Tax Watch

Summer 2010

TAX FOUNDATION Since 1937

In the Trenches: Fighting for Better State Taxes

When it comes to tax debates, most headlines focus on federal taxes in Washington. But many of the most important tax battles in America are happening much closer to home.

From state lotteries to city income taxes, local taxes matter for taxpayers—and they matter to Tax Foundation experts.

"Unlike many Washington think tanks, the Tax Foundation has always been active in local tax debates in Americans' own backyards," said Joseph Henchman, Director of State Projects at the Tax Foundation. "But in recent years we've expanded our state level work, and we're seeing results."

With dozens of states facing budget crises, the Tax Foundation's *Center for State Fiscal Policy* has been busy offering pro-growth solutions to lawmakers around the country this year.

Battling Tax Hikes in Illinois

Facing a budget shortfall of $11 billion, Illinois Governor Pat Quinn proposed a predictable solution this spring: a 33 percent increase in the state's personal income tax rate. Within one day of Quinn's proposal, Tax Foundation experts countered with a study warning of economic harm from the proposed tax hike and offering market-friendly alternatives.

"Illinois shouldn't rely on taxes alone to bring the state out of the red, but a change in tax policy could help its economy," said Tax Foundation analyst Justin Higginbottom. "Increasing taxes would worsen the state's already harsh business tax climate and make the state less attractive to the businesses and individuals it should be courting."

The study listed a range of pro-growth options, including expanding the sales tax and corporate income tax bases and lowering rates, and ending targeted business incentives for film production and bio-fuel companies.

"The best feature of Illinois's tax system is its flat personal income tax rate of 3 percent, the lowest flat rate in the country," said Henchman. "There are many ways to solve budget problems without raising personal income tax burdens."

Targeting Smokers in Georgia

The first place revenue-hungry states usually look is taxes on unpopular

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TaxWatch

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TAX FOUNDATION Since 1937

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Message from the President:
A Smaller Federal Budget Starts at Home

Not all redistribution occurs between groups of today's taxpayers. The $1.5 trillion federal deficit makes us all, in effect, today's "takers" at the expense of tomorrow's workers and taxpayers.

This year, taxes will cover just 58 cents of every dollar the federal government will spend. That's $2.1 trillion in revenues versus $3.6 trillion in spending. The $1.5 trillion deficit means that, on average, every American household will consume about $13,000 more government this year than they'll pay in taxes. That's $251 per week in extra government goods and services we'll receive above our tax bills.

Before you say, "Wow, I'm getting great value for my tax dollars!" don't forget that the deficit is simply borrowed money. You and I are consuming $13,000 in taxes today that will be paid for by future taxpayers. Pity them.

Economists have identified a phenomenon they call "fiscal illusion." When people perceive the cost of government is less than it really is, they will tend to demand ever more government spending. The real danger today is not just that we have so many non-payers, but that these massive deficits are making the cost of government look misleadingly cheap for all of us. So much spending is raining down on us that it seems like we're enjoying "free money."

For any nation, this is a recipe for fiscal disaster. The recent crisis in Greece is a vivid illustration.

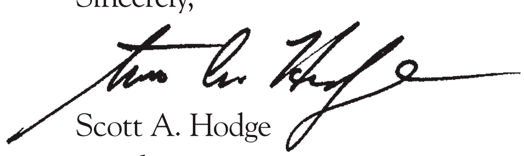
The solution to this disconnect between taxes and spending is not to raise taxes to match spending levels, as Obama's deficit commission seems bent to do, but to convince Americans to consume less government without causing the kind of riots we're seeing in Greece and elsewhere.

The question is: How can we personalize these solutions in such a way that Americans will feel like their individual actions can make a difference?

This is the fiscal equivalent of trying to raise money to solve hunger in Africa. A $25 contribution alone cannot solve the hunger problem, so why would people ever contribute to the cause? Well, one way to persuade them to help is to personalize the solution by showing them that their $25 contribution, while small, can still achieve the noble goal of feeding a particular pictured starving child. As they say, every dollar helps solve the problem.

My challenge to you is this: What is the one thing you personally can do to consume less government? Send me your solutions at hodge@taxfoundation.org.

Sincerely,



Scott A. Hodge
President

Health Care Bill May Redistribute Billions

This year's controversial health care bill may have been designed to boost health coverage, but a new Tax Foundation study finds it will also redistribute billions of dollars between American families each year.

"The new health care law increases income redistribution from high-income families," said Tax Foundation economist Gerald Prante, Ph.D. "This is largely due to the bill's targeted Medicare tax hike on those earning over $200,000, which for the first time incorporates a taxpayer's filing status into his or her payroll tax liability and also applies to investment income as well as wages."

