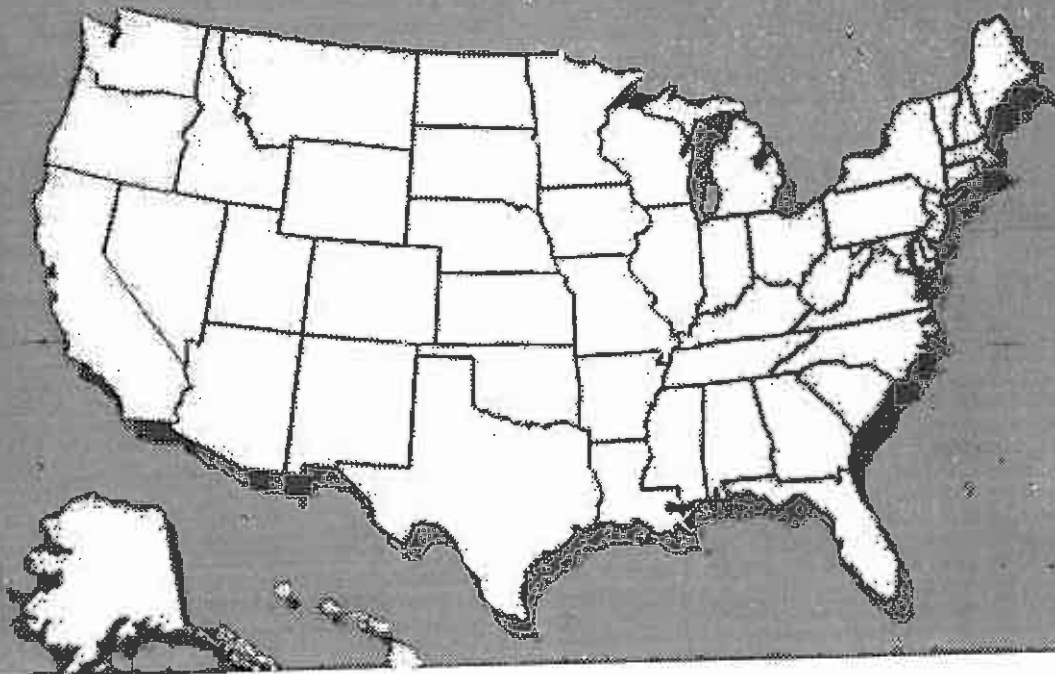


Who Pays?

**A Distributional Analysis of the
Tax Systems in All 50 States**

2ND Edition



Acknowledgments

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Who Pays? A Distributional Analysis of the Tax Systems in All 50 States
2nd Edition

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The Institute on Taxation and Economic Policy
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State governments are facing a profound fiscal crisis. In the past year, states have grappled with mounting budgetary shortfalls, as tax revenues have slumped while spending pressures have continued to grow—and these problems will probably get even worse in the upcoming year. As state and local governments are forced to make hard decisions about how to balance their books, it is an appropriate time to look at who pays for state and local government services.

