

# **The Structure of State and Local Taxes in New Jersey**

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# Introduction

What constitutes good state and local tax policy varies from jurisdiction to jurisdiction and there is no one-size-fits-all description of what constitutes an ideal tax system. There is, however, consensus as to the general principles of sound taxation. Essentially, the ideal system will collect the greatest amount of revenue fairly, with minimal economic distortions, and minimal compliance and administrative costs.

This report is divided into two parts. The first part explores the concept of an ideal tax structure, while the second part compares New Jersey's state and local public finance system compares to that in other states.

By determining the components of an ideal structure the groundwork can be laid for understanding and evaluating New Jersey's tax structure. The report explores the ideal mix of taxes. In particular, it discusses the commonly held belief that states should use a system based on a "three-legged stool" of income, sales, and property taxes each contributing about one-third of combined state and local tax revenue. The first part of the report also identifies the best ways to structure 1) individual income taxes, 2) corporate income taxes, 3) sales taxes, and 4) property taxes.

The second part takes a comparative approach to assessing New Jersey's tax system. It examines particular aspects of the New Jersey tax system, including relative reliance on different types of taxes and non tax revenue, relative tax burdens, the mix of business and personal taxes, as well as how New Jersey compares with nearby states with respect to tax rates.

# Part 1: Comparison of State and Local Revenues

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The purpose of this section is to examine various aspects of the New Jersey state and local revenue system, including relative reliance on different types of taxes and non-tax revenues, relative tax levels, and how New Jersey compares with neighboring states. To compare the composition of state and local revenues across states we use data from the US Census Bureau. These data come from the Census Bureau's government finance series. For purposes of this research note, we report data on total state and local general revenues. According to the Census Bureau, general revenues include intergovernmental revenues from other governments, taxes, current charges and miscellaneous general revenues. The definition of general revenues does not include revenues from liquor stores, utilities, and social insurance trust funds, in large part, because these revenues are not available to the local government to cover general expenditures.

## **Size of the State and Local Public Sector**

Before looking at the distribution of state and local general revenues by source across states, it is important to get a picture of how the size of the state and local public sector varies across states. Table 1 presents data on the size of state and local government for New Jersey and neighboring states measured as total state and local own-source revenues expressed per capita and as a share of state personal income. On average nationally, total state and local government own-source revenues are approximately \$5,791 per capita and about 16.0 percent of total personal income. State and local

governments in New Jersey generate own-source revenues of approximately \$7,065 per capita, about 22 percent more than the national average. Because New Jersey is a relatively rich state, these revenues account for just 15.2 percent of state personal income, about 5 percent below the national average.

<b>State</b>	<b>PC Own Rev</b>	<b>% National Average</b>	<b>Own Rev as % PI</b>	<b>% National Average</b>
<b>Connecticut</b>	\$ 6,946.99	120.0%	13.9%	87.3%
<b>Delaware</b>	\$ 7,001.76	120.9%	17.9%	112.4%
<b>Maryland</b>	\$ 6,045.53	104.4%	13.7%	85.9%
<b>Massachusetts</b>	\$ 6,603.60	114.0%	14.4%	90.2%
<b>New Jersey</b>	\$ 7,065.29	122.0%	15.2%	95.5%
<b>New York</b>	\$ 8,584.17	148.2%	20.2%	126.9%
<b>Pennsylvania</b>	\$ 5,576.46	96.3%	15.2%	95.3%
<b>US Average</b>	\$ 5,790.89	100.0%	16.0%	100.0%
Source: US Census Bureau, Government Finance, 2006.				

Of the neighboring states, only New York has higher state and local own-source revenues per capita than New Jersey (\$8,584). Own-source state and local government revenues account for 20.2

percent of personal income in New York and 17.9 percent in Delaware. State and local own-source revenues in all of the other neighboring states account for a smaller share of personal income than state and local governments nationally, and lower than New Jersey (except for Pennsylvania which is 15.2 percent like New Jersey).

Another perspective on this issue is to look at the capacity of the state and local system in New Jersey to generate revenues and their actual revenue effort. Measures of revenue capacity and effort were developed by the U.S. Advisory Commission on Intergovernmental Relations (ACIR) which developed two measures of revenue raising potential that reflect the importance of state and local tax bases and tax practices – the Representative Tax System (RTS) and the Representative Revenue System (RRS). (ACIR 1962, 1987)

These approaches focus on the hypothetical ability of state and local governments to raise revenues. The ability of jurisdictions to raise revenues is estimated by calculating the amount of revenue that would be raised if a jurisdiction applied a standard, representative tax rate to its existing tax base. The standard tax rate is defined as the national average tax rates as they apply to different tax bases. Revenue effort is calculated by comparing actual revenues raised to this measure of potential revenue capacity.

There are eight types of taxes included in the RTS measure and twelve types of tax and non-tax revenues included in the RRS measure. The general categories of tax bases included in the RTS measure include: general sales and gross receipts taxes, selective sales and gross receipt taxes, license taxes, individual income taxes, corporate income taxes, property taxes, estate and gift taxes, and severance taxes. The RRS includes all of the tax bases in the RTS as well as: all other own source taxes, rents and royalties taxes, payments under the Mineral Leasing Act, and user charges (ACIR 1987).



Yilmaz and Zahradnik recently estimated the revenue capacity and effort for each state and local system in the US for FY2005. Table 2 presents estimated revenue capacity and effort for the system of state and local governments in New Jersey and its neighboring states. The data indicate that state and local governments in New Jersey and all of its neighboring states have a greater potential capacity to raise revenues than state and local governments nationally (except for state and local governments in Pennsylvania). Similarly, the data indicate that state and local governments in New Jersey and its neighboring states (except for New York and Pennsylvania) have a revenue effort below state and local governments nationally.

<b>Table 2</b>				
<b>Revenue Capacity and Effort for State and Local Systems Using the ACIR Representative Revenue System, FY2005</b>				
<b>State</b>	<b>Revenue Capacity</b>		<b>Revenue Effort</b>	
	<b>Capacity</b>	<b>Pct National</b>	<b>Effort</b>	<b>Pct National</b>
<b>Connecticut</b>	\$7,214	135	\$6,630	92
<b>Delaware</b>	\$6,581	123	\$6,137	93
<b>Maryland</b>	\$5,976	112	\$5,680	95
<b>Massachusetts</b>	\$7,258	136	\$6,150	85
<b>New Jersey</b>	\$6,587	123	\$6,448	98

<b>New York</b>	\$5,882	110	\$7,531	128
<b>Pennsylvania</b>	\$5,031	94	\$5,244	104
<b>US Average</b>	\$5,345	100	\$5,345	100
Source: Yilmas and Zahradnik, Appendix Table 8.				

## Financing State and Local Government: Intergovernmental and Own-Source Revenues

While the size of the state and local public sector varies across states, how those state and local governments are financed also varies across state. At the most basic level, Table 3 presents data on the extent to which state and local governments in New Jersey and its neighboring states rely on intergovernmental and own-source revenue. According to the data in Table 3, nationally, state and local governments receive 20.7 percent of their general revenues from intergovernmental assistance from the federal government. Own-source revenues account for 79.3 percent of state and local general revenues nationally.

<b>Table 3</b>				
<b>Distribution of General Revenues by Source, 2006</b>				
<b>State</b>	<b>Intergovernmental as Share of Gen Rev</b>	<b>Own Source Share of Gen Rev</b>	<b>Taxes as Share of Gen Rev</b>	<b>Charges as Share of Gen Rev</b>

<b>Connecticut</b>	15.9%	84.1%	68.7%	8.4%
<b>Delaware</b>	17.2%	82.8%	50.1%	16.0%
<b>Maryland</b>	18.8%	81.2%	61.6%	12.2%
<b>Massachusetts</b>	18.6%	81.4%	58.6%	11.1%
<b>New Jersey</b>	16.0%	84.0%	64.5%	11.5%
<b>New York</b>	20.9%	79.1%	59.0%	10.8%
<b>Pennsylvania</b>	20.7%	79.3%	56.1%	14.1%
<b>US Average</b>	20.7%	79.3%	54.7%	15.3%
Source: US Census Bureau, Government Finance, 2006.				

The relative importance of intergovernmental, and own-source, revenues as a share of state and local general revenues varies substantially across states. For example, state and local governments in New Jersey depend on intergovernmental revenues for 16.0 percent of their general revenues. Only state and local governments in New York (20.9 percent) depend more heavily on intergovernmental grants than those nationally, or in the region. Of the neighboring states listed in Table 3, only Connecticut (15.9 percent) has a state and local government system less dependent on intergovernmental grants than New Jersey.

All of the comparison states (listed in Table 3) have state and local governments more dependent on own source revenues than state and local governments nationally, except for New York. In the aggregate, state and local governments in New Jersey generate 84 percent of their total general revenues from own-sources, higher than any of the comparison states except for Connecticut (84.1

percent). Nationally, state and local governments generate just over half of their total general revenues from taxes (54.7 percent). The state and local government system in New Jersey generates a greater share of total general revenues from taxes (64.5 percent) than any comparison state except for Connecticut (68.7 percent). Alternatively, the state and local government system in New Jersey (11.5 percent) is about in the middle of the comparison states in terms of their reliance on charges as a source of general revenues, but well below the average state and local reliance on charges nationally (15.3 percent).

In summary, the state and local system of government in New Jersey takes a somewhat smaller share of state personal income than state and local governments nationally, but is relatively more dependent on own source revenues and tax revenues than state and local governments nationally or in the neighboring states.

### ***Reliance on Own-Source Revenues: Taxes***

As mentioned above, state and local general revenues from own-sources account for 79.3 percent of total state and local general revenues in 2006 nationally. Own-source revenues are broken down into three categories – taxes, current charges and miscellaneous general revenues. Table 4 reports data on the relative importance of each of these sources of revenue. Nationally, state and local taxes accounted for 68.9 percent of state and local own-source revenues while current charges accounted for 19.3 percent and miscellaneous general revenues accounted for 11.7 percent.

State and local governments in New Jersey depend on taxes for 76.7 percent of own-source revenues. All the neighboring states (except Delaware) have state and local governments more dependent on tax revenues than state and local governments nationally, albeit state and local

governments in New Jersey have a higher dependence on taxes as a share of own source revenues than all neighboring states except for Connecticut.

<b>State</b>	<b>Taxes</b>	<b>Property</b>	<b>General sales</b>	<b>Selective sales</b>	<b>PIT</b>	<b>Other Taxes</b>	<b>Current charges</b>	<b>Misc general revenue</b>
<b>Connecticut</b>	81.6%	31.1%	12.5%	7.9%	23.7%	6.4%	10.0%	8.3%
<b>Delaware</b>	60.6%	8.9%	0.0%	7.4%	18.0%	26.3%	19.3%	20.1%
<b>Maryland</b>	76.0%	17.6%	10.0%	8.4%	29.0%	11.1%	15.1%	9.0%
<b>Massachusetts</b>	72.1%	25.5%	9.4%	4.9%	24.7%	7.6%	13.7%	14.3%
<b>New Jersey</b>	76.7%	33.3%	11.1%	6.1%	17.0%	9.2%	13.7%	9.6%
<b>New York</b>	74.6%	22.0%	13.2%	5.9%	23.3%	10.3%	13.6%	11.7%
<b>Pennsylvania</b>	70.7%	20.5%	12.4%	8.2%	17.8%	11.9%	17.8%	11.5%
<b>US Average</b>	68.9%	20.7%	16.3%	7.5%	15.5%	9.0%	19.3%	11.7%

Nationally, property taxes account for 20.7 percent of state and local own-source revenues, while they account for one-third of state and local own-source revenues in New Jersey – the highest level of dependence of any state in Table 4 (only slightly higher than state and local governments in Connecticut).

State and local governments in New Jersey are less dependent on general and selective sales taxes than state and local governments nationally. Other than Delaware, which does not have a sales tax, only two neighboring states are less dependent on general sales tax revenues than New Jersey – Maryland (10.0 percent) and Massachusetts (9.4 percent). In large part, these two states have a lower reliance on sales taxes because state and local governments in Maryland and Massachusetts are the most dependent on personal income taxes as a source of general revenue. New Jersey has the lowest dependence on personal income taxes as a source of state and local general revenues of any state listed in Table 4, albeit it is somewhat higher than state and local governments nationally.

State and local governments in New Jersey generate 6.1 percent of general own-source revenues from a myriad of selective sales taxes, nearly 20 percent below the average for state and local governments nationally (7.5 percent). Of the comparison states in Table 4, only New York (5.9 percent) and Massachusetts (4.9 percent) have state and local governments less dependent on selective sales taxes than New Jersey (6.1 percent).

### ***Local Reliance on Own-Source Revenues: Current Charges***

Nationally, according to data in Table 4, state and local governments generate 19.3 percent of their own source revenues from current charges. All state and local governments in the region depend less on current charges than state and local governments nationally, and New Jersey state and local governments depend on current charges for 13.7 percent of their own-source revenues, nearly 30 percent below the relative importance of current charges nationally.

Current charges include revenues from a number of different activities carried out by state and local governments. The Census Bureau defines current charges as “amounts received from the public for performance of specific services which benefit the person charged and from the sale of commodities

or services other than utilities and liquor stores.” Current charges are reported on a gross basis without deducting the cost of providing related services. The various elements of current charges include the following major categories of revenue:

- Education which includes revenues from higher education and from school lunch programs, school tuition from pupils and parents for tuition and transportation, and other revenues from athletic contests, sale or rental of textbooks, student activity funds, and the like. Education generates 28.9 percent of state and local revenues from current charges nationally, and 34.1 percent in New Jersey.
- Public Hospitals which includes charges from patients, private insurance companies, and public insurance programs (such as Medicare) of public hospitals and of institutions for care and treatment of the handicapped; and receipts of hospital canteens, cafeterias, gift shops, etc. Public hospitals generate 25.0 percent of state and local revenues from current charges nationally, and 10.1 percent in New Jersey.
- Highways which includes reimbursements for street construction and repairs; fees for street cuts and special traffic signs; and maintenance assessments for street lighting, snow plowing, and other highway or street services unrelated to toll facilities. Also may include fees from turnpikes, toll roads, bridges, ferries, and tunnels; rents and other revenue from concessions (service stations, restaurants, etc.); and other charges for use of toll facilities. Highways generate 4.9 percent of state and local revenues from current charges nationally, and 12.8 percent in New Jersey.

