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Tax Cuts Promise To Be Major Domestic Issue of Presidential Election

Bush Pushes for Permanence; Kerry Wants Repeal of High-Income Tax Cuts, Promising New Tax Credits and Spending Programs

As members of Congress debate the budget resolution for the FY 2005 federal budget, many lawmakers are claiming that the 2001 and 2003 Bush tax cuts — especially for high-income taxpayers — are the principal cause of today's high tide of red ink: $477 billion according to the Congressional Budget Office (CBO) but $521 billion according to the Office of Management and Budget.

Sen. Kerry says the Bush tax cuts, especially for high-income taxpayers, have created the huge federal deficit. ... President Bush believes the deficit is caused by an economy that's only now recovering from 2001, when a normal recession was worsened by the attacks of September 11th, the internet bubble, and corporate criminality.

President Bush believes the high deficit is primarily caused by an economy that's recovering slowly from a series of jolts in 2001: a normal cyclical recession, the attacks of September 11 and the popping of the internet bubble which revealed outrageous corporate criminality. On the subject of excessive federal spending, he has called on the Congress to restrain itself.

To maximize the chances of full recovery, the President believes the tax cuts should be made permanent at their highest levels instead of rising and falling in value over the next several years and finally expiring completely at the end of 2010.

Meanwhile, others assert that repealing all of the tax cuts for upper-income Americans would make a significant dent in the deficit. For example, Senator John Kerry considers all the tax cuts that benefitted couples making $200,000 or more to be unjustified. He does not focus on federal overspending; indeed, he has proposed hundreds of billions of dollars worth of new government spending.

These are the essential tax policy positions that voters will be assessing in the presidential election come November.

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FRONT & CENTER

Fundamental Tax Reform in Central Europe

Martin Chren, President, F.A. Hayek Foundation, Slovakia

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Tax Cuts *from page 1*

How Much Revenue Is There In Tax Cut Repeal?

There has been some dispute over which provisions of the Bush tax cuts Kerry would target for repeal. After all, high-income people benefit from many of the same tax cuts that middle-income taxpayers do.

Using an individual tax model similar to the one used by Congress's Joint Committee on Taxation, Tax Foundation economists estimated how much revenue could theoretically be raised in 2004 if provisions of the Bush tax cuts were retroactively repealed.

The table above compares those amounts to the CBO deficit estimate, showing what fraction of the deficit is caused by tax cuts, or could be eliminated by repealing tax cuts.

Can the Deficit Be Eliminated by Repealing Tax Cuts?

	New Taxes Raised ($billions)	Deficit Remaining ($billions)
CBO Estimate for This Year's Deficit		$ 477
Step 1: Return top two tax rates to 36% and 39.6% — and apply those rates to dividend income	$ 27	$ 450
Step 2: Restore the higher tax rates on dividend and capital gains income for remaining tax brackets	$ 20	$ 430
Step 3: Restore all other tax rates to 2000 levels and repeal the 10% bracket	$ 70	$ 360
Step 4: Restore Marriage Penalty and eliminate the EITC and AMT adjustments	$ 26	$ 334
Step 5: Return the value of the child credit to $500 from $1,000	$ 21	$ 313

Tax Cuts at the High End of the Income Spectrum

Our first step was to return the top two income tax rates to their 2000 levels (the 35 percent rate back up to 39.6 percent, and the 33 percent rate back to 36 percent) and repeal the preferential 15 percent tax rate on dividend income for these taxpayers.

This repeal would raise $27 billion, only 6 percent of the current deficit, most of which would come from the roughly 700,000 taxpayers earning more than $500,000 per year. Unfortunately, this would only lower our current year deficit to $450 billion, a very long way from balance.

Keep in mind that our estimates here are "static," by which we mean that we ignore any changes people would make in their earning, saving and spending habits when their tax rates change. In real life, people (especially high-income people) certainly do respond to higher tax rates in ways that lower tax revenue. And because that isn't taken into account in these estimates, they likely overstate the amount of new revenue that tax cut repeal could generate.

We next repealed the new 15 percent rate on dividend income for taxpayers in all other tax brackets and reset the capital gains tax rate to 20 percent. Restoring these rates to their 2000 levels would raise $20 billion, cutting the deficit to $430 billion.

That wraps up the "tax cuts for the rich," and yet the deficit is reduced by only 10 percent. From here on down, the tax cuts overwhelmingly benefit middle-income people, and Sen. Kerry has consistently defended those cuts. In fact he recently told the AFL-CIO in Florida that he wants new tax credits for health care and college tuition. But if he changed his mind, adopting the Dean-Gephardt position of total tax cut repeal, and resisted the temptation to spend the extra tax revenue, how much more could he cut the deficit?

Middle- and Low-Income Tax Cuts

Too few in Washington recognize that a sizeable majority of the 2001 and 2003 tax cuts benefited millions of working families across the country by lowering their income tax rates, lifting the so-called marriage penalty, and raising the value of the child credit to $1,000 from $500.

We found that restoring all of the old individual tax rates, as well as eliminating the new 10 percent bracket, would raise $70 billion and, thus, lower the deficit to $360 billion. Repealing even more "middle-class" tax cuts, such as the marriage penalty and the adjustment to the Alternative Minimum Tax, would raise an additional $26 billion and cut the deficit to $334 billion, still miles away from balance.

Lastly, we returned the value of the child tax credit to its old level of $500 per child. It is important to note that few tax measures in history have had such a profound impact on the tax burden of working families as the child credit.

By our estimates, the increased value of the child credit knocked at least 3.6 million families from the tax rolls. Currently, more than 44 million taxpayers (one-third of all filers) file tax returns but pay no income taxes after all of their credits and deductions are taken into account. This is up from 29.9 million no-tax filers in 2000. Restoring the child credit to its old level would raise another $21

To borrow and amend an old Clintonian slogan, the cause of today's deficits is not a lack of tax revenue, "It's the spending stupid."

billion, leaving Uncle Sam $313 billion in the red.

