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# State Tax Reform in a Challenging Environment: *What's Working, What's Not*

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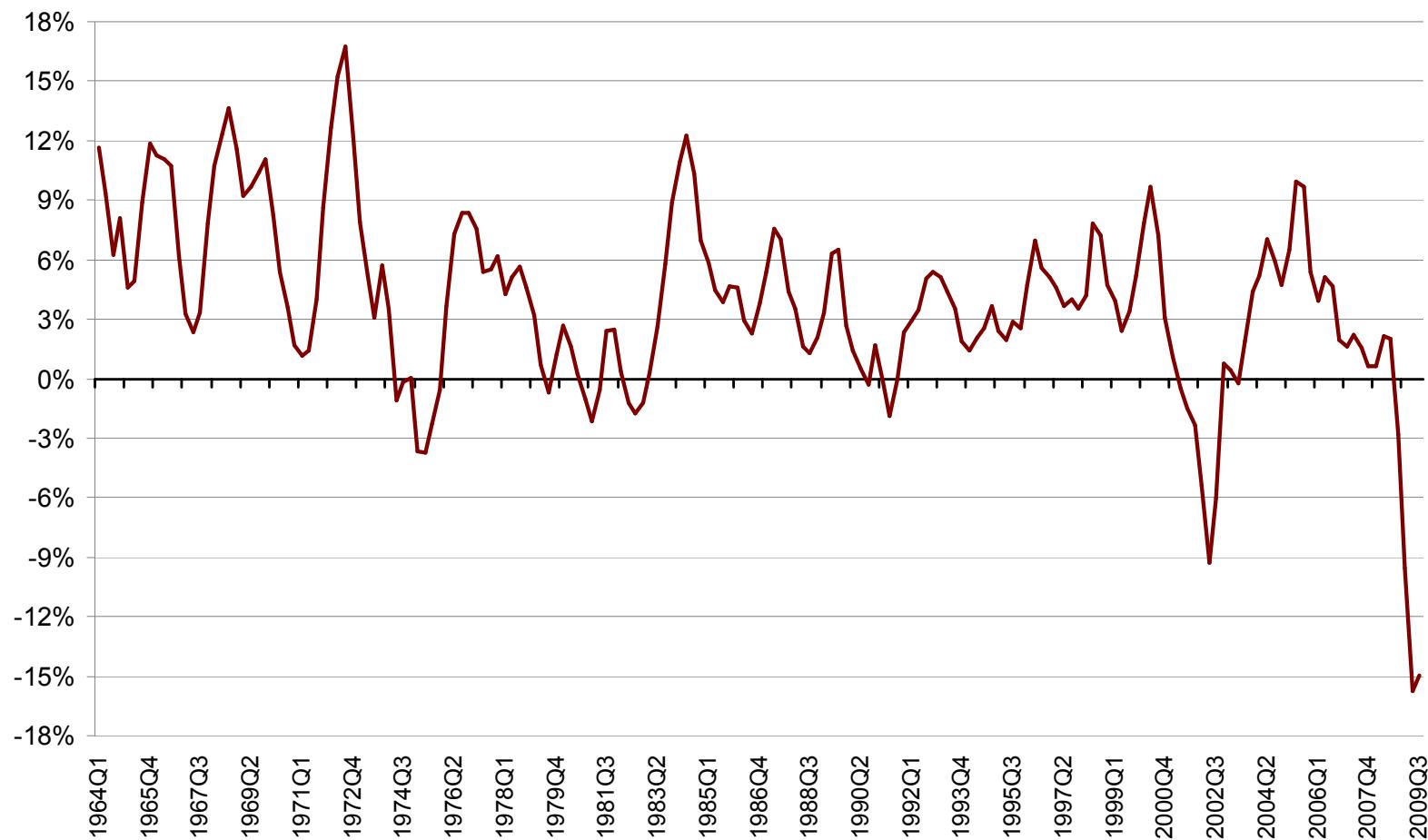


# Topics for Discussion

- What structural problems are we trying to solve with state tax reform?
- What tax changes are other states enacting?
- What proposals are being considered in other states—and in neighboring states in particular?
- What “outside the box” proposals are under discussion?
- How do these proposals/changes stack up on basic principles of sound tax policy?
- How should we think about the linkage between taxes and economic development?

# An Unprecedented Revenue Decline

Annual Change in Real State Taxes, 1964-2009



Sources: U. S. Census Bureau (Quarterly tax collections); Bureau of Economic Analysis (real GDP).

