Reform the tax code so that it raises sufficient revenue fairly and efficiently

The Great Recession left state budgets in tatters. The recession resulted in huge budget deficits as states saw their revenues from taxes and other sources plummet. Even after the official end of the recession in June 2009, state revenue levels are still below prerecession levels. According to the Center on Budget and Policy Priorities, revenues were 5.5 percent below their prerecession level as of the first quarter of 2012.¹

These persistently low levels of revenue resulted in state governments slashing government spending, reducing the provision of important services, and laying off thousands of government employees. Important investments in the future, such as education, suffered as state governments worsened the unemployment situation. Thirty-five states are now funding education at levels below spending levels in 2008.² Yet these types of forward-looking investments not only help state economies in the long term but also help prevent layoffs and even create jobs in the short term.

Additionally, as extensively documented by the Center for Budget and Policy Priorities, problems of insufficient revenue collection are further exacerbated by outdated state tax systems that fail to tax a multitude of services; budgeting processes that do not scrutinize all forms of spending—including programmatic expenditures made in the form of tax breaks; and insufficient state “rainy day” funds.³

![FIGURE 3](source: Institute on Taxation and Economic Policy, “Who Pays?: A Distributional Analysis of the Tax Systems in All Fifty States” (2013).)
Beyond these collection problems, state revenues also come from regressive tax systems. In contrast to the federal tax system, where the wealthy generally pay a greater proportion of their incomes than do the middle class and the poor, state tax systems force those at the middle and the bottom to pay a greater share of their incomes than those at the top. According to the Institute on Taxation and Economic Policy, “even the least regressive states generally fail to meet what most people would consider minimal standards of tax fairness.” The regressive nature of state tax systems is largely due to a heavy reliance on sales taxes. Furthermore, the corporate income tax is raising less money than it did in the past. Corporate income taxes raised 10.2 percent of total state revenue in 1979, but that figure declined to 6.5 percent by 2005. This decline has taken place as corporate profits have risen by almost 80 percent over the same timeframe.

State governments must reform their tax codes to ensure that everyone—including the wealthy and corporations—pays their share and that middle-class and poor families are not unfairly burdened.

Ensure that individual income tax systems are fair and produce adequate revenue

Background

Supermajorities of Americans believe that the U.S. tax structure favors the wealthy, and unfortunately the public is right. In states across the country, outdated tax structures and exemptions that favor the rich have allowed low- and middle-income families to shoulder an unfair tax burden and weaken the tax base of states.

The state income tax is the primary revenue generator available to state governments through which it's possible to tax wealthy residents at a rate higher than that of low- and middle-income residents. Sales and excise taxes and tolls and user fees all require low- and middle-income residents to pay a higher share of their income in taxes than those who are better off. And while state estate taxes are very progressive, they raise far less revenue. To achieve greater fairness in a state's tax code, it is critical that individual income taxes be more progressive to help balance the cumulative regressive effect of other state taxes and fees. But most state income taxes are not implemented in a way that makes the overall tax burden progressive.
In addition, updating the personal income tax is not only popular but it is also mathematically necessary for states to raise the revenue they need. For several decades America has witnessed a historic increase in income inequality. From 1979 to 2007 the wealthiest 1 percent of Americans saw their average real after-tax household income increase 275 percent, and the rest of the top 20 percent saw their income grow by 65 percent. The 60 percent in the middle experienced income growth of only 40 percent, while the income of the poorest 20 percent grew only 18 percent over those 28 years.\(^9\)

Tax brackets and rates must reflect the fact that incomes are growing faster at the top.

Critics will claim that state policymakers will harm the economy and put their state at a competitive disadvantage by making income tax policies fairer. But analysis from the Institute on Taxation and Economic Policy discredits the idea that states can boost their economies by reducing or eliminating state income taxes, and demonstrates that in terms of the economic conditions of state residents, high-income-tax states are doing at least as well—if not better—than states without an income tax.\(^10\)

Fortunately, states have many tools available to them to modernize their tax codes and to make them fairer and more effective at raising the revenue they need.