- Air Transportation which includes hangar rentals, landing fees, terminal and concession rents, sale of aircraft fuel and oil, parking fees at airport lots, and other charges for use of airport facilities or for services associated with their use. Air transportation activities generate 4.6 percent of state and local revenues from current charges nationally, and 0.2 percent in New Jersey.
- Parks and Recreation which includes gross revenues of facilities operated by a government (swimming pools, recreational marinas and piers, golf courses, skating rinks, museums, zoos, etc.); auxiliary facilities in public recreation areas (camping areas, refreshment stands, gift shops, etc.); lease or use fees from stadiums, auditoriums, and community and convention centers; and rentals from concessions at such facilities. Parks generate 2.6 percent of state and local revenues from current charges nationally, and 5.5 percent in New Jersey.
- Housing and Community Development Charges which includes gross rentals, tenant charges, and other revenue from operation of public housing projects; and fees for housing mortgage insurance (e.g., FHA-insured loans). Housing and community development charges generate 1.5 percent of state and local revenues from current charges nationally, and 2.0 percent in New Jersey.
- Sewerage which includes charges for sewage collection and disposal, including sewer connection fees. Sewerage fees generate 10.1 percent of state and local revenues from current charges nationally, and 14.3 percent in New Jersey.
- Solid Waste Management which includes fees for garbage collection and disposal; operation of landfills; sale of recyclable materials; cleanup of hazardous wastes; and sale of electricity, gas, steam, or other by-products of



waste resource recovery or cogeneration facilities. Solid waste management fees generate 4.1 percent of state and local revenues from current charges nationally, and 6.1 percent in New Jersey.

While there is some variation in some of the categories which account for relatively small shares of state and local revenue from current charges, six categories account for nearly three-quarters of state and local revenues from current charges – education (28.9 percent), hospitals (25.0 percent), highways (4.9 percent), sewerage (10.1 percent) and solid waste management (4.1 percent). While these six categories of current charges account for 73 percent of revenues from current charges nationally, they account for 77.4 percent of state and local revenues from current charges in New Jersey.

### ***Local Reliance on Own-Source Revenues: Miscellaneous General Revenue***

The final component of own source revenues is miscellaneous general revenue. According to the Census definition, miscellaneous general revenue is comprised of general revenue that does not fall into one of the other categories of general revenue – taxes, intergovernmental revenue, or current charges. Specifically, miscellaneous general revenues include revenues from:

- Special Assessments -- compulsory contributions and reimbursements from owners of property who benefit from specific public improvements; and impact fees to fund extension of water, sewer, roads, and other infrastructure facilities in new developments.
- Sale of Property -- amounts received from sale of real property, buildings, improvements to them, land easements, rights-of-way, and other capital assets (buses, automobiles, etc.), including proceeds from sale of operating and non-operating property of utilities.

- Interest Earnings -- amounts from interest on all interest-bearing deposits and accounts; accrued interest on investment securities sold; interest on funds held for construction; and interest related to public debt for private purposes.
- Fines and Forfeits -- revenue from penalties imposed for violations of law; civil penalties (e.g., for violating court orders); court fees if levied upon conviction of a crime or violation; court-ordered restitutions to crime victims where government actually collects the monies; and forfeits of deposits held for performance guarantees or against loss or damage (such as forfeited bail and collateral).
- Rents -- revenue from allowing temporary possession of government-owned buildings, land, or other fixed properties, such as from grazing fees, timberland leases, rental of unused land or property (including non-operating property of a government utility), and revenue from leases (or lease bonus payments) of land relating to natural resource exploration and production.
- Royalties -- compensation or portion of proceeds received by a state or local government for granting the privilege of using or developing property or operating under a right, primarily those related to natural resources, such as oil, gas, and mineral rights.
- Net Lottery Revenue -- proceeds from the operation of government-sponsored lotteries after deducting the cost of prizes.

According to data in Table 5, state and local governments nationally generate 11.7 percent of their own revenues from miscellaneous general revenues. For the comparison states in the region, the range is from 20 percent in Delaware to 8.3 percent in Connecticut. State and local governments in New Jersey generate 9.6 percent of their own revenues from miscellaneous revenues – a share that is nearly

20 percent below the share for state and local governments nationally, and the lowest in the region other than Connecticut (8.3 percent) and Maryland (9.0 percent).

<b>Table 5</b>	
<b>Share of State and Local Own-Source Revenues from Miscellaneous General Revenues</b>	
<b>Connecticut</b>	8.3%
<b>Delaware</b>	20.1%
<b>Maryland</b>	9.0%
<b>Massachusetts</b>	14.3%
<b>New Jersey</b>	9.6%
<b>New York</b>	11.7%
<b>Pennsylvania</b>	11.5%
<b>US Average</b>	11.7%

## **Summary of State and Local Revenue Comparisons**

There are 50 state/local systems of government in the US. Each system creates governmental organizations and institutions in a manner reflecting their history, culture and political environment. The only generalization that one can make about this system of subnational government is that things vary significantly across states so that one cannot make meaningful generalizations about systems of state and local government finance in the US.

In this context we have looked at various dimensions of the state and local system of government in New Jersey to see how its financing compares to state and local governments nationally and to its neighboring states. The data indicate that in per capita terms state and local revenues in New Jersey are 22 percent greater than per capita revenues for state and local governments nationally, and are second highest in the region. In terms of state and local revenues as a share of state personal income, the state and local sector in New Jersey is smaller than state and local governments nationally and about average for the states in the immediate region. This reflects the fact that, according to the ACIR's Representative Revenue System, revenue raising capacity in New Jersey is 23 percent greater than for state and local governments nationally, and is about in the middle of the neighboring states. While the state has a greater capacity to raise revenues than state and local governments nationally, the actual revenue raised from the system of state and local governments is actually somewhat below the effort of state and local governments nationally.

We also see that state and local governments in New Jersey depend more on own source revenues than state and local governments nationally and more than state and local governments in its neighboring states. In addition, state and local governments in New Jersey depend more on tax revenues than state and local governments nationally, and state and local governments in neighboring states, except for state and local governments in Connecticut. Generally, reliance on own revenues is considered a positive because it promotes government accountability to citizens.

We also see that state and local governments in New Jersey are more dependent on property taxes than state and local governments nationally, or in all of the neighboring states. This is a bit misleading because, as mentioned above, New Jersey is a relatively rich state with a greater ability to raise revenues than state and local governments nationally.

The following table present effective property tax rates, after all property tax relief measures have been applied, for the median priced residential property in the largest city in each state. The data indicate that the effective property tax on the median price residential property in Newark is high, but certainly not the highest in the country and not as high as some of the neighboring states. The effective tax rate, as a measure of how heavily the property tax is actually used, is not an outlier in New Jersey.

<b>Table 6</b>		
<b>Effective Property Tax Rates for the Median Priced Home in the Largest City in Each State, From the Minnesota Taxpayers Association, 2005</b>		
<b>State</b>	<b>Largest City</b>	<b>Effective Property Tax Rate</b>
New Jersey	Newark	\$2.17
Maryland	Baltimore	\$2.29
Pennsylvania	Philadelphia	\$2.23
Michigan	Detroit	\$3.23
Nebraska	Omaha	\$2.06
Texas	Houston	\$2.33
Wisconsin	Milwaukee	\$2.47
Connecticut	Bridgeport	\$1.81
Delaware	Wilmington	\$1.03
Massachusetts	Boston	\$0.68
New York	New York	\$0.64
Source: Michael E. Bell and Charlotte Kirschner, 2009, "A Reconnaissance of Alternative Measures of Effective Tax Rates," <i>Public Budgeting and Finance</i> , Volume 29, Number 2, Summer 2009, Table 6, pp. 125-26.		

In addition, we see that state and local governments in New Jersey are less reliant on sales taxes, selective sales taxes, the personal income tax, and current charges than state and local governments nationally. New Jersey is about in the middle of its neighboring states in terms of state and local reliance on general and selective sales taxes, but state and local governments in New Jersey are the least reliant on personal income taxes and current charges (except for Connecticut) than its neighboring states. If average revenues were raised from these other sources of state and local own-source revenues, with no decrease in property tax revenues, the relative importance of property tax revenues would be more in line with state and local governments nationally, and relative to neighboring states.

# Part II: Features of an Ideal Tax System

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No one tax system meets all of the criteria of an ideal tax structure. There are inherent tradeoffs between equity and efficiency, between maximizing economic activity and maximizing revenue. In addition, culture, history, the type of economy in a particular state, wealth, demographics, and political philosophies greatly influence individual states' views on sound tax policy.

Despite these differences, there is consensus among public finance experts as to what constitutes sound tax policy. It is critical to identify these principles in order to evaluate individual state and local tax systems.

Over the past several decades, a framework for identifying the principles of sound tax policy has emerged. While there may be disagreement as to their relative importance, public finance scholars have been able to generally agree on the elements of a good tax system.

Set forth below is a discussion of the features of an ideal tax structure, as expounded by the American Institute of Certified Accountants (AICA) and the National Conference of State Legislatures (NCSL). The features identified by the NCSL are consistent with elements of sound tax policy identified in other works, namely, by Hildreth and Richardson, Brunori, Joint Venture's Tax Policy Group, and Musgrave and Musgrave.

## **Feature 1: An ideal tax system comprises elements that are complementary, including the finances of both state and local governments.**

An ideal tax system insures that the revenue needs of both state and local governments are met. State and local governments often vie for tax bases (NCSL 2001). State policymakers should take into account how state tax decisions impact local governments and vice versa. State lawmakers also should consider how local government imposition of sales, income or excise taxes affect the state's ability to impose those taxes, as well as the overall effect of those taxes on the combine state and local system.

For example, different rates and filing requirements across jurisdictions increase the costs of taxpayer compliance. State and local officials should cooperate to avoid a patchwork of rate structures across the state since a revenue system that minimizes complexity reduces compliance costs (Feature 5) and increases the efficiency of revenue collections (Feature 6).

A high-quality state revenue system reveals the limitations and financial responsibilities that state government places upon local governments. For example, state policymakers should be aware of the costs that state mandates impose on local government, and local governments should have the authority to raise sufficient revenues to meet these obligations. If local governments lack the revenue bases necessary to provide services mandated by state government, state policymakers should consider statewide solutions to avoid inequalities. In some cases, state governments may subsidize local governments to ease local tax burdens or raise service levels for governments that lack enough taxing capacity to meet some standard of services. This approach needs to be weighed against the principle of



local autonomy, in which local voters decide which services they want to receive and raise money to pay for them.

State tax and expenditure limitations can undercut the ability of state and local governments to meet their responsibilities. Limitations can have various effects upon different governments, depending, for example, on a government's ability to charge for its services or to find new revenue sources. Restrictions may shift burdens or create new ones, and they can undermine the ability of local citizens to increase or reduce the level of services they are willing to fund.

## **Feature 2: An ideal tax system produces revenue in a reliable manner. Reliability involves stability, certainty and sufficiency.**

Stability, certainty and sufficiency provide the framework for discussing reliability.

***Stability.*** The amount of revenue collected should be relatively constant over time, not exposed to unpredictable fluctuations. A high-quality state revenue system promotes stability by imposing a mix of taxes, with some responding less sharply to economic change (NCSL 2001). For example, taxes (e.g., personal income taxes) whose revenue yield grows faster than personal income in expansions but slower than personal income in contractions should be offset by taxes (e.g., broad-base sales taxes) whose yield tends to be more consistent over the business cycle. A diversified revenue structure with broad bases tends to be steadier than an undiversified structure with narrow bases (Feature 3).

Some instability in state revenue systems is inevitable, however, because fluctuations in the business cycle affect all state revenue sources somewhat. Stability is imperative as most public services are intended to last for an indefinite period of time. Much of what state governments spend money on (e.g., schools, roads, prisons) remains constant from year to year (Brunori 2005).

***Certainty.*** The tax rules should clearly explain when the tax is to be paid, how it is to be paid, and how the amount to be paid. A person's tax liability should be predictable and relatively constant rather than subject to fluctuations. Tax regulations must allow taxpayers to ascertain what is subject to tax and at what tax rate(s). Taxpayers should be able to establish their tax liabilities with reasonable certainty based on the nature of their transactions. If the transactions subject to tax are easy to identify and value, the feature of certainty is more likely to be revealed. Then again, if the tax base is dependent on subjective valuations or transactions that are difficult to categorize, the feature of certainty might not arise. As The Tax Policy Group (2003) notes, for example, if a taxpayer cannot determine whether an expenditure should be capitalized or expensed or whether a particular transaction is subject to sales tax, then certainty does not exist for that tax. Moreover, how the taxes are paid and when the taxes are due should be enumerated in applicable laws, in addition to tax forms and instructions.

Certainty is vital to a tax system because it helps to improve compliance with the rules and to enhance respect for the system. Certainty normally comes from unambiguous statutes as well as timely and clear administrative guidance that are readily available to taxpayers. Changes in tax structure should be kept to a minimum.

The feature of certainty is closely related to the feature of simplicity (Feature 5). It is more likely that the principle of certainty will be compromised under a system with complex rules and regulations.

***Sufficiency.*** Sufficiency calls for revenue to be adequate to balance the state or local government budget in the short run and to vary at nearly the same rate as desired state spending. An ideal tax structure generates adequate revenue to finance the level of services that the jurisdiction chooses to provide, as determined by what the voters and elected officials decide. The level will differ by jurisdiction according to its political, cultural, social and economic characteristics. Developing a tax

system that is capable of producing the government's desired level of taxes will help lawmakers avoid frequent tax increases or spending cuts. Spending needs will vary over the long run as political and economic developments unfold.

In addition, a high-quality tax system minimizes the use of tax earmarking, the method of allocating particular tax revenue for a specific expenditure. State programs may be placed in danger if they are funded only by earmarked revenues because there is no promise of a consistent revenue stream (stability) or of adequate ongoing revenue (sufficiency). Earmarking often imposes rigidities into the budgeting system that do not permit flexible allocations of general revenue among competing earmarked revenue source (e.g., the highway department receiving gasoline tax revenues). Earmarking is justified on the basis that some part of the earmarked revenue source is supporting the benefit received. Normally, earmarking should not be used for general expenditures (NCSL 2001).

### **Feature 3: An ideal tax system relies on a balanced variety of revenue sources.**

Having a balanced variety of revenue sources makes it possible for the tax system to produce revenue in a reliable manner. In other words, balance (feature 3) insures reliability (feature 2).

All taxes have their advantages and disadvantages, but reliance on a diverse assortment can neutralize their biases. One of the aims of a tax system is economic neutrality to prevent the distortion of individual and business behavior. If revenue is divided among numerous sources and their bases are broad, tax rates can be made low to minimize the impact on behavior. A broad base itself helps meet the goal of diversification since it spreads the burden of the tax among more payers than a narrow base does. The low rates that broad bases make possible can improve a state's competitive position relative to other states.

