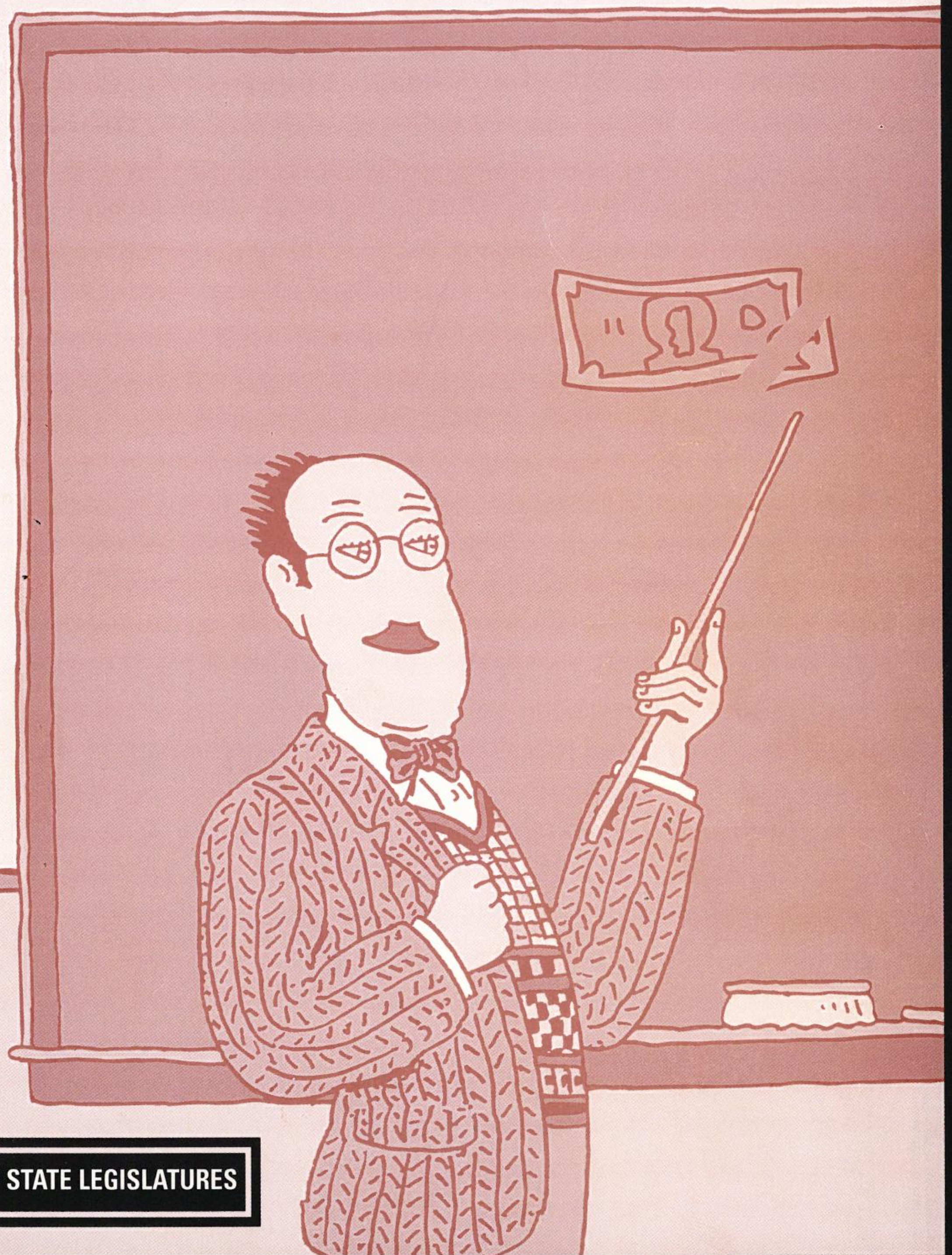
TAX POLICY HANDBOOK FOR STATE LEGISLATORS



NATIONAL CONFERENCE OF STATE LEGISLATURES

Tax Policy Handbook for State Legislators

by

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The National Conference of State Legislatures serves the legislators and staffs of the nation's 50 states, its commonwealths, and territories. NCSL is a bipartisan organization with three objectives:

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- To foster interstate communication and cooperation,
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Preface and Acknowledgments

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Executive Summary

The role of state government continues to evolve and grow. The federal government is "devolving" or returning control of programs to the states, and state courts are requiring states to contribute more money to elementary and secondary education. As a result, state revenue systems are being asked to provide more funding for public services that previously were supported by federal or local governments.

These pressures have led lawmakers in many states to take a fresh look at their tax systems to see whether they meet the current and future needs of their respective governments. In the last decade, roughly half the states have convened tax study commissions—legislative, executive, private sector or some combination—to examine the tax structure and recommend changes.

This report is designed to provide new legislators—or legislators with limited experience in tax policy—with basic tools for evaluating different state taxes. It provides an overview of the current state tax systems. It also evaluates each major state tax on six criteria developed by a group of legislators, legislative staff and other tax experts convened by NCSL in the early 1990s. The six criteria are reliability, equity, compliance and administrative issues, interstate and international competition, economic neutrality, and accountability.

This report is designed to summarize economists' analyses of the key feature of each state tax source in a concise format. Suggestions for additional reading are provided for policymakers interested in exploring these issues more fully.

Introduction

During the past three decades, the states have emerged as an important force in the American federal system. State legislatures have improved their capacity to develop programs and oversee their financing and performance. Working together, state legislatures and governors have given state government a voice in most of the important public policy debates in the country today.

The approach of a new millennium finds state governments poised to assume an even greater fiscal role for two primary reasons. First, Congress and the administration appear ready to make a serious effort to balance the federal budget, which could place additional demands upon states. The welfare reform legislation of 1996—which ended the federal entitlement and ultimately makes states responsible for welfare programs—may set the stage for the transfer of additional responsibilities to states. Such a transfer of program and financing responsibilities would shift more of the burden of financing safetynet programs to the states.

Second, the states are assuming more responsibility for financing K-12 education. State supreme court decisions, voter dislike of the local property tax, and a growing legislative concern about inequities in school funding are pushing states to assume a greater role in funding schools from state revenue sources. The replacement of local property taxes with state tax revenues has major implications for state tax systems, and for local taxes as well.

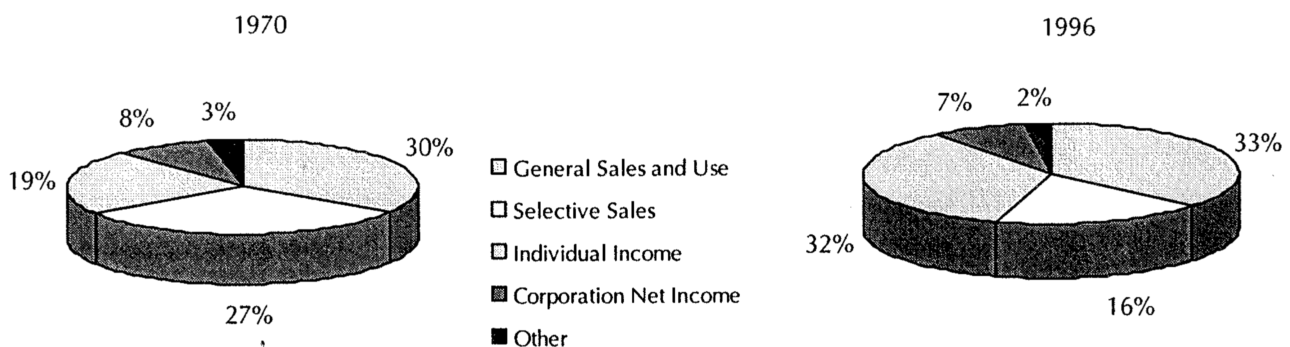
At the same time that states are ready to assume additional responsibilities from federal and local governments, voters have imposed term limits on state legislators in 20 states and rates of legislator "turnover" are increasing even in those states without term limits. Increasingly, state lawmakers who do not have extensive legislative experience are serving on, and in some cases chairing, committees that have jurisdiction over state and local tax policy. The format of this handbook—short analyses of the major features of state tax sources and sources for additional information—is designed to assist legislators who must operate in this new environment.

Composition of State Tax Revenues: An Overview

States rely on a broad range of revenue sources to fund government. On average, states generate about one-third of their revenues from general sales and use taxes and another one-third from personal income taxes. The remaining revenues are split between excise taxes (on gasoline, cigarettes and alcohol); corporate income and franchise taxes; and taxes on business licenses, utilities, insurance premiums, severance, property and several other sources.

Figure 1 shows how the mix of the top five state revenue sources has changed between 1970 and 1996. Key trends during this period include the growing role of the personal income tax and the reduced role of selective sales (excise) taxes in the state revenue mix. General sales and use taxes and corporation income taxes have remained relatively constant during this period, while the share of state taxes from "other" sources declined.

Figure 1. State Tax Mix, 1970 and 1996



Source: U.S. Census Bureau.

Although figure 1 shows how the composition of state revenue has changed, it does not indicate whether the state share has shrunk or grown in relation to the total governmental tax burden. Table 1 and figure 2 show that state tax revenue as a share of personal income, and as a share of total government tax revenue, has grown slightly throughout the period.

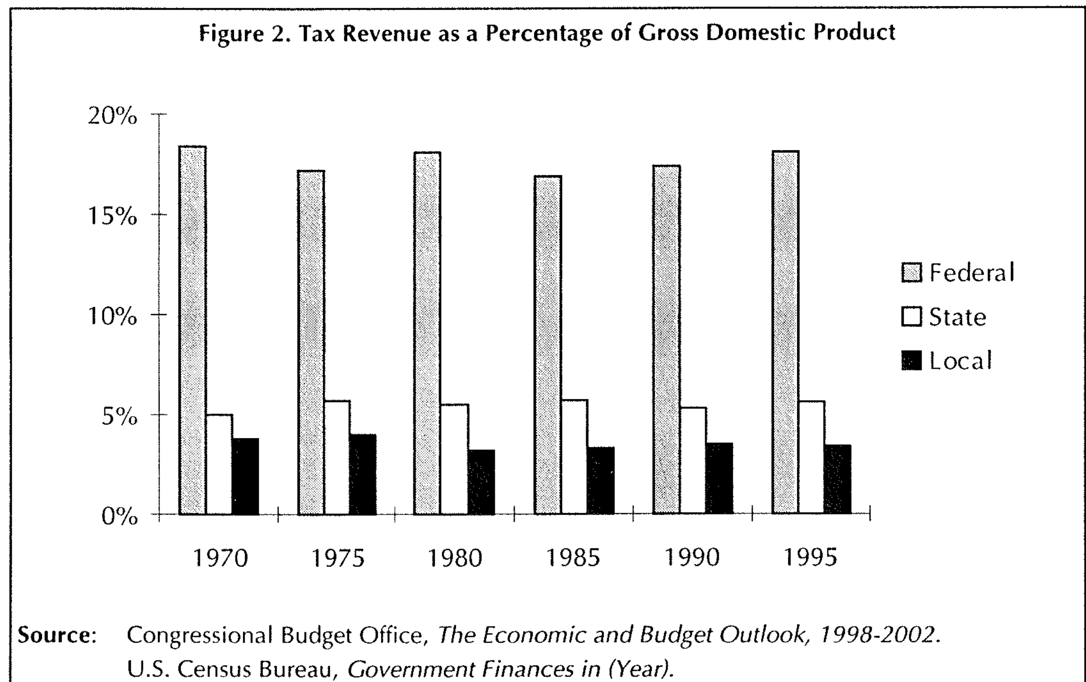
Table 1. State-Local Tax Levels per $100 Personal Income, 1970–1996

	Total			State				
Fiscal Year	Combined	Local	State	General Sales	Personal Income Tax	Corporation Income Tax	Selective Sales	Other
1996	N/A	N/A	$6.89	$2.29	$2.21	$0.48	$1.09	$0.81
1995	N/A	N/A	$6.98	$2.31	$2.20	$0.51	$1.13	$0.83
1994	$11.46	$4.61	$6.85	$2.26	$2.16	$0.47	$1.15	$0.82
1993	$11.43	$4.66	$6.77	$2.20	$2.15	$0.46	$1.15	$0.82
1992	$11.35	$4.69	$6.66	$2.18	$2.12	$0.44	$1.12	$0.80
1991	$11.15	$4.61	$6.54	$2.17	$2.09	$0.43	$1.06	$0.79
1990	$11.33	$4.59	$6.74	$2.24	$2.15	$0.49	$1.06	$0.80
1989	$11.41	$4.55	$6.86	$2.25	$2.14	$0.58	$1.09	$0.80
1988	$11.43	$4.57	$6.86	$2.26	$2.08	$0.56	$1.12	$0.83
1987	$11.30	$4.50	$6.80	$2.19	$2.10	$0.57	$1.11	$0.84
1986	$11.05	$4.37	$6.68	$2.19	$1.97	$0.54	$1.10	$0.88
1985	$11.12	$4.34	$6.78	$2.19	$2.01	$0.55	$1.12	$0.91
1984	$11.20	$4.35	$6.85	$2.17	$2.05	$0.54	$1.16	$0.92
1983	$10.60	$4.25	$6.35	$1.99	$1.84	$0.49	$1.12	$0.91
1982	$10.52	$4.12	$6.40	$1.98	$1.80	$0.55	$1.12	$0.95
1981	$10.79	$4.20	$6.59	$2.04	$1.80	$0.62	$1.16	$0.97
1980	$11.00	$4.26	$6.74	$2.12	$1.83	$0.65	$1.21	$0.92
1979	$11.37	$4.46	$6.91	$2.19	$1.80	$0.67	$1.34	$0.92
1978	$12.09	$5.01	$7.08	$2.20	$1.82	$0.67	$1.44	$0.95
1977	$12.16	$5.17	$6.99	$2.14	$1.76	$0.63	$1.49	$0.97
1976	$12.01	$5.17	$6.84	$2.09	$1.64	$0.56	$1.54	$1.01
1975	$11.75	$5.09	$6.66	$2.06	$1.56	$0.55	$1.54	$0.94
1974	$11.94	$5.16	$6.78	$2.07	$1.56	$0.55	$1.64	$0.96
1973	$12.40	$5.43	$6.97	$2.03	$1.59	$0.56	$1.77	$1.02
1972	$12.24	$5.51	$6.73	$1.98	$1.46	$0.50	$1.76	$1.04
1971	$11.50	$5.26	$6.24	$1.87	$1.23	$0.41	$1.71	$1.02
1970	$11.31	$5.07	$6.24	$1.84	$1.19	$0.49	$1.70	$1.01
Average								
1990s	$11.34	$4.63	$6.78	$2.24	$2.15	$0.47	$1.11	$0.81
1980s	$11.04	$4.35	$6.69	$2.14	$1.96	$0.57	$1.13	$0.89
1970s	$11.88	$5.13	$6.74	$2.05	$1.56	$0.56	$1.59	$0.98

Key: N/A = Not available

Sources: U.S. Census Bureau, *Government Finances in* (Year).
U.S. Census Bureau, State *Government Finances in* (Year).
U.S. Commerce Department, *Survey of Current Business*, October 1996.

