



# State Revenue Systems and Principles of Tax Policy

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Blue Ribbon Tax Structure Commission  
Vermont General Assembly

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National Conference of State Legislatures

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# State Revenue Systems

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- First, What is a Revenue System?
  - The entire means of government funding
  - Variety of revenue sources, diversification
  - Apply criteria to systems, not sources

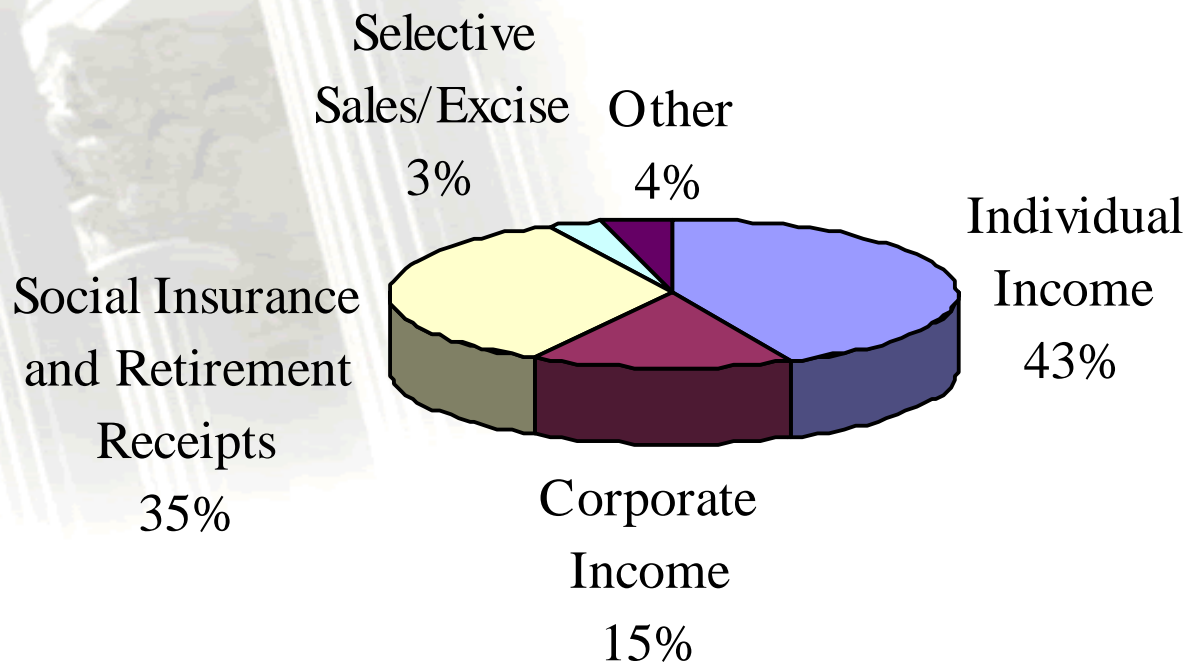
# State Revenue Systems

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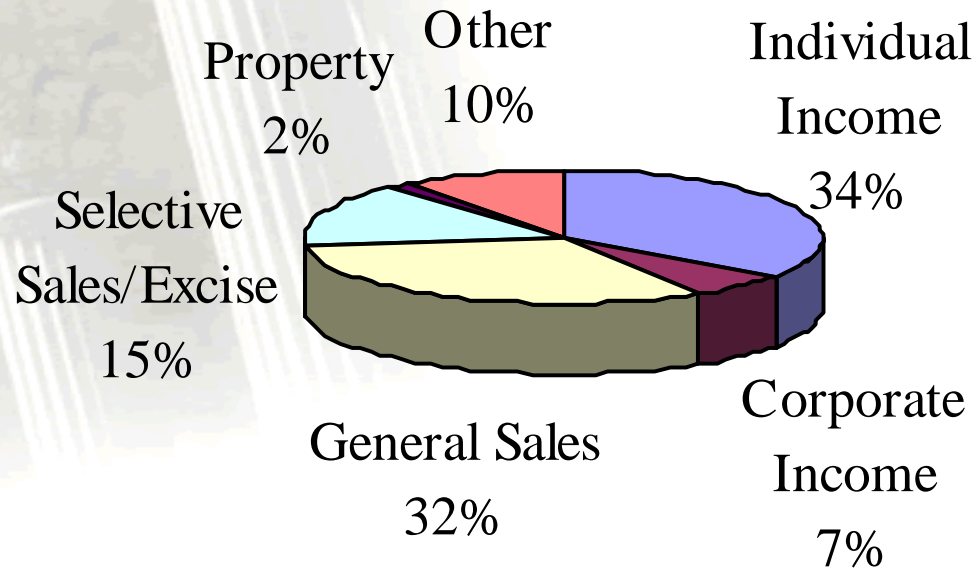


- Where State Revenue Comes From
- Total income and total sales taxes represent more than 80 percent of revenues
- Property taxes are 2 percent of state revenues nationally, Vermont is an exception.

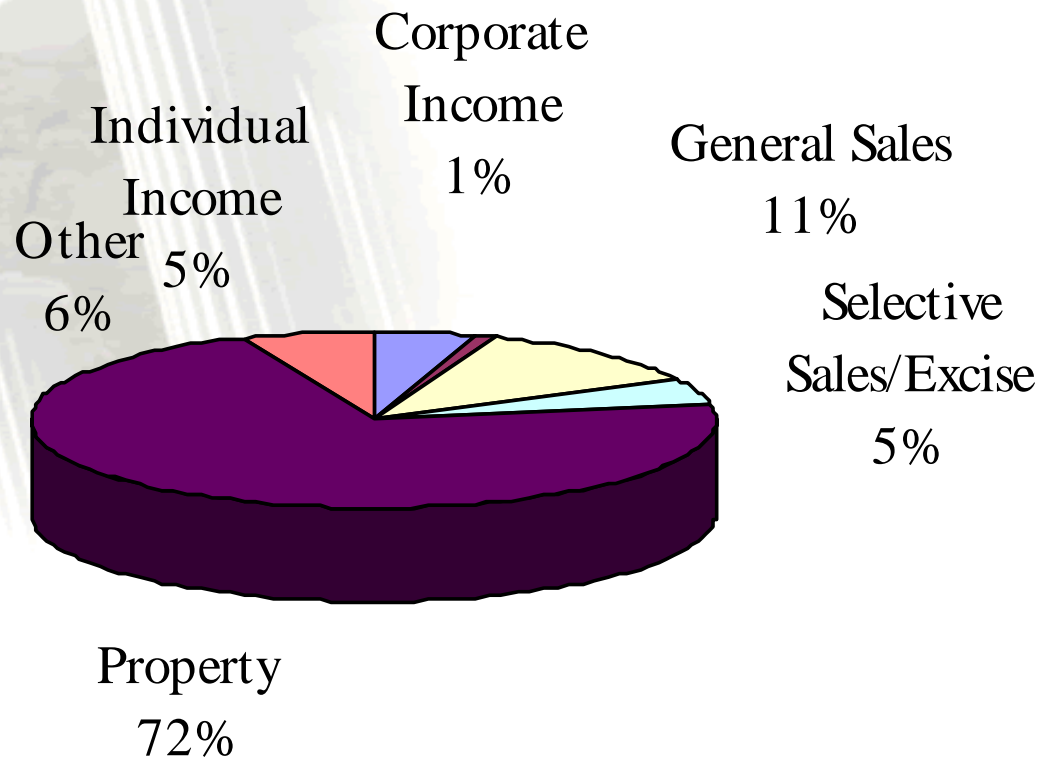
# Components of Federal Tax Collections



# Components of State Tax Collections



# Components of Local Tax Collections






# State Revenue Systems and the Personal Income Tax

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- 41 states have an income tax, 7 have flat rates, others graduated rates.
  - 27 states use adjusted gross income as starting point; 10 states use federal taxable income.
  - Deductions, exemptions reduce the base but may boost progressivity.
  - Conformity with the federal tax system eases compliance and simplifies administration.
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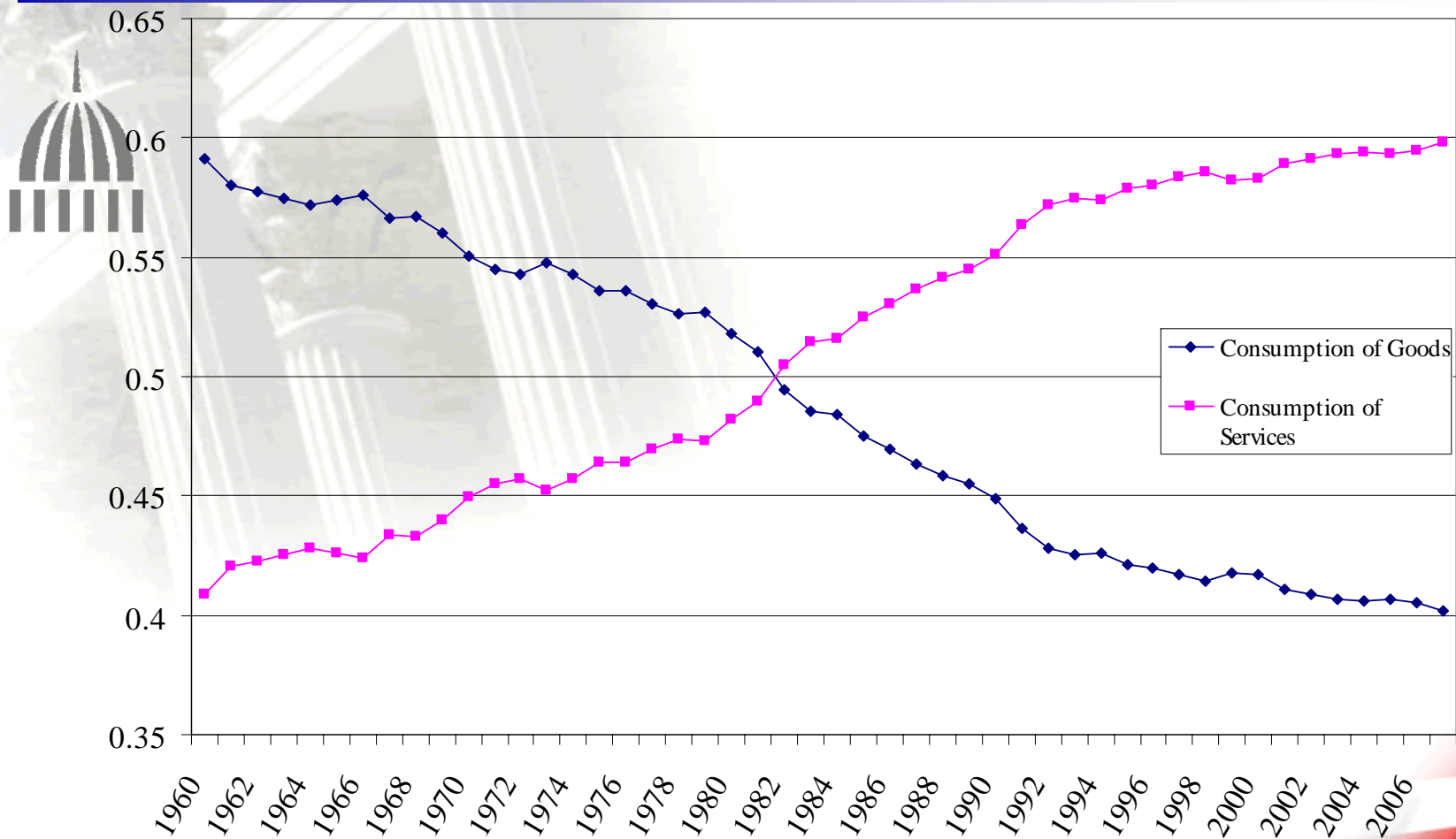