A broad base permits fewer opportunities for avoiding the tax by changing behavior. A broad base maintains a type of equity in the tax structure since no one is exempted from paying the tax because of how income is spent or earned.

A broad base with a low rate also reduces the political opportunities to amend the tax law (Richardson and Hildreth 1999). A high tax rate affords occasions and meaningful reasons for individuals or businesses to argue before the appropriate legislative body to appeal for a tax or spending exemption. As soon as one type of income or one type of spending has been exempted from the tax, one can expect other persons and businesses to propose tax amendments that benefit them.

States and local governments should balance their tax systems through reliance on the “three-legged stool” of income, sales, and property taxes in roughly equal proportions, with excise taxes, business taxes, gaming taxes, severance taxes and user charges playing an important supplemental role. This issue is discussed in more detail in Part II.

Many states do not utilize all three main taxes. Economic circumstances or policy decisions have led some states to develop tax structures that do not rely on one of the broad based taxes. States with extensive mineral resources (Alaska, Texas, Wyoming), a significant tourist industry (Nevada and Florida), or particular political cultures (Oregon, Delaware, New Hampshire) do not impose broad based income or sales taxes.

Some state policymakers justify taxes with narrow bases on the grounds that rates have to be raised substantially to increase revenue very much. They think that, because it is politically difficult to increase rates sharply, narrow tax bases help to limit the growth of government spending. Although such states may not revamp their present systems, they should try to avoid over-reliance on any single tax.

The effect of the tax law on a taxpayer's decision as to how or whether to carry out a particular transaction should be kept to a minimum. The impact of the tax law on business and personal decisions should be curtailed. In other words, taxpayers should not be unduly encouraged or discouraged from engaging in particular activities or taking certain courses of action due to the effect of the tax law on the activity or action. The chief purpose of a tax is to raise revenue for governmental activities, rather than to affect business and personal decisions. Also, the use of earmarking – dedicating revenues to specific purposes – should be minimized.

Ultimately, whatever the mix, the tax system should reflect the state's attempt to reach its fiscal policy objectives. The reasons for selecting one set of revenue instruments over another should be clear. State policymakers should be encouraged to evaluate new revenue systems, especially if they can be shown to be more equitable (such as fees that pass a portion of the service costs to users), but revenue decisions should comply with the state's fiscal policy objectives.

**Feature 4: An ideal tax system treats individuals equitably. An equitable system imposes similar tax burdens on people in similar circumstances, and minimizes regressivity.**

There are two widely held principles of fair taxation. The first principle is *ability to pay*, which assigns tax burdens “to individuals so that individuals with a higher ability to contribute will pay more” (Musgrave 2005). The second principle is the *benefit* principle, which Cordes (2005a) states “holds that people should pay taxes according to the benefits they receive from government programs. This requires that public expenditures be financed by taxes that place a heavier burden on taxpayers who derive greater benefits from those expenditures...Just as it is fair for consumers to ‘pay for what they get’ in the marketplace, so too it is fair for them to pay taxes according to how much they benefit from government spending.” For example, the Minnesota Governor's 21<sup>st</sup> Century Tax Reform Commission

(2009) describes an ideal business tax structure as having “a strong direct relationship between the nature and level of business taxation in the state and the cost of benefits and services provided to businesses by state and local governments.”

**Horizontal equity.** According to Cordes (2005b), horizontal equity is “a principle used to judge the fairness of taxes, which holds that taxpayers who have the same income should pay the same amount in taxes.” A tax displays horizontal equity if two taxpayers with equal abilities to pay do pay the same amount of tax.

Two taxpayers, both making \$50,000 per year and owning a home worth \$100,000 in the same locality and having the same number of dependents, expect to pay just about the same in federal, state, and local taxes. If for some reason these two taxpayers pay quite different amounts of taxes, then the tax structure is not horizontally equitable. Such inequities within a tax structure may cause citizens to distrust not only the tax system, but the government as a whole.

The benefit principle dictates that tax burdens should be assigned according to the benefits that taxpayers receive from government goods and services. If one assumes that the benefits taxpayers receive from government spending vary with their income level, a case can be made that taxation according to the benefit principle would require taxpayers with the same income to pay the same amount of tax.

Under the ability-to-pay principle, people with the same incomes have the same ability to pay, and thus should pay the same amount in taxes. In contrast to the benefit principle, however, regressive taxes would not be deemed fair under the ability-to-pay principle.

**Vertical equity.** According to Cordes (2005c), vertical equity is “a principle used to judge the fairness of taxes, which holds that taxpayers with different incomes should pay different amounts of tax.” Vertical equity means that the taxpayer with the greater ability to pay should pay more tax.

A person who is earning \$20,000 per year cannot pay the same amount of taxes as a person earning \$200,000 per year. The real question is not about the absolute amount, but about the relative amount. Should the person earning \$20,000 per year only pay two percent of his income for taxes, but should the person earning \$200,000 per year pay 20 percent of his income for taxes? The answer depends on perceptions of fairness.

Under the benefit principle, vertical equity would require taxpayers with different incomes to pay different amounts of tax. However, depending on how benefits vary with income, vertical equity can require that benefit tax burdens be distributed regressively, proportionately, or progressively, depending on whether benefits from public goods and services rise less than proportionately, proportionately, or more than proportionately as income increases.

**So, what is fair?** For sure how much more tax should be paid has been a topic of debate under our current income tax system. So, rather than settling on how equity is achieved, the framework emphasizes the importance of equity.

The principle of equity is often viewed as a fairness principle. However, the term fair has different meanings for different people due to contrasting opinions on what “similarly situated” means and how progressive a tax should be. According to the AICPA (2001), for instance, with respect to an income tax, an income tax system might be considered fair if

1. All taxpayers are taxed at the same rate (a flat tax) because those with higher incomes will pay more than taxpayers with lower incomes.
2. Taxpayers with higher incomes pay tax at higher rates than lower income taxpayers (a progressive tax).
3. Many different types of income are taxed the same (meaning, for instance, that few or no types of income are excluded from taxation).
4. It combines elements of items 1 and 3 above.
5. It combines elements of items 2 and 3 above.

Consequently, using the word fair in describing a tax might be better used in regards to whether a system is *perceived* as fair. This approach acknowledges some of the subjectivity surrounding the term *fair*. Taxes should be easy to implement and uniformly applied.

As taxpayers usually pay an array of taxes, equity is best measured by considering the range of taxes the taxpayers are subject to, rather than just looking at a single tax.

**Feature 5: An ideal tax structure facilitates taxpayer compliance. It is easy to understand and minimizes compliance costs.**

The tax law should be simple so that taxpayers can understand the rules and can comply with them appropriately and in a cost-effective manner. Simplicity in the tax system is essential to taxpayers and to those who administer the various taxes. Complex rules bring about errors and disregard for the system that can reduce compliance. Simplicity is central to enhance the compliance process and to



enable taxpayers to better understand the tax consequences of transactions in which they partake in or plan to partake.

Reducing complexity also helps taxpayers confirm that taxes are being applied fairly and uniformly. Because tax compliance is largely voluntary, it is important that taxpayers feel the system is fair.

Some complexity is inevitable, however. As stated in Feature 1, a state or local tax system pursues multiple policy objectives that lead to some complexity. For example, some states have created sales tax credits for low-income households to reduce the regressivity of the sales tax. Applying for the credits becomes more complex and burdensome for eligible individuals, but the benefits of low-income tax relief are considered to outweigh the trouble of applying. Compliance is facilitated by certainty (future tax obligations are predictable), consistency (tax bases are identical throughout a state), simplicity (taxpayers costs are reduced), and stability of revenue collections (changes in the rates and bases of the taxes are minimized).

Brunori (2005) observes that “by and large, state tax systems get high marks for the administrative ease and efficiency of taxes paid by individuals.” Sales taxes and personal income taxes place relatively small compliance burdens on individual taxpayers and minimal enforcement burdens on state revenue departments. Take for instance an individual’s compliance obligations for sales taxes end at the time of purchase -- no forms need to be filed, no records kept, no accountants consulted. By the same token, withholding requirements and general conformance with federal tax laws minimize the burdens of complying with individual income taxes.

While compliance costs should be minimized for the whole gamut of taxpayers, policymakers should be responsive to special compliance obligations that primarily concern businesses, especially

when businesses may be subject to numerous rates and requirements if they operate in multiple jurisdictions. States can reduce this burden by working with local governments to coordinate business tax policy and administration (Feature 1), consolidating industry-specific taxes into general forms, and coordinating business tax policy with other states and the federal government.

**Feature 6: An ideal tax structure promotes fair, efficient, and effective administration. It is simple as possible to administer, raises revenue efficiently, is administered professionally and is applied uniformly.**

Tax administration involves assessing and collecting taxes. Generally, taxes that are inexpensive to administer and easy to comply with should be adopted (Roose, Schaufele, and Manev 2009; The Minnesota Governor’s 21<sup>st</sup> Century Tax Reform Commission 2009; Lee, Johnson, and Joyce 2008; Washington State Tax Structure Study Committee 2002). A tax system that is easy to administer reduces the likelihood of errors and facilitates fairness. Professional and uniform tax administration – both throughout the state and within individual jurisdictions – enhances the effectiveness of the system by improving taxpayer compliance. Poor tax administration will mean that tax burdens are distributed among taxpayers in ways the law did not intend. If the tax system is administered fairly, individuals and businesses are more likely to pay their rightful share of the tax burden.

Tax collection involves a number of costs. Some costs are borne by the government, some accrue to the taxpayer, and some go to an intermediary, such as the retail store owner who collects the sales tax. The individual income tax, for instance, may be rather inexpensive for the state government to administer (considering the level of revenue produced), but individuals may find it costly to follow all of the particular requirements of reporting income and calculating taxes owed. These high compliance

costs come about due to the intricacy of the tax structure. The more complex the tax, the greater is the cost for the government to administer it and the greater the compliance costs for taxpayers to determine their tax liability and report it. But, this complexity, in part represents the cost of attempting to promote equity. Furthermore, as Musgrave and Musgrave (1989) state, “administration and compliance costs should be as low as possible as is compatible with the other [features of an ideal tax structure].”

Besides the cost involved in the initial collection, there is another cost the government incurs by making sure that the tax is applied uniformly -- the cost of enforcement. Enforcement tends to be more thorny and costly in situations where the laws and rules governing the revenue source are byzantine, and where the responsibility for initial collection, i.e., determining the level of tax to be paid, lies with the taxpayer. That is why the income tax is rather costly to enforce, while the property tax is much less costly. As for the property tax, there is much less room for interpretation by the taxpayer – the amount is not normally in dispute.

## **Feature 7: An ideal tax structure is responsive to interstate and international economic competition.**

According to the Tax Policy Group (2003), “a tax system should be aligned with the economic goals of the jurisdiction imposing the tax.” The tax system should neither deter nor hinder goals such as economic growth, capital formation, and international competitiveness (The Minnesota Governor’s 21<sup>st</sup> Century Tax Reform Commission 2009; Washington State Tax Structure Study Committee 2002).

Usually, the system should not favor one industry or type of investment at the expense of others. For example, a jurisdiction would probably not want to design an income tax that imposes a 90% rate on the

top 25 percent of income earners because such a system would harm the jurisdiction's economic growth.

As a broad rule, broad tax bases and a balanced variety of revenue sources would improve a state's competitiveness relative to other states. Tax burden should not be very different from other states. The tax base should provide for services that are similarly provided in surrounding states.

Benefits have to be measured against costs when state revenue systems are used as a tool of economic development policy. Interstate tax competition can deplete state resources without significantly enhancing job creation, and concessions in the form of tax breaks can erode tax bases. The steady erosion of state corporate tax base is the pervasive use of targeted tax incentives. The most prominent example is the "Mercedes-Benz" law. Passed in Alabama, the law was meant to persuade the German automaker to remain in the state. Under the law, companies that invest at least \$5 million and employ at least 50 people in the state are allowed to issue tax-exempt bonds to finance their operations. The companies can then claim corporate income tax credits for the amount spent servicing the debt on the bonds. The law provided Mercedes-Benz with more than \$250 million in tax breaks, the majority of which reduced the company's corporate income tax liability. "Alabama raises less than 4 percent of its total tax revenue from corporate income taxes, a below-average percentage that is almost certainly related to the Mercedes-Benz law," writes Brunori (2005). And according to the NCSL (2001), "in evaluating its competitive position, a state should be aware that tax policy is only one consideration in business location decisions; service levels are also important."

Similar goods should face similar taxes. Consumers are responsive to price changes on a good if close substitutes are available and are available at a lower price. Therefore, tax policy should tax similar goods at similar rates and should tax firms providing the goods at the same rate.

The feature of responsiveness to interstate and international competition might seem to be in conflict with the feature of neutrality. This need not be the case though. This feature just recognizes that rules to calculate the tax base and tax rate have economic effects. Taking an example from the Tax Policy Group (2003), if the income tax system calls for a 30-year depreciable life for semiconductor manufacturing equipment, the jurisdiction must recognize that such a rule will have an effect (here, an adverse one) on the cost of semiconductors and site location decisions of semiconductor manufacturing companies.

### **Feature 8: An ideal tax structure minimizes its involvement in spending decisions and makes any such involvement explicit.**

According to Musgrave and Musgrave (1989), “taxes should be chosen so as to minimize interference with economic decisions in otherwise efficient markets. Such interference imposes ‘excess burdens’ which should be minimized.”

The primary purpose of a tax system is to raise money. One of the goals of a tax system is to be economically neutral, a goal that is inconsistent with the use of tax policy to make budget decisions or to influence behavior. According to Brunori (2005), state tax systems have generally failed to achieve neutrality. Tax systems can affect budgets in two main ways – through deductions, exemptions and credits intended to foster certain activities and through the use of earmarking.

An ideal tax structure may include such devices. However, policymakers should be certain that these measures not only would do what is expected of them, but also reach their goal at a reasonable

cost. Tax deductions, credits, and exemptions transfer tax burdens from a favored set of taxpayers to less favored taxpayers. That's why the costs should be explicit and should be reviewed annually

Businesses are provided deductions, credits, and exemptions as incentives to invest in plants and equipment and to expand their workforces. While these incentives are sometimes offered to all businesses in the state, in some cases they are offered to particular industries or specific companies. The incentives usually involve reductions in corporate income, sales and use, or property taxes. The tax incentives are typically used to motivate businesses to act in ways in which policymakers believe the businesses would not otherwise act.