Figure 2. Tax Revenue as a Percentage of Gross Domestic Product



Source: Congressional Budget Office, *The Economic and Budget Outlook, 1998-2002.* U.S. Census Bureau, *Government Finances in (Year).*

Most of the growth in state tax burden—measured as a share of personal income—occurred during the 1970s as states expanded social programs and boosted state spending on K-12 education. Since 1984, state tax levels have been stable at about 6.8 percent of personal income.

Growth in the relative state share of government revenue has come at the expense of local government. The property tax revolt in California and its aftermath in other states significantly reduced the role of the property tax in public finance.

Some fluctuations in federal and state revenues are attributable to economic cycles. With their heavy reliance on income taxes, federal revenues tend to fall as a share of gross domestic product (GDP) during recessions and grow as a share of GDP during expansions. States rely on both income and consumption taxes, which are more stable than federal revenues but still exhibit cyclical fluctuations. Local revenues, anchored by the property tax, are more stable than federal or state revenues but do not grow as quickly during economic expansions.

Figure 2 indicates that structural factors affect governmental revenues as well. Federal revenues declined between 1980 and 1985 due to the 1981 personal and business income tax cuts. Local revenues as a share of GDP fell between 1975 and 1980 due to the property tax revolt in California and other states. State revenues grew during the 1970s as states expanded social service programs and assumed new K-12 funding responsibilities.

Sales and use taxes and personal income taxes are the most relied upon state tax systems, generating about two-thirds of all tax revenues. However, as table 2 shows, states vary

dramatically in their mix of tax sources. At the extremes are Florida, which raises 58 percent of its tax revenue from the sales tax and none from personal income taxes; Oregon, which lacks a sales tax and raises 64 percent of its tax revenue from the personal income tax; New Hampshire, which lacks both sales and personal income taxes and raises nearly 50 percent of its revenues from "other" sources such as lodging and restaurant taxes; and Alaska, which raises 60 percent of its revenues from severance taxes on oil and gas producers.

Table 2. FY 1996 Distribution of Selected State Taxes

	Statewide Property	General Sales	Alcohol Excise	Motor Fuel Excise	Tobacco Excise	Personal Income	Corporate Income	Death	Other
New England									
Connecticut	0.0%	31.2%	0.5%	0.1%	1.6%	33.4%	8.2%	3.1%	21.9%
Maine	2.3	34.7	1.8	8.2	2.4	37.4	3.7	0.7	8.8
Massachusetts	0.0	21.0	0.5	4.8	1.9	53.9	9.9	1.5	6.5
New Hampshire	0.1	0.0	1.3	12.8	5.3	6.2	21.5	4.5	48.3
Rhode Island	0.6	30.0	0.6	8.1	3.5	37.5	5.6	0.6	13.5
Vermont	1.3	21.7	1.6	7.0	1.7	33.4	5.3	0.7	27.3
Middle Atlantic									
Delaware	0.0	0.0	0.7	5.6	1.3	37.4	9.8	1.3	43.9
Maryland	2.8	24.5	0.3	7.4	1.6	42.7	4.0	1.3	15.4
New Jersey	0.0	30.0	0.5	3.2	1.7	32.9	8.0	2.2	21.5
New York	0.0	20.4	0.6	1.5	2.0	50.9	8.0	2.3	14.3
Pennsylvania	1.2	30.7	0.8	4.1	1.8	28.8	9.1	2.9	20.6
Great Lakes									
Illinois	1.2	29.3	0.3	6.9	2.4	33.5	9.4	1.1	15.9
Indiana	0.0	34.0	0.4	7.3	1.0	41.2	10.6	1.2	4.3
Michigan	8.6	34.4	0.6	4.1	3.1	30.7	11.4	0.5	6.6
Ohio	0.1	31.9	0.5	7.7	1.9	37.7	5.2	0.6	14.4
Wisconsin	0.9	28.2	0.4	7.0	2.1	43.2	6.0	0.5	11.7
Plains									
Iowa	0.0	32.8	0.3	8.3	2.2	35.8	4.6	1.8	14.2
Kansas	1.0	35.2	1.5	7.4	1.4	34.6	6.4	2.5	10.0
Minnesota	0.1	28.8	0.6	5.2	1.8	41.1	7.0	0.4	15.0
Missouri	0.2	33.6	0.3	8.0	1.6	39.7	5.1	0.8	10.7
Nebraska	0.2	34.4	0.7	11.4	2.0	35.5	5.4	0.4	10.0
North Dakota	0.2	28.6	0.5	9.7	2.5	15.4	7.5	0.4	35.2
South Dakota	0.0	52.5	1.4	12.3	3.0	0.0	5.2	3.0	22.6
Southeast									
Alabama	2.6	27.4	2.2	8.8	1.3	30.0	4.1	0.6	23.0
Arkansas	0.2	37.1	0.7	8.9	2.6	31.3	6.2	3.2	9.8
Florida	3.8	58.0	2.8	6.8	2.3	0.0	5.1	2.1	19.1
Georgia	0.3	37.2	1.2	5.3	0.8	41.2	7.0	0.6	6.4
Kentucky	6.3	27.5	0.9	6.2	0.3	32.0	4.4	1.3	21.1
Louisiana	0.4	33.1	1.1	10.2	1.8	23.6	6.7	1.2	21.9
Mississippi	0.6	47.4	1.0	9.2	1.5	19.2	5.2	0.4	15.5
North Carolina	0.1	25.0	1.4	8.0	0.4	41.5	7.9	1.0	14.7
South Carolina	0.2	37.5	2.3	6.3	0.5	35.5	4.9	0.4	12.4
Tennessee	0.0	57.2	1.1	11.6	1.4	1.9	8.6	1.1	17.1
Virginia	0.2	22.4	1.2	7.9	0.2	48.3	4.1	0.8	14.9
West Virginia	0.1	28.8	0.3	7.4	1.2	27.1	8.5	0.4	26.2

Table 2. FY 1996 Distribution of Selected State Taxes
(continued)

	Statewide Property	General Sales	Alcohol Excise	Motor Fuel Excise	Tobacco Excise	Personal Income	Corporate Income	Death	Other
Southwest									
Arizona	5.7%	42.4%	0.7%	7.8%	2.7%	23.3%	7.0%	0.8%	9.6%
New Mexico	1.2	41.9	1.2	7.4	0.8	21.0	5.3	0.3	20.9
Oklahoma	0.0	26.2	1.3	7.4	1.7	32.8	3.5	1.5	25.6
Texas	0.0	50.9	2.0	10.9	2.7	0.0	0.0	0.8	32.7
Rocky Mountain									
Colorado	0.0	27.4	0.5	9.2	1.4	47.2	4.3	0.7	9.3
Idaho	0.0	32.3	0.3	8.6	1.8	35.3	8.2	0.3	13.2
Montana	18.3	0.0	1.5	14.0	1.2	30.5	6.0	1.2	27.3
Utah	0.0	40.2	0.8	7.1	1.0	39.1	6.1	0.3	5.4
Wyoming	13.4	33.7	0.2	6.9	1.0	0.0	0.0	0.7	44.1
Far West									
Alaska	3.7	0.0	0.8	2.5	1.1	0.0	21.5	0.1	70.3
California	5.8	32.9	0.5	4.7	1.1	36.0	10.1	1.1	7.8
Hawaii	0.0	46.6	1.2	2.5	1.3	32.6	2.1	0.6	13.1
Nevada	1.9	54.4	0.5	6.8	1.9	0.0	0.0	1.3	33.2
Oregon	0.0	0.0	0.3	8.6	2.7	63.9	6.8	0.9	16.8
Washington	17.0	58.4	1.3	6.4	2.6	0.0	0.0	0.6	13.7
United States	**2.4**	**33.3**	**0.9**	**6.2**	**1.8**	**32.1**	**7.0**	**1.3**	**15.0**

Source: U.S. Census Bureau, State Tax Collections 1996 (available at www:census.gov/).

Principles for Evaluating State Tax Sources

In 1991, a bipartisan group of state legislators, legislative staff, and other public and private sector representatives identified nine principles to evaluate the quality and effectiveness of state revenue systems.[1] Six of these nine principles are especially appropriate for evaluating individual tax sources within the state revenue mix, while the remaining three principles address the interrelationships of tax systems within the state revenue system as a whole.

This handbook evaluates major state revenue sources by the six principles that are appropriate for evaluating individual tax sources. These six principles are as described below:

Reliability

Reliability has three primary components: stability, certainty and sufficiency. *Stability* implies that revenues are relatively constant over time and not subject to unpredictable fluctuations. *Certainty* means that the number and type of tax changes are kept at a minimum to allow businesses and individuals to plan for the future. *Sufficiency* requires that revenue sources provide the revenue growth necessary to finance the desired rate of growth of spending. The reliability of different types of tax sources varies greatly, depending on the type of activity being taxed. States can improve the reliability of their tax systems by imposing a balanced mix of taxes.

Equity

Equity has two primary components—horizontal equity and vertical equity. *Horizontal equity* means that taxpayers with similar economic circumstances have similar tax burdens. *Vertical equity* refers to the distribution of tax burdens among taxpayers with different economic circumstances. In a progressive tax system, the share of income paid in taxes increases as income rises. In a regressive tax system, the share of income paid in taxes is greatest for low-income taxpayers and falls as income rises. States rely on many

consumption tax sources that are regressive by nature; it is very difficult to design a progressive state tax system. However, many tax policy experts believe that, at a minimum, a fair state tax system minimizes both regressivity and the tax burden on low-income households.

Compliance and Administration

A quality tax system facilitates taxpayer compliance by minimizing the time and effort necessary to comply with the law. It also minimizes the cost of the state administrative apparatus necessary to collect revenue, enforce the law and audit to ensure compliance with the law. Complex taxes that are expensive to enforce reduce the yield of the tax system and result in wasted taxpayer resources.

Responsiveness to Interstate and International Competition

A state tax system does not operate in a vacuum—lawmakers must recognize that the tax policies of surrounding states can limit the revenue potential of some taxes. Businesses that sell in a national or global marketplace can relocate if state business taxes are too burdensome. Individuals may choose to shop in neighboring states if state consumption tax differentials are high.

Economic Neutrality

Taxes, by their very nature, are not economically neutral. Tax policy can encourage or discourage consumption of goods and services, influence decisions to save and invest, and affect fundamental business decisions about the use of labor and capital. A quality tax system tries to minimize the effect of the tax system on the allocation of resources in the economy. When lawmakers decide to use the tax system to make budget decisions or influence behavior, these decisions should be explicit and subject to frequent evaluation and review. Taxes with broad bases and low rates, spread across a wide range of sources and economic activities, reduce the effect of taxation on economic decisions.

Accountability

The essence of accountability is that tax burdens should be explicit, not hidden. This principle can be applied to state taxes in two ways. First, credits and exemptions in the tax code should be minimized and reviewed frequently to determine their cost (in lost revenue) and to determine whether they are unfairly benefiting some taxpayers at the expense of others. Second, taxes that are designed to be "passed through" to consumers provide less accountability than taxes that are paid directly and openly by taxpayers.

Evaluation of State Tax Sources

This section evaluates each major state tax source according to the six major principles presented in the previous section.

Personal Income Tax

The personal income tax is the second largest source of state tax revenues, providing 32.1 percent of tax revenue in fiscal year 1996. The role of the personal income tax in the state tax mix has increased dramatically since 1970, when it provided only 19 percent of state revenues. Part of this growth in state reliance is explained by enactment of income taxes in Ohio (1971), Pennsylvania (1971), Rhode Island (1971), New Jersey (1976) and Connecticut (1991). Some states also have replaced local property tax funding for schools with state sources like the income tax.

Figure 3 shows the states that levy a personal income tax in 1997. New Hampshire and Tennessee have a limited income tax on interest, dividends and capital gains but do not tax wages and salaries. All but five of the 41 states with broad-based income taxes use a graduated rate structure, with income taxed at higher marginal rates as income increases. Colorado, Illinois, Indiana, Michigan and Pennsylvania have a single, flat tax rate on all income, while Massachusetts levies flat taxes of 5.95 percent on wages and salaries and 12 percent on interest, dividends and capital gains. Appendix table A1 provides additional detail on state income tax structure.

Sixteen states index tax brackets or personal exemption amounts to prevent inflation from pushing taxpayers into higher tax brackets, either directly in the state tax code or implicitly by conforming to federal indexing provisions. Although inflation has been relatively low for the past decade, *bracket creep*—the effect of inflation pushing taxpayers into higher tax brackets—was a major concern in the late 1970s when double digit inflation was prevalent. States with progressive income taxes that do not index for inflation tend to experience automatic growth in income tax revenues over time, even when wages are increasing more slowly than inflation.

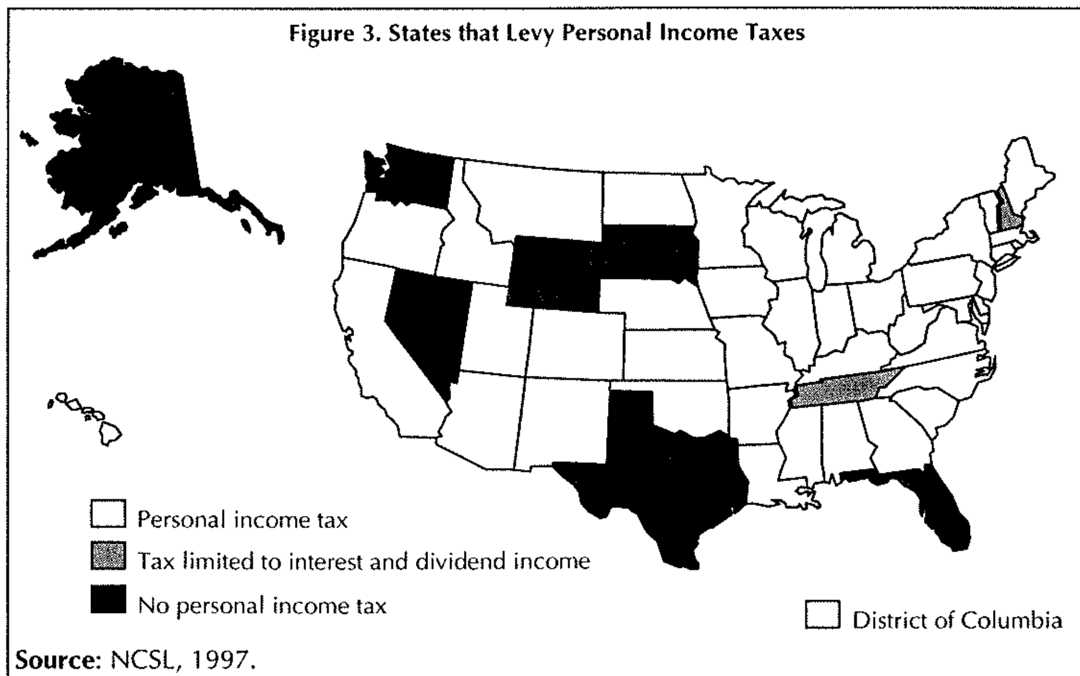


Figure 3. States that Levy Personal Income Taxes

Source: NCSL, 1997.