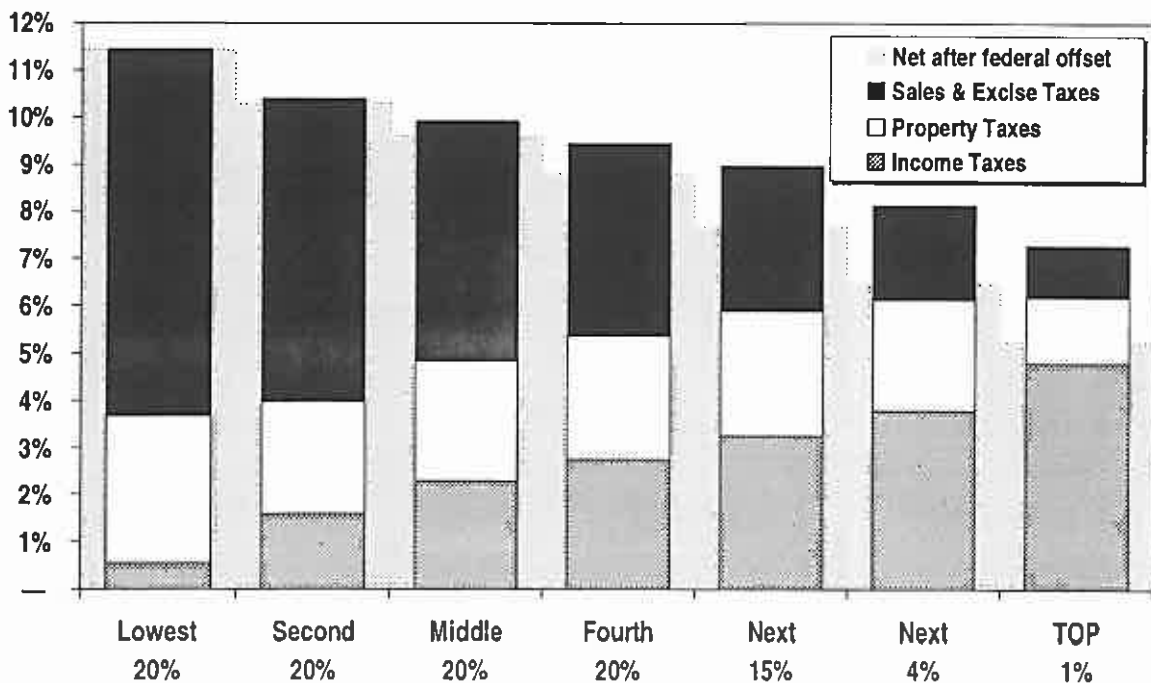
While the primary concern of lawmakers in the 2003 legislative sessions is likely to be tax *adequacy* (ensuring that sufficient revenue is available to fund important services), it is equally important to assess the *fairness* of state tax systems—both currently and as they have changed over time. This study looks at the state and local taxes paid by each income group in 2002 as shares of income for every state and the District of Columbia—and how changes in tax policy since 1989 have affected the distribution of state tax burdens.

Our primary finding is that most state and local tax systems take a much greater share of income from middle- and low-income families than from the wealthy. That is, most state tax systems are *regressive*.

In fact, only four states require their best-off citizens to pay as much of their incomes in taxes as middle-income families have to pay. Only eight states tax their wealthiest residents at effective tax rates as high as the poorest taxpayers are required to pay. And the disparities in effective tax rates between middle- and low-income families and the well-off are not trivial. Most states tax the wealthy at rates that are much lower than the rates on middle- and low-income families.