Notes: (1) Percentage changes averaged over 2 quarters; (2) No legislative adjustments; (3) Recession periods are shaded.

# Systemic Challenges Facing State Tax Systems: An Overview

- **Sales Tax**

- Riddled with exemptions; e-commerce largely untaxable

- **Corporate Tax**

- Multi-state corporations avoid tax by shifting profits from one state to another; company-specific giveaways shift tax load to less favored firms.

- **Income Tax**

- Expensive tax breaks for capital gains, seniors, itemized deductions create inequities. Other, contestable charges: excessive “volatility,” competitive effects (Maryland millionaire tax)

- **“Sin Taxes”**

- Slow-growth, regressive taxes are popular among voters but not a sustainable funding source.

# The Big Picture: Tax (and Non-Tax) Solutions to State Budget Deficits

- **Shrinking Payroll:** 192,000 state/local gov't jobs lost in 18 months
- **Other spending cuts:** education, transportation, health
- **Scaling back:** Selling state assets, closing rest stops
- **Federal Stimulus Aid:** Offset 1/3 of shortfalls in FY10.
- **Tax Hikes** (As of August, 35 states in the last two years):
- **"Sin taxes":** 22 states raised \$3 billion
- **Sales tax:** 18 states raised \$8 billion
- **Income tax:** 11 states raised \$11 billion
- **Corporate tax:** 17 states raised \$4 billion

# Income Tax Reform: A Survey of Policy Choices

- **Tax Rate or Tax Base?** Loophole-closing allows revenue-raising without rate hike.
- Base changes include: deductions, exemptions, credits.
- Base changes tend to be *permanent* structural improvements in the tax.
- **Permanent or Temporary?** Most recent rate hikes have been temporary.
- **Hike taxes on “millionaires” or on everyone?** Most have chosen to hike only upper-income rates.

# Base-Broadening Income Tax Reform: Recent Actions: *Itemized Deductions*

- **Rhode Island:** Repealed itemized deductions; increased basic standard deduction, dropped top rate, repealed some credits.
- **Utah:** Replaced itemized deductions/personal exemptions with means-tested tax credit; reduced top tax rate.
- **Maine:** Repealed all itemized deductions, lowered and flattened rate structure (rejected by ballot measure, June 2010).
- **New Mexico:** Repealed itemized deduction for state income taxes
- **Hawaii:** Put a cap on the \$ value of itemized deductions. (Vetoed by governor, June 2010)
- **Vermont, New Jersey, New York:** Put caps on specific itemized deductions.

# Base-Broadening Income Tax Reform: Recent Actions: *Capital Gains, Other*

- **Colorado, Rhode Island, Vermont, Wisconsin:** Pared back existing capital gains tax preferences.
- **Virginia:** Pared back retirement tax break for upper-income taxpayers only (\$>\$75K married).
- **Utah:** Converted “retirement income” exemption to tax credit
- **Delaware, New Jersey:** include lottery winnings in tax base.

# Other Income Tax Changes of Note:

- 9 states: temporary high-end rate increases
- **Ohio (2009)**: delayed scheduled rate cut
- **California (2009)**: temporary “across the board” tax rate increase
- **California (2009)**: temporary cut in exemption credit for children
- **Georgia, Minnesota, New Jersey, Virginia (2010)**: pare back refundable tax credits.
- **Georgia (2010)**: exempt most retirement income for upper-income families

# Base-Broadening Income Tax Reform: Recommendations: *South Carolina*

- **Minimum Tax:** Everyone should pay >\$0. Token \$25 “fee.” Implication: no refundable credits.
- **Tax Brackets:** Unadjusted for inflation; increase top bracket start point from \$13K to \$21K.
- **“No Tax Floor”:** Stop indexing exemptions and standard deduction for inflation.
- **Capital Gains:** Reduce the current 44% exclusion, but maybe *increase* it for SC-based investments.
- **Senior tax breaks:** Think about paring back tax breaks other than for Social Security benefits.

# Base-Broadening Income Tax Reform Recommendations from Other States:

- **North Carolina (2008):** eliminate most itemized deductions; turn others into credits; reduce top tax rate
- **Mississippi (2008):** consider capping value of retirement income exemption at \$25,000.
- **California (2009):** Flatten tax rates. Eliminate credits, repeal some itemized deductions, create large standard deduction (\$45,000 married).

