need to be developed for taxing services that businesses purchase for company-wide use in multiple states, such as accounting.

But economists' greatest concern about taxing these services is that it can distort the allocation of economic resources by favoring businesses that have their own, in-house sources of services (such as legal services or accounting) over businesses that purchase these services from other firms.

These arguments against taxing business purchases of services have merit. However, there are at least two countervailing considerations.

First, state sales taxes already apply to numerous goods that businesses purchase. If the concern that taxing business inputs can distort resource allocation is valid, economic theory suggests that the distortion grows as the tax rate increases. Thus, if the choice is between increasing the tax rate at which business-to-business sales of goods are taxed and taxing some business-to-business sales of services in order to hold down the tax rate, the latter could be preferable.

Second, since a growing number of people run their own businesses, exempting all business purchases of services would open the door to substantial tax evasion by providing an incentive for business owners to claim that the services they purchase are for business purposes when they are actually intended for personal use.

States that have broadened their taxation of services generally have struck what arguably is a reasonable balance among these various considerations by largely avoiding taxing services purchased almost exclusively by businesses (like advertising and accounting) and instead targeting household services (like haircuts) or mixed household/business services (like landscaping).

The average state with a sales tax exempts a little more than half of the possible household services from the sales tax. (See **Table 3.**) Nine states — California, Colorado, Illinois, Maine, Massachusetts, Michigan, Nevada, Rhode Island, and Virginia — tax fewer than an eighth of possible household services.

### *Property Tax Collections in a Service Economy*

Producing services takes less real property and less personal property than producing goods does. Local governments are finding it difficult to value the intangible assets that have become increasingly important to businesses, such as patents, databases, software, trademarks, and formulas. Therefore, the shift to a service economy keeps property taxes from businesses from growing as fast as they would otherwise.

## Policy Responses – Property Tax

To help them assess businesses and their assets more accurately and comprehensively, some states have increased training for assessors or centralized assessment at the county or state level. Beyond improving assessments, there is little that states can do to mitigate the loss of property tax revenues that accompanies the shift to a service economy. States should, however, be aware of the issue and monitor whether there are particular communities in the state in which the property tax base has shrunk for this reason. States can help such communities through school funding formulas or other equalization aid.

## Table 3: Taxation of Selected Household Services

| | Number of Household Services Taxed (out of 40) |
|---|---|
| Alabama | 9 |
| Alaska | No General Sales Tax |
| Arizona | 18 |
| Arkansas | 22 |
| California | 2 |
| Colorado | 2 |
| Connecticut | 25 |
| Delaware | No General Sales Tax |
| District of Columbia | 18 |
| Florida | 22 |
| Georgia | 11 |
| Hawaii | 39 |
| Idaho | 10 |
| Illinois | 3 |
| Indiana | 6 |
| Iowa | 34 |
| Kansas | 27 |
| Kentucky | 6 |
| Louisiana | 20 |
| Maine | 2 |
| Maryland | 8 |
| Massachusetts | 0 |
| Michigan | 4 |
| Minnesota | 24 |
| Mississippi | 21 |
| Missouri | 11 |
| Montana | No General Sales Tax |
| Nebraska | 20 |
| Nevada | 2 |
| New Hampshire | No General Sales Tax |
| New Jersey | 17 |
| New Mexico | 39 |
| New York | 23 |
| North Carolina | 10 |
| North Dakota | 9 |
| Ohio | 17 |
| Oklahoma | 10 |
| Oregon | No General Sales Tax |
| Pennsylvania | 15 |
| Rhode Island | 1 |
| South Carolina | 12 |
| South Dakota | 40 |
| Tennessee | 27 |
| Texas | 24 |
| Utah | 22 |
| Vermont | 10 |
| Virginia | 4 |
| Washington | 21 |
| West Virginia | 37 |
| Wisconsin | 29 |
| Wyoming | 21 |
| **US Average** | 16 |

| | |
|---|---|
| **Less than 5** | 9 |
| **Less than 10** | 14 |

Data Source:
Federation of Tax Administration. *Sales Taxation of Services: 1996 Update,* Research Report No. 147 (Washington, DC: Federation of Tax Administrators), April 1997. Partially updated for known changes. See report for extensive footnotes that affect classification as taxable or exempt. Available at www.taxadmin.org/fta/pub/sevices/services.html.

## III. State Corporate Tax Erosion

In this day and age, interstate business transactions are commonplace. Credit card payments are often sent to a bank in another state. Catalog and Internet purchases from out-of-state businesses have grown substantially over time. Businesses often have locations in more than one state, the local department store is likely to be a part of a national conglomerate, and locally owned restaurants are being replaced by national chains.

The volume of international business is growing as well. In 1970, imports equaled 5.5 percent of gross domestic product and exports made up just 5.6 percent. By 2000, those figures had grown to 14.0 percent for imports and 9.5 percent for exports.[4] United States corporations with more than 50 percent foreign ownership comprised just 1.3 percent of U.S. corporate assets in 1971; in 2000, their share was ten times larger (12.9 percent).[5]

The expansion of interstate and international business presents enormous challenges to state tax systems. A number of these challenges were discussed in *Financing State Government in the 1990s*.

- Many states have failed to update their laws regarding which share of a multi-state corporation's income should be taxable in any given state to take account of the increasingly complex nature of corporate structures. As a result, corporations have been able to legally shift income from one state to another to avoid taxation. States' failure to coordinate their tax systems and tax administration with one another has made it easier for corporations to shift income and thereby avoid taxation as well.

- State tax collections also suffer when multi-national corporations shift operations or income out of the United States to other countries in order to reduce federal taxes.

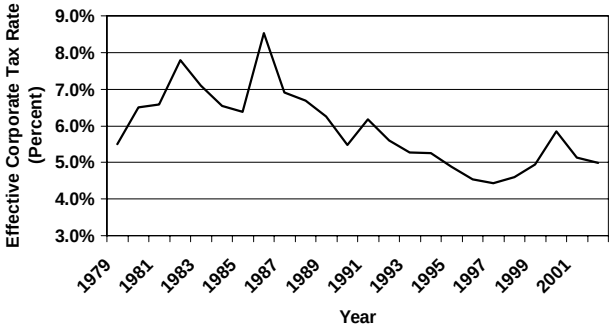
[4] U.S. National Income and Product Accounts, U.S. Department of Commerce, Bureau of Economic Analysis.
[5] James R. Hobbs, "Foreign-Controlled Domestic Corporations - 2000", SOI Bulletin, Summer 2003. October 2003.

- The federal government has often worsened states' problems in this area through actions it has (or has not) taken. Federal rules that tell states what businesses and sales they may tax have been extended to the point where they seriously constrain states' ability to tax interstate businesses and transactions.

  For example, the Supreme Court has restricted states' ability to apply sales taxes to mail-order sales made to state residents. In addition, a federal law and subsequent legal decisions have restricted states' ability to impose corporate income taxes on many out-of-state corporations doing business in the state.

Corporations' growing sophistication in exploiting the flaws in state corporate income tax laws has undoubtedly contributed to the tax's declining significance over the past two decades. According to the U.S. Census Bureau, corporate income taxes supplied 10.2 percent of state tax revenue in the states levying them in 1979, but just 6.3 percent in 2000.[6]

**Figure 3**




Source: Steven Maguire, *Average Effective Corporate Tax Rates, 1958 to 2002*, Congressional Research Service, Sept 5, 2003

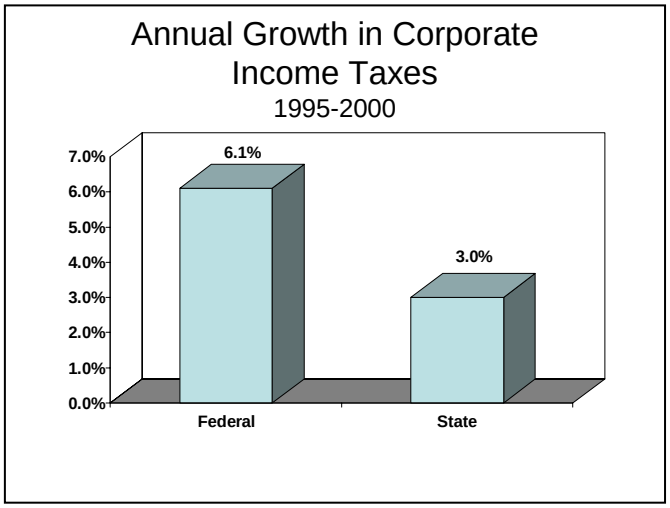
The erosion of state corporate income taxes can also be seen in the decline in the effective state corporate income tax rate, or the percentage of corporate profits that is actually paid in taxes (as opposed to the tax rate that is nominally imposed). The effective corporate tax rate is measured by dividing actual corporate tax collections by an estimate of corporate profits. The top *nominal* state corporate tax rates are generally in the range of 6-10 percent; only five of the 45 states imposing corporate taxes (including the District of Columbia) have top nominal rates of less than 6 percent. A recent report by the Congressional Research Service estimated, however, that the average *effective* state corporate income tax rate declined from an average of 6.9 percent in the 1980s to 4.6 percent in 1998. The rate then rose as corporate profits soared in the late 1990s but has been declining again and equaled 4.99 percent in 2002, the most recent year available.[7] A report by Professor William Fox of the University of Tennessee, which found that the decline in effective corporation tax rates occurred despite an increase in the average nominal rate of .1 percent, demonstrates that it was the result of a narrowing of the base rather than the result of rate reduction. (See Figure 3.)

[6] These are averages for the states levying corporate income taxes in both years. These two years were selected to illustrate the long-term trend because they both represent the same point in the business cycle, specifically, the year before the U.S. economy slipped into a recession.

[7] Steve Maguire, *Average Effective Corporate Tax Rates*, Congressional Research Service, September 2003. This study examines the effective corporate income tax rate of state and local governments combined. The only local corporate income taxes of economic significance are those imposed by New York City and the District of Columbia.

Finally, it is noteworthy that during the strong economic expansion of 1995-2000, state corporate income tax revenue grew at just half the rate of federal corporate tax revenue — an average of three percent annually versus six percent for the federal tax. (See Figure 4.) Since corporate income tax rates at both the federal and state levels were fairly stable throughout this five-year period, the relatively slow growth of state corporate tax receipts suggests that a significant share of corporate profits is being taxed at the federal level but is falling through the cracks at the state level.[8]

**Figure 4**




Since 1979, the share of total state taxes contributed by the corporate income tax has declined in all but three states. (See **Table 4**.) Between 1989 and 2002, this share declined by more than five percentage points in nine states: Alaska, California, Connecticut, Kansas, Louisiana, Massachusetts, New Jersey, North Carolina, and Rhode Island.

## Policy Responses

States have a number of options for addressing the decline in state corporate tax revenue.

- **Close corporate tax loopholes.** Numerous changes are needed in most states' corporate income tax laws to reestablish this tax as a robust source of state revenue. Three such changes seem particularly worthy of early consideration by policymakers because they would likely gain substantial revenue, they would not require fundamental changes in the structure of the corporate tax, additional

[8] During the past decade, there has been a growing trend toward organizing new businesses as (and converting some existing businesses to) limited liability companies, Subchapter S corporations, limited partnerships, and other so-called "pass-through entities." A pass-through entity is a business that is exempt from direct income taxation, with any profits of the business instead passed-through pro-rata to the personal income tax returns of the owners. It is often suggested that the growing use of pass-through entities is a major contributor to the declining contribution of corporate income taxes to state coffers revealed in Table 4. Proponents of this theory assert that corporations are still paying their fair share of state taxes, it is just that the profits are now being reported on the state personal income tax returns of the owners of these businesses rather than on state corporate tax returns. While this is undoubtedly true to some degree, the use of pass-throughs reduces state *and federal* corporate tax receipts. The fact that federal corporate income tax collections grew twice as fast as state corporate income taxes in the late 1990s (as revealed in Figure 5) demonstrates that whatever the contribution of pass-throughs to the decline shown in Figure 4, Figure 5 suggests that loopholes that uniquely plague state corporate taxes and state corporate tax policy changes contribute significantly to the declining contribution of corporate income taxes to state treasuries.

## Table 4: Share of State Taxes Contributed by Corporate Income Tax

| | Share of Total State Taxes Contributed by Corporate Income Tax, States with Corporate Income Taxes | | | *Point Change in Corporate Income Taxes as % of total tax revenue* | |
|---|---|---|---|---|---|
| | *1979* | *1989* | *2002* | *89-02* | *79-02* |
| Alabama | 5.8% | 5.9% | 5.0% | (0.9) | (0.8) |
| Alaska | 31.5% | 32.6% | 24.7% | (7.9) | (6.8) |
| Arizona | 5.9% | 4.9% | 4.1% | (0.8) | (1.8) |
| Arkansas | 8.4% | 5.1% | 3.4% | (1.8) | (5.0) |
| California | 14.5% | 12.3% | 6.9% | (5.4) | (7.7) |
| Colorado | 7.8% | 5.9% | 3.0% | (2.9) | (4.8) |
| Connecticut | 13.5% | 16.6% | 1.7% | (15.0) | (11.8) |
| Delaware | 10.2% | 13.7% | 11.6% | (2.2) | 1.4 |
| District of Columbia | NA | NA | NA | NA | NA |
| Florida | 7.3% | 5.8% | 4.8% | (1.0) | (2.5) |
| Georgia | 9.2% | 8.3% | 4.1% | (4.1) | (5.1) |
| Hawaii | 4.6% | 4.0% | 1.5% | (2.4) | (3.0) |
| Idaho | 8.4% | 6.9% | 3.4% | (3.5) | (5.0) |
| Illinois | 7.7% | 9.1% | 6.2% | (3.0) | (1.6) |
| Indiana | 4.8% | 4.8% | 7.0% | 2.2 | 2.2 |
| Iowa | 8.3% | 6.4% | 1.8% | (4.6) | (6.5) |
| Kansas | 11.9% | 7.9% | 2.5% | (5.4) | (9.3) |
| Kentucky | 7.9% | 7.6% | 3.8% | (3.8) | (4.1) |
| Louisiana | 9.7% | 8.7% | 3.6% | (5.1) | (6.1) |
| Maine | 7.4% | 6.1% | 2.9% | (3.1) | (4.5) |
| Maryland | 5.5% | 5.3% | 3.3% | (2.0) | (2.2) |
| Massachusetts | 13.4% | 13.0% | 5.5% | (7.6) | (7.9) |
| Michigan | No Corporate Income Tax | | | NA | NA |
| Minnesota | 11.4% | 7.6% | 4.0% | (3.6) | (7.3) |
| Mississippi | 4.9% | 6.3% | 4.1% | (2.1) | (0.7) |
| Missouri | 6.5% | 5.2% | 3.4% | (1.7) | (3.0) |
| Montana | 9.0% | 7.7% | 4.7% | (3.0) | (4.3) |
| Nebraska | 6.7% | 5.6% | 3.6% | (2.0) | (3.1) |
| Nevada | No Corporate Income Tax | | | NA | NA |
| New Hampshire | 24.2% | 24.8% | 19.9% | (4.9) | (4.3) |
| New Jersey | 11.5% | 12.5% | 6.0% | (6.5) | (5.5) |
| New Mexico | 4.8% | 4.0% | 3.4% | (0.6) | (1.4) |
| New York | 10.5% | 7.6% | 5.2% | (2.3) | (5.3) |
| North Carolina | 8.7% | 10.7% | 4.3% | (6.4) | (4.4) |
| North Dakota | 8.9% | 6.4% | 4.5% | (1.9) | (4.4) |
| Ohio | 10.9% | 6.8% | 3.8% | (3.0) | (7.2) |
| Oklahoma | 6.2% | 3.4% | 2.9% | (0.5) | (3.4) |
| Oregon | 12.0% | 6.1% | 3.8% | (2.3) | (8.2) |
| Pennsylvania | 12.6% | 9.2% | 5.4% | (3.8) | (7.2) |
| Rhode Island | 10.4% | 6.7% | 1.3% | (5.4) | (9.1) |
| South Carolina | 9.2% | 5.9% | 2.6% | (3.3) | (6.6) |
| South Dakota | No Corporate Income Tax | | | NA | NA |
| Tennessee | 10.1% | 9.1% | 6.5% | (2.7) | (3.6) |
| Texas | No Corporate Income Tax | | | NA | NA |
| Utah | 4.7% | 5.7% | 2.8% | (2.9) | (1.9) |
| Vermont | 8.9% | 6.0% | 2.5% | (3.6) | (6.5) |
| Virginia | 7.7% | 5.2% | 2.4% | (2.8) | (5.2) |
| Washington | No Corporate Income Tax | | | NA | NA |
| West Virginia | 2.2% | 10.8% | 6.2% | (4.6) | 4.0 |
| Wisconsin | 10.0% | 7.0% | 3.8% | (3.2) | (6.3) |
| Wyoming | No Corporate Income Tax | | | NA | NA |
| | | | | | |
| Total US | 10.2% | 8.8% | 4.7% | (4.083) | (5.5) |

Source: Mazerov, Michael. *Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States.* Washington, D.C.: Center on Budget and Policy Priorities, May 20, 2003.

Note: Texas data omitted because its "earned surplus tax" — the functional equivalent of a corporate income tax — was not enacted until 1991.

revenue could begin flowing relatively quickly, and a substantial share of the additional revenue would arise from the taxation of corporate profits that currently are escaping taxation completely. The three options are:

- √ Enacting the so-called "throwback rule" to ensure that profits earned in a state in which a corporation may not be subject to an income tax are taxed instead by the corporation's home state.

- √ Enacting laws to nullify a corporate tax-avoidance strategy based on the use of "passive investment company" (PIC) subsidiaries, such as the well-known Geoffrey, Inc. subsidiary of Toys R Us. Such laws prevent corporations from using payments of royalties and interest to PIC subsidiaries as a means of siphoning taxable income out of the states in which the income is actually earned and into tax-haven states like Delaware and Nevada.

- √ Amending the definition of apportionable "business income" to strengthen states' ability to tax capital gains from the sale of corporate subsidiaries and other major assets, reversions from over-funded pension plans, damage awards in lawsuits, and other irregular sources of income.

These three changes could make a meaningful contribution to closing the gap between revenues and expenditures in a large number of states and help stem the long-term erosion of the corporate tax base.

Each of these policies has been implemented in approximately half the states levying corporate income taxes. (Since the policies do not overlap, states can adopt one, two, or all three of them.) **Table 5** summarizes which states have not yet implemented each of the three options. Almost forty percent of the states with corporate income taxes have failed to close two of these loopholes; three states — Kentucky, Louisiana, and Tennessee — have not closed any of them.[9]

- **Adopt "combined reporting."** Under this method of assigning income for tax purposes, all related corporations that are run as a single business enterprise, any part of which is operating in the state, are essentially treated as one taxpayer for apportionment purposes.[10] Combined reporting would eliminate the passive investment company loophole described above, as well as other tax-avoidance schemes that are based on shifting income or profits from one state to another.

[9] Kentucky recently enacted a corporate tax reform law that attempted to close the PIC loophole but failed to do so in an effective manner.

[10] Corporate income is apportioned to each state based on a measure of the share of the corporation's activity that takes place in the state. The classic formula is based on the share of the corporation's property, employees, and sales that take place in the state, although some states now give greater (or even sole) weight to sales. At issue, however, is the amount of corporate income to which the formula is applied. Combined reporting ensures that all of the corporation's income is accounted for and apportioned.

