GROWTH & TAXES

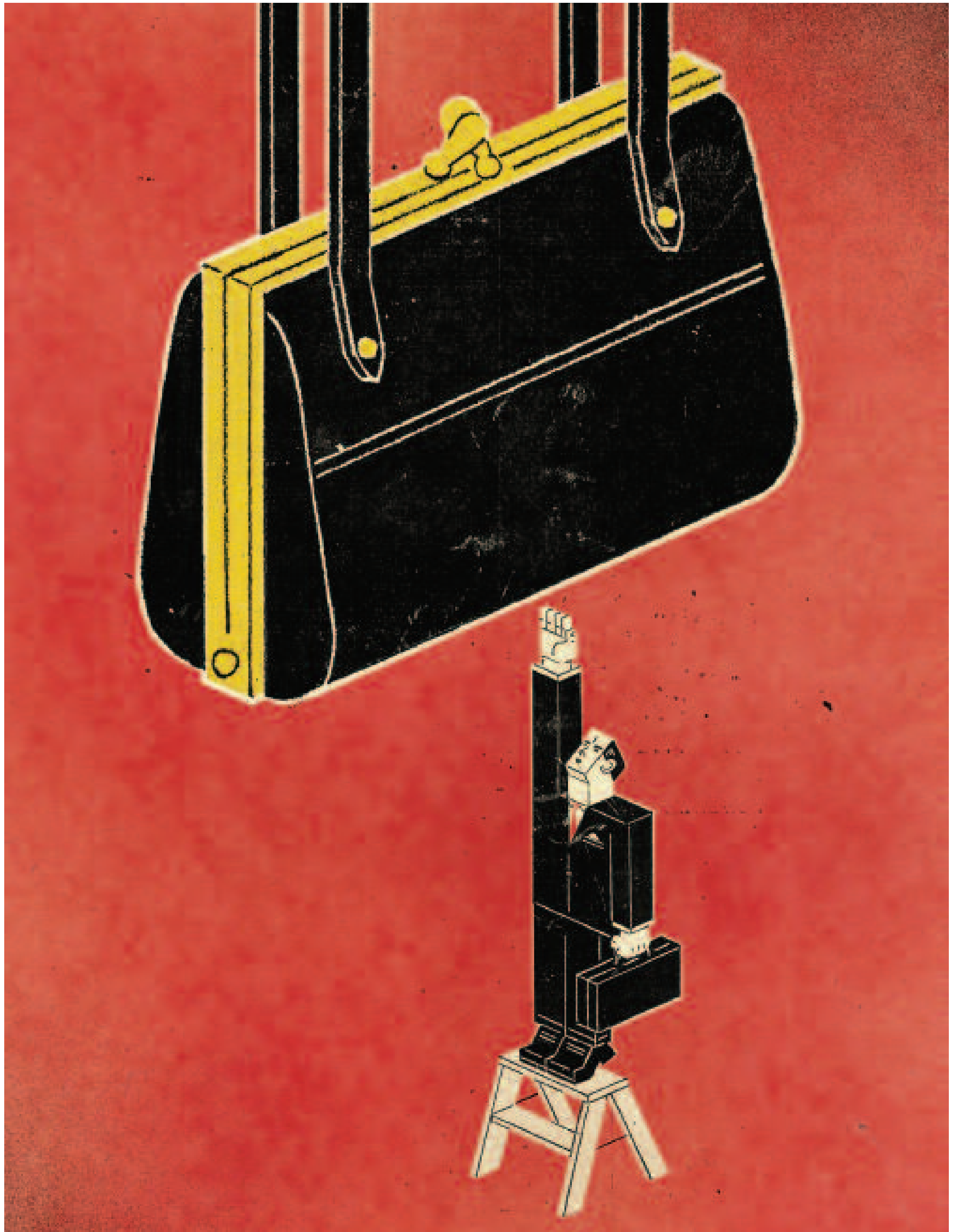
Why outdated state tax systems undercut economic vitality, and what states can do about it.

BY KATHERINE BARRETT AND RICHARD GREENE

It's been known for a long time that obsolete state tax systems are not producing the revenue states need. But what's becoming clear today is that those tax systems are not only failing to keep up with the dramatic shifts in the U.S. economy. They are a drag on economic growth.

The new economy is more than a swing from manufacturing to services. Thanks to new technology and telecommunications, products can be purchased as easily from an outlet 3,000 miles away as from one down the block. Small businesses are increasingly vital—they now account for about a third of the value of U.S. exports. Moreover, the service economy is moving toward a further evolution: It's becoming increasingly knowledge-based. Where managerial and professional jobs accounted for roughly one-fifth of total employment in 1979, such jobs are now moving past the one-third mark.

And yet, state tax structures, developed at a time when computers—



DAVID PLUNKERT

Source: Pew Center on the States, based on data from the National Conference of State Legislatures, the Center on Budget and Policy Priorities, and state documents

"thinking machines"—were the stuff of science fiction, and the American economy flourished with the automobile industry, have failed to evolve. They are "completely inefficient," says Ray Scheppach, executive director of the National Governors Association. They stifle economic vitality by creating an environment that's inhospitable to businesses.

To take one example, there is the outmoded way in which telecommunications companies are taxed. A reliable, high-quality and affordable telecommunications system is essential to the economic competitiveness of states—to say nothing of the nation. And yet, these systems are subject to very high taxation rates in a number of states—by a tax approach set when the industry, dominated by one telephone company, was highly regulated. The result is a damper on the telecom industry. According to a 2004 report by the Council on State Taxation, the average effective rate of state and local transaction taxes for telecommunications services is around 14 percent, compared with about 6 percent for general businesses nationwide.

That's not the only fallout from antiquated state tax systems. They are often unfair—undertaxing one portion of the economy at the expense of others. In many states, for example, a number of services—including things such as tattoo parlors, car washes and gardeners—are free from any sales tax, while tangible goods—things such as pencils, cars and garden hoes—are subject to a higher tax rate to make up for the slack.

Over the past year, the Pew Center on the States has researched the question of how state tax systems can adjust to a new economy in which fundamental business rules have been changing. The report that follows looks not so much at the basic principles of taxation but at specific tax systems and practices that are critical to promote economic vitality.

Those tax systems are no longer a parochial matter of interest to each of the 50 states as an independent entity. That is, the battle for economic growth is not a civil war among the states anymore. It's a world war. The U.S. is already at a huge disadvantage in competing internationally based on cost. Wages in India and China, for instance, are as much as 90 percent lower than those in the U.S. The competitive strengths in the U.S. are in innovation, productivity, marketing and entrepreneurship. All of these things can be either helped or hurt by the nature of the states' tax systems—as can the revenue base, which states need to make the investments necessary to succeed.

"States are aware that their tax structures aren't up to snuff," says Michigan Governor Jennifer Granholm. "The question for us as the state of Michigan, is, 'What is it that is going to make us competitive?' If it's not going to be price, then

Source: Pew Center on the States, based on data from the Federation of Tax Administrators