Adding It All Up

Repealing all of the major Bush tax cuts would raise about $164 billion in "new" tax revenues, roughly one-third of what is needed to erase the deficit. When all is said and done, if our goal is to cut the deficit through higher taxes, there is very little blood left in the stone of individual income to find new revenues.

To put the $477 billion deficit forecast in perspective, it is well in excess of the $404 billion in income taxes that will be collected from every taxpayer making more than $200,000 this year. Thus, to balance the budget on the backs of these upper-income Americans would require effective tax rates more than double what they are today, a level far beyond what they have ever been in our history.

Truth be told, repealing the tax cuts won't lower the deficit much, and neither party seems to want a balanced budget enough to cut spending.

When Bill Clinton ran for president, one of his campaign slogans was, "It's the economy, stupid." He used it whenever some other issue threatened to distract people from what he considered to the issue that mattered the most.

In the current debate over why the government is spending so much more than it is bringing in, pushing the federal deficit up to about a half a trillion dollars, an appropriate version of that slogan would be, "It's the spending stupid."

Truth be told, repealing the tax cuts won't lower the deficit much, and neither party seems to want a balanced budget enough to cut spending.

How the Federal Government Plans to Spend Your Tax Dollar In Fiscal Year 2005

How does President Bush propose to spend your federal tax dollar in FY2005? A lot differently than it was spent in FY1995, '85, '75 or '65, according to the Tax Foundation's annual comparison.

Assuming that Congress makes no dramatic changes in the President's FY2005 Budget, 59¢ out of every tax dollar spent will go to three areas — Social Security, health and medical, and income security (see Chart 1). These program areas are "mandatory," so the federal government automatically spends a legally determined amount of money.

Compared to previous budgets (see pie charts on page 4), the biggest changes in the last four decades can be found in how much Uncle Sam spends on health-related programs and on national defense. In FY 1965, Uncle Sam spent only 1¢ out of every tax dollar on health, and even after Medicare and Medicaid had been enacted, that cost only rose to 8¢ on the dollar in 1975 and 10¢ in 1985. Those are small slices of the national pie compared to the 23¢ that is planned for 2005.

On the other hand, the portion of federal spending devoted to national

See Budget Dollar on page 4

Where Your Federal Tax Dollar Will Go, FY 2005

Notes: "Income Security" includes General Retirement and Disability, Federal Employee Retirement and Disability, Unemployment Compensation, Food and Nutrition Assistance, Supplemental Security Income, Family and Other Support Assistance, Earned Income Tax Credit, Offsetting Receipts, and Housing Assistance.

"Other" includes Energy, Natural Resources and Environment, Commerce and Housing Credit, Community and Regional Development, International Affairs, General Science, Space and Technology, Agriculture, Administration of Justice, General Government, Allowances and Undistributed Offsetting Receipts.

Source: Tax Foundation calculations based on OMB projections.

Budget Dollar *from page 3*

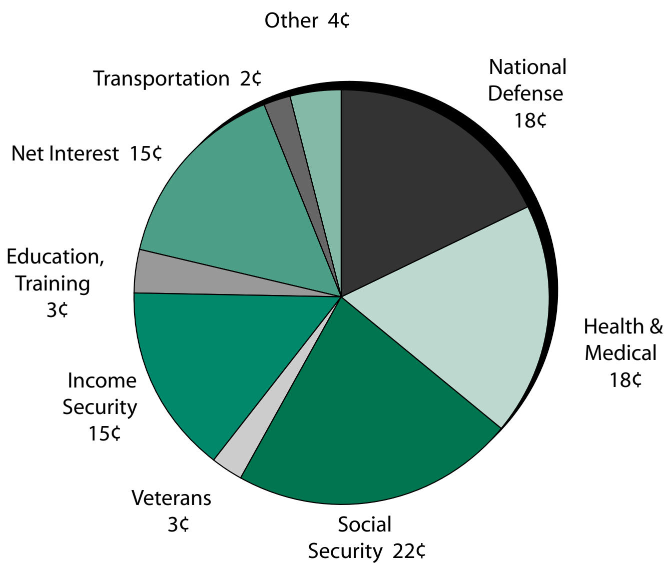
defense has fallen from 43¢ out of every tax dollar in FY 1965, to 27¢ in FY 1985, to a proposed 19¢ in FY 2005.

Net interest payments on the federal debt are projected to fall significantly in FY 2005 compared to ten years ago, from almost 15¢ on a dollar in 1995 to 8¢ in the coming fiscal year.

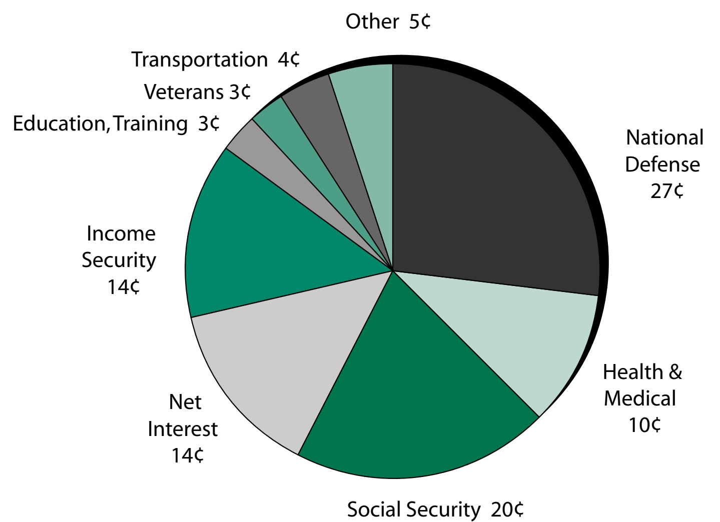
The FY 2005 budget shows that "discretionary" spending — such as defense, education, agriculture and transportation — now plays a comparatively minor role — only about 33¢ on a dollar. Mandatory spending and net interest now account for 67¢. In contrast, back in FY 1965, the portions were reversed: discretionary spending was roughly 69¢ out of every federal tax dollar while entitlements and net interest payments took up about 31¢.