## Table 5: Corporate Tax Loopholes

| | *How many of the 3 loopholes could the state close?* | *Enact Throwback Rule* | *Nullify PICs* | *Broaden Business Income Definition* |
|---|---|---|---|---|
| Alabama | 1 | | | ● |
| Alaska | 1 | | | ● |
| Arizona | 2 | ● | | ● |
| Arkansas | 2 | | ● | ● |
| California | 1 | | | ● |
| Colorado | 1 | | | ● |
| Connecticut | 1 | ● | | See Note |
| Delaware | 2 | ● | ● | See Note |
| District of Columbia | 1 | | | ● |
| Florida | 2 | ● | ● | |
| Georgia | 1 | ● | | See Note |
| Hawaii | 1 | | | ● |
| Idaho | 1 | | | ● |
| Illinois | 1 | | | ● |
| Indiana | 2 | | ● | ● |
| Iowa | 2 | ● | ● | |
| Kansas | 1 | | | ● |
| Kentucky | 3 | ● | ● | ● |
| Louisiana | 3 | ● | ● | ● |
| Maine | 0 | | | See Note |
| Maryland | 1 | ● | | See Note |
| Massachusetts | 1 | ● | | See Note |
| Michigan | NA | | | |
| Minnesota | 1 | ● | | |
| Mississippi | 1 | | | ● |
| Missouri | 2 | | ● | ● |
| Montana | 1 | | | ● |
| Nebraska | 1 | ● | | See Note |
| Nevada | NA | | | See Note |
| New Hampshire | 0 | | | |
| New Jersey | 1 | | | ● |
| New Mexico | 2 | | ● | ● |
| New York | 2 | ● | | ● |
| North Carolina | 1 | | | |
| North Dakota | 1 | | | ● |
| Ohio | 2 | ● | | ● |
| Oklahoma | 1 | | ● | See Note |
| Oregon | 1 | | | ● |
| Pennsylvania | 2 | ● | ● | |
| Rhode Island | 2 | ● | ● | See Note |
| South Carolina | 2 | ● | ● | See Note |
| South Dakota | NA | | | |
| Tennessee | 3 | ● | ● | ● |
| Texas | NA | | | |
| Utah | 1 | | | ● |
| Vermont | 0 | | | See Note |
| Virginia | 2 | ● | ● | See Note |
| Washington | NA | | | |
| West Virginia | 2 | | ● | ● |
| Wisconsin | 2 | | ● | ● |
| Wyoming | NA | | | |
| | Number with 0 | 3 | | |
| Total US | Number with 1 | 24 | | |
| | Number with 2 | 16 | | |
| | Number with 3 | 3 | | |

Source: Mazerov, Michael. *Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States.* Washington, D.C.: Center on Budget and Policy Priorities, May 20, 2003.
Note: See Appendix B of paper cited above for discussion of taxation of business income in this state.

- **Adopt a corporate alternative minimum tax.** To guarantee that all businesses that benefit from state services pay at least something into the state treasury, some states have instituted a corporate alternative minimum tax. Such a tax requires that all corporations pay some minimum amount in income taxes even if their exemptions and deductions reduce the tax owed under the standard tax laws to zero. States that do not have an alternative minimum tax could adopt one; states that already have one could consider raising the level if it has not been updated in a number of years.

- **Adopt a state-level value-added tax.** Like the sales tax, a value-added tax (VAT) is based on the value of goods and services. It is collected from businesses based on the value that is added at each step in the production and distribution processes.

  For example, in the case of a car plant, the tax would be levied not on the value of the cars produced by the plant, but just on that portion of the value contributed at the plant. The amount subject to the VAT would be the total revenue received by the plant when it sells the cars it has produced *minus* the cost of the parts, materials, and services the plant purchased to make the cars.[11]

  A low-rate VAT can be used as a kind of backstop to the corporate income tax. Under this approach, the VAT would capture the business activity of companies that are not subject to the corporate income tax, as well as of service companies whose products are not subject to the traditional sales tax. It could be designed to avoid having companies pay both the VAT and the other tax. For example, New Hampshire — whose main state business tax consists of a VAT and a corporate income tax — gives companies a credit against their corporate income tax liability for the VAT payments they make.

  Only one state, Michigan, uses a VAT in place of a corporate income tax. As the law stands in early 2005, the Michigan VAT is being phased out. The governor has however, proposed reforming and retaining the VAT. As noted above, New Hampshire uses a VAT in conjunction with a corporate income tax, an approach other states should consider.

[11] The base of the VAT — that is, the amount of value that a processor or supplier adds — can be calculated in one of two ways. An "operational VAT" is applied to the value added by operations within a particular state regardless of where the resulting product is sold. By contrast, a "transaction-based VAT" is a type of consumption tax that is levied in the state where the final product is bought. At the state, as opposed to national level, an operational VAT is the only practical form of VAT for a number of legal and technical reasons. The base of an operational VAT for an individual company is the taxpayer's gross receipts minus the cost of purchases from other firms. The base can be determined on a subtractive basis by subtracting purchases from gross receipts or on an additive basis by adding up payrolls, rent, interest and profits. Either approach should lead to the same base for individual corporations.

- **Shore up enforcement measures.** States could, for example, hire more auditors, provide them with additional training, and expand information-sharing with the IRS and other state revenue departments. These measures, accompanied by stiffer penalties, could increase state business tax collections.

## IV. The Growth of Interstate Sales

In addition to the growth of the service economy, another factor that is shrinking the sales tax base is the growth of remote sales such as those made by phone, through catalogs, and through electronic commerce (the Internet). The rise of "e-commerce" is having a significant impact on state and local revenues.

When a person makes an in-store purchase of a product to which sales tax applies, he or she pays the sales tax to the store; the store periodically sends its sales tax collections to the state or local government levying the tax.

If the purchase is made from an out-of-state company over the phone, through a catalog, or through electronic commerce, the purchaser still owes the sales tax (which is then called a use tax). However, the state cannot *require* the company that sells the product to collect the tax because two Supreme Court decisions have barred states from requiring sales taxes to be remitted when the vendor does not have a physical presence in the state. Instead, it is the customer's responsibility to pay the tax directly to the state or local government.

In practice, few customers actually pay sales taxes directly, and most states do not enforce this requirement except when a very expensive item such as a car is purchased. This hurts small businesses and in-state retailers, which become less competitive with Internet and catalog sellers. It also prevents states and localities from collecting significant amounts of revenue that is due to them. Donald Bruce and William Fox of the University of Tennessee estimate that the inability to collect tax on Internet purchases cost states and localities about $15 to $16 billion in lost revenue in 2003.[12] The revenue loss is projected to grow rapidly in future years, undermining state sales taxes and contributing to structural deficits.

[12] States would likely not collect all of this potential revenue under a politically feasible solution to this problem because at a minimum, states would have to provide some compensation to vendors for collecting the tax, and there would have to be some exemptions from the requirement of collecting the tax to protect small vendors. However, they could collect a substantial share.

According to Bruce and Fox's most recent estimates, electronic commerce is projected to cost every state with a sales tax an amount equal to at least one percent of its state and local taxes by 2008. (See **Table 6.**) Seven states — Arizona, Arkansas, Hawaii, Louisiana, Mississippi, Tennessee, and Washington — are projected to lose more than 3.5 percent of their state and local taxes by 2008 under the lower of two estimates provided by Bruce and Fox.

## Policy Responses

One of the above-mentioned Supreme Court decisions, the 1992 *Quill* decision, made clear that Congress *can* pass legislation to empower states to tax sales made to state residents by vendors not physically present in the state. Such legislation has been introduced in almost every session of Congress but has consistently been blocked by a coalition of legislators, whether out of general anti-tax ideology or in response to strong pressure from the politically potent direct marketing and electronic commerce industries.

In the past, an argument against federal action in this area has been that the many differences among state sales tax systems would make collecting and remitting sales taxes too difficult for out-of-state vendors. In the last few years, however, states have made substantial progress under their "Streamlined Sales Tax Project" in harmonizing state sales tax systems in ways that will substantially reduce the burden of collecting these sales taxes. Thus, the time is ripe for Congress to enact a solution to this problem and stem the hemorrhage of state and local revenues. So far, however, Congress shows no sign of doing so.

In the meantime, many states are addressing this problem on their own. Some are attempting to encourage compliance with use taxes owed by consumers. For example, a number of states provide a line on their income tax forms (or include a separate form) where individuals can record the use tax owed the state from Internet or phone purchases and then pay the amount owed along with their income tax payment.

In addition, a number of states — Indiana, Kansas, Louisiana, and Minnesota, for example — have enacted laws to broaden the definition of when a company has a presence (or "nexus") in a state. A more expansive definition could allow states to require Internet-based businesses that are closely linked to "brick-and-mortar" businesses in the state to collect and remit sales taxes from their in-state customers. For example, Barnes and Noble's Internet sales operation is a legally separate entity from the operation that runs the company's stores, yet the website benefits from advertising for the stores and the two operations are linked in many ways including offering the same items for sale. States can explicitly define nexus to recognize these connections and then enforce these nexus laws through enhanced collection activities.

Some states — such as North Carolina and South Dakota — have also modified their state procurement laws to require that the state only do business with companies that collect and remit sales taxes collected from state residents.

# Table 6: Estimated Revenue Loss Due to E-commerce, 2008

| | *Low Growth Scenario* | | *High Growth Scenario* | |
|---|---|---|---|---|
| | *State and Local Revenue in Millions* | Revenue Loss as % of 2002 Total State and Local Taxes | *Revenue in Millions* | Revenue Loss as % of 2002 Total State and Local Taxes |
| Alabama | 287.6 | 2.96% | 449.7 | 4.63% |
| Alaska | No General Sales Tax | No General Sales Tax | No General Sales Tax | No General Sales Tax |
| Arizona | 525.0 | 3.64% | 821.1 | 5.69% |
| Arkansas | 229.7 | 3.56% | 359.2 | 5.56% |
| California | 2954.6 | 2.45% | 4620.4 | 3.84% |
| Colorado | 346.8 | 2.49% | 542.4 | 3.90% |
| Connecticut | 320.5 | 2.12% | 501.2 | 3.31% |
| Delaware | No General Sales Tax | No General Sales Tax | No General Sales Tax | No General Sales Tax |
| District of Columbia | 58.7 | | 91.9 | |
| Florida | 1504.1 | 3.35% | 2352.1 | 5.25% |
| Georgia | 722.9 | 3.00% | 1130.5 | 4.70% |
| Hawaii | 157.0 | 3.70% | 245.5 | 5.79% |
| Idaho | 79.9 | 2.43% | 125.0 | 3.80% |
| Illinois | 701.5 | 1.69% | 1097.0 | 2.64% |
| Indiana | 389.9 | 2.30% | 609.7 | 3.59% |
| Iowa | 170.3 | 2.04% | 266.4 | 3.20% |
| Kansas | 215.4 | 2.70% | 336.9 | 4.22% |
| Kentucky | 258.6 | 2.40% | 404.3 | 3.75% |
| Louisiana | 493.8 | 4.05% | 772.2 | 6.34% |
| Maine | 81.0 | 1.78% | 126.6 | 2.79% |
| Maryland | 320.4 | 1.61% | 501.1 | 2.52% |
| Massachusetts | 345.1 | 1.44% | 539.6 | 2.26% |
| Michigan | 707.6 | 2.31% | 1106.6 | 3.61% |
| Minnesota | 459.3 | 2.49% | 718.3 | 3.89% |
| Mississippi | 231.2 | 3.54% | 361.6 | 5.54% |
| Missouri | 378.2 | 2.50% | 591.5 | 3.91% |
| Montana | No General Sales Tax | No General Sales Tax | No General Sales Tax | No General Sales Tax |
| Nebraska | 148.6 | 2.80% | 232.4 | 4.37% |
| Nevada | 224.8 | 3.49% | 351.5 | 5.46% |
| New Hampshire | No General Sales Tax | No General Sales Tax | No General Sales Tax | No General Sales Tax |
| New Jersey | 566.2 | 1.64% | 885.5 | 2.56% |
| New Mexico | 169.2 | 3.47% | 264.6 | 5.42% |
| New York | 1552.4 | 1.75% | 2427.7 | 2.73% |
| North Carolina | 489.1 | 2.17% | 764.9 | 3.39% |
| North Dakota | 41.3 | 2.39% | 64.6 | 3.74% |
| Ohio | 733.3 | 2.03% | 1146.8 | 3.17% |
| Oklahoma | 223.4 | 2.54% | 349.3 | 3.98% |
| Oregon | No General Sales Tax | No General Sales Tax | No General Sales Tax | No General Sales Tax |
| Pennsylvania | 705.6 | 1.88% | 1103.4 | 2.93% |
| Rhode Island | 70.5 | 1.95% | 110.3 | 3.05% |
| South Carolina | 252.3 | 2.59% | 394.5 | 4.05% |
| South Dakota | 56.7 | 3.08% | 88.6 | 4.81% |
| Tennessee | 612.5 | 4.72% | 957.9 | 7.38% |
| Texas | 1969.5 | 3.34% | 3079.9 | 5.22% |
| Utah | 181.6 | 3.01% | 284.0 | 4.71% |
| Vermont | 35.1 | 1.79% | 54.8 | 2.79% |
| Virginia | 355.2 | 1.60% | 555.4 | 2.51% |
| Washington | 692.3 | 3.55% | 1082.7 | 5.55% |
| West Virginia | 104.4 | 2.25% | 163.2 | 3.52% |
| Wisconsin | 365.6 | 1.96% | 571.7 | 3.07% |
| Wyoming | 46.9 | 2.58% | 73.3 | 4.03% |
| Total US | 21,535.6 | 2.39% | 33,677.8 | 3.74% |

Data Source:
Bruce, Donald and William F. Fox. "State and Local Sales Tax Revenue Losses from E-Commerce: Estimates as of July 2004," State Tax Notes, August 2004.

## V. Impact of an Aging Population on State Revenues

The population of the United States is aging as a result of medical advances that have increased life expectancy as well as the movement of the baby boomer cohort through middle age. Nationally, the proportion of the population that is age 65 and older is projected to grow from 12.4 percent in 2000 to 19.7 percent by 2030. In 2000, residents age 65 and over made up more than 17.5 percent of the total population in only one state (Florida); by 2030, 44 states plus DC will be in this category.

The aging of the population is one of the major demographic changes facing the country over the next few decades and will have profound impacts on state finances. Much of the impact will be felt on the spending side of the state budget. For example, demand for Medicaid and other health services financed at least in part by states will grow.

The aging of the population also will likely cause collections of two major state taxes — the personal income tax and the sales tax — to decline as a share of the economy, because of preferences for senior citizens built into state and local tax systems and because elderly people have different income and consumption patterns than younger people. Income tax revenue growth will decline because seniors' incomes tend to be lower and to consist more of forms of income that are taxed at lower rates. Sales tax revenue growth will decline because older households tend to consume less, especially in terms of taxable goods.

The aging of the population will depress growth in state tax collections because many states have enacted income tax preferences that disproportionately benefit the elderly. (See **Table 7.**)

- Twenty-five states and the District of Columbia exempt all Social Security benefits from taxation. Ten states provide the same tax exemption for Social

Security benefits as the federal government.[13] The remaining six states provide a partial exemption that is more favorable than the federal exemption.

- Nine states exempt all public pensions from state taxation. Twenty-three states and the District of Columbia exempt some public pension income from state taxation, and at least 13 of them exempt $5,000 or more. Twenty-one states provide some degree of preferential tax treatment for private pensions as well.

- Some states exempt capital gains or dividends from taxation or tax them at a lower rate than other income. These provisions disproportionately benefit the elderly, who receive a larger share of their income from these sources than younger people do.

In addition to preferences for specific types of income such as pension or capital gains income, 39 states offer more generous exemptions, deductions, or credits to elderly people than to those under 65.

The combined effect of these tax preferences is to lower the effective rate of state income taxes for the elderly. **Table 8** shows the estimated difference between effective rates for the elderly and for other taxpayers, based on a 2002 study by Georgia State University professor Sally Wallace and Barbara Edwards at the Congressional Budget Office. The states with the largest reduction in income taxes for the elderly are Michigan, Virginia, Kentucky, Georgia, South Carolina, Hawaii, Indiana, Idaho, Oregon, Wisconsin, Connecticut and Illinois — although Virginia has remedied most of this problem since this study was completed.[14] Wallace and Edwards estimated that in Georgia and Michigan, tax preferences will reduce income tax revenue growth by approximately 6 percent and almost 4 percent per year, respectively.

Property tax preferences for elderly taxpayers are widespread as well. These can take the form of an exemption of a certain amount of a home's assessed value (a homestead exemption) or a reduction in taxes owed (a homestead credit). Ten states offer these exemptions or credits to elderly residents regardless of their income. Another two states provide them without age or income limits. (See **Table 9.**) Local governments and the states often share the cost of these provisions.

Some 36 states offer property tax circuit-breaker programs that provide credits to taxpayers whose property taxes exceed a certain percentage of their income. The elderly are eligible for these credits in all states that offer them, and 24 of the credits are aimed specifically at the elderly. (Disabled taxpayers are also often eligible in these states.) Circuit-breakers target property tax relief to those most in need more cost-effectively than programs that are not means-tested; thus, they are less likely to contribute to structural deficits as the population ages.

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[13] Between 50 and 85 percent of the social security benefits of taxpayers whose "provisional income" is $25,000 or higher (single) or $32,000 or higher (married, filing jointly) are subject to the federal income tax. Provisional income consists of federal adjusted gross income, tax-exempt interest, some foreign source income and one-half of Social Security benefits.

[14] This analysis was done before Virginia's tax reform of 2004. As part of this package, the state added means testing to its deduction. For joint filers, the benefit is reduced for taxpayers with incomes above $75,000 and phases out completely at income of $97,000.