Set progressive income tax brackets

Many state individual income tax brackets were set many years ago at a time with far less income inequality, and are significantly out of sync with current income distribution. Today these states collect too much revenue from low- and middle-income taxpayers and too little from their highest-income households.

And although many states use graduated tax brackets, their systems do not achieve significant progressivity because the difference in the tax rate of the poorest and the most wealthy is quite small. States should achieve the greatest degree of fairness by having tax brackets with a wide margin between the lowest and the highest rates that reflect today’s increasingly unequal incomes.\(^11\)

Maryland, for example, retained the same graduated bracket system—established in 1967—for 40 years. The state operated with three income tax brackets drawn to capture income above $1,000, $2,000, and $3,000. But because the brackets were
bunched so narrowly, the state had an effective flat tax: Every resident who earned more than $3,000 in taxable income was paying the same rate as Maryland’s millionaires. In 2007 Gov. Martin O’Malley (D) proposed and the General Assembly approved three new brackets set at $150,000 ($200,000 for joint filers), $300,000 ($350,000 for joint filers), and $500,000 to make the tax code more progressive.  

But given the degree to which states and localities depend on regressive forms of taxation, having progressive income tax brackets alone is not sufficient to achieve a tax system that is progressive overall.

California and Vermont, for example, have highly progressive income taxes but achieve a basically flat tax system overall when other taxes levied by the state are taken into consideration. For this reason, even states with fairly distributed income tax brackets should also consider adopting the reforms discussed below.

Create a millionaires’ or high-income tax bracket

At the federal level the average tax rate paid by the very highest-income Americans is at near 50 year lows. The wealthiest one-tenth of 1 percent pay about a quarter of their income in federal income and payroll taxes today—according to a 2012 report from the National Economic Council—half of what they would have contributed in 1960. And at the state and local level, the top 1 percent spend approximately 8 percent of their income on state and local taxes while the bottom 99 percent spend nearly 11 percent. At the same time the incomes of the super rich have skyrocketed.

State legislatures should institute millionaires’ tax brackets to ensure the richest residents pay their fair share.

Several states have updated their tax systems to reflect the fact that the wealthiest residents have captured an outsized amount of overall income gains. New Jersey, for example, taxes income of more than $500,000 at 8.97 percent. And despite hyper-reluctance to raise taxes during a weak economy, a few states took some action on high-income taxes in 2012. In Maryland a special session of the legislature in May 2012 resulted in raising taxes on individuals with adjusted gross incomes of more than $100,000 and couples with incomes of more than $150,000—the top 14 percent of earners. And in California voters approved a referendum to increase taxes on high-income taxpayers in the November 2012
Income tax will increase 1 percent on households making $500,000 or more a year, 2 percent on households making $600,000 or more a year, and 3 percent on households making $1 million or more a year.22

Opponents often repeat unproven claims that passing high-income tax brackets will result in millionaires leaving the state. The Center on Budget and Policy Priorities demonstrated in a recent paper, “Tax Flight is a Myth,”23 that household moves are rare, involving only 1.7 percent of Americans each year, and are usually attributable to other reasons like housing prices, job changes, climate, or age, rather than tax policy.

And the San Jose Mercury News recently found that the greatest number of millionaires per capita live in states with high-income tax rates for the wealthy, including California, New York, and New Jersey, while two-thirds of states with no income tax have fewer millionaires per capita than average.24 Also, California retained its share of the super rich after passing its first millionaires’ tax in 2004, according to the same report.