State & Local Taxes in 2002, All States

State & local taxes imposed on own residents as shares of income

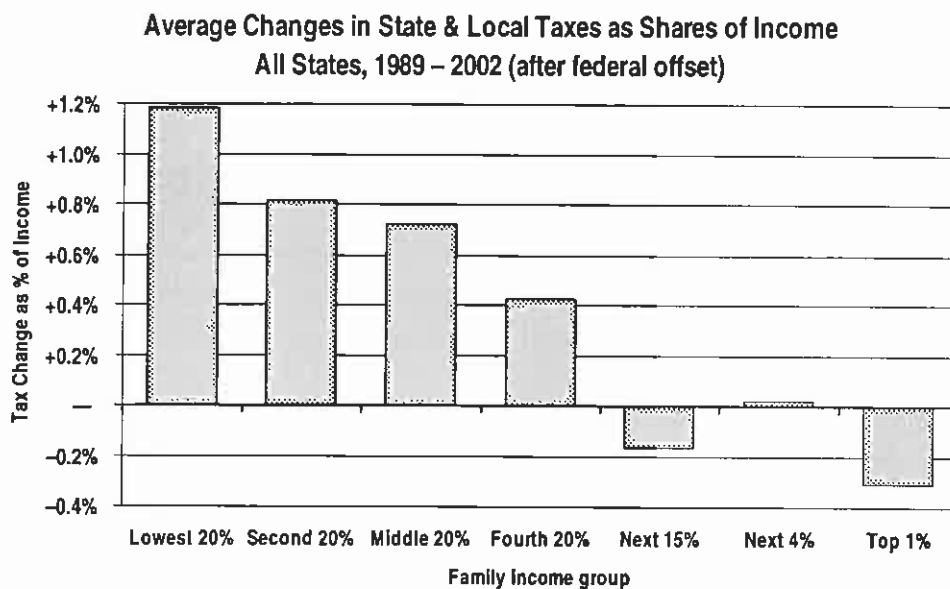


Nationwide, effective state and local tax rates on non-elderly families¹ follow a strikingly regressive pattern:

- The average state and local tax rate on the best-off one percent of families is 7.3 percent before accounting for the tax savings from federal itemized deductions. After the federal offset, the effective tax rate on the best-off one percent is a mere 5.2 percent.
- The average tax rate on families in the middle 20 percent of the income spectrum is 9.9 percent before the federal offset and 9.6 percent after—almost twice the effective rate that the richest people pay.
- The average tax rate on the poorest 20 percent of families is the highest of all. At 11.4 percent, it is more than double the effective rate on the very wealthy.

A second key finding of the study is that overall, changes in state and local taxes over the past decade have made state tax systems even more regressive. While lawmakers in many states have taken steps to provide low-income tax relief through earned-income tax credits and similar mechanisms, these progressive changes have often been insufficient to offset the growing use of regressive consumption taxes—and many states have not enacted substantial low-income tax relief at all. At the same time, many states have actually lowered taxes on their best-off residents.

State and local taxes in the United States as a whole rose slightly as a share of income from 1989 to 2002, as states were required to assume additional program responsibilities abdicated by the federal government due to its budget problems. Fair enough. But because of the way those tax increases were structured, state and local taxes rose most on poor and middle-income families, and least—or not at all—on upper-income families.



¹The study's scope is limited to non-elderly families (singles and couples, with and without children) because state tax systems often treat elderly families very differently from the vast majority of families.

- Wisconsin allows a deduction for 60 percent of capital gains income. Because capital gains are realized almost exclusively by the wealthiest 20 percent of taxpayers, this deduction makes the state income tax much less progressive. Five other states allow substantial capital gains tax breaks.

Sales and Excise Taxes

Sales and excise taxes are the most regressive element in most state and local tax systems. Because sales taxes are levied at a flat rate, and because spending as a share of income falls as income rises, sales taxes inevitably take a larger share of income from low- and middle-income families than they take from the rich.⁵ Thus, while a flat-rate general sales tax may appear on its face to be neither progressive nor regressive, that is not its practical impact. Unlike an income tax, which generally applies to most income, the sales tax applies only to a portion of income that is spent—and exempts income that is saved. Since the rich are able to save a much larger share of their incomes than middle-income families—and since the poor can rarely save at all—the tax is inherently regressive.

The average state's consumption tax structure is equivalent to an income tax with a 7 percent rate for the poor, a 4.8 percent rate for the middle class, and a 1 percent rate for the wealthiest taxpayers. Obviously, no one would intentionally design an income tax that looks like this—yet by relying on consumption taxes as a revenue source, this is effectively the policy choice lawmakers nationwide have made.

The single most important factor affecting the fairness of different state sales taxes is the treatment of groceries. Taxing groceries is a particularly regressive strategy because poor families spend most of their income on groceries and other necessities. Of the ten most regressive states in the country, four apply their sales taxes to groceries.

Sales taxes are usually calculated as a percentage of the price of a fairly broad base of taxable items. Excise taxes, by contrast, are imposed on a small number of goods, typically ones for which demand has a practical per-person maximum (for example, one can only use so much gasoline). Thus, wealthy people don't keep buying more of these goods as their income increases. Moreover, excise taxes are typically based on volume rather than price—per gallon, per pack and so forth. Thus better-off people pay the same absolute tax on an expensive premium beer as low-income families pay on a run-of-the-mill variety. As a result, excise taxes are usually the most regressive kind of tax.

