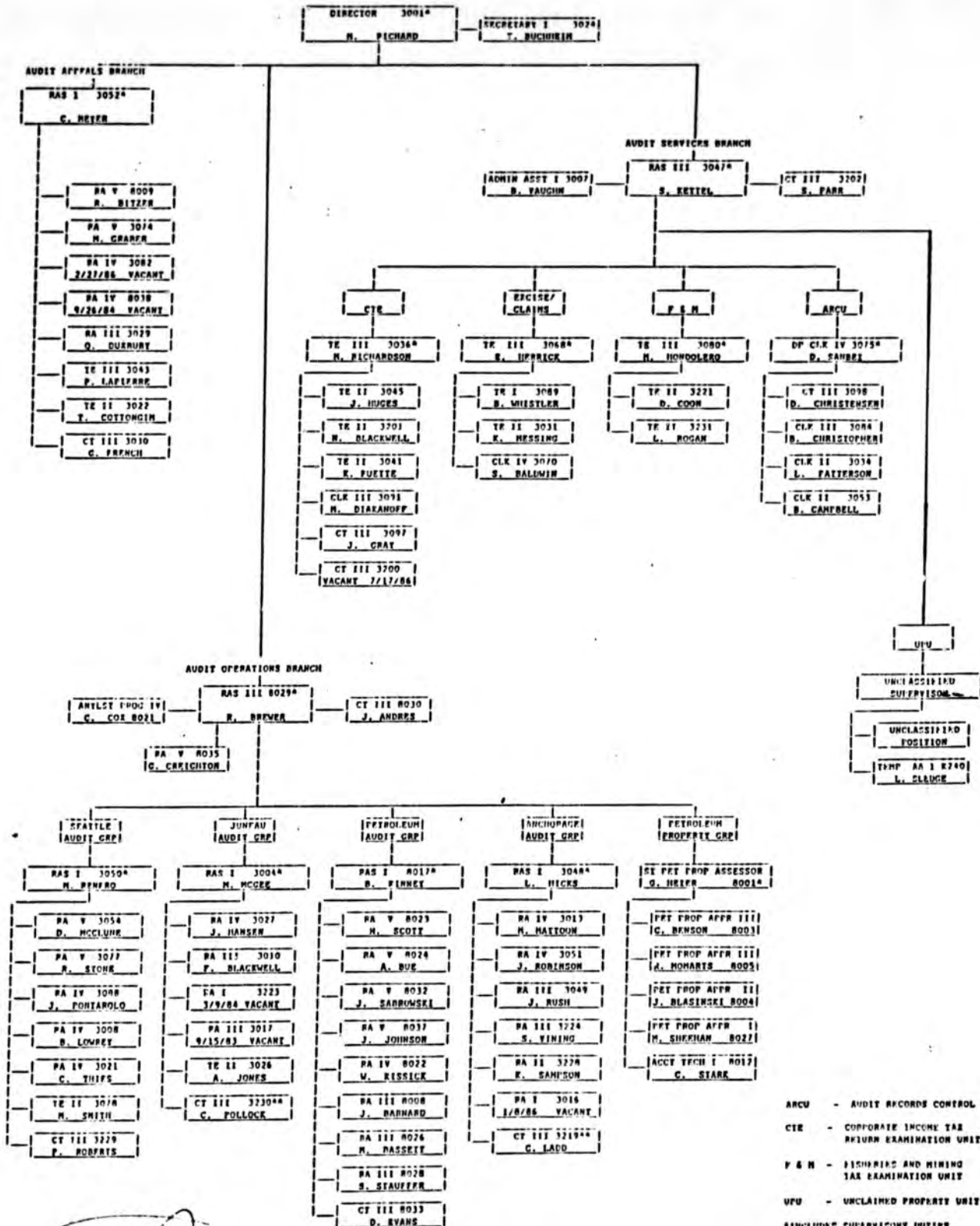


ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILES 8672
1525 SCOMM 55: JNT. SPEC. COMM. ON STATE TAX POLICY, 1986-1987 1335

STATE OF ALASKA
DEPARTMENT OF REVENUE
DIVISION OF AUDIT
8/08/86



ARCU - AUDIT RECORDS CONTROL UNIT

CTE - CORPORATE INCOME TAX RETURN EXAMINATION UNIT

F & M - FISHING AND MINING TAX EXAMINATION UNIT

UPU - UNCLAIMED PROPERTY UNIT

*INCLUDES SUPERVISORY DUTIES
**PART-TIME POSITIONS

Director of Audit

Date

STATE OF ALASKA

DEPARTMENT OF REVENUE

BILL SHEFFIELD, GOVERNOR

STATE OFFICE BUILDING
P.O. BOX 5A
JUNEAU, ALASKA 99811

October 10, 1986

The Honorable Ben Grussendorf
Speaker of the House
P.O. Box 928
Sitka, Alaska 99835

At a recent meeting of the Special Joint Committee for State's Tax Policy, you requested this Division provide you with a basic explanation of the tax issues involved in the majority of our cases currently in appeal status. The following discussion covers the five major taxes on the petroleum industry.

AS 43.55 - Oil and Gas Properties Production Tax
AS 38.05 - Royalties

Royalty audits (with the exception of Net Profit Share Lease audits) have been tentatively curtailed pending the outcome of the Amerada Hess litigation. In prior audits, however, the value basis used for the purpose of calculating the standard royalty was, with minor exceptions, virtually identical to that used for production tax. The audit issues listed below, therefore, pertain to both. It should be noted that royalties are the responsibility of the Department of Natural Resources, and royalty audits performed by the Department of Revenue result in recommendations only and not assessments per se. (Statutory and regulatory references relate to production taxes; royalty provisions are included in the lease contract.)

Gross value:

Issues relating to the value of the production at its sales delivery point or, in the case of producers that refine their own, at the gate to the refinery. Specific issues include calculation of the full consideration received in the sale and the prevailing value of the production in a particular sales market. [AS 43.55 and 15 AAC 55.150-172]

Transportation costs:

Issues relating to the cost of transporting oil or gas from its point of production to the sales delivery point or gate to the refinery. Examples are issues relating to pipeline tariffs, canal tolls and tanker costs, including depreciation and rate of return. [AS 43.55.150 and 15 AAC 55.180-200]

AS 38.05 - Royalties: Net Profit Share Lease (NPSL)

For purposes of a NPSL the State of Alaska is a joint venturer with the leaseholder(s). NPSL audits are, therefore, joint venture audits, with issues relating primarily to the pricing of goods and services charged to a particular lease. As with other royalty audits performed on behalf of the Department of Natural Resources, results are in the form of a recommendation. [11 AAC 83.201-295]

AS 43.20 - Alaska Net Income Tax

Internal Revenue Code:

Issues relating to those sections of the Internal Revenue Code that have been adopted by the State of Alaska. [AS 43.20.021]

Unitary vs separate accounting:

Issues relating to worldwide combination, primarily involving the determination of members of the unitary group.
[AS 43.20.031(i) and 15 AAC 20.300-320]

Business income vs non-business income:

Issues relating to the differentiation of non-business income under the Multistate Tax Compact. Specific issues involve certain interest and dividend income and income arising from the sale of certain investments. [AS 43.19.010 and 15 AAC 19.011-091]

Apportionment factors:

Issues relating to the calculation of the property, payroll and sales factors under the Multistate Tax Compact. Specific issues include both the determination of whose property, payroll and sales to include (unitary type issues) as well as what type of property, payroll and sales qualifies.
[AS 43.19.010 and 15 AAC 19.141-302]

.072 issues:

Issues relating to modifications to the Multistate Tax Compact specified in AS 43.20.072 to be used by taxpayers engaged in oil or gas production or pipeline transportation in the State. Specific issues include the classification of business entities and activities into petroleum and non-petroleum business categories, the handling of Outer Continental Shelf properties, and various adjustments made to intangible drilling and development costs and depletion and depreciation deductions. [AS 43.20.072 and 15 AAC 20.410-590]

AS 43.21 - Alaska Oil and Gas Corporate Income Tax

The gross value and transportation cost calculations used for the AS 43 21 income tax are, with minor exceptions, virtually identical to those used for royalty and production tax purposes. The related audit issues are therefore identical.

Gross value:

Issues relating to the value of the production at its sales delivery point or, in the case of producers that refine their own, at the gate to the refinery. Specific issues include calculation of the full consideration received in the sale and the prevailing value of the production in a particular sales market. [AS 43.21.020 and 15 AAC 21.120-125]

Transportation costs:

Issues relating to the cost of transporting oil or gas from its point of production to the sales delivery point or gate to the refinery. Examples are issues relating to pipeline tariffs, canal tolls and tanker costs, including depreciation and rate of return. [AS 43.21.020 and 15 AAC 21.128-130]

Production expenses:

Issues relating to the calculation of certain deductible expenses pertinent to Alaskan production including royalties, production taxes, windfall profits tax, direct operating costs and certain exploration costs; the amortization of capitalized costs such as those for acquisition and development (includes the issue of oil and gas reserves calculation); and a pro rata deduction for uncapitalized interest and overhead expense. [AS 43.21.020 and 15 AAC 21.200-290]

Pipeline income:

Issues relating to taxable income from oil and gas pipelines in the State. The issue of the deductibility of uncapitalized interest on capital borrowed to acquire, construct, or enlarge the facilities of a pipeline is included in this category [AS 43.21.030 and 15 AAC 21.300-450]

Apportionable income:

Issues involving taxable income that is not related to oil and gas production or pipeline transportation. Specific issues are similar to the first four categories listed under AS 43.20. [AS 43.21.040 and 15 AAC 21.500-550]

The Honorable Ben Grussendorf
Page 4
October 10, 1986

AS 43.56 - Oil and Gas Exploration, Production and Pipeline
Transportation Property Taxes

Taxable property:

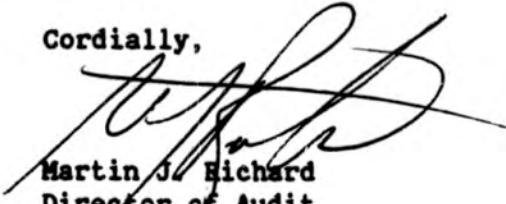
Issues relating to the taxability of certain property.
[AS 43.56 and 15 AAC 56.]

Valuation of taxable property:

Issues relating to the assessed valuation of the pertinent
property. [AS 43.56 and 15 AAC 56.]

Thank you for the opportunity to share with you the major issues
facing the Department at this time.

Cordially,



Martin J. Richard
Director of Audit
(907) 465-2320

MJR:GBC:sp

86-140

Halls
for the policy file

August 13, 1986

The Honorable John Sund
Alaska State Legislature
2336 Sixth Avenue
Ketchikan, AK 99901

Dear Representative Sund:

At the Joint Special Committee on Tax Policy meeting in Anchorage, you requested clarification of the statement in the Department of Revenue's June 1986 Revenue Forecast that "the magnitude of the recent decline in estimated corporate tax payments was totally unexpected. Unfortunately, the correct revenue picture will not be revealed until the Department conducts audits of the companies involved."

Vince Wright, chief of our petroleum research section, advises me that this statement is correct as written--although perhaps it was not as clearly written as one might wish. Corporate taxpayers are required to make quarterly pre-payments of taxes. See, 15 AAC 21.710. That is, in the year the tax liability is incurred, they pay the State of Alaska what they estimate their tax liability will be, on a quarterly basis. If a corporation estimates that its tax bill for the spring quarter of 1986 will be \$100,000, for example, it must forward to the Department of Revenue that amount at the end of the spring quarter. These are estimated quarterly pre-payments.

As you pointed out at the meeting, the companies do not actually file their tax returns until April of the following year at the earliest. In point of fact, most of the larger taxpayers obtain an automatic extension and do not file their tax returns until September of the following year.

Thus, the Department would receive the hypothetical taxpayer's estimated quarterly pre-payment of \$100,000 in April, 1986; but would not receive the final tax return until September, 1987. At that time, the taxpayer would either request a refund of any overpayments (if the estimated quarterly pre-payments were high), or would send in additional payment (if the estimated quarterly pre-payments were low).

The problem described in the June 1986 Revenue Forecast is an unanticipated decline in the estimated quarterly tax pre-payments for the spring quarter of 1986. The final tax returns covering these estimated quarterly pre-payments will not be received for another year. However, we rely on the estimated quarterly pre-payments for a portion of our current revenue flow.

The Honorable John Sund
August 13, 1986
Page 2

It may be that the energy related businesses of many of Alaska's larger corporate taxpayers have suffered as a result of the decline in oil prices. Consequently, their estimates of their ultimate tax liability to the state may have been scaled down, and the quarterly payments reduced commensurately. Whether or not these taxpayers have accurately estimated their tax liabilities will not be known until the Department has audited their final returns.

I hope this answers your question. Enclosed for your information is a brief summary of the audit-assessment-appeal process for tax collection. Also, as requested, is a copy of Dr. Charles Logsdon's analysis of the Jones Act/oil export situation.

Please give me a call if you have any further questions or comments about this or any other matter pending before the Committee.

Sincerely,



Richard D. Monkman
Deputy Commissioner, Taxation

RDM:mkw
86-117

Enclosure

cc: Dr. Charles Logsdon
Vincent Wright
Members of the Committee (w/enclosure)

Assistant Attorney General Deborah Vogt (w/enclosure)
Royce Keller

Department of Revenue
Audit and Appeal Process
August 7, 1986

The Audit Division is responsible for reviewing tax returns and monitoring taxpayers through audits to insure that taxable income is properly calculated and reported. If the Division determines that an adjustment is required, it will inform the taxpayer that either more taxes are owed or a refund is warranted. If more taxes are due, an assessment notice will be issued.

As a practical matter, assessments are often made as the three year statute of limitations for assessments is about to expire. Assessments may be appealed. The taxpayer has the right to appeal an assessment to informal conference within 60 days of being notified of an assessment or waive informal conference and proceed to formal hearing.

There are two levels of administrative appeal within the Department, the informal conference and the formal hearing.

1. Informal Conference

The informal conference is the first level of review of a challenged assessment. A conference officer from the Appeals Section discusses the assessment with the taxpayer in-person, through telephone conference or through correspondence. Unlike the formal hearing in which the Appeals Section takes an adversary role on behalf of the Audit Division, the purpose of the informal conference is to provide an opportunity for discussion. As a result of this nonadversarial approach, the expertise of the Appeals Section, and its ability to settle cases, nearly 90% of all assessment disputes are resolved at the informal conference level of review.

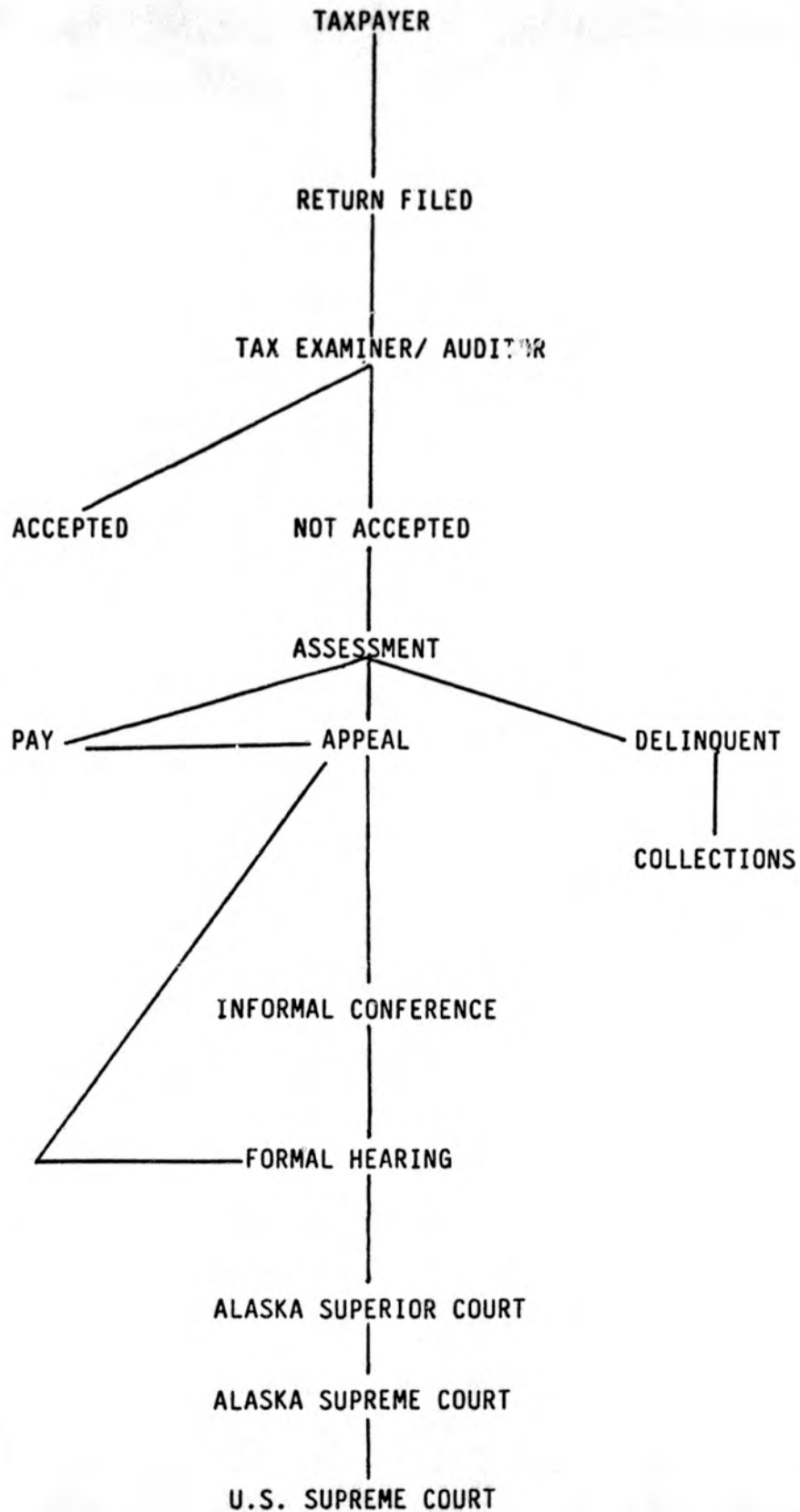
2. Formal Hearing

The formal hearing is the administrative trial level for tax disputes. A Department of Revenue hearing examiner is appointed by the Commissioner to serve as a hearing officer for the appeal. A formal hearing is often preceded by a prehearing conference, motions, briefing, and discovery requests. Full due process safeguards are provided with adequate notice and full opportunity to be heard by an impartial hearing officer. A formal hearing decision is issued after the record is closed and reviewed.

After a formal hearing decision the taxpayer may appeal to the Alaska Superior Court. In rare cases, the appeal process can proceed through Alaskan courts to the U.S. Supreme Court. Final resolution of the appeal occurs after exhaustion or waiver of judicial appeal rights. It is only then that the disputed taxes must be paid if the final determination is against the taxpayer.

DEPARTMENT OF REVENUE

APPEAL PROCESS



MEMORANDUM

State of Alaska

Department of Revenue

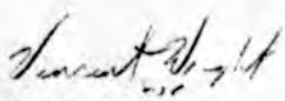
TO: Vincent Wright
Chief of Research

DATE: July 18, 1986

FILE NO:

TELEPHONE NO: 276-5364

SUBJECT: ANS Export

FROM: 
Charles Logsdon
Petroleum Economist

I have reviewed the March 1983 analysis that we made of the revenue potential of ANS Export to Japan. The analysis remains essentially correct as the relative transportation cost and relevant price assumptions have not materially changed. I have made a very rough best guess estimate of what ANS export would mean for oil production revenues if it were to go today. The key assumptions and estimates are as follows:

1. Alaska would sell 100,000 b/d of its royalty oil to Japan (Alaska currently has over 120,000 b/d available for export)
2. Major Alaska producers would sell an additional 200,000 b/d to Far East purchasers
3. The price received would not be substantially different than would have been received if the oil were sold at the U.S. Gulf
4. The transportation cost savings due to avoiding the Gulf haul would be \$2.50/bbl if shipped in Jones Act Tankers or \$3.40/bbl if shipped in foreign tankers
5. All cost savings would translate directly into higher wellhead prices. This means that wellhead values would be \$2.50/bbl higher if Jones Act Tankers are used and \$3.40/bbl higher if foreign tankers are used for oil shipped to Japan.

	<u>State of Alaska Gross Revenue Effect</u>	<u>Less State of Alaska Permanent Fund Effect</u>	<u>State of Alaska Net Revenue Effect to General Fund</u>
Jones Act Tankers	\$ 80 million/yr at current prod.	\$ 14.5 million/yr at current prod.	\$65.5 million/yr at current prod.
Foreign Tankers	\$110 million/yr at current prod.	\$ 19.75 million/yr at current prod.	\$90.25 million/yr at current prod.

CL:nkw

Miscellaneous Reports

TAXES REPEALED
(SINCE STATEHOOD)

1. Alaska Net Income Tax Act (Individual) - AS 43.20
(repealed SLA 1980, ch. 1, second special session)
2. Alaska Net Income Tax Act (Fiduciary) - AS 43.20
(repealed SLA 1980, ch. 1, second special session)
3. Oil and Gas Corporate Income Tax (separate accounting) - AS 43.21
(repealed SLA 1981, ch. 19)
4. Inheritance and Transfer Taxes - AS 43.30
(repealed SLA 1970, ch. 24)
5. School Tax - AS 43.35
(repealed SLA 1980, ch. 113)
6. Disaster Taxes (Disaster Relief tax) - AS 43.43
(repealed SLA 1969, ch. 48)
7. Disaster Severance Tax - AS 43.43
(repealed SLA 1970, ch. 247)
8. Oil & Gas Reserves Ad Valorem Tax - AS 43.58
(repealed SLA 1984, ch. 6)
9. Alaska Business License Act (Bus. Gross Receipts) - AS 43.70
(repealed SLA 1978, ch. 144)
10. Alaska Business License Act (Financial Institutions) - AS 43.70
(repealed SLA 1984, ch. 96)

MATERIAL FROM
Committee Notebooks
1st MEETING

TERRITORIAL TAX STRUCTURE

TITLE 4

LEGISLATIVE DEPARTMENT

4-2-1 General Power and Limitations

TITLE 35

BUSINESS AND PROFESSIONS

Article 2

35-1-11 Territorial License Taxes

Article 3

35-1-31 Mining License Tax

Article 6

35-1-71 Alaska Business License Act

Article 7

35-1-91 Salmon Canneries: certain fish processors

Article 8

35-1-111 Cold Storage and other fish processors

Article 8a

35-121 Taking of fisheries products which are sold outside taxing jurisdiction

Article 9

35-1-131 Punchboards

Article 3

35-4-31 Excise tax (Alcoholic Beverages)

TITLE 36

CORPORATIONS AND ASSOCIATIONS

36-6-1 Fees and taxes

36-6-6 Annual corporation tax

TITLE 37

EDUCATION

37-4-1 School tax

TITLE 42

INSURANCE

42-3-9 Annual statement of business by agent or broker: Premium Tax

TITLE 44

MILITARY AND VETERANS

44-2-13 Creation of Fund

TITLE 47

PUBLIC RESOURCES: MINING

47-7-15 Oil & Gas Conservation Fund: Tax on gas and oil produced

TITLE 48

REVENUE AND TAXATION

48-1-2 Maximum Annual Levy for Territorial Purposes

48-3 Coin Operated Amusement and Gaming Devices

48-4 Inheritance and Transfer Taxes

48-5 Motor Fuel Oil Tax

48-6 Sales Profit Tax

48-8 Railroad Income Tax

48-10 Income Taxes (Individual, fiduciaries, corporations and banks)

48-11 Tobacco Tax

48-12 Oil and Gas Properties Production Tax

TITLE 50

VEHICLES

50-3-11 Annual Tax: Plates

Alaska State Legislature

Dieckmannsche Reaktion

Barbra Herman AS

Gordon Harrison



Speaker of the House of Representatives

Pouch V
State Capitol
Juneau, Alaska 99811
(907) 465-3720

Official Business

July 14, 1986

To: Rep. Ben Grussendorf
From: Mary Halloran

BRIEFING PAPER ON TAX POLICY

This briefing paper is based on a review of documents made available through House Research, Dept. of Revenue, OMB, and NCSL.

