

# Tax Policy Handbook for State Legislators

Third Edition

by  
the Fiscal Affairs Program



NATIONAL CONFERENCE *of* STATE LEGISLATURES

*The Forum for America's Ideas*

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## Preface and Acknowledgments

This is the third edition of the *Tax Policy Handbook for State Legislators*. Scott Mackey was the primary author of the original publication with contributions from Arturo Pérez, Mandy Rafool and Judy Zelio. Mandy Rafool and Arturo Pérez updated the second version of the report with assistance from Lisa Houlihan and Graham Williams. This edition was updated by Ian Pulsipher with assistance from other fiscal affairs program staff. Ron Snell and Corina Eckl provided valuable editorial advice.

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## Executive Summary

Changes in fiscal federalism over the 20<sup>th</sup> century, recessions in the early and late years of the first decade of the 21<sup>st</sup> century, and recent extraordinary budget pressures beginning in early 2008 have led lawmakers in many states to take a fresh look at their tax systems and consider whether they meet the current and future needs of their respective governments. Since 2000, at least 37 states have convened tax study commissions—legislative, executive, private sector or some combination—to examine the state tax structure and recommend changes.

This report is designed to provide new legislators—or legislators who have limited experience in tax policy—with basic tools for evaluating various state taxes. It provides an overview of current state tax systems. It also evaluates each major state tax on seven criteria developed by a group of legislators, legislative staff and other tax experts convened by NCSL in the early 1990s. The seven criteria are reliability, equity, compliance, administrative issues, interstate and international competition, economic neutrality, and accountability.

# Introduction

Since the 1970s, the states have emerged as an important force in the American federal system. State legislatures have improved their capacity to develop programs and oversee their financing and performance. Working together, state legislatures and governors have given state government a voice in most of the important public policy debates in the country today.

The 21<sup>st</sup> century finds state governments poised to assume an even greater fiscal role for two primary reasons. First, changes at the federal level have financial implications for states. Federal initiatives on education, election reform and homeland security have added responsibility for programs to the states. At the same time, federal tax cuts have resulted in lower state tax revenues, causing a number of states to decouple from the federal tax base.

Second, the states are assuming more responsibility for financing K-12 education. State court decisions, voter dislike of the local property tax, and a growing legislative concern about inequities in school funding are pushing states to assume a greater role in funding schools from state revenue sources. The partial replacement of local property taxes with state revenues as a funding source for education has major implications not only for state tax systems, but also for local taxes.

At the same time states are being asked to assume additional responsibilities from federal and local governments, voters have imposed term limits on state legislators in 15 states. Increasingly, state lawmakers who do not have extensive legislative experience are serving on—and, in some cases, chairing—committees that have jurisdiction over state and local tax policy. The format of this handbook—short analyses of the major features of state tax sources—is designed to assist legislators who must understand state tax policy and operate in this ever-changing environment.

# Principles for Evaluating State Tax Sources

In 1991, a bipartisan group of state legislators, legislative staff, and other public and private sector representatives identified nine principles to evaluate the quality and effectiveness of state revenue systems.<sup>1</sup> Seven of these nine principles are especially appropriate for evaluating individual tax sources within the state revenue mix, while the remaining two—complementary state and local financial systems and balanced revenue sources—address the interrelationships of tax systems within the state revenue system as a whole.

This handbook evaluates major state revenue sources by the seven principles—reliability, equity, compliance, administration, responsiveness to interstate and international competition, economic neutrality, and accountability—that are appropriate for evaluating individual tax sources. These seven principles are described below; two of them—compliance and administration—are discussed together.

## Reliability

Reliability has three primary components:

- Stability
- Certainty
- Sufficiency

Stability implies that revenues are relatively constant over time and not subject to unpredictable fluctuations. Certainty means that the number and type of tax changes are kept at a minimum to allow businesses and individuals to plan for the future. Sufficiency requires that revenue sources provide the revenue growth necessary to finance the desired rate of spending growth.

The reliability of different types of tax sources varies greatly, depending on the type of activity being taxed. States can improve the reliability of their tax systems by imposing a balanced mix of taxes. The reliability of a tax also depends on its elasticity. Elasticity here refers to how much revenues expand or contract when there is a change in the activity being taxed.

In *The Income Elasticity of State Tax Systems: New Evidence*, Steven Gold provides a definition and explanation of tax elasticity in terms of income:<sup>2</sup>

"The income elasticity of a tax relates the growth of the revenue it produces to the change in personal income. For example, if revenue increases 15 percent when personal income rises 10 percent, the elasticity is 1.5. If revenue increases only 4 percent in response to a 10 percent rise in personal income, the elasticity is 0.4."

Elasticity varies among the different taxes, with income taxes generally more responsive to changes in income than sales taxes:

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<sup>1</sup> National Conference of State Legislatures, *Principles of a High-Quality Revenue System* (Denver: NCSL, 1992).

<sup>2</sup> Steve Gold, *The Income Elasticity of State Tax Systems: New Evidence* (Albany, N.Y.: State University of New York, Center for the Study of the States, 1995), 1-2. Note also that the elasticity of personal income tax is related to the tax rate structure, the definition of the tax base, and "the extent to which the tax is indexed for inflation." See Gold, pp. 2-3, for explanation. See also Ron Snell, *New Realities in State Finance* (Denver: National Conference of State Legislatures, 2004), 44-45.

"The personal income tax usually has a relatively high elasticity, nearly always more than 1. Excise taxes as a group usually have an elasticity considerably less than 1. The sales tax has an elasticity in between these extremes."

It is important to consider the effect of both sides of elasticity on the revenue stability of the tax system. When incomes are rising, tax collections on income increase at a greater magnitude. However, when incomes fall, personal income tax revenue falls further.

### **Equity**

Equity has two primary components—horizontal equity and vertical equity. Horizontal equity means that taxpayers with similar economic circumstances have similar tax burdens. Vertical equity refers to the distribution of tax burdens among taxpayers with different economic circumstances. In a progressive tax system, the share of income paid in taxes increases as income rises. In a regressive tax system, the share of income paid in taxes is greatest for low-income taxpayers and falls as income rises. Because states rely on many consumption tax sources that are regressive by nature, it is difficult to design a progressive state tax system. However, many tax policy experts believe that, at a minimum, a fair state tax system minimizes both regressivity and the tax burden on low-income households.

### **Compliance and Administration**

A quality tax system facilitates taxpayer compliance by minimizing the time and effort necessary to comply with the law. It also minimizes the cost of the state administrative apparatus necessary to collect revenue, enforce the law, and audit to ensure compliance with the law. Complex taxes that are expensive to enforce reduce the yield of the tax system and result in wasted taxpayer resources.

### **Responsiveness to Interstate and International Competition**

A state tax system does not operate in a vacuum—lawmakers must recognize that the tax policies of surrounding states can limit the revenue potential of some taxes. Businesses that sell in a national or global marketplace can relocate if state business taxes are too burdensome. Individuals may choose to shop in neighboring states if specific state consumption tax differentials are high.

### **Economic Neutrality**

Taxes, by their very nature, are not economically neutral. Tax policy can encourage or discourage consumption of goods and services, influence decisions to save and invest, and affect fundamental business decisions about the use of labor and capital. A quality tax system tries to minimize the effect of the tax system on the allocation of resources in the economy. When lawmakers decide to use the tax system to make budget decisions or influence behavior, these decisions should be explicit and subject to frequent evaluation and review. Taxes with broad bases and low rates, spread across a wide range of sources and economic activities, reduce the effect of taxation on economic decisions.

### **Accountability**

The essence of accountability is that tax burdens should be explicit, not hidden. This principle can be applied to state taxes in two ways. First, credits and exemptions in the tax code should be minimized and reviewed frequently to determine their cost (in lost revenue) and to determine whether they are unfairly benefiting some taxpayers at the expense of others—"picking winners and losers," as it is often described by critics. Second, taxes that are designed to be "passed through" to consumers provide less accountability than taxes that are paid directly and openly by taxpayers and should likewise be minimized.



# State Taxes in Principle

## Personal Income Tax

The personal income tax is one of the largest sources of state tax revenue, providing around a third of total collections since 1990. Forty-one states, the District of Columbia and Puerto Rico levy broad-based personal income taxes. Two others (New Hampshire and Tennessee) tax interest, dividends and capital gains, but do not collect taxes on wages and salaries.

### *Reliability*

The personal income tax is a fairly reliable source of state revenue. Most long-term estimates of the responsiveness of the income tax to economic growth show that income taxes tend to increase more quickly than state personal income.<sup>3</sup> Like other state revenue sources, the growth of personal income tax revenues declines during recessions. However, personal income taxes are “elastic” over the entire business cycle—that is, a 1 percent change (increase or decrease) in personal income produces more than a 1 percent change in tax collections.

The responsiveness of the income tax also makes it more volatile and vulnerable to economic downturns, especially due to its heavy reliance on high-income earners. Yet this same responsiveness to economic growth helps explain why state income tax reliance has increased over time. Consumption taxes, particularly excise taxes, tend to grow more slowly than the economy. Lawmakers must pass rate increases to ensure that consumption tax revenues keep pace with economic growth. The political process is biased toward revenue sources that produce revenue growth without lawmakers voting to increase the tax rate or expanding the base to keep revenues growing at the same rate as the economy. In the late 1990s, however, states across the country experienced consecutive years of surplus revenues. In response, state legislatures reduced personal income taxes, offsetting some of the automatic growth in personal income tax revenues that comes from economic expansion.