# State Sales Tax Systems

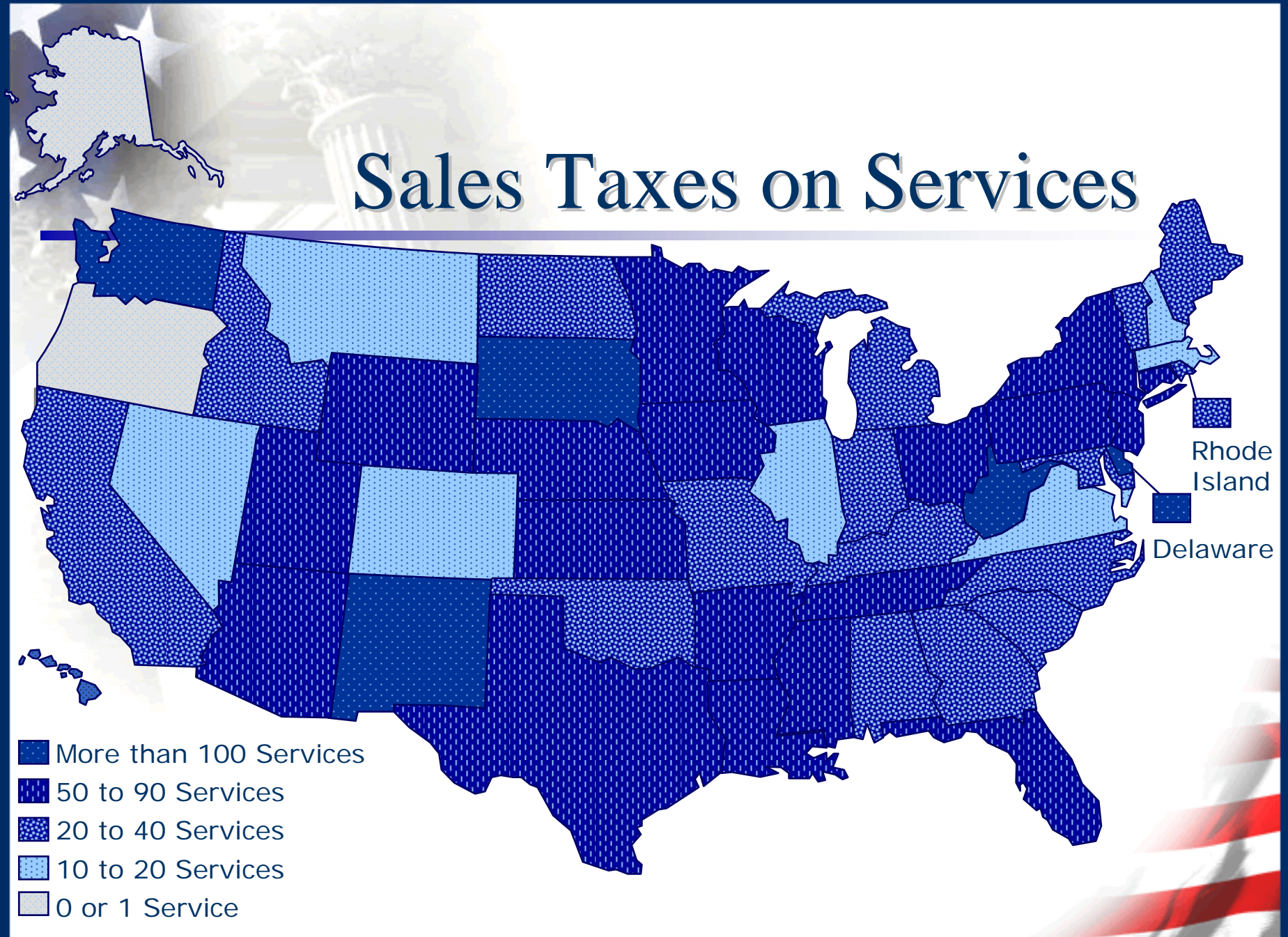
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- 45 states have them. 34 states allow local sales taxes.
  - The average state rate is 5.75%, the average state-local rate is 6.5%.
  - Few rate increases the past few years, until 2009, except to pay for property tax relief.
  - Few expansions to services.

# Consumption of Goods and Services, 1960-2007



# Sales Taxes on Services





# Business Taxes

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- Corporate income is taxed in 46 states. Not a large or growing source of overall state revenues.
- Why? Erosion risk due to exclusions from (incentives) the base, business tax planning, or tax cuts.
- Some states are experimenting with alternative tax systems to broaden the tax base.



# Sustainability is the New Key Driver for State Tax Policy

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- Prices set the retail sales tax calculation so potential tax base growth will be in services.
  - Future developments - consumer behavior, higher inflation or federal fiscal changes - have implications for state tax systems.
  - Revenue source and base diversification reduces volatility, spreads tax burden, and helps match a tax system to a state's economic activity.
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# Origin of Tax Policy Principles

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- From The Wealth of Nations to NCSL
    - Adam Smith spoke of equity, explicitness, simplicity and economy of administration.
    - NCSL convened legislators and policy experts; its 1992 principles also consider evolution in federalism and economies.



# Tax Policy General Principles: Ability-to-Pay

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- Regressive, proportionate or progressive impacts
- Earned income credit, circuit-breakers and grocery exemptions are examples
- Rules of thumb (progressive income tax, regressive sales tax) are affected by duration or design.



# Tax Policy General Principles: The Benefit Principle

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- Assumes a market relationship between citizen and government: a price is assigned to public services.
- Assumes taxpayers should pay for what they receive, and tax policy should not redistribute income.

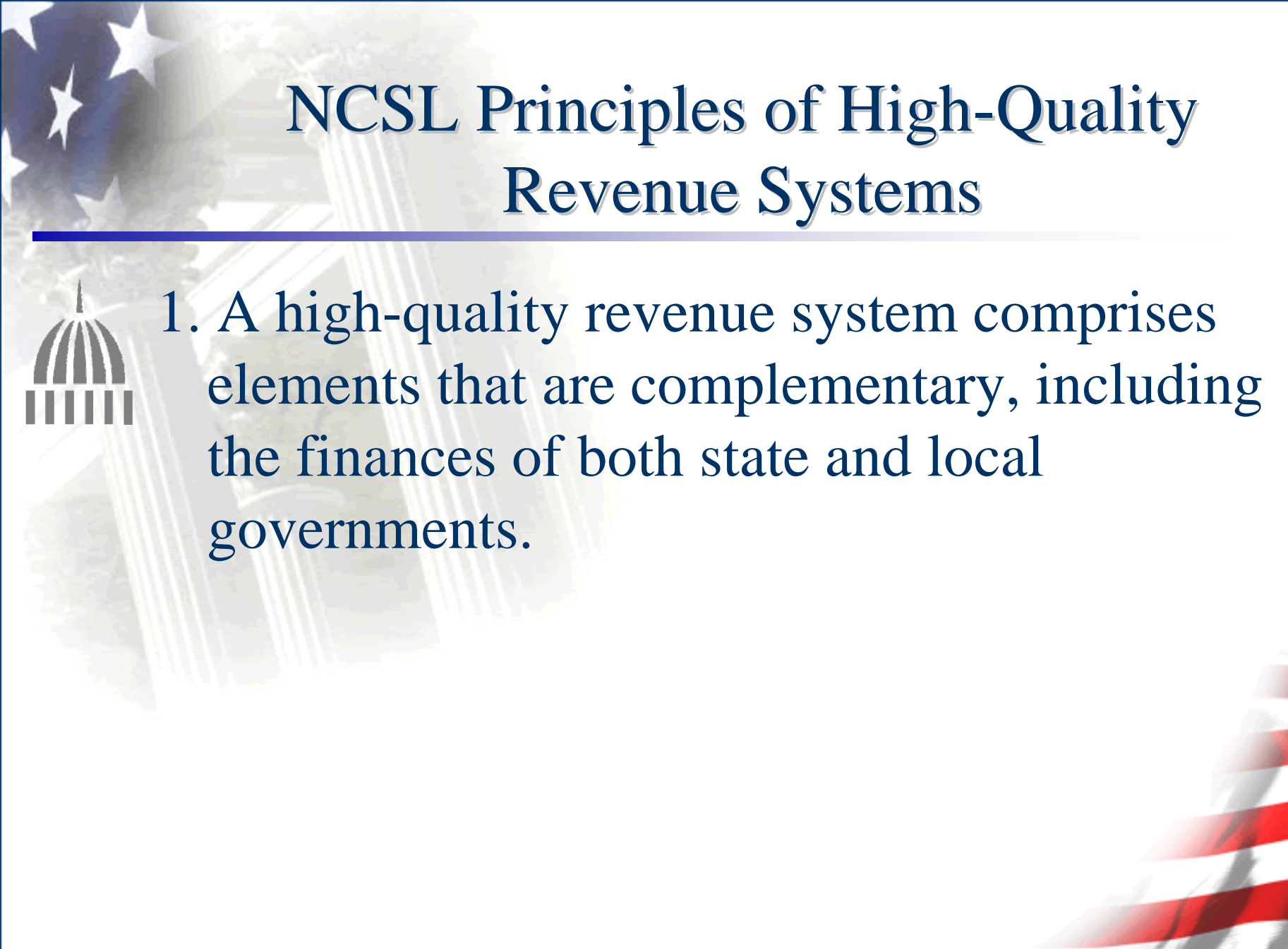


# Tax Policy General Principles: Equity and Simplicity

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- Horizontal Equity
  - Similar income, similar tax obligation
- Vertical Equity
  - Income variance, tax burden variance
- Associated rules of thumb
  - Broad Base, Low Rates
  - Simplicity



# NCSL Principles of High-Quality Revenue Systems

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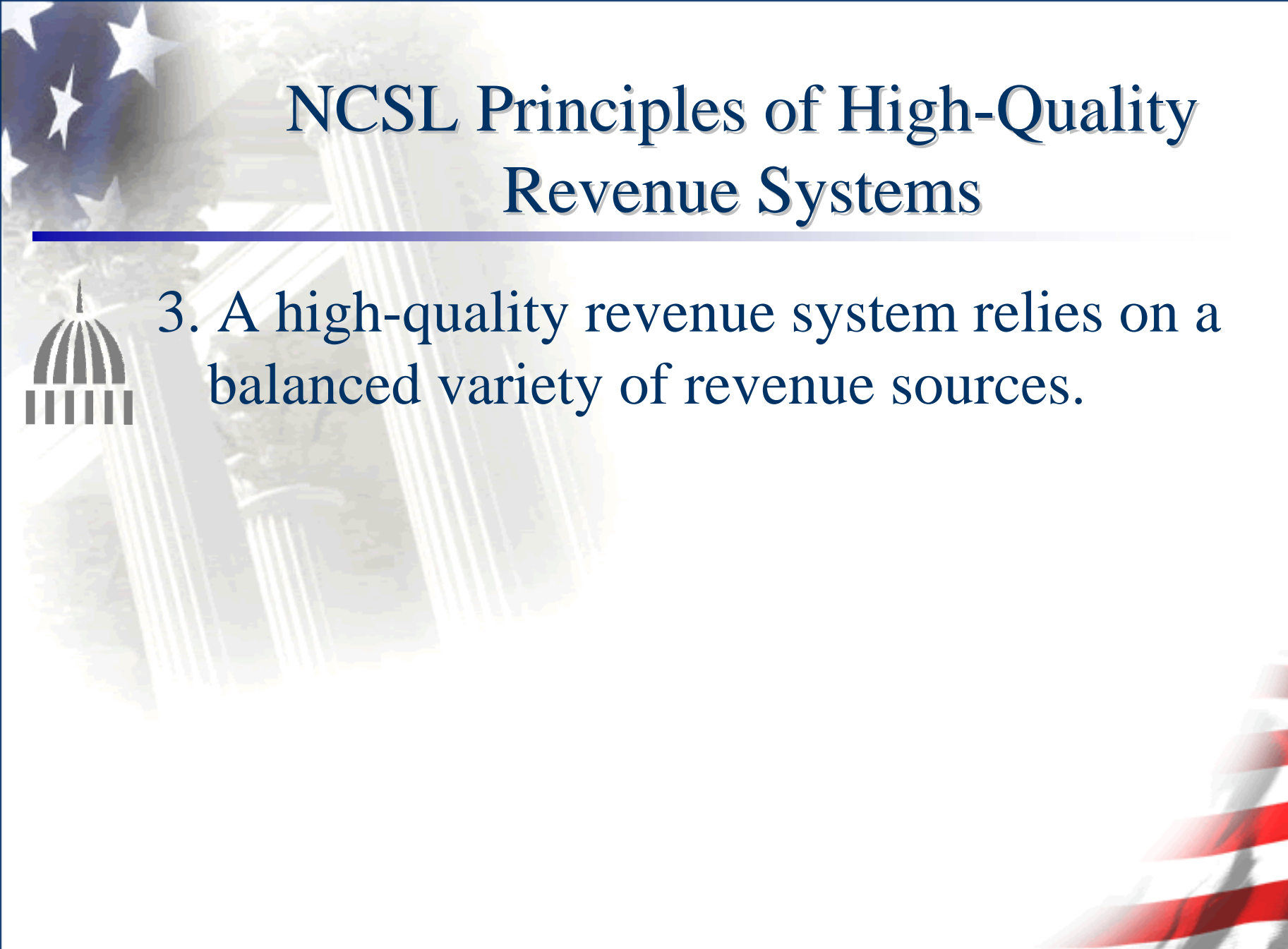
1. A high-quality revenue system comprises elements that are complementary, including the finances of both state and local governments.

# NCSL Principles of High-Quality Revenue Systems

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2. It produces revenue in a reliable manner. Reliability involves stability, certainty and sufficiency.