Sales Taxes in the 10 Most Regressive States

State	Heavy reliance on sales tax	Food in base
Washington	✓	
Florida	✓	
Tennessee	✓	✓
South Dakota	✓	✓
Texas	✓	
Illinois		✓
Michigan		
Pennsylvania		
Nevada	✓	
Alabama	✓	✓

⁵A few states have enacted preferential tax rates for taxpayers perceived to have less ability to pay—for example, South Carolina's sales tax rate is lower for taxpayers over 85—but these special rates usually apply to taxpayers regardless of income level. Arkansas exempts some utilities for low-income taxpayers.

Overall, state excise taxes on gasoline, cigarettes and beer take about 1.4 percent of the income of the poorest families, 0.7 percent of the income of middle-income families, and just 0.06 percent of the income of the very best-off. In other words, these excise taxes are 24 times harder on the poor than the rich, and 12 times harder on middle-income families than the rich.

In addition to being the most regressive tax, excise taxes are relatively poor revenue-raising tools because they decline in real value over time. Since excise taxes are levied on a per-unit basis rather than *ad valorem* (percentage of value), the revenue generated is eroded due to inflation. That means excise taxes must continually be increased merely to keep pace with inflation, not to mention real economic growth. Policy makers using excise tax hikes to close fiscal gaps should recognize that reliance on excise tax revenues means balancing state budgets on the back of the very poorest taxpayers—and that these revenues represent a short-term fix rather than a long-term solution.

Property Taxes

Property taxes have historically been the most important revenue source for state and local governments. Today, a state's property tax base typically includes only a subset of total wealth: primarily homes and business real estate, and in some states cars and business property other than real estate. Our analysis shows that, overall, the property tax is a regressive tax—albeit far less regressive than sales and excise taxes. There are several reasons for this:

- For average families, a home represents the lion's share of their total wealth. At high income levels, however, homes are only a small share of total wealth. Because the property tax usually applies mainly to homes and exempts most other forms of wealth, the tax applies to most of the wealth of middle-income families, and hits a smaller share of the wealth of high-income families.
- For homeowners, home values as a share of income tend to decline at higher incomes. Thus, a typical middle-income family's home might be worth double the family's annual income, while a rich person's home might be valued at one-and-a-half times his or her annual income or less.
- Renters do not escape property taxes. A portion of the property tax on residential rental property is passed through to renters in the form of higher rent—and these taxes represent a much larger share of total income for poor taxpayers than for the wealthy. This adds to the regressivity of the property tax.

The regressivity of the property tax is reduced by the business tax component, which generally falls on owners of capital, and to a significant degree is "exported" to residents of other states. On average, we found that about 40 percent of a typical state's property taxes fall on business (excluding the portion of apartment taxes that we assigned to renters).

The regressivity of property taxes is dependent on factors within the control of policy makers, such as the use of exemptions, tax credits and preferential tax rates for homeowners, and external factors such as housing patterns in the state. The least regressive property taxes are generally those that use the following tax relief strategies:

Homestead exemptions

The most frequently used form of broad-based state property tax relief for homeowners is the homestead exemption, which usually exempts a flat dollar amount, or a flat percentage of home value, from property tax. Some states apply the exemption only to certain types of property tax levies, such as school taxes, while other states apply the exemption to all homeowner property taxes.

Allowing a generous homestead exemption is what sets less regressive property-tax states apart from the most regressive states. Six of the 10 most regressive state property taxes had no homestead exemption in 2002.

While several states introduced homestead exemptions during the 1990s, many other states allowed the real value of their homestead exemptions to diminish, as growing home values made fixed-dollar exemptions less valuable.

Property Tax Relief (or not) in the 10 Most Regressive States

State	Homestead Exemption	Low Income Credit
Washington		
Florida	✓	
Tennessee		
South Dakota		
Texas	✓	
Illinois	✓	
Michigan		✓
Pennsylvania		
Nevada		
Alabama	✓	

Low Income Credits

A less expensive—and more precisely targeted—form of property tax relief is a credit against property taxes that is allowed only when property tax bills exceed a certain percentage of a person's income. Most states now provide this kind of property tax break, known as a "circuit breaker," to some extent, because it provides relief only when the ratio of taxes to income becomes too high. But the majority of state circuit breakers go only to elderly taxpayers; only ten states offer circuit breakers to all low-income property taxpayers. Notably, only one of the most regressive states has a low-income circuit breaker.