### *Equity*

The personal income tax scores well on horizontal equity because income taxes are levied based upon a standard set of rules that apply to all taxpayers. Although tax credits, deductions and exemptions may erode horizontal equity somewhat, the income tax is widely recognized as reinforcing horizontal equity in state tax systems. An increasingly important exception to this evaluation is the exemption of people over age 65 from income taxes.

The personal income tax is also generally accepted as promoting vertical equity. The underlying assumption for this judgment is that progressive taxation promotes vertical equity. This is a widely, though not universally, held assumption. The personal income tax is the only state tax that is progressive by design, so inclusion of personal income taxes in the overall mix of state taxes is seen as reducing the regressivity of the system.<sup>4</sup>

Income taxes achieve progressivity either through a graduated rate structure or with a flat rate structure that includes personal exemptions and standard deductions that remove low-income taxpayers from the tax rolls or reduce their burden vis-à-vis higher earners. In addition, about half the states have earned income tax credits—provisions targeted toward low-income working taxpayers—that offset income tax liability and actually may provide refunds in excess of tax liability.<sup>5</sup>

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<sup>3</sup> Steve Gold, *The Income Elasticity of State Tax Systems: New Evidence*, 9.

<sup>4</sup> Citizens for Tax Justice and Institute on Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* (Washington, D.C.: Citizens for Tax Justice, 2009).

<sup>5</sup> Jason Levitis and Jeremy Koulisch, *State Earned Income Tax Credits: 2008 Legislature Update* (Washington D.C.: Center on Budget and Policy Priorities, 2008).

### *Compliance and Administration*

Most state income tax systems are closely linked to the federal tax code. States that link their personal income taxes closely to the federal code gain efficiency in administration. They also reduce compliance costs because taxpayers are already required to maintain records and calculate figures for federal tax forms. State administrative costs are reduced through joint federal/state audit programs that allow the Internal Revenue Service to share the results of audits and enforcement actions with states.

Although there are benefits to linking to the federal tax code, states also lose a measure of control over their income tax systems because any changes in federal law that increase or decrease federal revenue also will affect state revenues. States may choose to decouple from the federal code to avoid such changes.

### *Interstate and International Competition*

The personal income tax is a factor in interstate competition for retirees and corporate headquarters. Some states have reduced income taxes on retirement income to compete for retirees with states such as Florida, Nevada and Texas that do not levy a personal income tax. Some executive recruiting firms also claim that businesses seeking to relocate corporate headquarters look closely at the top marginal income tax rate (the rate on the last dollar of income earned), which is of concern to highly compensated executives.

Interstate competition requires states to consider whether their taxes are out of line with neighboring or competing states. Corporate recruiters suggest it is most appropriate to examine the effect of the entire state-local revenue system—not just a single tax—on the cost of doing business. Since firms do not pay personal income tax, this is more a concern to senior executives than a direct factor in the cost of doing business.

### *Economic Neutrality*

Like other taxes, the personal income tax is not economically neutral. The very existence of the tax, in theory, can influence individual decisions about whether and how much to work, save and invest. The higher the marginal rate, the stronger the work disincentive provided by state income taxes. High capital gains tax rates also can discourage investment. However, the effect of state income taxes on work and investment decisions is dwarfed by the federal income tax. State income taxes may be a factor in decisions about work effort, but they probably are not the deciding factor for most taxpayers. In addition, over the years a number of states have reduced their highest marginal rates.

Most state income tax preferences are specifically designed to not be economically neutral. Some state policymakers favor using the income tax code to provide incentives for certain behavior (saving for retirement or college) and disincentives for other behavior. Massachusetts has a higher tax rate on short-term capital gains, but the tax rate falls as assets are held for longer periods of time. The provision discourages short-term, speculative gains, while rewarding investors who hold assets over a longer period. Other states have exempted interest earned in college savings plans from state income taxes to encourage taxpayers to participate in such plans.

### *Accountability*

The personal income tax is one of the most visible taxes paid by individuals. Unlike consumption taxes and business taxes that may be concealed in the price of products, taxpayers know exactly how much they pay in income taxes each year because they are required to file a tax return that specifies the tax paid. The high visibility of the income tax makes it a popular target for tax reductions by lawmakers who want to reduce the tax burden.

### *Additional Issues*

During times of inflation, states with progressive income taxes tend to experience automatic growth in income tax revenues over time as the cost of living goes up, even when wages are increasing more slowly than inflation. To address bracket creep—the effect of inflation pushing taxpayers into higher tax brackets—a number of states index their personal income tax brackets to some measurement of inflation. Although inflation has been relatively low for some time, this was a major concern in the late 1970s when double-digit inflation was prevalent.

State income taxes paid can be claimed as an itemized deduction on the federal form 1040 for taxpayers who itemize deductions. This deduction can reduce the effective state tax rate significantly for taxpayers in the highest federal tax bracket. Prior to 2004 when Congress also made the sales taxes deductible, the deductibility of state income taxes was an important consideration in states that were examining major tax shifts. Even so, states tended to cut income taxes and raise sales taxes, which suggests that taxpayer preference—and, perhaps, a goal of equalizing reliance on the two kinds of taxes—is more important than deductibility.

### **Sales and Use Taxes**

Mississippi adopted the first state sales tax in 1932. Since then, this tax has become one of the most important taxes in state revenue systems, consistently contributing approximately one-third of total state own-source revenues. Forty-five states, the District of Columbia and Puerto Rico levy a sales tax. Designed to tax consumption, sales taxes are levied on general retail sales transactions and, to a lesser extent, purchases of services.

Every state that taxes sales also imposes a state use tax at the same rate. The use tax was designed to capture revenues on purchases that are not subject to the state sales tax; namely, purchases from out-of-state vendors who are not responsible for collecting tax on interstate transactions. Most states impose a use tax on the storage, use or consumption of tangible personal property within the state upon which sales tax has not been paid. The state collects the use tax from out-of-state vendors that are registered with the state or from the purchaser in the state. As one might expect, collection of the use tax can be difficult. Furthermore, the increase in remote sales as a result of the Internet and expansion of electronic commerce has focused more attention on the problem of collecting use taxes and the resulting foregone revenues.

#### *Reliability*

The sales tax has been a stable state revenue source, although rate increases have been necessary to preserve its share of the state revenue mix. Since it is levied as a percentage of the retail sales price, the sales tax provides some automatic revenue growth as general price levels rise. However, most states have been slow to broaden the sales tax base to include services. Therefore, as personal consumption expenditures continue to shift toward services, the sales tax captures a smaller share of the total consumption dollar.

The elasticity of the state sales tax depends greatly on what is included in the tax base. A sales tax that includes services tends to be more elastic because many services are discretionary and changes in consumption correlate to changes in income. State estimates of the elasticity of the sales tax range from 0.65 to 1.23, with most estimates between 0.9 and 1.1.<sup>6</sup>

The stability of the sales tax is improved if food and other necessities are included in the base. States that exempt services but tax food have the most revenue stability but are likely to have less revenue growth over time. States that exempt food but tax services will be most

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<sup>6</sup> Steve Gold, *The Income Elasticity of State Tax Systems*, 9.

susceptible to revenue shortfalls during economic downturns but will likely enjoy strong revenue growth during economic expansions. States that tax both food and services are likely to enjoy both stability and revenues that grow commensurately with personal income growth.

### *Equity*

Three primary issues dominate the debate over the equity of the sales tax. The first is regressivity. Sales taxes claim a larger share of low-income taxpayers' incomes than those of higher-income taxpayers, especially if food is included in the tax base. The second issue involves whether exemptions for certain goods and services make the sales tax inequitable, and the third issue is the limit on government's ability to collect sales taxes from out-of-state sellers, particularly Internet retailers.

Sales taxes are regressive. Taxpayers with lower incomes tend to spend a higher proportion of their incomes on consumption. These taxpayers also spend a larger share of their income on goods rather than services, and services tend not to be taxed in many states. As a result, low-income taxpayers pay a higher proportion of their incomes in sales taxes than do middle- and upper-income taxpayers.

In an attempt to reduce the regressivity of the sales tax, some states have adopted specific exclusions for necessities, such as groceries and prescription drugs. Although food exemptions lessen the regressivity of the tax, food is the largest component of the sales tax base, and food exemptions produce large state revenue losses.

States face a tradeoff when they attempt to reduce the regressivity of the sales tax. Removing grocery food and other necessities from the sales tax base can significantly reduce state revenues and make the sales tax less stable through the business cycle. Many economists also argue that a food exemption benefits the wealthy proportionately more than the poor because they consume more expensive food items. Some states that tax food have tried to mitigate the effect on the poor through special rebates. Another mitigating factor is a federal prohibition on state sales taxes on food items that are purchased with food stamps.

Another equity issue concerns the disparate treatment of goods and services in many state sales taxes. The sales tax is designed to tax consumption, yet a growing share of the consumer expenditure dollar is spent on services that may not be subject to taxation. The shrinking relative share of the consumer dollar spent on goods has forced states to raise the rate to maintain the sales tax share of state tax revenues. However, four states that tried to dramatically expand the sales tax to services—Florida and Massachusetts in the 1980s, Michigan in 2007, and Maryland in 2008—were met with such political resistance that the laws were repealed soon after enactment or before they took effect.

