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DOING BETTER:

Progressive Tax Reform for the American South

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for the Center for a Better South

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Table of contents

Executive summary

The South's economy has changed considerably since the 1930s and 1940s. The days of travel on dusty, bad roads or by train are gone, only to be replaced by Interstate highways and airplanes. Gone are most afternoon newspapers, a lot of mill villages and corner stores. In their place are modern communications networks, factory farms and consumer superstores.

But as the economy has changed and millions of new residents have flocked to the Sunbelt, many aspects of Southern tax systems have remained static. Income tax structures, for example, have changed little from the times when $12,000 was a good annual income. Likewise, the sales tax has continued to focus on goods purchased from local merchants, even as more and more Southern shoppers are buying services and shopping online.

In this policy book offered by the Center for a Better South, we argue it is incumbent for lawmakers across the South to revisit their state tax codes in a holistic manner to bring our tax systems into the 21st century. All components—the income tax, sales tax, property tax and others—should be thoroughly examined and modernized to improve and ensure the fairness, adequacy and integrity of our tax systems. In other words, lawmakers can truly represent people across the South by restructuring state tax codes to make them more representative of today's complex and rapidly changing economy.

This publication is the first of a Better South series that will examine tax and budget issues in the Southern states. The 11 ideas presented in this discussion are an introduction to progressive tax reform that can lead us to a truly better South. Among the ideas explored in *Doing Better: Progressive tax reform for the American South* are:

> **Idea 1: Broaden the sales tax base.** Each Southern state should abolish sales tax holidays and review sales tax exemptions to eliminate those that don't meet contemporary economic needs.
>
> **Idea 2: Modernize sales taxes for the new economy.** Each Southern state should modernize its policy on taxing services and Internet sales to respond to the region's shift to the knowledge and service economy.
>
> **Idea 3: Raise cigarette taxes to promote public health.** Each Southern state should raise cigarette taxes to the national average of $0.92 per pack to reduce smoking and promote public health.
>
> **Idea 4: Enact a state Earned Income Tax Credit.** Each Southern state with an income tax should enact a refundable earned income tax credit to bring working families' incomes above poverty.

Idea 5: Modernize state income brackets. Each Southern state with an income tax should modernize its income tax structure by adjusting brackets and consider creating a new top rate to provide progressive balance.

Idea 6: Deal with hidden income tax increases. Each Southern state with an income tax should modify its tax policies to account for inflation to preserve long-term fairness and reduce back-door inflationary tax hikes.

Idea 7: Rethink tax relief based on age alone. Each Southern state should redesign tax codes to provide fair tax treatment to seniors so benefits are based on ability-to-pay instead of age alone.

Idea 8: Eliminate corporate tax loopholes. Each Southern state should review and update its income tax structures to eliminate corporate tax loopholes and promote fairness.

Idea 9: Enact a property tax circuit breaker. Each Southern state should consider enacting a property tax circuit breaker to shield residents from excessive taxation and connect property taxes with ability-to-pay.

Idea 10: Strengthen accountability for better decisions. Each Southern state should annually publish a comprehensive tax expenditure report to provide more accountability and information to lawmakers so they can make better decisions.

The report should highlight missed revenue opportunities due to tax exemptions, breaks and deductions.

Idea 11: Conduct performance reviews. Each Southern state should conduct a comprehensive performance review to boost government efficiency, save money and improve customer service.

To learn more about the Center for a Better South, go online to:

www.bettersouth.org

For frequent postings of news articles and discussions related to issues followed by the Center, visit our ThinkSouth blog at:

www.thinksouth.org

A few words about terms

Throughout this publication, you will find words like fairness, equity, adequacy, transparency and neutrality in *italics*. If you're unsure of the meaning of an italicized term while reading any of the ideas that follow, we encourage you to refer to this opening section of definitions to refresh your memory.

These economic terms are fundamental tax principles that describe the benefits of the 11 tax modernization and reform ideas presented in this publication. Each of our ideas strengthens one or more of these principles.

If Southern lawmakers use the ideas in this book holistically—as the backbone of several institutional reforms for their state's tax code—the tax system of their states should become more *progressive*. These longstanding tenets of good tax systems are accepted by many economists throughout the nation:

Fairness. "*Fairness*" refers to the treatment of taxpayers according to their *ability-to-pay*. *Fairness* can be achieved through both *horizontal* and *vertical equity*.

Horizontal equity means taxpayers with a similar *ability-to-pay* or circumstance receive similar treatment under the tax system. For example, a property tax system has *horizontal equity* when neighbors along the same street pay the same rate of tax, regardless of the worth of their tax.

Vertical equity, on the other hand, refers to taxpayers with differing abilities-to-pay. In terms of *vertical equity*, a *regressive* tax system takes a greater portion of income from lower-income citizens than from higher-income citizens. Sales taxes, for example, are *regressive* because poorer people generally pay a greater share of their income to pay these taxes, compared to wealthier people. On the other hand, a *progressive* tax system places a higher tax rate on higher levels of income. Therefore, those with a higher *ability-to-pay* spend a larger share of income in taxes. The income tax system, when set up three generations ago, was set up as a *progressive* tax system because people with higher incomes were to pay more in income taxes.

> *Note: When the term "progressive" is used in economic discussions, it should not be confused with the political term "progressive." The former has a specific economic meaning, as outlined above. The latter, which is not italicized when used in this book, has a broader non-partisan meaning that can be equated to "moving things forward to benefit all in a fairer way." A progressive policy idea moves political debate forward toward a new solution or policy.*

Adequacy. A tax system is "adequate" if it raises enough revenues to fund the government services that citizens call for. To achieve this *adequacy*, the tax system should grow as the economy grows and do so at a stable, predictable pace. Other tax terms associated with *adequacy* are elasticity, stability and predictability.

Neutrality. A "neutral" tax system does not affect the economic decisions of taxpayers. For example, if a taxpayer purchases one item over another because of taxes, then the tax system is not neutral.

Transparency and simplicity. "*Transparency*" and "*simplicity*" refer to the ease with which taxpayers can understand and comply with their tax obligation and government can administer and enforce the tax system. Simplifying a tax system removes obstacles that make the tax system more complex to follow and administer.

There are other principles of tax policy, such as accountability, exportability and economic efficiency, that can also strengthen or improve state tax systems. This publication, however, will focus primarily on the principles detailed above. Due to the *regressive* nature of state and local tax systems across the South, we will take a particular look at ways to improve *fairness* and *progressivity* in Southern tax systems.

Readers also might benefit from a brief explanation of a few other tax-related terms used in this publication:

Ability-to-pay. Often considered a form of "means-testing," "*ability-to-pay*" is a term that refers to a taxpayer's capacity to pay a particular tax based on their income or wealth. For example, a family making $15,000 will feel a sales tax increase more than a family making $250,000 since the lower-income family already consumes most, if not all, of its income. The lower-income family is said to have a lower or limited *ability-to-pay*. In tax systems, the income tax recognizes *ability-to-pay* by having a *progressive* rate system that places a higher tax rate on higher levels of income. In contrast, sales taxes, which have a flat rate, do not recognize *ability-to-pay* and take the same amount of money from low and high income consumers.

Performance review. As outlined in Idea 11, a *performance review* is a management tool to review government functions to find savings, remove duplication, improve government efficiency and provide better service to state residents.

Tax expenditure. A *tax expenditure* is an amount of revenue that a government will lose because it extends a tax credit, tax exemption or tax break to a group or organization. For example, if a state loses $1 million because it doesn't charge sales tax on newsstand newspaper sales, the state has a *tax expenditure* of $1 million in potential lost revenue.

Tax preference. As used in this publication, "*tax preference*" is a broad term used infrequently to refer to a preferable tax treatment given to one group over another. For example, providing a lower property tax rate through homestead exemptions for seniors gives them a property *tax preference* because of their age alone. This term often is related in discussions to *ability-to-pay*.

Tax threshold. The *tax threshold* for any taxpayer is the point at which they start paying taxes. If, for example, all families in a state have a $10,000 income tax exemption, their income *tax threshold* is $10,000 because they won't be charged income taxes on income up to $10,000.

For a fuller discussion of economic terms used throughout this work, you may want to go online to the following link:

http://www.irs.gov/app/understandingTaxes/jsp/tools_glossary.jsp

Introduction

Taxes. It's a word that sends chills down the spines of even the grisliest of soldiers.

Nobody likes taxes. Even before the days of Old Testament tax collectors or the sheriffs of old England, nobody's really been for taxes—regardless of any political rhetoric out there.

But taxes get a bad rap. Like them or not, taxes are not something that should be vilified because of their very nature. Instead, people might consider looking at them in another light—as the necessary price we pay to keep our democracy alive.

Taxes are the price of our freedom. Imagine what we wouldn't have if taxes didn't fuel government programs and services.

We might not have good roads and bridges. We wouldn't have a system of public education. We wouldn't have an efficient system to protect our borders (soldiers), communities (police) and homes (firefighters).

In fact, when you think about the quality of life throughout the country and American South, we wouldn't have a lot of the benefits of civilized society if taxes weren't there to pay for public services and invest in the common good.

In America, we have taxes because generations of people have learned that shared sacrifices (taxes) are the best and fairest way for everyone to build a better country, a better quality of life. In other words, taxes and the governments that administer them are the means through which America moves forward.

Taxes fuel a better quality of life for businesses as well as people. If you want to open up a business, for example, you surely want to make sure roads are in place so workers can get to their jobs and customers can visit to make purchases. If you want to open a restaurant, you want to ensure clean water is available.

Government does these things. But somebody has to pay for it. If we want everyone to share in this common good, everyone should pay a fair share. In turn, we all will reap rewards.

That being said, it's OK for people to disagree about taxes and what they should be used for. That's what a lot of politics is about. But through the years, state legislators across the region generally have not stepped back to take comprehensive looks at how tax structures are working in today's new economy.

Unlike the past, today's South is fueled more by services and knowledge than the goods-driven economy of the

20th century. It's time for state governments to recognize the shift and adapt how they operate. In other words, it's high time to modernize taxing structures for the 21st century.

A fairer tax system

This policy book seeks to provide some tools to help lawmakers take a more holistic vision of taxing structures and how they affect Southern taxpayers today.

Throughout the work, you'll read about how tax systems across the South are filled with inequities. And if you step back and look at the systems as a whole, you may be able to see how comprehensive tax reform will make tax structures fairer.

In this book, you'll learn about how:

- Southern states lose billions of dollars every year through special tax breaks, exemptions and holidays. They also miss opportunities to boost *fairness* by failing to tax more services as the economy is transforming.

- Southern states can improve public health by raising the cigarette tax to the national average;

- Southern states can modernize how they tax incomes and increase *fairness* by using new tools;

- Southern states can provide fairer relief to seniors; and

- Southern states can take proactive actions to increase accountability and improve government performance.

The overall approach suggested in this work is much different than the normal political process, which tends to fix one piece of the tax puzzle at a time. Instead, we believe lawmakers need to look at the whole puzzle. If they do and use the ideas in this book, they'll boost *fairness* and make their tax structures stronger.

The book features 11 ideas, each of which has a chapter-length discussion that highlights the idea's background and merits. Each section also includes brief talking points to help people put the concepts in everyday language.

Following the chapters of ideas, we offer an appendix for each state in the study—Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, South Carolina, Tennessee and Virginia. Each appendix includes a scorecard that generally illustrates how each state currently performs in implementation of the 11 ideas. Each appendix also provides a summary of each idea to highlight how it can offer a better tax structure for taxpayers.

A better way

The Center for a Better South is a pragmatic, progressive, non-partisan think tank dedicated to developing progressive ideas, policies and information for thinking leaders who want to make a difference in the American South.

It is crafted in the spirit of the LQC Lamar Society, which was started in 1969 by "men and women who believed the South could achieve practical solutions to its problems, regardless of whether these men were liberal or conservative, white or black, Democrat or Republican, establishment or student."

As Alabama publisher H. Brandt Ayers wrote in 1971, "The [LQC Lamar] Society would be a network of Southern competence…it would be a conduit which could trap and disseminate good ideas before they were lost in the journals of professional and learned societies…it would be a catalyst which actually made things happen."

We believe the Center for a Better South serves a similar function today—to develop, discuss and spread good ideas to move the South forward as a region.

We offer this policy book as an effort to work with all leaders to move the South forward. If we want to maintain our republican system of democratic government, and if we want to ensure all Southerners can pursue the freedoms they're guaranteed, then we have to ensure government's framework is strong enough to make things happen. In doing so, Southerners will be able to achieve individual goals and, perhaps, their Southern dreams.

Taking a long look at how we raise revenues and trying to make those ways fairer will make the South stronger. The time is now.

—Andy Brack
Chairman and President,
Center for a Better South, Charleston, S.C.
June 2006

Idea

1

Broaden the sales tax base

Each Southern state should abolish sales tax holidays and review sales tax exemptions to eliminate those that don't meet contemporary economic needs.

Background

Just about every time you buy something, a few pennies are tacked on to the price to help fund necessary government programs and services. These sales tax collections are a significant portion of tax systems throughout the South.

Tennessee and Florida, which do not have a broad-based individual income tax, rely the most heavily on sales taxes among the Southern states. In Tennessee, sales taxes contributed 61.1 percent of total taxes in 2005. In Florida in the same year, they contributed 56.2 percent of total taxes for the state budget. Other Southern states ranged from a low of 19.4 percent in Virginia to 47.6 percent in Mississippi.[1]

Across the region, sales tax rates range from 4 percent to 7 percent. When combined with local sales tax rates, the percentage jumps to a range of 5 percent to 11.5 percent, as highlighted in Figure 1. But sales tax rates are only one determinant of how much revenue a state can collect through sales taxes. The sales tax base—the array of goods and services that are taxed—is another important factor in the size of a state's sales tax collections. In recent decades, the sales tax base has eroded in many states because of actions by state legislatures, as well as changes in the economy, which will be discussed in Idea 2.

Figure 1: State and local sales tax rates, 2004

	State tax rate	Maximum state/ local tax rate
Alabama	4	11
Arkansas	6	11.5
Florida	6	7.5
Georgia	4	7
Kentucky	6	6
Louisiana	4	10.25
Mississippi	7	7.25
North Carolina	4.5	7.5
South Carolina	5	7
Tennessee	7	9.75
Virginia	4	5

Source: Federation of Tax Administrators[2]
Note: State and Local maximum rate includes general purpose taxes, not specified taxes such as lodging and meals.

Sales tax exemptions and holidays have been part of this erosion. In essence, they serve as special tax breaks to certain businesses, organizations and individuals. Each state can be more proactive in broadening its sales tax base by examining the use of sales tax holidays and exemptions to eliminate those that no longer serve the needs of the state.

Sales tax exemptions and holidays have been eroding the sales tax base, which means sales tax rates are higher than they should be.

Removing unnecessary sales *tax preference*s will create a fairer tax and open the door for meaningful tax reform. Removing exemptions and holidays will create another payoff because states can decide whether to lower their sales tax rates or use extra revenues to improve programs and services sought by taxpayers. The Center also believes removing exemptions and holidays may create a more competitive business environment.

Reducing sales tax exemptions

States across the South offer a variety of sales tax exemptions on everything from groceries and medicine to fuel for pig farmers in Georgia. Households, businesses and organizations receive special exemptions, credits and exclusions from the sales tax because a state legislature deems it appropriate. But each of these exemptions comes at a cost to the state. While many exemptions are minor, the total cost of a state's exemptions can add up to a sizeable revenue loss. In South Carolina, for example, a fiscal year 2006 to 2007 forecast of the maximum revenue loss from all sales tax exemptions was $1.34 billion.[3]

Certain sales tax exemptions serve a tax policy purpose, such as making the tax system fairer. For example, a sales tax exemption on groceries removes the necessity of food from the sales tax base. This assists low-income families with their food purchases and makes the sales tax less *regressive*. Florida, Georgia, Kentucky Louisiana, and North Carolina exempt food for consumption at home (i.e., groceries) from the state sales tax, while Tennessee and Virginia tax groceries at a lower rate than other items.[4] While this exemption helps lower the sales tax burden on low-income taxpayers, it comes at a high cost to states. In Louisiana, the exemption on groceries will cost an estimated $182 million in Fiscal Year 2006.[5] North Carolina lost $416.8 million in sales tax revenue in 2004 to the groceries exemption.[6] In addition, the sales tax exemption on groceries is poorly targeted as it goes to everyone who purchases food, not just those taxpayers in need. Research has found that only 25 percent of the benefits of this exemption go to the 40 percent of taxpayers with the lowest-incomes.[7]

Research has found that only 25 percent of the benefits of exempting groceries from sales tax go to the 40 percent of taxpayers with the lowest-income.

While some exemptions serve one valuable tax policy purpose, such as *fairness*, they often harm other tax policy goals, such as *adequacy* and administrative ease:

- **Higher rates.** With each exemption, states lose money and run the risk of having to raise the sales tax rate to cover the cost of government services.

- **More red tape.** In addition, each exemption can create an administrative burden since all retailers are not subject to the same rules.

Rather than continually exempting certain items, individuals or businesses from the sales tax, states should strive to have the broadest possible tax base that achieves its tax goals. A broader base serves to spread taxes over all taxpayers—not just those who purchase a taxable item over an exempt item -- and gives states the opportunity to lower the sales tax rate.

Case study: Tennessee

It is estimated that Tennessee loses more than $2.7 billion in state revenues from 50 major tax exemptions.[8] This significant tax loss is comprised of more than $2.2 billion in sales and use tax exemptions, more than $211 million in gross receipts tax exemptions, more than $97 million in corporate franchise and excise tax exemptions, and some $222 million in other miscellaneous tax exemptions.

Tennessee loses an estimated $2.7 billion annually in state revenues from 50 major tax exemptions.

Examples of individual tax exemptions include:

• Gasoline, diesel and aviation fuel	$663.1 million
• Prescription drugs, insulin and syringes	$341.4 million
• Energy fuels sold for residential use	$254.8 million
• Energy and water sales to manufacturers	$231.8 million

• Industrial machinery and equipment	$164.7 million
• Food sales	$77.8 million
• Farm machinery and equipment	$19.1 million
• Cable Television	$18.2 million
• Membership dues of civic and business organizations	$11.8 million
• Non material cost of manufactured homes	$8.6 million
• Physical fitness activity fees	$4.1 million

Abolishing sales tax holidays

One particular sales tax exemption that has few tax policy merits is the sales tax holiday, which eight Southern states implement (Figure 2). These annual sales tax holidays sound good. They offer tax exemptions on certain items, such as back-to-school clothes and supplies, and are limited to a specific time-period, generally three or four days. But a closer look shows they don't seem to be worth the trouble.

Figure 2: Southern states with sales tax holidays
Alabama
Florida
Georgia
Louisiana
North Carolina
South Carolina
Tennessee
Virginia

Georgia, for example, offers a combined sales tax holiday for energy efficient appliances and back-to-school items such as clothes, supplies and computers. Georgia legislators renew the exemption annually and decide on a three-day period towards the end of summer to hold the tax holiday. Consumers receive the tax exemption on clothes and shoes that are less than $100 per article, books and supplies less than $20 per item, and computers and computer accessories less than $1,500 per sales transaction. In addition to the back-to-school items, residents receive a holiday tax exemption on the purchase of energy efficient appliances, such as EPA-approved or Energy Star dishwashers, ceiling fans and refrigerators, which cost less than $1,500 per product.[9]

Some tax experts refer to the sales tax holiday as a gimmick.

Florida was the first Southern state to offer a sales tax holiday in 1998. Georgia, Louisiana, North Carolina, South Carolina and Tennessee implemented holidays soon thereafter. Recently, Alabama and Virginia passed legislation to start a sales tax holiday in 2006. The amount of revenue lost because of such tax holidays ranges, as shown in Figure 3. Florida has the greatest revenue loss with $31.2 million in 2005, while Virginia is estimated to have the smallest revenue loss of $2.6 million in FY 2007. Often, these tax holidays also reduce local sales tax revenues. Such is the case in Georgia where the annual tax holiday will cost local governments an estimated $8.5 million in 2006.[10] Sales tax holidays are not a significant revenue drain on states when measured as a percent of total general sales tax collections. When comparing recent estimates of the cost of such holidays to 2004 actual sales tax collections, the holiday represents less than half of one percent of general sales tax collections in every state (Figure 3).

While the sales tax holiday does not harm the *adequacy* of funds significantly, it also does not achieve any significant tax policy benefits either. In fact, some tax experts refer to the sales tax holiday as a gimmick.[11] David Brunori of George Washington University notes it is laudable legislators would want to give low- and moderate-income families assistance with sales taxes since it is the most *regressive* tax and takes a larger portion of income from poor residents than from wealthy residents. But he says the sales tax holiday is a gimmick because it does not achieve those goals of making the tax more just and fairer in any significant way. Among the problems:

- **Short-term relief.** First, what little relief the sales tax holiday does provide is for three or four days a year. For the other 361 days of the year, taxpayers are left with a *regressive* tax. Reforms such as a broader sales tax base and a lower rate would provide more meaningful improvements and would be available year-round.

- **May not be passed on to consumers.** Second, Brunori and other tax analysts warn that retailers do not necessarily have to pass sales tax holiday discounts on to consumers at all.[12] Retailers can forego their own discounts and sales prices and rely solely on the state tax discount, so that families end up paying about the same as they would without the sales tax holiday.

- **Poorly targeted.** Lastly, the sales tax holiday is poorly targeted if its goal is to assist families in need. Every individual making certain purchases receives the tax benefit in the sales tax holiday, no matter what their income.

States with sales tax holidays would be well-advised to:

- **Study the effects of the sales tax holiday.** How much are consumers saving? What is the distribution of this tax holiday among low, moderate, and high income residents? Are retailers passing along the discounts to consumers?

- **Review the alternative uses of the holiday sales tax losses.** Should Florida, for example, provide consumers with $30 million in shopping discounts or should it use $30 million to give more targeted tax assistance or to fund a needed state program?

- **Consider better ways to help working families and make the sales tax fairer.** Is a three-day sales tax holiday reversing the *regressivity* of the sales tax? Or is it better to make comprehensive reforms, such as a broader sales tax base and a lower rate, that last year-round and will help low- and moderate-income families more? Is a sales tax holiday that goes to people regardless of need prudent, or would a tax reform such as a refundable earned income tax credit (See Idea 4) be more effective in making the tax system fairer and more *progressive*?

Figure 3: Estimated cost of southern sales tax holidays, 2004 to 2007			
State	**Estimated cost of sales tax holidays (dates vary from 2004 to 2007)**	**Total general sales tax collections, 2004**	**Sales tax holidays as a percent of general sales tax collections**
Alabama	$3.4 million	$1,893 million	0.18 percent
Florida	$31.2 million	$17,129 million	0.18 percent
Georgia	$11.3 million	$4,921 million	0.23 percent
Louisiana	$10.1 million	$2,681 million	0.38 percent
North Carolina	$11.0 million	$4,352 million	0.25 percent
South Carolina	$5.2 million	$2,727 million	0.19 percent
Tennessee	$10.0 million	$5,845 million	0.17 percent
Virginia	$2.6 million	$2,977 million	0.09 percent

Source: State Tax Expenditure Reports and Fiscal Notes[13]; U.S. Census Bureau[14]; Author's calculations
Note: Estimates are for revenue losses to the state general fund. Local revenue losses are not included. For the year of each estimate see footnote 13. Florida cost is back-to-school sales tax holiday. Tennessee is a rough estimate. Louisiana had a sales tax holiday in December 2005, which will not necessarily be an annual event.

A better sales tax

Each year, Southern states chip away at their sales tax bases by providing more and more exemptions and implementing new sales tax holidays. While many of these individual exemptions do not cost significant amounts of money, they create imbalances in the sales tax system because they provide special treatment to some individuals and businesses.

Rather than providing a multitude of exemptions and special breaks, states should seek to modernize their sales tax system by creating as broad of a sales tax base and as low of a sales tax rate as possible. A broader base and lower rate will provide meaningful tax reform by improving the *fairness* and administrative ease of the sales tax without lowering state revenues.

There is a viable, but less palatable alternative. Instead of using new revenues from broadening the base to lower sales tax rates, lawmakers could steer new revenues from abolished holidays and exemptions into programs and services sought by taxpayers.

Talking points

- Sales taxes are *regressive* because poorer people spend a larger share of their income to pay them.

- Over the years, special interests have gotten millions of dollars of customized sales tax breaks which eroded the pot of goods and services from which governments taxed sales. In turn, governments have had to increase sales tax rates to balance the revenues lost to special interests.