Retain or restore a state estate tax or inheritance tax

State governments should use estate taxes—which are paid by taxable estates upon death—and inheritance taxes—which are paid by those individuals who receive gifts from estates—to help offset the regressive effects of the state property and sales tax. While estate and inheritance taxes make up only a small portion of state revenue collections and are paid by the wealthiest of state residents, they are one of the most progressive taxes and help reduce the transmission of concentrated wealth between generations.25

Since 2001, however, many states that previously levied an estate tax are losing out on this source of revenue as a result of federal estate tax cuts. The tax cuts phased out a federal dollar-for-dollar tax credit against the estate taxes levied by states. The credit gave states an incentive to levy an estate “pick-up tax,” which was calculated to be exactly equal to the maximum federal tax credit.26

Most states lost billions of dollars in “pick-up” revenue they had been receiving as a result of the phase out of the federal credit. To avoid losing that revenue, states are “decoupling” from the federal estate tax so that they can continue to collect taxes on estates or inheritances despite the lack of a federal credit.
According to Elizabeth McNichol, senior fellow at the Center on Budget and Policy Priorities, 22 states levy an estate or inheritance tax, including:

Fifteen states that levied pick-up taxes prior to 2001 retained estate taxes. Of these, twelve states—Delaware, Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, North Carolina, Rhode Island, and Vermont—and the District of Columbia, decoupled from the federal estate tax law and continue to levy an estate tax that is the same or very similar to the earlier pick-up tax. Three states—Connecticut, Oregon, and Washington—replaced their pick-up taxes with estate taxes that are not tied to the federal tax.  

States that have not already done so should restore their estate taxes by “decoupling” from the federal law or by enacting estate taxes that are similar in structure to the pick-up tax. In a few states, however, there are legal barriers to reinstating the tax. The constitutions of Alabama, Florida, and Nevada contain provisions restricting the amount of estate tax levied, and in California decoupling would require a referenda.

Tax capital gains at the same rate as wages

One of the most unfair features of the U.S. tax system is the fact that capital gains are often taxed at a much lower rate than wages. This often means that a wealthy person living off investments can pay a significantly lower income tax rate than low- and middle-income wage earners.

Tax-favored capital gains are heavily concentrated at the top. According to the Tax Policy Center, 47 percent of capital gains accrue to just the top one-tenth of 1 percent of the population. And according to the IRS, in 2008, 12 percent of all capital gains went to just 400 of the highest-earning taxpayers, each of whom had an average adjusted gross income of $202 million that year.

Unfortunately, a growing number of states have exacerbated the inequity in the federal tax code—which taxes capital gains at a lower rate than ordinary income—by passing their own tax cuts for capital gains income. According to the Institute for Taxation and Economic Policy, at least six states provide tax breaks for all long-term capital gains income—and many others provide tax breaks for gains from assets located within state boundaries. South Carolina’s 44 percent exclusion for all long-term capital gains income—the Institute on Tax and
Economic Policy found—cost the state $115 million in 2010 and almost exclusively benefited the wealthiest fifth of state residents. Adding insult to injury, lower tax rates for capital gains do nothing to help a state’s economy.\(^{32}\)

States should repeal these tax breaks and tax capital gains and dividends the same as ordinary income. Indeed, several states are beginning to reconsider tax preferences for capital gains. Rhode Island recently eliminated its preferential tax rates on capital gains, while Vermont and Wisconsin each reduced their capital gains exclusions.\(^{33}\)

Establish or improve a state earned income tax credit

States can help pull working families and children out of poverty, provide a valuable incentive for people to leave welfare for work, and ensure that low-income families receive fair tax treatment by establishing or strengthening a state-level earned income tax credit, or EITC.

The earned income tax credit—widely considered an effective poverty-fighting tax policy—provides low-income workers with targeted tax reductions.\(^{34}\) The federal earned income tax credit lifted about 5.7 million people out of poverty, including about 3.1 million children in 2010.\(^{35}\) The value of the federal credit varies with family income as well as with the number of dependents.

Yet in too many states, the working poor have significant state tax liability even if they have no federal liability.\(^{36}\) States can help ensure that low-income families receive fair tax treatment by establishing a state-level earned income tax credit. Since taxpayers have calculated their federal earned income tax credit by the time they complete their state taxes, the state earned income tax credit is simple for eligible recipients to claim and easy for state tax administrators to track.