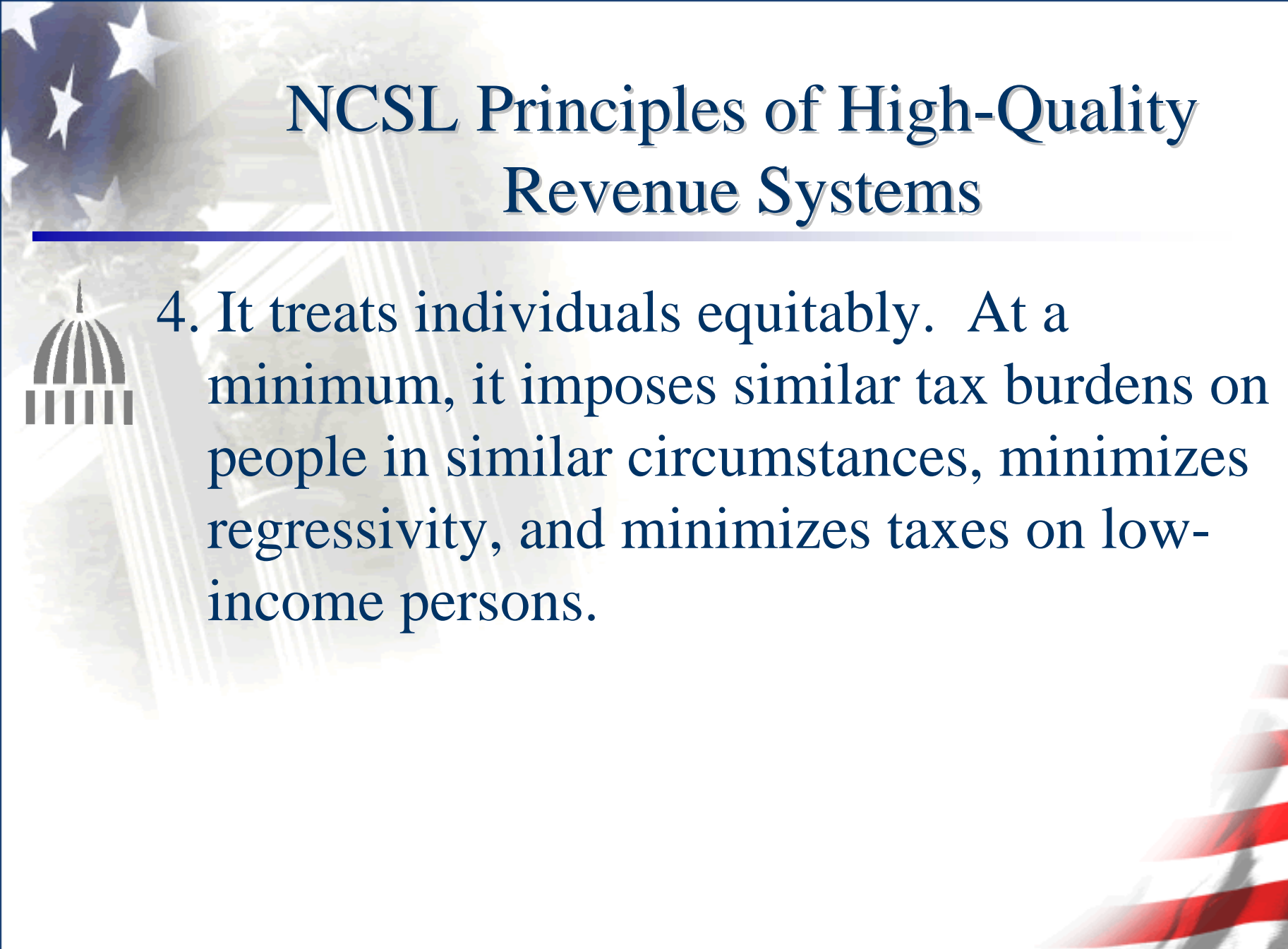


# NCSL Principles of High-Quality Revenue Systems

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3. A high-quality revenue system relies on a balanced variety of revenue sources.



# NCSL Principles of High-Quality Revenue Systems

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4. It treats individuals equitably. At a minimum, it imposes similar tax burdens on people in similar circumstances, minimizes regressivity, and minimizes taxes on low-income persons.

# NCSL Principles of High-Quality Revenue Systems

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5. A high-quality revenue system facilitates taxpayer compliance. It is easy to understand and minimizes compliance costs.

# NCSL Principles of High-Quality Revenue Systems

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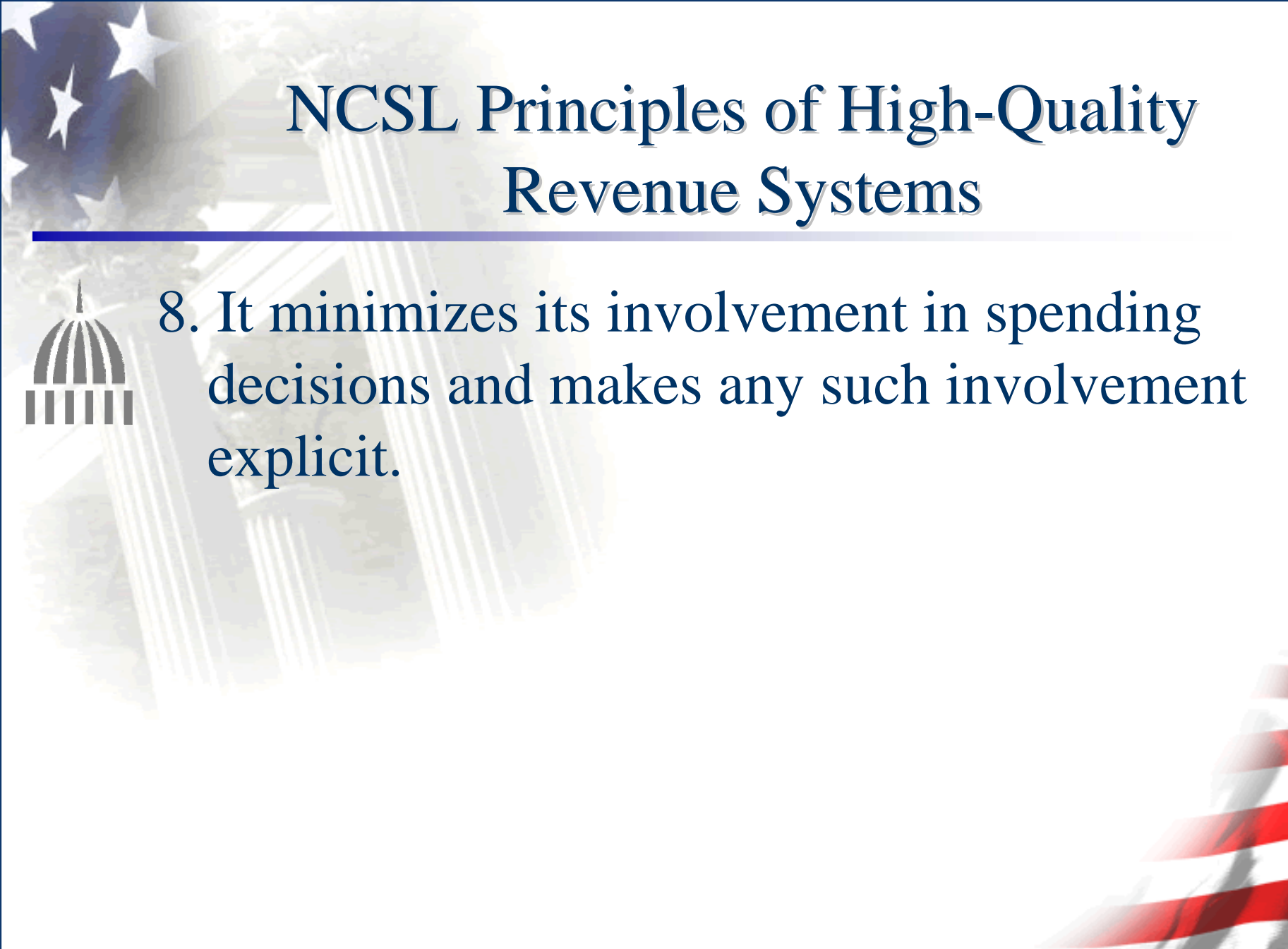
6. It promotes fair, efficient and effective administration. It is as simple as possible to administer, raises revenue efficiently, is administered professionally, and is applied uniformly.

# NCSL Principles of High-Quality Revenue Systems

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7. A high-quality revenue system is responsive to interstate and international economic competition.



## NCSL Principles of High-Quality Revenue Systems

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8. It minimizes its involvement in spending decisions and makes any such involvement explicit.

# NCSL Principles of High-Quality Revenue Systems

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9. A high-quality revenue system is accountable to taxpayers.



# NCSL Tax Policy Principles Summary

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- Distribute burdens equitably
  - Provide timely and appropriate revenues (adequacy)
  - Promote economic efficiency and growth (neutrality)
  - Achieve workable compliance and administration
  - Have accountability and transparency