Federal Itemized Deduction Offset

State and local personal income and property taxes, unlike sales and excise taxes, are allowed as itemized deductions in computing federal income taxes. This means that federal itemizers—a mostly better-off group—can effectively export part of their state tax burden to the federal government. This has a significant impact on the real tax burdens facing better-off state taxpayers, and on cross-state differences in total tax burdens.

On average, a fifth of all state personal income and individually-paid property taxes are exported to the federal government (and to taxpayers nationwide) as a result of itemized federal deductions. For the very best-off taxpayers, close to 40 percent of their state and local income and property tax bills are effectively paid by the federal government.

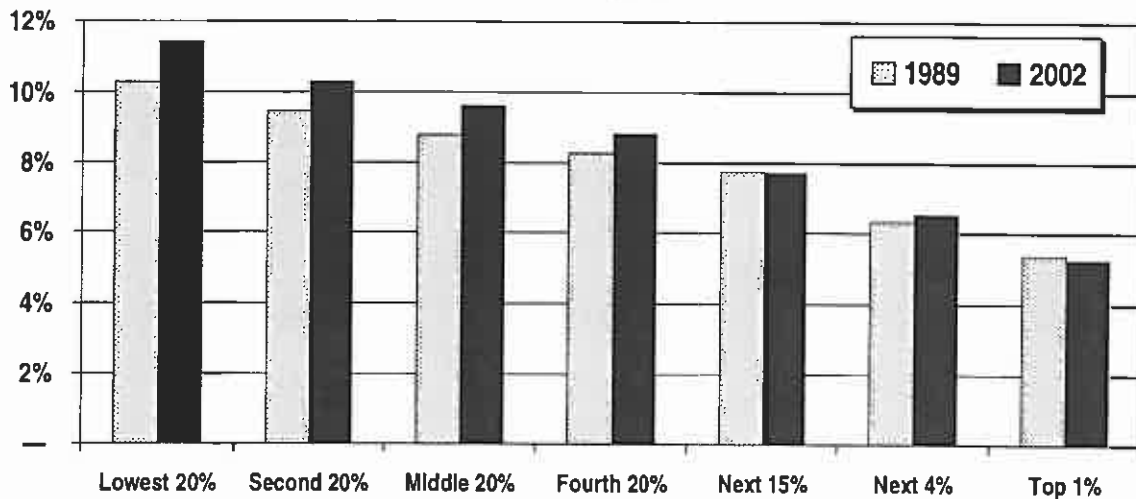
For example, if a wealthy family pays \$5,000 in state personal income tax, it gets a deduction from its federal taxable income of \$5,000. So \$5,000 comes off of income that would be taxed at a rate much higher than the state rate.

For a taxpayer in the top federal tax bracket, 38.6 percent of the \$5,000 state tax is essentially paid by the federal government. The state receives the \$5,000 from the taxpayer but the taxpayer only pays \$3,070, or three-fifths of the state tax bill. Since federal itemizers tend to be wealthier, and because state income taxes vary in the degree to which their burdens fall on these wealthy itemizers, some states are better than others at exporting part of their tax burdens to the federal government.

and Policy Priorities calculates that 33 of the 42 states with personal income taxes lowered that progressive tax during the economic boom. At the same time, 11 of the 46 states with general sales taxes passed measures reducing their sales taxes.

The bottom line for the nation as a whole is that state and local taxes became even more regressive from 1989 to 2002. As shares of income, taxes on poor and middle-income families rose the most, while taxes on the very best-off families actually fell.