- A better way to tax sales is to remove exemptions and holidays, which will broaden the base—and allow states to lower sales tax rates. In turn, the sales tax will become fairer for all. The Center also believes removing exemptions and holidays also may create a more competitive business environment.

Endnotes

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Idea 2

Modernize sales taxes for the new economy

Each Southern state should modernize its policy on taxing services and Internet sales to respond to the region's shift to the knowledge and service economy.

Background

As discussed in Idea 1, Southern states exempt or exclude certain items from sales taxes. This has created millions of dollars of holes in the tax base that have caused some to refer to sales taxes as a Swiss cheese approach to taxation. Certain exemptions are for intentional policy reasons, such as shielding poor residents from taxes on essentials goods like groceries.

But there are other tax exemptions and exclusions that have developed under the radar screen or just unintentionally. Often, they haven't even been debated by lawmakers. Instead, they arose as our economy changed, but governments didn't.

In this section, we'll review two ways that state governments can respond better to the new economy. First, they can adapt the way they tax sales to include more services, such as pet grooming, haircuts and landscaping, as Southerners continue to increase the amount of services they buy over goods. Second, lawmakers can respond more effectively to the increasing trend of people to make purchases online.

By modernizing state sales tax structures to include more services in the tax base and encouraging Internet sales taxes, states will be able to lower the sales tax rate without sacrificing revenues. In turn, the sales tax will become more representative of our 21st century spending habits.

Figure 1: Southern states on services and internet sales

State	Taxes the national average of services	Approved Streamlined Sales and Use Tax Agreement (SSUTA)
Alabama	No	No
Arkansas	Yes	Yes
Florida	Yes	No
Georgia	No	No
Kentucky	No	Yes
Louisiana	No	No
Mississippi	Yes	No
North Carolina	No	Yes
South Carolina	No	No
Tennessee	Yes	Yes
Virginia	No	No

A shrinking base

In the 1930s, Mississippi became the first Southern state to create a sales tax.[1] Other states followed suit, and every Southern state had a general retail sales tax by the late 1960s. When Southern states were designing sales taxes, primarily between 1930 and 1951, households spent a majority of their income on goods, which includes items such as clothing, appliances and furniture. However, the 21st century economy is very different from the goods-dominated economy of the 1930s.

> **Today's economy focuses more on services and is very different than the goods-dominated economy of the 1930s to 1950s.**

Today's households spend less on goods than services, such as landscaping, tanning salons and pest control. The Center on Budget and Policy Priorities notes that goods made up 39 percent of household purchases in 1970 but dropped to 33 percent by 2001. In contrast, services continue to grow as a share of purchases, increasing from 31 percent of household purchases in 1970 to 44 percent in 2001.[2] As services continue to outpace goods in household purchases, the sales tax will suffer since sales tax bases continue to focus primarily on goods. Bottom line: the current sales tax base will continue to decline unless lawmakers reform the way sales are taxed.

In addition to more purchases of services, Americans are buying more items through the Internet. Recent estimates by Forrester Research show national online business-to-consumer sales totaled $104 billion in 2003, up 39 percent over 2002.[3] Moreover, such sales are expected to grow rapidly over the next few years. By 2008, total online sales will reach $230 billion, according to Forrester Research predictions.

As more and more purchases are made online rather than in a local store, the sales tax base will shrink since states cannot tax remote sellers (i.e., a business that does not have a physical presence in the state, such as online stores, mail order businesses and home shopping companies). And as the tax base shrinks, states lose potential revenues. This inability of states to require remote sellers to collect sales taxes results from a series of rulings by the U.S. Supreme Court. Unlike the taxation of services, which states can authorize, the taxation of Internet sales and other remote purchases is beyond the authority of the states. That means Congress must give states the authority to tax remote sellers for this part of the tax base to become available.

Treating services fairer

Southern states have the opportunity to broaden their *sales tax base* by making more services taxable. The Federation of Tax Administrators identified 168 services states could tax in 2004. As shown in Figure 2, Southern states tax between 18 and 74 of those possible 168 services. On average, Southern states tax 47 services, while the national average is 57. Hawaii, New Mexico, South Dakota and West Virginia each taxed more than 100 of the possible 168 services. Likewise, Delaware and Washington taxed more than 100 services, but did so through a gross receipts tax rather than a general sales tax.[4]

Figure 2: Taxation of services, 2004	
	Total number of services taxed (168 possible)
U.S. Average	57
Alabama	37
Arkansas	72
Florida	62
Georgia	36
Kentucky	29
Louisiana	55
Mississippi	74
North Carolina	30
South Carolina	34
Tennessee	67
Virginia	18
Source: Federation of Tax Administrators[5]	
Note: U.S. average does not include Alaska or Oregon, neither of which has a general retail sales tax.	

Southern states should review the 168 services available for taxation and consider increasing the taxation of services to at least the national average (57). While economists warn against the taxation of business-to-business services since the final product will also be taxed, most Southern states continue to have many options for taxing services that are not in that category. This progressive reform of taxing services can achieve several tax policy goals:

Fairness. Taxing more services can enhance the *fairness* of the tax between taxpayers of similar income. Economists call this an improvement in "*horizontal equity*." Taxing more services means that two similarly situated taxpayers would be taxed similarly whether they purchased goods or services. Take an example of lawn care. Currently, many states tax the purchase of a lawnmower, but do not tax the purchase of services from a landscaping business. The sales tax provides a preference for the landscaping service even though the activity is the same—a well-manicured lawn. Broadening the sales tax base to include more services will remove this unfair treatment to those who purchase goods over services.

> **Broadening the sales tax base to include more services will remove the unfair treatment to those who currently purchase more goods than services.**

Taxing more services also can improve something called "*vertical equity*," which increases the *fairness* between low and high incomes. Wealthy households consume more services than poor households. Therefore, broadening the tax base to include a balance of goods and services makes the sales tax *fairer* across incomes—or increases *vertical equity*.[6] While including services in the tax base could slightly improve the sales tax's *vertical equity*, it will not reverse the *regressive* nature of the sales tax. Poor households will continue to pay a larger share of income in sales taxes than wealthier households.

Adequacy. Broadening the tax base to include services means more items and purchases will be taxable. Making more purchases taxable will cause an increase in sales tax collections. While the increased revenues are worth considering, it is also worthwhile for states to study how lowering the sales tax rate after the base is broadened can achieve further gains in tax *fairness*. As mentioned throughout this publication, the sales tax is today's most *regressive* tax. It takes a larger share of income from poor residents than from wealthy residents.

While taxing more services can make the tax more fair in the treatment of goods and services, it does little to reduce the current burden low-income taxpayers have when purchasing goods. Lowering the sales tax rate after broadening the base provides an even further gain in terms of tax *fairness* since all goods would be taxed at a lower rate. Legislators must weigh the need for increased funds against the need for more *progressive* taxation when deciding whether to reap the revenue gains from broadening the base or whether to lower the tax rate for a revenue-neutral approach. Other reforms, such as an earned income tax credit (Idea 4), would also help offset the *regressive* nature of the sales tax.

***Neutrality*, Stability and Administrative Ease.** *Neutrality*, stability and administrative ease can also be increased under a broader sales tax base. In terms of *neutrality*, taxing a balance of goods and services reduces the incentive for consumers to seek one economic activity over another for tax purposes. The Center on Budget and Policy Priorities also includes stability and administrative ease among the gains, since a broad base can be more stable over economic cycles and improve administration through more uniformity on purchases.[7]

Case study: South Carolina

South Carolina has many options for expanding its sales tax base by taxing more services. In 2004, South Carolina taxed only 34 out of a possible 168 services. While economists warn against taxing some business-to-business transactions since the end product will also be taxed, there are numerous household services South Carolina could tax to enhance the *fairness*, *neutrality* and stability of the tax and possibly lower the rate. For example, household services taxed in several states, but not in South Carolina, include: pet grooming, mini-storage, barber shops and beauty parlors, dating services, clothes alterations and repairs, and personal instruction, such as golf and dance lessons.[8]

Using data from the U.S. Department of Commerce Bureau of Economic Analysis, South Carolina's Board of Economic Advisors estimated that comprehensively taxing services could generate $1.3 billion in additional sales tax revenue in 2005.[9] Figure 3 provides a few examples of how much revenue certain services could generate in South Carolina according to those estimates. That estimate, however, includes many services that states are not likely to tax, such as business-to-business services like accounting and advertising services.

If South Carolina taxed more services in 2001, it could have generated an additional $669 million—which could have been used to lower the state's sales tax rate.

Michael Mazerov of the Center on Budget and Policy Priorities provides another estimate for South Carolina using only "readily-taxable" services, which are defined as services purchased primarily by households excluding education, health, legal, housing, public transit, banking, funeral, and insurance services. Mazerov estimates that taxing readily-taxable services in South Carolina would have generated $669 million in 2001.[10] Mazerov's estimate includes services that might be currently taxed in South Carolina; thus, the actual collections from taxing new services could be slightly less. While the state would need to decide which services are appropriate for taxation in South Carolina, there are numerous options for taxing more services and potentially lowering the tax rate.

Figure 3: Estimates of taxing services in South Carolina, 2005	
Type of service:	Sales Tax Revenue (in millions)
Personal Services	$41.4
Auto Repair Services and Parking	$60.3
Miscellaneous Repair Services	$23.6
Amusement & Recreation Services	$39.4
Membership Organizations	$41.3
Source: South Carolina State Budget and Control Board[11]	

Internet sales taxes

Another way to broaden the sales tax base is to address Internet sales and other remote sales. To date, Congress has not given states the authority to tax remote sales, which are sales made by businesses or stores that do not have a physical presence in the state. The Supreme Court has noted that sound reasons exist for state-level taxation of remote sales and Congress could authorize such taxation. Furthermore, the Court suggested Congress would be more likely to grant approval if states simplified their tax systems.[12] In an effort to simplify sales tax codes and encourage Congress to grant such authority, states have joined the Streamlined Sales Tax Project (SSTP). In 2002, participating SSTP states adopted the Streamlined Sales and Use Tax Agreement (SSUTA), model legislation that provides states "with a blueprint to create a simplified sales and use tax collection system that, when implemented, provides justification for Congress to allow states to request remote sellers to collect sales taxes."[13]

As of 2006, 19 states had enacted SSUTA. Of these states, 13 had adopted all of the SSUTA provisions, while six more states are on track to fully implement SSUTA by 2008. But only four Southern states—Arkansas, North Carolina, Tennessee and Kentucky—have approved the agreement. Kentucky and North Carolina are in full compliance, while Arkansas and Tennessee are scheduled to achieve full compliance in 2008.[14] States that join the Streamlined Sales Tax Project efforts may eventually realize several benefits from broadening the sales tax base to cover remote sales:

- ***Simplicity.*** One of the founding principles behind the Streamlined Sales Tax Project is a simplified sales tax system. *Simplicity* in the sales tax is important since retailers collect the tax and then remit it to government. When retailers are selling in multiple states that have different sales tax structures, the collection of sales taxes is more complicated and time-consuming. A simplified structure would ease the collection process and provide justification to Congress that states are prepared to tax remote sellers.

- ***Fairness.*** Excluding Internet and other remote sales from taxation lessens the *fairness* of the system for several reasons. First, online retailers have a cost advantage not enjoyed by traditional "bricks and mortar" retailers who must collect sales taxes in their stores. Similarly, out-of-state retailers can also gain an unfair advantage over in-state operators, who must collect taxes on sales. Finally, the exclusion is unfair to consumers who shop at traditional stores rather than online or through other remote sellers. Online shoppers, likely to include more wealthy households than low-income households, are able to avoid the sales tax on certain purchases.[15] This further exacerbates the *regressivity* of the sales tax.

Out-of-state online retailers have an unfair advantage over in-state retailers because some out-of-state retailers don't have to collect sales taxes currently.

- ***Adequacy.*** Nationally, e-commerce sales cost states a combined loss of between $15.5 and $16.1 billion in state and local sales tax revenues in 2003.[16] An estimate of the potential loss in state sales tax revenue in

Figure 4: Estimated state revenue losses from e-commerce in 2008

State	Low estimate (millions)	High estimate (millions)
Alabama	$179	$279.9
Arkansas	179.5	280.8
Florida	1,455.1	2,275.5
Georgia	451.4	705.9
Kentucky	258.5	404.3
Louisiana	255.6	399.7
Mississippi	231.2	361.6
North Carolina	378.3	591.7
South Carolina	243	380
Tennessee	493	771
Virginia	283.8	443.9

Source: Bruce and Fox[17]

2008 for Southern states is shown in Figure 4. In the 11 states of the American South, state governments could lose up to $6.9 billion—yes, billion—in sales tax revenues in 2008. Losses range from a high of $1.46 to $2.28 billion in Florida to a low of $179.0 to $279.9 million in Alabama.[18] These revenue losses will likely continue and increase as more consumers shop online and more businesses offer online shopping.

A more modern sales tax

Over the past several decades, the Southern economy has changed significantly. Purchasing more services than goods and buying from Internet sites instead of a local merchant are common practices today. In spite of these changes in the way we consume, states have not modernized their sales tax structures to capture the shifting consumption patterns.

Southern states need to broaden their sales tax bases by including more services, as well as encouraging Congress to grant authority for Internet sales taxation. Broadening the sales tax base should allow Southern states to lower the overall sales tax rate, a feature that would add greatly to the *fairness* of the tax system. With a broad base and a low rate, the sales tax would become more representative of our 21st century economy.

Talking points

- Southern states generally haven't modernized their sales tax structures in 50 years. Current state sales tax structures don't reflect the 21st century economy.

- States can broaden their sales tax base—and ultimately reduce sales tax rates—by taxing more services. Such a move would make the sales tax fairer and reduce hidden tax breaks that go to those who purchase more services than goods. The Center also believes reducing rates may make states more competitive.

- States also can broaden the base by taxing Internet sales. They should encourage Congress to allow them to reduce unfair competition to local merchants that results when consumers buy online from vendors who don't have to collect sales taxes.

Endnotes

[1] Conflicting reports put this date at 1930 and 1932. Also, some scholars classify earlier taxes in Alabama and Kentucky as the first sales taxes, although they were not the broad-based sales tax we generally think of today.

[2] Mazerov, Michael. "Expanding Sales Taxation of Services: Options and Issues." Center on Budget and Policy Priorities. June 2003.

[3] Carrie Johnson, "The Growth of Multichannel Retailing." Washington, DC: National Conference of State Legislatures and the National Governor's Association.

[4] Federation of Tax Administrators. "FTA Releases 2004 Survey on State Taxation of Services." *www.taxadmin.org/fta/pub/services/services04.html#summary*

[5] *Ibid.*

[6]Institute on Taxation and Economic Policy. "Should Sales Taxes Apply to Services?" Policy Brief #3, 2005.

[7] Mazerov (2003)

[8] Federation of Tax Administrators. "Services Taxed in South Carolina." 2004 Survey of Services Taxation. *www.taxadmin.org/fta/pub/services/online/service_state.taf?_function=list*

[9] Gillespie, William. Estimates on Taxing Services. South Carolina State Budget and Control Board, Board of Economic Advisors. October 2005. (Note: Gillespie notes that this estimate has a wide margin of error as the state does not have a long history of taxing services.)

[10] Mazerov (2003)

[11] Gillespie (2005)
[12] Institute on Taxation and Economic Policy. "Should States be Allowed to Tax Internet Sales?" Policy Brief #2. 2005.:
[13] National Conference of State Legislatures, "Governor Owens' Nine Misconceptions about the Streamlined Sales and Use Tax Agreement."
[14] Official web site of the Streamlined Sales Tax Governing Board. Available at *http://www.streamlinedsalestax.org/*
[15] Institute on Taxation and Economic Policy. "Should States be Allowed…" (2005)
[16] Bruce, Dr. Donald and Dr. William F. Fox. "State and Local Sales Tax Revenue Losses from E-Commerce: Estimates as of July 2004." University of Tennessee, Center for Business and Economic Research. July 2004. *http://cber.bus.utk.edu/ecomm/ecom0704.pdf.*
[17] *Ibid.*
[18] *Ibid.*

Idea

3

Raise cigarette taxes to promote public health

Each Southern state should raise cigarette taxes to the national average of $0.92 per pack to reduce smoking and promote public health.

Background

In the last five years, every Southern state—except Florida, Mississippi and South Carolina—has raised cigarette taxes. Even though the taxes are increasing, Southern states continue to levy among the lowest cigarette taxes in the nation.

Southern states continue to levy among the lowest cigarette taxes in the nation.

As a public health measure, cigarette taxes—if set at high-enough levels—can reduce adult and teen smoking, and can lower expensive long-term health costs. Viewed from a tax perspective, however, cigarette taxes are highly *regressive* and represent a declining revenue stream. Thus, Southern leaders should view this tax reform as a tool for improving public health rather than as a mechanism for financing core governmental services.

In other words, if states are going to tax cigarettes anyway, they should set the tax rate at a high enough level that it will do some public good, such as reducing the rate of smoking among Southerners. But revenues should be used for one-time costs, not continuing costs.

Cigarette taxes in the South

All Southern states charge an excise tax (i.e. cigarette tax per pack) and state sales tax on packs of cigarettes.[1] Cigarette taxes in the South range from a low of $0.07/pack in South Carolina to a high of $0.59/pack in Arkansas (Figure 1). Half of all Southern states charge at least $0.30/pack.[2] These state taxes, combined with the federal cigarette tax of $0.39/pack and wholesale prices, result in a Southern median retail price of $3.61 for a pack of cigarettes.[3]

Figure 1: State cigarette tax rates, revenues and smoking rates, Southern states

State	2005 cigarette tax (per pack)	National rank (1=highest)	Year of last increase	FY 2004 tax revenues	Youth smoking rate (percent)	Adult smoking rate (percent)	Retail price per pack (all taxes)
AL	$.43	39	2004	$64.2	24.7	24.9	$3.80
AR	$.59	32	2003	$128.1	29.3	25.7	$3.82
FL	$.34	44	1990	$421.9	15.7	20.4	$3.55
GA	$.37	41	2003	$216.2	20.9	20.1	$3.62
KY	$.30	45	2005	$20.5	27.9	27.6	$3.61
LA	$.36	42	2002	$130.3	25.0	23.6	$3.65
MS	$.18	49	1985	$42.9	22.4	24.6	$3.53
NC	$.30	45	2005	$39.8	24.8	23.2	$3.62
SC	$.07	51	1977	$25.4	24.4	24.5	$3.38
TN	$.20	48	2002	$110.2	27.6	26.1	$3.56
VA	$.30	45	2005	$16.1	21.0	20.9	$3.66

Bold = major tobacco production state
Source: Campaign for Tobacco Free Kids
Note: Revenues are for FY 2004 and thus do not reflect recent increases in the tax rate. North Carolina's tax per pack is scheduled to increase to $0.35 in July 2006.

Since 2000, eight Southern states—including every major tobacco production state except for South Carolina—have raised cigarette taxes. In 2005 alone, North Carolina, Kentucky and Virginia increased cigarette tax rates.[4] Nevertheless, Southern states continue to levy some of the lowest cigarette taxes in the nation. The regional average of $0.31/pack equals just one-third of the national average of $0.92/pack. Moreover, the average cigarette tax is even lower in the six Southern states that traditionally have been major producers of tobacco: Kentucky, Virginia, North Carolina, South Carolina, Georgia and Tennessee. The average cigarette tax in these states totals $0.26/pack.[5]

Collectively across the South, cigarette taxes generated $1.2 billion in revenues during fiscal year 2004. The amount of tax revenue collected in each state ranged from a high of $421.9 million in Florida to a low of $16.1 million in Virginia. Half of all Southern states collected at least $64.2 million in cigarette taxes.[6] Overall, cigarette taxes contribute a small portion of a state's annual budget. In North Carolina, for example, the revenues generated by the cigarette tax during fiscal year 2004 equaled just 0.3 percent of the state's general fund.[7]

A problematic revenue tool…

From a *progressive* tax perspective, cigarette taxes are a deeply-flawed tool. Not only are cigarette taxes *regressive*, meaning they fall more heavily on low-income individuals, but they also represent a declining revenue stream that, if used inappropriately, can contribute to structural deficits.[8]

The major problem with the tax on cigarettes is its *regressive* nature. Like any consumption tax, cigarette taxes take "a greater proportion of the income of poor and near-poor households than they do of higher income households."[9] In fact, the Institute on Taxation and Economic Policy estimates that cigarette taxes are about 10 times as burdensome for the nation's poorest taxpayers as they are for the wealthiest taxpayers.[10] The *regressive* nature of cigarette taxes likely is magnified in the South due to the region's relatively high rates of poverty and adult smoking.

> **One study shows cigarette taxes are about 10 times as burdensome for the nation's poorest taxpayers as they are for the wealthiest taxpayers.**

A second flaw of cigarette taxes is they represent declining sources of revenue. Because cigarette taxes are levied on a per-pack basis rather than as a percentage of the sales price, tax revenues fail to increase along with price increases or periods of economic growth. This means tax revenues associated with cigarette taxes only grow when demand increases or the tax rate increases.[11] For example, consider a state with a $0.30 per pack cigarette tax. If the price of a pack of cigarettes increases by $1, the state will still only receive $0.30 when a consumer buys a pack of cigarettes. On the other hand, if the consumer decides to buy two packs of cigarettes, then the state receives $0.60. The amount of revenues only increases if consumers buy more packs or the state raises the tax rate per pack.

Demand is not increasing, though. Data collected by the U.S. Department of Agriculture show cigarette consumption in the United States has declined in recent years—a decline attributable to such factors as higher taxes and a growing awareness of the harmful health consequences of smoking.[12] Raising the tax rate can generate more revenues, but that also can spark a decrease in demand. At the same time, increasing taxes can lead to more tax avoidance, which is caused when consumers go out of state to buy cigarettes, buy them over the Internet or through the mail, or engage in smuggling from lower-tax states.[13] This possibility of increased tax avoidance should be a consideration in estimates of what a tax increase would generate in terms of new revenues.

A final concern deals with the use of cigarette tax revenues. In times of financial difficulty, such as the recession in 2001, it is tempting for politicians to raise more politically-popular taxes, such as the cigarette tax, rather than other broad-based taxes, such as the personal income tax. Raising the tax on a pack of cigarettes can bring additional revenues for some years, but any revenue surge will

Cigarette tax revenues are better suited for one-time purposes like building state rainy-day funds.

likely decline after a number of years if demand falls in response to the increased prices or health concerns. Since cigarette tax revenues are a declining revenue source, it is problematic when cigarette taxes are used to fund core government services, which continue to increase in cost.

Using this declining revenue source to fund services that are increasing in cost can cause structural deficits, which occur when state revenue systems cannot generate the funds needed to meet current services.

Cigarette tax revenues are better suited for one-time purposes like building state rainy- day funds.[14] Other revenue sources, such as the *progressive* income tax, are more appropriate for raising general fund revenues for core government services. When states rely on cigarette taxes for general fund needs, not only do they increase the risk of creating structural deficits, but they also contribute to the growing trend of shifting the responsibility of funding government from the most affluent to those least able to pay.[15]

…but a potentially powerful public health measure

Despite its considerable flaws as a revenue tool, a cigarette tax can, if set at a high enough level, yield tangible public health benefits. Studies show that increases in cigarette taxes discourage smoking, especially teen smoking, and reduce public health costs.

> **In the South, raising cigarette taxes to the national average could generate long-term health care savings ranging from an estimated $2.27 billion in Florida to a low of $271.4 million in Arkansas.**

Research by the Campaign for Tobacco Free Kids finds that "every 10 percent increase in the price of cigarettes will reduce youth smoking by about 7 percent and overall cigarette consumption by about 4 percent."[16] As shown

Figure 2: Estimated impact of raising cigarette taxes to national state average			
Southern state	Tax increase needed to reach national state average of 91.7 cents per pack	Number of current adult smokers who would quit	Long-term health care savings from adult & youth smoking declines
Alabama	49.2¢	16,600	$584.0 million
Arkansas	32.7¢	7,100	$271.4 million
Florida	57.8¢	70,700	$2.27 billion
Georgia	54.7¢	29,600	$1.17 billion
Kentucky	61.7¢	23,700	$845.8 million
Louisiana	55.7¢	18,800	$716.2 million
Mississippi	73.7¢	17,700	$742.1 million
North Carolina	61.7¢	40,700	$1.57 billion
South Carolina	84.7¢	30,600	$1.10 billion
Tennessee	71.7¢	38,500	$1.24 billion
Virginia	61.7¢	31,400	$1.21 billion
Source: Campaign for Tobacco-Free Kids, 2006[18]			

in Figure 2, the number of current adult smokers who quit smoking after the tax increase would be in the tens of thousands for all states except Arkansas, which already taxes at a higher rate than other Southern states. Such reductions translate into lower health costs. In the South, long-term health care savings could range from an estimated $2.27 billion in Florida to a low of $271.4 million in Arkansas.[17]

Lessons from Kentucky

In 2005, Kentucky raised the cigarette tax from 3 cents per pack to 30 cents per pack as part of comprehensive tax reform. The increase came from a combination of two bills:

- House Bill 272, which contained reforms in the income tax and other tax structures, raised the cigarette tax by 26 cents. In an analysis of HB 272 by the Kentucky Appropriations and Revenue Committee, the state estimated the 26 cent increase would raise revenues by approximately $172 million in FY 2006, $151 million in FY 2007 and $150 million in FY 2008. HB 272 also levied taxes on other tobacco products, which were expected to bring in an estimated $4.8 million annually.[19]

- Another bill, HB 267, raised the cigarette tax by an additional one cent and dedicated those additional revenues to two cancer research centers. The additional one cent will bring in an estimated $2.5 to $3.0 million and will be matched by the universities that house the research centers.[20]

After Kentucky raised its cigarette tax, sales decreased much more than expected, but revenues generated were 10 times that of the same period in the previous year.

