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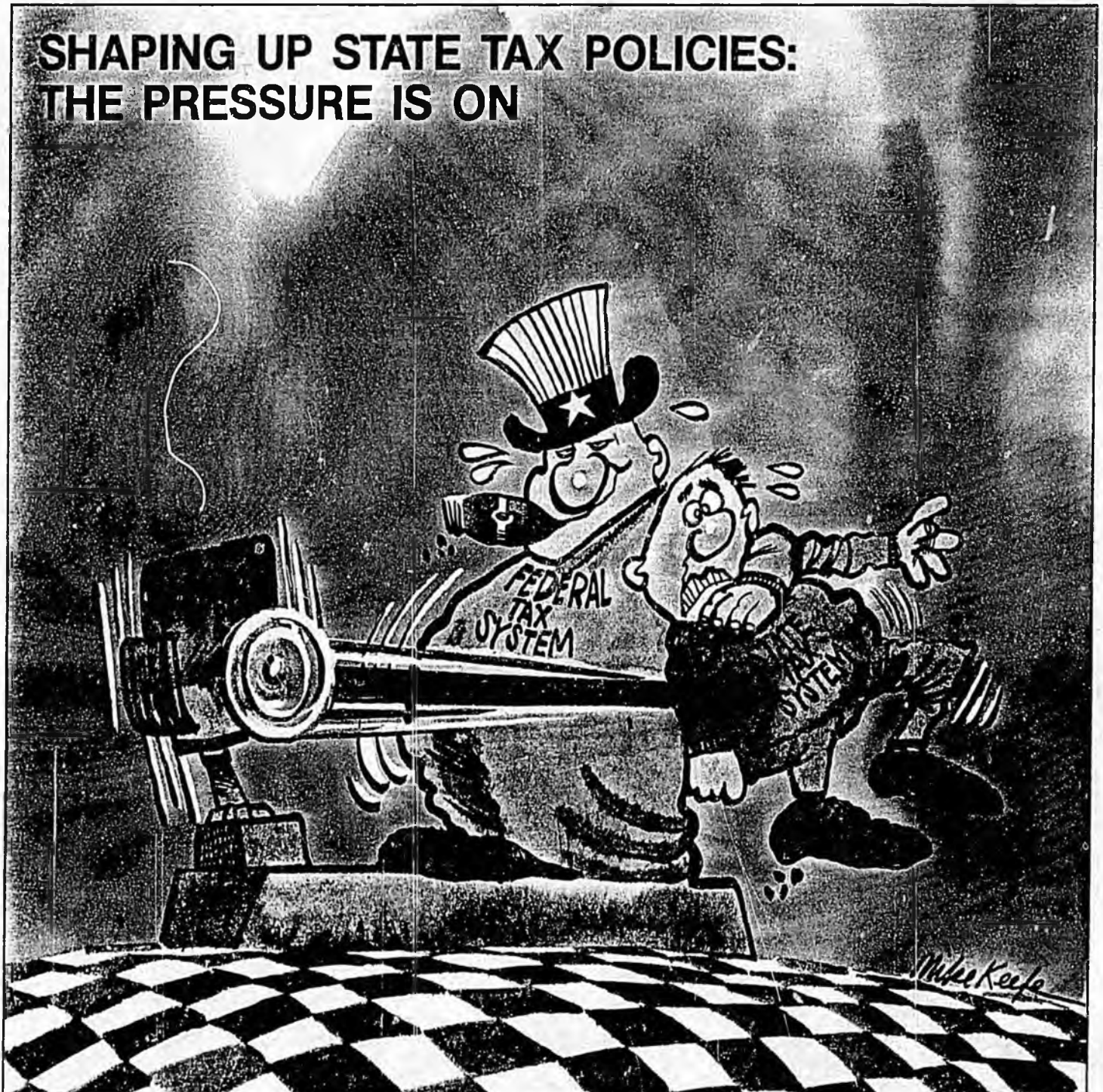
State Legislatures

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SHAPING UP STATE TAX POLICIES: THE PRESSURE IS ON



Preachers and Politics • Purchasing a Computer System
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Taxing Problems Spark State Reforms

By Steven D. Gold

Ironically, the odds for improving tax policy could increase if state fiscal conditions worsen.