1. COMMITTEE PROCESS/METHODOLOGY:

The work of other states in tax policy review indicates that certain procedures are more productive than others. In general, the following recommendations should be considered by the committee:

1. That the committee's first meeting include a discussion of the policies or goals of the work;
2. That advice or counsel be actively sought from the following entities: big business, small business, labor, legal and accounting professions, the university, state agencies (OMB, Revenue, Law), public interest groups, and the public at large;
3. That a computer model be constructed of any proposed tax changes to provide an adequate analysis of the impacts;
4. That technical workshops be held with tax experts, such as CPAs and tax attorneys;
5. That staff work should include information on the proposed administration of each tax, including collection and auditing;
6. That staff be directed to issue a staff report with options which can then be discussed by the committee and serve as the basis for public review.

ALASKA STATE TAX POLICY REVIEW

Staff work outline:

1. Identification of Existing Taxes, Tax Credits, Licenses, User Fees, Program Receipts. For each, identify the following:
 - A. Tax/Tax Credit/User Fee/Program Receipt
 - B. Statutory Authority
 - C. Effective Tax Rate
 - D. Tax Incidence
 - E. FY 85 and FY 86 Revenue Generated (Both Amount & Percentage of Total State GF Revenues)
 - F. FY 87 and FY 88 Revenue Estimated (Amount & Percentage of Total State GF Revenues)
 - G. Date Tax/etc. Was Begun
 - H. Associated Administrative Costs (Collection, Processing, etc.)
2. Identification of Taxes Deleted Since 1975 or Earlier
3. Identification of Tax Modifications Since 1975
4. Outstanding Litigation Regarding Alaska State Tax Statutes
5. Implications of Recent/Pending Federal Tax Code Revisions on State Tax Statutes - Impact on Ability to Raise Revenues And Ability to Bond
6. Review of Taxes Currently Collected by Other Natural Resource-Based States Not Authorized in Alaska
7. Identify Economic Components of Alaska; Which of Those Components Are Taxed and How; Relationship of Each Tax to Economic Growth
8. Relationship of Tax Statutes to Royalty Statutes, i.e. Will Any Proposed Changes in Tax Statutes Affect Royalties?
9. Relationship of Tax Revenues to Permanent Fund Income From 1990 On, Assuming Stable Budgetary Levels of X Amount
10. Impacts of Inflation Upon Previously Enacted Taxes With No Inflation Adjustment Formula

11. Areas of Review:

- A. Which Approach:
 - i. Separate Accounting
 - ii. "Water's Edge"
 - iii. Worldwide Unitary Tax
- B. ELF
- C. Sales
- D. Personal Income
- E. Corporate Income
- F. Gross Receipts
- G. Alcohol Excise Tax
- H. Cigarette Tax
- I. Major Fuel Taxes: Highway, Aviation, Marine
- J. Fisheries Business Tax
- K. Gambling Tax (tour boat casinos)
- L. Banking & Financial Institutions
- M. Existing tax credits
- N. Licenses, permits, user fees

ITEMS OF INTEREST:

1. Alaska is one of only two states which does not have either a general sales tax or personal income tax (New Hampshire is the other). Thus, Alaska "has not been in the main stream of the movement toward more progressive and broadly based forms of taxation." Thirty-seven states levy both, 11 others have one or the other. Nationwide, property tax has been de-emphasized and personal income tax increasingly relied upon for a stable tax base.
2. Current Alaska statutes provide several tax incentives for industry. But the research consensus overwhelmingly labels tax incentives the "least effective means of encouraging economic development." More important to most development are labor force quality, adequate transportation, public infrastructure, land availability and reduction in red tape. Hence, an appropriate analysis would be of the efficiency of current tax incentive credits.
3. A recent cost analysis of state permits and licenses showed that it costs more to administer permit and licenses for some departments than is collected. The difference is \$3 million annually -- a sufficient amount to warrant the review of the permits and licenses: are the permits such that the state should absorb the loss, i.e. the public purpose of the permit is more important than the revenue loss? Or are the permits/licenses not set at the proper fee level? Or are the permits/licenses merely nuisances which should be eliminated rather than revised?
(DCED, Fisheries Entry Commission, Public Safety, Revenue and the judicial system show positive net revenues. Labor breaks even. DEC, DHSS, DNR, and DOT-PF show negative net revenues.)
4. Tax "troubles" in most states are common. New Mexico, finding itself in a situation similar to Alaska this year, passed \$150 million in tax increases to address revenue shortfalls related to oil price declines. That legislation, as well as that of other states, should be reviewed.
5. There is general agreement that 50 to 80 percent of new jobs are created by small businesses. Therefore, in most states, an increase in tax revenues is linked to small business growth.
6. The Permanent Fund earnings are projected to outstrip oil revenues in FY 92, based on the March revenue estimates. Given the current situation, the Permanent Fund earnings will probably provide the major source of Alaska's revenues before FY 92, perhaps as early as FY 89.
7. Alaska's taxing approach is not philosophically consistent. Water's edge vs. worldwide vs. separate accounting are the three main thrusts of taxation -- one of the first tasks of the committee should be to review and understand the differences among these three approaches.

April 18, 1986

POTENTIAL "ELF" PROBLEM

Alaska's petroleum severance tax is a major source of the state's revenues, an estimated \$770.5 million of the \$2077.6 million projected for FY 87. North Slope producers currently pay the full 15 percent nominal severance tax rate, with a downward adjustment scheduled to begin in 1987 on the Prudhoe Bay field.

The formula for the adjustment of the nominal severance tax rate is called the economic limit factor, fondly known as the ELF. Under the ELF, actual severance tax paid equals [ELF X statutory tax rate]. The severance tax features an 80¢/barrel minimum tax, supposedly an insulating barrier from low oil prices. But, the 80¢/barrel minimum tax is also subject to the ELF under AS 43.55.011(a). The ELF is not operative until its calculated value is .7 or less, or until a field begins its eleventh year of production.

The ELF formula is:

$$[(460 \times WD)/PEL]$$

$$ELF = (1 - PEL/TP)$$

This unwieldy formula can be simplified to the following:

1.533

$$\text{Current ELF} = (1 - 300/\text{well production})$$

The controlling factor of the ELF formula is the PEL. Put simply, PEL is the amount of production needed to cover direct operating costs. Under current statute, that amount is specified to be 300 barrels per day. But, as wellhead values decrease, PEL increases since it takes more barrels to cover actual operating costs. The producers can request a change in the official PEL, based on one month's market prices and four consecutive months' of operating costs. Given the predictions that prices will stay low, on average, for the next 18 months, then operating costs will be proportionately larger as a percentage of the total production than in the past. As the PEL increases, the value of ELF decreases, eventually becoming zero. A zero ELF means, of course, zero severance taxes.

Low wellhead prices make it conceivable that producers will request the necessary administrative hearing(s) to increase the PEL which will, in turn, decrease the ELF, which will, in turn, decrease the amount of severance tax received by the State. The Dept. of Revenue calculates that at today's prices the PEL is greater than 300 barrels/day at three North Slope fields - Kuparuk, Milne Point and Lisburne.

The ELF for Prudhoe Bay production becomes sensitive to price after wellhead prices go below \$2/barrel, or \$11/barrel on the West Coast and \$13.50 on the Gulf. The Prudhoe Bay wellhead value becomes zero at a West Coast market price of \$6.50 and a Gulf Coast price of \$9.00. Thus, it may be to the producers' economic advantage to ask for a new Prudhoe Bay PEL/ELF calculation if the price falls to \$11 West Coast and \$13.50 Gulf. Prudhoe Bay will provide between 83.7 and 86 percent of the expected FY87 production.

The ELFs for the Kuparuk, Milne Point and Lisburne fields are considerably more sensitive to probable oil prices than is Prudhoe Bay. The ELF for Kuparuk becomes sensitive to prices when the wellhead price falls below \$3/bbl. The Kuparuk ELF reaches .7 at approximately \$12.50 West Coast and \$15.00 Gulf, and drops to zero at \$8.10 West Coast and \$10.60 Gulf. Kuparuk will provide between 11.8 and 12 percent of the expected FY87 production.

The ELF for Milne Point becomes sensitive to prices when the wellhead falls below \$5.00/bbl. The Milne Point ELF reaches .7 at approximately \$13.70 West Coast and \$16.20 Gulf, and drops to zero at \$10.30 West Coast and \$12.80 Gulf. Milne Point will provide between 1.6 and 2 percent of the expected FY87 production.

Production at Lisburne is still scheduled to begin in December 1986 or early 1987. The Lisburne ELF also becomes sensitive to prices when the wellhead drops below \$5.00/bbl. The Lisburne ELF reaches .7 at approximately \$10.60 West Coast and \$13.10 Gulf, and drops to zero at \$7.20 West Coast and \$9.50 Gulf. If Lisburne goes on line on schedule, it will provide about 2.7 percent of the expected FY87 production.

To trigger the re-evaluation of the value of the PEL/ELF, the producers must request an administrative hearing, either by February 15 of the affected year or within the first six months after commencement of a field's production. Once set, the ELF cannot be changed during that calendar year [AS 43.55.013(d)].

For Prudhoe Bay, the ELF kicks in automatically under current statute on June 17, 1987, although a change could take place as early as the beginning of 1987. A changed PEL/ELF could be established for Kuparuk, effective January 1, 1987, while different PEL/ELFs for both Milne Point and Lisburne fields could be established retroactive to the beginning of production as both fields are or will be in their respective first six months of production. Once the PEL/ELF is changed, its new valuation is set for the calendar year. Whether a change takes place depends on market prices and the producers' willingness to request the necessary administrative hearing this fall. Under the provisions of AS 43, the hearing would be confidential and action would proceed without any notification to the legislature.

Also, the statute does not provide the Dept. of Revenue with discretionary powers. The direct operating costs are tightly and narrowly defined in statute [AS 43.55.013(e)]. Thus, the request would be evaluated on mathematics -- does it now take more than 300 barrels per day to pay direct operating costs? At this time it appears that the actual PEL is more than 300 barrels/day in the Kuparuk, Milne Point, and Lisburne fields.

At risk is some portion of about \$38.5 million in FY 87 severance taxes from Milne Point, Lisburne, and Kuparuk production. The Dept. of Revenue and OMB expect the loss of at least \$12 to 14 million. The \$38.5 million equals about 5% of total severance taxes expected, or about 2% of total state revenues. Also at risk is some portion of about \$28.2 million in FY 88 severance taxes, or about 2% of total state revenues.

These calculations are based on the March 1986 revenue projections, including TAPS. For FY87, Milne Point and Lisburne are each expected to bring in \$7.7 million, while Kuparuk would bring in \$23.1 million for the period January 1, 1987 through June 30, 1987. For FY88, Milne Point, Lisburne, and Kuparuk should generate \$56.4 million in severance taxes. Half this amount, or \$28.2 million would be at risk because the new ELF's would remain in effect through the calendar year 1987.

A simple statutory change can provide a fundamental protection for the State's severance tax income so that it is never calculated on less than the 80¢/bbl floor set out in AS 43.55.011(c).

The necessary language would be as follows:

* Section 1. AS 43.55.011(a) is amended to read:

Sec. 43.55.011. OIL PRODUCTION TAX. (a) There is levied upon the producer of oil a tax for all oil produced from each lease or property in the state, less any oil the ownership or right to which is exempt from taxation. The tax is equal to either the percentage-of-value amount calculated under (b) of this section, multiplied by the economic limit factor determined for the oil production of the lease or property under AS 43.55.013, or the cents-per-barrel amount calculated under (c) of this section, whichever is greater[, MULTIPLIED BY THE ECONOMIC LIMIT FACTOR DETERMINED FOR THE OIL PRODUCTION OF THE LEASE OR PROPERTY UNDER AS 43.55.013]. If the amounts calculated under (b) and (c) of this section are equal, the amount calculated under (c) [(b)] shall be treated as if it were the greater for purposes of this section.

* Section 2. Section 1 of this Act takes effect immediately in accordance with AS 01.10.070(c).

This language does not attempt to solve another identified issue - inflation-proofing the cents-per-barrel floor. The 80c/bbl floor was originally established in 1977, and has not been revised since that time, despite the considerable effects of inflation during the past nine years. In today's dollars, the 80c of 1977 would be about \$1.25.

There also exist potential problems with royalty revenue. At zero wellhead value, the State receives no royalty revenue except from those sales contracts which specify a premium over "in value" price. Those contracts affect only about 25% of the royalty share, providing 30c to 35c/barrel premium. (The following royalty contracts currently provide premiums above the "in value" price: Tesoro- second contract, 13.876% of Prudhoe Bay royalty production; Chevron, 9.6% of Prudhoe Bay royalty production; GVEA, 2.667% of Prudhoe Bay royalty production; and Petrostar, 19.198% of Kuparuk royalty production).

Unfortunately, the economic interests of the producers and the State are not the same because of the TAPS tariff, shipping costs, and the producers' federal taxes. It is apparently in the producers' economic interests to maintain the flow of Prudhoe Bay oil until the market price drops to approximately \$3 on the West Coast and \$5.50 on the Gulf. Thus, the State could conceivably find itself in the situation where its royalty oil has little or no value in terms of state revenues yet the oil is pumped daily into TAPS. In fact, there is even the remote possibility of a 70c/bbl cleaning and dehydration charge on all royalty barrels being levied against the State by the producers even when the wellhead value is zero.

The possible actions necessary to protect the State's royalty revenue seem to be administrative in nature, and would involve cooperative negotiations with the producers. In contrast, the severance tax floor can be fixed only through legislative action.

This paper was prepared by Mary Halloran, Special
Assistant to the Speaker of the House of Representatives.

FIELD	PRUDHOE BAY	KUPARUK	MELNE POINT	LISBURNE
Wellhead price at which field becomes sensitive to ELF	\$2.00 or less/bbl	\$3.61 or less/bbl PEL > 300 at 3.61 WH	\$5.00 or less/bbl PEL > 300 at \$4.85 WH	\$5.00 or less/bbl PEL > 300 at \$4.90 WH
Sales price/value at which ELF reaches .7 West Coast Gulf	Now above .7 7.15 WC 9.65 Gulf	Now below .7 Approx 12.50 WC 15.00 Gulf	Now below .7 Approx 13.70 WC 16.20 Gulf	Now below .7 Approx 10.60 WC 13.10 Gulf
Sales price/value at which ELF reaches 0 West Coast Gulf	6.50 WC 9.00 Gulf	> \$1.20 Wellhead 8.10 WC 10.60 Gulf	> \$1.50 Wellhead 10.30 WC 12.80 Gulf	> \$1.50 Wellhead 7.20 WC 9.50 Gulf
Time period for confidential hearing request	By Feb. 15, 1987	By Feb. 15, 1987	(1) Within first 6 months of production (by May 15, 1986) or (2) By Feb. 15, 1987	(1) Within first 6 months of production (Scheduled to begin Dec. 1986 or Jan 1987), or (2) Feb 15, 1987, whichever is latest
Time period when new ELF would apply	1987	1987	(1) Retroactive to beginning of production or (2) 1987, depending on timing of request	(1) Retroactive to beginning of production or (2) 1987
Basis for calculation of current direct operating costs (PEL)	300 bbls/day	300 bbls/day	300 bbls/day	300 bbls/day
Percentage of North Slope productions w/o Lisburne with Lisburne	85% 83.7%	12% 11.8%	2% 1.6%	N/A 2.7%
Percentage of expected severance tax for FY 87 (based on March forecast) and dollar value	92% \$708.9 million	6% \$46.2 million	1% \$7.7 million	1% \$7.7 million
Percentage of expected severance tax for FY 88 (based on March forecast) and dollar value	89.4% \$476.5 million	7.1% \$37.8 million	1.3% \$6.9 million	2.2% \$11.7 million



Report of the
FIRST TAX REVIEW COMMISSION

to the
THIRTEENTH LEGISLATURE
STATE OF HAWAII

December 17, 1984



Report of the
FIRST TAX REVIEW COMMISSION

to the
THIRTEENTH LEGISLATURE
STATE OF HAWAII

December 17, 1984

GEORGE R. ARIYOSHI
GOVERNOR

JACK P. SUYDERHOUD
EXECUTIVE DIRECTOR



TAX REVIEW COMMISSION
STATE OF HAWAII
P.O. BOX 259
HONOLULU, HAWAII 96809
(808) 548-6490

HIDETO KONO
CHAIRMAN

CHRISTOPHER PABLO
VICE-CHAIRMAN

MEMBERS:

THOMAS M. FOLEY
CAROLE ANN GIBBS
ALBERT S. NISHIMURA
RUSSELL K. OKATA
RICHARD POLLOCK

December 17, 1984

To the Honorable Members of the Thirteenth Legislature:

The Tax Review Commission is pleased to present this report containing its recommendations regarding the adequacy, fairness, and economic impact of Hawaii's tax structure.

Article VII, Section 3 of the Hawaii Constitution as amended in 1978, provides that "there shall be a tax review commission which shall be appointed by law on or before July 1, 1980, and every five years thereafter." Act 218, State Laws of Hawaii 1979, established a seven-member Hawaii Tax Review Commission to be appointed by the Governor with the advice and consent of the Senate.

The first Commission, sworn in on May 28, 1980, observed that Hawaii's tax system had not been subject to comprehensive study since the mid-1950's, and it agreed to focus on the larger issues of taxation: fairness of the State's taxes, adequacy and responsiveness of the tax structure, degree to which taxes are exported and further exportable to nonresidents, and effects of taxation on business and economic efficiency. A lack of funding to support its research agenda caused the Commission members to resign.

Act 212, State Laws of Hawaii 1983, authorized the appointment of replacement members to the Commission, and the new Commission held its first meeting in August of the year. The present Commission endorsed the focal points of study established by the earlier Commission with emphasis on the general excise and the net income taxes. Other sources of revenue were evaluated within the context of the broader policy issues noted above under the assumption that more narrow issues can be addressed by subsequent commissions.

The Commission would like to take this opportunity to thank the many individuals and organizations providing information and assistance to the Commission in carrying out its tasks. The Hawaii Department of Taxation, under its former director George Freitas and present director Herbert Dias, contributed administrative support, data necessary to carry out analytical studies, and comments on the administrative implications of the Commission's recommendations. The state Department of Budget and Finance made available its resources for the Commission's expenditure estimates and the Department of Social Services and Housing provided data on the relationship between taxes and welfare benefits. Data on the Hawaiian economy and the Hawaii input-output model was supplied by the Department of Planning and Economic Development. A volunteer panel of national and local tax policy experts also provided guidance and input on the Commission's technical research agenda (see Appendix C). Finally, the Commission benefited from the suggestions and critiques of local tax practitioners and members of the general public.

Respectfully submitted,
HAWAII TAX REVIEW COMMISSION

Hideto Kono, Chairman

Thomas M. Foley

Carole Ann Gibbs

Richard Pollock

Christopher G. Pablo, Vice Chairman

Albert S. Nishimura

Russell K. Okata

Table of Contents

	Page
Introduction	1
General Findings and Conclusions	3
Adequacy of Revenues	3
Equity and Efficiency Adjustments to the Tax System	3
County Revenue Structure	3
The Business Tax Burden	4
New Revenue Sources	5
Recommendations Related to the Overall Tax Structure	5
Overall Equity Considerations	5
Overall Revenue Adequacy Considerations	6
Tax Exporting	6
Business Impact of Hawaii's Taxes	6
Recommendations Related to the General Excise Tax	7
Equity Considerations	7
Excise Tax Revenue Adequacy	11
Recommendations Related to the Individual Income Tax	12
Equity Considerations	12
Recommendations Related to the Corporate Net Income Tax	16
Equity Considerations	16
Revenue Adequacy of the Corporate Income Tax	16
Corporate Income Tax Administration	16
Recommendations Related to the Public Service Company Tax	17
Revenue Adequacy	17
Recommendations Related to Other Revenue Sources	17
Fuel and Liquor Taxes	17
Insurance Companies and Financial Institutions	18
State Lottery	18
Miscellaneous Recommendations	19
Appendixes	21

INTRODUCTION

In developing its findings and recommendations the Tax Review Commission established a comprehensive research agenda and secured input of the general public. The research was carried out by the Commission's staff and consultants. The results of this research are presented in ten consultant's reports and thirteen staff working papers (see Appendixes D and E). The Commission's "Background Report" provides a synthesis of these research efforts. The technical work of the Commission was scrutinized by a volunteer panel of national and local tax policy experts. Public input was solicited at hearings held in each county in both May and November of 1984. In addition, the commissioners and staff met with tax practitioners and interested public groups to obtain their suggestions and advice. While the Commission's agenda was comprehensive, time and resource constraints prevented the Commission from addressing all structural inconsistencies in the tax system.

The Commission's recommendations reflect an attempt to strike a balance among often conflicting goals in tax policy. These goals include the fairness of taxes (equal treatment of equal taxpayers), simplicity of the tax system, efficiency of the tax structure in generating revenue with a minimum of economic dislocation, and the ability of revenues to meet future expenditure needs. Not all of these criteria can be satisfied simultaneously. For example, a tax that is simple, as is the present gross receipts tax, may create some inefficiencies since inter-business transactions are subject to

taxation. As a second example, a progressive income tax that provides tax adjustments to reflect ability to pay may not be simple to comply with or administer. Since not all goals of tax policy can be achieved at the same time, the Commission was forced to accept compromises of one goal versus another.

The findings and recommendations of the Commission also reflect the Commission's assumption that the current level of State spending in Hawaii is consistent with that desired by Hawaii's people. Thus, recommendations that result in reduced taxes to the State are accompanied by others that offset these losses. (See Appendix A for a tally of revenue effects of the recommendations.) The recommendations are thus a package that is "revenue neutral," and the failure to adopt recommendations that increase revenues or shifting of those revenues out of the state general fund will require a pull-back from the tax reductions proposed by the Commission.

The report is divided in two sections. The first presents the general findings and conclusions of the Commission as they relate to the overall tax structure of the state. These conclusions form a philosophical framework for the specific recommendations presented in the second part of the report. Each recommendation is accompanied by a statement of rationale and justification and an estimate of the revenue implications of the recommendation.

