Balancing State Budgets

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Summary

- **Budget deficits in the states will likely exceed $40 billion in 2004.**
- **State budget deficits were caused by tax cuts, not by overspending.**
- **A wide variety of policies are available to increase revenues and cut state expenses.**
- **If progressives don't offer a program to balance state budgets, the conservative program—laying off government workers and slashing social services—will prevail.**

Budget deficits in the states will likely exceed $40 billion in 2004.

The National Conference of State Legislatures estimates that over the last three years, states have been forced to address a cumulative budget deficit of nearly $200 billion.[1] The states' fiscal problems are expected to continue.

State budget deficits were caused by tax cuts, not by overspending.

Adjusted for inflation and population growth, spending of state-raised funds increased by only about two percent annually during the 1990s—substantially less than the increases in state spending over the past five decades.[2] Recent budget deficits are primarily the result of states' responding to the strong economy of the 1990s with large, permanent cuts in personal and corporate income taxes. In most states, if taxes were restored to pre-1994 levels, current budget problems would essentially be solved.

A wide variety of policies are available to increase revenues and cut state expenses.

Most states have now depleted their reserve funds and exhausted short-term accounting fixes. Nobody likes to raise taxes or cut government services, but most legislatures will be forced to do one or both in 2004. The following are 28 possible ways to close budget deficits:

■ **Tobacco Excise Tax—Increase the tax and cover more tobacco products.** One of the quickest and most popular ways for states to raise hundreds of millions of dollars is to raise the tobacco tax. Different state polls conducted across the country have found that Americans strongly favor large tobacco tax increases—raising cigarette taxes by 50 or 75 cents per pack. Since 2002, 31 states have increased their cigarette tax rates, raising the state average from 43 to 73 cents per pack. Twenty-eight state legislatures (AR, CT, DE, GA, HI, ID, IL, IN, KS, LA, MD, MA, MI, MT, NE, NV, NJ, NM, NY, OH, PA, RI, SD, TN, UT, VT, WV, WY) and the District of Columbia raised cigarette taxes. Voters in Arizona, Oregon and Washington increased their taxes by statewide referendum. States have also expanded the tax to cover chewing tobacco and snuff. Higher tobacco taxes save thousands of lives by reducing teen smoking, as well as adult tobacco use.

■ **Alcohol Excise Tax—Increase the tax.** All states impose a "sin" tax on alcohol, but most tax alcohol at low rates. The average excise tax on liquor is about $4 per gallon, while several state taxes exceed $6 per gallon. Some states tax beer and wine at much lower rates than spirits, based on the percentage of alcoholic content. States with the lowest alcohol taxes include AK, CO, IN, KS, KY, LA, MD, MO, NE, NV, ND and TX.

■ **Estate Tax—Decouple from federal estate tax.** States are losing billions of dollars in tax revenue because of a change in the federal estate tax enacted in 2001. Most estate taxes in the states are linked to the federal estate tax credit, which is being phased out over the next three years. As a result, state tax revenues are plummeting. Only 18 states are currently decoupled from the federal estate tax: IL, KS, ME, MD, MA, MN, NE, NJ, NY, NC, OH, OR, PA, RI, VT, VA, WA, WI.

■ **Personal Income Tax—Raise the rate for the highest incomes.** The simplest method of making income tax rates more progressive is to institute a surcharge, or new tax bracket, for individuals earning over $250,000, $500,000 or $1 million per year. The Connecticut legislature passed a "Millionaire's Tax" in 2002—a one percent surtax on incomes above $1 million that would have raised an estimated $140 million. However, the governor vetoed the bill. This kind of increase can be enacted as a permanent or temporary tax. During the last recession, four states increased top rates permanently, while five others increased those rates temporarily.

■ **Personal Income Tax—Implement a more graduated scale.** If taxes need to be raised, why not do it fairly? Of the 41 states with a personal income tax covering earnings, only 14 have graduated tax brackets that truly differentiate between lower and upper-income taxpayers. Six states have a flat tax rate—no income brackets at all. In 16 other states, the top tax bracket is $25,000 or less, giving very little meaning to the tax bracket system. In other words, about half the states are ripe for a fundamental reform of income tax brackets.

■ **Personal Income Tax—Eliminate or suspend exemptions, credits and/or deductions.** Virtually every state with an income tax has created or expanded income tax exemptions, credits and/or deductions over the past 10 years. Advocates should research tax loopholes—changes designed to benefit special interests instead of families—and the amount of revenue lost because of each loophole. Legislation can either eliminate the loopholes permanently or suspend them temporarily.

■ **Personal Income Tax—Tax non-resident gambling income.** Net gambling winnings are taxable as income, and state residents are taxed. But states can also tax non-residents who have gambling winnings in the state. CA, CO, IL, MN and NJ tax non-resident gambling income. The value of such a tax expansion depends, of course, on the amount of gambling activity in the state.