INFOGRAPHICS BY ERIC MACDICKEN

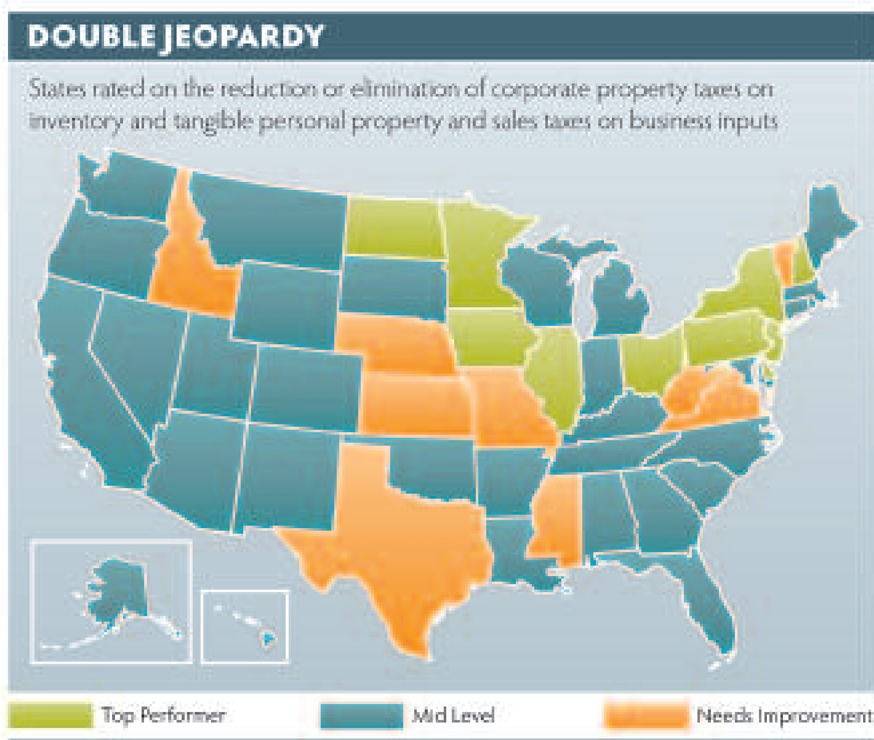
perhaps it's going to be quality, and that means investing in your talent. If you have class sizes of 37, then you're going to be uncompetitive."

Since 2000, virtually every state has commissioned at least one major tax reform panel to study the issue and develop proposals for modernization. Seventeen states now have in place at least an informal mechanism for continuous review of their structures. Much of this action has been propelled by fiscal shortfalls or the realization that various revenue streams are declining relative to spending pressures. In more than a handful of states, the property tax—which has tended to rise inexorably to make up for some of these gaps—has led to citizen rebellions. Both Florida and New Jersey, for example, have been responding to public fury about the property tax by considering major tax restructurings.

The tax questions the states will need to grapple with in coming decades are ones that lie at the heart of the new economy. How can states reshape and modify their tax systems to encourage greater interstate, federal-state and state-local cooperation—and still retain the autonomy of each level of government? In an age of globalization, how do states compete with other countries, yet minimize tax competition among the various levels of government? How do states generate revenues from the intangible products of knowledge-based firms? How do they capture business activity within state borders when borders are increasingly irrelevant in conducting business?

There's a shortage of proven solutions for dealing with a borderless, knowledge-based economy. But some good ideas have emerged—and are already being tested by some states—to deal with the most basic, underlying issue: creating a tax structure that encourages economic vitality.

The material in the pages that follow has been informed not just by predictions of the world to come but by respect for the deep-seated fundamentals of a solid tax system—one that is simple and transparent, with broad-based taxes that provide a balanced revenue stream, spread the tax burden fairly and heighten the chance of compliance.



Source: Pew Center on the States, based on data from Ernst & Young's Robert Cline, Council on State Taxation, Minnesota Taxpayers Association, Federal Reserve Bank of Boston, and state documents

Our research acknowledges the idea that some powerfully held beliefs about appropriate tax policy have little chance of prevailing. For example, some tax policy experts believe there should not be any corporate income taxes, because they raise a relatively small amount of money, are complex and end up being passed along to consumers anyway. Politically, however, it is unlikely that taxpayers will stand for an abolition of the corporate income tax. "Most economists come down saying corporate income taxes are really bad ideas for states," says William Fox, director of the Center for Business & Economic Research at the University of Tennessee. "But then they have to talk about the real world." Similarly, many people believe that tax incentives to corporations are a zero-sum game and potentially unproductive as an economic development tool. But incentives are not going away.

One cluster of questions addresses tactics that pertain to specifics of the new economy: the transition to services; the rapid growth of untaxed Internet sales; the need to encourage newer high-tech industries while not overburdening old-time manufacturing; an adjustment of telecommunication tax rates and complexity to a world in which telecom companies are no longer monopolies; and strategies to tax multi-state and multi-national corporations in a fair way. Those tactics have grown increasingly critical in order to preserve any kind of equity between large multi-state or multi-national firms and smaller, in-state businesses.

Four areas pertinent to vitality in the new economy are examined in the stories that follow. Fifty-state evaluations inform these articles on the transparency of tax incentives, the efficiency of tax collection, the stability of revenue streams and the tax flexibility states allow their localities—which provide many of the key services that support the new economy.

The Rate Debate

Much of the argument over reform has tended to focus on the notion that a tax increase to any segment of the economy will

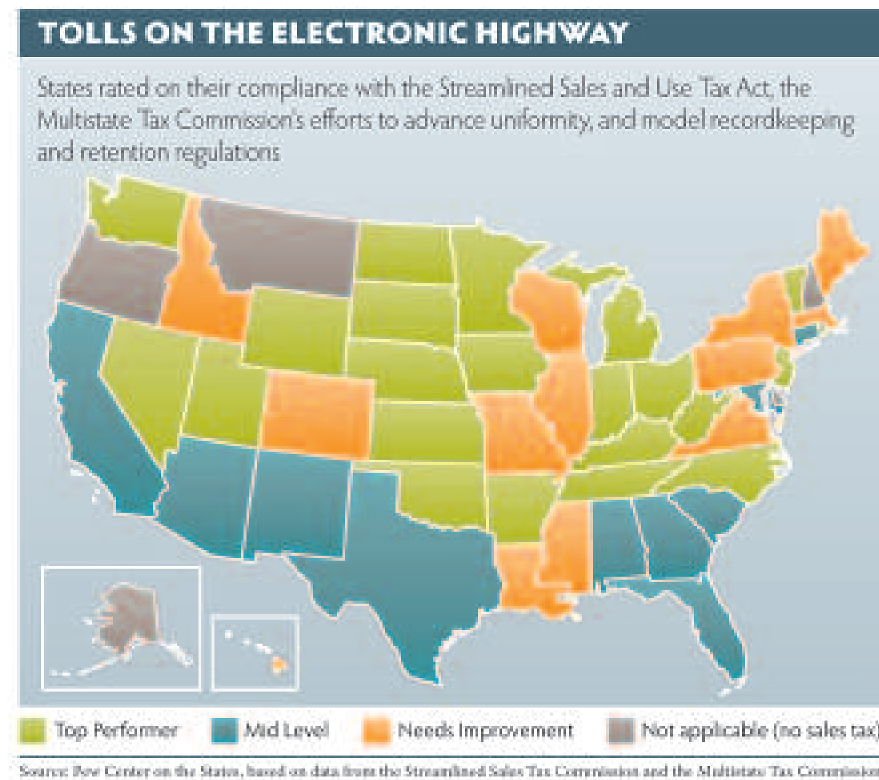
A nonprofit organization, the Pew Charitable Trusts applies an analytical approach to improve public policy and stimulate civic life. The Pew Center on the States (PCS) identifies and advances effective policy approaches to critical issues facing states. This series of articles on state tax systems is based on research by PCS. More data and analysis will be available at www.pewcenteronthestates.org.

drive away business, while a tax cut will do the opposite. This was the point Wisconsin state Senator Alan Lasee made during the 2006 campaign season. "High taxes," he told voters, "are driving our employees and businesses to move to other states for higher paying jobs and lower taxes."

Tax rates doubtless play some role in creating a fertile economic climate—and if all other things were equal, businesses might choose to settle in lower-tax realms. But in the real world, all things are never equal. Some states have better-educated workforces, a better-developed network of roads or nicer public amenities. These elements, all of which require steady flows of tax revenues, are crucial to the equation.

There is now evidence that low tax rates by themselves are not a silver bullet. In his New Economy Index, Rob Atkinson, president of the Information Technology and Innovation Foundation, measures the progress of states in adapting to the new economy by looking at factors such as workforce creation, entrepreneurial activity and patent creation. Five of the eleven lowest-scoring states on his list are among those having the lowest tax burden: Alabama, Montana, Oklahoma, South Dakota and Wyoming. As Tom Clark, executive vice president of the Metro Denver Economic Development Corp. and the Denver Metro Chamber of Commerce, puts it, "If low tax rates were the only factor, Wyoming would be the economic epicenter of the world."