# Current Fiscal Situation and Other State Reform Actions

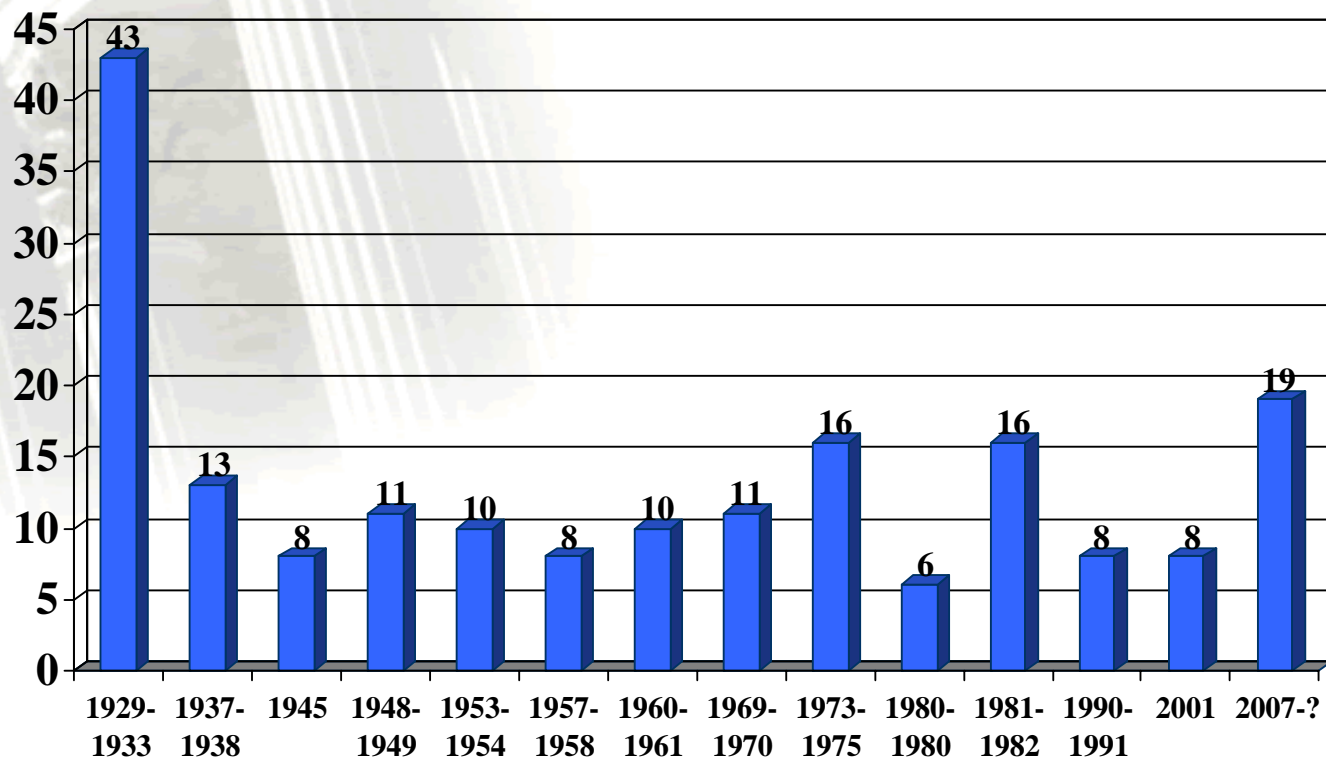


# Overview

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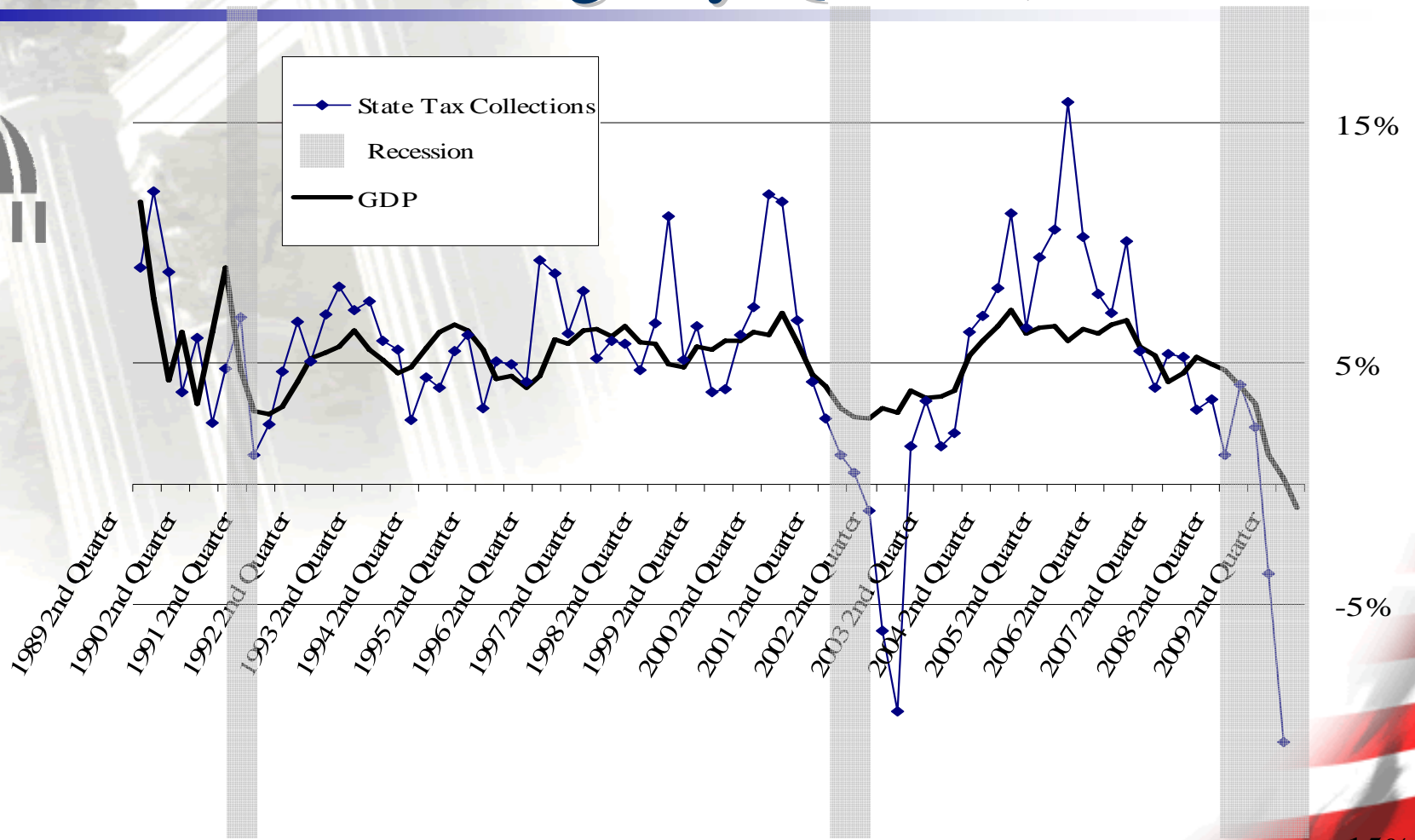
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- The state fiscal situation is growing increasingly dire.
  - The current revenue situation is nearly unprecedented, at least in recent decades.
  - To date, states have reported a total estimated budget gap of \$348.3 billion (FY 2008 through FY 2012).
  - States are bracing for prolonged fiscal problems.
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# U.S. Business Cycle Downturns 1929-2009: Duration in Months



Source: National Bureau of Economic Research

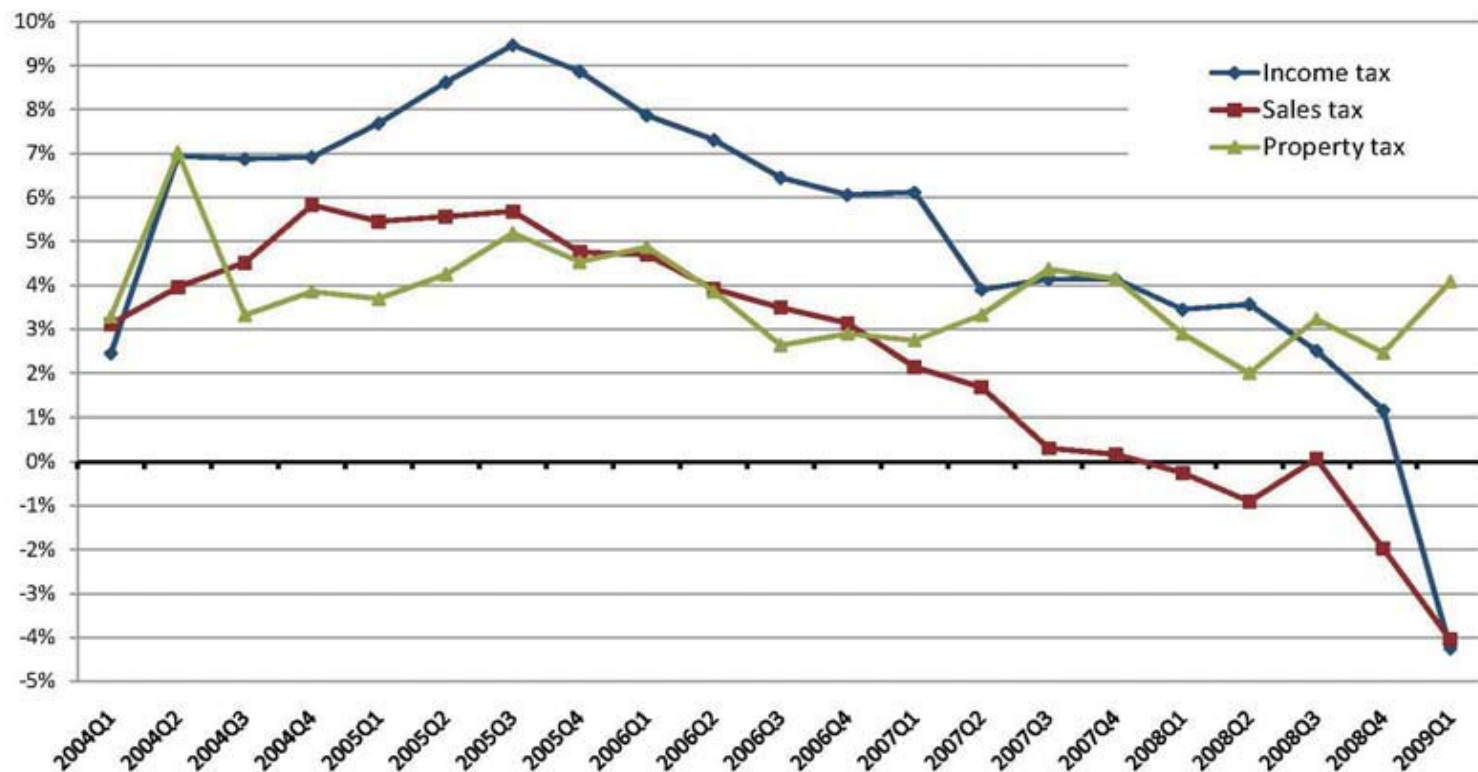
# State Tax Collections and GDP: Annual Change by Quarter, 1989-2009



Sources: NCSL calculations based on data from the Bureau of the Census, Bureau of




# Year-Over-Year Percent Real Change in Major Taxes Four-Quarter Average of Percent Change



Sources: U.S. Census Bureau (tax revenue) and Bureau of Economic Analysis (GDP price index).  
 Notes: (1) 4-quarter average of percent change in real tax revenue; (2) No adjustments for legislative changes.

Source: The Nelson A. Rockefeller Institute of Government. *State Revenue Report*, July 2009 .

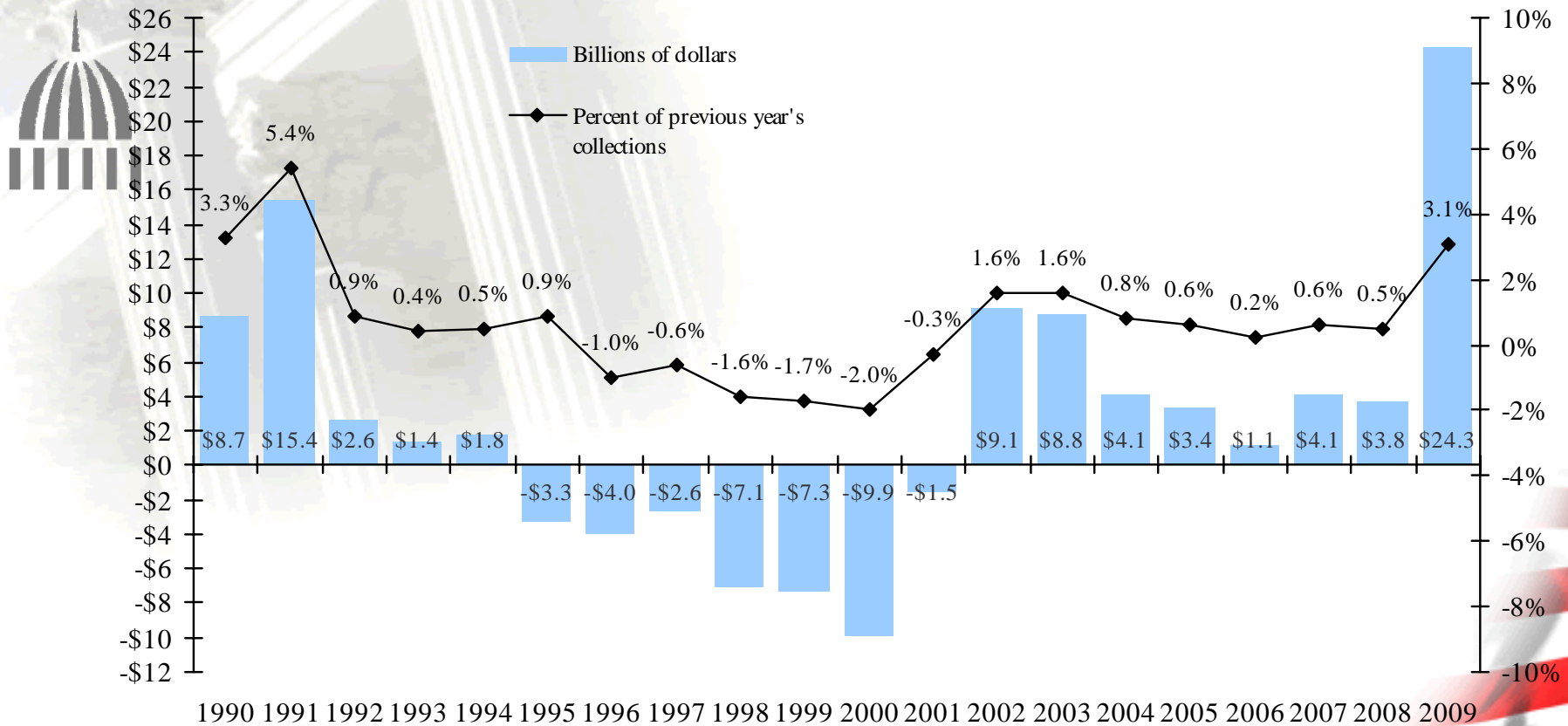
# FY 2009 Net State Tax Changes by Type of Tax



Type of Tax	Dollars (in millions)	Percent of Total
<b>Personal Income</b>	<b>\$10,601.4</b>	<b>43.5%</b>
<b>Corporate Income</b>	<b>\$1,387.4</b>	<b>5.7%</b>
<b>Sales and Use</b>	<b>\$6,163.0</b>	<b>25.3%</b>
<b>Health Care</b>	<b>\$1,544.0</b>	<b>6.4%</b>
<b>Tobacco</b>	<b>\$1,589.3</b>	<b>6.5%</b>
<b>Motor Vehicle</b>	<b>\$1,807.6</b>	<b>7.4%</b>
<b>Alcoholic Beverage</b>	<b>\$179.7</b>	<b>0.7%</b>
<b>Miscellaneous</b>	<b>\$1,066.3</b>	<b>4.4%</b>
<b>Net Change</b>	<b>\$24,348.7</b>	<b>100%</b>