To date, 24 states and the District of Columbia have established such laws, according to the Center on Budget and Policy Priorities.\(^{37}\)

States that have an earned income tax credit should consider increasing the percentage of the federal credit that state taxpayers can claim. Vermont allows a taxpayer to claim 32 percent of the federal credit, Minnesota allows 33 percent on average, Wisconsin allows 34 percent for families with three or more children, and the District of Columbia allows 40 percent.\(^{38}\)
It is also critical that state earned income tax credits be refundable. This will strengthen the policy’s ability to reduce poverty by giving families an income boost and ensuring that low-wage workers can afford to stay working. All but four of the states—Delaware, Maine, Rhode Island, and Virginia—that currently offer the earned income tax credit have made it fully refundable.\(^3^9\)

**Reform the dependent care tax credit**

The child and dependent care tax credit can be a key support for working families with children, since low- and middle-income families often spend an enormous portion of their budgets on child care. The federal government allows single, working parents and two-earner married couples to claim a nonrefundable credit to partially offset up to $6,000 of child care expenses. Low-income families can claim up to 35 percent of the cost, and the credit percentage drops for higher-income earners.\(^4^0\)

Twenty-two states and the District of Columbia have a child care credit, and most model theirs on the federal program. Eleven states and the District of Columbia have nonrefundable credits, seven states have refundable credits, and four states have nonrefundable deductions.

States should make the dependent care tax credit fully refundable and use a sliding scale in order to target benefits to low-income families. Nebraska targets its tax relief very efficiently—the state allows low-income parents to claim 100 percent of their federal credit as a refundable Nebraska child care tax credit, and has a sliding scale that allows higher-income parents to claim 25 percent.\(^4^1\)

**Create a circuit breaker for homeowners and renters**

State governments should create and expand “property tax circuit breakers” in order to provide relief to families whose property taxes are high relative to their incomes.

Property tax circuit breakers—which provide refunds from the state to residents whose property tax payments are deemed to be too great—are another effective, targeted tax break for low-income families.\(^4^2\) When a property tax bill exceeds a certain percentage of a taxpayer’s income, circuit breakers provide rebate for all or a portion of the property taxes in excess of this level. This is often structured as an
income tax rebate or a rebate check, and one state, Maryland, structures its circuit breaker so that it is applied as a property tax credit against future property bills.\textsuperscript{43}

The Institute on Taxation and Economic Policy profiled state property tax circuit breaker best practices in its 2011 report “State Tax Codes as Poverty Fighting Tools.”\textsuperscript{44} The best circuit breakers give homeowners and renters a credit equal to the amount by which their property tax bill exceeds a certain percentage of their income. Also, programs should be made available to all low-income taxpayers with a relatively high property tax burden—although many programs are targeted to senior citizens and the disabled.

Many states also extend their circuit breaker credit to renters since they pay property taxes indirectly through higher rents. Renters calculate their eligibility by assuming that their property tax bill is equal to a certain percentage of their rent—for example renters in Michigan may assume that 20 percent of their rent goes to property taxes for the purposes of calculating their circuit breaker eligibility.

Finally, the Institute on Taxation and Economic Policy recommends that circuit breaker programs must be paired with a successful outreach programs, so that eligible families take advantage of the credits.

**Enact other targeted low-income tax credits**

Because the earned income tax credit is targeted at families with children, it is much less helpful to older adults or families without children. States without a targeted low-income credit or no-tax floor as a complement to their earned income tax credit should pass such a policy, and states that already have one should consider expanding it or making it refundable.

