TAX FOUNDATION 65 YEARS

TAX FEATURES

www.taxfoundation.org *Summer 2002 Volume 46, Number 3*

Federal Tax and Spending Patterns Benefit Some States, Leave Others Footing the Bill

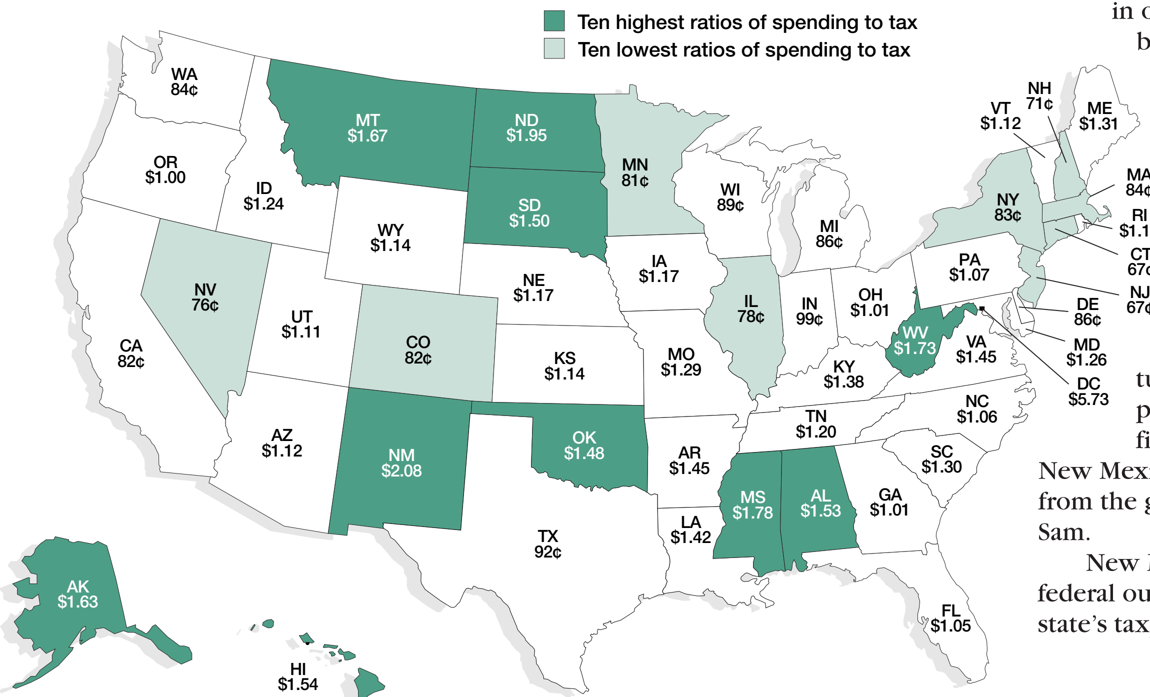
full report on line at:
www.TaxFoundation.org/taxingspending.html

Some states feast at the expense of others, according to the Tax Foundation's annual analysis of federal fiscal operations.

By comparing the federal tax burden in each state with an adjusted set of the Census Bureau's most recent data (2001) on federal spending in each state, Tax Foundation senior economist Scott Moody has ranked states in order of which got the best deal in 2001 from Uncle Sam's tax and spending policies.

Federal Spending by State for Each Tax Dollar Sent to Washington

FY 2001



Federally Favored States

In No. 116 of the Tax Foundation's Special Report series, titled "Federal Tax Burdens and Expenditures by State," Moody points out that during fiscal 2001, taxpayers in New Mexico benefited the most from the give-and-take with Uncle Sam.

New Mexico received $2.08 in federal outlays for every $1.00 the state's taxpayers sent to Uncle Sam.

Taxes vs. Spending *continued on page 2*

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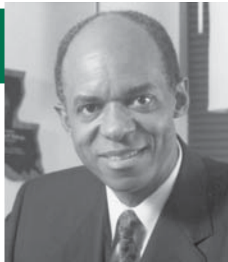

FRONT & CENTER

Permanently Repeal a Tax Detrimental to Minority Wealth: The Estate Tax

William Jefferson (D-LA), Member, Committee on Ways and Means, U.S. House of Representatives

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Taxes vs. Spending *from page 1*

No other state got a 2-1 ratio, but Uncle Sam spent $1.95 in North Dakota for each tax dollar, $1.78 in Mississippi, and $1.73 in West Virginia.

Though not comparable as a state, the District of Columbia is by far the biggest beneficiary of federal spending: In 2001 it received $5.73 in federal outlays for every dollar its taxpayers sent to the U.S. Treasury.

States That Help Others

If some states are beneficiaries, then naturally some states must be benefactors — those states where so much is collected in federal taxes that any federal largesse they receive is overwhelmed.

New York has often been the biggest loser in the Tax Foundation's annual comparison of taxes to spending, which inspired Daniel Patrick Moynihan and the Kennedy School of Government to launch their annual reference book comparing state taxes with spending (www.ksg.harvard.edu/fisc99) more than 25 years ago. In recent years, however, other states have eclipsed New York for the "blessing" of being the state that gives far more than it receives.

Combining the second highest tax burden per capita with low federal spending (33rd highest), New Jersey had the lowest federal spending-to-tax ratio (0.67). The 0.67 ratio means that New Jersey only receives 67¢ in federal spending for every dollar its taxpayers send to Washington and is therefore the nation's biggest loser from federal fiscal operations. Other states that had low federal spending-to-tax ratios in FY 2001 are Connecticut (67¢), New Hampshire (71¢), Nevada (76¢) and Illinois (78¢).