A guiding principle in many legislative arenas is, "if it ain't broke, don't fix it." Applied to tax policy, however, this dictum can cause serious problems because often a provision is considered "broke" only when important constituents decide it is. Although benign neglect is not necessarily the best policy, it often seems to reign in tax deliberations.

But this attitude may be changing. During the past decade, extreme strain was placed on state tax systems by a set of problems that either are continuing or could resurface in the near future: the tax revolt, the severest recession since the Great Depression, federal aid cutbacks and interstate tax competition.

On top of these carry-over concerns, a new one has emerged during the past two years—federal tax reform, which could have profound impacts on the climate in which states must raise money.

State tax systems are much stronger today than they were 30 years ago. In the 1950s, '60s and '70s, states took major steps to improve the fairness and productivity of their tax systems by adopting many new income and sales taxes. These actions were responses to fiscal crises caused in part by the passage of the baby boomers through public education systems.

But since the early 1970s, many of the important changes in tax structures have occurred through inertia. Inflation, rising income and shifting production and consumption patterns have had perhaps more to do with the level and distribution of taxes than deliberate new policies.

Five crucial facts about state tax systems stand out.

They bring in a great deal of revenue. During the current fiscal

year, state tax collections should top \$225 billion, more than 10 times as much as in 1962 and 3½ times as much as in 1972.

Their growth can be likened to a roller coaster. Tax revenue rose faster than personal income for a quarter century, from the end of World War II to the early 1970s, as states assumed new responsibilities in the federal system. The growth of revenue plunged when the tax revolt hit in the late 1970s and then recovered in 1983 as three-fourths of the states raised tax rates. Since then tax cuts have predominated.

Every state tax system is different.

incomes. Tax levels also differ a great deal. The ratio of state tax revenue to personal income is more than twice as high in 30 states as it is in New Hampshire.

Local taxes are also major parts of state tax systems. States dictate which taxes cities, counties and school districts may use and also influence the level of local taxes by giving financial aid or by paying for local functions. Local tax revenue this fiscal year will be close to \$140 billion. The role of localities in raising revenues differs greatly from one state to another, with local taxes representing only 16 percent of total state and

State and Local Tax Revenue per \$100 of Personal Income, 1970 to 1985

Fiscal Year	Total	State				
		State	Local	Property ¹	General Sales	Personal Income
1985	\$11.45	\$7.08	\$4.37	\$3.43	\$2.27	\$2.11
1984	11.71	7.22	4.49	3.53	2.30	2.16
1983	11.07	6.69	4.38	3.47	2.09	1.94
1982	11.07	6.79	4.28	3.41	2.10	1.91
1981	11.31	6.95	4.36	3.47	2.15	1.90
1980	11.57	7.13	4.45	3.55	2.24	1.93
1979	12.03	7.34	4.69	3.80	2.32	1.92
1978	12.75	7.49	5.26	4.37	2.33	1.93
1977	12.81	7.39	5.42	4.55	2.26	1.86
1976	12.47	7.13	5.34	4.53	2.18	1.71
1975	12.28	6.99	5.29	4.47	2.16	1.64
1974	12.36	7.05	5.31	4.51	2.15	1.62
1973	11.95	7.31	5.65	4.84	2.13	1.68
1972	11.81	7.02	5.67	4.92	2.07	1.52
1971	11.81	6.48	5.40	4.74	1.95	1.28
1970	11.81	6.47	5.19	4.57	1.91	1.24

¹At least 95 percent of property tax revenue is raised by local governments but some state governments also levy a property tax, usually on specific classes of property.