It is theoretically possible to use low tax rates to drive economic vitality. Robert G. Lynch, chair of the Department of Economics at Washington College in Maryland, points out that academic studies on tax rates "suggest that state and local tax cuts and incentives may help economic growth, provided that government services are not reduced to pay for the tax cuts."



Source: Pew Center on the States, based on data from the Streamlined Sales Tax Commission and the Multistate Tax Commission

But as Lynch makes clear, in reality, lower taxes tend to lead to service reductions, some of which inevitably fall in areas that fuel economic vitality. Bruce Johnson, a former lieutenant governor of Ohio and head of economic development for that state, notes that "ground zero for economic development is a high-value workforce." That requires a considerable investment in education as well as in quality of life to enable states to compete effectively in the worldwide market for talent. Then there are investments in R&D at a time when innovation is key to economic development and in infrastructure, including broadband access, bridges, airports and, of course, roads.

Taxing Services

One of the tectonic shifts that marks the new economy is the long-term transition to a service economy. In 2005, service industries accounted for some 68 percent of the total U.S. gross domestic product and 79 percent of growth in the GDP. Yet, only a handful of states tax more than 80 of the 143 or so common services, according to Federation of Tax Administrators' data. "We've ignored services in the past," says Tennessee's Fox. "But with all the new forms of technology available to expand the service sector, that's no longer a reasonable idea."

A number of obstacles stand in the way. The power of interested or affected parties is high on the list. They can and do lobby their legislators effectively. Last summer, a potentially forward-looking reform in Maine failed to pass the Senate largely because a slew of services—everything from haircuts to car towing—would become subject to tax. "Expanding the tax base to consumer services is good tax policy," says George Washington University professor David Brunori, "but the service providers rarely see it that way."

When it comes to the taxation of professional services—such as those provided by lawyers, accountants, financial advisers—things get even tougher. About 20 years ago, Florida attempted a bold experiment aimed at vastly broadening its taxation of services—to professionals and just about every service in the state's economy. When the state's newspapers and magazines realized that meant that advertising would be taxed, they mounted a full frontal assault. The state backed off, the governor suffered politically and ever since there have been very few states with the fortitude to move in the same direction at full force. Only last month, the Michigan legislature repealed a new service tax—mostly on business-to-business transactions but also on such things as manicures and ski lift tickets—just hours after it went into effect.

Even states that consider adding service taxes in a more marginal way have to deal with the knotty problem of taxing business

inputs. The issue is sometimes called pyramiding—at an extreme, a state could tax the services an accountant provides to a law firm, and then tax the services the law firm provides to a car manufacturer, which either builds those taxes into the price of a car or reduces its investments in the state. Most tax experts agree that that placing sales taxes on assets or services purchased by businesses is a form of double taxation and to be avoided.

States are making progress in reducing or eliminating the taxing of business inputs in an arena other than straightforward sales taxes. States that tax inventory and tangible personal property are dwindling in number. Ohio eliminated its taxation of tangible personal property, Indiana is on its way to doing so, and Michigan has enacted a 35-to-40 percent reduction in its tangible property tax.

Meanwhile, the rise of the high-tech and services-based economy has ushered in another trend: The reliance of corporations on customers who are remarkably mobile and geographically widespread. The steadily growing number of sales transactions over the Internet—Jupiter Research Online Retail Forecasts anticipates growth of 10 to 15 percent per year over the next decade—puts local retailers at a disadvantage. Those that sell their wares electronically often escape the sales tax. That, in turn, is contrary to the precept that taxes should be levied over as broad a base as possible so that states and localities can generate the revenue they need at the lowest possible rates.

The biggest obstacle to taxing Internet transactions has been the wide variety of sales tax structures used by the individual states (and their localities), which make it extremely difficult to coordinate a means of taxing them. The Streamlined Sales Tax Project is the clearest effort by states to deal with the complications of this world in which there are virtually no physical barriers to commerce. The ultimate goal of the project is to create an environment in which transactions conducted over the Internet could be easily taxed by states. The agreement would simplify state and local tax returns and the administration of exemptions; it would also provide for streamlined tax returns and a centralized electronic registration system for all member states. Nearly half of the states have made a commitment to either fully or partially comply with the Streamlined Sales and Use Tax Act, which requires uniformity in state and local tax-based definitions and sourcing rules for all taxable transactions.

Catching Corporate Dollars

Even as the technological complexity of the world has advanced, so too has the capacity of large companies to create business forms designed, in part, to shift tax burdens from high-tax states to low- or no-tax states. Many states allege that interstate income shifting amounts to little more than tax evasion, while corporations argue they are legally taking advantage of competing state tax systems. The state courts are divided on the issue, and the U.S. Supreme Court has yet to rule on it.

Source: Pew Center on the States, based on data from the Center on Budget and Policy Priorities, Institute on Taxation and Economic Policy, and state tax databases and documents

As a remedy, states have been adopting combined reporting as a more comprehensive approach to curbing artificial interstate income shifting. Combined reporting forces corporate parents and their subsidiaries to add profits together. This enables the state to tax the percentage of an out-of-state subsidiary's profits that can legitimately be attributed to the corporation's in-state operations. Many big corporations, obviously, are not advocates of combined reporting. For one thing, it closes a loophole that many enjoy. In addition, there are potentially significant compliance costs for companies required to alter their bookkeeping. Despite these drawbacks, there is no evidence that the economies of combined-reporting states have suffered compared with those without combined reporting.

Among the states that don't use combined reporting is Iowa. "Our state," says Peter Fischer, professor of urban and regional planning at the University of Iowa, "loses a pretty big chunk of corporate taxes because of its unwillingness to take on combined reporting." Fischer thinks it may be that people who are simply anti-tax see it as a tax increase. Whatever the reason, it has been proposed in Iowa a number of times, but the legislature has not moved on it.

An aligned area in which states are gaining some control is in taxing a growing array of new business structures. James Edward Maule, a professor at Villanova University's School of Law, was one of the first to study the tax treatment of limited-liability companies, limited-liability partnerships and S corporations. The new entities are similar to corporations but have a more flexible ownership

structure. His initial findings on the tax picture made Maule reflect that they were in a state of "chaos."

Take S corporations. The simple problem is that they pass all their profits through to shareholders and are essentially immune from corporate taxes. These profits are taxed by a state personal income tax imposed on the individual shareholders. There are now some 3.6 million S corporations in the United States. Obviously, this means that whenever a company elects to use this form, the state may lose some revenues—and the problem is even more intense for the nine states that don't tax income.

Like S corporations, limited-liability corporations and limited-liability partnerships are also "pass-through entities"—states generally don't impose tax at the corporate level but instead collect taxes by imposing the personal income tax (if they have one) on individual members and partners.

The chaos to which Maule refers came from states having no model for how to tax these various new business forms that aren't exactly corporations but aren't individuals, either. Without guidance, confusion reigned in the states over how to apply their tax structures to these alien new business forms. Until the states got a handle on the very concept of what these new business forms were, they couldn't properly capture taxes duly owed, if they captured any taxes at all. Fortunately, the states have gained a large measure of control in recent years. There is now a Model S Corporation Income Tax Act that provides states with a template for how to tax S corporations and is endorsed by both the American Bar Association and the Multistate Tax Commission. It gives state lawmakers and tax administrators a way to think consistently about state tax treatment of pass-through entities.

As for LLCs and LLPs, one breakthrough came when states, en masse, determined that they would no longer allow the owners of these new business forms to elect to be classified as one type of entity for federal tax purposes but another for state taxation, which might have given them more favorable treatment. A number of states also now require LLCs and LLPs to withhold taxes on the distributive state share of nonresident members' and partners' earned income. This helps ensure that the taxes properly owed to the state don't slip away as they did in the past.