An analysis of Kentucky's cigarette tax increase prior to its implementation illustrates the *regressive* nature of cigarette taxes. As shown in Figure 3, the estimate of the likely tax increase for each income group showed that those with the lowest incomes would have the highest tax hike as a percent of income. Taxpayers with incomes below $14,000 would pay an estimated 0.8 percent more of income in taxes, while taxpayers with the highest incomes would have virtually no tax change.[21]

Figure 3: Estimated tax increase as a percent of income in Kentucky	
Income group	Tax change as a percentage of income
Lowest 20% of incomes (Less than $14,000)	0.8%
Second 20% ($14,000 to $25,000)	0.4%
Middle 20% ($25,000 to $42,000)	0.3%
Fourth 20% ($42,000 to $67,000)	0.2%
Next 15% (67,000 to $124,000)	0.1%
Next 4% ($124,000 to $270,000)	0.1%
Top 1% ($270,000 and above)	0.0%

Source: Institute on Taxation and Economic Policy.
Note: The estimate includes all Kentucky taxpayers in 2006. Thus, the tax increase is an average as both smokers and nonsmokers are included.

While Figure 3 displays the downside of cigarette tax increases—the *regressivity*, recent reports on the effects of the tax increase show the benefits. Three months after increasing the tax, reports noted decreases in cigarette sales and increases in states revenues. Estimates prior to the tax increase suggested cigarette sales would decline by four percent; however, for the short-term, the actual decrease in sales turned out to be between 10 and 20 percent. In addition, cigarette tax revenues were 10 times higher than the same period in the previous year.[22]

Raise the cigarette tax to promote public health

Southern legislators need to view increasing cigarette taxes as a public health measure rather than as a tool for funding core public services. Cigarette tax increases can reduce smoking and lower long-term health costs across the region. But because they also are a declining revenue source, they are unlikely to grow with the economy and adequately fund public services.

Southern progressives therefore should insist that cigarette taxes be viewed as a tool for improving public health, not a revenue measure. This means:

- Tax rates should be set at a high-enough level to achieve health benefits;

- The resulting revenues should be spent on concrete, one-time expenses, and

- The tax should not be used as a way to shift the responsibility for funding government to low-income citizens.

Talking points

- Cigarette taxes are *regressive* because they cause more of a burden on poorer people than those who have higher incomes.

- The smoking population, however, is declining, which means revenues gained from cigarette taxes are a declining revenue stream.

- Any revenues from declining streams shouldn't fund continuing needs of governments, because costs will increase as revenues decrease. That doesn't make sense economically and can lead to long-term structural deficits.

- Even though *regressive* and a declining stream of revenue, states should raise cigarette taxes to the national average to further reduce the smoking rate. Lowering the number of people who smoke will have great public health benefits—and save billions in government spending on rising future health care costs.

- While raising the cigarette tax isn't technically *progressive*, it can serve as a *progressive* tool to lower smoking rates and reduce long-term health costs.

Endnotes

[1] Author's analysis of data compiled by the Campaign for Tobacco Free Kids (*www.tobaccofreekids.org*). Note that Alabama and Georgia do not charge sales tax on the "portion of retail cigarette prices that is the state's cigarette excise tax." Also, state cigarette taxes are not levied on sales that occur on Indian reservations and military bases.
[2] Campaign for Tobacco Free Kids. See note 1.
[3] *Ibid.*
[4] *Ibid.*
[5] *Ibid.*
[6] *Ibid.*
[7] Author's analysis of data presented in: Cameron, Amna, *Following the Money*. Raleigh, NC: North Carolina Budget & Tax Center, 2004.
[8] Iris Lav, *Cigarette Tax Increases: Cautions and Considerations,* Washington, DC: Center on Budget and Policy Priorities, 11 July 2002 (*www.cbpp.org*).
[9] *Ibid*, p. 4.
[10] *Cigarette Taxes: Issues and Options*. Washington, DC: Institute on Taxation and Economic Policy, April 2004 (*www.itepnet.org/pb1cigs.pdf*).

[11] Institute on Taxation and Econmic Policy, note 10.
[12] Lav, p. 6.
[13] Seaman, Bruce. "The Economics of Cigarette Taxation: Lessons from Georgia." Georgia State University, Fiscal Research Center. FRC Report No. 89. October 2003.
[14] Lav., p. 12.
[15] Rob Schofield, "Cutting Through The Cigarette Tax Haze." Raleigh, NC: NC Justice Center, March 17, 2003 (*www.ncjustice.org*).
[16] Web site of the Campaign for Tobacco Free Kids (*www.tobaccofreekids.org*).
[17] Campaign for Tobacco Free Kids. Analysis by Katie McMahon on May 10, 2006.
[18] *Ibid.* Analysis included the following comments on the methodology, "These projections are fiscally conservative because they include a generous adjustment for lost state pack sales (and tax revenues) from new tax avoidance efforts after the tax increase by continuing in-state smokers, and from fewer sales to smokers from other states or to informal or small-scale smugglers. The projections are also based on research findings that a 10% cigarette price increase reduces youth smoking rates by 6.5%, adult rates by 2%, and total consumption by 4%, and assume that the state tax will keep up with inflation. Long-term savings accrue over lifetimes of persons who stop smoking or never smoke because of tax increase."
[19] Kentucky Appropriations and Revenue Committee Staff. "HB 272 Free Conference Balance Sheet." Excel spreadsheet.
[20] White, Charlie. "Kentucky Cigarette Tax Hike Draws Praise for Cancer-Fighting Component." *State Tax Notes*. 2005 STT 110-7. June 9, 2005.
[21] Institute on Taxation and Economic Policy. "Impact of Kentucky Tax Changes Proposed by Gov. Ernie Fletcher." February 2005.
[22] White, Charlie. "Kentucky Cigarette Sales Drop but Revenue Rises Sharply After Tax Hike." *State Tax Notes.* 2005 STT 201-10. October 19, 2005.

Idea 4

Enact a State Earned Income Tax Credit

Each Southern state with an income tax should enact a refundable earned income tax credit to bring working families' incomes above poverty.

Background

Every year on April 15, working families who live month-to-month or paycheck-to-paycheck can take a breath. Why? Because they get relief from a federal tax break that makes life easier.

In 2003, the federal Earned Income Tax Credit (EITC) helped 22.1 million poor and near-poor working families and individuals across the nation through income tax reductions and wage support. In fact, the federal EITC brought 4.4 million people above the poverty line in 2003.[1] Commonly described as a work incentive, the federal EITC reduces or eliminates income taxes for poor and near-poor working families and individuals, and provides a refund for the remaining amount of the credit. The refund helps offset other federal payroll taxes, such as Social Security, and can bring working families' income above the poverty line.

> **No Southern state currently offers a refundable Earned Income Tax Credit.**

Since its inception in 1975, the federal EITC has received enhancements under the Reagan, Bush and Clinton administrations. Following the example set by the federal government, 19 states and the District of Columbia have enacted state-level earned income tax credits. In 2005 and 2006, Delaware and Nebraska created new EITCs, while Indiana, Oregon, Rhode Island, and the District of Columbia expanded their existing EITC programs. As other states have learned, linking to this federal program can improve tax *fairness* and provide wage enhancements for working families and individuals.

Effective in tax year 2006, Virginia will be the first Southern state to provide a state-level EITC, but it is not a refundable credit. All Southern states should consider the benefits of enacting a refundable state-level earned income tax credit for low and moderate-income families in the South.

Figure 1: State Earned Income Tax Credits

Alabama	No
Arkansas	No
Florida	No income tax
Georgia	No
Kentucky	No
Louisiana	No
Mississippi	No
North Carolina	No
South Carolina	No
Tennessee	No broad-based income tax
Virginia	Yes, 20% of federal EITC, non-refundable

How the federal EITC works

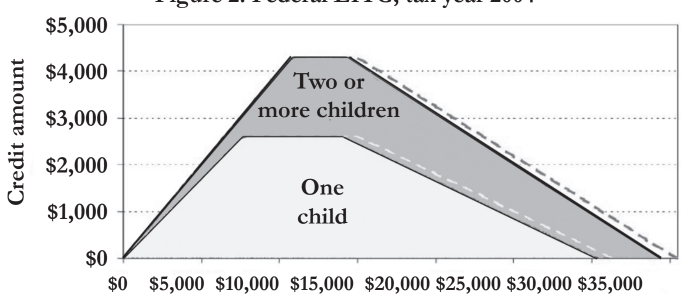
The federal EITC provides a credit and refund based on income and family size. Figure 2 illustrates the credit structure for different income levels and family compositions. Initially, the credit increases as income increases. After families reach a certain level of income however, the credit begins to decrease as income rises and phases out completely by $37,263. For tax year 2005:[2]

- Workers with one child and income less than $31,030 (or $33,030 for married filing jointly) could receive an EITC of up to $2,662.

- Workers with two or more children and income less than $35,263 (or $37,263 for married filing jointly) could receive an EITC of up to $4,400.

While the graph does not show credits for childless workers, there are smaller credits available for those workers. For tax year 2005, childless workers ages 25 to 64 with income below $11,750 (or $13,750 for married filing jointly) could receive an EITC of up to $399.

Figure 2: Federal EITC, tax year 2004



Source: *Center on Budget and Policy Priorities*
Note: Married couples with income in the phaseout range qualify for a higher credit than single parents—shown by dashed lines. Childless taxpayers are not shown but do qualify for a smaller credit

As shown in Figure 3, the federal EITC helps families across the South. In tax year 2003, the most recent year for available data, more than 6.4 million taxpayers in the South claimed the federal EITC for a total of over $12.1 billion.

Figure 3: Federal EITC claims, tax year 2003				
State	Total tax returns	EITC claims	Share of returns claiming EITC	EITC amount
Alabama	1,835,245	473,872	25.8%	$966,598,821
Arkansas	1,094,925	272,269	24.9%	$520,673,980
Florida	7,611,223	1,522,835	20.0%	$2,741,529,828
Georgia	3,561,885	800,957	22.5%	$1,567,024,328
Kentucky	1,706,885	335,477	19.7%	$580,496,974
Louisiana	1,823,446	522,367	28.6%	$1,099,107,340
Mississippi	1,137,636	366,518	32.2%	$768,994,361
North Carolina	3,561,309	729,862	20.5%	$1,344,514,547
South Carolina	1,757,244	414,707	23.6%	$779,353,959
Tennessee	2,521,874	539,154	21.4%	$979,905,225
Virginia	3,302,139	482,732	14.6%	$833,408,420
Source: Brookings Institution, Metropolitan Policy Program[3]				

Southern families in need

With a generous federal EITC program, is there a need for a similar state-level program? As discussed previously, state and local tax systems across the South are *regressive*. That is, those with the lowest incomes pay the highest share of their incomes in state and local taxes. Although low-income families pay a smaller share in income taxes, those families pay an excessively high share of income in sales and property taxes as compared to wealthier households. For example, non-elderly Arkansans in the lowest income quintile (average income of $7,000) pay an estimated 12.4 percent of their income in state and local sales, income and property taxes. That compares to a range of 6.1 percent to 9.5 percent tax obligation for Arkansas's highest earners after federal offsets.[4]

While low-income families pay a smaller share in income taxes, they pay an excessively high share of their income in sales and property taxes. The federal Earned Income Tax Credit is a *progressive* strategy that helps more than 6.4 million Southern taxpayers to get a better tax balance every year.

To illustrate further, consider a family of four living in Arkansas with one parent working and one parent providing childcare. At a full-time, year-round job, the worker earns $9.00 an hour for an annual salary of $18,720, or just below the poverty guideline for a family of four in 2005. On its federal income tax form, this family, like more than 270,000 other Arkansans, applied for the federal EITC. The family received a refundable earned income credit of $3,900, which brought the family's income above the poverty line, offsets other federal withholding taxes, and provides wage enhancements to a family that likely has trouble paying the bills. In contrast to the federal refund, the Arkansas family owes an estimated $350 in state income taxes.[5] This $350 income tax obligation is in addition to the *regressive* sales and property tax the family faces.

A state EITC can correct for such circumstances by lowering income taxes on working poor families. If the state EITC is refundable, it can also offset other taxes, such as state sales and property taxes. Enacting a state EITC increases the *fairness* of the state tax system overall by increasing the *progressivity* of the income tax system and lessening the *regressivity* of the sales and property taxes.

Designing a state EITC

Designing a state EITC is relatively straightforward as examples exist in 19 other states and the program piggybacks on the structure of the federal EITC. For the most part, variations in design center around three components related to how generous the program will be:

- **Level of credit.** States base their credit levels and eligibility rules on the federal EITC. The level of credit is a percentage of the federal credit and ranges from 5 percent to 50 percent among states. For example, Oklahoma's EITC is 5 percent of the federal EITC. Vermont's EITC is 32 percent. Thus, a family qualifying for a federal EITC of $4,000 would receive a $200 state credit if they live in Oklahoma or a $1,280 state credit if they live in Vermont. Figure 4 shows the state EITC benefits at the 5 percent, 10 percent and 20 percent levels of the federal credit for different family incomes and sizes.

Figure 4: EITC by family type and income level, 2005					
	Gross earnings	Federal EITC	20% state EITC	10% state EITC	5% state EITC
Family of four with two children					
Full-time minimum wage	$ 10,700	$ 4,290	$ 858	$ 429	$ 215
Wages equal to poverty line	$ 19,350	$ 3,767	$ 753	$ 377	$ 188
Wages equal to 150% of poverty line	$ 29,025	$ 1,735	$ 347	$ 174	$ 87
Family of three with one child					
Full-time minimum wage	$ 10,700	$ 2,662	$ 532	$ 266	$ 133
Wages equal to poverty line	$ 16,090	$ 2,662	$ 532	$ 266	$ 133
Wages equal to 150% of poverty line	$ 24,135	$ 1,423	$ 285	$ 142	$ 71

Source: GBPI calculations using IRS EIC tax tables and Nagle (2005)[6]

- **Refundable versus non-refundable.** As noted previously, the federal EITC is a refundable credit. That means families receive a refund for the amount of the credit that is in excess of the income taxes they owe. If a family owes $300 in federal income taxes and qualifies for a $2,000 EITC, they will receive a refund of $1,700. The majority of states with an EITC also make the credit refundable. This provides income tax assistance and offsets other taxes, such as sales and property. Delaware, Iowa, Maine, and Virginia have non-refundable credits, which lowers the income tax liability but does not offer further assistance. Consider a family with a $100 state income tax liability that qualifies for a $150 state EITC. With a non-refundable EITC, their taxes are reduced to zero but they do not receive the additional $50. Since 2000, the majority of states that have created or expanded their EITC have chosen to make the credit refundable.

- **Interaction with Existing Low-Income Tax Credit.** A final design concern is the interaction of existing low income tax credits with a new state earned income tax credit. Several states already have low income tax credits; however, those credits often suffer from the following drawbacks: they are not indexed to inflation and they do not reward work. In contrast, state EITCs automatically adjust for inflation since they are linked to the federal EITC, which is indexed for inflation. Additionally, state EITCs reward work by providing a tax credit that rises as income increases, thus encouraging additional work and earnings. Although state-level EITCs offer many advantages over existing low income credits, they are mainly focused on working families with children. For this reason, certain taxpayers (usually those without children) would benefit more under existing credit programs. Thus, a state EITC should not necessarily replace existing low income tax credits, but instead, work as a complement.

Estimating the cost

The cost of a state EITC depends on the level of credit and refundable component discussed above, as well as the number of residents claiming the EITC. A non-refundable credit would be a loss of income tax revenues, while a refundable credit would be both a loss of income tax revenues and the cost of the refundable portion that is beyond a family's tax liability.

Using 2004 data on the number of federal EITC claims in each state, the Center on Budget and Policy Priorities estimated the following cost for a refundable EITC in Southern states that have income taxes and do not currently have EITCs (Figure 5).

Figure 5: Estimated cost of refundable state EITC for FY 2007

State	Percentage of federal credit		
	5% of federal credit	10% of federal credit	20% of federal credit
Alabama	$47 million	$95 million	$190 million
Arkansas	$26 million	$51 million	$102 million
Georgia	$79 million	$159 million	$318 million
Kentucky	$28 million	$57 million	$114 million
Louisiana	$54 million	$108 million	$216 million
Mississippi	$38 million	$75 million	$150 million
North Carolina	$66 million	$133 million	$266 million
South Carolina	$38 million	$76 million	$153 million

Source: Center on Budget and Policy Priorities[7]
Note: Cost estimate assumes a 90 percent participation rate.

An additional cost consideration is the availability of Temporary Assistance for Needy Families (TANF) funds. While states can pay for the program through General Fund revenues, the federal government also allows states to pay for the refundable portion of state EITCs using federal TANF funds or state Maintenance of Effort (MOE) funds. The federal government recognizes that the EITC is a work incentive since it provides assistance for families transitioning to work, and thus, can be included in the goals of TANF. One consideration, however, is that the use of TANF or MOE funds for a state EITC would reduce the amount of money going to other assistance programs such as cash assistance, child care and other programs. Thus, there would need to be a thoughtful policy discussion on whether to include the EITC in this stream of funding, as it might affect funds available to other programs.

The federal Earned Income Tax Credit is considered a work incentive because it helps families transition to work. States can consider it to be the same.

Learning from and improving upon Virginia's example

In 2004, Virginia's General Assembly passed legislation (HB 5018) establishing a state-level earned income tax credit. Beginning in tax year 2006, qualifying Virginians can claim a non-refundable state EITC equal to 20 percent of the federal credit. The cost of the EITC program will be an estimated \$61.3 million in FY 2007, \$62.4 million in FY 2008, and \$63.7 million in FY 2009.[8] Virginia offers a blueprint for other states that already have low-income tax credits since Virginia's EITC will not replace the existing low-income tax credit. Rather, residents will be able to apply for either the new EITC or the existing low-income tax credit. While Virginia's EITC would benefit from a refundable component, Southern states should watch to see how

Virginia's program works and how they can implement similar programs in their own states.

> **Virginia offers a blueprint for other states that already have low-income tax credits since Virginia's EITC will not replace the existing low-income tax credit.**

Helping low-income families by making work pay

The federal earned income tax credit has long been associated with making work pay. Through tax assistance and work supplements, the EITC brings incomes above the poverty line and helps working families make ends meet. Nineteen states and the District of Columbia have also recognized that state-level EITCs can balance the *regressive* nature of state and local taxes and assist working families. Virginia remains the only Southern state to enact an EITC, which itself is non-refundable.

Southern states, including Virginia, should consider the benefits of creating a refundable state EITC as one more step towards a fair, balanced tax structure.

Talking points

- Millions of working families across the South live at or below the poverty level.
- One way to give hope to these Southerners and to help balance the *regressive* sales and property taxes is to provide an Earned Income Tax Credit to families that work.

- An Earned Income Tax Credit is not welfare. It is a tool to help working families get out of poverty.

- No Southern state has a refundable EITC and only one—Virginia—has a non-refundable credit. Refundable credits are preferable because they provide needed cash that can lift some families out of poverty.

- A state-level Earned Income Tax Credit should not be a partisan issue. At the federal level, the EITC program has been expanded under Republican and Democratic administrations.

- The issue for Southern states is to help lessen the burden of sales and property taxes for working poor families by taking advantage of the *progressive* nature of the income tax.

Endnotes

[1] Greenstein, Robert. *The Earned Income Tax Credit: Boosting Employment, Aiding the Working Poor*. Center on Budget and Policy Priorities. August 17, 2005. *www.cbpp.org*.

[2] Internal Revenue Service.

[3] *2005-2006 Congressional Districts EITC Data*. Brookings Institution, Metropolitan Policy Program. *www.brookings.edu/es/urban/eitc.htm. (excel spreadsheet download)*

[4] Calculations by the Institute on Taxation and Economic Policy, August 2004 from: Metzger, James. *Property Tax Reform for Arkansas.* Arkansas Advocates for Family and Children. March 2005. *www.aradvocates.org/_images/pdfs/propertytax.pdf*.

[5] GBPI estimates based on H&R Block Tax Estimator and Arkansas Department of Finance and Administration tax publications.

[6] Nagle, Ami and Johnson, Nick. *A Hand Up: How Earned Income Tax Credits Help Working Families Escape Poverty in 2006*. Center on Budget and Policy Priorities. March 2006. *www.cbpp.org*.

[7] *Ibid.*

[8] Interview with staff at the Virginia Department of Taxation. May 10, 2005.

Idea

5

Modernize state income brackets

Each Southern state with an income tax should modernize its income tax structure by adjusting brackets and should consider creating a new top rate to provide *progressive* balance.

Background

Southern states began implementing individual income taxes in the first half of the 20th century. The income tax structures were *progressive* by design. That meant an earlier generation of lawmakers created a system for higher tax rates on higher levels of income. But since that time, many of those income tax structures have not been significantly altered. While the tax structures were *progressive* for 1930s and 1940s incomes, they are now outdated and act much like a flat tax system (Figure 1). Georgia, for example, begins taxing at the top tax rate (6 percent) at just $7,000 of income for single filers and $10,000 for married households filing jointly. So in Georgia, just about everyone who pays income tax has much of their income taxed in the top bracket. In contrast, Kentucky, which updated its rate structure for 2005, has a top tax rate of 6 percent beginning at $75,000. Prior to those changes, Kentucky's top rate started with $8,000 of income.

Income tax brackets in Southern states are so outdated that they're much like a flat tax system.

Southern states are now in a 21st century economy with 21st century incomes. It is imperative for states to modernize their tax systems for today's economy by expanding tax brackets and by possibly creating new top rates to reflect actual conditions of today's Southern residents. Making these improvements in state individual income tax systems will ensure the *progressivity* of the income tax as it originally was designed.

No tax system is perfect. But a having a *progressive* income tax is a vital part of the overall tax system because it can offset the *regressive* nature of other taxes, such as sales and property taxes, which hurt working families.

Figure 1: Individual income tax structures

Southern state	Tax structure (Singles, 2005)	
	Rate	Brackets
Alabama	2%	Less than $500
	4%	500—3,000
	5%	$3,000 and above
Arkansas	1%	Less than $3,500
	2.50%	3,500—7,000
	3.50%	7,000—10,500
	4.50%	10,500—17,500
	6%	17,500—29,200
	7%	$29,200 and above
Florida	None	

Figure 1: Individual income tax structures		
Southern state	Tax structure (Singles, 2005)	
	Rate	Brackets
Georgia	1%	Less than $750
	2%	750—2,250
	3%	2,250—3,750
	4%	3,750—5,250
	5%	5,250—7,000
	6%	$7,000 and above
Kentucky	2%	Less than $3,000
	3%	3,000—4,000
	4%	4,000—5,000
	5%	5,000—8,000
	5.80%	8,000—75,000
	6%	$75,000 and above
Louisiana	2%	Less than $12,500
	4%	12,500—25,000
	6%	$25,000 and above
Mississippi	3%	Less than $5,000
	4%	5,000—10,000
	5%	$10,000 and above
North Carolina	6%	Less than $12,750
	7%	12,750—60,000
	7.75%	60,000—120,000
	8.25%	$120,000 and above
South Carolina	2.50%	Less than $2,530
	3%	2,530—5,060
	4%	5,060—7,590
	5%	7,590—10,120
	6%	10,120—12,650
	7%	$12,650 and above
Tennessee	None (6% on interest and dividend income only)	
Virginia	2%	Less than $3,000
	3%	3,000—5,000
	5%	5,000—17,000
	5.75%	$17,000 and above

Source: Tax Foundation[1]
Note: Arkansas has an additional tax rate and bracket table for low-income taxpayers.

