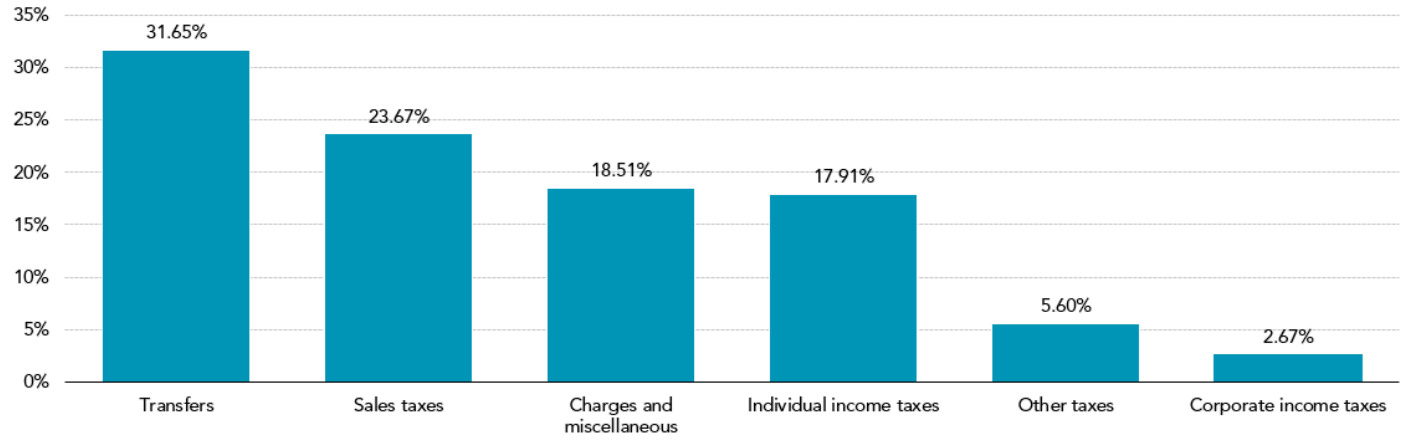
The State of State (and Local) Tax Policy

What are the sources of revenue for state governments?

Q. What are the sources of revenue for state governments?

A. State governments collected more than $1.7 trillion of general revenue in 2014. Revenue from income, sales, and other taxes totaled nearly $870 billion—half of all general revenue (figure 1).

FIGURE 1
Total State General Revenue by Source
2014



Sources: Urban-Brookings Tax Policy Center, State & Local Government Finance Data Query System.

INTERGOVERNMENTAL TRANSFERS

Intergovernmental transfers—primarily from the federal government—totaled $551 billion in 2014. The largest were federal grants for public welfare programs, predominately for Medicaid.

The State of State (and Local) Tax Policy

What are the sources of revenue for state governments?

OWN-SOURCE REVENUE

Revenue from state sales and gross receipts taxes (including taxes on general purchases and selective taxes on products such as alcohol, cigarettes, and motor fuels) was $412 billion in 2014, or 24 percent of state general revenue. Revenue from individual income taxes totaled $312 billion—18 percent of general revenue—while revenue from other taxes (including license fees, estate taxes, and severance taxes) was $97 billion—6 percent of general revenue. Charges and fees—notably tuition paid to state universities, payments to public hospitals, and tolls on highways or bridges—provided another $322 billion, —19 percent of state general revenue in 2014.

General revenue does not include revenue collected by states from "business-like" enterprises, such as state-run liquor stores, utilities, and pension funds.

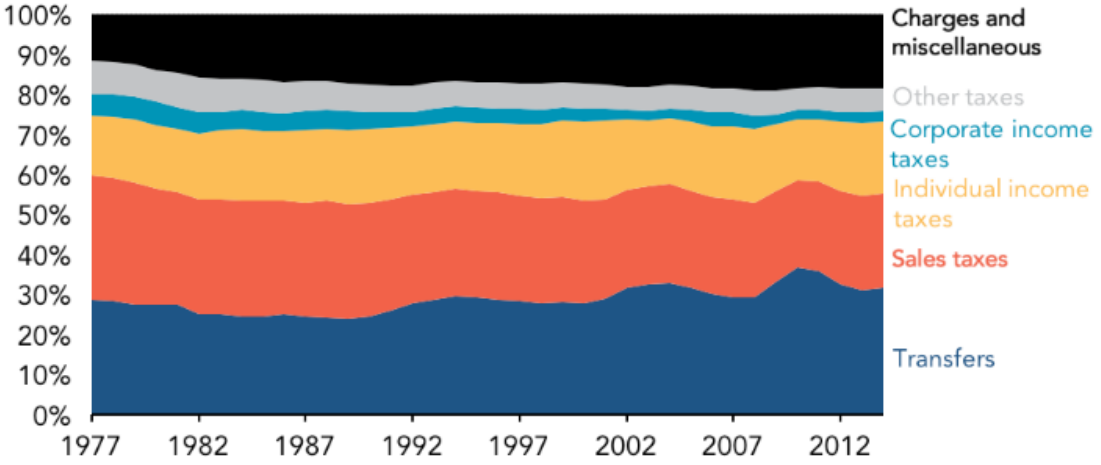
CHANGING SOURCES

Since 1977, the shares of state general revenue from intergovernmental transfers as well as charges and users fee have increased, while the share from taxes has declined (figure 2). The change in the charges and user fee category was especially striking, with its share rising by 8 percentage points (from 11 percent to 19 percent) from 1977 to 2014, as states sought to broaden their revenue bases.

Over the same period, the share of general revenue from state taxes declined by 10 percentage points, from 60 percent to 50 percent. The portion from individual income taxes rose slightly over the period, while the share from all other taxes declined.

FIGURE 2

State General Revenue, 1977-2014



Source: Urban-Brookings Tax Policy Center, State and Local Government Finance Data Query System.

The State of State (and Local) Tax Policy

What are the sources of revenue for state governments?

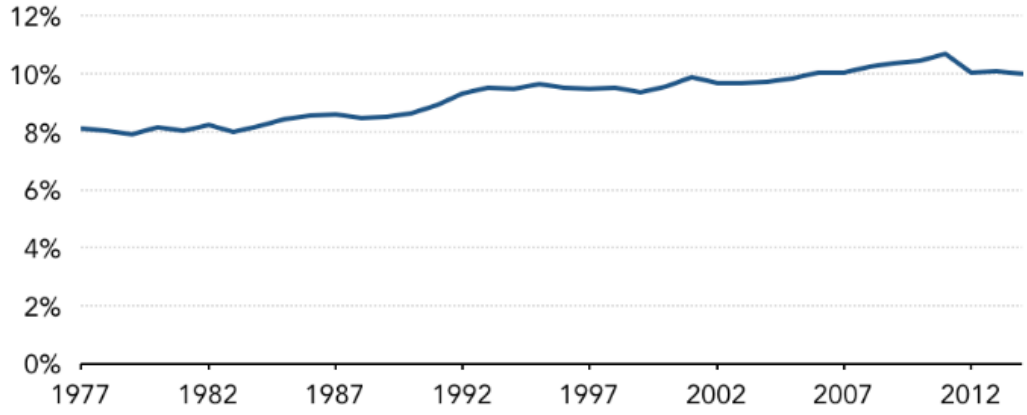
RELATIVE GROWTH

State revenue grew slightly faster than the national economy between 1977 and 2014, rising from 8 percent of GDP in 1977 to 10 percent in 2005 and staying there for the next decade (figure 3). State revenues peaked at 11 percent of GDP in 2011 before falling back to 10 percent in 2014, largely because of a decline in federal transfers in the wake of the economic recovery.

FIGURE 3

Total State General Revenue, 1977-2014

As a share of national GDP



Source: BEA; Urban-Brookings Tax Policy Center, State and Local Government Finance Data Query System.

Revenue from charges and miscellaneous fees as well as individual income taxes grew a small amount relative to GDP from 1977 to 2014, while sales tax revenue remained fairly constant at about 2.5 percent of GDP (figure 4). Intergovernmental transfers grew the most over that period, rising about 1 percent of GDP. The American Recovery Reinvestment Act of 2009 created a sharp uptick in federal transfers to state governments from 2009 to 2011, hitting a peak of 3.8 percent of GDP in 2010 and 2011. Federal transfers to the states dropped as a share of GDP in 2012 as spending on economic stimulus programs receded.

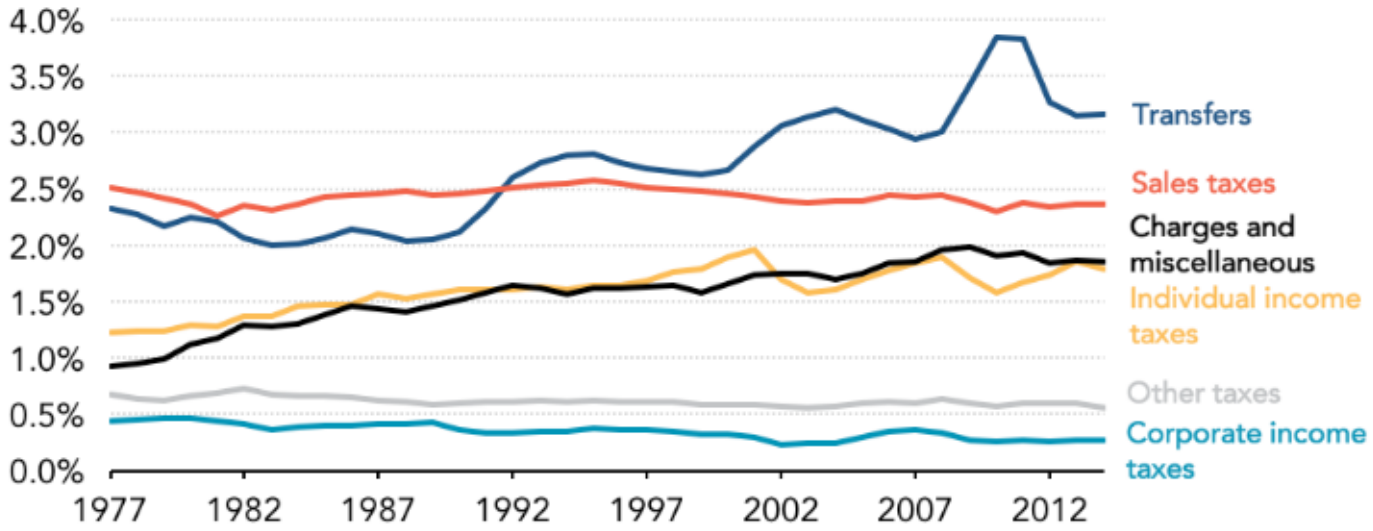
The State of State (and Local) Tax Policy

What are the sources of revenue for state governments?

FIGURE 4

State General Revenue by Source, 1977-2013

As a share of national GDP



Source: BEA; Urban-Brookings Tax Policy Center, State and Local Government Finance Data Query System.

Data Sources

US Department of Commerce, Bureau of Economic Analysis. BEA National Economic Accounts: Current-dollar and 'real' GDP.

Tax Policy Center. State and Local Finance Data Query System. Urban Institute and Brookings Institution, Washington, D.C.

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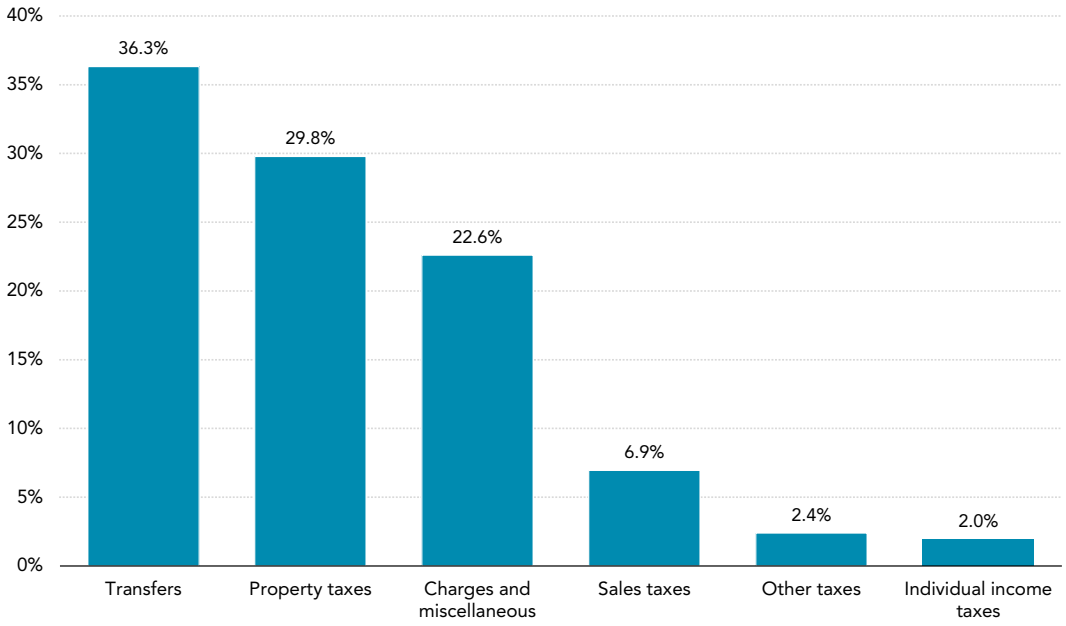
Q. What are the sources of revenue for local governments?

