Tax Watch

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TAX FOUNDATION Since 1937

Competing for Companies: Which States Are Best for Business?

When states began losing jobs during the latest recession, "outsourcing"—U.S. companies sending jobs overseas—started making headlines nationwide.

But behind the stories of laid-off tech workers and turncoat U.S. companies is an often-overlooked fact about outsourcing: compared to other job threats, the roar of outsourcing sounds more like a squeak.

According to a recent Government Accountability Office report, of the 1.5 million jobs lost last year in major layoffs less than 1 percent went overseas. Department of Labor statistics tell a similar story. Most job relocations in recent years haven't gone overseas at all. Instead, they have shifted from one U.S. state to another.

That suggests the important competitor facing states for jobs and investment may not be India, China and Pakistan after all. It may be neighboring U.S. states—especially those with more attractive taxes on business.

"States do not enact tax changes in a vacuum," said Scott A. Hodge, president of the Tax Foundation. "Every tax change will affect a state's competitive position relative to its neighbors, as well as globally."

Many factors affect companies' location decisions, and tax climate can be an important one. Tax burdens vary dramatically from state to state. Companies gravitate toward places where costs are low and returns are high, and between equally attractive locations, better state taxes can tip the balance in one's favor. That gives states with business-friendly tax codes a competitive advantage in attracting and keeping new jobs and investment.

So which states are tax-friendly? One answer comes from the Tax Foundation's "2004 State Business Tax Climate Index," by Scott A. Hodge and J. Scott Moody. The report ranks the business-tax friendliness of the 50 states and the District of Columbia, providing a roadmap to lawmakers concerned with keeping their states tax-competitive.

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TaxWatch

Tax Watch is published four times per year by the Tax Foundation in Washington, D.C., a nonprofit, nonpartisan research organization that has monitored tax policy at the federal, state and local levels since 1937.

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Visit us on the web at www.taxfoundation.org or call (202) 464-6200.

Message from the President: Getting Ready for Tax Reform

With rumors of a possible flat tax or national sales tax if President Bush is elected to a second term, tax reform is back on the table.

And just in time. Although Republicans have cut taxes every year for four years running, they unfortunately added 10,000 pages to the tax code in the process. Today the tax code needs simplification more than ever.

As the debate unfolds reformers should beware of the partisan bickering that has plagued past reform efforts—political infighting over whether a flat tax or a national sales tax is the better system.

Regardless of which system we choose, we should keep our eye on four goals of tax reform:

Simplicity: With 60,000 pages in the tax code and regulations, even the IRS can't answer taxpayer questions anymore. Tax compliance in 2002 alone burned off $204 billion in wealth from the U.S. economy. Both a flat tax and a national sales tax would plug this economic sinkhole.

Economic neutrality: The goal of taxes is to raise revenue while doing the least to wreck the economy—what Jean Baptiste Colbert called "plucking the goose so as to get the most feathers with the least hissing." Today's tax code ignores this. It is riddled with political favors and attempts to socially engineer the economy. Both a flat tax and a national sales tax would solve this.

Flat rates, wide bases: Good taxes have low, flat rates and broad bases. It's no surprise countries like Russia, Poland, Slovakia, and even Iraq have chosen flat income tax systems when redesigning their tax codes from scratch recently. Ireland's flat corporate tax rate of 12.5 percent has led to an economic boom that's the envy of Europe. Both a flat tax and a national sales tax would help do the same for America.

Fairness: A common misconception is that only progressive taxes, with higher rates on higher income, are fair. But progressive taxes have many unfair features, like the marriage penalty and disincentives to work and invest. A more common-sense standard of fairness is proportionality, where everyone pays the same rate with no loopholes. That guarantees the rich pay their fair share—for example, 20 percent of $250,000 is a larger tax burden than the same rate applied to $25,000—and no one avoids taxes.

The real challenge of tax reform isn't choosing between flat income taxes or sales taxes. It's eliminating exemptions—from home mortgage interest to hybrid gas-electric cars—in order to keep rates low. Every deduction has its own interest group. And getting these taxpayers to trade personal benefits for a simpler tax system will be a tough sell, no matter which path to reform we take.