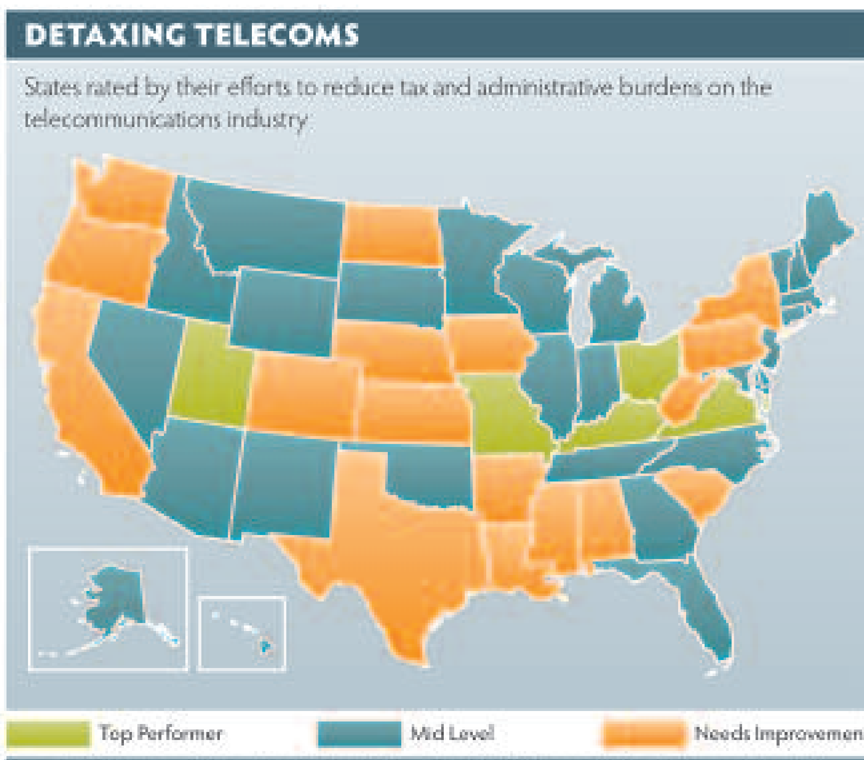
Marconi's Legacy

Telecommunications was once an industry dominated by telephone companies that were monopolies—and states taxed them accordingly. This was a quid pro quo for the lack of competition.

But today's industry is totally different. Not only don't telecom companies have monopolies, there is bitter competition over a business that has changed dramatically from just supplying phone lines to one that permits transfer of data through a variety of technologies—technologies undreamt of when the codes were written. But states continue to apply the old, outdated tax regimes. Only a handful of states have undertaken telecommunications tax reform over the past decade, and in many of those states, the primary reform has been in centralizing return filing.

Telecommunications companies are also hampered by major administrative burdens. Many states still require telecom companies to file more than 500 returns. This area would be another beneficiary of the streamlined sales tax movement, which requires centralized filing and payment of local taxes—including local telecommunications taxes—to the state governments. The agreement also contains uniform telecommunications sourcing rules and definitions. And if the states succeeded in resolving nexus questions for Internet-based sellers, the change would, for the first time, put telecommunications companies on a level playing field with Internet-based companies that sell essentially the same products and services to customers.

These taxing issues are germane not only to the economic vitality of a state but to its compact with taxpayers—be they individuals or businesses. The way in which revenues are raised—the fairness and transparency—is fundamental to the trust constituents have in their government. Right now, most of the states need to modernize their tax policies to encourage growth, and to do that they need to look beyond immediate and purely political considerations. "The biggest problem we have is policy makers making decisions in a vacuum," says Utah state Senator Howard Stephenson. "Overcoming that is crucial to making good tax policy."



Source: Pew Center on the States, based on data from the Council on State Taxation and state tax databases and documents

Katherine Barrett and Richard Greene can be reached at barrettgreene@governing.com

BREATHING ROOM

States that give localities greater leeway to raise revenue help create robust partners for investing in the future.

On January 29, Florida's voters will decide whether to approve a constitutional amendment—sent to them by the state legislature—that would set sharp limits on what the state's localities can collect in property taxes. While end-of-year polling data suggest that the amendment is not likely to pass, the specter of losing $2 billion for schools and yet more dollars for infrastructure, technology updates, public amenities and all the things that attract business, has been a constant worry for cities, counties and school districts.

Tax decisions are always a tradeoff. While the state's beleaguered homeowners would rejoice over any constraints on the much-loathed property tax, there's a downside to removing taxing power from localities: They come up short of money to invest in things that make an economy tick.

"Local governments are a key local economic actor—not just an extension of state government," says Michael Pagano, a dean at the University of Illinois at Chicago. "They need to be nimble in the face of economic circumstances—just like a company does."

Without flexibility, a locality is at the mercy of economic ups and downs and decisions made elsewhere. The locality can't even work with its local business community and taxpayers to craft a system that might best meet all their needs.

Flexibility also is key to global competitiveness, working to attract companies from all over the world and to keep a highly mobile labor force in place. "Any restriction on their ability to raise the money to invest," says Barry Bluestone, director of the Center for Urban and Regional Policy at Northeastern University, "can harm them"—and, by extension, the home state as well.

NOTHING IS SIMPLE

Within the 50 state-local fiscal systems lie different sets of rules for cities, counties, towns, townships, villages—at which point the variation spreads from 50 states to 19,000 municipalities, 16,000 towns and villages and 3,000 counties.

Yet a number of states hold local revenue streams hostage, even though most state andlocal tax experts agree that giving localities greater flexibility or breathing room—with appropriate controls by the state, of course—is solid fiscal policy. They also agree that it can lead, as Bluestone suggests, to more vibrant support for economic development.

Control Room

When a locality has authority over its taxes, it can match its revenue-raising tools to the underlying economy. "If a state imposes a uniform revenue and tax structure on its localities," says Chris Hoene, head of research for the National League of Cities, "it ignores the variation of its localities' economic bases and their diverse spending needs." It is, course, up to each locality to figure out whether a particular revenue-raising tool is worth levying on its constituents—whether the administrative or transaction costs outweigh the amount of revenue the tax would raise.

At the same time, localities with a great deal of flexibility need to be cognizant of how their taxes and rates fit in with those the state is already levying—and make sure that the sum total doesn't create an unsupportable tax burden. Or that different local variations on a single tax don't impose unfair strains on businesses in a state.

That said, flexibility is still key and one way states give cities or counties leeway is through a local option to control the tax rate and to use the revenues they raise as they see fit—that is, without state earmarks. Localities also can breathe better if they have a

range of taxes to use. For a locality to weather economic ups and downs, it can't be overly reliant on any one source of revenue.

Most states limit localities to the property and sales tax as a sources of revenue. A few keep their localities really short of breath, limiting them to one tax source. Cities, towns and counties in many New England states, for instance, have access only to a local property tax. "On its own, reliance on the property tax produces powerful inequities in development," Bluestone says. "Rich communities get rich because they can provide better schools and police protection than communities with stagnant and falling property values."

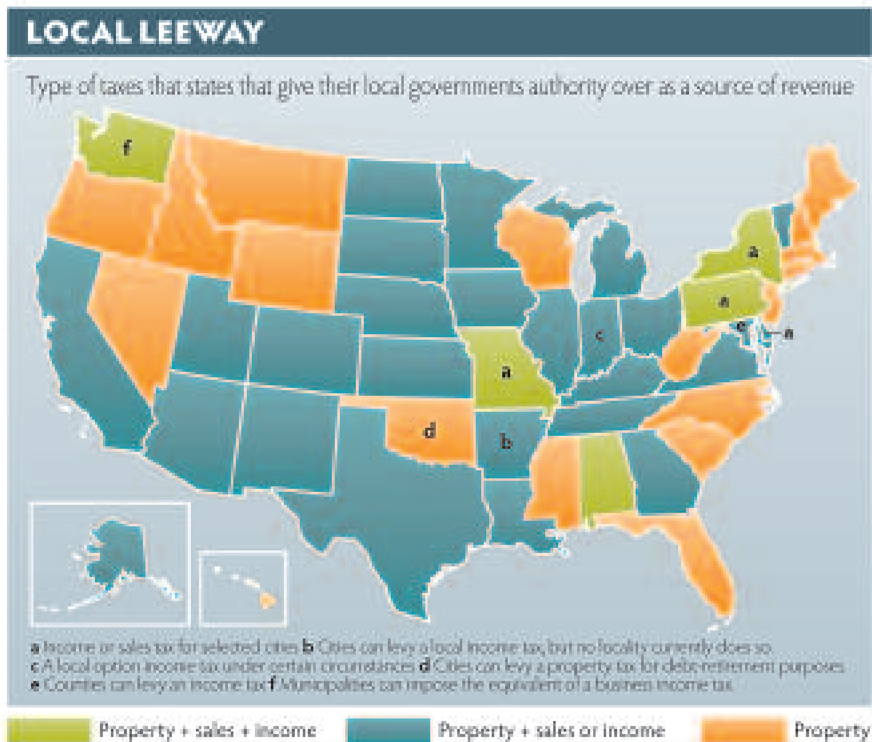
The intersection between local authority and revenue independence is what's known as "own-source capacity." That is, the extent to which fiscal policy decisions made by local government officials actually determine the fiscal direction of the locality. In addition to the tax revenue, there are fees and charges that localities set and that flow into the general revenue coffers. These add to the own-source capacity and enhance a locality's ability to pay for services it wants to provide. This is particularly important in localities that have the primary responsibility for their school funding.