New Mexico has enacted the Low-Income Comprehensive Tax Rebate, a refundable tax credit for households with a maximum income of $22,000.\textsuperscript{45} Ohio has enacted a nonrefundable credit that ensures that families with incomes of less than $10,000 are not subject to state taxes.\textsuperscript{46} Likewise, Kentucky has a similar nonrefundable credit to prevent families who live below the poverty line from paying state taxes.\textsuperscript{47} Like the earned income tax credit, such credits are more effective if made refundable.\textsuperscript{48}
Other targeted tax credits include sales tax credits on groceries, which can help offset the regressive effects of sales taxes on low-income residents. They are usually administered as refundable state income tax credits available to taxpayers below a certain income threshold. Idaho, for example, offers a $90 refundable grocery credit for each qualifying resident and their dependents, and residents over age 65 receive an additional $20 credit.

Reform the corporate income tax to prevent tax avoidance

Background

The corporate income tax is used to provide a sustainable, reliable revenue stream for the more than 40 state governments that have such a tax. Numerous research reports, however, suggest that this tax base has eroded as corporations have come up with an impressive array of strategies to minimize state income tax payments. In 1979 state corporate income taxes made up 10.2 percent of total state tax revenue. By 2005, however, that revenue source dropped to just 6.5 percent, although corporate profits rose by nearly 80 percent during that period.

Tax minimization strategies are used most frequently by large and multinational corporations and much less so by in-state, small- and medium-sized businesses. Businesses operating in a single state, by definition, cannot use multistate tax avoidance strategies. And most small businesses have limited resources to invest into tax avoidance.

The effect of this tax avoidance means that state governments miss out on billions of dollars in lost revenue, and it forces states to either cut government services or raise personal income taxes, corporate income tax rates, or find other revenue streams to make up for the uncollected revenue.

The problem of tax avoidance is underscored by a 2011 report by Citizens for Tax Justice and the Institute on Taxation and Economic Policy that looked at 265 Fortune 500 companies. According to the report, if these companies had paid the 6.2 percent average state corporate tax rate on the $1.33 trillion in U.S. profits that they reported to their shareholders from 2008 through 2010, they would have paid $82.6 billion in state corporate income taxes. Instead they paid only $39.9 billion, avoiding a total of $42.7 billion in state corporate income taxes over just three
years—more than $16 million per corporation with some of this difference due to corporate tax-shifting strategies and only some of it due to state tax incentives.

And a study by the Citizens for Tax Justice and Change to Win estimated that tax minimization by one large big box retailer alone cost states $2.3 billion between 1999 and 2005. Over those seven years, the retailer reported $77.4 billion in pretax U.S. profits but reported a total state income tax bill of only $2.4 billion, or 3.16 percent of its profits. The report found that if the company paid taxes at the statutory state corporate tax rates for the same period, it would have paid almost twice as much—$4.7 billion.

States must aggressively crack down on tax avoidance strategies and update their state tax codes to keep pace with new tax avoidance approaches. They also need to increase enforcement of their corporate tax laws.

Pass combined reporting

Most multistate corporations are comprised of a parent company and any number of subsidiaries. These corporations commonly use accounting methods to shift income generated by a subsidiary in one state to a subsidiary in a state with no corporate income tax. Even more perverse is the existence of so-called “nowhere income,” which because of the interaction of poorly designed state tax codes with federal restrictions on what income states can tax, is income that’s allocated to “nowhere” and hence goes untaxed by any jurisdiction. The goal is to minimize the profits reported by subsidiaries in states with a corporate income tax.

Of the more than 40 states that have a corporate income tax, 23 states have now enacted combined reporting to end this corporate accounting shell game. With combined reporting, corporations are required to report to the state their combined income, including parent companies and subsidiaries. The state then uses a formula to determine what percentage of the company’s overall profits will be taxed there, with that percentage based on the amount of real business activity in that state compared to other states.

Two states that have recently passed combined reporting laws are Vermont in 2004 and West Virginia in 2007. The AFL-CIO also has drafted model combined reporting legislation, as has the Multistate Tax Commission, the intergovernmental state tax agency.
State corporate income tax laws should also include “throwback” rules to recapture for the state where goods are produced any taxes on the profits that cannot be collected by the recipient states. To date, 25 states have enacted this rule. The other states with a corporate income tax would gain revenue and improve fairness by enacting a throwback rule.