# Table 7: Income Tax Treatment of Pension Income

| | *Treatment of Retirement Income* | | | |
|---|---|---|---|---|
| | *Additional Exemption/Deduction for Elderly (Joint filers)* | *Additional Credit for Elderly (Joint filers)* | *Private Pension/Retirement Exclusion* | *Full Social Security Benefit Exclusion* |
| Alabama | — | — | Income from defined benefit plan | Yes |
| Alaska | No broad income tax | | | |
| Arizona | $4,200 | — | — | Yes |
| Arkansas | — | $40 | $6,000, including IRA distributions after age 59.5 | Yes |
| California | — | $160 | — | Yes |
| Colorado | $1,800 | — | 65+, $24,000 maximum<br>55-65, $20,000 maximum | No |
| Connecticut | — | — | — | No |
| Delaware | $5,000<br>Additional $4,000[a] | $200 | 60+, $12,500 maximum | Yes |
| District of Columbia | $2,740 | — | — | Yes |
| Florida | No broad income tax | | | |
| Georgia | $2,600 | — | $14,500 maximum | Yes |
| Hawaii | $2,080 | — | Pensions w/ only employer contribution are exempt; pensions with employee contribution are partially exempt | Yes |
| Idaho | $1,800 | — | — | Yes |
| Illinois | $2,000 | — | All pension/annuity | Yes |
| Indiana | $2,000 to $3,000 | $80-$140[b] | — | Yes |
| Iowa | — | $40 | $12,000 maximum | No |
| Kansas | $1,400 | — | — | No |
| Kentucky | — | $40 | $38,775 maximum | Yes |
| Louisiana | $2,000 | — | $12,000 maximum | Yes |
| Maine | $1,800 | 20% of federal elderly credit | $6,000 maximum[c] | Yes |
| Maryland | $2,000 | — | $18,500 maximum | Yes |
| Massachusetts | $1,400 | — | — | Yes |
| Michigan | $3,800 plus federal elderly credit | — | $74,220 maximum | Yes |
| | Interest, dividends, capital gains up to $16,545 | | | |
| Minnesota | $1,800 | — | $12,000 maximum[d] | No |
| Mississippi | $3,000 | — | All pension/annuity | Yes |
| Missouri | $1,700 | — | $12,000 maximum[e] | No |
| Montana | $3,480 | — | $3,600 maximum[f] | No |
| Nebraska | $1,800 | Federal elderly credit | — | No |
| Nevada | No broad income tax | | | |
| New Hampshire | No broad income tax | | | |
| New Jersey | $2,000 | — | $17,500 maximum | Yes |
| New Mexico | $1,800 | — | $16,000 maximum[g] | No |
| New York | — | — | $20,000 maximum | Yes |
| North Carolina | $1,200 | — | $4,000 maximum | 2 |
| North Dakota | $1,800 | — | — | No |
| Ohio | — | $50 | $200 maximum credit | Yes |
| Oklahoma | $2,000 | — | $5,500 maximum[h] | Yes |
| Oregon | $2,000 | 40% of Federal elderly credit | 9% maximum credit[i] | Yes |
| Pennsylvania | — | — | All pension/annuity | Yes |
| Rhode Island | $1,800 | — | — | No |
| South Carolina | $1,800 | — | $10,000 maximum | Yes |
| | 30000[j] | | | |
| South Dakota | No broad income tax | | | |
| Tennessee | No broad income tax | | | |
| Texas | No broad income tax | | | |
| Utah | $1,700 | — | $15,000 maximum[k] | No |
| Vermont | $1,800 | — | — | No |
| Virginia | $1,600 | — | | Yes |
| | $24,000[l] | | | |
| Washington | No broad income tax | | | |
| West Virginia | $16,000 | — | — | No |
| Wisconsin | 500[m] | — | — | No |
| Wyoming | No broad income tax | | | |

Source: David Baer, "State Handbook of Economic, Demographic & Fiscal Indicators," AARP Public Policy Institute, 2003.

**Table 7 Notes:**

[a] For those 60 or over, $4,000 exemption for those with AGI (minus pension and social security income) under $20,000 and earned income under $5,000.
[b] Limit less than $10,000 income.
[c] Exemption is reduced by Social Security and Railroad retirement benefits.
[d] Limit$42,000 AGI. This exemption amount from any income sourse is reduced by non-taxable Social Security, Railroad Retirement benefits and one-half of federal AGI over $18,000.
[e] Exemption is phased out between $32,000 and $44,000 for joint filers.
[f] Phased out at $33,600 of income.
[g] All income exemption, phased out between at $51,000 for married filing jointly.
[h] Available to joint filers with income less than $50,000.
[i] Limit less than $45,000 income (minus Social Security benefits) or $15,000 in Social Security benefits.
[j] Senior Citizen Deduction is reduced by any retirement deduction taken.
[k] Phased out above $32,000
[l] Grandfathered for those currently over 65, for future beneficiaries $1 for $1 reduction in benefit as AGI rises above $75,000.
[m] Phased out for AGI above $40,000.

In addition, to the effect of tax preferences, the growth of state revenues will be affected by the different income and consumption patterns of elderly people.

- Consumption patterns change significantly as people age, though not as dramatically as income patterns. According to the Consumer Expenditure Survey, older households' average annual consumption is about one-third less than that of households aged 55 to 64. In addition, older households tend to spend less than younger households do on goods that are generally subject to the sales tax (such as furniture, cars, and gasoline), while spending more on services, many of which are untaxed (such as health care).

- People's income declines significantly as they age. According to Treasury Department calculations of data from 2000, the average income of persons 65 and over is $25,200, only slightly more than *half* of the average income of the 55- to 64-year-old group.

- The type of income also changes dramatically as people age. Income from wages, salaries, and businesses makes up more than 70 percent of the income of 55- to 64-year-olds but only 27 percent of the income of persons 65 and over. Conversely, income from Social Security and pensions makes up about 8 percent of total income prior to age 65 but 40 percent of total income for those over age 65. As explained above, income from pensions is often taxed at lower rates than wages. Some of this slowing will be offset by the fact that — to the extent states do tax this type of income — the elderly pay taxes on income earned during their working life that were deferred through deposit of that income into IRA's, 401(k)s, and pension plans.

## Table 8: Effective Rate of Income Tax for the Elderly

| | ***Difference in Effective income tax rate for elderly vs others (income <$200K) (elderly rate minus others)*** |
|---|---|
| Alabama | -0.21% |
| Alaska | No Income Tax |
| Arizona | -0.52% |
| Arkansas | -1.09% |
| California | -0.04% |
| Colorado | -0.78% |
| Connecticut | -1.08% |
| Delaware | -0.70% |
| District of Columbia | NA |
| Florida | No Income Tax |
| Georgia | -1.57% |
| Hawaii | -1.31% |
| Idaho | -1.19% |
| Illinois | -1.05% |
| Indiana | -1.22% |
| Iowa | -0.51% |
| Kansas | -0.21% |
| Kentucky | -1.64% |
| Louisiana | -0.47% |
| Maine | 0.07% |
| Maryland | -0.61% |
| Massachusetts | -0.84% |
| Michigan | -2.17% |
| Minnesota | -0.45% |
| Mississippi | -0.62% |
| Missouri | -0.03% |
| Montana | -0.71% |
| Nebraska | 0.09% |
| Nevada | No Income Tax |
| New Hampshire | 1.21% |
| New Jersey | -0.64% |
| New Mexico | -0.86% |
| New York | -0.54% |
| North Carolina | 0.31% |
| North Dakota | 0.03% |
| Ohio | -0.81% |
| Oklahoma | -0.24% |
| Oregon | -1.16% |
| Pennsylvania | -1.04% |
| Rhode Island | -0.75% |
| South Carolina | -1.45% |
| South Dakota | No Income Tax |
| Tennessee | -0.20% |
| Texas | No Income Tax |
| Utah | -0.57% |
| Vermont | -0.57% |
| Virginia | -1.70% |
| Washington | No Income Tax |
| West Virginia | -0.20% |
| Wisconsin | -1.10% |
| Wyoming | No Income Tax |
| US Median | -0.64% |

Data Source: Wallace, Edwards, How Much Preference: Effective Personal Income Tax Rates for the Elderly, April 2002

In conclusion, the aging of the U.S. population will have serious implications for state tax systems. Some of the resulting decline in state revenues is the result of seniors' lower income and consumption. Much, however, is the result of policies states adopted when their impact on state revenue was less and elder poverty was more of a problem.

## Policy Responses

While demographic trends are out of states' control, states can change the preferential tax provisions they have enacted over the years.

- States can reduce tax exemptions for pension income, or at least not create or expand them. States that offer a more generous exemption for Social Security income than the federal government can adopt the federal treatment instead.

- Similarly, states can eliminate or reduce age-related exemptions in income and property taxes. Many of these exemptions were offered at a time when poverty among the elderly was a bigger problem. Now, Social Security and private pensions have reduced senior poverty: the share of people over 65 who are poor dropped from one-quarter in 1970 to 10 percent in 2003.

  States could, for example, replace across-the-board exemptions with ones targeted by income as well as age; means-tested exemptions would retain the original purpose of these exemptions at a significantly lower cost.

Opposing new preferential tax provisions may be politically difficult, but it is not impossible. As a part of a large tax package adopted in 2004, Virginia scaled back its preferential treatment of pension income by phasing out the exemption for higher-income people.

## Table 9: Property Tax Exemptions or Credits for the Elderly

| | ***Non-means tested property tax preferences (homestead exemption or credit)*** |
|---|---|
| Alabama | 1 |
| Alaska | 1 |
| Arizona | 0 |
| Arkansas | 0 |
| California | 0 |
| Colorado | 1 |
| Connecticut | 1 |
| Delaware | 1 |
| District of Columbia | 0 |
| Florida | 0 |
| Georgia | 0 |
| Hawaii | 0 |
| Idaho | 0 |
| Illinois | 0 |
| Indiana | 0 |
| Iowa | 0 |
| Kansas | 0 |
| Kentucky | 1 |
| Louisiana | 0 |
| Maine | 0 |
| Maryland | 0 |
| Massachusetts | 1 |
| Michigan | 0 |
| Minnesota | 0 |
| Mississippi | 1 |
| Missouri | 0 |
| Montana | 0 |
| Nebraska | 0 |
| Nevada | 0 |
| New Hampshire | 0 |
| New Jersey | 1 |
| New Mexico | 0 |
| New York | 0 |
| North Carolina | 0 |
| North Dakota | 0 |
| Ohio | 0 |
| Oklahoma | 0 |
| Oregon | 0 |
| Pennsylvania | 0 |
| Rhode Island | 0 |
| South Carolina | 1 |
| South Dakota | 0 |
| Tennessee | 0 |
| Texas | 1 |
| Utah | 0 |
| Vermont | 0 |
| Virginia | 0 |
| Washington | 0 |
| West Virginia | 1 |
| Wisconsin | 0 |
| Wyoming | 0 |
| Total | 12 |

Data Source: Baer, David. *State Programs and Practices for Reducing Residential Property Taxes*, AARP, May 2003.

## VI. Revitalizing State Income Taxes

In most states, the two largest revenue sources are the sales tax and the income tax. Of these, only the income tax can grow as quickly as personal income.[15] Thus, to avoid a structural deficit, it is particularly important for a state to have a strong income tax.

While income tax revenue can have strong growth relative to personal income, certain economic trends and policy choices are curbing that growth. The first is the changing composition of income. The portion of income that comes from taxable wages — by far the largest category of income — has been declining, while the share from pensions and other non-wage sources that often are not taxable has been increasing. This trend is expected to continue. During the 1990s, it was offset by unusually high growth in taxable capital gains income, but that level of capital gains growth is highly unlikely to occur frequently in the future. As a result, the income tax is likely to decline as a share of personal income over time. The degree of this decline will be affected by a number of factors including the extent to which states tax income from pensions and withdrawals from retirement accounts which were not taxed when contributed.

Beyond these economic trends, the structure of an income tax will determine its growth rate. Chapter 5, for example, discussed the impact of exempting certain types of income for the expanding elderly population.

The rate structure is another important factor. Under a completely flat income tax — one with no exemptions or deductions and a single rate that applies to all income — tax revenue would increase at the same rate as personal income. However, the typical state income tax includes a number of deductions and exemptions; most income taxes also have a graduated rate structure, which means the tax rate increases as income increases. As a result, $1 of growth in income generates *more than* $1 in new income tax revenue.

[15] It is possible, in theory, to design a comprehensive sales tax on all personal consumption which could grow at the same rate as personal income, however, it is highly unlikely that states would extend their sales taxes to all health care, housing and education services.

The income taxes that are most responsive to economic growth have graduated rate structures with a number of income brackets that extend up the income scale. For example, California's 2004 income tax has six brackets; the top rate applies to married filers with taxable incomes above $78,000. In 2005, California will create an additional bracket for taxpayers with taxable incomes above $1 million.

By contrast, 19 states have flat rates or a top bracket for married filers that starts at less than $30,000 of taxable income. Six of these states — Colorado, Illinois, Indiana, Massachusetts, Michigan, and Pennsylvania — have flat rates; in another nine of these states, the top bracket starts at $10,000 or less. Income tax revenues tend to grow more slowly than personal income in states whose top bracket begins at a relatively low income level. (See **Table 10.**)

## Policy Responses

In many states, the fact that the top income tax bracket starts at a low income is the result of inaction rather than an explicit policy choice. Many states' income tax structures were put in place in the distant past and have not been updated in many years so have become flatter as incomes rose over time and more taxpayers moved into the top bracket.

Changing a state's income tax structure can be difficult. Raising the cut-off levels for higher tax brackets would make the tax more progressive, but it also would reduce revenues unless some rates are raised at the same time or new brackets with higher rates are added. Great care is required to restructure the income tax in a way that maintains state revenues while restoring progressivity, especially if the effects of many years of inflation — and the erosion of the value of brackets — are addressed all at once. States can avoid this predicament by periodically updating their income tax structures or — if they have achieved a progressive rate structure — by indexing their tax brackets so the changes are more gradual.

## Table 10: Degree of Progressivity of Personal Income Tax

High = top bracket starts at $30,000 or greater
Low = no broad based tax, flat rate or top bracket starts at less than $30,000
(Income amounts are taxable Income)

| | | |
|---|---|---|
| **Alabama** | Top bracket begins at $30,000 or less | Low |
| **Alaska** | No broad income tax | Low |
| **Arizona** | Top bracket begins at greater than $30,000 | High |
| **Arkansas** | Top bracket begins at $30,000 or less | Low |
| **California** | Top bracket begins at greater than $30,000 | High |
| **Colorado** | Flat rate | Low |
| **Connecticut** | Top bracket begins at $30,000 or less | Low |
| **Delaware** | Top bracket begins at greater than $30,000 | High |
| **District of Columbia** | Top bracket begins at $30,000 or less | Low |
| **Florida** | No broad income tax | Low |
| **Georgia** | Top bracket begins at $30,000 or less | Low |
| **Hawaii** | Top bracket begins at greater than $30,000 | High |
| **Idaho** | Top bracket begins at greater than $30,000 | High |
| **Illinois** | Flat rate | Low |
| **Indiana** | Flat rate | Low |
| **Iowa** | Top bracket begins at greater than $30,000 | High |
| **Kansas** | Top bracket begins at greater than $30,000 | High |
| **Kentucky** | Top bracket begins at greater than $30,000 | High |
| **Louisiana** | Top bracket begins at greater than $30,000 | High |
| **Maine** | Top bracket begins at greater than $30,000 | High |
| **Maryland** | Top bracket begins at $30,000 or less | Low |
| **Massachusetts** | Flat rate | Low |
| **Michigan** | Flat rate | Low |
| **Minnesota** | Top bracket begins at greater than $30,000 | High |
| **Mississippi** | Top bracket begins at $30,000 or less | Low |
| **Missouri** | Top bracket begins at $30,000 or less | Low |
| **Montana** | Top bracket begins at greater than $30,000 | High |
| **Nebraska** | Top bracket begins at greater than $30,000 | High |
| **Nevada** | No broad income tax | Low |
| **New Hampshire** | No broad income tax | Low |
| **New Jersey** | Top bracket begins at greater than $30,000 | High |
| **New Mexico** | Top bracket begins at greater than $30,000 | High |
| **New York** | Top bracket begins at greater than $30,000 | High |
| **North Carolina** | Top bracket begins at greater than $30,000 | High |
| **North Dakota** | Top bracket begins at greater than $30,000 | High |
| **Ohio** | Top bracket begins at greater than $30,000 | High |
| **Oklahoma** | Top bracket begins at $30,000 or less | Low |
| **Oregon** | Top bracket begins at $30,000 or less | Low |
| **Pennsylvania** | Flat rate | Low |
| **Rhode Island** | Top bracket begins at greater than $30,000 | High |
| **South Carolina** | Top bracket begins at $30,000 or less | Low |
| **South Dakota** | No broad income tax | Low |
| **Tennessee** | No broad income tax | Low |
| **Texas** | No broad income tax | Low |
| **Utah** | Top bracket begins at $30,000 or less | Low |
| **Vermont** | Top bracket begins at greater than $30,000 | High |
| **Virginia** | Top bracket begins at $30,000 or less | Low |
| **Washington** | No broad income tax | Low |
| **West Virginia** | Top bracket begins at greater than $30,000 | High |
| **Wisconsin** | Top bracket begins at greater than $30,000 | High |
| **Wyoming** | No broad income tax | Low |

Data Source: Commerce Clearinghouse State Tax Guide

## VII. The Growing Mismatch Between Tax Policy Choices and Spending Needs

The mix of taxes a state uses — that is, the types of taxes and their relative contribution to state revenues — has a large impact on state revenue growth, and thus on the question of whether the state has sufficient revenue to pay for the programs and services it offers.

State policymakers have made tax policy choices that are leading to a mismatch between future revenue growth and spending needs. When states cut taxes during the economic boom of the late 1990s, they primarily cut income taxes, which provide stronger growth over the long term than sales and excise taxes. Yet when states responded to the recent fiscal crisis by raising taxes, they primarily raised sales and excise taxes. (Many states have failed to decouple from the repeal of the federal estate tax, as well.) The net result is that states are trading in revenue sources that keep up with economic growth for ones that grow more slowly.

At the same time, states are facing additional spending pressures. Health care costs continue to grow much faster than the general rate of inflation, and as the baby boom generation ages, states will face increasing costs for the large share of prescription drug costs they must finance under the new Medicare bill and for long-term care. In addition, many states are facing pressure to improve public education from three fronts: public demands, court challenges, and student sub-populations with special needs (including special education students, low-income students, and students with limited English proficiency).

### *State Tax Cuts of the 1990s*

From the mid-1990s into 2001, state revenue collections grew substantially as a result of unusually high — and, as it turned out, unsustainably high — levels of economic activity. Yet many states used those *temporary* levels of revenue growth to finance largely *permanent* tax cuts. Some 43 states enacted large tax cuts in 1994 through 2001. Those tax cuts, minus a few

### Another Kind of Revenue Problem

When a state faces a gap between estimated revenues and expenditures in any given budget year, the problem may be the result of both a structural deficit and a revenue adequacy problem.

A revenue adequacy problem occurs when the amount of revenue raised by a state's tax and fee structure is less than the amount needed to fund the mix of state programs in place at a given time because the state:

- enacted permanent tax cuts using one-time surplus revenues, as a number of states did during the expansion of the late 1990s, or
- enacted new spending initiatives without adequate revenues, or
- must bear the cost of unfunded mandates from the federal government.

This situation is different from the structural deficits discussed in this paper, even though states can, and often do, face both problems at the same time. The structural deficits discussed in this paper are defined as deficits that result from the chronic inability of state revenue to grow in tandem with economic growth and the cost of government. Two elements of this definition are particularly important.

- States that face structural deficits suffer from an imbalance in the *growth* rates of revenues and spending — rather than in the revenue and spending levels at any particular point in time.
- The problem is *chronic* — that is continuing, not short-term.

The practical result is that states with structural deficits face situations year after year where expenditures exceed available revenue and must act time and again to increase revenue levels or cut spending to close these gaps. Because these gaps result from a mismatch in the growth rate of revenues versus spending they can only be addressed on a long-term basis by making changes that affect those growth rates.

In a state that faces both a revenue adequacy problem and a structural deficit — that is, the growth rate of state revenue is less than the growth rate of state spending — the gap caused by the revenue adequacy problem will widen each year.

The distinction between structural deficits and revenue adequacy problems is important because the solutions are different. Reversing previous tax cuts, increasing tax rates, enacting new taxes, or eliminating spending programs can address revenue adequacy problems by bringing revenue and spending in line for a particular year. However, if the state also suffers from an underlying structural gap in revenue and spending growth rates, the gap will simply reappear unless the revenue structure is strengthened in some of the ways suggested in this paper so that its future growth rate matches the growth in the state's economy and spending needs.

tax increases enacted in those years, reduced revenue by some 7.6 percent of state tax revenue nationwide and are costing states more than $33 billion each year.[16]

[16] Nicholas Johnson, *The State Tax Cuts of the 1990s, the Current Revenue Crisis, and Implications for State Services*, Center on Budget and Policy Priorities, November 18, 2003.