There's another part of the equation, of course. Some states that allow for minimal own-source capacity help to make up for the shortfalls with state aid. While too much state aid can make localities too dependent on the state—and create state budget problems—generally speaking, state aid increases the overall capacity of a local government. In many instances, it provides a level of equalization and base support for localities that may lack other resources. State aid to school districts, for example, often relies on an equalization formula to ensure that the state meets its constitutional responsibility of providing adequate support to schoolchildren.

In Massachusetts, which keeps its localities dependent on one tax, state aid has been used to keep the local communities from diverging dramatically, making up in large measure for whatever inequities are produced by reliance on the property tax.

TEL Talk

Another way that local tax systems are constrained significantly is through tax and expenditure limitations—TELs. There are two main types of TELs: those that put restrictions on revenue raising and those that set limits for overall spending. Spending limits on localities are a good deal less common than tax limits.



Sometimes, TELs are imposed by voters. But state legislatures also do it or, as in Florida, ask voters to approve it. It can, however, be short-sighted. "There's an assumption at the state level," says Kevin O'Brien, former director of the Center for Public Management at Cleveland State University, "that every day is a sunny day and there are no extraordinary circumstances—that you won't need firefighters on the ridge."

For localities, the most common TELs have to do with property taxes. California's Proposition 13 and Massachusetts' Proposition 2.5 are the uber-TELs. They were imposed by voters, and they have made their mark. "Prop 13 turned California from a state that was among the best in primary and secondary education to a ranking in spending that was near the bottom," says O'Brien, who is currently executive director of the Great Lakes Environmental Finance Center. "That is the legacy of their TEL."

The Massachusetts TEL limits towns and cities from increasing the total property tax levy to no more than 2.5 percent of the community's total assessed value (the levy limit) and from increasing the tax levy to no more than 2.5 percent of the prior year's levy limit. "Homeowners felt they were paying enormously high property taxes," says Bluestone. "And that was because the property tax was essentially the only real source of local revenue."

The bottom line, though, is that the TEL makes it much more difficult for cities and towns to raise the revenue they need. "That you can't raise revenue by more than 2.5 percent on existing property is a powerful constraint," Bluestone says. Towns and cities in Massachusetts often ask voters for an override but these are increasingly unsuccessful, leading to cutbacks in schools and social services—"just when," Bluestone says, "these communities are competing like never before for jobs and investment."

For state policy makers, there are obvious policy levers to pull to improve the fiscal and economic vitality of local governments. More local tax authority is perhaps most obvious. Maintaining or increasing state aid levels, particularly where state aid reduces inequities, is another—but one that is often pulled in the opposite direction, particularly in response to economic downturns. Doing so, however, can harm the ability of the state and its localities to recover from the downturn.

BAITING HOOKS

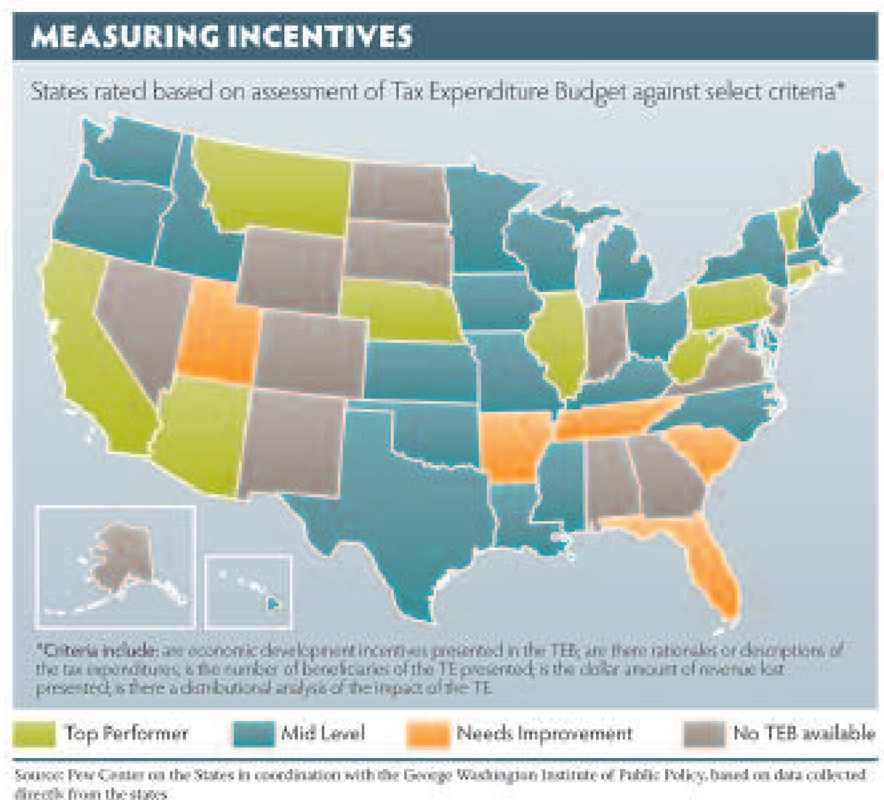
Tax incentives will always be with us, but states are finally keeping tabs on what they're getting for their money.

Tax incentives have long been endorsed as the highway to prosperity—attracting businesses, providing jobs and enriching the state. That's been conventional wisdom in most states and cities.

One problem: Most public finance experts consider them bad policy. Tax incentives that target specific companies create inequities, complications and inefficiencies—and they shrink the tax base. Meanwhile, there's little evidence that targeted incentives bring growth in good-paying jobs. In short, big-ticket targeted tax incentives fail the test of any investment: the presence of a clearly identifiable return.

For some companies, they aren't a major factor. In 2006, when Honda decided to put a $550 million automobile plant in Indiana instead of Ohio, it seemed at first blush that it was tax incentives that won the day for Indiana. In truth, Honda encouraged both states to stay away from pure cash tax incentives. "They needed a 100 percent check-off on what the states could provide in terms of water, sewer, environmental characteristics, roads, bridges and so on," says Bruce Johnson, former lieutenant governor and head of economic development in Ohio. In the end, the deciding factor revolved around Honda's concern that settling in Ohio would have potentially driven up workforce costs for suppliers located there.

Many companies still seek incentives, and it's difficult for states to back away—particularly when there are lots of jobs involved. But there are questions states can



Source: Pew Center on the States in coordination with the George Washington Institute of Public Policy, based on data collected directly from the states

focus on to mitigate the damage: Are the incentives transparent? Is there a look back to see if promises are met? Are there clawbacks—to retrieve the dollars spent if companies fail to hold up their end of the bargain?

