TAX FOUNDATION

TAX FEATURES

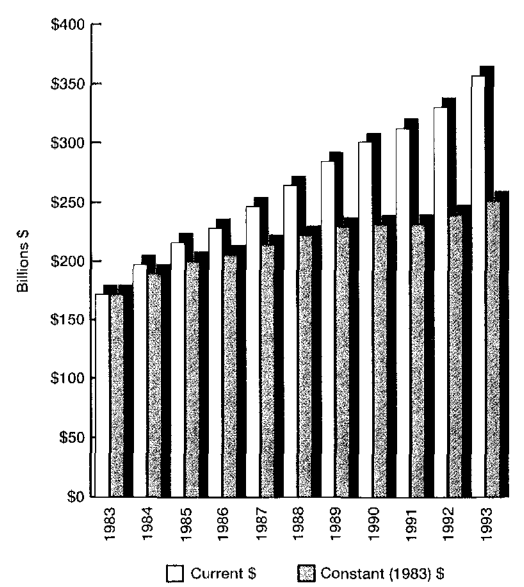
January 1994 Volume 38, Number 1

State Tax Collections Jump 4.9 Percent in 1993

Tax Receipts Grew Nearly Two Times Faster than Personal Income

States increased total tax collections an inflation-adjusted 4.9 percent from FY 1992 to FY 1993, according to a new study by the Tax Foundation, constituting the largest annual increase in state tax receipts since 1985 (see *Charts 1* and *4*).

Chart 1
State Tax Collections 1983–1993, Current and Constant (1983) Dollars



Source: Tax Foundation.

In his latest *Special Report,* titled "State Tax Rates and Collections in 1993," Dr. Arthur Hall notes that from FY 1992 to FY 1993 state tax collections grew 3.7 percentage points (or 1.7 times) faster than personal income. In comparison, between 1983 and 1993 state tax collections grew at an inflation-adjusted annual average of 1.1 percentage points (or 1.4 times) faster than personal income.

Between 1992 and 1993, Alaska (a special case because of oil drilling) saw the highest tax growth relative to personal income growth, followed by Mississippi, Colorado, North Dakota, and Tennessee. In contrast, Nebraska, Idaho, Pennsylvania, West Virginia and Montana constitute the top five states where personal income grew faster than state taxation. (If Washington, D.C., were a state, it would rank third, ahead of Pennsylvania. See *Chart 2*.)

Among those state taxes and fees that saw the fastest revenue growth between 1992 and 1993 were property taxes (22.7 percent growth), corporate income taxes (13 percent), public utility taxes (12.8 percent), severance taxes (10.9 percent), and license fees (10.6 percent). In contrast, state collections from

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1993 State Tax Collections Rose at Rapid Pace

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insurance-premium taxes (1.3 percent), tobacco taxes (1.9 percent), and alcohol taxes (3.7 percent) saw the least amount of growth.

In FY 1993, almost a third of state tax collections (32.3 percent) came from general sales and use taxes, and another third (31.9 percent) stemmed from individual income taxes. Others sources of state tax receipts in 1993 included corporate income taxes (6.8 percent of the total), licenses (6.7 percent), and motor fuels taxes (6.6 percent). All other taxes accounted for 15.7 percent of receipts. (See *Chart 3*.)

In addition to showing the growth in total tax collections, Dr. Hall offers a snapshot of changes in various statutory tax rates for the 50 states and the District of Columbia. Most changes in 1993 were aimed at cigarettes and gasoline: 16 states increased their tax rate on cigarettes (Montana decreased its rate) and 13 states increased their tax rate on gas. But while this continues a trend among states to try to extract increasing amounts of revenue from the consumption of these two commodities, actual revenue from cigarette and gasoline excise taxes have shown relatively slow growth compared to other types of taxes.

In 1994, only Ohio appears likely to seek new revenue by raising personal income tax rates, adding a top rate of 7.5 percent to its previous top rate of 6.9 per-cent. Missouri may be the only state seek-ing new revenue by increasing its statu-tory corporate income tax rate, raising the top rate from 5 to 6.25 percent.