■ **Personal Income Tax—Implement a tax amnesty.** Over the past 20 years, 40 states have implemented tax amnesty periods in order to collect overdue taxes. Connecticut, for example, has offered tax amnesties in 1990, 1995 and 2002. The most recent amnesty collected more than $100 million in back taxes. A 2003 Illinois amnesty collected back taxes from almost 20,000 businesses and individuals. However, by offering amnesties too often, states risk lowering taxpayers' incentive to pay on time.

■ **Corporate Income Tax—Implement a more graduated scale.** Thirty states use a flat tax for corporate income. That means there is only one tax bracket, with no graduated scale at all. These states can adopt a graduated system, increasing the tax rate for corporate income over certain levels, e.g., $25,000, $100,000, $250,000, $500,000 and $1 million. For example, Iowa, Kentucky and Maine have graduated scales from $25,000 to $250,000, with tax rates ranging from 3.5 percent at the lowest to 12 percent at the highest. If necessary, a graduated scale can be implemented temporarily, by imposing a surcharge on corporate profits over a certain level—for example, a 5 percent surcharge on corporate profits over $250,000.

■ **Corporate Income Tax—Require combined reporting.** When filing tax returns, corporations that operate across state lines apportion their income among the states where they do business. Corporations use many strategies to artificially shift the reporting of their income to low-tax or no-tax states. Combined reporting is the broadest and fairest reform to stop the most common tax avoidance strategies. Because combined reporting requires corporations to add together the profits of related businesses before the combined profit is subject to apportionment, the company gains little or no advantage by shifting profit among its subsidiaries in different states. Combined reporting ensures that a corporation's state income tax liability remains the same regardless of the corporation's legal structure. Sixteen states use combined reporting: AK, AZ, CA, CO, HI, ID, IL, KS, ME, MN, MT, NE, NH, ND, OR and UT.

■ **Corporate Income Tax—Close the PIC trademark loophole.** Large corporations commonly shift the reporting of income by using a "passive investment company" (PIC), a corporate affiliate that is often no more than a file in a Delaware lawyer's office. The PIC holds legal ownership to the parent corporation's patents and trademarks and charges huge royalties to the parent company, shielding those funds from taxation. This tax dodge was made famous by Toys R Us, which charged its parent company for the use of the "Geoffrey" giraffe trademark, and other intangible assets. This tax loophole has been closed in 24 states. The following states could gain tax revenue by eliminating this income-shifting tactic: AR, DE, FL, GA, IN, IA, KY, LA, MD, MO, NM, OK, PA, RI, SC, TN, TX, VT, VA, WV, WI and the District of Columbia. Enactment of combined reporting also blocks the PIC trademark loophole.

■ **Corporate Income Tax—Redefine "business income."** The U.S. Supreme Court has limited the types of business income that are subject to apportionment among the states. To comply with Supreme Court rulings, most states define and tax "business income." But the commonly-used definition allows corporations to avoid taxes by declaring certain transactions to be "irregular" and therefore "non-business income," cheating states out of their fair share of corporate tax revenue. States can close the "non-business income" loophole by redefining "business income" to be as broad as the Supreme Court allows, that is, "business income means all income which is apportionable under the United States Constitution." Only six states (FL, IA, MN, NC, PA and TX) have adopted this definition. All other states with a corporate income tax could increase revenue by adopting this definition as well.

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

■ **Corporate Income Tax—Tighten rules on "silent partners."** Certain business entities such as S-corporations, partnerships and limited-liability companies are not taxed because their income flows directly to the partners, who are supposed to pay tax on that income. But many out-of-state partners do not report their earnings to the states where the partnerships earned profits. Often, states do not check to see if these "silent" partners reported any income to the state. Most states' efforts to check on pass-through reporting are inadequate, and millions of dollars of tax revenue is lost. Ohio and New Jersey are two states that have tightened the rules on pass-through entities in recent years.

■ **Corporate Income Tax—Eliminate or suspend exemptions, credits and/or deductions.** Over the past 20 years, states have created hundreds of different exemptions, credits or deductions to the corporate income tax in order to encourage or reward different types of businesses or business behavior. Advocates should research the corporate tax loopholes created since the early 1980s, and the amount of revenue lost because of each loophole. Legislation can either eliminate the loopholes permanently or suspend them temporarily.

■ **Corporate Income Tax—Accelerate sunset dates for tax exemptions.** A number of states have created corporate tax exemptions that sunset after a period of years. States can gain additional revenue by moving exemption sunset dates to 2004.