Senior Economist Gerald Prante explains the tax provisions in the health care bill on The 700 Club.

> "The health care bill will sharply increase the number of Americans who are net 'takers' of government spending."

Who Wins and Loses

The health care bill signed into law by President Obama is one of the most significant pieces of domestic legislation since the 1960s. The law transforms the financing of U.S. health care and expands Medicaid so that more Americans above the poverty line will be eligible for benefits.

But subsidizing health care is no free lunch. The new Tax Foundation analysis estimates who will pay and who will benefit from health care reform, quantifying how much income is transferred from higher-income Americans to pay for benefits to low- and middle-income groups.

The study's findings show dramatic redistribution between taxpayers.

"The health care reform bill would take an additional $52,000 per year on average from families in the top 1 percent of the income scale," said Prante. "This is on top of the existing income redistribution of roughly $485,000 from those families under current policy."

The families that stand to benefit most from the bill are low-earners. Those earning an average of $23,600 per year stand to benefit most, by about $2,000 per household every year.

As a group, the study finds the nation's top 1 percent of earners will pay an additional $61.2 billion in taxes from the bill. In contrast, lower-income families in the 10th to 20th income percentile will receive a bonus of $37.4 billion from the health care bill.

One surprise is that families in the nation's lowest income group don't receive the most redistribution from the bill. Instead, the second-lowest income group will profit most. The reason is that most of the lowest-income families already receive Medicaid and Medicare benefits, while many families in the second-lowest income group will now enjoy those benefits for the first time.

The study is part of the Tax Foundation's ongoing "fiscal incidence" project, which is designed to gauge the level of income redistribution by measuring the effects of tax and spending policies.

The study's methodology is simple. The authors first estimate how much redistribution already takes place due to federal taxes and spending. This "baseline scenario" is then compared to how much redistribution would occur under the new health care bill. This approach answers the question, "How much does the health care bill redistribute income?"

"The bottom line is that the health care bill will sharply increase the number of Americans who are net 'takers' of government spending, while further shrinking the number who pay for federal spending," said Scott A. Hodge, President of the Tax Foundation.

Read the full study, "Health Care Reform: How Much Does It Redistribute Income?" at www.taxfoundation.org/publications/show/26200.html.

Tax Fact:

Highest state-local sales tax rate: Tennessee, 9.41 percent.

Lowest: Delaware, 1.92 percent.

Testimony: Protect the Economy from State Taxes

The Tax Foundation took its message of sound tax policy into the halls of Congress this spring, testifying on how to prevent states from derailing the U.S. economy with poor tax policy.

"State fiscal pain does not justify beggar-thy-neighbor policies that impose significant compliance and deadweight losses on the national economy," said Joseph Henchman, Tax Counsel and Director of State Projects at the Tax Foundation, who prepared the testimony. "State power to tax should not extend to everything everywhere."

Tax Counsel and Director of State Projects Joseph Henchman explains the economic harm from "Amazon taxes" on Fox Business Network.

"A state's power to tax should not extend to everything, everywhere."

The hearing was before the U.S. House Judiciary Committee's Subcommittee on Commercial and Administrative Law. The subject was state taxation, and was held on the occasion of the April 15th tax-filing deadline.

Curbing State Power

The hearing was held to discuss a number of state tax proposals, including enshrining a physical presence standard for corporate income taxes, allowing states to tax out-of-state companies, limiting income taxes on nonresidents and restricting punitive local hotel taxes.

Henchman explained the need for Constitutional limitations on states' desire to tax the national economy.

"One of the reasons we have a Constitution is because of states' impulse to do death-with-a-thousand-cuts to the national economy through their tax policy," said Henchman. "The Founders inserted constitutional provisions empowering Congress and the courts to restrain state tax power."

For more than 150 years, states' power of taxation stopped at their border and didn't extend to interstate commerce. According to Henchman, in 1977 that changed when the Supreme Court allowed states to tax interstate commerce if the tax met a four-part legal test.

"Unfortunately, states today ignore much of that original legal test," said Henchman.

The testimony points to harmful policy on state corporate income taxes, personal income taxes and sales taxes.

On corporate income taxes, revenues have been falling for years thanks to beggar-thy-neighbor apportionment policies, destructive gross receipts taxes, film and investment credits and other corporate welfare. But rather than fix these problems, many states are reaching across borders to tax outsiders.