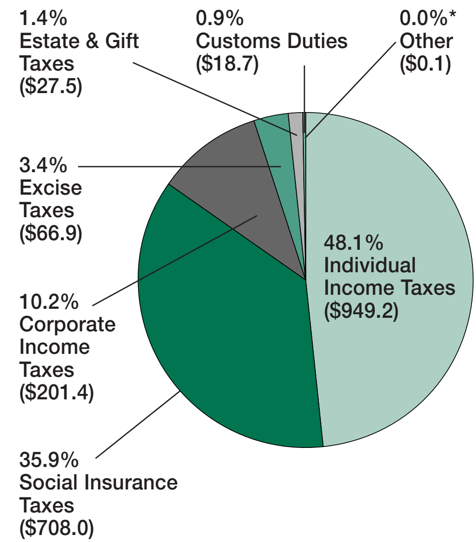
Changing Ranks

The state that raised its ratio the most between 1991 to 2001 is Alaska where federal spending rose from $1.19 to $1.63 for each dollar in taxes. This 44¢ increase beats out Hawaii, where federal spending increased 42¢

Federal Tax Collections by Type of Tax

Fiscal Year 2001e

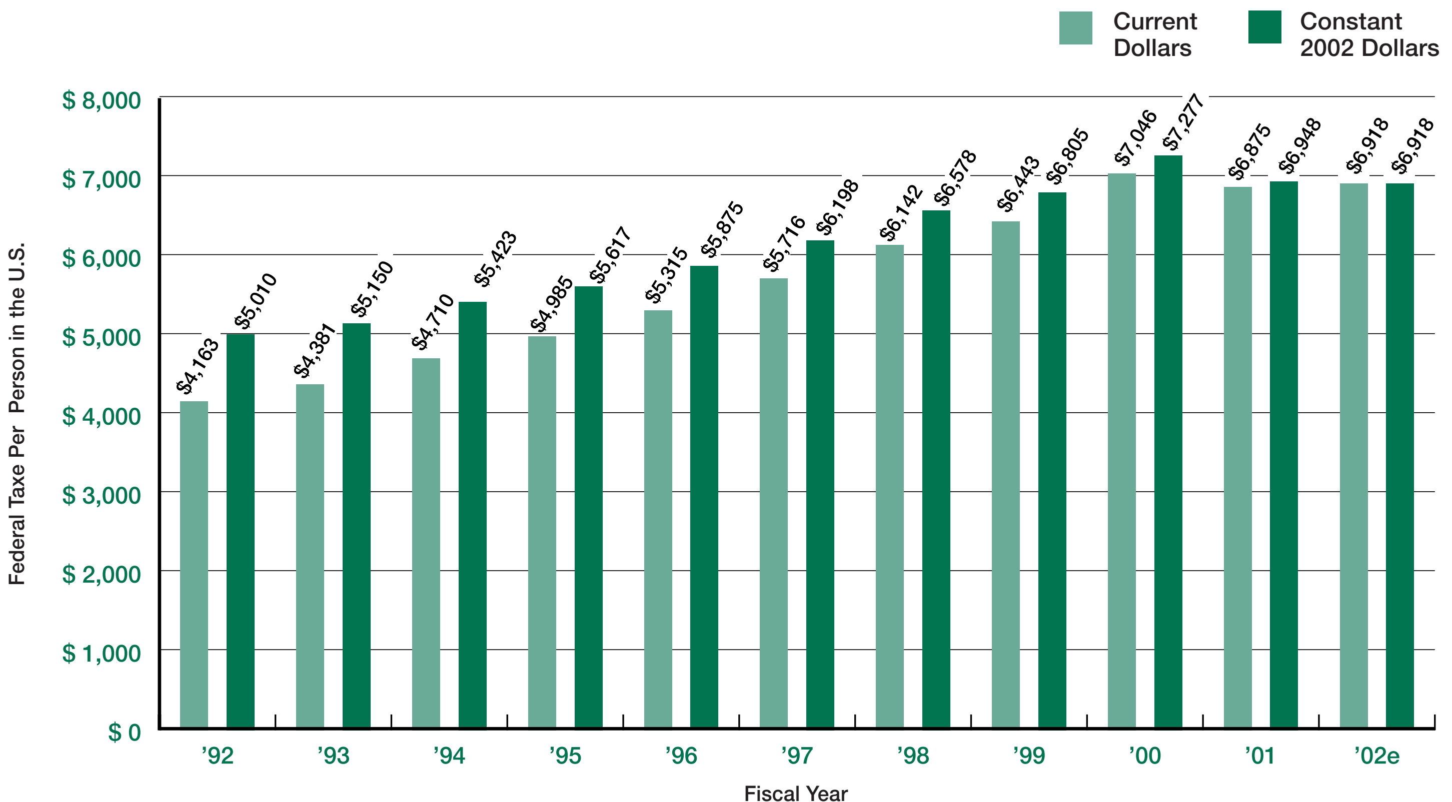
($Billions)



* Less than 0.5 percent.

Federal Tax Burden Per Capita in Current and Constant Dollars

Fiscal Years 1992 – 2002



per dollar of tax, North Dakota (40¢ more spending per dollar), and West Virginia (31¢ more spending per dollar).

States where the ratio dropped most dramatically are Colorado and Massachusetts. Colorado has seen its federal spending-to-tax ratio fall 33¢ from $1.15 in FY 1991 to 82¢ in FY 2001. Massachusetts's has dropped 23¢.

How Can States React?

Federal spending on defense and other procurement dollars are often funneled to the states of powerful congressmen, and state governments can grab more federal grant money by skillfully — some would say slavishly — manipulating their spending to comply with federal regulations.

However, demography is at least as influential as politics. States with more residents on Social Security, Medicare and other large federal entitlements are bound to rank fairly high. Similarly, the high spending levels in Virginia, Maryland and the District of Columbia are explained by the predominance of federal employees.

On the tax side of the equation, states with higher incomes per capita — Connecticut stands out — pay much higher federal taxes per capita because of the income tax's progressive structure.