A. Local governments collected more than $1.5 trillion of general revenue in 2014. Revenue from local property, sales, and other taxes totaled $624 billion, about 41 percent of general revenue (figure 1).

FIGURE 1
Local General Revenue by Source
2014



Source: Urban-Brookings Tax Policy Center, State & Local Government Finance Data Query System.

INTERGOVERNMENTAL TRANSFERS

Of the 36 percent of local government general revenue that were transfers from other levels of government, 32 percent came from state governments (including indirect federal funds), and 4 percent came directly from the federal government. Local governments include county governments, municipalities, townships, special districts (such as water and sewage authorities), and school districts. Aid to school districts account for more than half of all state government transfers to localities. Housing programs make up 40 percent of federal transfers to local governments.

The State of State (and Local) Tax Policy

What are the sources of revenue for local governments?

OWN-SOURCE REVENUE

Revenue from property taxes was $452 billion in 2014—30 percent of local government general revenue and the largest single source of tax revenue (figure 1). Revenue from sales taxes was $105 billion—7 percent of general revenue. Revenue from individual income taxes was $30 billion—another 2 percent—while revenue from other taxes (such as stadium taxes and business license taxes) was $36 billion— just over 2 percent. Charges and miscellaneous fees, such as water, sewerage, and parking meter fees collected by municipal or county governments, provided $343 billion or 23 percent of general revenue.

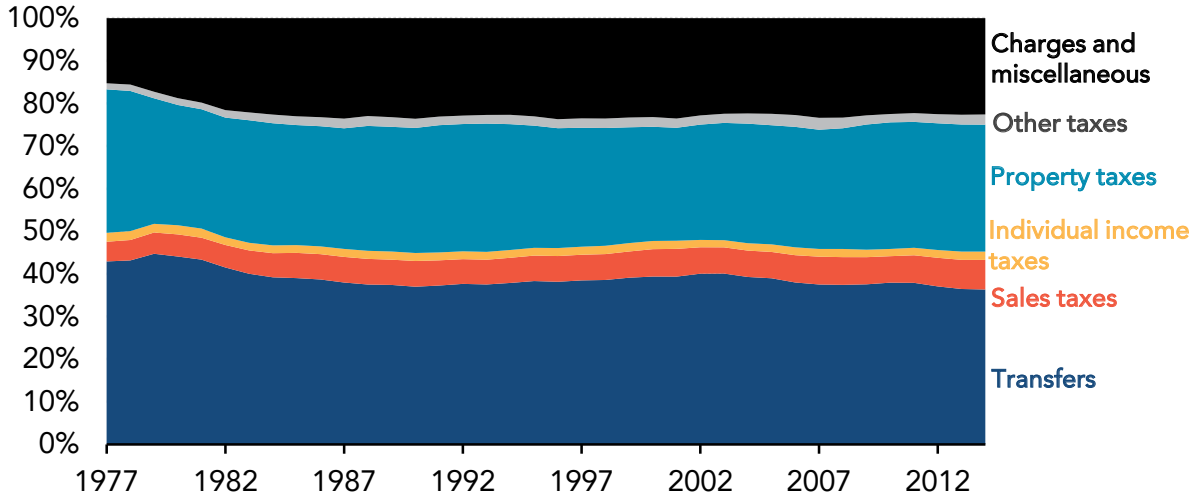
CHANGING SOURCES

Since 1977, the share of local government revenue from nontax sources has remained fairly steady at 60 percent of general revenue. However, the composition of non-tax revenue has changed. The portion from intergovernmental transfers declined from 43 percent of general revenue in 1977 to 36 percent in 2014, while revenue from charges and fees increased from 15 percent to 23 percent.

Likewise, while the share of general revenue from local taxes has remained at about 40 percent, the composition of tax revenue changed. The contribution of property taxes to general revenue declined from 34 percent in 1977 to 30 percent in 2014, while revenue from sales taxes increased from 5 percent to 7 percent.

FIGURE 2

Local General Revenue by Source, 1977-2014



Source: Urban-Brookings Tax Policy Center, State and Local Government Finance Data Query System.

REVENUE GROWTH COMPARED WITH ECONOMIC GROWTH

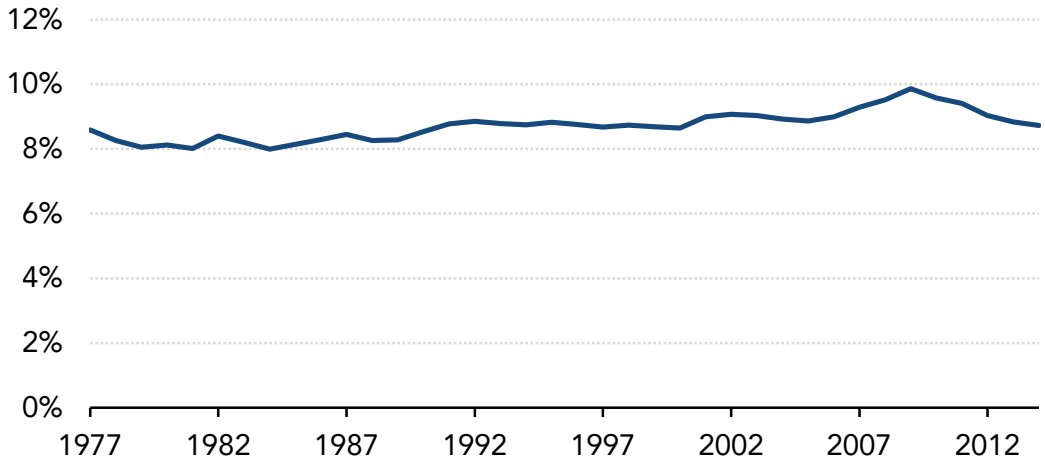
Although local government revenue was about the same relative to GDP in 2012 as it was in 1977, there were fluctuations over that period (figure 3). The figure fell to a low of 8.0 percent in 1980 and peaked at 9.9 percent in 2009.

The State of State (and Local) Tax Policy

What are the sources of revenue for local governments?

FIGURE 3

Total Local General Revenue, 1977-
As a share of national GDP



Source: Bureau of Economic Analysis; Urban-Brookings Tax Policy Center, State and Local Government Finance Data Query System.

Much of the change in local government revenue relative to the economy was because of fluctuations in transfers provided by the federal and state governments. Transfers fell from 1977 through most of the 1980s and increased slowly though the 1990s. This source of revenue is cyclical; it grew sharply during the 2001 and the 2007–09 recessions, receding in both cases as the economy recovered (figure 4).

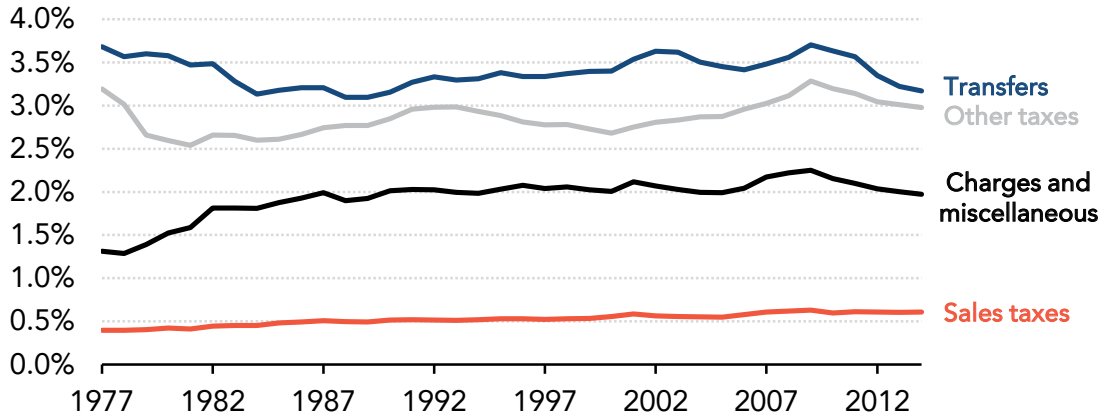
The State of State (and Local) Tax Policy

What are the sources of revenue for local governments?

FIGURE 4

Local General Revenue by

As a share of national GDP



Source: Bureau of Economic Analysis; Urban-Brookings Tax Policy Center, State and Local Government Finance Data Query System.
Note: Other includes revenue from the individual income tax, property taxes, and other local taxes.

Data Sources

US Department of Commerce, Bureau of Economic Analysis. BEA National Economic Accounts: Current-dollar and 'real' GDP.

Tax Policy Center. State and Local Finance Data Query System. Urban Institute and Brookings Institution, Washington, D.C.

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Q. How do state and local individual income taxes work?

Forty-one states and the District of Columbia levy broad-based taxes on individual income. New Hampshire and Tennessee tax only individual income from dividends and interest. Seven states do not tax individual income of any kind. Local governments in 12 states levy their own income tax on top of state taxes.

HOW MUCH REVENUE DO STATE AND LOCAL GOVERNMENTS COLLECT FROM INDIVIDUAL INCOME TAXES?

State governments collected $312 billion—26 percent of state own-source general revenue—from individual income taxes in 2014 (table 1). "Own-source" revenue excludes intergovernmental transfers. By contrast, local governments, concentrated in Maryland, New York, Ohio, and Pennsylvania, collected just $30 billion—3 percent of revenue.

TABLE 1

State and Local Individual Income Tax Revenue
2014

	Revenue (billions)	Percentage of own-source general revenue
State and local	341	16
State	312	26
Local	30	3

Source: State & Local Government Finance Data Query System. The Urban Institute-Brookings Institution Tax Policy Center.

Note: Own source general revenue does not include intergovernmental transfers.

Forty-one states and DC levy a broad-based individual income tax. Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not have a state individual income tax. Maryland relied most on the tax, collecting 29 percent of combined state and local own-source general revenue from it in 2013. Connecticut, Massachusetts, and Oregon each collected 25 percent of revenue from the tax.

Three states with a broad-based individual income tax collected less than 10 percent of total state and local own-source general revenue from that tax. North Dakota (8 percent of revenue) relied least on the tax. New Hampshire and Tennessee, with much more limited individual income taxes, collected about 1 percent of revenue from them.

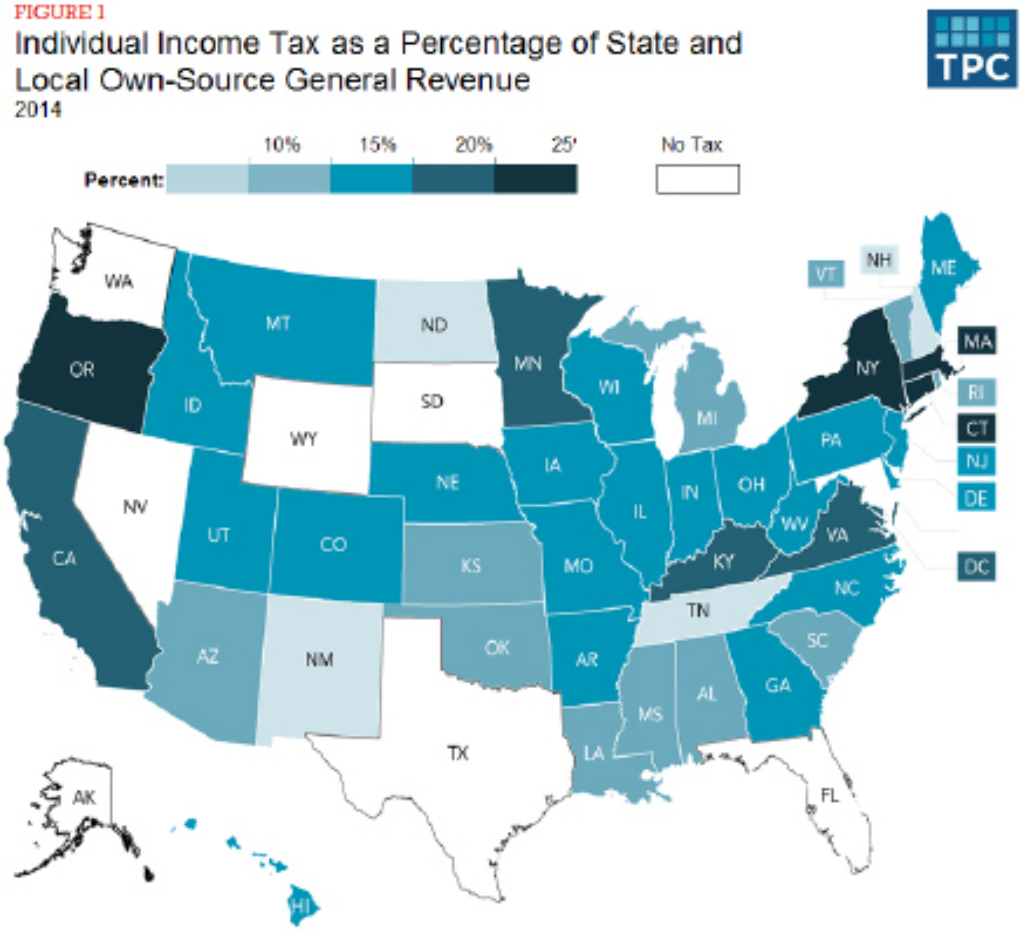
The State of State (and Local) Tax Policy

How do state and local individual income taxes work?