Earmarked taxes also may not in the long run to perform as efficiently as originally expected, providing a different amount of revenue for services or programs than policymakers would allocate if it were a matter of appropriation. All these devices tend to remain on law books without regular consideration of their impact and possibly after the need for them are gone.

On the other hand, these measures are versatile and they will continue to be part of state revenue systems. According the NCSL (2001), "they should be used carefully with full consideration given to the tax shifting that may be involved and to the long-term costs and benefits."

## **Feature 9: An ideal tax structure is accountable to taxpayers.**

For a revenue system to be accountable to taxpayers, states are required to play several roles, according to Brunori (2005). First, the government must ensure that those responsible for the administration and enforcement of the tax laws are carrying out their duties efficiently and fairly. Few things are more injurious to taxpayer morale than corrupt or ineffective collection.

Second, the government must implement the laws. People and business owners must pay their outstanding taxes. The government must also demonstrate the means and political will to ensure the collection of those taxes. Each feature of ideal tax structure discussed here requires the government to enforce the tax laws. As many developing countries have discovered, lax tax enforcement leads to widespread tax evasion.

Third, achieving open, transparent tax policy has proved difficult for states as tax laws ought to be explicit not implicit. If there are proposals for changes, the public should be made well aware of them in order to foster debate. Local governments may suffer from media and voter inattention and may need to undertake special efforts to notify voters to proposed changes. Truth-in-taxation policies that necessitate clearly written notifications to taxpayers and hearings on tax increases are simple methods for providing accountability.

For state governments, tax expenditure budgets are used to enhance accountability. A tax expenditure budget shows the costs, expressed in lost tax revenue, of a tax credit or exemption that is to intentionally benefit some group of taxpayers or encourage a public policy objective. A tax expenditure budget shows revenue losses just as a regular budget shows expenditures. For example, states may exempt a portion of retirement income from personal income taxes or provide deductions for business subsidies for child care. In addition to identifying the revenue loss from such tax preferences, tax expenditures also provide data that can be used to evaluate the effectiveness and efficiency of these policies.

In reality, much state tax policy is developed and implemented behind closed doors at the legislative and executive levels of government. The legislative secrecy that often surrounds tax law is nothing out of the ordinary; this has been the situation for years. Usually, a person, corporation, or

industry will apply pressure to a legislator for some tax benefit. For various reasons, the entity or legislator may not want to reveal the particular tax benefit to the public. In many cases, the legislator will then attempt to conceal the true beneficiary by hiding the proposed change in legislation that appears to apply to generally to the public.

Administrative secrecy is also endemic in state tax matters. Many laws either clearly or implicitly check public access to state administrative actions. Not many would dispute that ideal tax policy requires confidential taxpayer information to be released. Tax return information of all individuals, and some businesses', should, as a general rule, not be unveiled to the public. Nevertheless, administrative documents that set tax policy should clearly reside in the public domain. Such documents may not always be available for review.

From a broader perspective, accountability implies that policymakers must weigh the costs and benefits of using revenue measures as tools to implement non-fiscal policies. Because tax policy will certainly be used to achieve other policy objectives, lawmakers have a duty to ensure that the policy produces the desired effect and does so at a reasonable cost. Earmarked funds, tax expenditures and all other special tax preferences should be reviewed regularly to assess their efficiency and effectiveness as policy measures.

Regardless of the importance of preserving the integrity of tax systems, a good number of states do poorly in evaluating their tax laws and policies. States fail to evaluate their tax laws regularly because they are not legally required to do so. Some states have created commissions to study tax reform needs (McGuire and Rio 1995). Unfortunately, few states evaluate their revenue systems consistently. For instance, not a state conducts regular incidence studies to determine who is paying what share of government services. Moreover, just a few states perform these studies when



considering legislation (Mazerov 2002). State legislatures have not mandated (or appropriated funds for) such studies.

# Part 3: How Ideal Personal, Corporate, Sales, Property Tax Systems Should Be Structured

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## I. Personal Income Taxes

### *Personal Income Defined*

Personal income includes all income regularly received by persons, including wages, salaries, and other labor income; rent; interest; dividends; and transfer payments (Fisher 2007). Ideally, personal income tax should be imposed on a broad base. The income tax should be used at a minimum to promote certain behaviors. To achieve efficiency in administration and to minimize compliance costs, most states link the personal income tax with the federal tax code.

### *Strengthen Progressivity of the Personal Income Tax*

The personal income tax achieves vertical equity and to a lesser degree, horizontal equity. The personal income tax is the only state tax that is progressive by design, so including personal income taxes in the overall mix of state taxes helps strengthen progressivity of the system.

The progressivity of the income tax systems varies widely from state to state. Income taxes achieve progressivity through using a graduated rate structure or a flat tax structure allowing personal exemptions and standard deductions removing low-income taxpayers from tax rolls. Furthermore, 23 states and the District of Columbia make use of earned income tax credits – aimed at low-income working taxpayers – that offset income tax liability and may offer refunds beyond tax liability (Levitis and Koulis 2008).

During the 1990's the state income tax system as a whole became decidedly less progressive (Johnson and Tenny 2002). Widespread tax cuts, deductions, credits, and exclusions narrowed the tax base and reduced the relative tax burden on the wealthiest taxpayers. In the 1990's most state adjustments to the income tax narrowed the base and benefited the wealthy more than the poor. For example, in 1996, eight states lowered their personal income tax rates which decreased the progressivity of the income tax; six states increased their standard deductions which increased the progressivity of the income tax (Mackey 1996).

By 2009, state income tax regimes could be deemed only mildly progressive (Rosenberg 2007; ITEP 2009). Most states have few designated brackets. In fact, as of 2004, 31 of 41 states imposed taxes on families at or near the poverty level (Llobrera and Zahradnik 2004). A study by Lav, McNichol, and Zahradnik (2005) find that only 23 states had top tax brackets starting at \$30,000 or more.

Still, the income tax satisfies the requirements of vertical equity far more than any other state tax. Even in states with flat rates, enough income is exempt from the tax that lower-income persons are removed from the tax rolls. Thus, even in these states, the tax is levied somewhat progressively.

A goal of the income tax is to support horizontal equity. Personal income tax systems vary widely across states, leading to different levels of progressivity (Rosenberg 2007). Income taxes are imposed based upon an established formula that requires jurisdictions to levy the same tax on taxpayers with the same income. A slew of tax credits, deductions, and exemptions may erode horizontal equity, though.

In recent years, as a result of the economic crisis, states have turned to higher and more progressive income taxes to raise new revenue. Top rates were increased and/or capital gains breaks were scaled back by several states. In FY 2009, tax increases have contributed to a total \$10.6 billion net

tax increase or 43.5% of total net change in state tax revenue (NCSL 2009). To cite some examples, Oregon added new top marginal tax rates of 10.8 percent and 11 percent to raise \$243 million, while California raised income tax rates by 0.25 percent and reduced the dependent credit. The result of such actions is to increase the overall progressivity of the tax system.

### ***Minimize Use of Deductions and Exclusions to Promote Certain Behaviors***

Governments should refrain from using the income tax to promote certain behaviors, even if they meet a societal ideal. Wallace and Edwards (1999) find that “the growth in the number of exemptions and exclusions from income taxation are potentially reducing its stability as a long-run revenue source for state and local governments.” So, the ideal income tax should be imposed on a broad base such that it can promote neutrality, increase revenue, and minimize compliance costs.

Similar to other taxes, the personal income tax is not economically neutral. The very existence of the tax, can theoretically affect individual decisions about whether and how much to work, save, and invest. The higher the marginal rate, the stronger the work disincentive provided by state or local income taxes. High capital gains tax rates also can discourage investment. Nonetheless, the effect of state or local income taxes on work and investment decisions is swamped by the federal income tax. State or local income taxes may be a factor in decisions about work effort, but they probably are not the deciding factor for most taxpayers.

Most state income tax preferences are purposely designed not to be economically neutral. Some state or local policymakers favor using the income tax code to provide incentives for certain behavior (saving for retirement, attending college) and offer disincentives for other behavior. For instance, Massachusetts has a high tax rate on short-term capital gains, but the tax rate falls when assets are held for longer periods of time. This condition is meant to deter short-term speculative gains,

while rewarding investors who hold assets over a longer period of time. Other states have exempted interest earned in college savings plans from state income taxes to encourage taxpayers to participate in these plans.

### ***Tie Personal Income Tax with the Federal Tax Code***

An ideal income tax structure ties the personal income tax with the federal tax code to realize efficiency in administration and to minimize compliance costs for taxpayers.

Most state income tax systems are closely connected with the federal tax code. But, federal tax changes have caused a number a number of states to reconsider this practice. As recently as 1997, three states – North Dakota, Rhode Island, and Vermont – levied their income tax as a percentage of federal tax paid, that is, taxpayers in these states calculated their federal tax due and then paid a percentage of that amount to the state. That practice has been discontinued in all states but Rhode Island. Now North Dakota and Vermont – along with eight additional states – use federal taxable income as the starting point to apply state tax rates. Another 25 states and the District of Columbia use federal adjusted gross income as a starting point. Just 5 states do not use the federal tax code as a starting point for calculating state tax liability.

States that tie personal income tax closely with the federal code obtain efficiency in administration as well as reduce compliance costs for businesses and individuals. Yet, states also lose an amount of control over their income tax systems as any changes in federal law that increase or decrease federal revenue also will impact state revenues.

A familiar assessment of the federal income tax is the tremendous complexity of the system and the sizeable compliance costs thrust upon taxpayers. At the state level, conforming to the federal tax code reduces compliance costs because taxpayers are already required to keep records and perform

calculations for federal tax forms. State administrative costs are reduced through joint federal/state audit programs where the Internal Revenue Service shares the results of audits and enforcement actions with states.

### ***Index Tax Brackets and Exemptions to Inflation***

States that are not indexing tax brackets and exemptions to inflation should consider doing so. As of 2008, only 16 states indexed either brackets or exemptions to inflation. (FTA 2008). In states without indexing, inflation pushes taxpayers into higher income brackets (or decreases the value of their exemptions) every year. Thus, their tax liability increases at a faster rate than their real income. The lack of inflation indexing creates a more regressive tax system overall. Eventually, it can lead to a system that taxes citizens with incomes at or below the poverty level (see Llobrera and Zahradnik 2004). Periods of high inflation, such as the 1970's magnify the problems posed by a lack of indexing.

The failure to index brackets and exemptions runs counter to the philosophy of the personal income tax – that individuals who earn more should pay proportionately more in taxes. It also amounts to a tax increase without the benefit of legislative debate or approval. Most important, the public is unlikely to sanction a tax on the income of persons living well below the poverty level.

## **II. Corporate Income Taxes**

### ***Require Combined Reporting***

States should require combined reporting to counter the tax-avoidance strategies of corporations. Combined reporting treats the parent and most or all of its subsidiaries as a single

corporation for state income tax purposes. States could require unitary-based combined reporting for all related corporations. Under this requirement, all related corporations would apportion their respective state tax returns as a single business. Combined reporting would severely limit corporations' ability to avoid state corporate tax liability through a variety of tax-avoidance strategies that are based on artificially shifting profits to subsidiaries located in no or low tax states. It would also add billions of dollars to state tax revenue. Corporations are generally believed to be against combined reporting requirements and would likely challenge any attempt to mandate them.

According to Mazerov (2007), combined reporting nullifies most of the common tax avoidance strategies. Attacking them one by one, as some states are doing, is inefficient and costly. Moreover, some of the strategies simply cannot be shut down effectively by any policy other than combined reporting.

However, combined reporting is not a cure-all. Some combined-reporting laws themselves contain significant loopholes. See Pomp (1998) for a discussion. More importantly, the fact that almost no combined-reporting states include foreign subsidiaries in the combined group leaves them vulnerable on an international basis to some of the same strategies corporations use with non-combined reporting states to artificially shift profits on an interstate basis. Nonetheless, a well conceived and well drafted combined-reporting law – such as the model statute recently developed by the Multistate Tax Commission – will nullify most of the aggressive corporate-tax avoidance techniques developed by lawyers and accountants advising major multistate corporations.<sup>1</sup>

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<sup>1</sup> There are critics who question the basic arguments proponents have made in advocating for combined reporting. Cline (2008) has identified several ways in which combined reporting leads to a less favorable outcome than separate filing. He found that combined reporting does not necessarily raise additional revenue, reduces investment, and increases administrative and compliance costs.

There is growing recognition that states that do not mandate combined reporting are vulnerable to a variety of corporate tax-avoidance strategies. Sixteen states have mandated combined reporting for at least two decades. Vermont enacted the policy in 2004, and it went into effect there in 2006. New York enacted a combined reporting law in April 2007, retroactive to the beginning of the year. Texas and West Virginia have implemented combined reporting in 2008 and 2009, respectively. Combined reporting is also included in a “Michigan Business Tax” that went into effect in 2008. As of 2009, a total of 23 states now require combined reporting (Mazerov 2009a).

### ***States Should Use the Three-Factor Formula***

States should use the three-factor formula as it has been identified as a fair, uniform way of allocating income in such a way that would result in multi-state businesses’ profits being taxed exactly once. As of 2004, 13 states and the District of Columbia use the three-factor formula (Ernst & Young 2004).

Most large corporations do business in more than one state and, as a result, are typically subject to the corporate income tax in multiple states. However, according to ITEP (2008a), each state faces two important limits on how much of these corporations’ profits it can tax.

First, if a corporation does not conduct at least a minimal amount of business in a particular state that state is not allowed to tax the corporation at all. Corporations that have sufficient contact in a state to be taxable are said to have “nexus” with that state.

Second, each state with which a corporation has nexus must devise rules for dividing the corporation’s profits into an in-state portion and an out-of-state portion – a process known as “apportionment.” The state can then only tax the in-state portion.



These limits exist for a good reason: if every state taxed all of the income of all corporations operating within the state's borders, businesses could find their profits taxed multiple times. Through the Uniform Division of Income for Tax Purposes Act (UDITPA), states found a fair, uniform way of allocating income among states that would result in multi-state businesses' profits being taxed exactly once.

UDITPA recommends an apportionment rule that relies equally on three different factors in determining the share of a corporation's profits that can be taxed by a state. These factors are as follows:

- The percentage of a corporation's nationwide property that is located in a state.
- The percentage of a corporation's nationwide sales made to residents of a state
- The percentage of a corporation's nationwide payroll paid to residents of a state.