Reliability

The personal income tax is a reliable and stable source of state revenue. Most long-term estimates of the responsiveness of the income tax to economic growth show that income taxes tend to increase more quickly than state personal income.[2] Like other state revenue sources, the growth of personal income tax revenues declines during recessions. However, personal income taxes are "elastic" over the entire business cycle—that is, a 1 percent increase in personal income produces more than a 1 percent increase in tax collections.

The responsiveness of the income tax to economic growth also helps explain why state income tax reliance has increased over time. Consumption taxes, particularly excise taxes, tend to grow more slowly than the economy. Lawmakers must pass rate increases just to ensure that consumption tax revenues keep pace with economic growth. The political process is biased toward revenue sources that produce revenue growth without lawmakers voting to increase the tax rate or expanding the base to keep revenues growing at the same rate as the economy. In the mid-1990s, however, state legislatures across the country reduced personal income tax rates. These actions have offset some of the automatic growth in personal income tax revenues.

Equity

The personal income tax scores well on both vertical equity and horizontal equity. The personal income tax is the only state tax that is progressive by design, so inclusion of personal income taxes in the overall mix of state taxes helps minimize the regressivity of the system.[3]

Income taxes achieve progressivity either through a graduated rate structure, or with a flat rate structure that includes personal exemptions and standard deductions that remove low-income taxpayers from the tax rolls. In addition, eight states have earned income tax credits—targeted toward low-income working taxpayers—that offset income tax liability and actually may provide refunds in excess of tax liability.[4]

The income tax also promotes horizontal equity. Unlike the property tax, where the process of valuing property may add a subjective element to determining tax liability, income taxes are levied based upon a set formula that requires states to levy the same tax on taxpayers with a given income. Although tax credits, deductions and exemptions may erode horizontal equity somewhat, the income tax is widely recognized as reinforcing horizontal equity in state tax systems.

Compliance and administration

Most state income tax systems are closely linked to the federal tax code. North Dakota, Rhode Island and Vermont piggyback their income tax as a percentage of federal tax paid—that is, taxpayers in these states calculate their federal tax due and then pay a percentage of that amount to the state. Seven additional states use federal taxable income as the starting point to apply state tax rates, while 27 more use federal adjusted gross income as a starting point (see table 3). Only four states do not use the federal tax code as a starting point for calculating state tax liability.

Table 3. State Individual Income Taxes: Exclusions and Adjustments to Income

State	Conformity to Federal Income Tax	State	Conformity to Federal Income Tax
Alabama	None	Montana	AGI
Alaska	No state income tax	Nebraska	AGI
Arizona	AGI	Nevada	No state income tax
Arkansas	None	New Hampshire	Only interest and dividends are taxed
California	AGI	New Jersey	None
Colorado	FTI	New Mexico	AGI
Connecticut	AGI	New York	AGI
Delaware	AGI	North Carolina	FTI
Florida	No state income tax	North Dakota	Percentage of federal liability
Georgia	AGI	Ohio	AGI
Hawaii	FTI	Oklahoma	AGI
Idaho	FTI	Oregon	AGI
Illinois	AGI	Pennsylvania	None
Indiana	AGI	Rhode Island	Percentage of federal liability
Iowa	AGI	South Carolina	Based on federal taxable income
Kansas	AGI	South Dakota	No state income tax
Kentucky	AGI	Tennessee	Only certain interest and dividends are taxed
Louisiana	AGI	Texas	No state income tax
Maine	AGI	Utah	FTI
Maryland	AGI	Vermont	Percentage of federal liability

Table 3. State Individual Income Taxes: Exclusions and Adjustments to Income
(continued)

State	Conformity to Federal Income Tax	State	Conformity to Federal Income Tax
Massachusetts	AGI	Virginia	AGI
Michigan	AGI	Washington	No state income tax
Minnesota	FTI	West Virginia	AGI
Mississippi	None	Wisconsin	AGI
Missouri	AGI	Wyoming	No state income tax
District of Columbia	AGI		

Key: AGI—Adjusted Gross Income
FTI—Federal Taxable Income

Source: ACIR, *Significant Features of Fiscal Federation*, Volume 2, 1995.

States that link personal income tax closely to the federal code gain efficiency in administration and reduce compliance costs for businesses and individuals. However, states also lose a measure of control over their income tax systems because any changes in federal law that increase or decrease federal revenue will affect state revenues as well. The Tax Reform Act of 1986, for example, produced a revenue windfall for 34 of the 43 states with income taxes due to their conformity to the federal code.[5]

A common criticism of the federal income tax is the tremendous complexity of the system and the significant compliance costs imposed upon taxpayers. At the state level, conformity with the federal tax code minimizes compliance costs because taxpayers are already required to maintain records and calculate figures for federal tax forms. State administrative costs are reduced through joint federal/state audit programs that allow the Internal Revenue Service to share the results of audits and enforcement actions with states. If the federal government abandoned the income tax, as has been proposed in Congress, administrative and compliance costs would become major issues for the states.

Interstate and international competition

The personal income tax is a factor in interstate competition for retirees and corporate headquarters. In recent years, Mississippi and Michigan have reduced or eliminated income taxes on retirement income to compete with Florida (no income tax) for retirees. Some executive recruiting firms also claim that businesses seeking to relocate corporate headquarters look closely at top marginal income tax rates, which are of concern to highly compensated executives. However, the relative importance of personal income tax rates in economic development decisions is highly debatable.

As with most major state and local taxes, interstate competition requires states to consider whether taxes are out of line with neighboring or competing states. Corporate recruiters suggest that it is most appropriate to examine the effect of the entire state-local revenue system on the cost of doing business, not at a single tax. Since firms do not pay a personal

income tax, this is more an intangible concern in the mind of senior executives than a direct factor in the cost of doing business.

Economic neutrality

Like other taxes, the personal income tax is not economically neutral. The very existence of the tax, in theory, can influence individual decisions about whether and how much to work, save and invest. The higher the marginal rate, the stronger the work disincentive provided by state income taxes. High capital gains tax rates also can discourage investment. However, the effect of state income taxes on work and investment decisions is dwarfed by the federal income tax. State income taxes may be a factor in decisions about work effort, but they probably are not the deciding factor for most taxpayers.

Most state income tax preferences are specifically designed not to be economically neutral. Some state policymakers favor using the income tax code to provide incentives for certain behavior (saving for retirement, attending college) and disincentives for other behavior. Massachusetts has a high tax rate on short term capital gains, but the tax rate falls as assets are held for longer periods of time. The provision discourages short-term, speculative gains, while rewarding investors who hold assets over a longer period. Other states have exempted interest earned in college savings plans from state income taxes to encourage taxpayers to set up these plans.

Accountability

The personal income tax is the most visible tax paid by individuals. Unlike consumption taxes and business taxes that are concealed in the price of products, taxpayers know exactly how much they pay in income taxes each year because they are required to file a tax return that specifies the tax paid each year. The high visibility of the income tax makes it a popular target for tax reductions by lawmakers who want to reduce the tax burden.

Additional issues

The state income tax can be claimed as an itemized deduction on the federal form 1040 for taxpayers who itemize deductions. This deduction reduces the effective state tax rate by up to 40 percent for taxpayers in the highest federal tax bracket. Deductibility is a key issue in states that are examining major tax shifts involving income taxes (deductible), sales taxes (not deductible), property taxes (deductible) and other state taxes (not deductible).

Sales and Use Taxes

Mississippi adopted the first state sales tax in 1932. Since then, the sales tax has become one of the most important taxes in state revenue systems, consistently contributing more

than one-third of total state revenues. Designed to tax consumption, sales taxes are levied on general retail sales transactions. Currently, 45 states and the District of Columbia impose a tax on general retail sales. Alaska, Delaware, Montana, New Hampshire and Oregon do not impose a state sales tax. The "General Sales" column in table 2 (page 5) shows the percentage of state revenues generated from the general sales tax in 1996 by state.

State sales tax rates range from 3 percent in Colorado to 7 percent in Mississippi and Rhode Island. Eighteen states levy the sales tax at the median rate of 5 percent. Thirty states allow local option (city, county or special district) sales taxes in addition to the state sales tax. States with the highest rates, like Mississippi and Rhode Island, typically do not allow local option taxes. Some states with low rates, like Colorado, allow extensive use of local option sales taxes. State rates alone typically do not accurately represent of the relative sales tax rates paid by taxpayers in most states.

Sales taxes are regressive. Taxpayers with lower incomes tend to spend a higher proportion of their incomes on consumption. As a result, low-income taxpayers pay a higher proportion of their incomes in sales taxes than do middle- and upper-income taxpayers.

In an attempt to reduce the regressivity of the sales tax, some states have adopted specific exclusions for necessities, such as groceries and prescription drugs. Nearly every state sales tax exempts prescription medicine and 26 states exempt groceries.

Although food exemptions lessen the regressivity of the tax, food is the largest component of the sales tax base and food exemptions produce large state revenue losses. Since 1995, Georgia, Missouri and North Carolina have reduced or eliminated the state sales tax on food purchases.[6]

States vary significantly in identifying taxable and exempt transactions. Several states, in an effort to broaden their tax base, have extended the sales tax to include a variety of services. Connecticut, Iowa, South Dakota, Texas and West Virginia have successfully included a number of consumer services in their tax bases.

As demonstrated in table 4, Delaware, Hawaii, New Mexico and Washington tax a much larger number of services than other states. This is because these states each impose a unique derivative of the sales tax, where taxes are imposed on businesses for the privilege of doing business in the state. As a result, services are implicitly included in the tax base. These taxes are discussed in more detail in the business tax section of this report.

Table 4. Number of Services Taxed by Category and State

State	Utilities	Personal Services	Business Services	Computer Services	Admissions	Professional Services	Fabrication Repair and Installation	Other Services	Total
Alabama	9	2	6	1	10	0	1	3	32
Alaska	0	0	0	0	0	0	0	1	1
Arizona	12	2	5	3	11	0	2	25	60
Arkansas	14	3	5	1	11	0	11	7	52
California	4	2	3	1	1	0	3	5	19
Colorado	4	0	2	1	2	0	3	3	15
Connecticut	9	11	20	6	13	0	14	11	84
Delaware	7	20	34	6	10	8	19	37	141
Florida	7	4	8	3	13	0	16	14	65
Georgia	10	3	2	1	11	0	2	6	35
Hawaii	14	20	34	6	13	8	18	42	155
Idaho	0	3	4	0	11	0	6	5	29
Illinois	12	0	1	1	0	0	1	1	16
Indiana	8	4	3	2	2	0	0	5	24
Iowa	13	15	18	0	13	0	14	22	95
Kansas	10	10	9	2	13	0	16	16	76
Kentucky	10	1	4	0	7	0	3	1	26
Louisiana	12	8	4	1	7	0	13	8	53
Maine	9	1	6	3	2	0	4	2	27
Maryland	5	3	11	1	11	0	3	2	36
Massachusetts	9	1	4	0	1	0	2	3	20
Michigan	10	4	6	1	1	0	2	2	26
Minnesota	15	6	11	2	13	0	4	10	61
Mississippi	8	4	8	3	10	0	13	23	69
Missouri	8	1	2	1	11	0	0	5	28
Montana	12	0	0	0	3	0	0	4	19
Nebraska	14	6	5	3	11	0	5	4	48
Nevada	0	1	4	0	1	0	2	3	11
New Hampshire	8	1	0	0	0	0	0	2	11
New Jersey	6	2	6	0	6	0	14	11	45
New Mexico	16	20	33	6	13	8	18	41	155
New York	9	5	15	4	7	0	16	18	74
North Carolina	10	4	4	1	8	0	1	1	29
North Dakota	6	1	2	0	10	0	1	1	21
Ohio	8	5	8	2	1	0	12	6	42
Oklahoma	7	1	4	2	11	0	0	6	31
Oregon	0	0	0	0	0	0	0	0	0
Pennsylvania	8	6	17	6	1	0	15	8	61
Rhode Island	10	1	6	3	3	0	3	2	28
South Carolina	4	5	6	4	9	0	1	3	32
South Dakota	10	19	28	6	13	4	18	32	130
Tennessee	11	11	6	3	12	0	13	14	70
Texas	12	11	14	6	11	1	11	13	79
Utah	7	7	5	2	8	0	13	7	49
Vermont	3	2	4	1	10	0	2	1	23

Table 4. Number of Services Taxed by Category and State
(continued)

State	Utilities	Personal Services	Business Services	Computer Services	Admissions	Professional Services	Fabrication Repair and Installation	Other Services	Total
Virginia	1	3	4	0	1	0	4	5	18
Washington	16	20	34	6	10	8	15	43	152
West Virginia	10	17	26	4	13	1	13	26	110
Wisconsin	11	11	6	1	13	0	14	13	69
Wyoming	11	7	6	2	7	0	16	15	64
District of Columbia									
Puerto Rico									

Source: Federation of Tax Administrators, Sales Taxation of Services Survey, 1996.

Any discussion of sales taxes also must include mention of the use tax. Every state that taxes sales also imposes a state use tax at the same rate. The use tax was designed to capture revenues on purchases that are not subject to the state sales tax; namely, purchases from out-of-state vendors who are not responsible for collecting tax on interstate transactions. Most states impose a use tax on the storage, use or consumption of tangible personal property within the state on which sales tax has not been paid. The state collects the use tax from out-of-state vendors that are registered with the state or from the purchaser in the state. As one might expect, collection of the use tax can be difficult.

Reliability

The sales tax has been a stable state revenue source, although rate increases have been necessary to preserve its share of the state revenue mix. In 1970, states received about 30 percent of total revenues from the sales tax compared to approximately 33 percent in 1996. Since it is levied as a percentage of the retail sales price, the sales tax provides some automatic revenue growth as general price levels rise. However, most states have been slow to broaden the sales tax base to include services. Therefore, as personal consumption expenditures continue to shift toward services, the sales tax captures a smaller share of the total consumption dollar.

The *elasticity* of the state sales tax depends greatly on what is included in the tax base. Including food in the base lowers the elasticity of the sales tax because food purchases are not very responsive to income growth. A sales tax that includes services tends to be more elastic because many services are discretionary and changes in consumption correlate to changes in income. State estimates of the elasticity of the sales tax range from .65 to 1.23, with most estimates between 0.9 and 1.1.[7]

The stability of the sales tax is improved if food and other necessities are included in the base. States that exempt services but do tax food have the most revenue stability but are likely to have less revenue growth over time. States that exempt food but tax services will be the most susceptible to revenue shortfalls during economic downturns but will likely enjoy

strong revenue growth during economic expansions. States that tax both food and services are likely to enjoy both stability and revenues that grow commensurate with personal income growth.

Equity

Two primary issues dominate the debate over the equity of the sales tax. The first is regressivity, in which sales taxes claim a larger share of low-income taxpayers' incomes, especially if food is included in the tax base. The second issue involves whether exemptions for certain goods and services make the sales tax inequitable.