FIGURE 1

Individual Income Tax as a Percentage of State and Local Own-Source General Revenue

2014



Source: Urban-Brookings Tax Policy Center, State & Local Government Finance Data Query System.

Note: Own source general revenue does not include intergovernmental transfers.

In 12 states local governments levied their own individual income taxes in 2013. DC also has its own individual income tax. Individual income taxes provided an average of 10 percent of local own-source general revenue in those states and DC, ranging from 1 percent in Alabama and Iowa to 21 percent in DC and 25 percent in Maryland.

WHAT INCOME IS TAXED?

Most states follow the federal definition of taxable income, but there are exceptions. New Hampshire and Tennessee tax only dividends and interest. States, however, often apply different rules than the federal government for certain types of income. Unlike the federal government, states often tax municipal bond interest from securities issued outside that state, and many allow a full or partial exemption for pension income. Recently, Kansas and Ohio exempted some or all sole proprietor income and partnership income. In many states, taxpayers who itemize their federal tax deductions and claim deductions for state and local taxes may not deduct those taxes on their state income tax returns.

The State of State (and Local) Tax Policy

How do state and local individual income taxes work?

HOW DO INDIVIDUAL INCOME TAX RATES VARY ACROSS STATES?

Most state income taxes are fairly flat, even in those states that apply graduated rates. Eight states impose a single tax rate on all income, while Missouri has the most with 10 tax brackets. Top marginal rates for state income tax in 2016 ranged from 3.07 percent in Pennsylvania to 13.3 percent in California—including a 1 percent surcharge on incomes over $1 million in that state (figure 2). In states with multiple tax brackets, the top tax bracket often begins at a very low level of taxable income. Alabama, for example, has three rates, but the top tax bracket starts at taxable income of $3,000, making it essentially a flat tax. In other states, the difference between the lowest and the highest tax rates is small: about 2 percentage points in Kansas and Mississippi, for example.

While most states followed the federal government's lead in reducing the number of income tax brackets in the 1980s, there has been a lot of regression. California and New York have imposed new brackets (often called "millionaire's taxes") for high-income taxpayers. California approved a millionaire's tax in 2013 that adds 1 percentage point to the rate applied to incomes over $1 million. Similarly, New York's top tax rate of 8.82 percent applies to income above about $1 million.

California, Minnesota, and Oregon have top rates above 9 percent. Iowa, New Jersey, New York, Vermont, and DC have top income tax rates above 8.8 percent.

HOW DO STATES TAX CAPITAL GAINS AND LOSSES?

Eleven states and DC treat capital gains and losses the same as under federal law. They tax all realized capital gains, allow a deduction of up to $3,000 for net capital losses, and permit taxpayers to carry over unused capital losses to subsequent years. However, most states tax capital gains at the same rate as ordinary income, while the federal government provides a preferential rate. New Hampshire fully exempts capital gains, and Tennessee taxes only capital gains from the sale of mutual fund shares. Arizona exempts 25 percent of long-term capital gains, and New Mexico exempts 50 percent. Massachusetts has its own system for taxing capital gains, while Hawaii has an alternative capital gains tax. Pennsylvania and Alabama only allow losses to be deducted in the year that they are incurred, while New Jersey does not allow losses to be deducted from ordinary income. The remaining 25 states that tax income generally follow the federal treatment of capital gains, with the exception of various state-specific exclusions and deductions.

HOW DO STATES TAX INCOME EARNED IN OTHER JURISDICTIONS?

Income tax is generally imposed by the state in which the income is earned. Some states, however, have entered into reciprocity agreements with other states that allow outside income to be taxed in the state of residence. For example, Maryland's reciprocity agreement with DC allows Maryland to tax income earned in the District by a Maryland resident. As of 2010, 15 states and DC had adopted reciprocity agreements. Typically, these are states with major employers close to the border and large commuter flows in both directions.

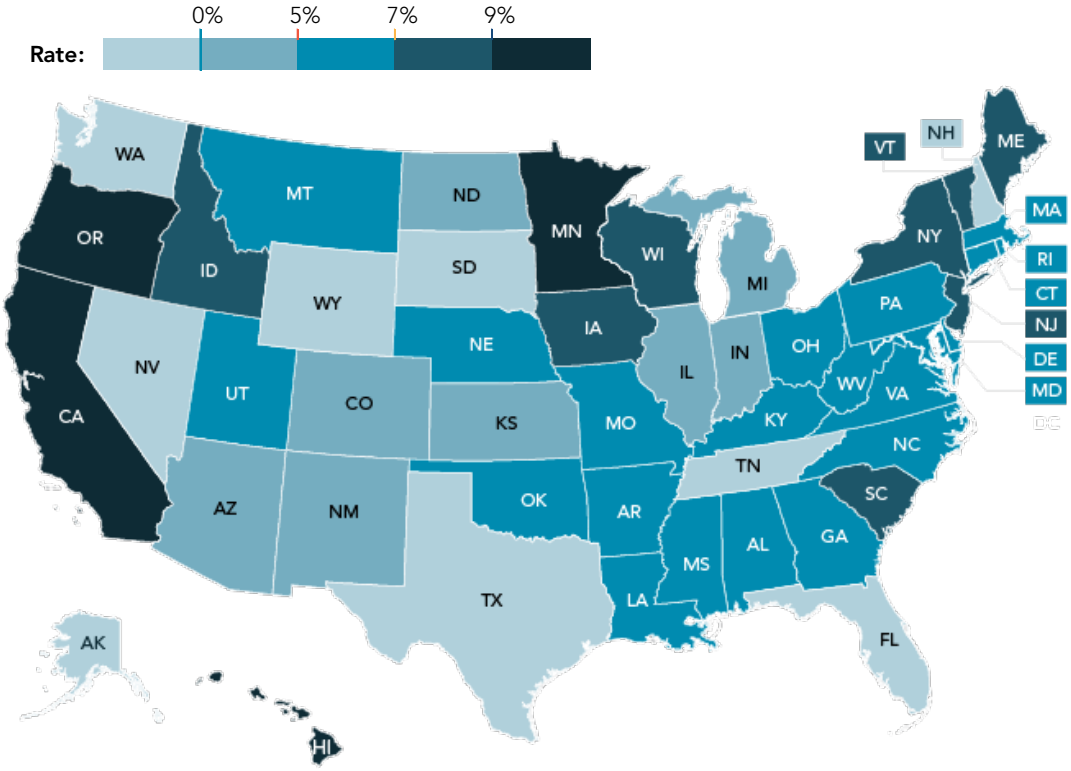
The State of State (and Local) Tax Policy

How do state and local individual income taxes work?

FIGURE 2

Top State Individual Income Tax Rates

2015



Source: Federation of Tax Administrators.

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Q. How do state and local sales taxes work?

A. Forty-five states and the District of Columbia levy general sales taxes that apply (with some exemptions) to all goods and certain services. Thirty-eight states (including, Alaska, which has no state sales tax) also allow sales tax at the local level. Most states apply separate sales taxes to particular goods, typically tobacco, alcohol, and motor fuels.

HOW MUCH REVENUE DO STATE AND LOCAL GOVERNMENTS RAISE FROM SALES TAXES?

States rely on sales taxes more than local governments do. States collected $412 billion—35 percent of own-source general revenue—from sales taxes in 2014 (figure 1). "Own-source" revenue excludes intergovernmental transfers. Nearly two-thirds of that ($272 billion) came from general sales taxes, and one-third ($140 billion) came from selective sales taxes (excise taxes) on tobacco, alcohol, and the like. Local governments, for their part, collected $105 billion—11 percent of local government own-source general revenue—from sales taxes in 2014, with $75 billion coming from general sales taxes and $30 billion from selective sales taxes.

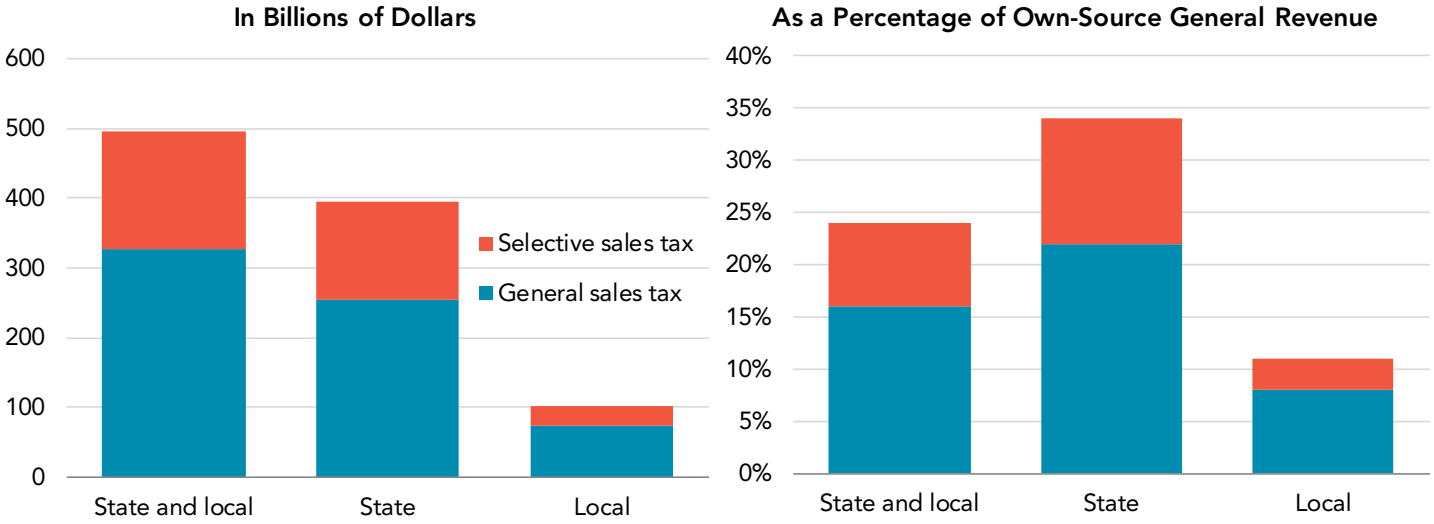
Nevada relied on sales tax revenue more than any other state in 2014, with sales and selective sales taxes accounting for 44 percent of combined state and local own-source general revenue. Sales and selective sales taxes represented more than 35 percent of combined state and local revenue in Arkansas, Hawaii, South Dakota, Tennessee, and Washington in 2014, and more than 30 percent in Arizona, Florida, Louisiana, and Texas. Among the states with a general sales tax, Massachusetts (15 percent of revenue) relied least on sales and selective sales tax revenue.

The State of State (and Local) Tax Policy

How do state and local sales taxes work?

FIGURE 1

State and Local Sales Tax Revenue
2013



Source: Urban-Brookings Tax Policy Center, State & Local Government Finance Data Query System.
Note: Own source general revenue does not include intergovernmental transfers.

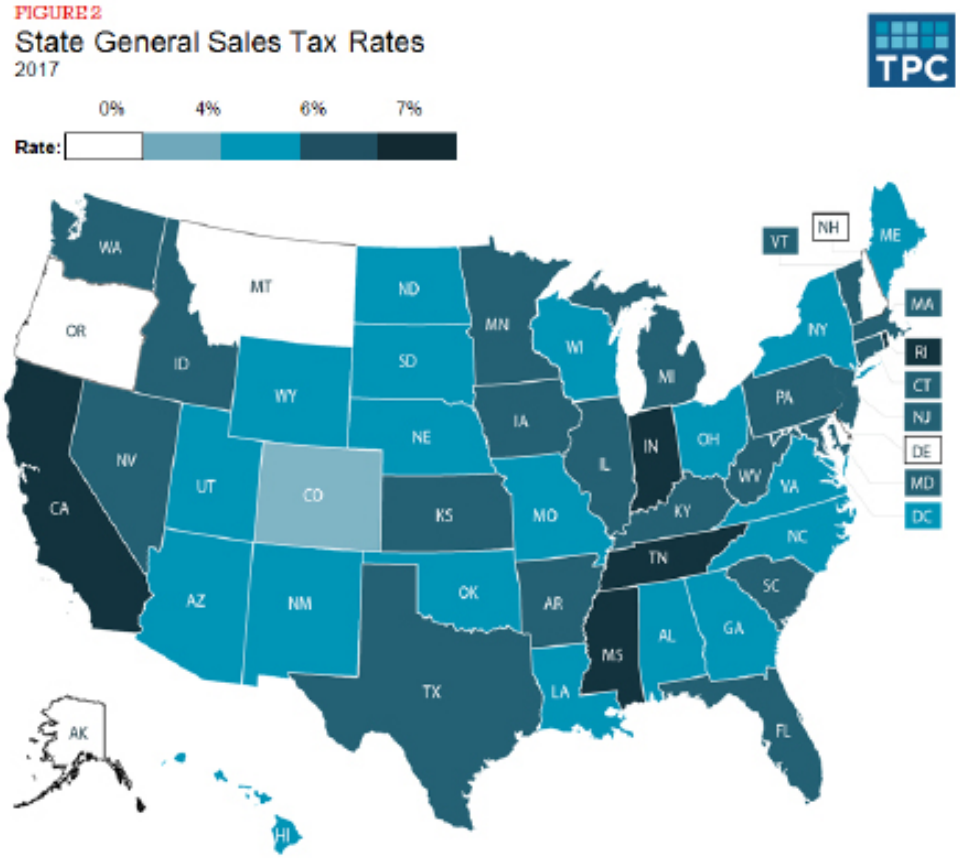
Every state and DC collected some revenue from selective sales taxes, with average revenue from such taxes accounting for 8 percent of state and local own-source general revenue. Sixteen states collected 10 percent or more of combined state and local revenue from selective sales taxes. Nevada had the highest revenue share from selective sales taxes—17 percent, while Alaska and Wyoming collected the least, around 3 percent of revenues, from selective sales taxes. combined state and local revenue from excise taxes. Nevada had the highest revenue share from excise taxes—16 percent, while Alaska and Wyoming each collected less than 3 percent of revenues from excises.