The main rationale for using these three factors to determine taxable income is that companies benefit from a state's public services in a variety of ways, including owning property in a state, making sales within a state, and having an in-state employee base. The three-factor formula ensures that corporate tax liability reflects the benefits received by each type of corporation.

If every state used the apportionment rule UDITPA recommends, it would be an important step towards ensuring that all corporate profits are subject to taxation (ITEP 2008a). However, over the past twenty years many states have chosen to reduce the importance of the property and payroll factors and increase the importance of the sales factor. The majority of states now use apportionment formulas that give "double-weight" or greater to the sales factor: in such formulae, a corporation's in-state sales are at least twice as important as each of the other factors. At the extreme, more than a dozen states

now rely entirely on the sales factor in determining at least some corporations' tax liabilities. This approach is known as the "single sales factor" or SSF.

The use of SSF has created a lack of uniformity in corporate tax rules. As a result, corporations now face the same inequitable treatment that prompted the UDITPA rules fifty years ago: some multi-state businesses find their income taxed more than once, while other are not taxed at all. This inequitable treatment undermines the perceived legitimacy of the tax system by arbitrarily discriminating in favor of certain corporations and creates perverse tax incentives that can deter corporations from moving to, or remaining in, some states. According to ITEP (2008a), returning to a more uniform set of apportionment rules is an important first step in preventing widespread tax avoidance and ensuring that state corporate income taxes are applied fairly.

### ***States Should Consider "Throwback" or "Throwout" Rules to Deal with "Nowhere Income"***

States should consider implementing "throwback" or "throwout" rules to deal with "nowhere income." Ideally, all of a company's sales would be attributed to the states in which it operates, but, due to differences among states' corporate income tax rules, this is not always the case. In some instances, a portion of a business' sales tax are not attributed to any state, either because that state does not levy such a tax or because the company doesn't have sufficient level of activity in the state to be subject to the tax. This means that a corresponding portion of its profits go untaxed, a phenomenon often referred to as "nowhere income." Many large businesses are aware that they can set up their operations to maximize nowhere income and minimize the taxes they owe (ITEP 2008b).

One remedy for the problem of nowhere income is enacting a “throwback rule”, which mandates that sales into other states that are not taxable will be “thrown back” into the state of origin for tax purposes. Twenty-eight states use the throwback rule (Levin 2009).

One alternative to the throwback rule is the “throwout” rule. Rather than seeking to assign all sales to the states in which the company operates, the throwout rule simply excludes from overall sales any sales that are not assigned to any states. West Virginia is the only state with a throwout rule (Levin 2009).

Companies aggressively pursuing this “nowhere income” tax avoidance strategy can reduce their state tax bill far below what they ought to pay – and far below the taxes paid by competing companies. Allowing companies to minimize their tax liability through these strategies distorts the economic incentives they face, puts other businesses at a disadvantage, and drains away tax revenue that could be used to finance vitally important long-term public investments. Throwback and throwout rules can help to level the economic playing field among all businesses and to reduce state fiscal stress, just by simply ensuring that all of the profits companies earn are subject to taxation in the states in which they do business (ITEP 2008b). Mazerov (2003) finds evidence that suggests that states with throwback rules and combined reporting in place are disproportionately represented among states that experienced net manufacturing job gains during the economic boom of the late 1990’s.

On the other hand, Fox, Murray, and Luna (2005) argue against throwback rules for two reasons. First, the tax base that results from the imposition of the throwback rule is inconsistent with the intended tax base. The throwback income is taxed, not because the state has determined that the income was earned in the state, but, instead because another state is unable or unwilling to tax the base – an odd justification to impose a tax. Further, the tax is imposed at the home state rate rather than at

the destination state rate. Thus, the income does not meet the state's definition of earned in the state, the income is probably taxed at the wrong rate, and the revenues go to the wrong state (Fox, Murray, and Luna 2005). Second, the throwback rule converts at least part of the sales factor to an origin-based tax since the tax is imposed in the state from which transactions originate. Imposition of the throwback rule increases the incentive to move firms (or never locate them in the first place) that are selling tangible personal property into no-tax or non-throwback rule states.

### ***Minimize the Use of Tax Incentives to Corporations***

States should minimize the granting of tax incentives to corporations. Such actions violate the features of an ideal tax system by shrinking the tax base, undermining equity, and undermining efficiency.

One type of tax incentives, targeted tax incentives, are available only for specific types of firms or firms in specific circumstances. Such incentives offer special tax treatment to specific companies in return for some specified business activities in the state. These incentives often include property tax abatements, sales and use tax exemptions, job and investment credits, and accelerated depreciation deductions (Brunori 1997).

The idea is that general business tax reductions provide benefits to some firms that have no intention of either expanding or relocating their business; thus, some of the tax reduction is considered wasted as an economic development device. However, targeting tax incentives requires government and the political process to make decisions about what firms are to receive the incentives. Because officials never have complete information about investment options, those governmental decisions may also entail "waste" or error of two types. Government officials may decide to grant tax reductions to firms that would invest in the state or locality anyway, and tax reductions may be denied to firms when

the incentive would have influenced the investment location decision. It is not clear, therefore, that targeted tax incentives are any different or any more efficient than general business tax reductions (Fisher 2007).

As mentioned earlier, targeted tax incentives violate the notions of an ideal tax system; they do so in several ways. This discussion follows Brunori (1997). First, such tax incentives not only cost localities tax revenue in the short run, but may not generate the intended revenue stream in the long run.

Second, targeted tax incentives are not equitable. They fail to meet horizontal equity as they do not treat similarly situated taxpayers equally, i.e., a corporation moving into a state gets qualifies for tax incentives while existing businesses do not. Targeted tax incentives fail vertical equity as individual taxpayers, which includes the poor, face higher taxes as they need to help the state raise the tax revenue that it would have gotten had not been for granting targeted tax incentives.

Third, because targeted tax incentives inevitably lead to more frequent changes in tax laws, they make administration of the revenue system more difficult and more expensive for both taxpayers and the government. Once an incentive has been offered to attract a new company, existing business may rush to claim these benefits. For political reasons, it is difficult for the state to turn them down, which leads to a more complicated tax system.

Many states and local governments have waived taxes and given hefty subsidies to specific industries such as manufacturing plants or professional sports teams, creating inequities with businesses in the same neighborhoods that did not receive preferential treatment. The incentives were offered without the knowledge that the state will ever recoup its payout and without specifying what measures the state could take against the company if the plant or facility does not live up to its billing. Under the

threat of moving facilities and jobs elsewhere, Citigroup has received a total of at least \$285.9 million from 1989 to 2007 in subsidies just in New York, New Jersey, Kentucky, and Texas combined (Stecker and Steinberg 2007). It is no surprise for one commentator to conclude that “[a]ll the evidence points to a single conclusion: state tax incentives are a thoroughly unproven tool for promoting economic development” (Enrich 1996).

### **III. Sales and Use Taxes**

#### ***All Final Consumption Should Be Taxed: Minimize Exemptions***

So that the base is as broad as possible and the tax is as easy to administer, all final consumption should be taxed. The use of exemptions should be kept to a minimum.

Many exemptions to sales tax are well-intentioned: they reduce the tax burden on poorer citizens who spend a greater portion of their income on consumption goods than the rich, or ease the administration of the tax. To help lessen the regressivity of the tax on the poor, 32 states fully or partially exempted food for home consumption from the tax, all 45 states exempted prescription medicine, and 12 states exempted non-prescription medicine (Federation of Tax Administrators 2005).

There are two main problems associated with the abundance of exemptions. First, excessive exemptions forces states to hike up rates or forgo revenue, thereby adversely affecting the poor – the people exemptions were supposed to help. According to Brunori (2005) sales tax revenue would probably double if all consumption were taxed. Second, the widespread use of exemptions has resulted in higher tax rates on products and services subject to tax (Mikesell 1992). It was estimated that from 1979 to 1997, 21 percent of total sales tax revenue has been the result of rate increases, despite an anti-

tax fever spreading through the U.S. (Fox 1997). As exemptions became more commonplace, rates had to be increased on the remaining tax base to maintain existing revenues.

States should consider adding items deemed necessities back to the tax base and this will help broaden the tax base. Granted that such exemptions were intended to alleviate the tax burden of the poor, the evidence is mixed, at best, as to whether these exemptions accomplish their goal (Brunori 2005). Furthermore, these exemptions cost states substantial revenue because middle- and upper-income individuals enjoy the exemptions as well. If states are serious about helping the poor, what states should look into are refundable income tax credits and other direct payments.

It is without a doubt that ending the exemption for necessities would be a difficult matter politically. However, a lower sales tax for all taxpayers is possible if all final consumption is taxed.

## **Remote Sales Should Be Taxed**

Internet and mail order catalogue sales should be taxed. By not doing so, states are forgoing ever increasing amounts of potential tax revenue. It is estimated that 25 percent of taxes due on e-commerce go uncollected (Bruce, Fox, and Luna 2009). With the lack of taxation, the consumer shops by remote sales instead of brick-and-mortar stores. Horizontal inequities are created when a brick-and-mortar shop collects tax on the same item that an Internet-based store does not.

The *Quill* Supreme Court decision proclaimed that only businesses that have presence or nexus in a state are legally obligated to collect sales tax on goods sold to that state. Brick-and-mortar stores are usually quite diligent at collecting the appropriate amount of sales tax because they are liable for uncollected or unremitted taxes.

One problem is that many remote sales are made by vendors with no physical presence in the state and thus lack legal responsibility for tax collection. But states face significant revenue losses as a result. From 2010 to 2012, Internet sales are projected to jump from \$3 trillion to \$4 trillion (Bruce, Fox, and Luna 2009), while the loss in state sales tax revenue grew from \$8.6 billion to \$11.4 billion over the same time period (Bruce, Fox, and Luna 2009).

The other problem that arises from states' failure to tax remote sales is that horizontal inequities are created between traditional in-store purchases and transactions conducted by mail order or the Internet. States have essentially created an economic incentive to buy and sell remotely at the expense of brick and mortar retailers. It is no surprise that traditional retailers have complained about "the state tax system's tendency to place them at a competitive disadvantage in the marketplace" (Brunori 2005).

The most viable way of collecting taxes on remote sales is through the Streamlined Sales Tax Project (SSTP). The SSTP is a multistate project with the objective of designing and establishing, through state legislation, a voluntary, streamlined multistate system for administering and collecting sales and local government sales and use taxes. The project's main goal is to reduce the complexity and administrative burden currently borne by businesses in collecting use taxes in interstate transactions. As of July 1, 2009, 23 states have passed legislation to bring state sales tax laws into compliance, or at least partial compliance, with the Streamlined Sales and Use Tax Agreement (SSTP 2009).

## **Services Should Be Taxed**

Services should be taxed to account for the changing makeup of personal consumption from that of mostly goods to that of mostly services. Taxing services would raise considerable additional



revenue. Taxing services would reduce the year-to-year volatility of sales tax collections. By broadening the base, taxing services would make the sales tax fairer.

There is general consensus that services – particularly, consumer services – should be taxed (Fox 1998; Mikesell 1998). Nonetheless, most services are exempt in most states imposing the sales tax (Federation of Tax Administrators 2005). There is no special reason that services remain largely untaxed; it is simply due to historical trends. When sales tax was first implemented in the 1930's, services were a small fraction of the national economy, so states did not miss much revenue from not taxing it.

However, not taxing services nowadays results in a significant loss of revenue for the states. Services now account for nearly 60 percent of personal consumption (Forsberg 2009). Even though states have broadened the tax base to include more services in the past decade, many of the services that would yield the most revenue, e.g., health care, construction, legal, and accounting, go untaxed (Forsberg 2009).

Brunori (2005) discusses several reasons for taxing services. First, there is no theoretical or economic reason for excluding services from the tax base. Services are consumed like tangible personal property. By exempting services, the tax system discriminates against taxable goods. So, a person who consumes goods bears a greater tax burden than a similarly situated person who consumes services.

Taxing services will likely make the sales tax less regressive (Lav et al. 2005). Wealthier people have and will continue to spend a greater percentage of their income on services. Therefore, taxing services would likely improve vertical equity.

Second, taxing services would broaden the tax base and provide some opportunity to raise more revenue or reduce rates. With a great percentage of consumption sales exempt from sales taxation,

broadening the base would result in significant additional revenue for the states. Mazerov (2009b) estimates that if all services besides health care, education, housing, and a few others were to be taxed, \$87 billion of additional tax revenue could be realized annually on a nationwide basis. In Georgia alone, in 2006 \$1.6 billion in extra revenue could have been collected had household services been taxed (Matthews, Sjoquist, and Winters 2007). States that do not tax services to any significant degree currently – such as California, Illinois, Massachusetts, and Virginia -- probably could increase their sales tax revenue by more than one-third if they taxed a wide range of services (Mazerov 2009b).

Third, taxing services would lead to a more elastic tax base. One of the virtues of the sales tax is that it is a relatively stable source of revenue. It neither rises nor falls as quickly as personal income. But that stability is dependent on a broad base and it is challenged when large segments of potentially taxable consumables are removed from the tax base. The sales tax base is not nearly as stable as it was designed to be, or could be. And the most viable policy for broadening the base is to tax services.

Services must be taxed to broaden the tax base (Hendrix and Zodrow 2004). In a modern economy, professional services make up a substantial proportion of GDP. If services were to be included in the tax base, then we should see a significant increase in tax revenue. As a result, legislators could have the opportunity to lower tax rates, perhaps significantly, on tangible personal property.

### ***Business Inputs Should Not Be Taxed***

Business inputs should not be taxed because by doing so, the consumer of the final good is paying a tax on top of a tax. Consumers ultimately pay a higher price than they needed to if inputs had not been taxed.

There is general agreement that sales and use tax should not be imposed on consumption of business inputs (Fox 1997; Mikesell 1998). Even with many purchases exempt from the tax (e.g.,

purchases for resale, ingredients for a manufactured product, and sales of machinery), a significant portion of business inputs is taxed. In FY 2008, sales taxes paid by businesses on purchases of inputs, including capital equipment totaled \$130.8 billion (Phillips, Cline, and Neubig 2009).

Serious problems can result when a state places business inputs under sales taxation. From a theoretical perspective, the tax was designed as a levy on *personal consumption* – which leaves no basis for taxing products or services before consumption occurs. When business inputs are subject to tax, the ultimate product price will contain the tax. Thus, consumers are taxed on the tax itself; this process is called pyramiding. It's safe to say that pyramiding was an unintended consequence.

Consumers aren't aware that there is this additional tax, so transparency becomes an issue here. Taxing business inputs raises revenue in a way that obfuscates what the ultimate tax burden is.