Updating income tax brackets

States can make several reform measures to improve and update the individual income tax system. Deductions, exemptions and earned income credits can be created and expanded to establish tax floors or thresholds, which protect poor taxpayers from paying income taxes on poverty wages, as highlighted in Idea 4 and Idea 6. Updating state income tax brackets is another measure to make state tax systems more *progressive* and more relatable to the 21st century economy for all taxpayers. While creating *tax thresholds* can shield the lowest incomes, broadening brackets creates a fairer tax on all income.

Tax brackets are structured so that increments of income (or marginal amounts of income) are subject to different tax rates. For example, the first $3,500 of income in Arkansas is subject to a 1 percent tax rate. The income between $3,500 and $7,000 is taxed at a rate of 2.5 percent. As income increases, the marginal tax rate continues to increase until all income over $29,200 is taxed at a rate of 7 percent (see Figure 1).

Case study: Georgia

Broadening the brackets means that higher marginal tax rates will occur at higher levels of income. An illustration can be seen in Georgia's income tax system. Broadening the brackets, as demonstrated in Figure 2, would stretch the tax brackets to make lower increments of income subject to a lower tax rate. Under the current system, single filers are taxed at 1 percent for the first $750 of income. At $750, the tax rate increases to 2 percent, so that the income between $750 and $2,250 is taxed at 2 percent. In the expanded brackets example in Figure 2, the first $2,500 of income for single filers would be taxed at 1 percent. The next $1,250 of income (i.e. income between $2,500 and $3,750) would be taxed at 3 percent.[2] Figure 3 shows the change in a single filer's income tax liability under the new brackets. With broader brackets, the single taxpayer with $20,000 of taxable income has a 5.6 percent drop in taxes.

If Georgia were to modernize its tax brackets, a family with $20,000 of taxable income would pay $57 less in state taxes every year.

The Georgia example also removes the marriage penalty that currently exists in the Georgia income tax structure. Removing this bias makes the system more neutral, and could be included among the broadening reforms.

Increasing *progressivity*

While broadening income brackets and making other bracket reforms will make the income tax more *progressive* and *neutral*, it will also cause revenues to decrease. To ensure that revenues remain at an adequate level, those states that broaden income tax brackets should also consider creating a new top tax rate. Enacting a new top tax rate can make this *progressive* tax reform revenue neutral, while again increasing the *progressivity* of the tax structure.

Enacting a new top tax rate can make this *progressive* tax reform revenue neutral, while again increasing the *progressivity* of the tax structure.

Figure 2: Georgia income tax brackets, current and expanded

Current tax brackets			Expanded tax brackets		
Tax rate	Single	Married filing jointly/ HH	Tax Rate	Single	Married filing jointly/Head of Household
1.00%	$0	$0	1.00%	$0	$0
2.00%	$750	$1,000	3.00%	$2,500	$5,000
3.00%	$2,250	$3,000	4.00%	$3,750	$7,500
4.00%	$3,750	$5,000	5.85%	$7,000	$14,000
5.00%	$5,250	$7,000	7.10%	$35,000	$70,000
6.00%	$7,000	$10,000			

Source: Institute on Taxation and Economic Policy[3]
Note: The new brackets remove the marriage penalty that exists in the current Georgia tax brackets.

Figure 3: Hypothetical Georgia taxpayer

Income	Tax rate	Tax	Income	Tax rate	Tax
$0 to $750	1.00%	$7.50	$0 to $2,500	1.00%	$25.00
$750 to $2,250	2.00%	$30.00	$2,500 to $3,750	3.00%	$37.50
$2,250 to $3,750	3.00%	$45.00	$3,750 to $7,000	4.00%	$130.00
$3,750 to $5,250	4.00%	$60.00	$7,000 to $20,000	5.85%	$760.50
$5,250 to $7,000	5.00%	$87.50			
$7,000 to $20,000	6.00%	$780.00			
Total Tax:		$1,010.00	Total Tax:		$953.00

Source: Author's calculations

The example provided on the opposite page for Georgia includes a new top rate of 7.1 percent to make the bracket reforms revenue neutral. Approximately 19 percent of Georgia taxpayers would reach the new top tax rate. While this new bracket would raise taxes for a minority of Georgians, those increases might not be as high as one might think. First, the top rate (7.1 percent) occurs at $35,000 of taxable income for singles and $70,000 for married taxpayers filing jointly and head of households. Again, that is a marginal rate.

Thus, if a married taxpayer had $72,000 of taxable income, only $2,000 would be taxed at 7.1 percent (i.e. the income between $70,000 and $72,000). The difference in taxing that $2,000 at the current 6 percent rate and the new 7.1 percent rate would be $22. Another example: a married taxpayer with $100,000 of taxable income would pay about $330 more per year—less than a dollar a day—in state income taxes.

If Georgia were to add a new higher tax bracket, a family with $72,000 of taxable income would pay only $22 more in state taxes every year. A family with $100,000 of taxable income would pay only about $27 more per month in state taxes.

It's also important to note that the $35,000 and $70,000 benchmarks are taxable income—which means deductions and exemptions have been taken out of earned income. Bottom line: Single taxpayers could earn up to $41,750 before hitting the top rate. Likewise, married/head of household taxpayers could earn up to $95,000 before having taxable income of $70,000.[4]

For many higher-income taxpayers, the higher state tax liability would be somewhat offset by a decrease in federal tax liability. In other words, since state income taxes can be taken as a deduction when itemizing on federal tax returns, the increased state income tax would cause a decrease in federal taxes. And like all other taxpayers, they would receive the same benefits of broader tax brackets with income taxed at lower marginal rates until reaching the top bracket.

Creating a more progressive, modern income tax

In 2005, Kentucky reformed much of its tax system, including the individual income tax structure. The Bluegrass State updated its income tax structure by broadening brackets and expanding the low-income tax credits. Kentucky did not increase its top tax rate, but performed income tax reform in combination with reforms throughout the tax code.

> **Southern states should improve upon the steps taken by Kentucky and modernize their rates and brackets to ensure a truly *progressive* income tax structure.**

Southern states should improve upon the steps taken by Kentucky and modernize their rates and brackets to ensure a truly *progressive* income tax structure. As discussed elsewhere in this publication, the combination of state and local taxes throughout the South creates a *regressive* tax system. Sales taxes, in particular, fall more heavily on low- and moderate-income taxpayers than higher earners. Protecting and enhancing the *progressive* structure of the income tax system is vitally important to balancing the *regressive* sales and property taxes, and thereby, lessening the overall *regressivity* of the state and local tax system. In addition, Tennessee and Florida, which do not have broad-based individual income taxes, should consider the benefits of this progressive element in the overall state tax system.

Talking points

- When lawmakers from the 1930s to 1950s implemented state income taxes, they adopted the tools as ways to generate more state revenue and to make the state's taxing structure more *progressive*. This new tool helped to balance aspects of sales and property taxes that put more of an income burden on working families.

- Through the years, the South's economy has changed, but its governments haven't changed the income tax structure to keep up with the times.

- If states want to recapture the *progressive* structural benefits provided in the early days of the income tax, they need to change the brackets to reflect modern wages. And they should consider adding a new top rate to protect revenues and make the tax system even more *progressive*.

Endnotes

[1] Tax Foundation. "State Individual Income Tax Rates." December 31, 2005. *www.taxfoundation.org/files/7ee86c80446a807117594787f17fbba5.pdf.:*
[2] Davis, Kelly. Analysis for the Georgia Budget and Policy Institute. Institute on Taxation and Economic Policy. April 2006.
[3] *Ibid.*
[4] *Ibid.*

Idea

6

Deal with hidden income tax increases

Each Southern state with an income tax should modify its tax policies to account for inflation to preserve long-term *fairness* and reduce back-door inflationary tax hikes.

Background

The federal government indexes income taxes for inflation. In other words, every year the income tax changes slightly to account for inflationary increases in the cost of living. Adjusting the income tax structure for inflation protects taxpayers from having a tax increase without having a true increase in income. Unlike the federal government, not all states account for the effects of inflation in their income tax codes. The result: a hidden tax increase. Taxpayers can get higher tax bills even though incomes have not really risen and tax rates have remained unchanged.

Consider an example of a taxpayer living in Mississippi who receives a 3 percent salary increase the same year inflation is 3 percent. The taxpayer's raise offsets this higher cost-of-living, or inflation of 3 percent. But this increase in salary really doesn't represent a real increase in income or well-being because everything costs 3 percent more. In the meantime, Mississippi does not account for inflation in its income tax structure. The taxpayer is treated as if he had a salary increase of 3 percent without regard to increased cost-of-living. In turn, the taxpayer could pay a higher income tax bill—even though neither the state's tax rates nor the livelihood of the taxpayer changed. Thus, the state could raise taxes on the taxpayer in a complex but hidden manner.

If states don't index their income tax for inflation, you end up with a hidden tax increase—a slightly higher tax bill even if your income doesn't change and the income tax rates don't change.

To avoid this problem, Southern states should consider adopting a variety of strategies that will account for inflation in state tax codes. These strategies would improve the *fairness* and *transparency* of state personal income taxes. While these strategies improve the tax system in certain respects, they will cost the state money since income tax collections will not rise with inflation. Thus, these strategies should not be enacted in isolation, but rather should be part of comprehensive tax reform that balances the revenue losses.

Inflation and personal income taxes

State income tax structures create *tax thresholds*, which set a point at which residents start paying taxes. For example, Louisiana's *tax threshold* was $16,400 in 2005 for a family of four. So in Louisiana in 2005, families of four with income below $16,400 did not owe state income taxes.[1]

Standard deductions, personal exemptions and tax credits within state income tax systems create these *tax thresholds* by making a certain amount of income nontaxable. These provisions not only protect the lowest incomes from taxation and help make the income tax a progressive tool, but they also go to other taxpayers as well to exempt a certain amount of income from taxation.

The failure to control for inflation can push people into higher tax brackets and erode the value of standard deductions, personal exemptions and tax credits over time.

Most Southern states peg deductions, exemptions, credits and tax brackets to fixed dollar amounts. The failure to control for inflation can push people into higher tax brackets and erode the value of standard deductions, personal exemptions and tax credits over time. An example of the erosion of exemptions can be found in Georgia. Since 1998, Georgia's personal exemption has been $5,400 for married joint filers. Accounting for inflation, the $5,400 exemption in 1998 should have risen to around $6,470 in 2005.[2] Since Georgia does not index for inflation, however, the exemption remained at $5,400 and taxpayers in 2005 were not receiving the same benefit from the personal exemption as they did earlier (Figure 1).

Who pays for inflationary tax increases?

Inflationary tax increases most directly impact low- and middle-income taxpayers. Unlike affluent taxpayers who

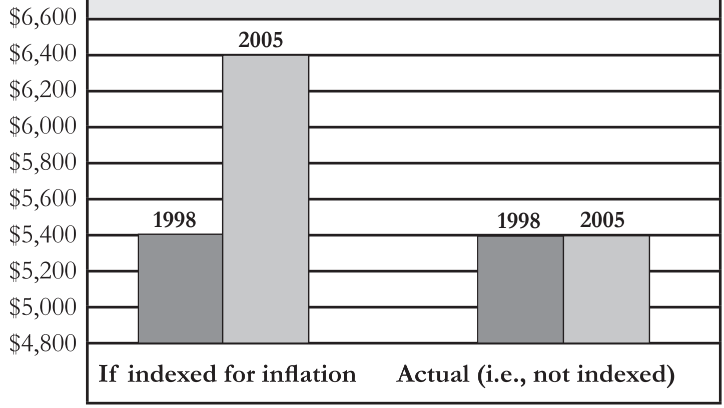


Figure 1: Georgia's personal exemption, 1998 and 2005

already pay the highest tax rate, low- and middle-income taxpayers can be forced into higher tax brackets or past the *tax threshold* as a result of inflation.[3] For example, an analysis of inflationary tax increases in Georgia found income taxes would have been $170 million lower in 2004 if Georgia had indexed features of its income tax to inflation since 1998. The bottom 40 percent of taxpayers in income bore the bulk of that tax increase, when measured as a share of income.[4]

If states don't adjust the income tax for inflation, they can force low- or middle-income earners into higher brackets, which makes them pay even more in income tax.

Allowing unintentional but hidden tax increases is even more troublesome in the South since Southern states already have some of the nation's lowest *tax thresholds* (Figure 2). In 2005, for example, eight of the nine Southern states with income taxes taxed four-person families with incomes below the federal poverty level. South Carolina was the only state not to do so. Tax liabilities ranged from $11 in Mississippi to $538 in Alabama. (It should be noted that Alabama recently raised its *tax threshold* significantly from $4,600 to $12,600.) Furthermore, the growth in the tax liability of poor Southern families over the past decade has outpaced inflation in five Southern states: Alabama, Arkansas, Louisiana, Mississippi and Virginia.[5] Because these *tax thresholds* are pegged at fixed dollar amounts, inflation steadily has left more poor families owing more and more in state income taxes.

Figure 2: Tax thresholds and tax liability for poor 4-person families, 1994-2005, Southern states

	1994		2004		2005	
State	Threshold	Tax bill at poverty ($15,141)	Threshold	Tax bill at poverty ($19,311)	Threshold	Tax bill at poverty ($19,961)
AL	$4,600	$348	$4,600	$513	$4,600	$538
AR	$10,700	$214	$15,500	$403	$15,900	$406
FL	--	--	--	--	--	--
GA	$11,100	$116	$15,900	$89	$15,900	$112
KY	$5,000	$499	$5,600	$652	$19,400	$78
LA	$11,000	$83	$15,900	$168	$16,400	$178
MS	$15,900	$0	$19,600	$0	$19,600	$11
NC	$13,000	$128	$19,400	$0	$19,400	$39
SC	$16,800	$0	$25,200	$0	$27,000	$0
TN	--	--	--	--	--	--
VA	$8,200	$217	$18,900	$425	$19,400	$389

Threshold is the level at which a family starts owing state income taxes. The tax bill shows what a family of four at the poverty level owed in state income taxes. Florida and Tennessee do not levy personal income taxes. Source: Center on Budget and Policy Priorities

Eight of nine Southern states with income taxes made families of four pay income taxes when they had incomes below the poverty line.

Consider the experience in North Carolina. During the 1990s, policymakers decided four-person families with incomes below the poverty level should not owe state income taxes. The state set a higher *tax threshold*—a higher point at which families started owing taxes—to shield these poor families from income taxes. But Tarheel State lawmakers did not adjust that threshold for inflation. As a result, inflation gradually pushed four-person families with incomes below the poverty level above the adjusted threshold, and in 2005, these families again owed state taxes.[6]

States have several policy options

States have several policy options available to address the issue of inflationary tax increases, including indexing the following income tax components (Figure 3):

Figure 3: Southern states indexing for inflation

	Tax brackets	Personal exemption	Standard deduction	Tax credits
AL				
AR	Yes			Yes
FL	No income tax			
GA				
KY				
LA				
MS				
NC				
SC	Yes	Yes	Yes	
TN	No broad-based income tax			
VA				Yes

Source: Federation of Tax Administrators

- **Tax brackets.** States can index their tax brackets for inflation so brackets are set at a slightly higher dollar amount every year (Figure 4). South Carolina, for example, links the state brackets to the federal tax code, which bases its inflation adjustment on the Bureau of Labor Statistics' Consumer Price Index. South Carolina adjusts its brackets using the federal standards, but limits the inflation adjustment to one-half of the federal adjustment and less than 4 percent annually.[7] While indexing brackets to inflation allows brackets to keep pace with the economy, it does not reverse the years of neglect when such indexing did not occur. For example, Arkansas began indexing its brackets in 1999. So from 1999 until today, the brackets have kept pace with the economy. But from 1971 (when the brackets were last reformed) to 1999, the brackets were not indexed and lost a great deal of their *progressivity*. As discussed in Idea 5, broadening brackets is the first step towards a better income tax, one which is *progressive* for today's economy rather than that of the 20th century. After broadening brackets, indexing them for inflation will keep the brackets current and modern for the years ahead.

Figure 4: Arkansas indexed income tax brackets

Tax Rate	2004 Tax Brackets	2005 Tax Brackets
1%	\$0 to \$3,399	\$0 to \$3,499
2.5%	\$3,400 to \$6,799	\$3,500 to \$6,999
3.5%	\$6,800 to \$10,299	\$7,000 to \$10,499
4.5%	\$10,300 to \$17,099	\$10,500 to \$17,499
6.0%	\$17,100 to \$28,499	\$17,500 to \$29,199
7.0%	\$28,500 and over	\$29,200 and over

Source: Arkansas Department of Finance & Administration

- **Personal exemptions and standard deductions.** Personal exemptions and standard deductions are the components of a tax system that create a *tax threshold*, as discussed above. Personal exemptions are provided to taxpayers and their dependents in recognition of the increased costs of having a larger family. For example, a single mother with two children may take three exemptions, one for herself and one for each of her dependents. The standard deduction is available to taxpayers who do not itemize deductions on their federal income taxes and provides a varying amount for single filers, married filing jointly, and head of household. The federal government began indexing both personal exemptions and standard deductions for inflation in the Tax Reform Act of 1986.[8] Numerous states across the nation have also indexed these features to ensure the *tax threshold* increases annually with the cost-of-living. South Carolina, for example, offers an indexed deduction for taxpayers with children under age 6 equal to the federal personal exemption, if the state has enough revenues to allow this revenue loss. Since the South Carolina deduction links to the federal exemption (which indexes for inflation), the deduction is automatically indexed for inflation.

- **Tax credits.** Tax credits can assist taxpayers with certain activities, such as child care, or can work with personal exemptions and standard deductions to create a higher *tax threshold*. Tax credits are a final component of state income tax systems that can be indexed to inflation. Arkansas, for example, has a small personal tax credit for elderly or disabled taxpayers that is indexed annually, but only if the budget allows. The tax credit increased from $20 in 2004 to $21 in 2005.[9] Another example is the state Earned Income Tax Credit, which is outlined in detail in Idea 4. Nineteen states and the District of Columbia offer a state-level Earned Income Tax Credit (EITC) based on the refundable federal tax credit for working-poor families. Since the federal

EITC is indexed to inflation, states that piggyback on the federal EITC will also adjust for inflation. Thus, the credit will increase every year to shield low-income working families from tax increases. In tax year 2006, Virginia will become the first Southern state to offer a state-level EITC.

By automatically increasing the value of these tax features, policymakers can avoid situations like North Carolina's where inflationary increases reversed an intentional policy decision to end the tax liability of poor families. Such a strategy not only would make states tax systems fairer, but it also would make the system more *transparent* since hidden tax increases would be removed.

Indexing the income tax to inflation can make state tax systems fairer and more transparent because it would remove hidden tax increases.

While all of these strategies could improve the *fairness* and *transparency* of state tax systems, they come at a cost to states. Indexing for inflation will restrict the current hidden, inflationary tax increases that currently provide states with increased income tax collections. In addition, linking to the federal tax code puts state revenues at risk since changes at the federal level will ripple through the state tax system and affect revenues.

But the policy intention of shielding taxpayers from inflationary tax increases is valuable. It is, however, critical for state leaders to protect the *adequacy* of funds by offsetting the revenue declines caused by these approaches. As discussed in Idea 5, adding a new top income tax rate is one way to offset the revenues lost due to inflationary reforms. There are other reform options available, such as expanding the sales tax base to include services (Idea 2) that also would offset the lost income tax revenues through increases in other revenue streams. Adjusting for inflation within the tax code should be part of comprehensive tax reform, which will protect and enhance the *adequacy* of funds while maintaining the gains in *fairness* achieved through these inflationary improvements.

Case study: Alabama makes strides, but misses out on inflation solution

Alabama's legislature and governor passed significant income tax reform in 2006 by moving the *tax threshold* from $4,600 to $12,600 for a family of four.[10] These gains, which will begin in 2007, provide the largest tax breaks to those with the lowest incomes and make Alabama's income tax more *progressive*. While the improvements in Alabama are considerable, the final legislation did not include indexing deductions and exemptions for inflation. The original legislation (HB 292) linked state personal exemptions and standard deductions to the federal amounts. This provision would have annually increased those exemptions and deductions, and thus the threshold, but was removed prior to final passage. Without the link to the federal code, and thus to inflation-adjustment, Alabama will face the same problems encountered in North Carolina and will have to continually update its *tax threshold* in future years if it wishes to shield poor residents from income taxes.

Deal with inflationary increases by indexing income taxes

By failing to account for inflation in income tax codes, many Southern states have allowed hidden, inflationary tax increases to occur. Individuals whose incomes have not grown apart from cost-of-living adjustments often find themselves paying higher tax bills—even though their incomes really have not changed and tax rates have remained steady. There are, however, compelling and pragmatic measures for states to address this problem and improve the *fairness* and *transparency* of state income tax systems. Indexing components such as brackets, personal exemptions, standard deductions and tax credits for inflation will allow states to maintain their *tax thresholds* and automatically shield those with the lowest-incomes from unintended tax hikes. It's important for lawmakers to recognize that these improvements should be part of comprehensive tax modernization and reform to ensure the *adequacy* of revenues.

Talking points

- When the cost of living rises due to inflation, the federal government automatically adjusts the income tax to take rising prices into account so people don't face annual hidden tax increases.

- South Carolina, Arkansas and Virginia are the only Southern states to adjust parts of their income tax for inflation. In other states, taxpayers who get cost-of-living salary increases that allow them to keep up with higher prices are penalized because their home states do not index for inflation. This is a hidden tax increase.

- States across the South can take proactive steps to halt hidden income tax increases every year by indexing their state income tax for inflation.

- Indexing the income tax for inflation is just plain common sense because it keeps the level of income taxation about the same, instead of the slow, silent rise that otherwise occurs.

- States shouldn't have tax structures that take advantage of cycles of inflation just to generate more revenue. State leaders need to be forthright with people about tax structures so taxpayers will have more confidence in the system.

Endnotes

[1] Jason Levitis and Nicholas Johnson, "The Impact of State Income Taxes on Low-Income Families in 2005." Washington, DC: Center on Budget and Policy Priorities, February 2006.
[2] Calculation using the Bureau of Labor Statistics' Inflation Calculator.
[3] Institute for Taxation and Economic Policy, "Indexing Income Taxes for Inflation: Why It Matters," Policy Brief, 2005.
[4] *Ibid.*
[5] Levitis and Johnson (2005)
[6] *Ibid.*
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[8] Cordes, Joseph J. "Personal exemption, federal." *The Encyclopedia of Taxation and Tax Policy.* Second Edition. Ed. Joseph J. Cordes et. al. Washington D.C.: The Urban Institute Press. 2005. p. 297.

[9] Arkansas Department of Finance and Administration. "Instructions for AR1000 and AR1000NR—Long Form." 2005. *www.ark.org/dfa/income_tax/documents/AR1000_Instr_2005.pdf*.
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Idea
7

Rethink tax relief based on age alone

Each Southern state should redesign tax codes to provide fair tax treatment to seniors so benefits are based on *ability-to-pay* instead of age alone.

Background

All Southern states offer preferential[1] tax treatment to senior citizens who are 65 and older. The most common strategies include income tax exclusions for Social Security and pension income, higher standard deductions or personal exemptions for income taxes, and property tax breaks, such as higher homestead exemptions.

> **Typical senior *tax preferences* include tax exclusions, higher tax deductions and property tax breaks.**

These tax relief measures generally were adopted at a time when the South's elderly population was smaller and more likely to be poor than today. Significant improvements to the socioeconomic well-being of senior citizens, coupled with the upcoming retirement of the baby boomer generation, have called into question the wisdom of such tax relief measures. Southern leaders should revisit state tax *preferences* targeted to seniors to ensure they still achieve worthy policy goals, generate an adequate flow of revenues and treat all taxpayers fairly.

Figure 1: Select senior tax preferences in Southern states

State	Full exemption of Social Security income	Private pension exemption	Added exemption or higher standard deduction	Property tax benefits
AL	X	X		X
AR	X	X		
FL	N/A	N/A	N/A	X
GA	X	X	X	X
KY	X	X		X
LA	X	X	X	
MS	X	X	X	X
NC	X	X	X	X
SC	X	X	X	X
TN	N/A	N/A	N/A	X
VA	X		X	X

Note: FL and TN have no personal income tax. Source: Center on Budget and Policy Priorities

Tax preferences for seniors in the South

Along with savings and investment, two major sources of retirement income are Social Security and pensions. Workers contribute to the federal Social Security program throughout their careers by having a portion of each paycheck go to the Social Security Administration. Upon retirement, workers receive Social Security payments from the federal government based on their earnings over the years. In addition, many retirees receive pension payments from past employers.