How Uncle Sam Has Sliced Up the Federal Pie in the Past

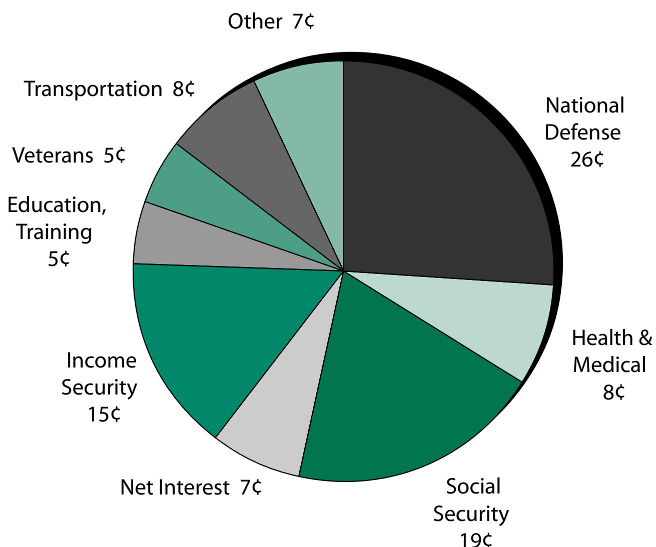
FY 1995



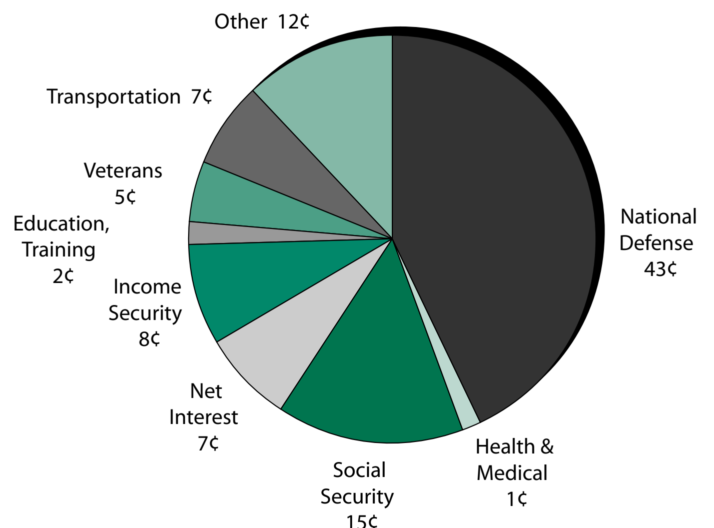
FY 1985



FY 1975



FY 1965



U.S. Jobs Picture Brighter than Reported

There is a growing but erroneous consensus that U.S. job growth is anemic. The source of the story is consistently pessimistic results from the Bureau of Labor Statistics' payroll survey, but a closer look at other evidence on job creation and employment gives a different impression.

On one hand, the payroll survey shows payroll employment is growing so slowly that recent average gains of less than 60,000 jobs per month would not offer a full recovery for over a decade. On the other hand, February's unemployment rate fell to 5.6 percent of the civilian labor force, down from a peak of 6.3 percent eight months earlier.

Some commentators suggest that the reduction in the unemployment rate did not signify job gains. According to this view, the dip only meant that job seekers had dropped out of the labor force and therefore were no longer counted. This notion is contradicted by several statistical observations.

In February the civilian labor force did decline, but so did employment and the number unemployed (see table at right). These declines reflect the month-to-month volatility of the household survey data used to measure employment and the unemployment rate. Something as simple as unusual slowness in the normal seasonal pattern of post-Christmas lay-offs and labor force exit could account for the vagaries of these data. The evidence over two months supports this notion, as employment shows a strong gain, matching a sharp drop in the number of unemployed.

Over the past eight months the gains in employment are even stronger. The number of unemployed dropped by more than a million, or about 125,000 per month, and this was matched by nearly the same rise in civilian employment.

Looking back even further, civilian employment in February was 1.9 million workers greater than at the end of the recession in November 2001, after adjusting the numbers for breaks due to changing population controls. It even exceeds the level of employment at the business cycle peak in March 2001 by almost 400,000 workers. On this basis the economy's employment recovered over three months ago and employment is expanding briskly, a radically different picture than that provided by the non-farm private jobs count that gets so much attention.

Civilian Employment Is Improving

Number of Months	From	To	Change in Employment	Change in Unemployed
1	Jan. 2004	Feb. 2004	–265,000	–127,000
2	Dec. 2003	Feb. 2004	+230,000	–204,000
8	June 2003	Feb. 2004	+1,034,000	–1,047,000

Source: Bureau of Labor Statistics household survey, adjusted for break due to population controls.

If unemployment keeps falling at this rate, which would be fully consistent with widespread forecasts of accelerating output, the unemployment rate could reach 5.2 percent by midsummer, generally considered to the lowest sustainable or "natural" rate of unemployment.

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What will the policy debate look like this summer if growth has pushed the economy into boom territory, with accelerating inflation, but the falsely dismal impression of employment is still being perpetuated? The normal monetary policy action — raising interest rates — will certainly be much more difficult to sell.

The manufacturing jobs count, part of the dismal payroll employment survey, has gotten the most attention. Over the last 4 months, the survey shows manufacturing jobs declining 0.9 percent annually. Yet the Institute of Supply Management's reliable index shows that net job creation in manufacturing began 4 months ago. Since then, the number of manufacturing jobs has risen at a 3.6 percent annual clip.