The following states can lay claim to the highest tax rates this year:

• Individual income tax: California and Montana, with top rates of 11 percent. (Massachusetts has a 5.95

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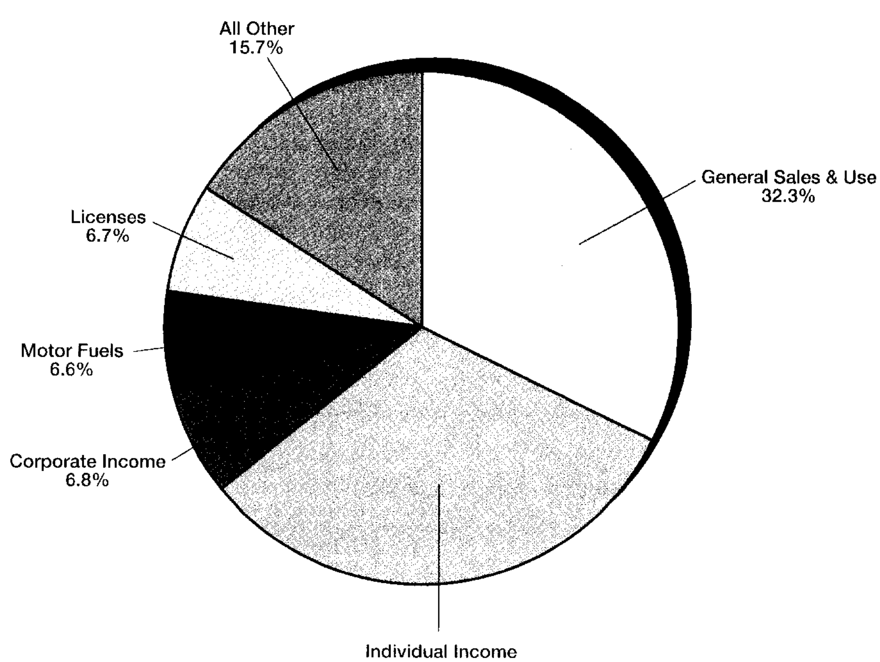
Chart 3
Distribution of State Tax Collections by Source (Fiscal Year 1993)



Source: Tax Foundation.

Chart 2
Average Annual State Tax Growth vs. Personal Income Growth 1992-1993

	Taxes* Relative to Personal Income	Tax Burden Per Household
Alabama	6.8%	$ 3,097
Alaska	38.1	11,223
Arizona	6.5	3,689
Arkansas	3.1	3,285
California	2.0	4,451
Colorado	22.9	3,417
Connecticut	7.4	5,393
Delaware	1.0	5,471
Dist. of Col.	-4.5	10,456
Florida	6.2	2,965
Georgia	4.6	3,225
Hawaii	-1.8	7,559
Idaho	-5.3	3,840
Illinois	-1.0	3,308
Indiana	1.9	3,325
Iowa	6.9	3,782
Kansas	12.7	3,433
Kentucky	-0.7	3,755
Louisiana	-0.4	2,898
Maine	1.0	3,593
Maryland	6.8	3,957
Massachusetts	1.0	4,499
Michigan	-0.9	3,362
Minnesota	4.2	4,884
Mississippi	26.8	3,554
Missouri	8.6	2,891
Montana	-3.3	3,123
Nebraska	-8.1	2,995
Nevada	2.4	3,994
New Hampshire	2.6	2,103
New Jersey	-1.7	4,638
New Mexico	5.1	4,399
New York	1.3	4,750
North Carolina	-3.3	3,509
North Dakota	13.9	3,725
Ohio	3.0	3,135
Oklahoma	4.8	3,450
Oregon	0.1	3,137
Pennsylvania	-4.1	3,587
Rhode Island	4.5	3,559
South Carolina	1.7	3,192
South Dakota	4.6	2,386
Tennessee	13.8	2,848
Texas	0.5	2,841
Utah	2.8	3,936
Vermont	-2.2	3,585
Virginia	-1.9	3,024
Washington	-1.5	4,526
West Virginia	-4.0	3,475
Wisconsin	7.0	4,200
Wyoming	4.7	4,241
State Average	3.7%	$3,737

* Percentage change in tax receipts less percentage change in personal income.

Source: Tax Foundation.

Background Paper Published

Foundation Examines Taxation of Business Hedging

The taxation of business hedging has been a contentious issue for six decades, but Congress now has a unique opportunity to resolve the existing tax problems inherent in the Internal Revenue Code, according to a new monograph written by Tax Foundation Special Tax Counsel J. Dwight Evans.