Sincerely,

Scott A. Hodge

The Case Against Lotteries

We've all heard that "lotteries are a tax on people who are bad at math." What's less often heard is that lotteries are also bad tax policy.

That's according to a forthcoming Tax Foundation study exploring the flaws of raising tax revenue through lotteries. The study addresses a common fallacy used to promote lotteries: the idea that lottery revenue is not actually tax revenue since playing the lottery is voluntary.

> *"Taxes should be transparent and neutral. Lottery taxes violate these principles."*

Lotteries, like other forms of taxation, should adhere to basic principles of sound tax policy like transparency and neutrality. But according to the study, lotteries violate these principles.

"Sound tax policy requires taxes that are transparent, or clear to taxpayers," said Hansen. "Taxpayers should understand what is being taxed and at what rate."

Since state governments refuse to call lotteries taxes and advertise them as recreational activities rather than as revenue-raising activities, the tax is implicit and transparency is impossible.

Another problem is that lottery taxes are not economically neutral. A neutral tax system is one that doesn't encourage the consumption of one good over another, thereby distorting consumer spending. However, lotteries are singled out for a higher tax rate than other forms of gambling. This lowers the payout rate—the amount of money gamblers win as a percentage of the money they bet—which causes economic distortion.

A third problem with lotteries is that they're regressive, meaning the poor bear a disproportionately heavy share of the tax burden.

For example, the National Gambling Impact Study Commission found that in 1997, although people of all incomes played the lottery, players with incomes under $10,000 spent almost three times as much as those with incomes over $50,000.

Lotteries Spread as Revenue Source

Forty states and the District of Columbia currently run lotteries and other states are considering them.

In Fiscal Year 2003 total spending on lotteries was almost $45 billion, or $155 for every man, woman and child in the United States. Roughly 31 percent of this, or almost $14 billion, went into state coffers, making lottery taxes 2.2 percent of the own-source general revenue lottery states raise.

In 2002, the average American spent more on lotteries than on reading materials or movies. Lotteries are now the most popular form of gambling in the U.S., with more than half of Americans playing the odds in any given year.

"State-run lotteries make state tax systems more regressive, less transparent, and less economically neutral," said Hansen. "For all these reasons, the lottery is an example of poor tax policy."

Advance copies of the study, "Lotteries and State Fiscal Policy" by Alicia Hansen, are available by calling (202) 464-6200.

Key Tax Bills to Watch

H.R. 25—"Fair Tax Act of 2003"

Sponsor: John Linder (R-GA)
What it does: Abolishes all federal income taxes, "death" taxes, capital gains taxes and payroll taxes in favor of a 23 percent national retail sales tax.

H.R. 3220—"Business Activity Tax Simplification Act of 2003"