Southern states provide special tax treatment to both sources of retirement income, as shown in Figure 1.[2] Each of the nine Southern states with an income tax fully exempt Social Security benefits, and eight states exempt some or all private pension income. In addition, six states offer seniors a higher personal exemption or standard deduction on income taxes. For example, taxpayers over age 65 in Mississippi receive an extra $1,500 exemption on income taxes. Seniors also receive preferential treatment on property taxes in every Southern state except Arkansas and Louisiana.

Special tax treatment for seniors creates inequities between elderly and non-elderly taxpayers.

Is there a need for special treatment?

Senior tax relief measures were adopted decades ago "when elder poverty was much more widespread in the United States than today" and "it seemed reasonable …for states to attempt to relieve the tax burden on the elderly."[3] Since the creation of these relief tools, broad social and economic changes have occurred nationally and the condition of seniors is not what it once was. Poverty among seniors has declined sharply over the past 30 years. According to the U.S. Census Bureau, the national proportion of seniors living in poverty declined from 24.6 percent in 1970 to 10.2 percent in 2003—a lower rate than the poverty rates of either children or non-elderly adults.[4] When compared to historical counterparts, today's seniors generally have higher incomes and greater wealth.[5]

Such trends mean state tax relief measures based on age alone are not necessarily targeting those taxpayers in need anymore. Consider a tax break that goes to all seniors, regardless of *ability-to-pay*. A senior with $100,000 can receive the tax break, while a non-senior making $20,000 does not. Since the senior *tax preferences* are based on age rather than need, they shift the tax obligation to non-elderly, including low-income non-elderly taxpayers. These senior tax breaks can even create distortions between taxpayers of similar income since the measures are often based on age alone.

Figure 2: Average effective income tax rates in Virginia, 2002

	Effective Income Tax Rate	
Income Range	Seniors	Non-Seniors
All Income Groups	1.29%	2.99%
$0 to $20,000	0.01%	1.08%
$20,000 to $30,000	0.26%	2.90%
$30,000 to $50,000	0.64%	3.57%
$50,000 to $100,000	1.93%	4.01%
$100,000 to $200,000	3.28%	4.43%

Source: Georgia State University[6]

Figure 2 offers an illustration of how senior *tax preferences* create inequities between the elderly and non-elderly. As shown, seniors in Virginia experienced a lower effective tax rate than non-seniors at every income level studied in 2002.[7] Effective tax rates are the actual tax rates experienced by a taxpayer. For example, the income tax rate might be 6 percent, but after exemptions and credits, the effective, or real, tax rate that a taxpayer actually experiences is 3 percent. Since 2002, Virginia has scaled back some of the senior tax exemptions for wealthier seniors and the effective tax rate should be closer for higher income seniors and non-seniors.

Is there a cost?

The need for senior tax relief has changed over time. So has the cost. A recent study by the Center on Budget and Policy Priorities, a think tank in Washington, D.C., estimated the cost of senior *tax preferences* in four Southern states: Kentucky, Louisiana, Mississippi and North Carolina (Figure 3).[8] *Tax preference*s for pension income and Social Security benefits cost the four states approximately $1 billion. The cost ranged from $12.6 million in Louisiana to $494 million in North Carolina. When expressed as a share of general fund revenues, the cost was relatively small in Louisiana, but much higher in the three other states. In Mississippi, for example, the cost of senior *tax preferences* equaled 5.2 percent of general fund revenues.

Figure 3: Cost estimates for select senior tax preferences, Southern states

State	Estimate year	Pension preference	Annual cost (millions)	Social Security preference	Annual cost (millions)	Total of available estimates	% of general fund revenues
KY	2004	X	$235.1	X	$71.6	$306.7	4.3%
LA	2004	X	$12.6			$12.6	0.2%
MS	2005	X	see note	X	$203.3	$203.3	5.2%
NC	2004	X	$314.8	X	$179.2	$494.0	3.4%

Note: Cost of pension preference in MS is included in cost of Social Security preference. Source: Center on Budget and Policy Priorities

The cost of special tax treatment for senior citizens likely will increase along with the anticipated growth of the nation's elderly population. By 2030, according to Census Bureau projections, 20 percent of all Americans will be at least age 65 or older.[9] The South will be especially affected by society's aging, as Southern states have experienced some of the nation's largest percentage increases in senior citizens.[10] By 2030, the share of each Southern state's population that is age 65+ will range between 27.1 percent in Florida and 15.9 percent in Georgia (Figure 4).

Figure 4: Percent of population age 65+, 2005 vs. 2030, South

State	2005 Population	2030 Population
AL	13.3	21.3
AR	13.8	20.3
FL	17.2	27.1
GA	9.6	15.9
KY	12.5	19.8
LA	11.9	19.7
MS	12.2	20.5
NC	11.9	17.8
SC	12.5	22.0
TN	12.5	19.2
VA	11.5	18.8

Source: U.S. Census Bureau

With more seniors, there will be more taxpayers taking advantage of senior *tax preferences*. In Mississippi, for example, the cost of senior *tax preferences* is expected to jump from 5.2 percent of general fund revenues to 9.3 percent, based on 2004 costs with the projected 2030 senior population. Kentucky, meanwhile, will see its costs rise from 4.3 percent of general fund revenues to an estimated 7.5 percent in 2030.[11] A study of Georgia's tax system found that senior income *tax preferences* would lower income tax collections by 3 percent every year from 2000 to 2005. The loss in revenue would double after 2005, and Georgia would lose 6 percent of income tax revenues to senior *tax preferences* every year from 2005 to 2015.[12] Similarly, Virginia would lose 5.3 percent of income tax collections every year from 2005 to 2015 because of senior income *tax preferences*.

The cost of special tax relief for senior citizens likely will increase in the South as the region is expected to add millions of elderly residents in the next 26 years. If state leaders continue to provide such *tax preferences*, the burden on state budgets will dramatically rise.

While these states are losing potential revenue due to an increased senior population, they will also likely experience increased costs of services used by seniors. These services include Medicaid, departments of aging and health care costs for retired state employees. One recent study of these three areas in North Carolina found that applying current spending levels to the estimated elderly population in 2030 would require an additional $2.7 billion in state spending.[13]

Seniors: Boon or drain on state coffers?

The unprecedented demographic shifts remaking the nation and region have left analysts and public officials unsure of the impacts an aging society will have on state coffers. Some argue a large elderly population will drain state resources because of the high levels of medical care demanded by elderly residents and the fact that many seniors no longer work. Other observers look at the aging of society as a positive development because seniors tend to have higher levels of net worth and little need for expensive public education.

The truth likely lies somewhere in between and depends on the size, proportion and composition of a state's elderly population.[14] Younger seniors (ages 65-74) tend to be healthier than older peers and have higher incomes and greater wealth. A population with many younger seniors may actually be a benefit from a state fiscal perspective. The situation changes for older seniors, especially those over the age 85. Older seniors tend to be in worse health, have lower incomes and have less wealth as a result of having spent down their savings in retirement.

Consider net worth. In 2000, the median net worth of households headed by an individual older than age 65 equaled $108,885. Households headed by a senior between the ages of 65-69 had a median net worth of $114,000, compared to a median net worth of $100,100 for households led by someone over the age of 75. Regardless of age, however, most of a senior household's wealth is tied up in housing equity. When housing wealth is excluded, the median net worth of elderly drops to $23,369.[15]

Observers who argue seniors are beneficial to state coffers often say senior tax exemptions and other incentives targeted to older adults should be used to attract seniors into a state. Studies, however, consistently find "most older people do not move" and that roughly half of all elderly movers remain in the same county.[16] If policymakers wish to benefit from the perceived positive demographic characteristics of elderly citizens, they may want to focus on attracting younger workers who then will remain in the area for retirement and "age in place."[17] This means investing in the amenities—such as affordable housing, good infrastructure and high quality schools—valued by younger workers who likely have school-aged children.

Better ways to help seniors

If the purpose of tax breaks for seniors is to alleviate poverty among the elderly, current benefits miss the mark. Because age and poverty are no longer inextricably intertwined, many existing senior tax advantages flow to older taxpayers with high incomes. As a consequence, the tax obligation shifts to non-seniors, including low-income taxpayers.

If the purpose of special tax treatment for seniors is to alleviate poverty among the elderly, current benefits miss the mark.

To restore balance and help the intended beneficiaries, states should provide tax benefits on the basis of income rather than age alone. As an added bonus, income-based preferences would benefit non-elderly lower-income households. While the exact policy changes would depend on each state's tax code, five general options appear worthy of consideration:[18]

- **Social Security.** States should consider adopting the federal standard for the taxation of Social Security income or limiting the Social Security exemption to taxpayers within certain income ranges. The federal government starts taxing Social Security for individuals with combined income over $25,000 and for couples with income over $32,000. Connecting tax relief to income ensures benefits go to those seniors who truly have a limited *ability-to-pay*.

- **Pension income.** States should establish income limits for the exemption of pension income. Virginia, for example, recently changed its tax code to phase out the pension exemption for single taxpayers with incomes of more than $50,000, and for joint filers with incomes above $75,000.

- **Age-based exemptions.** States might want to convert age-based personal exemptions to higher standard deductions available to all ages. This reform would provide more relief to low- and moderate-income taxpayers regardless of age.

- **Property tax benefits.** States could link property tax benefits to income-based criteria (e.g. circuit breaker program; see Idea 9).

- **Eligibility Age.** States should consider setting the eligibility for age-based *tax preferences* above the age of 65. For example, people older than age 75 are more likely than those between 65-74 to be poor, so a preference designed to alleviate poverty might be more effective if set at an older age.

While reforming senior *tax preferences* might appear politically impossible, Virginia made progress in 2004 as part of a larger statewide tax reform package. State lawmakers in Virginia reduced senior tax breaks by phasing out income tax exemptions going to seniors with income of $50,000 for singles and $75,000 for couples. The senior tax reforms gained the support of leaders from both political parties as well as the AARP.[19]

Revisit senior tax relief measures

States adopted preferential tax treatment for senior citizens when senior citizens were more likely to be poor than today's seniors. As a result, benefits now go to many unintended senior taxpayers who qualify on age rather than income. The conditions of seniors have changed, yet the *tax preferences* have remained the same or even grown in certain states.

To ensure that tax benefits go to senior taxpayers truly in need, states should revisit how they give tax relief to seniors and tailor specific measures for seniors in the 21st century. *Fairness* in taxes should not be based on age alone, but rather, on *ability-to-pay* among taxpayers of any age.

Talking points

- Through the years, states adopted specific measures to provide favored tax treatment to seniors to help them, in part, get out of poverty.

- But over the years, the senior population has changed. Not as many seniors are in poverty. In fact in recent years, seniors have had a lower poverty rate than children and non-senior adults.

- It makes common sense to review tax breaks for seniors to see if they're still needed. And if they are, they should be provided on *ability-to-pay*, not just because they're older taxpayers.

Endnotes

[1] For purposes of the discussion in this chapter, the term "tax preference" should be viewed as synonymous with "tax-favored treatment." It should not be confused with specific meanings associated with the federal Alternative Minimum Tax.
[2] Author's analysis of data contained in Elizabeth McNichol, "Revisiting State Tax Preferences for Seniors" Washington, D.C.: Center on Budget and Policy Priorities, March, 6, 2006.
[3] McNichol (2006), p. 2.
[4] Wan He, Manisha Sengupta, Victoria Velkoff and Kimberly DeBarros, "65+ in the United States: 2005." Washington, D.C.: U.S. Census Bureau, December 2005, p. 103.
[5] *Ibid.*, pp. 100 and 109.
[6] Edwards, Barbara and Sally Wallace. "How Much Preference: Effective Personal Income Tax Rates For The Elderly." Georgia State University, Fiscal Research Center. FRP Report No. 70. April 2002, p. 27.
[7] *Ibid.*
[8] McNichol (2006)
[9] He (2005), p. 1.
[10] *Ibid.*, p. 119.
[11] McNichol (2006), p. 20.
[12] Edwards (2002)
[13] Amna Cameron, "Tax Retirement Income? The Impact of Population Shifts on State Revenue and Spending." Raleigh, N.C.: North Carolina Budget and Tax Center, 2006.
[14] He (2005), 123.
[15] *Ibid.*, p. 109.
[16] *Ibid.*, pp. 138 and 140.
[17] William Frey, "Elderly Demographic Profiles of U.S. States: Aging-in-Place, Migration and Immigration Impacts." Ann Arbor, M.I.: Population Studies Center at the University of Michigan, March 1995.
[18] These recommendations are adapted from McNichol, p. 21.
[19] Greenblatt, Alan. "Solidarity on Solvency." *Governing*. November 2004. 24-25.

Idea

8

Eliminate corporate tax loopholes

Each Southern state should review and update its income tax structures for businesses to eliminate corporate tax loopholes to promote *fairness*.

Background

Southern states have historically taxed corporations on their income, or profits for similar reasons to taxing individuals. Corporations, like people, use government services, such as schools that train the workforce. Forty-six states, including every Southern state, have a corporate

Every Southern state has corporate income taxes. Likewise, every Southern state has corporate income tax loopholes that some companies take advantage of to avoid their corporate tax responsibilities.

income tax to allow corporations to contribute to the cost of schools, universities, courts and other government services. While the corporate income tax is not as large of a revenue source as the individual income tax or sales tax, it has long been part of tax systems throughout the South and has provided another element of diversity to complement other taxes.

In recent years, state corporate income tax revenue has declined so much that there is considerable debate about whether states should continue to tax corporate incomes at all. There are several causes for the decline of the corporate income tax, including the use of income tax loopholes by some multi-state corporations. Loopholes are anomalies or inconsistencies in a state's tax system—some intentional, others not—that companies use to escape or lower their state corporate income taxes. These loopholes cause decreases in state revenues. But just as importantly, they cause un*fairness* in the tax system because companies not using the loopholes have a higher tax burden than those who game the system.

Just like individuals who avoid taxes, corporations that take advantage of weaknesses in the tax code are shifting the burden and cost of state services to other businesses and creating an unfair tax system. If states do away with corporate income tax, that's one thing. But until they do, businesses across the board should be treated fairly. Small corporations, for example, shouldn't be forced to pay the same tax that larger corporations or multi-state corporations avoid.

Just like individuals who avoid taxes, corporations that take advantage of weaknesses in the tax code shift the burden and cost of state services to other businesses and create an unfair tax system.

States need to ensure their corporate taxing structure avoids including anomalies and inconsistencies that can be exploited and cause smaller, in-state businesses to pay more corporate taxes. Southern states have an opportunity to strengthen their corporate income tax by updating their tax code and enacting new requirements to close tax loopholes. While corporate tax reforms will not completely reverse the tax's deterioration, they will improve the *adequacy* and *fairness* of the corporate income tax.

The intentional and unintentional tax decline

State corporate tax revenues have declined nationwide over the past few decades. While state corporate tax collections have fluctuated with the business cycle, they have declined to a fundamentally lower level when measured as a percent of reported corporate profits, falling from 6.6 percent in 1980 to 4.0 percent in 2000.[1] This national trend has hit many Southern states. Recent research found that South Carolina, for example, had a "very large divergence" between the growth in state corporate income taxes and the growth in gross state product from 1980 to 2000.[2]

The causes for the decline in corporate income taxes are numerous, including some that were intentional and others that were not. Two intentional causes include state efforts to provide more kinds of corporate structures and to provide special tax credits to some companies.

First, states across the nation have legislatively encouraged the rise in more pass-through small business structures, such as S corporations, limited-liability corporations (LLCs) and limited-liability partnerships (LLPs). While states have taxed traditional C Corporations through corporate income taxes, most states have chosen to tax S Corporations, LLCs and LLPs through individual income taxes. These corporations are often called pass-through entities because profits and losses are "passed-through" to the shareholders, who pay income taxes on profits and get credits for losses. As more companies have incorporated as pass-through entities, state revenues have shifted away from corporate income taxes and into the individual income tax collections.

Another intentional cause of decline in corporate income taxes is the use of corporate tax credits by states. States widely have increased the use of tax credits as an economic development strategy to lure new businesses and assist growing establishments. These corporate income tax credits reduce tax liabilities for activities such as job creation or investment, as discussed further in Idea 10.

Corporate tax loopholes diminish tax revenue in every Southern state by at least $72 million a year.

While granting corporate tax credits and promoting the use of more small business structures can be seen as intentional by states, corporate tax loopholes can be viewed as unintentional mechanisms for corporations to avoid corporate income taxes. These tax loopholes allow corporations to escape a portion of their state corporate tax liability by shifting money to states with lower taxes or by finding ways to make money non-taxable. Corporate tax loopholes have diminished the *adequacy* and *fairness* of corporate taxes and helped to foster the creation of a costly, inefficient use of resources for tax-planning purposes.

- ***Adequacy.*** According to estimates by the Multistate Tax Commission, corporate tax loopholes and tax sheltering—the "sheltering" of income from taxation—diminished state tax revenues in every Southern state in Fiscal Year 2001, as shown in Figure 1. The loss in revenue ranged from a high of $554 million in Florida to a low of $72 million in Alabama in 2001.[3] The loss due to tax sheltering was a significant share of possible collections. For example, if Mississippi were able to collect all of the revenue lost to sheltering, the state's corporate tax revenues would have been 42 percent higher than their actual 2001 levels. These tax losses include multiple tax sheltering schemes, both domestic and international, some of which states corrected since 2001. Southern states can improve the *adequacy* of their corporate income tax system by correcting loopholes and ensuring compliance with the system.

- ***Fairness.*** Corporate tax loopholes also allow some corporations to avoid tax responsibilities as other businesses pay their fair share. Historically, the intention of the corporate income tax has been to allow companies to contribute to the cost of government services—the schools, colleges, roads, bridges, courts, police protection, and other infrastructure that provide a marketplace for business. When corporations use loopholes to escape or avoid tax responsibilities, they are not complying with the intentions of the tax. States should strengthen the corporate income tax to promote tax *fairness* and consistency within the tax code. Getting tough on corporate loopholes would not be the imposition of a new tax. Rather, states would enforce the intentions of a long-standing tax.

Figure 1: Revenue loss due to tax sheltering and actual tax collections, 2001		
State	Estimated revenue loss from tax sheltering, FY 2001 (in millions)	Corporate income tax collections, 2001 (in millions)
Alabama	$72	$202
Arkansas	$77	$202
Florida	$554	$1,591
Georgia	$287	$691
Kentucky	$150	$361
Louisiana	$122	$293
Mississippi	$88	$211
North Carolina	$301	$724
South Carolina	$80	$192
Tennessee	$280	$673
Virginia	$151	$364
Source: Multistate Tax Commission[4]; US Census Bureau[5]		

Strengthening the corporate income tax

States can address various corporate tax loopholes through legislation. While states should undertake a comprehensive review of corporate tax loopholes to promote *fairness*, the following discussion highlights two of the bigger loopholes: passive investment companies and nowhere income. Numerous states have already taken measures to close one or more corporate tax loopholes, including several Southern states as shown in Figure 2. For a more detailed analysis of how these and other loopholes work and how states across the nation correct them, see recent publications by Michael Mazerov of the Center on Budget and Policy Priorities and Professor Peter Fisher of the Iowa Fiscal Partnership.[6]

Loophole Example 1: Passive Investment Companies

Corporations avoid paying taxes on some types of income, such as royalties, by creating subsidiaries known as passive investment companies (PICs), or Delaware-holding companies. By locating PICs in states that do not tax royalties and other types of income, corporations are able to shift income to these companies and avoid taxation. Take, for example, a hypothetical Louisiana corporation, LouisCorp. It easily can create a passive investment corporation in Delaware to hold its trademarks. When LouisCorp uses that trademark, it pays a fee to its sister PIC in Delaware, and thus transfers income to the PIC. This income now becomes nontaxable since Delaware does not tax royalties. In addition, the PIC can shift that income back to LouisCorp in the form of a loan. LouisCorp can deduct the interest of the PIC loan from its taxes, which further reduces its tax burden.

Bottom line: LouisCorp is easily able to avoid paying a portion of its Louisiana corporate income taxes by creating a PIC and transferring taxable income out of state—all to the detriment of Louisiana's state government and business owners who pay their taxes in good faith.

Solution: Combined reporting. To stop the use of PICs, states can require corporations to report on the profits of PICs along with their own profits in a combined corporate income tax return, a requirement known as "combined reporting." This kind of return not only addresses problems relating to PICs, but also restricts the use of other income-transferring mechanisms. The benefits of enacting combined reporting have been noted to be the following:

> "a uniform treatment of corporate groups without regard for differences in their organizational structure, a strong bulwark against the use of tax-haven jurisdictions to avoid state taxation, a significant reduction in administrative burdens on the tax department and on complying taxpayers, and the removal of the competitive disadvantage currently imposed on local firms that are unable to engage in cross-border tax-avoidance."[7]

Michael Mazerov of the Center on Budget and Policy Priorities, however, notes that combined reporting is a significant change to the corporate tax law and should be studied carefully. He observes that states can precede combined reporting with legislation that only involves passive investment corporations rather than all income-transfer mechanisms.[8] In the South, Alabama, Arkansas, Georgia, Kentucky, Mississippi, North Carolina and Virginia have enacted such legislation to address PICs alone. Georgia estimated it would receive $504.7 million in additional corporate income tax revenues from 2006 to 2015 after enacting Anti-PIC legislation.[9] Virginia estimated closing the Delaware-holding company loophole (anti-PIC legislation) would bring an additional $34.0 million in FY 2005.[10]

While several Southern states have anti-PIC rules with varying levels of effectiveness, none of the Southern states have combined reporting requirements to protect against multiple tax avoidance schemes.[11] The gains from closing this loophole vary greatly. In Kentucky, combined reporting would bring in an estimated $10 million in additional corporate income tax revenue.[12] If Florida had combined reporting in 2006, it would increase revenues by an estimated $494 million.[13]

After enacting legislation to control the use of passive-investment corporations, Georgia estimated it would get an extra $504.7 million in corporate tax revenues over 10 years.

As states consider strengthening their Anti-PIC laws by moving to combined reporting, Southern states can look to several places for guidance. Sixteen states in the U.S. have combined reporting requirements and provide a template for implementing the reform option in Southern states. In addition, several Southern tax commissions throughout the last decade have studied and recommended combined reporting.[14] Finally, the Multistate Tax Commission has added combined reporting to its agenda and provides model legislation for such measures.[15]

Loophole Example 2: Nowhere income

"Nowhere income" involves the apportionment of profits among states by multi-state corporations. Corporations must pay taxes to states in which they have a presence, but only after reaching a certain level of presence, or nexus. If the corporation does not reach that nexus, then the profits produced in that state become "nowhere income" since they are not subject to tax in any state.

Solution: A throwback rule. States can correct for the problem of nowhere income by enacting a "throwback rule." Through this mechanism, a corporation's home state, or rather the production state, can tax the profits that are not taxed in the purchase state. For example, if an Alabama manufacturer makes a sale in Nevada that is not taxed, then the profit from the sale is thrown back to Alabama to be taxed. Alabama, Arkansas and Mississippi already have throwback rules to address this loophole.

Some state estimates of the effects of nowhere income are small in comparison to the combined reporting requirements. For example, Kentucky legislative analysts

Figure 2: Status of Loophole Closures in Southern States

	Combined Reporting	Throwback Rule
Alabama	No (a)	Yes
Arkansas	No (a)	Yes
Florida	No	No
Georgia	No (a)	No
Kentucky	No (a)	No
Louisiana	No	No
Mississippi	No (a)	Yes
North Carolina	No (a)	No
South Carolina	No	No
Tennessee	No	No
Virginia	No (a)	No

(a) Has Anti-PIC rules (also known as anti-Delaware-holding company rules)
Source: Department of Revenue interviews and websites, State Code websites, Mazerov[18] Note: This does not apply to banks, insurance companies, and others which are not subject to the corporate income tax in many states.

estimated that the throwback rule would bring in $3 million in additional corporate tax revenue, whereas combined reporting would increase revenues by $10 million.[16] Likewise, enacting a throwback rule in Florida would bring in an estimated $29.5 million, compared to the $494 million combined reporting would garner.[17] While the throwback rule might not alter corporate tax collections greatly, closing the nowhere income loophole is a reform states should consider when debating whether multi-state corporations and smaller, in-state companies are treated consistently under the corporate income tax.