Vertical integration occurs when a business determines that producing a needed product or service in-house is more efficient than purchasing it from an unrelated party. Taxation of business inputs may also induce vertical integration, which hurts smaller businesses. Because the sales tax often represents a significant cost of purchase, especially when the costs cannot be fully passed on to customers, taxing business inputs could lead to increased vertical integration. Thus, the principle that taxes should remain as neutral as possible when it comes to influencing business decisions is largely ignored in cases where business inputs are subject to sales tax.

Of course, eliminating taxes on business inputs is easier said than done. State budgets depend on the billions of dollars of revenue from sales taxation of business purchases. So, exempting business purchases would result in acute revenue shortfalls resulting in increases in other taxes or cutbacks in services.

There is another reason why sales tax on business purchases is difficult to eliminate: There is widespread support for the taxation of business consumption, especially when the alternative is to tax wages or personal consumption. In this regard, providing widespread tax cuts for businesses in the name of sound tax policy would not be politically feasible. More important, the sales tax on businesses is invisible to the consumer. Surely this invisibility is a problem from an accountability standpoint, but from a political standpoint, such a tax is considered preferable to the alternatives. And, quite a large share of the tax burden falls on out-of-state businesses.

To truly reform the sales tax into a consumption tax, business inputs should be excluded from the tax base. Although this reform runs counter to the overarching goal of broadening the tax base, it addresses an important problem in imposing a hidden tax on consumers. Taxes on business inputs, while politically attractive, are generally passed on to consumers in the form of higher prices.

#### **IV. Property Taxes<sup>2</sup>**

The property tax remains an important source of revenue for local governments essentially because it meets all the characteristics of an ideal tax system (Bird 1993). It continues to generate significant revenue for local governments. The property tax is considered to be a stable and reliable source of revenue for local governments (Mikesell 1993; Shuford and Young 2000). The property tax serves as a cornerstone of a balanced state and local public finance system, with states and local governments relying on other sources of tax revenue as well.

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<sup>2</sup> This section relies heavily on data and analysis set forth in Bell and Bowman (2002).

## ***Uniformity of Assessment Ensures Fairness***

Why might one consider uniformity essential for evaluating the property tax? There are two ways to look at uniformity – uniformity within each jurisdiction and uniformity across jurisdictions. In considering uniformity within each jurisdiction, the values set for individual properties determine the distribution of responsibility for funding local government activities across taxpayers. Individual properties must be assessed at the same percentage of market value for the property tax amounts to be considered fair. This will ensure the distribution of tax liability, i.e., the support of local government activities, is distributed across individual property owners in relation to their share of the true value of the total tax base.

Uniformity across jurisdictions is truly as important, to the extent that the property base is either levied upon by larger governmental units or used for nontax purposes. For example, the valuation base may be used as a factor in addressing disparities in intergovernmental fiscal capacity, or it could be used to regulate the amount of debt incurred by local governments. In all such cases, comparisons must be based on comparable information. If valuations per capita across cities are used as an allocation factor in local fiscal equalization, it is important that low valuations per capita represent poor jurisdictions, not jurisdictions valuing property at a low percentage of market value.

## ***Property Should Be Assessed at Full Market Value***

An implication of the uniformity goal is that properties should be valued at 100 percent of market value. This has intuitive appeal because the individual taxpayer generally has an idea of a property's selling price. Full market-value assessment thus contributes to the transparency and acceptance of the tax. In addition, research shows that assessment at market value enhances attainment of uniformity in the outcome of the valuation process, in part because market value is

meaningful to taxpayers and to administrators. Valuation at market level is also relatively easy to administer, because information on actual market transactions is available to the assessor. Finally, it facilitates comparison of fiscal capacity across jurisdictions.

### ***Property Should Be Assessed on a Regular Basis***

Maintaining values at market level requires periodic revaluation or adjustment to reflect changes that occur in a dynamic market setting. Without timely adjustment, property valuations tend to fall relative to the market and at different rates, over time, as market pressures differ across types of properties and areas. Therefore, timely revaluation is required, at least every three years, but in no case more than every five years (Bell and Bowman 2002).

### ***Property Tax Must Achieve Equity Across Taxpayers***

A property tax system must achieve equity across taxpayers within a taxing jurisdiction if it is to gain respect over time. Such equity has two dimensions. First is equity across taxpayers in similar circumstances, which means that taxpayers with property of similar value should pay a similar tax. This is horizontal equity. Second, taxpayers with properties of different value should pay different tax amounts, proportionate to the differences in the underlying market values. This is vertical equity. Reliance on 100 percent of market value as the base of the tax helps assure attainment of this goal. Frequent (generally annual) assessment-sales ratio studies are necessary to determine the extent to which these equity objectives are met (Bell and Bowman 2002).

### ***Efficiency Involves Simplicity and Neutrality***

To view the big picture, efficiency implies the avoidance of waste. There are two dimensions of efficiency involved. One concerns simplicity: making administration of and compliance with the tax as

easy as possible; otherwise, excessive resources are devoted to making the tax function. Simplicity is met by broad coverage of the tax that is uniform in both valuation and rates.

The other dimension involves neutrality. Without uniform treatment, multiple categories of property are created, and each is treated differently. In such a system, taxpayers seek either placement into the more favorable categories or the creation of new categories to gain more favorable treatment than existing ones offer, resulting in higher costs for both taxpayers and taxing authorities. As a result, the principle of neutrality is violated.

### ***Taxpayer Relief from Extraordinary Tax Burden***

Governments must provide explicit relief from onerous property tax liabilities for those in need, basically to acknowledge the cash-flow problem that can result from an annual tax on accumulated wealth that must be paid out of current income. The logic is that such relief will free valuers from having to provide ad hoc relief to taxpayers, and thus allow them to perform better valuations.

There is a perception that property taxes are unfairly burdening low- and moderate- income taxpayers, in particular, the elderly (Youngman 1999). State governments have instituted various programs to relieve homeowners' property tax burdens through homestead exemptions, homestead credits and circuit breakers, and property tax deferrals.

### **Homestead Exemptions**

According to Bowman (2009), homestead exemptions typically come in two forms. They can reduce assessed value by a specified number of dollars, thus reducing the property tax base to which statutory tax rates are applied. Or, a given percentage of value may be exempt.

Twenty-eight states and the District of Columbia grant homestead reductions. In effect, all homeowners in these states benefit from homestead exemptions. In four states (Nebraska, North Dakota, Ohio, and Washington), however, the exemption phases out as income increases. Homestead exemptions are based on the political belief that homeownership benefits the community and society (Youngman 1996).

Homestead exemptions are generally mandated by state law (Eom, Duncombe, and Yinger 2005), with most states requiring local governments to absorb the costs of the exemption. Requiring local governments to fund homestead exemptions has the same effect as unfunded mandates. Only 12 states reimburse local governments for some of or all of the costs of the exemption. Unfortunately, even state-financed homestead exemptions have been criticized as inefficient (Eom et al. 2005).

## **Homestead Credits and Circuit Breakers**

In addition to homestead exemptions, many states provide credits directly to homeowners, and renters in many cases, to alleviate the burdens of property tax liability. The credits are generally the same for all eligible households in a particular jurisdiction, and they typically take the form of homestead credits or circuit breakers.

Circuit breakers generally involve setting an income threshold that property tax liability cannot exceed. That threshold ranges from 1 to 9 percent of income. Homeowners and renters with property tax burdens exceeding the threshold receive the tax credits directly from the state. As of 2007, 35 states use circuit breakers (Bowman 2009). Eighteen of those states grant the relief to renters as well as homeowners.

The advantage of using circuit breakers, as opposed to homestead exemptions, is that the state, rather than the local government, incurs the cost of the credits. Circuit breakers enable the state to



target relief to those who need it most (Allen and Woodbury 2006). A fully refundable credit makes the state income tax more progressive, even in states with flat income tax rates.

## **Property Tax Deferrals**

One of the most effective, and underused methods of providing property tax relief is through deferrals. In 2007, 22 states and the District of Columbia allowed the elderly and disabled to defer property tax payments until the homes are sold or the taxpayers die. The deferred property tax becomes liens against the value of the property. Local governments generally charge interest on the amount of tax liability deferred. When the property is sold or the homeowner dies, the local government collects the unpaid property tax and any interest accrued.

Property tax deferrals are less expensive than homestead exemptions or circuit breakers. But, as Youngman (2002) notes, deferrals are underused. In 2001, only 10 senior citizens in Boston took advantage of such deferrals. And nationwide, only 1 out of 72 eligible households requested deferrals.

Although the elderly generally do not like tax liens on their property, this group often has liens placed on their homes through second mortgages, home equity loans, and reverse mortgages. Thus, educating elderly homeowners about the benefits of tax deferral may lead to increased use.

## ***Repercussions of Public Dissatisfaction with Property Taxes***

The property tax is perhaps the most visible as well as the most complained about tax. The public is generally displeased with the way the local property tax is levied and administered. The property tax is quite visible; one expects the tax bill to come from the city or county once or twice a year. The amount of the tax is the single largest tax payment on the property one has to make. And, it is a mandatory tax that one has to pay, unlike a sales tax where one can shift consumption to avoid

some of the tax. Although its visibility is a hallmark of a sound tax system, visibility has led to public dislike of the tax.

The property tax is perceived as unfairly administered. For example, the property tax has been said to lack horizontal equity: similarly situated properties can be assessed at different values. Many local governments have traditionally failed to meet legal requirements to maintain current market values through timely property reassessments. As a result, property values are often understated for tax purposes (Strauss 2001). And this treatment has contributed to unhappiness with the property tax. Problems with uneven valuation are made glaringly obvious because property tax records are public documents and are available for inspection. Property tax inequities are easier to identify than inequities resulting from the administration of other taxes, making the property tax a ready target for criticism. Finally, for various reasons (See Brunori (2005)) property tax burden has shifted from commercial and industrial real estate to residential real estate. Increased property tax, unfortunately, has not come hand-in-hand with improved public services.

The public's dissatisfaction with the property tax has limited the tax's role in local government finance system. The public's displeasure led directly to the property tax revolts of the 1970s and 1980s. These revolts, in turn, resulted in significant statutory and constitutional limitations on the property tax. Over time, the public's dissatisfaction has also created a strong political bias against the tax.

In conclusion, negative public perception of the property tax has made it more difficult to raise additional tax revenue. To counter this perception, local government has to demonstrate how increased tax revenue can lead to more or better public services.

# Part IV: Assessing New Jersey's Personal, Corporate, Sales, and Property Tax Structures

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New Jersey has had mixed success in terms of complying with the accepted notions of imposing personal income, sales, corporate income, and property taxes. The state meets many of the requirements of an ideal tax system yet falls short on many others.

The following discussion examines and evaluates the way New Jersey imposes each of these taxes. Each section is followed by policy recommendations that could result in a system that better complies with the principles of sound tax policy.

## **I. Personal Income Taxes**

New Jersey levies a broad based personal income tax on “salaries, wages, tips, fees, commissions, bonuses, and other remuneration received for services rendered whether in cash or in property” as well as on all non excluded investment income. N.J. State. Ann. Sec 54A:2-1. Since its inception, the New Jersey income tax has been earmarked for the property tax relief fund and used for the purpose of offsetting property taxes. The state does not provide for a local option income tax.

New Jersey imposes income tax rates between 1.4 percent and 10.75 percent. The highest rate applies to incomes of more than \$1,000,000. This structure imposes greater burdens on higher income citizens. But it allows the state to provide relief to lower income residents. For example, individuals earning between \$20,000 and \$35,000 are taxed at the second lowest applicable rate (1.75 percent).

Comparatively, New Jersey has slightly higher income tax rates than neighboring states as evidenced by the following chart.

**Table 7: State Individual Income Tax Rates, 2009**

**(2009's noteworthy changes in bold)**

State	Federal Deductibility	Marginal Rates and Tax Brackets for Single Filers (a)	Standard Deduction		Personal Exemptions	
			Single	Joint	Single	Dependents
Connecticut	No	3.0% > \$0  (s)	N.A.	N.A.	\$13,000 (d)	\$0
Delaware (x)		2.2% > \$2000  3.9% > \$5,000  4.8% > \$10,000  5.2% > \$20,000  5.55% > \$25,000  <b>6.95% &gt; \$60,000</b>  (s) (hh)	\$3,250	\$6,500	\$110 (c)	\$110 (c)
Maryland (x)	No	2% > \$0  3% > \$1,000  4% > \$2,000  4.75% > \$3,000	\$2,000 (k)	\$4,000 (k)	\$3,200	\$3,200

		<b>5% &gt; \$150,000</b>  <b>5.25% &gt; \$300,000</b>  <b>5.5% &gt; \$500,000</b>  <b>6.25% &gt; \$1,000,000</b>  (s)				
New Jersey (x)	No	1.4% > \$0  1.75% > \$20,000  3.5% > \$35,000  5.525% > \$40,000  6.37% > \$75,000  <b>8.0% &gt; \$400,000</b>  <b>10.25% &gt; \$500,000</b>  <b>10.75% &gt; \$1,000,000</b>  (s) (dd)	N.A.	N.A.	\$1,000	\$1,500
New York (x)	No	4% > \$0  4.5% > \$8,000  5.25% > \$11,000  5.9% > \$13,000  6.85% > \$20,000  <b>7.85% &gt; \$200,000</b>	\$7,500	\$25,000	N.A.	\$1,000

		<b>8.97% &gt; \$500,000</b>				
		<b>(s) (bb)</b>				
Pennsylvania (x)	No	3.07% > \$0	N.A.	N.A.	N.A.	N.A.

Source: <http://www.taxfoundation.org/publications/show/228.html>

(c) Tax credit

(d) Maximum equals \$13,500. Value decreases as income increases. There is a \$1,000 reduction in the exemption for every \$1,000 of CT AGI over \$27,000.

(k) The standard deduction is 15 percent of income with a minimum of \$1,500 and a cap of \$2,000 for single filers, married filing separately filers and dependent filers earning more than \$13,333. The standard deduction is capped at \$4,000 for married filing jointly filers, head of household's filers and qualifying widowers earning more than \$26,667.

(s) CT effectively doubles the bracket widths for joint filers. NY increases but doesn't double all or some bracket widths for joint filers. DE does not adjust their brackets for joint filers. MD decreases some of its bracket widths and increases others. NJ adds a 2.45% rate and doubles some bracket widths.

(x) Local rates are excluded; 5 states in this table have county or city level income taxes. In each of these states the average rate for all counties and cities, weighted by total personal income within each jurisdiction is 0.16% in Del.; 2.98% in Md.; 0.09% in N.J.; 1.7% in N.Y.; and 1.25% in Pa.