■ **Corporate Income Tax—Decouple from federal bonus depreciation.** States are losing billions of dollars in tax revenue because of a change in the federal corporate income tax enacted in March 2002. A new federal tax deduction, called "bonus depreciation," allows businesses to claim 30 percent depreciation for certain business machinery placed in service after September 2001. Last year, 30 states that had previously followed federal depreciation rules decoupled from the federal tax code, effectively disallowing the new bonus depreciation provision. However, AL, CO, DE, FL, KS, LA, MO, MT, NM, NC, ND, OK, OR, SD, UT, VT and WV stand to lose more than $1.1 billion over the next two years if they do not permanently decouple from the federal depreciation rules.[3]

■ **Corporate Income Tax—Reform the Alternative Minimum Tax.** It is all too common for corporations to use a series of tax loopholes in order to avoid paying any state tax at all. The federal government has an Alternative Minimum Tax (AMT) for these situations. Currently 13 states also impose a corporate minimum tax that is a fixed amount—ranging from $10 in Oregon to $2,000 in New Jersey. Seven states go further, requiring businesses to pay the higher of a tax calculated as a percentage of profit or a tax calculated on some other basis. In Texas, the alternative base is the business' net worth; in New Hampshire it is "value-added" within the business; and in New Jersey it is the business' gross receipts.[4]

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

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

■ **Luxury Tax—Impose a special sales tax on luxury goods and services.** Sales taxes are regressive; they absorb a larger proportion of the income of lower-income taxpayers than of higher-income taxpayers. To counter this, states can single out "luxury" goods or services for a sales tax that is either equal to, or greater than, the normal sales tax rate. A surtax can apply to goods that are unusually expensive, for example, non-business purchases over $50,000. Or a tax can apply to athletic club, country club, or golf club memberships.

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

■ **Gasoline Tax—Increase the state tax.** Every state levies a gasoline tax in addition to the federal tax of 18.4 cents per gallon. Some states charge a flat rate per gallon while others tax the price, rather than the quantity, of gas sold. Some states charge as much as 29-31 cents per gallon (NY, RI, WI). 20 states have gas taxes below 20 cents per gallon: AL, AK, AZ, CA, FL, GA, HI, IL, IN, KY, MI, MS, MO, NH, NJ, NM, OK, SC, VA, and WY.

■ **Tax Enforcement—Hire tax investigators to collect more revenue.** Most states do a very poor job of enforcing tax law. As a result, hundreds of millions of dollars in revenue go uncollected. It has been estimated, for example, that Illinois could generate $160 million by hiring 100 additional tax investigators. Similarly, a report in Minnesota found that the state was losing $288 million in uncollected tax revenue. In 2001, Kansas invested $3 million to create 75 new tax collection positions. While the legislature projected that the additional collection efforts would yield $48 million, the state actually collected nearly $110 million in additional revenue.

■ **Medicaid Spending Cut—Obtain supplemental rebates for prescription drugs.** States are being overcharged for the prescription drugs they buy through state programs. On average, states pay 20-25 percent more for outpatient drugs in their Medicaid programs than the federal government pays for the exact same medicines. States can save money by negotiating supplemental rebates from drug manufacturers. Prior to 2001, only California authorized the use of preferred drug lists and negotiated supplemental rebates to lower prescription drug prices paid by the state Medicaid program. Since 2001, at least 26 states have initiated these policies (AL, CT, FL, GA, HI, IL, IN, KY, LA, ME, MD, MA, MI, MN, NM, NC, OH, SC, SD, TN, TX, UT, VT, VA, WA, and WV), saving over one billion dollars per year.

■ **Interest Payments Spending Cut—Refinance existing general obligation debt at lower interest rates.** Several states have saved millions of dollars by refinancing debt. States should re-evaluate state debt with an eye toward refinancing at today's lower interest rates.

■ **Corporate Subsidies Spending Cut—Delete or suspend subsidy and grant programs.** Many states offer subsidies, loan guarantees, grants, and other financial benefits to businesses under a variety of business development programs. States can save revenue by eliminating, suspending or freezing these subsidy programs.

■ **Corrections Department Spending Cut—Divert incarcerated non-violent drug offenders to drug treatment programs.** Over the last decade, a wave of laws intended to get tough on crime has resulted in the incarceration of over 125,000 non-violent drug offenders. While it costs states more than $26,000 per year to house an inmate, community corrections and drug treatment programs are substantially less expensive. Coupled with a moratorium on the construction of new prison cells, this policy could save states hundreds of millions of dollars.

If progressives don't offer a program to balance state budgets, the conservative program—laying off government workers and slashing social services—will prevail.

A budget is a statement of a government's fundamental values. It allocates resources among the programs and policies that are important to state residents. Progressives must demonstrate that their budget proposals reflect American values by apportioning taxes fairly and spending the funds wisely.

The portions of this policy summary dealing with corporate and estate taxes rely in large part on information from the Center on Budget and Policy Priorities.

Endnotes

[1] National Conference of State Legislators, "State Budget & Tax Actions 2003."

[2] Liz McNichol, "The State Fiscal Crisis Was Not Caused By Overspending," Center on Budget and Policy Priorities, May 2003.

[3] Nicholas Johnson, "Federal Tax Changes Likely To Cost States Billions Of Dollars In Coming Years," Center on Budget and Policy Priorities, June 2003.

[4] Michael Mazerov, "Many States Could Avoid An Unnecessary Revenue Loss During The Current Fiscal Crisis By Disallowing Business Operating Loss Carrybacks," Center on Budget and Policy Priorities, May 2003.

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