Increase disclosure of corporate taxes

A debate exists about the causes of the sharp drop in state collection of the corporate income tax over the last 30 years. Corporations frequently claim that they are simply taking advantage of incentives and other economic development strategies that state lawmakers have intentionally inserted into state tax codes to encourage business investment. Taxpayer advocates often argue that corporations are exploiting weaknesses and loopholes in state statutes.

One way to sort this out is for states to require company-specific corporate tax disclosure to give lawmakers the information they need to assess the effectiveness of their tax codes and their economic development incentives. The Center on Budget and Policy Priorities offers model language for corporate tax disclosure statutes.

Tighten rules on silent partners for S-corporations and LLCs

Certain business entities, including S-corporations, partnerships, and limited liability corporations, are not taxed because income flows directly to their partners, who are required to pay tax on the income. But often out-of-state partners do not report their earnings to all the states in which the partnerships earned profits, and states do not adequately check on whether each of these “silent” partners reported income to the state.

States should adopt rules to ensure that these out-of-state partners pay their fair share. Ohio, New Jersey, and New York have all tightened their rules on pass-through entities in recent years.

Reform the alternative minimum tax

Too often, large profitable corporations use tax avoidance to pay no state taxes at
all.\textsuperscript{71} At least 20 states and the District of Columbia address this problem by having a corporate alternative minimum tax, or AMT, though some set the minimum tax far too low.\textsuperscript{72}

Twelve states impose a minimum tax at a fixed amount,\textsuperscript{73} ranging from $20 in Idaho to up to $100,000 in Oregon for companies with more than $100 million in sales.\textsuperscript{74} Other states, such as New Hampshire with its “Business Enterprise Tax,” take an alternative approach by requiring businesses to pay the higher of a tax calculated as a percentage of profit or a tax calculated on some other basis.

Decouple from the federal bonus depreciation tax break

A federal tax deduction, called bonus depreciation, allows businesses to claim 50 percent depreciation for certain business machinery newly placed in service.\textsuperscript{75} President Obama recently signed an extension that revived this tax break for two additional years to help provide a temporary incentive to boost business investment. While this policy may benefit the national economy, as the Center on Budget and Policy Priorities argues: “there are no benefits to states from following suit.”\textsuperscript{76}

But since most states follow federal depreciation rules, those states stand to lose billions of dollars in revenue unless they decouple from the federal code regarding this rule.

As of April 2011, 18 states were on track to lose a combined $4.6 billion over three state fiscal years unless they decouple. And according to the Center on Budget and Policy Priorities, states should decouple in such a way that the decoupling applies to any future change in federal depreciation rules beyond 2012.\textsuperscript{77}

Moreover, another 24 states and the District of Columbia could lose a combined $10.8 billion\textsuperscript{78} during the same timeframe if they altered their tax codes to conform to such federal changes. These states should ignore this federal rule change and remain decoupled.\textsuperscript{79}
Increase sales tax revenues and fairness

Background

Forty-five states and the District of Columbia levy a sales tax, and nearly all of them count on the sales tax to supply a major portion of their state budgets. State general sales taxes generated $234.5 billion in 2007, making up an average of 31 percent of state revenue.  

States began adopting sales tax policies 75 years ago when the American economy was dominated by manufacturing and the service sector was far smaller. Mississippi enacted the first state sales tax in 1930 with 23 others joining them by World War II. At that time, consumption of services was below two-fifths of all economic activity.  

Today, however, the consumption of services makes up a full two-thirds of the nation’s economic activity. But state sales tax policy has not kept pace with the economic transition and most states raise far less revenue through the sales tax than they could because it is applied to the sale of tangible goods but not to the sale of most services.  