(bb) New York added two income tax brackets (7.85% and 8.97%), retroactive to January 1, 2009. The new rates are in effect for 3 years.

(dd) New Jersey added three new rates on income over \$400,000 that will apply only to tax year 2009. After 2009, the tax rates will revert to their previous structure of 6.37% on income over \$75,000 and 8.97% on income over \$500,000.

(hh) The Delaware legislature increased the top income tax rate from 5.95% to 6.95% in July 2009, retroactive to January 1, 2009.

Under current law, New Jersey imposes the income tax on a relatively broad base. N.J. State Ann. Secs. 54A:6-1, et. seq. Modest exemptions exist for the taxpayer (\$1,000), spouse or domestic partner (\$1,000), and dependents (\$1,500). Other, equally modest, exemptions exist for elderly taxpayers (\$1,000), and the blind and/or disabled (\$1,000). These common exemptions are used by virtually all states imposing personal income taxes. They are designed to provide additional relief to citizens in general or to specific targeted groups.

New Jersey allows relatively few deductions from taxable income. Alimony, limited un-reimbursed medical expenses, and property taxes are deductible from taxable income. These items are almost universally deductible throughout the country and are justified on tax or social policy grounds. The only deduction from taxable income allowed by New Jersey that has raised issues in policy context is

the “qualified conservation contribution” deduction. These deductions have been criticized as expensive programs that often allow the wealthiest landowners to retain significant property rights (through easements) while garnering tax benefits (Youngman 2006).

While not necessarily shrinking the base, New Jersey does allow several credits against state income taxes. These credits directly reduce tax burdens for the recipient on a dollar for dollar basis and thus are much more valuable to individual taxpayers than deductions or exemptions. Of course, credits are also much more expensive to the state than deductions in terms of lost revenue.

Most of the available credits are for state and local taxes paid to other states, by an S Corporation or partnership, for certain property taxes, and for excess employment taxes. These credits are commonly used and are justified under generally accepted tax policy rules. Indeed, every state that imposes a personal income tax allows some or all of these credits.

The Earned Income Tax Credit (EITC) and the Sheltered Workshop Credit are less common at the state level and, thus at least for the EITC, relatively more controversial. The EITC provides a refundable credit to low income taxpayers and serves as a means of redistributing wealth. Twenty- two states and the District of Columbia use some form of EITC to provide relief to low income taxpayers (Lav and Oliff, 2008).

From a tax policy perspective, the EITC has been criticized because it is generally operated by the revenue departments in the various states (including New Jersey), as well as by the Internal Revenue Service for the federal program. The criticism generally centers on the belief, by some, that the revenue laws (and administration) are not the most efficient or effective means for redistribution of wealth in this manner. (see e.g. Brunori 2007).

## ***Personal Income Tax Policy Recommendations***

In general, New Jersey meets the generally accepted principles of imposing personal income taxes. The state takes advantage of the virtues of the personal tax by adopting graduated rates (increasing the progressivity of the tax and reducing the regressivity of the overall system). The state minimizes the use of exemptions and credits which is essential to maintaining efficiency and effectiveness. Indeed, the state imposes its personal income tax on a broader base than the federal government or most other states (Forsberg 2006b).” There are no serious tax policy issues presented by the manner in which personal income taxes are imposed in New Jersey.

## **II. Corporate Income Taxes**

The Corporation Business Tax Act imposes a franchise tax on a domestic corporation for the privilege of existing as a corporation under New Jersey law, and on a foreign corporation for the privilege of having or exercising its corporate charter in this State or doing business, employing or owning capital or property, maintaining an office, deriving receipts, or engaging in contracts in New Jersey. N.J. Stat. Ann. 5410A-2.

The tax applies to all domestic corporations and all foreign corporations having a taxable status in New Jersey. The tax also applies to joint-stock companies or associations, business trusts, limited partnership associations, financial business corporations, and banking corporations, including national banks. A corporation is defined as any other entity classified as a corporation for Federal income tax purposes and any state or federally chartered building and loan association or savings and loan association.

Taxpayers must pay the greater of their liability under the net income tax or the alternative minimum assessment. The income-based tax is measured by that portion of the net income allocable to



New Jersey. The tax applies to net income for the firm's accounting period (calendar year or fiscal year), or any part thereof during which the corporation has a taxable status within New Jersey. The alternative minimum assessment is based on apportioned gross receipts or gross profits.

Exempt from the tax are certain agricultural cooperative associations; Federal corporations which are exempt from state taxation; corporations created under the limited-dividend housing corporation law; nonprofit cemetery corporations; nonprofit corporations without capital stock; nonstock mutual housing corporations; railroad and canal corporations; sewerage and water corporations; insurance companies subject to premiums tax; and certain municipal electric corporations. These exemptions are common and do not generally present significant tax policy issues.

The tax rate is 9% upon entire net income, or the portion of entire net income allocated to New Jersey. For tax years beginning in calendar year 2002 and thereafter, the minimum Corporation Business Tax is \$500 or \$2,000 for all members of a controlled or affiliated group of corporations if the aggregate annual payroll for all corporations is \$5 million or more. Rates for New Jersey S corporations were also changed in 2002. New Jersey S corporations with an entire net income of \$100,000 or less are still subject to the minimum tax, but if entire net income exceeds \$100,000, the rate for periods ending on or before June 30, 2006, is 1.33%. For periods ending on or after July 1, 2006, but on or before June 30, 2007, the rate is 0.67%. For taxable years 2009 and 2010, New Jersey imposes a four percent surtax on all corporate income tax liabilities.

For accounting years beginning on and after January 1, 2002, the 7.5% Corporation Business Tax rate for corporations with entire net income of \$100,000 or less is reduced to 6.5% for corporations with entire net income of \$50,000 or less. The corporate rate schedule in New Jersey is similar to that in neighboring states.

**Table 8: State Corporate Income Tax Rates**

**As of July 1, 2009**

State	Tax Rates and Brackets	Special Rates or Notes
Connecticut	7.5%	Pay higher of income tax or tax on capital (3.1 mills per dollar, with a minimum of \$250 and a maximum of \$1,000,000).
Delaware	8.7%	Banking tax: 8.7% on first \$20 million, 6.7% for next \$5 million, 4.7% for next \$5 million, 2.7% for next \$620 million, and 1.7% for amounts greater than \$650 million. A franchise tax is due on the greater of the tax calculated on authorized shares or gross assets (\$35 minimum, \$165,000 maximum). Delaware also levies a business and occupational gross receipts tax; rates range from 0.104% to 2.08%, depending on the business activity.
Maryland	8.25%	
New Jersey	6.5% > \$0 7.5% > \$50,000 9.0% > \$100,000	Companies with income greater than \$100,000 pay 9% on all income, companies with income greater than \$50,000 but less than \$100,000 pay 7.5% on all income and companies under \$50,000 pay 6.5%. The minimum tax is \$500. An Alternative Minimum Assessment based on gross receipts or profits applies if greater than corporate franchise tax. 4% surtax applied to tax liability for 2009 and 2010. Banking and financial institutions are subject to the income tax.

New York	7.1%	Businesses pay greatest of regular income tax, 1.5% AMT, 0.178% of capital base, or a fixed dollar minimum tax between \$100 and \$1500. There is an additional 0.09% tax on subsidiary capital. Some banking corporations are subject to a tax of 7.5% of entire net income, or an alternative tax on net income or assets. A surcharge of 17% of the computed tax is imposed on business activity within the Metropolitan Commuter Transportation District.
Pennsylvania	9.99%	Imposes a capital stock and foreign franchise tax of 0.189% on taxable income over \$125,000. Bank and Trust Company Shares Tax is 1.25%.

Source: <http://www.taxfoundation.org/publications/show/230.html>

New Jersey imposes a minimum tax on all corporate entities. For New Jersey gross receipts of less than \$100,000, the minimum tax is \$500. For New Jersey gross receipts equal to or greater than \$100,000, but less than \$250,000, the minimum tax is \$750. For New Jersey gross receipts equal to or greater than \$250,000, but less than \$500,000, the minimum tax is \$1,000. For New Jersey gross receipts equal to or greater than \$500,000, but less than \$1,000,000, the minimum tax is \$1,500. For New Jersey gross receipts equal to or greater than \$1,000,000, the minimum tax is \$2,000. The minimum tax for affiliated or controlled groups remains the same, \$2,000 for each member of a group that has a total payroll of \$5,000,000 or more for a privilege period.

If a taxpayer has a regular place of business outside New Jersey, its tax liability is measured by net income allocated to New Jersey, according to a three-fraction formula based on an average of property, payroll, and sales, which is counted twice. The factor is computed by adding the percentage of

the property and payroll fractions, and a fraction representing two times the sales receipts, and dividing the total by four. In this regard, New Jersey is in line with neighboring states.

**Table 9: State Apportionment of Corporate Income**

(Formulas for tax year 2008 – as of January 1, 2008)

State	
Connecticut	Double wtd. Sales (1)
Delaware	3 Factor
Maryland	Double wtd. Sales
New Jersey	Double wtd. Sales
New York (2)	Sales
Pennsylvania	70% Sales, 15% Property

1 State uses single sales factor for non manufacturing corps.

2 State is phasing in a single sales factor.

Source: [http://www.taxadmin.org/fta/rate/corp\\_app.html](http://www.taxadmin.org/fta/rate/corp_app.html)

In December 2008, New Jersey eliminated its “throwout rule” on corporations apportioning income outside the State. The new law is effective July 2010. The throw-out rule increased the sales factor by requiring a corporation to “throw-out” or exclude from the denominator of the sales factor all receipts that are assigned to jurisdictions where the corporation is not subject to a net income tax. By reducing the denominator while leaving the numerator unchanged, the sales factor is increased and the portion of a taxpayer's income that is subject to New Jersey tax is increased. Since the sales factor is double-weighted, the effect of this increase is even more significant. New Jersey is currently just one of two states that use the throw-out rule (although some states use a similar provision called the

"throwback" rule). New York, Pennsylvania, and Connecticut previously eliminated their throw out provisions.

Eliminating the throw-out rule brings New Jersey in line with neighboring states like New York, Pennsylvania, and Connecticut, which do not have a similar provision. Unlike New York and Connecticut, which use a single factor sales apportionment, and Pennsylvania, which triple weights the sales factor, New Jersey still double weights the sales factor.

Chapter 40, P.L. 2002, introduced an alternative minimum assessment (AMA) on apportioned gross receipts or gross profits of C corporations when the AMA exceeds the normal Corporation Business Tax. The assessment is based on either gross receipts or gross profits, with the taxpayer electing which formula to use. This formula must also be used for the next four tax periods. S corporations, professional corporations, investment companies, and unincorporated businesses are exempt from the AMA. The AMA also applies to non-New Jersey businesses deriving income from New Jersey sources with or without physical presence in the State that are not currently subject to the Corporation Business Tax.

### ***Credits and other incentives***

New Jersey provides for an inordinate amount of corporate tax benefits. As of 2009, New Jersey offers at least a half dozen tax incentive programs. The state offers incentives to companies relocating to New Jersey, high technology companies, to companies conducting research and development, to companies providing child care, to companies investing in economically challenged areas, to companies employing the handicapped, and to companies making movies in the state. It is unclear how many corporations receive tax benefits or the cost of such benefits. It is also unclear if the goals of the tax incentives were achieved.

## ***Corporate Tax Policy Recommendations***

### **1. Adopt Combined Reporting**

New Jersey does not require corporations to use combined reporting. Without combined reporting, New Jersey corporations can and will use planning techniques to avoid the state's corporate tax. Twenty three states now require combined reporting. And numerous commentators have asserted that the state cannot effectively impose a corporate income tax without requiring combined reporting.

### **2. Retain the Current Apportionment Formulas**

There have been several attempts in recent years to revise the apportionment formula used by New Jersey. Policy makers should resist arguments to weaken the modified three factor formula currently in use. In particular, policy makers should reject attempts to adopt a single sales factor apportionment formula. The single sales factor is often lauded as a means of spurring economic development. Because a corporation is not taxed based on the amount of employees or property in a state, this factor apportionment favors manufacturers that export all or most products out of state. But the economic benefits from adopting a single sales factor have largely not materialized (Mazerov 2001).

### **3. Reinstate the Throwout Rule or Adopt a Throwback Rule**

New Jersey repealed its throwout rule in 2008. Policy makers should consider reinstating the rule. The throw out rule helps prevent corporations from creating "no where income", i.e., income that is not taxed by any state.

The "throwback rule" is a fallback provision of state corporate tax law that is intended to deal with this conflict between nexus law and state apportionment formulas. The throwback rule effectively allows a state in which a corporation produces its products to tax the profit on any sales made by the

corporation into states in which the corporation has insufficient presence to be subjected to a tax on its profit from those sales. (The sales are said to be "thrown-back" for tax purposes from the state in which the purchaser is located to the state in which the seller is located.) If a state does not have a throwback rule in effect, 50-100 percent of the profits of its resident corporations frequently will be what tax officials call "nowhere income" profit that is earned somewhere in the United States but not subject to tax by any state.

#### **4. Rescind the Net Operating Loss Expansion**

On November 24, 2008 Governor Jon Corzine signed into law SB2130 which extends the time for corporations to carry losses forward from seven to twenty years. Effectively, losses from previous years can be subtracted from the current year's taxable income, reducing the corporation's tax liability. That means a portion of loss from previous years can be subtracted from the current year's taxable income, leading to lower taxes. The expanded carry forward period mirrors provisions in the federal tax code and 18 states, including New York, Pennsylvania, Connecticut, and Delaware.

The total revenue loss from the expanded carryforward is impossible to determine. The legislature would not place a cost figure on the bill as no revenue will be lost for ten years. But expanding the loss period so far into the future makes revenue projections more difficult and creates uncertainty in the fiscal system. Neither outcome is desirable from a tax policy perspective.

#### **5. Review Current Corporate Tax Exemptions and Credits**

New Jersey, like many states, provides substantial tax benefits to corporations that serve to narrow the corporate tax base. New Jersey policy makers should consider reviewing all existing economic development incentives and evaluating their effectiveness. Such a review would allow political

leaders to better assess the effectiveness of tax expenditure programs, particularly those concerning incentives to foster economic development.

The most effective and transparent method for reviewing exemptions and credits is to prepare a tax expenditure budget for all taxes. New Jersey is one of only eight states that does not produce any form of tax expenditure report (Levitis, Johnson, and Koulis 2009). New Jersey should prepare an annual expenditure budget.