Mr. Evans, formerly Assistant General Counsel for Mobil Corporation, notes in his analysis that the initial problems started in 1934 when Congress, in changing the definition of "capital asset," failed to deal with a basic question: Are gains or losses realized in a hedging transaction considered "capital" or "ordinary" in character? "The answer to this income tax question is vitally important in realizing the economic objective of the business hedge to manage business risks," says Mr. Evans.

As explained in the monograph—titled "A Critical Analysis of the Taxation of Business Hedging and the Case for Comprehensive Legislation"—a hedge involves a counterbalancing transaction designed to reduce or eliminate the risk of loss in another business transaction. The income from this underlying business transaction is taxed as ordinary gain or loss. For the business hedge to accomplish its counterbalancing objective after tax, says Mr. Evans, the gain or loss from the hedge should likewise be ordinary in character. "Otherwise there may be a mismatch in tax results because, under the provisions of the Internal Revenue Code, while ordinary loss is currently deductible from ordinary income, capital loss—with limited exceptions—can only be deducted from capital gain."

After the Supreme Courts's decision in *Arkansas Best* in 1988, the IRS adopted a narrow interpretation and disallowed ordinary tax treatment for many hedges, frustrating the economic objective of such transactions. The IRS position was rejected by the U.S. Tax Court in 1993, further confusing the case.

With this in mind, the Treasury Department has issued proposed and temporary regulations resolving many—"but concededly not all," says Mr. Evans—of the outstanding issues. It appears that under the present provisions of the Code, the Treasury Department probably cannot resolve these remaining issues without legislative action.

This offers Congress a "unique opportunity at this time . . . to hold hearings and to enact a comprehensive statutory system for the taxation of the business hedge which fully resolves existing tax problems inherent in the Code," concludes Mr. Evans. ●

State Tax Rates

Continued from page 2

percent rate, but levies a 12 percent rate on interest, net capital gains, dividends for state residents, and state business income earned by nonresidents.)

- Corporate income tax: Pennsylvania, with a single rate of 12.25 percent.
- General sales tax: Rhode Island, Nevada, Mississippi, with a rate of 7 percent.
- Gas tax: Connecticut, with a levy of 29¢ per gallon.
- Cigarette tax: Hawaii, with a levy of 60¢ per pack. (Washington, D.C., has a levy of 65¢ per pack.)

Based on state revenue collections, Alaskans have the highest average state tax burden per household, at $11,223, followed by Hawaii ($7,559), Delaware ($5,471), Connecticut ($5,393), and Minnesota ($4,884). If Washington, D.C., were a state, it would rank second, with a per household tax burden of $10,456. Residents of New Hampshire have the lowest average state tax burden per household, at $2,103, followed by South Dakota ($2,386), Texas ($2,841), Tennessee ($2,848), and Missouri ($2,891). (See *Chart 2*.) ●

Chart 4
State Government Tax Collections by Source ($Billions), FY 1983 - 1993

Type of Tax	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	Avg. Growth Rate '83-'93	Growth Rate '92-'93
Total State Taxes	$171.5	196.9	215.9	228.1	246.5	264.1	284.4	300.8	313.1	330.4	356.5	7.6%	7.9%
Annual % Change	5.5%	14.8	9.7	5.7	8.0	7.1	7.7	5.8	4.0	5.5	7.9		
Total State Taxes (Constant 1983 $)	$171.5	189.3	199.9	205.5	214.3	221.9	229.4	231.4	231.9	239.4	251.1	3.9%	4.9%
Annual % Change	1.3%	10.4	5.6	2.8	4.3	3.5	3.3	0.9	0.2	3.2	4.9		

Note: All years include data from the District of Columbia.

Source: 1983-1992 Bureau of Census; 1993 Tax Foundation survey of state revenue offices.

Capital Gains Tax Cut: Prescription for Economic Growth and Deficit Reduction

Rep. David Dreier (R-Calif.)

During the 1960s and 1970s, the country's major economic concerns were unemployment and inflation. Fiscal policy was defined by the Phillips Curve, which said that market economies faced an inevitable trade-off between those two forces. Encouraging job creation meant accepting higher inflation, according to the model, while fighting inflation demanded higher unemployment. It was not until Washington policy makers faced "stagflation," with high unemployment and high inflation, that radical policies were given a chance to prove that creating jobs and reducing inflation could be achieved simultaneously.