Source: U.S. Census Bureau

Alaska and New Hampshire manage to get along without either a general sales or a personal income tax. Eleven other states have only one or the other. The remaining 37 states levy both but each in its own way. In total, 26 states rely on the sales tax more than the income tax, and 22 get more from the tax on

local revenue in Alaska but 50 percent or more in Colorado, New Hampshire and New York.

The shape of state and local tax systems has changed considerably in the past 15 years. The property tax has been sharply de-emphasized, declining from 4.9 percent of personal in-

Steven D. Gold is director of NCSL's Fiscal Studies program.

come in 1972 to 3.4 percent in 1984. One of the main reasons for this trend was increased reliance on personal income taxes, which jumped from 1.2 percent of personal income to 2.1 percent between 1970 and 1985. States used much of their new income tax money to boost aid for local schools and assume other financial burdens from localities, such as welfare programs.

Despite the diversity in taxes, some important developments are occurring that are common to most states—interstate tax competition, erosion of tax bases, increasing instability and reduced responsiveness to economic growth.

State and local governments seem to be competing with each other more avidly than in the past to make themselves attractive to industrial investment. This intensified competition has arisen from many sources, including the especially high unemployment of the early 1980s, the decline of heavy industry in the Rust Belt and agriculture in the Farm Belt, and the increased exposure to international competition everywhere.

Interstate tax competition has resulted in a proliferation of exemptions for business and downward pressure on personal income tax rates. For example, at least a dozen states have exempted inventories from the property tax since 1980. Most of the states with the highest income taxes have been cutting them recently. As Lowell Norland, majority leader of the Iowa House of Representatives, says, "Because of our overriding economic development crusade, we're afraid to be out of step in taxation with other states."

Erosion of tax bases undermines the productivity of tax systems just as soil erosion reduces the yields from farmland. One source of tax base erosion

is new exemptions granted by states, particularly from the sales, property and income taxes. Economic trends may also erode the tax base. Two examples: A portion of pension income is often exempt from income tax; as the population ages, pension income tends to grow faster than wages. Most services are usually exempt from the sales tax; as the service economy develops, exempt sales

tend to grow more rapidly than taxable sales. Result: an eroded tax base. John Mikesell, a sales-tax expert at the University of Indiana, estimates that each penny of sales tax levied in 1984 yielded only 85 percent as much as it did in 1960, per dollar of personal income.

Ben Rose, assistant House minority leader in Ohio, helped put together a proposal for substantially broadening