States face a tradeoff when trying to reduce the regressivity of the sales tax. Removing food and other necessities from the sales tax base reduces revenue by up to 30 percent and makes the tax less stable through the business cycle.[8] Many economists also argue that a food exemption benefits the wealthy proportionately more than the poor because they consume more expensive food items. Some states that tax food have tried to mitigate the effect on the poor through special rebates. Another mitigating factor is a federal prohibition on state sales taxes on food items that are purchased with food stamps.

The second equity issue concerns the disparate treatment of goods and services in many state sales taxes. The sales tax is designed to tax consumption, yet a growing share of the consumer expenditure dollar is spent on services that may escape taxation. The shrinking relative share of the consumer dollar spent on goods has forced states to raise the rate to maintain the sales tax share of state tax revenues. However, the two states that tried to dramatically expand the sales tax to services—Florida and Massachusetts—met with such political resistance that the laws were repealed soon after enactment.

Administration and compliance

From the state perspective, sales tax administration is very straightforward—much of the administrative burden is shifted to the vendor. The vendor collects the tax from the consumer and the vendor is responsible for knowing what is taxable and what is tax-exempt. Given advances in technology, administrative burdens on most retailers are not as great as they were before the widespread use of universal product code scanners. Compliance is relatively easy to monitor since taxes are based on sales transactions and sales records are maintained by vendors. States typically provide a vendor compensation allowance to retailers, allowing them to collect a percentage of the revenue collected as compensation for their administrative costs.

The use tax, on the other hand, is much more difficult to monitor since transactions take place across state lines and vendors may not be registered with the state in which the item is being used. Clearly, the use tax is the weak link for sales tax enforcement. Under a line of U.S. Supreme Court cases, states may legally impose a use tax on purchases made in

another state. For practical and political reasons, states have chosen to focus enforcement efforts on vendors instead of on consumers. However, they cannot require the out-of-state retailer to collect and remit the sales tax unless the retailer has a physical presence, or *nexus,* in the taxing state. The establishment of nexus is an evolving area of state tax law that imposes significant administrative burdens on state revenue departments and retailers.

Another state policy issue is whether to impose a sales tax on energy and raw materials—or inputs—used or consumed in the manufacturing process. In a competitive interstate and international marketplace, states that tax business inputs may put firms at a competitive disadvantage. The prices for many agricultural commodities, for example, are set by the world marketplace, so producers may not be able to pass to consumers sales taxes on machinery and supplies in the form of higher prices. Many economists argue that inputs in the production of goods later sold at retail should not be taxed because the sales tax is intended to be a tax on final consumption. Taxes on inputs cause *pyramiding*—the imposition of taxes on goods whose retail price already has taxes embedded in it (a tax on a tax).

Economic neutrality

The disparate treatment of goods and services affects the economic neutrality of the sales tax. For example, states that exempt labor repairs but tax new purchases may affect decisions about whether to fix a machine or buy a new one. The higher relative price of durable goods resulting from sales taxes may affect the mix of goods and services purchased by consumers if services continue to be excluded from sales taxes. Also, states that tax services may disproportionately burden small business because larger firms may provide services (legal, accounting) in-house.

Accountability

Most states require the sales tax to be separately stated on the receipt. This makes that sales tax visible to the taxpayer because consumers have an accounting of the tax paid with each purchase. However, since Congress repealed the federal income tax deduction for sales taxes, there is no incentive for taxpayers to save receipts to determine their annual sales tax burden. Therefore, most taxpayers are unaware of the total annual sales tax burden.

Corporation Income and Franchise Tax

The corporation income and franchise tax is the third largest source of state revenues, providing 7 percent of state tax revenue in fiscal year 1996. Twenty-three states use net income as the exclusive basis for levying the tax. Twenty states use a combination of net income and net worth as the base for determining tax liability. Table 5 details the primary bases for corporation taxes in the states.

Table 5. State Corporation Taxes: Primary Bases

State	Gross Receipts	Net Income (1)	Capital Stock or Net Worth	State	Gross Receipts	Net Income (1)	Capital Stock or Net Worth
Alabama (2)		✓	✓	Montana		✓	
Alaska	✓			Nebraska		✓	
Arizona		✓		Nevada			
Arkansas		✓	✓	New Hampshire (8)			
California		✓		New Jersey		✓	
Colorado		✓		New Mexico		✓	
Connecticut (3)		✓		New York (9)		✓	✓
Delaware (4)		✓	✓	North Carolina		✓	✓
Florida		✓		North Dakota		✓	
Georgia		✓	✓	Ohio		✓	✓
Hawaii	✓	✓		Oklahoma		✓	✓
Idaho		✓		Oregon		✓	
Illinois		✓	✓	Pennsylvania		✓	✓
Indiana	✓	✓		Rhode Island		✓	✓
Iowa (5)		✓		South Carolina		✓	✓
Kansas		✓	✓	South Dakota (10)		✓	
Kentucky		✓	✓	Tennessee (11)		✓	✓
Louisiana		✓	✓	Texas		✓	✓
Maine		✓		Utah		✓	
Maryland		✓		Vermont		✓	
Massachusetts (6)		✓	✓	Virginia		✓	
Michigan (7)				Washington	✓		
Minnesota		✓		West Virginia		✓	✓
Mississippi		✓	✓	Wisconsin		✓	
Missouri		✓	✓	Wyoming			✓
District of Columbia		✓		Puerto Rico			
				Totals	3	46	22

1. Some corporation income tax bases, such as Connecticut's, have a capital stock component.
2. **Alabama**—Alabama has two separate corporation franchise taxes
3. **Connecticut**—Tax is on the highest of two bases, or minimum tax. The income and capital bases are not combined.
4. **Delaware**—Delaware has two separate corporation taxes: income and franchise, which is based on capital stock outstanding. The corporate franchise tax is levied for the privilege of being incorporated in the state.
5. **Iowa**—Iowa annual filing fee with the secretary of state no longer is based on the value of capital stock; $30 fee for all corporations.
6. **Massachusetts**—Massachusetts also has nonincome measure of the tax based on tangible personal property or net worth allocable to the state.
7. **Michigan**—Michigan levies a single business tax, which is a modified value-added tax.
8. **New Hampshire**—New Hampshire levies a modified value-added tax.
9. **New York**—New York's net income base pertains primarily to the taxation of general business corporations. Transportation and transmission companies (i.e., utilities), except airlines, pay tax on gross receipt base.
10. **South Dakota**—South Dakota levies a limited income tax on certain banks and financial institutions.
11. **Tennessee**—Tennessee has two distinct corporate taxes: (1) corporate excise (income) tax; and (2) corporate franchise tax imposed on higher of either (a) apportioned capital stock or (b) value of property owned and leased in the state.

Source: ACIR, *Significant Features of Fiscal Federalism*, Volume 1, 1995; NCSL update, December 1997.

Most states levy the corporation income tax at a flat rate, although 13 states impose a graduated corporation income tax. In the states with flat taxes, rates range from 3.4 percent in Indiana to 10.75 percent in Connecticut. In states with graduated rates, the range is from a low of 1 percent of taxable income below $10,000 in Alaska to 10.5 percent of income above $50,000 in North Dakota. Most states with a corporation income tax levy a minimum tax at a fixed dollar amount, ranging from $10 in Oregon to $800 in California. Appendix table A2 lists the rate structure and minimum tax in each state.

States that use capital stock or net worth as a portion of the tax base typically levy the tax at a flat share of capital stock outstanding or net worth. For example, the capital stock component of Pennsylvania's tax is 1.3 percent of the outstanding value of capital stock. Wyoming's tax—based only on corporate assets located in Wyoming—is levied at $200 per $1 million in assets.

Three states use gross receipts as a basis for taxing corporations. Hawaii and Indiana use both net income and gross receipts in the tax base, while Washington levies a tax only on gross receipts. Washington's tax is levied at varying percentages of gross receipts, depending upon the type of business. Rates range from 1.5 percent of gross receipts for providers of financial services to 0.11 percent for purchases of certain agricultural commodities for wholesale resale.

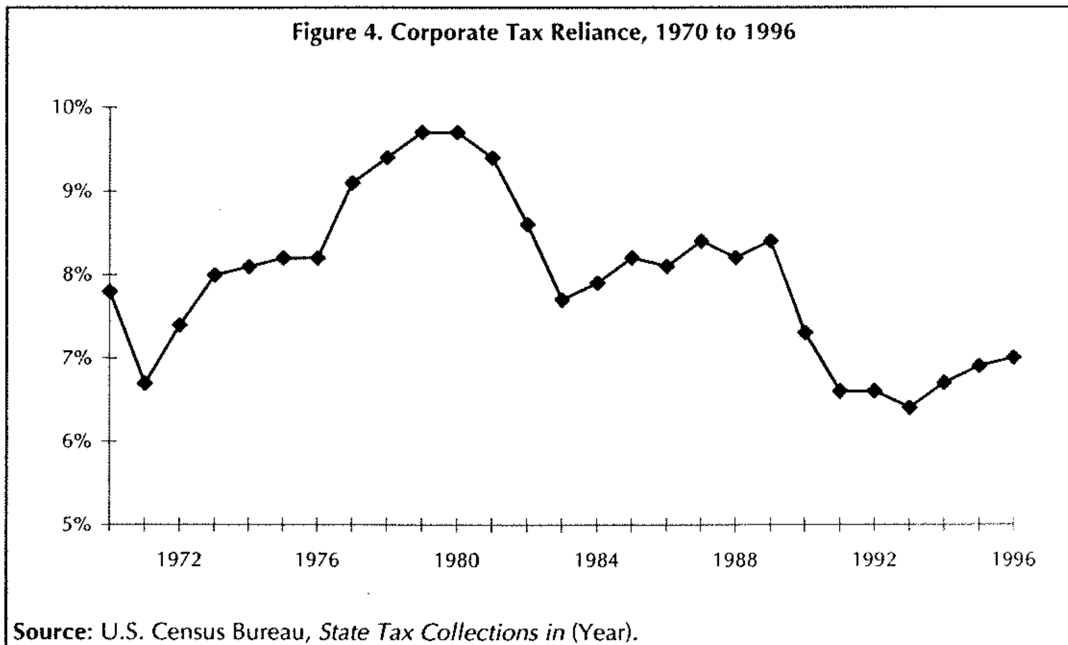
Two other states—Michigan and New Hampshire—tax corporations using a value-added tax. A value-added tax imposes taxes on the capital, entrepreneurial profit and labor inputs that add value to products in the production process. For example, New Hampshire levies a tax at 0.25 percent of the sum of compensation, interest paid and dividends paid, plus a 7 percent tax on business profits. Michigan's single business tax is levied at 2.3 percent of the sum of compensation, interest paid, retained earnings, dividends and depreciation less capital expenditures.

States offer a wide variety of tax credits and deductions that are designed to provide incentives for business expenditures in certain areas. Common credits include investment in machinery and equipment, research and development, employee training and investments in enterprise zones.

Corporations that conduct business in more than one state must apportion their incomes and assets among those states. Most states follow a method developed in the 1950s that employs a formula that gives equal weight to sales, payroll and property. States calculate the percentage of sales, payroll and property attributable to each state and apply the aggregate percentage to their total income. However, more states are moving to procedures that give additional weight to the sales factor. This method provides favorable treatment to firms that export products for sale in other states.

Figure 4 shows the changing state reliance on corporation income taxes since 1970. State reliance peaked at 9.7 percent of state tax collections in the late 1970s and has dropped to an average of 6.8 percent in the 1990s. Corporation income taxes have declined as a share of state personal income as well. In the 1970s and 1980s, state corporation income taxes were 0.56 percent and 0.58 percent of personal income, respectively. In the 1990s, they averaged just 0.46 percent of state personal income.

Figure 4. Corporate Tax Reliance, 1970 to 1996



Source: U.S. Census Bureau, *State Tax Collections in* (Year).

Several factors may be responsible for the decline in the share of state revenues from corporation income taxes. First, as mentioned above, more states are using apportionment formulas that weight sales more heavily. Inconsistent state apportionment formulas may allow interstate firms to legally avoid taxation on some income.[9] Second, most states have adopted S-corporation and limited liability corporation laws that allow profits to be taxed as ordinary income of owners (through the personal income tax) instead of as a corporate entity. Finally, states have expanded the use of credits, incentives and abatements to lure businesses and create jobs. The cumulative effect of these provisions may be eroding overall corporation income tax collections in relation to other taxes.

Reliability

Corporation taxes are one of the most volatile state revenue sources. Corporate profits are highly vulnerable to national economic cycles, not only due to the nature of business operations but also because corporation income taxes use accounting procedures that allow firms to carry losses forward against future profits. States that use capital stock or value added in the tax base can mitigate fluctuations inherent in corporation taxes that are levied solely on net income.

Equity

Considerations of vertical equity typically do not apply to corporation taxes. However, horizontal equity is affected by tax abatements, exemptions and preferences that some states grant to lure new businesses and to promote economic development generally. These inequities have not provoked significant complaints from the business community.

Corporations have long complained that the taxation of both corporation income and dividends (through the personal income tax) is unfair. Firms argue that the taxation of both dividends and profits is double taxation because dividends are paid from profits that already have been taxed.

Economists note that corporation taxes really are paid by individuals, in one of three ways: by firm owners, in the form of reduced profits; by firm employees, in the form of lower wages; and by consumers, in the form of higher prices. How this shifting occurs depends upon the nature of the business taxed. Firms that sell products in highly competitive global markets or in commodity markets may not be able to pass taxes along through higher prices. However, firms that sell services in local markets or in monopoly or oligopoly markets have a greater ability to shift taxes to consumers.

The primary argument in favor of corporation taxes is the benefit principle of taxation. Businesses benefit from the educational system (skilled workers), infrastructure and other services financed by state governments. The corporation income tax helps ensure that firms share part of the costs of services that benefit them directly.

A key equity question for corporation taxes is whether to levy taxes only on net income, or to use a *value added* or a capital stock component in the tax base. Firms that are taxed only on net income are not required to pay corporation taxes in years when they are not profitable, while the other tax bases create tax liability even when firms lose money. The benefit principle would favor value-added taxes or capital stock taxes, since firms benefit from public services regardless of profitability. However, some firms argue that such taxes exacerbate losses in bad years and are inequitable.

Administration and compliance

Thirty-eight of the 43 states that use net income as a basis for corporation taxes use federal taxable income as the starting point for determining state taxable income. However, despite this fact, complying with state corporation taxes is a very complex undertaking for firms that operate in more than one state.

First, even though most states conform to the three-factor apportionment formula designed to provide uniformity in how multistate firms apportion their income among the states, state definitions vary on what types of income are included in the formula. Second, firms that

have intangible property like copyrights or patents face different state rules governing whether such property should be included in the apportionment formula. Third, states have different rules about whether corporate subsidiaries must file separate returns of file combined returns. Finally, a multitude of different state rules govern when returns must be filed (or if they can be), when estimated payments are due and what types of income are reported.

This complexity leads to high compliance costs for businesses. It also requires that state departments of revenue spend a disproportionate share of their resources on compliance audits and other administrative tasks.

