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Progressive Options to Close the Budget Deficit

INTRODUCTION: CAUSES OF THE BUDGET DEFICITS

When considering solutions to your state budget deficit, it is important for the public (through the media) to understand what caused the problem. The fiscal crisis was not caused by reckless spending. Across the states, spending increased only 2% annually during the 1990s—the lowest rate of increase for state spending in five decades.

Instead, the budget deficits were caused by state tax cuts implemented between 1994-2000, costing states a total of \$40 billion per year. About 80% of these revenues were lost because of cuts in personal and corporate income taxes.

In sum, today's levels of state taxation aren't "normal." The go-go days of the 1990s brought temporary budget surpluses, and states responded with permanent tax reductions. In most states, if tax levels were restored to pre-1994 normal, most or all of the current budget deficits would be solved.

MENU OF BUDGET OPTIONS

- 1. ESTATE TAX—Decouple from federal estate tax.** States are losing billions of dollars in tax revenues because of a change in the federal estate tax enacted in 2001. Most estate taxes in the states are linked to the federal estate tax credit, which is being phased out over the next four years. As a result, state tax revenues will plummet. If states don't decouple from the federal tax, they will collectively lose \$23 billion between 2003-07. Only 17 states are currently decoupled from the federal estate tax: KS, ME, MD, MA, MN, NE, NJ, NY, NC, OH, OR, PA, RI, VT, VA, WA, WI.
- 2. TOBACCO EXCISE TAX—Increase the tax and cover more tobacco products.** One of the quickest and most popular ways for states to raise hundreds of millions of dollars is to raise the tobacco tax. Seventeen different state polls conducted across

the country in 2002 found that Americans strongly favor large tobacco tax increases—raising cigarette taxes by 50 or 75 cents per pack. Today, 12 states have tobacco taxes between \$1 and \$1.51 per pack. Higher tobacco taxes also save thousands of lives by reducing teen smoking, as well as adult tobacco use.

- 3. ALCOHOL EXCISE TAX—Increase the tax.** All states impose a “sin” tax on alcohol, but most tax alcohol at low rates. The average excise tax on liquor is about \$4 per gallon, while several state taxes exceed \$6 per gallon. Some states tax beer and wine at much lower rates than spirits, based on the percentage of alcoholic content. States with the lowest alcohol taxes include AK, CO, IN, KS, KY, LA, MD, MO, NV, ND, SC and TX.
- 4. PERSONAL INCOME TAX—Raise the rate for the highest incomes.** The simplest method of making income tax rates more progressive is to institute a surcharge, or new tax bracket, for individuals earning over \$250,000, \$500,000 or \$1 million per year. The Connecticut legislature passed a “Millionaire’s Tax” in 2002—that is—a 1% surtax on incomes above \$1 million raising an estimated \$140 million. Although the governor vetoed that measure, he has since changed positions on the tax. Similarly, New Jersey Policy Perspective has proposed raising \$555 million by increasing the tax rate for families earning more than \$500,000. This kind of increase can be enacted as a permanent or temporary tax. During the last recession, four states increased top rates permanently while five others increased those rates temporarily.
- 5. PERSONAL INCOME TAX—Implement a more graduated scale.** If taxes need to be raised, why not do it right? Of the 41 states with a personal income tax covering earnings, only 14 have graduated tax brackets that truly differentiate between lower and upper-income taxpayers. Six states have a flat tax rate—no income brackets at all. In 16 other states, the top tax bracket is \$25,000 or less, giving very little meaning to the tax bracket system. In other words, about half the states are ripe for a fundamental reform of income tax brackets.
- 6. PERSONAL INCOME TAX—Eliminate or suspend exemptions, credits and/or deductions.** Virtually every state with an income tax has created or expanded income tax exemptions, credits and/or deductions over the past 10 years. Advocates should research tax loopholes—changes designed to benefit special interests instead of families—and the amount of revenues lost because of each loophole. (Legislators can usually obtain this information from a fiscal services office.) Legislation can either eliminate the loopholes permanently or suspend them temporarily.
- 7. PERSONAL INCOME TAX—Tax non-resident gambling income.** Net gambling winnings are taxable as income, and state residents are taxed. But states can also tax non-residents who have gambling winnings in the state. CA, CO, IL, MN and NJ tax non-resident gambling income. The value of such a tax expansion depends, of course, on the amount of gambling activity in the state.