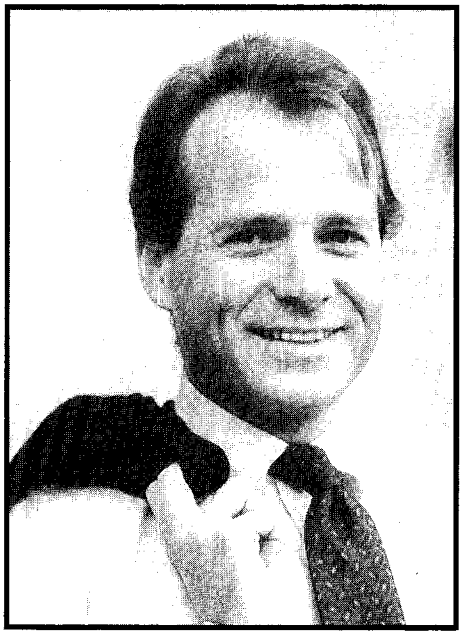
Eliminating taxes on capital gains promises to create long-term private sector jobs and reduce the deficit. As a bonus, it will increase worker wages, and increase revenues to state and local governments as well.

Today, fiscal policy doctrine is again controlled by a presumed economic trade-off. This time, the trade-off is between stimulating job creation and adding to the federal deficit. Conversely, the doctrine concludes that reducing the deficit requires some economic pain. This new, and equally incorrect, Phillips Curve mentality dominates conventional wisdom, as President Clinton's first-year economic proposals illustrate. His $16 billion "stimulus" bill was nothing more than a deficit-financed make-work public sector jobs plan. At the same time, the President pushed through a so-called "deficit reduction" plan that contains the largest tax increase in history and will hamper job creation for years to come.

The Clinton solutions are not capable of solving the twin problems of deficit reduction and job creation. The economic "recovery" that began in early 1992 is producing weak job growth. In California, high unemployment has been exacerbated by massive job-killing tax increases at the state and federal level in the name of deficit reduction. The public is no longer buying what the big-spending liberals want to sell, namely make-work programs that only add to the $280 billion a year federal deficit, and tax increases that destroy jobs.

It is time to relearn a lesson from Jimmy Carter's stagflation. Then, "radical" tax-cutting proposals by Jack Kemp, William Roth, Bill Steiger, and Ronald Reagan proved that the Phillips Curve did not exist. Now, another radical sounding tax-cutting proposal has emerged to dispel the Clinton Curve. Specifically, capital gains tax reduction is the one major fiscal policy tool that addresses both goals that dominate the economic debate. Eliminating taxes on capital gains promises to create long-term private sector jobs and reduce the deficit. As a bonus, it will increase worker wages, and increase revenues to state and local governments as well.

If the goal is to create jobs and increase living standards, a zero capital gains tax would be best. A recent study by the Institute for Policy Innovation (IPI), using a dynamic analysis that takes into account many of the variables that drive economic activity, predicts impressive results in job creation, capital formation, economic activity, private sector wages, and government revenue. From 1994 to 2000, a zero capital gains would result in an additional GDP growth of $1.5 trillion, 1.1 million new private sector jobs, a $1,884 increase in average annual wages for all workers, and $25 billion in additional government tax revenue.



Completely eliminating the tax on capital gains might sound far-fetched, but it's not a new idea. Back in 1978, when stagflation forced creative thinking, Data Resources Inc. (DRI) did a static Keynesian econometric analysis of a zero capital gains tax. DRI predicted that eliminating capital gains taxes would boost GNP by $200 billion, increase capital formation by $81 billion, and create 3 million new jobs. Just as important from a 1990s perspective, DRI predicted that a zero capital gains tax would increase net government tax revenue by $38 billion over five years.

The zero capital gains proposal, while heavy on the economic growth side, admittedly does not promise much in the way of reducing the burgeoning federal deficit. A different approach that maximizes government revenue while also expanding economic growth is to reduce the capital gains tax to 15 percent, and index it to inflation. According to the IPI study, this would create nearly one million new jobs, increase GDP by $1.3 trillion, boost average annual wages by $1,500, create $2.7 trillion in new capital, and provide $211 billion in additional federal revenues. No other plan can promise comparable job creation and deficit reduction results.

Two things stand in the way of this win-win policy approach. First, government budget scorekeepers—gurus of conventional economic wisdom—will incorrectly claim that a capital gains tax cut will add to the deficit. Second, capital gains tax policy is a rhetorical weapon of class warfare that liberal Democrats will not easily give up.