Interstate and international competitiveness

The proliferation of tax incentives, credits and abatements reflects states' heightened concern about the role of state taxation in decisions by firms about where to locate operations. States are competing with each other, as well as with other nations, for facilities and jobs. For many firms, particularly manufacturing firms with high capital requirements, the corporation income tax is less onerous than local property taxes and sales taxes on machinery and equipment.

Businesses that specialize in helping firms with location decisions report that tax rates that are out of line with neighboring states can be a disqualifying factor in business location decisions. However, as long as overall state tax burdens (income, sales, property and other taxes combined) are not excessive compared to other states, taxes are not nearly so important as labor, energy and transportation costs.[10]

Economic neutrality

One common complaint about the economic neutrality of corporation taxes is their disparate effect on businesses that have different capital structures. Firms may deduct interest payments from net income but may not deduct the cost of equity financing, so the tax code provides an incentive for firms to use debt financing.

Accountability

The corporation income tax is a cost of doing business that is embedded in the cost of goods and services, just like energy and other production or operating costs. Consumers do not know the proportion of the price of a good or service that is attributable to the corporation income tax. By this measure, the corporation income tax is not accountable to the public.

Motor Fuel Excise Taxes

The motor fuel excise tax is the primary funding source for state highway and other transportation programs. The tax typically includes gasoline, diesel fuel and blended motor fuels. All 50 states, Puerto Rico and the District of Columbia impose a motor fuel excise tax. The motor fuel tax has been a traditional source of transportation funding, with 48 states adopting the tax before 1929. All states earmark motor fuel tax revenues to highway or transportation trust funds.

State tax rates range from a low of 7.5 cents per gallon in Georgia to a high of 36 cents per gallon in Connecticut. State motor fuel taxes provided about 6.2 percent of state tax revenue in FY 1996, making the motor fuel tax the fourth largest state tax source with collections of $26 billion in FY 1996. Appendix table A3 lists the motor fuel tax rate in each state.

Like most selective sales taxes, the motor fuel excise tax is assessed on a per unit basis. Revenue is dependent upon gallons consumed, which is influenced by oil prices, motor vehicle fuel efficiency, alternative fuel sources and consumer driving patterns. Following the oil price hikes of the 1970s and early 1980s, states increased their motor fuel excise tax rates to offset the decline in motor fuel consumption.

Reliability

The motor fuel tax is an inelastic state revenue source—that is, collections fail to keep pace with inflation and economic growth at a given tax rate. States must periodically increase tax rates to generate the revenue growth required to keep pace with highway maintenance and construction needs. The problem is exacerbated by increases in the fuel efficiency of cars and trucks that have prevented fuel tax collections from keeping pace with the number of miles driven. The motor fuel tax share of total state taxes has dropped from 13.1 percent in 1970 to 6.2 percent in 1996.

One way that states have addressed the inelastic nature of the motor fuel tax is by indexing the tax rate. Indexing motor fuel tax rates annually to changes in the consumer price index, total fuel consumption or vehicle miles traveled may provide the revenue growth needed to meet transportation maintenance demands. States that do not use indexing face the task of raising motor fuel excise tax rates periodically when material and construction costs for highway and transportation systems have risen while motor fuel excise tax rates have remained the same. Wisconsin and nine other states index their gas tax.[11]

Equity

The motor fuel tax is a benefits tax—with gasoline consumption used as a proxy for highway use, with every state earmarking tax revenues for highway maintenance, repair and construction. The benefits of motor fuel taxes are widely accepted by the public, and opposition to motor fuel tax increases typically is less vociferous than with other state taxes.

Some experts argue, however, that drivers of passenger automobiles pay a disproportionately large share of highway costs when measured by their contribution to highway wear and tear. Equity in motor fuel taxation would require that taxes be distributed according to costs generated, with relatively higher tax burdens on users that generate higher costs. Several studies argue that motor fuel taxes violate this definition of equity because heavy trucks generate a disproportionate share of highway maintenance costs. Truckers argue that all consumers benefit from the current system because higher taxes on the industry would be passed to consumers through higher prices on consumer goods.

The motor fuel tax is a regressive tax, particularly in rural areas where residents must commute longer distances for work, shopping and other necessary activities. The poor pay a much larger percentage of their incomes in motor fuel taxes than do middle and upper income taxpayers.

Administration and compliance

Motor fuel excise taxes generally are easier to administer and collect than other state taxes because the point of taxation may be limited to a few distributors or refiners. Depending on the size of the state, fuel tax collection may be limited to a dozen refiners or to a few hundred certified distributors. For gasoline, 34 states tax at the distributor level, while eight states tax at the terminal rack (refiners) and the remainder define their point of taxation on a first sale or receipt basis.

All the states, with the exception of Alaska and Hawaii, participate in the International Fuel Tax Agreement (IFTA). IFTA was mandated by Congress in 1991 to make uniform the administration of motor fuel use taxation laws with respect to motor carrier vehicles that operate across state lines. Under the agreement, states are able to act cooperatively in the administration and collection of motor fuel use taxes. This essentially allows motor freight carriers to base their operations in one state and report their taxable activities on one fuel tax report in that state, rather than file separate reports in each state in which they operate. Fuel tax collections are allocated to states based upon miles traveled.

Interstate and international competitiveness

IFTA has helped alleviate tax avoidance problems caused by differentials in state tax rates as applied to the trucking industry. However, the potential still exists for taxpayers in private vehicles to purchase gasoline in neighboring states that have lower rates.

Economic neutrality

Gasoline, gasohol and diesel are not the only motor fuels that state governments tax. Others include alternative motor fuels such as methanol, ethanol, compressed natural gas (CNG), liquid natural gas (LNG) and liquefied petroleum gas (propane). States provide preferential tax treatment for nonpolluting or "clean" fuels to encourage consumers to use them, sometimes in conjunction with state or regional air quality programs.

An issue regarding the taxation of alternative fuels is that, although they often burn more cleanly, some vehicles must use more than a gallon of alternative fuels to achieve the same energy output as a gallon of gasoline or diesel. This results in alternative fuels being a more expensive option than gasoline in many cases. That is why some states have given preferential treatment to CNG and LNG. For example, a few states—Alaska, Michigan, Montana, Rhode Island, Vermont and Wyoming—do not tax CNG or LNG at all, while Ohio taxes LNG but not CNG. Given that fleet use of alternative fuel will be increasing as of the 1997 automobile model year, states may want to reevaluate fuel tax policies to determine if they need to be modified to accommodate the different qualities of alternative fuels. States are examining substitute methods (i.e., fuel permit fees) for collecting revenue from the alternative fuel powered motor vehicles, but no state currently has made such a change.

Accountability

Like other excise taxes, motor fuel taxes are not separately stated on the customer receipt. And although motor fuel retailers in some states post information on the pumps about the amount of state and federal taxes paid, most consumers are unaware of the total annual tax burden imposed by gasoline taxes.

Unlike other taxes that accrue to the state general fund, most motor fuel excise taxes are deposited in state transportation funds. In terms of expenditure accountability, most state taxpayers believe that their motor fuel taxes are used for the upkeep and maintenance of highways and other transportation functions. However, in fact, substantial shares are sometimes allocated to other purposes.

Cigarette and Tobacco Taxes

Cigarette and tobacco taxes are levied in all states. Most cigarette and tobacco taxes were adopted before 1950, with only eight states adopting tobacco taxes since 1951. Cigarette and tobacco taxes provided about 1.8 percent of total state tax revenue in 1996. Tax rates range from $1 per pack in Alaska to 2.5 cents per pack in Virginia. The median rate in 1997 is about 31 cents per pack. Appendix table A4 provides the tax rate for each state.

Proponents of increasing cigarette taxes argue that such taxes improve the efficiency of the free market by including the social costs of tobacco use—public health care costs, for example—in the price of tobacco products. Opponents argue that smokers already pay their fair share of these costs, and that excise taxes are a highly regressive form of taxation that single out one class of citizens for punitive taxation.

Reliability

Cigarette taxes are not a stable source of revenue. Like other excise taxes, they are levied on a per unit basis that does not automatically provide revenue growth in response to price increases. The decline in per capita cigarette consumption, coupled with the failure of tax rates to keep pace with inflation, has led to a significant decline in the share of state revenues attributable to cigarette taxes—from 4.8 percent of state tax revenue in 1970 to 1.8 percent in 1996.

A popular trend in recent years has been to earmark cigarette tax revenues for health-related programs. However, cigarette taxes are not a growth revenue source. Any program that relies on cigarette taxes is likely to see declining revenues in the future.

Equity

Cigarette taxes are highly regressive. In fact, recent studies show that cigarette taxes are the most regressive of the major excise taxes, with households with incomes below $30,000 contributing about 47 percent of the total tobacco taxes paid. This is because low-income taxpayers statistically are more likely to smoke than are upper-income taxpayers. Also, unlike other goods that are subject to excise taxes, cigarette consumption is unlikely to vary significantly with income.[12]

Cigarette tax proponents argue that the tax is equitable because it helps recoup some of the social costs of smoking that are not included in the market price of cigarettes. Using cigarette taxes to include public health costs in the price of cigarettes, they contend, actually leads to a more economically efficient market outcome by reducing consumption levels below where they would be without taxes.

Administration and compliance

States typically levy the cigarette tax at the wholesale level. Wholesalers are required to affix a tax stamp to each pack of cigarettes, proving that the tax has been paid. All states except Hawaii and Michigan have a tax stamp requirement. The small number of wholesalers minimizes direct administrative and compliance costs for the states. However, states reimburse wholesalers for some of their costs of compliance by allowing them to retain an administrative fee (similar to the dealer collection allowance on the sales tax).

States also levy a wholesale tax on tobacco products that is roughly equivalent to the per pack or per cigarette excise tax. This tobacco products tax is levied on cigars, pipe tobacco and chewing tobacco at a percentage of the wholesale price.

Interstate and international competition

As mentioned above, cigarette taxes vary greatly among the states. This makes interstate competition and bootlegging an important issue, especially in states that share populated border areas. Alaska and Hawaii have the highest cigarette taxes, in part because they are not constrained by interstate competition. Several studies show significantly reduced cigarette sales in higher-tax states bordered by states with lower taxes.

The Supreme Court has ruled that states may not tax the sale of cigarettes on Indian reservations, provided that they are sold to residents of the reservation. However, sales on reservations to non-Indian customers are taxable. The difficulty for states is requiring Indian retailers to segregate sales to Indian and non-Indian customers. Some states, such as Arizona, have reached cooperative agreements with tribes that respect the legal exemptions for sales to tribe members and provide for voluntary tax collections from non-Indian customers. Other states, however, still have significant problems with cigarette tax evasion. Evasion is also a problem on military bases, which also are not required to collect and remit state or federal sales taxes.

Economic neutrality

As with other excise taxes, cigarette taxes are deliberately designed to violate the principle of economic neutrality. Cigarette taxes single out a specific product for higher tax rates and influence consumer consumption choices.

Accountability

Cigarette excise taxes are hidden in the price of a pack of cigarettes. Although most taxpayers know that cigarette taxes are levied, most probably do not know how much of the price of cigarettes is actually the taxes and how much they pay in taxes annually. Therefore, cigarette taxes do not score highly on the principle of accountability.

Alcoholic Beverage Taxes

Most states have imposed excise taxes on alcoholic beverages since the 1930s. Alaska and Oklahoma, in 1959, were the last states to impose the tax.

States fall into two categories in the taxation of alcoholic beverages. Thirty-four states are *license* states that allow licensed private retailers to sell liquor, beer and wine. State revenues are generated exclusively through excise taxes that are imposed at the wholesale level. States also may impose sales taxes on retail sales, but these revenues are included in sales tax figures instead of in excise tax figures.

In the 17 control states, government-owned stores sell liquor at retail while licensed stores sell beer and wine at retail. State revenues are generated through a retail markup on liquor and through an excise tax on beer and wine. Markups in the control states are categorized as "other revenue" by the Census Bureau, while excise taxes are counted as taxes. This makes tax comparisons difficult between license and control states.

In most states, alcoholic beverage taxes are imposed at proportionately higher rates on beverages with higher alcohol content. Most have separate tax rates for beer, wine, sparkling wine and spirits. Rates on beer range from 2 cents per gallon in Wyoming to 89 cents per gallon in Hawaii. Wine and liquor tax rates display the same dramatic variations among states.

Alcoholic beverage taxes have fallen to minimal importance in the state revenue mix due to the effect of inflation, the growth in other revenue sources and decreasing consumption. Taxes on alcoholic beverages provided less than 1 percent of state tax collections in FY 1996, down from 3 percent in 1970 and a high of 7.7 percent in 1940. Like other excise taxes levied on a per unit basis, inflation erodes the relative proportion of the sale price paid in taxes unless tax rates are periodically increased through legislative action.

Excise taxes on alcohol are intended to discourage consumption by increasing prices to the consumer. Proponents argue that alcoholic beverage excise taxes improve the efficiency of the free market by including the social costs of drinking in the price of the product, while opponents argue that alcoholic beverage taxes are a highly regressive form of taxation.

Reliability

Collections from alcoholic beverage taxes have been declining relative to other state taxes for two primary reasons. First, unlike sales taxes, per unit taxes fail to generate additional revenue when prices increase. Rates must be increased legislatively simply to keep revenues on par with inflation and economic growth, and lawmakers have not been inclined to adopt significant increases in alcoholic beverage taxes during the last decade.

Second, per capita consumption of alcoholic beverages has been stable or declining for the last two decades. This declining consumption further erodes the productivity of the tax.

Equity

Alcoholic beverage taxes are regressive. Lower income households pay a larger share of their incomes in taxes than do higher income households, assuming the same level of consumption. Price elasticity estimates show that beer consumption is the least responsive to price changes, while wine consumption is most responsive. This suggests that beer taxes may have the least effect on reducing consumption and therefore would affect low-income beer consumers the most. Excise taxes also tend to impose higher tax burdens on low-income taxpayers because they are levied at flat rates, instead of on the sales price. Taxpayers pay the same tax on a $100 bottle of wine as on a $5 bottle.

Alcoholic beverage tax proponents argue that the taxes are equitable because they help recoup some of the social costs of drinking that otherwise are not included in the price. They further contend that including these social costs in the price of alcoholic beverages reduces consumption and leads to a more economically optimal level of consumption.

Administration and compliance

Excise taxes typically are levied on the manufacturer, distributor or importer of alcoholic beverages. Markups are determined by state liquor control agencies. States have been shifting from a payment system that requires sellers to affix tax stamps to each bottle of liquor to a report system that allows sellers to remit taxes based upon reported sales. The report system significantly reduces compliance costs for businesses but may increase the likelihood of tax evasion. From the state perspective, administrative costs are low because the tax is collected monthly from a limited number of wholesalers, importers and distributors instead of from a large number of retailers. However, states provide collection allowances that reduce the yield of the tax.

Interstate and international competition

Although differentials in state tax rates can be significant, the weight and volume of alcoholic beverages makes large-scale smuggling much more difficult than for tobacco products. However, states that have significantly higher taxes than neighboring states may experience reduced sales at border locations.