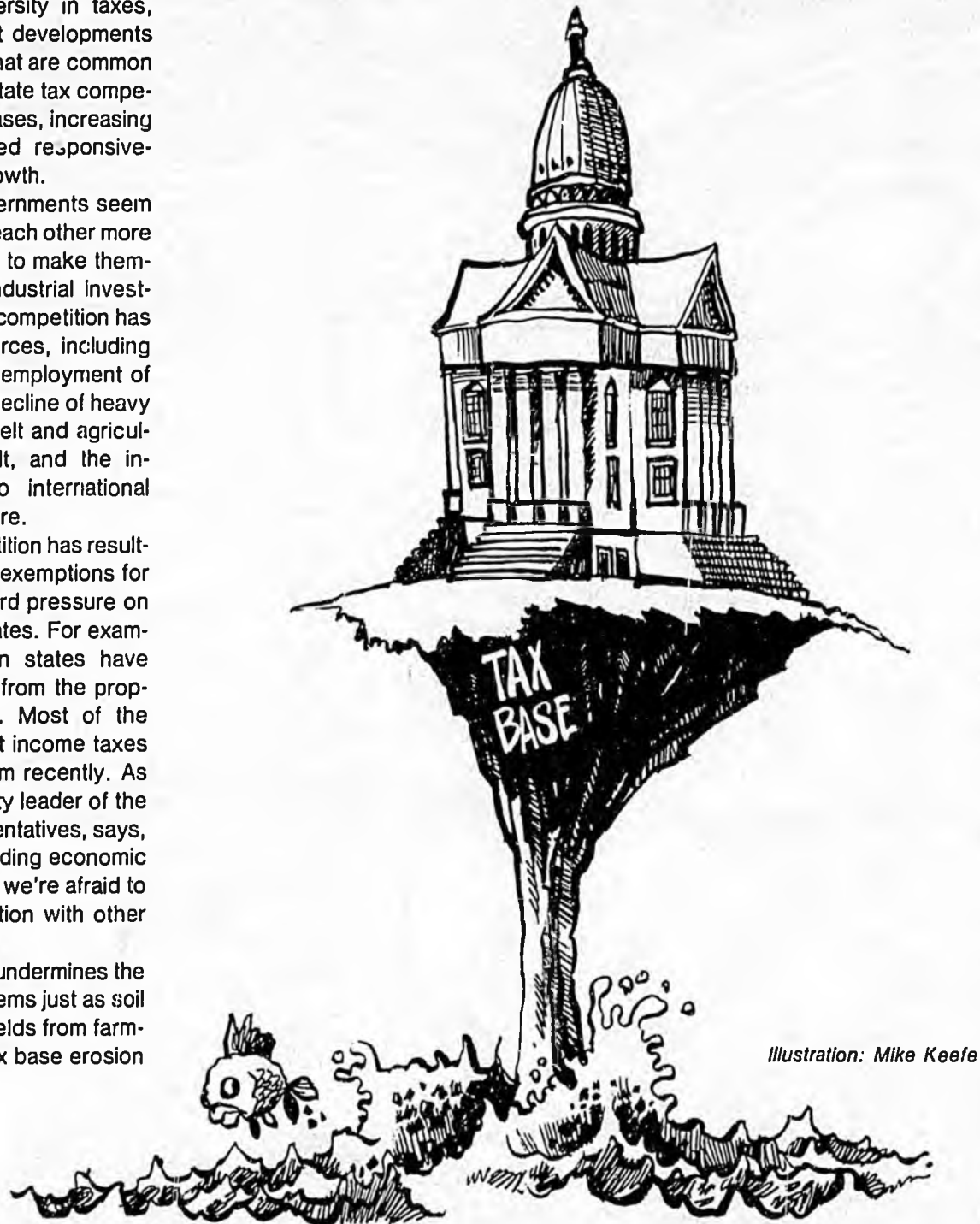


Illustration: Mike Keefe

Erosion of tax bases—from such factors as exemptions granted by states from sales, property and income taxes as well as from larger economic trends—undermines the productivity of tax systems just as soil erosion reduces the yields from farmland.

the sales-tax base several years ago. Ohio eventually did extend the sales tax to repairs and data processing services. He warns that trying to tax services is "a tough political thicket," and that interstate tax competition limits the extent to which services can be taxed.

Erosion of the sales-tax base has led to exemption of food and utility outlays in about two-thirds of the sales-tax states and prescription drugs in virtually all states. The result of exempting these and other "necessities" has been to increase the instability of state tax revenue. Formerly when the economy went into a recession, the sales tax continued to produce revenue from such "necessities" while sales of discretionary products plummeted. Now this firm base is no longer taxable in most states.

State tax revenue does not respond as strongly to economic growth as it did in the 1970s because, among other reasons, 10 states adopted income tax indexation, marginal tax rates for high income taxpayers were reduced and exempt income grew relatively rapidly. The U.S. Treasury Department estimates that each 10 percent increase in personal income now produces only 14 percent growth in personal income tax revenue as opposed to 16 percent before 1978.

Because of these problems, as well as the severe fiscal problems experienced in the early 1980s, nearly half of the states have recently conducted major studies of their tax systems. Despite high hopes for these studies, they have not yet resulted in significant reform in most states.

Why has the implementation of tax reform been so poor?

First of all, reforming state tax systems is not as easy as it used to be. In the 1950s and 1960s the solution to a state's fiscal problems was usually obvious—adopt an income or a sales tax, whichever the particular state was missing. Most states followed that prescription, and now the answers are not so simple.