# Base-Broadening Sales Tax Actions

- **Arkansas:** 2004 law taxed various services: dry cleaning, pest control, self-storage, docking fees, pet grooming.
- **New Jersey:** 2007 law taxes landscaping services, limo rental, tattoo parlors, and more.
- **Michigan:** governor's 2011 budget proposal would tax many services.
- **Cigarettes/Alcohol:** CO, KY, MA, VT
- **“Digital Downloads”** taxed in NC, VT, WI
- **“Amazon” laws:** Colorado encourages affiliates to collect tax on Internet transactions; NC, NY, RI require them to.

# Other Sales Tax Actions and Recommendations

- **9 states:** Increased sales tax rate on at least some items.
- **South Carolina:** 2006 legislation narrows the base by exempting groceries, and increases the tax rate to pay for it.
- **South Carolina:** 2010 tax reform commission recommends taxing more services, reducing tax rate to make revenue neutral.
- **North Carolina:** 2007 tax reform commission recommends taxing services (landscaping, pet grooming, storage), reducing tax rate to make revenue neutral.
- **California:** 2009 tax reform commission recommends broad service expansion, 2% reduction in state sales tax rate
- **New Mexico:** 2002 law exempts groceries, hikes the statewide sales tax rate.
- **Alabama:** biggest tax issue of last two years is proposal to exempt groceries, to be paid for with income tax increase.

# State Corporate Income Trends

- “Combined Reporting”
- Greater disclosure of info on corporate tax breaks (CA, IL, MA)
- Strengthening “Minimum Tax” (OR)
- Hiking tax rates (OR)
- Outright repeal (Ohio)

# State Corporate Income Tax: Criticisms

- Low yield compared to other taxes
- Loopholes you can drive a bus through
- Federal linkage forces “decoupling” decisions
- Varying state rules create inequities for multi-state corporations
- Lawmakers act like they want to repeal it (death by 1,000 cuts strategy)

# Corporate Income Tax Repeal: Who's Selling— and Who's Buying

- **South Carolina:** gubernatorial candidate proposes repeal
- **Virginia:** active repeal legislation in 2010 session
- **Rhode Island:** governor calls for repeal of 9% profits tax, February 2009
- **California:** 2009 commission calls for repeal, creation of “net receipts tax”.
- **Ohio, Texas:** actually replaced profit-based taxes with alternative taxes. Jury still out on effectiveness of replacement taxes.

# Business Tax Incentives: Do They Have An Impact?

- **Incontestably, yes: they cost money.**
- More contestable is whether they change business investments decisions, or simply reward them for what they would have done anyway.
- And even if they do affect behavior, that likely means channeling investment from its most efficient use to a less optimal use. Encouraging investment in inefficient industries is many things, but NOT a development strategy.

# Business Tax Incentives: Maximizing “Bang for the Buck”

- Case study: Rhode Island “Jobs Development Act.”
- Corporate income tax credit reduces corporate tax rate by 0.25% for each 10 jobs created (50 jobs for larger businesses).
- Can take 9% tax rate down as far as 3%. Rate cut is permanent, as long as company doesn’t reduce its aggregate employment numbers in-state.
- Does the credit create jobs? How many? What pay/benefit level? Basic questions- no answers available.

# Business Tax Incentives: Maximizing “Bang for the Buck”

- Case study: Arizona “Alternative Fuel Credit”
- In 2000, Arizona legislature enacts income tax credit for businesses or individuals’ purchase of cars that can run on alternative fuel— or conversion of existing vehicle fleets to do so.
- Initial revenue estimate: a \$5 million tax credit.
- Cost quickly ballooned to \$680 million as people discovered how to game the system.
- Lesson: sometimes even when an incentive “works,” the outcome isn’t what you wanted.

# Gasoline Excise Taxes: Revitalizing a Neglected Tax

- Every state's gas tax actually shrank, as a share of personal income, between 1990 and 2008.
- States that have a sales tax component to their gas tax (like GA) have *some* built-in growth capacity.
- Reform commissions in Arkansas and South Dakota have recommended indexing their gas excise tax to the cost of highway construction.
- SD legislative commission also recommended a 10 cent hike (22 to 32 cents) in the basic gas tax.
- Other states have chosen to simply increase the gasoline tax rate (Oregon, Minnesota) or are considering doing so.

# Summary Thoughts:

- Broadening the base is a sensible first step. No tax break is sacred: all should be evaluated regularly.
- Rate reductions are a possible next step—but hardly a given. Depends on fiscal circumstances.
- Linkage between tax rate reductions and economic development is not obvious.
- Always be able to quantify “bang for the buck” from those tax breaks you choose to preserve (or expand).