The permanent tax cuts of the 1990s had the short-term effect of exacerbating the state fiscal crisis that states have grappled with during the 2001-2005 period.

In addition, the composition of the tax cuts will aggravate the long-term structural problems that states are facing. This is because the great majority of the tax reductions enacted from 1994 to 2001 — some 81 percent of total tax cuts, totaling some $27 billion in annual lost revenue to 37 states — were reductions in personal income taxes or similarly progressive taxes. Economic research has shown that personal income taxes grow at or above the rate of growth of the economy, while other typical state taxes do not.

### *Recent State Tax Increases (and Reductions)*[17]

The economic downturn that began in 2001, combined with the large tax cuts of the 1990s, left states grappling with large budget deficits. States dealt with these deficits through a combination of spending cuts, tax increases, and one-time measures such as using reserves and borrowing. However, the tax increases imposed during the downturn were much smaller and less widespread than the tax cuts of the 1990s.

During the fiscal crisis, state policymakers had the opportunity to raise revenue in a way that would address both the short-term cyclical downturn and the long-term erosion of personal income taxes. However, many states instead chose to deepen the structural flaws in their tax systems by increasing their reliance on sales and excise taxes. Some 16 states that had cut income taxes more than sales and excise taxes during the 1990s made themselves more dependent on consumption taxes during the early part of this decade. (See **Table 11.**) Altogether, increases in consumption taxes — general sales, cigarette, alcohol, and gasoline taxes — made up 54 percent ($9.9 billion) of the total net tax increases of 2002 and 2003, while personal income tax increases made up about 18 percent ($3.4 billion) of the total. More states raised consumption taxes than income taxes in 2002 and 2003.

In addition, a few states — Georgia, Montana and New Mexico — have enacted future-year reductions in personal income taxes that will further undermine their ability to support services over the long term. The return of improved fiscal conditions is likely to bring new pressure for income tax reductions in additional states.

Meanwhile, pressures for increased spending are being caused by factors such as increased health costs, the aging of the population, and increased demands on public education systems. **Table 12** summarizes some of these factors. On average, about 17 percent of state general fund budgets are devoted to Medicaid. In three states — Michigan, Tennessee and Washington — Medicaid spending makes up one-quarter or more of the state's general fund budget.

[17] This section draws heavily from Nicholas Johnson, Jennifer Schiess and Joseph Llobrera, *State Revenues Have Fallen Dramatically: Tax Increases So Far Have Failed to Fill the Gap*, Center on Budget and Policy Priorities, November 25, 2003.

## Table 11: Recent State Tax Policy Changes

| | Recent Tax Policy Changes | |
|---|---|---|
| State | Income tax cuts greater than sales/excise tax cuts, 1994-2000 | Sales/excise tax increases greater than income tax increases, 2001-2004 |
| Alabama | No | Yes |
| Alaska | No | Yes |
| Arizona | No | Yes |
| Arkansas | Yes | Yes |
| California | Yes | No |
| Colorado | No | Yes |
| Connecticut | Yes | No |
| Delaware | Yes | No |
| District of Columbia | NA | NA |
| Florida | No | No |
| Georgia | No | Yes |
| Hawaii | Yes | No |
| Idaho | Yes | Yes |
| Illinois | Yes | Yes |
| Indiana | Yes | Yes |
| Iowa | Yes | No |
| Kansas | Yes | Yes |
| Kentucky | Yes | No |
| Louisiana | No | No |
| Maine | No | Yes |
| Maryland | Yes | Yes |
| Massachusetts | Yes | No |
| Michigan | Yes | Yes |
| Minnesota | No | No |
| Mississippi | Yes | No |
| Missouri | Yes | No |
| Montana | No | Yes |
| Nebraska | Yes | Yes |
| Nevada | No | No |
| New Hampshire | No | No |
| New Jersey | Yes | No |
| New Mexico | Yes | Yes |
| New York | Yes | No |
| North Carolina | Yes | Yes |
| North Dakota | No | No |
| Ohio | Yes | Yes |
| Oklahoma | Yes | No |
| Oregon | Yes | Yes |
| Pennsylvania | Yes | Yes |
| Rhode Island | Yes | Yes |
| South Carolina | Yes | No |
| South Dakota | No | No |
| Tennessee | No | Yes |
| Texas | No | No |
| Utah | Yes | Yes |
| Vermont | Yes | Yes |
| Virginia | No | Yes |
| Washington | No | Yes |
| West Virginia | No | Yes |
| Wisconsin | Yes | No |
| Wyoming | No | Yes |
| US Total\Average | Yes=30 | Yes=30 |

Sources: CBPP calculations of NCSL data; *The Rising Regressivity of State Taxes*, Nicholas Johnson, CBPP, January 2002.

# Table 12: Spending Needs

| State | Medicaid Spending as Share of General Fund Spending, Actual FY 2003 (NASBO) | SSI recipients as percent of non-elderly population (2003) | Percentage point difference in growth in elderly population vs. general population, 2005 2015 | Special education students (based on Federal IDEA data) as percent of school age population 2004 | Percentage point difference in growth in k-12 age population vs. general population, 2005-2012 | Percentage point difference in growth in high school graduates vs. general population, 2005-2012 |
|---|---|---|---|---|---|---|
| Alabama | 5.3% | 3.7% | 22.8% | 10.0% | -8.1% | -6.7% |
| Alaska | 8.3% | 1.4% | 64.0% | 11.1% | 1.1% | -14.6% |
| Arizona | 14.1% | 1.7% | 30.7% | 8.7% | -6.2% | 14.9% |
| Arkansas | 11.4% | 3.3% | 18.0% | 10.8% | -9.0% | -4.5% |
| California | 13.6% | 2.6% | 25.5% | 8.4% | -10.3% | -2.1% |
| Colorado | 18.3% | 1.1% | 31.5% | 8.2% | -4.5% | 3.3% |
| Connecticut | 22.8% | 1.5% | 19.2% | 9.9% | -12.2% | -0.7% |
| Delaware | 12.9% | 1.7% | 27.6% | 11.2% | -6.1% | 2.3% |
| District of Columbia | NA | 3.6% | 5.6% | 15.2% | -8.0% | -19.7% |
| Florida | 17.8% | 2.3% | 19.2% | 11.8% | -13.4% | 2.0% |
| Georgia | 11.0% | 2.2% | 26.7% | 10.0% | -7.2% | 3.3% |
| Hawaii | 8.0% | 1.4% | 28.2% | 9.6% | -0.7% | -15.3% |
| Idaho | 11.6% | 1.6% | 25.8% | 9.0% | 3.4% | -4.1% |
| Illinois | 18.9% | 2.0% | 15.6% | 11.5% | -6.6% | 5.9% |
| Indiana | 14.6% | 1.6% | 16.0% | 12.5% | -5.9% | 3.2% |
| Iowa | 9.5% | 1.5% | 13.7% | 12.8% | -5.2% | -3.3% |
| Kansas | 11.8% | 1.5% | 15.6% | 10.7% | -4.2% | -9.4% |
| Kentucky | 10.4% | 4.6% | 20.8% | 11.2% | -6.1% | 8.8% |
| Louisiana | 12.2% | 3.8% | 22.8% | 10.1% | -6.5% | -18.2% |
| Maine | 20.3% | 2.7% | 28.8% | 14.7% | -7.6% | -18.5% |
| Maryland | 19.1% | 1.6% | 22.0% | 9.6% | -8.0% | -5.6% |
| Massachusetts | 16.2% | 2.2% | 18.2% | 12.8% | -10.7% | -8.6% |
| Michigan | 18.5% | 2.3% | 19.5% | 10.8% | -7.0% | -2.2% |
| Minnesota | 17.3% | 1.3% | 18.2% | 10.6% | -6.8% | -8.3% |
| Mississippi | 5.8% | 4.4% | 21.6% | 10.3% | -6.9% | -2.1% |
| Missouri | 16.3% | 2.1% | 16.8% | 12.0% | -6.4% | -6.2% |
| Montana | 9.8% | 1.7% | 31.7% | 10.8% | 1.5% | -18.9% |
| Nebraska | 17.3% | 1.3% | 16.0% | 12.2% | -2.6% | -9.1% |
| Nevada | 25.1% | 1.2% | 32.0% | 8.9% | -7.0% | 34.3% |
| New Hampshire | 25.1% | 1.1% | 30.5% | 11.7% | -8.3% | -10.9% |
| New Jersey | 15.8% | 1.6% | 17.4% | 13.5% | -9.0% | 2.8% |
| New Mexico | 11.1% | 2.6% | 41.3% | 12.1% | 0.1% | -17.3% |
| New York | 18.1% | 2.9% | 18.2% | 11.0% | -8.9% | -2.0% |
| North Carolina | 14.7% | 2.3% | 19.8% | 10.9% | -12.1% | 4.9% |
| North Dakota | 12.9% | 1.3% | 17.9% | 11.4% | -2.9% | -20.9% |
| Ohio | 20.0% | 2.3% | 16.9% | 10.7% | -5.8% | -2.7% |
| Oklahoma | 12.3% | 2.2% | 17.5% | 13.0% | -9.3% | -12.6% |
| Oregon | 17.1% | 1.6% | 22.9% | 10.4% | -7.3% | -7.9% |
| Pennsylvania | 19.4% | 2.7% | 13.0% | 11.1% | -6.7% | -3.9% |
| Rhode Island | 23.5% | 2.7% | 13.1% | 15.4% | -10.8% | -2.2% |
| South Carolina | 9.1% | 2.7% | 32.3% | 12.7% | -10.5% | -4.4% |
| South Dakota | 17.7% | 1.7% | 16.0% | 10.4% | 1.1% | -18.3% |
| Tennessee | 25.2% | 2.8% | 23.6% | 10.5% | -6.8% | -2.1% |
| Texas | 16.4% | 1.8% | 22.7% | 10.0% | -5.7% | -0.3% |
| Utah | 5.6% | 0.9% | 22.6% | 9.6% | -1.0% | -3.0% |
| Vermont | 14.8% | 2.1% | 36.0% | 11.1% | -5.5% | -18.2% |
| Virginia | 15.8% | 1.8% | 28.9% | 11.3% | -7.9% | 4.1% |
| Washington | 23.8% | 1.8% | 28.7% | 9.6% | -8.6% | -9.9% |
| West Virginia | 6.1% | 4.8% | 20.9% | 15.1% | -6.2% | -6.8% |
| Wisconsin | 13.2% | 1.7% | 18.9% | 10.9% | -4.9% | -9.5% |
| Wyoming | 9.6% | 1.2% | 41.2% | 12.4% | 3.7% | -25.7% |
| US Total\Average | 16.5% | 2.3% | 21.0% | 10.6% | -7.5% | -2.0% |

Source: Medicaid: 2003 NASBO State Expenditure Report (MA and OH figures adjusted to exclude federal payments); SSI: Georgetown University Health Policy Institute analysis based on Social Security Administration Annual Reports 1996-2003; March 1991-2003 CPS. Current as of November 2004; Elderly population: CBPP calculation of census population projections; Special Education: Federal IDEA data; K-12 and High School graduates: CBPP calculations of Dept. of Education and Census

In some states there is a particularly high proportion of poor disabled residents. The bulk of Medicaid spending is for elderly and disabled people. In every state except the District of Columbia, the elderly population is projected to grow faster than the general population for the foreseeable future. In ten states — Alaska, Arizona, Colorado, Montana, Nevada, New Hampshire, New Mexico, South Carolina, Vermont, and Wyoming — growth in the elderly population is expected to outstrip general population and growth by more than 20 percentage points between 2005 and 2015. On average, 2.3 percent of the U. S. population under 65 years old receive Supplemental Security Income (SSI) as a result of being blind or disabled.[18] The states with the highest percentage of residents on SSI are Alabama, Kentucky, Louisiana, Mississippi and West Virginia.

The situation is somewhat different for education. In all but six states — Alaska, Idaho, Montana, New Mexico, South Dakota, and Wyoming — the K-12 school age population is projected to shrink as a share of total population. However, there is increasing public demand for smaller class sizes and other improvements in public education and many states are home to a large number of students with special needs who are expensive to educate. As of 2004, more than 1 in 10 school-age children in the United States required special education. The states with the largest number of special education students as a share of school of school-age children were New Jersey, Oklahoma, Rhode Island, West Virginia and Washington, DC. In addition, in a number of states the number of students graduating from high school and moving into college is projected to grow more quickly than the general population. This growth plus the fact that the percentage of high school students who go on to college has been increasing over time is putting increased pressure on public colleges and universities.

### *Growing Health Care Costs*

Health spending is one of the largest and fastest-growing areas of state budgets. The largest component of health spending in state budgets is Medicaid, which accounts for about 16.5 percent of state general fund spending.[19] Based on Congressional Budget Office estimates, state Medicaid spending is likely to increase about 8.5 percent annually on average between 2004 and 2014, well above projected average annual inflation (2.1 percent) and projected average annual GDP growth (4.6 percent).

Eligibility or benefit expansions have not contributed to Medicaid cost growth for some time. In fact, states have instituted an unprecedented series of Medicaid budget cuts and cost-containment practices in recent years. Millions of low-income Americans do not meet their state's stringent Medicaid eligibility criteria, while Medicaid payments to health-care providers often are well below those paid by Medicare and the private sector. Medicaid costs per beneficiary have grown much more slowly in recent years than private insurance costs and are substantially lower than those for private health insurance.

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[18] SSI is a federal income supplement program designed to help aged, blind, and disabled people who have little or no income by providing cash to meet basic needs for food, clothing, and shelter.

[19] 2003 State Expenditure Report, National Association of State Budget Officers. The share of the general fund budget spent on Medicaid equaled 16.5 percent. Some other state funds also support Medicaid. The share of all state funds (general and other funds) spent on Medicaid equals 13.3 percent.

Rather, the rapid growth in Medicaid spending is being driven in large part by increases in health care costs that are affecting the U.S. health care system as a whole. Much of this increase reflects advances in medical technology that improve health and prolong life but increase costs. Another important cause of the growth in Medicaid spending is the aging of the population, which will lead to increased needs for prescription drugs and long-term care.[20]

Medicaid is the primary provider of prescription drugs and long-term care for low-income elderly and disabled people who are enrolled in both Medicare and Medicaid. Over the last several years, an increasing share of the cost of health care for these individuals (known as "dual eligibles") has been shifting from Medicare, a federal program, to Medicaid, a program in which states bear an average of 43 percent of the costs. This has occurred in part because the duration of hospital stays (covered by Medicare) has decreased while the use of pharmaceuticals to manage health conditions (covered by Medicaid) has increased. About 35 percent of all Medicaid expenditures are made on behalf of "dual eligibles."[21]

Because Medicare does not cover nursing home coverage, Medicaid must pick up nursing home costs not only for individuals who already are poor but also for the much larger number of elderly and disabled people who deplete their assets in paying for health care, fall into poverty at some point before entering a nursing home, and qualify for Medicaid from that time forward. Medicaid picks up nearly half (46 percent) of the country's nursing home costs.

The creation of a Medicare drug benefit means that prescription drug coverage for dual eligibles will shift to Medicare. Under the Medicare drug legislation, however, states will remain responsible in perpetuity for 75 percent or more of the drug costs they would have incurred if these beneficiaries had continued to receive drugs through Medicaid. Moreover, a sizable share of the remaining savings will be consumed by new costs that the legislation imposes on states, such as the costs of determining eligibility for the new Medicare low-income drug subsidies.[22]

In sum, state Medicaid costs are likely to continue rising rapidly until broader efforts are made to address health care cost increases throughout the U.S. heath care system and to close gaps in Medicare coverage. In the absence of such broader efforts, states face a difficult choice as they work to bring structural balance to their budgets. They must either modify their tax systems to grow in line with this portion of their budgets or enact significant cutbacks in Medicaid eligibility and benefits. The latter course will inevitably expand the ranks of the uninsured. It also will increase the amount of uncompensated care provided, which in turn will place additional strains on state budgets by raising costs for state and local government hospitals and clinics.

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[20] Census population estimates indicate that between 2005 and 2012, the general population growth excluding those over 65 is projected to be 4.5 percent while the population growth of those over 65 is projected to be 15 percent.
[21] Iris Lav. "Federal Policies Contribute to the Severity of the State Fiscal Crisis." *Center on Budget and Policy Priorities*, December 3, 2003.
[22] Edwin Park, et. al. "The Troubling Medicare Legislation," *Center on Budget and Policy Priorities*, December 8, 2003.

*Growing Education Costs*

Though elementary and secondary education is primarily a local government responsibility, state governments play a significant role in financing education through grants to localities and school districts. Education accounts for roughly 35 percent of general fund spending.[23]

States face continued public demand for additional investments in education, even as school-age enrollment is projected to decline slightly over the next decade.[24] Over the last few years, the education finance systems in several states have been ruled inadequate by the court system; these states must find additional revenue. In addition, there is evidence that certain sub-populations of students, such as special education students, low-income students, and students with limited English proficiency, will require growing attention and expenditures over the next decade.

Voters have consistently expressed concern that public education is underfunded. For three straight years, respondents in an annual poll have listed "lack of financial support/funding/money" as the most pressing problem facing public schools.[25] In some states, voters have supported an increased state role in order to reduce the reliance on local property taxes for funding education. As evidence of this support, in recent years voters in several states have passed initiatives to increase or earmark state funds for public education. For example:

- In 2002, voters in Florida passed two education-related initiatives, one mandating publicly funded pre- kindergarten and another requiring funding to reduce class sizes.

- In 2002, voters in California passed an initiative that increases state funding for before- and after-school programs providing tutoring, homework assistance, and educational enrichment.

- In 2000, Colorado voters passed Amendment 23, which establishes a minimum funding level for K-12 education and guarantees that education funding will grow at least by one percent above the inflation rate each year.

The courts are a second source of budgetary pressure on education spending. Over the last 35 years, they have played a critical role in the development of education finance policy, as lawsuits have been filed asserting that the distribution of public resources among school districts in various states is inequitable, inadequate, illegal, and/or unconstitutional. In recent years, state courts have found the school funding systems in Arkansas, Kansas, New Hampshire, and New

[23] National Association of State Budget Officers, *State Expenditure Report*, FY 2002..
[24] In a handful of states K-12 enrollment growth is projected to exceed general population growth over the next decade: Alaska, Idaho, Montana, New Mexico, South Dakota, and Wyoming.
[25] Lowell C. Rose and Alec M. Gallup, "The 35th Annual Phi Delta Kappa/Gallup Poll Of the Public's Attitudes Toward the Public Schools," *Phi Delta Kappan*, September 2003. In 2001, "lack of financial support/funding/money" was tied with "lack of discipline, more control." In 2000, 2002, 2003, and 2004, "lack of financial support/funding/money" was alone in first place, mentioned by 18, 23, 25, and 21 percent of the respondents, respectively.

York to be inadequate. Also, courts in Alaska, Idaho, New Jersey, and New Mexico have ruled that certain aspects of the state's education system (such as capital improvements and schools in low-income areas) require additional funding. These decisions can have a significant fiscal impact: they have increased spending by an estimated 15 to 40 percent.