Closing tax loopholes to make a fairer tax system

Forty-seven states have a corporate income tax, including every Southern state. Over the years, these corporate tax systems have become riddled with loopholes, which some companies use to avoid income taxes. To ensure that businesses are treated consistently and fairly under the corporate income tax, Southern lawmakers need to continuously review and update corporate tax codes and requirements to close tax loopholes. Reform options include combined reporting to protect against income-transfer schemes and throwback rules to protect against nowhere income. Closing these and other loopholes would improve the tax's *fairness* as well as raise funds for education and other business infrastructure, which make states more competitive.

Talking points

- Almost every state in the union—and every Southern state—currently implements a corporate income tax. Lawmakers originally implemented these taxes to ensure that companies paid their fair share of government programs and services they use and benefit from, such as education that schools new workers and roads that allow them to distribute goods to customers.

- Through the years, intentional and unintentional loopholes have developed that allow companies to escape or lower their corporate income tax burden. States are losing millions of dollars due to these tax-avoidance mechanisms.

- State lawmakers should insist upon a prompt review of anomalies and inconsistencies in the corporate tax structure to ensure that large corporations pay a fair share of corporate taxes and to assure smaller, in-state businesses that they are not shouldering an unfair burden.

- As long as Southern states tax corporate incomes, the tax should be administered fairly and not provide preferential treatment to some corporate taxpayers.

Endnotes

[1] Cornia, Gary, et al. "The Disappearing State Corporate Income Tax." *National Tax Journal*. Vol. LVIII, No. 1. March 2005. 115-138.
[2] *Ibid*. 117.
[3] "Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections." Multistate Tax Commission. July 15, 2003.
[4] *Ibid*.
[5] "State Government Finances: 2001." U.S. Census Bureau, Government Services Division. March 19, 2004. *www.census.gov.*
[6] Mazerov, Michael. "Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States." Center on Budget and Policy Priorities, Washington D.C.: May 23, 2003; Fisher, Peter. "Revitalizing Iowa's Corporate Income Tax." Iowa Fiscal Partnership. April 2006. *www.iowafiscal.org/2006docs/060411-CIT-full.pdf.*

[7] McIntrye, Michael, Paull Mines, and Richard D. Pomp. "Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana." *Louisiana Law Review*. Vol 61. 2001. pg. 700-701.
[8] Mazerov (2003).
[9] Hinton, Russell W. "Fiscal Note, House Bill 191 (LC 18 4033)." State of Georgia, Dept. of Audits and Accounts. January 31, 2005.
[10] Virginia Department of Taxation. "Fiscal Impact Statement HB 5018." April 6, 2004. *http://leg1.state.va.us/cgi-bin/legp504.exe?042+oth+HB5018F161+PDF.*
[11] Florida previously had combined reporting requirements and a throwback rule, but removed both measures in the 1980s in exchange for a higher corporate tax rate.
[12] Pierce, Louis. "House Bill 299 State Fiscal Note Statement." Commonwealth of Kentucky, General Assembly, Legislative Research Commission. February 3, 2004.
[13] State of Florida Legislature. "2006 Florida Tax Handbook Including Fiscal Impact of Potential Changes." *http://edr.state.fl.us/reports/taxhandbook2006/ii.staterevenuesources.pdf.*
[14] For examples, see: Bahl, Roy. "Reforming the Georgia Tax Structure." Final Report of the Joint Study Commission on Revenue Structure. January 1995. Georgia State University, FRP Report No. 95.1; "Final Report." Governor's Commission to Modernize State Finances. State of North Carolina. December 2002.; Fox, William. "Report to the Sub-Committee on Tax Policy Issues." Kentucky General Assembly, Committee on Appropriations and Revenue. February 27, 2002. *http://www.lrc.state.ky.us/ijcomm/a&r/taxpolicy/kyfinalreport.pdf.*
[15] Dagostino, Emily. "MTC Executive Committee OKs Survey of States on Combined Reporting." *State Tax Today.* June 20, 2005. *www.taxanalysts.com.*
[16] Pierce (2004)
[17] State of Florida Legislature (2006)
[18] Mazerov (2003)

Idea

9

Enact a property tax circuit breaker

Each Southern state should consider enacting a property tax circuit breaker to shield residents from excessive taxation and connect property taxes with *ability-to-pay*.

Background

Property tax reform is an increasingly hot topic in legislatures across the South. The 2006 legislative session included proposals to replace property taxes with an increased sales tax (South Carolina), enact a property assessment cap (Georgia) and make property tax exemptions portable for homeowners who move (Florida).

No Southern state offers a property tax circuit breaker, which is a *progressive* solution to excessive property taxation.

The arguments supporting property tax breaks often are compelling, such as accounts of fixed-income elderly homeowners being taxed out of their homes and neighborhoods. While the need for relief is sometimes warranted, legislators frequently seek solutions that are poor tax policy, such as assessment caps, freezes and other methods that provide broad-based tax cuts regardless of need or income.

The use of property tax restrictions and breaks is widespread. Many states have layers of programs. But none of the eleven Southern states have a property tax circuit breaker, a tool that offers a progressive solution to excessive property taxation. The property tax circuit breaker instills a measure of *ability-to-pay* into the property tax system because it limits property taxes to a certain percent of income. For example, if a homeowner's property tax bill goes over 3 percent of his income, then he is "overloaded" by property taxes and the circuit breaker kicks in to refund a portion of his tax payment. While property taxes are predominantly local, the circuit breaker is a way for states to ensure property taxes stay at a reasonable level of income.

Many reform options, many policy pitfalls

Property taxes in most Southern states are low relative to the rest of the nation, as highlighted in Figure 1 below. Except for Florida and Virginia, all Southern states rank in the bottom half of states for property taxes per capita and as a percent of personal income. In spite of those low rankings, property taxes have become the most hated tax in many states due in part to the visibility of the tax and the disconnect between property taxes and income.

In contrast to sales taxes, which accumulate through pennies on the dollar every time somebody buys something, property taxes are a visible tax. Homeowners know the cumulative property tax bill every year when the annual bill arrives. In part because they see the impact in one big chunk, taxpayers often resist the property tax even if their annual property taxes take a lower share of income than other taxes.

While the visibility of the property tax is not necessarily grounds for tax relief, there's a second concern—the disconnect between property taxes and income. Because of the way the system is set up, property taxes are tied to a property's value, not the income of a property owner.

Figure 1: State and local property tax rankings in Southern states, 2002

State	Property taxes per capita	Rank	Property taxes as % of personal income	Rank
United States	*$992*		*3.1%*	
Alabama	$331	51	1.3%	51
Arkansas	$375	50	1.6%	49
Florida	$986	18	3.2%	22
Georgia	$811	35	2.7%	35
Kentucky	$489	46	1.9%	44
Louisiana	$434	47	1.7%	45
Mississippi	$579	42	2.6%	37
North Carolina	$674	39	2.4%	41
South Carolina	$772	36	3.0%	27
Tennessee	$607	41	2.2%	42
Virginia	$948	24	2.8%	32

Sources: National Conference of State Legislatures[1]
Note: Rankings include 50 states and the District of Columbia. The most current available census data on state and local finances is for 2002.

This “disconnect” deserves policy attention because it can create unfair tax burdens. For example, a homeowner’s property taxes can increase substantially because home values increase even though the homeowner’s income might stay the same or fall.

Hating the property tax isn’t necessarily rational, but understandable since the impact arrives once a year instead of cumulatively like the sales tax does every time you buy something.

In an attempt to alleviate these concerns, states use a variety of property tax programs and restrictions to lessen the property tax obligation. Legislators attempt to either restrict the growth in taxes through limits, caps and freezes, or provide relief through homestead exemptions, credits and deferrals (Figure 2). While these programs offer some benefits to residents in need, they often do not recognize *ability-to-pay* (i.e. income), which creates many unintended beneficiaries.

Restrictive Measures: Limits, caps and freezes

Property tax limits provide broad-based tax relief, which can create long-term inequities and tax shifts. These restrictive measures come in many forms, including revenue limits, assessment caps and tax freezes, and are used varyingly across the South. As shown in Figure 2, property tax rate limits are the most common. An example of a tax rate limit is North Carolina’s $1.50 per $100 of appraised property value. Thus, local jurisdictions can only tax at a rate at or below $1.50 per $100 of value. Often these rate limits can be changed through voter approval.

Another tax restriction is a property assessment cap, which is currently used in Florida and Arkansas. In Florida, property assessments can only increase annually by 3 percent or inflation, whichever is less. The property is reassessed at its true value (or fair market value) only when a home is sold or improved. Under such assessment caps, two similar houses might have significantly different property tax bills because of the length of ownership. Longtime homeowners would enjoy lower property taxes than new homeowners even though they owned similar property. Such caps shift the tax burden among residents and provide tax breaks regardless of income.

While assessment caps make the tax less fair, they do not necessarily restrict the amount of property taxes collected. Local governments can still raise additional revenue by increasing the millage rate. In contrast, property tax revenue limits restrict the total amount of revenue a jurisdiction is allowed to collect. Revenue limits can threaten the *adequacy* of funds and create inflexibility within government such that it cannot raise new property taxes to meet additional service demands.

Relief Measures: Exemptions, credits and deferrals

Homestead exemptions, credits and deferrals are relief programs offered in numerous states, also as shown in Figure 2. Homestead exemptions remove a certain amount of a home's assessed value from taxation. Several states offer homestead exemptions to all homeowners and more generous exemptions to elderly or disabled homeowners. In Alabama, for example, the first $4,000 of assessed value is exempted from state taxation. Elderly homeowners, however, receive an additional exemption which eliminates all state property taxes for those aged 65 and over. Homestead credits, which are similar, are a defined amount that the state exempts from the property tax bill. In Arkansas, the state pays the first $300 of the property tax bill.

Tax deferrals are available in four Southern states, mainly to elderly and disabled homeowners. Through this tool, property owners defer property tax payments until they sell a home or they die. Through deferrals, state and local governments allow the fixed-income homeowner to pay when money is available. According to surveys by the AARP, tax deferral programs are the least used property tax relief program by those who are eligible.[2]

Tax deferral programs are the least used property tax relief measure by those who are eligible, according to the AARP.

While these programs do not have the policy pitfalls of the caps, freezes and limits, they also do not always take income into account. They generally offer broad tax breaks to all homeowners without fully addressing the income limitations of some homeowners. These relief measures can leave some low- and moderate-income homeowners as well as renters with pressure that stems from the property tax system, which fluctuates with property values rather than income.

Figure 2: Property tax restrictions and relief programs						
State	Rate limits	Revenue limits	Assessment caps	Homestead exemption and credit	Tax deferral	Circuit breaker
Alabama	X			X		
Arkansas	X	X	X	X		
Florida	X		X	X	X	
Georgia	X			X	X	
Kentucky	X	X		X		
Louisiana	X	X		X		
Mississippi		X		X		
North Carolina	X			X		
South Carolina	X			X		
Tennessee				X	X	
Virginia				X	X	

Source: Baer, David. *State Programs & Practices for Reducing Residential Property Tax*[3]
Note: The above list includes major programs. Certain states allow local jurisdictions to enact limits, which are not necessarily included in this analysis.

A progressive approach to property taxes

A progressive alternative to the options discussed above is a property tax "circuit breaker." As of 2005, thirty-five states and the District of Columbia had some form of circuit breaker program.[4] In spite of its popularity, none of the eleven Southern states have circuit breaker programs.[5] (In 2006, a South Carolina Senate subcommittee proposed a property tax circuit breaker during long debate on property tax reform, but the measure failed to make it out of committee.)

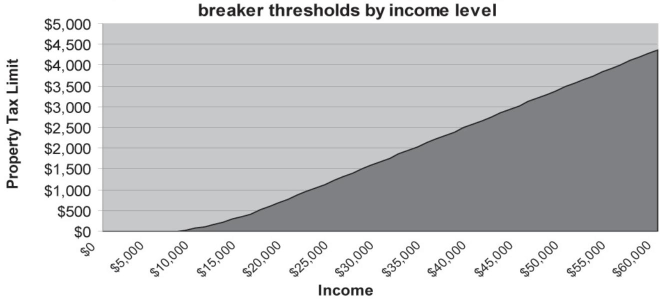
Caps, limits and freezes weaken the property tax system in terms of *fairness* and *adequacy*. In other words, these restrictive measures can cause unevenness between taxpayers and can put stress on the tax system if they provide less money than needed. Likewise, homestead exemptions and credits suffer from being poorly targeted. Often, exemptions and credits are spread across all homeowners, rather than providing greater tax breaks to those homeowners and renters with a limited *ability-to-pay*. In contrast, circuit breakers can increase the fairness of the tax system and offer targeted relief to homeowners and renters in need. Circuit breakers accomplish this targeted, fair relief by restricting property taxes to a certain amount of income. When taxes exceed that amount of income and the taxpayer is "overloaded," the excess tax is refunded or credited through the income tax system.

> **Property tax circuit breakers can increase *fairness* of the tax system and provide targeted, *progressive* relief.**

Circuit breaker programs vary widely. Some programs target seniors or low-income homeowners only, while others also target a broader spectrum of moderate-income residents. Several circuit breaker programs also include renters, since they pay property taxes that are incorporated into rent prices. Circuit breakers are designed to phase out as income increases and to stop entirely when income reaches a certain threshold. For example, Wisconsin's circuit breaker phases out by $24,500 in income, while Michigan and New Jersey have more generous thresholds of $82,000 and $200,000, respectively.

Maryland is in the process of updating its 1975 circuit breaker program and offers a good example of how the program works. Under the new guidelines, the first $8,000 of income would have a circuit breaker of 0 percent.[6] So if a taxpayer has an income below $8,000, then any property tax liability is considered excessive and the circuit breaker program refunds the property tax payment. The circuit breaker increases from 0 percent to 4 percent for income between $8,000 and $12,000. This is a marginal increase—meaning, the first $8,000 still is not taxed, while the next $4,000 in income is subject to a 4 percent circuit breaker. The percent of income allowable in property taxes continues to rise to 6.5 percent of income from $12,000 to $16,000 and 9.0 percent of income from $16,000 to $60,000. The circuit breaker program does not apply to taxpayers with incomes of more than $60,000 or assets over a certain limitation.

Figure 3: How much is too much? Proposed Maryland circuit breaker thresholds by income level



Source: Author's calculations based on Maryland House Bill 5 Fiscal and Policy Note, 2006

As illustrated in Figure 3, the amount of property taxes that residents should be able to afford increases with income, which means the circuit breaker program has a progressive impact. For a Maryland taxpayer with $15,000 in income, the circuit breaker takes effect at around $350 in property taxes. If the taxpayer's bill exceeds $350, the taxpayer is considered to be "overloaded" and the circuit breaker kicks in to relieve the tax obligation. For a taxpayer with $40,000 of income, that circuit breaker begins at around $2,500 in annual property taxes.

Although property taxes primarily are a local tax, the circuit breaker should be considered in this discussion since states bear the cost of circuit break programs. When a taxpayer qualifies for the circuit breaker, the state rebates or credits the excessive taxes through the income tax system. The cost of a circuit breaker program in Southern states would vary depending on several factors:

- **Tax threshold.** The *tax threshold* is the point at which the circuit breaker kicks in. If the circuit breaker begins when taxes exceed 5 percent of income, then only residents who pay over 5 percent of income in property taxes will be eligible. If the circuit breaker kicks in at 3 percent of income, then more people will qualify and the cost of the program to the state will be greater.

- **Income limit.** The income limit is the point at which the circuit breaker program ends. In the Maryland example above, the limit is $60,000. Households with income over $60,000 do not qualify for the program. The cost of the program increases as the income limit increases because more residents become eligible. If the income limit is low, then fewer residents will qualify and the cost of the program will be less. In contrast, if Southern states set a high income limit, such as New Jersey's $200,000, the cost will be much greater.

- **Type of household.** States include different populations in their circuit breaker programs—homeowners, renters, elderly, disabled, low-income, moderate-income and others. Southern states would need to decide on the target population and consider that programs should be based on need rather than age alone. The more people included in the program, the greater the cost of the circuit breaker to a state.

- **Refund limit.** States do not provide the full amount of excess tax back to the homeowner or renter. In Minnesota, for example, the maximum refund is $1,690. The level of the credit, or the refund available, is another component driving the cost of the program.

A tool that can work

Southern states currently have several programs to lower property taxes, such as homestead exemptions, tax deferrals and revenue and assessment limits. But no Southern state has a circuit breaker program, which can have a progressive effect on property taxes.

If Southern residents need property tax relief, as many legislators argue, then a circuit breaker should be created to restrict property taxes to a certain percentage of income for residents in need. Legislators rightly fear that *ability-to-pay* is not always part of the current property tax system. Enacting a circuit breaker would infuse an ability-to-pay measure into property taxes. In turn, taxpayers would know what the state thinks is too much for them to pay.

Talking points

- Southern policymakers are under increasing pressure to provide property tax relief.

- Current solutions to property tax relief are inadequate and unfair because they cause budget stresses that aren't sound fiscal policy or they are not targeted to people in need.

- A way to provide property tax relief to people who need it is to base such relief on how much they can pay.

- A property tax circuit breaker is a flexible tool that can be used to provide relief to people who need it—those with low incomes or elderly people on fixed incomes.

- It's a smart way to provide relief because it is means-tested.

Endnotes

[1] *Ranking of State-Local Revenue and Expenditure Data.* National Conference of State Legislatures. *www.ncsl.org/programs/fiscal/cb02proptrank.htm.*
[2] Baer, David. *State Programs and Practices for Reducing Residential Property Taxes.* May 2003. AARP. *http://www.aarp.org/ppi.*
[3] Baer (2003); Baer , David. *State Programs and Practices for Reducing Residential Property Taxes.* October 6, 2005. AARP. *http://ppa.boisestate.edu/centerppa/documents/20051006pm0315-baer.pdf.*
[4] Baer (2005).
[5] Florida has a program somewhat similar to a circuit breaker in that it is activated when property taxes exceed a certain level of income. In contrast to true circuit breaker programs, Florida's program is a deferral program that requires taxpayers to pay the excess tax in later years. In addition, Arkansas had a circuit breaker program, but replaced it with a homestead credit program.
[6] Sanelli, Michael. *Fiscal and Policy Note to House Bill 5: Revised.* Maryland General Assembly, Department of Legislative Services. 2006 Session.

Idea

10

More tax accountability leads to better decisions

Each Southern state should annually publish a comprehensive *tax expenditure* report to provide more accountability and information to lawmakers so they can make better decisions. The report should highlight missed revenue opportunities due to tax exemptions, breaks and deductions.

Background

Southern states annually lose a significant amount of possible revenue through tax credits, exemptions, deductions and other tax breaks that exempt some goods, services, income, people or property from taxation. Idea 1 discussed these revenue losses for the sales tax base, but there are considerable losses in the income tax, corporate income tax and property tax bases too.

States provide these special tax breaks for varied reasons. Corporate income tax credits, for example, often are enacted with the intention of stimulating job growth or investment. Sales tax breaks on food, on the other hand, carry the intention of helping low-income taxpayers with necessities. Although these tax breaks, which more formally are known as *tax expenditures*, cost states large amounts of foregone revenue, many states surprisingly do not keep track of the lost potential revenue.

While state budgets and appropriations are reviewed and voted on annually, these special tax breaks often remain in the tax code for years without debate or review. Like budget spending, this "tax spending" needs to be held accountable to the goals and values of the state and also needs to be used efficiently. Enacting measures such as annual *tax expenditure* reports and other accountability methods will improve tax systems of Southern states by ensuring legislators and voters know where the money goes—and where they're not realizing potential revenue due to state policy decisions.

While Southern states publish annual budgets, many don't publish a comprehensive report that highlights how much in total revenue they're not taking in due to special tax breaks.

Tax expenditure reports

Most states publish a budget document annually that shows all appropriations, such as spending on education, healthcare and prisons. But many states do not do the same for *tax expenditures,* such as corporate tax credits and sales tax exemptions, even though these "cost" the state money because they're missed opportunities.

The cost of any *tax expenditure* is the amount of tax the state would have collected if the credit or exemption did not exist. For example, if a state provides a $100 million corporate tax credit to an automobile company so it will locate in the state, from a tax perspective that means the incentive will "cost" the state $100 million because it could have collected that amount more in corporate income tax revenue if that credit did not exist.

To account for this loss in revenue, several Southern states offer annual *tax expenditure* reports, which list the credits and exemptions in the states and the cost of those expenditures (Figure 1). By providing this data, *tax expenditure* reports offer a tool for legislators and the public when discussing the needs of the state, the funds available, and the allocation of resources.

Figure 1: Comprehensive tax expenditure reports	
Alabama	No (a)
Arkansas	No (a)
Florida	Yes
Georgia	No
Kentucky	Yes
Louisiana	Yes
Mississippi	Yes (b)
North Carolina	Yes
South Carolina	No
Tennessee	Yes
Virginia	No (a)

Sources: Author's research and information provided by Michael Mazerov, Center on Budget and Policy Priorities

(a) Limited to sales tax.
(b) Hard-copy only.

Across the U.S., 38 states had some form of *tax expenditure* report in 2004. In the South, six states have comprehensive *tax expenditure* reports and three have reports limited to sales *tax expenditures.* Georgia and South Carolina are the only two Southern states without a *tax expenditure* report.

Each state has a different method of reporting *tax expenditures*. The most basic examples include a list of credits and the cost of each credit. Other reports provide more detail, such as number of jobs created and number of businesses using the credit. Some even provide company-specific detail, known as disclosure reports, to show who receives the tax break and what that specific tax break is. North Carolina's "William S. Lee" tax credits have such a disclosure report that annually lists the number and location of jobs created and provides the information online.[1]

Louisiana offers an annual Tax Exemption Budget, which recognizes the concept that tax breaks should be considered a budget item by policymakers.

Louisiana's Tax Exemption Budget offers an example for Southern states to follow.[2] Louisiana requires the annual report by state law and includes valuable data, such as purpose of each exemption and a five-year estimated revenue loss. Additional features of Louisiana's report are an overview of report methodology, a summary of *tax expenditures* and a detailed description of each *tax expenditure*.[3] It is worth noting that Louisiana uses the word "budget" in the title of its report as it brings to the forefront the concept of tax breaks as a budget item. These tax exemptions represent spending through the tax system on special purposes, businesses or individuals. Without them, the state would have additional revenues to spend through the regular budgeting process.

By requiring annual *tax expenditure* reports, Southern states would bring tax spending into the budget process. Those states that already mandate such reports can make improvements, such as including all credits and expenditures, not just sales. They also can analyze the effectiveness of such exemptions and study who the expenditures benefit as done in Texas. Equally important, *tax expenditure* reports should be made accessible to legislators and the public, as North Carolina does online.

Other accountability measures

In addition to annual *tax expenditure* reports, states can improve their tax exemption process by including provisions in tax credit and exemption legislation.

- **Sunset dates.** States can include sunset dates in legislation to provide a specific time period for a tax credit to be available. When the sunset date arrives, legislators then will be required to revisit the credit or exemption and pass new legislation to continue it. Having this provision will ensure credits and exemptions are not left on the books forever and that each exemption is continually debated and studied, just as all appropriations in a state's budget are reviewed annually.

- **Expenditure caps.** A second measure to limit the use of *tax expenditure*s and control the cost is an expenditure cap. Legislation proposing a new tax credit can include an expenditure cap that limits the amount of revenue that can be lost to a certain credit.

- **Evaluation.** Finally, *tax expenditures* should include evaluation measures, which will provide data on the effectiveness of the program when the credit is reevaluated at the sunset date. Evaluation is a key component of good accountability in *tax expenditure* legislation since it provides evidence of what is working and what is not.

An example of recent legislation containing all three provisions is Georgia's telework tax credit from the 2006 legislative session. This program offers businesses an income tax credit for certain expenses relating to teleworking employees. The legislation included a two-year sunset date, a $2 million expenditure cap and an incentive for evaluation and assessment of telework programs.[4] Through these measures, the state ensured it would not lose more than $2 million in revenues and the credit will be reevaluated in two years. If the credit proves to be worth the cost, policymakers in Georgia may propose legislation to continue the program for another specified amount of time and cost.

Other tools: Job-quality standards and clawback provisions

Other reform measures to increase accountability are more deal- or company-specific. Legislation on *tax expenditures* for companies can include measures to encourage the creation of good jobs and to protect government subsidies. Job-quality standards are a requirement for corporate tax credits in many states. They require that jobs have a specific level of income or wages for employers to qualify for the tax credit. Health care standards can also be a job-quality standard required for such credits.

