

ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILES 8672
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economic growth. A recent study by economists Michael Wasylenko and Therese McGuire found that job creation during the 1970s was greater in states that had relatively low effective income tax rates. (The multiple regression study also found that several other factors were statistically related to employment growth, including education spending, which had a positive effect.)⁶ Both Minnesota's Tax Commission and Wisconsin's Strategic Development Commission late in 1984 urged lowering the income tax because that would boost the economy.

Wisconsin's commission focused specifically on high marginal tax rates as an impediment to business investment. Other observers have also argued that high marginal rates discourage high-income individuals from locating in a state and suggested that if such individuals avoid a state, less investment will occur.⁷

The top marginal rate may have a significance beyond that which is logical. It may be viewed by some as a measure of a state's "liberalism," which in turn may simplistically be regarded as synonymous with anti-business sentiment. Viewed in this light, a high marginal rate may deter economic development.

Despite the Wasylenko-McGuire statistical findings, there is reason to be skeptical about the strength of the impact of income taxes on the economy. State income taxes are deductible for those who itemize deductions on federal income tax returns, so for taxpayers in the 50 percent bracket every \$2 paid to the state reduces federal taxes by \$1. Thus, even in Vermont, with the highest marginal state tax rate in the nation, the marginal cost of an additional \$100 of state income tax is half of \$13.25, or \$6.625. This

is not such a large amount that it is likely to have a major effect on location decisions. People decide where to reside on the basis of many considerations, such as employment opportunities and proximity to recreation opportunities, family, and friends. Taxes are not that important. Besides, places with high income taxes may, other things being equal, tend to have lower sales and property taxes and provide better government services.⁸

How can we reconcile the research showing a link between income taxes and employment with the theoretical reasons why this relationship is unlikely to be strong? One answer is that econometric analysis shows statistical relationships, not causality; separating the influence of various factors is difficult, so even carefully done research should be accepted only with caution. Secondly, Wasylenko and McGuire found a statistically significant relationship in only three out of six industries studied, and not for their total sample.⁹ Their results support the belief that high income taxes tend to reduce employment growth, but they do not necessarily indicate that the relationship is a strong one.

Distribution of tax burdens. One of the major roles of the personal income tax in state tax systems is to offset the regressivity of most other state and local taxes. The personal income tax is the most important progressive tax levied by states. Despite the progressivity of this tax, the great majority of state-local tax systems are regressive.¹⁰

Income tax reductions may affect progressivity in two ways. First, reducing the proportion of state revenue derived from the income tax has a regressive effect on the overall tax system because other taxes are on balance regressive while the income tax is progressive. Second, the manner

in which the income tax is reduced can either increase or decrease the progressivity of the income tax itself, or leave progressivity unchanged. Reducing the top marginal rate tends to diminish the progressivity of the tax because only relatively high-income households benefit. Increasing the personal exemption enhances progressivity because it reduces tax burdens for low- and middle-income households proportionately more than for high-income households.¹¹

Massachusetts' 1985 income tax reduction illustrates the complexity of analyzing progressivity. Massachusetts' tax cut had three parts--a proportional rate reduction, an increase in the minimum level of income at which tax must be paid, and a reform of the personal exemption, with an increase in the exemption for lower income households and a phase out of the exemption as income increases. The second and third parts of the cut increase the progressivity of the income tax, but the rate reduction tends to diminish the role of the income tax in the total tax system. The paradoxical result is that high-income taxpayers received a much larger proportion of the tax savings than their proportion of the population, but the tax cut increased the progressivity of the income tax because the percentage tax reduction for low-income households was greater than for others.

Yet to be established is the extent to which recent tax structure changes have reduced the progressivity of personal income taxes. Some states, such as Ohio, Oregon, and Rhode Island reduced rates proportionately. Others, like Delaware and Wisconsin, reduced effective rates more at the high end of the income scale. In New York, nominal rates were reduced only at the highest level, but other changes in the tax may have benefitted lower income taxpayers more than others.

Effect on state revenue. An income tax reduction reduces state revenue both in the year when it becomes effective and in future years. Four of the income tax cuts enacted in 1985 (Massachusetts, New York, North Carolina, and Ohio) are being phased in over two- or three-year periods.

The form of an income tax reduction also affects the elasticity of the income tax. Revenue estimators define a tax's elasticity as the percentage growth of tax revenue for each 1 percent increase of personal income. If states reduce their top marginal tax rate but no other rates, the effect is to reduce elasticity. Such a change would not only lower revenue in the year the tax cut takes effect, but also would reduce the growth rate of revenue in future years. If all rates are reduced proportionately, elasticity is relatively unaffected.¹²

Reductions in top marginal tax rates are only one reason why the elasticity of state income taxes has tended to fall over the past decade.¹³ Indexation of the income tax in 10 states has also contributed to lower elasticity, as has the increasing proportion of taxpayers in each state's top marginal tax bracket. As Table 7 shows, in 17 states the top marginal rate begins at taxable income of \$10,000 or less, so a large proportion of taxpayers are paying the highest marginal rate in many states.

VI. THE OUTLOOK

State tax systems seem to have reached an equilibrium position, at least for 1986, with few major tax changes likely this year. This quiet period follows turbulent years since 1978. Tax systems were first buffeted by the Tax Revolt and then by severe recessions. During the past two years, states

were busy eliminating the emergency tax increases passed in the previous years.

This period of inactivity may not last long. Among the forces that could stimulate a new wave of activity are federal aid reductions, federal tax reform, and a possible economic downturn. The year 1987 could see a new burst of tax activity if any of these forces materializes in 1986 or early 1987. Aside from these three potential problems, intense interstate tax competition could also stimulate tax policy change, as could a delayed response to the many state tax study commissions that were created over the past few years. Some of these commissions floated proposals for major reforms, and a consensus could develop to support such changes.

One of the major issues facing the states will be how to treat the personal income tax. If the system is allowed to operate as currently in place, the income tax will resume its climb as an ever more important source of state revenue because it has a higher elasticity than other major taxes. After 1984 and 1985, however, an assumption that states will allow the income tax to increase significantly is open to question.

NOTES

The author is very grateful for the helpful comments made on earlier versions of this report by Barbara Yondorf. She is not, however, responsible for any deficiencies of the report that may remain.

1. See Steven D. Gold, "State Tax Increases of 1983: Prelude to Another Tax Revolt?", National Tax Journal 37 (March 1984): 9-22; Steven D. Gold and Corina L. Eckl, State Budget Actions in 1984 (Denver: NCSL, 1984); and Steven D. Gold, Corina L. Eckl, and Max Price, State Budget Actions in 1985 (Denver: NCSL, 1985).
2. Similar estimates for FY1984 turned out to be within 3 percent of the U.S. Census Bureau figures in three-quarters of the states.
3. Alaska has a small amount of personal income tax revenue in Table 4 because of delayed payments from a tax repealed several years ago. New Hampshire has an income tax on interest and dividends but not on other income such as wages.
4. See Steven D. Gold, Property Tax Relief (Lexington, Mass.: D.C. Heath, 1979) for a discussion of how states reduced reliance on property taxes.
5. In analyzing progressivity, one should focus on the effective tax rates (tax as a proportion of total income) rather than nominal tax rates. Even a flat rate tax may be progressive because of personal exemptions. On the other hand, a tax in which marginal tax rates increase as income rises may be regressive if certain exemptions are concentrated at high income levels.
6. Michael Wasylenko and Therese McGuire, "Jobs and Taxes: The Effect of Business Climate on States' Employment Growth Rates," National Tax Journal 38 (December 1985): 497-512.
7. Hal Hovey, "Interstate Tax Competition and Economic Development," in Steven Gold, ed., State Tax Policy, forthcoming.
8. What is important is the differential in tax rates, not their absolute level. Thus, Vermont's disadvantage relative to neighboring New York is less than two percentage points difference in income tax rates after considering the federal deductibility of state taxes. Vermont's disadvantage relative to New Hampshire is the full 6.625 percent because the latter state has no broad-based income tax.
9. Income taxes were significantly related to employment growth in wholesale and retail trade and finance, but not in transportation, communications,

and public utilities, manufacturing, or services. Wasylenko and McGuire, "Jobs and Taxes," 506-508.

10. Donald Phares, Who Pays State and Local Taxes? (Cambridge: Oelgeschlager, Gunn and Main, 1980).
11. In states with increasing marginal tax rates, personal exemptions reduce taxes more for high-income households than for others, but as a proportion of income, this tax reduction is greater for low-income households. The tax savings from a personal exemption are equal to the exemption times the marginal tax rate.
12. Elasticity equals the marginal rate divided by the average rate. If rates are reduced proportionately, elasticity would not be affected at all were it not for exemptions and other deductions. If the top marginal rate is reduced, this reduces the tax's average marginal rate more than it reduces the average effective rate, so elasticity is reduced.
13. Daniel Feenberg and Harvey Rosen have shown that the elasticity of the average state income tax fell between 1977 and 1983, but their estimates do not consider indexation, and they weight all taxpayers equally rather than counting more heavily those who pay the most taxes. See their Personal Income and Sales Taxes: 1977-83 (National Bureau of Economic Research Working Paper 1631).

Appendix A

Per Capita Versus Personal Income Measures

This report focuses on comparisons of tax revenue in relation to personal income rather than per capita. Such an approach has three advantages:

- o It suggests what percentage of people's income their governments are taking--which is one of the most common ways of looking at taxation.
- o It abstracts from one of the major factors influencing the level of tax revenue--a state's income. Affluent states tend to have higher spending and taxes simply because citizens demand more services and can afford to pay for them. For example, Connecticut will always tend to rank higher than Mississippi on per capita measures because its per capita income is 84 percent greater.
- o It partially adjusts for differences in price levels among states. To take an extreme example, one reason why Alaska has high spending and revenue is that things cost more there. Since both income and tax revenue are influenced by price levels, adjusting for income is more informative than adjusting for population.

Despite the advantages of relating taxes to personal income, the other perspective is also relevant. Some states may have a high tax effort relative to income and yet have only average tax revenue per capita. Such states (Vermont is an example) will not have particularly high levels of spending despite their high tax effort. The opposite is also true. For example, Connecticut's tax effort relative to income is slightly below the median, but its per capita taxes are far above average.

Table 8 shows how states ranked on the two different measures in 1984. In many states there is not much difference: 23 had ranks that are within five places on the two measures. But this is not always the case. Colorado, Connecticut, and New Jersey all rank much higher when taxes are measured on a per capita basis because they are high-income states. States in the opposite situation are Maine, Mississippi, New Mexico, Utah, West Virginia.

Neither the per capita nor the income measure is ideal since both are influenced by states' ability to export taxes. Both also represent averages and do not take into account geographic differences in tax levels within a state and differences in progressivity and regressivity across income levels.

Table 8

**RANKINGS OF STATE-LOCAL TAX REVENUE PER CAPITA
AND PER \$100 OF PERSONAL INCOME, 1984
(low numbers indicate high rank)**

<u>State</u>	<u>Per Capita</u>	<u>Income</u>	<u>State</u>	<u>Per Capita</u>	<u>Income</u>
<u>New England</u>			<u>Southeast</u>		
Connecticut	5	27	Alabama	47	44
Maine	29	12	Arkansas	50	45
Massachusetts	9	19	Florida	40	47
New Hampshire	38	49	Georgia	39	37
Rhode Island	15	14	Kentucky	45	40
Vermont	24	10	Louisiana	35	31
			Mississippi	49	32
<u>Middle Atlantic</u>			North Carolina	41	34
Delaware	16	26	South Carolina	43	33
Maryland	12	20	Tennessee	48	50
New Jersey	6	21	Virginia	30	41
New York	3	3	West Virginia	36	15
Pennsylvania	21	24			
			<u>Southwest</u>		
<u>Great Lakes</u>			Arizona	26	16
Illinois	14	25	New Mexico	31	11
Indiana	37	38	Oklahoma	32	36
Michigan	7	5	Texas	34	46
Ohio	27	28			
Wisconsin	8	6	<u>Rocky Mountain</u>		
			Colorado	18	35
<u>Plains</u>			Idaho	46	42
Iowa	23	17	Montana	22	8
Kansas	25	39	Utah	33	9
Minnesota	4	4	Wyoming	2	2
Missouri	42	48			
Nebraska	28	30	<u>Far West</u>		
North Dakota	19	23	Alaska	1	1
South Dakota	44	43	California	11	22
			Hawaii	10	7
			Nevada	17	29
			Oregon	20	13
			Washington	13	18

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

Appendix B

Tax Versus General Revenue Measures

State and local governments obtain funds not only from taxes but also from charges and miscellaneous revenue. Some analysts prefer to compare each governments' total general revenue rather than its tax revenue alone. Both approaches have some merit, but if one is interested in comparing burdens imposed on citizens, tax revenue is the better choice. Much of the variation in charges and miscellaneous revenue is related to the scale of higher education and hospital operations in a jurisdiction, rents and royalties (particularly high in oil-rich states), and interest received. None of these factors have much to do with taxes paid. Some kinds of charges, for example for refuse collection, really are close substitutes for taxes, but the majority of charges and miscellaneous revenue are not.

State Government

In FY1984 (to which all of these data refer) states had total general revenue of \$330.7 billion, of which \$81.5 billion was intergovernmental. Since we are interested in money that a government raises on its own, intergovernmental revenue should be subtracted, leaving \$249.3 billion. This sum included \$196.8 billion of taxes, \$25.7 billion of charges, and \$26.8 billion of miscellaneous revenue. (Incidentally, licenses are counted as taxes.) Thus, 21 percent of own-source general revenue was in charges and miscellaneous revenue.

Charges consisted mostly of those for higher education (\$14.4 billion) and hospitals (\$5.7 billion), which together account for 78.3 percent of total charges. The variation in charges for these facilities depended heavily on whether a state had many or few of such facilities in operation.

The main components of miscellaneous revenue were interest (49.6 percent) and rents and royalties (23.1 percent). Other miscellaneous revenue included donations, fines and forfeits, and sales of property. Such revenue has to be counted if one is interested in comparing sources of funds for government, but it is not a burden on citizens as taxes are.

State and Local Governments

The situation is not quite as clear-cut when local governments are included because localities do rely to a greater extent than states on charges that are paid by citizens and businesses instead of taxes. Hospitals loom larger, however, and school lunches combine with higher education tuition as education-related charges not analogous precisely to taxes. Hospitals (16.4 percent), higher education and school lunches (15.0) percent, and interest received (21.9 percent) account for more than half of total charges and miscellaneous revenue.

Examples for Specific States

State local charges and miscellaneous revenue per \$100 of personal income are highest in Alaska, New Mexico, Montana, and Wyoming, all of which have substantial mineral revenue. These states benefit not only from royalties, but also from interest received on their Permanent Funds that are fed by mineral revenues.

Oregon has the fourth highest state interest revenue per \$100 of personal income because it has a particularly large mortgage subsidy program for veterans. Massachusetts' higher education charges are the third lowest (relative to income) because it has so many private and so few public colleges and universities.

Appendix C

Recent Income Tax Changes

Recent income tax changes have been so frequent that it may be difficult to keep track of them. This Appendix compares 1986 state income tax rates with where they were in 1982. It is concerned with nominal tax rates, personal exemptions or credits, and major changes in deductions. Effective tax rates are influenced by these changes but also may be affected by other factors, such as the elasticity of the income tax structure.

The analysis summarized below shows that most of the income tax increases enacted in 1982 and 1983 have been removed or reduced. In addition, four states lowered their income tax in 1984 or 1985 without having raised it during the two previous years.

Three states have maintained the full income tax increase enacted: Louisiana, Mississippi, and New Mexico.

Five states have maintained part of the income tax increase enacted: Indiana, Michigan, New Jersey, Ohio, and West Virginia.

Seven states have eliminated their entire income tax increase, and three of these states have lowered income tax rates below their 1982 level: Illinois, Kansas, Minnesota (lower), Oregon*, Pennsylvania, Rhode Island (lower), and Wisconsin (lower).

Three states where the income tax is a percentage of federal tax liability have raised the percentage, but not sufficiently to offset the 25 percent federal tax rate reduction that occurred during this period: Nebraska, North Dakota, and Vermont. (Rhode Island also has this kind of income tax, but it has reduced the percentage.)

Four states reduced the income tax although they did not have an earlier increase: Delaware, Massachusetts, New York, and North Carolina.

Eighteen states have not changed their income tax rates.

Ten states have no broad-based income tax.

The three states where income tax increases have remained fully in effect all have low effective income tax rates.

*Oregon changed its personal exemption into a personal credit, resulting in about a 2 1/2 percent revenue increase. This change is not reflected in the text.

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A COMPARISON OF THE SENATE FINANCE COMMITTEE BILL WITH H.R. 3838 AND PRESENT LAW

by The Touche Ross & Co.
Washington Service Center

The Washington Service Center of the accounting firm Touche Ross & Co. has prepared the following comparison of the tax revision bill reported out of the Senate Finance Committee with current law and the House tax bill. The comparison includes those provisions Touche Ross considers the most important and far-reaching items in the Finance bill. Because many of the details of the bill are as yet unknown, the firm has inserted question marks following the provisions where information is missing or where the effective dates are uncertain.

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I. INDIVIDUALS

The dramatic drop in the top individual tax rate from 50 percent to 27 percent—which would be its lowest point in more than 50 years—would cut taxes for the average person by 6.2 percent. But the elimination of numerous tax benefits, such as individual retirement accounts and the deduction for two-earner couples, which middle-income taxpayers rely on, could more than offset the lower tax resulting from the decreased rates. Particularly affected will be taxpayers who invest in tax shelters, invest heavily in 401(k) plans, or pay large amounts of consumer interest. As under the House bill, the deductions would be repealed as of January 1, 1987, but rate cuts would not be effective until July 1 of that year. One important side effect is that with the broader tax base, income taxes in many states would rise—unless the states revise their rules or rates.

Rates and Brackets

Present Law

Maximum rate: 50 percent.

Individual brackets: 15; indexed.

Maximum long-term capital gain rate: 20 percent (60 percent exclusion).

Alternative minimum tax: 20 percent on excess of taxable income plus "preference" deductions over \$40,000 (joint return) or \$30,000 (single).

House Bill

Maximum rate: 38 percent. Effective: July 1, 1986.

Individual brackets: 4. Effective: July 1, 1986 (indexing effective 1987).