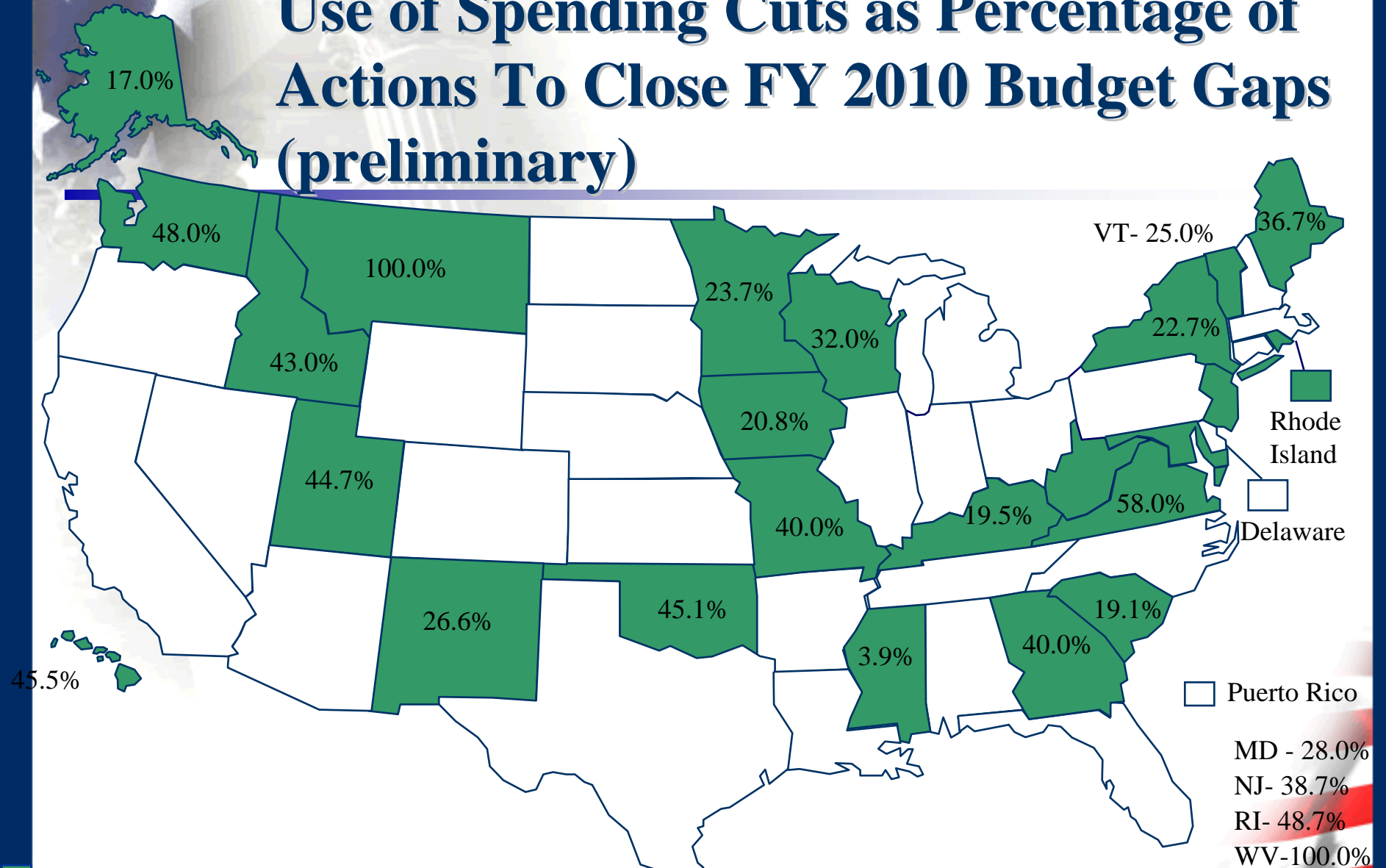
Source: National Conference of State Legislatures, 2009.

# Net State Tax Changes by Year of Enactment



Source: NCSL survey of legislative fiscal offices, various years

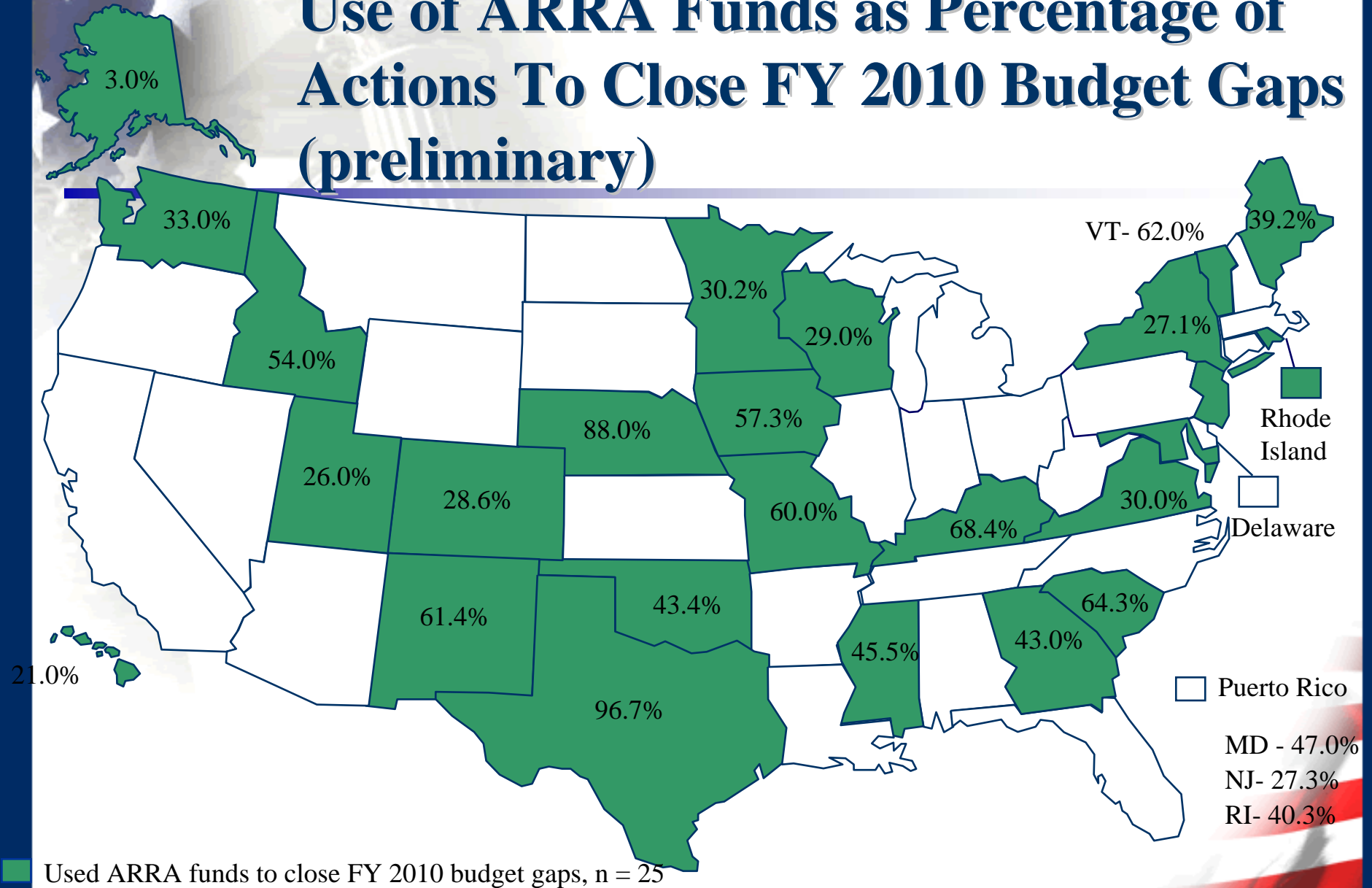
# Use of Spending Cuts as Percentage of Actions To Close FY 2010 Budget Gaps (preliminary)



Used spending cuts to close FY 2010 budget gaps, n = 24

Source: NCSL survey of state legislative fiscal offices, July 2009.

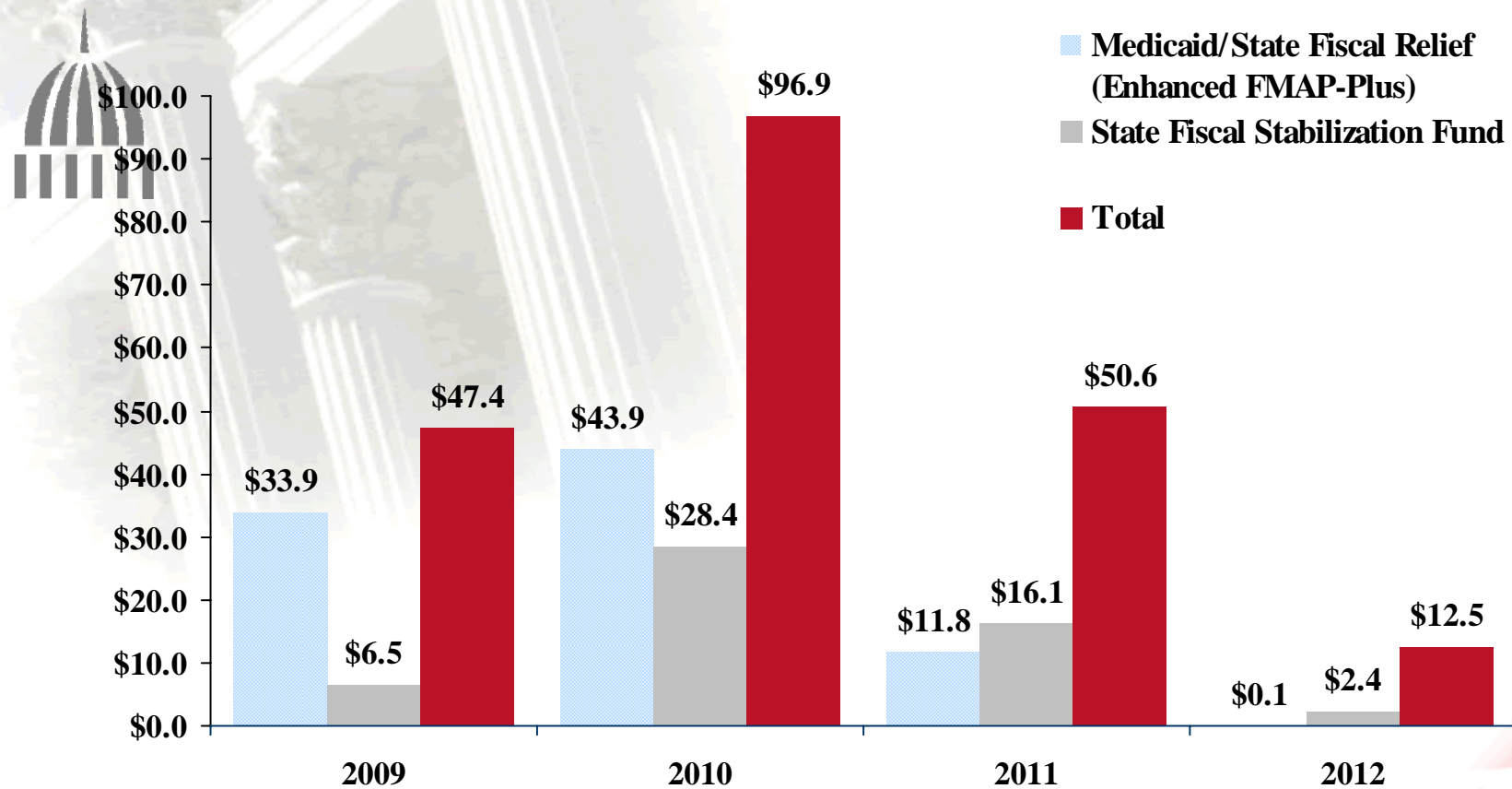
# Use of ARRA Funds as Percentage of Actions To Close FY 2010 Budget Gaps (preliminary)



Source: NCSL survey of state legislative fiscal offices, July 2009.

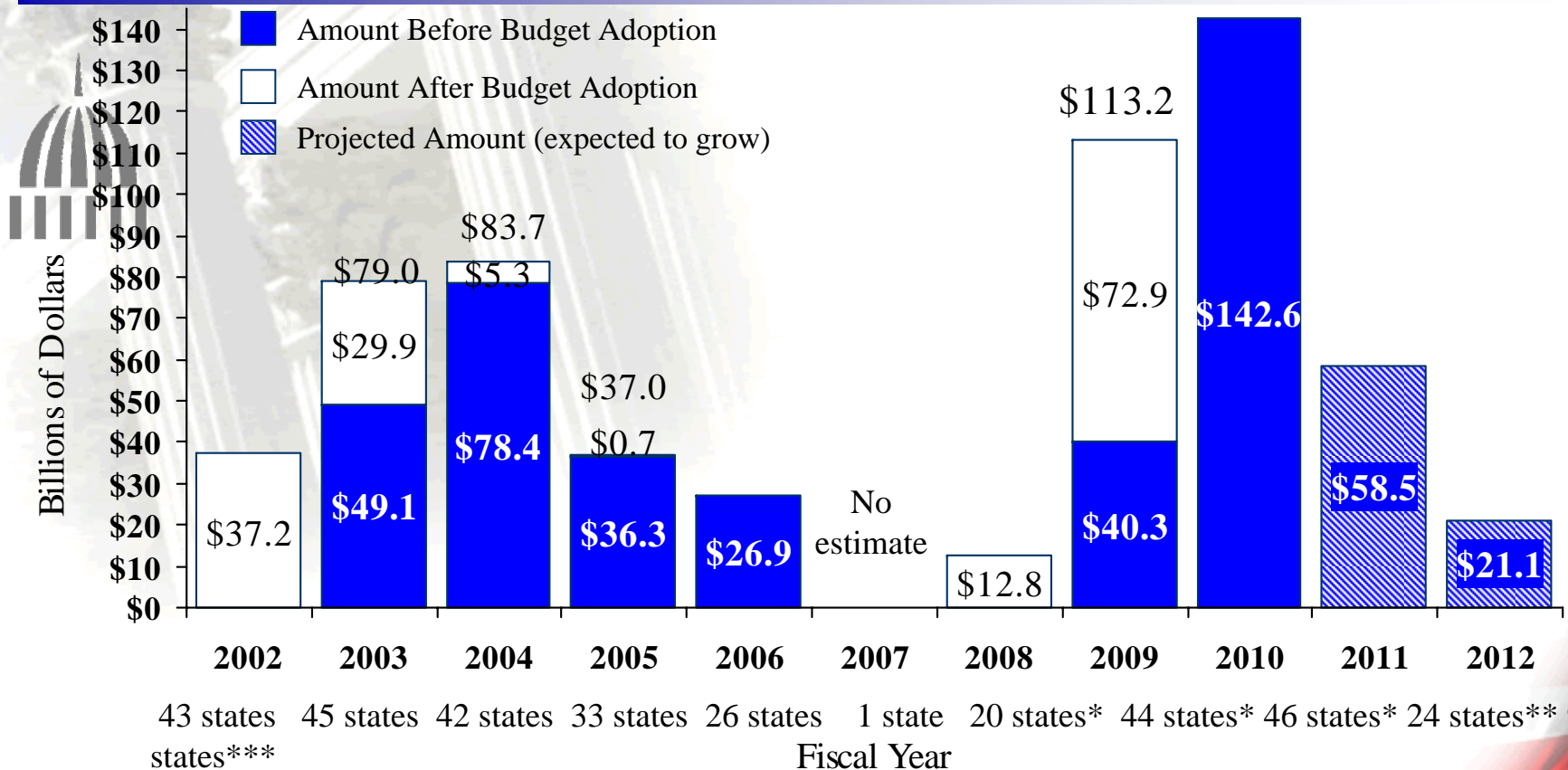
# Federal Outlays for Major Provisions of ARRA Affecting State and Local Governments

(\$ in billions)



Source: Congressional Budget Office

# State Budget Gaps FY 2002-FY 2012 (projected)



43 states 45 states 42 states 33 states 26 states 1 state 20 states\* 44 states\* 46 states\* 24 states\*\* 9 states\*\*\*  
Fiscal Year

\* Includes Puerto Rico

\*\* 31 states and Puerto Rico forecast FY 2011 gaps. The amount shown for FY 2011 indicates the 24 states that provided gap estimates.