Federal Spending by State Per Dollar of Federal Tax

FY 1991 and 2001

	Expenditures Per Dollar of Taxes		Change in Spending Per Dollar of Tax	Ranking		Change in Rank
	FY 1991	FY 2001		FY 1991	FY 2001	
Total	$ 1.00	$ 1.00	–	–	–	–
Alabama	$ 1.37	$ 1.53	+ 15¢	7	8	– 1
Alaska	1.19	1.63	+ 44	20	6	+ 14
Arizona	1.20	1.12	– 8	19	25	– 6
Arkansas	1.29	1.45	+ 16	11	11	0
California	0.89	0.82	– 8	39	44	– 5
Colorado	$ 1.15	$ 0.82	– 33¢	22	43	– 21
Connecticut	0.79	0.67	– 12	45	49	– 4
Delaware	0.74	0.86	+ 12	48	39	+ 9
Florida	1.07	1.05	– 2	26	31	– 5
Georgia	0.92	1.01	+ 9	37	33	+ 4
Hawaii	$ 1.11	$ 1.54	+ 42¢	23	7	+ 16
Idaho	1.28	1.24	– 4	14	19	– 5
Illinois	0.73	0.78	+ 5	49	46	+ 3
Indiana	0.88	0.99	+ 11	40	35	+ 5
Iowa	1.02	1.17	+ 15	29	21	+ 8
Kansas	$ 1.07	$ 1.14	+ 7¢	27	24	+ 3
Kentucky	1.29	1.38	+ 9	12	14	– 2
Louisiana	1.22	1.42	+ 20	17	13	+ 4
Maine	1.32	1.31	– 2	10	15	– 5
Maryland	1.22	1.26	+ 4	16	18	– 2
Massachusetts	$ 1.06	$ 0.84	– 23¢	28	41	– 13
Michigan	0.80	0.86	+ 7	44	38	+ 6
Minnesota	0.85	0.81	– 5	41	45	– 4
Mississippi	1.67	1.78	+ 12	2	3	– 1
Missouri	1.37	1.29	– 8	8	17	– 9
Montana	$ 1.46	$ 1.67	+ 21¢	4	5	– 1
Nebraska	1.08	1.17	+ 9	24	22	+ 2
Nevada	0.78	0.76	– 2	46	47	– 1
New Hampshire	0.75	0.71	– 4	47	48	– 1
New Jersey	0.66	0.67	0	50	50	0
New Mexico	$ 2.00	$ 2.08	+ 7¢	1	1	0
New York	0.84	0.83	– 1	42	42	0
North Carolina	0.95	1.06	+ 10	33	30	3
North Dakota	1.55	1.95	+ 40	3	2	1
Ohio	0.98	1.01	+ 3	31	32	– 1
Oklahoma	$ 1.24	$ 1.48	+ 24¢	15	10	+ 5
Oregon	0.93	1.00	+ 6	36	34	+ 2
Pennsylvania	0.98	1.07	+ 9	32	29	+ 3
Rhode Island	1.08	1.11	+ 4	25	27	– 2
South Carolina	1.29	1.30	+ 2	13	16	– 3
South Dakota	$ 1.36	$ 1.50	+ 14¢	9	9	0
Tennessee	1.16	1.20	+ 4	21	20	+ 1
Texas	0.94	0.92	– 2	35	36	– 1
Utah	1.21	1.11	– 10	18	28	– 10
Vermont	0.94	1.12	+ 18	34	26	+ 8
Virginia	$ 1.42	$ 1.45	+ 4¢	6	12	– 6
Washington	0.90	0.84	– 6	38	40	– 2
West Virginia	1.43	1.73	+ 31	5	4	+ 1
Wisconsin	0.83	0.89	+ 6	43	37	+ 6
Wyoming	1.00	1.14	+ 14	30	23	+ 7
District of Columbia	$ 5.83	$ 5.73	– 10¢	–	–	–

Sources: Census Bureau; Tax Foundation's "State–by–State Tax Burden Allocation Model."

Publication Summary

General: Special Report No. 116; ISSN 1068-0306; 12pp.; $10 or $50/yr. for 6 issues on varied fiscal topics

Title: Federal Tax Burdens and Expenditures by State

Author: J. Scott Moody

Date: July 2002

Subject: Calculation of how much each state's citizens pay in federal taxes, including adjustments for federal taxes collected in other states. The tax burden in each state is then compared to federal funds that are spent in each state.

Tables: Federal Tax Burden, Total and Per Capita, FY1934–2002; Federal Tax Burden by State and Rank, Selected Fiscal Years, 1970–2002; Federal Tax Burden by State, Per Capita and Rank, Selected Fiscal Years, 1970–2002; Federal Tax Burden by State, Type of Tax and Rank, FY2001; Federal Tax Burden by State and Type of Tax, Per Capita and Rank, FY2001; Federal Expenditures by State, Type of Expenditure and Rank, FY2001; Federal Expenditures by State and Type of Expenditure, Per Capita and Rank, FY2001; Federal Tax Burdens and Expenditures Per Capita as a Percentage of the U.S. Average, FY1991 and FY2001; Adjusted Federal Expenditures Per Dollar of Taxes by State, FY1991 and FY2001

Employees of Professional Sports Franchises Paying Income Taxes in Up to 20 States as State Governments Compete for Funds

A new report from the Tax Foundation on the so-called jock tax reveals how state governments are extending their income taxes to more and more non-residents who just work for a few days in their states.

In Tax Foundation Special Report No. 115, economist David Hoffman explains that the so-called jock tax began with California trying to get back at Michael Jordan for beating the Lakers in 1991. (See Publication Summary.)

After the championship series that year, California extended its state income tax to the Chicago Bulls on a daily basis whenever they were in town. Illinois responded with the "Michael Jordan's Revenge" tax on California athletes, and 11 years later, what started as a pernicious California tax has spread to every other state that has an income tax and hosts a professional sports franchise in the National Football League (NFL), National Basketball Association (NBA), the National Hockey League (NHL) or Major League Baseball (see map).

Even though the visiting players are just like any other people whose work brings them out of state, they must file an income tax return in each state they visit. The tax is due whether a player actually plays in the games or not.