To protect government subsidies, deals can include so-called "clawback provisions," which are money-back guarantees that assure government will receive its expenditures back if a deal falls through or a company leaves. Examples of clawback provisions are those in Georgia's Business Expansion Tax Credit program, North Carolina's Job Development Investment Grant, South Carolina's Economic Impact Zone Investment Tax Credit and Virginia's Major Business Facility Job Tax Credit.[5] Clawback provisions and job-quality standards promote accountability within each deal and further protect taxpayers' money.

Making government more accountable

States spend hundreds of millions of dollars every year through the tax system. Tax credits, deductions and exemptions are all considered *tax expenditures* because they cause a decrease in revenues. These large expenses can go undocumented if states do not implement annual *tax expenditure* reports to track the cost of each of program.

Like budget items, tax spending should be accounted for and should be debated as to the effectiveness and need for the myriad of credits and exemptions. Other accountability measures, such as job-quality standards and clawback provisions, should also be implemented to ensure all credit and exemption programs fulfill the goals of the state and are limited to a desired time and cost.

Talking points

- While Southern states offer annual budgets for spending, they generally don't provide as good of information on the revenues they're missing because of public policy decisions that created corporate, sales and other tax credits, breaks and exemptions.

- To be more responsive to lawmakers and the public, states should annually publish a report that highlights all *tax expenditures*—the revenues they're missing from tax incentives, tax credits, tax breaks, exemptions and other measures.

- By providing *tax expenditure* information, a state's tax system will become more transparent. And if lawmakers better understand the effects of providing *tax expenditure*s, they likely will discover opportunities and better be able to rethink their state's public policy on taxes to be fairer to all.

- Just as lawmakers discuss the state budget annually, they should review state tax breaks annually to provide better value and management for taxpayers.

Endnotes

[1] Good Jobs First. "Company-Specific Subsidy Disclosure in States." September 2005.
[2] Richie, Clare S. "Show Us the Money: Full Disclosure on Needed on Tax Breaks." Georgia Budget and Policy Institute. November 2004.
[3] Richie (2004)
[4] Georgia General Assembly. "House Bill 194." 2005-2006 Legislative Session.
[5] Good Jobs First. "Examples of Clawback Provisions in State Subsidy Programs." September 2005.

Idea 11

Conduct performance reviews

Each Southern state should conduct a comprehensive performance review to boost government efficiency, save money and improve customer service.

Background

While Southern states should strive to have fair, equitable and efficient revenue collection systems, they also need to ensure that state spending is as efficient as possible. Many Southern states have management practices that have not been updated in 40 or 50 years. Using 20th century management practices in the 21st century not only leads to inefficient and wasteful spending, but citizens receive poor results from state government. As private businesses have been forced to examine management practices to remain competitive in the 21st century, state governments, especially the fast-growing states of the South, need to examine their management practices to ensure taxpayer dollars are not wasted and state programs achieve the desired results. To do otherwise is fiscally unsound and wasteful.

Working to maximize efficient management practices is more than a practice for states to get rid of "waste, fraud and abuse." Tight budgets over the past few years have done much to root out the "fat" in state agencies. State legislators need to move beyond the negative assumption that state agencies waste taxpayer funds through fraud or incompetence. Instead, they should focus more on the positive mission of fundamentally improving overall performance and results. Modern and flexible management practices that strive to fulfill core agency missions successfully need to become the permanent culture of state governments.

It's time for states to get beyond simplistic calls to rid government of "waste, fraud and abuse." States should take a much deeper look at core government functions to improve performance and results through better and more flexible management practices.

Performance review models

Performance reviews originated in Texas in 1991 as a management tool to review government functions to find savings, remove duplication, improve government efficiency and provide better service to state residents. In Texas, the state auditor undertook the first comprehensive state *performance review* with a staff specifically dedicated to questioning the premises of every agency program in Texas. The effort produced 1,000 recommendations and resulted in $4 billion in savings in its first budget. Since then, the

Texas Performance Review has been institutionalized and has produced total savings of $13 billion over the past 10 years. Recently the responsibility for the Texas Performance Review moved from the State Comptroller to the Legislative Budget Board.

More recently, several states have implemented *performance review* commissions and task forces that have resulted in hundreds of millions of dollars in savings, and, more importantly, improved services through the modernization of management practices. The most successful of these states have permanently incorporated these commissions and task forces into the budget making process. These are not one-time entities, but a positive and permanent part of state government. Two recent examples of successful models are the *Commission for a New Georgia* and the *New Mexico Performance Review*.

Case study: Georgia

The Commission for a New Georgia[1] is a non-profit corporation established in 2003. It is led by 27 CEOs and senior executives from throughout Georgia and includes 18 task forces employing more than 300 experts from the public and private sectors. Each of the task forces convened for 60 to 90 days and then produced a final report and recommendations. An Office of Implementation that reports directly to the governor was established in August 2004 to ensure the recommendations of the Commission for a New Georgia were implemented.

Commission for A New Georgia Task Forces

Tourism	Receivables	Procurement
Space Management	Fleet Management I	Fleet Management II
Competitiveness	Capitol Construction	Administrative Services
Eminent Scholars	Workforce Development	Strategic Industries
Public Finance Options	Community Care	Leadership Development
Telecommunications and Technology	Customer Service	State Health Benefits Plan

Recommendations from The Commission for A New Georgia have resulted in four pieces of legislation that have been adopted by the Georgia General Assembly.

- **Administrative Services and Procurement** (HB 312)—Initiated changes to help transform the state's procurement function and improve the management of the state's assets, including motor vehicles. It is estimated this legislation will help capture an estimated $135 million in procurement saving and contribute to the elimination of an estimated 2,000 state vehicles.

- **Capital Asset Management** (SB 158)—Provided for the comprehensive revision of the State's capital asset management structure. It is estimated savings will total $32 million.

- **New Georgia Foundation for Tourism Act** (SB 125)—Created the New Georgia Foundation for Tourism to coordinate marketing efforts and consolidate funding to improve the promotion of the state's tourism resources.

- **Deferred Compensation Transfer** (HB 275)—Transferred employee deferred compensation programs from the Georgia Merit System to the Employees' Retirement System to consolidate administration and expertise.

Implementation of the Commission for a New Georgia initiatives includes:

- A reduction of over 1,770 state vehicles for a projected operating cost savings of $4.3 million;
- The sale of more than $5.6 million in surplus equipment and vehicles;
- The appointment of the first State Property Officer, who sold more than $14 million in surplus land and buildings, and renegotiated leases resulting in a savings of $5.6 million;
- The development of the first comprehensive State Construction Manual. Processes have not been updated since 1954. It is estimated new processes will result in savings of between $12 million and $60 million per year;
- A savings of more than $1.6 million in energy rates through correction of over-billings and rate changes; and
- The modernization of state purchasing management processes and technology for a projected savings of $135 million over four years.

Case study: New Mexico

New Mexico Gov. Bill Richardson established the New Mexico Performance Review through executive order in May 2003. The state Department of Finance and Administration, with the help of a private contractor, coordinated the work of eight teams made up of private-sector consultants and state employees. The *performance review* evaluated state government services, alternative ways to deliver services and organizational structures. The goal of the Performance Review was to identify key issues and opportunities, and to implement recommendations to improve service delivery and reduce costs.

New Mexico projects savings of $469 million by 2009 due to its two-part *performance review* process.

New Mexico Performance Review Teams

Criminal Justice	Information Technology and Telecommunication Management	Health and Human Services
Alpha	Transportation	Human Resources
Contract Management	Fiscal Implications Review	Reorganization

The Performance Review delivered its first report, *Moving New Mexico Forward*, in August 2003, followed by a second report, *Moving New Mexico Forward: Further Along*, in August 2004. *Moving New Mexico Forward* featured 92 specific recommendations with an estimated savings of $379 million between 2004 and 2008.[2] Eighty of the 92 recommendations have been implemented and more than $75 million in savings were identified in the first year. *Moving New Mexico Forward: Further Along* contained an additional 56 recommendations totaling more than $90 million between 2005 and 2009.[3]

Projected savings from the New Mexico Performance Review through 2009 include:

- $16 million through retrofitting fixtures to achieve energy cost savings;
- $9.8 million through an automated state employee time and attendance system;
- $7.8 million through increased use of procurement cards;
- $7.1 million through improved contract management;
- $6.5 million through the implementation of workforce planning and a reduction of manager to staff ratios;
- $6.1 million through consolidation of Information Technology Services; and
- $2.5 million through increased on-line tax filing.

Performance reviews can save money, promote efficiencies

Not only should Southern lawmakers insist that state governments develop a fair and efficient tax system, they should demand that state government spend revenues in as efficient and effective manner as possible. State governments need to move beyond the negative assumption that state agencies are wasting taxpayer funds through fraud or incompetence. Instead, they should focus on the positive mission of fundamentally improving overall performance and results.

The formation of task forces or commissions that continuously undertake in-depth professional and highly-sourced studies of state management practices will help ensure that state tax dollars are spent in the most efficient and effective manner. Such task forces and commissions must be staffed by professionals, not by personnel who do not have the skills and expertise necessary to undertake the studies and analysis. Governors and state legislatures must give such task forces and commissions the resources and political support needed to succeed.

> **If state lawmakers give the resources and political support to a real *performance review* effort, they're almost guaranteed to generate millions of dollars of savings, improve services to residents and make government work better for everyone.**

Lawmakers should keep in mind that these commissions and task forces must not be used as an excuse to cut programs for policy or ideological reasons. Instead they should focus on ensuring the excellence of government services.

States should set up a permanent *performance review* entity that includes private sector expertise, a full-time professional state staff and a detailed implementation plan linked to the state budget process. Getting started in such a way will promote success.

Every dollar Southern states spend unwisely due to inefficient or wasteful management practices left over from the 20th century is a dollar that could be invested in the physical and human infrastructure that Southern states need to be competitive in the 21st century.

Figure 1: Performance reviews in the South within the last 5 years

Alabama	No
Arkansas	No
Florida	See note
Georgia	Yes
Kentucky	No
Louisiana	No
Mississippi	No
North Carolina	Yes
South Carolina	Yes
Tennessee	No
Virginia	Yes

Source: Author's research
Note: A constitutional amendment will be on Florida's ballot in 2006 to establish a Government Efficiency Task Force.

Talking points

- Much of the so-called "waste, fraud and abuse" often cited by politicians has been cut out of state government after state policymakers grappled with lean budgets, trimmed agencies, limited functions and cut fat from the system over the last few years.

- Now legislators need to take a positive approach to providing better service, more efficient government and more effective government—as well as find millions in savings—by implementing a 21st century management tool known as a *performance review*.

- If lawmakers give the *performance review* process a chance with political support and by investing resources, they're almost guaranteed to succeed in making government more effective and efficient, improving customer service and saving money.

- To fail to invest in a *performance review* fails taxpayers. Not conducting a professional review will cost taxpayers millions of dollars. It's a wise political and policy decision to undertake this kind of performance audit.

Endnotes

1 Commission for a New Georgia Home page - *http://www.new-georgia.org/index.shtml*

2 "Moving New Mexico Forward: A Report From the New Mexico Performance Review." August 2003. *http://www.governor.state.nm.us/perfreview/MAF.pdf*

3 "Moving New Mexico Forward: Further Along A Report From the New Mexico Performance Review." August 2004. *http://www.governor.state.nm.us/perfreview/MAF%20Further%20Along.pdf*

States at a glance scorecards

ALABAMA AT A GLANCE:

Alabama has a long way to go to create a truly progressive tax structure. It should, however, be lauded for curbing some corporate tax loopholes and taking some steps to improve accountability.

Has the state…	YES	NO	More Work Needed
1. Broadened sales tax base?		☒	🕘
2. Modernized sales taxes?		☒	🕘
3. Raised cigarette tax to US average?		☒	🕘
4. Enacted Earned Income Tax Credit?		☒	🕘
5. Modernized income tax bracket?	✔		🕘
6. Dealt with hidden income tax increases?		☒	🕘
7. Rethought senior tax preferences?		☒	🕘
8. Eliminated corporate loopholes?	✔		🕘
9. Linked property taxes and ability to pay?		☒	🕘
10. Strengthened accountability?	✔		🕘
11. Conducted a performance review?		☒	🕘

A better Alabama…

Idea 1: Broaden the sales tax base. Alabama should abolish its sales tax holiday and review sales tax exemptions to eliminate those that don't meet contemporary economic needs. Its new sales tax holiday will cost an estimated $3.4 million.

Idea 2: Modernize sales taxes for the new economy. Alabama should modernize its policy on taxing services. In 2004, it taxed 37 out of 168 possible services. It also should approve the Streamlined Sales and Use Tax Agreement.

Idea 3: Raise cigarette taxes to promote public health. Alabama should raise its 43-cent-per-pack cigarette tax to the national average of $0.92 per pack to reduce smoking and promote public health. Research shows that doing so likely would cause 16,600 current adult smokers to quit. Long-term health savings from both adult and youth smoking declines would be $584 million.

Idea 4: Enact a state Earned Income Tax Credit. Alabama should enact a refundable earned income tax credit to help bring working families' incomes above poverty. Some 473,872 Alabama taxpayers in 2003 claimed the federal earned income tax credit for a total of $966,598,821. A refundable state EITC would cost an estimated $95 million if set at 10 percent of the federal credit.

Idea 5: Modernize state income brackets. Although Alabama modernized part of its income tax structure in 2006, it failed to expand its income tax brackets or create a new top tax rate. Alabama's top tax bracket is 5 percent for income over $3,000 for single filers.

Idea 6: Account for inflation. Alabama should enact strategies to adjust taxes for inflation. The state does not index personal exemptions, standard deductions or brackets for inflation.

Idea 7: Rethink senior tax preferences. Alabama should redesign tax codes to provide fair relief to seniors based on *ability-to-pay* instead of age alone. The state, which will grow to having a senior population of 21 percent in 2030, currently provides seniors with a full exemption for Social Security income, a private pension income exemption and property tax preferences.

Idea 8: Eliminate corporate tax loopholes. While Alabama does not require combined reporting, it does restrict the use of the passive investment company (or Delaware-holding company) loophole. In addition, Alabama is one of the few Southern states to enact a throwback rule.

Idea 9: Connect property taxes and *ability-to-pay*. If Alabama insists on property tax reform, it should use a property tax circuit breaker to shield residents from excessive taxation and connect property taxes with *ability-to-pay*. The state had the lowest property taxes in the nation when measured per capita and as a percent of personal income in 2002.

Idea 10: Strengthen accountability. Alabama has a tax expenditure report, but it is limited to sales. Alabama should work to incorporate all tax expenditures into an annual report that includes cost projections and is readily available to lawmakers and the public.

Idea 11: Review the performance of government. Alabama should conduct a comprehensive performance review to boost government efficiency, save money and improve customer service. The state has not done a statewide performance review in the last five years.

ARKANSAS AT A GLANCE:

Arkansas taxes a greater number of services than most Southern states. But other components of its tax system are ripe for modernization. It should consider broadening income tax brackets and enacting a refundable state Earned Income Tax Credit.

Has the state…	YES	NO	More Work Needed
1. Broadened sales tax base?		☒	🕛
2. Modernized sales taxes?	✔		
3. Raised cigarette tax to US average?		☒	🕛
4. Enacted Earned Income Tax Credit?		☒	🕛
5. Modernized income tax bracket?		☒	🕛
6. Dealt with hidden income tax increases?	✔		🕛
7. Rethought senior tax preferences?		☒	🕛
8. Eliminated corporate loopholes?	✔		🕛
9. Linked property taxes and ability to pay?		☒	🕛
10. Strengthened accountability?	✔		🕛
11. Conducted a performance review?		☒	🕛

A better Arkansas…

Idea 1: Broaden the sales tax base. Arkansas should review sales tax exemptions to eliminate those that don't meet contemporary economic needs. Arkansas is one of the few Southern states without a sales tax holiday.

Idea 2: Modernize sales taxes for the new economy. Arkansas is one of the few Southern states to tax more services than the national average. In 2004, it taxed 72 out of 168 possible services.

Idea 3: Raise cigarette taxes to promote public health. Arkansas should raise its 59-cent-per pack cigarette tax to the national average of $0.92 per pack to reduce smoking and promote public health. Research shows that doing so likely would cause 7,100 current adult smokers to quit. Long-term health savings from both adult and youth smoking declines would be $271 million.

Idea 4: Enact a state Earned Income Tax Credit. Arkansas should enact a refundable earned income tax credit to help to bring working families' incomes above poverty. Some 272,269 Arkansas taxpayers in 2003 claimed the federal earned income tax credit for a total of $520,673,980. A refundable state EITC would cost an estimated $51 million if set at 10 percent of the federal credit.

Idea 5: Modernize state income brackets. Arkansas should modernize its income tax structure by broadening brackets and considering the creation of a new top rate to provide progressive balance. The state's top tax bracket is 7 percent for income $29,200 and above for single filers.

Idea 6: Account for inflation. Deal with hidden income tax increases. Arkansas should enact additional strategies to adjust taxes for inflation to promote long-term *fairness* and reduce back-door inflationary tax hikes. It currently indexes part of its income tax system, its tax brackets and a tax credit.

Idea 7: Rethink senior tax preferences. Arkansas should redesign tax codes to provide fair relief to seniors based on *ability-to-pay* instead of age alone. The state, which will grow to having an estimated senior population of 20.3 percent in 2030, currently provides seniors with a full exemption for Social Security income and a private pension income exemption.

Idea 8: Eliminate corporate tax loopholes. While Arkansas does not require combined reporting, it does restrict the use of the passive investment company (or Delaware-holding company) loophole. In addition, Arkansas is one of the few Southern states to enact a throwback rule.

Idea 9: Connect property taxes and *ability-to-pay*. If Arkansas insists on property tax reform, it should use a property tax circuit breaker to shield residents from excessive taxation and connect property taxes with *ability-to-pay*. The state had the second lowest per capita property taxes in the nation in 2002.

Idea 10: Strengthen accountability. Arkansas has a tax expenditure report, but it is limited to sales. Arkansas should work to incorporate all tax expenditures into an annual report that includes cost projections and is readily available to lawmakers and the public.

Idea 11: Review the performance of government. Arkansas should conduct a comprehensive performance review to boost government efficiency, save money and improve customer service. Arkansas performed a performance review of its health spending in the last five years, but has not done a statewide performance review.

FLORIDA AT A GLANCE:

Florida taxes a greater number of services than most Southern states and has a tax expenditure report for accountability. But Florida lacks the progressive element of income taxes and should consider the benefits of enacting one.

Has the state…	YES	NO	More Work Needed
1. Broadened sales tax base?		☒	🕘
2. Modernized sales taxes?	✔		🕘
3. Raised cigarette tax to US average?		☒	🕘
4. Enacted Earned Income Tax Credit?	n/a	n/a	🕘
5. Modernized income tax bracket?	n/a	n/a	🕘
6. Dealt with hidden income tax increases?	n/a	n/a	🕘
7. Rethought senior tax preferences?	n/a	n/a	🕘
8. Eliminated corporate loopholes?		☒	🕘
9. Linked property taxes and ability to pay?	✔		🕘
10. Strengthened accountability?	✔		
11. Conducted a performance review?		☒	🕘

A better Florida…

Idea 1: Broaden the sales tax base. Florida should abolish sales tax holidays and review sales tax exemptions to eliminate those that don't meet contemporary economic needs. The back-to-school holiday cost Florida an estimated $31.2 million in 2005.

Idea 2: Modernize sales taxes for the new economy. Florida should continue to modernize its policy on taxing services. In 2004, it taxed 62 out of 168 possible services, above the national average. It also should approve the Streamlined Sales and Use Tax Agreement.

Idea 3: Raise cigarette taxes to promote public health. Florida should raise its 34-cent-per pack cigarette tax to the national average of $0.92 per pack to reduce smoking and promote public health. Research shows that doing so would likely cause 70,700 current adult smokers to quit. Long-term health savings from both adult and youth smoking declines would be $2.3 billion.

Idea 4: Enact a state Earned Income Tax Credit.
Idea 5: Modernize state income brackets.
Idea 6: Account for inflation.
Idea 7: Rethink senior tax preferences.

Since Florida is one of only two Southern states that do not have a broad-based personal income tax, the state may want to consider an income tax to boost *progressivity*. Adding an income tax could allow the state to reduce its relatively high sales tax. In considering the creation of an income tax, Florida should strive to design a modern, fair tax that includes such aspects as a refundable EITC, broad brackets, inflation adjustments and relief based on *ability-to-pay* rather than age.

Idea 8: Eliminate corporate tax loopholes. Florida should review and update its corporate income tax structure to eliminate tax loopholes and promote *fairness*. In the 1980s, Florida removed combined reporting requirements and a throwback rule in exchange for a higher corporate tax rate.

Idea 9: Connect property taxes and *ability-to-pay*. If Florida insists on property tax reform, it should use a property tax circuit breaker to shield residents from excessive taxation and connect property taxes with *ability-to-pay*. While Florida levies the highest property taxes per capita and as a percent of income in the South, it also has a property tax deferral program similar to a circuit breaker. The program restricts taxes to a certain level of income, but taxes that exceed the circuit breaker level must be repaid at some point.

Idea 10: Strengthen accountability. Florida publishes a tax expenditure report.

Idea 11: Review the performance of government. Florida has a constitutional amendment on its 2006 ballot to establish a Government Efficiency Task Force. If created, this Task Force should conduct a comprehensive performance review to boost government efficiency, save money and improve customer service. If not, the state should take other steps to conduct the review.

GEORGIA AT A GLANCE:

Georgia has a long way to go to create a truly progressive tax structure. It has partially curbed corporate tax loopholes and has initiated a comprehensive performance review. But the Peach State needs to take other steps, such as reforming tax brackets and expanding the sales tax base.

Has the state…	YES	NO	More Work Needed
1. Broadened sales tax base?		☒	🕛
2. Modernized sales taxes?		☒	🕛
3. Raised cigarette tax to US average?		☒	🕛
4. Enacted Earned Income Tax Credit?		☒	🕛
5. Modernized income tax bracket?		☒	🕛
6. Dealt with hidden income tax increases?		☒	🕛
7. Rethought senior tax preferences?		☒	🕛
8. Eliminated corporate loopholes?	✔		🕛
9. Linked property taxes and ability to pay?		☒	🕛
10. Strengthened accountability?		☒	🕛
11. Conducted a performance review?	✔		

A better Georgia…

Idea 1: Broaden the sales tax base. Georgia should abolish sales tax holidays and review sales tax exemptions to eliminate those that don't meet contemporary economic needs. In 2006, the holiday will cost the state an estimated $11.3 million and will cost local governments $8.5 million.

Idea 2: Modernize sales taxes for the new economy. Georgia should modernize its policy on taxing services. In 2004, it taxed 36 out of 168 possible services. It also should approve the Streamlined Sales and Use Tax Agreement.

Idea 3: Raise cigarette taxes to promote public health. Georgia should raise its 37-cent-per-pack cigarette tax to the national average of $0.92 per pack to reduce smoking and promote public health. Research shows that doing so would likely cause 29,600 current adult smokers to quit. Long-term health savings from both adult and youth smoking declines would be $1.17 billion.

Idea 4: Enact a state Earned Income Tax Credit. Georgia should enact a refundable earned income tax credit to help to bring working families' incomes above poverty. Some 800,957 Georgia taxpayers in 2003 claimed the federal earned income tax credit for a total of $1,567,024,328. A refundable state EITC would cost an estimated $159 million if set at 10 percent of the federal credit.

Idea 5: Modernize state income brackets. Georgia should modernize its income tax structure by broadening brackets and consider the creation of a new top rate to provide progressive balance. The state's top tax bracket is 6 percent for income $7,000 and above for single filers. Brackets haven't been altered significantly since 1937.

Idea 6: Account for inflation. Georgia should enact strategies to adjust taxes for inflation to promote long-term *fairness* and reduce back-door inflationary tax hikes. Georgia does not index personal exemptions, standard deductions, brackets or tax credits for inflation.

Idea 7: Rethink senior tax preferences. Georgia should redesign tax codes to provide fair relief to seniors based on *ability-to-pay* instead of age alone. The state, which will grow to having an estimated senior population of 15.9 percent in 2030, currently provides seniors with a full exemption for Social Security income, a private pension income exemption, an additional deduction/exemption, and property tax preferences.

Idea 8: Eliminate corporate tax loopholes. While Georgia does not require combined reporting, it does restrict the use of the passive investment company (or Delaware-holding company) loophole. Georgia does not, however, have a throwback rule.

Idea 9: Connect property taxes and *ability-to-pay*. If Georgia insists on property tax reform, it should use a property tax circuit breaker to shield residents from excessive taxation and connect property taxes with *ability-to-pay*.