"State corporate income taxes are dying, killed off by thousands of credits, deductions, abatements, and incentive packages," said Henchman. "Corporations try to plan their way out of it, resulting in serious compliance and administrative costs."

States are also reaching out to tax outsiders with personal income taxes. The testimony notes half of the fifty states today require nonresident employees to set up personal income tax withholding on their first day of travel into the state for business.

"A few years ago, we got a call from a woman in Ohio," said Henchman. "Her son was a soccer goalie and had earned $28,000. Spread across her kitchen table were 10 state income tax returns, divvying up the tax on $28,000."

Another worrisome trend is the movement toward "Amazon taxes" by states, forcing out-of-state companies to collect sales taxes wherever they have customers or business affiliates. Courts have traditionally shielded out-of-state businesses from having to comply with over 8,000 constantly changing sales taxes with different bases, rates and exemptions.

"The sophistication of technology does not override the timeless constitutional principles designed to restrain states from burdening interstate commerce and imposing uncertainty on the national economy," said Henchman.

Read the full testimony, "The Role of Congress in State Tax Legislation," at www.taxfoundation.org/publications/show/26193.html.

Study: Bag Taxes Don't Work

Just a few years ago, grocery bag taxes to help the environment were considered a fanciful idea. Today a dozen states are considering them, but a new Tax Foundation study shows bag taxes are bad tax policy and fall short of promised environmental gains.

"Sometimes they are pitched as 'fees' and sometimes as 'taxes,'" said Tax Foundation policy analyst Justin Higginbottom. "In almost all cases, grocery bag taxes do not come close to meeting the definition of a fee. Even when pitched more honestly as taxes, they are likely to fall short of ambitious environmental clean-up goals."

Economist Mark Robyn discusses tax credits for film companies on FoxBusiness.com Weekend.

> *"In reality, bag taxes may be just another way for lawmakers to grab general revenue."*

Bag taxes are currently pending in 15 states, ranging from 5 cents to 20 cents per bag. At the city level, Baltimore has proposed a more aggressive tax of 25 cents per bag. In January, Washington, D.C. enacted a 5-cent bag tax, while voters in Seattle rejected a 20-cent bag tax in November 2009.

Exaggerated Benefits

According to the study, advocates of grocery bag taxes often promise an unrealistic list of environmental benefits from the taxes. For example, the Washington, D.C. bag tax was titled the "Anacostia River Cleanup and Protection Act." Pictures of the litter-strewn river and its tributaries served as campaign posters for the new tax.

"City officials promised the tax revenue would be used for environmental education campaigns and cleaning up the Anacostia River," said Higgenbottom. "But the reality was very different."

Just four months after Washington, D.C.'s bag tax was enacted, the city's mayor proposed raiding the $150,000 in bag tax revenue to pay for general city services with no connection to environmental clean-up.

Seattle's proposed bag tax promised even more ambitious environmental gains, including cutting greenhouse gas emissions, shrinking landfills, and curbing ocean litter. In reality, several studies have found small plastic bag taxes would have a negligible effect on global warming or landfill deposits.

"Pictures of marine life killed by plastic have been an effective tool for promoting bag taxes to combat ocean litter," said Higgenbottom. "But a 1997 study on the subject showed bags weren't the culprit, identifying other plastic products such as fishing gear and ropes instead."

Many lawmakers have labeled grocery bag taxes as "fees" to defuse political opposition. In some states fees are easier to pass, as they require only a simple majority while taxes require a two-thirds majority. Also, because fees often benefit those who pay them—such as entry fees to state parks—fee proposals are more likely to be accepted by voters than new taxes.

"To identify a properly designed fee, follow the money," said Higgenbottom. "If the fee revenue is spent on general services unrelated to the taxed product, it is not a fee."

By this reasoning, the Washington, D.C. bag tax is not a "fee," nor are most other bag taxes proposed throughout the states.

"Government-imposed charges for bags are what economists call 'pigouvian taxes,' but it's not clear how much environmental benefit citizens will receive if fewer bags are used," said Higgenbottom. "In reality, bag taxes may be just another way for lawmakers to grab general revenue."

Read the full study, "Bag Taxes Disappointing in Debut" at www.taxfoundation.org/publications/show/26285.html.

Tax Fact:

Highest cigarette tax: New York, $4.35 per pack.

Lowest: Virginia, $0.30 per pack.

(continued from page 1)

behaviors like smoking, drinking and gambling. Facing a $1 billion deficit this year, lawmakers in Georgia proposed a dramatic hike in the state's cigarette tax from 37 cents to $1.37 per pack.