Future education spending will also be driven by growing needs among certain sub-populations of students. During the 1990s, special education enrollment grew 30 percent, compared to only 12 percent for all other K-12 students. While some of this increase can be attributed to better methods of identifying students with special needs (and thus may level off), costs for special education are likely to continue to rise faster than for education generally as diagnostic methods continue to improve and remedial education becomes more specialized and more costly. A recent study stated that the average cost of educating disabled students is 90 percent greater than the cost of educating students without disabilities.[26]

In addition, over the last few years, states have made adjustments to school funding formulas to account for the increased costs of serving children for whom English is not the primary language. Demographic data indicate that this population will be increasing over the next several years.

A third sub-group of students with additional needs is low-income students. A significant body of research has emerged over the last ten years to suggest that educating these students will require much more funding than is currently being provided; educating a poor child costs more than twice as much as educating a non-poor child, the research indicates.[27] While it is unclear whether the low-income student population will grow faster than other students, this population clearly has an unmet funding need that should be addressed over the next decade.

## Policy Responses

In light of these increasing costs in their two largest areas of responsibility — health care and education — states must either modify their tax systems to grow in line with these costs or enact significant cutbacks in their budgets. Given the large share of state budgets that go to health care and education, these cuts would likely weaken the state's health care and/or educational systems. Ways in which states can avoid these cuts and modify their tax structures are discussed elsewhere in this report.

Another step that states can take to address the mismatch between tax policy decisions and future spending needs is to make sure they have adequate information on trends beyond the coming year. Fewer than a dozen states routinely prepare "current service" budgets that project the expected costs of existing programs for two or more years into the future. Current service projections can be compared to revenue projections to determine whether proposed changes to tax policies would create or worsen a structural gap.

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[26] Jay Chambers, Tom Parrish, Jennifer Harr, *What Are We Spending on Special Education Services in the United States: 1999-2000?*, Advance Report #1, Special Education Expenditure Project, American Institute for Research, March 2002.

[27] Kevin Carey, "Overview of Education Finance," *Center on Budget and Policy Priorities*, November 5, 2002.

## VIII. Procedural Barriers to Structural Balance

Many states and localities have enacted, or are considering enacting, tax and spending limits, supermajority requirements for tax and budget changes or property tax limits. These types of process barriers are sometimes presented as a way to address structural deficits by reducing the rate of growth of spending but, rather than helping to solve these problems, they often complicate the process of addressing gaps and can have serious unintended consequences.

Tax limits that restrict growth in taxes to an arbitrary level or super-majority requirements that make it difficult to increase taxes can leave a state without the revenues needed to maintain services at a constant level given changes in the cost of providing the services and changes in populations served. Spending limitations have the same effect when they restrict the rate of growth of state budgets to an arbitrary amount that is below the level needed to meet normal growth in program costs.

Process barriers do not eliminate the needs of state residents or the public's demands for services such as education, healthcare or transportation. In efforts to fulfill the demand, states often make future gaps worse by relying on gimmicks or one-time measures to maintain services in order to comply with arbitrary limits.

Supermajority requirements for tax increases can also create a barrier to certain kinds of modifications to a state's tax system or create an incentive to use one revenue source over another without regard for which will provide a better future revenue stream. For example, Arkansas has relied heavily on sales and alcohol tax increases because increases in the rates of these taxes require only a simple majority while others require supermajorities under Arkansas' constitution. In some states, the ability of states to strengthen taxes such as the corporate income tax by removing loopholes is restricted when supermajorities are needed to eliminate them.

In addition, when a state has a tax or spending limit that applies only to one level of government — either the state or local level — responsibility for funding and delivering services can shift from one level of government to the other without regard to which has the best tax system for maintaining growth in programs.

Decisions about the appropriate size and growth of state government and the structure of a state's tax systems are best made during the state's annual or biennial budget process, not through a sterile formula.

### *What Are Tax and Expenditure Limits?*

As the name indicates, tax and expenditure limits (TELs) are limits on how much money a state can raise and/or spend. Currently, 29 states have some form of a TEL. TELs differ in many different ways, including the amount of allowable growth in taxes or expenditures each year, the amount or proportion of state revenue or spending that is subject to the limit, the mechanism for overriding the limitation, the mechanism for distributing any surplus, and whether the provision is constitutional or statutory. A TEL's most important elements are the amount of allowable growth (typically determined by a formula) and the scope of the limit. Whether or not the TEL is embedded in the state constitution is also important, since constitutional limits cannot be adapted to changing circumstances. (See **Table 13** for a summary of the structure of individual state limits.)

### *The Problem with TELs*

The strictest TEL is Colorado's Taxpayer Bill of Rights (TABOR), a constitutional amendment that limits the annual growth of state and local revenues to the rate of growth of population plus inflation. Such a formula may sound reasonable, but it falls far short of providing adequate funds to support the ongoing cost of government, in part because health care costs are growing much faster than inflation and the population is aging. Thus, limiting the rate of spending growth to inflation plus population growth forces annual *reductions* in the level of government services.

- If a population-plus inflation TEL had been in place in all states from 1990 to 2004, in 2004 they would have spent $162.7 billion, or 21 percent, less of their own funds than they actually spent.

- Closing this gap in 2004 could have been achieved by cutting 78 percent of all state K-12 education budgets, all state Medicaid and transportation spending, or 60 percent of all other state spending.[28]

As noted above, TABOR was enacted as a constitutional amendment. Constitutional TELs impose a permanent restriction on the growth of state government that may be difficult for future citizens and policymakers to overturn. For example, TABOR does not allow policymakers to adjust for external changes — such as demographic shifts, environmental disasters, or increased homeland security requirements — that may require state governments to increase spending and to raise taxes to pay for that spending.

[28] David Bradley, Nicholas Johnson, and Iris J. Lav, *The Flawed "Population plus Inflation" Formula: Why TABOR's Growth Formula Doesn't Work*, Center on Budget and Policy Priorities, January 13, 2005

# Table 13: Tax and Expenditure Limits

| | *Yes/No* | *Constitution or Statute* | *Limit Applies to:* | *Limit* |
|---|---|---|---|---|
| **Alabama** | No | | | |
| **Alaska** | Yes | Constitution | Appropriations | $2.5 billion plus inflation and population growth since 1981; voters may override |
| **Arizona** | Yes | Constitution | Appropriations | 7.41 percent of personal income; 2/3 vote to override |
| **Arkansas** | No | | | |
| **California** | Yes | Constitution | Appropriations of state tax revenue | Personal income growth and population; may exceed in emergency |
| **Colorado** | Yes | Statute | General fund appropriations | 6 percent growth over previous year |
| | | Constitution | General fund revenue | Population growth and inflation; referendum to override |
| **Connecticut** | Yes | Constitution | Appropriations | Greater of 5-yr personal income growth or inflation; 3/5 vote of legislature to override in emergency |
| **Delaware** | Yes | Constitution | Appropriations | 98 percent of estimated revenue |
| **District of Columbia** | No | | | |
| **Florida** | Yes | Constitution | Revenue | 5-yr personal income growth; 2/3 of legislature required to override |
| **Georgia** | No | | | |
| **Hawaii** | Yes | Constitution | Appropriations | 3-yr personal income growth; 2/3 of legislature required to overrride |
| **Idaho** | Yes | Statute | Appropriations | 5.33 percent of personal income |
| **Illinois** | No | | | |
| **Indiana** | Yes | Statute | Expenditure | Personal income growth |
| **Iowa** | Yes | Statute | Appropriations | 99 percent of adjusted general fund receipts |
| **Kansas** | No | | | |
| **Kentucky** | No | | | |
| **Louisiana** | Yes | Statute | Revenue | 1978-1979 revenue divided by 1977 personal income |
| | | Constitution | Appropriations from own sources | 1992 appropriations plus per capita personal income growth; 2/3 of legislature required to override |
| **Maine** | Yes | Statute | Appropriations | Personal income and population growth, depending on tax burden rank |
| **Maryland** | No | | | |
| **Massachusetts** | Yes | Statute | Revenue | Growth in wages & salaries; majority of both houses and governor required to override |
| **Michigan** | Yes | Constitution | Revenue | 9.49 percent of personal income; 2/3 of legislature to override |
| **Minnesota** | No | | | |
| **Mississippi** | Yes | Statute | Appropriations | 98% of Projected Revenue |
| **Missouri** | Yes | Constitution | Revenue | 5.64 percent of personal income; two-thirds of legislature required to override |
| **Montana** | Yes | Statute | Appropriations | Growth in personal income; two-thirds of legislature required to override |
| **Nebraska** | No | | | |
| **Nevada** | Yes | Statute | Expenditure | Growth of population and inflation |
| **New Hampshire** | No | | | |
| **New Jersey** | Yes | Statute | Appropriations | Personal income growth |
| **New Mexico** | No | | | |
| **New York** | No | | | |
| **North Carolina** | Yes | Statute | Appropriations | 7 percent of state personal income |
| **North Dakota** | No | | | |
| **Ohio** | No | | | |
| **Oklahoma** | Yes | Constitution | Existing Program Appropriations | Growth of 12 percent plus inflation; no override mechansim |
| **Oregon** | Yes | Statute | Appropriations | 8% of personal income growth for biennium |
| | | Constitution | Revenue | Actual revenue during biennium cannot exceed 2% over projected revenue |
| **Pennsylvania** | No | | | |
| **Rhode Island** | Yes | Constitution | Appropriations | 98% of Projected Revenue |
| **South Carolina** | Yes | Constitution | General fund expenditure | Greater of personal income growth, or 9.5 percent of personal income; two-thirds of legislature required to override |
| **South Dakota** | No | | | |
| **Tennessee** | Yes | Constitution | Appropriations | Growth in personal income; majority of legislature required to override |
| **Texas** | Yes | Constitution | Appropriations | "Growth of economy" (personal income growth); majority vote of legislature to override |
| **Utah** | Yes | Statute | Appropriations | Growth in population plus inflation |

## Table 13: Tax and Expenditure Limits (Cont'd)

| | | | | |
|---|---|---|---|---|
| **Vermont** | No | | | |
| **Virginia** | No | | | |
| **Washington** | Yes | Statute | General fund state supported expenditure | Population growth and inflation; two-thirds of legislature required to override |
| **West Virginia** | No | | | |
| **Wisconsin** | No | | | |
| **Wyoming** | No | | | |
| SUM: YES | 29 | | | |
| SUM: NO | 22 | | | |

Data Source: National Conference of State Legislatures, April 2005; Individual state budget offices.

TABOR also includes a feature that periodically sharply lowers (or "ratchets down") the permissible level of government services. Each year's revenue limit is based on the previous year's actual revenues, not the revenues permitted under the TABOR formula. Thus, when revenue collections fall short of the TABOR limit, that depressed revenue level becomes the new base for the following year's revenue limit. This means that public services *never* recover from an economic downturn, because the state is forbidden to exceed the TABOR limit in a given year to compensate for falling short of the limit in a prior year.

Another problematic feature of TABOR is that taxes may be increased only with voter approval. This puts the fate of tax changes in the hands of whoever can afford the high cost of placing a measure on the ballot and supporting it with advertisements. And it allows those who can muster the resources to conduct all-out campaigns against reasonable changes that may be needed.

While TABOR is often presented as a way to slow the growth of government — and potentially help address structural deficits — in Colorado it has weakened government's ability to provide basic services. Despite having the nation's seventh-highest per-capita personal income in 2003, Colorado performs poorly on key measures of public services. For example, the proportion of low-income children who lack health insurance rose from 15 percent in 1991-1992 to 27 percent in 2002-2003, even as health coverage among low-income children was expanding on a national basis. In addition, Colorado ranks 49$^{th}$ in K-12 education funding as a share of state income, 48$^{th}$ in high school graduation rates, and 48$^{th}$ in its level of taxpayer support for colleges and universities. The state now invests $3.69 per $1,000 of personal income in higher education, down from $8.89 in 1992.

### *What Are Super-Majority Requirements?*

Super-majority requirements state that some or all tax increases must be approved by more than 50 percent (two-thirds, three-fourths, or three-fifths) of both legislative chambers. Currently, 16 states have some form of super-majority requirement regarding tax increases (see **Table 14.**) Of these, 12 apply to all taxes.

Super-majority requirements are based on the false premise that tax increases always harm the economy and therefore should be more difficult to enact than spending increases. In

**Table 14: State Supermajority Requirements for Tax Increases**

| State | Legislative Majority Required | Applies To |
|---|---|---|
| Arizona | Two-thirds | All taxes |
| Arkansas | Three-fourths | Rates for all taxes except those enacted after 1934 such as sales and alcohol |
| California | Two-thirds | All taxes |
| Colorado | Two-thirds | All taxes[a] |
| Delaware | Three-fifths | All taxes |
| Florida | Three-fifths | Corporate Income Tax[b] |
| Kentucky | Three-fifths | All taxes (Only applies when legislature meets in odd-numbered years) |
| Louisiana | Two-thirds | All taxes |
| Michigan | Three-fourths | State Property Tax |
| Mississippi | Three-fifths | All taxes |
| Missouri | Two-thirds | All taxes[c] |
| Nevada | Two-thirds | All taxes |
| Oklahoma | Three-fourths | All taxes |
| Oregon | Three-fifths | All taxes |
| South Dakota | Two-thirds | All taxes |
| Washington | Two-thirds | All taxes[d] |

[a] Tax increases automatically sunset unless approved by the voters at the next election.
[b] The constitution limits corporate income tax rate to 5 percent. A three-fifths vote needed to increase beyond 5 percent.
[c] The constitution requires voter approval for significant tax increases. If the governor declares an emergency, the legislature can increase taxes with a two-thirds vote.
[d] Tax increases producing revenue that do not exceed the spending limit must be approved by two-thirds legislative vote; tax increases that produce revenue over the limit, must be approved by two-thirds legislative majority and the voters.
Source: Mandy Rafool, Supermajority Requirements for Tax Increases, National Conference of State Legislatures, January 2004.

reality, an adequate level of revenue growth is important for maintaining an adequate level of public services, which in turn is important for maintaining a healthy business climate.[29] Studies have shown that good schools, highways, and amenities not only help to attract and retain businesses, but are often rated by businesses as more important factors in location decisions than

[29] Legislators and governors should be free to weigh all of the considerations with respect to whether a tax increase — or a change in the form of taxes that might also raise additional revenue — is warranted at a particular time. Permanently tilting the playing field so reductions in expenditures (or taxes) require a simple majority while increases in revenue require a supermajority can lead to tyranny of the minority and rarely results in balanced policies.

tax levels. In addition, taxes represent a very small share of the cost of doing business, which is why studies show they have at most a very modest effect on economic growth. [30]

### *Other Process Barriers*

Another feature of tax laws that can act as a barrier to modernizing tax systems is when the laws are part of the state's constitution rather than simply a part of state statutes. In general, statutory tax laws can be changed by a vote of the legislature while constitutional provisions are subject to a more lengthy and difficult process and generally require approval by voters. This has the effect of making it considerably more difficult to address structural problems with state tax systems in a timely way. For example, Alabama's tax laws are part of the state constitution and can only be changed through a referendum. Similarly, some states such as Illinois and Pennsylvania include constitutional prohibitions on progressive rate structures which limits the ability of the state to adopt a tax system that is more responsive to economic growth.

### *Property Tax Limits*

Restrictions on the growth of property tax revenue can take a number of different forms. (See Table 15.) States can place limits on property tax rates, total property tax revenue collections, or the annual increase in property assessments. Like other restrictions discussed earlier in this section, these limits arbitrarily reduce revenue growth even when economic growth or demographic changes may be increasing spending needs.

In addition, assessment limits can produce significant inequities when economic growth is uneven across the state, since they benefit only those taxpayers who live in areas with high assessment growth, regardless of whether taxpayers in other areas face higher property tax burdens relative to their income. Even when such inequities are recognized, these kinds of limits are difficult to undo because the beneficiaries of the caps have a strong incentive to retain them.

## Policy Responses

Over the next several years, many states will face demands for increased services, which their revenue systems will be structurally incapable of meeting unless reforms are made. As states begin to make those reforms, they would be ill-advised to enact procedural barriers that would impose artificial constraints on their ability to meet future service demands. The decision about the appropriate size and growth of state government is best made during the state's annual or biennial budget process — when legislators have the opportunity to evaluate the amount of spending necessary to fund programs and services — and not through a sterile formula.

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[30] See for example, Robert G. Lynch, "Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development, *Economic Policy Institute*, 2004; Michael Wasylenko, "Taxation and Economic Development: The State of the Economic Literature," *New England Economic Review*, March-April 1997, reprinted in *State Tax Notes*, June 23, 1997, pp. 1883-95; Robert G. Lynch, *Do State and Local Tax Incentives Work?*, Economic Policy Institute, Washington, D.C., 1996; Timothy Bartik, *Who Benefits From State and Local Economic Development Policies?*, W.E. Upjohn Institute for Employment Research, Kalamazoo, Michigan, 1991.

# Table 15: Property Tax Limits

| | *Overall Property Tax Rate Limit* | *Property Tax Revenue Limit* | *Assessment Increase Limit* |
|---|---|---|---|
| Alabama | Yes | No | No |
| Alaska | No | Yes | No |
| Arizona | Yes | Yes | Yes |
| Arkansas | No | Yes | Yes |
| California | Yes | No | Yes |
| Colorado | No | Yes | No |
| Connecticut | No | No | No |
| Delaware | No | Yes | No |
| District of Columbia | No | No | No |
| Florida | No | No | Yes |
| Georgia | No | No | No |
| Hawaii | No | No | No |
| Idaho | Yes | No | No |
| Illinois | No | Yes | No |
| Indiana | No | Yes | No |
| Iowa | No | No | Yes |
| Kansas | No | No | No |
| Kentucky | No | Yes | No |
| Louisiana | No | Yes | No |
| Maine | No | No | No |
| Maryland | No | No | Yes |
| Massachusetts | No | Yes | No |
| Michigan | Yes | Yes | Yes |
| Minnesota | No | No | No |
| Mississippi | No | Yes | No |
| Missouri | No | Yes | No |
| Montana | No | Yes | No |
| Nebraska | No | Yes | No |
| Nevada | Yes | Yes | No |
| New Hampshire | No | No | No |
| New Jersey | No | Yes | No |
| New Mexico | Yes | Yes | Yes |
| New York | No | No | Yes* |
| North Carolina | No | No | No |
| North Dakota | No | Yes | No |
| Ohio | Yes | Yes | No |
| Oklahoma | Yes | No | Yes |
| Oregon | Yes | Yes | Yes |
| Pennsylvania | No | Yes | No |
| Rhode Island | No | Yes | No |
| South Carolina | No | No | No |
| South Dakota | No | No | No |
| Tennessee | No | No | No |
| Texas | No | Yes | No |
| Utah | No | No | No |
| Vermont | No | No | No |
| Virginia | No | No | No |
| Washington | Yes | Yes | No |
| West Virginia | Yes | Yes | No |
| Wisconsin | No | No | No |
| Wyoming | No | No | No |
| SUM: YES | 12 | 26 | 11 |

Source: National Education Association, "Protecting Public Education from Tax Giveaways to Corporations," Working Paper, January 2003. Updated from Daniel R. Mullins and Kimberly Cox, Tax and Expenditure Limits on Local Governments. Advisory Commission on Intergovernmental Relations, Washington D.C., March 1995

No budget process is perfect, and most states could benefit from certain reforms. For example, states could make their budget processes more transparent by allowing for additional public hearings and by ensuring that legislators have sufficient time and staff to analyze budget proposals. These types of reforms make more sense than saddling future generations with arbitrary revenue restrictions.