Maximum long-term capital gain rate: 22 percent. Effective: 1986. 50 percent exclusion in 1986. 42 percent exclusion starting 1987.

Alternative minimum tax: Retains present law, raises rate to 25 percent; adds preferences for gifts of appreciated property; interest on new exempt bonds; losses from passive investments; and others.

Senate Finance Committee

Maximum rate: 27 percent. Effective: July 1, 1987.

Individual brackets: 2; 15 percent and 27 percent. 27 percent starts at taxable income of \$17,600 for individuals, \$29,300 for joint returns, and \$23,500 for heads of household. 15 percent phased out starting at \$45,000 of adjusted gross income (AGI) for singles, \$75,000 for joint filers, and \$55,000 for heads of household.

Maximum long-term capital gain rate: 27 percent. Effective: (?) No exclusion.

Alternative minimum tax: 20 percent rate (same as present law). Exemption phased out for minimum taxable income over \$150,000 (?). Preferences generally same as House except tax-exempt interest not a preference.

Exemptions

Present Law

Self, spouse; dependents: \$1,080 (indexed).

Elderly, blind: \$1,080 (indexed).

House Bill

Self, spouse; dependents: \$2,000 for nonitemizers; \$1,500 for itemizers. Effective: 1986. (Indexed in 1987.)

Elderly, blind: Extra \$600 standard deduction (indexed). Effective: 1986.

Senate Finance Committee

Self, spouse; dependents: \$1,900 in 1987, \$2,000 in 1988 (indexed (?)). Phased out starting with AGI over \$87,240 for individuals, \$145,320 for joint returns, and \$111,400 for heads of household. Dependent gets no exemption if claimable by another taxpayer.

Elderly, blind: Same as House. Effective: 1987.

Zero Bracket Amount/Standard Deduction

Present Law

Single return: \$2,480 (indexed).

Married, joint return: \$3,670 (indexed).

Head of household: \$2,480 (indexed).

House Bill

Single return: \$2,950. Effective: 1987 (indexed in 1988).

Married, joint return: \$4,800. Effective: 1987 (indexed in 1988).

SPECIAL REPORT

Head of household: \$4,200. Effective: 1987 (indexed in 1988).

Senate Finance Committee

Single return: \$3,000. Effective: 1988 (indexed in 1989 (?)).

Married, joint return: \$5,000. Effective: 1988 (indexed in 1989 (?)).

Head of household: \$4,400. Effective: 1988 (indexed in 1989 (?)).

Savings and Investment

Present Law

Dividend exclusion: \$100 (\$200 joint) exclusion of dividends.

Private-purpose tax-exempt bonds: Interest is exempt.

Life insurance and annuity contracts. Yearly earnings ("inside buildup") on contracts not taxed currently.

Insurance contracts; loans and partial withdrawals: Loans not taxed; withdrawals taxed if they exceed investment.

House Bill

Dividend exclusion: Repeal (but note proposed corporate deduction for dividends paid).

Private-purpose tax-exempt bonds: Interest exempt for most purposes.

Life insurance and annuity contracts: Retains present law except for corporate-owned annuities bought after September 25, 1985.

Insurance contracts; loans and partial withdrawals: Same as present law.

Senate Finance Committee

Dividend exclusion: Repeal. Effective: January 1, 1987.

Private-purpose tax-exempt bonds: Same as present law.

Life insurance and annuity contracts: Same as House except date could change to February 28, 1986 (?).

Insurance contracts; loans and partial withdrawals: Same as present law.

Deductions

Present Law

Charitable contributions: Deductible by individuals up to 30 percent or 50 percent of AGI; by corporations up to five percent or 10 percent of taxable income.

Interest deduction: All interest paid is deductible whether or not incurred in a business, for investment, or for personal reasons (except on loans to acquire tax-free bonds). Investment interest is limited to investment income plus \$10,000.

State and local income taxes: Deductible.

State and local real and personal property taxes and sales tax. Deductible.

Miscellaneous deductions: Union dues, tax return preparation, other expenses related to earning income, etc. deductible if itemized. Employee business expenses subtracted to reach AGI.

Two-earner deduction: 10 percent of lower salary; \$3,000 cap.

House Bill

Charitable contributions: Same as present law, except nonitemizer deduction made permanent for excess over \$100.

Interest deduction: Interest on principal and second residence fully deductible. All other interest only to

extent of passive investment income plus \$20,000. Effective: 1986, with 10-year phase-in.

State and local income taxes: Same as present law.

State and local real and personal property taxes and sales tax. Same as present law.

Miscellaneous deductions: Combines all miscellaneous itemized deductions, plus above-the-line employee business expenses. Excess over one percent of AGI would be deductible.

Two-earner deduction: Repealed.

Senate Finance Committee

Charitable contributions: Same as present law for itemizers; no deductions for nonitemizers after 1986.

Interest deduction: Interest on principal and second residence fully deductible. Consumer interest not deductible. Investment interest expense in excess of investment income not deductible. Effective: 1987, with five-year phase-in.

State and local income taxes: Same as present law.

State and local real and personal property taxes and sales taxes: Same as present law except sales taxes not deductible after 1986 (?).

Miscellaneous deductions: Repealed. Above-the-line employee business expenses limited to itemizers and subject to floor of one percent of AGI.

Two-earner deduction: Repealed. Effective: 1987 (?).

Tax Shelters

Present Law

Limits on passive losses: Losses from tax shelters may be used to offset other income.

At-risk limitations on deductions: Applies to passive investments of closely held corporations and to all activities of individuals except real estate.

House Bill

Limits on passive losses: No provision (some passive losses treated as preferences for alternative minimum tax).

At-risk limitations on deductions: At-risk extended to seller-financed real estate. Old law applies if loans are made by financial institutions.

Senate Finance Committee

Limits on passive losses: Passive losses from tax shelters and losses from all rental activities could offset only income from those activities. Exception for working interests in oil and gas. Exception for some rental losses up to \$25,000; phased out for income above \$100,000. Effective: 1987, with five-year phase-in.

At-risk limitations on deductions: Same as House.

Family Income Shifting

Present Law

Clifford trusts: Income taxed to beneficiary.

Irrevocable trusts: Trust taxed as person; deduction for distributions.

Uniform Gifts to Minors custody accounts: Taxed to child.

House Bill

Clifford trusts: Taxed to grantor. Effective: all trusts funded after Sept. 25, 1985.

Irrevocable trusts: Only taxed to beneficiary if "Qualified Beneficiary Trust." Effective: trusts funded after September 25, 1985.

Uniform Gifts to Minors custody accounts: Taxed at parents' rate where income greater than child's personal exemption and child is under age 14.

Senate Finance Committee

Clifford trusts: Similar to House. Effective: March 1, 1986.

Irrevocable trusts: Present law, but brackets start at lower levels for retained income.

Uniform Gifts to Minors custody accounts: Same as House, except child might not get exemption.

II. CORPORATIONS

The corporate minimum tax proposed by the Senate Finance Committee includes an expanded list of preference items. Although tax-exempt income is not specifically listed, that income can still be taken into account under a catchall provision that includes as a preference one-half of a corporation's pretax book income not otherwise included in the minimum tax base.

Present Law

Maximum rate: 46 percent.

Corporate brackets (not indexed): Five brackets: 15 percent, 18 percent, 30 percent, 40 percent up to \$100,000, then 46 percent. Lower brackets phased out between \$1 million and \$1.4 million.

Long-term capital gain rate: 28 percent.

Minimum tax: 15 percent of amount by which 10 specific preferences exceed greater of \$10,000 or regular corporate tax for year.

Deductions for dividends paid: Not deductible by corporations.

Corporate liquidations (distributions of appreciated assets in: (a) complete liquidations, (b) one-month liquidations, (c) 12-month liquidating asset sales, and (d) stock purchases treated as asset acquisitions): At corporate level no gain recognition; only recapture and tax benefit items included in income. Gain only at shareholder level.

Net operating loss carryovers: There are separate rules for stock purchases and tax-free reorganizations, and, if limitations apply, NOL carryovers are reduced or eliminated.

Structured settlement companies: Not taxed on earnings on amount received to fund annuity obligation.

House Bill

Maximum rate: 36 percent.

Corporate brackets (not indexed): Three brackets: 15 percent to \$50,000, 25 percent to \$75,000, then 36 percent. Lower brackets phased out between \$100,000 and \$350,000. Effective: July 1, 1986.

Long-term capital gains rate: 36 percent. Effective: 1986.

Minimum tax: Applies existing individual AMT at 25 percent on excess over \$40,000. Possessions-tax-credit corporations exempt. Credit for minimum tax paid allowable against subsequent regular tax.

Deductions for dividends paid: Corporate deduction for 10 percent of distributed corporate profits, phased in one percent a year. Effective: 1987.

Corporate liquidations (distributions of appreciated assets in: (a) complete liquidations, (b) one-month liquidations, (c) 12-month liquidating asset sales, and (d) stock purchases treated as asset acquisitions): Full gain recognized at both corporate and shareholder levels, with certain exceptions (repeals General Utilities). Effective: plans adopted after November 19, 1985.

Net operating loss carryovers: One provision for stock purchases and tax-free reorganizations, allowing parent firm to absorb NOLs at rate base on long-term tax-exempt bond rate.

Structured settlement companies: Same as present law but settlement must be for physical injury or sickness.

Senate Finance Committee

Maximum rate: 33 percent.

Corporate brackets (not indexed): Three brackets: 15 percent to \$50,000, 25 percent to \$75,000, then 33 percent. Lower brackets completely phased out at \$350,000. Effective: July 1, 1987 (?).

Long-term capital gain rate: Same as present law.

Minimum tax: 20 percent of taxable income plus 14 specific preferences, including one-half of book income over alternative minimum taxable income.

Deductions for dividends paid: Same as present law.

Corporate liquidations (distributions of appreciated assets in: (a) complete liquidations, (b) one-month liquidations, (c) 12-month liquidating asset sales, and (d) stock purchases treated as asset acquisitions): Same as present law (retains General Utilities).

Net operating loss carryovers: Allows absorption of NOLs up to two percent of purchase price per month for 60 months (?).

Structured settlement companies: Taxed on investment income on contracts purchased to fund settlement agreement.

III. BUSINESS

Capital Cost Recovery System

Present Law

Depreciation: All assets use 3-, 5-, 10-, 15-, 19-year ACRS tables.

Research credit: 25 percent of increase in research expenses over base period.

Investment tax credit: Generally, 10 percent credit on equipment purchases.

Sale of depreciable business property (Section 1231 property): Capital gain treatment for net gains, subject to depreciation recapture rules; ordinary loss treatment for losses.

Expensing costs of business assets: Up to \$5,000 a year. Scheduled to increase in 1988.

Rehabilitation credit: 15 percent, 20 percent, or 25 percent credit on rehabilitation expenses.

Business energy credit: Expired December 31, 1985.

House Bill

Depreciation: New 10-class depreciation system. Basis partially indexed for inflation over five percent. Effective: property placed in service after 1985. Transition rule for binding contracts on September 25, 1985.

Research credit: Credit reduced to 20 percent; rules tightened.

Investment tax credit: Repealed for property placed in service after 1985. Transition rule for binding contracts on September 25, 1985.

Sale of depreciable business property (Section 1231 property): All gain over straight-line depreciation taxed as ordinary income.

Expensing costs of business assets: Up to \$10,000 a year, restricted to taxpayers who put less than \$200,000 of eligible property in service.

Rehabilitation credit: Reduced to 10 percent for buildings built before 1936; 20 percent for certified historic

SPECIAL REPORT

structures. Transition rules for binding contracts on September 25, 1985.

Business energy credit: Solar and geothermal credits extended at reduced rates through 1988.

Senate Finance Committee

Depreciation: Similar to present law. More accelerated deductions for most equipment; real property depreciated by straight-line method over 27½ years for residential property and 31½ years for commercial property. Effective: 1987 (?).

Research credit: Present 25 percent credit extended through 1989; rules tightened.

Investment tax credit: Same as House bill. Transition rules for certain property placed in service after 1985. Unused investment tax credits reduced by 30 percent.

Sale of depreciable business property (Section 1231 property): Same as present law, but capital gain is taxed at maximum of 27 percent for individuals, 28 percent for corporations.

Expensing costs of business assets: Same as House bill, but deduction phases out when more than \$200,000 of property placed in service.

Rehabilitation credit. Same as House bill; transition rules unknown.

Business energy credit: Business energy credit extended through 1988 for solar, geothermal, and ocean thermal; through 1987 for biomass. Rates of credit reduced.

Deductions

Present Law

Entertainment expenses and skyboxes: Deductible if for business purpose.

Meals and lodging away from home: Deductible if for business purpose.

Travel as education; seminars on cruise ship: Deductible if for business purpose.

House Bill

Entertainment expenses and skyboxes: 80 percent deduction for meals and entertainment, including sporting events; no deduction for skyboxes.

Meals and lodging away from home: No dollar limitation. One-year rule defines "away from home."

Travel as education; seminars on cruise ship: No deduction.

Senate Finance Committee

Entertainment expenses and skyboxes: 80 percent of business meals and entertainment deductible; rules tightened. Skyboxes retained (?).

Meals and lodging away from home: Same as House (?).

Travel as education; seminars on cruise ship: No deduction.

Accounting Methods

Present Law

Cash method: Acceptable for businesses without inventories, despite use of accrual method for financial reporting.

Bad-debt reserves: Deductible.

Business installment sales: Allows deferral.

Uniform capitalization rules: Manufacturers must capitalize most costs of production under "full absorption" method.

Long-term contracts: Completed-contract or percentage-of-completion method allowed.

House Bill

Cash method: Disallowed for corporations not rendering professional services if gross receipts exceed \$5 million. Effective: years beginning after 1985, with five-year spread.

Bad-debt reserves: Deduction allowed only for actual losses written off. Exception for small banks (assets under \$500 million). Effective: tax years beginning after 1985, with five-year spread.

Business installment sales: Pledge of installment note as security for loan triggers recognition of deferred gain except for short-term notes (payments in less than nine months). New anti-abuse rules. Pre-1986 pledges exempt.

Uniform capitalization rules: Would require manufacturers to capitalize indirect costs, including overhead.

Long-term contracts: Repeals completed-contract method. Percentage-of-completion method allowed based on costs incurred.

Senate Finance Committee

Cash method: Disallowed for financial institutions. Otherwise, retains present law. Effective: tax years beginning after 1986, with five-year spread.

Bad-debt reserves: Deduction allowed only for actual losses written off except for all financial institutions. Effective: tax years beginning after 1986, with five-year spread.

Business installment sales: Installment method denied for revolving credit plans and portion of sales by dealers in personal or real property or sales of publicly traded property. Effective: sales after 1986, with five-year spread.

Uniform capitalization rules: Same as House for all taxpayers except would apply to retailers and wholesalers with gross receipts of over \$5 million. Effective: after 1986, with five-year spread.

Long-term contracts: Retains present law, with requirement to capitalize overhead costs on cost-plus or federal contracts. Effective: contract: after March 1, 1986 (?).

IV. EMPLOYEE PLANS AND BENEFITS

The Senate Finance Committee, like the House, did not set out to overhaul the taxation of employee benefits (for fringe benefits, that was done in the 1984 Act). It merely tightened various requirements to cut tax expenditures and help arrive at revenue-neutrality. One controversial change would curtail 401(k) plans significantly; other changes could be even more costly. Even though rules are tightened, many fringe benefit rules are left untouched by both the House and Senate Finance bills. These include employer-paid medical insurance, employer-paid group-term life insurance, employer-paid death benefits, and incentive stock options.

Fringe Benefits

Present Law

Employee awards for productivity, service, and safety: Employer deducts up to \$400 value, but IRS has claimed this is income to employee.

Uniform fringe benefit nondiscrimination rule: Each tax-free fringe benefit (other than insured medical plans) subject to separate nondiscrimination rules.

House Bill

Employee awards for productivity, service, and safety: No provision.

Uniform fringe benefit nondiscrimination rule: Establishes uniform nondiscrimination rules for eligibility and benefits in six specific areas.

Senate Finance Committee

Employee awards for productivity, service, and safety: Awards of tangible personal property excluded to extent deductible by employer.

Uniform fringe benefit nondiscrimination: Nondiscrimination rules modified to make them more uniform.

Retirement Plans

Present Law

Individual retirement accounts (IRAs): Annual contribution limit for individuals is \$2,000, for married couples \$2,250 if one is working, \$4,000 if both are working.

Distributions before age 59½: An additional 10 percent penalty income tax is charged on IRA distributions before age 59½.

Lump-sum distributions: Lump sums from pension and profit-sharing plans are taxed under 10-year averaging.

Employer securities: Appreciation in employer stock held by a pension or profit-sharing plan is taxed to employee as capital gain when the employee sells the stock.

401(k) plans (cash or deferred arrangements, or CODAs): Employees are not taxed currently on salary they elect to defer under employers' 401(k) profit-sharing plans. Annual deferral can be as much as 20 percent of pay or \$30,000, if less.

Deferred compensation plans of states and tax-exempt employers: State and local government employees may elect to defer up to \$7,500 a year in an unfunded plan.

Loans from retirement plans: Loans over the lesser of one-half of vested plan benefits or \$50,000 treated as distribution.

Employee stock ownership plans (ESOPs): Special tax benefits for employer ESOP contributions, sales of employer stock to ESOP, dividends on ESOP stock, and interest received by banks lending to ESOP.

Pension plan reversions: Amounts reverting to employers on terminating overfunded plans are taxable income.

Vesting: Except for special situations, pension benefits can vest either after 10 years or gradually over five to 15 years.

House Bill

Individual retirement accounts (IRAs): Same as present law, except \$2,000 limit is reduced dollar for dollar by employee deferrals under 401(k) plans. Effective: 1986.

Distributions before age 59½: Conforms early withdrawal rules to those for IRAs and increases penalty to 15 percent.

Lump-sum distributions: One-time five-year averaging allowed after age 59½.

Employer securities: Same as present law.

401(k) plans (cash or deferred arrangements, or CODAs): Limit cut to \$7,000, but first \$2,000 offsets employee's IRA contribution. Hardship distributions permitted. New nondiscrimination rules. Governments and tax-exempts can sponsor 401(k)s if IRS has approved plan. Effective: plan years beginning after 1985.