Idea 10: Strengthen accountability. Georgia should annually publish a comprehensive tax expenditure report to provide more accountability and information to lawmakers so they can make better-informed decisions.

Idea 11: Review the performance of government. Georgia initiated a performance review through the Commission for a New Georgia in 2003. Such studies are helpful to policymakers because they boost government efficiency, save money and improve customer service.

KENTUCKY AT A GLANCE:

Kentucky has taken progressive steps by modernizing income tax brackets, curbing corporate tax loopholes and publishing an annual tax expenditure report. But the state should look to broaden and modernize its sales tax, as well as enact a state Earned Income Tax Credit.

Has the state…	YES	NO	More Work Needed
1. Broadened sales tax base?		☒	🕒
2. Modernized sales taxes?	✔		🕒
3. Raised cigarette tax to US average?		☒	🕒
4. Enacted Earned Income Tax Credit?		☒	🕒
5. Modernized income tax bracket?	✔		🕒
6. Dealt with hidden income tax increases?		☒	🕒
7. Rethought senior tax preferences?		☒	🕒
8. Eliminated corporate loopholes?	✔		🕒
9. Linked property taxes and ability to pay?		☒	🕒
10. Strengthened accountability?	✔		
11. Conducted a performance review?		☒	🕒

A better Kentucky…

Idea 1: Broaden the sales tax base. Kentucky should review sales tax exemptions to eliminate those that don't meet contemporary economic needs. Kentucky is one of the few Southern states without a sales tax holiday.

Idea 2: Modernize sales taxes for the new economy. Kentucky should modernize its policy on taxing services. In 2004, it taxed 29 out of 168 possible services.

Idea 3: Raise cigarette taxes to promote public health. Kentucky should raise its 30-cent-per-pack cigarette tax to the national average of $0.92 per pack to reduce smoking and promote public health. Research shows that doing so would likely cause 23,700 current adult smokers to quit. Long-term health savings from both adult and youth smoking declines would be $845.8 million.

Idea 4: Enact a state Earned Income Tax Credit. Kentucky should enact a refundable earned income tax credit to help to bring working families' incomes above poverty. Some 335,477 Kentucky taxpayers in 2003 claimed the federal earned income tax credit for a total of $580,496,974. A refundable state EITC would cost an estimated $57 million if set at 10 percent of the federal credit.

Idea 5: Modernize state income brackets. Kentucky reformed its tax brackets in 2005, making the top rate (6 percent) begin at $75,000 rather than $8,000 for single filers. However, the state added a new rate of 5.8 percent at $8,000, diminishing a portion of the gains from the expanded brackets. Kentucky should consider further modernizing its brackets and rates.

Idea 6: Account for inflation. Kentucky should enact strategies to adjust taxes for inflation to promote long-term *fairness* and reduce back-door inflationary tax hikes. Kentucky does not index personal exemptions, standard deductions, credits or brackets for inflation.

Idea 7: Rethink senior tax preferences. Kentucky should redesign tax codes to provide fair relief to seniors based on *ability-to-pay* instead of age alone. The state, which will grow to having an estimated senior population of 19.8 percent in 2030, currently provides seniors with a full exemption for Social Security income, a private pension income exemption and property tax preferences.

Idea 8: Eliminate corporate tax loopholes. While Kentucky does not require combined reporting, it does restrict the use of the passive investment company (or Delaware-holding company) loophole. Kentucky does not, however, have a throwback rule.

Idea 9: Connect property taxes and *ability-to-pay*. If Kentucky insists on property tax reform, it should use a property tax circuit breaker to shield residents from excessive taxation and connect property taxes with *ability-to-pay*. Kentucky had the 6th lowest property taxes in the nation when measured per capita and the 8th lowest as a percent of personal income in 2002.

Idea 10: Strengthen accountability. Kentucky currently has an annual tax expenditure report.

Idea 11: Review the performance of government. Kentucky should conduct a comprehensive performance review to boost government efficiency, save money and improve customer service. Kentucky hasn't conducted a statewide performance review in the last five years.

LOUISIANA AT A GLANCE:

Louisiana has a long way to go to create a truly progressive tax structure. It should broaden and modernize its sales tax base, close corporate loopholes and enact a refundable state Earned Income Tax Credit.

Has the state…	YES	NO	More Work Needed
1. Broadened sales tax base?		☒	🕘
2. Modernized sales taxes?		☒	🕘
3. Raised cigarette tax to US average?		☒	🕘
4. Enacted Earned Income Tax Credit?		☒	🕘
5. Modernized income tax bracket?		☒	🕘
6. Dealt with hidden income tax increases?		☒	🕘
7. Rethought senior tax preferences?		☒	🕘
8. Eliminated corporate loopholes?		☒	🕘
9. Linked property taxes and ability to pay?		☒	🕘
10. Strengthened accountability?	✔		
11. Conducted a performance review?		☒	🕘

A better Louisiana…

Idea 1: Broaden the sales tax base. Louisiana should abolish sales tax holidays and review sales tax exemptions to eliminate those that don't meet contemporary economic needs. Louisiana had a sales tax holiday in December 2005 that cost $10.1 million. It is unclear whether the Pelican State will make it annual.

Idea 2: Modernize sales taxes for the new economy. Louisiana should modernize its policy on taxing services. In 2004, it taxed 55 out of 168 possible services. It also should approve the Streamlined Sales and Use Tax Agreement.

Idea 3: Raise cigarette taxes to promote public health. Louisiana should raise its 36-cent-per-pack cigarette taxes to the national average of $0.92 per pack to reduce smoking and promote public health. Research shows that doing so would likely cause 18,800 current adult smokers to quit. Long-term health savings from both adult and youth smoking declines would be $716.2 million.

Idea 4: Enact a state Earned Income Tax Credit. Louisiana should enact a refundable earned income tax credit to help to bring working families' incomes above poverty. Some 522,367 Louisiana taxpayers in 2003 claimed the federal earned income tax credit for a total of $1,099,107,340. A refundable state EITC would cost an estimated $108 million if set at 10 percent of the federal credit.

Idea 5: Modernize state income brackets. In 2003, Louisiana reformed its income tax brackets by expanding the lowest bracket and lowering the top bracket to $25,000 for single filers. While other changes to the income tax structure balanced this reform, Louisiana's brackets are now narrower than before.

Idea 6: Account for inflation. Louisiana should enact strategies to adjust taxes for inflation to promote long-term *fairness* and reduce back-door inflationary tax hikes. Louisiana does not index personal exemptions, standard deductions, credits or brackets for inflation.

Idea 7: Rethink senior tax preferences. Louisiana should redesign tax codes to provide fair relief to seniors based on *ability-to-pay* instead of age alone. The state, which will grow to having an estimated senior population of 19.7 percent in 2030, currently provides seniors with a full exemption for Social Security income, a private pension income exemption and an additional deduction/exemption.

Idea 8: Eliminate corporate tax loopholes. Louisiana should review and update its corporate income tax structure to eliminate tax loopholes and promote *fairness*. It should enact combined reporting and a throwback rule.

Idea 9: Connect property taxes and *ability-to-pay*. If Louisiana insists on property tax reform, it should use a property tax circuit breaker to shield residents from excessive taxation and connect property taxes with *ability-to-pay*. Louisiana had the 5th lowest per capita property taxes in the nation and the 7th lowest as a percent of personal income in 2002.

Idea 10: Strengthen accountability. Louisiana currently has an annual tax expenditure report.

Idea 11: Review the performance of government. Louisiana should conduct a comprehensive performance review to boost government efficiency, save money and improve customer service. Louisiana hasn't conducted a statewide performance review in the last five years.

MISSISSIPPI AT A GLANCE:

Mississippi's tax system benefits from a broader sales tax base than most other Southern states. But its income tax is far from modern with its relatively low top rate, narrow brackets and lack of a refundable earned income tax credit.

Has the state...	YES	NO	More Work Needed
1. Broadened sales tax base?		☒	🕘
2. Modernized sales taxes?	✔		🕘
3. Raised cigarette tax to US average?		☒	🕘
4. Enacted Earned Income Tax Credit?		☒	🕘
5. Modernized income tax bracket?		☒	🕘
6. Dealt with hidden income tax increases?		☒	🕘
7. Rethought senior tax preferences?		☒	🕘
8. Eliminated corporate loopholes?	✔		🕘
9. Linked property taxes and ability to pay?		☒	🕘
10. Strengthened accountability?	✔		🕘
11. Conducted a performance review?		☒	🕘

A better Mississippi...

Idea 1: Broaden the sales tax base. Mississippi should review sales tax exemptions to eliminate those that don't meet contemporary economic needs. Mississippi is one of the few Southern states without a sales tax holiday.

Idea 2: Modernize sales taxes for the new economy. Mississippi should continue to modernize its policy on taxing services. In 2004, it taxed 74 out of 168 possible services, above the national average. It also should approve the SSUTA.

Idea 3: Raise cigarette taxes to promote public health. Mississippi should raise its 18-cent-per-pack cigarette tax to the national average of $0.92 per pack to reduce smoking and promote public health. Research shows that doing so would likely cause 17,700 current adult smokers to quit. Long-term health savings from smoking declines are estimated to be $742.1 million.

Idea 4: Enact a state Earned Income Tax Credit. Mississippi should enact a refundable earned income tax credit to help to bring working families' incomes above poverty. Some 366,518 Mississippi taxpayers in 2003 claimed the federal earned income tax credit for a total of $768,994,361. A refundable state EITC would cost an estimated $75 million if set at 10 percent of the federal credit.

Idea 5: Modernize state income brackets. Mississippi should modernize its income tax structure by broadening brackets and consider the creation of a new top rate to provide progressive balance. The state's top tax bracket is 5 percent for income $10,000 and above for single filers.

Idea 6: Account for inflation. Mississippi should enact strategies to adjust taxes for inflation to promote long-term *fairness* and reduce back-door inflationary tax hikes. The state does not index personal exemptions, standard deductions, credits or brackets for inflation. The state did not tax poor households in 2004, but did in 2005 because its income tax system does not automatically adjust for inflation.

Idea 7: Rethink senior tax preferences. Mississippi should redesign tax codes to provide fair relief to seniors based on *ability-to-pay* instead of age alone. The state currently provides seniors with a full exemption for Social Security income, a private pension income exemption, an additional deduction/exemption, and property tax preferences.

Idea 8: Eliminate corporate tax loopholes. While Mississippi does not require combined reporting, it does restrict the use of the passive investment company (or Delaware-holding company) loophole. In addition, Mississippi is one of the few Southern states to enact a throwback rule.

Idea 9: Connect property taxes and *ability-to-pay*. If Mississippi insists on property tax reform, it should use a property tax circuit breaker to shield residents from excessive taxation and connect property taxes with *ability-to-pay*. Mississippi had the 10th lowest per capita property taxes in the nation and the 15th lowest as a percent of personal income in 2002.

Idea 10: Strengthen accountability. Mississippi currently has an annual tax expenditure report. It is important for it to be made easily accessible to the public.

Idea 11: Review the performance of government. Mississippi should conduct a comprehensive performance review to boost government efficiency, save money and improve customer service. Mississippi has not conducted a comprehensive statewide performance review over the last five years.

NORTH CAROLINA AT A GLANCE:

North Carolina has an income tax system that reflects today's incomes, but needs a refundable earned income tax credit and inflation adjustment. The state also needs to modernize its sales tax base to include more services.

Has the state…	YES	NO	More Work Needed
1. Broadened sales tax base?		☒	🕛
2. Modernized sales taxes?	✔		🕛
3. Raised cigarette tax to US average?		☒	🕛
4. Enacted Earned Income Tax Credit?		☒	🕛
5. Modernized income tax bracket?	✔		🕛
6. Dealt with hidden income tax increases?		☒	🕛
7. Rethought senior tax preferences?		☒	🕛
8. Eliminated corporate loopholes?	✔		🕛
9. Linked property taxes and ability to pay?		☒	🕛
10. Strengthened accountability?	✔		
11. Conducted a performance review?	✔		

A better North Carolina…

Idea 1: Broaden the sales tax base. North Carolina should abolish sales tax holidays and review sales tax exemptions to eliminate those that don't meet contemporary economic needs. North Carolina's sales tax holiday cost an estimated $11 million in 2004.

Idea 2: Modernize sales taxes for the new economy. North Carolina should modernize its policy on taxing services. In 2004, it taxed 30 out of 168 possible services.

Idea 3: Raise cigarette taxes to promote public health. North Carolina should raise its 35-cent-per-pack cigarette tax (scheduled for July 2006) to the national average of $0.92 per pack to reduce smoking and promote public health. Research shows that doing so would likely cause 40,700 current adult smokers to quit. Long-term health savings from smoking declines are estimated to be $1.57 billion.

Idea 4: Enact a state Earned Income Tax Credit. North Carolina should enact a refundable earned income tax credit to help to bring working families' incomes above poverty. Some 729,862 North Carolina taxpayers in 2003 claimed the federal earned income tax credit for a total of $1,344,514,547. A refundable state EITC would cost an estimated $133 million if set at 10 percent of the federal credit.

Idea 5: Modernize state income brackets. North Carolina has the highest income tax rate among the Southern states, 8.25 percent on income of $120,000 and above for single filers.

Idea 6: Account for inflation. North Carolina should enact strategies to adjust taxes for inflation to promote long-term *fairness* and reduce back-door inflationary tax hikes. North Carolina does not index personal exemptions, standard deductions, credits or brackets for inflation. The state did not tax poor households in 2004, but did in 2005 because its income tax system does not automatically adjust for inflation.

Idea 7: Rethink senior tax preferences. North Carolina should redesign tax codes to provide fair relief to seniors based on *ability-to-pay* instead of age alone. The state currently provides seniors with a full exemption for Social Security income, a private pension income exemption, an additional deduction/exemption, and property tax preferences. In 2004, pension and Social Security tax preferences cost North Carolina an estimated $494 million.

Idea 8: Eliminate corporate tax loopholes. While North Carolina does not require combined reporting, it does restrict the use of the passive investment company (or Delaware-holding company) loophole. North Carolina does not, however, have a throwback rule.

Idea 9: Connect property taxes and *ability-to-pay*. If North Carolina insists on property tax reform, it should use a property tax circuit breaker to shield residents from excessive taxation and connect property taxes with *ability-to-pay*. North Carolina had the 13th lowest property taxes in the nation per capita and the 11th lowest as a percent of personal income in 2002.

Idea 10: Strengthen accountability. North Carolina has a tax expenditure report and makes it easily available online.

Idea 11: Review the performance of government. Through a Governor's commission, North Carolina conducted a comprehensive performance review in 2002.

SOUTH CAROLINA AT A GLANCE:

South Carolina is one of the few Southern states that indexes the income tax for inflation. But numerous other aspects of the tax system are ripe for modernization, including income tax brackets, the sales tax base and cigarette taxes.

Has the state...	YES	NO	More Work Needed
1. Broadened sales tax base?		☒	🕘
2. Modernized sales taxes?		☒	🕘
3. Raised cigarette tax to US average?		☒	🕘
4. Enacted Earned Income Tax Credit?		☒	🕘
5. Modernized income tax bracket?		☒	🕘
6. Dealt with hidden income tax increases?	✔		
7. Rethought senior tax preferences?		☒	🕘
8. Eliminated corporate loopholes?		☒	🕘
9. Linked property taxes and ability to pay?		☒	🕘
10. Strengthened accountability?		☒	🕘
11. Conducted a performance review?	✔		🕘

A better South Carolina…

Idea 1: Broaden the sales tax base. South Carolina should abolish sales tax holidays and review sales tax exemptions to eliminate those that don't meet contemporary economic needs. South Carolina's sales tax holiday will cost an estimated $5.2 million in 2006.

Idea 2: Modernize sales taxes for the new economy. South Carolina should modernize its policy on taxing services. In 2004, it taxed 34 out of 168 possible services. It also should approve the Streamlined Sales and Use Tax Agreement.

Idea 3: Raise cigarette taxes to promote public health. South Carolina should raise its lowest-in-the-nation cigarette tax (7 cents per pack) to the national average of $0.92 per pack to reduce smoking and promote public health. Research shows that doing so likely would cause 30,600 current adult smokers to quit. Long-term health savings from both adult and youth smoking declines would be $1.1 billion.

Idea 4: Enact a state Earned Income Tax Credit. South Carolina should enact a refundable earned income tax credit to help to bring working families' incomes above poverty. Some 414,707 South Carolina taxpayers in 2003 claimed the federal earned income tax credit for a total of $779,353,959. A refundable state EITC would cost an estimated $76 million if set at 10 percent of the federal credit.

Idea 5: Modernize state income brackets. South Carolina should modernize its income tax structure by broadening brackets and consider the creation of a new top rate to provide progressive balance. The state's top tax bracket is 7 percent for income $12,650 and above for single filers.

Idea 6: Account for inflation. South Carolina is one of the few Southern states that indexes several parts of its income tax system for inflation.

Idea 7: Rethink senior tax preferences. South Carolina should redesign tax codes to provide fair relief to seniors based on *ability-to-pay* instead of age alone. The state, which will grow to having an estimated senior population of 22 percent in 2030, currently provides seniors with a full exemption for Social Security income, a private pension income exemption, an additional deduction/exemption, and property tax preferences.

Idea 8: Eliminate corporate tax loopholes. South Carolina should review and update its corporate income tax structure to eliminate tax loopholes and promote *fairness*. It should enact combined reporting and a throwback rule.

Idea 9: Connect property taxes and *ability-to-pay*. South Carolina should consider enacting a property tax circuit breaker to shield residents from excessive taxation and connect property taxes with *ability-to-pay*. In 2006, lawmakers insisted on property tax relief, but threw out consideration of a property tax circuit breaker.

Idea 10: Strengthen accountability. South Carolina should annually publish an accessible and comprehensive tax expenditure report to provide more accountability and information to lawmakers so they can make better-informed decisions.

Idea 11: Review the performance of government. In the last five years, South Carolina has conducted a volunteer-driven performance review. While this review provided some useful information, a more thorough effort is needed and would involve creating a permanent review system.

TENNESSEE AT A GLANCE:

Tennessee is one of two Southern states without a broad-based individual income tax. Tennessee should consider a state income tax to improve the *progressivity* and *adequacy* of the tax code, as well as other reform options, such as raising the cigarette tax and closing corporate tax loopholes.

Has the state…	YES	NO	More Work Needed
1. Broadened sales tax base?		☒	🕛
2. Modernized sales taxes?	✔		🕛
3. Raised cigarette tax to US average?		☒	🕛
4. Enacted Earned Income Tax Credit?	n/a	n/a	
5. Modernized income tax bracket?	n/a	n/a	
6. Dealt with hidden income tax increases?	n/a	n/a	
7. Rethought senior tax preferences?	n/a	n/a	
8. Eliminated corporate loopholes?		☒	🕛
9. Linked property taxes and ability to pay?		☒	🕛
10. Strengthened accountability?	✔		
11. Conducted a performance review?		☒	🕛

A better Tennessee…

Idea 1: Broaden the sales tax base. Tennessee should abolish sales tax holidays and review sales tax exemptions to eliminate those that don't meet contemporary economic needs. Tennessee's sales tax holiday will cost roughly $10 million.

Idea 2: Modernize sales taxes for the new economy. Tennessee should continue to modernize its policy on taxing services. In 2004, it taxed 67 out of 168 possible services.

Idea 3: Raise cigarette taxes to promote public health. Tennessee should raise its 20-cent-per-pack cigarette tax to the national average of $0.92 per pack to reduce smoking and promote public health. Research shows that doing so likely would cause 38,500 current adult smokers to quit. Long-term health savings from both adult and youth smoking declines would be $1.24 billion.

Idea 4: Enact a state Earned Income Tax Credit.
Idea 5: Modernize state income brackets.
Idea 6: Account for inflation.
Idea 7: Rethink senior tax preferences.

Since Tennessee is one of only two Southern states that do not have a broad-based personal income tax, the state may want to consider an income tax to boost *progressivity*. Adding an income tax could allow the state to reduce its relatively high sales tax. In considering the creation of an income tax, Tennessee should strive to design a modern, fair tax that includes such aspects as a refundable EITC, broad brackets, inflation adjustments, and relief based on *ability-to-pay* rather than age.

Idea 8: Eliminate corporate tax loopholes. Tennessee should review and update its corporate income tax structure to eliminate tax loopholes and promote *fairness*. It should enact combined reporting and a throwback rule.

Idea 9: Connect property taxes and *ability-to-pay*. If Tennessee insists on property tax reform, it should use a property tax circuit breaker to shield residents from excessive taxation and connect property taxes with *ability-to-pay*. Tennessee had the 11th lowest property taxes in the nation when measured per capita and the 10th lowest as a percent of personal income in 2002.

Idea 10: Strengthen accountability. Tennessee currently has an annual tax expenditure report. It is important for it to be published annually to provide accountability and information to lawmakers so they can make better-informed decisions.

Idea 11: Review the performance of government. Tennessee should conduct a comprehensive performance review to boost government efficiency, save money and improve customer service. Tennessee hasn't conducted a comprehensive statewide performance review in the last five years.

VIRGINIA AT A GLANCE:

Virginia has made several improvements to its tax code in recent years, including scaling back its tax preferences for higher income seniors and creating a non-refundable state Earned Income Tax Credit. It should continue these reform efforts by modernizing the sales tax base and making further improvements to the state income tax.

Has the state…	YES	NO	More Work Needed
1. Broadened sales tax base?		☒	🕒
2. Modernized sales taxes?		☒	🕒
3. Raised cigarette tax to US average?		☒	🕒
4. Enacted Earned Income Tax Credit?	✔		🕒
5. Modernized income tax bracket?		☒	🕒
6. Dealt with hidden income tax increases?		☒	🕒
7. Rethought senior tax preferences?	✔		🕒
8. Eliminated corporate loopholes?	✔		🕒
9. Linked property taxes and ability to pay?		☒	🕒
10. Strengthened accountability?	✔		🕒
11. Conducted a performance review?	✔		

A better Virginia…

Idea 1: Broaden the sales tax base. Virginia should abolish sales tax holidays and review sales tax exemptions to eliminate those that don't meet contemporary economic needs. Virginia recently passed a sales tax holiday, which will cost an estimated $2.6 million in FY 2007.

Idea 2: Modernize sales taxes for the new economy. Virginia should modernize its policy on taxing services. In 2004, it taxed 18 out of 168 possible services. It also should approve the Streamlined Sales and Use Tax Agreement.

Idea 3: Raise cigarette taxes to promote public health. Virginia should raise its 30-cent-per-pack cigarette tax to the national average of $0.92 per pack to reduce smoking and promote public health. Research shows that doing so likely would cause 31,400 current adult smokers to quit. Long-term health savings from both adult and youth smoking declines would be $1.21 billion.

Idea 4: Enact a state Earned Income Tax Credit. Virginia is the only Southern state to offer an earned income tax credit, which will go into effect in tax year 2006. However, Virginia's EITC is non-refundable.

Idea 5: Modernize state income brackets. Virginia should modernize its income tax structure by adjusting brackets and consider the creation of a new top rate to provide progressive balance. The state's top tax bracket is 5.75 percent for income $17,000 and above for single filers.

Idea 6: Account for inflation. Virginia should enact strategies to adjust taxes for inflation to promote long-term *fairness* and reduce back-door inflationary tax hikes. Virginia does not index personal exemptions, standard deductions or brackets for inflation. But Virginia's EITC is indexed to inflation since it is based on the federal EITC.

Idea 7: Rethink senior tax preferences. Virginia is the only Southern state to have scaled back its senior tax preferences. Tax exemptions will phase out for seniors with more than $50,000 of income. It should revisit the issue periodically.

Idea 8: Eliminate corporate tax loopholes. While Virginia does not require combined reporting, it does restrict the use of the passive investment company (or Delaware-holding company) loophole. Virginia does not, however, implement a throwback rule.

Idea 9: Connect property taxes and *ability-to-pay*. If Virginia insists on property tax reform, it should use a property tax circuit breaker to shield residents from excessive taxation and connect property taxes with *ability-to-pay*. Compared to all states in the U.S., Virginia ranked in the middle for property taxes per capita in 2002.

Idea 10: Strengthen accountability. Virginia has a tax expenditure report, but it is limited to sales. Virginia should work to incorporate all tax expenditures into an annual report that includes cost projections and is readily available to lawmakers and the public.

Idea 11: Review the performance of government. Virginia has established the Council on Virginia's Future, which is in the process of conducting a comprehensive performance review.

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To learn more about the Center, visit our Web site *(www.bettersouth.org)* and blog *(www.thinksouth.org)*.

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