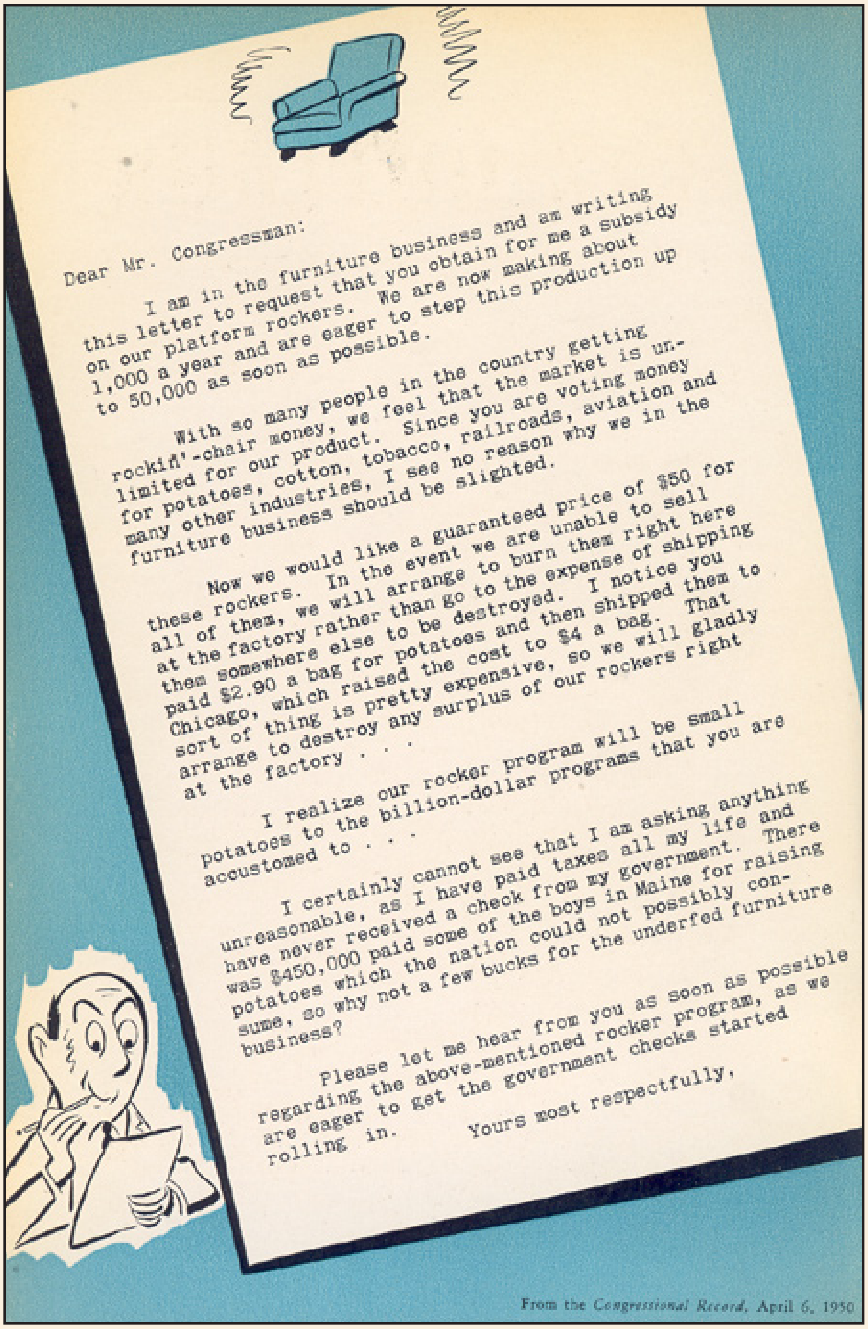
Sponsor: Bob Goodlatte (R-VA)
What it does: Prevents state tax collectors from imposing state income taxes on non-residents who visit on business, ending the so-called "jock tax."

H.R. 1308—"Working Families Tax Relief Act of 2004"

Sponsor: William M. Thomas (R-CA)
What it does: Provides a range of tax cuts for middle-income families, extends many Bush tax cuts from 2001 and 2003.

From the Archives: 1950

Some things never change. A letter from the June 1950 issue of the Tax Foundation's Tax Outlook, as printed in the Congressional Record of April 6, 1950:



Dear Mr. Congressman:

I am in the furniture business and am writing this letter to request that you obtain for me a subsidy on our platform rockers. We are now making about 1,000 a year and are eager to step this production up to 50,000 as soon as possible.

With so many people in the country getting rockin'-chair money, we feel that the market is unlimited for our product. Since you are voting money for potatoes, cotton, tobacco, railroads, aviation and many other industries, I see no reason why we in the furniture business should be slighted.

Now we would like a guaranteed price of $50 for these rockers. In the event we are unable to sell all of them, we will arrange to burn them right here at the factory rather than go to the expense of shipping them somewhere else to be destroyed. I notice you paid $2.90 a bag for potatoes and then shipped them to Chicago, which raised the cost to $4 a bag. That sort of thing is pretty expensive, so we will gladly arrange to destroy any surplus of our rockers right at the factory . . .

I realize our rocker program will be small potatoes to the billion-dollar programs that you are accustomed to . . .

I certainly cannot see that I am asking anything unreasonable, as I have paid taxes all my life and have never received a check from my government. There was $450,000 paid some of the boys in Maine for raising potatoes which the nation could not possibly consume, so why not a few bucks for the underfed furniture business?

Please let me hear from you as soon as possible regarding the above-mentioned rocker program, as we are eager to get the government checks started rolling in.