States vary significantly in identifying taxable and exempt transactions. A handful of states have historically taxed services much more than the rest of the states. This is because these states each impose a unique version of the sales tax that was more widespread from 1900 to 1930—a gross receipts tax—where taxes are imposed on businesses for the privilege of doing business in the state. As a result, services are implicitly included in the tax base.

The third equity issue is proliferation of electronic commerce and the tax treatment of on-line sales versus sales in traditional retail stores. Under current law, many on-line retailers are not required to collect taxes on remote sales, which may give them a competitive advantage over Main Street retailers. This issue is discussed in greater detail below.

### *Administration and Compliance*

From the state perspective, sales tax administration is straightforward—much of the administrative burden is shifted to the vendor. The vendor collects the tax from the consumer, and the vendor is responsible for knowing what is taxable and what is tax-exempt.

Given advances in technology, administrative burdens on most retailers are not as great as they were before use of Universal Product Code scanners became widespread. Compliance is relatively easy to monitor, since taxes are based on sales transactions and sales records are maintained by vendors. States typically provide a vendor compensation allowance to retailers, allowing them to retain a percentage of the revenue collected as compensation for their administrative costs. When dealing with large budget shortfalls, some states have eliminated the vendor allowance

The use tax, on the other hand, is much more difficult to monitor because transactions take place across state lines, and states where items are consumed may not have administrative authority over vendors. Clearly, the use tax is the weak link in sales tax enforcement. Under a line of U.S. Supreme Court cases, states can legally impose a use tax on purchases made in another state. For practical and political reasons, states have chosen to focus enforcement efforts on vendors instead of on consumers. However, they cannot require the out-of-state retailer to collect and remit the sales tax unless the retailer has a physical presence, or nexus, in the taxing state. This restriction, however, can be reconsidered due to a collaborative effort by the private sector and state and local government officials. Representatives from these groups began meeting in 2000 to develop measures to design, test and implement a sales and use tax system that radically simplifies sales and use taxes so that remote collection is less burdensome. Their recommendations—published in the Streamlined Sales and Use Tax Agreement<sup>7</sup>—may eventually be realized.

### **Streamlining State Sales Taxes**

In November 2002, 35 states, known as the Streamlined Sales Tax Implementing States, ratified the terms of an interstate agreement that combines uniform administration procedures with simplification measures. Taken collectively, the Streamlined Sales and Use Tax Agreement attempts to address the undue burden on interstate commerce cited by the U.S. Supreme Court in establishing the physical presence test for sales tax nexus. The agreement does not require any action by states; rather, states that choose to join the agreement would simplify the process and move significant burdens of collection from the retailer to the state. Currently, a number of states are considering modifications to their present structure to meet the requirements of the agreement. For states to require remote sellers to collect sales or use taxes on items shipped into the state, either Congress or the Supreme Court must find that the system imposes no undue burdens on remote sellers and grant mandatory collection authority to states that have adopted this agreement.

Another state policy issue is whether to impose a sales tax on energy, raw materials and services—or inputs—used or consumed in the manufacturing process. In a competitive interstate and international marketplace, states that tax business inputs may put firms at a competitive disadvantage. The prices for many agricultural commodities, for example, are set by the world marketplace, so producers may not be able to pass to consumers sales taxes on machinery and supplies in the form of higher prices. A major argument against extending sales taxes to services is the extent to which producers employ other services in the production process. Many economists argue that inputs in the production of goods later sold at retail should not be taxed because the sales tax is intended to be a tax on final consumption. Taxes on inputs cause pyramiding—the imposition of taxes on goods where the retail price already has taxes embedded in it (a tax on a tax).

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<sup>7</sup> Streamlined Sales Tax Project, “Streamline Sales and Use Tax Agreement”, (November 2002); <http://www.streamlinedsalestax.org>.

### *Economic Neutrality*

The disparate treatment of goods and services affects the economic neutrality of the sales tax. For example, states that exempt labor repairs but tax new purchases may affect decisions about whether to fix a machine or buy a new one. The higher relative price of durable goods resulting from sales taxes may affect the mix of goods and services purchased by consumers if services continue to be excluded from sales taxes. Also, states that tax services may disproportionately burden small businesses because larger firms may provide services (legal, accounting) in-house. In addition, Internet retailers may have an advantage over local stores if they are able to sell their goods tax-free.

### *Accountability*

Most states require the sales tax to be separately stated on the receipt, making the tax burden per purchase explicit. However, the total burden of sales taxes over a longer period of time is less obvious to most taxpayers. Other taxes that are paid quarterly or yearly can easily be compared to income, thus demonstrating the overall burden of the tax. With sales taxes, knowing how much one pays over months or years requires record keeping for every purchase that most individual taxpayers are not likely to maintain. (Exceptions to this are those who itemize and deduct state and local sales taxes paid for their federal income taxes—see below.)

In addition, many state tax incentive programs for certain businesses include deductions or abatements of sales tax requirements. This selective application also affects the accountability of the sales tax.

### *Additional Issues*

In 2004, federal tax law was enacted that allowed taxpayers to choose whether they wanted to deduct state sales taxes paid instead of state income taxes paid as an itemized deduction on federal form 1040. The amount of the deduction is calculated in one of two ways: 1) calculating the actual amount of sales tax paid during the year, or 2) using the IRS optional state sales tax tables. The sales tax deduction is particularly beneficial for residents of states that impose a state sales tax but not an income tax (e.g., Florida), as well as low-income residents who have no income tax liability; however, it is beneficial only if they choose to itemize. Historically, low-income households are not likely to do so.

## **Corporation Income and Franchise Tax**

The corporation net income tax generates the least revenue of the major state tax categories, although it is a major revenue producer in a few states. Forty-seven states, the District of Columbia and Puerto Rico impose corporate income taxes. Most states use either net income as the exclusive basis for levying the tax or a combination of net income and net worth as the base for determining tax liability.<sup>8</sup>

Most states levy the corporation income tax at a flat rate, although a number of states impose a graduated corporation income tax. States that use capital stock or net worth as a portion of the tax base typically levy the tax at a flat share of capital stock outstanding or net worth. A few states use gross receipts as the basis for taxing corporations. New Hampshire taxes corporations using a value-added tax, which imposes taxes on the capital, entrepreneurial profit and labor inputs that add value to products in the production process.

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<sup>8</sup> In some states the franchise tax is different from the corporation income tax, and in some states a different name is used for what most states call the corporation income tax. In some states, the franchise tax is a privilege tax imposed on each taxable entity chartered or organized in or doing business in the state. The Bureau of the Census includes taxes determined by net corporation income in its corporation net income category referenced here, regardless of the name given by individual states.

States offer a wide variety of tax credits and deductions that are designed to provide incentives for business expenditures in certain areas. Common credits include investment in machinery and equipment, research and development, employee training and investments in enterprise zones (economically distressed areas that have been targeted for redevelopment through favorable public policies and financial incentives).

### *Reliability*

Corporation taxes are one of the most volatile state revenue sources. Corporate profits are highly vulnerable to national economic cycles, not only due to the nature of business operations but also because corporation income taxes use accounting procedures that allow firms to carry losses forward against future profits. States that use capital stock or value added in the tax base can mitigate fluctuations inherent in corporation taxes that are levied solely on net income.

### *Equity*

Considerations of vertical equity typically do not apply to corporation taxes. However, horizontal equity is affected by tax abatements, exemptions and preferences that some states grant to lure new businesses and to promote economic development generally. For example, many state and local governments have waived taxes and provided large subsidies for specific industries such as manufacturing plants or for professional sports teams, creating inequities with businesses in the same neighborhoods that did not receive preferential treatment.

Corporations have long complained that taxation of both corporation income and dividends (through the personal income tax) is unfair. Firms argue that taxation of both dividends and profits amounts to double taxation because dividends are paid from profits that already have been taxed.

Some economists note that corporation taxes really are paid by individuals, in one of three ways: by firm owners, in the form of reduced profits; by firm employees, in the form of lower wages; and by consumers, in the form of higher prices. How this shifting occurs depends upon the nature of the business taxed. Firms that sell products in highly competitive global markets or in commodity markets may not be able to pass taxes along through higher prices. However, firms that sell services in local markets or in monopoly or oligopoly markets can more easily shift taxes to consumers.

The primary argument in favor of corporation taxes is called the benefit principle of taxation (those who benefit the most should pay the most). Businesses benefit from the educational system (skilled workers), infrastructure and other services financed by state governments. Other public services that are particularly important to businesses are the judicial system and public safety. Without these, businesses could not function. The corporation income tax helps ensure that firms share part of the costs of services that benefit them directly.

A key equity question for corporation taxes is whether to levy taxes only on net income, or to use a value-added or a capital stock component in the tax base. Firms that are taxed only on net income are not required to pay corporation taxes in years when they are not profitable, while the other tax bases create tax liability even when firms lose money. The benefit principle would favor value-added taxes or capital stock taxes, since firms benefit from public services regardless of profitability. However, some firms argue that such taxes exacerbate losses in bad years and are inequitable.