Similarly, sharp declines in initial claims for unemployment insurance, continuing claims and in mass lay-offs in the past nine to twelve months suggest that the number of jobs are expanding at the rapid pace suggested by civilian employment.

While Alan Greenspan strongly endorsed the payroll jobs count recently as a reliable indicator, there are many reasons for doubting it.

The jobs count is not intended to measure overall employment, it counts jobs and even then it excludes large numbers of jobs. It counts each job held by multiple jobholders, but it excludes government and farm workers.

Most importantly, it excludes the self-employed and has a biased sample excluding new firms just when employment at such small firms is expanding rapidly. This is usually fixed by revisions but only many months later.

That is exactly what happened after the last recession. Dismal data from the non-farm payroll jobs count were big news from June 1991 until June 1992, but those stories of a "jobless recovery" were ultimately proven wrong by revised data. A similar scenario is likely this year.

Fundamental Tax Reform in Central Europe

by Martin Chren

Slovakia, a small country of five and a half million people in Central Europe still hasn't been discovered by many American travelers and businessmen.

Those who have already visited it, or who have at least heard about it, know that it is a young country, born after the split-up of former Czechoslovakia just a dozen years ago. Some may even know it as the "Heart of Europe" — a nickname given to Slovakia thanks to its favorable geographical location, numerous historical sightseeing spots and picturesque countryside.

However, it seems that now the day has come for Slovakia to attract the attention of economists, business people and politicians from the world over. The reason is a comprehensive tax reform enacted in the last week of October.

Pursuing the main goals of fairness, simplicity and no double taxation, the Slovakian government has adopted major changes to the current tax system, based on the idea of the flat tax as the best option for the Slovak economy.

The flat rate we decided on is 19 percent, and that one rate replaces a typical structure of income tax rates that started at 10 percent and went progressively higher, up to 38 percent. In addition, the 19 percent rate replaces the 25 percent rate that had been levied on corporate income.

This will decrease the income and profit tax burden for both individuals and businesses. Slovakia was already offering multinational firms a tempting combination of central location and a skilled but relatively cheap labor force. Now that we have added a tax code that is unquestionably one of the most competitive in Europe, if not the world, we should be able to attract the foreign investment that will be the lifeblood of the Slovak economy in the final stages of its transition to the free market.

Main Features of the Tax Reform in Slovakia

Flat income tax	A single, flat, 19-percent tax on personal and corporate income
VAT	A single, 19-percent tax on purchases
Tax simplification	Elimination of most exceptions and special treatments from the tax code
No double taxation	Abolition of tax on dividends
No death tax	Elimination of the inheritance tax
No taxation of goodwill	Elimination of the gift tax
No real estate transfer tax	To become effective in 2005

I would not go so far as to say the tax system will be "user friendly." A tax return will still not fit on a postcard, but let us not hold the standard up so high that no improvement seems enough. This is truly a dramatic, fundamental tax reform.

Although enactment of a single income tax rate will possibly have the most evident impact on Slovak taxpayers' wallets, it is not the most important change in the Income Tax Act. The flat tax simplifies the whole tax code. Just as in most of the world's developed countries, the income tax code in Slovakia used to be a mess of different exemptions, various specially treated income sources, different tax rates for different subjects, and many other special rules tailored for narrow interest groups. There were more than two hundred departures from the rules before the reform. Most of them are to be eliminated, and this will certainly make the tax system more transparent for all types of taxpayers, from wage-earners to large firms.

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Aside from individual income taxes, the biggest tax in most European countries is the Value Added Tax (VAT). This European version of the American sales tax is levied on

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everything that businesses buy, and then subtracted when they sell, so that the tax burden is passed down the chain of production until it gets to the retail consumer, the one who can't pass it on to someone else. Slovakia's VAT had a basic rate of 20 per cent, and a special reduced rate of 14 percent for some products. They are now unified to one rate of 19 percent, the same as the rates on individual and corporate income.

Another rule that guided the reformers when designing the new tax laws was the no-double-taxation approach. Therefore, every type of income should be taxed in the same way regardless of its source, and no type of income should be taxed more than once. This had been the case, for example, on dividend income which was taxed first as the profit of a company, and then a second time as individual income when the firm sent out the dividend. Corporate income will continue to be taxed, but the second level of taxation on individuals' dividends has been eliminated.

And there is more good news for Slovak taxpayers, such as the elimination of one of the most unfair and meaningless taxes — the inheritance tax, better known as the death tax. After a strong and long-lasting campaign led by the Slovak Taxpayers Association, tax on inheritance for close relatives was abolished in Slovakia two years ago. Now, after the tax reform, the death tax will be totally abolished, and the same fate awaits the gift tax. There will be no taxation of goodwill in Slovakia any more. Moreover, beginning in 2005, the real estate transfer tax is scheduled to disappear as well.

I am truly convinced that such a fundamental reform warms the heart of any reasonable economist, but the first question that comes to their minds is: "Okay, sounds great, but where's the hitch?" Well, there really is a hitch.

The necessary precondition for passing such a tax reform through the political process was making it fiscally neutral. In layman's terms, the state will collect just as much in taxes as it used to. If predictions of revenue-neutrality fall short, a drop in income tax revenues will be replaced by an expansion in excise taxes, such as taxes on gas and tobacco products.

Replacement of the 14 percent VAT on some products with the 19 percent rate will raise significant revenue, and this will affect almost all the products most commonly used in daily life. Many people feel the flat tax rate on income could have been significantly lower than 19 percent. Reliable estimations show that if the income tax rate dropped to 16 or even 15 percent, the government budget would not be hurt seriously.