Last November, New Jersey passed major legislation aimed directly at providing this kind of disclosure and transparency. Under terms of the new law, companies that receive a subsidy will have to report such things as their job-creation numbers, benefit rates on subsidized jobs, the number of current workers who get health insurance, and the number of subsidized employees represented by a union. "So many companies are more or less gaming the system," says state Senator Shirley K. Turner, one of the bill's sponsors. "This is our way of holding them to their commitments."

The Pew Center on the States, working in collaboration with the George Washington Institute of Public Policy, looked into the 282 tax incentive programs aimed at encouraging investment and job creation in the 48 states that offer tax incentives for economic development. (Alaska and Wyoming do not.) Some of the findings:

- In a dramatic change from a decade ago, every state that offers tax incentives for economic development undertakes one of three forms of incentive monitoring. Some states pre-certify: Before the recipient of an incentive can claim the tax break, it must prove that a level of investment or job creation has been met. In some states, recipients are allowed to begin taking advantage of the tax benefits before investment and job criteria are met, but they must file periodic reports with the state showing that progress on the criteria is being made. And in other states, the government conducts audits of recipients to determine if they are meeting their obligations.
- Eighty percent of states impose a penalty on recipients that do not meet their obligations. A decade ago, almost no states did so. Penalties include repayment of tax benefits received plus interest. In some states, there are fines and damages as well. Over the past two years, for instance, Pennsylvania took enforcement actions against 10 companies that received incentives from the state—recovering about $2.3 million.
- Thirty-two states publicly disclose information about tax incentive recipients—either identifying the recipients, identifying the amounts of tax dollars involved or both.
- Eighty percent of states have tax expenditure budgets, which provide data on the amount of potential tax revenue lost when exemptions or credits are granted. These reports provide information on the total cost, or fiscal impact, of all tax preferences, personal income tax deductions and sales tax exemptions. In practice, however, states vary widely in how much information they provide. California, Connecticut and Pennsylvania provide a great deal of useful information; Florida, South Carolina and several others do not.

Building on the work of tax expert John Mikesell, the Pew-George Washington team categorized state tax expenditure budgets according to various characteristics, including whether the reports are available online and which taxes are included. They also asked questions such as whether there was a description of the tax expenditure, whether the dollar amount of revenue lost is presented, and whether there is a distributional analysis of the impact of the tax expenditure. These criteria were used to rank the states.

PEW CENTER ON THE STATES

Susan Urahn, managing director

PROJECT TEAM

Katherine Barrett and Richard Greene, principal authors

Kil Huh

Lori Grange

Michele Mariani Vaughn

Mary Jo Waits

Jessica Riordan

Emily Cheramie Walz

Kate McMullen

CONSULTANTS

Don Boyd, Boyd Research (*volatility*)

David Brunori and Lori Metcalf, George Washington Institute of Public Policy (*tax incentives*)

Harley Duncan, Verenda Smith and Ryan Burruss, Federation of Tax Administrators (*tax administration*)

Amy Hamilton (*new economy*)

Christopher Hoene, National League of Cities and Michael Pagano, University of Illinois at Chicago (*state and local tax systems*)

RESEARCHER

Karen Cook

ACKNOWLEDGEMENTS

This series of articles also has benefited from the insights and expertise of an advisory panel, and expert reviewers. While these experts provided feedback and guidance at various stages in the project, neither they nor their current organizations necessarily endorse its findings or conclusions.

PROJECT ADVISORY PANEL

David Brunori, Editorial Operations for Tax Analysts and George Washington Institute of Public Policy

Tom Clark, Metro Denver Economic Development Corp.

Gary Cornia, Brigham Young University

Harley Duncan, Federation of Tax Administrators

William Fox, Center for Business & Economic Research, University of Tennessee

David Johnson, Summitville Tiles Inc.

Richard Pomp, University of Connecticut School of Law

Scott Pattison, National Association of State Budget Officers

Scott Peterson, Streamlined Sales Tax Governing Board

Ray Scheppach, National Governors Association

Ron Snell, National Conference of State Legislatures

REVIEWERS

William Fox, Center for Business & Economic Research, University of Tennessee

Dennis Hoffman, W.P. Carey School of Business, Arizona State University

For additional information on the Pew Center on the States, please visit www.pewcenteronthestates.org .

STAYING STABLE

Volatile revenue streams and unpredictable taxes bring misery to everyone from state budgeters to businesses.

"We'd always take a tax cut, of course," says David Johnson, the former chairman of the Ohio Manufacturers' Association. Nothing surprising in those words, but the businessman—he heads a mid-sized tile company in Summitville, Ohio—doesn't stop there. Of even greater importance, he says, "is having a fixed code. If it's going to change every two years—even if it's a change for the better—it's confounding to business plans."

Johnson was deeply involved in a tax reform in Ohio in 2005. A major accomplishment was to replace the state's tangible personal property tax and corporate franchise tax—both of which were perceived as anti-business—with a broad-based, low-rate corporate activity tax, levied on taxable gross receipts from most business activities. Throughout the debate, one focus was on keeping that state's tax system as stable as it has been.

But not all states have been able to keep their focus on stability. The most significant concern for many corporations is the tendency for state legislatures, moved by a variety of causes, to alter their tax policies on a regular basis.

"People who run businesses successfully need to know what the variables are," says Bill Blazar, senior vice president for the Minnesota Chamber of Commerce. If a company wants to expand its factory in Minnesota, its planners would factor into that decision how much more the company would have to pay, say, in property taxes and sales taxes on equipment. "They want to write an equation that leads to profitability," Blazar says. "They have to have certainty that the equation will be true."

Meanwhile, a volatile revenue stream is a problem for governments. It makes it hard to maintain programs and invest for future growth. And that is a concern for taxpayers and the business community as well. "Instability in the revenue base obviously leads to difficult budgeting at certain times," says Michael Allen, director of economic research for Maine Revenue Services. "Government programs that businesses may depend on, such as job training or other economic development programs, can be susceptible to cuts."

Volatility is a close cousin of unpredictability. The distinction is that a highly volatile tax structure—one in which revenues bounce around a great deal from year to year—might be predictable if the factors driving those swings are well understood and are themselves predictable. For example, income taxes are driven in part by stock market capital gains, making them very volatile. They are not very predictable, though, because the market itself isn't and because taxpayers choose when to sell their stocks and realize gains.

One problem with reducing volatility is that the economy gets in the way. A downturn in the business cycle has a negative effect on receipts but rarely reduces the need or demand for government services and programs; an uptick opens the fiscal spigots. Some states are more affected by these cycles than others.

But the economy is just the beginning of the story. As Alison J. Grinnell and Robert B. Ward point out in one of their reports for the Fiscal Studies Program at the Neslson A. Rockefeller Institute of Government, "Even if growth affected all regions and states to exactly the same degree and at exactly the same time, the effect on state revenue would vary because the tax systems used by the states react differently to similar economic situations."

Whatever the cause, the bottom line is the same. "Volatility," says Don Boyd, an independent consultant affiliated with the Rocke-

feller Institute, "has negative effects, whether they're caused by underlying economic fluctuations or by a volatile tax structure."

Taming the Wild Ride

States have tools available to tamp down tax revenue volatility and to ease its impact. They can reduce the overall revenue ups and downs by building a diversified portfolio of taxes, relying not just on a single tax or on a single industry but instead using several taxes, such as an income tax, a sales tax and selective excise taxes. Such a diversified base can sometimes draw a large portion of its revenues from sales taxes, which are themselves diversified among various areas of consumption. Individual taxes imposed on different bases almost never move in lockstep, even in recessions and booms, so their instabilities tend to offset each other partially, reducing the volatility of total tax collections.

In the last recession, many states were clobbered by the sudden downward swing in personal income tax receipts. As the stock market and other investments declined, income tax collections collapsed much faster than the economy, creating large holes in the budget of almost every state with an income tax—even in states such as New York and Colorado that have had moderate tax volatility on average over the long term. Colorado's real per-capita state government tax revenue fell by 12.1 percent in 2002 and by another 7.6 percent in 2003. New York's fell by 5.7 percent and 4.7 percent in these years—despite a tax increase. "Both states rely on very high-income taxpayers for a disproportionate share of their income tax revenue, with highly variable capital gains income and other forms of non-wage income," Boyd points out. "With the right kind of economic conditions, these states have extremely volatile revenue."