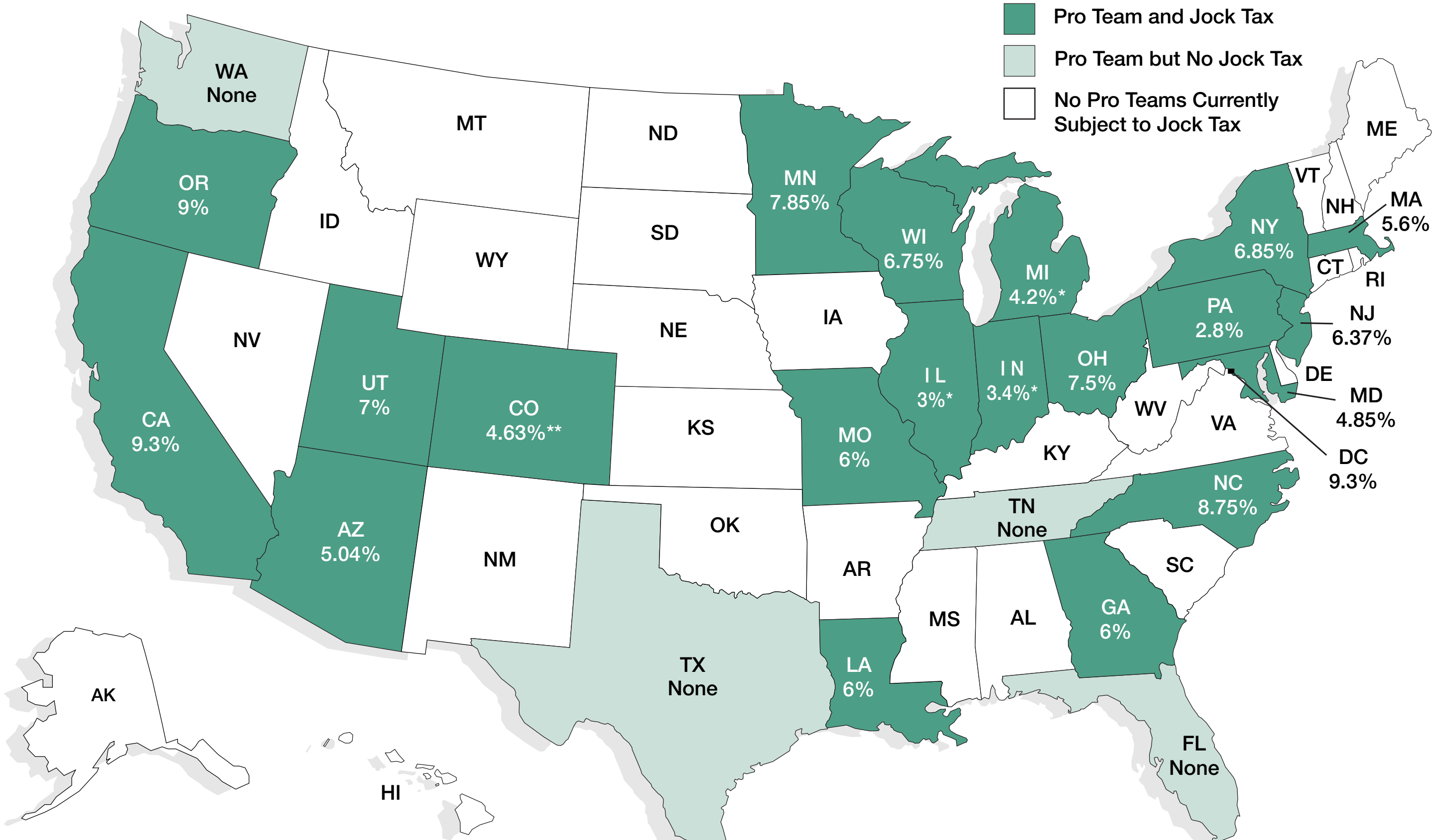
full report on line at:
www.TaxFoundation.org/jocktax.html

As taxes often do, the jock tax has spread. Coaches and support staff were the first non-athletes to be hit, and now thousands of people are forced to file income tax returns in dozens of states, many of whom earn typical middle-class salaries.

The report was released to coincide with Major League Baseball's All-

States That Levy Income Taxes on Visiting Employees of Sports Franchises

(Top Income Tax Rate Shown for Each State)



* Tax base is federal AGI with modifications.
** Tax base is federal taxable income.
See Table 2 for more details.

Star Game in Milwaukee, where every player, coach, trainer or announcer racked up taxes owed to Wisconsin (even though neither side won).

Surveys of key personnel in the industry indicate that members of the Professional Golf Association, the Women's National Basketball Association, the Arena Football League, and many others are currently spared. That may change, since the tax is not limited to the four biggest leagues by statute, and it is already being collected by many states from "rock stars" and the people who travel with them.

The total take for Wisconsin on July 9 was estimated to be over $136,000 from the players alone. Alex Rodriguez, who carries the highest salary, will pay $8,864 himself for the privilege of playing a couple innings in the annual exhibition.

While most states enacted the tax as retaliation against other states, professional athletes are a tempting target for state lawmakers because they represent a highly concentrated pool of wealth that can be taxed with little enforcement. Like other nonresidents, athletes can be taxed by states without fear of political pressure. And professional athletes cannot take their business elsewhere: each professional sports league is a government-backed monopoly that decides when and where its employees will work.

A Case Study of Poor Tax Policy

Since 1991, the jock tax has masqueraded as a tax that only affects multi-millionaire superstars. In fact, all players, coaches, and support staff of sports teams in four professional leagues have to pay it.

Second, the jock tax is arbitrary because it targets a specific occupation. Many doctors and lawyers have comparable lifetime earnings, and some business executives have far more, but they do not have to pay state income taxes in every state where they work for a few days.

Third, those affected by the jock tax have to file numerous state income tax forms. This complexity adds to the overall compliance costs borne by taxpayers, a burden that is proportionately much greater on the employees with lower incomes.

See table below for examples of how the jock tax applies to three professional athletes.

Publication Summary

General: Special Report No. 115; ISSN 1068-0306; 12pp.; $10 or $50/yr. for 6 issues on varied fiscal topics

Title: State Income Taxation of Nonresident Professional Athletes

Author: David K. Hoffman

Date: July 2002

Subject: Discussion of the recent trend for state governments to extend their income taxes to selected nonresidents, a trend that started with professional athletes.

Tables: Salaries and Jock Taxes of Major League Baseball All-Star Game Participants, 2002; Individual Income Tax Rates in States with NFL, NBA, NHL or Major League Baseball Franchises; The Complex State Income Tax Obligations of Three Professional Athletes; Salary Ranges of Non-Athletic Members of Professional Athletic Teams; Statistical Comparison of the Incomes and Taxation of Athletes and Doctors