## IX. Federal Tax Policies That Reduce State Revenues

Federal policies have contributed to the erosion of state tax bases in a number of ways. Certain federal tax cuts have reduced state revenues because of the linkages between state and federal tax systems. In addition, Congress has failed to address Supreme Court rulings that prevent states and localities from collecting taxes owed to them, and the federal government has preempted state and local taxing authority in some cases.

A number of provisions of the federal tax cuts enacted in 2001, 2002, and 2003 have reduced state as well as federal revenues. One example is the phase-out between 2002 and 2005 of the federal estate tax credit, which reduces the federal estate tax by a dollar for each dollar paid in *state* estate taxes. Every state in the nation levied a state estate tax that was tied to this federal credit; most states simply set their own estate tax at a level equal to the federal tax credit. As a result, the elimination of the federal credit threatens to effectively eliminate most states' estate taxes. Some 17 states and the District of Columbia have managed to maintain their estate taxes by "decoupling" them from this change in federal law. but the remaining states stand to lose $6 billion through fiscal year 2005 and $14 billion through fiscal year 2007 as a result of this federal action.

Another federal tax cut that cost states revenue was a temporary business tax cut (now expired) known as "bonus depreciation." As enacted in 2002, it allowed businesses to deduct immediately 30 percent of the cost of equipment they purchase, rather than writing it off over the equipment's useful life. Since most states tie their depreciation tax rules to the federal depreciation rules, states stood to lose approximately $14 billion in state revenue from the federal tax cut. Moreover, Congress and the Administration enlarged and extended "bonus depreciation" in 2003, thereby increasing the potential state revenue loss. Most states were reluctant to experience this revenue loss at a time when state revenues were declining, and 34 states "decoupled" from the new tax cut. The non-decoupled states lost approximately $4 billion through fiscal year 2005.

Federal policies also have prevented states from raising revenues in certain areas. The Internet Tax Freedom Act (ITFA) bars states from collecting taxes on the monthly charges that

Internet users pay to companies such as AOL for their Internet accounts. This ban cost states and localities more than $4 billion over the four years of the state fiscal crisis (state fiscal years 2002-2005).[31] Furthermore, Congress enacted legislation at the end of 2004 to expand the types of Internet-related services that states are barred from taxing . The Federation of Tax Administrators estimates that the 2004 expansion of ITFA will cost states an additional $600 million in forgone revenues annually when it takes effect in late 2006.

A larger example of federal restrictions on state taxing authority is the government's failure to empower states to collect sales taxes on items purchased over the Internet and through catalogs, even though states can collect such taxes on the same purchases if they are made in stores. This costs states a substantial share of their sales tax revenue each year. This issue is discussed in more detail in Chapter 4.

Other cases of federal preemption of state taxing authority exist as well, although they tend to be harder to quantify. For example, federal law prohibits state and local governments from applying sales taxes to airline and bus tickets purchased for interstate travel, which would produce large revenue gains. Federal law also prohibits states and localities from taxing the income of an out-of-state corporation if the corporation's only activity within the state is soliciting orders for physical goods; this allows corporations to have an unlimited number of salespeople in a state at all times yet remain tax-exempt so long as the salespeople work out of their homes. When this legislation (P.L. 86-272) was enacted in 1959, it was intended to be temporary. However, it has never been repealed, and over the years, it has shielded tremendous amounts of corporate profits from state taxation.

In addition, most states stand to be net losers from the American Jobs Creation Act of 2004, which repealed "Extraterritorial Income" provisions that had been declared illegal by the World Trade Organization but contained a number of other tax provisions as well. States that do not decouple from the provisions in this bill will experience a loss of corporate income tax collections and (to a lesser extent) personal income tax collections.

## Policy Responses

Federal tax actions have contributed to states' structural deficits by eroding the faster-growing segments of state tax bases: estate taxes, e-commerce, and income taxes. These actions not only reduce state revenues in the short term but also slow future revenue growth.

There are two ways states can address these problems. They can work with Congress and the Administration to prevent or reverse the federal provisions that reduce state revenues, or in some cases they can nullify the effects of these provisions by delinking state tax law from the federal change. As noted, most states decoupled from the federal "bonus depreciation" changes, and one-third of the states have decoupled from the federal estate tax changes. (See **Table 15.**) In anticipation of additional actions, states could follow the lead of states like Maryland that have adopted provisions that prevent automatic adoption of future federal tax changes that would reduce state taxes.

[31] Lav and Brecher, *Passing Down the Deficit.*

## Table 16: Impact of Federal Tax Cuts on States

| | *Decoupled From the Estate Tax, Yes/No* | *State's Standard Deduction Based on Federal, Yes/No* |
|---|---|---|
| **Alabama** | No | No |
| **Alaska** | No | N/A |
| **Arizona** | No | No |
| **Arkansas** | No | No |
| **California** | No | No |
| **Colorado** | No | No |
| **Connecticut** | No | No |
| **Delaware** | No | No |
| **District of Columbia** | Yes | No |
| **Florida** | No | N/A |
| **Georgia** | No | No |
| **Hawaii** | No | No |
| **Idaho** | No | No |
| **Illinois** | Yes | No |
| **Indiana** | Yes | No |
| **Iowa** | No | No |
| **Kansas** | No | No |
| **Kentucky** | No | No |
| **Louisiana** | No | No |
| **Maine** | Yes | Yes |
| **Maryland** | Yes | No |
| **Massachusetts** | Yes | No |
| **Michigan** | No | No |
| **Minnesota** | Yes | Yes |
| **Mississippi** | No | No |
| **Missouri** | No | Yes |
| **Montana** | No | No |
| **Nebraska** | Yes | Yes |
| **Nevada** | No | N/A |
| **New Hampshire** | No | N/A |
| **New Jersey** | Yes | No |
| **New Mexico** | No | Yes |
| **New York** | Yes | No |
| **North Carolina** | Yes | No |
| **North Dakota** | No | Yes |
| **Ohio** | Yes | No |
| **Oklahoma** | No | No |
| **Oregon** | Yes | No |
| **Pennsylvania** | No | No |
| **Rhode Island** | Yes | Yes |
| **South Carolina** | No | Yes |
| **South Dakota** | No | N/A |
| **Tennessee** | No | N/A |
| **Texas** | No | N/A |
| **Utah** | No | Yes |
| **Vermont** | Yes | Yes |
| **Virginia** | Yes | No |
| **Washington** | Yes | N/A |
| **West Virginia** | No | No |
| **Wisconsin** | Yes | No |
| **Wyoming** | No | N/A |
| SUM: YES | 18 | 10 |

Source:
McNichol, Elizabeth C.. *Many States Are Decoupling from the Federal Estate Tax Cut.* Washington, D.C.: Center on Budget and Policy Priorities, June 19, 2003.
Johnson, Nicholas. *Federal Tax Changes Likely to Cost States Billions of Dollars in Coming Years.* Washington, D.C.: Center on Budget and Policy Priorities, June 5, 2003.

In addition, states can continue to inform Congress and the Administration about the effects that federal tax policy can have on state revenues — and thus on state services. Often, a simple design change to proposed federal legislation can protect states from revenue loss. For example, the dividend tax reduction passed in 2004 was originally designed in such a way that it would have caused revenue losses in most states. However, after those impacts were made clear to federal policymakers, the tax reduction was redesigned so it would not affect state revenues.

## X. Putting it all Together: A Structural Deficit Scale

The earlier chapters of this report discussed a number of factors that can put a state at risk of structural budget problems. Any one of these factors could cause problems for a state. But the more of these issues that a state faces, the more likely it is that the state is experiencing — and is likely to continue to experience — serious structural gaps in its budget.

In order to assess the severity of the structural problems faced by each state, we developed a scale based on the measures discussed in this report. We first identified nine basic features of state fiscal systems that tend to affect the severity of a state's structural problems. For each of these features, we developed one or more measures of how exposed the state is to problems in this area. In addition, we developed a tenth factor based on previous studies of structural deficits. Table 17 identifies the features and measures we used.

The scores assigned to states are indended to summarize the degree of risk a state faces for structural problems that result in a gap between *the rate of growth* of revenues and expenditures. States also face gaps between revenues and expenditures that result from other factors such as the use of one-time measures to balance budgets or the use of temporary surpluses for permanent tax cuts or spending increases. As discussed in more detail in the box on page 42 the solutions to these problems differ from the solutions to the structural growth problems that are the focus of this paper

With these measures as a starting point, we developed a scale to measure a state's propensity to face structural problems. We used three steps to come up with a score for each state on this scale.

First, for each of the measures (or "sub-factors"), we determined if the state's results on this measure would contribute to structural imbalance in the state. For example, the first factor is taxation of services under the sales tax. It has two sub-factors: the change in the breadth of the sales tax base over time and the number of household services included in the sales tax base. The first sub-factor is considered to contribute to a structural deficit if the state has experienced a larger-than-average decline in the breadth of the sales tax base. The second sub-factor is considered to contribute if the state taxes fewer than the average number of household services.

## Table 17: Summary of Factors in Scale

| Factor | Measure (sub-factor) | Increased Structural Deficit Risk |
|---|---|---|
| Taxation of Services Under the Sales Tax | Change in breadth of sales tax base | Larger than average decline in breadth of sales tax base |
| | Number of household services in sales tax base | Smaller than average number of household services taxed |
| State Corporate Income Taxation | Change in corporate income tax as share of taxes | Larger-than-average decline in corporate income tax as share of taxes or no corporate income tax |
| | Number of loopholes | Either two or more loopholes present or no corporate income tax |
| Taxation of Electronic Commerce | Amount of sales tax revenue lost due to electronic commerce | Greater-than-average loss of revenue |
| Elderly Preferences | Income tax preferences for elderly | Greater-than-average elderly tax preferences as measured by Wallace/Edwards study |
| | Property tax preferences for elderly | Non-means-tested homestead exemption or deduction for elderly |
| State Income Tax Structure | Degree of progressivity of personal income tax | Either less progressive income tax (flat rate or low top bracket) or no personal income tax (extra point added if no personal income tax) |
| Spending Needs of State Residents | Share of General Fund budget for Medicaid | Greater-than-average share of budget for Medicaid |
| | Difference in growth in elderly population compared to general population | Higher-than-average difference in elderly population growth compared to general population growth |
| | Share of non-elderly population on SSI | Greater-than-average share of population on SSI |
| | Share of students identified as having special needs | Higher-than-average share of students with special needs |
| | Difference in growth in K-12-aged population compared to general population | Growth in K-12 aged population exceeds general population growth |
| | Difference in growth in high school graduates compared to general population | Growth in high school graduates exceeds general population growth |
| Tax Policy Choices | Cut progressive and/or raised regressive taxes | Cut progressive tax during the expansion, raised regressive taxes during the downturn, or both |
| Process Barriers | Presence of state tax or spending limit | State taxes or spending are subject to limit |
| | Supermajority requirement | Supermajority vote is required for tax increases |
| | Presence of property tax limits | Property taxes or assessments are subject to limit |
| Impact of Federal Tax Policies on State Taxes | Linkage with federal tax changes | Linked to one or more of the federal tax changes in 2001 |
| Summary Measures from Other Studies | Results of studies by Hovey, Boyd or Baker/Bessendorf/Kotlikoff | Two or more studies found a structural deficit of 1 percent or more |

## Figure 5

### Number of Factors Contributing to Structural Gap

| 10 or 9 | 8 | 7 | 6 | 5 | 4 or 3 |
|---|---|---|---|---|---|
| Alaska | Alabama | Arizona | Connecticut | Kansas | Minnesota |
| Arkansas | Georgia | California | Delaware | Louisiana | Nebraska |
| Colorado | Kentucky | Hawaii | Illinois | Maine | New Jersey |
| Florida | Missouri | Idaho | Iowa | Maryland | North Dakota |
| Nevada | Rhode Island | Indiana | Massachusetts | New York | Vermont |
| New Mexico | South Dakota | Michigan | Montana | | Wisconsin |
| Pennsylvania | Washington | Mississippi | New Hampshire | | |
| South Carolina | | Oklahoma | North Carolina | | |
| Tennessee | | Virginia | Ohio | | |
| Texas | | | Oregon | | |
| Wyoming | | | Utah | | |
| | | | West Virginia | | |

Most at Risk ⟷ Least at Risk

In the second step, we assigned points to a state for each of the ten major factors that contained one or more sub-factors that were determined to contribute to a structural deficit. (If the state lacks an income tax, the state received an extra risk point because of the key role that the income tax plays in making state tax systems responsive to economic growth.) Continuing the example above, the state received a point for the taxation of services factor if either of the two sub-factors was found to contribute. The more points a state receives, the more susceptible it is to structural problems. Table 17 describes the specific measures.

The third step in creating this score was to sum the number of points that each state received. State scores on this scale could range from 0 to 11, with 11 representing the greatest risk of structural problems. Table 18 below shows the results of these calculations for each state. It also shows how many states were assigned a point because of each of the ten factors. The underlying data and sources are shown in tables throughout the report.

For example, Arkansas has experienced a larger than average decline in the breadth of its sales tax base and has a greater-than-average loss resulting from the growth of e-commerce. It has significant loopholes in its corporate income tax. Its income tax has low progressivity, and it provides preferences to seniors in its income tax. It also has a greater-than-average share of residents on SSI and students with special needs. It recently has made a choice to raise the sales tax, which contributes to slower revenue growth. Arkansas has a limitation on property taxes, which limits the growth in that revenue source and requires a super majority for raising many of its taxes. It remains linked to the federal phaseout of the estate tax, which is eliminating a rapidly growing revenue source. Finally, two or more other national studies found that Arkansas has a structural gap.

The overall results are summarized in the Figure 5. No state received lower than a 3 on the scale, as all states have some structural problems in their fiscal systems. More than half (27) of the states scored 7 or higher, which reflects the many structural problems facing most states.

# Table 18: Structural Deficit Scale Factors and Measures

| | Taxation of Services Under the Sales Tax | | | Corporate Income Tax | | | Taxation of Electronic Commerce | Senior Tax Preferences | | | Personal Income Tax |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | **Summary** | Measure | Measure | **Summary** | Measures | | **Measure** | **Summary** | Measures | | **Measure** |
| | | Decline in breadth of sales tax | Less than average (16) taxation of household services | | Greater than average decline as share of taxes or no corp. income tax | 2 or more loopholes or no corporate income tax | Greater than average loss from e-commerce | | Greater than average elderly preference in income tax | Non-means tested elderly homestead | No income tax or less progressive income tax |
| Alabama | **1** | 0 | 1 | **0** | 0 | 0 | **1** | **1** | 0 | 1 | **1** |
| Alaska | **0** | NA | NA | **1** | 1 | 0 | **NA** | **1** | NA | 1 | **2** |
| Arizona | **1** | 1 | 0 | **1** | 0 | 1 | **1** | **0** | 0 | 0 | **0** |
| Arkansas | **1** | 1 | 0 | **1** | 0 | 1 | **1** | **1** | 1 | 0 | **1** |
| California | **1** | 1 | 1 | **1** | 1 | 0 | **1** | **0** | 0 | 0 | **0** |
| Colorado | **1** | 0 | 1 | **0** | 0 | 0 | **1** | **1** | 1 | 1 | **1** |
| Connecticut | **0** | 0 | 0 | **1** | 1 | 0 | **0** | **1** | 1 | 1 | **1** |
| Delaware | **0** | NA | NA | **1** | 0 | 1 | **NA** | **1** | 1 | 1 | **0** |
| District of Columbia | **0** | 0 | 0 | **0** | 0 | 0 | **0** | **0** | NA | 0 | **1** |
| Florida | **1** | 1 | 0 | **1** | 0 | 1 | **1** | **0** | NA | 0 | **2** |
| Georgia | **1** | 1 | 1 | **1** | 1 | 0 | **1** | **1** | 1 | 0 | **1** |
| Hawaii | **1** | 1 | 0 | **0** | 0 | 0 | **1** | **1** | 1 | 0 | **0** |
| Idaho | **1** | 0 | 1 | **0** | 0 | 0 | **1** | **1** | 1 | 0 | **0** |
| Illinois | **1** | 1 | 1 | **0** | 0 | 0 | **0** | **1** | 1 | 0 | **1** |
| Indiana | **1** | 1 | 1 | **1** | 0 | 1 | **0** | **1** | 1 | 0 | **1** |
| Iowa | **1** | 1 | 0 | **1** | 1 | 1 | **0** | **0** | 0 | 0 | **0** |
| Kansas | **0** | 0 | 0 | **1** | 1 | 0 | **1** | **0** | 0 | 0 | **0** |
| Kentucky | **1** | 0 | 1 | **1** | 0 | 1 | **1** | **1** | 1 | 1 | **0** |
| Louisiana | **0** | 0 | 0 | **1** | 1 | 1 | **1** | **0** | 0 | 0 | **0** |
| Maine | **1** | 0 | 1 | **0** | 0 | 0 | **0** | **0** | 0 | 0 | **0** |
| Maryland | **1** | 0 | 1 | **0** | 0 | 0 | **0** | **0** | 0 | 0 | **1** |
| Massachusetts | **1** | 0 | 1 | **1** | 1 | 0 | **0** | **1** | 1 | 1 | **1** |
| Michigan | **1** | 0 | 1 | **1** | 1 | 1 | **0** | **1** | 1 | 0 | **1** |
| Minnesota | **0** | 0 | 0 | **1** | 1 | 0 | **1** | **0** | 0 | 0 | **0** |
| Mississippi | **0** | 0 | 0 | **0** | 0 | 0 | **1** | **1** | 0 | 1 | **1** |
| Missouri | **1** | 1 | 1 | **1** | 0 | 1 | **1** | **0** | 0 | 0 | **1** |
| Montana | **0** | NA | NA | **0** | 0 | 0 | **NA** | **1** | 1 | 0 | **0** |
| Nebraska | **0** | 0 | 0 | **0** | 0 | 0 | **1** | **0** | 0 | 0 | **0** |
| Nevada | **1** | 1 | 1 | **1** | 1 | 1 | **1** | **0** | NA | 0 | **2** |
| New Hampshire | **0** | NA | NA | **1** | 1 | 0 | **NA** | **0** | 0 | 0 | **2** |
| New Jersey | **0** | 0 | 0 | **1** | 1 | 0 | **0** | **1** | 0 | 1 | **0** |
| New Mexico | **1** | 1 | 0 | **1** | 0 | 1 | **1** | **1** | 1 | 0 | **0** |
| New York | **1** | 1 | 0 | **1** | 0 | 1 | **0** | **0** | 0 | 0 | **0** |
| North Carolina | **1** | 1 | 1 | **1** | 1 | 0 | **0** | **0** | 0 | 0 | **0** |
| North Dakota | **1** | 0 | 1 | **0** | 0 | 0 | **1** | **0** | 0 | 0 | **0** |
| Ohio | **0** | 0 | 0 | **1** | 1 | 1 | **0** | **1** | 1 | 0 | **0** |
| Oklahoma | **1** | 1 | 1 | **0** | 0 | 0 | **1** | **0** | 0 | 0 | **1** |
| Oregon | **0** | NA | NA | **1** | 1 | 0 | **NA** | **1** | 1 | 0 | **1** |
| Pennsylvania | **1** | 0 | 1 | **1** | 1 | 1 | **0** | **1** | 1 | 0 | **1** |
| Rhode Island | **1** | 0 | 1 | **1** | 1 | 1 | **0** | **1** | 1 | 0 | **0** |
| South Carolina | **1** | 1 | 1 | **1** | 1 | 1 | **1** | **1** | 1 | 1 | **1** |
| South Dakota | **1** | 1 | 0 | **1** | 1 | 1 | **1** | **0** | NA | 0 | **2** |
| Tennessee | **1** | 1 | 0 | **1** | 0 | 1 | **1** | **0** | 0 | 0 | **2** |
| Texas | **1** | 1 | 0 | **1** | 1 | 1 | **1** | **1** | NA | 1 | **2** |
| Utah | **1** | 1 | 0 | **0** | 0 | 0 | **1** | **0** | 0 | 0 | **1** |
| Vermont | **1** | 1 | 1 | **1** | 1 | 0 | **0** | **0** | 0 | 0 | **0** |
| Virginia | **1** | 1 | 1 | **1** | 0 | 1 | **0** | **1** | 1 | 0 | **1** |
| Washington | **1** | 1 | 0 | **1** | 1 | 1 | **1** | **0** | NA | 0 | **2** |
| West Virginia | **0** | 0 | 0 | **1** | 1 | 1 | **0** | **1** | 0 | 1 | **0** |
| Wisconsin | **0** | 0 | 0 | **1** | 1 | 1 | **0** | **1** | 1 | 0 | **0** |
| Wyoming | **1** | 1 | 0 | **1** | 1 | 1 | **1** | **0** | NA | 0 | **2** |
| | | | | | | | | | | | |
| Total | **35** | 24 | 22 | **37** | 26 | 25 | **27** | **27** | 21 | 12 | **28** |