### *Administration and Compliance*

Forty-six states, the District of Columbia and Puerto Rico tax corporate income. Almost all of them use the federal income tax code as a starting point in calculating state liabilities. Despite this fact, however, complying with state corporation taxes is a complex undertaking for firms that operate in more than one state.

First, even though most states conform to the three-factor apportionment formula (described below) designed to provide uniformity in how multi-state firms apportion their income among the states, state definitions vary on what types of income are included in the formula. Second, firms that have intangible property such as copyrights or patents face different state rules governing whether such property should be included in the apportionment formula. Third, states have different rules about whether corporate subsidiaries must file separate returns or combined returns. Finally, a multitude of state rules govern when returns must be filed, when estimated payments are due, and what types of income are reported.

This complexity leads to high compliance costs for businesses. It also requires that state departments of revenue spend a disproportionate share of their resources on compliance audits and other administrative tasks.

### *Interstate and International Competition*

The proliferation of tax incentives, credits and abatements reflects states' heightened concern about the role of taxes in business decisions about where to locate operations. States are competing with each other as well as with other nations for facilities and jobs. However, for many firms—particularly manufacturing firms with high capital requirements—the corporation income tax is less onerous than local property taxes and sales taxes on machinery and equipment.

Businesses that specialize in helping firms with location decisions report tax rates that are out of line with neighboring states can be a disqualifying factor in business location decisions. However, as long as overall state tax burdens (income, sales, property and other taxes combined) are not excessive compared to other states, taxes are rarely as important as labor, energy and transportation costs.<sup>9</sup>

### *Economic Neutrality*

One common complaint about corporation taxes is their disparate effect on businesses that have different capital structures. Firms can deduct interest payments from net income but cannot deduct the cost of equity financing, so the tax code provides an incentive for firms to use debt financing.

### *Accountability*

The corporation income tax is a cost of doing business that is embedded in the cost of goods and services, just like energy and other production or operating costs. Consumers do not know the proportion of the price of a good or service that is attributable to the corporation income tax. By this measure, the corporation income tax is not accountable to the public.

### *Additional Issues—Apportionment Formulas*

Another business tax issue is the apportionment of corporate income for firms operating in more than one state. For firms that do business in only one state, determining how much of their income the state can tax is fairly straightforward. Similar to most individual income tax calculations, the taxable income of a corporation is the amount that remains after adjusting gross income for tax deductions and credits. That taxable income is then multiplied by the state's corporate income tax rate, and the result is the firm's tax liability.

In the case of multi-state corporations, state corporate income taxes are more complicated. This is because the corporation's gross income is the aggregate of business done in various states. The question then becomes, "What portion of a multi-state corporation's total income should be taxed by each of the states in which it operates?"

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<sup>9</sup> Robert Ady, "Taxation and Economic Development: The State of Economic Literature (Discussion)" *New England Economic Review* (March/April 1997): 80.



States use apportionment formulas to answer that question. A number of states still follow a method developed in the 1950s that focuses on three factors of a company's operations in a state—sales, payroll and property. The idea is to arrive at a number representative of the amount of a company's total (or gross) income that comes from business in the state in question.

The formula involves first calculating the ratios of how much of the company's total values in each category (sales, payroll and property) come from the state in question. That is, a state considers how much of the company's total sales come from sales in that state, how much of the company's total payroll comes from employment in that state, and how much of the company's total property is located in that state.

These three separate ratios (or percentages) of in-state to total (multi-state) company operations are added and divided by three. The result is a final ratio of in-state to total business operations. This ratio represents the portion of a company's total income derived from the state, and hence subject to taxation.

The ratio then is applied to the company's total income. The resulting amount (the company's taxable income) may be further adjusted with state tax deductions or credits, and the remainder is then multiplied by the state's corporate income tax. The final amount after any adjustments is the amount a multi-state company must pay in the state's corporate income taxes.

An apportionment formula with equal focus on the three parts of a company's operations described above (sales, payroll and property) is referred to as "three-factor apportionment." About one-third of the states use this formula.

More states have moved to other apportionment formulas that give added weight to a company's sales in the state. The method is similar to that described above where the in-state to total ratios of sales, payroll and property are added together for a final ratio that is then applied to total income. In double weighted sales apportionment, however, the in-state to total sales ratio is included twice in the arithmetic: sales+sales+payroll+property, rather than sales+payroll+property.

Even further emphasis on sales in determining corporate income tax liability is applied in the states that use a single sales factor formula. In this case the only ratio or portion considered is how much of a company's total sales are derived from sales in the state in question. That ratio then is applied directly to the firm's gross income to calculate taxable income. Single sales apportionment also simplifies the state corporate tax codes.

Increased emphasis on sales in apportioning corporate income may make a state more attractive for business expansion or relocation if property and payroll factors are not used to calculate corporate tax liability.

## **Motor Fuel Excise Taxes**

The motor fuel excise tax is the primary funding source for state highway and other transportation programs. The tax typically includes gasoline, diesel fuel and blended motor fuels and is imposed in all 50 states, the District of Columbia and Puerto Rico. The motor fuel tax has been a traditional source of transportation funding; 48 states adopted the tax before 1929. All states earmark motor fuel tax revenues to highway or transportation trust funds.

As is the case with most selective sales taxes, the motor fuel excise tax is assessed on a per-unit basis. Revenue is dependent upon gallons consumed, which is influenced by oil prices, motor vehicle fuel efficiency, alternative fuel sources and consumer driving patterns. Following the

oil price hikes of the 1970s and early 1980s, states increased their motor fuel excise tax rates to offset the decline in motor fuel consumption.

### *Reliability*

The motor fuel tax is an inelastic state revenue source—that is, collections fail to keep pace with inflation and economic growth at a given tax rate. States must periodically increase tax rates to generate the revenue growth required to keep pace with highway maintenance and construction needs. The problem is exacerbated by increased fuel efficiency of cars and trucks, which has prevented fuel tax collections from keeping pace with the number of miles driven. Reductions in miles driven in reaction to high gasoline prices, particularly in 2008, likewise undermine the reliability of revenue generation from motor fuel taxes.

One way states have addressed the inelastic nature of the motor fuel tax is by indexing the tax rate. Indexing motor fuel tax rates annually to changes in the consumer price index, total fuel consumption or vehicle miles traveled may provide the revenue growth needed to meet transportation maintenance demands. States that do not use indexing must periodically raise motor fuel excise tax rates to meet higher material and construction costs for highway and transportation systems.

### *Equity*

The motor fuel tax is a benefits tax—gasoline consumption is used as a proxy for highway use—and every state earmarks tax revenues for highway maintenance, repair and construction. The benefits of motor fuel taxes are widely accepted by the public, and opposition to motor fuel tax increases typically is less vociferous than for other state taxes.

Some experts argue, however, that drivers of passenger automobiles pay a disproportionately large share of highway costs compared to their contribution to highway wear and tear. Equity in motor fuel taxation would require that taxes be distributed according to costs generated, with relatively higher tax burdens on users that generate higher costs. Several studies argue that motor fuel taxes violate this definition of equity because heavy trucks generate a disproportionate share of highway maintenance costs. Truckers argue that all consumers benefit from the current system because higher taxes on the industry would be passed to consumers through higher prices on consumer goods.

The motor fuel tax is a regressive tax, particularly in poor rural areas where residents must commute longer distances to work, shopping and other necessary activities. The poor pay a much larger percentage of their incomes in motor fuel taxes than do middle- and upper-income taxpayers.

### *Administration and Compliance*

Motor fuel excise taxes generally are easier to administer and collect than other state taxes because the point of taxation may be limited. Depending on the size of the state, fuel tax collection may be limited to a dozen refiners or to a few hundred certified distributors.

All states except Alaska and Hawaii participate in the International Fuel Tax Agreement (IFTA). The agreement was mandated by Congress in 1991 to make uniform the administration of motor fuel use taxation laws with respect to motor carrier vehicles that operate across state lines. Under the agreement, states can cooperate in administration and collection of motor fuel use taxes. This essentially allows motor freight carriers to base their operations in one state and report their taxable activities on one fuel tax report in that state, rather than file separate reports in each state in which they operate. Fuel tax collections are allocated to states based upon miles traveled.

### *Interstate and International Competition*

IFTA has helped alleviate tax avoidance problems caused by differentials in state tax rates as applied to the trucking industry. However, the potential still exists for taxpayers in private vehicles to purchase gasoline in neighboring states where rates are lower.

### *Economic Neutrality*

Gasoline, gasohol and diesel are not the only motor fuels state governments tax. Others include alternative motor fuels such as methanol, ethanol, compressed natural gas (CNG), liquid natural gas (LNG) and liquefied petroleum gas (propane). States often provide preferential taxes for nonpolluting or “clean” fuels to encourage consumers to use them, sometimes in conjunction with state or regional air quality programs.

An issue regarding the taxation of alternative fuels is that in many cases, they may be a more expensive option than gasoline. Although alternative fuels often burn more cleanly, some vehicles use more than a gallon of alternative fuel to achieve the same energy output as a gallon of gasoline or diesel. Thus, some states have given preferential treatment to alternative fuels. States also are examining substitute methods (i.e., vehicle permit fees) for collecting revenue from alternative fuel powered motor vehicles.

### *Accountability*

As with other excise taxes, motor fuel taxes are not separately stated on customer receipts. Although motor fuel retailers in some states post information on the pumps about the amount of state and federal taxes paid, most consumers are unaware of the total annual gasoline tax burden imposed.