The Complex State Income Tax Obligations of Three Professional Athletes

2001–2002

	Steve Francis (home state: Texas) (salary: $3,441,000)		David Bell (home state: Washington) (salary: $2,140,000)		Reggie Miller (home state: Indiana) (salary: $12,000,000)			
States Imposing a Jock Tax	Number of Games Played in Jock Tax States	Additional Taxes Paid	Number of Games Played in Jock Tax States	Additional Taxes Paid	Number of Games Played in Jock Tax States	Jock Taxes Paid	Amount that Indiana Would Have Collected	Additional Taxes Paid
Total	28	$ 66,948	72	$ 60,667	35	$ 205,540	$ 97,043	$ 108,497
Arizona	2	$ 2,951	–	–	1	$ 5,177	$ 3,462	$ 1,716
California	8	26,598	26	$ 28,237	4	45,432	13,846	31,586
Colorado	2	3,540	6	3,456	1	5,724	3,462	2,262
Georgia	1	2,104	–	–	2	14,968	8,589	6,378
Illinois (a)	–	–	–	–	3	7,418	6,702	715
Indiana	1	$ 1,300	–	–	–	–	–	–
Louisiana	–	–	–	–	–	–	–	–
Maryland	–	–	8	$ 4,682	–	–	–	–
Massachusetts	1	2,237	6	4,367	2	$ 14,003	$ 6,702	$ 7,301
Michigan	1	1,606	5	2,613	2	10,053	6,702	3,351
Minnesota	2	$ 5,219	6	$ 5,076	2	$ 5,034	$ 3,462	$ 1,572
Missouri	–	–	3	2,015	–	–	–	–
New Jersey	1	761	–	–	5	13,729	6,702	7,027
New York	1	1,842	6	7,060	1	24,611	10,385	14,227
North Carolina	1	2,549	–	–	3	16,163	6,702	9,460
Ohio	1	$ 1,258	6	$ 3,162	2	$ 6,236	$ 3,462	$ 2,775
Oregon	2	6,711	–	–	1	10,955	3,462	7,494
Pennsylvania	1	1,071	–	–	2	–	–	–
Utah	2	5,232	–	–	2	17,187	6,702	10,485
Wisconsin	1	1,970	–	–	2	8,851	6,702	2,149

(a) Illinois only taxes nonresidents whose home states tax residents of Illinois.

Sources: www.bskball.com, USA Today Baseball Salaries. Computations by Tax Foundation.

Permanently Repeal a Tax Detrimental to Minority Wealth: The Estate Tax

by U.S. Rep. William Jefferson (D-LA)

The freedom to attain prosperity and accumulate wealth is the basis of the "American Dream." We are taught that through hard work we can achieve that dream and, God willing, pass it on to our children. Unfortunately, for many the estate tax turns that dream into a nightmare.

The current tax treatment of a person's life accumulations is so onerous that when one dies, the children are often forced to turn over half of their inheritance to the federal government. The estate tax, which is imposed at an alarming 37 to 55 percent rate, is higher than in any other industrialized nation in the world except Japan. Thus, many families must watch their loved one's legacy being snatched away by the federal government at an agonizing time. This is tragically wrong and nullifies the hard work of those who have passed on.

In the minority community there are numerous examples of the injurious effects of the estate tax. The Chicago Daily Defender, the oldest African American–owned daily newspaper in the United States, is a good example of the unique problem presented for minority families. It was forced into bankruptcy due to financial burdens imposed by the estate tax. But, beyond that, the question was – were the Chicago Defender family forced to sell, could a minority owner be found to purchase it, or would it become a white-owned asset, reducing the overall wealth of the African American community?

On a smaller scale, another potential victim, a storeowner named Leonard L. Harris who is a first generation owner of Chatham Food Center on the South Side of Chicago is frightened that all the work and value he has put into his business will be for naught because it will be stripped from his two sons. According to Mr. Harris, "My focus has been putting my earnings back into growing the business. For this reason, cash resources to pay federal estate taxes, based on the way valuation is made, would force my family to sell the store in order to pay the IRS within 9 months of my death. Our yearly earnings would not cover the payment of such a high tax. I should know. I started my career as a CPA."

These two stories are not isolated. According to the Life Insurance Marketing Research Association, less than half of all family-owned businesses survive the death of a founder, and only about five percent survive to the third generation.

I share my colleagues' concerns about protecting the tax base and ensuring that our tax code remains progressive. However, I find these arguments in support of the estate tax unconvincing.

Many of my colleagues who are proponents of the estate tax contend that the tax adds progressivity to the Tax Code and provides needed tax revenue. They argue that the estate tax falls on wealthier and higher income individuals and increases the total tax paid by this segment of the population relative to their income. This helps offset the regressivity of payroll taxes and excise taxes, which fall more heavily on low-income groups relative to their income. They also argue that increasing the unified credit to $4 or $5 million would remove small and minority-owned businesses and farms from the harsh impact of the estate tax.

The insignificant amount of money the estate tax raises for the federal government cannot justify the harmful effects it has on business owners who spend more to avoid the tax than the federal tax revenue raised.

I share my colleagues concerns about protecting the tax base and ensuring that our Tax Code remains progressive. However, I find these arguments in support of the estate tax unconvincing in the face of substantial evidence otherwise. First, there is no clear evidence that the estate tax is progressive or that larger estates are paying a greater portion of the tax. Wealthier members of our society are able to reduce and or eliminate the impact of the estate tax by stuffing money away here and there at the suggestion of high-priced attorneys and accountants. Similarly, tax planning techniques such as gift tax exclusions or valuation discounts reduce the size of the gross estate but do not appear in the IRS data causing effective tax rates to be overstated for many larger estates. The Institute for Policy Innovation recently revealed evidence of this fact in a study showing that the effective tax rate on the most valuable estates was actually lower than that on medium-sized estates.

Second, the insignificant amount of

William Jefferson, Democrat of Louisiana, serves on the House Committee on Ways and Means.

money the estate tax raises for the federal government cannot justify the harmful effects it has on business owners who spend more to avoid the tax than the federal tax revenue raised. According to the President's FY 2003 Budget, the estate and gift tax brought in $28.4 billion in revenues to the federal government in 2001. This represents less than 1.5 percent of the total revenues out of a nearly $2 trillion federal budget and less than the amount of money spent complying with, or trying to circumvent, the death tax.

In 2000, Congress's Joint Economic Committee reported that the death tax brought in $23 billion in annual revenue, but cost the private sector another $23 billion in compliance costs. Therefore, the total impact on the economy was a staggering $46 billion. And, when one calculates the amount of money spent on complying with the tax, the number of lost jobs resulting from businesses being sold, or the resources directed away from business expansion and into estate planning, it is clear why this punitive tax must be eliminated.

It is also important to note that many economists believe that overall tax revenues would increase if the estate tax were repealed. According to a study of estate tax repeal proposals, which was prepared by Dr. Allen Sinai for the American Council for Capital Formation and Center for Policy Research, federal tax receipts would rise in response to a stronger economy, feeding back 20 cents of every dollar of estate tax reduction. In fact, over the years 2001 to 2008, estate tax repeal would increase real Gross Domestic Product by $90 billion to $150 billion, and U.S. employment by 80,000 to 165,000.

Finally, it is not clear that increasing the unified credit to $4 or $5 million would remove small family-owned businesses and farms from the threat of the estate tax. The Small Business Administration's definition of a small business is based on industry size standards. For example, a construction company or grocery store with less than $27.5 million in annual receipts is considered a small business. Thus, families who build their businesses past the exemption amount will continue to face estate taxes that range from the aforementioned, alarming rate of 37 to 55 percent. The exemption threshold would not help these small businesses.