Deferred compensation plans of states and tax-exempt employers: Employees of tax-exempts could defer salary only on same basis as state employees, except that total salary deferred under 401(k) plan, tax-sheltered 403(b) annuity, and unfunded plan could not exceed \$7,500. Effective: 1986.

Loans from retirement plans: Only the excess of loans over \$50,000 limit treated as a distribution.

Employee stock ownership plans (ESOPs): Tax credit ESOP repealed effective for compensation after 1985. Repeals incentives for leveraged ESOPs and tightens rules on vesting, voting rights, nondiscrimination, diversification, etc.

Pension plan reversions: 10 percent deductible excise tax on reversions. Effective: terminations after 1985.

Vesting: No provision.

Senate Finance Committee

Individual retirement accounts (IRAs): No deduction if covered by a qualified retirement plan. Taxation of earnings on nondeductible contributions is deferred.

Distributions before age 59½: Similar to House, with exceptions for life annuities, hardships, early retirement after age 55, and transfers to ESOPs.

Lump-sum distributions: Same as present law for those age 50 by January 1, 1986 (?). Otherwise, same as House.

Employer securities: Same as present law.

401(k) plans (cash or deferred arrangements, or CODAs): Limit of \$7,000 plus \$2,500 more if paid to ESOP. Tax-exempt groups can have CODAs. No new government plans after March 1, 1986. Otherwise similar to House. Simplified Employee Plan can have CODA. Effective: plan years beginning after 1986.

Deferred compensation plans of states and tax-exempt employers: Generally, same as present law.

Loans from retirement plans: Same as House.

Employee stock ownership plans (ESOPs): Tax credit ESOP repealed effective for compensation after 1986. Retains present law leveraged ESOP incentives, etc. Minor modifications to other ESOP rules.

Pension plan reversions: Same as House unless reversion transferred to ESOP. Effective: termination after 1985 (?).

Vesting: Vesting must be at least as fast as five years of service or gradually over three to seven years. Effective: plan years beginning after 1988 (?).

V. SPECIFIC INDUSTRIES

Energy

Present Law

Intangible drilling costs: Deductible.

Percentage depletion: Qualified producers may deduct a percentage of gross income from the property.

House Bill

Intangible drilling costs: Deductible up to sinking of drilling pipe.

Percentage depletion: Three-year phase-out, except for stripper wells and royalty interests in them.

Senate Finance Committee

Intangible drilling costs: Same as present law.

Percentage depletion: Same as present law.

Financial Institutions

Present Law

Bad-debt reserves: Deduction allowed for formula additions to reserves.

Interest to carry tax-exempt bonds by depository institutions: Deduction allowed for 80 percent of interest to acquire or carry tax-exempt bonds.

Net operating taxes: Special NOL carryover rules apply.

(Continued on next page)

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House Bill

Bad-debt reserves: Deduction allowed only for actual losses as incurred. Exception for banks with no more than \$500 million in assets. Thrifts' percentage-of-income deduction limited to five percent.

Interest to carry tax-exempt bonds by depository institutions: No deduction.

Net operating losses: Special NOL rules repealed. General rules apply (three-year carryback; 15-year carryover).

Senate Finance Committee

Bad-debt reserves: Same as present law except thrifts' percentage-of-income deduction limited to 25 percent. Effective: 1987 (?).

Interest to carry tax-exempt bonds by depository institutions: Same as present law.

Net operating losses: Same as present law except thrifts' NOLs (from 1981 through 1986) may be carried forward eight years.

Life Insurance Companies

Present Law

Reserve deduction: Deduction for increase in reserves.

Special and small-company deduction: Deductions for percentage of taxable income.

House Bill

Reserve deduction: Same as present law.

Special and small-company deduction: Repeals special deduction; retains small-company deduction.

Senate Finance Committee

Reserve deduction: Same as present law.

Special and small-company deduction: Same as House.

Property and Casualty Insurance Companies

Present Law

Unpaid losses: Deduction for estimate of losses to be paid in future.

Unearned premiums and acquisition expenses: Premiums not taxed until earned; acquisition expenses currently deductible.

Protection against loss (PAL) account: Additional deduction for contributions to special account for mutual P/Cs.

Policyholder dividends: Deduction for dividends paid by mutuals.

Blue Cross-Blue Shield; TIAA-CREF: Certain organizations providing insurance benefits to members are tax-exempt.

House Bill

Unpaid losses: Minimum tax of 20 percent of adjusted statement gain from operations.

Unearned premiums and acquisition expenses: Acquisition expenses currently deductible; 20 percent of annual increase in unearned premiums taxable; 20 percent of unearned premiums at beginning of year taxable over five years.

Protection against loss (PAL) account: Repealed, with existing account balance taxable over five years.

Policyholder dividends: Treasury study required.

Blue Cross-Blue Shield; TIAA-CREF: Repeals exemption BC-BS and TIAA-CREF.

Senate Finance Committee

Unpaid losses: Pretax discounting rule on each line of business (including A&H); rate starts of five percent and changes to 75 percent of applicable federal rate.

Unearned premiums and acquisition expenses: Same as House except beginning-of-year balance taxable over 7½ years; for bond insurance, 10 percent rate used.

Protection against loss (PAL) account: Same as House.

Policyholder dividends: Same as present law.

Blue Cross-Blue Shield; TIAA-CREF: Same as present law.

VI. INTERNATIONAL

The Senate recommendations specifically affecting international transactions would have fewer far-reaching consequences than earlier proposals. An important "non-change" is retention of the present title-passage test for determining the source of income from sales of inventory. The overall foreign tax credit would be retained, with the addition of a "passive income" basket. For U.S. multinationals, the drop to a 33 percent rate and new rules allocating deductions will significantly increase excess foreign tax credits. For foreign investors in U.S. real property, there is the prospect of tax-free gain on the sale of that property (i.e., FIRPTA would be repealed).

Present Law

Foreign tax credit; source of income; allocation of deductions; deemed-paid credits: Foreign tax credit is computed on overall basis and allows income from sales of inventory and intangibles to be foreign source based on title passage. Dividend income is generally sourced in the country where the paying corporation is incorporated.

Subpart F: Limited amounts of tax haven income taxed currently to U.S. shareholder of CFC. "CFC" means more than 50 percent voting control in U.S. persons, 10 percent *de minimis* protection.

U.S. expatriates: Exclusion of up to \$80,000 of foreign earned income.

House Bill

Foreign tax credit; source of income; allocation of deductions; deemed-paid credits: Retains overall limitation with new "low-tax income" (foreign personal holding company income but not active rent and royalties) and banking and insurance baskets. Adopts source rule changes and pooling proposal, and requires consolidation for all allocation of deduction rules.

Subpart F: Voting control test changed to 50 percent vote or value test, "partnerships" become related persons, and types of "tax haven" income expanded significantly.

U.S. expatriates: Exclusion is reduced to \$75,000 and made a preference item for the minimum tax.

Senate Finance Committee

Foreign tax credit; source of income; allocation of deductions; deemed-paid credits: Retains overall limitation but with new "passive" income limitation (does not apply to banking, shipping, or insurance activities). Adopts some source rule changes and requires some consolidation for allocating all types of deductions.

Subpart F: Certain passive income taxed currently. Five percent *de minimis* protection.

U.S. expatriates: Exclusion is reduced to \$70,000, but would not be a preference item for the minimum tax.

VII. PENALTIES AND INTEREST

Present Law

Failure to pay tax: One-half percent per month up to 25 percent. Applies after notice of levy.

Fraud: 50 percent of total underpayment.

Negligence: Five percent of total underpayment.

Substantial understatement: 10 percent of underpayment due to understatement.

Interest rate on deficiencies and refunds: Same rate for both.

House Bill

Failure to pay tax: Jumps to one percent per month up to 25 percent after notice of levy.

Fraud: 75 percent of underpayment due to fraud.

Negligence:

- Five percent applies to all types of taxes.

- Five percent of underpayment due to negligence.
- Ten percent if item subject to information reporting.

Substantial understatement: Same as present law.

Interest rate on deficiencies and refunds: Rate on deficiencies one percent higher than on refunds.

Senate Finance Committee

Failure to pay tax: Same as House (?).

Fraud: Same as House (?).

Negligence:

- Same as House (?).
- Same as House but applies only to portion due to negligence at 10 percent rate.
- Same as House (?).

Substantial understatement: Increases to 20 percent (?).

Interest rate on deficiencies and refunds: Same as House.

WASHINGTON ROUNDUP

PRICE WATERHOUSE RELEASES FINANCE COMMITTEE TAX BILL SUMMARY. The accounting firm of Price Waterhouse released a study May 15 which summarizes the major proposals in the Senate Finance Committee's tax revision bill. The summary explains how the lower individual and corporate rates are financed and details the major revenue raising devices used, such as: the repeal of the capital gains exclusion for individuals, the elimination of the deduction for contributions to individual retirement accounts for persons covered by a pension plan, the limitation of the amount of passive losses that can be used to offset other income, and the implementation of an alternative minimum tax.

The 35-page Price Waterhouse study has been placed in the June 2, 1986 *Tax Notes Microfiche Database* as Doc 86-3988.

CENTER FOR RURAL AFFAIRS OUTLINES FINANCE TAX REVISION PROPOSALS. The May newsletter of the Nebraska-based Center For Rural Affairs (CRA) outlines provisions in the Senate Finance Committee tax bill which may prove beneficial to the family farm operator. According to the newsletter, "Several harmful tax shelters would be reduced or repealed." The article discusses farm-related provisions such as depreciation, tax loss cattle feeding, tax-exempt bonds, conservation incentives, and expensing.

The CRA newsletter has been placed in the May 26, 1986 *Tax Notes Microfiche Database* as Doc 86-3921.

ABA TAXATION CHAIRMAN SEES QUALITY PROBLEMS WITH IRS PERSONNEL. Hugh Calkins, Chairman of the American Bar Association's (ABA) Section of Taxation, testified before Congress May 15 that the IRS urgently needs more funding, especially to upgrade the quality of the IRS's examinations personnel, according to an ABA press release. Calkins said, "Too many examining agents are unable to comprehend the documents which they are expected to understand, and unable to interpret correctly detailed provisions of the Code and the regulations." Calkins added that IRS's personnel is critical to tax

compliance. "If these agents are unable to understand the law, how can they enforce it?" he asked.

The ABA press release has been placed in the May 26, 1986 *Tax Notes Microfiche Database* as Doc 86-3924.

SBA SUMMARIZES SMALL BUSINESS RELATED PROVISIONS IN SENATE FINANCE COMMITTEE BILL. The Small Business Administration (SBA) recently compiled a summary of provisions in the Senate Finance Committee tax revision bill that would affect small businesses. Positive highlights of the bill, according to the SBA, include the three-bracket rate structure, the new 50 percent deduction of health-care cost premiums for owner-employees, and the 33 percent top rate for corporations.

Other provisions which may or may not be negative, depending on the type of business, according to the SBA, include the repeal of the investment tax credit, the disallowance of all consumer interest, the faster depreciation schedule for equipment, and the slower depreciation schedule for real estate.

The SBA also studied the repeal of the capital gains differential, the changes in the alternative minimum tax, and the restrictions on passive income losses. The summary does not discuss the effects of these provisions on small business, and is based on the Joint Committee on Taxation summary of the Finance Committee bill.

The SBA's summary has been placed in the June 2, 1986 *Tax Notes Microfiche Database* as Doc 86-3987.

READER COMMENTS WELCOMED

Advice from readers has contributed greatly to the development of Tax Notes. If you have comments, suggestions, or criticisms, please take a moment to drop us a note. Address your letter to Thomas F. Field, Publisher, Tax Notes, 6830 North Fairfax Drive, Arlington, Virginia 22213. Thanks, in advance, for your help.

EVOLUTION OF THE 1991 PENNSYLVANIA TAX COMMISSION

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I. INTRODUCTION

A number of states have systematically reviewed their overall tax structure from time to time with the objective of achieving tax reform through legislation and executive fiat. Professor Brazer's work for Michigan¹ in the 1950's is but one example of a continuing interest by state officials and academics in the revision of state and local tax laws.

Such tax studies may be characterized in terms of their clients and in terms of the amount of time available and time horizon for recommendations. Governors or state legislatures typically create commissions to report back to them with recommendations and lengthy analyses. With regard to timing, some serve to define and collect a consensus on how to meet immediate revenue needs; some take a very long-run perspective and propose far-reaching goals and change; and, others have provided a menu of proposed reforms which address both long and short-run problems. Those with a long term perspective often take several years to complete and as such justify legislative reticence to act until the study is available. Those with a short term perspective are often more concerned with identifying revenue sources than any particular principle of finance; these succeed more often in obtaining legislation. Few of any category consider simultaneously the expenditure and revenue sides of the budget, due in part to the sheer complexity of both tasks as well as the intractable nature of measuring the benefits of state and local public goods. One may conjecture that had there been more publically supported studies which examined both taxes and spending, there would be less enthusiasm for expenditure and/or tax limitations, and those limitations put in place would be more administratively manageable.

Pennsylvania is among those states which have periodically reviewed their tax system. Since 1889, Pennsylvania has averaged a state tax study every 6.4 years,² and in the view of some, such tax commissions have become something of a cottage industry. Undoubtedly the major reason for their frequency is the inadequacy of public revenues resulting from the constitutional prohibition against progressivity. The State's revenue elasticity could be unity at best. Since Pennsylvania's appetite for public goods is not materially different from most other states, chronic revenue shortfalls vis-a-vis desired expenditures have required a wide variety of emergency revenue measures over the years. Moreover, since the lack of revenue elasticity prevails at the local level as well, local governments have constantly been at the doorstep of the General Assembly to have various tax rate ceilings raised and/or lowered to obtain new taxing authority.

In the summer of 1979, Governor Richard Thornburgh of Pennsylvania invited Richard M. Cyert, President of Carnegie-Mellon, to chair a major study of the state's taxes, and created the Pennsylvania Tax Commission. The invitation was tendered at a time when the State's finances were stable. Over the period October, 1979–March, 1981, I served as its Director of Research. Three aspects of the work of the Commission are of greatest likely interest, (i) the assumptions, process, and organization of the Commission; (ii) the major substantive tax issues which were addressed and recommendations made by the Commission; (iii) and the methodology and data bases that were used. Given the recent Federal cuts in aid to the states, and likely tax reductions due to state reliance on Federal depreciation schedules, the market for state tax studies is likely to be quite strong in the next five years.

II. ORGANIZATION OF THE TAX COMMISSION, KEY ASSUMPTIONS, AND GOALS

In forming the Commission, the Governor sought to make the appointed membership representative politically (prominent Republicans and Democrats were appointed), geographically (residents of the Philadelphia and Pittsburgh SMSA's were well represented), demographically (there were two black representatives, and one woman out of 11 appointees), and professionally (large and small industry were represented; labor and management were represented; and the accounting and legal professions were represented). Achieving balance in each of these areas was thought essential for the final work of the Commission to be taken seriously throughout the state and in the General Assembly. In order to involve the legislature per se, the majority and minority leaders of the House and Senate were made *ex officio* members, as were the Secretaries of Revenue and Budget. Also, the Governor appointed an executive

director from his office to serve as liaison to the executive branch.

The purview of the Commission was quite broad. The Governor charged it to:

... gather the best available advice, recommendations, and data on tax policy, make a comprehensive assessment of our tax system . . . [have task forces report to the Commission on] . . . local tax reform, local tax problems in the Delaware Valley, the state corporate net income, and capital stock and franchise tax, state taxation of utilities, financial institutions, and insurance companies, transportation taxes, personal income, inheritance, estate, fiduciary, and personal taxes, sales, cigarette and alcohol taxes, the administration and enforcement of tax laws, and the impact of the tax system on economic development, community conservation, and energy conservation and development.³

In addition, the Governor asked that the matters of unemployment and workmen's compensation not be reviewed by the Commission as they were currently before the legislature, that the overall effective rate of state and local taxation, as measured by the ratio of state and local taxes to personal income in the state, should in the aggregate remain constant, and that consideration be given to not raising the matter of the constitutional prohibition against progressivity.

I should note parenthetically Pennsylvania is roughly a median state in terms of per capita spending and taxation. In terms of overall tax burden, Pennsylvania is also close to the median. It relies at the local level on reasonably broad based taxes, and taxes business principally at the state level.

Given 15 months to perform the study, the Commission organized its schedule into three distinct phases: public hearings, task force research and reports to the Commission, and Commission deliberations on its final recommendations.⁴ Also, in order to develop expert assistance to the Commission, academicians in Pennsylvania with interests in public finance were recruited to serve as research directors to the various task forces and to assist the full Commission subsequently. (See Table 1)

As may be evident, this three step process ensured that the public and interested parties could make their views on state and local taxes publically known to the Commission, and ensured that the Commission members would become expert in at least one area of taxation as a result of leading a task force group. Since it was expected that representatives of various organizations would serve on these task forces to provide expert and practical advice about particular areas of taxation, the three step process served both to educate and build consensus within the Commission and among interested parties on the definition of tax reform. The presence of the academicians in the task forces served not only to get the research and writing done, but also to educate representatives of organizations on the first principles of public finance. Finally, the separation of the task force efforts from the final Commission deliberations served to make the Commission more independent of particular interests.

The Commission identified six goals of a desirable tax system: simplicity, certainty, equity, economic efficiency, economy of administration, and revenue adequacy. In addition, the Commission required that the reformed system's tax components be justified either by the ability to pay or benefit principles. The Commission also viewed the matter of tax administration quite seriously and was repeatedly concerned about the administrative details of various taxes and the overall appeals process.

During the public hearings, representatives from industry and labor reminded the Commission of the 1968 Commission's recommendation⁵ (which industry and labor endorsed) that the burden of taxation on industry and labor should be 30% and 70% respectively. While the 1981 Commission was cognizant that the real issue of burden involved the ultimate incidence of various taxes on capital and labor, and so stated in the *Final Report*, the tacit acceptance of this additional constraint by Commission members (in conjunction with the one that the effective overall rate of taxation should remain constant) insured that the total revenue from major state taxes would remain the same, and that enhancements at the state level would have to come from within each major state tax. Also during the public hearings, mention was made by some witnesses of the desirability of tax and expenditure limitations being within the purview of the Commission. However, a number of Commission members objected strongly to considering the expenditure side of the budget in addition to the tax side of the budget. Others noted that because Pennsylvania had a median effective tax rate, there was not a compelling need to consider tax limitations. Both matters were ultimately dropped as topics for final commentary by the Commission.