**State and Local Taxes as Shares of Income
All States, 1989 and 2002 (after federal offset)**



On a brighter note, it's worth noting that five of the 11 states that reduced their sales taxes in the late 1990s—Georgia, Louisiana, Missouri, North Carolina, and Virginia—did so in a highly progressive way, by partially exempting groceries from sale taxes. Iowa moved in a progressive direction on its sales tax by exempting residential utilities (although other Iowa tax changes were quite regressive). Other progressive state tax developments include a proliferation of state earned-income tax credits and other low-income credits.

One of the more troubling developments in state tax policy over the decade has been the use of excise tax hikes as a quick-fix solution to short-term fiscal crises. As previously noted, these taxes are a flawed revenue-raising mechanism for two reasons. First, they are highly regressive; low-income taxpayers spend 12 times more on cigarettes as a percentage of income, for example, than do the wealthiest taxpayers.⁶ A second reason for avoiding reliance on excise taxes as a revenue source is that the taxes are calculated on a per unit basis, so the real value of the revenue declines over time due to inflation. In other words, the excise tax hikes enacted by states hit low-income taxpayers most heavily in the short-run—and the revenues provided tend to dry up in the long run.

- Cigarette tax hikes since 1989 have driven the average state cigarette tax from \$0.22 to \$0.60 per pack—an average hike of 38 cents per pack. And 12 states have raised their cigarette taxes by more than \$0.75 per pack since 1989.

⁶Bureau of Labor Statistics, *Consumer Expenditure Survey* 2001.

- Statutory changes in excise tax rates raised the excise tax burden by almost one percent of income on the poorest fifth of families nationwide.
- In 16 states, the inflation-adjusted cigarette tax burden has actually *decreased* in the past decade. (In 12 of these states, the cigarette tax rate was not changed at all during the decade; in the other four, tax increases did not offset inflation.)
- Thirty-nine states hiked their nominal gasoline excise tax rate since 1989, with 12 states leaving the rate unchanged. Yet when inflation is factored in, the real gasoline tax burden declined in 37 states.
- Beer excise taxes were less frequently hiked in the 1990s than either cigarette or gas taxes. As a result, the effective beer excise tax rate declined in 41 states between 1989 and 2002.

The deepening fiscal hole in which many states now find themselves has been opening gradually for more than a year—allowing some preliminary evidence on how states will react to this latest cycle of deficits. There is already mounting evidence that states' reliance on "sin taxes" to close fiscal shortfalls is backfiring, as declining consumption and widespread tax evasion lowers the expected yield of cigarette tax hikes. Coupled with the clear regressivity of the 2002 state tax changes, this suggests that state lawmakers' tax-change efforts in 2002 managed to avoid achieving either of the basic goals of good tax reform—long-term tax adequacy and tax equity.

In 2003, legislators would do well to focus more clearly on real tax reform that achieves both improved tax fairness and long-term revenue stability. The alternative—increasing a wide range of taxes in times of fiscal difficulty but reducing mainly progressive taxes in times of plenty—undermines both progressivity and revenues.

Conclusion

In 2001, the federal government enacted substantial tax cuts that will be phased-in over ten years. These regressive and expensive tax cuts will almost inevitably result in lower federal aid to states. The huge fiscal shortfalls facing many states today present lawmakers with the same challenge they faced a decade ago: how to raise sufficient revenues for both the short- and the long-run, while not making their tax structures even more inequitable. As this study has shown, the vast majority of states currently require low-income and middle-income taxpayers to shoulder a greater share of the tax burden than the wealthy—and many of these states exacerbated this problem during the last fiscal cycle.

State lawmakers are increasingly aware that the tax structures they have built burden low-income taxpayers most heavily as a share of income—and the recent growth in low-income tax credits is a testament to this awareness. Yet the same lawmakers have continued to use regressive sales and excise tax hikes to fund essential services, swamping the progressive impact of the low-income credits. The bleak reality is that of the seventeen states that have taken steps to reduce the tax burden on the working poor by enacting state earned-income tax credits, fifteen still require their poorest taxpayers to pay the

highest tax burden as a share of their income. And many of the states that have been most generous in enacting low-income tax credits have provided even greater benefits to the wealthiest taxpayers in the form of income tax rate reductions.