GENERAL FINDINGS AND CONCLUSIONS

Adequacy of Revenues

The Tax Review Commission concludes that the present tax structure will provide adequate revenues to meet state spending needs over the next five years at current levels of service. This conclusion is based on the assumption that there will be neither a severe recession nor major cutbacks in Federal aid during the period and the understanding that the present state tax system is responsive to economic growth. This responsiveness (or "elasticity") should permit very modest expansion of state services consistent with the growth of population and real incomes. In any given year, however, the probability is that there will be a revenue overage or shortage.

To offset possible revenue losses from cyclical declines in the economy or fluctuations in the flow of Federal aid the Commission considers it desirable that a formal general fund stabilization fund ("rainy day" fund) be established. Since Hawaii's tax structure is "elastic," revenue growth will exceed long-term expenditure needs during periods of prosperity making it possible to expand programs and/or reduce tax rates. Conversely, revenues can be expected to fall below requirements during down-turns in the economy. Thus while the present elasticity is consistent with long-term revenue needs, there will be year-to-year imbalances between revenues and base-line spending levels. Instead of having to adjust spending up or down to match available revenues for a given year, the State should divert revenues to a rainy day fund when excess revenues occur and draw on this fund during periods of revenue shortfalls (see Recommendation #3).

Equity and Efficiency Adjustments to the Tax System

The Commission finds that the legislative intent to have a progressive ability-to-pay tax structure has been substantially undermined by inflation and by an increasingly complex tax code that provides opportunities to avoid taxation. To counteract these effects there will have to be changes in the structure of some of the State's taxes.

The Legislature has historically supported the concepts of a progressive tax system wherein individual tax liabilities are reflective of ability to pay taxes. For this reason the state individual income tax was formulated to exempt very low incomes from taxation and to tax higher incomes at progressively increasing rates. Likewise, the State has provided income tax credits for excise taxes paid and structured these credits to provide the greatest relief to the lowest income taxpayers. However, legislative intent and actual outcomes do not always coincide.

With respect to the individual income tax, inflation has eroded the value of exemptions and deductions. In addition,

because income tax brackets have remained unchanged since 1966, taxpayers with inflated incomes have been pushed into higher tax brackets. This effect has been most adverse for those with the lowest incomes. To a lesser degree, the value of income tax credits available to low income households for excise taxes paid has not kept pace with inflation in spite of periodic adjustments by the Legislature.

The Commission finds that simplifying the tax system is necessary to achieve a more efficient taxing structure. This includes a more uniform treatment of taxpayers for both excise and income tax purposes. Concurrent with inflation, the income and excise tax codes have become proliferated with special interest exclusions, exemptions, deductions, and credits. The effect of these is to narrow the tax base and reduce collections compared to what they would have been otherwise. Thus tax rates are higher than might otherwise be the case. In addition, these special provisions create confusion and compliance problems among taxpayers. They create incentives to minimize tax liabilities by undertaking economic activity that is otherwise not productive. Simplifying the tax codes and treating taxpayers more uniformly will reduce the incentives to avoid taxes.

County Revenue Structure

The Commission finds that conditions such as increased population (including tourists), urbanization, and general societal attitudes of the time have resulted in considerable financial pressure on county administration. In addition, there is concern among the counties that the degree of fiscal centralization in Hawaii does not permit sufficient flexibility to meet the perceived needs of each individual county.

However, it was not demonstrated to the Commission's satisfaction that the revenue raising powers held by county authorities are not adequate to finance the expenditure needs of the respective counties at this time.

Compared with other local governments in the United States, Hawaii's counties have only limited functional responsibilities. Inasmuch as the State directly administers general education, social welfare, health care and hospitals, the financing requirement on the counties' major tax source, the property tax, is relatively low. Thus, even with very high property values, Hawaii's property tax is low compared to virtually all other states. Even with stable, or even declining, state aid to the counties, the property tax should remain an adequate source of revenue. Table 1 shows that rising property values since 1975 have made it possible for the counties to steadily lower the tax rate per \$1000 net assessed value. Had the rate remained unchanged between 1983 and 1984, the counties would have had an additional \$16.5 million in revenue. Additional revenues can also be obtained through expanded and more realistic county user charges.

TABLE 1: COUNTY PROPERTY TAX RATES*, 1975-84

FISCAL YEAR	Honolulu	Maui	Hawaii	Kauai	Average
1984	7.60	4.50	9.19	8.05	7.34
1983	8.06	4.50	10.01	8.70	7.76
1982	9.14	4.50	10.74	8.70	8.53
1981	9.14	3.88	10.74	8.70	8.57
1980	9.14	5.45	10.74	8.70	8.55
1979	9.14	7.18	10.74	8.70	8.87
1978	9.22	7.50	10.74	8.70	9.15
1977	9.22	7.50	10.74	8.70	9.19
1976	10.76	9.80	12.53	10.15	10.72
1975	12.40	10.50	12.53	10.15	10.72

*All rates computed at dollars per \$1000 of 100% of net assessed value.

Source: Tax Foundation of Hawaii, *Government in Hawaii*, 1984, p. 30.

In public testimony, it was not established to the Commission's satisfaction that the unmet needs of the counties are any more pressing than those of the State. To shift the tax burden from real property to the excise and income tax would further throw out of balance the state-local revenue structure which already intensively taxes consumption and income. However, the Commission does suggest that as part of a reform of the Public Service Company Tax counties tax the property of public service companies (see Recommendation #24).

The Commission did receive input indicating dissatisfaction with the high degree of fiscal and functional centralization in Hawaii state-local government. This degree of centralization may have been appropriate for conditions 15 or 20 years ago, but since then the counties have evolved into more populous jurisdictions with greater political sophistication. The degree of dominance held by the State is thus called into question. However, the Commission concludes that the appropriate forum to address these concerns is the State Legislature and the Constitutional Convention.

The Business Tax Burden

The Commission finds that Hawaii's business tax structure is, on average, not disproportionately burdensome when compared with other States and should not be altered significantly in uncertain expectation of stimulating new business investment. However, there are several areas in the tax system that require adjustment to remove inequities and inefficiencies, and possibly to help improve Hawaii's business climate or the perception thereof.

Among the many factors that businesses consider in making investment decisions are costs of land, labor, transportation, energy and taxes. In the light of adverse national publicity and some local dissatisfaction with

Hawaii's business environment, the impact of the State's taxes on business is of urgent concern to the Commission. In response, the Commission has made an extensive study of the issues and has obtained a broad spectrum of input from the public.

Hawaii's tax structure is unique in its reliance on the broad-based general excise and use tax and its low property taxes. To compare Hawaii with other states (notably California, Massachusetts and Texas, several development "success stories") requires that all state and local taxes be compared and that the interaction of the Federal and state taxes be taken into account. When this is done it is found that Federal taxes are far more significant than state taxes in affecting returns on business investment. Nevertheless, differences exist among states, and when compared, Hawaii's business taxes are moderate; they are lower than those of California and Massachusetts but higher than in Texas. In no case can the differences be considered large. Thus, while taxes are one of many factors that may contribute to the perception by some that Hawaii is a difficult place to do business, the State's aggregate tax structure should not be considered as contributing significantly to any adverse business climate which may exist in the state.

Nevertheless, there are several specific aspects of the tax system that, when adjusted, may improve people's perceptions. These relate to the excise tax levied on inter-affiliate transactions and exports from Hawaii. The Commission has made specific recommendations regarding these issues (see Recommendations #11 and #12).

The Commission did not address non-tax sources of business frustration. These include unemployment and workers compensation insurance which have been evaluated in separate State studies. In addition, regulatory and land use policies also contribute to perceptions of an adverse business climate, but these issues were deemed not to be within the scope of the Commission's mandate.

New Revenue Sources

To replace lost revenues associated with some of the recommended specific equity and efficiency adjustments, the Commission concludes that the following new sources should be adopted: a transient accommodations tax, or variant thereof, and a state lottery (see Recommendations #15, 16, and 29).

In view of its findings that the present tax structure will generate revenues sufficient to meet the State spending needs for the next five years, the Commission sought a package of proposals that is "revenue neutral," i.e., that will produce

neither higher nor lower levels of revenues than those projected under the present system.

Several Commission recommendations intent on improving the equity and efficiency of the tax system will result in considerable losses of revenue. These losses must be made up by rate increases, further broadening of the present tax base, and/or adding new sources of revenue. The recommendation to utilize the revenue sources above is based on the Commission's need to make up losses of revenue from priority given to equity and efficiency adjustments of the present system.

RECOMMENDATIONS RELATED TO THE OVERALL TAX STRUCTURE

In this section of the report the Commission presents its recommendations related to the overall tax structure of the State. Each recommendation is accompanied by a brief statement of rationale and justification as well as an estimate of the revenue effects, if any. Details of the justification for the Commission's actions can be found in the Commission's background report, consulting reports, and staff working papers.

Overall Equity Considerations

Recommendation #1:

The Commission recommends continued adherence to the policies that State taxes used to support the general fund should be levied in a manner that reflects, in aggregate, the ability of residents to pay these taxes. The incidence pattern of these taxes should reflect no taxation of income up to a threshold level with progressive marginal rates thereafter leveling off to a flat rate.

Rationale and Justification: The Legislature has long held that Hawaii's general fund taxes should reflect ability to pay and should not be levied on subsistence incomes. Thus, income exclusions, standard deductions, and progressive tax credits have been provided. In addition, tax rates have been progressively formulated with a leveling-off to a flat rate. This rate structure and exemption of subsistence income creates what is known as a "digressive" incidence pattern. The intent of this digressive incidence pattern is to exclude low incomes from taxation, i.e., households should not be required to pay tax on subsistence income. In the ideal, it provides for fair progressive taxation of higher incomes at marginal rates which level off and never become sufficiently high to create incentives for undesirable tax avoidance or evasion.

However, real growth coupled with significant inflation since the late 1960's has altered the actual distribution pattern of Hawaii's taxes. In aggregate, the State's taxes are regressive. Even the income tax, with its statutory progressive structure, effectively has a proportional distribution pattern. This violates the basic principles established by the State. Specific recommendations by the

Commission are aimed at returning some of the intended equity features to the tax structure (see Recommendations #8, 17, and 21).

Revenue Implications: While this recommendation results in no change in aggregate tax revenues, some change in revenue mix is suggested.

Recommendation #2:

To broaden the tax bases and to keep tax rates low, the Commission recommends that many narrow tax preferences in the existing state tax code should be eliminated. Since it is difficult to consider the large number of such tax provisions involved in any one legislative session, all provisions should be "sunsetting" to expire by 1987 unless explicitly retained by the Legislature. The specific preferences recommended for review are discussed under their respective tax in this report (see Recommendations #14 and #20).

Rationale and Justification: The public acceptance and understanding of the state tax system is called into serious question when the code is proliferated with selective special interest tax preferences. Frequently these preferences do not stand close examination when viewed individually, and there is serious question if the complex of exemptions and preferences makes much sense from an equity or efficiency perspective when viewed together.

There is growing evidence that narrow tax preferences for specific industries or individuals have very little impact on economic behavior. Thus, whatever positive goals may be intended by these preferences the effect is to reduce revenues while doing little to achieve these goals.

Indeed, selective tax preferences can have detrimental effects. They can be challenged on constitutional grounds as being discriminatory, thus subjecting the entire tax structure to the uncertainties of legal battles. Further, some tax preferences serve as precedents to other or larger preferences thus adding to tax revenue erosion and complexity.

To avoid these problems, the narrow preferences should be eliminated.

Revenue Implications: Increased revenues are anticipated reflecting the Commission's specific recommendations.

Overall Revenue Adequacy Considerations

Recommendation #3:

The State should establish a formal general fund stabilization ("rainy-day") fund to stabilize the year-to-year expenditure changes. Contributions to this fund should be made during times of budget surpluses and draw-downs should occur in times of fiscal stress. The fund balance should be allowed to grow to a level which can provide adequate reserves in the event of revenue shortfalls.

Rationale and Justification: The year-to-year growth of expenditures and tax revenues do not necessarily coincide. In some periods the growth of receipts exceeds that of expenditures while in others the reverse occurs. Given the ongoing program needs of the state, it is better to have a level trend in spending rather than to accelerate spending in good fiscal times and have spending cutbacks when fiscal stress occurs. Too rapid expansion raises costs of government while severe contractions create dislocations in public services that could readily be avoided.

The stabilization of expenditures can be accomplished through the use of a rainy day fund which can be built up during the periods when receipts exceed expenditures and drawn down when the reverse is the case. This sort of system already exists implicitly. State budget data indicate that during times of stress unreserved balances are drawn down (but expenditure growth is also slowed). The Constitution requires that excess revenues be returned to taxpayers, thereby establishing an implicit 5% rainy day fund. Formalizing this procedure could further reduce unnecessary fluctuations in expenditures.

The Commission estimates that during periods of above-average growth the annual contributions to the stabilization fund should range from 5 to 6% of current general fund expenditures after other needs are met. Balances should be allowed to accumulate to about 12% of expenditures. The failure of voters to repeal the Constitutional requirement for a mandated tax rebate when general fund surpluses exceed 5% of general fund receipts need not prevent establishing a rainy day fund. A transfer of cash balances to a special fund will reduce the general fund surplus in which case only the Constitutional spending limit must be considered. Since expenditures have been consistently below the spending ceiling, funding the rainy day fund should be possible without exceeding the ceiling.

In 12 of 20 states that use a formal rainy day fund, expenditures from the fund are automatic when revenue shortfalls occur. In the remaining states, expenditures require explicit appropriations by the Legislature.

Revenue Implications: Since the built-in responsiveness of the tax structure is adequate to meet expenditure needs with some cushion, financing of a "rainy-day" fund can over time be accomplished without having to increase taxes.

Recommendation #4:

The following state special funds should be self-supporting and should not be subsidized by infusion from the general fund on a permanent basis: highways, airports, harbors, parking, unemployment compensation, and disability compensation.

The financing requirements should reflect realistic costing of services provided by the funds, including overhead charges to the general fund, sinking funds adequate to replace depreciating capital, and balances to offset revenue declines during periods of fiscal stress.

In addition to the special funds mentioned above, the state should evaluate its other user charges and fees to determine if they are consistent with the value of services exchanged and the true cost of providing those services. This includes regulatory activities, recreation, licensing, inspection services, and water supply.

Rationale and Justification: Special fund financing is justified in those areas of government activity where the users or beneficiaries can be readily identified and charged for the use of the service or activity. In view of this, it is equitable and efficient that the users of such services do pay their own way. This is particularly true in an inflationary period when the costs based on accounting data do not reflect the full economic or replacement costs of the service or facility. Levying of user charges or benefit taxes related to the current real economic replacement costs will generate a more adequate flow of funds to the activity.

Revenue Implications: Adequate charges will reduce the need to make transfers from the General Fund to special funds. In 1984 this amounted to \$15 million. More realistic user charges will add to non-tax revenues and will reduce the pressure on tax revenues.

Tax Exporting

Recommendation #5:

Hawaii's taxes should be structured in such a way as to maximize the "exporting" of taxes consistent with constitutional criteria and other goals of the state.

Rationale and Justification: Most states attempt to "export" their taxes to nonresident taxpayers. This is done in three ways: exported commodities are taxed at high rates (e.g., oil and coal in energy-rich states), services provided to nonresidents are taxed (e.g., hotel rooms, car rentals, gambling), and state taxes are "exported" to the Federal treasury through taxes on Federal construction. Under the present tax structure about 30% of Hawaii's taxes are exported. Two-thirds of this amount (20%) is exported to visitors through their purchases of goods and services. In spite of the significant tax exporting that occurs in Hawaii, other states, such as Alaska, Nevada, Texas, and Wyoming, export their taxes to a comparable or even greater extent.

Through judicious structuring of the tax system, Hawaii can increase its tax exporting.

Revenue Implications: Depending on how this recommendation is implemented some revenue increase is possible.

Business Impact of Hawaii's Taxes

Recommendation #6:

The Commission recommends that there should be no large-scale reduction or increase in direct business taxes.

Rationale and Justification: Hawaii has a high per-capita tax burden when compared to other states, but this does not translate into a burdensome tax pattern on businesses. The higher per capita taxes are the result of high costs of living in Hawaii, the degree of urbanization in the state and the relatively low reliance on user charges. Further, it may be overstated by the degree to which taxes are exported out-of-state.

The Commission has found that the total state and local tax burden on businesses for Hawaii is not out of line with other states. Hawaii compares favorably to numerous states including California, Massachusetts, and Oregon. Thus, while Hawaii levies a 4% excise tax on capital purchases, its corporate income tax is comparatively low and property taxes are extremely low.

Given these results, neither a broad-based business tax reduction nor tax increase is called for.

Revenue Implications: No changes in revenues are specifically related to this recommendation.

Recommendation #7:

The Commission recommends that if the Legislature perceives the need to provide specific reliefs or incentives to business that this be done via case-by-case expenditure assistance.

Rationale and Justification: The Commission is guided by the principle that business taxes should be uniform and structured in such a manner as to minimize differences in effective tax rates across similar firms and across industries. This applies to both the overall design of major business taxes (for example, the corporate income tax) as well as the question of special tax preferences. Further, the Commission has found that special tax preferences have very little impact on the economic behavior of businesses. Thus, tax

preferences cannot be generally justified on the basis that they will stimulate new investment.

The recent experience with the state liquor tax indicates the dangers of providing narrow, highly selective tax preferences or tax expenditures to specific firms or industries. The portion of the business community that does not benefit from the tax breaks will have incentives to legally challenge the state, as occurred in the liquor tax case.

Even in the absence of court challenges and accompanying financial disruptions, serious equity and efficiency questions are raised by the use of selective tax preferences. If the breaks are provided to only "new" firms or industries, existing firms can claim unfair advantage. However, if the tax break is provided to an industry inclusive of both the old and new firms, the revenue loss is likely to be significant. The less-favored industries or firms are likely to pay higher taxes than would be the case if the tax revenues were raised in a more even-handed, broad-based manner. Moreover, the granting of significant tax preference to any large group of firms would establish a precedent that could be used as a wedge to elicit less justifiable tax distortions.

The prospect of receiving preferential tax treatment gives rise to proposals that distract legislative attention from more important features of tax policy refining.

As an alternative to narrowly targeted tax preferences the Legislature can opt to provide direct expenditure assistance to worthy businesses. This can be done through direct loans (as is done in 21 states including Hawaii), loan guarantees (used in 11 states), state-funded interest subsidies, state-funded or -chartered equity venture capital corporations (established in 5 states), or privately sponsored development credit corporations.

Revenue Implications: To the extent that this recommendation forms the basis for other recommendations to reduce tax preferences, revenues will be increased.

RECOMMENDATIONS RELATED TO THE GENERAL EXCISE TAX

Equity Considerations

Recommendation #8:

Income tax credits are the appropriate vehicles to offset the regressive effects of excise taxes on food and drugs. While past inflation and equity considerations require some adjustment of the value of these credits, the Commission recommends that the credit approach is advantageous compared to across-the-board exemption of food and drugs from excise taxes.

Rationale and Justification: As a general principle of good tax policy, any tax should be applied to as wide and uneroded a base as possible. Given the tax revenue to be raised, this permits a lower marginal tax rate to be used, thus facilitating tax efficiency. Broader tax bases are also consistent with efficiency in that fewer administrative costs have to be incurred in making and monitoring distinctions among the many firms and products subject to the tax. Moreover, any exemption, however meritorious, provides a

precedent for other exemptions, the cumulative effect of which narrows the tax base further and gives rise to differential treatment among taxpayers that may lead to legal action challenging the preferences granted.

Any adverse effect of such a broad-based tax policy can be mitigated by a system of tax credits applied against the state individual income tax. In general the tax credit approach is more equitable and efficient than exemptions as a means of mitigating adverse tax effects on low income households. Based on data compiled by the U.S. Bureau of Labor Statistics, exempting food from the excise tax in 1984 would have reduced a low-budget family's excise tax paid by \$269, and intermediate-budget family's tax \$337, and a high-budget family's tax by \$430. A tax credit, on the other hand, can be targeted specifically at those with the greatest need: low-income wage earners and low-income senior citizens.

Income tax credits are extensively used by low-income people. In 1982, 208,644 tax returns (50% of the total) had taken an excise tax credit. Among these were 55,300 returns with adjusted gross income below \$1,000.

There is evidence that tax credits are reaching poverty level taxpayers. In 1979, 204,000 returns had claimed an excise tax credit while there were 17,771 families and 24,775 individuals below the poverty line. In 1979 the poverty threshold for income was \$4,080 for a single person and \$8,300 for a family of four.

Revenue Implications: No change in revenues is anticipated due to this general recommendation.

Recommendation #9:

The amount of the excise tax credits and the income brackets that determine the levels of the credit should be adjusted for inflation. The accompanying table makes the suggested changes.

It is further recommended that adjusted gross income be modified for determining the amount of the credit. This modification should add back to income the following exclusions: 60% of capital gains, excluded dividends and interest, payments to IRA and Keogh plans, unemployment and worker's compensation payments, public assistance benefits, and payments to individual housing accounts.

Proposed Excise Tax Credit Schedule

Modified Adjusted Gross Income	Tax Credit Per Exemption
under 9,700	\$58
9,700 - 11,600	54
11,600 - 13,500	50
13,500 - 15,500	46
15,500 - 17,400	43
17,400 - 19,300	39
19,300 - 21,300	33
21,300 - 23,200	27
23,200 - 25,100	21
25,100 - 27,000	15
27,000 - 29,000	12
29,000 and over	0

Rationale and Justification: The excise tax credit is designed to counteract the regressive nature of the general excise tax. Inflation is a two-edged sword which reduces the effectiveness of the credit in achieving this goal. First, inflation reduces the real value of the credit to individuals. Second, it simultaneously pushes individuals into higher income brackets where the amount of the credit is reduced. Inflation adjustments of both the levels of the credits and the qualifying income brackets counteracts these effects keeping constant the credit's ability to offset the regressive nature of the excise tax, as designed.

To qualify for the credit, all sources of income regardless of taxability should be included. That is to say, the need for the credit is the same for a low-income wage earner as a low-income person who receives tax free interest income.

Revenue Implications: Adjusting both the levels and the income brackets of the credit for inflation would increase the value of credits taken for 1984. However, this is in part offset by expanding the definition of income. The net effect of this recommendation in the context of other proposals is to reduce taxes by \$7 million.

Recommendation #10:

The Commission recommends that no substantial changes be made in the present general excise tax with the exception of minor adjustments which will remove some of the more inequitable aspects of the tax (see Recommendations #11, 12, and 13).

Rationale and Justification: The present general excise tax is actually two taxes in one. While it is technically a privilege of business tax on all those doing business in Hawaii, the differential rate structure creates the image of a business privilege tax plus a broad-based sales tax.

Beyond the confusion it creates, the present general excise tax is perceived to have certain detrimental effects. There are cases of tax pyramiding due to the fact that many intermediate business transactions are taxed at 4%. In addition, the general excise tax is levied on gross receipts from inter-affiliate transactions thus creating some incentives for integration of business. Finally, the existence of a preferential rate for certain gross receipts creates inequities among essentially equal taxpayers. For example, receipts from some intermediate business services are taxed at 1-2% while others are taxed at 4%. Still other gross receipts, because of exemption, are not taxed at all.