HOW DO GENERAL SALES TAX RATES DIFFER ACROSS STATES?

Among states with general sales taxes, Colorado has the lowest rate (2.9 percent) (figure 2). No other state with a general sales tax has a rate below 4.0 percent. Six states have rates at or above 7.0 percent. California has the highest rate (7.7 percent). Alaska, Delaware, Montana, New Hampshire, and Oregon have no state general sales taxes.

The State of State (and Local) Tax Policy

How do state and local sales taxes work?



Source: Federation of Tax Administrators

Thirty-eight states (including Alaska, which has no statewide tax) allow local governments to impose their own general sales taxes. The maximum sales tax rates levied by local governments range from 0.5 percent in Hawaii to 8 percent in Colorado.

WHAT PURCHASES ARE SUBJECT TO THE GENERAL SALES TAX?

General sales taxes typically apply to most tangible goods. One notable exception is food purchased for use at home: only 13 states tax such purchases, and six of these states tax food at a lower rate than their general rate. Five of the 13 states that tax food for home consumption provide income tax credits to low-income residents to help offset the tax. In contrast, food bought for immediate consumption at restaurants is taxed, often at a higher rate than the general sales tax rate.

Many states also exempt nonprescription drugs, textbooks, and clothing from general sales taxes. Some states have sales tax holidays, periods in which specific purchases—for example, clothes and school supplies right before the start of a new school year—are sold tax-free.

The taxation of services (e.g., dry cleaning, carpentry work, barbershops) is more complicated. All states tax some services, but exemptions are common. Very few states tax professional services such as doctors and lawyers. Hawaii and New Mexico are exceptions to that rule, taxing nearly all services.

The State of State (and Local) Tax Policy

How do state and local sales taxes work?

DO SALES TAXES APPLY TO ONLINE PURCHASES?

The treatment of online and other remote sales (e.g., catalog sales) is complex. Under the commerce clause of the US Constitution, if a retailer has no physical presence in the online purchaser's state of residence (technically called a "nexus" requirement) the state cannot require the retailer to collect a state or local sales tax from the consumer.

Many consumers do not realize, however, that in addition to sales taxes, states also levy use taxes. Consumers are subject to these taxes on goods purchased outside their states of residence for consumption in their home states. The use tax rate is the same as the sales tax rate, but few consumers actually pay it. Most states with both a sales tax and an individual income tax (such as California, Kentucky, Virginia, and Utah) give taxpayers a chance to declare liability and pay use taxes on their income tax returns.

The Supreme Court (*Quill Corp. v North Dakota*) ruled that states cannot require remote sellers to collect sales taxes, but that Congress could enact new rules. The Marketplace Fairness Act, first introduced in Congress in 2011, would allow states to require remote sellers to collect sales taxes on online purchases by their residents. The act would require that states simplify their sales taxes to make it easier for out-of-state sellers to collect the tax. It would also exempt sellers with less than $1 million of sales from the obligation. Congress has yet to pass the legislation.

WHAT TAXES DO STATES LEVY ON TOBACCO, ALCOHOL, AND MOTOR FUELS?

Most states levy "selective" sales taxes—with different rates than the general sales tax—on particular goods and services. Three of the best-known are taxes on cigarettes (and other tobacco products), alcohol, and motor fuels. Those products are also subject to a federal tax. For cigarettes and alcohol, the taxes are sometimes called "sin" taxes because one purpose of the tax is to discourage consumption.

Cigarette taxes are typically levied per pack. Missouri has the lowest rate (17 cents per pack) and New York has the highest ($4.35). In six states (Alabama, Illinois, Missouri, New York, Tennessee, and Virginia), local governments sometimes levy an additional cigarette tax. Local cigarette tax rates range from 1 cent per pack in Alabama and Tennessee to $4.18 per pack in Chicago (Cook County tax of $3.00, plus city tax of $1.18). Some states and cities levy their general sales taxes on the prices of cigarettes inclusive of the excise tax, while others include the general sales tax in the excise tax rate. Taxes are also levied on other tobacco products, including cigars and loose tobacco. There is new discussion about whether other nicotine delivery devices such as e-cigarettes should be taxed.

Alcohol taxes are generally paid at the wholesale level, so the cost is incorporated into the retail price. The excise taxes are levied per gallon (not as a percentage of the price), and beer, wine, and distilled spirits have different tax rates. In addition to the excise tax, many states also levy a general sales tax on the final purchase price of alcohol, and some states and cities have special sales tax rates for alcohol.

The State of State (and Local) Tax Policy

How do state and local sales taxes work?

Motor fuel taxes are mostly per-gallon taxes. Consumers pay tax based on how much gas they purchase, not as a percentage of the final retail price of gasoline. However, 20 states and the District of Columbia tie at least a portion of their gasoline tax rate to the retail price. The lowest gasoline tax rate is in Alaska (8.95 cents per gallon) and the highest is in Pennsylvania (58.2 cents per gallon). States earmark much of their motor fuel tax revenue for transportation spending, which has meant funding gaps for transportation in recent years as gasoline consumption is decreasing. States are considering options like tying the gas tax rate to inflation and taxing miles traveled instead of gas to raise more revenue.

Some cities (e.g., Boston, San Francisco, and Washington, DC) also have special tax rates for specific goods and services (e.g., restaurant meals, hotel accommodations, rental cars, and parking) that are higher than their general sales tax rates. The higher tax rates on these purchases are often designed to collect a significant share of their revenue from visitors, who presumably have less political clout than local voters.

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Q. How do state and local property taxes work?

A. Jurisdictions in all 50 states and the District of Columbia impose property taxes. Most property tax revenue comes from levies on land and improvements, but states often tax personal property (such as machinery, equipment, and motor vehicles) as well. The tax equals a percentage of the taxable value of the property and may be levied in some form at every level of government: state, county, municipal, township, school district, and special district.

HOW MUCH REVENUE DO STATE AND LOCAL GOVERNMENTS RAISE FROM PROPERTY TAXES?

While property taxes are a significant source of local government revenue, they are a very small revenue source for most states (table 1). State governments levy property taxes in 36 states, collecting $13 billion in revenue from such taxes in 2013—about 1 percent of own-source general revenue ("own-source" revenue excludes intergovernmental transfers). Vermont relied on property taxes for 26 percent of state own-source general revenue in 2013, far and away the highest percentage in any state. Property taxes were 5 percent or more of state revenue in only six other states: Arkansas, Michigan, Montana, New Hampshire, Washington, and Wyoming. Fourteen states did not levy a state-level property tax.

Local governments depend much more on property tax revenue. Local governments collected $442 billion from property taxes in 2013—47 percent of own-source general revenue. Property taxes provide three-quarters or more of local own-source revenue in six states; Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, and Rhode Island.

Property taxes are the largest own-source of revenue for counties, cities, townships, school districts, and special districts, which are specific-purpose units, such as water and sewer authorities. School districts rely quite heavily on property taxes, collecting $181 billion in 2012, which was 82 percent of their own-source general revenue. Because school districts receive substantial intergovernmental transfers, own-source revenue makes up less than half (about 45 percent) of their total general revenue.

The State of State (and Local) Tax Policy

How do state and local property taxes work?

TABLE 1

State and Local Property Tax Revenue
2013

	Revenue (billions)	Percentage of own source general revenue
State and local	$455	22%
State	$13	1%
Local	$442	47%

Source: Urban-Brookings Tax Policy Center, State & Local Government Finance Data Query System

Note: Own source general revenue does not include intergovernmental transfers.

IN WHICH STATES ARE PROPERTY TAXES MOST IMPORTANT?

New Hampshire, which has neither a broad-based income tax nor a general sales tax, was the most reliant on property taxes in 2013, with property tax revenue accounting for 44 percent of combined state and local own-source general revenue. Property taxes also contributed more than 30 percent of state and local revenue in Connecticut, Maine, New Jersey, Rhode Island, and Vermont. All told, 11 states, including seven in the Northeast, collected at least one-quarter of their state and local own-source general revenue from property taxes (figure 1).

North Dakota relied least on property tax revenue in 2013, with less than 10 percent of its combined state and local own-source general revenue generated from property. Eleven states collected less than 15 percent of combined state and local revenue from property taxes.

HOW DO STATES LIMIT PROPERTY TAXES?

In recent decades, many states have imposed limits on property tax rates, property tax revenue, or increases in assessed property values, reducing reliance on the property tax as a source of revenue. California, for example, limits the tax rate to 1 percent and annual assessment increases to 2 percent until a property is sold. As a result, neighbors with similar houses may have dramatically different tax liabilities depending on when their houses last changed hands.

States and local governments also often use limits, exemptions, deductions, and credits to lower tax liability. Here are some examples:

- Assessment limits prevent a property's assessed value from increasing by more than a fixed percentage between assessments. These limits can reduce a property's assessed value below its market value and prevent rapid property value increases from raising the owner's tax burden. When the property is sold, its assessed value is reset at market value.
- Homestead deductions and exemptions decrease the taxable value of real property by a fixed amount (much the same way a standard deduction decreases taxable income) for residents who occupy the property. Forty-one states and DC have homestead exemptions that reduce the fraction of the assessed property value subject to tax.

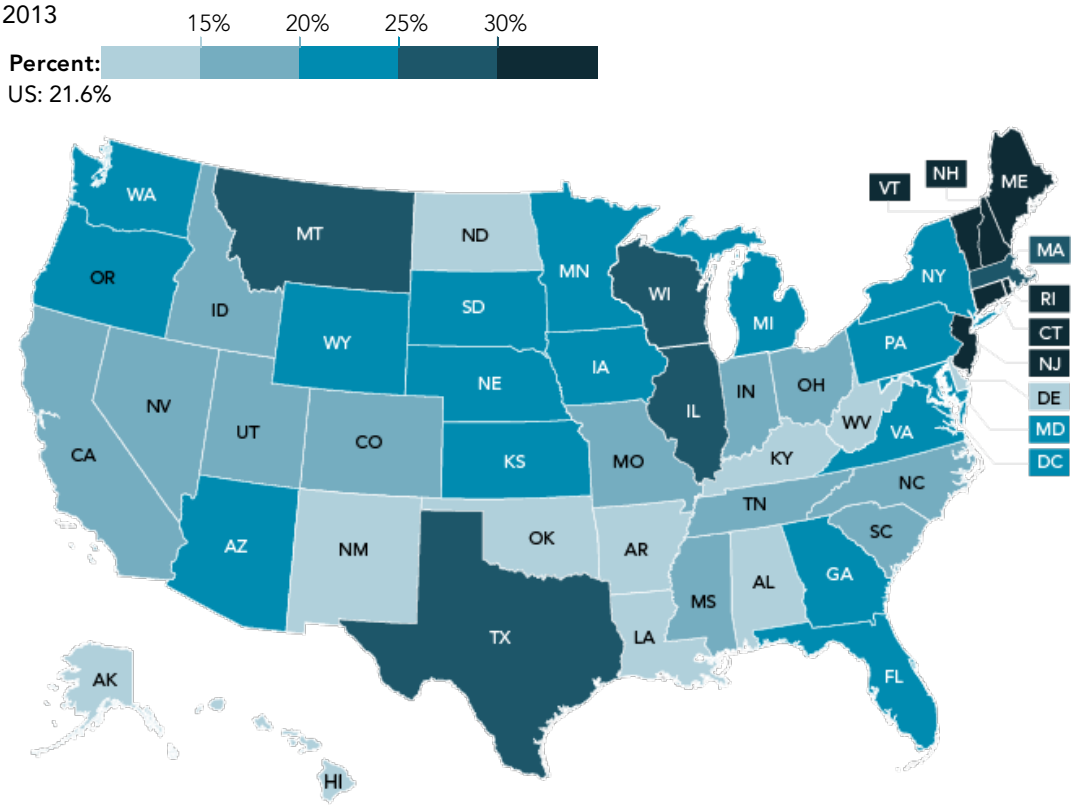
The State of State (and Local) Tax Policy

How do state and local property taxes work?

FIGURE 1

Property Tax Revenue as a Percentage of State and Local Own-Source General Revenue

2013



Source: Urban-Brookings Tax Policy Center, State & Local Government Finance Data Query System.
Note: Own source general revenue does not include intergovernmental transfers.