In many states, 2003 will require a new cycle of revenue raising. The results of this study will provide a blueprint for lawmakers seeking to understand the inequitable tax structures enacted by their predecessors. States may ignore these lessons and continue to balance state budgets on the backs of their poorest citizens. Or they may decide instead to ask wealthier families to pay tax rates more commensurate with their incomes. In either case, the path that states choose in the near future will have a major impact on the well-being of their citizens—and on the fairness of state and local taxes.

Using the State-by-State Tables

The following pages show state-by-state estimates of the distribution of state and local taxes by income group for non-elderly taxpayers.⁷ For each state, two sets of tax burden data are presented: first, the distribution of state and local taxes in 2002, and second, the impact of income, consumption and property tax changes since 1989.⁸

In each distributional chart, the non-elderly population is divided into income quintiles (groups of 20 percent of the population). The wealthiest quintile is further subdivided into three groups: the wealthiest one percent, the next wealthiest four percent, and the next wealthiest 15 percent.

For each state, the distributional analysis of tax changes since 1989 is accompanied by information about changes in each state's revenue-raising patterns since 1989. These charts, based on Census Bureau data through 2000 (the latest available), differ from ITEP's distributional charts in that they include all tax and non-tax revenues, whether they are paid by state residents or not. For example, Alaska derived more than 70 percent of its own-source revenues from non-tax revenues such as user fees and other charges. The state's heavy reliance on these non-tax revenues is one reason why the tax burden on Alaskans is among the lowest in the nation. While this analysis does not include the impact of these non-tax revenues on taxpayers, user fees are usually regressive ways to raise revenue.

⁷As noted in footnote 1, the study's scope is limited to non-elderly families (singles and couples, with and without children) because state tax systems often treat elderly families very differently from the vast majority of families.

⁸The 2002 figures show the effects of 2002 state and local tax laws, at 2000 income levels (the latest year with complete state-by-state income information), indexed when necessary. The 1989 figures used for comparisons were computed at 1989 income levels.

**PROPERTY TAX EXEMPTION OF
INTANGIBLE ASSETS**

Report of the Department of Revenue

*Prepared Pursuant to
Chapter 191, Laws of 1997 (ESSB 5286)*

**Washington State Department of Revenue
Frederick C. Kiga, Director**

**Analysis by the Property Tax, Research, and
Legislation and Policy Divisions**

December 2000

PROPERTY TAX EXEMPTION OF INTANGIBLE ASSETS
Implementation of Chapter 191, Laws of 1997
(ESSB 5286, 1997 Session)

EXECUTIVE SUMMARY

Washington's 1997 Legislature passed Chapter 181, Laws of 1997, amending RCW 84.36.070 to exempt from ad valorem taxation intangible personal property. Washington's property tax exemption statutes already excluded certain financial intangibles such as cash and accounts receivable from property taxation, but this change in the law significantly broadened the exemption. The exemption became effective for assessments as of January 1, 1998, and taxes collectible in 1999.

Section 7 of the legislation stated the following:

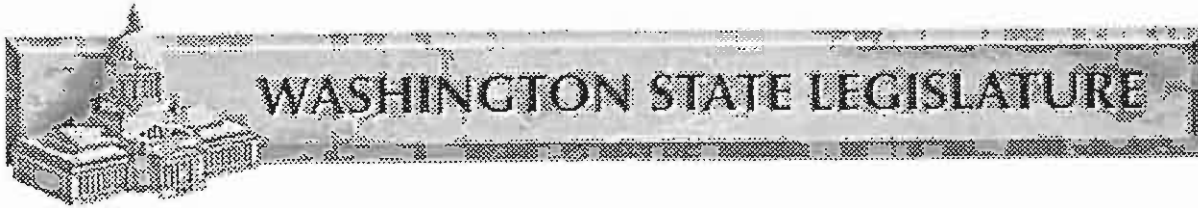
By December 1, 2000, the department of revenue shall submit a report to the house finance committee, the senate ways and means committee, and the office of the governor on tax shifts, tax losses, and any litigation resulting from this act.