Leaving the general excise tax structure essentially as is does not eliminate pyramiding of the tax. The Commission has found that the degree of pyramiding is not as large as some have suspected. That is to say, the 4% retail rate is actually about a 5.0% rate, on average, when the pre-retail general excise tax imbedded in the price is considered. Even though the degree of pyramiding is small, the present structure of the general excise tax causes pyramiding to have different effects for different types of transactions, e.g., services are more highly taxed than goods.

To eliminate pyramiding of the general excise tax while still retaining the productiveness of the tax necessarily complicates the tax structure. There are several ways in which this can be done: a retail sales tax, a non-pyramiding gross receipts tax, and a net excise tax.

Retail Sales Tax. Most states levy a retail sales tax. The base of this tax usually includes sales of only tangible personal property (and not services) and frequently excludes food consumed at home and drugs. This base is much smaller than that of the present Hawaii general excise tax, and the Commission estimates that such a base would require nearly a 20% tax rate to equal the revenue generated by the present general excise tax.

Non-Pyramiding Gross Receipts Tax. A non-pyramiding gross receipts tax would exempt inter-business transactions from the tax. However, this is easier said than done. In New Mexico, which also has a broad-based gross receipts tax, sales of tangible personal property that becomes a physical ingredient of another product are not taxed. Services sold to businesses are taxed. The so-called "physical ingredient" rule provides a narrow exemption and may not significantly alter the degree of pyramiding in Hawaii because much of the pyramiding arises out of taxation of service transactions and goods that do not satisfy this rule.

Ohio, by contrast, employs a "direct use rule" whereby any product that is used or consumed in the production of another product or used to produce a product used in the production of another product (use on use) is exempt from

their sales tax. A system like this was proposed by A. D. Little in their 1968 report on the Hawaii general excise tax. Since Ohio does not tax services, the issue of intermediate services does not arise. Defining direct use is not straightforward especially for new production processes. After years of experience and litigation, the system in Ohio is well understood except for new industries and production processes. Ohio has 43 volumes of court cases since 1935 of which 60% relate to the direct use rule applied to manufacturing. Thus, while a direct use rule appears attractive to taxpayers because it requires fewer accounting records, it will create administrative problems for the Tax Department.

Administering either the direct use rule or the physical ingredient rule is not easy. It requires that a certificate of exemption be attached to or be part of each invoice of an exempt transaction. This places a compliance burden on the taxpayer as well as an administrative cost on the Tax Department.

Net Excise Tax. In its preliminary recommendations report, the Commission proposed to eliminate pyramiding by taxing the net receipts of a business. There are two ways in which this can be done: a tax on net receipts (the net approach) or a tax on gross receipts plus a credit for taxes paid on intermediate services (the credit approach).

Net Approach: This would levy a tax on the difference between a firm's gross receipts and the costs of goods sold. Effectively this taxes value added. When combined with the 1/2% gross receipts tax proposed by the Commission, this would increase the tax on all transactions now only subject to the 1/2% general excise tax (manufacturers, producers, wholesalers, intermediate services) but reduce it on most transactions now taxed at 4% of gross receipts. This approach requires that the taxpayer keep track of legitimate deductions from gross receipts. This is done presently in Hawaii for certain types of inter-business transactions: cash discounts, sales returns, bad debts, trade-ins, reimbursements for cost advances, payments by contractors to licensed sub-contractors if the sub-contractor is subject to the tax. If this net approach were to be used, it could be expected that confusion would arise about what is deductible and that litigation and refining legislation will be needed to settle some disagreements. However, administration of the net approach might be made less difficult by the fact that aggregate accounting data is required to compute net receipts; data that already must be calculated for net income tax purposes.

Credit Approach: The credit approach would levy a 4% tax on the gross receipts of a firm but provide a credit for taxes paid on intermediate business purchases. Defining these purchases raises the same issues as defining deductible transactions. Mississippi uses this approach for its wholesale tax. Prior to 1984, the state levied a 5/8% wholesale tax and retailers took a credit for taxes paid to wholesalers. Effective in 1984, the wholesale tax was repealed. However, some wholesale transactions are still taxed and credits are still provided. The credit system appears to be working well and auditors can use wholesalers' records to confirm the credits claimed by retailers. While the credit approach is clearly workable, it will require firms to keep records that they may

not currently keep, i.e., the sum of all excise taxes paid on intermediate purchases.

In Sum. Removing pyramiding would complicate the present tax system for both taxpayer and Tax Department. A non-pyramiding gross receipts tax is probably easier for businesses than for the Tax Department. The credit approach is probably easiest for the Tax Department but would require firms to keep additional records.

While the present general excise tax has problems, any attempt to resolve them along the lines suggested above may create new and more significant problems. The Commission found considerable opposition to the complexities created by its net excise tax proposal especially from small businesses. The present general excise tax is familiar to all, easy to comply with and its economic effects have been integrated into prices, land costs, rents, etc. Thus no large-scale change is recommended.

Revenue Implications: No specific revenue effects are implied by this recommendation.

Recommendation #11:

To remove the inequitable taxation of certain inter-affiliate business transactions, the Commission recommends that receipts from the sale of goods or services by a parent company doing business in Hawaii to its wholly-owned subsidiaries not be taxable if the parent to whom the receipts accrue is not in the business of providing those goods and services to anyone but its subsidiary firms.

Rationale and Justification: One of the more frequently cited equity problems of the general excise tax is its treatment of payments received by one firm from affiliated firms for what are essentially in-house transactions, e.g., accounting, payroll, computing services, legal services. The Commission is convinced that taxing such transactions discriminates against those firms that choose to organize their internal operations into separate companies versus those that are entirely integrated. If the firm in question sells the goods or services to other persons as well as its affiliated firms, then the sale to the affiliate should be treated as any other sale and be taxable.

Revenue Implications: Some reduction in revenue is anticipated though the amount is likely to be small since firms are presently minimizing their general excise tax liability by organizing in a manner to avoid the tax on inter-affiliate transactions.

Recommendation #12:

The Commission recommends that the price paid by the purchaser for a good or service should be the measure of gross receipts. In the event that such a price is not directly observable because the good or service is sold through an agent, the actual receipts should be "grossed up" by a reasonably assumed or demonstrable sales commission. This commission should not automatically be assumed equal to the difference between actual receipts and receipts based on the list or "rack" price.

Rationale and Justification: The general excise tax defines taxable income as the gross receipts of a business without any deductions, including selling commissions. Thus a firm that has a sale staff cannot deduct from gross receipts the

commissions paid to these sales personnel. Some businesses, including many in the visitor industry, sell their products through outside sales agents. The sales agents resell the products at prices frequently unknown to the original provider. If these products are sold by the agent as part of a package, the resale price of any component of that package is frequently indeterminable. The difference between the sales agent's receipts and the price paid to the provider is the agent's implicit sales commission and is taxable at 4% under the general excise tax.

To treat businesses equally, the firm that sells its product via outside sales agents rather than having its own sales staff is subject to having its receipts "grossed up" to reflect the implicit commissions paid to the outside sales agents. The suggested retail price stated by the firm is often used by the Department of Taxation to calculate the appropriate gross-up amount.

While use of the suggested retail price is generally a reasonable guide to constructing gross receipts, it can, in some cases, be unrealistic. For example, a hotel that posts a \$65 "rack rate" on standard rooms may actually be selling these rooms at an average price of \$45. If the hotel received \$30 from a tour packager, the grossed-up receipts of the hotel should reflect the \$45 price actually paid on average rather than the \$65 rack rate.

The Commission recognizes that there can be reasonable differences in interpretation of appropriate gross-up amounts between taxpayers and the Department of Taxation. The burden of proof should be on the taxpayer to show that the suggested retail price, or rack rate, is not the appropriate measure of gross receipts.

This recommendation does not suggest that the practice of constructing prices for intra-firm transactions be changed. It is recognized that there are situations where list prices are the appropriate measure of the gross receipts that should be attributable to a specific transaction. However, when goods or services are sold for prices below their list price, the actual price should serve as the indicator of gross receipts.

Revenue Implications: A small decrease in general excise tax revenues is anticipated. However, the thrust of this recommendation is to prevent additional taxation of gross income not realized.

Recommendation #13:

The receipts from goods shipped outside the state should be exempt from the 4% general excise tax. Includes in the definition of goods are services with tangible by-products such as computer software and mailing lists.

Rationale and Justification: If tangible goods change title outside the state (i.e., they are shipped CIF destination), they are subject to at most a 1 2% general excise tax. On the other hand, goods shipped FOB Honolulu so that title changes in the state are taxed at 4%. This puts those who choose to export in the latter manner at a disadvantage. Reducing the tax for all exported goods provides an incentive, albeit small, for export activities. The Commission does not intend that purchases made by individuals and subsequently transported out of state be exempt from the 4% general excise tax.

Under the present general excise tax, the gross receipts from exported services are taxed at 4% since the service is

performed in Hawaii regardless of who pays for the service. However, services rendered to out-of-state clients are "exported" as much as tangible goods. Removing this inequity for services with tangible by-products is consistent with state goals to enhance exports. Restricting the preference to services with tangible by-products establishes safeguards that these services are not "sent back" and consumed in Hawaii after making a trip out-of-state to avoid the excise tax.

Revenue Implications: This is a tax reduction on exported goods and services and thus revenues will decline. The estimate for 1984 is \$14 million.

Recommendation #14:

To reduce the complexity of the general excise tax, certain narrow tax preferences should be reviewed for possible sunset by no later than 1987. These include, but are not limited to, the following exempt organizations:

- fraternal, charitable, religious, scientific organizations
- Hansen's disease patients
- state-supported radio promoting tourism
- local development companies approved by the Small Business Administration
- prepaid legal services
- nonprofit cemeteries
- nonprofit shippers association
- nonprofit hospitals

Further, exempt transactions including, but not limited to the following, should also be granted renewed specific legislative exemption or be required to sunset by 1987:

- first \$2000 of gross receipts of blind, deaf, disabled
- foster home receipts
- brooms manufactured by the blind
- certain petroleum products to be further refined
- bagasse by-products
- scientific contracts with the U.S. government
- low-income housing
- air pollution devices
- repairs of Federally owned ships or ships in international or interstate business
- gasohol

In addition, the following classes of activities should be reviewed for the low rates at which they are currently taxed:

- insurance commissions (.15% versus 4% on other commissions) (see also Recommendation #27)

- alternate energy receipts (1/2% versus 4%)
- receipts by blind, deaf, and disabled person (1/2% versus 4%)

Rationale and Justification: As noted in Recommendation #2, special tax preferences create complexities which undermine public understanding of and confidence in the tax system. Since the economic benefits of these preferences are often not significant enough to alter behavior, they cannot be justified on the grounds that they will stimulate new or expanding businesses or retain existing ones. If the Legislature is guided by cases of compassion or severe economic distress, the present exemptions should be explicitly reaffirmed through the legislative process.

In considering the extension of special preferences, the Legislature should weigh the relative merits of using tax preferences versus other, more direct approaches. Using the tax system as a vehicle for promoting economic or social change may provide preferences for those who are not necessarily the target of such policies. As noted previously, preferences beget attempts to create more preferences and or litigation challenging the equity of the tax breaks. The state

may be better served by a less complex tax system and more direct assistance to businesses or organizations that merit special treatment (see also Recommendation #20).

Revenue Implications: Only the revenue impact of insurance commissions can be estimated. In 1984 these commissions taxed at 4% would have yielded \$8.6 million instead of \$323,000 at the present .15%. However, since the Commission only recommends legislative review of the noted excise tax preferences, no revenue gain is presumed.

Excise Tax Revenue Adequacy

Recommendation #15:

Consistent with the Commission's intent to increase the degree of tax exporting, a differential tax on short-term (less than 30 days) transient accommodations is recommended without earmarking the resulting revenues.

Rationale and Justification: A Commission survey of a large number of localities indicates that transient accommodations are virtually always taxed and at rates in excess of 6%, and that tourist as well as business destinations levy hotel room taxes (see Table 2). Hawaii, by contrast, levies only the 4% excise tax on room rentals.

TABLE 2: TOTAL TAXES APPLIED TO HOTEL ROOM BILLS IN SURVEYED LOCALITIES

Percent Total Tax on Hotel Room Bills*	Number of Cities
0.00 - 2.00	5
2.01 - 4.00	6
4.01 - 6.00	6
6.01 - 8.00	12
8.01 - 10.00	12**
10.01 - 12.00	2
over 12.00	1
Total localities surveyed	44

* Includes applicable sales and separate room taxes.

**Washington, D.C., included in this bracket, also adds a flat payment of \$1/day room tax.

Increasing the tax on short-term rentals will generate significant revenues to the state. Two-thirds of these revenues will be exported to out-of-state taxpayers. Calculations made by the Commission indicate that for each additional one percent tax on gross receipts of hotel and condominium rentals, the number of visitors coming to Hawaii will decrease by .35% (or 15,750 visitors, assuming 4.5 million total visitors per year). Since visitor arrivals are forecast to grow over the next few years, even an additional 3% room tax will slow the rate of tourism growth but not reduce visitor arrivals. Revenues from a transient accommodations tax will be offset somewhat by reduced visitor spending on other goods and services. The net revenue effect to the state will still be approximately \$7 million per 1% additional tax.

The Commission acknowledges that a differential tax on transient accommodations may appear to discriminate against the hotel industry. However, since the demand for hotel and condominium rooms is less responsive to price changes than that for many other goods and services in Hawaii, a tax on rooms serves to export a greater proportion of Hawaii's taxes without creating economic distortions or inefficiencies.

The Commission strongly recommends that revenues from a room tax not be earmarked to specific spending programs. Doing so will reduce the extent to which such a tax could be used to support the tax cuts advocated in the Commission's other recommendations.

Revenue Implications: An additional 3% excise tax on hotel and condominium rentals would have yielded \$21 million in 1984. Earmarking any of this revenue to new expenditures would reduce the extent to which the new revenues could be used to make equity and efficiency adjustments in the present tax system.

Recommendation #16:

As an alternative to the hotel room tax, the Legislature should consider raising the general excise tax and to refund the proportion not exported to resident taxpayers through enlarged excise tax credits. Again, the net new revenues should not be earmarked.

Rationale and Justification: A hotel room tax in excess of the general tax levied on gross receipts of all business may be regarded by some as discriminatory and "anti-visitor." A uniform higher general excise tax, or its successor, would not be subject to this criticism.

Since approximately 32% of the general excise tax is exported (paid by nonresidents), increased tax exporting occurs when this tax is increased across the board. By using the revenues to provide tax relief to residents there is a shift of taxes from residents to visitors. Care must be taken to increase the resident tax relief as revenues grow otherwise the intent of the policy is undermined. While this approach is not as direct as taxing rooms at higher rates, it does avoid the perception that the state is singling-out the tourist industry for higher taxes.

Again, the Commission strongly recommends that the net new revenues generated by this proposal not be earmarked for spending on specific programs.

Revenue Implications: For example, increasing the present 4% general excise tax to 4.5% would have generated an additional \$75 million in 1984. Approximately 32% of this would have been exported. Thus, the rebate to Hawaii residents would have to be \$51 million and net new revenue to the State would be \$24 million. If any part of this revenue is earmarked to increased expenditures, the amount available for equity and efficiency adjustments of other taxes is reduced.

RECOMMENDATIONS RELATED TO THE INDIVIDUAL INCOME TAX

Equity Considerations

Recommendation #17:

The Hawaii State individual income tax should be adjusted to take into account the effects of inflation since the income tax was last adjusted. The rate brackets and standard deduction should be enlarged. However, formula or automatic tax indexation should be avoided. The state standard deduction should be made equal to that provided by the Federal government: \$2300 for a single taxpayer or a single head of household, \$3400 for those married filing a joint return, and \$1700 for married filing separately. The tax brackets in effect since 1966 should be doubled. It is further recommended that these income tax reductions should be phased in over a four-year period.

Rationale and Justification: Some countries and states have adjusted or responded to income tax distortions introduced by inflation by indexing their income tax to one degree or another. This indexing has occurred in either an ad hoc or automatic manner. Automatic indexing such as is achieved by writing formulas into the statutes should be avoided in view of the difficulties of other states in selecting the right form and extent of indexing.

Since Hawaii has not utilized either form of indexing it is appropriate that the Hawaii income tax be indexed in an ad hoc manner. Moreover, in view of the other changes in the Hawaii tax system being recommended, excessive and or unpredictable changes in tax system elasticity should be avoided.

Since inflation has changed and distorted the nature and effects of the Hawaii income tax as it was last enacted, it is necessary to restore some of the progressivity, elasticity, and equity features afforded by the system when prices were lower. This can be done by a one-time increase in the dollar amount of the brackets and the standard deduction, or zero bracket amounts. No change is recommended in the level of the personal exemption since this matches the present Federal level and has been periodically adjusted to keep up with inflation.

Figure 1 shows that tax rate structure for joint returns that existed in 1966 and 1984 and what the rates would have been had the 1966 income tax been fully adjusted for inflation. Clearly, legislated changes did not keep up with inflation, and, as a result, larger proportions of Hawaii's income tax filers were pushed into the higher marginal tax brackets. Table 3 shows that in 1966, 90.3% of taxable income accrued to people with adjusted gross income below \$30,000. By 1982 this had dropped to 48.1%.

FIGURE 1: MARGINAL TAX RATE COMPARISONS FOR JOINT RETURN, FAMILY OF FOUR

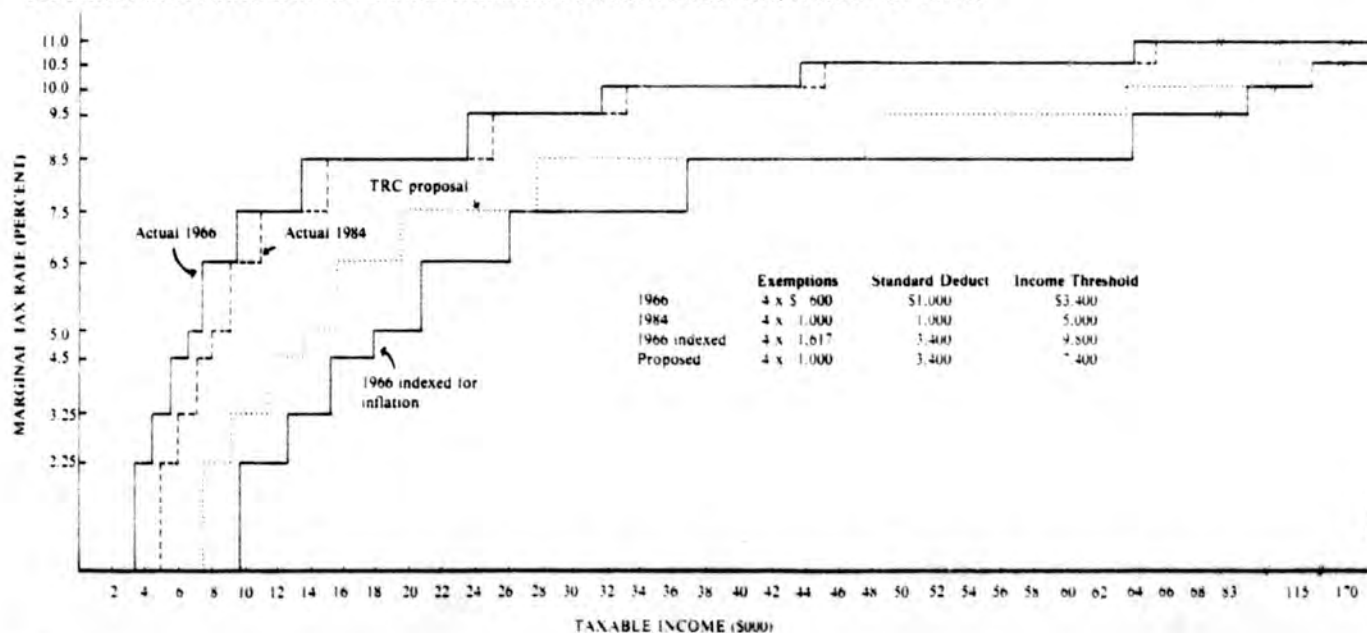


TABLE 3: DISTRIBUTION OF HAWAII TAXABLE INCOME, 1966 and 1982

Adjusted Gross Income Class	Percent of Net Taxable Income	
	1966	1982
\$ 0 - 9,999	40.5%	7.7%
10,000 - 29,999	49.8	40.4
30,000 - 49,999	5.0	31.9
50,000 - 99,999	2.9	15.0
over 99,999	1.8	5.0
	100.0%	100.0%

Source: Hawaii Department of Taxation, Hawaii Income Tax Patterns, Individuals, 1966 and 1982.

The Commission's recommendation to adjust the standard deduction and widen the tax brackets will, to a large extent, offset the adverse effects of inflation. As an example, the proposed rate structure for a joint return is illustrated in Figure 1 and the brackets are presented in Table 4, exclusive of the "zero-bracket amount."

TABLE 4: TAX RATE SCHEDULE - MARRIED TAXPAYERS FILING JOINT RETURNS. PROPOSED COMPARED TO 1966

1966 Brackets	Marginal Rate	Proposed Brackets
0 - 1,000	2.25	0 - 2,000
1,000 - 2,000	3.25	2,000 - 4,000
2,000 - 3,000	4.50	4,000 - 6,000
3,000 - 4,000	5.00	6,000 - 8,000
4,000 - 6,000	6.50	8,000 - 12,000
6,000 - 10,000	7.50	12,000 - 20,000
10,000 - 20,000	8.50	20,000 - 40,000
20,000 - 28,000	9.50	40,000 - 56,000
28,000 - 40,000	10.00	56,000 - 80,000
40,000 - 60,000	10.50	80,000 - 120,000
over 60,000	11.00	over 120,000

Since the standard deduction is used most extensively by low-income taxpayers, increasing its value provides the largest benefit to those people. In addition, the bracket widening will also have the largest impact on low- and middle-income filers. Table 5 shows that the income tax relief is largest for lower income taxpayers and smallest for high-income filers.

TABLE 5: TAX LIABILITY FOR FAMILY OF FOUR UNDER PRESENT AND PROPOSED INCOME TAX STRUCTURES, 1984

	Present	Proposed	% Change
LOW-INCOME FAMILY:			
Adjusted Gross Income	\$ 7,438	\$ 7,438	
Personal Exemption	4,000	4,000	
Standard or Itemized Deduction	1,228	3,400*	176.9
Taxable Income	2,210	38	-98.3
Income Tax	64	1	-98.4
MIDDLE-INCOME FAMILY:			
Adjusted Gross Income	44,429	44,429	
Personal Exemption	4,000	4,000	
Standard or Itemized Deduction	11,436	11,436	
Taxable Income	28,993	28,993	
Income Tax	2,288	1,924	-15.9
HIGH-INCOME FAMILY:			
Adjusted Gross Income	178,004	178,004	
Personal Exemption	4,000	4,000	
Standard or Itemized Deduction	48,393	48,393	
Taxable Income	125,611	125,611	
Income Tax	12,707	11,597	-8.7

*Standard deduction.

Source: Tax Review Commission calculations based on Hawaii Department of Taxation profiles of taxpayers.