Unlike taxes that accrue to the state general fund, most motor fuel excise taxes are deposited in state transportation funds. In terms of expenditure accountability, most state taxpayers realize their motor fuel taxes are used for highway maintenance and other transportation needs.

## **Tobacco Taxes**

All states, the District of Columbia and Puerto Rico impose excise taxes on cigarettes, chewing tobacco, cigars, snuff and other tobacco products. Most cigarette and tobacco taxes were adopted before 1950; only 10 states have adopted such taxes since 1951. States also can impose sales taxes on retail sales, but these revenues are included in sales tax figures rather than in excise tax figures.

Proponents of increasing tobacco taxes argue that they improve the efficiency of the free market by including the social costs of smoking—public health care costs, for example—in the price of tobacco products. However, some in the public health community believe that any rational tax strategy should be based on the relative risks of the various tobacco products. Opponents argue that smokers and tobacco users already pay their fair share of these costs, and that excise taxes are a highly regressive form of taxation that single out one class of citizens for punitive taxation.

### *Reliability*

Cigarette taxes are not a stable source of revenue. Like other excise taxes, they are levied on a per-unit basis that does not automatically provide revenue growth in response to price increases. The decline in per capita cigarette consumption since 1970 and the failure of tax rates to keep pace with inflation have led to a significant decline in the share of state revenues attributable to cigarette taxes.

Taxes on other tobacco goods usually are levied as a percentage of the product price. Generally, when the price goes up so does the tax revenue. High tax rates, however, provide a significant incentive for consumers to shift to lower priced—and thus lower taxed—products. In addition, other tobacco products make up a small share of total tobacco sales. A

popular trend in recent years has been to earmark tobacco tax revenues for health-related programs. Even if tax rates go up, however, tobacco taxes are not a growth revenue source in the long run. Any program that relies on tobacco taxes will likely see future revenues decline.

### *Equity*

Cigarette and tobacco taxes are highly regressive. In fact, studies show that these taxes are the most regressive of the major excise taxes; households with incomes below \$30,000 contribute about 47 percent of total tobacco taxes paid. This is because low-income taxpayers statistically are more likely to use tobacco than are upper-income taxpayers.<sup>10</sup>

Tobacco tax proponents argue that the tax is equitable because it helps recoup some of the social costs of smoking that are not included in the market price of tobacco products. They contend that using taxes as a way to include public health costs in the price of tobacco products actually leads to a more economically efficient market outcome by reducing consumption levels below a no-tax level.

### *Administration and Compliance*

States typically levy the cigarette tax at the wholesale level. In nearly all states, wholesalers must affix a tax stamp to each pack of cigarettes, proving that the tax has been paid.<sup>11</sup> The small number of wholesalers minimizes direct administrative and compliance costs for states. Stamping is an expensive process, however, and states reimburse wholesalers for some of their compliance costs by allowing them to retain an administrative fee (similar to the vendor collection allowance on the sales tax).

The tobacco products tax is paid by the wholesaler and levied on cigars, snuff, pipe tobacco and chewing tobacco at a percentage of the wholesale price. The varying size and composition of this wide range of tobacco products makes administrative compliance difficult.

### *Interstate and International Competition*

Tobacco taxes vary greatly among the states. This makes interstate competition and bootlegging an important issue, especially in states that share populated border areas. Complicating the issue is the possibility that, when consumers cross state lines to buy cigarettes, other goods also might be purchased and the economic loss will be spread beyond lost tobacco product sales. Geography becomes less relevant, however, as on-line sales of tobacco products increases.

The Supreme Court has ruled that states cannot tax the sale of tobacco products on Indian reservations if they are sold to residents of the reservation. Sales on reservations to non-Indian customers are taxable; however, it is difficult for states to require Indian retailers to segregate sales to Indian and non-Indian customers. Some states, such as Arizona, have reached cooperative agreements with tribes that respect the legal exemptions for sales to tribal members and provide for voluntary tax collections from non-Indian customers. Other states, however, still face significant problems with regard to tobacco tax evasion. The Internet and growth of on-line tobacco sales has exacerbated this problem. Evasion also is a problem on military bases; base sales are not subject to state sales taxes.

### *Economic Neutrality*

As with other excise taxes, tobacco taxes are deliberately designed to violate the principle of economic neutrality. Tobacco taxes single out specific products for higher tax rates to influence consumer consumption choices. For tobacco products taxed as a percentage of

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<sup>10</sup> KPMG/Barents Group, *The Burden of Consumer Excise Taxes on Lower-Income Taxpayers* (Washington, D.C.: KPMG/Barents Group, May 1997), 3.

<sup>11</sup> As of Jan. 1, 2010, every state except North Carolina, North Dakota and South Carolina had a stamp tax requirement. Alaska, the last state to adopt one, did so in 2003.

wholesale prices, the lack of economic neutrality is even more pronounced because identical products may carry different tax burdens based solely on price differences.

### *Accountability*

Tobacco excise taxes are hidden in the price of a pack of cigarettes or a can of snuff. Although most taxpayers know tobacco taxes are levied, most probably do not know how much of the price of a tobacco product is tax and how much they pay in taxes annually. Accordingly, tobacco taxes may not score high on the principle of accountability.

## **Alcoholic Beverage Taxes**

All 50 states, the District of Columbia and Puerto Rico tax alcoholic beverages. Most states have imposed excise taxes on alcoholic beverages since the 1930s. Alaska and Oklahoma, in 1959, were the last states to impose the tax.

Excise taxes on alcohol are intended to generate revenue and discourage consumption by increasing prices to the consumer. Proponents argue that alcoholic beverage excise taxes improve the efficiency of the free market by including the social costs of drinking in the price of the product, while opponents argue that alcoholic beverage taxes are a highly regressive form of taxation.

States fall into two categories in taxing of alcoholic beverages. About two-thirds are license states that allow licensed private retailers to sell liquor, beer and wine. For these states, revenues are generated through wholesale excise taxes.

In the other states, government-owned stores sell liquor at retail, and licensed stores sell beer and wine at retail. State revenues are generated through a retail markup on liquor and an excise tax on beer and wine. Markups in these control states are categorized as “other revenue” by the Census Bureau, and excise taxes are counted as taxes. This makes tax comparisons difficult between license and control states.

### *Reliability*

Alcoholic beverage tax collections have been declining relative to other state taxes for two primary reasons. First, like some other excise taxes, per-unit taxes fail to generate additional revenue when prices increase. Rates must be increased legislatively to keep revenues on par with inflation and economic growth. Second, per capita consumption of alcoholic beverages has been stable or declining since 1970, further eroding tax productivity.

### *Equity*

Alcoholic beverage taxes are regressive; beer taxes are the most regressive of the three major categories. Lower-income households pay a larger share of their incomes in taxes than do higher-income households, assuming the same level of consumption. Price elasticity estimates show that beer consumption is least responsive to price changes, while wine consumption is most responsive. This suggests that beer taxes may have the least effect on reducing consumption and, therefore, would most affect low-income beer consumers. Excise taxes also tend to impose higher tax burdens on low-income taxpayers because they are levied at flat rates, instead of on the sales price. Taxpayers pay the same excise tax on a \$100 bottle of wine as on a \$5 bottle because the volume is the same.

Alcoholic beverage tax proponents argue that the taxes help recoup some of the social costs of drinking that otherwise are not included in the price, and that including these social costs in the price of alcoholic beverages reduces consumption and leads to a more economically optimal level of consumption. However, there is no agreed-upon methodology for social cost accounting, nor any movement to apply social cost tax adjustments consistently for products thought to have social costs.

### *Administration and Compliance*

Excise taxes typically are levied on the manufacturer, distributor or importer of alcoholic beverages. Markups are determined by state liquor control agencies. States have been shifting from a payment system that requires sellers to affix tax stamps to each bottle of liquor to a report system that allows sellers to remit taxes based upon reported sales. The report system significantly reduces compliance costs for businesses but may increase the likelihood of tax evasion. From the state perspective, administrative costs are low because the tax is collected monthly from a limited number of wholesalers, importers and distributors instead of from a large number of retailers. However, states may provide collection allowances that reduce the tax yield.

### *Interstate and International Competition*

Although differentials in state tax rates can be significant, the weight and volume of alcoholic beverages and state regulations on direct shipping of alcohol make large-scale smuggling much more difficult than for tobacco products. However, states where prices are significantly higher than neighboring states, with higher taxes contributing to the price differential, may experience reduced sales at border locations. In addition, once consumers make the choice to purchase alcohol in a neighboring state, it is possible that other goods also will be purchased, and the economic loss will be spread beyond lost alcoholic beverage sales.

### *Economic Neutrality*

Some policymakers argue that alcoholic beverage taxes should be designed to reduce consumption. This perspective violates the principle of economic neutrality. In practice, however, alcoholic beverage taxes rarely have been raised on the basis of this perspective. States typically have raised these taxes when revenues have dropped during national recessions. Federal tax increases have followed a similar pattern. For instance, beer taxes were levied for the first time to raise funds to pay for the Civil War and in modern history have been increased only to help pay for the Korean War and to raise revenues during the 1990-1991 national recession.