- Circuit breaker programs provide relief for elderly and low-income residents with property tax liabilities above a specified percentage of their income. Although relief is based on property tax payments, it is typically provided via an income tax credit. In most states, the state government collects income tax while local jurisdictions collect property tax, making circuit breakers a type of subsidy from state to local governments. Unlike the other approaches described here, circuit breakers benefit renters as well as homeowners in some jurisdictions. Twenty-eight states and the DC use circuit breaker credits and refunds to limit the share of income claimed by property taxes.
- Property tax deferrals allow elderly and disabled homeowners to defer payment until the sale of the property or the death of the taxpayer. All told, 22 states and the DC allow such deferrals, but they are not widely used.

The State of State (and Local) Tax Policy

How do state and local property taxes work?

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Q. How do state and local corporate income taxes work?

A. Forty-four states and the District of Columbia levy corporate income taxes. Ohio and Texas tax corporate gross receipts rather than income. Nevada, South Dakota, Washington, and Wyoming had no corporate income tax or gross receipts tax in 2016.

HOW MUCH REVENUE DO STATE AND LOCAL GOVERNMENTS RAISE FROM CORPORATE INCOME TAXES?

State and local governments raise a relatively small share of revenue from corporate income taxes (table 1). States collected just $45 billion—4 percent of state own-source general revenue—from corporate income taxes in 2013 (own-source revenue excludes intergovernmental transfers). Local governments, including DC, collected only $8 billion—less than 1 percent of local government own-source general revenue. Only seven states allowed localities to levy a corporate income tax. New York City was responsible for 84 percent of corporate income tax revenue collected by local governments; DC accounted for another 6 percent.

TABLE 1

State and Local Corporate Income Tax Revenue
2013

	Revenue (billions)	Percentage of own source general revenue
State and local	$53	3%
State	$45	4%
Local	$8	1%

Source: Urban-Brookings Tax Policy Center, State & Local Government Finance Data Query System.
Note: Own source general revenue does not include intergovernmental transfers.

New Hampshire collected 13 percent of state own-source general revenue from corporate income taxes in 2013, the highest share of revenue of any state. Corporate income taxes were 5 percent or more of state revenue in eight other states; Alaska, Delaware, Illinois, Massachusetts, Minnesota, New Jersey, New York, and Tennessee—also in DC. Among the 44 states with corporate income taxes three (Hawaii, Louisiana, and South Dakota) collected less than 2 percent of revenue from the tax.

Corporate income tax revenue was 6 percent of local government own-source general revenue in New York, the only state among the seven that permit local government to levy a corporate income tax in which revenue from the tax was more than 2 percent of revenue. DC's corporate income tax provided nearly 6 percent of its own-source general revenue in 2013.

The State of State (and Local) Tax Policy

How do state and local corporate income taxes work?

WHAT INCOME IS TAXED?

Most states use the federal definition of corporate income as a starting point. However, states deviate from federal rules in some instances. For example, when the federal government enacted "bonus depreciation" in 2008, which allowed businesses to deduct a larger portion of capital investment in the year the investment is first made, many states did not enact conforming rules.

While states benefit from federal tax administration and enforcement by following the federal definition of corporate income, they must take additional steps in the case of multistate corporations to determine what portion of that income is taxable in their states.

States must first establish whether a company has "nexus" in the state, that is, enough physical or economic presence to owe income tax. Next, they must determine the taxable income generated by activities in the state. For example, multistate companies often have subsidiaries in no-tax or low-tax states that hold intangible assets such as patents and trademarks. The rent or royalty payments to those wholly owned subsidiaries may or may not be considered income of the parent company operating in another state. Finally, states must determine how much of a corporation's taxable income is properly attributed to that state.

Until recently, most states used a three-factor formula based on the Uniform Division of Income for Tax Purposes Act to determine the portion of corporate income taxable in the state. That formula gave equal weight to the shares of a corporation's payroll, property, and sales in the state. In the last 20 years, however, states have moved toward formulas that either weight more heavily or rely exclusively on sales within the state to apportion income. By using the portion of a corporation's sales rather than employment or property to determine tax liability, states hope to encourage companies to relocate or to expand their operations within these states.

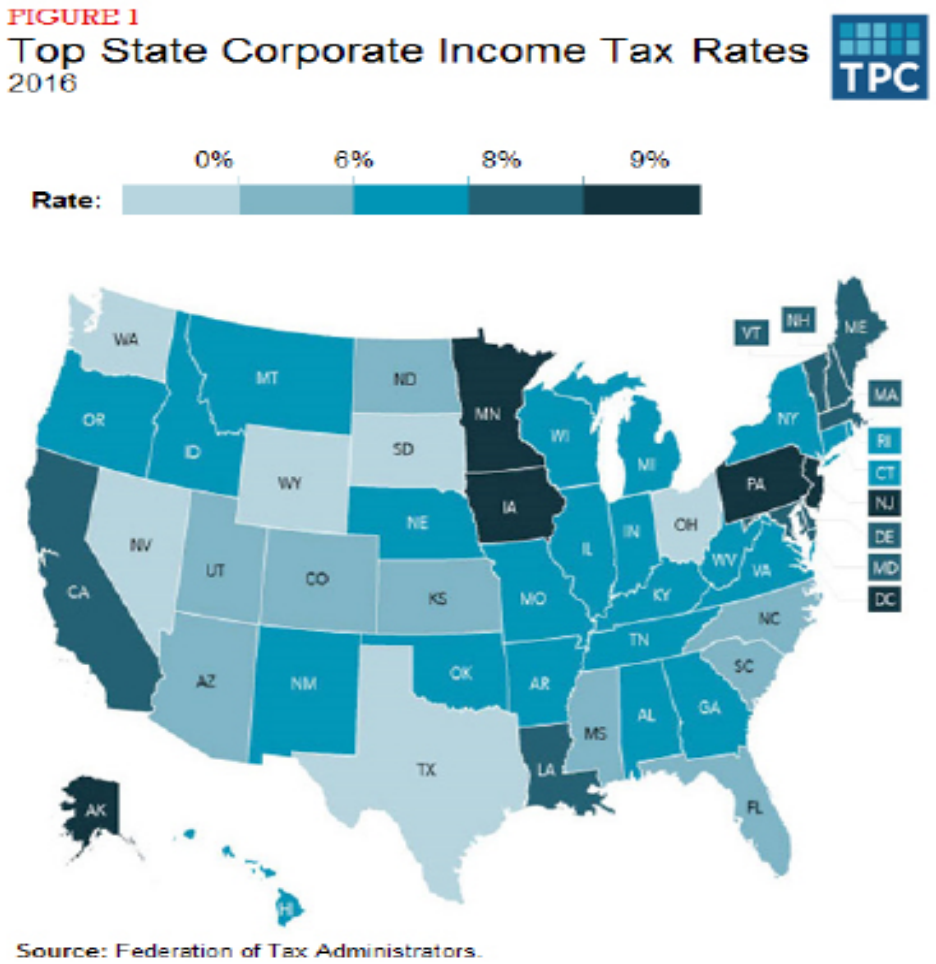
HOW MUCH DO CORPORATE INCOME TAX RATES DIFFER ACROSS STATES?

In 2016, top corporate income tax rates ranged from 4 percent (in Kansas and North Carolina) to 12.0 percent (in Iowa) (figure 1). Five states (Alaska, Iowa, Minnesota, New Jersey, and Pennsylvania) and DC had top corporate income tax rates at or above 9.0 percent. Nine others (Arizona, Colorado, Florida, Kansas, Mississippi, North Carolina, North Dakota, South Carolina, and Utah) had top rates below 6.0 percent.

Nevada, South Dakota, Washington, and Wyoming levied no corporate income taxes in 2015. Ohio and Texas taxed corporate gross receipts rather than income.

The State of State (and Local) Tax Policy

How do state and local corporate income taxes work?



Source: Federation of Tax Administrators.

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Q. How do state estate and inheritance tax work?

A. Eighteen states and the District of Columbia have either an estate tax or an inheritance tax. Maryland has both and New Jersey had both but repealed its estate tax as of 2018. Before 2001, when a federal credit offset the cost of state taxes, all states taxed the transfer of wealth at death.

In 2000 when all 50 states and the District of Columbia had an estate or inheritance tax, revenues from those taxes totaled $11 billion. In 2013, when only 19 states and D.C. had such taxes, revenues were $5 billion.

ESTATE OR INHERITANCE TAX?

Estate Tax

An estate tax is paid by the estate itself on the transfer of property at the time of a person's death. States must allocate assets across jurisdictions if the deceased person lived or owned property in multiple jurisdictions. Many of the states with estate taxes use the federal estate tax value as a starting point but vary in the exemptions allowed. The federal government exemption is $5.45 million in 2016, and current state exemptions are either equal to or less than the federal exemption.

Only 14 states and DC currently have estate taxes (figure 1). New Jersey is scheduled to repeal its estate tax starting in 2018. By contrast, in 2000, all states had estate taxes equal to the federal "credit for state death taxes" (CSDT); many of these states still have these taxes on their books in case the federal credit is restored.

Inheritance Tax

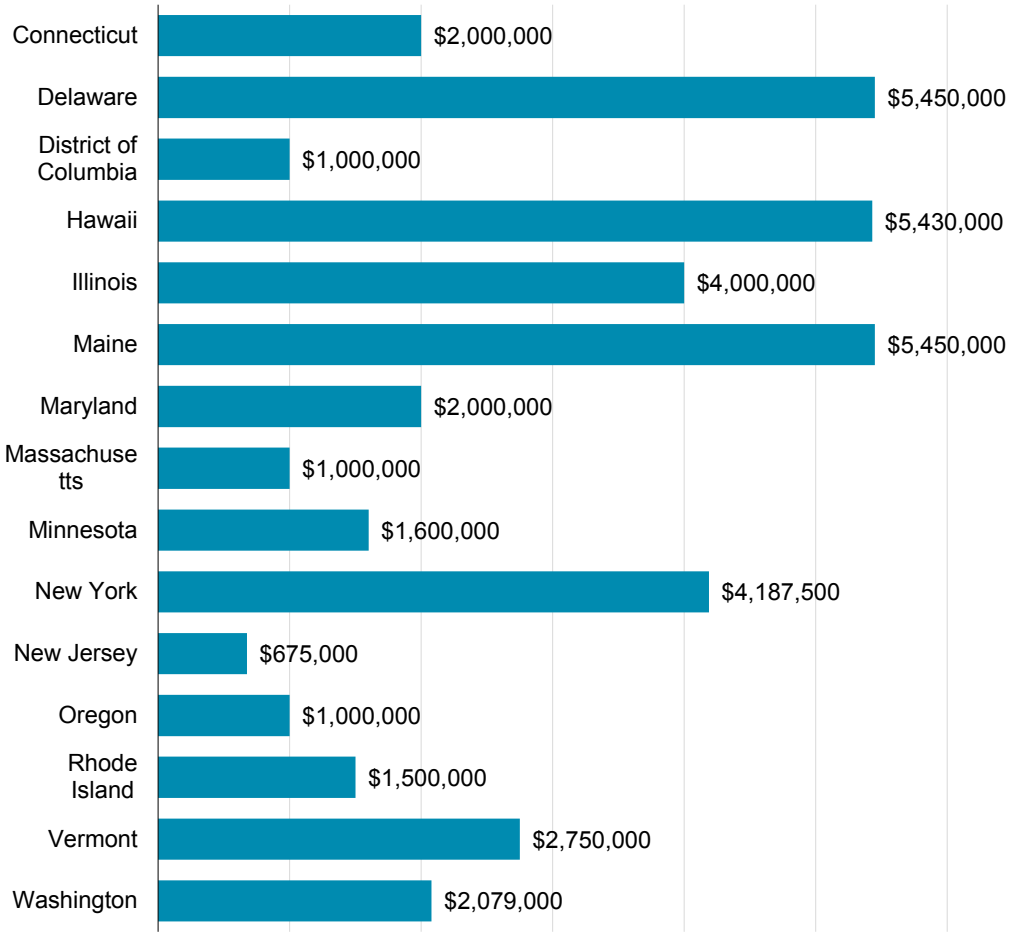
An inheritance tax is similar to the estate tax but the tax depends on the heir's relationship to the decedent. The tax is levied on the estate of residents or the in-state property of nonresidents at the time of death. There are exemptions for surviving spouses in all of the states with inheritance taxes; some also exempt direct descendants. Iowa, Kentucky, Maryland, Nebraska, New Jersey, and Pennsylvania have inheritance taxes. Maryland and New Jersey have both an estate and in-heritance tax, but New Jersey recently repealed its estate tax effective January 1, 2018.

The State of State (and Local) Tax Policy

How do state estate and inheritance taxes work?

FIGURE 1

Exemption Amounts for States with Estate Taxes
2016



Source: Tax Policy Center.
Notes: The federal exemption threshold is $5,450,000. Hawaii, Delaware, and Maine use the same threshold. New York's exemption amount rises to $5,250,000 on April 1, 2017 and starting on January 1, 2019, will match the federal exemption. On or after April 1, 2017, and on or before December 31, 2018, the exemption amount for New York will rise to $5,250,000.