Economic neutrality

Alcoholic beverages are designed to reduce consumption. Therefore, policymakers deliberately seek to violate the principle of economic neutrality to achieve social aims.

Accountability

Alcoholic beverage excise taxes and markups are embedded in the price of products sold at retail. Although most taxpayers are aware that taxes are levied, the exact amount of the sales price that represents taxes is not known to most consumers. Therefore, alcoholic beverage taxes do not score well on the principle of accountability.

Electric Utility Taxes

States vary greatly in how they tax electric utilities. In addition to property taxes, most states tax utility profits under their general corporation income tax or franchise tax statute. Forty-five states levy additional taxes based upon the gross receipts of electric utilities, while four additional states impose a tax based upon kilowatt hours of electricity generated. Only Kansas and Michigan impose no taxes other than their regular tax on corporations.

Of the 45 states that levy gross receipts taxes on electric utilities, over half (24) levy taxes designed to recover the costs of regulatory agencies. These taxes typically are levied at rates lower than 1 percent of gross receipts and are either levied at variable rates set by public utility commissions annually to cover costs (subject to statutory maximum rates) or levied at a rate fixed in statute. Twenty-one states levy gross receipts taxes at rates higher than 1 percent, with revenue from the taxes contributing not only to public utility commission costs but to the state general fund as well.

States collected about 2 percent of total tax revenues from taxes on public utilities, but this figure includes revenues from electric, gas, telecommunication and other utilities. Electric utility taxes contribute between one-third to one-half of the total, or between 0.67 percent and 1 percent of total state revenues.

States may tax only the gross receipts earned from sales within their borders or levy kilowatt hours taxes based upon electricity consumed within state borders. In cases where utilities operate across state lines, gross receipts must be allocated to the respective states.

Reliability

Electricity consumption is closely correlated with the strength of the overall economy, because large industrial customers add to demand during economic expansions. Therefore, electric utility taxes are relatively stable subject to cyclical fluctuations in the economy.

Equity

Electricity gross receipts taxes are a regressive form of taxation, particularly given electricity pricing structures. Many utilities provide declining marginal electricity rates for large

industrial customers as an incentive to keep them from fuel switching. Many residential customers pay among the highest electricity rates per kilowatt hour. Gross receipts taxes, therefore, most significantly affect residential customers, with low-income customers paying a larger share of their incomes for utility bills. Some states use revenue from gross receipts taxes or kilowatt-hour taxes to provide subsidies for low-income customers, however.

Another equity issue involves the tax treatment of investor-owned utilities, municipal utilities and member-owned cooperatives. In some states, municipals and co-ops are exempt from income and property taxes while investor-owned utilities are not. Differential taxation can place investor-owned utilities at a competitive disadvantage.

Administration and compliance

One of the major strengths of electric utility taxes is the low cost of administration and compliance. States typically have a small number of utilities, which means few tax returns are filed and only a small administrative staff is necessary to process them. From the perspective of the regulated utility, taxes are a cost of doing business that regulators allow to be passed directly to customers in the form of higher rates. Calculating gross receipts is straightforward, so compliance costs are minimal.

Interstate and international competition

With the electric industry moving toward competition, interstate competition and competitiveness are becoming major issues. In the old, regulated environment, utilities could sell only within their service territories and customers could buy only from their local utility. Differentials in state tax rates and policies were not relevant because industrial customers could not purchase cheaper power from out-of-state utilities. The only options available to reduce power costs were to relocate to another state or switch fuels.

The federal Energy Policy Act of 1992 and subsequent regulatory changes opened the marketplace for wholesale competition in power sales and gives states the opportunity to open the retail marketplace for competition. Large industrial users now may contract with utilities outside their immediate area for cheaper power, and the local utility is required to transmit this power to the customer. In this new marketplace, state tax policies that place local utilities at a competitive disadvantage can have a major effect on the utility market. Competition has forced states to reexamine their electric utility tax policies.

Economic neutrality

Economic neutrality has become a more important concern in the taxation of electric utilities with the advent of wholesale and retail competition. State tax policy should treat between in-state and out-of-state generators equally in a competitive marketplace. Gross receipts taxes are levied on the electricity supplier, not on the end user. Companies that buy

power from out-of-state generators may receive a price break because the state gross receipts tax cannot be applied to out-of-state companies. States will need to reconsider any tax policy that imposes different tax burdens on firms in the same industry.

Accountability

Electric utility taxes are hidden in the final cost of power, and therefore are not accountable to taxpayers. In some states, utilities are prohibited by statute from separately stating the tax on customers' bills.

Other issues

Gross receipts taxes are well suited for utilities that operate in monopoly markets. They are simple to collect and administer, are stable, and are hidden from taxpayers. Regulated monopolies can pass taxes directly to consumers without affecting shareholder returns. However, in a competitive market, gross receipts taxes may create *horizontal inequities* by placing in-state firms at a competitive disadvantage. Also, competition may provide incentives for utilities to restructure in ways that will make imposition of the gross receipts tax difficult. For example, if a utility *divests* its generation capacity and retains only transmission and distribution, its gross receipts may include only the charge for transmitting power from generators to end users.

For this reason, states that plan to deregulate the retail energy marketplace may shift from gross receipts taxes on producers to taxes on consumers. Taxes levied on the end user treat generators equally and avoid nexus problems. Such taxes could include a sales tax on electricity sold at retail, or a kilowatt-hour tax imposed on end users.

Death Taxes

Death taxes are imposed on the transfer of accumulated wealth at death or in anticipation of death. States levy three types of death taxes: inheritance taxes, estate taxes and gift taxes. Inheritance taxes are levied on the person receiving the bequest, while estate taxes are levied on the estate of the deceased person before assets are distributed to heirs. Gift taxes are imposed on transfers of wealth from living donors.

Inheritance taxes typically are levied at graduated rates based upon the amount of the bequest and upon the relationship between the deceased and the beneficiary. Rates are typically lower for immediate family members (spouse and children) and highest on unrelated beneficiaries. Estate taxes also are levied at graduated rates based upon the value of the estate. However, the tax rates are imposed on the estate as a whole and do not vary based upon the relationship of the beneficiary to the donor.

Federal statutes allow taxpayers to claim a credit against state estate taxes paid. In effect, this allows states to collect estate taxes that would be levied by the federal government anyway. All states impose this so-called *pick-up* tax up to the allowable federal credit. In addition, six states levy an additional estate tax beyond the pick-up tax, while 16 additional states levy an inheritance tax in addition to the pick-up tax. Six of these states also levy a gift tax on transfers while the donor is still alive.

Death taxes provided 1.3 percent of state tax collections in FY 1996. Although death taxes have never represented a large share of state tax revenues, their share of state tax revenues has fallen from more than 2 percent in the 1940s and 1950s to the current level. The 1990s saw an acceleration of the trend toward repeal or reduction of death taxes, particularly the state inheritance tax. Since 1990, seven states—Kentucky, Massachusetts, Michigan, New York, North Carolina, Ohio and Pennsylvania—repealed or otherwise reduced inheritance or estate taxes.

Death taxes are designed to prevent the extreme and permanent accumulation and concentration of wealth. Critics of death taxes argue that they can cause the breakup of family-owned businesses and provide disincentives for savings and investment, while proponents argue that exemptions and credits included in most state statutes allow all but the wealthiest citizens to avoid tax liability. Another concern about death taxes is that many wealthy individuals can legally avoid the tax through estate planning techniques.

Reliability

Death tax collections often fluctuate, especially in small states where the death of one very wealthy person can dramatically affect collections. Therefore, the estate tax is notoriously difficult to forecast. Most forecasters conservatively estimate revenues and treat large collections from a single estate as a windfall. Since estate taxes represent only a small percentage of state tax collections, the lack of stability in collections exposes the state to minimal risk. Using long-term averages, death taxes provide a reasonably steady flow of income to the state treasury.

Equity

The equity of death taxes is subject to considerable debate. Proponents of estate taxes argue that they promote vertical equity by preventing excessive accumulation and concentration of wealth. This is especially important in the United States, where federal and state income tax policies allow individuals to keep a significant portion of their earnings compared to other industrialized nations.

Death taxes create problems of horizontal equity because of an increase in estate planning and legal avenues for avoidance. Most death taxes have exemptions for bequests to charitable institutions, for example. In many instances, wealthy individuals bequeath money

to colleges and universities or create charitable foundations rather than pay the tax. Therefore, depending upon the estate planning techniques used, two estates with similar assets may pay dramatically different taxes.

Opponents also charge that estate taxes are unfair because they sometimes prevent family farms, small businesses and other closely held firms from being passed to family members.

Compliance and administration

The probate system for disposing of assets at death requires an accounting of the decedent's assets. Therefore, death taxes cause few additional administrative burdens on the state. The tax imposes a relatively small paperwork and reporting burden on taxpayers and does not require an extensive state bureaucracy to administer.

Taxpayers may argue that significant compliance costs are incurred in estate planning activities. Taxpayers, however, choose to incur these costs to avoid tax liability—they are not mandated by state law or administrative rules.

Interstate competition

One of the main causes for the trend toward elimination or reduction of state death taxes is the role of interstate competition. Wealthy taxpayers can easily avoid state estate, inheritance and gift taxes by establishing residence in a state that imposes only the federal pick-up tax. Death taxes can legally be imposed on real and tangible property located within a state, even if the taxpayer lives in another state. However, much of the value of a wealthy person's estate is typically intangible property—stocks, bonds and cash—that is taxable to the state of residence.

Interstate competition limits the revenue that states can generate from death taxes. If these taxes are significantly lower in other states, taxpayers easily can change residence. Some experts argue that high death taxes can harm a state's economy if wealthy citizens leave, because they no longer consume goods and services that generate other types of tax revenue.

Economic neutrality

Death taxes can discourage owners of family businesses from investing in the business as they approach old age because any equity added to the business becomes taxable upon their death. Also, the additional debt that sometimes is necessary to pay estate taxes can jeopardize the viability of closely held businesses. This may put these firms at a competitive disadvantage to publicly-owned companies.

Accountability

Death taxes are a key consideration in the settlement of large estates. Wealthy taxpayers know about the tax and its consequences, giving rise to a thriving estate planning industry. Like the income tax, the filing of returns allows taxpayers to know the exact amount of their tax liability. Therefore, death taxes measure very well on the yardstick of accountability.

State Property Tax

The property tax is the primary revenue source for local governments. Some states, however, also impose a property tax. State property taxes fall into several categories. First, eight states levy broad-based property taxes on all property subject to local property taxes. Second, some states levy state property taxes on certain utility property that crosses many local jurisdictions. Finally, some states levy intangible property taxes on the value of financial instruments—stocks and bonds, for example—held by individuals. State property taxes provided an average of 2.4 percent of all state revenue in 1996. Montana, Washington and Wyoming each received more than 10 percent of state tax collections from the state property tax.

The property tax is one of the oldest forms of taxation, both in the United States and worldwide. It was the primary revenue source for state and local governments until the Depression era, when most states abandoned the property tax in favor of excise, sales and income taxes. In the last decade, two important trends have emerged. First, the handful of states that still levy an intangible property tax have been repealing them. Since 1990, Michigan, North Carolina and Kentucky have repealed their intangible property taxes. Second, several states have reimposed broad-based state property taxes to equalize funding between rich and poor school districts. Since 1990, Kansas, Michigan and Vermont have imposed statewide school levies, while Arizona repealed its statewide school levy.

Reliability

The property tax is the most stable and reliable tax used by state and local governments. Property values tend to be stable in the short-term, and when changes in value occur, it typically takes several years for the changes to take effect in the property valuation process. Changes in the income or consumption patterns of taxpayers do not affect property tax liability, and most types of taxable property cannot be moved to avoid tax liability.

Equity

Horizontal and vertical equity both are major concerns with the property tax. Property taxes have the potential to be regressive because tax liability is not dependent upon income. A family at the poverty level and a middle-income family pay the same amount of tax on a

$100,000 home regardless of their incomes. However, income and property wealth tend to be correlated, so families with different income levels are not likely to live in homes of the same value. Leading economists disagree about whether the property tax is regressive or proportional, primarily due to differing assumptions about how much of the property tax burden is shifted from landlords to renters.

Another concern is horizontal equity. Property taxes depend upon subjective decisions about how market trends affect the value of property. In some instances, similar properties in the same regions can have different valuations for tax purposes, allowing taxpayers in similar circumstances to be treated differently. This is particularly true in states where property valuation cycles are very long. Issues of horizontal equity are particularly important in a statewide property tax because, with one statewide rate, variations in the quality of assessment directly affect whether property owners in different parts of a state are paying their fair share of the tax.

Compliance and administration

The administrative costs of a statewide property tax are low. States typically use valuations provided by county or municipal assessors, and many states already have divisions within their revenue departments that review the accuracy of local valuations to ensure fair distribution of state education and other aid based upon property values. Costs of collection also are low because state taxes are calculated by county or municipal tax collectors.

Business and individual taxpayer compliance costs also are low compared to other types of taxes. Businesses usually are required to self-report their personal property using information that already is maintained for accounting purposes. The assessment appeals process usually is available to taxpayers without the need to hire legal experts.

Interstate and international competitiveness

The effect of property taxes on the business climate varies dramatically by the type of business and by the type of property taxed. In addition to land and buildings, businesses may pay taxes on machinery and equipment, vehicles and inventories. The type of property taxed under a statewide property tax usually is the same as that subject to local property taxes. Heavy manufacturers that use expensive machinery and equipment in the production process bear a much higher property tax burden than do service and knowledge-based firms.

Statewide property taxes may exacerbate or alleviate the tax burdens on businesses depending upon how they are structured. A statewide property tax that replaces some or all local school property taxes will create a more uniform business tax burden across the state, with businesses in high tax localities paying less, but firms in low tax localities paying more.

Economic neutrality

One significant and growing problem with the property tax is the disparate treatment of intangible property. Traditional manufacturing firms that have heavy investments in plant and equipment face a much higher property tax burden than do service firms that derive their value from intellectual property such as a skilled labor force, patents and copyrights. As these types of firms become more important, the property tax will capture a relatively smaller proportion of the total returns to capital employed by firms. In addition, the relative burden of the tax on manufacturing will increase.

Another issue is the use of classification systems in 22 states. Classification systems set the taxable values of property at different percentages of market value, depending upon the type of property in question. Table 6 summarizes the classification rates in these 22 states.

In Alabama, for example, the taxable value of residential property is 10 percent of market value, while the taxable value of commercial and industrial property is 20 percent of market value. Finally, telecommunications and utility property is taxed at 30 percent of market value.

Classification systems can create disparities in industries that are shifting from regulated monopolies to competition. For example, some states tax the property of traditional telephone companies at a higher percentage than that of cellular telephone companies. This also is becoming an issue in the electric industry, where some states are providing for retail competition. In some instances, generating plants owned by traditional, regulated utilities are taxed at a higher rate than similar plants owned by competing companies that sell power at wholesale.