Cigarette taxes may seem like easy revenue, but dozens of studies have shown they have a sinister side-effect: increased smuggling, crime and cross-border shopping in nearby lower-tax states. Tax Foundation experts quickly issued a study warning Georgia lawmakers against the proposal.

"Advocates of boosting Georgia's cigarette tax so dramatically should consider the consequences," said Higginbottom. "A dollar increase in Georgia's cigarette tax would increase the incentive for border shopping and cigarette smuggling as well as benefit higher-income residents at the expense of low-income smokers."

Previous Tax Foundation studies have found high cigarette taxes provide powerful incentives for the creation of black markets and smuggling, pushing an innocent but unhealthy habit into the criminal realm. States lose about $5 billion a year to cigarette smuggling.

"As states turn to tax hikes and gimmicks to conceal their budget woes, we'll be there to correct them."

Bad Policy in Maryland

Facing a severe budget crisis, Maryland lawmakers proposed a variety of tax changes this winter. Unfortunately, most would have raised taxes or worsened the state's tax climate rather than putting it on the road to recovery.

Tax Foundation experts submitted a blizzard of testimony in response. While Maryland lawmakers were considering new taxes on high-earners, Tax Foundation expert Rob Shrum proposed a market-friendly alternative: an across-the-board cut in the state's sales tax.

"Maryland's uncompetitive sales tax rate does nothing to encourage consumers in the surrounding states to come to Maryland to make purchases," Shrum said. "A sales tax reduction would signal that Maryland recognizes the impacts of regional competition and is seeking to steer the state back in the right direction."

Maryland's 6 percent sales tax is tied for the highest tax in the region with Pennsylvania, West Virginia and Washington, D.C.—well above nearby Virginia (5 percent) and Delaware (0 percent).

Tax Foundation economist Kail Padgitt also testified on several Maryland bills that would index the state's tax rates for inflation, cap growth in property taxes and more.

"Maryland taxpayers have for years been hit by a hidden tax increase each year as inflation pushes them into higher tax brackets," Padgitt said. "The Taxpayer Protection Act would make sure Marylanders don't pay higher income taxes unless their purchasing power actually increases."

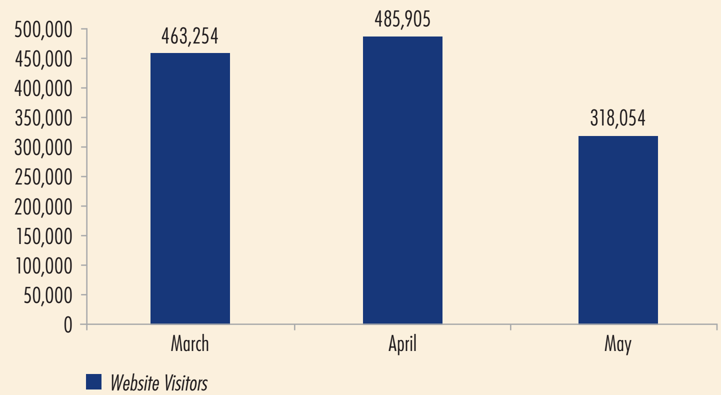
With several states still facing budget shortfalls, Tax Foundation experts are looking forward to a busy second half of the year.

"As states turn to tax hikes and gimmicks to conceal their budget woes, our economists will be there to correct them," said Hodge.

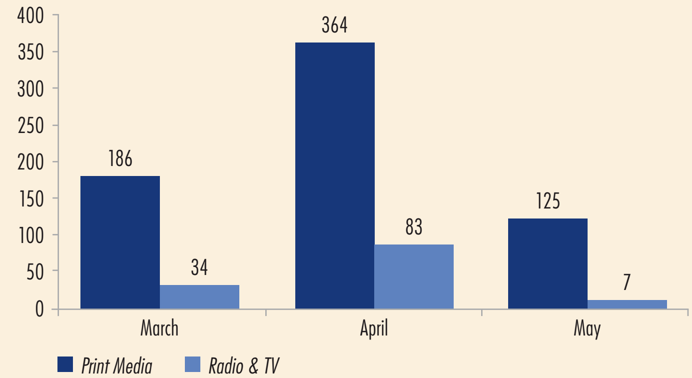
Learn more about the Tax Foundation's state policy work at www.taxfoundation.org/research/topic/9.html.

By the Numbers…

Website Visitors



TV & Radio Citations



Media Impact Report

President Scott A. Hodge discusses the costs of tax complexity on CNN's "Headline News."

With new reports on "Tax Freedom Day," health care reform and more, Tax Foundation experts were cited throughout the media this spring.