The Chicago Daily Defender — the oldest African American-owned daily newspaper in the U.S. — was forced into bankruptcy due to financial burdens imposed by the estate tax.

A similar exemption established in 1997 and expiring in 2004, which shields $1.3 million in assets for farms and businesses from the tax, has reportedly not been successful. According to reports, less than 3 percent of family businesses qualify for relief under this provision; hence, the exemption fails to help many of those that need it. Accordingly, the Real Property and Probate Division of the American Bar Association has condemned raising the exemption as an approach and has instead urged estate tax repeal.

Repeal is the right approach for the American people and the American economy. Permanent repeal of the estate tax will provide American families with fairness in our tax system and remove the perverse incentive that makes it cheaper for an individual to sell the business prior to death and pay the individual capital gains rate than pass it on to heirs. But for minorities, it provides an additional benefit. It will allow wealth created in one generation of an African–American or Hispanic family, for example, to be passed on to the next, with assets representing that wealth remaining minority-owned. Generations of African American or other minority-owned wealth will create economically powerful minority communities with the capacity to create jobs and minority employment.

The Tax Foundation invites a national leader to provide a "Front and Center" column each month in Tax Features*. The views expressed are not necessarily those of the Tax Foundation.*

Tax Foundation Center for International Tax Policy Promotes Understanding of Key Issues

WTO Rejection of U.S.'s ETI Requires Prompt Action by Congress

Anticipating that international tax issues and reform of the corporate income tax code would dominate the congressional calendar in the second half of this year, the Tax Foundation led a delegation of senior congressional staff and corporate executives to Copenhagen, Brussels, and Paris this past May. The trip was the Foundation's twelfth International Tax Policy Seminar to be held in European capitals.

As in previous years, the Tax Foundation was joined in sponsoring the Seminar by the Organization for International Investment and the European-American Business Council. The seminar is the cornerstone of the Tax Foundation's Center for International Tax Policy, giving senior congressional staff the opportunity to immerse themselves in international tax policy and meet with their European counterparts to discuss tax policy.

The Tax Foundation-led delegation met with U.S. Embassy staff and Danish officials in Copenhagen to discuss the Danish government's agenda for their six-month tenure as President of the European Union.

In Brussels, the delegation received a briefing on current U.S.-EU tax issues from Joann Weiner, former Treasury official and now a senior writer for *Tax Notes International,* Jack Anderson, a Director of Ernst and Young's European tax practice, and Dina Shapiro of Citibank, London. Topics of discussion included the World Trade Organization's recent ruling that U.S. Extra-Territorial Income Exclusion (ETI) provisions violate anti-subsidy rules, the EU's recent electronic VAT directive, and recent American steel tariffs and agricultural subsidies.

The briefing served as background to the delegation's meeting with Rod Abbott, Deputy Director General of Trade for the EU. Abbott noted that since 2000, the balance in EU filings before the WTO has shifted from mostly defensive (filings in which the EU is defending its trade policies) to offensive (filings in which the EU is petitioning against the trade policies of another country, primarily the United States). Abbot said that EU officials were very concerned about the recently enacted steel tariffs and various agricultural subsidies contained in the 2002 farm bill. These concerns are in addition to the EU's ongoing consideration of the "proper" response to the WTO's ruling that the ETI is anti-competitive.

The congressional delegation responded that Congress was moving toward elimination of the ETI to comply with the WTO's ruling and that any retaliation against the steel tariffs or agricultural subsidies would make reform (and passage of Trade Promotion Authority or TPA) more difficult.

Tax Foundation Executive Director Scott A. Hodge (r.) talks with Jeffrey Owens, leader of the OECD's Centre for Tax Policy and Administration.

Also while in Brussels, the delegation met with the Union of Industrial and Employers' Confederation of Europe (UNICE), an association of businesses located throughout Europe. The meeting focused on two major issues: American concern over the EU's electronic VAT initiative, which treats electronic delivery of goods by non EU-based firms less advantageously than electronic delivery of goods by EU-based firms; and second, European concern over the Bush Administration's proposals to prevent corporate inversions, which, if enacted, would treat non-U.S. firms active in the United States more harshly than U.S.-based firms in regard to the way they can allocate debt among subsidiary companies.

Finally, the delegation met with senior officials from the Organization for Economic Cooperation and Development (OECD), including U.S. Ambassador Jeanne Phillips and Jeffrey Owens, the Head of the Organization's Centre for Tax Policy and Administration. The meetings, held at OECD headquarters, provided the congressional staff and business executives with an opportunity to learn more about the manner in which OECD research is determined, conducted, and disseminated.

Although arcane at times, and always confusing, international tax policy has come to dominate the tax debate in Washington, DC. Public outrage over corporate inversions such as that attempted by Stanley Works and the need to reform the corporate income tax code in light of the World Trade Organization's ruling against the U.S. in a recent dispute have placed these issues at the forefront of discussion.

The Tax Foundation's 12th annual International Tax Policy Seminar in Europe was a valuable opportunity for senior congressional staff and key corporate executives to examine these issues in greater detail and continue a dialogue with their European counterparts.

The Tax Foundation's Center for International Tax Policy plans to continue these successful seminars. The next one is planned for early December and will take participants to Asia to discuss similarly timely and important issues.

Moody Testifies on the Impact of State Income Tax Complexity at ALEC Conference

On August 8, 2002, in testimony before the American Legislative Exchange Council's Task Force on Fiscal Policy, Tax Foundation Senior Economist Scott Moody praised the model bill under consideration by the task force and discussed new Tax Foundation research on the complexity of state income taxes.

Moody defined the general economic costs of tax complexity, reporting the most recent results from the Tax Foundation's longstanding research project to quantify the economic impact of federal income tax complexity (see article in March/April Tax Features about *Tax Foundation Special Report No. 114*, "The Cost of Complying with the Federal Income Tax").

Overhead and Opportunity Costs

The complexity generated by the growth and constant change of tax codes creates two general types of economic cost, overhead costs and opportunity costs.

Overhead costs can be divided into three principal activities: the economically sterile exercises of tax planning, compliance, and litigation, all of which act like surcharges on taxpayers.

Excluding tax planning and litigation, Moody recently estimated the federal income tax compliance burden at $194 billion in 2002. This amounts to imposing a 20.4-cent tax compliance surcharge for every dollar the income tax system collects.