III. MAJOR TAX ISSUES AND RECOMMENDATIONS OF THE PENNSYLVANIA TAX COMMISSION

The Commission reviewed tax issues in five major areas (local taxation, state taxation of individuals, transportation taxation, business taxation, and tax administration) and made numerous recommendations in each. Without going through every issue and recommendation,⁶ let me sketch the major areas of concern and the recommendations.

TABLE I
Organization of the Pennsylvania Tax Commission

	Affiliation	
	Task Force	Academic Research Director
Richard M. Cyert	President, Carnegie-Mellon	Director of Research Executive Director
Robert P. Strauss	Carnegie-Mellon	
Raymond P. Pepe	Governor's Office	
Donald Y. Clem	President, McConway & Torley Corporation, Pittsburgh	Taxation of Small Business
Charles G. Kopp	Senior Partner, Wolf, Block, Schorr & Solis-Cohen, Philadelphia	Personal and Inheritance
Richard J. McConnell	Vice-President, Girard Bank, Philadelphia	Local Property Tax
Henry Nicholas	President National Union of Hospital Workers, Philadelphia	Transportation
Farrell Rubenstein	Managing Partner, Touche-Ross & Company, Pittsburgh	Utilities, Financial Institutions & Insurance
Herman Schneebell	Former U.S. Congressman, Williamsport	Sales & Excise
Carol S. Smith	League of Women Voters of Pennsylvania	Local Non-Property
Ralph S. Snyder	Partner, Schnader, Harrison, Segal & Lewis, Philadelphia	Tax Administration
Robert W. Sorrell	President, Urban League of Philadelphia	Delaware Valley Tax Problems
W. Bruce Thomas	Vice President for Finance, U.S. Steel	Taxation of Large Business

A. Local Taxation

The major problems of local Pennsylvania taxes include: (i) the worst property tax assessment system of any major state in the U.S., (ii) continuing controversy over whether or not local school districts should be forced onto the local wage tax base and forced off of the local property tax, (iii) the imposition of a bewildering variety of local head and occupation taxes which are allowed under state law which is broadly permissive as to the type of taxes localities can impose; (iv) the absence of a local tax on unearned income, and the lack of a consistent policy toward commuters; and (v) the taxation of resident and non-resident wages at 4 5/16% in Philadelphia which has had the demonstrated effect of driving business out of the city.

Given that Pennsylvania has over 500 school districts, 2500 cities and boroughs, and 67 counties, fashioning a series of coherent local tax recommendations proved to be quite challenging. The political importance of Philadelphia and the magnitude of their unique tax problems further complicated the creation of a rational series of recommendations. However, I think that the Commission made the greatest progress of any study group in recent experience, and am optimistic that its structure of local tax reform will be endorsed and enacted by the legislature.

The basic thrust of the local tax reform recommendations can be summarized as follows:

(i) increased access for school districts to the income tax (as contrasted to the current wage tax) but without a mandatory decrease in property taxes; (ii) reform of the assessment and appeals process as relates to the property tax in specific, and operational ways with attending financing and state supervision; (iii) elimination of the various head and occupation taxes and other "nuisance taxes" such as the residential construction tax, and the recommendation that localities be permitted only to use enumerated taxing powers provided under state law; (iv) reduction in Philadelphia's tax on commuters from 4 5/16% to 2.9% which could be locally financed as a result of the broader local tax base (replacement of the earnings tax by an income tax) and the elimination of Philadelphia's \$32 million contribution to the regional transit authority, SEPTA; (v) a consistent policy toward commuters by the imposition of a tax on their earnings of .25%, except in Philadelphia which would be 2.9%, and the elimination of all crediting arrangements; (vi) provision for municipalities of a local income tax base in lieu of the current earnings base; (vii) the recommendation of state administration or piggybacking of the local income tax on to the state; and (viii) a modest liberalization of the state's property tax circuit breaker.

The local tax recommendations thus simplify and broaden the tax base of local governments, inherently increase their revenue elasticity, and move the entire local tax structure in the state toward a more uniform structure. Generally, municipalities would have access to a local income tax up to 1% maximum rate, while school districts would generally have access to a local income tax up to 1.5% maximum rate. The provision of separate ceiling rates represents a change as under current law geographically overlapping schools and municipalities share the current wage tax.

This rather dramatic reshuffling of taxes was costed out, and the ceiling rates were set so that no municipality, school district, or county government, would be worse off in the sense of having access to smaller revenues than under current law.

B. State Taxation of Individuals

Pennsylvania's personal income tax has a broader base than its Federal counterpart; i.e., all capital gains are taxed as ordinary income; and as a result, it has a low nominal rate (2.2%). While the Pennsylvania Constitution requires that the rate be proportional, there is some latitude for tax forgiveness to low income individuals. With regard to the sales tax, the Commission reviewed the current exemption of clothing from taxation—Pennsylvania is one of 4 states which excludes clothing from the sales tax base—and reviewed the overall burden of the tax as measured in static terms. Finally, the Commission reviewed the inheritance tax and found that 50% of the inheritance tax returns pay only 10% of total receipts of the inheritance tax.

The issues identified in these areas of taxation involved how to provide more generous tax forgiveness for low income taxpayers, how to provide the Federal treatment of capital gains on the sale of a residence for those over age 55, and whether or not a small estate exclusion was warranted. In addition, a number of issues raised by various State Supreme Court decisions in the personal and inheritance taxes were reviewed.

The Commission made a series of recommendations which required that the state rate be raised from 2.2% to 2.28%; this kept whole personal and inheritance tax receipts. In particular, the Commission recommended that the low income tax relief be increased by the inflation experienced between 1974, when the forgiveness tables were enacted, and the present, that the Federal tax-free roll-over on the sale of a residence be provided, and that \$15,000 of clear value be excluded from the value of estates. The

Commission did not recommend that any changes be made in the state sales tax which was found to be proportional in effective tax burden through a fairly wide range of economic income.

C. Transportation Taxation

Pennsylvania's roads and bridges are in a state of rapid decay. The depreciation of these assets occurred because dedicated gas and motor fuel taxes have decreased in nominal terms while repair costs have increased faster than the general cost of living. Also, local governments have responsibilities for road maintenance without the financing to support it. The Commission found that the State's estimates of likely maintenance costs were 50% lower than those obtained by using historical trends. These considerations suggested that the system of fees and charges should be radically overhauled to be more elastic, and to be more in relation with actual state-local divisions of responsibilities.

A review of the formulas used by the state to reimburse mass transit agencies for their operating deficits indicated that they provide an incentive to run deficits since they are essentially open-ended matching formulas. Also, it was observed that the current method of setting fares results in large subsidies to middle income riders.

Finally, in briefly reviewing airport financing, the Commission found that the state currently subsidizes local airports as do some cities and counties.

The Commission recommended a variety of changes in the area of transportation finance which are increasingly germane in view of the significant Federal reductions in aid to transportation. In particular, the Commission recommended that fuel taxes be raised 2 cents/gallon, and various user fees raised 20%; these changes would raise dedicated revenues by \$170 million. Thereafter, the Commission recommended that all taxes and fees should be indexed to maintain a constant volume of road maintenance and reconstruction. The index should be based on the Federal cost index of highway construction and on the deviation between the predicted and actual flow of revenues into the dedicated road repair trust fund.

The Commission also recommended that vehicles should be taxed in relation to the estimated damage they impose on roads and bridges, and local roads be administered whenever possible by local governments. Allocation of necessary funding of the proposed road turnback should be based on mileage, cost, condition, and type of roads administered. There is a significant lack of reliable data on empirical damage relationships, and the Commission urged the State to do its own studies, rather than wait for Federal studies which are long overdue.

There were also several innovative proposals in the area of mass transit. First, it was recommended that the mass transit subsidy be made on the basis of a lump sum amount per passenger. Second, the Commission recommended that regional mass transit authorities be given access to their own tax base. In particular, the Commission recommended that SEPTA be given a small surcharge on the individual income tax base in return for the elimination of county subsidies to it. Third, it was suggested that an experiment be performed with transit stamps which would provide to Food Stamp recipients subsidized transit tokens, and would permit more realistic pricing for all other riders.

D. Business Taxation

Taxation of business in Pennsylvania, as in many other states, is composed of a series of special profit, property, and excise taxes imposed on various industries. The Commission reviewed the issue of whether or not such taxes are in a sense too high in Pennsylvania compared to other industrial states and act as a deterrent to new investment. While no definitive empirical evidence was found on the issue, the general feeling of tax practitioners is that the overall effective rate of state and local taxation in Pennsylvania is not dissimilar to other major states. Relatively modest local property taxes offset some of the disadvantages of a high state profits tax. The academic survey studies on the matter are generally inconclusive as to whether taxes are pivotal in location decisions.

That is not to say that there are not problems with these various business taxes. With respect to the net income or profits tax, the absence until 1981 of any loss carry-over provision and the absence of a subchapter S provision were viewed as impediments to new investment in the state. Also, the definition of business income was found to require clarification in line with that of other states.

Two special taxes were singled out as failing to meet any defensible criteria of taxation: the tax on the value of corporate loans made to residents within state, and the tax on the value of a firm's capital stock. Administration of the capital stock tax has been increasingly difficult in the last 10 years as valuation in periods of double digit inflation has been problematical. As a long run objective, the Commission recommended that the state move to a single income tax on businesses of all types; however, due to revenue considerations the recommendations made were more modest in nature, although a variety of changes were suggested in the future should additional revenues become available.

No business tax in Pennsylvania has been more criticized than the Capital Stock and Franchise Tax. As noted, inflation has made valuation difficult. Also, because the tax is literally a "negotiated tax," taxpayers continually find themselves in conflict with the Pennsylvania Department of Revenue as to their final liability. It has been estimated that 60% of the Department's legal staff is devoted to negotiating the Capital Stock levy, which brings in less than 5% of total state revenues in the general fund.

With regard to the special excise taxes imposed on various industries, a number of problems were identified. Various financial institutions pay one of four different types of taxes, several of which are problematical. Under the excise income tax imposed on savings banks and savings and loans, a form of reverse revenue sharing is permitted as the tax allows the deduction from the state base of all Federal taxes paid. Since the Federal tax is considerable, the effective rate of tax on these financial institutions is lower than others which are taxed on the basis of their Bank Shares tax. The current tax on the value of bank stock is being challenged in the courts on the basis of a successful challenge in Montana, and several past years of collection could be at risk.

Insurance companies are currently taxed on the basis of their gross premiums (2% rate), and are not subject to either the profits or property taxes levied on corporations *per se*. Also, exemption of Blue-Cross Blue Shield premiums from this tax results in considerable revenue loss to the state.

Several issues were raised about the taxation of utilities. Currently, a 4.5% excise is levied on the sale of residential electricity and gas; sales to manufacturing entities are also under the 4.5% excise, and both are exempt sales under the state sales tax. However, commercial and nonmanufacturing uses of utility services are subject to both the retail sales tax (6%) and the 4.5% gross receipts tax. With regard to the taxation of local utility realty under the property tax, Pennsylvania requires that the state levy a 30 mil tax on the book value of utility property, and share back part of the proceeds to jurisdictions on a formula basis. Localities are asked to assess utility property and report to the state what they would have collected had the tax been locally imposed. These local amounts are aggregated, and then shared back on the basis of total local revenues collected. Historically, the amounts localities would have collected has been less than the 30 mills imposed on book value which is paid by the utilities to the state. Considerable controversy has surrounded the state's payments to localities over the years. In periods of inadequate cash flow, the state has not promptly paid over the amounts to the localities. Also, some localities have underassessed utility property by considerable amounts. Another issue raised with regard to gas, electric, and telephone utilities in the state is whether or not they are more heavily taxed than their counterparts in other states.

The Commission recommendations in the business tax area involve a series of mainly incremental reforms. With regard to the profits tax, it was recommended that loss-carry-over be provided prospectively for three years; also, it was recommended that all business income be apportioned except income resulting from the sale or disposition of real or tangible personal property which would be allocated on a normal situs basis. The Commission also took issue with the emerging practice in New York and Massachusetts of double weighting the sales factor in the interstate apportionment formula for the profits tax as a way to export state taxes. With regard to the capital stock tax, the Commission recommended that new firms not be taxable until their third year of operation, and that valuation of all firms be based on a fixed valuation formula which capitalized at 9% the average of the past six year's earnings. Since the rate is .01, the tax would be a 10.5% tax on averaged earnings. With regard to the Corporate Loans tax, the Commission recommended its elimination.

With respect to financial institutions, the Commission recommended that the various taxes be replaced with a single excise income tax, and that interest from both Federal and state obligations be included in the base. Favorable transition rules were recommended to permit institutions to alter their portfolios in a systematic manner.

The Commission did not make any recommendations in the area of insurance taxation, partly because of the automatic retaliation provisions in other state's insurance tax laws, and partly because movement to a system of apportioned income and capital stock taxation of insurance companies would involve considerable revenue losses. Similarly, the Commission did not make any recommendations for the change in taxation of public utilities, although it did observe that the combined impact of Pennsylvania's state and local taxes treats utilities in a relatively beneficial manner in comparison with other states such as New Jersey, California and New York.

E. Tax Administration

As noted earlier, a major focus of the Commission was in the area of tax administration. Review of current state and local practices revealed both general and specific areas for reform; some could be achieved through administrative regulation while others required legislation. A number of reforms were

immediately made as the Commission reviewed current practice and brought issues to the attention of the Department of Revenue.

Perhaps the most obvious administrative problem taxpayers face in Pennsylvania is the fact that there is no single code of tax law which puts in one physical place all state and local taxes and all rules of administration. The legislative practice has been to enact tax laws which amend earlier acts of the legislature. Such amendments contain a consistency rider at the end which states that all other previous acts not amended specifically, but which are inconsistent with the changes or the intent of the current act, are null and void. Not surprisingly, significant litigation results on the issue of just what is consistent and what is inconsistent. For those familiar with the Internal Revenue Code, dealing with Pennsylvania tax law can be quite time consuming, and has resulted in the development of a highly specialized tax bar in Harrisburg and Philadelphia.

Other administrative issues identified include the absence of automatic cash refunds to corporate taxpayers on a analogous basis to refunds made to individuals. Corporate taxpayers currently must fill out separate petition for refund, and the state does not pay interest for the elapsed time during the petition period. Another problem with the current state tax administrative rules is that the interest rates for deficiencies vary among taxes (between 6 and 9%) and are well below market rates of interest. As a result, taxpayers have often been delinquent in paying their taxes and in turn caused cash flow problems for the state. Finally, the state has not purged its uncollectable accounts because there is not enabling legislation to do this. As a result, the Department of Revenue has open literally hundreds of thousands of small accounts which cause significant paperwork and computer problems.

Examination of the wage levels of Department of Revenue professional staff positions indicated that they are well below market in the areas of computer specialists, accountants, and attorneys. The Department has experienced significant turnover in these positions, and has increasingly had to recruit junior professionals in each of these areas.

Beyond these general administrative issues, the Commission found that the appeals process was time consuming and expensive. Also, the Commission observed that the state does not automatically accord reasonable extensions to taxpayers whose Federal tax status changes.

The Commission made a series of recommendations to remedy these and related administrative problems. Thus, the Commission recommended that the Department of Revenue in conjunction with the professional staffs of the legislature draft a tax code which would be similar to the Internal Revenue Code. Also, the Commission recommended that the various interest rates now used be made uniform and reflect current market interest rates in order to permit the state to more promptly collect its taxes. With respect to the internal operations of the Department, the Commission recommended that salary levels be made more competitive with those in the private sector, and that the operation of the inheritance tax be parallel to other state taxes. The Commission also recommended that taxpayers have more and more current information available and that a Pennsylvania Tax Register be published monthly along with information booklets.

The Commission was unable to agree on how to reform the appeals process, but did outline general principles and called for further study.

IV. DATA AND METHODOLOGY

A major reason why earlier Pennsylvania tax studies have not resulted in significant reform is that they frequently did not document the revenue implications of their recommendations, either in terms of the aggregate amounts of revenues raised or lost as a result of proposals or in terms of the relative impact of the proposals on individuals and firms. Unfortunately, most states do not have large-scale machine readable data bases which can readily provide analysis of alternative tax proposals. For those who wish to use Federal tax data sources, Section 6103 of the Internal Revenue Code can provide significant impediments to analysis. Accordingly, a major research objective of this Commission was to make use of all related Federal and state data bases, and, where necessary, develop new ones from administrative records.

It should be noted that all of the analysis done for the Commission by the various academics was static. That is, we did not speculate about the feedback effects of various tax changes on the tax base in question. Collecting and tabulating relevant data proved to be sufficiently challenging.

Data on local taxation came from several sources. The 1977 *Census of Governments* in conjunction with state data permitted the analysis of various types of local taxes. Estimation of the income base for school districts and municipalities was based upon state tabulations of state personal tax collections by school district, and the per capita income projections by municipality created for the general revenue sharing program by the Census Bureau. Micro-simulation of alternative property tax circuit breaker schemes was performed on the SMSA samples of households available from the Annual Housing Survey which is collected by the Census Bureau. The housing surveys are rather underutilized in my judgement.

and provide an excellent Federal data source on household income, taxes, and housing services.

Data on personal taxes was obtained by matching the Federal Statistics of Income sample for Pennsylvania with state tax returns by social security number. Such matched samples, when made anonymous, were available to the Commission for 1974 and 1977. Consideration of sales tax alternatives was performed through the use of the 1972 BLS Consumer Expenditure Survey. Analysis of alternative small estate exclusions was obtained through tabulations of administrative files by the Department of Revenue.

Analysis of various business tax reforms required the creation of a new data base. A random, stratified sample of Corporate Net Income and Capital Stock taxpayers was designed by the Commission staff and drawn, coded, and keypunched by the Department of Revenue. The stratification was based on the size of final, settled tax payments made under these two taxes, and on the basis of the major industry of the firm. The sample numbered slightly over 1,000 firms, and was drawn as a panel for 1977, 1976, and 1975. Tabulations of the universe of taxpayers from the Department's online administrative record system permitted the extrapolation of the 1975 sample to 1977 levels. Better than 450 variables were collected from the state and Federal returns.