Accountability

Like income taxes, property taxes are accountable to taxpayers because bills are paid annually and taxpayers know the exact amount of their bills. The high visibility of the tax, combined with the fact that property tax is not directly linked to income, makes the property tax a popular target for tax reductions by lawmakers who want to reduce the tax burden.

Other issues

The property tax can be claimed as an itemized deduction on federal form 1040 for taxpayers who itemize deductions. This deduction reduces the effective rate of the property tax by up to 40 percent for taxpayers in the highest federal income tax bracket. Deductibility is an important issue in states that are considering major tax shifts involving income taxes (deductible), sales and consumption taxes (not deductible) and property taxes (deductible).

Table 6. Selected Property Assessment Levels by Classification, 1997						
	Residential		Commercial/Industrial		Telecommunications/Utility	
State	Real	Personal	Real	Personal	Real	Personal
Alabama	10.0%	10.0%	20.0%	20.0%	30.0%	30.0%
Arizona	10.0	10.0	25.0	25.0	27.0	27.0
Arkansas	20.0	20.0	20.0	20.0	20.0	20.0
Colorado	10.4	x	29.0	29.0	29.0	29.0
Georgia	40.0	x	40.0	40.0	40.0	40.0
Idaho	50.0	x	100.0	100.0	100.0	100.0
Illinois	33.3	x	33.3	x	33.3	x
Indiana	33.3	x	33.3	33.3	33.3	33.3
Iowa	79.0	x	100.0	x	100.0	x
Kansas	11.5	x	25.0	25.0	33.0	33.0
Louisiana	10.0	x	15.0	15.0	10/25	25.0
Michigan	50.0	x	50.0	50.0	50.0	50.0
Mississippi	10.0	x	15.0	15.0	30.0	30.0
Missouri	19.0	x	32.0	33.3	32.0	33.3
Montana	3.9	x	3.9	3.9	12.0	12.0
Nevada	35.0	x	35.0	35.0	35.0	35.0
New Jersey	100.0	x	100.0	50.0	100.0	50.0
New Mexico	33.3	x	33.3	33.3	33.3	33.3
North Dakota	4.5	x	5.0	x	5.0	5.0
Ohio	35.0	x	35.0	25.0	35.0	25.0
Oklahoma	11.0 - 13.5	see below	11.0 - 13.5	11.0 - 13.5	22.8	11.0 - 13.5
South Carolina	4.0	x	6.0	10.5	10.5	10.5
Tennessee	25.0	5.0	40.0	30.0	55.0	55.0
Utah	55.0	x	100.0	100.0	100.0	100.0
West Virginia	60.0	60.0	60.0	60.0	60.0	60.0
Wyoming	9.5	x	11.5	11.5	11.5	11.5

Key: x — not taxed

Minnesota is not included due to the complexity of its classification system.
Oklahoma—Residential personal property is assumed to be 10 percent of residential real property.

Source: ACIR, *Significant Features of Fiscal Federalism*, February 1992. Updated by NCSL, April 1997.

Severance Tax

Severance taxes are excise taxes levied when natural resources are *severed* from the soil or water of a state. These revenues are intended to compensate a state and its citizens for depletion of their natural resource wealth, as well as to mitigate social and environmental effects. Severance taxes usually are associated with oil, natural gas, coal and ores, which generate the greatest portion of severance tax revenues. They also are applied to other natural resources, including salt, timber, fish, phosphates, sulfur, clay, sand, gravel and cement.

Severance taxes may be considered as a substitute for property taxes on the mineral value of a section of real property. Ownership titles to mineral rights (and thus taxation) often are separate from titles to surface property rights. Names given to the taxes vary from state to

state—production taxes, license taxes, conservation taxes, mining taxes or specific severance taxes.

Although 39 states impose severance taxes, they amount to only 1 percent of total tax collections. Ten states rely significantly on severance taxes in their revenue mix. Alaska's rich oil reserves put it in the lead, with more than 60 percent of its tax collections derived from severance taxes. The other nine states are Wyoming (30 percent); North Dakota (12 percent); New Mexico (10 percent); Louisiana, Montana and Oklahoma (7 percent); West Virginia (6 percent); Texas (4 percent); and Kentucky (3 percent).

Reliability

Severance taxes have the potential to produce large amounts of revenue, but they are less reliable than most other taxes for financing recurring expenses. Collections fluctuate in response to price changes in world markets. For example, 1982 and 1989 annual severance tax revenues varied by more than 50 percent in Texas, Alaska, Louisiana, North Dakota and Oklahoma. In addition, resources may become depleted, mines may close due to high costs or management problems, or a new development may make a resource obsolete. When collections drop, state budgets may face shortfalls, forcing policymakers to cut services or raise other taxes.

The bulk of severance tax collections depends on a cyclical combination of worldwide prices and production levels, making them an unstable revenue source. Even though energy prices in the early to mid-1990s were relatively stable and short-term production was fairly predictable, the lessons of the 1970s energy shortages were not forgotten. Severance tax-reliant states cope with the effects on budgets of minor fluctuations in worldwide markets by using risk-adjusted revenue forecasts (intentionally reducing revenue estimates by a risk factor), forward funding (using the previous year's revenues to fund the next year's expenditures), revenue-indexed budgeting (establishing minimum state appropriations using relatively certain revenues), and establishing rainy day funds (accumulating money during booms to be used during busts). In anticipation of ultimate resource depletion, some states have created resource revenue-based trust funds.

Equity

Generally, severance taxes are based on the value of the resource extracted or produced, with the tax imposed as a fixed percentage of the value (usually market) of the products severed. When based on the production quantity, taxes are imposed at a flat rate per unit of measure. Taxes may be graduated according to product value or volume of production. Some states use gross value, while others use net value or net proceeds. Taxing net proceeds can help distinguish between profitable and marginal operations and is consistent

with taxing according to ability to pay. Customary measures of equity, based on a person's annual or lifetime income, are not applicable to severance taxes.

The opportunity to export taxes rather than impose personal taxes on a state's residents is attractive if it is technically feasible and if it can be justified as offsetting social costs generated by out-of-state residents. Severance taxes can be exported because they fall upon resource owners rather than on a state's citizens as a whole. They have allowed Alaska, Texas and Wyoming to forego the imposition of a personal income tax, and may support Montana's choice to forego a sales tax. Some states split severance tax receipts between the state and local governments, which bear the burden of expanding public facilities and providing public services to the extractive industries.

Compliance and administration

In theory, a severance tax should be imposed at the earliest possible point, thus minimizing the effect of the tax on ensuing stages of use. A few states require first purchasers to pay the tax, but it usually is payable by the producer. The determination of what constitutes production may require allocation to a product's value at each stage of production, e.g. separation, refining or finishing. Over time, however, most states have developed complicated severance tax collection systems that require frequent reports, and their administration and compliance are highly specialized.

Interstate and international competition

As previously mentioned, the world market sets resource prices. States compete with one another for energy resource expansion and development investment, and they compete with other nations as well. Since energy prices are set by world markets, state taxes will not affect selling prices, but will affect decisions whether a resource can be commercially exploited at any given time. Tax increases cannot be passed to consumers, but are borne by resource owners whose royalties (property or mineral income) are reduced by taxes on production.

Economic neutrality

Severance tax revenues may allow resource-rich states to provide additional services or to keep other major taxes low relative to neighboring states. Producers argue that high severance taxes discourage resource exploration and jeopardize the nation's energy independence. In response to this concern, oil-producing states passed tax incentive legislation in the early 1990s to encourage oil production. State and local severance tax laws may distort investment allocation within and between states, but most likely will not have long-term effects. Regional disparities in wealth were a source of concern during the

1980s, but have not proven to be significant in the long run since prices and the corresponding highs and lows in state severance tax revenues leveled out.

Accountability

The citizen taxpayer is unlikely to be aware of severance taxes, and would be unable to determine their effect. Resource companies report the extraction and production activities on which severance taxes are based, but there does not appear to be an effective method to evaluate the tax benefits received against the social and environmental costs.

Appendix

Table A1. State Individual Income Tax Rates Tax rate for tax year 1997 -- as of January 1, 1997									
State	Tax Rates		Number of	Income Brackets (a)		Personal Exemption			Federal Tax
	Low	High	Brackets	Low	High	Single	Married	Children	Deductibility
Alabama	2.0%	5.0%	3	$500(b)	$3,000(b)	$1,500	$3,000	$300	*
Alaska				No State Income Tax					
Arizona	3.0	5.6	5	10,000(b)	150,000(b)	2,100	4,200	2,300	
Arkansas	1.0	7.0(e)	6	2,999	25,000	20(c)	40(c)	20(c)	
California	1.0	9.3	6	4,908(b)	223,390(b)	67(c)	134(c)	37(c)	
Colorado	5.0		1	Flat rate			None		
Connecticut	3.0	4.5	2	2,250(b)	2,250(b)	12,000(f)	24,000(f)	0	
Delaware	0.0	6.9	7	4,500	30,000	100(c)	200(c)	100(c)	
Florida				No State Income Tax					
Georgia	1.0	6.0	6	750(g)	7,000(g)	1,500	3,000	1,500	
Hawaii	2.0	10.0	8	1,500(b)	20,500(b)	1,040	2,080	1,040	
Idaho	2.0	8.2	8	1,000(g)	20,000(g)	2,650(d)	5,300(d)	2,650(d)	
Illinois	3.0		1	Flat rate		1,000	2,000	1,000	
Indiana	3.4		1	Flat rate		1,000	2,000	1,000	
Iowa	0.4	9.98	9	1,112	50,040	20(c)	40(c)	40(c)	*
Kansas	4.4	7.75	3	20,000(i)	30,000(i)	2,000	4,000	2,000	
Kentucky	2.0	6.0	5	3,000	8,000	20(c)	40(c)	20(c)	
Louisiana	2.0	6.0	3	10,000(b)	50,000(b)	4,500(j)	9,000(j)	1,000(j)	*
Maine	2.0	8.5	4	4,150(b)	16,500(b)	2,100	4,200	2,100	
Maryland	2.0	5.0	4	1,000	3,000	1,200	2,400	1,200	
Massachusetts	5.95(k)		1	Flat rate		2,200	4,400	1,000	
Michigan	4.4		1	Flat rate		2,500	5,000	2,500	
Minnesota	6.0	8.5	3	16,510(l)	54,250(l)	2,650(d)	5,300(d)	2,650(d)	
Mississippi	3.0	5.0	3	5,000	10,000	6,000	9,500	1,500	
Missouri	1.5	6.0	10	1,000	9,000	1,200	2,400	400	*(m)
Montana	2.0	11.0	10	1,900	66,399	1,520	3,040	1,520	*
Nebraska	2.62	6.99	4	2,400(n)	26,500(n)	69(c)	138(c)	69(c)	
Nevada				No State Income Tax					
New Hampshire	State Income Tax is Limited to Dividends and Interest Income only								
New Jersey	1.4	6.37	6	20,000(o)	75,000(o)	1,000	2,000	1,500	
New Mexico	1.7	8.5	7	5,500(p)	65,000(p)	2,650(d)	5,300(d)	2,650(d)	
New York	4.0	6.85	4	8,000(b)	20,000(b)	0	0	1,000	
North Carolina	6.0	7.75	3	12,750(q)	60,000(q)	2,500(d)	5,000(d)	2,500(d)	
North Dakota	2.67	12.0(r)	8	3,000	50,000	2,651(d)	5,301(d)	2,651(d)	*(s)
Ohio (s)	0.693	7.004	9	5,000	200,000	850(s)	1,700(s)	850(s)	

Table A1. State Individual Income Tax Rates
Tax rate for tax year 1997 -- as of January 1, 1997
(continued)

State	Tax Rates		Number of Brackets	Income Brackets (a)		Personal Exemption			Federal Tax Deductibility
	Low	High		Low	High	Single	Married	Children	
Oklahoma	0.5%	7.0(t)%	8	$1,000	$10,000	$1,000	$2,000	$1,000	*(t)
Oregon	5.0	9.0	3	2,200(b)	5,550(b)	124(c)	248(c)	124(c)	*(u)
Pennsylvania	2.8		1	Flat rate			None		
Rhode Island	27.5% Federal tax liability								
South Carolina	2.5	7.0	6	2,280	11,400	2,650(d)	5,300(d)	2,650(d)	
South Dakota	No State Income Tax								
Tennessee	State Income Tax is Limited to Dividends and Interest Income only								
Texas	No State Income Tax								
Utah	2.3	7.0	6	750(b)	3,750(b)	1,988(d)	3,975(d)	1,988(d)	*(v)
Vermont	25% Federal tax liability (w)								
Virginia	2.0	5.75	4	3,000	17,000	800	1,600	800	
Washington	No State Income Tax								
West Virginia	3.0	6.5	5	10,000(b)	60,000(b)	2,000	4,000	2,000	
Wisconsin	4.9	6.93(x)	3	7,500	15,000	0	0	50(c)	
Wyoming	No State Income Tax								
American Samoa	Information not provided								
District of Columbia	6.0	9.5	3	10,000	20,000	1,370	2,740	1,370	
Guam	Information not provided								
Northern Mariana Isl.	Information not provided								
Puerto Rico	Information not provided								
U.S. Virgin Islands	Information not provided								

Source: The Federation of Tax Administrators from various sources.

a) Seven states have statutory provision for automatic adjustment of tax brackets, personal exemption or standard deductions to the rate of inflation. Nebraska indexes the personal exemption amounts only.

b) For joint returns, the tax is twice the tax imposed on half the income.

c) Tax credits.

d) These states allow personal exemption or standard deductions as provided in the Internal Revenue Code. Utah allows a personal exemption equal to three-fourths the federal exemptions. Amounts reported include the 1996 index adjustment.

e) A special tax table is available for low-income taxpayers who are reducing their tax payments.

f) Combined personal exemptions and standard deduction. An additional tax credit is allowed ranging from 75 percent to 0 percent based on state adjusted gross income. Exemption amounts are phased out for higher income taxpayers until they are eliminated for households earning over $71,000. For tax years beginning after 1996, the tax bracket amount increases to $4,500.

g) The tax brackets reported are for single individuals and married households filing jointly. For married households filing separately, the same rates apply to income brackets ranging from $500 to $5,000.

h) For joint returns, the tax is twice the tax imposed on half the income. A $10 filing fee is charge for each return and a $15 credit is allowed for each exemption.

i) The tax brackets reported are for single individual and married households filing separately. For married households filing jointly, the rates range from 3.5 percent for income under $30,000 to 6.45 percent for income over $60,000.

j) Combined personal exemption and standard deduction.

k) A 12 percent tax rate applies to interest, dividends and capital gains.

l) The tax brackets reported are for single individuals. For married taxpayers filing jointly, the same rates apply to income brackets ranging from $24,140 to $95,920. An additional 0.5 percent tax is applied to certain income levels.

m) Limited to $10,000 for joint returns and $5,000 for individuals.