Secondly, tax reform produces losers as well as winners. Tax commis-

sions often recommend broadening the base of the income and sales taxes and lowering tax rates. These steps tend to even out the tax burden and "provide a level playing field" for business and individuals. But the beneficiaries of tax exemptions that would be eliminated frequently put up a stiff fight in defense of their tax breaks, while the winners from reducing exemptions and lowering rates tend to be silent for two reasons: They may not realize that they are winners, and there are many small winners and a small number of big losers. The political calculus makes it tough to broaden tax bases. Nowhere is this more evident than in extending the sales tax to services. Many legislators and governors contemplated such a policy in the 1980s, but when the dust settled, little had been done to change the status quo. "Politically, you don't want to create any losers, but it's next to impossible to have reform without some losers," says Bill Schreiber, chair of Minnesota's House Tax Committee.

Finally, it takes time to develop a consensus for a major tax change. States don't tinker with the fundamentals of their tax systems very often, so it is not surprising that it could take four or five years to build a coalition for a big tax change. Many of the new income and sales taxes of the 1950s, '60s and early '70s were adopted only after such a prolonged period of discussion, education and controversy.

Recent experience demonstrates that reform is not impossible. Last year two states did enact important reforms: Wisconsin simplified its income tax and West Virginia overhauled its business taxes. The chairman of the West Virginia House Finance Committee, George E. Farley, reports that it took three years of research and persuasion, a lot of patience and an "exorbitant" number of meetings" to push reform through. Even with all that effort, the proposal appeared to be a "long shot" before it was enacted.

The biggest battle in the state tax wars now is not about restructuring taxes, but rather about the role of the personal income tax. Because of tax rollbacks and reductions effective in

1984, income tax revenue rose only an estimated 7.5 percent in fiscal year 1985 compared with an estimated 10.5 percent rise in sales tax revenue. On top of that, 14 states lowered their income taxes during 1985 legislative sessions. Many of these reductions were rollbacks of increases in 1982 or 1983, but four were in states where tax rates had not been increased in the 1980s and three were reductions in rates to below the pre-1982 levels. By contrast, Connecticut was the only state to lower its sales tax, by exempting clothing priced at \$75 or less.

The income tax cuts of 1985 were concentrated in the states with the highest income taxes. Seven of the eight states with the top effective rates reduced their income taxes last year. These actions were at least partly in response to the growing belief that high income taxes deter business investment. While there is some empirical support for this belief, many economists and state officials question the strength of the adverse impact of income taxes on the economy. Special attention is often focused on the highest marginal income tax rate in the state. Wisconsin trimmed its highest rate from 10 percent to 7.9 percent; Delaware's went from 10.7 percent to 9.7 percent; Minnesota's fell from 16 to 14 percent (equivalent to 7 percent for high-bracket taxpayers because federal taxes are deductible) and New York's dipped from 10 percent to 9 percent on earned income over three years.

The flight from income taxes is worrisome to some legislators because the personal income tax is the only major state revenue source that is progressive. Reducing the income tax implies shifting the tax burden away from the well-to-do. Another progressive tax, on inheritances, has also been repealed or reduced recently in a large number of states. New York and Massachusetts targeted special relief to low-income families as part of their income tax cuts, but most states did not do so.