### *Accountability*

Alcoholic beverage excise taxes and markups are embedded in the price of products sold at retail. Although most taxpayers are aware that taxes are levied, the exact amount of the sales price that represents taxes is not known to most consumers. Alcoholic beverage taxes may not score well on the principle of accountability.

## **Electric Utility Taxes**

States vary greatly in how they tax electric utilities. In addition to property taxes, most states tax utility profits under their general corporation income tax or franchise tax statutes. Furthermore, most states levy additional taxes based upon the gross receipts of electric utilities, and a few impose a tax based upon kilowatt hours of electricity generated.

Legislative and regulatory changes in the early 1990s injected competition into the electric power industry that were designed to give customers a choice of power providers. By 2002, nearly half the states had laws to open power markets to retail competition. The competition has yet to materialize, however, at least on the retail side, although wholesale power markets have become more competitive.

Of the states that levy gross receipts taxes on electric utilities, taxes in at least 10 are designed to recover the costs of regulatory agencies. These taxes typically are levied at rates lower than 1 percent of gross receipts and are levied either at variable rates set by public utility commissions annually to cover costs (subject to statutory maximum rates) or at a rate fixed in statute. Other states levy gross receipts taxes at rates higher than 1 percent, and revenue from the taxes contribute not only to public utility commission costs but also to the state general fund.

States can tax only the gross receipts earned from sales within their borders or levy kilowatt-hour taxes based upon electricity consumed within state borders. In cases where utilities operate across state lines, gross receipts must be allocated to the respective states.

### *Reliability*

Electricity consumption is closely correlated with the strength of the overall economy, because large industrial customers add to demand during economic expansions. Therefore, electric utility tax collections are subject to cyclical fluctuations in the economy.

### *Equity*

Electricity gross receipts taxes are a regressive form of taxation, particularly given electricity pricing structures. Many utilities provide declining marginal electricity rates for large industrial customers as an incentive to keep them from fuel switching. Many residential customers pay among the highest electricity rates per kilowatt-hour. Gross receipts taxes, therefore, most significantly affect residential customers; low-income customers pay a larger share of their incomes for utility bills. Some states use revenue from gross receipts taxes or kilowatt-hour taxes to provide subsidies for low-income customers, however.

Another equity issue involves the tax treatment of investor-owned utilities, municipal utilities and member-owned cooperatives. In some states, municipals and co-ops are exempt from income and property taxes, while investor-owned utilities are not. Differential taxation can place investor-owned utilities at a competitive disadvantage.

### *Administration and Compliance*

One of the major strengths of electric utility taxes is the low cost of administration and compliance. States typically have a small number of utilities, which means few tax returns are filed and only a small administrative staff is necessary to process them. From the perspective of the regulated utility, taxes are a cost of doing business that regulators allow to be passed directly to customers in the form of higher rates. Calculating gross receipts is straightforward, so compliance costs are minimal.

### *Interstate and International Competition*

With the electric industry moving toward competition, interstate competition and competitiveness are becoming major issues. In the former, regulated environment, utilities could sell only within their service territories and customers could buy only from their local utility. Differentials in state tax rates and policies were irrelevant because industrial customers could not purchase cheaper power from out-of-state utilities. The only options available to reduce power costs were to relocate to another state or switch fuels.

The federal Energy Policy Act of 1992 and subsequent regulatory changes opened the marketplace for wholesale competition in power sales and gave states the opportunity to open the retail marketplace for competition. Large industrial users now can contract with utilities outside their immediate area for cheaper power, and the local utility is required to transmit this power to the customer. In this new marketplace, state tax policies that place local utilities at a competitive disadvantage can have a major effect on the utility market.

### *Economic Neutrality*

Economic neutrality has become a more important concern in the taxation of electric utilities with the advent of wholesale and retail competition. State tax policy should treat in-state and out-of-state generators equally in a competitive marketplace. Gross receipts taxes are levied on the electricity supplier, not on the end user. Companies that buy power from out-of-state generators may receive a price break because the state gross receipts tax cannot be applied to out-of-state companies. States will need to reconsider any tax policy that imposes different tax burdens on firms in the same industry.

### *Accountability*

Electric utility taxes are hidden in the final cost of power and, therefore, are not accountable to taxpayers. In some states, utilities are prohibited by statute from separately stating the tax on customers' bills.

### *Other Issues*

Gross receipts taxes are well-suited for utilities that operate in monopoly markets. They are simple to collect and administer, are stable and are hidden from taxpayers. Regulated monopolies can pass taxes directly to consumers without affecting shareholder returns. In a competitive market, however, gross receipts taxes may create horizontal inequities by placing in-state firms at a competitive disadvantage. Competition also may provide incentives for utilities to restructure so that it is difficult to impose the gross receipts tax. For example, if a utility divests its generation capacity and retains only transmission and distribution, its gross receipts may include only the charge for transmitting power from generators to end-users.

For this reason, states that plan to deregulate the retail energy marketplace may shift from gross receipts taxes on producers to taxes on consumers. Taxes levied on the end-user treat generators equally and avoid nexus problems. Such taxes could include a sales tax on electricity sold at retail or a kilowatt-hour tax imposed on end-users.

Competition has forced states to reexamine their electric utility tax policies because taxes can influence where, when and if companies build new power plants. In 2001, the nation experienced generation shortages and bottlenecks in the power delivery system. During that time, it became clear that new infrastructure investments in power plants were desperately needed simply to meet demand. State policymakers began to examine how they could use their tax systems to encourage new investment.

## **Inheritance, Estate and Gift Taxes**

Commonly referred to as "death taxes," these taxes are imposed on the transfer of accumulated wealth at death or in anticipation of death. States levy three types of death taxes: inheritance, estate and gift. Inheritance taxes are levied on the person receiving the bequest, while estate taxes are levied on the estate of the deceased person before assets are distributed to heirs. Gift taxes are imposed on transfers of wealth from living donors.

Inheritance taxes typically are levied at graduated rates, based upon the amount of the bequest and upon the relationship between the deceased and the beneficiary. Rates typically are lower for immediate family members (spouse and children) and highest for unrelated beneficiaries. Estate taxes also are levied at graduated rates, based upon the value of the estate. However, the tax rates are imposed on the estate as a whole and typically do not vary based upon the relationship of the beneficiary to the donor.

Death taxes are designed to prevent the extreme and permanent accumulation and concentration of wealth. Critics of death taxes argue that they can cause the breakup of family-owned businesses and provide disincentives for savings and investment. Proponents argue that exemptions and credits included in most state statutes allow all but the wealthiest citizens to avoid tax liability. Another concern about death taxes is that many wealthy individuals can legally avoid the tax through estate planning.

### *Reliability*

Death tax collections often fluctuate, especially in small states where the death of one very wealthy person can dramatically affect collections. Therefore, the estate tax is notoriously difficult to forecast. Most forecasters conservatively estimate revenues and treat large collections from a single estate as a windfall. Since estate taxes represent only a small percentage of state tax collections, the lack of stability in collections exposes the state to



minimal risk. Using long-term averages, death taxes provide a reasonably steady flow of income to the state treasury.

### *Equity*

The equity of death taxes is subject to considerable debate. Proponents of these taxes argue that they promote vertical equity by preventing excessive accumulation and concentration of wealth. This is especially important in the United States, where—in contrast to other industrialized nations—federal and state income tax rates are low and individuals retain a significant portion of their earnings.

Death taxes create problems of horizontal equity because of an increase in estate planning and legal avenues for avoidance. Most death taxes exempt bequests to charitable institutions, for example. In many instances, wealthy individuals bequeath money to colleges and universities or create charitable foundations rather than pay the tax. Therefore, depending upon the estate planning techniques used, two estates with similar assets may pay dramatically different taxes.

Opponents also charge that death taxes are unfair because they sometimes prevent family farms, small businesses and other closely held firms from being passed to family members.

### *Compliance and Administration*

The probate system for disposing of assets at death requires an accounting of the decedent's assets. Therefore, death taxes cause few additional administrative burdens on the state. The tax imposes a relatively small paperwork and reporting burden on taxpayers and does not require an extensive state bureaucracy to administer.

Taxpayers may argue that significant compliance costs are incurred in estate planning activities. Taxpayers, however, choose to incur these costs to avoid tax liability—they are not mandated by state law or administrative rules.

### *Interstate Competition*

One main cause for the trend to eliminate or reduce state death taxes is the role of interstate competition. Wealthy taxpayers can easily avoid state estate, inheritance and gift taxes by establishing residence in a state where tax laws are more favorable. Death taxes can legally be imposed on real and tangible property located within a state, even if the taxpayer lives in another state. However, much of the value of a wealthy person's estate is typically intangible property—stocks, bonds and cash—that is taxable to the state of residence.

Interstate competition limits the revenue that states can generate from death taxes. If these taxes are significantly lower in other states, taxpayers easily can change legal residence. Some experts argue that high death taxes can harm a state's economy if wealthy citizens leave, because they no longer consume goods and services that generate other types of tax revenue.

### *Economic Neutrality*

Death taxes can discourage owners of family businesses from investing in the business as they approach old age because any equity added to the business becomes taxable upon their death. The additional debt that sometimes is necessary to pay estate taxes also can jeopardize the viability of privately held businesses. This may put these firms at a competitive disadvantage compared to publicly owned companies.