The design of individual taxes matters, too. A broad-based tax usually is more stable than one that is narrowly based, and progressive tax rate structures tend to be more volatile than flatter taxes. Choices such as these, made in the interest of tax stability, often conflict with other tax policy goals. One way to stabilize revenue from the income tax, for instance, is to broaden its base and make it less progressive. A flat tax tends to ease volatility. But that stability comes at a cost to low-income taxpayers. With flat-tax proposals, notes Ray Nelson of Brigham Young University in his paper, "State Income Tax Revenue Volatility Causes and Effects," revenue volatility is largely dependent on the definition of taxable income while progressive taxes are dependent on many factors that lead to volatility, such as exemptions, deductions and phase-outs, to say nothing of broader tax brackets.

States have other ways to manage revenue volatility that need not conflict with other tax policy goals, but those, too, have shortcomings. Take rainy-day funds, which are supposed to help states weather the swings in the business cycle. States can withdraw money from the funds during a downturn to help stabilize services and

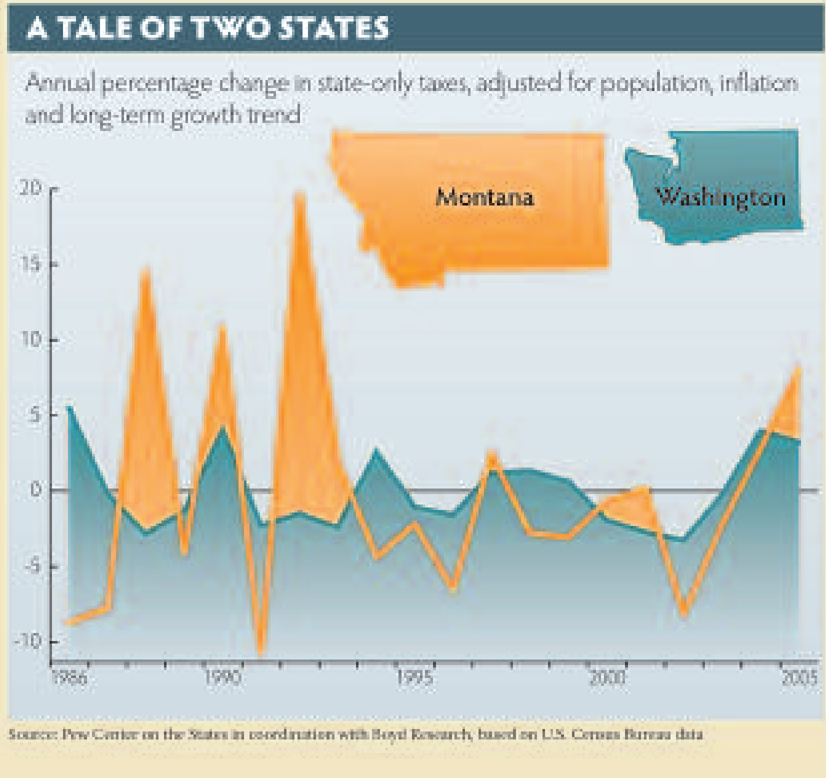
THE BROAD BEAM

The states of Montana and Washington are near the extremes of volatility versus stability. The difference has little to do with the states' economies and plenty to do with policy decisions. Montana relies on severance taxes and they can swing wildly depending on the price of natural resources. It also leans more heavily on the property tax—which it uses for state funding of schools—than does the typical state. It has no sales tax, and it depends on the income tax about as much as the typical state does.

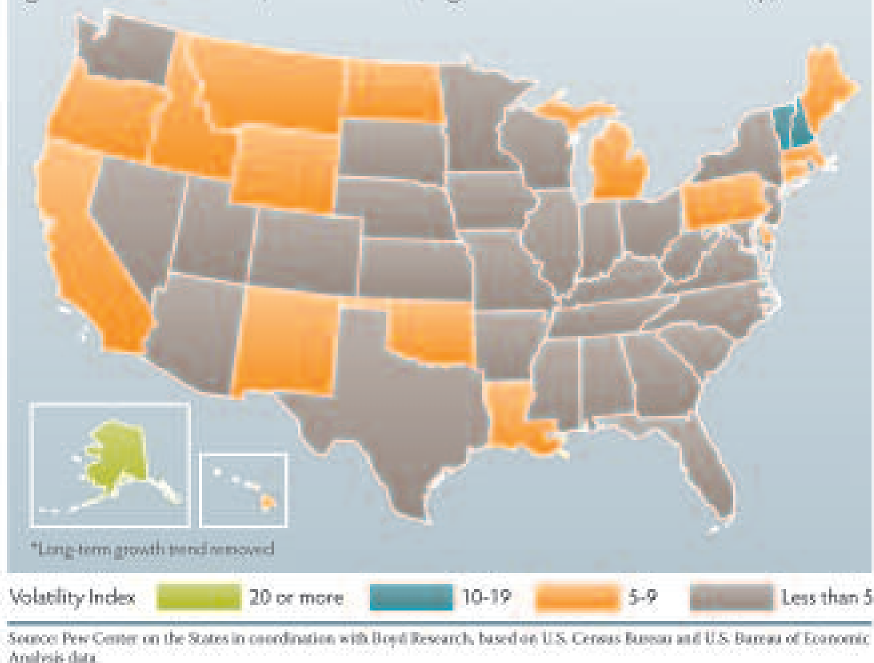
Washington, by contrast, has no income tax and relies disproportionately on the state sales tax. Although this lack of diversity can be seen as a shortcoming for the state's structure—and critics complain that sales taxes weigh too heavily on low-income groups—sales taxes tend to be far more stable than income taxes.

Both states are heavily dependent on a single kind of tax. But Montana is narrowly focused on all the natural resources that back up its slogan, "The Treasure State." Washington's sales tax, on the other hand, is broad-based.

Many of the steepest variations in Montana's revenues occurred in the early 1990s and were related in part to changing choices about how to finance schools. So, the state's revenue streams aren't as unpredictable as they used to be, although they are still more dicey than Washington's.



Source: Pew Center on the States in coordination with Boyd Research, based on U.S. Census Bureau data



SWINGING REVENUES

Standard deviation of year-to-year percentage changes in real per capita state government tax revenue, 1986 to 2005* (larger values indicate more volatility)

Source: Pew Center on the States in coordination with Boyd Research, based on U.S. Census Bureau and U.S. Bureau of Economic Analysis data.

allow orderly policy changes. During recoveries, they can replenish the fund. But several studies have shown that rainy-day funds rarely are large enough to fully stabilize spending during even a modest recession, and establishing funds large enough to achieve this goal would create a new set of political and financial issues.

"Rainy-day funds are great in concept," says Scott Pattison, executive director of the National Association of State Budget Officers, "but rarely are they funded adequately to make a material difference beyond a few projects in any given year." That was certainly the case in Maine during the 2000-01 downturn. The state burned right through its $140 million fund, says Michael Allen, director of economic research for Maine Revenue Services. As to the current fund, Allen says he doesn't "envision that it would be able to solve the problem entirely. It might lessen it."

There's one other problem with a robust rainy-day fund. "Tax collections high enough to allow states to build rainy-day funds large enough to address the falling revenues experienced in the last recession," says Ron Snell of the National Conference of State Legislatures, "would lead to demands for substantial tax cuts."

Someday, states may be able to use pure financial instruments to hedge revenue volatility related to economic volatility, much as businesses now hedge risk related to exchange rates, interest rates and the prices of specific commodities. The advantage of these instruments, if they become available, is that they would not require states to skew their tax policies to achieve stability goals. This benefit, however, would come at the price of, in essence, purchasing a revenue insurance policy. Then if revenue (or the underlying economy) performed as expected, the money paid for the equivalent of premiums would be gone forever.

Rating the States

Volatility results in large part from state policy choices. Since sharp shifts in policy can be a deterrent to economic activity, they have been included in the volatility index for assessing the states on the stability of their revenue.