Revenue Implications: If both the suggested standard deduction increases and the bracket widening had been enacted in entirety in 1984, the revenue loss would have been \$73 million. Phasing-in the proposed changes reduces the immediate revenue loss. A \$50 million reduction of income tax revenues can be achieved by partially adjusting the standard deduction and/or tax brackets. This maintains the revenue neutrality of the Commission's recommendations.

Recommendation #18:

To enhance the equity of the state individual income tax, the base of the state income tax should be brought into closer conformity with that of the Federal individual income tax. This would help to narrow the growing gap between taxable income and actual economic income received by individuals, thus reversing base erosion.

At a minimum the following types of personal income should be restored to the state individual income tax base consistent with Federal tax treatment: portions of pension income and part of social security benefits of high-income taxpayers. To protect elderly taxpayers from taxes on subsistence income, a double standard deduction should be provided when a single filer reaches age 65 or when either filer reaches 65 for a joint return.

Rationale and Justification: Erosion of the individual income tax base leads to various horizontal and vertical equity problems. Households with the same real or economic income may have widely disparate state income tax liabilities if a larger portion of household economic income is recognized in one case than in the other. Moreover, it is difficult to achieve progressivity if higher income groups are able to shelter or divert economic income into nontaxable forms. Any erosion of the individual tax base means that a higher tax rate has to be applied to the taxable income of all those households that are actually subject to the state individual income tax in order to raise the same amount of revenue. The higher marginal tax rates required by the base erosion may have adverse effects on work effort.

While it is not obvious that the Federal individual income tax base is as broad and free of questionable tax preferences, tax expenditures, and "loopholes" as it should be, the state should aim for the same degree of broadness of tax base achieved by the Federal government as a minimum tax policy goal.

The Federal income tax treatment of social security benefits is to tax one-half of the benefits if the filer has achieved a specific income threshold. That threshold is \$32,000 for those filing a joint return and \$25,000 for those filing a single return. Under federal statutes, pension and annuity benefits are taxable if this income was not previously taxed. Thus pensions paid from accumulated interest and the employers' contribution are taxable. National averages indicate that approximately 88% of pension income is taxable under the federal standard.

The Commission's recommendation reflects its philosophy that income is the appropriate measure of ability to pay taxes, regardless of the source of such income, while at the same time offering protection of subsistence income from taxation. It is inequitable that an elderly taxpayer who relies on interest and property income should be subject to the

income tax while another with equal pension income should escape income taxes entirely.

In addition, by providing an across-the-board exemption for all pension income, benefit is extended to not only the low-income elderly but also high-income retirees. As is demonstrated in Table 6, 62.5% of pension and annuity income accrues to taxpayers who have Federal adjusted gross income of over \$20,000.

TABLE 6: PENSION AND ANNUITY INCOME DISTRIBUTION, U.S. 1982

Size of Adjusted Gross Income	Amount (\$ million)	% of Total Amount	Cumulative %
All returns, total	76,677	100.0	-
under 5,000	2,222	2.9	2.9
5,000 - 10,000	7,379	9.6	12.5
10,000 - 15,000	9,463	12.4	24.9
15,000 - 20,000	9,637	12.6	37.5
20,000 - 75,000	43,866	57.2	94.7
75,000 or over	4,110	5.3	100.0
Mean amount	\$ 7,396		

Source: Internal Revenue Service, Statistics of Income 1982, October 1984, p. 48.

The combined effect of this recommendation and Recommendation #17 lowering tax rates will be to provide substantial income tax relief to many low-to-middle income elderly. The present double exemptions provided by the state combined with the larger and proposed double standard deductions will insure that for a couple who are both at least 65 years old the first \$10,800 of income is not taxed (two standard deductions of \$3,400 each and four exemptions of \$1,000 each). For a single taxpayer 65 years old this threshold is \$6,600 (two standard deductions of \$2,300 each and two exemptions of \$1,000).

Table 7 shows that with these provisions a middle-income retiree who relies on interest and property earnings will not be taxed on social security benefits and will experience a tax reduction on other income. The retiree with only pension income will not be subject to tax on social security income but will be taxed on pension benefits. This tax increase is not large and brings equity to the tax structure in that pension recipients are treated similarly to all other taxpayers.

Revenue Implications: At the proposed new tax rates, if all pension income had been taxed in conformity with Federal treatment, income tax revenues would have increased by \$17 million in 1984. Taxing Social Security benefits consistent with Federal taxability standards would have yielded an additional \$3 million in 1984.

TABLE 7: EFFECTS OF PROPOSED INCOME TAX CHANGES ON HYPOTHETICAL ELDERLY COUPLES

Elderly retired couple earning average social security benefits, interest, and other income:

	Present Law	Proposed Law
Income		
Pension	\$ 0	\$ 0
Social Security	10,776	10,776*
Interest and other inc	15,000	15,000
Adjusted Gross Income	15,000	15,000
Standard Deduction	1,000	6,800
Exemptions	4,000	4,000
Taxable Income	10,000	4,200
Income Tax	582	119

Elderly retired couple earning average social security benefits and pension income:

Income		
Pension	15,000	15,000
Social Security	10,776	10,776*
Interest and other inc	0	0
Adjusted Gross Income	0	15,000
Standard Deduction	1,000	6,800
Exemptions	4,000	4,000
Taxable Income	0	4,200
Income Tax	0	119

*Not included in adjusted gross income since joint return gross income is less than \$32,000.

Recommendation #19:

To provide equity in the State's income tax the conformity between the Hawaii individual income tax and the Federal individual income tax should be further enhanced by the adoption of the Alternative Minimum Income Tax for state purposes. The state minimum tax should be modeled after the Federal Alternative Minimum Tax.

Rationale and Justification: The Federal government has determined that the fair application of the Federal individual income tax to higher income groups requires the use of the Alternative Minimum Tax. This alternative tax becomes applicable to any high income individual taxpayer who would otherwise pay only a small income tax, if any at all, as the result of the combined or cumulative effects of several tax shelters or other tax minimization provisions in the Federal individual income tax code. Given the policy of generally conforming the state individual income tax code to the Federal code, these minimization provisions are available to higher income taxpayers in Hawaii without the state government having the same safeguard against perceived excessive use available to the Federal government, i.e., the Alternative Minimum Tax.

Adoption or adaptation of the Alternative Minimum Tax by Hawaii is consistent with present state tax policy since it would bring about a closer conformity of Hawaii state and federal income tax structures and/or policies. If this logical extension of the state income tax was not utilized, equity

considerations would require that each of the tax expenditures or tax preferences in the state income tax code would have to be reexamined provision by provision at the state level. This would not be as urgent once the Alternative Minimum Tax is used to mitigate or limit abuses or excessive use.

The Commission suggests that the Legislature review for possible adoption a state corporate minimum income tax modelled after that of the Federal government. However, given the uncertain status of Federal corporate income taxation, a state corporate minimum tax should await the resolution of the Federal debate.

Revenue Implications: Increased income tax revenues of \$2 million in 1984 are estimated had rates proportional to that of the Federal Alternative Minimum Tax been used.

Recommendation #20:

To reduce the complexity of the individual income tax the following special interest credits should be allowed to sunset as scheduled or be amended to sunset by 1987 unless specifically extended by the Legislature:

- credit to discourage sales of dangerous items
- credit for regulated investment companies
- solar energy device tax credit (scheduled to sunset Dec. 1985)
- heat pump tax credit (scheduled to sunset Dec. 1985)
- heater insulation tax credit (scheduled to sunset Dec. 1985)
- credit for child care expenses
- child passenger restraint system tax credit
- tax credit for fuel taxes paid by commercial fishers

In addition, the Commission recommends that no further "check-offs", such as that for the Hawaii Election Campaign Fund, be added to the current income tax.

Rationale and Justification: As noted in Recommendation #2, special tax preferences increase the complexity of the tax structure and place added administrative burdens on the Tax Department.

Alternate energy and energy conservation devices are economically justifiable without the state tax credits. The credit merely reduces the payback period on these investments. Since child passenger restraint devices are currently required by law, the credit has no impact on use of these devices other than to lower the cost of obeying the law. The rationale of Recommendations #2 and #14 is applicable here as well. The Legislature should evaluate these preferences taking into consideration that the primary purpose of a tax system is to equitably collect revenues to run the State. Attempting to promote economic and social goals may be better achieved through direct expenditure programs rather than tax preferences.

Revenue Implications: The following revenue losses are estimated for 1984:

- child care = \$2,400,000
- solar energy devices = \$2,200,000
- heat pump = \$228,000
- heater insulation = \$20,000
- child passenger restraint = \$70,000

The other credits listed have negligible revenue implications due to lack of use.

Since the Commission is recommending only legislative review of these credits, no specific revenue gain is presumed from this recommendation.

RECOMMENDATIONS RELATED TO THE CORPORATE NET INCOME TAX

Equity Considerations

Recommendation #21:

The Hawaii corporate income tax brackets should be adjusted to add a greater degree of progressivity to this tax and to offset the effects of inflation on the bracket structure. The table shows the recommended rates and brackets.

PROPOSED CORPORATE NET INCOME TAX RATES	
Taxable Income	Marginal Tax Rate
under \$25,000	2.0%
\$ 25,000 - 100,000	5.0
\$100,000 and over	7.0

Rationale and Justification: The present Hawaii corporate income tax rates are 5.85% on taxable income less than or equal to \$25,000 and 6.435% on amounts above that. This \$25,000 cut-off has been in effect since 1958. The same real value (after inflation) would require the threshold be set at \$85,000.

On the other hand, accelerated depreciation, safe-harbor provisions, and carry-back and forward losses have all contributed to more than offsetting the "bracket creep."

The table above shows how the rate structure can be adjusted to increase the progressivity of the tax while maintaining revenues. This requires higher rates at the upper levels of net income to afford lower rates at the smaller income levels. It should be noted that the Federal income tax offset reduces the effective tax rate increase of the higher income corporations just as it reduces the tax relief felt by lower income corporations.

Revenue Implications: There will be no change in current revenues; however the system is made more elastic by the greater progressivity of the structure.

Revenue Adequacy of the Corporate Income Tax

Recommendation #22:

Hawaii should partially "de-couple" from the federal accelerated depreciation rules (ACRS) by substituting pre-ACRS provisions for real property but not for personal property for purposes of determining both individual as well as corporate taxable income.

Rationale and Justification: The purpose of depreciation is to allow investors to deduct the cost of using capital. Accelerated depreciation rules (sum of the years digits, double declining balance) were adopted by the Federal government to provide an incentive for economic growth through higher profitability of investments. The recently enacted accelerated cost recovery system (ACRS) went even further in part because inflation had increased the replacement cost of capital.

While it is a Federal goal to stimulate economic activity with broadly targeted tax preferences, the primary goal of state taxation is to generate revenues to fund state services.

State conformity to Federal ACRS has contributed to the long-term decline of Hawaii corporate income tax revenues. Partial de-coupling would mitigate that decline and will not have significant adverse effects on rates of return for Hawaii investments.

Eighteen of 45 states that tax corporate income have already de-coupled in full or in part from ACRS.

Complete "de-coupling" from Federal rules would present an undue bookkeeping hardship to taxpayers especially small businesses. Further, accelerated depreciation for personal property changes the timing of taxes but not the eventual total tax liability since the deductions are eventually "recaptured" if the property is sold for more than its depreciated value. On the other hand, real property is allowed an 18 year useful life under ACRS. This is unrealistically low, and since income from such property is taxed at preferential capital gains rates, ACRS provides opportunities to substantially reduce taxes. For these reasons the Commission recommends returning to pre-ACRS depreciation rules for real property only.

Revenue Implications: Over an extended period of time the loss due to ACRS increases as a larger proportion of the capital base is subject to the accelerated depreciation rules. The Commission estimates that this loss will rise to \$20 million per year by 1986 for both individual and corporate taxes combined. Partial de-coupling would offset at least \$2 million of this loss.

Corporate Income Tax Administration

Recommendation #23:

Given the uncertainty regarding the Federal position on worldwide unitary taxation, the State should not adopt such a policy with regard to taxation of multi-state companies operating within several states, including Hawaii. The present policy of allowing either domestic apportionment policy or separate accounting is appropriate. The separate accounting approach for corporations operating in different countries will have to be continued with regard to their foreign operations.

Rationale and Justification: The use of domestic ("waters edge") apportionment taxation is accepted and widely used by other states on the mainland. Given the highly politicized and unsettled nature of the current worldwide unitary taxation controversy, it would be premature to shift state corporate taxation policy in that direction. The appropriate solution would appear to be a strengthening of the present option to allow separate accounting or domestic apportionment by devoting considerably more audit resources to it.

Revenue Implications: Since this recommendation makes no changes, no revenue effect is anticipated.

RECOMMENDATIONS RELATED TO THE PUBLIC SERVICE COMPANY TAX

Revenue Adequacy

Recommendation #24:

Public service companies should be subject to the general excise tax rather than to the in-lieu public service company tax.

The State Constitution should be amended to allow county governments to assess and tax at appropriate property tax rates the real property of public service companies in their jurisdiction.

Rationale and Justification: This change follows from the general Commission recommendation to reduce the complexity of the tax structure and to accordingly rationalize the General Excise Tax. Whatever rationale the public service in-lieu tax might have once had has been lost over the years. No one was able to provide the Commission with a defense of the present exemption of utility property from county property taxes. By applying a uniform general excise tax rate to the gross revenue of the public service companies these firms will be treated as other taxpayers and the administration of the Hawaii gross revenue taxes will be made more uniform.

Another basis for the recommendation is that counties should be permitted to extend and rationalize the property tax which is correctly the primary source of tax revenue at the local level of government in Hawaii. The property tax is still relatively underutilized by local governments in Hawaii as evidenced by various tax effort ratios. However, it is still good public policy to expand the property tax base available to all the counties so that further revenue needs can be satisfied with minimal increases in property tax rates.

For those counties that choose to tax the property of public service companies, this recommendation implies the property tax should displace the Public Utility Franchise Tax (Chapter 240, SLH). However, no change is suggested in the Public Utility Fee (Chapter 269, SLH).

Revenue Implications: In 1984, a 4% excise tax instead of the variable rate public service company tax would have reduced revenues by roughly \$4 million.

In addition, some intermediate purchases by public service companies now taxed at 4% under the present excise tax would qualify for taxation at the lower rate of 1-2% if these companies are taxed under the general excise tax. The resulting revenue loss would be \$2 million in 1984.

Some of the receipts of public service companies with interstate activities may be excluded from the tax base by virtue of the interstate commerce clause of the U.S. Constitution. The estimated lost revenue collections from this could have been \$5 million in 1984.

The total revenue loss associated with this recommendation is thus \$11 million. Some of this revenue would be recovered through the county property tax (which would not accrue to the state).

Recommendation #25:

The State should establish a mechanism (e.g., franchise tax) to insure that commercial airlines (interisland, domestic, and international) pay directly for the privilege of doing business in Hawaii and contribute to the general fund.

Rationale and Justification: As is the case for all businesses, airlines pay taxes indirectly through imbedded taxes on their purchases as well as through the payrolls and expenditures of their employees. However, a recent U.S. Supreme Court decision precludes Hawaii from directly taxing the gross receipts of airlines. This means that unlike all other businesses operating in the state, airlines presently pay no direct tax for the privilege of doing business and thus do not directly contribute to the general fund. The U.S. law which does not allow taxation of gross receipts does, however, permit other forms of taxation, including property taxes and franchise taxes not based on gross receipts.

Revenue Implications: Unknown increase in revenues.

RECOMMENDATIONS RELATED TO OTHER REVENUE SOURCES

Fuel and Liquor Taxes

Recommendation #26:

The Commission recommends that all excise taxes be imposed on an ad valorem basis rather than on a specific amount per unit. This pertains specifically to the wholesale liquor tax but it is also applicable to the fuel tax.

Rationale and Justification: The present difficulties of the Highway Special Fund are at root traceable to the use of a constant, specific amount per gallon tax in a period of

inflation. While inflation pushed up the expenditure requirements of the Highway Special Fund, income was relatively static since the tax revenue did not rise with inflation. Aside from the obvious financial problems, this tax feature has also given rise to serious equity and efficiency problems. Contrary to original tax policy, since the users of the highways are not paying their own way, general fund resources must be diverted from other programs that do not lend themselves to self-finance through user charges or benefit related taxes.

These same equity and efficiency problems arise even when the tax goes into the general fund, as in the case of the liquor wholesale tax. If a fixed, per unit tax rate were used, the users of that product and/or the industry itself would make ever smaller relative contributions to the state treasury as inflation proceeded, even at recent reduced rates. Such a revenue source would not keep up with inflation, and other state taxes would have to be raised to replace the revenue shortfall. These tax policy considerations argue against shifting any present ad valorem tax to a specific per unit basis and in favor of replacing the per unit fuel tax with an ad valorem levy.

Revenue Implications: No change in current revenues. However, future revenue shortfalls would be avoided by increased use of ad valorem taxes.

Taxation of Insurance Companies and Financial Institutions

Recommendation #27:

Firms presently taxed under the insurance premium tax should be required to pay the general excise tax on rentals and other business receipts.

Rationale and Justification: At the present time, insurance companies pay no excise tax on income other than that received from insurance premiums paid in Hawaii. Thus, an insurance company that owns a building, leases space and collects lease rents, pays no tax on the rental income. Any other firm in the same position would pay the 4% general excise tax on rental income. Requiring insurance companies to pay the tax on rental and other income would remove the inequity.

Revenue Implications: The revenue effect cannot be estimated because there is little data available on the receipts of insurance companies, specifically non-domestic (non-Hawaii) firms.

Recommendation #28:

The Commission feels it is appropriate to integrate financial institutions and insurance companies with other business in Hawaii under a single tax code instead of the current in-lieu taxes. However, the complexities of such a change suggest that it should be evaluated in detail, perhaps by a subsequent Commission, before action is taken.

Rationale and Justification: The reason for having separate in-lieu taxes may have lapsed. Insurance companies and financial institutions are participating in activities that go beyond their original activities.

The ramifications of the change suggested above are of such magnitude that careful study is required before changes are made, thus the need for more analysis.

Revenue Implications: This recommendation has no revenue effects.

State Lottery

Recommendation #29:

The State should adopt a lottery to replace revenues lost due to recommended equity and efficiency adjustment.

Rationale and Justification: Currently, 18 states have established lotteries which generate from 0.2% to 4.9% of general revenues. The gross receipts a lottery can generate depend on numerous factors including the population base, the variety of games offered, and the extent to which the games are marketed. Net receipts (the revenues to the state) depend on state law and/or practice. For example, Washington State requires that at least 40% of gross receipts be allocated to the state and at least 45% be awarded in prizes. National trends indicate that the larger the gross receipts, the higher the proportion that can be retained by the state.

There are three types of games under the general heading of "lotteries." One is the so-called "numbers" games whereby a participant selects a number which is entered into a computer. The winning number is selected daily (or weekly). A second class of games comes under the title of "lotteries" wherein a participant purchases a ticket. The winnings can be determined instantaneously (by rubbing off a covering substance to reveal the prize) or by drawings held weekly, monthly or at a time specified at the end of the game. The third form of state lottery is a "lotto." Here a person selects a number which is entered in a computer. The winning number is randomly generated periodically and the game continues until the random number matches one selected by a participant.

Prizes from a lottery usually cost the state less than what is advertised for a game since they are paid out over time. Thus a \$1 million prize may be paid out over 20 years at \$50,000 per year. At a 10% interest rate this could be financed by a \$470,000 annuity.

Those who favor a lottery in Hawaii assert that it is a painless way to generate new revenues and that it can be exported to tourists. Since participants act voluntarily to purchase lottery tickets there is no forced payment to the government (as would be the case for taxes) and thus "no pain." Further, since tourists form a large part of the economic base, their participation increases the extent to which they underwrite the state treasury.

Opponents of the lottery claim that the adverse aspects of a lottery outweigh the revenue gains. In spite of voluntary participation, all studies indicate poorer people are more likely to purchase lottery tickets. Thus the revenue incidence is quite regressive. Tourists make up only 10% of the de facto population. Since tourists already pay 20% of Hawaii's taxes they would have to participate at twice the rate of local residents if the lottery is to be exported in the same proportion as Hawaii's taxes.

Revenue Implications: A Hawaii lottery could have added about \$20 million in 1984 based on national patterns.

MISCELLANEOUS RECOMMENDATIONS

Recommendation #30:

The State tax structure should be carefully monitored to detect any long-term declines in its responsiveness to real or inflationary economic growth.

Rationale and Justification: The empirical studies conducted by the Commission indicate that the long-run elasticity of the tax structure is lower now than was calculated in earlier years. At the present time, the elasticity coefficient at the aggregate tax system is approximately 1.1. That is to say, a 10% increase in state personal income will, in the long-run, result in an 11% increase in tax revenues. This elasticity value is lower than was measured in previous studies but is adequate for the long-term spending needs of the state. However, a decline in the elasticity and the resulting loss in revenue responsiveness could place the state in fiscal stress. While some of the income tax recommendations made by the Commission increase the elasticity of that tax, the responsiveness of the aggregate revenue structure should be monitored to make certain that its long-run revenue adequacy can be maintained.

Revenue Implications: No impact on current revenues is anticipated.

Recommendation #31:

In addition to its current statistical studies of the individual and corporate income taxes, the Tax Department should conduct annual statistical analyses of general excise tax data.

Rationale and Justification: At present the Tax Department conducts annual statistical studies of the individual income tax and biennial analyses of the corporate income tax. Both of these are extremely useful for monitoring the respective tax structures as well as making policy judgments.

Prior to work done at the request of the Tax Review Commission there was little data available about the general excise tax other than aggregate information. It would be helpful if the Tax Department could, on a periodic basis, provide analysis as to the size distribution of general excise taxpayers, the number of separate activities general excise taxpayers report, the relationship between type of general excise tax activity and levels of taxes, etc.

It is difficult to make informed policy judgments without adequate data. Given its importance to the state, the general excise tax, or its successors, should be subject to at least as much ongoing scrutiny as the income tax.

Revenue Implications: This recommendation results in no change in revenues.