V. CONCLUDING REMARKS

The impact of most earlier Pennsylvania tax commissions on actual legislation has depended primarily on the fiscal condition of the state and localities. When revenues were needed, recommendations have been actively legislated.

A number of recommendations of the Commission have already been put in place. In late 1980, the General Assembly enacted a business loss-carryforward provision, principally on the strength of the revenue estimates obtained from the corporate data base collected for the Commission. Early this summer, the Department of Revenue revised through regulation its administration of the inheritance tax, and made it a truly self-assessed tax in line with Federal practice. Thus, the local Register of Wills no longer determines which debts and deductions are allowable, although the Register continues to be financed by a fraction of the tax collections obtained. These reforms were based in main on recommendations of the Commission. A number of major reforms of the local tax system are now before the General Assembly; I would expect that several of the Commission's recommendations will be enacted.

The type of tax reform contemplated by the Pennsylvania Tax Commission falls between the two extremes of raising emergency revenues or of stating a long-range set of philosophic objectives to move toward. The emphasis throughout the work of the Commission was to look systematically and empirically at all of the State's taxes with first principles of finance in mind, and to make a series of recommendations which could be acted upon in modules by the legislature.¹

The process of deliberation and recommendation of any tax commission is inherently political. In a sense, for a blue-ribbon study of a state's tax system not to face external and internal pressures for certain recommendations would mean that it was not to be taken seriously by legislators. Strategic awareness of these pressures was necessary throughout the life of the Pennsylvania Tax Commission to maintain an overall coherence in outlook. I would guess that many other states will be reviewing their tax structures over the next few years, and would urge that serious thought be given by those involved to the strategic matters of representation, organization, and the method of consensus building, as well as the systematic development and analysis of relevant data bases.

FOOTNOTES

¹See Harvey E. Brazer (editor), *Michigan Tax Study Staff Papers* (Lansing, 1958) or Committee on the District of Columbia, U.S. House of Representatives, 95th Congress, *Technical Aspects of the District's Tax System* (Washington, D.C. U.S. Government Printing Office, December 1, 1978).

²Jared Lobdell, *A Century of Pennsylvania Tax Revision by Commission* (Unpublished manuscript prepared for the Pennsylvania Tax Commission, Carnegie-Mellon University, Department of Applied History, April, 1980), Chapter 1.

³Commonwealth of Pennsylvania, Governor's Office, Executive Order 1979-14, *passim*.

⁴Publications of the Pennsylvania Tax Commission include:

Public Hearings before the Pennsylvania Tax Commission: Philadelphia, Pittsburgh, Harrisburg, Erie and Scranton; June, 1980.

Executive Summary: Final Report of the Pennsylvania Tax Commission; March, 1981.

Final Report of the Pennsylvania Tax Commission; March, 1981.

A Task Force Report to the Pennsylvania Tax Commission: Business Taxation and Business Taxation With Special Reference to the Problems of Small Business; March, 1981.

A Task Force Report to the Pennsylvania Tax Commission: Financial Institutions, Insurance and Utility Companies; March, 1981.

A Task Force Report to the Pennsylvania Tax Commission: Local Property Taxation: March, 1981.

A Task Force Report to the Pennsylvania Tax Commission: Local Nonproperty Taxation: March, 1981.

A Task Force Report to the Pennsylvania Tax Commission: Local Nonproperty Taxation with Special Reference to the Problems of Delaware Valley: March, 1981.

A Task Force Report to the Pennsylvania Tax Commission: Sales, Cigarette and Liquor Taxation: March, 1981.

A Task Force Report to the Pennsylvania Tax Commission: Tax Administration: March, 1981.

A Task Force Report to the Pennsylvania Tax Commission: Transportation Taxation: March, 1981.

²See *Report of the 1968 Tax Study and Revision Commission*. (Harrisburg, 1968).

³See *Final Report of the Pennsylvania Tax Commission* (Harrisburg, PA, 1981) for the complete set of recommendations.

⁴While the incrementalism of its proposals reflects initial Commission assumptions and constraints, it also is consistent with the pace of possible legislative consideration.

TAX STUDIES IN MICHIGAN: PAST IMPACT AND CURRENT ISSUES

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Until about ten months ago I was content in the knowledge that the Michigan Tax Study, for which I served as research director in 1957-1958, seemed to have achieved one of my major objectives. It promised to be the last large scale tax study undertaken in the State of Michigan. But before the end of December 1980 it became clear that something had gone wrong. I had agreed again to direct a study of the State's fiscal and economic structure.

During the 1950s, when it was common to find half or more of the states undertaking tax studies simultaneously, state expenditures were rising rapidly and revenues were not keeping pace. The dominant motive for these studies, therefore, was the widespread acceptance of the view that more revenue was needed than the existing tax system or level of rates was capable of producing. At that time most of the states had adopted either an income tax or a sales tax and the leading candidate to provide the additional revenue needed was typically the one of these two taxes that the state in question did not already levy. Thus, for example, the Governor's Minnesota Tax Study Committee recommended the adoption of a sales tax in 1956, and the Michigan Tax Study advocated personal and corporate income taxes in 1958.

A second motivation behind the tax studies of the '50s was reform. Reform, generally, meant three things, not always easy to reconcile. They were first, changes in the tax structure designed to remove what were seen to be elements that dissuaded new firms from entering the State or that encouraged existing firms to move elsewhere. For many, at least as important was the objective of achieving a more equitable tax system, one that would treat the poor less harshly while increasing the relative tax load carried by the well-to-do. Reform also meant removing discriminatory features in the tax laws that often were remnants of provisions in taxes that may have been appropriate to the circumstances of the 19th century, but which, in the 20th century, had become irrational anachronisms.

The Citizens' Advisory Committee to which the staff studies of the Michigan Tax Study were initially addressed produced a set of recommendations that was bold and far-reaching.¹ Its recommendations were aimed at improving equity by reducing the regressivity of the tax system; changing the tax system so as to make it more conducive to economic growth in the State; increasing revenue by enough to eliminate the growing deficit and to finance expansion of both direct state expenditures and aid to subordinate jurisdictions; and increasing the flexibility, simplicity, and rationality of the tax system.

The Committee recommended the introduction of new taxes and modest changes in existing taxes that were expected to yield an increase in revenue of over \$390 million. At the same time its tax reductions would have reduced revenues by about \$250 million, for a net increase of nearly \$140 million. This sum represented approximately 18 percent of total tax revenues realized by the State in 1958.

The Committee recommended the introduction of personal and corporate income taxes, retention of the corporate franchise tax at a sharply reduced rate and only as a minimum alternative to the income

Alaska Department of Revenue
Various Tax Types, Statutes, Rates, Incidence, Revenues
1986

<u>Statute</u>	<u>Tax Type</u>	<u>Yr. Estab.</u> <u>(Last Am.)</u>	<u>Effective Tax Rate</u>	<u>Tax Incidence</u>	<u>Revenues (projected)</u>		<u>FY 87</u>	<u>FY 88</u>
					<u>FY 85</u>	<u>FY 86</u>		
AS 10.25.550 - 555 Elec. & Tele. Coop. Tax		Elec. 1980 Tele. 1959 (1980)	1% under 5 yrs. 2% over 5 yrs.	gross receipts	1,800	1,800	1,800	1,800
AS 16.51 Seafood Marketing Assessment		1981	.002%	Purchase Price or Value	1,000	1,000	1,000	1,000
AS 21.09.210 Insurance Premium Tax		1939 (1986)	2.7% for Domestic and Foreign 6. % Hosiptal and Medical Service Corp's	Premium	17,500	18,000	18,000	18,000
AS 43.20 Corporate Income Tax		1949 (1982)	1% to 9.4%	Net Income	204,600	220,000	200,000	190,000
AS 43.31 Alaska Estate Tax		1919 (1980)	limited to Fed. credit for state tax	Estate	500	600	600	600
AS 43.35 Coin Operated Devices and Punchboards		1947						
AS 43.40 Motor Fuel Tax		1945 (1983)	Marine 5¢ per gallon Highway 8¢ per gallon Aircraft 4¢ gas 2.5¢ jet fuel	Excise	4,300 23,700 8,000	4,600 22,500 8,000	4,700 22,500 8,000	4,700 23,000 8,000
AS 43.50 Tobacco Tax		1955 (1985)	8 mills (16¢ per pack)	Excise	2,000	5,700	7,500	7,500

<u>Statute</u>	<u>Tax Type</u>	<u>Yr. Estab.</u> (Last Am.)	<u>Effective Tax Rate</u>	<u>Tax Incidence</u>	<u>Revenues (projected)</u>		<u>FY 85</u>	<u>FY 86</u>	<u>FY 87</u>	<u>FY 88</u>
AS 43.55	Oil & Gas Properties Production Tax	1955 (1981)	12.25% or 15% of gross value (or 80¢ per barrel) at point of production multiplied by E.L.F.	Severance	1,386,700	1,114,300	770,500	533,000		
AS 43.56	Oil & Gas Exploration, Production & Pipeline Transportation Property Tax	1973 (1981)	20 mills	Property	128,400	98,900	89,000	81,000		
AS 43.57	Oil & Gas Regulation and Conservation Tax	1955 (1973)	one eighth of one cent per barrel	Severance	700	700	700	700		
AS 43.60	Excise Tax on Intoxicating Liquors	1933 (1983)	malts 35¢ per gallon wines 85¢ per gallon distilled \$5.60 per gallon	Excise	13,900	13,900	13,900	13,900		
AS 43.65	Mining License Tax	1913 (1980)	3% to 7%	Net Income	300	300	300	400		
AS 43.70	Alaska Business License Tax	1949 (1984)	\$25.00 fee	Annual Fee	38,000*	2,000	2,000	2,000		
AS 43.75	Fisheries Business Tax	1913 (1986)	Canned Salmon, shore/based 45% shore/based 3.0% Floating 5.0%	Purchase Price or Value	5,600 8,300 4,800	5,200 9,000 5,000	5,200 9,000 5,000	5,200 9,000 5,000		
AS 43.76	Salmon Enhancement Tax	1980 (1981)	Cook Inlet 2% Prince William Sound 2% Northern Southeast 3% Southern Southeast 3%	Purchase Price or Value	2,000	4,200	4,200	4,200		

* The large amounts in FY 85 are the result of litigation in favor of the State on gross receipts taxes for years prior to 1979.

Overview of Experience with Recent State Tax Studies

Steven D. Gold
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National Conference of State Legislatures

New Jersey State and Local Expenditure and Revenue Policy Commission
Trenton, New Jersey
October 18, 1985

I have been requested to cover four topics today:

- o General objectives of state tax studies and areas covered;
- o Mechanics of the studies, including budget, duration, procedures, etc.;
- o General and specific problems encountered;
- o Short and long term benefits realized or anticipated.

To address these issues, it is necessary to emphasize the diversity of experiences that come under the rubric "tax study." You should realize that your New Jersey study resembles those elsewhere in some respects and also differs from many studies that have been conducted recently elsewhere. Here are some of the ways in which tax studies differ:

- o Purpose: some are broad, covering a wide variety of tax issues; others are narrow.
- o Context: some are highly political; others operate in a virtual political vacuum.
- o Resources: some have had budgets in excess of \$600,000; others have had \$25,000 or less.
- o Time horizon: some have lasted for only a few months; others have been in existence for more than three years (e.g., New York).
- o Organization: some have relied primarily on internal staff; others have used many consultants, and one delegated the work to a consulting firm. I recommend the use of consultants working with a core staff with several professionals.
- o Membership: some have been composed solely of legislators; others have had a mixture of public officials and private citizens, and others have been completely private citizens.
- o Thoroughness: some have been relatively thorough and systematic in explaining their assumptions, procedures, and objectives; others have been partial and unsystematic, with policy recommendations not well grounded in supporting analysis. I commend to you the explicit discussion of assumptions and principles in Minnesota and Hawaii. I recommend that the New Jersey commission discuss underlying assumptions and principles at an early stage of its work.
- o Care in presenting analysis and recommendations.
- o Innovativeness of analysis.
- o Results: some have had major success in having their recommendations implemented; others have been partially successful; and yet others have had no success yet. A major caution is that significant reform often takes years to accomplish; it is too early to conclude anything about the long-run effects of most recent tax studies.

Objectives

The most important motivation for recent tax studies has probably been state fiscal problems. Important focuses of the recommendations have been tax simplification, modernization of outdated provisions, and stimulating economic development. Coping with technological change, actual or prospective federal tax changes, and legal challenges to tax provisions have been relatively minor objectives. Some tax studies have also been concerned with improving tax administration. Equity concerns have frequently been addressed, but they have seldom been a principal motivator for initiating the tax study. It is probably accurate to say that equity has receded as a primary concern of state tax policy.

Mechanics

I suggest that you consult with persons who have worked on tax study commissions in other states for advice about mechanics. It would probably be wise to consider both successful and unsuccessful tax studies for guidance on mechanics. I would identify the following studies as among the more successful ones:

- o Minnesota: produced recommendations that have been approved by many parties, although in most important respects not yet by the majority of the legislature; and produced well-researched reports, including some innovative analyses in areas like the role of taxes in influencing employment trends and the long-run prospects for various taxes.
- o Hawaii: produced well-constructed analysis of tax system based on explicit premises; however, recommendations failed politically in first year.
- o Pennsylvania: produced good analysis of issues under study and resulted in reform of a major business tax; however, operated under numerous constraints that limited issues that could be studied.
- o New York: produced strong analyses in numerous areas, including both administration and policy areas, particularly related to simplification and modernization; however, produced no unified report and continues to be of indefinite duration.
- o West Virginia: resulted in reform of major business taxes.

The reason I single out these states is that they had tax studies that either had strong analyses that could be helpful in New Jersey or they resulted in significant reforms. In addition, this year's Wisconsin income tax reform is an important outcome that was helped along by a recommendation from that state's strategic development commission.

My impression is that New Jersey is off on the right foot: it has a reasonable timeframe and budget, an executive director who can successfully manage the study, and a commission membership reflecting important state interest groups. These ingredients are necessary but not sufficient for a successful tax study. Tax reform is a political process, and many pitfalls could derail it.

The budget necessary for a tax study depends upon the types of issues to be considered. Construction of large data bases such as Bob Strauss developed in West Virginia and Pennsylvania is expensive. The breadth of the tax issues to be considered also will have an important effect on the necessary budget.

My final comment about mechanics is that no universal pattern is applicable to all tax studies. What is successful in one state may fail in another state, and vice versa.

Problems Encountered

The problems encountered can be divided into the technical and the political.

Technical: It is important to identify the principal issues to be investigated and to devote sufficient resources to exploring these issues. Some tax studies have attempted to do too much and therefore spread their resources too thin. Time may be as much of a constraint as money.

A thorny issue is how detailed to make recommendations. As discussed below, a commission can be helpful by dealing with issues that are too sensitive for the legislature to confront. Considerable benefit can result from attention to a large number of relatively minor issues. But a danger exists of dissipating influence and attention if too many issues are addressed.

A common technical problem is that researchers may not be sufficiently familiar with the fine points of a particular state's tax system. A related problem is that the cooperation between the tax study's staff and the tax department may leave something to be desired.

Political: Timing is a key to the receptivity for tax reform. It is probably most feasible to implement reform at times when a state has a large surplus or is threatened by a deficit.

Implementing reform is a very difficult political process. If the reform involves significant issues, it is likely to encounter opposition from powerful entrenched interests. An important issue is the extent to which the commission's recommendations are shaped by perceived political constraints. Unless the commission ignores some political factors that have governed the legislature in the past, its recommendations may not be sufficiently bold. On the other hand, if too many politically unrealistic proposals are endorsed by the commission, it may be quickly written off.

The media are frequently a major problem for tax study commissions. They tend to report recommendations in a superficial manner, emphasizing "gainers" and "losers." Many people get the impression that they will lose due to particular proposals (e.g., eliminating tax preferences), while the gains that come from other proposals (e.g., tax rate reductions) are less appreciated.

With skillful leadership and a cooperative attitude among interest groups, a feasible compromise that embodies tax reform can be developed.

Benefits of Tax Studies

1. Raising the level of discourse about tax issues.
2. Addressing issues that are too politically sensitive for the legislature to confront, thereby broadening the scope of the politically feasible (e.g., property tax classification in Kansas this year).
3. Producing new data.
4. Producing new research.
5. Breaking a political logjam that has thwarted improvements in tax policy.
6. Taking a fresh look at how the tax system has gradually developed as a result of economic change and incremental legislative decisions. (According to Richard Pomp, state tax systems tend to "mutate" over time.)
7. Producing sensible recommendations that may not be adopted at once but will be referred to in the future when a crisis situation develops.
8. Taking an in-depth look at emerging issues that are not handled well in the customary legislative process, e.g., reform of state-local relations, impacts of federal tax reform, and technological changes. The tax study commission can take a longer term view than is customary and may be less concerned about how a proposal affects the outlook for the next election.

STATE TAX STUDY COMMISSIONS:
AN OVERVIEW OF FOUR APPROACHES

edited by
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Legislative Finance Paper #48C

April 1985

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SUMMARY

This document contains four papers written by directors of recent state tax study commissions. They are adapted from remarks presented at a session of the Annual Conference on Taxation of the National Tax Association-Tax Institute of America (NTA-TIA) held in Nashville, Tennessee, November 27, 1984. Although they will be published in the Proceedings volume from that conference later in 1985, NCSL is distributing them at this time because of widespread interest in the process and findings of tax study commissions. NTA-TIA has generously granted NCSL permission to use the papers in this manner.

Six authors have contributed to this document. Steven Gold, the editor, served as moderator of the session and placed the papers within the context of other tax studies that have recently been conducted. Richard Pomp is the director of the New York Legislative Commission on Modernization and Simplification of Tax Administration and the Tax Code. Robert Ebel has directed two tax studies, one in the District of Columbia completed in 1978 and one in Minnesota completed in 1984. Sylvia Dennen and Susan Gutchess directed a tax study in Iowa. W. Norton Grubb played a key role in a Texas tax study.

Under a grant from the Ford Foundation, NCSL will produce a series of reports in 1985 and 1986 about tax study commissions. NCSL does not necessarily endorse the views of the authors of these papers but rather has published this document to stimulate discussion of tax studies and to assist states that may be contemplating the creation of such a study.