To overcome this entrenched opposition, Americans need to be told the truth, and to help accomplish that, I have joined with colleagues in the House and Senate to form a bipartisan congressional "Zero Capital Gains Tax Caucus."

The Zero Capital Gains Tax Caucus was formed to develop a rational policy regarding the taxation of capital formation, moving beyond the rhetoric of class warfare and the spectrum of economists, both in the private sector and in academia. As the IPI study indicates, there are significant economic benefits to be had from drastic reduction, or complete elimination, of the capital gains tax. Compiling an overwhelming collection of evidence in support of this tax reform is the best way to counteract the incorrect budgetary postulations of the congressional budget scorekeepers.

In addition to bringing economic evidence to light, the Zero Capital Gains Tax Caucus will spearhead the political fight for specific legislative proposals. The politicization of capital gains has had immense negative implications for the economy.

The Caucus is starting with the conception that eliminating the taxation of capital gains will release hundreds of billions of dollars of tied-up capital in the economy, and bring immediate relief to small investors, small businesses, workers, farmers, homeowners, and the elderly.

debate over static revenue estimates. In doing so, the Caucus is starting with the conception that eliminating the taxation of capital gains will release hundreds of billions of dollars of tied-up capital in the economy, and bring immediate relief to small investors, small businesses, workers, farmers, homeowners, and the elderly.

In order to focus sound economic reasoning on the issue of capital gains tax reduction, the Zero Capital Gains Tax Caucus organized a Board of Economic Advisors. In addition, the caucus is dedicated to making every effort to garner the input of a broad Important economic reforms have been held hostage to political posturing, and it will take concerted action to return the capital gains debate to the important issues—jobs, capital formation, and our living standards. The Zero Capital Gains Tax Caucus is founded on the principle that job creation and deficit reduction are compatible, and that the proof lies just a capital gains tax cut away. •

The views expressed in Front & Center are not necessarily those of the Tax Foundation.

Foundation Undertakes Series of Estate Tax Studies

First of Three Monographs Reviews History of Transfer Tax in U.S.

In the first of three reports on estate taxes planned this year, the Tax Foundation has recently released a monograph titled "A History and Overview of Estate Taxes in the United States," written by Staff Economist Patrick Fleenor.

The report covers the federal government's unified transfer tax system, which consists of three taxes:
• the estate tax, paid on the contents of decedents' estates;
• the gift tax for transfers of wealth between living persons; and
• the generation-skipping tax, which includes transfers to grandchildren or more distant descendants.

One finding in the study revolves around who exactly bears the brunt of the estate tax burden. Out of the approximately 50,400 estates that file each year with the IRS, about 250 of them are worth over $20 million. These estates are composed largely of business assets, such as closely held stock, farm assets, limited partnerships, and other non-corporate businesses (see chart on this page).

"This implies that, very often, most of the wealth held in large estates is the life work of successful entrepreneurs and farmers, what might safely be termed 'first generation wealth,'" says Mr. Fleenor. These estates pay the highest tax rates and most tax per estate. Thus, it is here that the transfer tax system—by falling most heavily on the estates of some of the nation's most economically productive citizens—has its most deleterious effect on the economy.

Much of this monograph covers the legislative history of the estate tax. For most of U.S. history the federal government has not relied on transfer taxes as a permanent source of revenue. Such levies were instead used as temporary sources of revenue during national emergencies. This changed in 1916 when the federal government enacted an estate tax along with the income tax. To prevent avoidance of the estate tax, Congress enacted a gift tax in 1932.

Over the past two decades, Congress has passed a series of laws to overhaul and modify the federal transfer tax system. Portions of the separate estate and gift tax systems were unified and levies were imposed on generation-skipping transfers. These changes also lowered marginal transfer tax rates and significantly reduced the number of transfer tax returns filed each year by raising the filing requirements.