APPENDIX

A. Recommendations Scorecard

Key: + => better ; - => worse ; 0 => no change

Recom. #	Thrust	Equity	Revenue Effect	Tax Exporting	Tax Pyramiding	Business Impact
Overall						
1	Digressive incidence	+	-			
2	Limit specific preferences	+	+			
3	Rainy day fund		0			
4	Special funds self supporting		15			
5	Exporting taxes		+	+		
6	Business taxes		0			
7	Uniform preferences		0			+/-
General Excise Tax						
8	Credits to reduce regress	+				
9	Adjust credits for inflation	+	- 7			
10	No change in GET					
11	Exempt some inter-affiliate	+	-	-	+	+
12	Gross up some receipts	+	0	-	+	+
13	Exempt certain exports		-14	-		+
14	Review preferences	+	+			+/-
15	Transient accommodations tax	+	21*	+		-
16	Alternative to room tax	+	**	+		
Individual Income Tax						
17	Adjust for inflation	+	-50			
18	Base broadening	+	20			
19	State minimum tax	+	2			
20	Review credits	+	+			
Corporate Income Tax						
21	Adjust brackets	+	0	-		+
22	Partially decouple from ACRS	+	2	+		-
23	Domestic apportionment	+	0	-		
Public Service Tax						
24	Move PSC under excise tax		-11	-		+
25	Tax airlines		+	+		-
Fuel and Liquor Tax						
26	Ad valorem taxation		0			
Insurance and Financial Inst Tax						
27	Tax other incomes		+			-
28	Study combining with excise tax		+			
Lottery						
29	Adopt	-	20			
Miscellaneous						
30	Monitor elasticity of tax system					
31	Study excise tax regularly					
TOTAL REVENUE EFFECT			- 2			

Notes:

* Assumes no earmarking to new spending

** The tax rate and resident refund can be structured to yield net revenues equal to the room tax

B. Tax Review Commission

The present Commission was appointed by Governor George Ariyoshi in the summer of 1983 and confirmed by the Senate in April 1984. The Commission is chaired by Hideto Kono, former Director of the Department of Planning and Economic Development, and consists of Christopher G. Pablo (Vice Chairman), tax attorney and certified public accountant, Thomas M. Foley, attorney specializing in tax matters, Carole Ann Gibbs, Vice President, Hawaiian Trust Company, Albert S. Nishimura, Senior Vice President of First Hawaiian Bank, Russell K. Okata, Executive Director of the Hawaii Government Employees Association, and Richard Pollock, professor of economics, University of Hawaii.

The Commission's staff is directed by Dr. Jack P. Seyderhoud, professor in the College of Business Administration, University of Hawaii. Drs. Thomas A. Loudat and Prahlad Kasturi are research analysts. Amber A. L. Ling is the word processor operator and Laurie S. Matsuda is the secretary.

C. Technical Advisory Board

To obtain a broad spectrum of technical input the Commission solicited the advice of a group of local and national state-local tax experts. The individuals listed below volunteered their services. They reacted to and critiqued the Commission's research agenda, staff working papers, and/or consultants' reports. The members of the Advisory Board are:

George Freitas, Retired Director of Taxation, State of Hawaii.

Steven D. Gold, Director, State-Local Finance Project, National Conference of State Legislatures, Denver.

Thomas K. Hitch, Retired Senior Vice President and Economist, First Hawaiian Bank.

Robert M. Kamins, Attorney and Emeritus Professor of Economics, University of Hawaii.

Will S. Myers, Director of Economic Analysis, National Education Association, Washington, D.C.

James R. Nunns, Director of Tax Research and Statistics, Department of Revenue, State of New Mexico.

F. John Shannon, Assistant Director, U.S. Advisory Commission on Intergovernmental Relations, Washington, D.C.

Jon David Vasche, Senior Economist, Legislative Analyst's Office, State of California.

D. Consultants' Reports

"Impact of Hawaii's Taxes: A Look at Taxpayer Burden and Equity," Donald Phares, University of Missouri, St. Louis.

"The Hawaii Income Tax: A Case Study of Issues of Tax Base Conformity," William R. Singleton and Janet J. Singleton, Western Washington University.

"An Examination of Horizontal Inequities and Possible Structural Anomalies of the Hawaii General Excise Tax," John L. Mikesell and C. Kurt Zorn, Indiana University.

"Evaluation of Tax Pyramiding and Exporting Through Means of an Input-Output Model," Richard L. Bowen and PingSun Leung, University of Hawaii.

"Detailed Analysis of Tax Exporting," R. Bruce Billings, University of Arizona.

"Detailed Analysis of Tax Pyramiding," R. Bruce Billings, University of Arizona.

"Study Report on the Elasticity of General Fund Taxes," D. Ward Mardfin, Hawaii Loa College.

"Fiscal Projections for the State of Hawaii," Roy Bahl and Dana Weist, Syracuse University.

"Business Taxation in Hawaii: A Comparative Analysis with Policy Simulations," James A. Papke, Purdue University.

"The Incidence and Exportability of Hotel Occupancy and Other Tourist Taxes in Hawaii," Edwin Fujii, Mohammed Khaled, James Mak, University of Hawaii.

A copy of each consulting report is on file at the Hawaii Document Center of the State Library, Honolulu, and at the Hawaiian/Pacific Collection of Hamilton Library, University of Hawaii, Manoa.

E. Staff Working Papers

Working Paper #	Title
1	"Hawaii's Changing Economy: 1960-1980"
2	"A Comparative Review of Hawaii's Fiscal System: 1965-1981"
3	"Hawaii Government Revenue Trends"
4	"Hawaii Government Expenditure Trends"
5	"Inflation and Hawaii Income Taxes"
6	"Judgmental Issues Related to Tax Equity: Tax Incidence and Funding Methods"
7	"A Primer on Pyramiding"
8	"Revenue Diversification: User Charges, Gambling Taxes, and Local Non-Property Taxes"
9	"State Tax Preferences to Stimulate Investment"
10	"Ad Valorem Versus Per Unit Tax on Liquor"
11	"Special Issues of the Hawaii Income Tax"
12	"Results of the Transient Accommodations Tax Survey"
13	"Results of a Survey of Non-Profit Organizations on Oahu"

A copy of each working paper is on file at the Hawaii Document Center of the State Library, Honolulu, and at the Hawaiian/Pacific Collection of Hamilton Library, University of Hawaii, Manoa.



LEGISLATIVE FINANCE PAPERS



NATIONAL CONFERENCE OF STATE LEGISLATURES
FISCAL AFFAIRS PROGRAM
1125 SEVENTEENTH STREET, 15TH FLOOR
DENVER, COLORADO 80202

(303) 292-6600

STATE AND LOCAL TAX SYSTEMS IN THE MID-1980s

Legislative Finance Paper #52

Steven D. Gold
Director of Fiscal Studies
National Conference of State Legislatures
1050 17th Street, Suite 2100
Denver, Colorado 80265

February 1986

ISDN# 1-55516-052-2

This report was prepared by NCSL's Fiscal Federalism Project, funded by a grant from the Ford Foundation. The views expressed are the author's and not necessarily those of NCSL or the Ford Foundation.

TABLE OF CONTENTS

I. State and Local Tax Revenue In Fiscal Year 1984.	2
II. State and Local Tax Revenue In Fiscal Year 1985.	6
III. Tax Changes Not Reflected Yet In Statistics Reported	16
IV. Changes In Tax Levels During The Past 15 Years	18
V. Personal Income Taxes On The Defensive	22
Recent Income Tax Trends	22
Analysis of Income Tax Policy Options.	28
Effect on the Economy.	28
Distribution of Tax Burdens.	30
Effect on State Revenue.	32
VI. The Outlook.	32

LIST OF TABLES

1. State-Local Tax Revenue Per \$100 of Personal Income, FY1984.	3
2. State and Local Tax Revenue Per \$100 of Personal Income, Fiscal Year 1985 Estimates	7
3. Composition of State Tax Revenue, Fiscal Year 1985	10
4. State Tax Revenue Per \$100 of Personal Income, Fiscal Year 1985	11
5. State and Local Tax Revenue Per \$100 of Personal Income, 1970 to 1985	19
6. Tax Revenue Per \$100 of Personal Income, Selected Taxes, Selected Years	21
7. Marginal Tax Rates For State Personal Income Taxes, Joint Returns, 1986.	26
8. Rankings of State-Local Tax Revenue Per Capita and Per \$100 of Personal Income, 1984.	37

Executive Summary

This report describes the level and composition of state and local tax revenue in fiscal years 1984 and 1985 and discusses state sales and income tax changes legislated in calendar year 1985. It focuses particularly on recent reductions in personal income taxes and discusses some of the policy issues raised by these tax cuts.

1. State-local taxes per \$100 of personal income in FY1984 are compared for each state. Tax levels vary considerably, with the highest state having more than three times as much revenue as the lowest state. Trade-offs exist between state and local taxes, and states that have high taxes at one level often have low taxes at the other level.
2. State tax revenue in FY1985 is estimated using Census Bureau data and compared on the basis of its relation to personal income. To obtain an estimate of state-local tax levels, it is assumed that local revenue grew in proportion to personal income. For six major state taxes, the 10 highest and 10 lowest states are noted. State taxes per \$100 of personal income fell in 32 states between 1984 and 1985. On the average, local taxes also fell relative to personal income, but data for individual states are not available.
3. Fourteen states lowered their personal income taxes in calendar year 1985 and one lowered its sales tax. One state raised its income tax and one its sales tax.
4. State-local tax structures changed considerably during the period between 1970 and 1985. The personal income tax increased significantly, and the property tax was de-emphasized. State taxes rose as a proportion of personal income while local taxes decreased as a proportion of personal income. In total, state-local tax revenue per \$100 of personal income fluctuated considerably but ended the period close to where it began.
5. Most of the calendar year 1985 income tax cuts represented rollbacks of increases enacted in 1982 and 1983 when states were battling fiscal problems. Concern about economic development also motivated some income tax reductions, particularly in states with high marginal and effective tax rates. The effect of these tax cuts was to make state-local tax systems more regressive. Particular attention is focused on the states with high marginal income tax rates.

CORRECTION

**THIS DOCUMENT
HAS BEEN REPHOTOGRAPHED
TO ASSURE LEGIBILITY**

TABLE OF CONTENTS

I.	State and Local Tax Revenue In Fiscal Year 1984.	2
II.	State and Local Tax Revenue In Fiscal Year 1985.	6
III.	Tax Changes Not Reflected Yet In Statistics Reported	16
IV.	Changes In Tax Levels During The Past 15 Years	18
V.	Personal Income Taxes On The Defensive	22
	Recent Income Tax Trends	22
	Analysis of Income Tax Policy Options.	28
	Effect on the Economy.	28
	Distribution of Tax Burdens.	30
	Effect on State Revenue.	32
VI.	The Outlook.	32

LIST OF TABLES

1.	State-Local Tax Revenue Per \$100 of Personal Income, FY1984.	3
2.	State and Local Tax Revenue Per \$100 of Personal Income, Fiscal Year 1985 Estimates	7
3.	Composition of State Tax Revenue, Fiscal Year 1985	10
4.	State Tax Revenue Per \$100 of Personal Income, Fiscal Year 1985	11
5.	State and Local Tax Revenue Per \$100 of Personal Income, 1970 to 1985	19
6.	Tax Revenue Per \$100 of Personal Income, Selected Taxes, Selected Years	21
7.	Marginal Tax Rates For State Personal Income Taxes, Joint Returns, 1986.	26
8.	Rankings of State-Local Tax Revenue Per Capita and Per \$100 of Personal Income, 1984.	37

LIST OF APPENDICES

A.	Per Capita Versus Personal Income Measures	.36
B.	Tax Versus General Revenue Measures.	.38
C.	Recent Income Tax Changes.	.40

Executive Summary

This report describes the level and composition of state and local tax revenue in fiscal years 1984 and 1985 and discusses state sales and income tax changes legislated in calendar year 1985. It focuses particularly on recent reductions in personal income taxes and discusses some of the policy issues raised by these tax cuts.

1. State-local taxes per \$100 of personal income in FY1984 are compared for each state. Tax levels vary considerably, with the highest state having more than three times as much revenue as the lowest state. Trade-offs exist between state and local taxes, and states that have high taxes at one level often have low taxes at the other level.
2. State tax revenue in FY1985 is estimated using Census Bureau data and compared on the basis of its relation to personal income. To obtain an estimate of state-local tax levels, it is assumed that local revenue grew in proportion to personal income. For six major state taxes, the 10 highest and 10 lowest states are noted. State taxes per \$100 of personal income fell in 32 states between 1984 and 1985. On the average, local taxes also fell relative to personal income, but data for individual states are not available.
3. Fourteen states lowered their personal income taxes in calendar year 1985 and one lowered its sales tax. One state raised its income tax and one its sales tax.
4. State-local tax structures changed considerably during the period between 1970 and 1985. The personal income tax increased significantly, and the property tax was de-emphasized. State taxes rose as a proportion of personal income while local taxes decreased as a proportion of personal income. In total, state-local tax revenue per \$100 of personal income fluctuated considerably but ended the period close to where it began.
5. Most of the calendar year 1985 income tax cuts represented rollbacks of increases enacted in 1982 and 1983 when states were battling fiscal problems. Concern about economic development also motivated some income tax reductions, particularly in states with high marginal and effective tax rates. The effect of these tax cuts was to make state-local tax systems more regressive. Particular attention is focused on the states with high marginal income tax rates.

State tax systems have been volatile over the past several years. Most states raised taxes in 1982 or 1983 in response to severely depressed fiscal conditions, but many of those tax increases expired or were repealed in 1984 and 1985.¹ Due to these changes, the relative tax levels of some states have changed considerably. The role of the personal income tax has been reduced as a result of tax cuts during the past two years.

This report draws upon the latest available data to describe state and local tax systems. This material is of interest to legislators and others concerned about state tax policy because comparisons with other states are frequently a consideration when new tax policy initiatives are under consideration. It consists of five sections:

- o State and local tax revenue in fiscal year 1984 as reported by the U.S. Census Bureau.
- o State and local tax revenue in fiscal year 1985 as estimated by the National Conference of State Legislatures, including detailed data on state tax revenue.
- o A review of tax changes not reflected in the statistics yet, primarily because they were passed during calendar year 1985.
- o Changes in state and local tax revenue from fiscal years 1970 to 1985.
- o Changes in state personal income taxes during calendar years 1984 and 1985, focusing particularly on reductions in marginal tax rates on high income taxpayers.

The first four sections are primarily descriptive, but the fifth section, on the personal income tax, includes not only a description of recently enacted changes, but also a discussion of policy issues.

I. STATE AND LOCAL TAX REVENUE IN FISCAL YEAR 1984

State and local government taxes amounted to 11.7 percent of personal income in fiscal year 1984, but wide differences existed from state to state in both the level and structure of the tax system. Table 1 shows tax collections for each state in total and for state and local governments separately.

Great care is needed if these data are not to be misinterpreted. For example, Alaska has the highest tax collections--equal to more than 28 percent of personal income--because of the taxes paid by oil companies, which contribute close to 90 percent of tax revenue. The taxes actually paid by Alaska residents are lower than those in any other state. Another fallacy is to assume that the lower the tax burden, the better. Low-tax states often have low levels of services. States differ greatly in how their citizens assess the trade-off between tax and service levels.

A third source of misunderstanding arises because of the passage of time. Fiscal year 1984 ended nearly 18 months ago in most states. The following section contains estimates of more up-to-date data on tax levels.

Comparisons of state tax levels sometimes ignore local taxes because data on state taxes are more readily accessible, but Table 1 shows that this can cause a serious misreading of the tax situation. For example, Delaware had the eighth highest level of state taxes (9.29 percent of income) but the lowest local taxes, so its combined state-local taxes were moderate, ranking 26th. New Hampshire had the lowest state taxes but the fifth highest local

Table 1

STATE-LOCAL TAX REVENUE PER \$100 OF PERSONAL INCOME, FY1984
 (Rank in Parentheses: 1 is highest, 50 is lowest)

<u>State</u>	<u>Combined</u>	<u>State</u>	<u>Local</u>
NEW ENGLAND			
Connecticut	\$11.17 (27)	\$6.60 (38)	\$4.57 (18)
Maine	12.59 (12)	8.16 (15)	4.43 (20)
Massachusetts	11.75 (19)	7.63 (23)	4.12 (25)
New Hampshire	9.26 (49)	3.67 (50)	5.59 (5)
Rhode Island	12.10 (14)	7.26 (28)	4.84 (12)
Vermont	12.86 (10)	7.88 (19)	4.98 (10)
MID-ATLANTIC			
Delaware	11.18 (26)	9.29 (8)	1.89 (50)
Maryland	11.69 (20)	7.06 (31)	4.63 (16)
New Jersey	11.67 (21)	6.77 (35)	4.90 (11)
New York	16.46 (3)	8.20 (14)	8.26 (1)
Pennsylvania	11.44 (24)	7.05 (32)	4.39 (21)
GREAT LAKES			
Illinois	11.35 (25)	6.11 (40)	5.24 (8)
Indiana	10.47 (38)	7.04 (33)	3.43 (35)
Michigan	13.75 (5)	8.24 (12)	5.51 (6)
Ohio	11.12 (28)	6.63 (37)	4.49 (19)
Wisconsin	13.75 (6)	9.49 (7)	4.26 (24)
PLAINS			
Iowa	11.91 (17)	7.21 (29)	4.70 (14)
Kansas	10.34 (39)	6.03 (42)	4.31 (23)
Minnesota	14.39 (4)	10.28 (3)	4.11 (26)
Missouri	9.30 (48)	5.60 (46)	3.70 (32)
Nebraska	11.05 (30)	5.97 (43)	5.08 (9)
North Dakota	11.53 (23)	8.62 (10)	2.91 (39)
South Dakota	10.02 (43)	5.21 (49)	4.81 (13)
SOUTHEAST			
Alabama	9.99 (44)	7.39 (24)	2.60 (44)
Arkansas	9.74 (45)	7.38 (25)	2.36 (48)
Florida	9.51 (47)	5.92 (44)	3.59 (34)
Georgia	10.53 (37)	6.65 (36)	3.88 (30)
Kentucky	10.18 (40)	8.02 (16)	2.16 (49)
Louisiana	10.91 (31)	6.87 (34)	4.04 (29)
Mississippi	10.80 (32)	8.31 (11)	2.49 (46)
North Carolina	10.64 (34)	7.79 (20)	2.85 (41)
South Carolina	10.79 (33)	7.95 (18)	2.84 (42)
Tennessee	9.26 (50)	5.61 (45)	3.65 (33)
Virginia	10.14 (41)	6.05 (41)	4.09 (27)
West Virginia	12.07 (15)	9.52 (6)	2.55 (45)
SOUTHWEST			
Arizona	12.05 (16)	8.00 (17)	4.05 (28)
New Mexico	12.60 (11)	10.21 (4)	2.39 (47)
Oklahoma	10.57 (36)	7.36 (26)	3.21 (37)
Texas	9.71 (46)	5.35 (47)	4.36 (22)
ROCKY MOUNTAIN			
Colorado	10.62 (35)	5.32 (48)	5.30 (7)
Idaho	10.10 (42)	7.27 (27)	2.83 (43)
Montana	12.93 (8)	7.18 (30)	5.75 (4)
Utah	12.86 (9)	8.22 (13)	4.64 (15)
Wyoming	20.89 (2)	13.08 (2)	7.81 (2)
FAR WEST			
Alaska	28.56 (1)	23.95 (1)	4.61 (17)
California	11.54 (22)	7.68 (22)	3.86 (31)
Hawaii	12.93 (7)	10.07 (5)	2.86 (40)
Nevada	11.11 (29)	7.76 (21)	3.35 (36)
Oregon	12.35 (13)	6.47 (39)	5.88 (3)
Washington	11.76 (18)	8.67 (9)	3.09 (38)
TOTAL	\$11.71	\$7.22	\$4.49

Source: U.S. Census Bureau, Government Finances in 1983-84 (Washington, DC: U.S. Government Printing Office, 1985).

taxes. (It and Alaska are the only states with neither a personal income nor a general sales tax.) While its state taxes were half of the national average, its state-local taxes were only 21 percent below average.

A trade-off frequently exists between state and local taxes--if one is particularly high, the other tends to be relatively low, and vice versa. Thirteen states have rankings for state taxes at least 20 places higher than for local taxes. In the following list, the state rank is given first and the local rank second:

	<u>State</u>	<u>Local</u>
Minnesota	3	26
New Mexico	4	47
Hawaii	5	40
West Virginia	6	45
Delaware	8	50
Washington	9	38
North Dakota	10	39
Mississippi	11	46
Kentucky	16	49
South Carolina	18	42
North Carolina	20	41
Alabama	24	44
Arkansas	25	48

Ten states have much higher local than state taxes:

	<u>State</u>	<u>Local</u>
New Hampshire	50	5
South Dakota	49	13
Colorado	48	7
Texas	47	22
Nebraska	43	9
Illinois	40	8
Oregon	39	3
Connecticut	38	18
New Jersey	35	11
Montana	30	4

Not many states manage to have consistently low or high rankings for both state and local taxes. Only four states are among the 20 lowest at both levels of government--Florida, Indiana, Missouri, and Tennessee. Seven

are among the 20 highest at both levels--Alaska, Maine, Michigan, New York (with the highest local taxes because of New York City), Utah, Vermont, and Wyoming.

The ten states with the highest levels of taxes as a proportion of personal income were Alaska, Wyoming, New York, Minnesota, Michigan, Wisconsin, Hawaii, Montana, Utah, and Vermont. The ten states with the lowest tax levels were Tennessee, New Hampshire, Missouri, Florida, Texas, Arkansas, Alabama, South Dakota, Idaho, and Virginia.

A few regional patterns exist. New England and Far West states tend to have above-average tax levels. Southeast taxes are all below average except for West Virginia.

This analysis has focused on tax revenue per \$100 of personal income as an indicator of tax levels. Two alternatives which are sometimes used are discussed in appendices to this report. Appendix A compares per capita tax revenue measures with measures based on personal income. As it indicates, high-income states rank higher on per capita measures than income measures, while low-income states rank lower. Appendix B compares general revenue measures with tax measures. General revenue measures include fees, charges, and miscellaneous revenue as well as tax revenue. While some non-tax revenue burdens citizens in the same way as taxes and serves as a substitute for taxes, other non-tax revenue such as interest received is not burdensome to citizens in the same sense. Levels of non-tax revenue are often strongly influenced by the nature of activities undertaken, such as the magnitude of higher education and hospital programs.

II. STATE AND LOCAL TAX REVENUE IN FISCAL YEAR 1985

Table 2 presents NCSL estimates of state and local tax levels in 1985. These figures were derived from Census Bureau and other federal statistical sources. They provide a good indication of the tax levels that the Census Bureau will report in approximately November 1986. It should be understood, however, that these estimates are not as accurate as the Census Bureau's ultimate reports will be. They are presented here because of their timeliness--approximate 1985 data are more significant than precise 1984 data.²

The second column of Table 2 shows state tax revenue per \$100 of personal income for the year ending in June 1985. For 46 states that period coincides with fiscal year 1985. Texas (August 31), Michigan (September 30), and Alabama (September 30) have fiscal years ending later, while New York ends its fiscal year earlier (March 31).

The third column of Table 2 shows local tax revenue per \$100 of personal income for fiscal year 1984 (that is, the same number as in Table 1), the latest period for which state-by-state local data are available. If local tax revenue rose in proportion to personal income during fiscal year 1985, then local revenue per \$100 of personal income would be the same for fiscal year 1984 and fiscal year 1985. Unfortunately, no reliable data are available yet on local tax revenue by state in fiscal year 1985. In the aggregate, local taxes rose 6.6 percent during the year ending in June 1985, somewhat slower than the state tax increase during the relevant period (8.8 percent), and considerably less than personal income rose (10.4 percent).