STATE TAX REFORM AND
FORMAL STATE TAX STUDIES: AN OVERVIEW

Steven D. Gold
National Conference of State Legislatures

Our subject today is a timely one--state tax studies. 1984 has seen more tax studies than any other year in more than a decade--perhaps any year in history. We can learn from these studies in two ways. First, their substantive research may be of interest in many states as well as the one where the study takes place. Second, they can improve our understanding of the process of tax reform. Conducting a successful tax study is a difficult endeavor, facing many pitfalls.

There is great variety in what falls under the rubric of a "tax study." Some have an army of consultants; others have none. Some have large budgets, exceeding \$500,000; others get along with \$25,000 or less. Some have lasted for only a few months; others have extended for two years or longer. Some are associated with commissions, either of private citizens, public officials, or a combination; others operate without commissions.¹

One has to draw some lines somewhere, and I suggest that the following characteristics are useful in analyzing tax studies:

- o They cover a broad set of tax policy issues, not limiting themselves to a single tax, nor are they concerned simply with tax administration.

- o They have significant resources for research, which may include in-kind services of government agencies.
- o They last at least six months but no longer than three years.
- o They are created by the state government.
- o They focus on state policy issues.

Many so-called tax studies do not meet one or more of these tests, including one of those on this program, but these characteristics help to identify serious state tax studies.

The four tax studies represented on today's program reflect the diversity of purposes and approaches in recent tax studies:

- o New York's is especially concerned with modernization and simplification of the state tax system. It was created by the legislature and is directed by a lawyer.
- o Minnesota's was motivated by an extended period of state fiscal stress and a desire to re-examine some of the complex fiscal innovations adopted over the period since 1970. Like most studies, it was created by the governor and is directed by an economist.
- o Iowa's was created because of serious economic problems hanging over the entire state and state government in particular. The initiative for the study came from the legislature, but it was not controlled by the legislature. The most unusual aspect of Iowa's tax study is that its research has been done by a large profit-making consulting company.
- o Texas' was a short-term, low-budget study initiated because of a state government fiscal crisis. It was directed by an economist.

In order to provide a context for this program, I will list the other state tax studies of which I am aware and offer a capsule description. This list is probably not exhaustive, nor are many details known about some of the commissions. First I'll list the commissions currently in operation or those which completed their work this year. Then I'll turn to other state tax studies since 1978.

California: a low budget study with little original research.

Hawaii: an unusual study in that the state constitution mandates periodic tax studies; numerous consultants assist a small staff. Directed by Jack Suyderhoud.

Kansas: a low budget study with little original research; chaired by the Lieutenant Governor, with other members representing powerful interest groups.

Massachusetts: a study which has taken nearly two years to get underway; recommendations expected following 1986 election. Directed by Robert Tannenwald.

Tennessee: a legislative study staffed primarily by state officials; reducing high sales tax rates, perhaps by adoption of state income tax, is an important focus.

Utah: a study just getting under way.

West Virginia: a conventional study which reported early in 1984. Directed by William Dodge.

Wisconsin: a study focused on "strategic planning" for the state, expected to recommend reform and reduction of the state income tax.

Other recent studies include:

Connecticut: a study with a relatively small budget; considered but did not recommend a state income tax; concluded in January 1983. Directed by Will McEachron.

District of Columbia: a study with numerous consultants; many recommendations approved; concluded in 1978. Directed by Robert Ebel.

Georgia: a multi-year study with relatively little impact.

Illinois: a study with a relatively small budget; limited impact; concluded in January 1983. Directed by Sylvia Dennen.

Indiana: one of two recent studies without a commission; directed by James Papke, with research by faculty at Indiana universities; two volumes published in 1982 and 1984.

Louisiana: a brief, low-budget study directed by William Oakland in 1983.

Michigan: a study directed by Harvey Brazer in 1982 with chapters written by faculty at Michigan universities; not accompanied by a commission; report published.²

Ohio: a low-budget legislative study with little original research; conducted work primarily in 1982.

Pennsylvania: a study directed by Robert Strauss with research by faculty at Pennsylvania universities; concluded in 1981.³

Rhode Island: a study with research conducted by Rhode Island Public Expenditure Council.

Washington: a seven-month study conducted in 1982.

I have asked the four panelists on today's program to describe the approaches taken in their respective studies and to explain the reasons why their own study took the shape that it did (e.g., resource constraints, political setting, etc.) I also posed a series of questions for them to discuss:

- o What can a state reasonably expect to gain by conducting a major tax study and what lessons can be drawn from the successes and failures of your own study?
- o Is the role of a tax study different now than it was 20 years ago? Harvey Brazier has pointed out that the studies of the 1950s and 1960s often proposed adoption of either a sales or income tax, whichever the state in question did not already levy. Today states have more balanced tax systems and larger and better trained tax analysis staffs, so the nature of the task facing a tax study is different.
- o How often should a state have such a study?
- o What is the best way to organize a tax study today?
- o What are the appropriate measures of success for a study?

In addition to these process kinds of questions, the panelists may also address the substantive conclusions of their study. However, I requested that they not deal exclusively with the substantive conclusions because there are numerous discussions of tax issues but very few assessments of tax studies themselves.

1985 may be a watershed year for state tax policy, with some states making major changes in the design of their tax systems, and state tax studies are likely to contribute to these changes.⁴ Since the federal government will probably be making significant revisions in its own tax system and in its fiscal relations with states and localities over the next few years, state fiscal systems will probably be reexamined more closely than in many years. The "tax study business" will continue to be active for years

to come, and states may broaden their focus to include issues like state-local fiscal relations.

NOTES

1. Mary M. Lynch, a doctoral student in planning at Massachusetts Institute of Technology, has described many of these differences in an analysis of ten recent state tax studies for the Massachusetts Tax Reform Commission, "Tax Review Commissions in the United States: The Process and the Issues."
2. For a discussion of this study, see Harvey E. Brazer, "Tax Studies in Michigan: Past Impact and Current Issues," in National Tax Association-Tax Institute of America, Proceedings of the Seventy-fourth Annual Conference: 1981, pp. 218-20.
3. For a discussion of this study, see Robert P. Strauss, "Findings of the 1981 Pennsylvania Tax Commission," in National Tax Association-Tax Institute of America, Proceedings of the Seventy-fourth Annual Conference: 1981, pp. 210-218.
4. Steven D. Gold, "A Pivotal Year for State Finance", State Legislatures (January 1985), pp. 20-25.

State Tax Reform New York Style

Richard D. Pomp*

I. INTRODUCTION

The impetus for creating the New York Tax Study Commission was not an impending fiscal crisis, a court decision declaring some aspects of the tax structure unconstitutional, or any short-term pressures. Instead, the creation of the Commission was a testament to the law of entropy: Over time, tax systems move toward an increasing state of disarray, chaos, and internal inconsistency. These problems were particularly acute in New York, which has one of the oldest tax systems in the country. For example, the state's franchise tax has its origins in the nineteenth century.¹ A significant feature of the personal income tax, the use of separate returns by married couples, was adopted in 1919.² The basic structure of the state sales tax was developed in 1935 and contains a host of rather problematic or moralistic judgments.³ Some are petty and chauvinistic: New York State flags, for example, are exempt from the sales tax but other state flags are not.⁴ Other provisions distinguish between big and small marshmallows, Tang and Awake,⁵ and between Prell and Head and Shoulders,⁶ hardly burning social issues.

New York legislators were acutely aware that the tax system had evolved (perhaps mutated would be more appropriate) through a series of poorly researched or drafted laws, which were often adopted in the closing days of a legislative session. These changes, typically bandaids rather than major surgery, were superimposed upon existing law with which, in many cases, they

were actually working at cross-purposes. Moreover, statutes that had long outlived their usefulness nonetheless remained memorialized. In short, the tax system had grown through a process of accretion rather than deletion. Regrettably, the result was too familiar--a tax structure that was uncoordinated, complex, cumbersome, and lacking any conceptual framework.

New York policymakers were also wondering whether the existing tax structure was well-suited to deal with the dynamic nature of the existing economy. Legislators have had to cope with changes in the judicial climate;⁷ a relaxation of federal controls especially in the areas of transportation⁸ and banking; startling advances in technology that have facilitated innovative business practices;⁹ a flurry of federal legislation;¹⁰ the rise of multinational corporations and conglomerates; and the shift in the economy from manufacturing to services. These developments and trends challenge the premises that underlie much of the state's tax structure, which makes it increasingly difficult to continue tinkering with the sales, corporate, and income taxes and underscores the need for reform.

Legislators were also worried that they were worshipping a false god--the Internal Revenue Code. Probing questions were being raised about whether the state should simply mimic every federal provision. Thoughtful legislators suspected that the substantial differences in perspective between New York and the federal government required that the State re-examine its income tax.¹¹

Many officials were also concerned with the impact of the state's tax structure on business.¹² Numerous changes had been made in the law in order to attract and maintain corporations, especially manufacturing firms. A few key legislators, however, started to express private doubts about whether

using the tax system was an effective means of encouraging economic growth. Moreover, the Legislature had never even demanded an annual accounting of the loss in revenue attributable to special provisions like the investment tax credit, the employment incentive tax credit,¹³ or the double-weighted receipts factor.¹⁴ Questions about these provisions led logically to concerns over the extent of waste or slippage throughout the entire tax system.

This panoply of concerns provided the impetus for creating the Legislative Tax Study Commission, which consists of five Democrats and five Republicans, half from the Assembly and half from the Senate.¹⁵ Not all tax study commissions consist exclusively of legislators. The weakness in having only legislators is nicely captured by a comment made by a Commissioner during a discussion of a provision in the New York personal income tax: "Yes, that provision certainly appears asinine, but that's a provision that I just sponsored and I'll be damned if it's going to be eliminated."

II. PROCEDURAL ISSUES

However a commission is structured, it is critical in a state as large as New York that a wide spectrum of "movers and shakers" be involved. To further this goal, the Tax Study Commission created various advisory groups, consisting of representatives from academia, big business, small business, labor, public interest groups, and the legal and accounting professions. These advisory groups helped shape the Commission's agenda, which is the most ambitious ever undertaken by any state. Put simply, the Commission was to overhaul the personal income tax, the corporate franchise tax, the sales tax, and the taxation of transportation. In addition, certain issues, specific to New York, were placed on the agenda.¹⁶

Several "marching orders" were issued. First, the Commissioners did not want a "Readers Digest" report, full of platitudes and glittering generalities. Simplistic approaches, such as comparing state tax burdens using measures like taxes per thousand dollars, taxes per capita, or nominal rates, all of which fail to capture the diversity of a tax system, were to be avoided.¹⁷ Second, issues of tax administration were to be prominently emphasized because "good" tax policy and "bad" tax policy, however those terms are defined, can look remarkably similar if the law requires a higher order of administrative capacity than actually exists. Taxes are what they turn out to be in the real world and not what a legislature intended them to be in an ideal world. Issues of administration have too frequently played the role of the favored child of tax policy.¹⁸ Much of the work of the Commission reflects this philosophy by identifying what the applicable administrative constraints are and then designing a system that can function fairly and efficiently within those constraints.¹⁹ Third, in keeping within the spirit of not hiding behind broad recommendations, the staff was instructed to have legislation prepared to accompany its proposals. Moreover, the revenue impact and distributional implications of each recommendation were to be identified, which required building a computer model of the personal income tax and of the corporate tax.²⁰

These marching orders were rather intimidating for a full-time staff of lawyers and economists that has never exceeded four. Equally intimidating were the procedures agreed upon for the review of staff reports prior to their submission to the Commission. Preliminary drafts, depending on subject matter, were to be reviewed by some--or all--of the Commission's advisory groups and other selected persons. After this review, a rewritten

draft was released as a "Staff Report" to over 600 persons. A subsequent version was then formally submitted to the Commission.

This review process was tedious and painstaking. As one exasperated and frustrated staff member decried, "Our work must stand up in a court of law." In a state like New York, however, exactly such a standard was required to win the confidence and respect of the tax bar, the tax accountants, the various legislative committees and agencies, and the Fortune 500, many of whom are headquartered in New York. Each of these groups is capable (and willing) to second-guess the staff's analysis of most issues. This elaborate review process, besides ensuring a high standard of quality, had the additional benefit of facilitating a dialogue among different constituencies, which is a vital step in building a consensus for reform.

Undoubtedly, the participation of these various groups, although vexing at times, especially for some consultants hired by the Commission, resulted in a series of Staff Reports that established the Commission's reputation for objective and critical analysis. As a result, long before the Commission had formulated its own reform proposals, its advice was being solicited informally by legislators on bills they were proposing. Although this additional set of responsibilities was an unwanted diversion for the staff, the alternative was to remain aloof and passively watch legislation being adopted that could only make it harder to achieve the Commission's ultimate goals. Consequently, during the major research phase of the Commission's work--from August 1982 to August 1983--the staff was an active, although not a highly visible, participant in the legislative process. Somewhat ironically, the staff's early successes were best measured by the legislation that it prevented from being adopted. Indeed, in some cases, the staff became a useful scapegoat for a legislator who, on one hand, was forced to

sponsor a constituent's tax proposal but, on the other hand, recognized the bill's serious shortcomings. With clear conscience, such a legislator could assure a constituent that although the bill was introduced, it was opposed by the Commission's staff and thus did not receive the support of legislative leadership.

III. EVOLUTION IN ISSUES STUDIED

Since the Staff will shortly be unveiling its proposals for restructuring major components of the New York tax system, it is an appropriate time to consider two questions raised by Steve Gold in his introductory remarks to this session. First, are today's tax study commissions tackling problems similar to those of earlier groups? To be sure, we all stand on the shoulders of those who have come before us. In a field like taxation, which has traditionally attracted some of the ablest minds in law and economics, we are especially fortunate to have a rich legacy to draw upon. Nevertheless, tax commissions today are plowing new ground that was outside the purview of earlier studies. For example, most of the areas that are of interest in New York have not been addressed in any depth by other commissions, or even by most commentators. For example, should a state adopt ACRS? How should the taxation of transportation companies respond to the federal deregulation of that industry? Is a graduated corporate tax rate an effective means of assisting small business? What is the economic impact of a state's investment tax credit? How should a state corporate tax treat interest, capital gains, or dividends? Is a double-weighted receipts factor an efficient way of encouraging export industries? Do itemized deductions have a role to play in a state income tax? Although a few of these subjects are unique to New York, most of the others clearly indicate how the issues

faced in the 1980's are different from those of earlier commissions. Reading some of the earlier studies makes one yearn for the halcyon days when the most significant issue was whether a state should adopt a sales tax or a personal income tax. This evolution in agenda is entirely natural, and future commissions will undoubtedly pine for the uncomplicated days of the 1980's. One safe prediction is that future commissions will deal with the tax repercussions of the on-going technological evolution, an area which the New York Tax Commission has addressed,²¹ but not with the rigor or urgency that will be imposed on future studies.

IV. MEASURING THE SUCCESS OF A COMMISSION

Steve Gold's second question is more difficult and involves evaluating the "success" of a commission. One tempting criterion for success is whether a commission's recommendations were actually adopted. That test should be rejected, however, because the vagaries of the political process are independent of whether a commission or its staff discharged successfully their tasks. It is more important to bring people to their senses rather than to their feet.

If legislative adoption of a commission's recommendations were the most relevant criterion, the New York Tax Commission could easily be an overnight success by pursuing the following precepts. First, parade forth the commonly used tax burden studies, relying on over-simplified aggregate measures such as taxes per capita, or taxes per thousand dollars of income to show how "high" New York taxes are. Second, hire an accounting firm or some other group not versed in polling techniques to ask businesses whether taxes

are too high and to ask them to rank the importance of taxes in their decisions about where to locate.²² Third, conduct a regression analysis "proving" that high taxes have caused low growth in the state. Finally, wave the banner of business climate and economic development and recommend that taxes be reduced. In a year like the present, in which New York has a surplus, such a recommendation would be irresistible, but should that fact alone indicate that the Tax Study Commission was "successful"? Certainly, the quality of a commission's work must be factored into the "success" quotient.

Rejecting the criterion of whether a commission's recommendations were adopted, however, is easier than formulating the appropriate indicia for success. New ideas usually need a gestation period and a commission's impact on future developments might not be obvious. A commission can easily alter the contours of subsequent debate over state tax policy and be the progenitor of future legislation, yet the relationship may not always be obvious.²³ Further, a commission may influence the course of events elsewhere, as well as in its own state.²⁴ Even measuring the quality of a commission's work is difficult without completely understanding the budgetary, political, and time constraints imposed on its staff.

IV. INSTITUTIONALIZING TAX REFORM

Time constraints are probably the most serious impediments that can be imposed on a Tax Study Commission. Developing a data base, building computer models, performing sophisticated analyses, negotiating with various constituencies, and drafting legislation are inherently time-consuming tasks.

Our work in New York has convinced the staff that a short-term tax study is not an adequate response to the kinds of issues that have suffered from benign neglect throughout the years. Moreover, the U.S. Treasury's recent bold and courageous study of the federal tax system, which will be the centerpiece of future debate over federal reform, may have dramatic implications for most states. Unless the states have the capacity to analyze the repercussions of the Treasury's recommendations and any likely Congressional response, they might be forced to respond to major perturbations in their tax structure without an adequate "game plan." The prospect of serious federal tax reform provides one more justification for institutionalizing the process of state tax reform, that is, imposing some kind of permanent management system on the process of tax planning.²⁵

Most states lack any meaningful institutional leadership regarding tax planning and policy. One of the agencies that might be considered a candidate to assume that role--the state tax department--is typically too busy responding to other crises and is usually one crisis behind. Legislative committees on ways and means or finance usually fare no better. Consequently, few states have a permanent body capable of monitoring and providing oversight of the tax system.

Needed instead of an ad hoc, short-term commission is a permanent body, perhaps akin to the U.S. Congress' Joint Committee on Taxation, which is respected for its nonpartisan expertise. A permanent body, charged with protecting the integrity and intrinsic harmony of a state's tax structure, might be able to reduce the frequency of piecemeal legislation and to coordinate the different viewpoints of affected groups. This type of ongoing group could undertake necessary research and analysis, educate a legislature

about how the law is operating, evaluate alternatives, initiate proposals, and draft legislation more carefully than is usually possible.