### **III. Sales and Use Taxation**

New Jersey is typical in the manner in which it imposes its sales and use taxes. N.J. State. Ann. Secs: 54:32B et. seq. The state sales and use tax rate is seven percent. The tax is used for state general fund purposes. The state does not provide for a local option sales tax.

Under current law, the sales and corresponding use tax is imposed on receipts from retail sale, rental, or use of tangible personal property or digital property; retail sale of producing, fabricating, processing, installing, maintaining, repairing, and servicing tangible personal property or digital property; maintaining, servicing, or repairing real property; certain direct-mail services; tattooing, tanning, and massage services; investigation and security services; information services; limousine services; sales of restaurant meals and prepared food; rental of hotel and motel rooms; certain admission charges; certain membership fees; parking charges; storage services; sales of magazines and periodicals; delivery charges; and telecommunications services, except as otherwise provided in the Sales and Use Tax Act.

New Jersey specifically exempts: sales of newspapers; magazines and periodicals sold by subscription and membership periodicals; casual sales except motor vehicles and registered boats; clothing; farm supplies and equipment; flags of New Jersey and the United States; unprepared food and



food ingredients purchased for human consumption; food sold in school cafeterias; prescription and certain nonprescription drugs and other medical aids; motor fuels; textbooks; many professional and personal services; real estate sales; tangible personal property used in research and development; and production machinery and equipment.

The New Jersey Sales and Use Tax Act was amended, effective October 1, 2005, to conform New Jersey’s law to the requirements of the Streamlined Sales and Use Tax Agreement (SSUTA), which is a multi-state effort to simplify and modernize the collection and administration of sales and use taxes. The adoption of the SSUTA resulted in significant changes in New Jersey’s tax policy and administration, including uniform product definitions and changes in the taxability of specific items. In addition, the SSUTA provided for the creation of a new central registration system, certain amnesty provisions, and minor changes in the treatment of exemption certificates.

Comparatively, New Jersey is very similar to neighboring states in terms of rates and major exemptions.

**Table 10: State Sales Tax Rates**  
**As of July 1, 2009**

State	Tax Rates	Exemptions		
		Food	Prescription Drugs	Non-Prescription Drugs
Connecticut	6	*	*	*
Delaware	None			
Maryland	6	*	*	*

New Jersey	7	*	*	*
New York	4	*	*	*
Pennsylvania	6	*	*	*

Sources: <http://www.taxadmin.org/FTA/rate/sales.html> and <http://www.taxfoundation.org/publications/show/245.html>

\* - indicates exempt from tax

## ***Sales Tax Policy Recommendations***

New Jersey, like many states, has much room for improvement when it comes to sales and use taxation. The ideal tax falls on all final consumption. But New Jersey does not tax all, or even most, final consumption. In that regard, the state must impose a higher sales tax rate than if the base was broader. In that regard there are three courses of action New Jersey policy makers should entertain.

### **1. Review All Sales Tax Exemptions**

New Jersey should consider conducting an extensive review of its sales tax regime, with particular emphasis on exemptions and exclusions. New Jersey has numerous exemptions and exclusions for necessities, services, intangibles and other products consumed by individuals. New Jersey is not unique in this regard. Most states imposing a sales tax fail to tax many of the same products and services.

But broadening the sales tax base can have several desirable effects. First, broadening the base will enable the state to lower its overall sales tax rate while maintaining the same levels of revenue. This will have the twin benefits of directly providing tax relief to many residents and making the state more competitive. Second, expanding the tax base to include services and intangibles will likely mitigate the

regressive effects of the sales tax. The sales tax is regressive largely because many of the products and services purchases by wealthier citizens are not included in the sales tax base. Third, broadening the sales tax base will minimize the economic distortions present in the state's sales tax. By excluding services and many products, the state provides an economic rationale for purchasing exempt items over taxable items.

Two areas in particular warrant reevaluation by state policy makers. New Jersey exempts clothing and food for home consumption from sales taxation. In a 2006 study, The New Jersey Office of Legislative Services estimated that taxing clothing would result in approximately \$680 million more revenue while taxing food would result in an additional \$922 million (Forsberg 2006a). These items are exempt to lessen the regressive effects of the overall sales tax system. But many public finance experts believe that such exemptions are inefficient and expensive methods of providing relief to poor and middle class taxpayers. Because the wealthy enjoy exemptions for food and clothing, the effect on reducing the regressivity of the sales tax is minimized.

## **2. Expand the Sales Tax to Services**

Whether the state conducts a comprehensive review of its sales tax regime, policy makers should consider expanding the sales tax to include services. Services as a share of personal consumption has increased to nearly 60 percent. That New Jersey fails to tax most services results in lost revenue and economic distortions.

Some states have broadened their sales tax bases to include more services, yet only three states -- Hawaii, New Mexico, and South Dakota -- get a significant portion of their sales tax revenue from services. Many activities that would yield the most revenue (including such professional services as consulting, lobbying, and legal advice) remain largely untaxed.

In 2009, The Center on Budget and Policy Priorities has estimated that the annual nationwide revenue yield from taxing all services purchased by households except healthcare, education, housing, and a few others would be about \$87 billion (Mazerov 2009b). The same study found that taxing all services in New Jersey would raise approximately \$4.1 billion a year.

All 50 states exempt some or all services: housing, health and medical, personal, legal, and business. The Federation of Tax Administrators surveyed states in 2007 to gauge the level of state taxation of services used most commonly by consumers. The FTA identified 40 services that potentially could be taxed by the states. New Jersey taxes only 26 services on the list (FTA 2007). It should be noted that New Jersey is not unique in this regard. Indeed, 36 of the 45 states with a general sales imposed the tax on the same or fewer services.

### **3. Eliminate Sales Taxation of Business Inputs**

It is unclear how much sales tax revenue is collected from business purchases in New Jersey. A 2008 study estimated that businesses in New Jersey paid approximately \$3.1 billion in sales taxes (Phillips, Cline, and Neubig 2009). Nationwide, it is estimated that as much as fifty percent of all sales tax revenue is paid by business entities. The previously cited study estimated that businesses pay approximately \$101 billion a year in sales taxes.

New Jersey should consider explicitly eliminating some or all such taxes. It is a long held maxim that sales taxes should not be imposed on business purchases. Such taxation creates an effect known as cascading as the tax is passed on to consumers (or other businesses and then consumers) in the form of higher prices. Those consumers often pay sales tax on the price of the good that includes previous taxes. This results in economic distortions and “hidden burdens” on consumers.

## **IV. Property Taxes**

New Jersey imposes a locally administered tax on real property. The state does not impose a broad based personal property tax. The state imposes a general revenue/expenditure limit on local governments. With certain exceptions, Counties and municipalities are prohibited from increasing their final appropriations of the budget by more than 2.5% over prior year or cost-of-living adjustment, whichever is less. N.J. Rev. Stat. § 40A:4-45.1 et seq. This limit can be overridden by referendum. The state also imposes a statewide county property tax levy limit. A county may not increase the county tax levy to be apportioned among its constituent municipalities in excess of 2.5% or the cost-of-living adjustment, whichever is less, of the previous year's county tax levy, exempting new construction and improvements, debt service, capital expenditures, etc. N.J. Rev. Stat. § 40A:4-45.4.

### ***Property Tax Relief***

New Jersey has the highest property tax burden in the country. As a result, the state has numerous property tax relief programs in place. State law provides a homestead rebate for all homeowners with incomes less than \$75,000 and for elderly or disabled homeowners with incomes of \$150,000 or less. The rebate is paid by the state.

The state also provides a property tax reimbursement program for eligible senior citizens and disabled persons. The amount of the reimbursement is the difference between the amount of property taxes that were due and paid for the "base year" (the first year that you met all the eligibility requirements) and the amount due and paid for the current year for which you are applying for the reimbursement, provided the amount paid for the current year was greater.

The state also allows eligible homeowners and tenants who pay property taxes, either directly or through rent, on their principal residence in New Jersey are eligible for either a deduction or a

refundable credit on their New Jersey resident income tax return. Homeowners and tenants may be eligible for a deduction or credit even if they are not eligible for a homestead rebate. Qualified residents may deduct 100% of their property taxes due and paid or \$10,000, whichever is less. For tenants, 18% of rent paid during the year is considered property taxes paid. The minimum benefit is a refundable credit of \$50.

State law also authorizes three locally administered property tax relief programs. The Annual Property Tax Deduction for Senior Citizens, Disabled Persons allows an annual deduction of up to \$250 from property taxes for homeowners age 65 or older or disabled who meet certain income and residency requirements. The Annual deduction for veterans allows a deduction of up to \$250 from taxes due on the real or personal property of qualified war veterans and their unmarried surviving spouses/surviving civil union partners/surviving domestic partners. And the property tax exemption for disabled veterans allows a full exemption from property taxes on a principal residence for certain totally and permanently disabled war veterans and their unmarried surviving spouses/surviving civil union partners/surviving domestic partners. Unmarried surviving spouses/surviving civil union partners/surviving domestic partners of servicepersons who died on wartime active duty may also qualify.

### ***Exemptions and Abatements***

New Jersey exempts property owned by charitable, religious, and other non-profit organizations from property taxes. As in all other states, this exemption is widely used by virtually all charitable, religious, and educational organizations owning property in New Jersey.

New Jersey also allows municipalities to exempt property for economic development purposes. The Long-Term Tax Exemption Law of 1991 allows municipalities to grant property tax exemptions for

redevelopment projects and new housing projects. The exemptions can last for as long as 30 years from when the project is completed or 35 years after the tax exemption agreement is signed, whichever is shorter. Instead of paying conventional property taxes, abatement recipients make an annual payment, known as a payment in lieu of taxes, or PILOT, to the municipality. Since 2004, 5 percent of that money must be paid to the county. The local school district receives none of the money. The amount of the PILOT is negotiated, but can either be 2 percent of the total cost of the project or about 15 percent of the project's annual gross revenue, depending on the terms of the agreement.

New Jersey has another program aimed at spurring real estate development in urban areas. The Urban Enterprise Residential Tax Abatement provides for a full exemption from property taxes for five years for qualified property. Qualified properties are buildings (not land) used as a home or residence in a designated area. N.J. Stat. Ann Sec. 54:4-3.139.

The state also provides certain abatements and exemptions for contaminated property, air and water pollution abatement, and solar energy projects. The state also allows a one hundred percent exemption for certain designated historic properties. Eligible property includes "any building and its pertinent contents and the land whereon it is erected and which may be necessary for the fair enjoyment thereof owned by a nonprofit corporation and which has been certified to be an historic site." N.J. Rev. Stat. § 54: 4-3.52

The amount of property exempt from tax is considerable. In 2006, total exemptions were \$99,448,942,875, this includes church and charitable property, public and private school properties, public property, cemeteries and graveyards, and "other exemptions". The value of church and charitable property exempt from tax in 2006 was \$11,808,328,789 (State of New Jersey Department of the Treasury, Division of Taxation 2007).

## ***Assessment, Valuation, Classification***

The taxable value of real property established by a county board of taxation shall be expressed as a multiple of 10%, and no level so established shall be lower than 20% or higher than 100% of the standard of value. Taxable value is that percentage of true value as shall be established by each county board of taxation as the level of taxable value to be applied uniformly throughout the county. True value is the price at which, in the assessor's judgment, each parcel of real property would sell for at a fair and bona fide sale by private contract on October 1 next preceding the date on which the assessor shall complete his assessments.

The majority of property tax revenue in New Jersey is collected from residential property.

**Table 10: Classifications of Property for Assessment**

<b>Classification</b>	<b>Value</b>	<b>Percentage</b>
Agricultural	\$5,500,891,062.00	0.83%
Commercial	\$98,452,962,834.00	14.78%
Industrial	\$30,392,964,762.00	4.56%
Residential	\$498,194,325,841.00	74.78%
Vacant land	\$14,737,145,657.00	2.21%
Farm Homestead	\$416,024,247.00	0.06%



Apartment	\$18,523,292,756.00	2.78%
<b>Total</b>	<b>\$ 666,217,607,159.00</b>	<b>100.00%</b>

Source: <http://www.nj.gov/treasury/taxation/index.html?lpt/genlpt.htm~mainFrame>

The New Jersey Farmland Assessment Act of 1964 permits farmland and woodland actively devoted to an agricultural or horticultural use to be assessed at its productivity value (rather than fair market value). The Act does not apply to buildings of any kind, nor to the land associated with the farmhouse. Buildings and home sites on farms are assessed like all other non-farm property. When and if the land qualified under the Act changes to a non-agricultural or non-horticultural use, it is subject to a roll-back tax. N.J. Rev. Stat. § 54:4-23.1

***Property Tax Policy Recommendations***

**Review All Exemptions and Credits**

New Jersey periodically collects and publishes the amount of property exempt from property tax. The state should consider conducting a comprehensive study on the effectiveness of those tax benefits. With over \$100 billion of property exempt from tax, the state should assess the public benefits of those exemptions. Such a cost/benefit analysis will lead to greater transparency and more efficient policies.

**Consider Additional Local Option Taxes**

New Jersey’s heavy reliance on the property tax causes political and public opposition to the tax, requiring more and more costly tax relief programs. While the state should periodically review its

exemptions, there is nothing about New Jersey's property tax structure that gives rise to significant policy issues. Indeed, the structure of the tax is very typical when compared to other states.

The problem is that local governments do not have access to other sources of revenue. New Jersey should consider allowing local governments to impose sales taxes. Nationwide 33 of the 45 states with a sales tax allow localities to impose similar taxes. In those states, approximately 7,500 local governments impose the sales tax.

There are several policy reasons for allowing local governments to adopt sales taxes. The tax allows local governments to diversify their revenue sources. This allows governments to reduce their reliance on property taxes and intergovernmental aid. The tax can be efficiently administered as part of the state sales tax. And compared to the property taxes, the sales tax enjoys much wider public acceptance.

Similarly, the state should consider allowing local governments to impose local option income taxes. Currently, fifteen states allow local governments to impose income taxes. Three states (Maryland, Pennsylvania, Ohio) use local option income taxes on a large scale, and Iowa allows schools districts to impose the tax.

Like local option sales taxes, income taxes would allow local governments to diversify their revenue sources. Income tax revenue could be used to reduce reliance on property taxes and state aid. If the tax were imposed as part of the state income tax (commonly known as a piggyback tax), it would pose few administrative problems. In such a case, the tax is collected as part of the state levy, and the revenue is remitted to the local governments. Local option income taxes have the added benefit of reducing the regressivity of the overall state and local tax system.

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