This report answers the questions prescribed in the legislation on tax shifts and losses and litigation. Additionally, it provides background information on Washington's statutes, the property tax assessment process, circumstances in Washington leading up to the 1997 exemption, and national trends in litigation related to intangible personal property. The appendices include the full text of relevant legislation and the fiscal note on ESSB 5286, a survey of states on taxation of intangibles, a report on utility valuations prepared by the Department, and detailed information provided by county assessors.

The Department's response to the study requirements is summarized below:

Changes in Assessed Value for State-Assessed Property (Intercounty Utilities)

- A fiscal note completed before the legislation passed estimated the value of state-assessed properties would decline by \$811 million (6.7 percent) in 1998, the first year.
- Actual state-assessed values in 1998 were \$879 million less than they would have been without broadening the exemption. This represents a 7.1 percent reduction. Assessed values totaled \$11.5 billion rather than \$12.4 billion.
- For state-assessed properties, 1999 assessed values were \$775 million less than they would have been. This represents about a 5.9 percent reduction. Assessed values totaled \$12.4 billion rather than \$13.2 billion.



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RCW 84.36.070

Intangible personal property – Appraisal.

(1) Intangible personal property is exempt from ad valorem taxation.

(2) "Intangible personal property" means:

(a) All moneys and credits including mortgages, notes, accounts, certificates of deposit, tax certificates, judgments, state, county and municipal bonds and warrants and bonds and warrants of other taxing districts, bonds of the United States and of foreign countries or political subdivisions thereof and the bonds, stocks, or shares of private corporations;

(b) Private nongovernmental personal service contracts, private nongovernmental athletic or sports franchises, or private nongovernmental athletic or sports agreements provided that the contracts, franchises, or agreements do not pertain to the use or possession of tangible personal or real property or to any interest in tangible personal or real property; and

(c) Other intangible personal property such as trademarks, trade names, brand names, patents, copyrights, trade secrets, franchise agreements, licenses, permits, core deposits of financial institutions, noncompete agreements, customer lists, patient lists, favorable contracts, favorable financing agreements, reputation, exceptional management, prestige, good name, or integrity of a business.

(3) "Intangible personal property" does not include zoning, location, view, geographic features, easements, covenants, proximity to raw materials, condition of surrounding property, proximity to markets, the availability of a skilled work force, and other characteristics or attributes of property.

(4) This section does not preclude the use of, or permit a departure from, generally accepted appraisal practices and the appropriate application thereof in the valuation of real and tangible personal property, including the appropriate consideration of licenses, permits, and franchises granted by a government agency that affect the use of the property.

[1997 c 181 § 1; 1974 ex.s. c 118 § 1; 1961 c 15 § [84.36.070](#). Prior: 1931 c 96 § 1; RRS § 11111-1. FORMER PART OF SECTION: 1925 ex.s. c 130 § 5, part, now codified in RCW [84.04.080](#).]

NOTES:

Construction – 1997 c 181: "This act shall not be construed to amend or modify any

existing statute or rule relating to the treatment of computer software, retained rights in computer software, and golden and master copies of computer software for property tax purposes." [1997 c 181 § 3.]

Intent – No relation to other state's law – 1997 c 181: "Nothing in this act is intended to incorporate and nothing in this act is based on any other state's statutory or case law." [1997 c 181 § 4.]

Severability – 1997 c 181: "If any provision of this act or its application to any person or circumstance is held invalid, the remainder of the act or the application of the provision to other persons or circumstances is not affected." [1997 c 181 § 5.]

Applicability – 1997 c 181: "This act is effective for taxes levied for collection in 1999 and thereafter." [1997 c 181 § 6.]

Report to legislature – 1997 c 181: "By December 1, 2000, the department of revenue shall submit a report to the house finance committee, the senate ways and means committee, and the office of the governor on tax shifts, tax losses, and any litigation resulting from this act." [1997 c 181 § 7.]