Perhaps even more importantly, a permanent body would provide a balance to studies that occur in most states, which are usually sponsored by various vested interests, such as labor, business, or public interest groups. While the quality of these studies varies greatly, many are short on analysis but typically long on rhetoric and, in some cases, distortions. Repeated often enough without being challenged, however, the line between rhetoric and reality can become blurred. A Chinese proverb states that "in the land of the blind, the one-eye is king." Without a counter-weight, it is too easy for one of these groups to become "king" and exert a disproportionate influence on public debate over state tax policy. A permanent body can provide exactly that needed balance. In any event, institutionalizing the process of tax reform and planning is unlikely to be less effective than the already feeble attempts that most states make in this area.

* Richard D. Pomp, Director, New York Tax Study Commission, Visiting Scholar, Harvard Law School; and President, Institute on Taxation and Economic Policy. The text is based on a transcript of Professor Pomp's oral remarks at the Conference. Footnotes have been added.

1. See The Article 9-A Franchise Tax: The Alternative Tax on Capital, Staff Report of the New York Tax Study Commission.
2. See The State Personal Income Tax: Taxation of the Family and Low Income Relief, Staff Report of the New York Tax Study Commission.
3. The state sales tax was adopted in 1965 and appears quite modern if compared with the rest of the tax system. The state sales tax, however, was modeled after New York City's sales tax, which was enacted in 1934. This 1934 law was based on a sales tax that the state had used temporarily during the Depression. See, the New York Sales Tax: An Introduction, Staff Report of the New York Tax Study Commission.
4. New York Tax Law (NYTL) §1115(a)(11). This provision may be unconstitutional if anyone cares enough to challenge it.

5. New York State Department of Taxation and Finance, Publication No. 880, List of Taxable Exempt Foods and Beverages (1983).
6. New York State Department of Taxation and Finance, Publication No. 820, Taxable Exempt Drugs, Medicine, and Toiletries (1979).
7. See, e.g., Container Corp. of America v. Franchise Tax Board, 103 S. Ct. 2933(1983); F.W., Woolworth Co. v. Taxation & Revenue Dep't., 102 S. Ct. 3128(1982); Asarco, Inc. v. Idaho Tax Commission, 102 S. Ct. 3103(1982); the Article 9-A Tax; The Taxation of Investment Income, Staff Report of the New York Tax Study Commission.
8. See, e.g., Transportation Taxes in New York State, Staff Report of the New York Tax Study Commission.
9. See, e.g., The Article 9-A Franchise Tax: The Taxation of Investment Income, Staff Report of the New York Tax Study Commission.
10. See, e.g., The Article 9-A Franchise Tax: Should New York Adopt ACRS?, Staff Report of the New York Tax Study Commission.
11. The results of that re-examination appear in a lengthy series of Staff Reports on the personal income tax.
12. For a complete discussion, see Interstate Business Locational Decisions and the Effect of the State's Tax Structure on After-Tax Rates-of-Return of Manufacturing Firms, Staff Report of the New York Tax Study Commission.
13. See The Article 9-A Franchise Tax: The Investment and Employment Tax Credits, Staff Report of the New York Tax Study Commission.
14. See The Article 9-A Franchise Tax: The Double-Weighted Receipts Factor, Staff Report of the New York Tax Study Commission.
15. Members of the Commission are: Assemblyman Daniel B. Walsh, Chairman; Senator Mary G. Goodhue, Vice Chairman; Assemblymen Jerrold Nadler, Barbara A. Patton, William J. Larkin, Jr. and Robert A. Straniere; and Senators Joseph L. Bruno, Walter J. Floss, Jr., Donald M. Halperin, and Andrew Jenkins. Although not a member of the Commission, Stanley Fink, Speaker of the Assembly, was instrumental in its creation.
16. See, e.g., The Article 9-A Franchise Tax: The Interest Add Back Rule, Staff Report of the New York Tax Study Commission; The New York State Tax Appeals System, Staff Report of the New York Tax Study Commission; the Article 9-A Franchise Tax: The Income-Plus-Compensation Alternative, Staff Report of the New York Tax Study Commission; A Graduated Corporate Franchise Tax, Staff Report of the New York Tax Study Commission.
17. See Interstate Tax Comparisons: An Introduction, Staff Report of the New York Tax Study Commission; Interstate Tax Comparisons of Individuals, Staff Report of the New York Tax Study Commission; Interstate Tax Comparisons of Corporations, Staff Report of the New York Tax Study Commission.

18. See Gold, The Legislative Role in State Tax Policy Making, Proceedings of the 1983 NTA-TIA Conference, p. 226. Issues of tax administration often provide a large payback for a small amount of effort. In one afternoon, the staff of the New York Tax Study Commission uncovered millions of dollars in taxpayer errors by performing a rather simple computer match. See The Article 9-A Franchise Tax: The Investment Credit, Staff Report of the New York Tax Study Commission. For some of the Commission's work on tax administration, See Blueprint for Progress in Tax Administration (forthcoming Saga Press); An Evaluation of the Sales Tax Audit Program of the New York State Department of Taxation, Staff Report of the New York Tax Study Commission.
19. See, e.g., The Personal Income Tax: Introduction, Staff Report of the New York Tax Study Commission, in which the concepts of facial or recordkeeping conformity are developed.
20. The staff quickly came to appreciate the typical lament of a tax study commission--the lack of data for policy analysis. See Strauss, Findings of the 1981 Pennsylvania Tax Commission, Proceedings of the 1981 NTA-TIA Conference, p. 216. Logically, a tax department should be a cornucopia of useful data. Often, however, the criterion used for compiling data is whether they will be useful in auditing taxpayers. Information critical for policy analysis may be unavailable if it is not needed by tax auditors.
21. See, e.g., The Article 9-A Franchise Tax: The Property Factor, Staff Report of the New York Tax Study Commission.
22. The defects of such surveys are well known. See Interstate Business Locational Decisions and the Effect of the State's Tax Structure in After-Tax Rates-of-Return or Manufacturing Firms, Staff Report of the New York Tax Study Commission; Interstate Tax Comparisons: An Introduction, Staff Report of the New York Tax Study Commission.
23. Compare, for example, Governor Cuomo's recent proposals on ACRS and reforming the personal income tax with The Article 9-A Franchise Tax: Should New York Adopt ACRS?, Staff Report of the New York Tax Study Commission, and The State Personal Income Tax: Taxation of the Family and Low Income Relief, Staff Report of the New York Tax Study Commission.
24. Legislators in California, for example, are drafting bills based on the staff's proposal to limit losses from registered tax shelters. See The New York Personal Income Tax: Tax Shelters, Staff Report of the New York Tax Study Commission; Legislators in Florida have expressed interest in the staff's proposal to deny a deduction for franchise taxes paid to other states. See The Article 9-A Tax: The Deduction for Corporate Income Taxes Paid to Other States, Staff Report of the New York Tax Study Commission.
25. For an exhaustive and perceptive treatment of this proposal, See McIntyre & Oldman, Institutionalizing the Process of Tax Reform; A Comparative Analysis (1975).

STATE TAX REFORM: The Role of The Tax Study Commission

by

Robert D. Ebel

Executive Director,

District of Columbia Tax Revision Commission (1976-77)

Minnesota Tax Study Commission (1983-84)

Remarks Before the

Annual Proceedings of The National Tax Association -

Tax Institute of America

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One of the growth components of the state and local sectors may be that of the major Tax Study Commission, which is generally charged with providing a learned, systematic and comprehensive analysis and set of recommendations for tax policy. Such commissions are likely to become even more important in the next few years if at least two circumstances occur: the Congress makes the kind of sweeping changes in the federal tax code such as those that have been recently suggested (December 1984) and the work of the present set of tax study commission's are judged as having been successful in their particular political environments.

Although the structure of these Commissions varies from state to state, they typically consist of a group of distinguished citizens, most of whom are not tax practitioners, and who are broadly representative of diverse interests throughout the State (Exhibit 1). They are appointed by the Executive and/or legislative leadership and charged to hire staff, adopt rules for conduct and procedure, and then report out a set of policy recommendations.

The substantive issues these tax study commissions address vary according to their times as well as their particular (state/local) context. Accordingly, there is no easily transferrable set of lessons regarding policy outcomes. Thus, what is important -- and, in fact, what might be labeled as the first of three "principles" of tax study commissions -- is that process matters. Without early agreement on process, then the quality of everything else the Commission does, ranging from the production of technical papers to its final decisions, is compromised.

The second principle, which if it were not so important could be omitted since it is so obvious, is that that Commission process be well directed. And that direction must

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come from the members, generally, and, especially, the Commission Chair (I'll bet you thought I was going to say the Executive Director!) Because these commissions are fundamentally political -- in the sense here that politics means people bringing to bear their interests and values on issues of public policy -- their success ultimately depends on a chair and a membership that understands how their role and their final tax policy solutions will fit into the overall fiscal and political context of the State. It is the ability to recognize and exploit this characteristic that will make the effort a credible one.

A third principle is that the Commission be established with broad political support. That way the community sends a signal to the Commission that their work is important. Usually the commission members serve without pay and yet put in hundreds of hours; thus, at the very least, the public service aspect of the membership be recognized. One way to show this is for the State to provide an adequate budget for the Commission operations. Both of the Commissions that I have worked with, fared well in this general regard. The District of Columbia Commission (\$250,000) was the first such group of its type that was established by the post-1975 "Home Rule" D.C. government. D.C. was proud of its new status, and people wanted it to do well. Similarly, there was much agreement in Minnesota that a major state/local tax study was needed. The Minnesota Tax Study Commission (\$625,000), which was patterned after a similar 1956 effort (and along with the Harvey Brazier's 1958 Michigan study, provides the "model" for the subsequent generations of tax study Commissions)¹ was created by a Democratic governor, and had support of the previous Republican Administration, credible public interest groups such as the Minneapolis - St. Paul Citizen's League and the Minnesota Taxpayer's Association, and some key legislators.

Commission Membership

In the last few years the state/local tax study has usually taken one of two variants with respect to its membership. The membership either includes elected representatives of the legislature or Executive branch, or of citizens who represent the various interests in the State.

Both D.C. and Minnesota were citizen groups. The advantage in the citizen's commission is that it minimizes two problems: having a membership that feels it must defend past tax law decisions because "that is the way it worked in the conference committee" and the temptation to tailor the study scope and recommendations toward (or against) the appointing authority's interests. Although institutionalizing this distinction between Commissioner and Lawmaker may ultimately provide the sort of Report the appointing authority wishes had never been released, from a community perspective that risk is certainly well worth taking. In the case of the Minnesota Commission, some particularly difficult and bold choices were made. The Report, which was signed by all members, included recommendations for sales tax base expansion to clothing and services to persons, major property tax reform including reducing the number of tax classification for 70 to 3, the elimination of all but one of eleven tax relief credits and refunds, federal personal income tax conformity, and a 20% cut in personal tax rates. In a state where the Senate Majority leader proclaims that "a simple tax cannot be fair and a fair tax not simple," these recommendations are indeed heavy stuff, I assure you.²

Perhaps the same sort of bold and unanimous outcome could work with a group that includes Commissioner-Legislators. But I would expect that to be unlikely. At the very least, there is always the temptation (indeed, the necessity?) for a legislator to position onself for the

bargaining that will occur in the session. If there is agreement that tax commissions are not lawmaking bodies, then it follows that the membership should not consist of lawmakers.

The Schedule and Process

In its early stages a study commission must reach agreement on two related points: first what will the Final Report look like? And, second, what sort of work schedule does the membership have ahead in order to accomplish that goal? Again, perhaps these questions seem too obvious to mention. But, in fact, a lot of policy is implicit in the answers since it requires that decisions must be made not only on procedures, staff size and budget, but also on the calendar and thus, the study scope. Setting the calendar was a particularly important part of the Minnesota Commission's process since it was clear from the outset that there was to be no extension of its 15 month existence (October 1983 -- December 15, 1984). Accordingly, in order to avoid what was labeled the "accordion effect" -- viz, a concern that as the project neared completion that the research product and list of decisions to be made would be too great to permit informed policy judgments to be made -- in October 1983 the Minnesota Commission set (and then stuck to) a year long calendar that detailed 24 meetings by a date, length, place and substantive topic for discussion. Agreement on these points was not only important for the reasons already mentioned, but also for purposes of determining staff size (a combination of ten in-house staff persons plus 20 consultants who provided technical papers) and then organizing a clear set of staff deadlines, which were never, never missed (well, hardly ever).

The Minnesota calendar made explicit the following four part process:

- Public hearings and workshops. Public hearings were held in six locations throughout the State in November and December. Since Minnesota is a State where good government is taken very seriously and the media and private sectors sense of community responsibility is high, the hearings generated a voluminous amount of testimony and coverage. These hearings also set the precedent of having all subsequent Commission deliberations held in an open meeting format (although after those six hearings all other public testimony other than that submitted in written form was excluded). In addition to receiving testimony from the public, the Commission met in technical workshops organized by the tax section of the Minnesota Bar Association and the Society of CPAs.

- Principles and Goals. Rather than immediately delve into specific tax issues, the Commission members spent fully half of its existence educating themselves on broader issues. The first task was to debate and then unanimously agree upon a set of guiding principles and normative goals for state/local tax policy. This part of the process was most important since it provided an intellectual discipline for the subsequent discussions relating to the choosing between alternative recommendations for tax policy. By the time the Commissioners came to discussing, say, the appropriate tax treatment of health insurance, all were comfortably debating the tradeoffs with respect to such objectives as neutrality and equity. This is, of course, not to say that each Commissioner gave equal weight to the tradeoffs associated with the policy choices; but that there was a common understanding on what basis the final recommendations would ultimately be made. At this point the Commission had already emerged as something quite different

from the conference committee. An explicit set of long term principles and goals were "in" and logrolling was "out." That this characteristic was achieved in the early stages of the Commission was a key (though not the only) factor that permitted the membership to avoid the end-of-year accordion effect.

- Research and Development Specific Tax Policy. Once the principles and goals were established, the research presentations and policy deliberations were divided in two parts. The Commission first thoroughly examined the (non-tax) institutional arrangements and the long term economic, demographic and technological trends that characterized the State. Topics included relationship between the States's economic base and alternative tax bases (consumption, personal income, business receipts, consumption) state-local intergovernmental linkages (70% of Minnesota State taxes are passed through localities), and the relationship between Minnesota taxes and changes in private sector employment. Only once this research was presented and discussed did the attention then turn to specific taxes and their alternatives. Here the topics ranged from the big three taxes (with the property tax and its interplay with direct and indirect local aid emerging as Minnesota's equivalent of the Gordian knot) to how to tax telephone companies in an era of deregulation and rapid technological change. Although some observers worried that by putting off any discussion of specific tax reform until its last five months the Commission could never get its work done, quite the opposite proved true. By organizing itself to first thoroughly understand the framework for judging fiscal policy, the Commission membership achieved a (high) level of expertise that made its subsequent decision process on tax structure most efficient.

- Voting. Here is a tough one: should the Commission vote as it goes through its calendar on a topic-by-topic basis; or, wait until the end and make it a long day?

The District Commission took the first path by "tentatively" voting on each topic and then reaffirming the whole set on the last meeting day. This process worked well, with only one of about 65 recommendations being reversed from its tentative vote. There were two reasons for this success. First, although all D.C. meetings were open to the public, very little attention was paid to the Commission's deliberations until the very end. Why this is true is not clear, although one hypothesis is that it can be explained by the fact that since D.C. was new at home rule, people simply did not think about attending District government meetings.

The second reason the D.C. voting procedure worked is that the tax system there was (and still is) not of the overlapping variety. Thus, one could make a decision on property tax relief (the basic choice was circuit breaker vs. specific dollar homestead exemption) without raising the state vs. local aid and accountability issue. The most troublesome accountability issue in the District pertained to the "Federal Payment," the District's substitute for state to local aid.

Quite the opposite of these two conditions exists in Minnesota. First, to announce an open meeting in Minnesota at which taxes will be discussed can draw hundreds of people. Its not quite the crowd one gets on Mille Lacs lake on the first day of fishing season; but its something like that. Moreover, unlike

the Washington papers, local tax issues are thoroughly (and, in our experience, very accurately) covered in great detail. The very fact that the Minnesota Commission even discussed broadening the sales tax (in August) generated news articles and then an outcry from part of the public. Suffice it to say that although this openness was not a reason for not voting on issues on a tax-by-tax basis (as noted above, the Commission did vote to adopt a set of goals), it gave some members reason to consider whether waiting to the end might not make life easier.

However, more important to the decision to wait until the end to vote was a recognition that because the Minnesota system of income, sales, and property taxes and state aids are so intertwined, that any tax-by-tax process would have had to have been probably overhauled in the end anyway. So, rather than look indecisive by appearing to reverse itself on earlier votes once new information of the tax interplay became available from staff research, the Chair's recommendation to only vote at the end was agreed to. The alternative, which was preferred by some Commissioners, was to vote on a tax-by-tax basis with respect to the equal yield structure whenever possible. If that path had been chosen with an exception made to delay the vote on the property tax, things would have probably worked out. However, the Chair's approach turned out quite successfully and had the added dividend of letting the Commission approve a tax package in a manner that made the tradeoff among the goals explicit. For example, those Commissioners who were especially uncomfortable with higher sales tax burdens were able to show that in combination with lower income tax rates that the net effect was an overall reduced burden and increased fiscal stability.

Judging A Commissions Work

What are the criteria to be used for judging whether a tax study commission is "successful"? An appropriate way to begin the answer to that question is to first comment on one of the least important of the criteria -- viz, how well the recommendations fare in the next legislative session. Since the Commission took as its charge to make its recommendations in the context of long term trends and broad policy goals, what happens in the "next session" is not that important. Indeed, many recommendations will not even be designed for immediate enactment (the taxation of telephone companies is an excellent example).

What, then, might be an appropriate set of criteria for judging a tax study commission? By borrowing from and then supplementing a list that Paul Peterson provides in the Winter 1983 issue of the Brookings Review, let me suggest the following four.

- Did the Commission raise the level of the State's tax policy discussion? That is, did it provide the kind of information that cut through the veil that is often placed upon tax discussions with such popular devices as the anecdote, the survey respondent reporting bias, and the state ranking game. This is not to say that the Commission must, or even can, clear up all the local folklore relating to taxes; only that it should raise the level of and set the parameters for the discussion.