In addition to the federal income tax system, the 43 states with an income tax have layered additional levels of tax compliance costs onto taxpayers. Preliminary research indicates that taxpayers bear another $25 billion in compliance costs at the state level, amounting to roughly an 11-cent compliance surcharge for every dollar collected.

The second general type of economic cost, opportunity cost, is incurred when a less efficient economic activity displaces a more efficient one. Some can be quantified while others are of a more difficult and speculative nature, so no opportunity costs are included in Tax Foundation estimates.

As an example of a quantifiable tax opportunity cost, Moody cited the requirement that taxes be withheld from workers' paychecks. By pre-paying their tax bills, taxpayers lose any interest, profit, or dividends they might have generated between the time of withholding and the time when the taxes are actually due.

In 2001, state governments collected an estimated $218.7 billion in individual income taxes. In the absence of withholding, taxpayers could have conservatively invested this money in U.S. Treasury Bonds (T-Bills), pocketing $5.5 billion in interest payments.

> ***The 43 states with income taxes have added roughly $25 billion to taxpayers' compliance costs.***

As an example of an unquantifiable tax opportunity cost, Moody cited the lost creativity and productivity that results when talented people put aside what they're good at to spend considerable time wrestling with the tax code.

The Uneven Economic Impact of Tax Compliance Costs

Moody presented evidence that the Federal income tax compliance cost on individuals is quite regressive. In other words, the compliance cost hits lower income individuals harder than higher income individuals. In fact, taxpayers with less than $50,000 of adjusted gross income (AGI) pay almost 54 percent of the total compliance cost borne by all individuals — $46.8 billion of the total $86.1 billion compliance cost imposed on individuals.

As a percentage of AGI, taxpayers with AGI of less than $20,000 are hit the hardest. They pay a compliance cost of over 4.53 percent of their AGI. Because compliance costs are essentially a fixed cost, their compliance cost falls as AGI increases. For taxpayers with $40,000–$75,000 in AGI, their compliance cost consumes a much lower 1.32 percent of their AGI. The compliance cost drops to 0.29 percent for taxpayers with an AGI of over $200,000.

How States Could Mitigate Compliance Burdens

States could save their taxpayers a great deal of trouble by keeping basic attributes of their codes in common with other states or the federal government, according to Moody. In fact, most states do use some part of the federal individual income tax as their own starting point in order to calculate state income tax liability — such as federal adjusted gross income, taxable income or even tax liability. This "piggy-backing" on the federal income tax system reduces tax compliance costs for taxpayers.

Piggy-backing is unfortunately declining on the business side. Nearly all the states used the federal definition of taxable business income, but since the recent federal tax cut, 28 states have "decoupled" from the federal code, mostly because of the new tax deduction for "bonus depreciation."

Less obvious is the growing multistate tax compliance cost issue for individuals. For example, the interest earned on in-state municipal bonds is typically exempt from state income taxes, leaving individuals with multistate municipal bond holdings the administrative nightmare of subtracting the usually small amount of exempt interest from the non-exempt interest, which may not even be worth the tax savings.

In addition, the traditional link between residency and income as a basis for state income taxation has begun to fray (see article on nonresident taxation on page 4).

New Study Explores Impact of State Budgetary Institutions on Tax and Spending Levels

Balanced Budget Requirements, Line-Item Vetoes, and other Techniques Prove Less Effective than Generally Thought

The Tax Foundation's new Center for State Fiscal Policy has published a study on state budgetary institutions by J. Brian O'Roark, Assistant Professor of Economics at James Madison University.

Difficult decisions to raise taxes, increase other collections, or reduce spending are affected by budgetary institutions that vary substantially from state to state.

Number 41 in the *Tax Foundation Background Paper* series, and titled, "The Effect of Budgetary Institutions on Spending and Taxation by State Governments," the new study is the first in a series of papers that will investigate the nature and effectiveness of budgetary institutions at the state level (see Publication Summary).

This report on state budgetary institutions is timely because the tightening economy has created a difficult fiscal environment in many states for the first time in nearly a decade. Politically difficult decisions — to raise taxes, increase other collections, or reduce spending — are often necessitated or at least affected by budgetary institutions that vary from state to state, creating substantial differences in the way fiscal policy is carried out.

In O'Roark's first report, he defines and analyzes the seven most common and important budgetary institutions:

- the line-item veto
- biennial budgeting
- balanced budget restrictions (the deficit carry-over rule)
- the supermajority legislative vote
- tax or expenditure limitations
- term limits
- performance-based budgeting

States have typically adopted these institutions to constrain government spending. For instance, the acceptance of performance-based budgeting is predicated on the notion that such a tool will hold agencies within a government accountable for meeting predetermined goals. Therefore, if the performance of a specific program justifies the spending, the budget is increased.

Budgetary institutions have been less effective than generally thought at controlling state-level spending, taxation, or total collections, especially over the past seven years, a period of strong economic growth.

Similarly, tax and expenditure limitations were adopted during the tax revolt of the 1970s to limit the growth of a state's taxes and spending after a long period of state government expansion.

Interestingly, it was not until the anti-tax furor began to die down that economists and political scientists delved into the empirical evidence on the role of institutions in the fiscal process. A multitude of studies were undertaken looking at whether certain institutions "worked," focusing on state budgets. The results have been mixed.

Basically, the success or failure of an institution in lowering fiscal outcomes depends on the economic situation in which a state finds itself. However, there is empirical evidence and now a general acceptance among economists that institutions do matter.

The states pioneered much of the development and fine-tuning of institutions, and there is reliable data going back a number of years for each state. Thus, the states proved a natural testing grounds for the success or failure of budgetary institutions.

Unlike previous studies that focused on spending, O'Roark emphasizes the effect that each institution has on state-level tax collections including user fees, license charges and other sources of funds.

He finds that budgetary institutions are less effective than generally thought at controlling state-level spending, taxation, or total collections. Evidence shows this to be especially true over the past seven years, a period of strong economic growth.

Publication Summary

General: Background Paper No. 41; ISSN 1527-0408; 16pp.; $25 or $60/yr. for 4 issues on varied fiscal topics

Title: The Effect of Budgetary Institutions on Spending and Taxation by State Governments

Author: J. Brian O'Roark

Date: August 2002

Subject: Examination of state budgetary institutions, with discussion of how effectively they control spending and taxation.