The estimates in Table 2 rely on the assumption that the relative levels of local tax revenue per \$100 of personal income did not change much between

Table 2

**STATE AND LOCAL TAX REVENUE PER \$100 OF PERSONAL INCOME
FISCAL YEAR 1985 ESTIMATES**
(Rank in parentheses: 1 is highest, 50 is lowest)

<u>State</u>	<u>Combined</u>	<u>State</u>	<u>Local</u>	<u>Percentage Change, State, 1984-1985</u>
NEW ENGLAND				
Connecticut	\$11.33 (23)	\$ 6.76 (33)	\$ 4.57 (18)	2.42
Maine	12.48 (10)	8.05 (14)	4.43 (20)	-1.35
Massachusetts	11.83 (17)	7.71 (22)	4.12 (25)	1.05
New Hampshire	9.08 (50)	3.49 (50)	5.59 (3)	-4.90
Rhode Island	11.92 (16)	7.08 (30)	4.84 (12)	-2.48
Vermont	13.00 (7)	8.02 (15)	4.98 (10)	1.78
MID ATLANTIC				
Delaware	11.14 (26)	9.25 (7)	1.89 (50)	-4.43
Maryland	11.50 (21)	6.87 (32)	4.63 (16)	-2.69
New Jersey	11.54 (20)	6.64 (36)	4.90 (11)	-1.92
New York	16.72 (3)	8.46 (9)	8.26 (1)	3.17
Pennsylvania	11.32 (24)	6.93 (31)	4.39 (21)	-1.70
GREAT LAKES				
Illinois	11.02 (28)	5.78 (43)	5.24 (8)	-5.40
Indiana	10.17 (39)	6.74 (34)	3.43 (35)	-4.26
Michigan	12.61 (9)	7.10 (29)	5.51 (6)	-13.83
Ohio	10.76 (31)	6.27 (39)	4.49 (19)	-5.43
Wisconsin	12.25 (14)	7.99 (16)	4.26 (24)	-15.81
PLAINS				
Iowa	11.21 (25)	6.51 (37)	4.70 (14)	-9.71
Kansas	10.24 (37)	5.93 (42)	4.31 (23)	-1.66
Minnesota	13.60 (4)	9.49 (6)	4.11 (26)	-7.68
Missouri	9.24 (48)	5.54 (46)	3.70 (32)	-1.07
Nebraska	10.23 (38)	5.15 (48)	5.08 (9)	-13.74
North Dakota	11.11 (27)	8.20 (12)	2.91 (39)	-4.87
South Dakota	10.13 (40)	5.32 (47)	4.81 (13)	2.11
SOUTHEAST				
Alabama	9.84 (46)	7.24 (28)	2.60 (44)	-2.03
Arkansas	9.89 (45)	7.53 (24)	2.36 (48)	2.03
Florida	9.24 (48)	5.65 (44)	3.59 (34)	-4.56
Georgia	10.58 (33)	6.70 (35)	3.88 (30)	.75
Kentucky	10.04 (43)	7.88 (17)	2.16 (49)	-1.75
Louisiana	11.80 (18)	7.76 (19)	4.04 (29)	12.97
Mississippi	10.57 (34)	8.08 (13)	2.49 (46)	-2.77
North Carolina	10.61 (32)	7.76 (18)	2.85 (41)	-.39
South Carolina	10.40 (36)	7.56 (23)	2.84 (42)	-4.91
Tennessee	9.82 (47)	6.17 (40)	3.65 (33)	9.98
Virginia	10.07 (42)	5.98 (41)	4.09 (27)	-1.16
West Virginia	12.38 (11)	9.83 (4)	2.55 (45)	3.26
SOUTHWEST				
Arizona	12.38 (11)	8.33 (10)	4.05 (28)	4.13
New Mexico	12.19 (15)	9.80 (5)	2.39 (47)	-4.02
Oklahoma	10.94 (29)	7.73 (21)	3.21 (37)	5.03
Texas	9.94 (44)	5.58 (45)	4.36 (22)	4.30
ROCKY MOUNTAIN				
Colorado	10.42 (35)	5.12 (49)	5.30 (7)	-3.76
Idaho	10.10 (41)	7.27 (27)	2.83 (43)	.00
Montana	13.11 (6)	7.36 (26)	5.75 (4)	2.51
Utah	13.46 (5)	8.82 (8)	4.64 (15)	7.30
Wyoming	20.92 (2)	13.11 (2)	7.81 (2)	.23
FAR WEST				
California	11.61 (19)	7.75 (20)	3.86 (31)	.91
Nevada	10.86 (30)	7.51 (25)	3.35 (36)	-3.22
Oregon	12.29 (13)	6.41 (38)	5.88 (3)	-.93
Washington	11.37 (22)	8.28 (11)	3.09 (38)	-4.50
Alaska	26.19 (1)	21.58 (1)	4.61 (17)	-9.90
Hawaii	12.92 (8)	10.06 (3)	2.86 (40)	-1.10
U.S. TOTAL	11.57	7.08	4.49	-1.94

Note: State taxes for year ending June 1985. Local taxes per \$100 assumed to be the same in 1985 as in 1984.

Sources:

U.S. Census Bureau, Quarterly Summary of Federal, State, and Local Tax Revenue: April-June, 1985 (Washington, D.C.: Government Printing Office, 1985), p. 10.

U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business 65, No. 8 (August 1985): 18.

U.S. Census Bureau, Governmental Finances in 1983-84 (Washington, D.C.: U.S. Government Printing Office, October 1985), p. 81.

U.S. Census Bureau, State Government Finances in 1984 (Washington, D.C.: U.S. Government Printing Office, September 1985), p. 49.

1984 and 1985. The assumption appears reasonable for most states, although some states may have changed their relative position considerably between the two years. Since local tax revenue in total rose at a slower rate than personal income, the table overstates actual tax revenue per \$100 of personal income. If local taxes in a particular state are known to have risen significantly more or less than 6.6 percent in fiscal year 1985, that should be taken into account in using these estimates.

The first column of Table 2 shows the estimated total tax level in fiscal year 1985, which was computed by adding together the next two columns. The 1985 total tax level is considerably different from the 1984 tax level in a number of states. Since any change from 1984 to 1985 results from fluctuations of state taxes, the fourth column of the table shows the percentage change in state taxes between the two years.

Tax level decreases predominate, with 32 states having lower taxes per \$100 of personal income in 1985 than in 1984. The largest decreases were in Wisconsin (15.8 percent), Michigan (13.8 percent), Nebraska (13.7 percent), Alaska (9.9 percent), and Iowa (9.7 percent). The first two states lowered tax rates, while the latter two had weak economies (Alaska due to oil price decreases and Iowa due to agriculture). In Nebraska, both factors contributed to the decrease. Regionally, the Middle Atlantic, Great Lakes, Plains, and Far West states tended to have decreases. Only three of the 23 states in these regions did not have a lower tax level (California, New York, and South Dakota).

The largest increases were primarily in states that increased tax rates in 1984. Louisiana (13 percent), South Carolina (10 percent), Utah (7.3 percent), and Oklahoma (5 percent) had the biggest percentage increases.

The Southwest and Rocky Mountain regions both had majorities of states with higher tax levels.

Tables 3 and 4 provide additional details about how state tax systems differed during the year ending in June 1985, disaggregating state (but not local) tax revenue into eight categories. Table 3 shows the percentage composition of state tax revenue, and Table 4 indicates revenue per \$100 of personal income. The general sales and personal income taxes are clearly the mainstays of most state tax systems, accounting for 61.9 percent of total state tax revenue. But the energy-producing states are exceptions to the general pattern. Eight states obtain at least one-fifth of their revenue from severance taxes (Alaska, Louisiana, Montana, New Mexico, North Dakota, Oklahoma, Texas, and Wyoming). This is indicated by the high proportion of revenue from "other" taxes in the last column of Table 3. What this implies is that one cannot simply assume that data on tax levels such as those presented here are related to tax burdens on citizens. States differ in terms of their ability to export taxes to nonresidents. In particular, although Alaska and Wyoming have the highest levels of tax collections per \$100 of personal income, they actually have the lowest average tax burdens on their own citizens.

According to Table 4, the sales tax (including gross receipts taxes) produced more revenue than the personal income tax in 26 states, while the personal income tax generated more revenue in 22 states. Alaska and New Hampshire have neither a sales nor a broad-based income tax.³

Following is a description of which states have the highest and lowest tax levels for each tax. Numerous qualifications should be considered in reviewing this information. 1) The data are only for state taxes, although

Table 3

**COMPOSITION OF STATE TAX REVENUE
FISCAL YEAR 1985
(Percent of total)**

<u>State</u>	<u>Sales</u>	<u>Motor Fuel</u>	<u>Tobacco</u>	<u>Alcohol</u>	<u>Personal Income</u>	<u>Corp. Income</u>	<u>Motor Vehicle Regis.</u>	<u>Other</u>
NEW ENGLAND								
Connecticut	43.6	6.0	2.6	.9	8.6	14.8	3.1	20.4
Maine	35.2	8.8	2.9	3.1	29.5	5.3	4.7	10.4
Massachusetts	21.8	4.2	2.7	1.3	47.8	13.2	2.2	6.8
New Hampshire	.0	14.2	7.4	2.4	5.4	22.9	9.4	38.4
Rhode Island	31.6	5.3	3.3	.9	32.8	8.8	2.7	14.7
Vermont	19.2	8.1	2.8	3.1	31.6	7.4	6.5	21.3
MID ATLANTIC								
Delaware	.0	4.7	1.6	.7	45.9	9.9	4.4	32.8
Maryland	25.4	6.9	1.5	.7	40.9	5.7	2.3	16.6
New Jersey	29.4	4.1	2.8	.8	25.1	11.9	3.9	22.0
New York	20.3	1.9	2.0	.8	50.8	8.8	2.4	13.0
Pennsylvania	29.7	6.1	2.4	1.3	25.5	9.3	4.1	21.7
GREAT LAKES								
Illinois	34.6	6.6	1.8	.8	28.3	7.7	6.3	13.8
Indiana	48.7	7.7	1.8	1.0	29.7	4.1	2.7	4.4
Michigan	29.4	7.5	1.6	1.1	34.7	15.3	3.8	6.6
Ohio	30.7	7.5	2.2	.8	33.4	5.2	4.0	16.1
Wisconsin	27.7	7.1	2.9	.9	38.9	8.7	2.8	10.9
PLAINS								
Iowa	32.9	7.9	2.6	.6	35.8	6.7	5.6	8.0
Kansas	28.6	7.8	2.3	2.3	31.5	8.3	4.2	15.1
Minnesota	25.7	6.7	1.6	1.0	42.7	7.3	4.8	10.2
Missouri	42.2	6.2	2.4	.7	31.5	4.8	5.2	7.0
Nebraska	32.1	12.4	2.8	1.3	31.0	4.8	5.2	10.4
North Dakota	27.0	8.1	1.8	.9	11.0	12.1	4.9	34.4
South Dakota	52.6	17.3	2.5	2.2	.0	3.7	7.0	14.7
SOUTHEAST								
Alabama	27.9	8.8	2.5	3.2	24.1	7.2	1.6	24.8
Arkansas	39.8	8.6	3.6	1.4	27.2	7.5	4.3	7.6
Florida	54.2	7.8	3.6	5.3	.0	5.8	4.4	18.9
Georgia	34.0	8.5	2.0	2.4	38.0	9.3	1.6	4.1
Kentucky	27.1	6.5	.6	1.6	25.7	7.0	3.2	28.2
Louisiana	31.6	9.4	2.3	1.9	13.8	7.5	1.5	31.9
Mississippi	51.9	8.1	2.0	1.8	13.6	6.9	2.9	12.7
North Carolina	22.3	7.8	.3	2.4	39.0	9.4	4.2	14.6
South Carolina	32.5	9.8	1.2	4.0	33.7	7.9	2.2	8.7
Tennessee	57.6	9.5	2.6	2.0	2.0	8.6	4.6	13.0
Virginia	20.8	7.3	.4	2.1	43.5	6.4	4.5	14.9
West Virginia	42.9	8.5	1.9	.5	27.1	5.4	3.4	10.4
SOUTHWEST								
Arizona	46.8	7.5	2.0	1.3	20.2	6.7	5.1	10.4
New Mexico	42.1	7.3	1.0	1.1	5.9	4.5	3.0	35.1
Oklahoma	21.2	6.4	2.6	1.4	24.5	3.5	6.5	33.9
Texas	36.9	8.1	3.3	2.9	.0	.0	4.9	44.0
ROCKY MOUNTAIN								
Colorado	33.6	8.3	1.6	1.1	40.4	4.3	3.2	7.6
Idaho	32.5	10.8	1.4	1.3	35.2	5.8	4.5	8.6
Montana	.0	12.7	2.1	2.2	28.3	9.8	4.5	40.4
Utah	45.2	7.9	.9	1.0	30.8	3.7	2.4	8.0
Wyoming	22.3	4.9	.6	.2	.0	.0	4.0	68.1
FAR WEST								
California	33.7	4.0	.9	.5	37.4	12.7	2.1	8.7
Nevada	50.3	8.2	2.2	1.4	.0	.0	4.8	33.1
Oregon	.0	6.0	2.9	.5	65.9	7.7	7.6	9.4
Washington	57.7	8.1	2.1	2.2	.0	.0	3.0	26.8
Alaska	.0	1.9	.3	.7	.1	10.8	.8	85.3
Hawaii	50.1	2.6	1.4	1.6	31.5	3.6	.7	8.5
Dist. Columbia	22.5	1.7	.6	.5	27.2	7.1	1.1	39.4
U.S. TOTAL	32.1	6.2	2.0	1.4	29.8	8.2	3.5	16.7

Note: Figures for Alabama, Michigan, New York, and Texas are approximations because their fiscal years do not end on June 30, and these figures are for the 12 months ending on that date.

Sources:

U.S. Census Bureau, Quarterly Summary of Federal, State and Local Tax Revenue, April-June 1985 (Washington, D.C.: U.S. Government Printing Office, 1985), pp. 10-13.

U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business 65, No. 8 (August 1985): 18.

Table 4

**STATE TAX REVENUE PER \$100 OF PERSONAL INCOME
FISCAL YEAR 1985**

STATE	Total	Sales	Motor Fuel	Tobacco	Alcohol	Personal Income	Corp. Income	Motor Vehicle Regis.	Other
NEW ENGLAND									
Connecticut	6.76	2.95	.41	.17	.06	.58	1.00	.21	1.38
Maine	8.05	2.83	.71	.23	.25	2.38	.43	.38	.84
Massachusetts	7.71	1.68	.33	.21	.10	3.69	1.02	.17	.53
New Hampshire	3.49	.00	.50	.26	.08	.19	.80	.33	1.34
Rhode Island	7.08	2.24	.37	.24	.06	2.32	.62	.19	1.04
Vermont	8.02	1.54	.65	.23	.25	2.54	.59	.52	1.71
MID ATLANTIC									
Delaware	9.25	.00	.43	.15	.06	4.25	.92	.41	3.03
Maryland	6.87	1.75	.47	.11	.05	2.81	.39	.16	1.14
New Jersey	6.64	1.95	.27	.19	.05	1.67	.79	.26	1.46
New York	8.46	1.71	.16	.17	.07	4.30	.74	.20	1.10
Pennsylvania	6.93	2.06	.42	.16	.09	1.77	.64	.29	1.50
GREAT LAKES									
Illinois	5.78	2.00	.38	.10	.04	1.64	.44	.36	.80
Indiana	6.74	3.28	.52	.12	.07	2.00	.28	.18	.30
Michigan	7.10	2.09	.53	.11	.08	2.46	1.09	.27	.47
Ohio	6.27	1.92	.47	.14	.05	2.09	.33	.25	1.01
Wisconsin	7.99	2.22	.57	.23	.07	3.11	.70	.23	.87
PLAINS									
Iowa	6.51	2.14	.52	.17	.04	2.33	.44	.36	.52
Kansas	5.93	1.69	.46	.14	.13	1.87	.49	.25	.85
Minnesota	9.49	2.44	.63	.15	.09	4.05	.70	.45	.97
Missouri	5.54	2.34	.34	.14	.04	1.74	.26	.29	.39
Nebraska	5.15	1.65	.64	.14	.07	1.60	.25	.27	.54
North Dakota	8.20	2.21	.66	.15	.07	.90	1.00	.40	2.82
South Dakota	5.32	2.80	.92	.13	.12	.00	.20	.27	.78
SOUTHEAST									
Alabama	7.24	2.02	.64	.18	.23	1.75	.52	.11	1.80
Arkansas	7.53	3.00	.65	.27	.11	2.05	.57	.32	.57
Florida	5.65	3.06	.44	.20	.30	.00	.33	.25	1.07
Georgia	6.70	2.28	.57	.13	.16	2.55	.62	.11	.27
Kentucky	7.88	2.14	.51	.05	.13	2.03	.55	.25	2.23
Louisiana	7.76	2.45	.73	.18	.15	1.07	.58	.12	2.47
Mississippi	8.08	4.20	.66	.16	.14	1.10	.56	.24	1.02
North Carolina	7.76	1.73	.61	.02	.18	3.03	.73	.32	1.13
South Carolina	7.56	2.46	.74	.09	.31	2.55	.60	.17	.66
Tennessee	6.17	3.55	.59	.16	.12	.13	.53	.28	.80
Virginia	5.98	1.24	.44	.02	.12	2.60	.39	.27	.89
West Virginia	9.83	4.22	.83	.19	.05	2.67	.53	.34	1.02
SOUTHWEST									
Arizona	8.33	3.89	.62	.17	.10	1.63	.56	.43	.87
New Mexico	9.80	4.13	.71	.10	.11	.58	.44	.29	3.44
Oklahoma	7.73	1.64	.50	.20	.11	1.89	.27	.50	2.62
Texas	5.58	2.06	.45	.18	.16	.00	.00	.27	2.45
ROCKY MOUNTAIN									
Colorado	5.12	1.72	.42	.08	.06	2.07	.22	.16	.39
Idaho	7.27	2.36	.79	.10	.09	2.56	.42	.33	.62
Montana	7.36	.00	.94	.16	.16	2.08	.72	.33	2.98
Utah	8.82	3.99	.70	.08	.09	2.72	.32	.22	.71
Wyoming	13.11	2.92	.64	.08	.02	.00	.00	.53	8.92
FAR WEST									
California	7.75	2.61	.31	.07	.04	2.90	.99	.17	.67
Nevada	7.51	3.78	.61	.17	.11	.00	.00	.36	2.49
Oregon	6.41	.00	.38	.19	.04	4.22	.50	.48	.60
Washington	8.28	4.78	.67	.17	.19	.00	.00	.25	2.22
Alaska	21.58	.00	.41	.06	.16	.01	2.34	.18	18.42
Hawaii	10.06	5.05	.26	.15	.16	3.17	.36	.07	.85
Dist. Columbia	14.22	3.19	.24	.09	.07	3.87	1.00	.16	5.60
U.S. TOTAL	7.08	2.27	.44	.14	.10	2.11	.58	.25	1.18

Note: Figures for Alabama, Michigan, New York, and Texas are approximations because their fiscal years do not end on June 30, and these figures are for the 12 months ending on that date.

Sources:

U.S. Census Bureau, *Quarterly Summary of Federal, State, and Local Tax Revenue: April-June 1985* (Washington, D.C.: U.S. Government Printing Office, 1985), pp. 10-13.
U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business* 65, No. 8 (August 1985): 18.

in some cases local taxes are also levied. 2) Revenues obtained depend not only on tax rates but also on consumption patterns, i.e., low revenue could indicate low purchases of the taxed products. 3) Not all taxes are paid by residents, with some taxes exported to tourists and to nonresidents through higher prices or decreased earnings.

General sales

Highest: Hawaii, Washington, West Virginia, Mississippi, New Mexico, Utah, Arizona, Nevada, Tennessee, and Indiana.

Lowest: Virginia, Vermont, Oklahoma, Nebraska, Massachusetts, Kansas, New York, Colorado, North Carolina, and Maryland. In addition, five states have no general sales tax.

Comments: These tabulations do not reflect local sales taxes, which are significant in several of the states with low state sales taxes (Virginia, Oklahoma, New York, Colorado, and North Carolina in particular). The rankings reflect the narrowness of the sales tax base as well as the sales tax rate. Although Connecticut has the highest tax rate, it is not among the states with the highest revenue because it allows so many exemptions; for the same reason Massachusetts has one of the lowest levels of revenue although its rate is not low.

Personal income

Highest: New York, Delaware, Oregon, Minnesota, Massachusetts, Hawaii, Wisconsin, North Carolina, California, and Maryland.

Lowest: New Mexico, North Dakota, Louisiana, Mississippi, Nebraska, Illinois, New Jersey, Arizona, Missouri, and Alabama. In addition,

10 states do not have a broad-based income tax (although three of these 10--Connecticut, New Hampshire, and Tennessee--do tax certain categories of property income).

Comments: As discussed in the following section of this report, seven of the eight states with the highest income tax levels enacted tax reductions in 1985 legislative sessions which are not reflected here because they were not yet in effect. Some trade-offs are apparent in comparing the general sales and personal income tax rankings. New York, Massachusetts, Maryland, and North Carolina have high income taxes and low sales taxes, while Delaware and Oregon have high income taxes and no sales tax at all. New Mexico and Mississippi have low income taxes and high sales taxes. (New Mexico's data are distorted by its generous income tax credits that reduce income tax revenue as an offset to its high sales taxes.) Nebraska is the only state on both lists for low taxes, while Hawaii is the only state on both lists for high taxes.

Motor fuel

Highest: Montana, South Dakota, West Virginia, Idaho, Louisiana, South Carolina, New Mexico, Maine, Utah, and Washington.

Lowest: New York, Hawaii, New Jersey, California, Massachusetts, Missouri, Rhode Island, Oregon, Illinois, and Connecticut.

Comments: Urbanization is an important factor in explaining variations in motor fuel taxes because rural states tend to have much higher per capita spending for roads and highways than do urban states.

Tobacco

Highest: Arkansas, New Hampshire, Rhode Island, Maine, Vermont, Wisconsin, Massachusetts, Florida, Oklahoma, New Jersey, West Virginia, and Oregon.

Lowest: North Carolina, Virginia, Kentucky, Alaska, California, Colorado, Utah, Wyoming, Illinois, and New Mexico.

Comments: The New England states tend to have particularly high revenue from tobacco taxes, while the major tobacco-growing states tax tobacco more lightly than other states. Revenue reflects not only tax rates but also differences among states in consumption of cigarettes.

Alcoholic beverages

Highest: South Carolina, Florida, Maine, Vermont, Alabama, Washington, North Carolina, Georgia, Montana, Alaska, and Hawaii.

Lowest: Wyoming, Illinois, Iowa, Missouri, California, Oregon, Maryland, New Jersey, Ohio, West Virginia, California, Oregon.

Comments: Revenue from alcoholic beverage taxes is strongly influenced by the existence of state liquor stores; those states that operate such stores often receive profits from them as a partial substitute for alcoholic beverage taxes. Consumption patterns also affect revenue levels.

Corporation income

Highest: Alaska, Michigan, Massachusetts, Connecticut, North Dakota, California, Delaware, New Hampshire, New Jersey, and North Carolina.

Lowest: South Dakota, Colorado, Nebraska, Missouri, Oklahoma, Indiana, Utah, Ohio, Florida, and Hawaii. Four other states have no general corporation income tax.

Comments: Alaska's corporate revenue is the highest because of the taxes paid by oil companies. Michigan is listed as the second highest state by the Census Bureau although it does not really have a corporation income tax. Its Single Business Tax is a form of value added tax, but it is included in this category. South Dakota's corporate tax is only on certain financial companies.