However, though there certainly is still a lot of work to do, the Slovak tax reform is a real step towards a fairer, more economically efficient tax system. It could perhaps be said that the newly adopted Slovak flat tax is more consistent with the general principles of academic flat tax proposals than in any other country where this kind of reform has been introduced. Much of this is a credit to a few free market institutes that originally came up with this idea in Slovakia and promoted them.

In June this year, Steve Forbes, perhaps the best-known promoter of the flat tax concept, visited Slovakia at our invitation. Coming back from the three-day visit, he published a full page article about the reforms going on there, headlined "Investors' Paradise" in *Forbes*. Well, of course paradise doesn't happen overnight, even in Slovakia, but we are doing everything we can to grow our nation's economy.

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The Tax Foundation invites national leaders from all perspectives to contribute columns to Tax Features. *The opinions expressed are not always those of the Tax Foundation.*

State Governments Look Back in Relief at Fiscal 2002

State government officials are still complaining mightily about insufficient tax revenue, but looking back at the Census Bureau's final data for fiscal year 2002 should make them feel a bit better. The worst year for state coffers for at least a decade, FY'02 (July 2001 through June 2002) saw state tax and fee collections drop 4.7 percent from FY'01 levels (6.1 percent adjusted for inflation), according to a new *Tax Foundation Special Report,* "State Tax Collections and Rates" by Foundation economist Sumeet Sagoo.

"The principal culprit is capital gains taxes," explains Sagoo. "In FY'01 tax collections on capital gains flooded state coffers. When the bubble popped, states that had foolishly counted on the same amount in FY'02 were left in the red. Some responded the next year by raising taxes, but not as much as after earlier recessions."

The final income data for that period show growth of 2.1 percent, primarily because the Bureau of Economic Analysis does not count capital gains in income. Nevertheless a remarkably good figure considering that the year included the recessionary months of July-November 2001.

Combined with the drop in tax collections, income grew 6.8 percent faster than taxes, a remarkable disparity. This actually tilted the 10-year comparison of income growth to tax growth in favor of income. After adjusting for inflation, the annual growth rate of state governments' tax collections was 0.1 percent slower than the growth rate of their taxpayers' income between FY'92 and FY'02.

The fastest falling category of state collections between FY'01 and '02 was severance taxes on mineral extraction, down 34 percent, hurting Alaska and several other states. Corporate income tax receipts also fell dramatically, down 18.3 percent.

More problematic nationwide was the 11.1 percent fall-off in individual income taxes. Sales tax collections held steady, dropping just 0.2 percent. Meanwhile, taxes on tobacco, alcohol, licenses, public utilities, insurance and motor fuels were all up.

Table 1: State Tax Collections and Distribution by Source

Fiscal Year 2002

	Total ($Thousands)	Distribution: General Sales & Use	Individual Income	Corporate Income	Motor Fuels	Licenses	All Other
All States (a)	$ 533,432,378	33.5%	34.7%	4.9%	6.0%	6.6%	14.3%
Alabama	$ 6,878,923	25.4%	34.9%	4.7%	7.4%	5.7%	21.8%
Alaska	1,089,504	0.0	0.0	24.7	3.7	6.8	64.8
Arizona	8,477,001	50.6	24.7	4.1	7.4	3.2	10.1
Arkansas	5,034,109	38.1	29.6	3.2	8.2	4.7	16.2
California	77,755,376	30.6	42.5	6.9	4.2	7.3	8.4
Colorado	$ 6,923,171	27.5%	50.2%	3.0%	8.2%	4.0%	7.1%
Connecticut	9,032,787	33.7	40.8	1.7	4.7	4.5	14.7
Delaware	2,173,600	0.0	33.0	11.6	5.0	35.9	14.6
Florida	24,815,964	58.1	0.0	4.9	7.3	6.3	23.5
Georgia	13,772,147	35.1	47.1	4.1	4.7	3.6	5.4
Hawaii	$ 3,420,671	47.1%	32.5%	1.5%	2.3%	3.3%	13.3%
Idaho	2,271,075	35.0	37.1	3.4	9.4	9.8	5.3
Illinois	22,460,190	28.6	30.9	9.2	6.1	8.5	16.7
Indiana	9,994,595	38.0	35.4	6.7	6.7	3.0	10.2
Iowa	5,006,251	34.9	35.3	1.8	6.9	10.4	10.8
Kansas	$ 4,808,361	37.4%	38.6%	2.5%	7.8%	4.8%	8.9%
Kentucky	7,974,690	29.0	33.6	3.8	5.8	6.8	21.1
Louisiana	7,345,994	31.7	24.2	3.6	7.6	7.0	25.9
Maine	2,626,830	31.8	40.8	2.9	7.3	5.7	11.4
Maryland	10,821,276	24.9	43.5	3.3	6.5	4.0	17.8
Massachusetts	$ 14,819,794	24.9%	53.4%	5.5%	4.5%	3.4%	8.3%
Michigan	21,864,052	35.6	28.0	9.4	5.0	5.9	16.0
Minnesota	12,936,369	28.9	42.1	4.2	4.8	6.7	13.3
Mississippi	4,728,905	49.5	20.8	4.1	8.7	6.4	10.5
Missouri	8,678,611	32.9	41.7	3.5	8.0	5.4	8.6
Montana	$ 1,442,731	0.0%	35.9%	4.7%	13.3%	13.8%	32.3%
Nebraska	2,992,522	35.7	38.5	3.6	10.3	6.5	5.3
Nevada	3,945,329	52.5	0.0	0.0	6.7	11.1	29.7
New Hampshire	1,883,924	0.0	3.8	20.0	6.4	9.1	60.7
New Jersey	18,328,814	32.7	37.3	6.0	2.9	5.2	15.9
New Mexico	$ 3,628,055	36.9%	27.1%	3.4%	5.5%	4.7%	22.4%
New York	43,262,137	19.9	59.1	5.2	1.1	2.4	12.2
North Carolina	15,535,277	20.7	46.8	4.3	7.8	5.7	14.8
North Dakota	1,117,299	30.0	17.9	4.5	9.9	9.2	28.5
Ohio	19,616,569	32.6	42.5	3.9	7.0	8.0	6.1
Oklahoma	$ 6,052,680	25.3%	37.8%	2.9%	6.8%	13.6%	13.7%
Oregon	5,139,322	0.0	71.5	3.8	7.8	9.7	7.3
Pennsylvania	22,135,537	33.1	30.4	5.4	7.9	9.4	13.7
Rhode Island	2,127,609	34.4	38.7	1.3	6.1	4.3	15.1
South Carolina	5,748,585	40.6	34.0	3.8	7.2	5.4	9.1
South Dakota	976,596	53.6%	0.0%	4.2%	12.6%	13.6%	16.0%
Tennessee	7,797,681	60.0	1.9	6.5	10.4	10.7	10.6
Texas	28,662,395	50.8	0.0	0.0	9.9	13.2	26.1
Utah	3,925,382	38.2	40.9	2.8	8.6	3.8	5.7
Vermont	1,533,982	14.0	24.4	2.4	5.6	4.5	49.0
Virginia	12,781,149	21.9%	52.5%	2.4%	6.6%	4.2%	12.3%
Washington	12,628,567	62.6	0.0	0.0	5.9	5.0	26.5
West Virginia	3,551,756	27.1	29.1	6.2	8.4	4.9	24.2
Wisconsin	11,813,832	31.3	42.1	4.4	8.1	5.5	8.6
Wyoming	1,094,402	40.7	0.0	0.0	6.9	8.7	43.7
Dist. of Columbia (b)	3,215,289	20.3%	30.5%	3.6%	1.0%	0.7%	43.9%