Table A1. State Individual Income Tax Rates
Tax rate for tax year 1997 -- as of January 1, 1997
(continued)

n) The tax brackets reported are for single individuals. For married couples, the tax rates range from 2.62 percent for income under $4,000 to 6.99 percent over $46,750.

o) The tax brackets reported are for single individuals. A separate schedule is provided for married households filing jointly, which ranges from 1.4 percent under $20,000 to 6.37 percent for income over $150,000.

p) The tax brackets reported are for single individuals. For married individuals filing jointly, the rate ranges from 1.7 percent under $8,000 to 8.5 percent over $100,000. Married households filing separately pay the tax imposed on half the income.

q) The tax brackets reported are for single individuals. For married taxpayers, the same rates apply to income brackets ranging from $21,250 to $100,000. An additional middle income tax credit is allowed.

r) Taxpayers have the option of paying 14 percent of the adjusted federal income tax liability, without a deduction of federal taxes. An additional $300 personal exemption is allowed for joint returns or unmarried head of households, plus an additional $20 per exemption tax credit. Tax rates are temporarily adjusted downward for 1996 and 1997, based on the amount of revenue in the general fund. Rates reported are adjusted for the 1996 tax year, statutory rates range from 0.743 percent to 7.5 percent with the same brackets.

s) The rate range reported is for single persons not deducting federal income tax. For married persons filing jointly, the same rates apply to income brackets ranging from $2,000 to $21,000. Separate schedules, with rates ranging from 0.5 percent to 10 percent, apply to taxpayers deducting federal income taxes.

t) Limited to $3,000.

u) One half of the federal income taxes are deductible.

v) If Vermont tax liability for any taxable year exceeds the tax liability determinable under federal tax law in effect on December 31, 1994, the taxpayer will be entitled to a credit of 106 percent of the excess tax.

w) The tax brackets reported are for single individuals. For married taxpayers, the same rates apply to income brackets ranging from $10,000 to $20,000.

Table A2. State Corporate Income Tax Rates

Tax rate for tax year 1997 -- as of January 1, 1997

States	Tax Rates	Tax Brackets		Number of Brackets	Bank Tax Rates
		Low	High		
Alabama	5.0%	----Flat Rate----		1	6.0%
Alaska	1.0 - 9.4	$10,000	$90,000	10	1.0 - 9.4
Arizona	9.0 (b)	----Flat Rate----		1	9.0 (b)
Arkansas	1.0 - 6.5	3,000	100,000	6	1.0 - 6.5
California	8.84 (c)	----Flat Rate----		1	10.84 (c)
Colorado	5.0	----Flat Rate----		1	5.0
Connecticut	10.5 (d)	----Flat Rate----		1	10.5 (d)
Delaware	8.7	----Flat Rate----		1	8.7-2.7 (e)
Florida	5.5 (f)	----Flat Rate----		1	5.5 (f)
Georgia	6.0	----Flat Rate----		1	6.0
Hawaii	4.4 - 6.4 (g)	25,000	100,000	3	7.92 (g)
Idaho	8.0 (h)	----Flat Rate----		1	8.0 (h)
Illinois	7.3 (i)	----Flat Rate----		1	7.3 (i)
Indiana	7.9 (j)	----Flat Rate----		1	7.9 (j)
Iowa	6.0 - 12.0	25,000	250,000	4	5.0
Kansas	4.0 (l)	----Flat Rate----		1	4.5 (l)
Kentucky	4.0 - 8.25	25,000	250,000	5	--- (a)
Louisiana	4.0 - 8.0	25,000	200,000	5	--- (a)
Maine	3.5 - 8.93 (m)	25,000	250,000	4	1.0
Maryland	7.0	----Flat Rate----		1	7.0
Massachusetts	9.5 (n)	----Flat Rate----		1	11.72 (n)
Michigan	—Business Tax (see note)—				
Minnesota	9.8 (o)	----Flat Rate----		1	9.8 (o)
Mississippi	3.0 - 5.0	5,000	10,000	3	--- (a)
Missouri	6.25	----Flat Rate----		3	7.0
Montana	6.75 (p)	----Flat Rate----		1	6.75 (p)
Nebraska	5.58 - 7.81	50,000		2	--- (a)
Nevada	—No State Corporate Income Tax (see note)—				
New Hampshire	7.0 (q)	----Flat Rate----		1	7.0 (q)
New Jersey	9 (r)	----Flat Rate----		1	9 (r)
New Mexico	4.8 - 7.6	500,000	1 milli	3	4.8 - 7.6
New York	9.0 (t)	----Flat Rate----		1	9.0 (t)
North Carolina	7.5 (u)	----Flat Rate----		1	7.5 (u)
North Dakota	3.0 - 10.5 (v)	3,000	50,000	6	7.0 (v)
Ohio	5.1 - 8.9 (w)				
Oklahoma	6.0	----Flat Rate----		1	6.0
Oregon	6.6 (b)	----Flat Rate----		1	6.6 (b)
Pennsylvania	9.99 (s)	----Flat Rate----		1	--- (a)
Rhode Island	9.0	----Flat Rate----		1	8.0 (x)
South Carolina	5.0	----Flat Rate----		1	4.5 (y)

Table A2. State Corporate Income Tax Rates Tax rate for tax year 1997 -- as of January 1, 1997 (continued)					
States	**Tax Rates**	**Tax Brackets**		**Number of Brackets**	**Bank Tax Rates**
		Low	**High**		
South Dakota	---				6.0-1.0% (b)
Tennessee	6.0	----Flat Rate----		1	6.0
Texas		—Franchise Tax (see note)—			
Utah	5.0 (b)				5.0 (b)
Vermont	5.5 - 8.25 (b)	10,000	250,000	4	5.5 - 8.25 (b)
Virginia	6.0	----Flat Rate----		1	6.0 (z)
Washington		—No State Corporation Income Tax—			
West Virginia	9.0	----Flat Rate----		1	9.0
Wisconsin	7.9 (aa)	----Flat Rate----		1	7.9
Wyoming		—No State Corporation Income Tax—			
American Samoa		Information not provided			
District of Columbia	9.975 (bb)	—Flat Rate—			9.975 (bb)
Guam		Information not provided			
Northern Mariana Isl.		Information not provided			
Puerto Rico		Information not provided			
U.S. Virgin Islands		Information not provided			
Source: Compiled by Federation of Tax Administrators from various sources.					

Note: Michigan imposes a single business tax (sometimes described as a business activities tax or value-added tax) of 2.3 percent on the sum of federal taxable income of the business, compensation paid to employees, dividends, interest, royalties paid and other items. Similarly, Texas imposes a franchise tax of 4.5 percent of earned surplus.

a) Rates listed include the corporate tax rate applied to financial institutions or excise taxes based on income. Some states have other taxes based upon the value of deposits or shares.

b) Minimum tax is $50 in Arizona, $10 in Oregon, $250 in Rhode Island, $200 per location in South Dakota (banks), $100 in Utah, $150 in Vermont,

c) Minimum tax is $800. The tax rate on S-Corporations is 1.5 percent (4.67 percent for banks).

d) Or 3.1 mills per $1 of capital stock and surplus (maximum tax $1 million) or $250. Tax rate is scheduled to fall to 10.5 percent in 1997, 9.5 percent in 1998, 8.5 percent in 1999, and 7.5 percent after 1999.

e) The marginal rate decreases over four brackets ranging from $20 million to $30 million in taxable income. Building and loan associations are taxed at a flat 8.7 percent.

f) Or 3.3 percent alternative minimum tax. An exemption of $5,000 is allowed.

g) Capital gains are taxed at 4 percent.

h) Minimum tax is $20. An additional tax of $10 is imposed on each return.

i) Includes a 2.5 percent personal property replacement tax.

j) Consists of 3.4 percent on income from sources within the state plus a 4.5 percent supplemental income tax.

k) Fifty percent of the federal income tax is deductible.

l) Plus a surtax of 3.35 percent (2.125 percent for banks) taxable income in excess of $50,000 ($25,000).

m) Or a 27 percent tax on federal alternative minimum taxable income.

Table A2. State Corporate Income Tax Rates
Tax rate for tax year 1997 -- as of January 1, 1997
(continued)

n) Rate includes a 14 percent surtax, as does the following: an additional tax of $2.60 per $1,000 on taxable tangible property (or net worth allocable to state, for intangible property corporations); minimum tax of $456. The bank tax rate will decrease to 11.32 percent in 1997, 10.91 percent in 1998, and 10.5 percent after 1998.

o) Plus a 5.8 percent tax on any alternative minimum taxable Income over the base tax.

p) A 7 percent tax on taxpayers using water's edge combination. Minimum tax is $50; for small business corporations, $10.

q) Plus a 0.25 percent tax on the enterprise base (total compensation, interest and dividends paid). Business profits tax imposed on both corporations and unincorporated associations.

r) Minimum tax $200. Tax rate is 7.5 percent if entire net income is under $100,000. S-corporations are taxed at 2.63 percent, the rate is 1.13 percent if entire net income is under $100,000. S-corporation income that is subject to federal tax is taxed at the rate applicable as if it were an ordinary corporation.

s) Includes a 0.49 percent surtax, which is being phased out through 1997.

t) For tax years beginning after June 30, 1996 but before July 1, 1997 a 2.5 percent surcharge is applied. Or 1.78 (0.1 for banks) mills per $1 of capital (up to $350,000; or 5 percent (3 percent for banks) of the minimum taxable income; or a minimum of $1,500 to $325, depending on payroll size ($250 plus 2.5 percent surtax for banks); if any of these is greater than the tax computed on net income. An addition tax of 0.9 mills per $1 of subsidiary capital is imposed on corporations.

u) The tax rate is 7.25 percent for tax years beginning in 1998, 7.0 percent for 1999, and 6.9 percent for tax years beginning after 1999. Financial institutions also are subject to a franchise tax equal to $30 per one million in assets.

v) Or 6 percent alternative minimum tax. the bank tax rate includes a 2 percent privilege tax. Minimum tax is $50.

w) Or 5.82 mills time the value of the taxpayer's issued and outstanding share of stock; minimum tax $50. An additional litter tax is imposed equal to 0.11 percent on the first $25,000 of taxable income, 0.22 percent on income over $25,000; or 0.14 mills on net worth. Corporations manufacturing or selling litter stream products are subject to an additional 0.22 percent tax on income over $25,000 or 0.14 mills on net worth.

x) For banks, the alternative tax is $2.50 per $10,000 of capital stock ($100 minimum). Rate will increase to 9 percent for tax years ending on or after July 1, 1996.

y) Savings and loans are taxed at a 6 percent rate.

z) State and national banks subject to the state's franchise tax on net capital is exempt from the income tax.

aa) Plus a surtax set annually by the Department of Revenue to finance a special recycling fund.

Table A3: Motor Fuel Excise Tax Rates as of January 1, 1997
(in cents per gallon)

	Gasoline	Diesel	Gasohol		Gasoline	Diesel	Gasohol
Alabama	16	17	18	Montana	27	27.75	27
Alaska	8	8	0	Nebraska	42.8	42..8	42.8
Arizona	18	18	18	Nevada	24	27	24
Arkansas	18.5	18.5	18.5	New Hampshire	18	18	18
California	18	18	18	New Jersey	10.5	13.5	10.5
Colorado	22	20.5	22	New Mexico	17	18	17
Connecticut	36	18	35	New York	22.35	22.35	22.35
Delaware	23	22	23	North Carolina	22.6	22.6	22.6
Florida	12.8	12.8	12.8	North Dakota	20	20	20
Georgia	7.5	7.5	7.5	Ohio	22	22	22
Hawaii	16	16	16	Oklahoma	16	13	16
Idaho	25	25	22.5	Oregon	24	24	24
Illinois	19	21.5	19	Pennsylvania	25.8	30.77	25.82
Indiana	15	16	15	Rhode Island	28	28	28
Iowa	20	22.5	19	South Carolina	16	16	16
Kansas	18	20	18	South Dakota	21	21	19
Kentucky	15	12	15	Tennessee (1)	20	17	20
Louisiana	20	20	20	Texas	20	20	20
Maine	19	20	19	Utah	24.5	24.5	19.5
Maryland	23.5	24.25	23.5	Vermont	15	16	15
Massachusetts	21	21	21	Virginia	17.5	16	17.5
Michigan	19	15	15	Washington	23	23	23
Minnesota	20	20	20	West Virginia	20.5	20.5	20.5
Mississippi	18	18	18	Wisconsin	23.8	23.8	23.8
Missouri	17	17	15	Wyoming	8	8	8
American Samoa	Information not provided			N. Mariana Islands	Information not provided		
District of Columbia	20	20	20	Puerto Rico	Information not provided		
Guam	Information not provided			U.S. Virgin Islands	Information not provided		
Federal	18.3	24.3	13				

Source: Compiled by Federation of Tax Administrators from various sources. Used by permission.

Table A4. Cigarette Tax Rates in the 50 States

State	Rate	State	Rate	State	Rate
Alabama	$ 0.17	Kentucky	$ 0.03	North Dakota	$ 0.44
Alaska	1.00	Louisiana	0.20	Ohio	0.24
Arizona	0.58	Maine	0.74	Oklahoma	0.23
Arkansas	0.32	Maryland	0.36	Oregon	0.68
California	0.37	Massachusetts	0.76	Pennsylvania	0.31
Colorado	0.20	Michigan	0.75	Rhode Island	0.71
Connecticut	0.50	Minnesota	0.48	South Carolina	0.07
Delaware	0.24	Mississippi	0.18	South Dakota	0.33
District of Columbia	0.65	Missouri	0.17	Tennessee	0.13
Florida	0.34	Montana	0.18	Texas	0.41
Georgia	0.12	Nebraska	0.34	Utah	0.52
Hawaii	0.80	Nevada	0.35	Vermont	0.44
Idaho	0.28	New Hampshire	0.37	Virginia	0.025
Illinois	0.44	New Jersey	0.40	Washington	0.83
Indiana	0.16	New Mexico	0.21	West Virginia	0.17
Iowa	0.36	New York	0.56	Wisconsin	0.59
Kansas	0.24	North Carolina	0.05	Wyoming	0.12
American Samoa	Information not provided	Guam	Information not provided	Puerto Rico	Information not provided
District of Columbia	Information not provided	Northern Mariana Isl.	Information not provided	U.S. Virgin Islands	Information not provided

Source: NCSL compilation from Commerce Clearing House, *State Tax Guide* and surveys of legislative fiscal analysts, 1997.

Notes

1. National Conference of State Legislatures, *Principles of a High-Quality State Revenue System* (Denver: NCSL, 1992).

2. Steve Gold, *The Income Elasticity of State Tax Systems: New Evidence* (Albany, N.Y: State University of New York, Center for the Study of the States, 1995), 9.

3. Citizens for Tax Justice and Institute on Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*" (Washington, D.C.: Citizens for Tax Justice), 4.

4. Iris Lav and Edward Lazere, *A Hand Up: How State EITCs Help Working Families Escape Poverty* (Washington D.C.: Center on Budget and Policy Priorities, 1996), 28.

5. Steve Gold, Corina Eckl and Martha Fabricius. *State Budget Actions in 1988* (Denver: NCSL, 1988), 64.

6. Scott Mackey, *State Tax Actions 1996* (Denver: NCSL, 1996), 6.

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