BACKGROUND

From 1924 to 2005, the federal government shared estate tax revenue with the states by allowing a credit for state estate and inheritance taxes. From 1924 to 1954, the credit was equivalent to 25 percent of the federal estate tax. After 1954, estates could claim a credit for state estate and inheritance taxes according to a progressive schedule with a top rate of 16 percent of the taxable value of the estate. As a consequence, rather than establishing unique taxes, states enacted estate taxes that equaled the maximum credit. In 2000, the last year the full credit was available, the state tax credits totaled $6.4 billion.

The State of State (and Local) Tax Policy

How do state estate and inheritance taxes work?

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) phased out the credit, replacing it with a deduction that was less generous. The estate tax in many states was directly linked to the amount of the credit, and estate taxes would go to zero if they did not "decouple" from the federal law. In fact, 30 states let their tax go away by doing nothing. Fifteen states and DC did decouple, establishing separate estate taxes; five states explicitly repealed their taxes.

All of the provisions of EGTRRA were scheduled to expire in 2010 but were extended to 2012. In 2012, Congress did not address EGTRRA until the very end of the year, creating a fiscal cliff for most federal taxes and the possibility that the federal credit for state death taxes would return. In the end, Congress permanently replaced the state credit with a deduction for estate taxes paid to the states.

RECENT DEVELOPMENTS

Several states with estate or inheritance taxes have proposed or enacted changes. Indiana recently repealed its inheritance tax, while Kansas, North Carolina, Ohio, Oklahoma, and Tennessee re-pealed their estate taxes. Delaware, Hawaii, and Maine adjusted their exemptions to conform to the federal exemption. The District of Columbia will conform to the federal exemption if reve-nues are higher than projected. Maryland, Minnesota, and Rhode Island have all recently in-creased their exemptions.

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Q. How do state earned income tax credits work?

A. States typically structure their earned income tax credit (EITC) as a percentage of the federal EITC. In 2016, state EITCs varied from 3.5 to 40 percent of the federal credit. Some state EITCs are not refundable, which make them much less valuable to very low-income families who rarely owe income tax.

Twenty-six states and the District of Columbia had their own earned income tax credit in 2016, although Washington's credit has never been implemented or funded. Washington is the only state without an income tax to have an earned income tax credit.

All but one state set their credits as a percentage of the federal credit, the exception being Minne-sota which calculates its credit as a percentage of income (table 1). State credits varied from 3.5 percent of the federal EITC in Louisiana and North Carolina to 40 percent of the federal credit in DC. California's credit is 85 percent of the federal credit but is based on a smaller earnings range than the federal EITC. Setting state credits as a percentage of the federal credit avoids added complexity for families filing a state income tax return. After filling out a federal tax return, fam-ilies can use that information to calculate their state credit on their state tax return.

The state EITC is refundable in all but three states (Delaware, Ohio, and Virginia). A non-refundable EITC can only offset state income taxes but no other state-level taxes paid by low-income working families.

The State of State (and Local) Tax Policy

How do state earned income tax credits work?

TABLE 1

Description of State Earned Income Tax Credits
2016

State	Year enacted	Refundable	Percentage of federal EITC
California	2015	Yes	85 percent of the federal credit, up to half of the federal phase-in
Colorado	1999 (replaced) 2013 (enacted; funded in 2015)		10
Connecticut	2011	Yes	27.5, 30 in 2016
Delaware	2005	No	20
District of Columbia	2000	Yes	40
Illinois	2000	Yes	10
Indiana	1999	Yes	9
Iowa	1989	Yes	15
Kansas	1998	Yes	17
Louisiana	2007	Yes	3.5
Maine	2000	Yes	5
Maryland	1987	Yes	Refundable: 25; nonrefundable 50
Massachusetts	1997	Yes	23
Michigan	2006	Yes	6
Minnesota	1991	Yes	Varies
Nebraska	2006	Yes	10
New Jersey	2000	Yes	30
New Mexico	2007	Yes	10
New York	1994	Yes	30
Ohio	2013	No	10, limited to 50 percent of liability for Ohio Taxable Income over $20,000
Oklahoma	2002	Yes	5
Oregon	1997	Yes	8
Rhode Island	1986	Yes	12.5
Vermont	1988	Yes	32
Virginia	2004	No	20
Washington	2008 (but not yet implemented)	Yes	10 (or $50, whichever is greater)
Wisconsin	1989	Yes	4 for families with one child; 11 for families with two children; 34 for families with three children

Source: Tax Credits for Working Families.

The State of State (and Local) Tax Policy

How do state earned income tax credits work?

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Q. How do state and local severance taxes work?

A. Thirty-five states levy severance taxes, which are taxes on the extraction of natural resources (including oil and natural gas). The revenue from these taxes is extremely volatile because it rises and falls with the price and production of natural resources.

HOW MUCH REVENUE DO STATE AND LOCAL GOVERNMENTS RAISE FROM SEVERANCE TAXES?

State and local governments collected $1.7 billion from severance taxes in 2013. Nearly all of that ($1.6 billion) came from state taxes; only 11 states allow local severance taxes. This revenue only accounted for 1 percent of national state and local general revenue, but severance taxes provide a substantial amount of revenue in a few resource-rich states, such as Alaska, North Dakota, and Wyoming (figure 1).

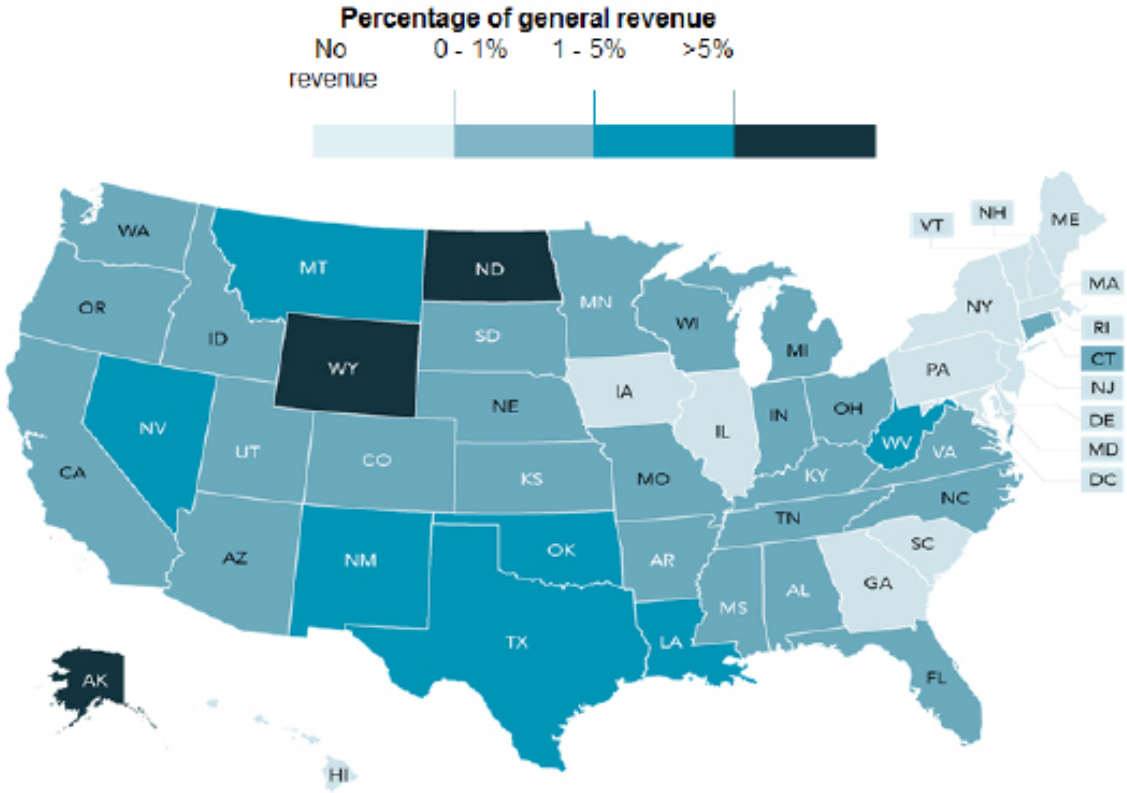
The State of State (and Local) Tax Policy

How do state and local severance taxes work?

FIGURE 1

Severance Tax Revenue

2013



Source: US Census Bureau, Census of Governments.

Alaska relied on severance tax revenue more than any other state in 2013, with severance taxes accounting for 27 percent of combined state and local own-source general revenue. Severance taxes were also a substantial percentage of combined state and local revenue in North Dakota (24 percent) and Wyoming (10 percent). In no other state were severance taxes more than 5 percent of general revenue, but they accounted for more than 1 percent in Louisiana, Montana, Nevada, New Mexico, Oklahoma, Texas, and West Virginia. Fifteen states and the District of Columbia do not levy severance taxes.

HOW HAVE FALLING OIL AND GAS PRICES AFFECTED SEVERANCE TAX REVENUE?

Since these data on severance revenue were reported in 2013, the price and production of oil and other natural resources have sharply declined, as has state severance tax revenue. Alaska's state severance tax revenue, in the most extreme example, fell from $1.3 billion in 2014 to less than $200 million in 2015. The volatility of severance taxes poses a challenge to states that use them as an important revenue source, requiring such states to have flexible budgeting arrangements, other readily exploitable revenue sources, or significant rainy-day funds to accommodate unforeseen changes in severance revenue flows.

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Q. How does the deduction for state and local taxes work?

A. Taxpayers who itemize deductions on their federal income tax returns can deduct state and local real estate and personal property taxes as well as either income taxes or general sales taxes.

State and local income and real estate taxes make up the bulk of total state and local taxes deducted (about 60 percent and 35 percent, respectively), while sales taxes and personal property taxes account for the remainder. The state and local tax (SALT) deduction is one of the largest federal tax expenditures, with an estimated revenue cost of $96 billion in 2017 and $1.3 trillion over the 10-year period from 2017 to 2026. (Tax expenditures are defined as "those revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income, or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.")

State and local taxes have been deductible since the inception of the federal income tax in 1913. Initially, all state and local taxes not directly tied to a benefit were deductible against federal taxable income. In 1964, deductible taxes were limited to state and local property (real and personal property), income, general sales, and motor fuels taxes. Congress eliminated the deduction for taxes on motor fuels in 1978, and eliminated the deduction for general sales tax in 1986. It temporarily reinstated the sales tax deduction in 2004, allowing taxpayers to deduct either income taxes or sales taxes, but not both. Subsequent legislation made that provision permanent starting in 2015.

WHO CLAIMS THE SALT DEDUCTION?

About one-third of tax filers opt to itemize deductions on their federal income tax returns (figure 1), and virtually all who do itemize claim a deduction for state and local taxes paid. High-income households are more likely than low- or moderate-income households to benefit from the SALT deduction. The amount of state and local taxes paid, the probability that taxpayers itemize their deductions, and the reduction in federal income taxes for each dollar of state and local taxes deducted all increase with income.

About 10 percent of tax filers with incomes less than $50,000 claimed the SALT deduction in 2014, compared with about 81 percent of tax filers with incomes exceeding $100,000. The latter group, which made up about 16 percent of tax filers, accounted for about 75 percent of the total dollar amount of SALT deductions claimed. The average claim in this affluent group was of about $12,300.

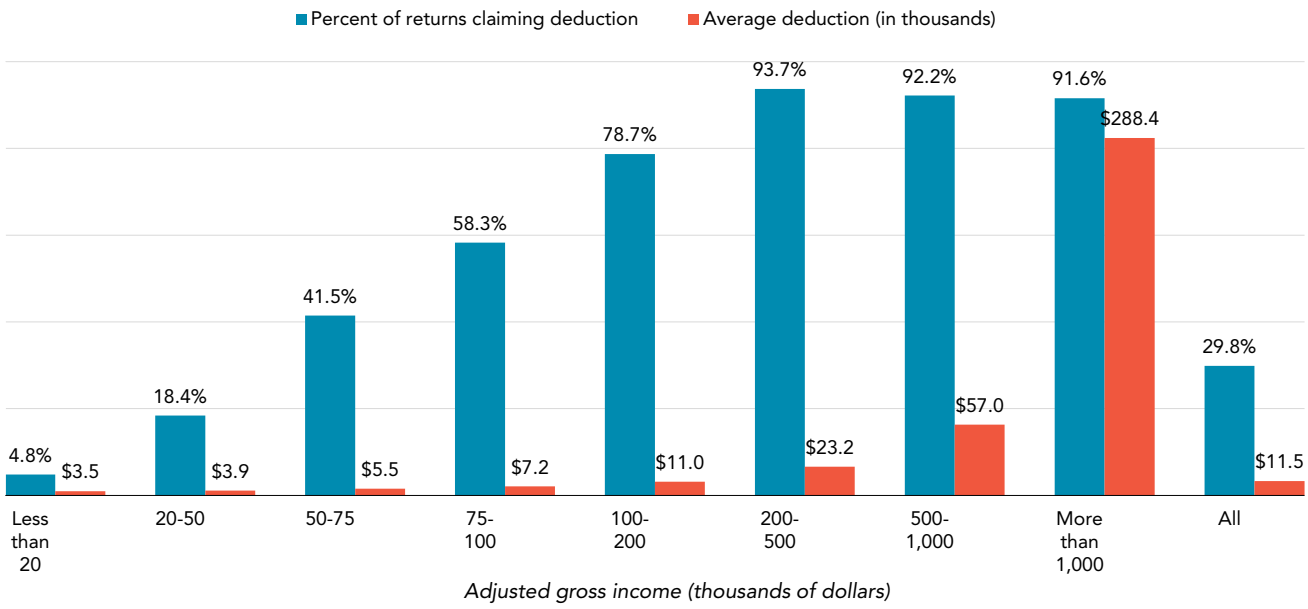
The State of State (and Local) Tax Policy

How does the deduction for state and local taxes work?