\*\*\* 15 states forecast FY 2012 gaps. The amount shown for the FY 2012 indicates the nine states that provided gap estimates.

Source: NCSL survey of legislative fiscal offices, various years

# Current and Past Recession Budget Gap Numbers



Past Recession		Current Recession	
Year	Amount (in Billions)	Year	Amount (in Billions)
<b>2002</b>	<b>\$37.2</b>	<b>2008</b>	<b>\$12.8</b>
<b>2003</b>	<b>\$79.0</b>	<b>2009</b>	<b>\$113.2</b>
<b>2004</b>	<b>\$83.7</b>	<b>2010</b>	<b>\$142.6*</b>
<b>2005</b>	<b>\$37.0</b>	<b>2011</b>	<b>\$58.5**</b>
<b>2006</b>	<b>\$26.9</b>	<b>2012</b>	<b>\$21.1**</b>
<b>Total</b>	<b>\$263.8</b>	<b>Total</b>	<b>\$348.2*</b>

Past Recession: March 2001 to November 2001 (8 months).

Current Recession: Began December 2007 to present (19 months and counting)

\*Preliminary figure (expected to increase)

\*\* Projected figure (expected to increase)

Source: NCSL survey of state legislative fiscal offices, various years.

# Fiscal Summary



- The states are facing a "cliff" once ARRA funding ends.
- State governments will face severe budgetary problems at least 12-24 months after the US recession ends.
- Lawmakers' endurance to resolve massive budget gaps will be tested in the coming years.



# State Update - Maryland

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- In 2007, Maryland raised top rate on income tax, increased sales tax rate and added IT services to close \$1.5 billion gap.
- In 2008, Maryland repealed the services tax and further expanded top income bracket taxes.
- In 2009, commissioned a business tax reform panel to report this year.



# State Update - Utah

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- In 2006-07, Utah followed its tax reform study and dialogue with a reform package that cut the grocery tax and changed income tax from a bracketed system, to a transition two calculation system to a modified flat system by 2008. AGI is starting point.
- Recent revenue projections "hanging in there".



# State Update - Indiana

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- Indiana in 2008 completed a property tax and sales tax reform plan that reduced property tax burdens, and increased the sales tax rate by 1%.
- Follows with permanent assessment caps, tax credits redirected to replace property tax revenue, senior protections.



# State Update - Maine

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- Maine 2009 reform package on income and sales tax followed review.
  - Flattening of rates offers relief for higher income earners. Expansion of sales tax base (rentals, lodging, amusements). Most of base change affects tourism by design.
  - Progressivity retained with new household credit to replace deductions and exemptions.
  - Seniors protected.

# State Update - Nevada

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- Gaming decline, foreclosure crisis, and construction decline hit state hard.
- No personal income or corporate income tax.
- This year, lodging and car rental taxes were increased.
- Payroll tax was increased. Slight sales tax increase 0.35%.



# Looking toward 2010

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- Colorado interim Commission on Long-Term Fiscal Stability
- California Commission on 21<sup>st</sup> Century Economy
- South Carolina tax review panel

Themes: Changing economy's fiscal impact, the role of government, financing it long term.





# Age, Taxes and State Revenue

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Ron Snell, National Conference of State Legislatures



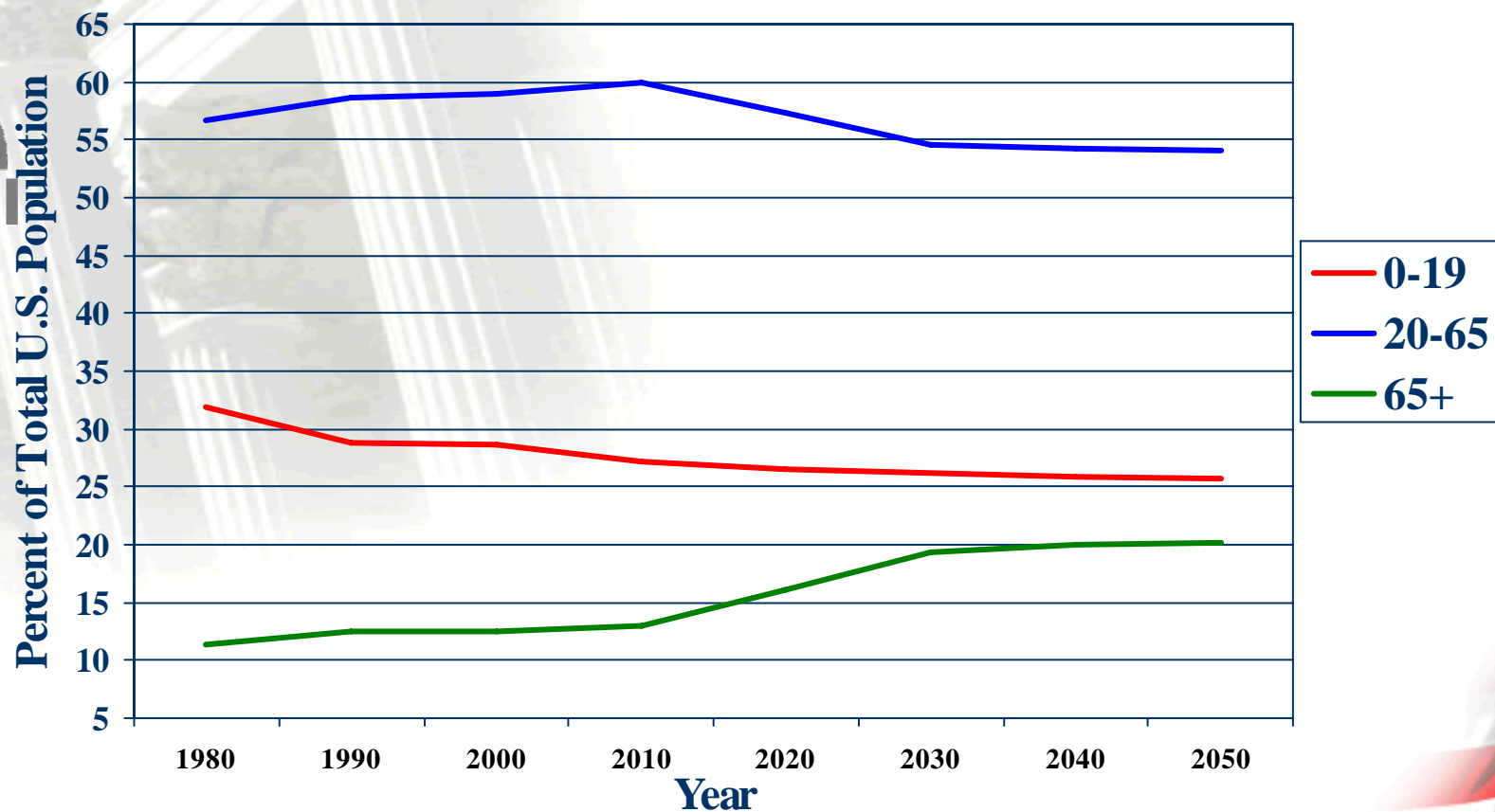
# Major points:

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- Population change will affect state tax policy
- The U.S. population is growing older because of greater longevity and lower birthrates
- One consequence of this will be challenges for state governments that rely on personal

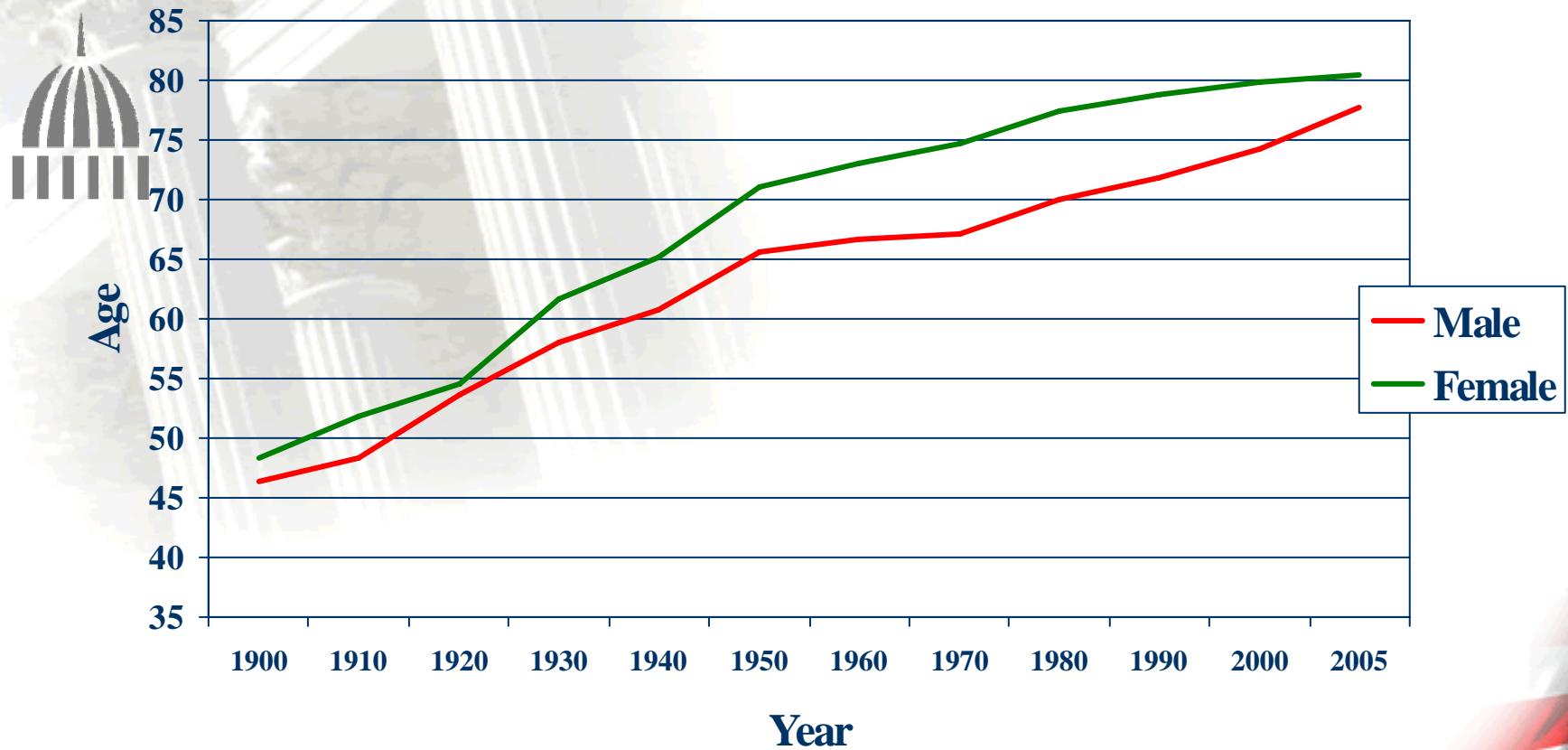
# U.S. Population by Age 1980 to 2050



Source: Bureau of the Census, Statistical Abstract, 2009, Tables 7 and 10.