A majority of states apply their sales tax to less than one-third of 168 potentially taxable services, according to the Federation of Tax Administrators. Five of the 45 states with sales taxes impose them on fewer than 20 services. This narrow application of sales tax to only a few services creates a tax structure that is overly complex, vulnerable to fluctuations as spending rises and falls, and is difficult to explain and understand. Moreover, the ability of states to raise sufficient revenues from the taxation of tangible goods has been further eroded by the increasing use of the Internet as a virtual marketplace.  

As a result, many states are looking for ways to modernize their sales tax policies to tax more sales of services.  

Pass a luxury tax

Although the sales tax is a regressive tax—since low- and middle-income taxpayers pay the same rate as the wealthy and spend more of their income—current exemptions of high-end services provide far more benefit to the rich than to the
rest of state residents. To counter this regressivity, policymakers should create a luxury tax for particularly high-end goods and services levied either as a surtax above a fixed amount—for example, $50,000—or applied to specific high-end items such as yachts, furs, fine jewelry, or country club memberships.

The Connecticut General Assembly—as part of its larger sales tax reform effort—created a 7 percent luxury tax in 2011, which applies to cars that cost more than $50,000, jewelry that costs more than $5,000, vessels that cost more than $100,000, and clothing items that cost more than $1,000.86

**Crack down on Internet retailers that do not collect sales taxes**

States should collect the sales tax they are owed and ensure a level playing field for local businesses by amending their laws to make online large retailers pay what they owe.

According to data from the National Conference of State Legislatures, states lost an estimated $23.3 billion in sales tax revenue due to their inability to collect sales taxes from online retailers.87 The Supreme Court ruled that states can only collect sales taxes from retailers with property, employees, or independent sales representatives in the state.88

For years this meant state governments were not collecting sales taxes from most Internet retailers. Moreover, this loophole gives an advantage to online merchants whose goods appear to have a lower price than goods from local brick-and-mortar retailers.

Several states, however, have found a way to get these companies to collect sales taxes. New York passed an innovative law in 2008 that has become a model for other states. Many online retailers have “affiliate programs” where independent individuals or organizations post links on their websites to the retailer in exchange for some of the proceeds from the sale. The New York law states that these affiliates are third parties helping to “establish and maintain” a market for the retailer in the state.89 Therefore, the retailer is subject to the state’s sales tax.

Several states have followed in New York’s steps, including Pennsylvania, Texas, and California.90 These laws do not totally solve the problem of collecting sales taxes from online retailers—federal action is required for that—but they are an important first step.
Raise tobacco taxes and fund cessation programs

Background

Tobacco use is the leading cause of preventable death in the United States and is associated with 400,000 deaths of smokers annually—more than AIDS, alcohol, car accidents, illegal drugs, murders, and suicides combined. And another 50,000 people die annually due to illness attributable to secondhand smoke.\textsuperscript{91}

In addition to the staggering human costs, tobacco use imposes a tremendous health care burden on state governments as well. Approximately 8.6 million Americans currently suffer from smoking-related illnesses. The Medicaid payments alone due to tobacco use cost $30.9 billion annually—$13.3 billion of which is borne by state governments.\textsuperscript{92}

Smoking is also estimated to cost the American economy $97 billion in lost productivity from the reduction in work lives shortened by tobacco alone—and not including lost time to disability, sick days, or productivity declines while on the job.\textsuperscript{93}

States can save lives and reduce government costs by raising taxes on cigarettes and investing a significant portion of the revenue generated by these taxes into tobacco cessation programs.

Raise tobacco taxes

States should significantly hike tobacco taxes to save lives and reduce over time the massive economic and health care costs they incur from tobacco use.