- 8. PERSONAL INCOME TAX—Implement a tax amnesty.** Over the past 20 years, 40 states have implemented tax amnesty periods in order to collect overdue taxes. Connecticut, for example, has offered tax amnesties in 1990, 1995 and 2002. The most recent amnesty collected more than \$100 million in back taxes. However, by offering amnesties too often, states risk lowering taxpayers' incentive to pay on time.
- 9. CORPORATE INCOME TAX—Implement a more graduated scale.** Thirty-one states use a flat tax for corporate income. That means there is only one tax bracket, with no graduated scale at all. These states can adopt a graduated system, increasing the tax rate for corporate income over certain levels, e.g., \$25,000, \$100,000, \$250,000, \$500,000 and \$1 million. For example, IA, KY and ME have graduated scales from \$25,000 to \$250,000, with tax rates ranging from 3.5% at the lowest to 12% at the highest. If necessary, a graduated scale can be implemented temporarily by imposing a surcharge on corporate profits over a certain level (e.g., a 5% surcharge on corporate profits over \$250,000).
- 10. CORPORATE INCOME TAX—Require Combined Reporting.** When filing tax returns, corporations that operate across state lines apportion their income among the states where they do business. Corporations use many strategies to artificially shift the reporting of their income to low-tax or no-tax states. Combined Reporting is the broadest and fairest reform to stop the most common tax avoidance strategies. It combines the income of parent and subsidiary corporations before applying the state's tax formula. In short, Combined Reporting ensures that a corporation's state income tax liability remains the same regardless of the corporation's legal structure. Sixteen states use Combined Reporting: AK, AZ, CA, CO, HI, ID, IL, KS, ME, MN, MT, ND, NE, NH, OR and UT.
- 11. CORPORATE INCOME TAX—Close the PIC trademark loophole.** Large corporations commonly shift the reporting of income by using a "passive investment company" (PIC), a corporate affiliate that is often no more than a file in a Delaware lawyer's office. The PIC holds legal ownership to the parent corporation's patents and trademarks and charges huge royalties to the parent company, shielding those funds from taxation. This tax dodge was made famous by Toys R Us, which charged its parent company for the use of the "Geoffrey" the giraffe trademark, and other intangible assets. This tax loophole has been closed in 31 states. The following states could gain tax revenues by eliminating this income-shifting tactic: AR, DE, FL, GA, IN, IA, KY, LA, MD, MA, MO, NJ, NM, NY, OK, PA, RI, SC, TN, TX, VT, VA, WV and WI. (Enactment of Combined Reporting also blocks the PIC trademark loophole.)
- 12. CORPORATE INCOME TAX—Redefine "business income."** The U.S. Supreme Court has limited the types of business income that are subject to apportionment among the states. To comply with Supreme Court rulings, most states define and tax "business income." But the commonly-used definition allows corporations to avoid taxes by declaring certain transactions to be "irregular" and therefore "non-

business income.” States can close the “non-business income” loophole by redefining “business income” to be as broad as the Supreme Court allows, that is, “business income means all income which is apportionable under the United States Constitution.” Only five states (FL, IA, MN, PA and TX) have adopted this definition. All other states with a corporate income tax could increase revenues by adopting this definition as well.

13. CORPORATE INCOME TAX—Enact a “throwback” rule for “nowhere income.”

A little-known federal law, P.L. 86-272, prohibits states from taxing corporate income if the corporation does not conduct a certain level of activity in the state. As a result, corporations often claim that a huge portion of their profits come from sales in those states where federal law prohibits taxation. For tax purposes then, the income seems to come from “nowhere.” Twenty-four states have a “throwback” rule directing that if income from a product is not taxed in the state where it is sold, it is taxed in the state where it was made. The throwback rule is so simple it can be accomplished by adding a single sentence to existing corporate tax law. Twenty-one states (AR, CT, DE, FL, GA, IA, KY, LA, MD, MA, MN, NE, NJ, NY, NC, OH, PA, RI, SC, TN and VA) could gain revenues by enacting a throwback rule.

14. CORPORATE INCOME TAX—Eliminate or suspend exemptions, credits and/or deductions.

Over the past 20 years, states have created hundreds of different exemptions, credits or deductions to the corporate income tax in order to encourage or reward different types of business or business behavior. Advocates should research the corporate tax loopholes created since the early 1980s, and the amount of revenues lost because of each loophole. (Legislators can usually obtain this information from a fiscal affairs office.) Legislation can either eliminate the loopholes permanently or suspend them temporarily.

15. CORPORATE INCOME TAX—Accelerate sunset dates for tax exemptions.

A number of states have created corporate tax exemptions that sunset after a period of years. States can gain additional revenues by moving exemption sunset dates to 2003.

16. CORPORATE INCOME TAX—Decouple from federal bonus depreciation.

States are losing billions of dollars in tax revenues because of a change in the federal corporate income tax enacted in March 2002. A new federal tax deduction, called “bonus depreciation,” allows businesses to claim a 30% depreciation for certain business machinery placed in service after September 2001. Last year, 30 states that previously followed federal depreciation rules decoupled from the federal tax code, in effect, disallowing the new bonus depreciation provision. AL, AK, CO, DE, FL, KS, LA, ME, MI, NM, NY, OR, UT and WV could increase revenues by rejecting the federal bonus depreciation rules.

17. CORPORATE INCOME TAX—Reform the Alternative Minimum Tax.

It is all-too-common for corporations to use a series of tax loopholes in order to pay no state tax at all. The federal government has an Alternative Minimum Tax (AMT) for these

situations, but only seven states have an AMT similar to the federal law (AK, CA, FL, IA, ME, MN, and NY). A few states have an AMT based upon something other than income, such as gross receipts, net worth or total capital stock. Twelve states (AZ, CA, CT, ID, MA, MT, NJ, OH, OR, RI, UT, and VT) impose an AMT of a flat dollar amount, ranging from \$50-\$800. In almost every case, states can increase revenues by reforming the AMT. The greatest revenues would likely come from value-added or gross receipts AMTs, such as the tax enacted by New Jersey in 2002. Based on corporate gross receipts, the tax is expected to net \$300 million in FY 2003.