FOUNDATION MESSAGE

Defending the "Indefensible"

Scott A. Hodge
Executive Director
Tax Foundation

It has never been easy or popular to defend lower taxes for businesses. As I learned recently by appearing on MSNBC's *Hardball*, it is even more challenging in today's highly charged political climate over corporate governance and financial irregularities.

I was asked to come on the program to defend, or at least explain, why some U.S. companies have taken the dramatic step of re-incorporating in low-tax countries such as Bermuda. As Mike Barnicle, the show's substitute host said to me: "Scott, you seem like a nice guy, you've just got an impossible position to defend."

Most politicians — including my opponent on the program, Rep. Bernie Sanders (I-VT) — are calling such re-incorporations "unpatriotic" and are seeking to outlaw them in the future.

Setting aside the political rhetoric (in some cases demagoguery), what these companies are doing is little different from what millions of Americans do every day — reside in one jurisdiction and work in another. Here in the nation's capital, thousands of us live in the Virginia and Maryland suburbs but work in Washington, DC. Why? Lower taxes are one of the main reasons.

In other cities, such as Philadelphia, most workers prefer to live in the low-tax suburbs than pay the city's 4.5 percent wage tax. Snowbirds flock to Florida for 51 percent of the year to take advantage of the Sunshine state's warm climate, of course, but the absence of a state income tax probably plays a major role.

Economist Charles Tiebout once described this behavior as "voting with your feet." The ability of people and firms to relocate to lower-taxed jurisdictions is often credited with promoting tax competition among cities, states, and even countries. At a minimum, the fear of losing residents or businesses can prevent politicians from raising taxes too high compared to their neighbors.

Politicians in New Jersey are about to learn that lesson. Earlier this year, lawmakers there enacted a $1.3 billion tax hike. Among the provisions was a change in the state's corporate income tax that is intended to double corporate income tax collections.

The effect on the state's business climate was immediate. As reported in the *NorthJersey Record*, Federated Department Stores (the parent company of Macy's and Bloomingdale's), announced that the new tax hike would more than double the company's state tax payments from $4.4 million to $10.1 million next year. In a letter to Gov. James McGreevey, the company's chairman wrote, "[Federated] cannot and will not absorb a $5.7 million New Jersey tax increase without taking commensurate measures to reduce expenditure there." The bottom line: Federated plans to lay off 50 to 60 employees at a distribution center and expects future closings of stores or facilities.

Ironically, business and political leaders in New York (which has traditionally been a high-tax state but has cut business taxes in recent years), are now encouraging New Jersey firms to consider moving to the Empire State.

But imagine what would happen if New Jersey had the legal authority to prevent firms from escaping to low-tax New York. Trapped New Jersey firms would become less competitive and continue to cut jobs or lose market share, while New York firms would become relatively more competitive, adding jobs and growing the local economy.

In a similar vein, politicians in Washington should not react to the recent wave of re-incorporations by building a legal wall around the country. They should instead fix the systemic problems in the U.S. international tax rules that are forcing companies to look for relief in offshore tax havens.

To his credit, House Ways and Means Committee Chairman Bill Thomas has introduced H.R. 5095, the American Competitiveness and Corporate Accountability Act, which includes 19 overdue improvements to the tax laws governing the foreign operations of U.S. companies and would curb the flight of companies to tax havens.

While these fixes to our international tax laws will clearly allow many firms to compete more effectively overseas, it is still an open question whether these changes are enough to prevent some firms from seeking additional tax relief on their own. Instead of relocating to Bermuda, some may re-incorporate in Ireland, which has a favorable tax treaty with the U.S. and will have a 12.5 percent corporate tax rate next year.

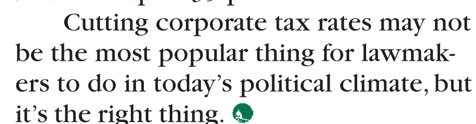
The tax fix missing from the Thomas bill is a cut in America's high corporate tax rate.

With the increased mobility of capital in the global marketplace, the investment decisions of U.S. multinational firms are much more sensitive to the tax rates of host countries. If taxes are a major determinant to where firms invest abroad, doesn't it make sense that they would be similarly sensitive to taxes at home? Of course.

At 35 percent, our corporate tax rate ranks as the fourth highest among the 24 leading industrial countries in the world. Countries with lower corporate rates include: France (33.3 percent); Great Britain (30 percent); and, Japan (30 percent). Even socialist countries like Denmark (30 percent), Finland (29 percent), and incredibly, even Sweden (28 percent) have lower rates.

The U.S. started the global tax competition race in 1986 when we lowered our 45 percent corporate tax rate to 34 percent. Sixteen years later the world has passed us by, and our rate has bounced up to 35 percent.

Cutting corporate tax rates may not be the most popular thing for lawmakers to do in today's political climate, but it's the right thing.



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Joseph O. Luby, Jr.
Chairman, Program Committee

Michael P. Boyle
Vice Chairman, Program Committee

Scott A. Hodge
Executive Director

Bill Ahern
Editor & Communications Director

John S. Barry
Chief Economist

Alicia Hansen
Staff Writer

J. Scott Moody
Senior Economist

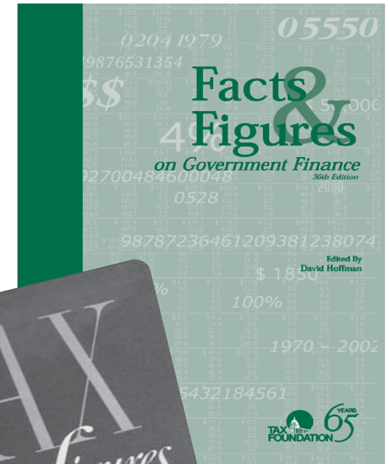
David Hoffman
Staff Economist

Tax Foundation
(202) 783-2760
(202) 783-6868 Fax
www.TaxFoundation.org
TF@TaxFoundation.org

To commemorate our 65th Anniversary, we are using this page during 2002 to remind our readers of Tax Foundation highlights from years past. One constant has been our reference book, Facts and Figures on Government Finance.

Despite the turmoil over public finances today, *Facts and Figures on Government Finance* has been through worse. On the back end of the Great Depression and the front end of WWII, the first edition of the book — titled *Tax Facts & Figures* — was published in 1941. For the first time, widely scattered facts on tax collections, government spending, and public debt were assembled in one convenient and concise handbook.

Now the newest edition is out, with over 200 tables of rates and collections data.



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