Raising taxes on tobacco reduces smoking, especially among children. Economic studies have shown that cigarette taxes or price increases reduce both adult and underage smoking. In fact, the single-most reliable method for reducing consumption is to increase the price of tobacco products.\textsuperscript{94} In general, for every 10 percent increase in the price of cigarettes, overall cigarette consumption drops by approximately 3 percent to 5 percent, the number of young-adult smokers drops by 3.5 percent, and the number of kids who smoke drops by 6 percent or 7 percent, according to research compiled by the Campaign for Tobacco Free Kids. \textsuperscript{95}
Moreover, states realize significant multiyear revenue increases following tobacco tax increases because the increase in per-pack revenue dramatically exceeds any decrease from reduced sales. Further, any drop-off in revenues from reduced use is dwarfed by savings from tobacco-related health care costs.96

Also, Americans overwhelmingly support raising tobacco taxes according to public opinion polls. And in order to balance state budgets, voters prefer raising tobacco taxes to other tax increases or cutting government programs, such as education, health care, and public safety.97

States should raise their per-pack tobacco tax as high as possible. Modest increases, such as less than 10 percent of the price of a pack, do not produce the deterrent effect, especially since cigarette companies can counter the impact of the tax increase with discounts, coupons, or other promotional strategies to maintain sales.98 Also, states should raise the tax on all tobacco products—smokeless tobacco, roll-your-own tobacco, and little cigars—at the same time to prevent diminished outcomes due to cigarette smokers switching to other consumption methods.99

As of October 2012, New York has the highest tobacco tax in the nation—$4.35 per pack.100 Research shows that the rate has helped New York cut adult and youth smoking by more than twice the rate of the rest of the nation between 2003 and 2010.101 New York’s high cigarette tax, in combination with a comprehensive smoke-free air law and effective tobacco prevention and cessation programs, has reduced the number of adult smokers by 664,000, prevented 305,000 kids from becoming smokers, and prevented 265,000 smoking-related deaths. New York’s smoking decline has also saved the state’s budget $11.6 billion in long-term tobacco-related health care costs.102

Policymakers should consider when raising tobacco taxes that these taxes, like other sales taxes, are regressive. So while there is good evidence that higher taxes on tobacco discourage use and create other policy benefits, the majority of smokers will continue to use tobacco despite higher taxes, and research shows that low-income people will bear the brunt of the tax.103 While we recommend that a significant portion of taxes be reinvested in state tobacco prevention and cessation programs, legislators could also consider using a portion of funds to fund or expand tax rebate programs for low-income families, as has been recommended by the Center on Budget and Policy Priorities.104
Maximize revenue for prevention and cessation programs

States can realize even greater health benefits and multiyear cost savings by allocating a significant portion of any new tobacco tax revenue and more of their tobacco settlement funds to programs that prevent children from smoking and help smokers quit.105

Antismoking education and cessation programs have been dramatically cut by states to fund other priorities—marking a major missed opportunity for states to save lives and lower health care costs. States promised in the 1998 Multistate Tobacco Settlement to allocate a significant portion of their settlement funds—$246 billion over 25 years—for antismoking efforts. But in every state, those funds have been spent in other areas. Only 2 percent of those funds are now spent on antismoking efforts on average.106

In some states the cuts are so severe that the Centers for Disease Control and Prevention has expressed concern that the states’ antismoking programs are facing elimination.107

States can reduce smoking and generate significant health care savings by dedicating more of their settlement funds and tobacco and cigarette tax revenues to antismoking programs.

States with the best-funded tobacco prevention programs during the 1990s—including Arizona, California, Massachusetts and Oregon—reduced cigarette sales by more than twice as much as the country as a whole, according to a 2003 study published in the Journal of Health Economics.108 California—with the longest running prevention program in the United States—saw a reduction in adult smoking from almost 24 percent in 1988 when the California Tobacco Control Program was established to less than 12 percent in 2010.109

The Centers for Disease Control offers best practice guidelines to states, including a community-based model to reduce youth smoking.110 They also offer recommended per capita funding levels for all 50 states111 which range from $9.23 to $18.02. Those levels represent the agency’s estimate of what an effective, state-specific, and evidence-based tobacco control program would cost.112 Only two states—Alaska113 and North Dakota114—currently fund antitobacco programs at or near Centers for Disease Control-recommended levels.115
Endnotes


6 Authors’ calculations using data from the Bureau of Economic Analysis.


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