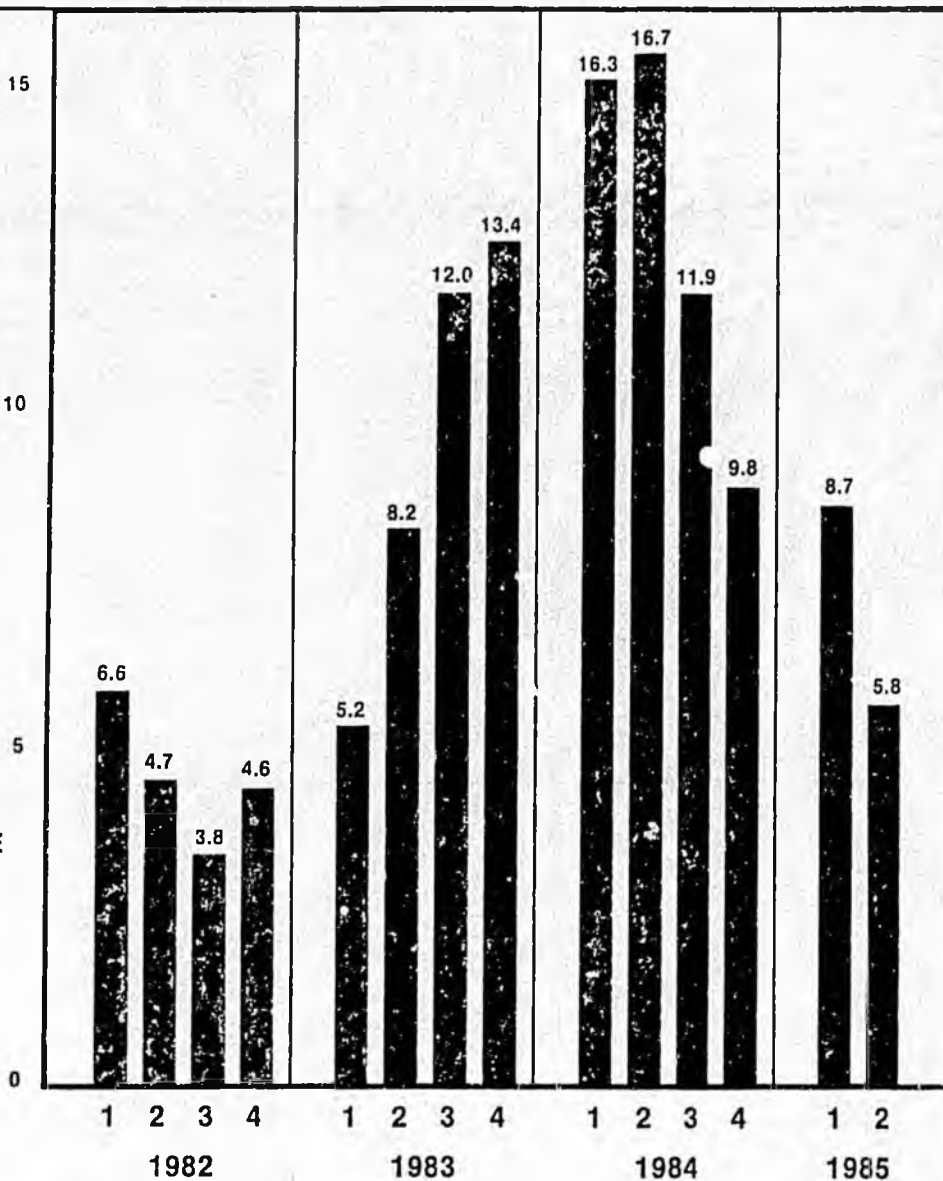
Are there any grounds for optimism that states will begin to take tax reform more seriously

Instability of State Tax Revenue

The chart demonstrates the instability of state tax revenue over the past few years by showing the percentage increase in each three-month period from the beginning of 1982 to the middle of 1985, compared to the corresponding period a year earlier. The growth rate of total state tax revenue fell in early 1982 because of the recession, bottomed out in the third quarter of 1982 and then rose steadily until it peaked at 16.7 percent in the second quarter of 1985. These ups and downs reflect two factors—the speedups and slowdowns of the economy and the imposition and later the lifting of a tax rate increase.

PERCENTAGE INCREASE

YEAR AND QUARTER



—abandoning the path of eroding tax bases and allowing tax systems to develop by inertia? Ironically, the odds for improving tax policy could increase if state fiscal conditions worsen. Adverse factors can still place stress on state tax systems.