Yours most respectfully,

From the *Congressional Record*, April 6, 1950

Our Economists in the News

Samples of recent Tax Foundation media mentions:

News Stories

Washington Post,
"Maryland Tax Truths"

Boston Globe,
"Bay State Nation"

New York Post,
"Tax Cuts, Jobs, and 'Jeopardy'"

Investor's Business Daily,
"Taxing Changes"

MSNBC,
"State tax could yield high returns"

Sacramento Bee,
"What California offers businesses"

Washington Times,
"Republicans insist Bush tax cuts working"

Orange County Register,
"Higher Taxes Are On the Way"

Kansas City Star,
"Rich still bear tax burden"

North Carolina Herald-Sun,
"Low-cost climate lures firms to N.C."

Indianapolis Star,
"Vote Indiana"

National Review Online,
"Taxing times for Democrats"

Human Events,
"Edwards' Class-Envy Demagoguery Exploits the Misinformed"

Op-Eds

Vero Beach Press Journal (FL),
"Sales Tax Exemptions Require Selective Approach" by Nicole Akar

Providence Journal (RI),
"Making sense of Bush, Kerry tax plans" by Andrew Chamberlain

Myrtle Beach Sun News (SC),
"Presidential plans fail on good-tax basics" by Andrew Chamberlain

Metrowest Daily News (MA),
"Presidential candidates' tax reform plans fail America" by Andrew Chamberlain

Visit our new "Press Room" at www.taxfoundation.org/pressroom.html.

Putting A Face On America's Tax Returns

Bush Tax Cuts Knocked Millions off Income Tax Rolls

For 7.8 million lucky American families, the tax man cometh no more.

That's according to a new Tax Foundation analysis showing 7.8 million low- and middle-income families had their entire income tax liabilities erased by the 2001 and 2003 Bush cuts—disproving claims that the cuts only helped the rich.

The two cuts that erased the most tax liability were the new 10-percent tax bracket and the doubling of the child tax credit from $500 to $1,000. Both these cuts will remain in effect until 2010.

Using the Tax Foundation's Individual Tax Model and Matched IRS/Census Database, Foundation economists painted a demographic portrait of the 7.8 million families who pay no income tax thanks to the Bush cuts.

Who are they? The analysis shows they're overwhelmingly modest-income, married couples with children who work full-time and are under 45. When dependents are added in, more than 25.5 million Americans were taken off the tax rolls.

How the Bush Tax Cuts Reduced Taxes For Families

Married Couple with Two Children	Before Bush Cuts (2000)	After Bush Cuts (2004)
Adjusted Gross Income in 2004	$40,000	$40,000
Minus Standard Deduction	-$7,350	-$9,700
Minus Personal Exemption	-$11,600	-$12,400
Taxable Income	$21,050	$17,900
Gross Taxes Owed	$3,158	$1,970
Minus Child Credit	-$1,000	-$2,000
Taxes Owed	**$2,158**	**$0**

Source: Tax Foundation

How to Pay Nothing

Here's how it works. The table below shows how the Bush cuts affect the taxes owed by a family of four earning $40,000 per year. Before the cuts, the couple would've owed $2,158. But afterward, they owe nothing, illustrating the benefits of the extended child credit for families with children.

Here are some facts to help put a face on these 7.8 million tax-free families:

- They have modest incomes: More than 90 percent earn less than $50,000 per year, and just 0.06 percent earn more than $100,000.
- They're overwhelmingly young and in the prime years for raising families: Nearly 38 percent are under 35, and 75 percent are under 45.
- They're mostly married couples or single mothers with children: Nearly 62 percent are married couples filing jointly or separately. Almost 25 percent are headed by a single parent filing as a "head of household." Since women are the major breadwinner in roughly 44 percent of these zero-paying families, Tax Foundation economists estimate that the majority of single parent households are in fact single mothers with children.
- They're full-time workers: Nearly 79 percent worked full-time during the past year, while less than 12 percent worked part-time.
- They work in all sectors of the U.S. economy: While they are concentrated in manufacturing (16 percent), retail (13 percent) and construction (8 percent), zero-paying workers also are found in business repair (6 percent), education (5.5 percent), transportation (5 percent) and more, illustrating the broad economic impact of the Bush cuts.