<http://www.census.gov/compendia/statab/cats/population.html>

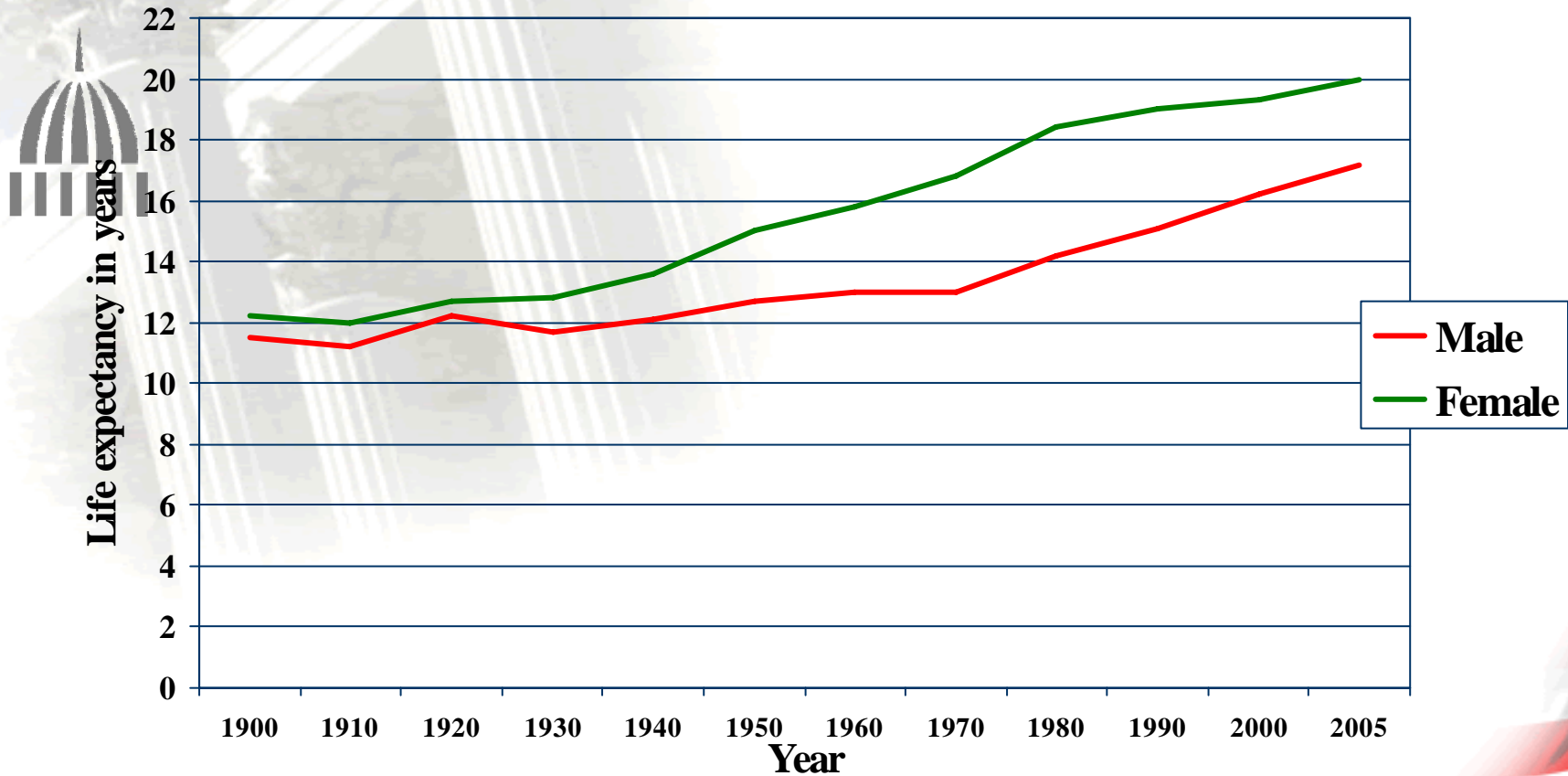
# Life Expectancy at Birth 1900-2005



Source: CDC; [http://www.cdc.gov/nchs/data/nvsr/nvsr56/nvsr56\\_09.pdf](http://www.cdc.gov/nchs/data/nvsr/nvsr56/nvsr56_09.pdf)

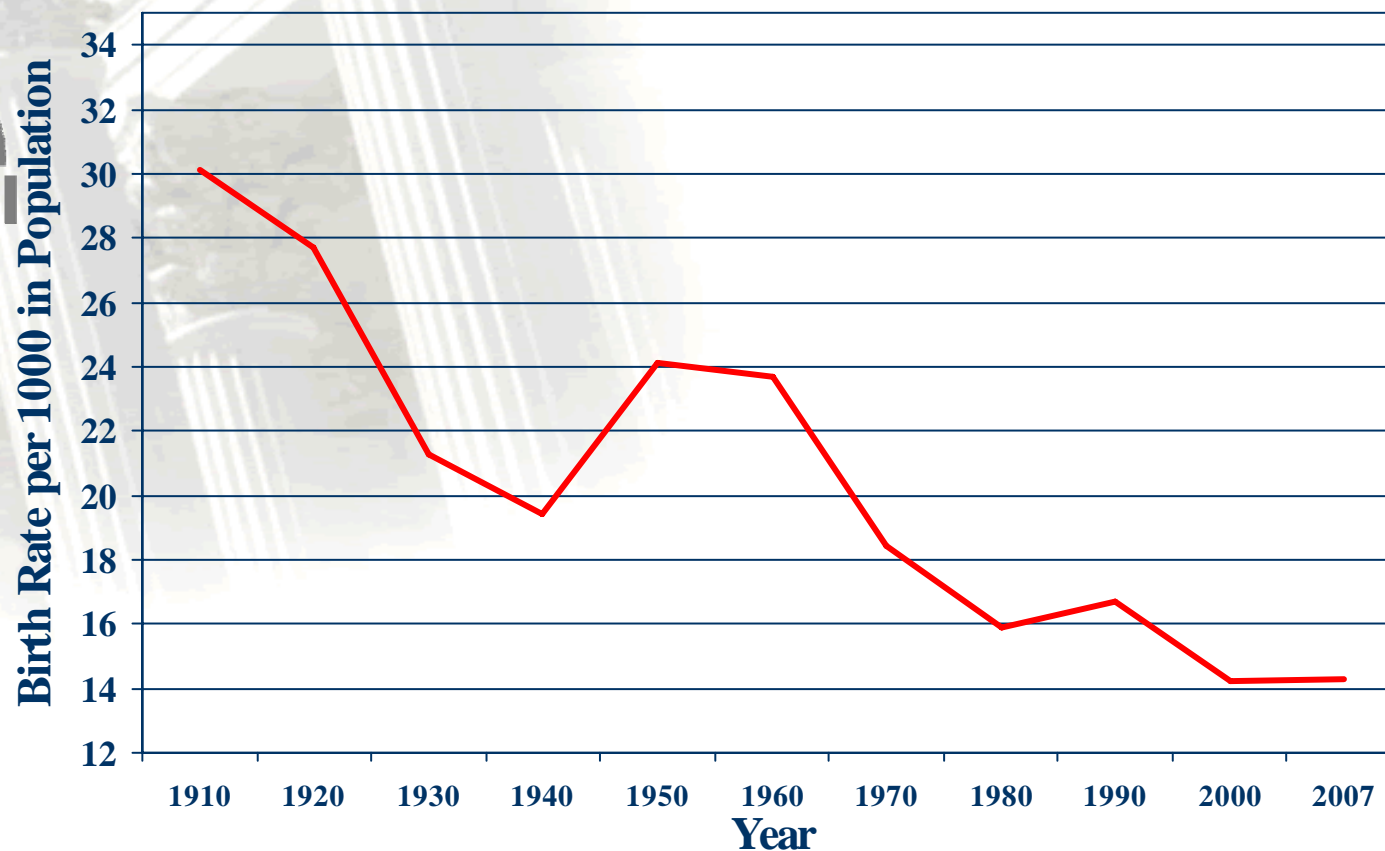
Data for 2005: <http://www.cdc.gov/nchs/data/hus/hus08.pdf#026>

# Life Expectancy at 65 Years of Age 1900-2005



Source: CDC; <http://www.cdc.gov/nchs/data/hus/hus08.pdf#026>

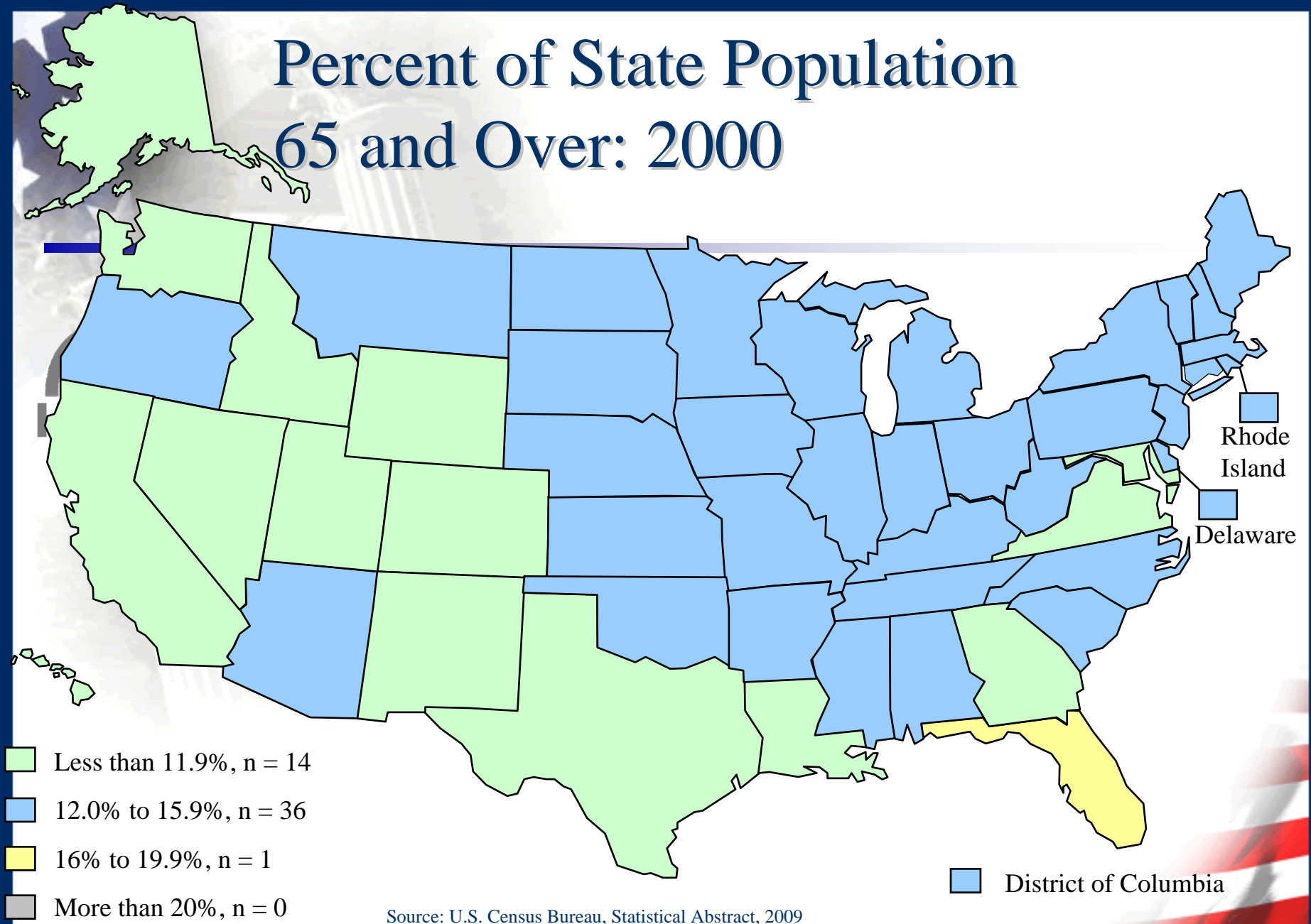
# U.S. Birthrate per 1000 Population 1910-2007



Source: US National Center for Health Statistics, CMMS

2007 Data: same, [http://www.cdc.gov/nchs/data/nvsr/nvsr57/nvsr57\\_12.pdf](http://www.cdc.gov/nchs/data/nvsr/nvsr57/nvsr57_12.pdf)