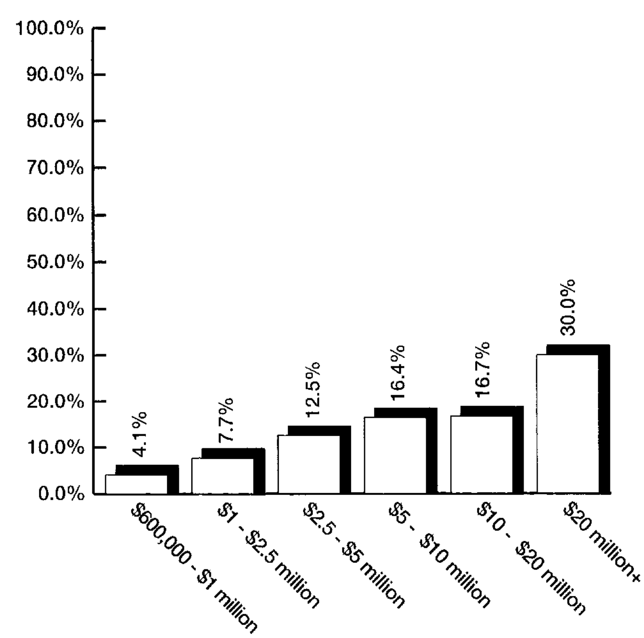
In fact, prior to 1976 estate taxes were paid by approximately seven percent of estates in any given year. After 1987, the estate tax was paid by no more than three-tenths of one percent in a given year.

The combined effect the various tax changes has been to create a range of effective marginal and average transfer tax rates that differ markedly from the statutory schedule.

Mr. Fleenor also notes that in 1989, the latest year for which data from estate tax returns is available, estate taxes paid by estates whose gross value exceeded $1 million accounted for nearly 96 percent of total federal estate tax receipts, although they represented less than half of all such returns filed.

The value of the wealth reported on the estate tax returns filed for 1989 decedents totaled almost $87.7 billion. Slightly over $27.2 billion, or 31 percent, was held by estates valued between $1 million and $2.5 million. The next largest share, $19.9 billion (22.8 percent) was held by estates valued at between $600,000 and $1 million. Estates valued over $20 million held 14.1 percent of this wealth, or $12.3 billion. ●

Business Assets as a Percent of Total Assets by Estate Size



Source: Internal Revenue Service, 1989 Estates.

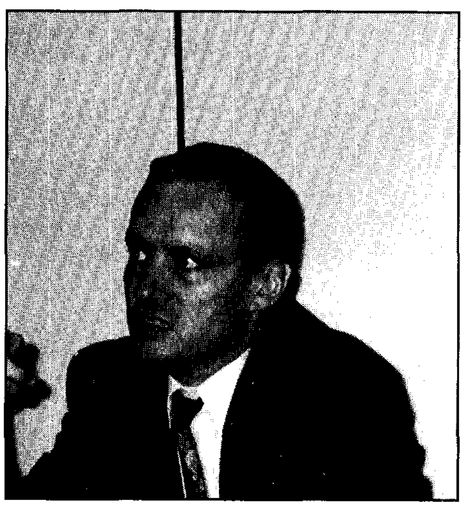
Foundation Holds 4th European Conference

A dozen top congressional staff and another 14 U.S. corporate tax leaders participated in the Tax Foundation's Fourth Annual U.S.-European International Taxation Conference January 5 through 12, meeting with European tax experts from the public and private sectors in London, Paris, and Frankfurt.

Key issues discussed during the week included: consumption taxes, particularly value-added taxes; health care financing; transfer pricing; and unitary taxation, which European firms are concerned could lead states to abandon the traditional "arms-length" standard of international taxation.

Among the highlights:

• Discussions in London with Sir Terrence Higgins, Member of Parliament and originator of the British VAT system.
• A meeting in London with top officials at Inland Revenue, including Ian Spence, Director of the International Division, and Mark Nellphorp, Principal of the International Division.
• A forum on health care financing in Paris with Michel Durraforg, Deputy Ministry for Health Care for the French Ministry for Health.
• A discussion with Dr. Berndt Runge of the German Finance Ministry on auditing transfer pricing and income allocations between nations. ●



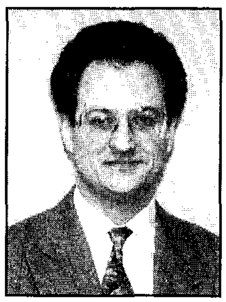
Michel Taly of the French Ministry of Finance discusses his country's transfer pricing policy with the Tax Foundation.

FOUNDATION MESSAGE

Seeking Arms-Length Taxation in the U.S.

When it comes to auditing transfer prices and sourcing international income, the U.S. is in a league by itself—because almost nobody wants to play ball. That is one of the key messages received by the delegation to the Tax Foundation's Fourth Annual U.S. European International Tax Conference, which is described in the column to the left.