(a) Does not include the District of Columbia.
(b) Based on quarterly data.
(c) The "all other" category is a subtraction of the 5 other sources of revenue from "Total."
Source: Tax Foundation, based on data from the Department of Commerce, Bureau of the Census.

State Tax Revenue by Source

The three staples of state finance continue to be individual income taxes (34.7 percent of revenue), general sales and use taxes (33.5 percent), and a combination of business and excise taxes, including corporate income taxes (4.9 percent) and licenses (6.6 percent). See Table 1.

Five states do not tax sales: Alaska, Delaware, Montana, New Hampshire and Oregon. Meanwhile, Florida, Neva-

da, South Dakota, Tennessee, Texas and Washington derived over half of their tax revenue from sales taxes.

Seven states have no individual income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming. Two more, New Hampshire and Tennessee, tax only interest and dividend income. On the other hand, five states depended on the individual income tax for over half of their tax revenue in FY'02: Colorado, Massachusetts, New York, Oregon and Virginia.

Ranking the States

Nationwide, the average per capita collection was $1,863 in FY'02, and the average amount of tax collected per $1,000 of income was $59.56.

Hawaii collected the most by either measure, $2,768 per capita and $91.85 per $1,000 of income. Delaware collected the second most per capita ($2,710), and Vermont collected the second most per $1,000 of income ($83.92).

South Dakota collected the least per capita ($1,286) while New Hampshire collected the smallest share of income, $42.75 per $1,000.

States without income taxes generally collected less, but Wyoming and Washington collected more than average by both measures.

Some states ranked near the top by one measure but near the bottom by the other. The widest disparities can be seen in New Jersey (12th per capita but 39th as a share of income) and Mississippi (35th per capita but 9th as a share of income).

State Tax Rate Changes in 2003

Aside from routine adjustments for inflation, no state raised income taxes during 2003. The only state to enact a rate cut was New Mexico, and Utah widened its brackets modestly.

Three states—Alabama, Indiana and Tennessee—and the District of Columbia raised their tax rates on all corporate income. North Dakota raised its tax on financial institutions.

Six states—Idaho, Kansas, Nebraska, Ohio, Tennessee and Vermont—raised general sales taxes, and numerous states raised excises on alcohol and tobacco.

Publication Summary

General: Special Report No. 128; ISSN 1527-0408; 12pp.; $10 or $50/yr. for 10 issues on varied fiscal topics

Title: State Tax Collections and Rates

Author: Sumeet Sagoo

Date: March 2004

Subject: State tax collections for FY2002 and selected tax rates as of December 31, 2003

Tables: State Tax Collections by Type, FY'92–'02; State Tax Collections and Distribution by Source, FY'02; State Tax Growth Compared to Income Growth, FY'92–'02; State Tax Collections Per Capita and Per $1,000 of Income, FY'02; Individual Income Tax Rates; Corporate Income Tax Rates; Various State Tax Rates

Table 2: State Tax Collections Per Capita and Per $ 1,000 of Income With Corresponding Ranks, Fiscal Year 2002