FIGURE 1

Share of Returns Claiming the State and Local Deduction, and Average Deduction Claimed

By income group, 2013



Source: Urban-Brookings Tax Policy Center based on data from the Internal Revenue Service.

Although most high-income taxpayers claim a SALT deduction, the federal individual alternative minimum tax (AMT) limits or eliminates the benefit for many of them. The AMT is a parallel income tax system with fewer exemptions and deductions than the regular income tax as well as a narrower set of tax rates. Taxpayers potentially subject to the AMT must calculate their taxes under both the regular income tax and the AMT and pay the higher amount. Taxpayers cannot claim the SALT deduction when calculating their AMT liability, and the disallowance of the deduction is the major reason why taxpayers are required to pay the AMT.

Although some taxpayers in every state and the DC claim the deduction, taxpayers in states with a disproportional share of high-income taxpayers and relatively high state and local taxes are more likely to claim the deduction (figure 2). The percentage claiming the deduction ranged from 17 percent in South Dakota and West Virginia to 45 percent in Maryland. In general, a higher percentage of taxpayers in states in the Northeast and the West claimed the deduction than in states in other regions. The average deduction claimed was also higher in those regions.

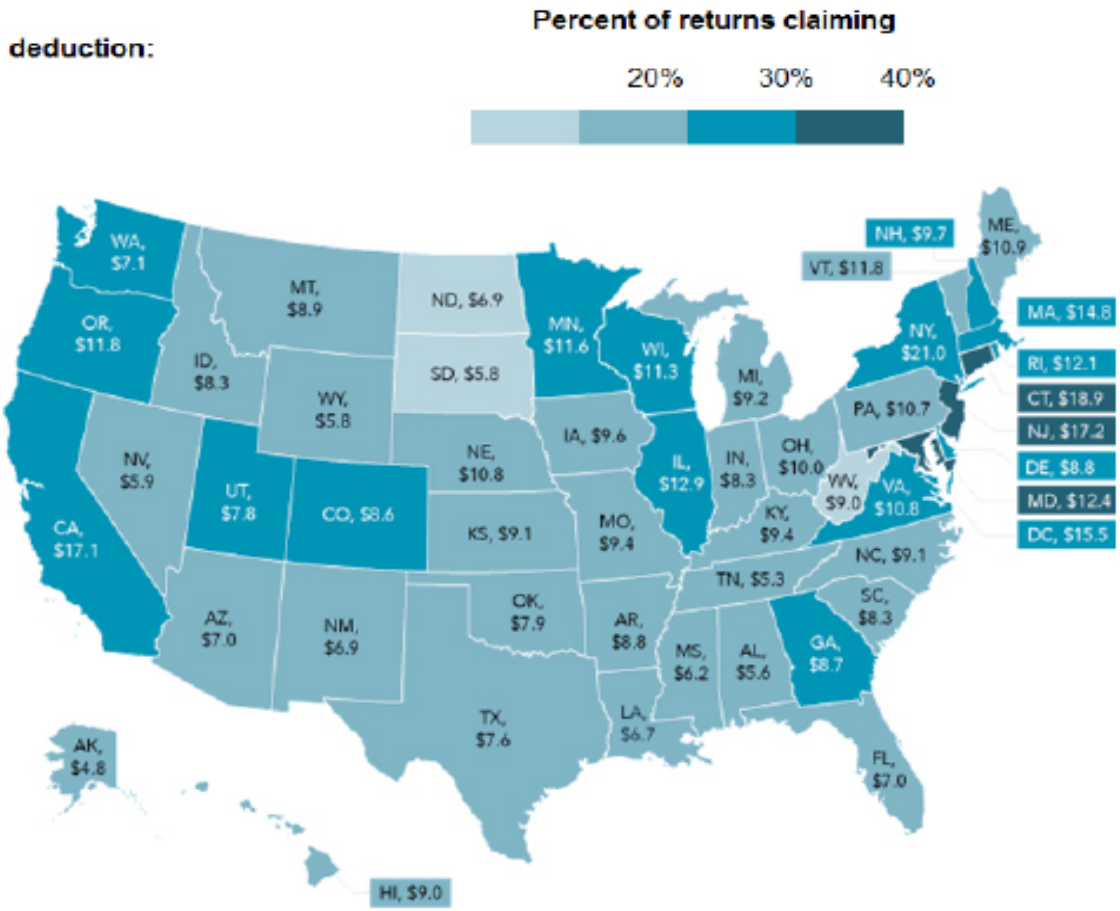
The State of State (and Local) Tax Policy

How does the deduction for state and local taxes work?

FIGURE 2

Returns Claiming the State and Local Tax Deduction and Average Deduction Claimed by State

Average deduction in thousands of dollars, 2014



Source: Urban-Brookings Tax Policy Center based on data from IRS: SOI Tax Stats - Historic Table 2. Tax Year 2014.

EFFECTS OF THE DEDUCTION

The SALT deduction provides an indirect federal subsidy to state and local governments by decreasing the net cost of nonfederal taxes to those who pay them. For example, if state income taxes increase by $100 for families claiming the SALT deduction on their federal returns who are in the 35 percent federal income tax bracket, the net cost to them is $65; that is, state taxes go up by $100, but federal taxes go down by $35. This federal tax expenditure encourages state and local governments to levy higher taxes (and, presumably, provide more services) than they otherwise would. It also encourages those entities to use deductible taxes in place of nondeductible taxes (such as selective sales taxes on alcohol, tobacco, and gasoline), fees, and other charges.

Critics of the deduction argue that state and local taxes simply reflect payments for services provided by

those jurisdictions and, as such, should be treated no differently than other forms of spending. They also point to the uneven distribution of benefits across income groups and states.

Proponents of the deduction counter that the portion of an individual's income claimed by state and local taxes is not really disposable income, and that taxing it at the federal level is double taxation. Moreover, they argue that federal subsidies are warranted because a significant portion of state and local government spending is for education, health, public welfare, and transportation, all of which have important spillovers that benefit the population in other jurisdictions as well. A counterargument, however, is that while federal support may be warranted, the substantial revenues gained by eliminating or limiting the deduction could be used to provide direct support through federal grants and loans.

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Q. What are municipal bonds and how are they used?

A. Municipal bonds (a term that encompasses both state and local government debt) are obligations that entitle owners to interest plus repayment of principal at a specified date. States and localities (cities, townships, counties, school districts, and special districts) issue bonds to pay for large, expensive, and long-lived capital projects, such as roads and schools.

State and local governments issue bonds to pay for large, expensive, and long-lived capital projects, such as roads and water treatment facilities. Although states and localities can and sometimes do pay for capital investments with current revenues, borrowing allows them to spread the costs across multiple generations. Future infrastructure users bear some of the cost through higher taxes or tolls that service the debts.

State and local governments borrow mainly by issuing bonds. Investors may buy bonds and hold them to maturity, or they may sell them on secondary markets. Bonds are often described in terms of their yield, or the interest rate that equates prices to cash flows. Bond prices and yields are inversely related to one another, so when prices rise, yields fall.

HOW LARGE IS THE MUNI BOND MARKET?

At the end of 2014, state and local governments had $3.65 trillion in debt outstanding (figure 1). Although the level of municipal debt has more than tripled in nominal terms since the mid-1980s, it has remained relatively stable as a percentage of GDP (15 to 20 percent). In fiscal year 2012, the latest year for which breakdowns are available, state governments were responsible for 40 percent and localities for 60 percent of the debt outstanding.

About 98 percent of this debt was issued for longer than one year. States and localities also borrow over the short term to smooth uneven cash flows (e.g., when tax revenues arrive in April but expenditures occur throughout the year).

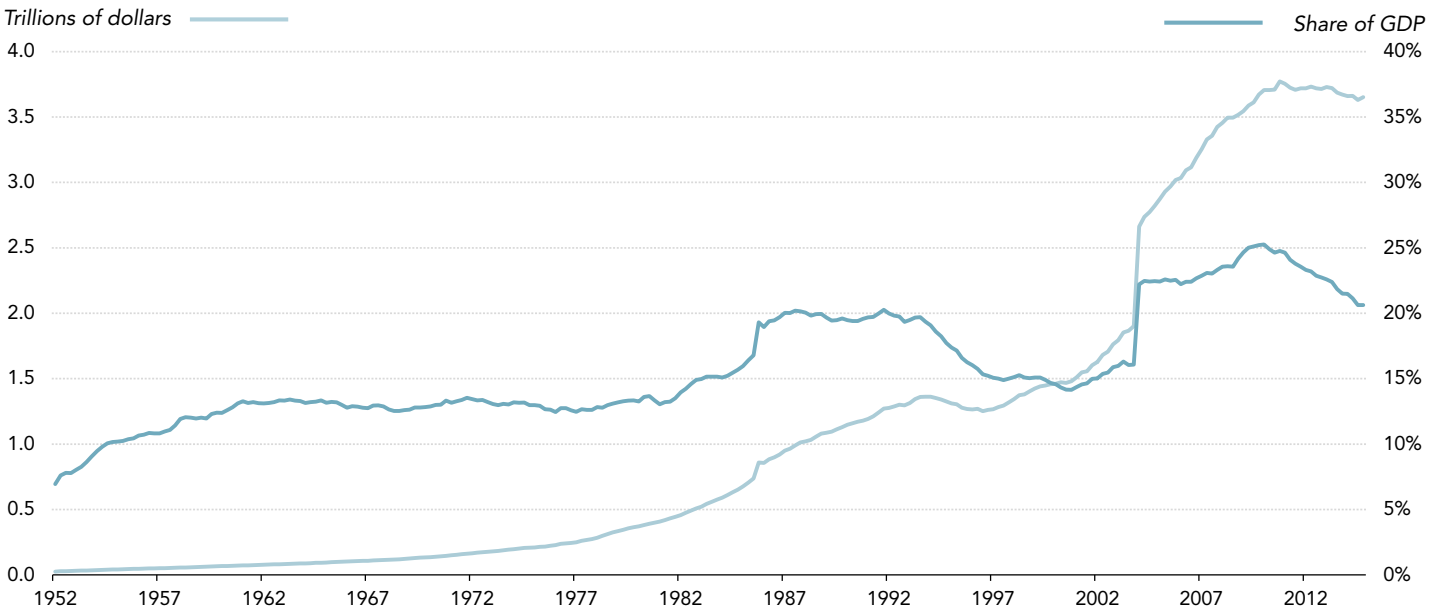
States vary widely in their long-term municipal debt outstanding (figure 2).

The State of State (and Local) Tax Policy

What are municipal bonds and how are they used?

FIGURE 1

State and Local Government Debt Outstanding
1952–2012



Source: Federal Reserve Bank, March 2015.
Note: Starting in the first quarter of 2004, the Federal Reserve made a one time $800 billion adjustment to the stock of municipal debt oustanding.

WHAT ARE THE MAIN TYPES OF STATE AND LOCAL GOVERNMENT DEBT?

General obligation (GO) bonds are generally considered the most secure form of municipal debt because they are backed by an issuer's "full faith and credit," including its power to tax. Bonds may also be secured by future revenue streams, such as tolls or other user charges and are called revenue bonds.