### *Accountability*

Death taxes are a key consideration in the settlement of large estates. Wealthy taxpayers know about the tax and its consequences, giving rise to a thriving estate planning industry. Like the income tax, filing returns allows taxpayers to know the exact amount of their tax liability. Therefore, death taxes measure very well on the accountability yardstick.

## State Property Taxes

The property tax is one of the oldest forms of taxation, both in the United States and worldwide. It was the primary revenue source for state and local governments until the Depression era, when most states abandoned the property tax in favor of excise, sales and income taxes. The property tax is the primary revenue source for local governments, and remains a modest source of revenue to the few states that levy a statewide property tax.

### *Reliability*

The property tax can be the most stable and reliable tax used by state and local governments. Property is generally categorized as real (land and all things attached to it) and personal (property owned by an individual or business that is not affixed to or associated with the land). Property values tend to be stable in the short-term, and when changes in value occur, it typically can be several years before they take effect in the property valuation process. Changes in taxpayers' income or consumption patterns do not affect property tax liability, and most types of taxable property cannot be moved to avoid tax liability.

However, as seen in the recession beginning in late 2007, dramatic fluctuations in real property values do occur. The effects of these fluctuations on property tax revenues can create serious fiscal challenges for states, and especially for local governments.

### *Equity*

Horizontal and vertical equity both are major concerns with the property tax. Property taxes have the potential to be regressive because tax liability is not dependent upon income. A family at the poverty level and a middle-income family pay the same amount of tax on a \$100,000 home, regardless of their incomes. However, income and property wealth tend to be correlated, so families with different income levels are not likely to live in homes of the same value. Leading economists disagree about whether the property tax is regressive or proportional (imposes an equal burden on everyone, regardless of income). This uncertainty about vertical equity is primarily due to differing assumptions about how much of the property tax burden is shifted from landlords to renters.

Another concern is horizontal equity. Property taxes depend upon subjective decisions about how market trends affect property value. In some instances, similar properties in the same region can have different valuations for tax purposes, allowing taxpayers in similar circumstances to be treated differently. This is particularly true in states where property valuation cycles are very long.

Another issue arises in states such as California that base assessed value on the purchase price and provide for very little increase in property taxes over the time one owner retains the property. California has a cap of 2 percent per year. In these cases, identical properties can be assessed at greatly differing amounts over time. These measures do not seem to have generated the public backlash that other property tax issues have, however, and seem to help preserve older housing stock.

Issues of horizontal equity are particularly important in a statewide property tax because, with one statewide rate, variations in the quality of assessment directly affect whether property owners in different parts of a state pay their fair share of the tax.

### *Compliance and Administration*

The administrative costs of a statewide property tax are low. States typically use valuations provided by county or municipal assessors, and many states already have divisions within their revenue departments that review the accuracy of local valuations for the sake of equitable education funding.

Business and individual taxpayer compliance costs also are low compared to other types of taxes. Many residential property taxes are included in standard mortgage payments.

Businesses usually are required to self-report their personal property using information that already is maintained for accounting purposes. The assessment appeals process usually is available to taxpayers so they need not hire legal experts.

### *Interstate and International Competition*

The effect of property taxes on businesses varies dramatically by the type of business and by the type of property taxed. In addition to land and buildings, businesses may pay taxes on machinery and equipment, vehicles and inventories. The type of property taxed under a statewide property tax usually is the same as that subject to local property taxes. Heavy manufacturers that use expensive machinery and equipment in the production process bear a much higher property tax burden than do service and knowledge-based firms.

Statewide property taxes can exacerbate or alleviate the tax burdens on businesses, depending upon how they are structured. A statewide property tax that replaces some or all local school property taxes will create a more uniform business tax burden statewide; businesses in high tax localities pay less, and firms in low tax localities pay more.

### *Economic Neutrality*

One significant and growing problem with the property tax is the disparate treatment of intangible property. Traditional manufacturing firms that invest heavily in plants and equipment face a much higher property tax burden than do service firms that derive their value from intellectual property such as a skilled labor force, patents and copyrights. As knowledge-based businesses grow and become more important in the national economic mix, the amount of property tax collected decreases. In addition, the relative burden of the tax on manufacturing firms increases.

Another issue is the use of classification systems in several states. Classification systems set the taxable values of property at different percentages of market value, depending upon the type of property in question, such as residential or commercial.

In Alabama, for example, the taxable value of residential property is 10 percent of market value, while the taxable value of commercial and industrial property is 20 percent of market value. Telecommunications and utility property are taxed at 30 percent of market value.

Classification systems can create disparities in industries that are shifting from regulated monopolies to competition. For example, some states tax the property of traditional telephone companies at a higher percentage than that of cellular telephone companies. This also is becoming an issue in the electric industry, where some states are providing for retail competition. In some instances, generating plants owned by traditional, regulated utilities are taxed at a higher rate than similar plants owned by competing companies that sell power at wholesale.

### *Accountability*

Like income taxes, property taxes are accountable to taxpayers because bills are determined annually and taxpayers know the exact amount of their bills. The high visibility of the property tax, combined with the fact that it is not directly linked to income, makes it unpopular and a frequent target for tax reductions by lawmakers who want to ease the tax burden.

### *Other Issues*

Taxpayers who itemize deductions can claim the property tax on federal form 1040, which can significantly reduce the effective rate of the property tax. As discussed earlier, deductibility is an important issue in states that are considering major tax shifts. This also can affect the equity of a state's tax system because higher-income taxpayers usually itemize deductions.

## Severance Taxes

Severance taxes are excise taxes levied when natural resources are severed from the soil or water of a state. These revenues are intended to compensate a state and its citizens for depletion of their natural resource wealth, and to mitigate social and environmental effects. Severance taxes usually are associated with oil, natural gas, coal and ores, which generate the greatest portion of severance tax revenues. They also are applied to other natural resources including salt, timber, fish, phosphates, sulfur, clay, sand, gravel and cement compounds.

Severance taxes can be considered as a substitute for property taxes on the mineral value of a section of real property. Ownership titles to mineral rights (and thus taxation) often are separate from titles to surface property rights. Names given to the taxes vary from state to state—production, license, conservation, mining or specific severance taxes.

### *Reliability*

Severance taxes potentially can produce significant revenue, but they are less reliable than most other taxes for financing recurring expenses. Collections fluctuate in response to price changes in world markets. Individual state conditions and production also can translate into widely different changes in revenue from year to year.

In addition, resources may become depleted or more difficult to extract, mines may close due to high costs or management problems, or a new development may make a resource obsolete. When collections drop, state budgets may face shortfalls, forcing policymakers to cut services or raise other taxes.

The bulk of severance tax collections depends upon a cyclical combination of worldwide prices and production levels, making them an unstable revenue source. The volatility in oil prices from 2007 to 2009 is an obvious example. Crude oil prices were approximately \$48 per barrel in mid-January 2007. A year later, the price had almost doubled to approximately \$93 dollars per barrel. Crude oil prices peaked seven months later in July 2008 at \$137 per barrel. By December 2008, the price had plummeted to \$43 dollars per barrel.<sup>12</sup>

Severance tax-reliant states cope with the effects on budgets of fluctuations in worldwide markets by using risk-adjusted revenue forecasts (intentionally reducing revenue estimates by a risk factor), forward funding (using the previous year's revenues to fund the next year's expenditures), revenue-indexed budgeting (establishing minimum state appropriations using relatively certain revenues), and establishing rainy day funds (accumulating money during booms to be used during busts). In anticipation of ultimate resource depletion, some states have created resource revenue-based trust funds.

### *Equity*

Generally, severance taxes are based on the value of the resource extracted or produced, with the tax imposed as a fixed percentage of the value (usually market) of the products severed. When based on the production quantity, taxes are imposed at a flat rate per unit of measure. Taxes can be graduated according to product value or volume of production. Some states use gross value, while others use net value or net proceeds. Taxing net proceeds can help distinguish between profitable and marginal operations and is consistent with taxing according to ability to pay. Customary measures of equity, based on a person's annual or lifetime income, are not applicable to severance taxes.

The opportunity to export taxes rather than impose personal taxes on a state's residents is attractive if it is technically feasible and if it can be justified as offsetting social costs generated by out-of-state residents. Severance taxes can be exported because they fall upon resource owners rather than on a state's citizens as a whole. They have allowed Alaska, Texas

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<sup>12</sup> U.S. Energy Information Administration, "World Crude Oil Prices" (Washington, DC: EIA, 2008).

and Wyoming to forego imposition of a personal income tax and have supported Montana's choice to forego a sales tax. Some states split severance tax receipts between the state and local governments, which bear the burden of expanding public facilities and providing public services to the extractive industries.

#### *Compliance and Administration*

In theory, a severance tax should be imposed at the earliest possible point, thus minimizing the effect of the tax on ensuing stages of use. A few states require first purchasers to pay the tax, but it usually is payable by the producer. The determination of what constitutes production may require allocation to a product's value at each stage of production, e.g., separation, refining or finishing. Over time, however, most states have developed complicated severance tax collection systems that require frequent reports, and their administration and compliance are highly specialized.

#### *Interstate and International Competition*

As previously mentioned, the world market sets resource prices. States compete with one another and with other nations for energy resource expansion and development investment. Since energy prices are set by world markets, state taxes will not affect selling prices, but will affect decisions about whether a resource can be commercially exploited at any given time. Tax increases cannot be passed to consumers, but are borne by resource owners whose royalties (property or mineral income) are reduced by taxes on production.