18. SALES TAX—Delete exemptions on some products. Each state tends to have different sales tax exemptions. Some are progressive (e.g. exemptions for food and medicines), but many states have created sales tax exemptions simply to encourage or reward certain industries, including newspapers, vending machines, technology, warehousing, and chemical sprays. Advocates can create a list of unjustified sales tax exemptions, and target some or all of them for suspension or elimination.

19. SALES TAX—Apply to some services. The sales tax, which is the largest source of revenue for many states, usually applies only to the purchase of tangible personal property (e.g., clothing, housewares, appliances), and in some cases, to the installation or repair of property (e.g., plumbing or auto repair). However, most business, financial and professional services are exempt from the sales tax. States could expand revenues by extending the sales tax to cover specific categories of services, such as advertising, data processing, business consulting, engineering or architectural services.

20. LUXURY TAX—Impose a special sales tax on luxury goods and services. States can single out “luxury” goods or services for a sales tax that is either equal to, or greater than, the normal sales tax rate. A surtax can apply to goods that are unusually expensive, for example, non-business purchases over \$50,000. Or a tax can apply to athletic club, country club, or golf club memberships.

21. INTANGIBLE WEALTH TAX—Cover stocks, bonds, etc. Following the lead of Florida, states can tax intangible wealth, such as stocks, bonds, and money market accounts. For example, a 1% tax on personal and corporate intangible wealth with a maximum exemption of \$3,000 (excluding IRAs and other retirement accounts) would raise nearly \$1 billion in the average state. A narrower version has been proposed in New Jersey. There, a one-quarter of one percent tax on the value of intangible assets of greater than \$2 million would affect only the richest 1% of taxpayers.

22. GASOLINE TAX—Increase the state gasoline tax. Every state levies a gasoline tax in addition to the federal tax of 18.4 cents per gallon. Some states charge a flat rate per gallon while others tax the price, rather than the quantity, of gas sold. Some states charge as much as 29-31 cents per gallon (NY, RI, WI). 21 states have gas

taxes below 20 cents per gallon: AL, AK, AZ, CA, FL, GA, HI, IL, IN, KY, MI, MS, MO, NH, NJ, NM, OK, SC, VA, and WY.

- 23. TAX ENFORCEMENT—Hire tax investigators to collect more revenues.** Most states do a very poor job of enforcing tax law. As a result, hundreds of millions of dollars in revenue go uncollected. It has been estimated, for example, that Illinois could generate \$160 million by hiring 100 additional tax investigators. Similarly, a new report in Minnesota found that the state was losing \$288 million in uncollected tax revenues. Last year, Kansas invested \$3 million to create 75 new tax collection positions. While the legislature projected that the additional collection efforts would yield \$48 million, the state actually collected nearly \$110 million in additional revenues.
- 24. MEDICAID SPENDING CUT—Obtain supplemental rebates for prescription drugs.** States are being overcharged for the prescription drugs they buy through state programs. On average, states pay 20-25% more for outpatient drugs in their Medicaid programs than the federal government pays for the exact same prescriptions. States can save hundreds of millions of dollars by negotiating supplemental rebates from drug manufacturers. Currently, only five states (CA, FL, IL, LA, MI) receive such rebates. Florida saves almost \$200 million per year. Michigan is saving \$900,000 per week. CT, HI, IN, KY, MD, MN, MS, NM, NC, OH, VT and WV are currently taking steps to capture those rebates.
- 25. INTEREST PAYMENTS SPENDING CUT—Refinance existing general obligation debt with lower interest rates.** Several states have saved millions of dollars by refinancing debt. States should re-evaluate state debt with an eye toward refinancing at today's lower interest rates.
- 26. CORPORATE SUBSIDIES SPENDING CUT—Delete or suspend subsidy and grant programs.** Many states offer subsidies, loan guarantees, grants, and other financial benefits to businesses under a variety of business development programs. States can save revenues by eliminating, suspending or freezing these subsidy programs.
- 27. CORRECTIONS DEPARTMENT SPENDING CUT—Divert incarcerated non-violent drug offenders to drug treatment programs.** Over the last decade, a wave of laws intended to get tough on crime has resulted in the incarceration of 125,000 non-violent drug offenders. While it costs states more than \$20,000 per year to house an inmate, community corrections and drug treatment programs are substantially less expensive. Coupled with a moratorium on the construction of new prison cells, this policy could save states hundreds of millions of dollars.

For more detailed information about items 1, 2, 24 and 27, see the Center for Policy Alternatives Website at www.stateaction.org.

For more detailed information about items 1, 10, 11, 13 and 16, see the Center on Budget and Policy Priorities website www.cbpp.org