To learn more about the "Putting a Face on America's Tax Returns" project, visit www.taxfoundation.org/face.html.

Business Tax Climate Index (continued from page 1)

Why an index?

The goal of the index is to help focus lawmakers on good-tax fundamentals in their states, rather than short-term tax boondoggles that temporarily lure jobs from other states.

"The temptation is for state lawmakers to lure high-profile companies from other states with packages of tax bonuses," said Hodge, who co-authored the study. "But that strategy can backfire."

For example, in 1996 Florida lawmakers lured a major credit card company to open a call center with a generous $3 million tax refund package. Just eight years later lawmakers were shocked at the announcement that the company was closing the Tampa call center and laying off 1,100 workers.

"Florida's experience shows preferential tax bonuses don't guarantee jobs will stay permanently," said Hodge. "Often they mask deeper flaws in state taxes, and the index helps draw those to lawmakers' attention."

"Tax systems are not created equal... The ideal system should be neutral to business activity."

How it works

The index evaluates state tax systems by several criteria, and ranks them numerically to allow easy comparison of the 50 states' complex tax systems. Generally the index rewards tax codes that are neutral, have low and flat rates, are simple and transparent, avoid double taxation, and have statutory or constitutional restraints that keep tax burdens low over time.

The results: who's best and worst?

Here are the states with the ten best business tax climates:

1. South Dakota	6. Nevada
2. Florida	7. Wyoming
3. Alaska	8. Colorado
4. Texas	9. Washington
5. New Hampshire	10. Oregon

The common characteristic? Almost all the best states don't have at least one of the three major state taxes—sales taxes, personal income taxes and corporate income taxes. Five of the top 10—Alaska, Nevada, South Dakota, Washington and Wyoming—have only enacted one of the three.

In contrast, the ten worst business tax climates are:

50. Hawaii	45. Vermont
49. New York	44. Kentucky
48. Minnesota	43. Arkansas
47. West Virginia	42. Maine
46. Rhode Island	41. Wisconsin

Generally the worst states have complex, multi-rate corporate and individual income tax codes that impose above-average tax rates, above-average sales tax rates that don't exempt business inputs, complex, high-rate unemployment tax systems, and high overall state tax collections with few tax or expenditure controls.

"The ideal tax system, whether at the state, federal, or international level, should be neutral to business activity," said Hodge. "In such a system, people would base their economic decisions on the merits of the transactions rather than the tax implications."

The bottom line? Tax systems are not created equal, and that makes competition between them inevitable. Lawmakers who ignore interstate tax competition and focus on outsourcing fears instead do so at their peril.

"The index offers a guide to states on becoming more competitive," said Hodge. "But implementing it may well require state tax reform."

As budget surpluses build in coming years, watch for pressure on state lawmakers to improve tax climates to build as well.

The full study, "2004 State Business Tax Climate Index" by Scott A. Hodge and J. Scott Moody, is available at www.taxfoundation.org or by calling (202) 464-6200.

Making Taxes Simple: Are Deficits Bad for the Economy?

Just like people, governments that spend more than they collect go into debt. This year the federal government will overspend by $422 billion—the biggest deficit as a percentage of national income since 1993.

Some warn that, like a spendthrift approaching bankruptcy, large budget deficits threaten future prosperity. Are deficits really bad for the economy?

In theory, yes. When governments run deficits they must borrow to make up the difference. That means they compete with companies, home buyers, and others for scarce funds, which can bid up interest rates. That makes it more expensive to start new companies and invest in new equipment, and that can slow productivity growth—the engine of rising living standards.

So does the theory fit the facts? Yes and no. The historical relationship between deficits and interest rates is murky, partly because many complex variables in the economy affect interest rates. Some studies find a slight relationship, while others find none. Often they move in opposite directions altogether.

The bottom line? At some level, deficits can cause harm. But they must be very large to do so. Compared to deficits of the 1980s and 1990s—which reached 4-5 percent of national income—today's deficit of 3.6 percent is hardly cause for panic. Though with booming Social Security, Medicare and Medicaid liabilities on the horizon, that may change soon enough.