Researchers generally have used several broad approaches to defining and measuring volatility, such as large or frequent year-to-year changes in tax revenue, large and persistent deviations in revenue from long-term trends, tax revenue that changes rapidly in response to economic changes and tax revenue that deviates substantially from the amount predicted.

Overall, the assessment found that almost every state had at least a 15 percent reduction in volatility due to diversification of its taxes—the portfolio effect—and that three-quarters of them had a benefit of 26 percent or more. In Arizona, for example, the tax-by-tax volatility indices for the individual taxes were 6.8 for income tax, 3.3 for sales tax, 5.7 for nonproperty taxes. Yet, the state's overall tax volatility measure of 2.8 was about 50 percent lower than the tax-share weighted average—a nearly 50 percent reduction in volatility due to diversification.

A state such as Oregon, on the other hand, relied on the individual income tax for about 67 percent of its tax revenue over the time period examined—more than any other state. And it had the 7th most volatile state tax system with a volatility index of 7.0 compared with the median of 4.3. Washington, meanwhile, relied on the sales tax for 60 percent of its tax revenue—more than any other state—compared with 32 percent for the median state. Yet over the 20-year period examined, Washington's state tax revenue was the least volatile in the nation. So despite the general rule that relying on a single tax can lead to great volatility, for this period, when income taxes were particularly volatile, Washington's sales tax-dependent revenue was relatively stable.

The general rule remains, however: A diversified tax base generally is more stable than a non-diversified base. In the wrong kind of recession, a state like Washington's revenue could be hit especially hard. Still, three of the other four states that relied on the sales tax for more than 50 percent of their tax revenue—Florida, Tennessee and South Dakota—had below-average tax volatility over the 1986 to 2005 period. Only Nevada, among the states heavily reliant on sales tax, had above-average volatility.

Even states with "low" volatility are likely to find in the next recession that they have far too much of it. The goal in crafting a tax structure is to put together one that works in tandem with other counter-cyclical fiscal devices. That will help a state weather broad economic downturns and take advantage of upswings. It will also help taxpayers, particularly business taxpayers, rely on the tax structure to plan for the future.

PLUGGING LEAKS

A tax policy is only as good as the systems that collect the taxes and make it simple for people to pay them.

Fifteen years ago, when a new business tried to put down roots in Kansas, the business owner had to mail in a paper registration and wait to be assigned a registration number. "It would take two or three weeks," says Steve Stotts, the state's director of tax operations. Now, thanks to reforms in the administration of the tax system in Kansas, a start-up business can register in 15 minutes.

States have been trying various ways to simplify collection and lock in compliance. The basic kit comes with five important tools: the effective use of the audit process, interstate cooperation, e-service offerings, a timely and fair appeals process and taxpayer buy-in to the design of the system and its administrative procedures.

Automating the Audits

Field audits of businesses can be unpleasant, especially for smaller firms with minimal access to professional tax guidance. The solution for many states is greater use of technology.

In some states, however, there's corporate resistance. In Mississippi, for instance, about 60 percent of companies are willing to provide the information electronically but that's only "after discussion and assurance that we are going to protect their data and not mess up their system," says Shelton Vance, director of audit and compliance in Mississippi. The other 40 percent make it difficult to obtain their information electronically or simply don't have their data in an electronic form.

Fortunately, there are ways for states to stretch their audit dollars by using so-called "limited audits," that look only at specific issues within an industry. Want to audit cash-related transactions? In Michigan, auditors aim right at restaurants—an industry that is known to be particularly susceptible to cash skimming.

Pennsylvania is trying a different low-cost approach: moderating its tone. When taxpayers are alerted to an audit, the letters, says Robert Coyne, deputy secretary for compliance and collections in Pennsylvania, "let taxpayers know exactly what we're looking for. They are more descriptive as opposed to threatening." In addition, Coyne's office does outreach and education so taxpayers understand the requirements. The benefits have been tangible. "People who got letters, read them, understood them, became compliant," says Coyne.

DIGITAL DIVIDE

One caution about the rush to e-service: There are taxpayers who don't have access to computers. "We can't leave those people and businesses too far behind," says Virginia's Tax Commissioner Janie Bowen.

The E of Collection

Through one model or another, all the states are doing e-collection of taxes—even electronic filing for sales and business taxes are coming into their own. Six states—Nevada, New Jersey, New York, Pennsylvania, Tennessee and Virginia—already have fully electronic systems that assign, track, complete, review and transmit audits.

So is it time for most of the states to declare victory? Not likely, according to a 50-

state survey by the Pew Center on the States in collaboration with the Federation of Tax Administrators. Some states keep coming up with new and important improvements.

New York State's Online Tax Center has a system that allows taxpayers to use the Web and set up a pay plan, file a "no sales tax due" return, apply for a penalty waiver, look up rates, register for the sales tax, fill in forms and print out returns that can't be e-filed. "When you enter this tax center," says Pat Mitchell, chief financial officer of the New York State tax system, "we can customize it so it's all about you." The system can help taxpayers make estimated tax payments and access records and assessments that are due.

The ability of a taxpayer to work hand in hand electronically with a state tax department is the way some states are going. About one-third now allow taxpayers to send and sometimes receive an account-sensitive e-mail through a secured e-mail system, although sometimes the e-mail must originate through a state portal or agency Web site, for security reasons.

Virginia and Michigan not only put a great deal of information into taxpayers' hands, they do the same for state employees who assist taxpayers—from customer service agents to auditors. These employees have access to calls, e-mails, notice responses, electronic returns, and even hard copies of documents that have been scanned.

Talking to Taxpayers

Is anybody listening out there? If not, a tax agency runs a high risk of repeating its mistakes or missing good ideas from the most knowledgeable sources of all—the companies and individuals who interact with the tax system on a daily basis.

Some states routinely sit down and have heart-to-heart talks with their taxpayers about what's working well and where they are falling short. Ohio hosts a large annual tax forum that covers both educational and administrative matters. North Dakota favors simple annual meetings with CPAs to discuss current matters.

North Carolina has reached out to neighborhoods. It used graduate students at Duke University to come up with recommended courses of action to improve compliance within North Carolina's immigrant community. The Department of Revenue then developed a strategy based on this work and hired a liaison to the Hispanic community.

Washington does a biennial taxpayer satisfaction survey, an independent study conducted by a neutral party, as well as Small Business Forums. When the office learned that the due date for returns for monthly filers was difficult for taxpayers to meet, it moved the date to a more amenable one.

While several states favor focus groups, the ultimate listening tool may be monthly and quarterly forums set up with chambers of commerce, industry groups, taxpayer representatives and policy or audit advisory groups.

Mutual Aid

With appropriate interstate cooperation, states can leverage their resources to address such multi-state issues as shared debtors or scofflaws.

New Mexico, for example, has partnered with the tax authorities from the Navajo Nation and the Arizona Department of Transportation to conduct joint audits on retail gas stations. While the audits are ongoing, the joint effort has been uncovering non-filers who would otherwise have slipped between the cracks.

New Mexico is also tackling regional issues by joining with Texas, California, Arizona, Oklahoma and the IRS to form the Border States Caucus. An independently organized team, it works with the Mexican government to deal with tax, motor vehicle and regulatory problems that flow out of the implementation of NAFTA.

An Appetite for Appeal

Much of compliance depends on giving taxpayers a fair shake at contesting decisions of the tax department. One of these is the ability to appeal without having to pay the assessment or a bond (called "pay to play"). This has been the subject of much reform. The other is ready access to a body that is independent of the tax administration agency.

A tax court or tribunal shouldn't report directly or indirectly to the department of revenue or to any subordinate executive agency. The logic here is pretty obvious: Executive branch agencies can be perceived as wanting to collect more taxes in order to balance the budget. Texas, for example, had placed responsibility for this function in the comptroller's office for years. Last year, the state moved it to an independent office of administrative hearings. "It is imperative," says Comptroller Susan Coombs, "to remove any appearance of bias and ensure that the integrity of the hearing process is beyond question."