Recognizing that as Executive Director of the District of Columbia and Minnesota studies, I may have a respondent reporting bias in judging these two efforts, I think the verdict on whether these Commissions satisfied this criterion was probably "yes" in D.C. and, based on initial reactions, will definitely be "yes" for Minnesota.

In the District, nearly all of that Commission's sixty plus recommendations have been debated and with one expert (D.C. Associate Revenue Director, Bill Cook) documenting that with respect to those issues that the Commission examined, the Report was a key part of these discussions.³ Again, this certainly does not mean that the Commission's view will necessarily prevail. For example, the District Commission recommended (1977) that the city not abandon the standard of assessment uniformity with respect to the real property tax. During the next two years, however, the D.C. Council did adopt a system of three classes -- an outcome that Cook notes would probably have been more complex had the 1977 Commission not urged uniformity.

It is much too soon to say whether the Minnesota study will be judged successful according to the above criterion. One will know much more about that over the next few years. But, the Report is off to a good start. While keeping clear of endorsing the whole range of the recommendations of the Tax Study Commission, the Democratic Governor and the Republican Chair of the House Tax Committee have both indicated that the Report will be a working document. The Governor has already (January 1985) followed up on two key Commission recommendations regarding the individual income tax; and the House Tax Committee has announced plans to use the Commission's document as a basis for educating the House regarding Minnesota state/local taxes. Furthermore, as of this writing, one public interest group that includes in its member academic, union, business, community, and elected state/local leaders has tentatively voted to endorse the report as "a basis for Minnesota tax policy discussions over the next decade." To quote one of its members, "at least everyone will be singing from the same song sheet."⁴

- Did the Commission Ask the Right Questions? In creating the Minnesota Commission, Governor Rudy Perpich called for a "systematic, and learned review of economic and tax policies in order to provide ... directions for Minnesota into the twenty first century." That charge not only set the tone of the tax study, but brought into focus a characteristic that a tax study must have in order to be pronounced a success: did it correctly identify the right set of economic, institutional, and technological developments that will impact the tax system in the years (e.g., decade) ahead? In D.C. and Minnesota it was certainly the intent to accomplish this goal. This was done by first designing the research agenda in order to address these topics and then, subsequently relating these research findings to specific tax issues throughout the policy deliberation process. Again, it will take some time before the judgement regarding the degree of the Minnesota success can be made.
- Did the Report adequately document and publish its Findings and Recommendations? The job of the staff is to document a problem and lay out the policy options. But that is not enough. In addition the Commission must make explicit why it reached the conclusions it did. This includes making explicit the policy tradeoffs and philosophical values that are inherent in its recommendations. I am confident that a reading of the final documents of both the D.C. and Minnesota studies will show that this criterion was met. Indeed, in the case of the Minnesota study, especially close attention was paid to this feature due to the fact that the Commissioners had to take on some hotly debated but largely unanalyzed views on specific topics (e.g., "business climate,"

the effect of state-financed property tax relief on mill rates). Because the Commission knew that its findings and recommendations were certain to stir controversy, it wrote the language of its recommendations in a manner that was designed to educate the public regarding the tradeoffs it had made in reaching a particular decision.

- Did the Commission make explicit how its solutions could be accomplished? One has to be careful in expecting too much regarding this last criterion. One cannot let a Commission become so bogged down in operational detail that it runs the risk of not only wasting its time (which, in turn, may mean missing deadline) but also failing to identify broad principles, goals, and policy directions for the year ahead. For example, in Minnesota, there is good evidence that due to the design of the property tax relief system, there is a local expenditure stimulation effect that over time generates even higher property tax burdens (which in turn leads to legislation providing for additional relief, and so it goes). Accordingly, in its recommendations, the Commission proposed an alternative property tax system designed to provide tax relief in a manner that would significantly reduce the built-in incentive for local units to increase mill rates. The alternative included a credit targeted to persons with low incomes and to owners of low valued homesteads and small farms. Because there are a large number of possible credit schedules (matrices) that could accomplish this task, the Commission stopped short of endorsing any single matrix as the "correct" one. What it did do, however, was provide an upper bound estimate of the cost to the state treasury assuming that most persons in the targeted class would be held harmless.

However, when it came to addressing the issue of the correct state/local "mix" of taxes among property, sales and individual income, the Commission concluded that because of the importance of their specific recommendations for achieving their broadly stated principles and goals, that it was necessary to show that its recommendations could be made operational, that is, that the numbers "worked" (Exhibit 2). In order to accomplish this, the major recommendations were carefully costed out on the basis of 1985 data. By doing this, the Commission did not mean to imply, however, (and there has been some misunderstanding on this), that it was therefore recommending immediate action on its package. What it did want to do was to show that their's had not been an "ivory tower" exercise.

THE PROPERTY TAX

Future Policy Directions

Implementation
(\$ FY 85)

- Simplify and make explicit the tax structure and its impact.
- Give preferential treatment to homeowners and farmers.
- Eliminate the "expenditure stimulation" effect of a tax credit system that automatically encourages higher property tax levels.
- Improve the accountability of the intergovernmental system.
- Add to property tax equity by designing a tax that more closely approximates a tax on wealth as measured by real estate value.
- Directly and explicitly address the need to reduce the property tax burden on low and middle income households and small farm homesteads.
- Free local assessors from administrative encumbrances of carrying out the task of fairly and accurately assessing property.
- Reduce the number of classifications (estimates range from 20 to 70) to three [residential homestead and agriculture; residential non-homestead and apartments; and all other property with assessed to market value ratios of 1/3, 2/3, and 3/3, respectively].
- Eliminate the nine existing property tax credits and three refund programs, thereby creating a windfall to the state General Fund of approximately 30% of gross property tax collections (\$803 million).
- Relieve this fiscal windfall in the form of tax relief through a combination of reduced mill rates and grants to equalize fiscal disparities among localities (\$624 million) and an income/wealth property tax credit (\$180 million) targeted to low income homeowners and small farm homesteads (520 acres and below).
- Classification reform plus retention of the comparable sales approach to agricultural land.

Personal Income Tax

Future Policy Directions

- Reduce use of taxes shown to have negative effects on employment growth.
- Make Minnesota's tax system more competitive by reducing taxes that exhibit tax efforts well above the other states.
- Use the progressive personal income tax as a tool for offsetting tax regressivity inherent in other parts of the Minnesota fiscal system.
- Simplify the tax in order to facilitate taxpayer compliance and government administration.
- Add to the certainty and predictability of revenues.
- Promote accountability.

Implementation (\$ CY 85)

- Reduce the level of the income tax and lower effective tax rates on all income classes (20% or \$477 million).
- Concentrate tax cuts in low and middle income groups; fund a property tax credit targeted to low - middle income homeowners, farmers, and renters designed to offset the additional tax burden for those least able to pay.
- Conform to federal taxable income while maintaining a separate Minnesota tax rate schedule.
- Eliminate the "federal deductibility" provisions and reduce effective tax rates accordingly.
- Adopt complete tax indexing.

GENERAL SALES AND USE TAX

Future Policy Directions

- Increase horizontal tax equity (equal treatment of equals).
- Add to the overall stability of the Minnesota fiscal system.
- Change the Minnesota tax mix by relying more heavily on sources for which there is an "excess capacity to tax" relative to the other states.

Implementation (\$ FY 85)

- Broaden the sales tax (now among the nation's most narrowly based) to personal services and new clothing.
- Maintain the present 6% tax rate (\$177 million in new revenues).

ENDNOTES

1. Report of the Governor's Minnesota Tax Study Committee (Minneapolis: Colwell Press, 1956). The Committee was chaired by J. Cameron Thomson and Directed by Harvey E. Brazer. Harvey E. Brazer, Ed., Michigan Staff Study Papers (Lansing: Michigan House of Representatives, 1958).
2. Senate Majority Leader, Roger Moe on Minnesota Public Television's Minnesota Issues, December 16.
3. Memorandum to the Minnesota Tax Study Commission, January 1984.
4. St. Paul CityBusiness, December 19-21 issue.

THE COOPERS & LYBRAND APPROACH TO THE IOWA TAX STUDY

Case Study on the Benefits
Brought by a Consulting Firm
to a
State Tax Study

(Speech Presented to the NTA-TIA Conference,
Session on State Tax Studies,
November 27, 1984
by
Sylvia Dennen and Susan Gutchess
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THE COOPERS & LYBRAND APPROACH TO THE IOWA TAX STUDY

The purpose of my discussion today is to review the benefits that can be gained from using an outside consulting firm to perform a review of a state's tax structure - either evaluating the structure as a whole or assessing the effectiveness of a specific aspect of the tax structure. To provide a framework for the discussion, I will focus on an analysis of the work Coopers & Lybrand performed for the State of Iowa and I will provide some background information on the study, describe the methodology we followed, and then make some observations on the benefits of outside consultants.

BACKGROUND

In the face of general worries about the fiscal health of the state, the tax burden borne by its citizens and the effect of the tax structure on economic development, the General Assembly of Iowa created a Tax Study Committee on June 1, 1983. The purpose of the Committee was to:

- * examine who pays state and local taxes in Iowa;
- * evaluate the impact of taxes on the economy, employment, state treasury and citizens;
- * assess changes which could raise revenues more equitably and improve the performance of the State's economy;
- * determine the enforceability of tax laws;
- * compare Iowa's tax structure with that of other states; and,
- * examine tax preference items.

The Committee was composed initially of nine representatives of the general public (two additional members were appointed early in 1984) and four ex-officio sitting legislators.

Although the Committee could rely on the services of general state government offices and agencies, no research staff were appointed directly to serve the Committee. In effect, the role of the consultant was to serve as the research staff. The Committee issued an RFP for a consultant to assist in the study and C&L was awarded the contract.

Coopers & Lybrand relied on three of its offices to conduct the study: the Chicago-based state and local tax practice; the Economic Development consulting practice located in Washington, D.C.; and, of course, the Des Moines practice office.

Our interaction with the Committee was extremely important to the conduct of the study. During the course of our participation which ran from February 1 to mid-December, 1984, we held fourteen meetings with the Committee.

During the meetings we would review the actual tasks we had performed in the interim period and discuss the significant findings resulting from these tasks. In addition, we would develop the framework for further analyses and obtain agreements from the Committee that these were areas of concern.

METHODOLOGY

The study was conducted in three distinct phases:

Phase I: Organization and Data Collection

Phase II: Data Analysis

Phase III: Policy Analysis and Report Preparation

The methodology used in conducting each of these phases is described below.

Phase I: Organization and Data Collection

The purposes of this phase were to establish the formal goals and objectives of the study, to develop an analytical framework for conducting the study, and to collect data to be used in the study in an appropriate format. This phase was organized into seven tasks.

Task 1: Project Initiation Meeting

During this meeting on February 1, the Tax Study Committee established the method of communication between the Committee and Coopers & Lybrand and agreed to the policy determinants, burden study categories, and study work plan as set forth in the proposal.

Task 2: Meetings with Representatives of Key State Agencies

During Phase I, the Coopers & Lybrand study team members met with members of the following state agencies:

- * Comptroller's Office
- * Department of Revenue
- * Legislative Service Bureau
- * Department of Job Services
- * Office for Planning and Programming
- * Iowa Development Commission

During these meetings we assessed the availability of data both on tax revenues and on economic parameters within Iowa, gained information on the specific components of the tax structure, and discussed the impact of the tax structure on the economy.

Task 3: Literature Search

A literature search was conducted during the initial stages of Phase I to gain a thorough understanding of issues pertinent to the study. Major topics covered by the literature search were:

- * Theoretical issues relating to tax incidence and tax capacity;
- * Changes in state taxes over the past five years, including an assessment of unitary taxation;
- * Relationships between tax structure and incentives on economic growth and development;
- * Significance of the underground economy; and,
- * U. S. and state court decisions on the constitutionality of various state and local taxes.

The result of the literature search provided us with a framework for analyzing key issues in the current Iowa tax structure and with guidelines for developing areas to be evaluated during the policy analysis.

Task 4: Collect Data Regarding Iowa's Economic Growth and Development

Data on Iowa's growth and development were collected at the state level from the Office for Planning and Programming, the Department of Job Services, and the Development Commission. These data were augmented on the national level by statistics collected from the Bureau of Labor Statistics, the Department of Commerce, and the Internal Revenue Service.

Task 5: Aggregate Data for Tax Burden Study

Task 6: Aggregate Data for Tax Expenditures Impact Analysis

(Because the work in each of these tasks was quite similar, they will be described together.) The initial work in this task was to determine for each tax (individual income, corporate income, sales and use, motor fuel, estate and inheritance and property) and each tax expenditure item the categories for analysis and the definition of terms.

Matrices for both the tax burden analysis and the tax expenditure analysis were compiled providing, by tax, a list of types of analysis and a description of each analysis. The matrices were distributed and discussed with the Tax Study Committee at the progress meetings on April 26 and June 20.

Categories for analysis were chosen to provide measures of both horizontal and vertical equity for each tax and tax expenditure item and to show the total impact of each tax expenditure item. Data were collected for the period 1978 to 1982 in order to gain information on historical changes and to assess the effect of these changes on the economy.

Data were provided to us by the Department of Revenue according to the specifications detailed in the matrices. The Comptroller's Office provided us with data, by county, detailing taxable value and levy value by urban and rural property class. As part of this task, data on property tax were input into a computer model for further analysis.

Task 7: Obtain Information Regarding Auditing and
Collection Activities

To conduct this task, interviews were held with officials representing the Department of Revenue in Iowa and other states to obtain information on the administration of each tax. This information was presented during Phase III, Policy Analysis.

Phase III: Data Analysis

The purpose of this phase was to evaluate the data collected during Phase I to provide a quantitative description of the impact of the current tax structure.

Task 8: Analysis of Tax Burden Data

Each tax was evaluated to determine the impact on vertical and horizontal equity and the relationship between tax revenues received and the performance of the state economy.

Each tax was evaluated as follows:

- * Personal income tax: Vertical equity was measured by dividing net taxes paid by Iowa Net Income by income bracket. Horizontal equity was measured by determining the impact of the tax structure by filing status, family size, urban and rural counties and geographical area.
- * Corporate income tax: Vertical equity was measured by dividing net income taxes paid by Iowa Taxable Income by income bracket. The impact of apportioning or non-apportioning status, type of business, and geographical area on tax revenues was evaluated.
- * Sales and use tax: Sales and use taxes were evaluated by type of business and by geographical area.

- * Motor fuel tax: Revenues received by type of fuel were measured.
- * Inheritance and estate tax: Taxes paid by type of beneficiary were measured.
- * Property tax: We evaluated taxes paid by urban/rural classifications. Revenues received before credits were compared to assessment values after equalization and rollbacks for all categories.

Task 9: Analysis of Tax Expenditure Data

The following tax expenditure items were evaluated:

Personal Income Tax:	Personal Credits Dependent Credits Federal Tax Deduction
Corporate Income Tax:	Federal Tax Deduction Venture Capital Credit R&D Credit
Sales & Use Taxes:	Food Exemption Prescription Drug Exemption Fuel Subject to Motor Fuel Tax Exemption
Motor Fuel Tax:	Gasohol

Estate and Inheritance Taxes:

Individual Exemptions
Surviving Spouse Credits

Property Tax:

Limitations (Rollbacks)
Personal Property Exemption
Urban Revitalization Tax
Exemption
Agricultural Land Credit
Elderly and Disabled Credit
Homestead Tax Credit
Machinery and Computer Credit
Military Service Exemption

For each tax expenditure item, we measured the total dollar amount of "lost" revenues, or the revenues that would result if the expenditure item were not allowed. In addition, for the personal income tax expenditure items, we estimated the impact of each expenditure on horizontal equity. Also, when a possible modification was analyzed involving elimination of any expenditure item, the specific amounts attributable to the expenditures were calculated.

**Task 10: Comparison of Iowa Tax Capacity and Tax Burdens
with Those of Other States**

Data on the tax structures of other states were collected during this task and added to tax capacity data collected during Phase I. Comparative data were gathered from Annual Reports produced by the Revenue Departments of the surrounding states for each of the last five years; from Commerce Clearing House and Prentice Hall State and Local Tax publications; from various papers published by the National Association of Tax Administrators, the International Association of Assessing Officials, and the Institute of Property Taxation; from the Journal of State Taxation; and from telephone interviews with state tax officials. These data were arrayed to compare Iowa's tax structure with that of competing states.

**Task 11: Examination of the Relationship Between Tax
Structure and Burden and the State's Economic
Performances**

As part of this task we evaluated the changes in tax revenues received from specific taxes compared to changes in measures of economic performance such as growth in personal income or gross state product.

To evaluate the impact of possible modifications to the system, a list of modifications which would require further analysis was developed. The list was based on discussions held at progress meetings throughout the course of the study on an evaluation of current trends in state taxes. It was presented to the Committee at progress meetings held on August and September. After discussions with the Committee, we arrived at a final list of modifications for further evaluation.

Each modification was assessed for the probable impact it would have on the policy criteria factors.

Where possible, the impact of the modification on equity and yield was quantified. To quantify the impacts we relied upon analyses performed during Phase II, previous reports prepared by the Iowa Department of Revenue and the Legislative Fiscal Bureau, and special analyses performed for specific modifications by the Department of Revenue and by Coopers & Lybrand.

In conducting the analysis, Coopers & Lybrand developed computer models to evaluate the impact of changes in the corporate income tax structure on total revenues and on hypothetical firms, representative of Iowa's industry, and to estimate the impact of modifications to the property tax.

In addition, we surveyed companies located in Iowa to gain an understanding of the impact of specific taxes on business location and expansion decisions. The survey results were compiled and presented at the September progress meeting.

Phase III: Policy Analysis and Report Preparation

This phase drew upon the results of the previous phases to provide the Tax Study Committee with an assessment of the current tax structure and a framework for evaluation of possible modifications to the tax structure.

Task 12: Conduct of Policy Analysis

This task was conducted in two steps: an analysis of the existing tax structure and an evaluation of possible modifications to the system.

To assess the current structure, we drew upon the work accomplished during Phase I and Phase II to provide a description of each tax and an evaluation of each tax in relation to four policy criteria factors: equity (both horizontal and vertical), neutrality, yield, and simplicity. In addition, the impact of tax expenditure items on the appropriate tax was discussed. The analysis of the current structure was presented to the Committee during progress meetings in September.