Motor vehicle registration fees

Highest: Wyoming, Vermont, Oklahoma, Oregon, Minnesota, Arizona, Delaware, North Dakota, Maine, and South Dakota.

Lowest: Hawaii, Alabama, Georgia, Louisiana, Maryland, Colorado, Massachusetts, South Carolina, California, Indiana, and Alaska.

Comments: No consistent relationship appears to exist between these fees and motor fuel taxes. Maine and South Dakota are among the highest for both, but California, Hawaii, and Massachusetts are among the lowest for both. Louisiana and South Carolina have high taxes and low fees, while Oregon has the opposite situation. Both fees and fuel taxes are means of financing highways, so they are substitutes in a sense. On the other hand, the relative need for highways may influence them both as well. Local fees may also be significant.

III. TAX CHANGES NOT REFLECTED YET IN STATISTICS REPORTED

Although the 1985 legislative sessions were moderately active ones in terms of state tax policy, the tax changes enacted by them are generally not reflected in the statistics reported in the previous section because it considers only taxes collected through June 1985. In addition, tax changes that took effect after July 1984 are also not fully reflected because they were not in force for an entire year. This section notes the most important of those changes, which will affect relative state tax levels in fiscal year 1986.

Twenty-four states raised taxes, and 20 states lowered them during calendar year 1985. The tax reductions tended to be larger than the increases, so the net effect was a decrease of somewhat more than \$1 billion. (This is not a large amount compared to total state tax revenue of \$214 billion.) The actions taken during regular legislative sessions were described in detail in NCSL's report State Budget Actions in 1985. Following publication of that reports three states passed additional tax cuts (Delaware, Massachusetts, and New Jersey) and Nebraska raised taxes.

These were the states with the major tax changes enacted in 1985:

- o Connecticut exempted clothing worth \$75 or less from the sales tax and passed numerous smaller tax reductions.
- o Delaware increased its personal exemption and lowered income tax rates.
- o Indiana increased the personal income tax exemption.
- o Kansas removed a temporary limit on the amount of federal income taxes that were deductible on the state income tax.

- o Massachusetts removed a 7.5 percent income tax surtax that had been in effect for nearly a decade and made other tax reductions.
- o Minnesota reduced its income tax an estimated 16 percent.
- o Nebraska raised its income tax from 19 percent to 20 percent of federal income tax liability.
- o New Jersey lowered its income tax by allowing a deduction for property tax payments.
- o New York reduced its income tax over a three year period, lowering rates and making other adjustments.
- o North Carolina provided a new personal income tax credit and made other small reductions.
- o Ohio reduced personal income taxes 15 percent over a three year period, with an additional contingent 5 percent reduction.
- o Oklahoma raised its general sales tax rate 1/4 percent and passed other tax increases.
- o Oregon allowed a temporary 8 percent income tax surcharge to expire.
- o Pennsylvania reduced its personal income tax rate from 2.35 percent to 2.2 percent.
- o Rhode Island reduced income tax rates twice.
- o West Virginia allowed a temporary income tax increase to expire.
- o Wisconsin reformed its income tax and reduced tax rates.

Of the 17 significant tax actions listed here, 15 were decreases and only two were increases (Nebraska and Oklahoma). All of the decreases except that in Connecticut involved the personal income tax. This tabulation ignores many small changes, particularly in excise taxes and corporation income taxes, because their revenue effects were not major. Continuations of temporary tax increases are not counted as tax changes, nor are changes that do not take effect for more than one year.

In addition to the changes listed above, some 1984 tax increases in Texas and a 1984 personal income tax reduction in Michigan were not in effect for all of the year ending in June 1985, so their full impact is not reflected in the statistics.

IV. CHANGES IN TAX LEVELS DURING THE PAST 15 YEARS

Table 5 shows how state and local taxes have fluctuated as a proportion of personal income since 1970. Despite large fluctuations and a considerable change in the composition of tax revenue, the aggregate tax level was not far in 1985 from where it began the period. Here are the highlights of what the table shows:

- o Taxes rose faster than personal income in the early 1970s, stayed on a plateau for several years, fell sharply during the Tax Revolt after 1978, and then rebounded in fiscal year 1984.
- o State taxes traced the same ups and downs as total taxes, but they wound up in fiscal year 1985 at a higher level than they started in fiscal year 1970.

Table 5

STATE AND LOCAL TAX REVENUE PER \$100 OF PERSONAL INCOME, 1970 to 1985

Fiscal Year	Total	State	Local	Property ^b	State	
					General Sales	Personal Income
1985 ^a	\$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	12.95	7.31	5.63	4.84	2.13	1.68
1972	12.69	7.02	5.67	4.92	2.07	1.52
1971	11.89	6.48	5.40	4.74	1.95	1.28
1970	11.66	6.47	5.19	4.57	1.91	1.24

Notes: Revenue for each fiscal year is divided by personal income in the preceeding calendar year.

- a. The figures for 1985 are preliminary estimates based on tax collections in the year ending June 1985.
- b. At 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, Governmental Finances, (Washington, DC: U.S. Government Printing Office, various years);
U.S. Census Bureau, State Government Finances, (Washington, DC: U.S. Government Printing Office, various years).

- o Local taxes, on the other hand, fell on balance in relation to income during these 15 years. Unlike state taxes, they did not rebound as a proportion of personal income in the 1980s.
- o Personal income taxes rose much faster than general sales taxes. Income tax revenue was not far behind sales tax revenue in fiscal year 1985, although income tax revenue was less than two-thirds as much as sales tax revenue in fiscal year 1970.
- o The property tax, on the other hand, fell sharply as a proportion of personal income, after peaking in 1972.

Some of the relationships among the various categories of taxes changed by design rather than by accident. Many states deliberately increased their income taxes (and, to a smaller extent, sales taxes) in order to relieve property taxes. Although property tax revenue continued to grow in absolute terms, effective rates fell sharply and the property tax played a much smaller role in state-local fiscal systems. In terms of financing specific services, the major shifts were increased state responsibilities for schools and welfare. Reducing the local role in paying for these programs resulted in less pressure on the property tax.⁴

Table 6 shows how these patterns were reflected in the tax systems of each state. While no state exactly mirrored the national aggregates, the generalizations stated above do apply in most states. The table also demonstrates the tremendous diversity of the federal system, with great differences from one state to another in how they raise revenue and how much revenue they collect.

Table 6

TAX REVENUE PER \$100 OF PERSONAL INCOME
SELECTED TAXES, SELECTED YEARS

State	Total State-Local Tax Revenue		Total State Tax Revenue		Personal Income Tax Revenue		Sales Tax Revenue		Property Tax Revenue	
	1971	1984	1971	1985	1971	1985	1971	1985	1971	1984
NEW ENGLAND										
Connecticut	\$11.11	\$11.17	\$5.38	\$6.76	\$.07	\$.58	\$1.79	\$2.95	\$5.69	\$4.51
Maine	12.75	12.59	7.07	8.05	.74	2.38	2.84	2.83	5.76	4.53
Massachusetts	12.71	11.75	6.03	7.71	2.29	3.69	.77	1.68	6.63	4.05
New Hampshire	10.75	9.26	4.45	3.49	.20	.19	-	-	6.36	5.65
Rhode Island	12.05	12.10	7.33	7.08	1.01	2.32	2.24	2.24	4.67	4.84
Vermont	14.68	12.86	9.13	8.02	2.77	2.54	1.26	1.54	5.47	4.95
MID-ATLANTIC										
Delaware	11.70	11.18	9.32	9.25	3.33	4.25	-	-	2.05	1.57
Maryland	12.11	11.69	6.88	6.87	2.47	2.81	1.57	1.75	3.97	2.95
New Jersey	11.00	11.67	4.54	6.64	.06	1.67	1.58	1.95	6.02	4.84
New York	14.54	16.46	7.17	8.46	2.91	4.30	1.35	1.71	5.46	5.02
Pennsylvania	11.39	11.44	6.68	6.93	.29	1.77	2.18	2.06	3.36	3.01
GREAT LAKES										
Illinois	11.47	11.35	6.27	5.78	1.54	1.64	2.04	2.00	4.46	4.15
Indiana	10.77	10.47	5.36	6.74	1.11	2.00	2.05	3.28	5.46	3.27
Michigan	12.24	13.75	7.04	7.10	1.32	2.46	2.43	2.09	5.04	5.24
Ohio	9.25	11.12	4.18	6.27	-	2.09	1.59	1.92	4.37	3.31
Wisconsin	14.64	13.75	8.70	7.99	3.10	3.11	2.08	2.22	6.34	4.50
PLAINS										
Iowa	12.34	11.91	6.16	6.51	1.11	2.33	2.04	2.14	6.15	4.61
Kansas	10.93	10.34	5.39	5.93	.96	1.87	1.85	1.69	5.51	3.84
Minnesota	13.25	14.39	7.54	9.49	2.54	4.05	1.46	2.44	5.61	3.93
Missouri	9.87	9.30	4.93	5.54	.97	1.74	1.88	2.34	4.02	2.15
Nebraska	11.72	11.05	5.29	5.15	.97	1.60	1.60	1.65	6.00	4.55
North Dakota	14.19	11.53	7.70	8.20	.91	.90	2.94	2.21	6.36	2.83
South Dakota	13.84	10.02	5.78	5.32	-	-	2.52	2.80	7.63	4.16
SOUTHEAST										
Alabama	9.76	9.99	7.23	7.24	.94	1.75	2.35	2.02	1.45	1.22
Arkansas	9.73	9.74	7.07	7.53	.82	2.05	2.24	3.00	2.49	1.92
Florida	10.58	9.51	6.37	5.65	-	-	2.87	3.06	3.58	3.10
Georgia	10.09	10.53	6.46	6.70	1.20	2.55	2.35	2.28	3.25	2.80
Kentucky	10.49	10.18	7.68	7.88	1.34	2.03	2.93	2.14	2.33	1.85
Louisiana	12.55	10.91	8.88	7.76	.74	1.07	2.10	2.45	2.38	1.62
Mississippi	12.30	10.80	9.07	8.08	.81	1.10	4.32	4.20	2.99	2.35
North Carolina	10.60	10.64	7.94	7.76	1.85	3.03	1.75	1.73	2.67	2.37
South Carolina	10.26	10.79	7.87	7.56	1.42	2.55	2.81	2.46	2.29	2.64
Tennessee	9.93	9.26	6.06	6.17	.10	.13	2.18	3.55	2.80	2.24
Virginia	10.43	10.14	6.18	5.98	1.86	2.60	1.36	1.21	3.06	2.88
West Virginia	11.13	12.07	8.30	9.83	1.12	2.67	3.65	4.22	2.47	2.08
SOUTHWEST										
Arizona	13.32	12.05	8.15	8.33	1.15	1.68	3.02	3.89	5.14	3.39
New Mexico	12.65	12.60	9.98	9.80	1.12	.58	3.74	4.13	2.84	1.56
Oklahoma	9.93	10.57	6.37	7.73	.75	1.89	1.19	1.64	3.00	1.82
Texas	9.90	9.71	5.54	5.58	-	-	1.60	2.06	3.96	3.64
ROCKY MOUNTAIN										
Colorado	12.06	10.62	6.07	5.12	1.69	2.07	1.85	1.72	5.05	3.53
Idaho	12.64	10.10	8.10	7.27	2.44	2.56	1.96	2.36	4.45	2.71
Montana	12.74	12.93	5.78	7.36	1.80	2.08	-	-	7.08	5.97
Utah	12.47	12.86	7.87	8.82	1.81	2.72	2.97	3.99	4.50	3.59
Wyoming	13.90	20.89	7.90	13.11	-	-	2.89	2.92	6.57	9.17
FAR WEST										
Alaska	10.43	28.56	7.29	21.58	2.99	.01	-	-	2.36	5.30
California	13.73	11.54	6.39	7.75	1.43	2.90	2.03	2.61	6.75	2.96
Hawaii	14.06	12.93	10.75	10.06	3.37	3.17	5.16	5.05	2.55	2.33
Nevada	12.96	11.11	7.61	7.51	-	-	2.90	3.78	4.24	2.45
Oregon	11.55	12.35	5.71	6.41	2.91	4.22	-	-	5.65	5.34
Washington	12.28	11.76	8.24	8.28	-	-	4.50	4.78	4.26	3.28
U.S. Total	11.89	11.71	6.48	7.08	1.28	2.11	1.95	3.19	4.74	3.53

Sources: U.S. Census Bureau, *Government Finances in 1983-84* (Washington, DC: U.S. Government Printing Office, 1985).
 U.S. Census Bureau, *Governmental Finances in 1970-71*, (Washington, DC: U.S. Printing Office, 1972).
 U.S. Census Bureau, *Quarterly Summary of Federal, State, and Local Tax Revenues: April-June 1985*, (Washington, DC: U.S. Government Printing Office, 1985).
 U.S. Department of Commerce, Bureau of Economics Analysis, *Survey of Current Business* 65, No. 8 (August 1985): 18.

V. PERSONAL INCOME TAXES ON THE DEFENSIVE

Following decades of steady growth, state personal income taxes are under attack. Fourteen states reduced their income tax rates or increased exemptions last year, and the momentum away from the income tax appears likely to continue, at least for awhile. The first part of this section reviews trends in income tax policy and particularly examines the tax rates imposed by states on high-income individuals. It is in the states with the highest marginal and effective tax rates where the pressure for income tax reduction is strongest. The second part of this section discusses policy issues raised by recent tax changes.

Recent Income Tax Trends

Forty states levy broad-based personal income taxes. Income taxes have been the most dynamic state revenue source since 1970, rising from 19.2 percent of total revenue in 1970 to 29.8 percent in 1985. In nearly every year during that period income taxes rose faster than general sales taxes, the only revenue source more productive than the income tax. The most important reasons for this increased fiscal significance of the income tax are its responsiveness to inflation and its tendency to grow faster than personal income because taxpayers move into higher tax brackets as their income rises. Several new adoptions in 1971 (as well as by New Jersey in 1976) and tax rate increases also contributed to income tax growth.

A backlash against the income tax surfaced in calendar year 1984. In that year and in 1985 most of the personal income tax increases enacted during the previous two years as states fought to stave off budget deficits were repealed or partially rolled back. (See Appendix C). In contrast,

most of the sales tax increases of 1982 and 1983 were retained, and several more states raised the sales tax in 1984. These trends are reflected in revenue data for the 12 months ending in June 1985. For the first time in many years, general sales tax revenue growth significantly outstripped the rise of the income tax. The sales tax rose 10.5 percent, nearly 50 percent faster than the income tax's 7.5 percent gain.

These figures do not reflect the tax cuts enacted in calendar year 1985. Each of the five states with the highest income tax revenue per \$100 of personal income--New York, Delaware, Oregon, Minnesota, and Massachusetts--reduced their income taxes significantly. Wisconsin and North Carolina--two of the other three states with the highest effective income tax rates--also lowered their income taxes. Only Hawaii, among the states with the eight highest income tax levels, did not trim its rates.

Two measures are used to compare income taxes. The effective tax rate is the ratio of tax paid to income; the discussion above concerning tax revenue per \$100 of personal income dealt with effective rates. The marginal tax rate is the tax on the last dollar of income earned; the rates which appear in laws and income tax forms are marginal rates. Effective state income tax rates are usually considerably lower than marginal tax rates because most states allow numerous deductions and all income is taxed at lower rates before the maximum marginal tax rate is reached. Table 4 showed state effective income tax rates. In the most recent period, only four states had effective tax rates above 4 percent (Delaware, Minnesota, New York, and Oregon), and all of these states have since enacted tax cuts that are not reflected in the table.

Several of the states with the highest marginal tax rates have been lowering them. Since 1976, New York's top rate on earned income has fallen from 15 percent to 9.5 percent (and will be 9 percent in 1987), Wisconsin's has gone from 11.4 percent to 7.9 percent, and Delaware's from 19.8 percent to 9.7 percent. Minnesota's top rate was reduced from 16 to 14 percent this year.

Which states have the highest marginal tax rates? The answer to this question requires some analysis. The first two columns of Table 7 show the top marginal tax rate in each state and the lowest level of income at which it is paid. Eleven states have nominal marginal rates of 10 percent or more--California (11 percent), Hawaii (11 percent), Iowa (13 percent), Maine (10 percent), Minnesota (14 percent), Montana (11 percent), Nebraska (10 percent), Oregon (10 percent), Rhode Island (10.95 percent), Vermont (13.25 percent), and West Virginia (13 percent). These figures are not directly comparable for two reasons:

- o The top rate is reached at different levels in each state. Maine's 10 percent rate is paid once taxable income reaches \$50,000, but the highest rates in Nebraska, Rhode Island, and Vermont do not come into play until income exceeds \$175,000. Each of the three latter states has a piggyback income tax which is levied as a percentage of federal income tax liability.
- o Several of these states allow federal income tax payments to be subtracted from taxable income in computing the income that is subject to state tax. For very high income taxpayers, federal deductibility cuts the true marginal state tax rate in half, since the top federal rate is 50 percent. (For example, a taxpayer with income over \$200,000 who

received an additional \$1,000 of income would pay \$500 in extra federal tax. State taxable income would therefore rise only \$500 rather than \$1,000. If the state's nominal marginal tax rate were 10 percent, state taxes would rise \$50 rather than the \$100 that would be the case if federal tax payments were not deductible. In this situation the true marginal tax rate would be 5 percent rather than 10 percent. Federal deductibility is not worth this much to all taxpayers; some taxpayers may be in the highest state tax bracket and still be below the 50 percent federal rate. For such taxpayers the highest "true" state marginal tax rate would be more than half of the nominal rate.)

The third column of Table 7 identifies the 11 states permitting federal income taxes to be deducted in full, so that the "true" marginal tax rate is half of the nominal marginal tax rate. Five other states permit federal income taxes to be deducted but they are not included in this column. In two of the states--North Dakota and Oklahoma--taxpayers have a choice of two different rate schedules, one with and the other without federal deductibility. Since the option with federal taxes deductible yields higher state tax liability in the great majority of cases, very few taxpayers choose it. The relevant tax rate is for the other option, without federal deductibility. Three other states--Delaware, Oregon, and South Carolina--limit the amounts of federal taxes that may be deducted (to \$600, \$7,000, and \$500 respectively for joint filers). Since very high income taxpayers would normally pay considerably more federal income tax than the limit, the deduction does not affect their tax rate at the margin.

Three of the 11 states where federal deductibility does have an effect at the margin are among the 11 states listed above as having marginal tax

Table 7

MARGINAL TAX RATES FOR STATE PERSONAL INCOME TAXES, JOINT RETURNS, 1986

State	Highest Nominal Rate (Percent)	Highest Rate Starts At This Taxable Income* (\$000)	Federal Deductibility Reduces Highest Rate	Highest Rate Adjusted for Federal Deductibility (Percent)
NEW ENGLAND				
Maine	10.00	50		10.00
Massachusetts	5.19 d,e	0		5.19
Rhode Island - c	10.95	175		10.95
Vermont - c	13.25	175		13.25
MID-ATLANTIC				
Delaware	9.70	40	a	9.70
Maryland	5.00	3		5.00
New Jersey	3.50	50		3.50
New York	9.50 e,g	16		9.50
Pennsylvania	2.20	0		2.20
GREAT LAKES				
Illinois	2.50	0		2.50
Indiana	3.00	0		3.00
Michigan	5.10 e	0		5.35
Ohio	8.55 e	100		8.55
Wisconsin	7.90	40		7.90
PLAINS				
Iowa	13.00	77	Yes	6.50
Kansas	9.00	50	Yes	4.50
Minnesota	14.00 f	32	Yes	7.00
Missouri	6.00	9	Yes	3.00
Nebraska - c	10.00	175		10.00
North Dakota - c	5.25	175	b	5.25
SOUTHEAST				
Alabama	5.00	6	Yes	2.50
Arkansas	7.00	25		7.00
Georgia	6.00	10		6.00
Kentucky	6.00	8	Yes	3.00
Louisiana	6.00	50	Yes	3.00
Mississippi	5.00	10		5.00
North Carolina	7.00	10		7.00
South Carolina	7.00	10	a	7.00
Virginia	5.75	12		5.75
West Virginia	13.00	120		13.00
SOUTHWEST				
Arizona	8.00	13	Yes	4.00
New Mexico	7.80	200		7.80
Oklahoma	6.00	15	b	6.00
ROCKY MOUNTAIN				
Colorado	8.00	15	Yes	4.00
Idaho	7.50	5		7.50
Montana	11.00	46	Yes	5.50
Utah	7.75	8	Yes	3.88
FAR WEST				
California	11.00	56		11.00
Hawaii	11.00	61		11.00
Oregon	10.00	5	a	10.00

Source: ACIR, Significant Features of Fiscal Federalism: 1984 Edition, and information obtained from states.

Table 7 Notes

The table does not reflect the deductibility of state taxes on federal income tax returns, which reduces effective marginal rates by 50 percent at high income levels. Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming have no personal income tax; Connecticut, New Hampshire, and Tennessee tax only limited forms of income.

- * Income at which highest rate starts (column 2) is rounded to nearest thousand dollars.

Some states that index tax rates had not yet established the income tax brackets for 1986 at the time this table was prepared. For those states, the second column refers to 1985.

- a. Federal deductibility is limited, so it is rarely relevant to the marginal tax rate of high-income taxpayers.
- b. Taxpayers may choose between two tax rate schedules, one of which does permit federal taxes to be deducted; the other schedule normally produces a lower state tax liability, so federal deductibility is not usually employed.
- c. State tax is a percentage of federal income tax liability. Highest state marginal rate is found by multiplying that percentage by 50 percent (highest federal marginal rate).
- d. This is rate on earned income. Unearned income taxed at 10.37 percent rate.
- e. Rate is scheduled to be reduced in later years.
- f. Taxpayers may choose between two tax rate schedules, one of which does permit federal taxes to be deducted; for high-income taxpayers that schedule normally produces lower state tax liability, so it is used in the table.
- g. This is rate on earned income. Unearned income taxed at 13.5 percent.

rates of 10 percent or higher--Iowa, Minnesota, and Montana. Federal deductibility reduces their true marginal rates to below 10 percent for taxpayers with very high incomes.

Eight states remain with true marginal tax rates of at least 10 percent. In descending order, they are Vermont (13.25 percent), West Virginia (13 percent), California (11 percent), Hawaii (11 percent), Rhode Island (10.95 percent), Maine (10 percent), Nebraska (10 percent), and Oregon (10 percent).

Analysis of Income Tax Policy Options

The design of a personal income tax involves many features such as tax rates, deductions, exemptions, and so forth. Together these features determine how much revenue is raised and the incidence of the tax, that is, how its burdens fall on different groups. One important aspect of incidence is the extent to which the tax is progressive. A tax is progressive if its effective tax rate is greater on high-income than on middle- and low-income households.⁵

A thorough discussion of income tax design issues is beyond the scope of this report. It focuses on three of the major considerations in formulating income tax policy--the effects on the state's economy, the distribution of tax burdens, and the revenue available to state government. Particular attention is devoted to two issues--how much money the income tax raises and how progressive it is.

Effect on the economy. The effect of income taxes on the economy is controversial. One of the motivations for the shift away from the income tax is the view that "excessive reliance" on it may interfere with a state's