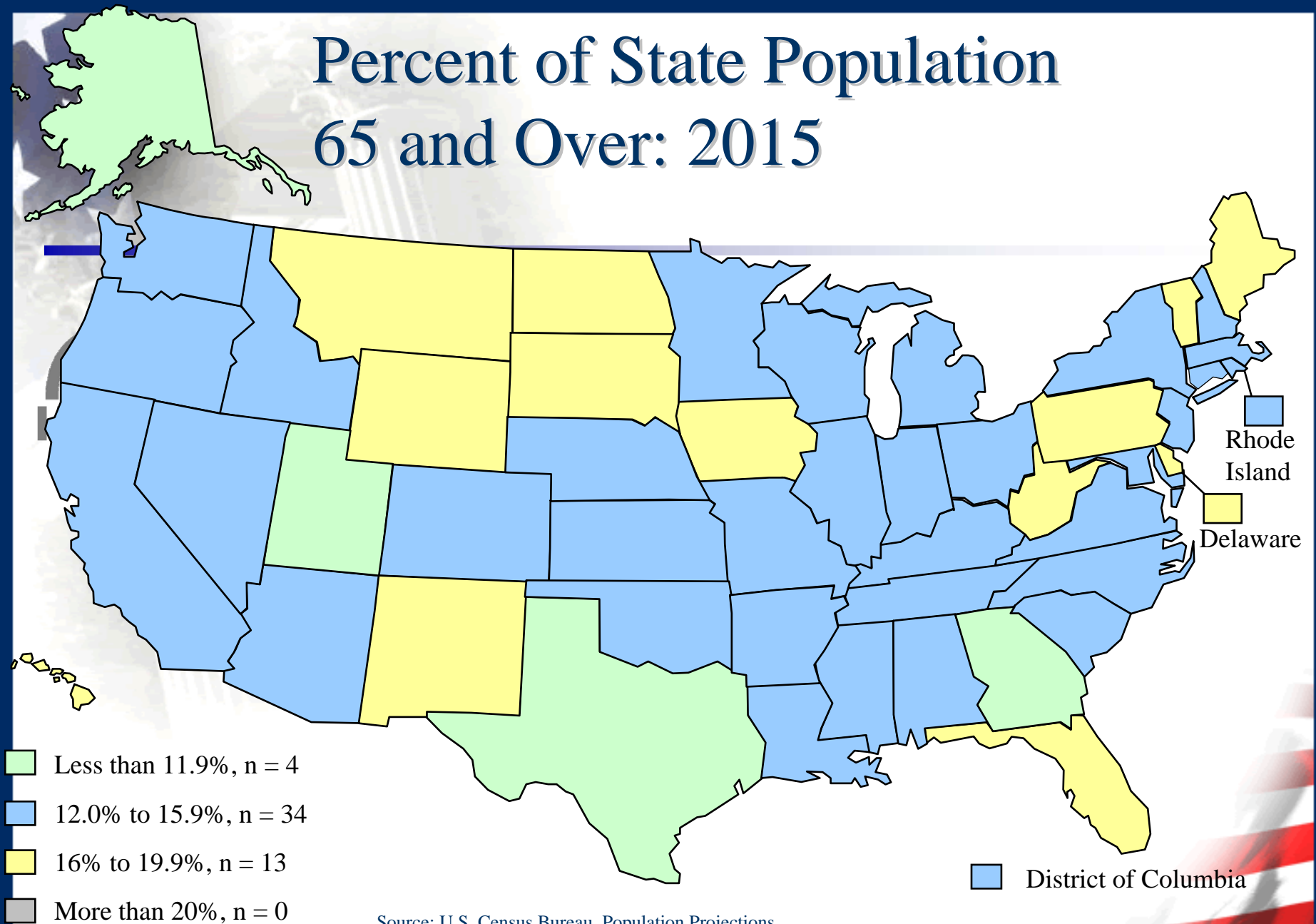
# Percent of State Population 65 and Over: 2000



Source: U.S. Census Bureau, Statistical Abstract, 2009

<http://www.census.gov/compendia/statab/tables/09s0016.xls>

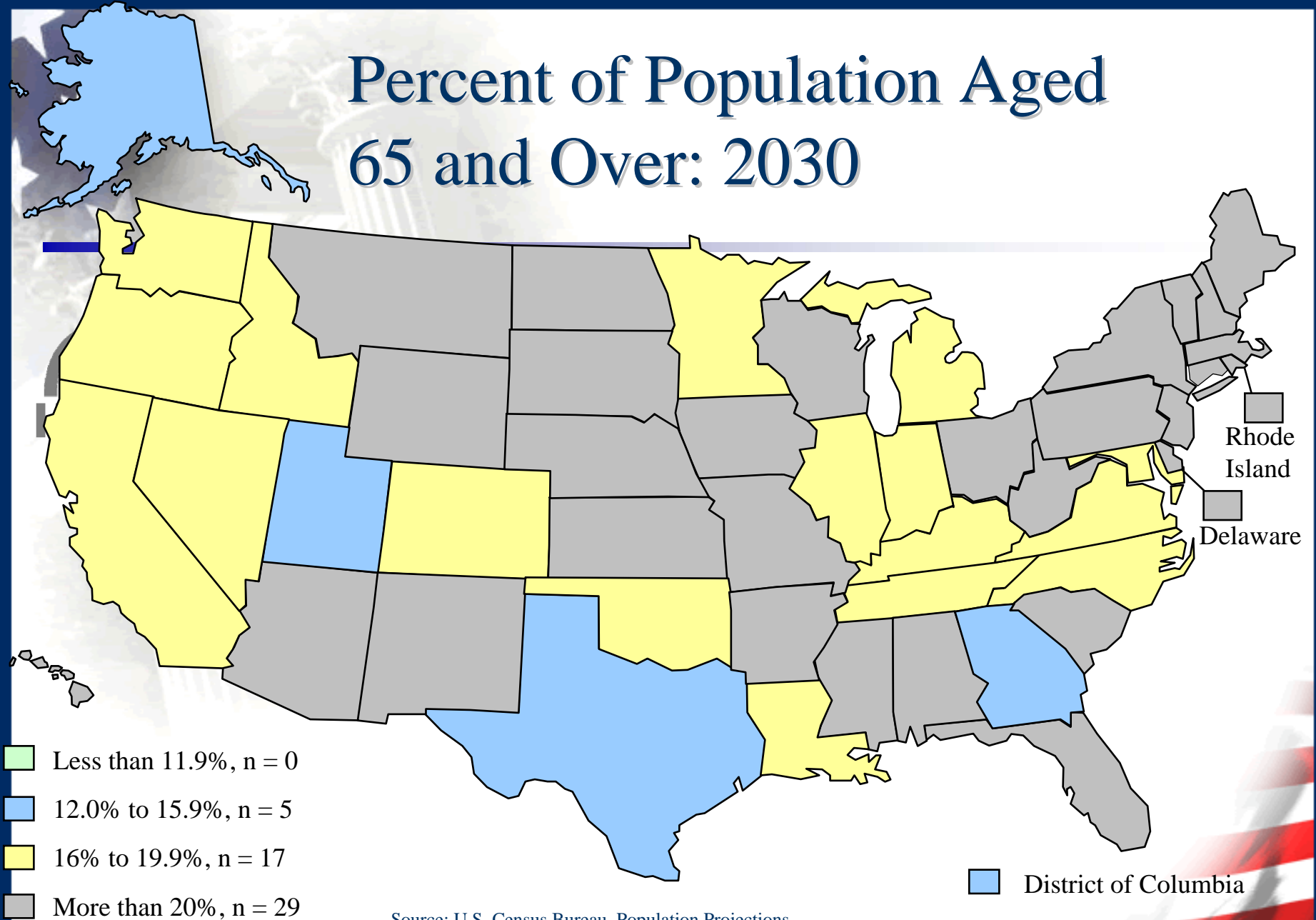
# Percent of State Population 65 and Over: 2015



Source: U.S. Census Bureau, Population Projections

<http://www.census.gov/compendia/statab/tables/09s0017.xls>

# Percent of Population Aged 65 and Over: 2030




Source: U.S. Census Bureau, Population Projections

<http://www.census.gov/population/projections/PressTab3.xls>



# Population and State Revenues

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- How does the fact of an aging population affect state revenues?
  - Both of the major sources of state tax revenue -- the personal income tax and the general sales tax -- will be unpredictably affected by changing demographics



# Spending Patterns for People over 65 Affect Sales Taxes

- People over 65 spend less than younger people on
  - Housing and utilities
    - Cars, travel and restaurant meals
    - Clothing, furniture, appliances, cosmetics, entertainment
- About the same or a little less on
  - Household repairs and maintenance
  - Groceries, books, gifts




# Incomes Fall as People Age, Affecting Income Tax Liability

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## Median Incomes In 2007

Households whose head was 55 to 65 years old:	\$57,386
Households whose head was more than 65 years old:	\$28,305



# Federal and State Government Policy Response




- Federal Policies:
  - Federal government supports major programs for the elderly -- Social Security, Medicare, Medicaid.
  - Income tax policy for the elderly is similar to that for the rest of the population
  
- State Policies:
  - The state share of Medicaid is the principal state income support program.
  - Increasingly favorable tax policy for the elderly.



# Federal Income Tax Policy

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- Federal income tax policy provides a limited additional benefit for people over 65.
    - Additional standard deduction of \$1,400 (\$1,100 for a married taxpayer) over 65 --about 20% more than for those under 65.
    - Up to 85% of Social Security benefits are taxed and the percentage will grow over time.

# State Income Tax Policy Contrasts with Federal

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- Social Security Benefits:
  - Nine states have no income tax.
  - 27 states fully exempt Social Security and Iowa will do so by 2014.
  - Remainder have a benefit equal to or greater than the federal exemption.

# State Income Tax Policy Contrasts with Federal

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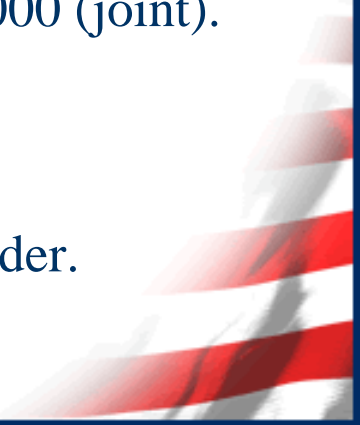
- Some states provide additional age-based tax exemptions for any kind of income, usually with an income test -- the exemption is phased out at higher income levels.
- Most states with an income tax provide additional exemptions for public pension income (state, local and federal), and increasingly for private-sector pensions and individual retirement accounts.



# Aged-based Exemptions-- Examples

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- New Mexico
    - \$10,000 exemption for taxpayers aged 62 and older (\$16,000 for those filing jointly) phased out at higher incomes, ending at \$51,000 for joint filers, \$25,500 for single.
  
  - Virginia
    - \$12,000 exemption for taxpayers aged 65 and older, phased out at higher incomes, ending at \$50,000 (single) or \$75,000 (joint).
  
  - West Virginia
    - \$8,000 exemption for each taxpayer aged 65 and older.
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# State Exemptions for Pension Income





- Ten states fully exempt federal civilian and military pensions and their own state and local pensions from income tax.
- Six states treat them like any other income (including Connecticut, Rhode Island and Vermont).
- Other states' pensions exemptions range from \$2,000 to more than \$40,000 (single).



# Trends in State Taxation of Retirement Income

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- Add or increase an exemption:
    - Georgia exemption increased from \$25,000 in 2006 to \$35,000 in 2008.
    - Iowa adopted a \$24,000 exemption for 2007 and 2008, to grow to \$32,000.
  - Expand a state/local pension exemption to other retirement income—IRA's, 401a's, 457b's and so on.
    - As much as \$84,000 in Michigan
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# What's the Rationale for Such Exclusions?

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- Years ago, state exclusion of public pensions from income taxes was a way to supplement low pensions.
  - Increased exclusions reflect assumption that the elderly have low incomes.
  - Desire to prevent elderly from leaving a state, or to attract them to a state.
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# What's the Rationale for Such Exclusions?


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- First rationale is less applicable.
    - State exclusions have been broadened to far more people than retired public employees.
    - Retirement benefits are increasingly comparable to, or better than, those provided by the private sector.
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# What's the Rationale for Such Exclusions?

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- Poverty among the elderly has declined sharply.
    - From 35% in 1959 to 9.7% in 2007 for those 65 and older;
    - For working-age Americans (18 to 64) the decline was from 17% to 10.9%;
    - For those under 18, from 27% to 18% in poverty.

# States Compete for Retired People




- Attracting the retired population is a means of economic development.
  - Many have resources.
  - They make few demands on state services other than Medicaid.
  - Florida contends that every 2.5 adult in-migrants yield the creation of one job.



# Competing with Tax Policy

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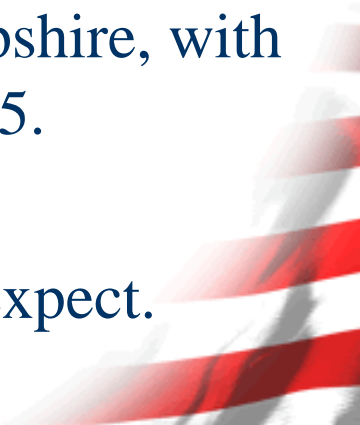
- 
- Florida's neighbors compete to reduce taxes on pensions:
    - Increasing exemptions in Georgia;
    - Repealed in Alabama and Mississippi
  - Northern states reduce taxes to retain retired people.
    - Not clear that this tactic affects decisions about staying home or going somewhere warm.



# Does Tax Policy Affect Choices?

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- 2006 study of Wisconsin (a high-tax state) suggests only the wealthiest are affected and that even on them the effect is uncertain.
    - Wisconsin loses people over 65 to warmer states but also it attracts people over 65 from neighboring states with lower taxes on the elderly.
  - Maine, another high-tax state, according to one study, has a net gain of people over 65 while New Hampshire, with no income tax, has a net loss of people over 65.
  - So, some evidence is contrary to what you'd expect.
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# Tentative Conclusions

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- An aging population will adversely affect tax collections in states that rely on sales and income taxes.
- Tax breaks targeted to the elderly have an uncertain effect on migration.
- They can have an adverse effect on state revenues and equity.