#### *Economic Neutrality*

Severance tax revenues may allow resource-rich states to provide additional services or to keep other major taxes low relative to neighboring states. Producers argue that high severance taxes discourage resource exploration and jeopardize the nation's energy independence. In response to this concern, many oil-producing states passed tax incentive legislation in the early 1990s to encourage oil production. State and local severance tax laws may distort investment allocation within and between states, but most likely will not have long-term effects. Regional disparities in wealth were a source of concern during the 1980s, but have not proven significant in the long run, since prices and the corresponding highs and lows in state severance tax revenues leveled.

#### *Accountability*

The citizen taxpayer is unlikely to be aware of severance taxes, and would be unable to determine their effect. Resource companies report the extraction and production activities upon which severance taxes are based, but there does not appear to be an effective method to evaluate the tax benefits received against the social and environmental costs.

# Sources for More Information on State Tax Rates and Policies

## Organization:

National Conference of State Legislatures (NCSL) - [www.ncsl.org](http://www.ncsl.org)

NCSL is a bipartisan organization that serves the legislators and staffs of the nation's 50 states, its commonwealths and territories. NCSL provides research, technical assistance and opportunities for policymakers to exchange ideas on the most pressing state issues. The NCSL Fiscal Affairs Program provides information on a number of state tax issues.

## Available Information:

Annual summaries of state tax actions <http://www.ncsl.org/default.aspx?tabid=18038> .

State personal income taxes on pensions and retirement income  
<http://www.ncsl.org/default.aspx?tabid=12657> .

Tax backgrounders - six articles that provide a data-driven overview of state tax systems  
<http://www.ncsl.org/default.aspx?tabid=17151>.

States with a legislative supermajority requirement to raise taxes  
<http://www.ncsl.org/?TabID=17421>.

State tax and expenditure limits <http://www.ncsl.org/default.aspx?tabid=12633>.

## Organization:

Federation of Tax Administrators (FTA) - [www.taxadmin.org](http://www.taxadmin.org)

FTA was organized in 1937 to improve the quality of state tax administration by providing services to state tax authorities and administrators. These services include research and information exchange, training, and intergovernmental and interstate coordination. The Federation also represents the interests of state tax administrators before federal policymakers where appropriate.

## Available Information:

State personal income tax rates [http://www.taxadmin.org/fta/rate/ind\\_inc.html](http://www.taxadmin.org/fta/rate/ind_inc.html) and federal income tax starting points [http://www.taxadmin.org/fta/rate/inc\\_stp.html](http://www.taxadmin.org/fta/rate/inc_stp.html).

State corporation income tax rates [http://www.taxadmin.org/fta/rate/corp\\_inc.html](http://www.taxadmin.org/fta/rate/corp_inc.html) and apportionment of corporate income [http://www.taxadmin.org/fta/rate/corp\\_app.html](http://www.taxadmin.org/fta/rate/corp_app.html).

State sales tax rates and exemptions for food and prescription drugs  
<http://www.taxadmin.org/fta/rate/sales.html> and vendor discounts  
[http://www.taxadmin.org/fta/rate/sale\\_vdr.html](http://www.taxadmin.org/fta/rate/sale_vdr.html).

State sales tax holidays [http://www.taxadmin.org/fta/rate/sales\\_holiday.html](http://www.taxadmin.org/fta/rate/sales_holiday.html).

State sales taxes on services <http://www.taxadmin.org/fta/pub/services/services.html>.

State motor fuel tax rates [http://www.taxadmin.org/fta/rate/motor\\_fl.html](http://www.taxadmin.org/fta/rate/motor_fl.html).

State cigarette tax rates <http://www.taxadmin.org/fta/rate/cigarett.html> and state taxes on other tobacco products <http://www.taxadmin.org/fta/rate/otp.html>.

State taxes on distilled spirits <http://www.taxadmin.org/fta/rate/liquor.html>, wine  
<http://www.taxadmin.org/fta/rate/wine.html> and beer  
<http://www.taxadmin.org/fta/rate/beer.html>.

State real estate transfer taxes <http://www.taxadmin.org/fta/rate/Realtytransfer.html>.

State and local tax burdens <http://www.taxadmin.org/fta/rate/burden.html>.

## Organization:

Wisconsin Legislative Fiscal Bureau - <http://www.legis.state.wi.us/lfb/>

The Wisconsin Legislative Fiscal Bureau is a nonpartisan service agency of the Wisconsin Legislature. The Bureau provides fiscal and program information and analyses to the Wisconsin Legislature, its committees, and individual legislators.

**Available Information:**

Summary of state individual income tax provisions

[http://www.legis.state.wi.us/lfb/Informationalpapers/4\\_individual%20income%20tax%20provisions%20in%20the%20states.pdf](http://www.legis.state.wi.us/lfb/Informationalpapers/4_individual%20income%20tax%20provisions%20in%20the%20states.pdf).

**Organization:**

Nelson A. Rockefeller Institute of Government Fiscal Studies Program, University at Albany, State University of New York - [http://www.rockinst.org/about\\_us/government\\_finance/](http://www.rockinst.org/about_us/government_finance/).

The Institute's Fiscal Studies Program was established in May 1990 in response to the growing importance of state governments in the American federal system. The mission of the Fiscal Studies Program is to provide high-quality, practical, independent research about state and local programs and finances. The program conducts research on trends affecting all 50 states and serves as a national resource for public officials, the media, public affairs experts, researchers, and others.

**Available Information:**

Quarterly analysis of state revenues

[http://www.rockinst.org/government\\_finance/state\\_revenue\\_reports.aspx](http://www.rockinst.org/government_finance/state_revenue_reports.aspx).

Periodic analyses of trends in state and local government spending and taxes in the form of the State Fiscal Briefs and News [http://www.rockinst.org/government\\_finance/](http://www.rockinst.org/government_finance/).

**Organization:**

Brookings Institution - <http://www.brookings.edu/>

The Brookings Institution is a private nonprofit organization devoted to independent research and innovative policy solutions.

**Available Information:**

The Economic Studies program monitors the global economy and seeks answers to economic policy issues in the United States and worldwide. Our research aims to increase the public's understanding of how the economy works and how to make programs and policies better <http://www.brookings.edu/Economy.aspx>.

**Organization:**

The Urban Institute - <http://www.urban.org/>

The Urban Institute gathers data, conducts research, evaluates programs, offers technical assistance overseas, and educates Americans on social and economic issues to foster sound public policy and effective government.

**Available Information:**

Research from the economy and taxes program <http://www.urban.org/economy/index.cfm>.

**Organization:**

Tax Policy Center – <http://www.taxpolicycenter.org/index.cfm>

The Tax Policy Center is a joint venture of the Urban Institute and Brookings Institution. The Center is made up of nationally recognized experts in tax, budget, and social policy who have served at the highest levels of government. TPC provides timely, accessible analysis and facts about tax policy to policymakers, journalists, citizens, and researchers on their website.

**Available Information:**

Tax Facts provides tax information for citizens, policy analysts, legislators, and the press. Data are compiled from a variety of sources, including the Urban Institute, Brookings Institution, Internal Revenue Service, the Joint Committee on Taxation, the Congressional Budget Office, the Department of the Treasury, the Federation of Tax Administrators, and the Organization for Economic Cooperation and Development.

<http://www.taxpolicycenter.org/taxfacts/index.cfm>

**Organization:**

Tax Analysts - <http://www.taxanalysts.com/>

Tax Analysts is a nonprofit publisher that provides the current and in-depth tax information. Although it is a subscription service, current tax news articles are available to the public on their website.

**Organization:**

The Institute on Taxation and Economic Policy - <http://www.ctj.org/itep/>

The Institute on Taxation and Economic Policy (ITEP) is a non-profit, non-partisan research and education organization that works on government taxation and spending policy issues. ITEP's goal is to provide policymakers, advocates, and the public with accurate, useful, and timely information regarding state and federal tax systems and how they affect taxpayers at different income levels.

**Organization:**

The Tax Foundation – <http://www.taxfoundation.org/>

The mission of the Tax Foundation is to educate taxpayers about sound tax policy and the size of the tax burden borne by Americans at all levels of government. From its founding in 1937, the Tax Foundation has been grounded in the belief that the dissemination of basic information about government finance is the foundation of sound policy in a free society. A number of tax reports are available on their web site.

**Organization:**

Multistate Tax Commission - <http://www.mtc.gov/Default.aspx>

The Multistate Tax Commission is an intergovernmental state tax agency working on behalf of states and taxpayers to administer, equitably and efficiently, tax laws that apply to multistate and multinational enterprises. Created by the Multistate Tax Compact, the Commission is charged with: facilitating the proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes; promoting uniformity or compatibility in significant components of tax systems; facilitating taxpayer convenience and compliance and compliance in the filing of tax returns and in other phases of tax administration; and avoiding duplicative taxation.

**Organization:**

Council of State Governments (CSG) - <http://www.csg.org>

CSG is an organization serving all three branches of state government. CSG is a region-based forum that fosters the exchange of insights and ideas to help state officials shape public policy. The CSG Fiscal and Economic Program monitors state fiscal concerns and economic stimulation activities to provide policymakers with best practices and policy options  
<http://www.csg.org/policy/fiscal.aspx>.