Taxes Then and Now

Some famous tax beginnings—and where they've ended up (all figures inflation-adjusted, in 2003 dollars):

Up in Smoke

The first federal tobacco tax was passed July 1, 1862, and raised $100 million in 1864. By 2003, federal tobacco taxes raised $8.2 billion, an 81-fold increase. At $4 per pack, that's enough to build 14 full-size replicas of the famous Leaning Tower of Pisa out of cigarette packs. Laid end to end, those cigarettes would stretch from the earth to the moon, nine times.

Fueling Taxes

The first state gas tax—one cent per gallon—was passed in Oregon on February 15, 1919, and raised $4.7 million the following year. Today, Oregon's gas tax is 24 cents per gallon, with 2002 collections of $405 million, an 85-fold increase. At today prices that's enough to buy the gas needed to drive a Honda Accord at 60 miles per hour for twelve and a half years—long enough to circle the earth about 265 times.

License to Tax

The first law requiring auto license plates passed in New York on April 25, 1901, and the $1 fee brought in $23,300 the following year. By 2001 motor vehicle registration fees raised $606 million, a stunning 26,000-fold increase. At $2 per mile, that's enough for a one-mile New York City cab ride for every man, woman and child in the United States—tip not included.

Lower Taxes for You, Better Tax Policy for America

Make a charitable stock gift to the Tax Foundation

How can you support sound tax policy and also lower your own tax burden? By making a charitable gift of stock to the Tax Foundation.

Gifting appreciated stock directly to the Tax Foundation helps leverage your charitable giving dollars. Not only do you avoid paying capital gains tax, but you may also be entitled to a full tax deduction for the value.

How Giving Stock Maximizes Your Charitable Gift*

	Stock gift	Sell stock, then give cash
Value of stock (1,000 shares at $50 per share)	$50,000	$50,000
Capital gain	$40,000	$40,000
Capital gains taxes paid (15%)	$0	-$6,000
Value of gift to Tax Foundation	**$50,000**	**$44,000**
Federal income taxes saved	$17,500	$15,400
Cost to you of gift (Gift value, minus capital gains tax and income tax savings)	**$26,500**	**$34,600**

Assumes a 15% long-term capital gains tax rate and 35% federal income tax rate where the donor is eligible to write the gift off against their income. These examples do not reflect the true and total cost to every donor. Please consult your attorney or accountant before making any tax-related decisions.

Here's how it works: Mr. Jones wants to give 1,000 shares of stock to the Tax Foundation. The stock currently sells for $50 per share, making it a $50,000 gift. Mr. Jones originally paid $10 per share for the stock.

Mr. Jones can either sell the stock and donate the proceeds, or he can transfer the stock to the Tax Foundation. If he sells the stock first, he'll pay capital gains tax on his $40 gain per share, reducing the size of his gift. But by transferring the stock to the Tax Foundation instead, he can donate the full $50,000 and avoid capital gains tax entirely.

Also, depending on his tax situation, he may be able to deduct the full value of the charitable stock gift from federal income taxes. In this way, giving stock lets Mr. Jones give more and feel the impact less.

To learn more about making an end-of-the-year stock gift to the Tax Foundation, please contact Julie Burden, Director of Development, at (202) 464-5102 or Chris Gabriel at UBS Financial Services at (404) 848-8522.

Join Us: 67th National Conference and Annual Dinner

Don't forget to register for the Tax Foundation's 67th anniversary celebration at our National Conference and Annual Dinner, both held on Thursday, November 18, 2004 at the Four Seasons Hotel in Washington, D.C.

The conference is titled "Global Tax Reform: Who's Leading, Who's Lagging and Is the U.S. in the Race?" The event is followed in the evening by our Annual Dinner, featuring our annual silent auction and presentation of our Distinguished Service Awards for major contributions to tax policy. This year's awards will be presented to Sen. Don Nickles (R-OK) and Mr. Lee R. Raymond, Chairman and CEO, ExxonMobil.

Seats are still available—reserve your place today by calling Julie Burden at (202) 464-5102 or visiting www.taxfoundation.org.