Television and Radio

Tax Foundation President Scott Hodge appeared on several Fox News Channel programs, CNBC's "Kudlow Report," and CNN Headline News to discuss "nonpayers" and tax complexity.

Economist Kail Padgitt appeared on the "Kudlow Report" to discuss Tax Freedom Day, and was interviewed by numerous radio stations including NPR and Clear Channel. Economist Gerald Prante was interviewed on Fox Business Network and CBN's "700 Club" to discuss tax provisions in the new health care law, and was interviewed by several radio stations around the country.

Director of State Projects Joseph Henchman was interviewed on Fox Business Network on "Amazon taxes" as well as Fox News Channel on "sin taxes." Several radio stations also interviewed him about his testimony before a U.S. House Judiciary Subcommittee on state taxation. Economist Mark Robyn appeared on Fox Business Network's "FoxBusiness.com Weekend" to discuss film tax credits.

Newspapers

Scott Hodge published op-eds in *Investor's Business Daily* and on CNN.com. Economist Patrick Fleenor published an op-ed on cigarette taxes in the *Buffalo News*. Manager of Media Relations Natasha Altamirano wrote an op-ed on film tax credits for the *Detroit News* and Analyst Justin Higginbottom wrote an op-ed on New Jersey's state-local tax burden for the *Star-Ledger*.

Learn more about the Tax Foundation's media impact at www.taxfoundation.org/press/.

Bringing Sound Tax Policy to the States

Tax Foundation experts have been busy throughout the states this spring:

District of Columbia: Analyst Justin Higginbottom's analysis of the city's new plastic bag tax showed it has exaggerated environmental benefits and hasn't generated much revenue.

Georgia: President Scott A. Hodge spoke to visiting Chamber of Commerce members.

Maryland: Director of State Projects Joseph Henchman testified on Internet tax proposals.

Michigan: Media Relations Manager Natasha Altamirano criticized the state's film tax credit program in a series of op-eds.

Missouri: The Tax Foundation hosted an expert from the Show-Me Institute to discuss income tax and sales tax reform in the state.

Nevada: The Tax Foundation is working with the Nevada Policy Research Institute to develop tax reform options for the state.

New Jersey: Economist Mark Robyn laid out tax and budget facts about the state in a series of news articles and editorials.

Pennsylvania: Director of State Projects Joseph Henchman was the guest speaker at a new legislative discussion caucus.

Staff Economist Kail Padgitt discusses "Tax Freedom Day" on CNBC's "Kudlow Report."

Rhode Island: A new report analyzing income tax reform in the state received wide coverage and may lead to legislative action.

Virginia: We filed a legal brief challenging two local property taxes that tax commercial property but not residential property.

Washington: Economist Kail Padgitt worked with two state think tanks on proposals to replace the state's B&O gross receipts tax and analyze flaws with a proposed income tax.

Learn more about the Tax Foundation's state policy work at www.taxfoundation.org/research/topic/9.html.

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Support the Future of Sound Tax Policy

Part of the Tax Foundation's mission is reaching out to young leaders and introducing them to sound tax policy.

Our internship program brings students from around the country to our Washington, D.C. headquarters. Interns work side-by-side with economists, learning to apply our free-market approach to tax policy.

Unfortunately, internships aren't free—they're only possible with your generous support. As a donor, your contributions help train young leaders like those profiled below. Please consider making a special gift to fund an internship at the Tax Foundation. To learn how, please contact Carter DeWitt at (202) 464-5110.

Megan Arnold, Ryan Forster, Kelli Gulite, Aaron Merchak, Steven Pahuskin, Xander Stephenson and Lawrence Summers.

Meet our 2010 Summer Interns:

Megan Arnold is a junior pursuing a double B.A. in Economics and Anthropology at George Mason University.

Ryan Forster is a junior at the University of San Diego pursuing a B.A. in Economics. Ryan's internship is generously supported by the Fund for American Studies.

Kelli Gulite is a sophomore at George Washington University pursuing a B.A. in Business Administration.

Aaron Merchak is a senior at the University of Maryland double majoring in Economics and Mathematics.

Steven Pahuskin is pursuing a J.D./L.L.M. at Georgetown University Law Center. Steven's internship is generously supported by the Equal Justice Foundation.

Xander Stephenson completed a B.A. in International Relations at Sussex University in 2008. Xander's internship is generously supported by the Institute for Humane Studies Koch Summer Fellow Program.

Lawrence Summers is pursuing an M.P.A. at the School of Public and Environmental Affairs at Indiana University.

Tax Foundation—The gold standard for nonpartisan research and analysis on sound tax policy...since 1937.