The tax revolt, for instance, is not dead but dormant and contributed to the decision to lower income taxes last year. The economy is sure to experience another recession at some point, and it could be a serious one because of the fragility of the domestic and international financial systems. In addition, federal-aid cutbacks could become more severe than they have been since 1982.

Another source of stress is the intense interstate tax competition, which shows no signs of abating. Federal tax reform also could create new dilemmas for states by curtailing, or eliminating, the deduction for state and local taxes or simply by reducing tax rates. If federal tax rates are lowered significantly, the importance of interstate tax rate differentials would grow, spurring even greater competition among states, particularly to lower the income tax.

In such an environment, interest in tax policy might well increase because the importance of finding revenue to fund popular programs shows no signs of lessening. As Joe Clarke, the chair

of the Kentucky House Appropriations and Revenue Committee, observes, "There is a growing recognition on the part of legislators that taxes have been enacted or modified in a manner that has no rhyme or reason. Like Topsy, the changes have just grown. These decisions have been based on politics rather than on any coherent policy."

The chairman of Ohio's House Ways and Means Committee, Dean Conley, adds, "When there are budgetary problems, the interest in tax policy is much greater."

With all the potential fiscal problems on the horizon, taxes may have their day in the spotlight before long. 



CITY OF KOTZEBUE

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442-3779 TEEN CENTER
442-3404 VOLUNTEER FIRE DEPARTMENT

January 24, 1986

The Honorable Senator F. Ferguson
The State Senate
Pouch V
Juneau, Alaska 99811

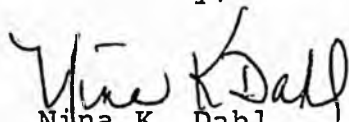
Dear Senator Ferguson;

The Kotzebue City Council is responding to Senate Bill #326; A bill for an act entitled "An Act making a special appropriation to the Office of Management and Budget for study of tax policy; and providing for an effective date.

We strongly support the above bill and encourage the passage of Senate Bill #326.

Should you require any information or need our assistance please contact us at your convenience.

Sincerely,


Nina K. Dahl
Mayor
City of Kotzebue

cc: File

"GATEWAY TO NORTHWEST ALASKA"

Anchorage Daily News 1-30-86

Hey, wait — more study *is* needed

The phrase "more study needed" is guaranteed to produce a yawn from most people. But Sen. Frank Ferguson is on target with his bill calling for a comprehensive study of state tax policy. Legislators should embrace the proposal to take a hard look at where and how the state raises its money.

The Kotzebue Democrat wants to spend \$500,000 to analyze how well existing state taxes, tax credits, licenses and user fees serve Alaska. He also wants to know if there is uniformity of taxation among taxpayers. And what about the relationship, and there must be one, between taxes and the state's economic health? Assumptions and prejudices about the important issue abound, but where are the facts?

Declining oil revenues is a hot topic in Juneau this year. And there's plenty of talk about higher oil taxes, altered tax methods, and even a return to the income tax. A comprehensive study, developed by the Office of Management and Budget and supplemented by private consultants, seems essential for formulating a tax policy that provides the state with broad, stable, and measurable revenue sources. After all, if Alaskans don't know how their taxes affect the economy today, how can they determine a realistic tax policy for tomorrow?

Actually, tax review is so fundamental it's hardly a novel government innovation. During the past three years, six states have instituted tax policy studies.

The Alaska State Senate typically moves at a glacial pace. Sometimes the senators get brickbats thrown their way because studies are viewed as expensive but effective delaying tactics. But this is one occasion when senators should join together in support of Sen. Ferguson's proposal and fast-track it.



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Alaska State Legislature

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State Capitol
Juneau, Alaska 99811

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MEMORANDUM

TO: Senator Abood
Alaska State Senator

FROM: Frank R. Ferguson *FRF*
Alaska State Senator

DATE: April 7, 1986

SUBJECT: Information on Senate Bill 326

Attached is additional information concerning Senate Bill 326.

As the session is drawing nearer, I believe it is important to have a hearing on this matter.

If you should have any questions, please contact my office.

FRF/cc