The U.S. Treasury maintains a far more adversarial relationship to taxpayers than arises between foreign governments and either U.S. or foreign companies. Most countries follow the principles of arms-length pricing: Even though a transaction is between related parties, for purposes of determining taxable income the price at which the goods or services were sold is deemed to be the price that would have been charged had the transaction occurred between unrelated parties—at arms-length.



J.D. Foster
Executive Director and Chief Economist

Because transfer prices can be manipulated to source income and expenses to yield the best tax result for the taxpayer, the IRS is on guard against this sort of tax evasion. The reverse is also true. By arguing for particular transfer prices, the IRS can manipulate a taxpayer's total U.S. liability, against which taxpayers are equally on guard.

In the U.K. the apparent principle is there is a right answer to each tax question, and both taxpayer and tax authority look for that answer with as little fuss as possible. Yes, tax cheating occurs, and when it is found it is corrected and prosecuted. But by and large, the presumption is that all parties are interested primarily in the right answer.

The IRS' approach seems to be to pursue every last tax dollar wherever it can be found, however improbable the claim. This attitude leads taxpayer's to sense that the IRS is capable of highly irrational positions, which in turn leads to a strong sense of "us versus them." This culture of adversity puts great pressure on the total tax system, but perhaps nowhere more so than on international transfer pricing.

Recognizing the Gordion knot it is tying, the Treasury has initiated the Advanced Pricing Agreement (APA) program in which it and the taxpayer collaboratively determine in advance the transfer prices that will be used for tax filing for certain intercompany transactions for a set period of time. This program is cooperative by design and marks a radical departure from the traditional relationship between the tax service and the taxpayer in the U.S.

Certainty is one of the great benefits for taxpayers entering into an APA. Without it, a taxpayer may not know at the time of the transaction (and for many years thereafter) the true after-tax consequences of his economic activity. The APA eliminates this uncertainty with respect to the transfer price.

Our foreign trading partners, in contrast, see little need for participating in the APA process because they put far less pressure on transfer price auditing. And, as our discussions with the finance ministry representatives in each of the countries we visited revealed, they do not have the resources to dedicate to a bilateral or multilateral APA process. Consequently, the certainty taxpayers are seeking in an APA with the Treasury may be partly lost by the failure to achieve a similar agreement with foreign tax authorities.

The APA program remains an important advance in the Treasury's approach to international taxation. At a minimum, it represents a recognition that transfer price policy is in trouble. Perhaps this breakthrough can be followed up with a more European-like approach to transfer pricing in which the focus is on finding the right answer, not necessarily on finding the last tax dollar. ●

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FOUNDATION UPDATE

Tax Foundation Expands Development Division

To keep up with growing corporate and foundation interest in the organization's research, the Tax Foundation has recently expanded its development division, hiring Gaye Bennett as Administrator and Director of Foundation Development and Eastlyn McIntyre as Development and Communications Assistant. Reneé Nowland, formerly Manager of Corporate and Foundation Development, was promoted to Director of Corporate Development.

Gaye Bennett

Eastlyn McIntyre

Ms. Bennett comes to the Tax Foundation from Morrison Knudson Corporation in Boise, Idaho, where she served as Administrator, Board Member, and Assistant Secretary for the firm's charitable foundation, and as Treasurer of MKPAC, the company's political action committee. Prior to that, she worked on Capitol Hill with Senator Steve Symms (R-Idaho).

Ms. McIntyre, prior to joining the Tax Foundation, was with IBM Corporation for 24 years. Most recently she served as Senior Publications Specialist, and as Technical Team Leader and software packaging consultant, in the Information Development Technology Division of the Bethesda, Md., office.

Those seeking assistance regarding their membership renewal, and those with questions about membership or contributor benefits, should call the Foundation's Development Division. ●

Foundation Welcomes Five Additional Contributors

The Tax Foundation is pleased to announce the addition of five companies to its list of contributors. The newest members:

- Association of American Railroads
- Chase Manhattan Bank
- Fidelity Graphic Company
- Oracle Corporation
- Morrison Knudson Corporation

Correction

In the December issue of Tax Features, an article on the impact of the Omnibus Budget Reconcilation Act of 1993 incorrectly stated the percentage of taxpayers who will see higher individual income taxes as a result of the changes. The correct figure is 4.6 percent.

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