	Total ($ Thousands)	Per Capita (c)	Per $ 1,000 of Income (c)	Rank Per Capita	Rank Per $ 1,000 of Income
All States (a)	$ 533,432,378	$ 1,863	$ 59.56	-	-
Alabama	$ 6,878,923	$ 1,536	$ 60.84	42	25
Alaska	1,089,504	1,705	53.37	34	40
Arizona	8,477,001	1,575	59.35	40	30
Arkansas	5,034,109	1,863	79.21	21	6
California	77,755,376	2,231	66.75	8	18
Colorado	$ 6,923,171	$ 1,549	$ 45.64	41	49
Connecticut	9,032,787	2,620	60.32	3	28
Delaware	2,173,600	2,710	82.38	2	4
Florida	24,815,964	1,500	49.91	44	45
Georgia	13,772,147	1,623	55.76	38	36
Hawaii	$ 3,420,671	$ 2,768	$ 91.85	1	1
Idaho	2,271,075	1,706	67.56	32	16
Illinois	22,460,190	1,788	52.83	24	42
Indiana	9,994,595	1,627	57.26	37	34
Iowa	5,006,251	1,706	60.36	33	27
Kansas	$ 4,808,361	$ 1,775	$ 60.73	25	26
Kentucky	7,974,690	1,954	75.92	19	7
Louisiana	7,345,994	1,641	64.73	36	20
Maine	2,626,830	2,038	73.08	14	10
Maryland	10,821,276	1,996	54.84	16	38
Massachusetts	$ 14,819,794	$ 2,310	$ 58.19	6	31
Michigan	21,864,052	2,180	71.50	10	13
Minnesota	12,936,369	2,586	75.66	4	8
Mississippi	4,728,905	1,650	73.71	35	9
Missouri	8,678,611	1,535	52.73	43	43
Montana	$ 1,442,731	$ 1,591	$ 63.48	39	23
Nebraska	2,992,522	1,735	58.14	29	33
Nevada	3,945,329	1,847	59.99	22	29
New Hampshire	1,883,924	1,487	42.75	45	50
New Jersey	18,328,814	2,144	53.79	12	39
New Mexico	$ 3,628,055	$ 1,969	$ 82.27	18	5
New York	43,262,137	2,263	62.02	7	24
North Carolina	15,535,277	1,880	67.23	20	17
North Dakota	1,117,299	1,758	65.74	27	19
Ohio	19,616,569	1,720	58.16	30	32
Oklahoma	$ 6,052,680	$ 1,738	$ 68.16	28	15
Oregon	5,139,322	1,469	50.68	46	44
Pennsylvania	22,135,537	1,797	56.49	23	35
Rhode Island	2,127,609	1,998	63.89	15	21
South Carolina	5,748,585	1,407	55.00	47	37
South Dakota	$ 976,596	$ 1,286	$ 47.16	50	47
Tennessee	7,797,681	1,351	49.03	48	46
Texas	28,662,395	1,328	45.98	49	48
Utah	3,925,382	1,709	69.69	31	14
Vermont	1,533,982	2,494	83.92	5	2
Virginia	$ 12,781,149	$ 1,764	$ 53.26	26	41
Washington	12,628,567	2,094	63.54	13	22
West Virginia	3,551,756	1,972	83.32	17	3
Wisconsin	11,813,832	2,178	72.12	11	11
Wyoming	1,094,402	2,204	71.54	9	12
District of Columbia	$ 3,215,289	$ 5,621	$ 131.29	-	-

(a) Does not include the District of Columbia.
(b) Based on quarterly data.
(c) Population and personal income figures adjusted into fiscal years.
Source: Tax Foundation, based on data from Department of Commerce, Bureau of the Census, and Bureau of Economic Analysis.

Virginia Tax Reform Plan Pushes Sales Tax Repeal

Flat Income Tax Would Make up Revenue, Save on Federal Taxes

A new Tax Foundation report proposes that Virginia repeal its sales tax and make up the revenue by enacting a flat 6-percent tax on individual income, matching the rate on corporate income.

Writing on the op-ed page of the *Richmond Times-Dispatch* on March 8, Tax Foundation President Scott Hodge called for a clean departure from the plans that have led to the current stalemate, asserting they would all stunt Virginia's economic growth.

"As shoppers from Maryland, Virginia and Pennsylvania prove every day," Hodge wrote, "Delaware's zero tax rate on sales is a magnetic draw. Virginia retailing could enjoy the same advantage, but Gov. Warner and the Senate would go the other way, giving neighboring states a competitive edge."

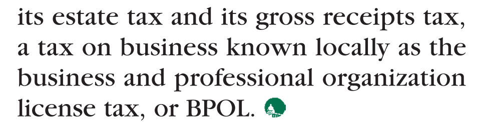
The Tax Foundation report is critical of the current legislative proposals because they raise the sales tax, a tax that is hard to enforce, hard on lower-income people and hard on the economy in general.

Sales taxes hit low-income people harder because they spend most of their money on basic, taxable products rather than untaxed services. The plan from the House of Delegates to rectify this problem by taxing more services would create "tax pyramiding." That happens when businesses pay sales tax on materials that they resell with tax, effectively charging tax on tax.

The sales tax is hard to enforce and hard on the economy because catalogs, the internet and nearby low-tax jurisdictions offer easy avoidance.

The Foundation's revenue-neutral plan makes up lost revenue by eliminating many deductions from the flat 6-percent state income tax, preserving only a per-person allowance of $3,700. As a by-product of relying more heavily on state income taxes, Virginia's taxpayers could deduct $3 billion more on their federal tax returns, saving about $390 million annually.

Extra revenue from a flat income tax would also allow Virginia to repeal its estate tax and its gross receipts tax, a tax on business known locally as the business and professional organization license tax, or BPOL.



Publication Summary

General: Special Report No. 127; ISSN 1527-0408; 12pp.; $10 or $50/yr. for 10 issues on varied fiscal topics

Title: The Path to Reforming Virginia's Tax Code

Authors: Steve Slivinski & Scott Moody

Date: February 2004

Web: taxfoundation.org/virginia

Subject: Reaction to the tax plans offered by legislators and the governor in Virginia, with a suggestion for more fundamental reform.

Tables: How Virginia Stacks Up – Tax Burdens in the Region; How Virginia Stacks Up – Statutory Tax Rates in the Region; Impact of Tax Reform Proposals on Two-Earner Families of Four Who Take the Standard Deduction; Impact of Tax Reform Proposals on Two-Earner Families of Four Who Itemize Deductions

New Studies from the Tax Foundation on Manufacturing Employment, Cross-Border Beer Purchases and the Impact of Alcohol Taxes

Publication Summary

General: Background Paper No. 42; ISSN 1527-0408; 16pp.; $25 or $60/yr. for 4 issues on varied fiscal topics

Title: Manufacturing Employment, Productivity and the Business Cycle

Author: John A. Tatom

Date: February 2004

Subject: Recent U.S. manufacturing job loss is consistent with the historical pattern of secular decline, with steep losses during recessions as well as during the months immediately before the business cycle peak and after the trough. Manufacturing jobs have declined worldwide for at least 20 years as manufacturers have found new ways to produce more with fewer employees.