# Table 18: Structural Deficit Scale Factors and Measures (Cont'd)

| | Spending Needs of State Residents | | | | | | | Tax Policy Choices |
|---|---|---|---|---|---|---|---|---|
| | **Summary** | Measures | | | | | | **Measure** |
| | | Greater than average share of GF budget for medicaid | Greater than average share of non-elderly population on SSI | Greater than average growth in elderly as share of population | Greater than average share of special education students | Growth in K-12 age children exceeds general population growth | Growth in highschool graduates exceeds general population growth | Cut progressive and/or raised regressive taxes |
| Alabama | **0** | 0 | 1 | 1 | 0 | 0 | 0 | **1** |
| Alaska | **1** | 0 | 0 | 1 | 1 | 1 | 0 | **1** |
| Arizona | **0** | 0 | 0 | 1 | 0 | 0 | 1 | **1** |
| Arkansas | **0** | 0 | 1 | 0 | 1 | 0 | 0 | **1** |
| California | **0** | 0 | 1 | 1 | 0 | 0 | 0 | **1** |
| Colorado | **1** | 1 | 0 | 1 | 0 | 0 | 1 | **1** |
| Connecticut | **0** | 1 | 0 | 0 | 0 | 0 | 0 | **1** |
| Delaware | **1** | 0 | 0 | 1 | 1 | 0 | 1 | **1** |
| District of Columbia | **1** | 1 | 1 | 0 | 1 | 0 | 0 | **NA** |
| Florida | **1** | 1 | 0 | 0 | 1 | 0 | 1 | **0** |
| Georgia | **0** | 0 | 0 | 1 | 0 | 0 | 1 | **1** |
| Hawaii | **0** | 0 | 0 | 1 | 0 | 0 | 0 | **1** |
| Idaho | **0** | 0 | 0 | 1 | 0 | 1 | 0 | **1** |
| Illinois | **1** | 1 | 0 | 0 | 1 | 0 | 1 | **1** |
| Indiana | **0** | 0 | 0 | 0 | 1 | 0 | 1 | **1** |
| Iowa | **0** | 0 | 0 | 0 | 1 | 0 | 0 | **1** |
| Kansas | **0** | 0 | 0 | 0 | 1 | 0 | 0 | **1** |
| Kentucky | **1** | 0 | 1 | 0 | 1 | 0 | 1 | **1** |
| Louisiana | **0** | 0 | 1 | 1 | 0 | 0 | 0 | **0** |
| Maine | **1** | 1 | 1 | 1 | 1 | 0 | 0 | **1** |
| Maryland | **0** | 1 | 0 | 1 | 0 | 0 | 0 | **1** |
| Massachusetts | **0** | 0 | 0 | 0 | 1 | 0 | 0 | **1** |
| Michigan | **0** | 1 | 0 | 0 | 1 | 0 | 0 | **1** |
| Minnesota | **0** | 1 | 0 | 0 | 0 | 0 | 0 | **0** |
| Mississippi | **0** | 0 | 1 | 1 | 0 | 0 | 0 | **1** |
| Missouri | **0** | 0 | 0 | 0 | 1 | 0 | 0 | **1** |
| Montana | **1** | 0 | 0 | 1 | 1 | 1 | 0 | **1** |
| Nebraska | **0** | 1 | 0 | 0 | 1 | 0 | 0 | **1** |
| Nevada | **1** | 1 | 0 | 1 | 0 | 0 | 1 | **0** |
| New Hampshire | **1** | 1 | 0 | 1 | 1 | 0 | 0 | **0** |
| New Jersey | **0** | 0 | 0 | 0 | 1 | 0 | 1 | **1** |
| New Mexico | **1** | 0 | 1 | 1 | 1 | 1 | 0 | **1** |
| New York | **1** | 1 | 1 | 0 | 1 | 0 | 0 | **1** |
| North Carolina | **1** | 0 | 1 | 0 | 1 | 0 | 1 | **1** |
| North Dakota | **0** | 0 | 0 | 0 | 1 | 0 | 0 | **0** |
| Ohio | **1** | 1 | 1 | 0 | 1 | 0 | 0 | **1** |
| Oklahoma | **0** | 0 | 0 | 0 | 1 | 0 | 0 | **1** |
| Oregon | **0** | 1 | 0 | 1 | 0 | 0 | 0 | **1** |
| Pennsylvania | **1** | 1 | 1 | 0 | 1 | 0 | 0 | **1** |
| Rhode Island | **1** | 1 | 1 | 0 | 1 | 0 | 0 | **1** |
| South Carolina | **1** | 0 | 1 | 1 | 1 | 0 | 0 | **1** |
| South Dakota | **0** | 1 | 0 | 0 | 0 | 1 | 0 | **0** |
| Tennessee | **1** | 1 | 1 | 1 | 0 | 0 | 0 | **1** |
| Texas | **0** | 0 | 0 | 1 | 0 | 0 | 0 | **0** |
| Utah | **0** | 0 | 0 | 1 | 0 | 0 | 0 | **1** |
| Vermont | **0** | 0 | 0 | 1 | 1 | 0 | 0 | **1** |
| Virginia | **1** | 0 | 0 | 1 | 1 | 0 | 1 | **1** |
| Washington | **0** | 1 | 0 | 1 | 0 | 0 | 0 | **1** |
| West Virginia | **0** | 0 | 1 | 0 | 1 | 0 | 0 | **1** |
| Wisconsin | **0** | 0 | 0 | 0 | 1 | 0 | 0 | **1** |
| Wyoming | **1** | 0 | 0 | 1 | 1 | 1 | 0 | **1** |
| | | | | | | | | |
| Total | **21** | **20** | **17** | **26** | **32** | **6** | **12** | **42** |

## Table 18: Structural Deficit Scale Factors and Measures (Cont'd)

| | Process Barriers | | | | Federal Tax Policies | Results of Other Studies | Total Score |
|---|---|---|---|---|---|---|---|
| | Summary | Measures | | | Measure | Measure | |
| | | State tax or spending Limit | One or more Property tax limit | Supermajority requirement for tax increases | Linked to 1 or more 2001 federal tax changes | Two or more national studies found gap of more than 1 percent | |
| Alabama | **1** | 0 | 1 | 0 | **1** | **1** | **8** |
| Alaska | **1** | 1 | 1 | 0 | **1** | **1** | **9** |
| Arizona | **1** | 1 | 1 | 1 | **1** | **1** | **7** |
| Arkansas | **1** | 0 | 1 | 1 | **1** | **1** | **9** |
| California | **1** | 1 | 1 | 1 | **1** | **1** | **7** |
| Colorado | **1** | 1 | 1 | 1 | **1** | **1** | **9** |
| Connecticut | **1** | 1 | 0 | 0 | **1** | **0** | **6** |
| Delaware | **1** | 1 | 1 | 1 | **1** | **0** | **6** |
| District of Columbia | **0** | 0 | 0 | 0 | **0** | **0** | **2** |
| Florida | **1** | 1 | 1 | 1 | **1** | **1** | **9** |
| Georgia | **0** | 0 | 0 | 0 | **1** | **1** | **8** |
| Hawaii | **1** | 1 | 0 | 0 | **1** | **1** | **7** |
| Idaho | **1** | 1 | 1 | 0 | **1** | **1** | **7** |
| Illinois | **1** | 0 | 1 | 0 | **0** | **0** | **6** |
| Indiana | **1** | 1 | 1 | 0 | **0** | **1** | **7** |
| Iowa | **1** | 1 | 1 | 0 | **1** | **1** | **6** |
| Kansas | **0** | 0 | 0 | 0 | **1** | **1** | **5** |
| Kentucky | **1** | 0 | 1 | 1 | **1** | **0** | **8** |
| Louisiana | **1** | 1 | 1 | 1 | **1** | **1** | **5** |
| Maine | **1** | 1 | 0 | 0 | **1** | **0** | **5** |
| Maryland | **1** | 0 | 1 | 0 | **0** | **1** | **5** |
| Massachusetts | **1** | 1 | 1 | 0 | **0** | **0** | **6** |
| Michigan | **1** | 1 | 1 | 1 | **1** | **0** | **7** |
| Minnesota | **0** | 0 | 0 | 0 | **1** | **1** | **4** |
| Mississippi | **1** | 1 | 1 | 1 | **1** | **1** | **7** |
| Missouri | **1** | 1 | 1 | 1 | **1** | **1** | **8** |
| Montana | **1** | 1 | 1 | 0 | **1** | **1** | **6** |
| Nebraska | **1** | 0 | 1 | 0 | **1** | **0** | **4** |
| Nevada | **1** | 1 | 1 | 1 | **1** | **1** | **9** |
| New Hampshire | **0** | 0 | 0 | 0 | **1** | **1** | **6** |
| New Jersey | **1** | 1 | 1 | 0 | **0** | **0** | **4** |
| New Mexico | **1** | 0 | 1 | 0 | **1** | **1** | **9** |
| New York | **0** | 0 | 0 | 0 | **0** | **1** | **5** |
| North Carolina | **1** | 1 | 0 | 0 | **0** | **1** | **6** |
| North Dakota | **1** | 0 | 1 | 0 | **1** | **0** | **4** |
| Ohio | **1** | 0 | 1 | 0 | **0** | **1** | **6** |
| Oklahoma | **1** | 1 | 1 | 1 | **1** | **1** | **7** |
| Oregon | **1** | 1 | 1 | 1 | **0** | **1** | **6** |
| Pennsylvania | **1** | 0 | 1 | 0 | **1** | **1** | **9** |
| Rhode Island | **1** | 1 | 1 | 0 | **1** | **1** | **8** |
| South Carolina | **1** | 1 | 0 | 0 | **1** | **1** | **10** |
| South Dakota | **1** | 0 | 0 | 1 | **1** | **1** | **8** |
| Tennessee | **1** | 1 | 0 | 0 | **1** | **1** | **10** |
| Texas | **1** | 1 | 1 | 0 | **1** | **1** | **9** |
| Utah | **1** | 1 | 0 | 0 | **1** | **0** | **6** |
| Vermont | **0** | 0 | 0 | 0 | **1** | **0** | **4** |
| Virginia | **0** | 0 | 0 | 0 | **0** | **1** | **7** |
| Washington | **1** | 1 | 1 | 1 | **0** | **1** | **8** |
| West Virginia | **1** | 0 | 1 | 0 | **1** | **1** | **6** |
| Wisconsin | **0** | 0 | 0 | 0 | **0** | **0** | **3** |
| Wyoming | **0** | 0 | 0 | 0 | **1** | **1** | **9** |
| | | | | | | | |
| Total | **41** | 29 | 33 | 16 | **38** | **37** | |

## XI. Conclusion

A range of factors, including policy decisions as well as economic and demographic changes, are keeping state and local revenue growth below expected rates of spending growth. As a result, structural gaps exist or are likely to develop in the majority of states.

A host of ways state and local policymakers could modify their tax structures to moderate or eliminate these structural deficits are identified in this report. These include:

- Expanding the sales tax base to include more services
- Closing corporate tax loopholes
- Streamlining sales tax provisions among states
- Reducing or eliminating tax breaks based on age
- Updating state income taxes
- Adopting a state value-added tax
- Strengthening property taxes
- Resisting new tax and spending limits or modifying existing ones
- Adopting state laws to increase sales tax collections on remote sales
- Improving budget transparency

No single policy will work in every state, of course, and many of the options considered here will not be easy to implement. Yet states' future growth and the well-being of their residents depend on the ability of state policymakers to ensure that their tax and budget decisions enhance the state's long-term fiscal stability.

## Appendix A: Literature Review

Over the past decade, several studies and reports have documented state structural deficits and discussed the consequences of those deficits for funding state services.

A key document in this literature is *Financing State Government in the 1990s*, the outgrowth of a cooperative effort of the five organizations representing state officials: the National Governors Association, National Conference of State Legislatures, Federation of Tax Administrators, Multistate Tax Commission, and National Association of State Budget Officers. These groups began meeting during the state fiscal crisis of the early 1990s, consulted extensively with a variety of interested parties, held hearings on a draft of a report, and finally issued their report in December 1993. The report finds problems with all three major state tax revenue sources (corporate income tax, sales tax, and personal income tax), most of which persist today.

The report identifies the following problem areas:

- **Interstate tax competition.** The efficacy of tax concessions in spurring economic development is uncertain, while poorly targeted concessions can shift the tax burden in inequitable ways. The report also notes that "Interstate competition can have a chilling effect on efforts to reform state tax codes, because of fears of making a state uncompetitive with its neighbors."

- **Shift from a goods-dominated economy to a services-dominated economy.** This affects the sales tax, since few states have expanded the sales tax base to cover most services. It also affects the corporate income tax: many services are delivered by businesses that are not organized as corporations, yet states have not dealt with the implications of this fact for their corporate taxes. Moreover, the rules most states follow for the apportionment of multistate corporations' income among states for tax purposes work less well for service-producing industries than for goods-producing industries.

- **The increasingly interstate and international scope of business activity**. Because state tax systems have not adapted to this trend, they create unintended loopholes and provide competitive advantages to some large interstate and multinational corporations. In addition, federal policies constrain the ability of states to tax interstate and international commerce adequately; states' inability to require catalog and Internet sellers to collect sales taxes is one example of this problem.

- **Federal preemption of state taxing authority.** In addition to the problem of sales taxes on remote commerce, the federal government has preempted state power to tax various kinds of real and personal property. The report also mentions concerns about future federal preemptions, some of which have come to pass.

- **Shift away from property taxes.** The report recognizes that there can be good reasons to reduce reliance on property taxes in some states, but notes that increasing reliance on state sales and income taxes that have their own structural problems can strain state resources.

- **Problems in the personal income tax.** These include the increase in the proportion of compensation that is paid in non-taxable benefits; various tax preferences, credits, and exemptions that erode the tax base; and preferential treatment for the income of the elderly without a means test. The report also notes that Americans' increasing mobility creates tax compliance problems.

*The Effects of Economic and Demographic Changes on States and Local Budgets*, a 1995 study by Sally Wallace of The Finance Project, looks at state structural problems from the point of view of state and local governments' ability to finance public goods, especially those associated with children's welfare. One trend it identifies is the shifting composition of personal income, as increases in the share of compensation paid as non-taxable contributions to pension and welfare funds, employer payments for private health insurance, and transfer payments such as Social Security erode state tax bases. The study notes that the problems this causes for state revenues will become more pronounced in the future as the population ages, and could lower the elasticity of taxes relative to income.

The report also notes other trends associated with the aging of the population that could affect revenues. They include changing consumption patterns, since the elderly buy more non-taxed services and health and medical goods. They also include reductions in property tax revenues resulting from special property tax credits for the elderly and reduced demand for housing by the elderly.

This report also addresses the shift from production and consumption of goods to production and consumption of services. It notes that the production of services involves less real and personal property than the production of goods, which could result in slower growth in property taxes from businesses. It also notes that states and localities do not apply sales taxes to two of the fastest-growing sectors of the economy, services and medical goods.

In 1998, the National Education Association commissioned Hal Hovey to attempt to quantify the structural deficits faced by individual states. In his report, *The Outlook for State and Local Finances*, spending and revenues for each state are projected forward eight years based on reasonable assumptions about future growth of major state taxes and programs. The report finds that 39 states face a structural gap — that is, projected spending exceeds projected revenue.

The report also discusses the causes of these gaps. These include the shift in production and consumption from goods to services, the failure of state tax systems to adapt to increased interstate and international business activity, the federal preemption of state taxing authority, and the use of tax incentives as a tool in interstate competition for businesses. The aging of the population is another cause, since the changes in income and expenditure patterns that occur as people age will reduce state and local tax collections. Still another cause is states' inability to apply the sales tax to catalog and Internet purchases.

The report also notes that states that rely more on sales taxes and excise fees are more likely to face structural deficits than those that rely on income taxes, since the latter tend to grow along with the economy, while the former lag behind.

The result of these factors is that in most states, state and local revenues grow more slowly than the economy unless rates are raised periodically. In addition, state and local *spending* generally grows at or above the rate of growth of the economy, even without the adoption of new initiatives; health care spending growth and changes in school enrollment are two reasons why. This mismatch between revenue and spending growth has produced structural deficits.

In 2002, Donald Boyd of the Rockefeller Institute at the State University of New York revised and updated Hovey's analysis. Using an updated base and somewhat revised assumptions, Boyd's report, *State Spending on Higher Education in the Coming Decade*, came to the same conclusion: most states face a structural deficit. Boyd's report finds structural deficits that are more widespread (44 states, versus 39 for the earlier analysis) but smaller on average than in the earlier report.

The results of Boyd's study, as well as the other two referenced here, are shown in **Table A-1.** Each of the studies finds structural gaps in two-thirds or more of the states.

In a separate report published in 2000, *State Fiscal Issues and Risks at the Start of a New Century*, Boyd outlines some of causes of these structural gaps, including the shift to a service economy, the increase in electronic commerce and mail-order sales, and rising health care costs.

A report commissioned by the National League of Cities, National Conference of State Legislatures, and National Governors Association in 1999 examines the impact of globalization on state and local taxes. Prepared by Tom Bonnett, the report notes the failure of state and local taxes to adapt to multi-state and international businesses as well as the erosion of business tax bases due to interstate competition for jobs; these trends are exacerbated by the impact of an aging population on state and local taxes and federal preemption of state taxes.

The report also discusses how the deregulation of telecommunications and utilities will affect state and local tax bases. Opening up these industries to competition will end the practice of specialized taxes on monopoly providers of utilities, thus eliminating or reducing a revenue source for some states and local governments. In addition, Bonett notes that state and local tax systems have yet to adjust to the rapid growth of the Internet and other technological innovations.