Publication Summary

General: Background Paper No. 43; ISSN 1527-0408; 16pp.; $25 or $60/yr. for 4 issues on varied fiscal topics

Title: A Critique of the National Research Council and Institute of Medicine's Recommendations to Raise Alcohol Excises to Curb Underage Drinking

Author: Patrick Fleenor

Date: March 2004

Subject: Asserts that higher alcohol taxes would hurt a large, low-wage population of legal drinkers, but provide no effective deterrent to underage drinking. Contends that enforcement measures targeted at alcohol abusers are more effective and practical.

Publication Summary

General: Background Paper No. 44; ISSN 1527-0408; 16pp.; $25 or $60/yr. for 4 issues on varied fiscal topics

Title: How Tax Competition Affects Cross-Border Sales of Beer in the United States

Authors: J. Scott Moody, M.A. and Wendy P. Warcholik, Ph.D.

Date: March 2004

Subject: Shows how often beer taxes induce customers to shop in adjacent low-tax jurisdictions. High taxes in Illinois, New York and Alabama cause residents to buy the most beer out of state. Low-tax shopping destinations include Delaware, New Hampshire, New Jersey and Oregon.

FOUNDATION MESSAGE

Reforming Virginia's Tax Code

Scott A. Hodge
President
Tax Foundation

Considering the anti-tax reputation of Virginia voters, it is not surprising that most state officeholders take a pledge not to raise taxes when they're up for re-election. Governor Mark Warner (D) was no exception, nor was Republican State Senator John Chichester.

By late 2003 those promises were forgotten as Gov. Warner submitted a budget that included $1 billion in tax hikes under the banner of "tax reform," and Senator Chichester responded with a tax hike almost 4 times bigger.

So far the truly anti-tax House of Delegates has opposed both tax hike plans, but even the House eventually passed a budget that raised some taxes.

Our concern is not with party, or even so much with revenue-raising. Our concern is with tax policy. Not one of the announced plans deserves the name of tax reform, and not one will improve the business tax climate.

In our annual ranking of the states' business tax climates, Virginia ranked 21st, which though respectable is low for a state with a comparatively low state-local tax burden. Gov. Warner was right that Virginia needs tax reform, but he is wrong to think that his plan is real tax reform.

The General Assembly needs a distinctly different plan that can raise needed revenue and deliver honest-to-goodness tax reform.

We have devised such a plan (see Tax Foundation Special Report, No. 127, described on page 10). It follows the principles of fairness and simplicity, and it would give Virginia one of the most economically competitive tax systems in the country. It is revenue neutral, as all tax reform should be, to put aside any suspicion that the ulterior motive is to raise or lower revenue. Of course, the same sound principles could be adapted to a higher or lower revenue stream.

The "6 and 6" Plan

We call our proposal the "6 and 6 plan" because it relies heavily on flat 6% taxes on individual and corporate income. Meanwhile, it targets for repeal the sales tax, the estate tax and the business and professional organization license tax (BPOL).

Scrap the Sales Tax

Sales tax collection has become a nightmare and will probably continue shrinking nationwide as a share of state revenue. Internet-shoppers have joined cross-border travelers and catalog users in avoiding the tax. Raising the rate just creates a vicious cycle, punishing "brick-and-mortar" retail and giving shoppers even more reason to avoid the tax. Virginia legislators should reverse the flow of shoppers and bring their business in state.

On the fairness front, sales taxes generally hit low-income people harder because they spend most of their money on basic, taxable products. Meanwhile, higher-income people spend a lot on untaxed services.

Attempts to make the sales tax fairer by extending it from basic products to tax exempt services—the House plan does this—causes "tax pyramiding." That's what happens when businesses pay sales tax on equipment and services, then resell their products with another sales tax, effectively charging tax on tax.

Flatten the Income Tax

Virginia should replacing its 4-bracket income tax structure with a flat 6% rate, allowing no deductions except for a generous exemption of $3,700 per person.

This higher tax with no deductions for interest or charitable giving would collect a lot more revenue. By itself, this would be a hardship, but as part of the whole package, it's worth it. Keeping popular deductions would force the rate up into uncompetitive territory.

One major bonus of this heavy reliance on the state income tax is federal deductibility. Virginians would deduct almost $3 billion more every year on their federal 1040s, saving $390 million in taxes. That savings alone could almost finance Gov. Warner's plans for higher spending.

Match Income Tax Rates for Individuals and Corporations

When tax time rolls around, many businesses can guide income into either the "corporate income" column or the "individual income" column. It's wise, therefore, for the state to keep the individual and corporate rates the same, and with as few deductions and exemptions as possible on both sides. In the matter of tax avoidance schemes, an ounce of prevention is worth a pound of audits.

Raise the Gas Tax 7 Cents

Currently, a half-cent of the sales tax is devoted to transportation. This would make up that revenue.

Repeal the Estate Tax

Virginia can keep its wealthy retirees and foster small business growth. Warner's plan comes so close to eliminating the estate tax that one wonders why he can't pull the trigger. Why keep that monstrous administrative superstructure in law for so little revenue?

Repeal the Business License Tax

The obscure business and professional occupation license tax (BPOL) is a job-killer because unlike a corporate income tax that varies with profitability, this gross receipts tax hits even during economic slumps.

Adopting the Tax Foundation's "6 and 6" plan would greatly improve Virginia's business tax climate, and save on federal taxes to boot.

Raising taxes isn't what tax reform is about, but the General Assembly could do the state a world of good by focusing on true tax reform while it does its revenue business.

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