A report by Robert Tannenwald, an economist with the Federal Reserve Bank of Boston, asks *Are State and Local Revenue Systems Becoming Obsolete?* It documents many of the trends mentioned above, including the growth of multinational and international corporations, interstate tax competition, and the increase in electronic commerce and mail-order sales.

**Table A-1: Results of 50 State Studies of Structural Gaps**
Gap of more than 1 percent projected? Yes/No

| | *Hovey 1998* | *Boyd 2002* | *Baker/Besendorf /Kottlikoff2002* |
|---|---|---|---|
| Alabama | Yes | Yes | Yes |
| Alaska | Yes | Yes | Yes |
| Arizona | Yes | No | Yes |
| Arkansas | Yes | Yes | No |
| California | Yes | Yes | Yes |
| Colorado | Yes | Yes | Yes |
| Connecticut | No | Yes | No |
| Delaware | Yes | No | No |
| District of Columbia | NA | NA | NA |
| Florida | Yes | Yes | Yes |
| Georgia | Yes | Yes | No |
| Hawaii | Yes | Yes | Yes |
| Idaho | Yes | Yes | No |
| Illinois | No | Yes | No |
| Indiana | Yes | Yes | No |
| Iowa | No | Yes | Yes |
| Kansas | Yes | No | Yes |
| Kentucky | No | Yes | No |
| Louisiana | Yes | Yes | Yes |
| Maine | No | No | No |
| Maryland | Yes | No | Yes |
| Massachusetts | No | No | Yes |
| Michigan | No | Yes | No |
| Minnesota | No | Yes | Yes |
| Mississippi | Yes | Yes | No |
| Missouri | Yes | Yes | No |
| Montana | Yes | No | Yes |
| Nebraska | No | Yes | No |
| Nevada | Yes | Yes | No |
| New Hampshire | Yes | No | Yes |
| New Jersey | Yes | No | No |
| New Mexico | Yes | Yes | Yes |
| New York | No | Yes | Yes |
| North Carolina | Yes | Yes | No |
| North Dakota | No | No | Yes |
| Ohio | No | Yes | Yes |
| Oklahoma | Yes | Yes | No |
| Oregon | No | Yes | Yes |
| Pennsylvania | Yes | Yes | Yes |
| Rhode Island | Yes | Yes | Yes |
| South Carolina | Yes | Yes | Yes |
| South Dakota | Yes | Yes | Yes |
| Tennessee | Yes | Yes | Yes |
| Texas | Yes | Yes | No |
| Utah | Yes | No | No |
| Vermont | Yes | No | No |
| Virginia | Yes | Yes | No |
| Washington | Yes | Yes | Yes |
| West Virginia | Yes | Yes | No |
| Wisconsin | Yes | No | No |
| Wyoming | Yes | Yes | Yes |
| SUM: YES | 37 | 37 | 27 |

Sources: The Outlook for State and Local Finances, NEA, Hovey, 1998.
State Spending for Higher Education in the Coming Decade, Boyd, 2002.
Intertemporal State Budgeting, Baker, Besendorfer, Kotlikoff, 2002.

## Table A2: Summary of Problems Identified in National Studies of State and Local Structural Deficits

| Study | NCSL/NGA | Finance Project | Outlook for State and Local Finances | Global Economy | Issues and Risks New Century | Are S/L Revenue Systems Becoming Obselete? | Tax Base Elasticities | New Realities in State Finance |
|---|---|---|---|---|---|---|---|---|
| Author | | Wallace | Hovey | Bonnett | Boyd | Tannenwald | Bruce, Fox, Tuttle | Snell (NCSL) |
| Year | 1993 | 1995 | 1998 | 1999 | 2000 | 2002 | 2004 | 2004 |
| Type of Study | National | National | 50 state analysis | National | National | National | National | National |
| **PROBLEMS IDENTIFIED:** | | | | | | | | |
| Shift in production and consumption of goods to services (affects sales and property taxes) | X | X | X | | X | X | X | X |
| Increased interstate/ international business activity (affects sales and business taxes) | X | | X | X | | X | | X |
| Federal preemption (affects all taxes) | X | | X | X | | | | |
| Interstate tax competition (affects all taxes) | X | | X | X | | X | | X |
| Lower reliance on property taxes | X | | | | | | | |
| Erosion of personal income tax base including shift from wages to other income | X | X | | | | | X | X |
| Aging of the population (affects personal income, sales, and property taxes) | X | X | X | X | | | X | X |
| Mix of taxes: low reliance on income tax and high reliance on sale and excise taxes | | | X | | | | | |
| Rising health care costs | | | X | | X | | | |
| School enrollment growth | | | X | | | | | |
| Deregulation of telecommunications and power supply (affects sales and property tax) | | | X | X | | | | |
| Increase in electronic commerce and mail order sales (affects sales tax) | | | X | X | X | X | | X |
| Declining federal support | | | | X | | | | |
| Growing Importance of Intangible Assets | | | | | | X | | |
| Less progressive rate structure | | | | | | | X | |
| Lower top bracket | | | | | | | X | |

Tannenwald's report also includes an in-depth examination of the impact of the growth of the service economy on state and local taxes. While the conventional wisdom is that increasing consumption of services is the principle cause of the declining yield of the sales tax, Tannenwald argues that this impact may be somewhat overstated.

The report also notes another trend that is reducing both sales and property taxes – the increasing importance of intangible assets such as, patents, databases, software, trademarks, and formulas to businesses. State sales taxes are not designed to measure and tax transactions as businesses buy and sell these intangible assets. In addition, local governments have difficulty valuing them for purposes of levying property taxes.

A recent report by three professors at the University of Tennessee, *Tax Base Elasticities: A Multi-State Analysis of Long-run and Short-run Dynamics*, examines how state income and sales taxes grow relative to personal income growth. The report finds that the shift to a service economy and the aging of the population have slowed the growth of state and local taxes relative to growth in the economy. It also finds that the exemption of pension income and flatter (i.e., less progressive) rate structures reduce growth in income tax collections.

In 2004, the National Conference of State Legislatures issued *New Realities in State Finance*, a book by Ron Snell that updates and expands on the 1993 report *Financing State Government in the 1990's.* The book confirms that most of the factors identified a decade ago as contributing to state structural deficits remain. These include the shift to a service economy, the growth of multistate and multinational companies, interstate competition for businesses, and the aging of the population. In addition, the book highlights the increased problem of Internet and mail-order sales and notes the impact on income tax receipts of the shift in income from wages to benefits.

## Solutions Discussed

While these reports contain a number of common themes in their discussions of the causes of state structural deficits, there is less agreement on how to address these problems. Five of the reports summarized examine potential policy responses. Only one option is mentioned in all reports: expanding the sales tax base to include more services. Other options mentioned by multiple reports include eliminating corporate income tax loopholes, replacing state business taxes with a value-added tax, improving property tax administration and eliminating some exemptions, reducing or eliminating age-based tax breaks, and streamlining sales tax provisions among states. These and other options are discussed in more detail below.

**Expanding the sales tax base to include more services.** This would bring a number of benefits: generating substantial new revenue, reducing the volatility of sales tax revenue by reducing reliance on big-ticket items such as cars and appliances, improving the fairness of the tax by reducing its regressivity (since services consumed by higher-income taxpayers would be taxed), and removing the incentive for businesses to purchase untaxed services rather than taxable goods. These benefits, as well as the important issue of whether to tax business inputs as well as services purchased just by households, are discussed in greater detail in Chapter 2 of this report.

**Eliminating corporate income tax loopholes.** The reports discuss a number of ways to combat the erosion of the corporate income tax. One "solution" discussed is to eliminate the tax as a state revenue source. However, other reports discuss fixing the tax instead. For example, states can update their taxes to reflect the modern reality of multistate and multinational corporations by adopting "combined reporting," under which all related corporations that are operated as a single business enterprise, any part of which is being conducted in the state, are essentially treated as one taxpayer. This would prevent corporations from shifting profits to another state or country simply to avoid taxes.

Short of adopting combined reporting, states could take another loophole-closing step. Some corporations shift income out of states with corporate income taxes by transferring ownership of their trademarks and patents to a subsidiary corporation located in a state that does not tax "intangible" income. Some states that have not adopted combined reporting address this problem by not allowing corporations to deduct from their income the royalties and interest they paid to related corporations.

Another way discussed to modernize the state corporate income tax is to enact a "throwback rule" to ensure that profits earned in a state in which a corporation may not be subjected to an income tax are taxed instead by its home state. Still another way is to amend the definition of apportionable "business income" to strengthen the state's ability to tax capital gains realized on irregular sources of income.

**Replacing state business taxes with a value-added tax.** Two of the reports cited discuss the feasibility of replacing both the corporate income tax and the sales tax on business transactions with a state-level VAT. The base of the VAT, the amount of value added by a processor or supplier, can be calculated in one of two ways. An "operational VAT" is applied to the value added by operations within a particular state, regardless of where the resulting product is sold. By contrast, a "transaction-based VAT" is levied only in the state where the final product is bought; it serves as a kind of consumption tax.

At the state level — as opposed to the national level — an operational VAT is the only practical form of VAT. The base for an individual company is its gross receipts minus the cost of purchases from other firms (or the sum of its payrolls, rent, interest, and profits, which should lead to the same result).

The VAT, with a very broad base and a low rate, should be stable over the business cycle and be fairly neutral — that is, it should not have a major effect on business decisions. On the down side, however, it is levied on corporations regardless of their profitability in a given year, which some businesses will consider unfair. In addition, the VAT is similar to a sales tax in many respects, and its cost may be passed on to consumers in the form of higher prices, which would make the overall tax burden more regressive. Thus far, only two states — Michigan and New Hampshire — have adopted VATs. New Hampshire's VAT was adopted in addition to its corporate income tax and corporate income tax payments are credited against VAT payments and vice versa. Michigan, in contrast, replaced its corporate income tax with a VAT. AS the law stands in early 2005, Michigan's VAT is in the process of being phased-out, however, the

governor has proposed reforming and retaining the tax. Value-added taxes have been suggested in many states by academics and tax reform commissions.

**Improving property tax administration and reducing exemptions.** The reports suggest two main ways to strengthen the property tax as a revenue source: improving the administration of the tax (that is, the processes of identifying, locating, and valuing taxable property, as well as levying the tax) and carefully examining the types of property that are exempted from the tax with an eye to eliminating some exemptions.

The strength and fairness of the property tax depend considerably on how well taxable assets are identified and assessed. Assessing property is done by different levels of government in different states, but the state generally establishes the rules that govern the assessment process. One report argues that there is much room for improvement in assessing property. For example, assessments in many areas do not occur often enough to keep up with rising property values; this can produce inequities (if comparable properties receive different assessments) and also deprive government of the added revenue that should result from a growing economy.

A number of ways have been suggested to improve property tax administration, such as requiring reassessments at regular intervals, assessing at full market value, and centralizing the operations of valuing property to permit more specialized training of assessors.

Another property tax issue the reports mention is the large number of exemptions that states and localities have granted over the years. Some have been enacted in the name of economic development, such as exemptions for certain types of property (like manufacturing machinery and equipment), inputs for specific types businesses (like horse feed or airline fuel), or specific companies (in order to persuade them to locate in a particular place). Some exemptions have been granted to homeowners as a method of property tax relief. Still others were adopted for ease of administration and fairness, to exempt types of property that are difficult or expensive to assess.

These exemptions have eaten away the property tax base. It could be strengthened by developing a standard set of criteria for exemptions, carefully examining existing exemptions, and eliminating those that do not meet the criteria.

**Reducing or eliminating age-related tax breaks.** States and governments cannot change some of the ways in which the aging of the population reduces tax collections, but they do have control over the age-related preferential provisions they have enacted over the years in their income and property taxes. States can eliminate or reduce these exemptions, such as by replacing across-the-board exemptions with ones targeted by income as well as age.

**Streamlining states' sales tax policies.** Congressional action is required to allow states to require companies to collect sales taxes on Internet and catalog purchases by out-of-state residents. One of the main arguments raised by opponents of this kind of action is that companies would be overly burdened administratively by having to comply with the different sales tax provisions that exist in different states and localities.

## Table A3: Summary of Solutions Discussed in National Studies of State and Local Structural Deficits

| Solutions Discussed: | NCSL/NGA | Finance Project | Outlook for State and Local Finances | Global Economy | Issues and Risks - New Century | Are S/L Revenue Systems Becoming Obselete? | New Realities in State Finance |
|---|---|---|---|---|---|---|---|
| Greater state cooperation in taxation of businesses | X | | | | | | |
| Expansion of sales tax base to include more services (paying attention to technical problems) and more exempt goods | X | X | X | | | X | X |
| Value added taxes to replace some business taxes | X | | | | | | X |
| Improve property tax administration and address inequities; limit or redesign exemptions and credits | X | X | X | | | | |
| Prevent federal preemption through cooperation, interstate compacts, etc. | X | | | | | | |
| Reduce or eliminate tax breaks based on age | | X | X | | | | |
| Expand user fees and charges to capture personal income growth | | X | | | | | X |
| Privatize government services to reduce expenditure side stress | | X | | | | | |
| Produce long-term financial plans | | | X | | | | |
| Expand corporate tax base by eliminating loopholes | | | X | | | | X |
| Abandon corporate income tax | | | | | | X | |
| Streamlined sales tax | | | | | | X | X |
| Federal restrictions on interstate competition | | | | | | X | |

Forty of the 45 states with a sales tax have embarked on a project to restructure their sales taxes in order to make it easier for businesses to comply with them. The participating states have agreed on ways to simplify the design, administration, and compliance requirements of their sales tax. Twenty states so far have adopted legislation to implement the agreement. Additional states should adopt the agreement and all should persuade Congress to pass legislation allowing participating states to require remote sellers to collect sales and use taxes.

**Other ideas.** Individual reports suggested other ideas as well, such as greater state cooperation in a number of areas (including taxation of business), preventing federal preemption of state and local taxing authority, and pursuing federal restrictions on interstate competition.

## Appendix B: Results of Selected State Structural Deficit Studies

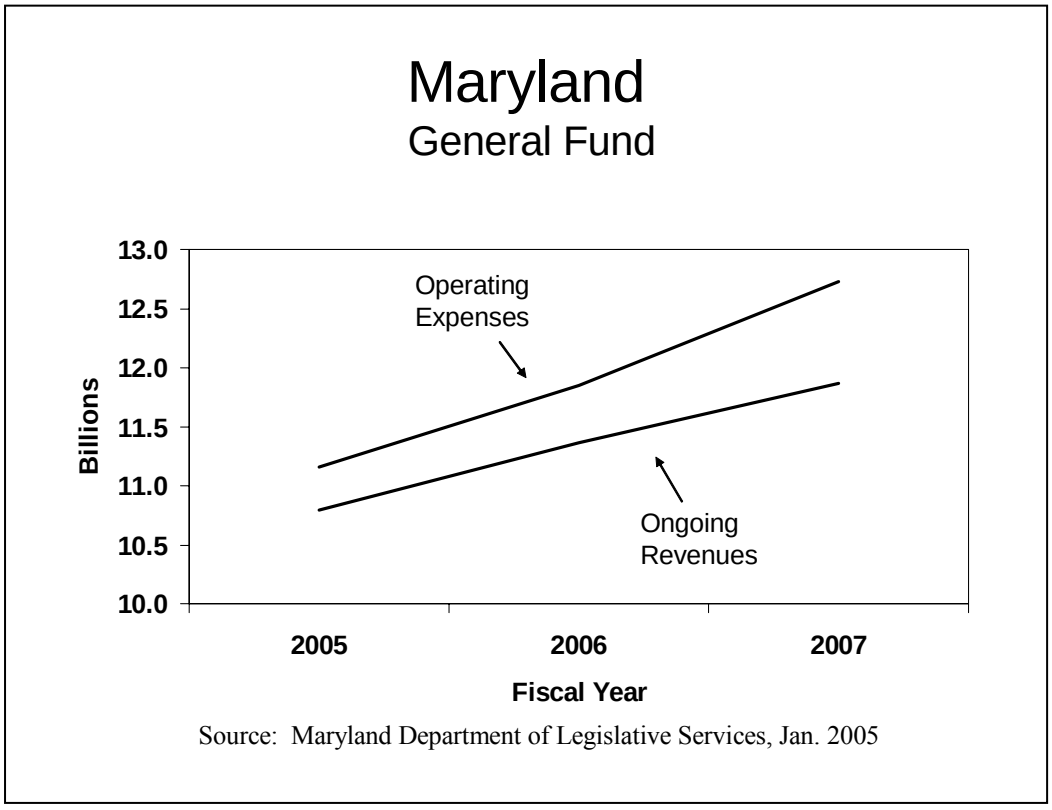
While the causes of structural budget deficits are well documented, the actual magnitudes of structural gaps are difficult to measure. Because states are required by law and tradition to balance their budgets each year, budget gaps are closed annually whether they result from structural problems, economic downturns, or other causes. However, a number of states have analyzed their revenue and spending trends to determine whether their tax system will generate sufficient revenue to fund existing programs on an ongoing basis.

Typically these analyses begin with a base-year level of revenues and spending and then project both of these into future years, using assumptions about future economic growth and growth in costs and workloads for large programs. These analyses hold the provisions of the tax system and existing programs constant over time. States that perform this kind of analysis generally find that they are facing a structural gap — in other words, expected spending outstrips expected revenue.

### Table B-1: Recent State Structural Deficit Studies

| | Size of Gap Found | | | |
|---|---|---|---|---|
| State | Year | Dollar amount (in millions) | Percent of budget | Source |
| Connecticut | 2008 | $ 741.0 | 4.4% | Office of Policy and Management, Governor's 2006-2007 budget, February 2005 |
| Idaho | 2007 | $ 168 | 8.0% | Idaho Center on Budget and Tax Policy, March 2005 |
| Kentucky | 2007<br>2010 | $1,400<br>2,300 | 12.5%<br>17.4% | Fox, University of Tennessee, February 27, 2002 |
| Maryland | 2007 | $ 856 | 6.7% | Department of Legislative Services Fiscal Briefing, Jan 24, 2005 |
| New Hampshire | 2007 | $ 116 | 8.0% | New Hampshire Center for Public Policy Studies, February 2004 |
| New Mexico | 2007 | $ 168 | 3.5% | Report of the State of New Mexico Legislative Finance Committee, January 2005 |
| New York | 2008 | $5,571 | 11.0% | New York State Division of Budget, February 8, 2005 |
| Ohio | 2008<br>2025 | $ 500<br>3,400 | 3.0%<br>8.0% | Federation for Community Planning, March 2004 |
| Virginia | 2008 | $ 597.4 | 3.9% | Virginia Department of Planning and Budget, January 14, 2004 (before tax reform) |
| Wisconsin | 2008<br>2011 | $ 358<br>$ -63 | 3.0%<br>-0.5% | Reschovsky, University of Wisconsin, May 2002 |

**Figure B-1**




Source: Maryland Department of Legislative Services, Jan. 2005

Table B-1 summarizes the results of a number of recent state studies. These studies were undertaken by different types of entities in the states — government agencies, academics, and independent policy organizations — but the results were similar. States as different as New York, New Hampshire, and Kentucky all found structural gaps. The gaps varied from 3 percent to 17 percent of the state's budget.

Figure B-1 shows projections for the state of Maryland. This is a fairly typical scenario with a gap that widens over time as the annual percent growth in spending exceeds that of revenue.

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