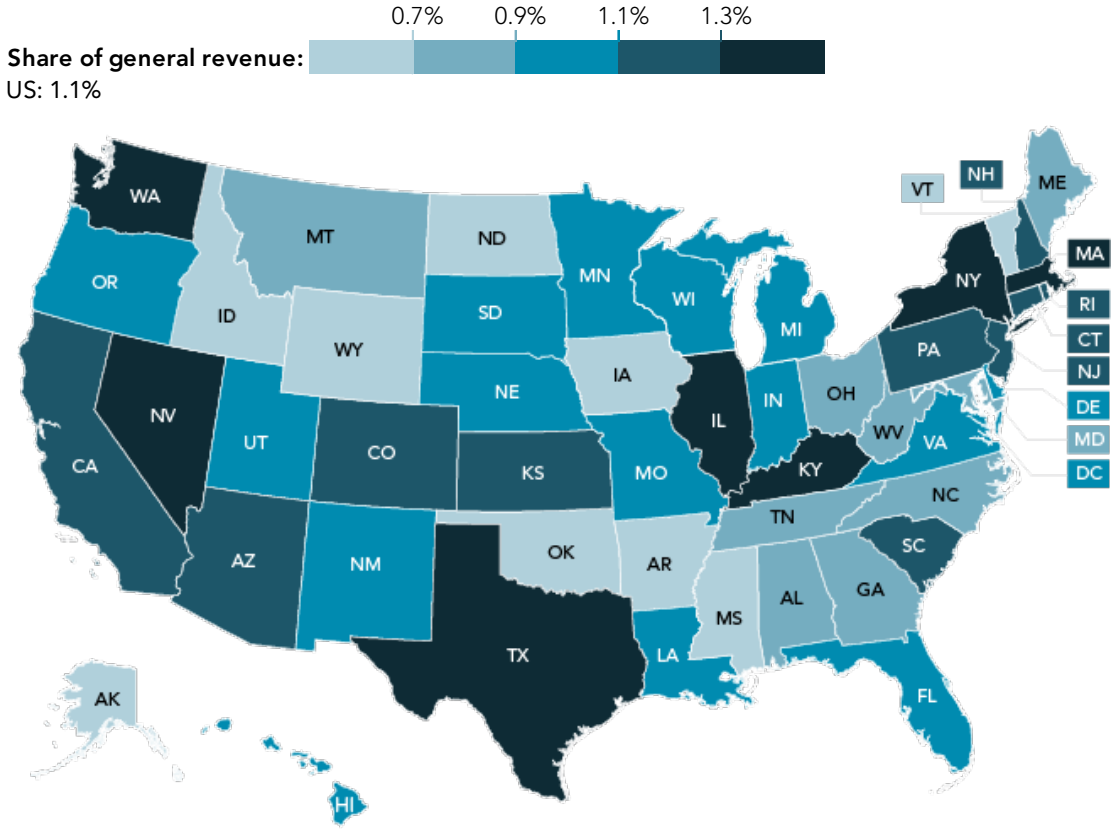
GO bonds typically require voter approval and are subject to limits on total debt outstanding. Revenue bonds and bonds secured by anticipated legislative appropriations are not subject to these requirements or limits. In addition to new borrowing, state and local governments may issue bonds to refinance or "refund" existing debt.

In 2014, roughly 60 percent of state and local issuances were revenue bonds and 40 percent were GO bonds. Issuances were lower than average and more heavily weighted than usual toward refunding, similar to a refinancing. Issuers were seeking to take advantage of low interest rates but were reluctant to issue new debt as revenue growth remained sluggish in the wake of the Great Recession.

FIGURE 2

Long-Term Outstanding Debt

2012



Source: US Census Bureau.

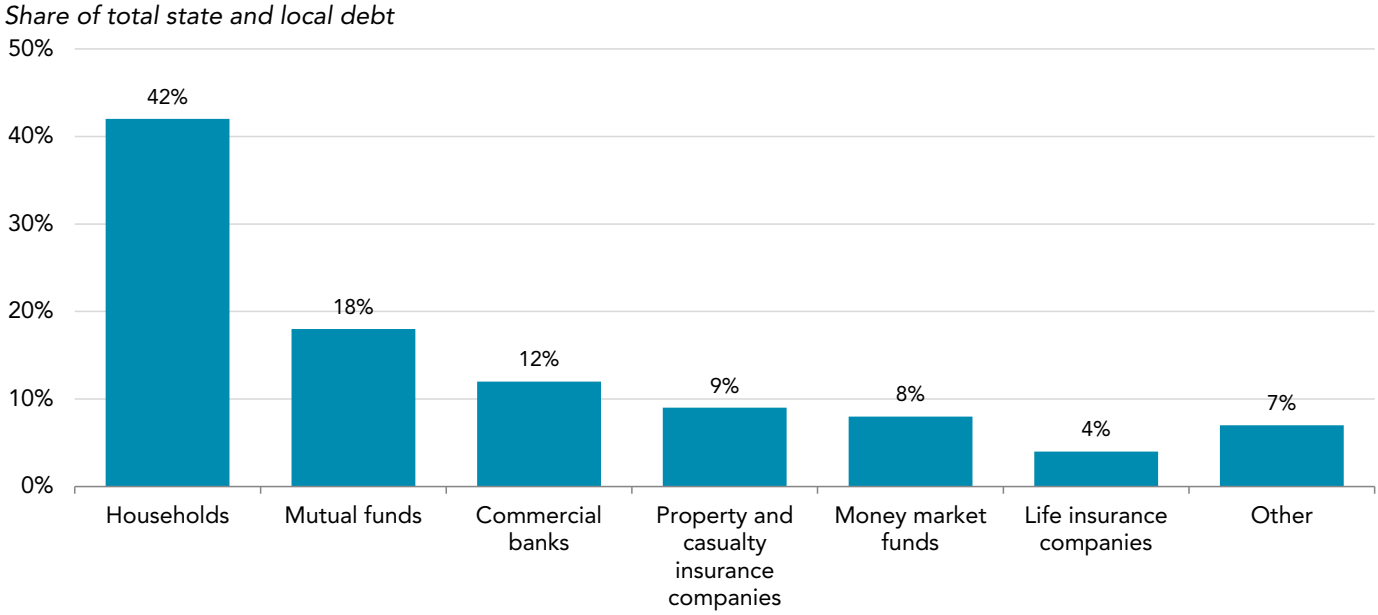
WHO HOLDS STATE AND LOCAL GOVERNMENT DEBT?

The largest quantity is held by households, followed by mutual funds (which also includes household investors) (figure 3). Banks and life insurance companies used to be more prominent municipal bond holders until the Tax Reform Act of 1986 and subsequent litigation limited the advantages of doing so.

FIGURE 3

Holders of State and Local Debt

2nd quarter, 2015



Source: Federal Reserve Bank, March 2015.
Notes: "Other" category includes: closed-end funds, foreign investors, brokers and dealers, nonfinancial corporate businesses, government-sponsored enterprises, savings institutions, exchange-traded funds, state and local government general funds, and state and local government retirement funds.

HOW DOES THE FEDERAL TAX EXEMPTION WORK AND WHAT ARE PROPOSALS FOR REFORM?

Since its inception in 1913, the federal income tax has exempted interest payments received from municipal bonds (a term that encompasses both state and local debt) from taxable income. State and local governments also typically exempt interest on bonds issued by taxpayers' state of residence. However, the US Supreme Court in *Department of Revenue of Ky. v. Davis* upheld states' ability to tax interest on bonds issued by other jurisdictions, though some jurisdictions, including the District of Columbia, do not tax municipal debt from any state.

Because of the tax exemption, state and local governments can borrow more cheaply than other debt issuers, such as corporations, for a given level of risk and length of maturity. The federal tax exemption therefore functions as a federal subsidy to state and local public infrastructure investment. This subsidy comes at a cost in foregone tax revenues, which amounted to $29 billion in fiscal 2014.

The tax exemption has been criticized as inefficient because high-bracket taxpayers receive more than the inducement needed to purchase municipal bonds. In 2007, for example, a high-grade taxable municipal bond (some do not qualify for the exemption) yielded 5.6 percent. The yield for a comparable tax-exempt bond was 4.4 percent. Thus, taxpayers in the 21 percent bracket should be just indifferent between the two types of bonds (the gap in yields—1.2 percentage points—is about 21 percent of 5.6 percentage points). Anyone in a higher bracket receives a windfall that generates no additional benefit for the borrower.

In light of this inefficiency, proposals have long circulated to cap the federal tax exemption (e.g., at 28 percent in President Obama's FY2016 and prior budgets) or to augment tax-exempt bonds with taxable bonds providing a direct subsidy to issuers as a tax credit to bondholders. The President's FY2016 budget included such a taxable bond proposal modeled after the 2009 American Recovery and Reinvestment Act's Build America Bonds. However, the revenue gain from eliminating or capping the deduction depends on whether bondholders responded by shifting their portfolios toward taxable bonds or other investments (Verdugo and Poterba 2011).

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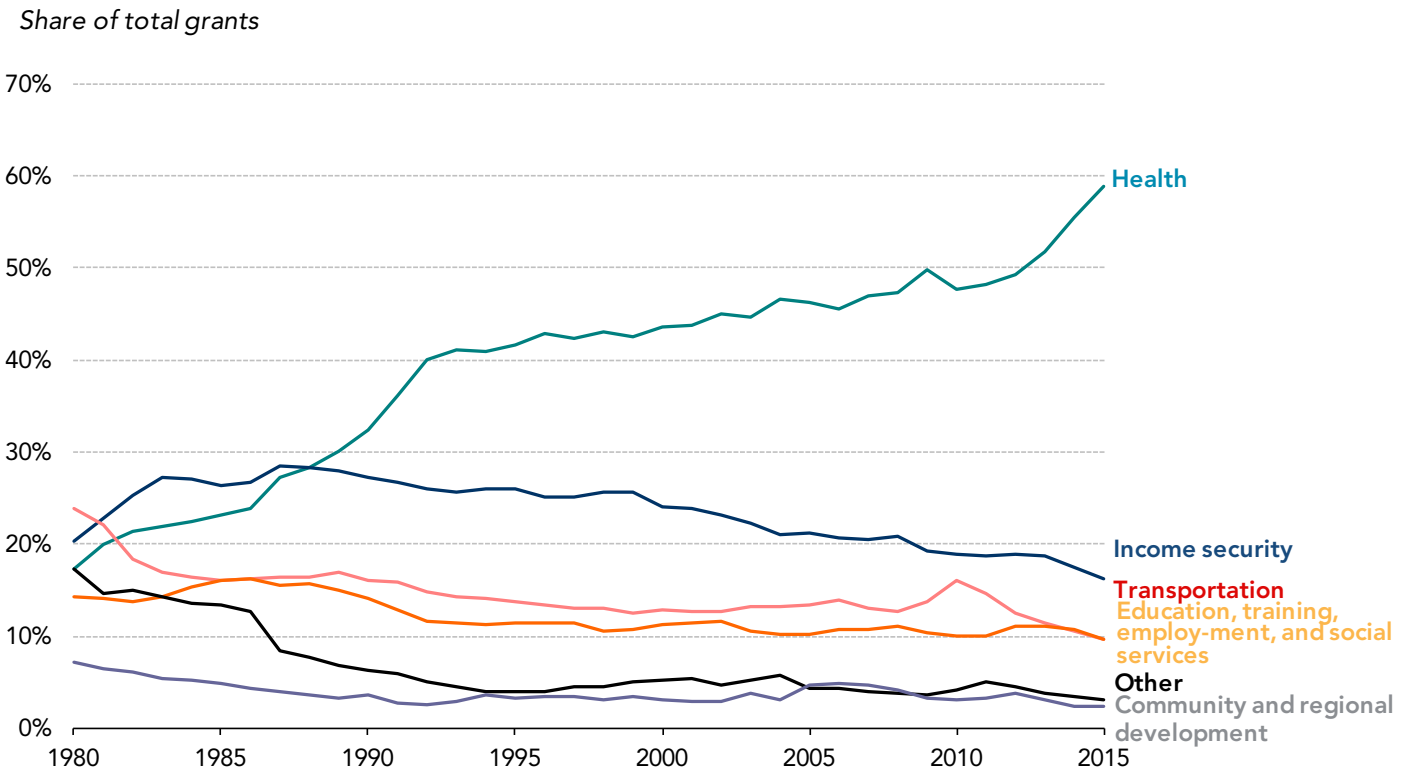
Q. What types of federal grants are made to state and local governments and how do they work?

A. The federal government distributes around $530 billion, about 14 percent of its budget, each year to states and localities, providing about a quarter of these governments' general revenues. The bulk of the funds are dedicated to health care (figure 1).

FIGURE 1

Federal Grants to State and Local Governments by Category
1980-2015



The State of State (and Local) Tax Policy

What types of federal grants are made to state and local governments and how do they work?

The federal government distributes grants to state and local governments for several purposes. In some cases, the federal government may devolve or share responsibility for a given service or function because state and local governments have better information about local preferences and costs. In others, the federal government may offer incentives to states and localities to undertake additional spending benefiting neighboring jurisdictions or the country as a whole. Less common are grants targeted to redistributing resources across jurisdictions, such as the General Revenue Sharing program that ended in 1986. Over the past 50 years, the composition of federal grants has shifted dramatically. Today, federal grants for health programs, predominantly Medicaid, represent 55 percent of total federal grant outlays, compared with 20 percent in 1980.

There are two types of federal grants. Categorical grants are restricted to a narrow purpose, such as providing nutrition to lower-income pregnant and postpartum women, infants, and children under the Special Supplemental Nutrition Program for Women, Infants, and Children, also known as WIC. Even more restricted are grants limited to specific projects, such as building a highway. Block grants give recipients more latitude in meeting program objectives, such as as-sisting needy families and promoting work under the Temporary Assistance for Needy Families (TANF) program. States also set TANF eligibility requirements within federal parameters.

Federal grants may also be classified according to how funds are awarded. Formula grants allo-cate federal dollars to states based on formulas set in law and linked to factors such as the num-ber of highway lane-miles, school-aged children, or low-income families. A prime example is the federal-state Medicaid program, which provides subsidized health insurance to low-income households.

Grants may also be awarded competitively according to specified criteria as in the Race to the Top or Transportation Investment Generating Economic Recovery (TIGER) awards. In addition, grants may require states and localities to contribute their own funds (matching requirements) or maintain previous spending levels despite the infusion of federal cash (maintenance of effort re-quirements).

Beyond grants, the federal government also subsidizes state and local governments by allowing federal income taxpayers to deduct state and local taxes already paid and by excluding bond in-terest from taxable income. The value of these subsidies has been estimated at $122 billion in foregone dollars to the US Treasury in FY2016 (Office of Management and Budget, 2016).

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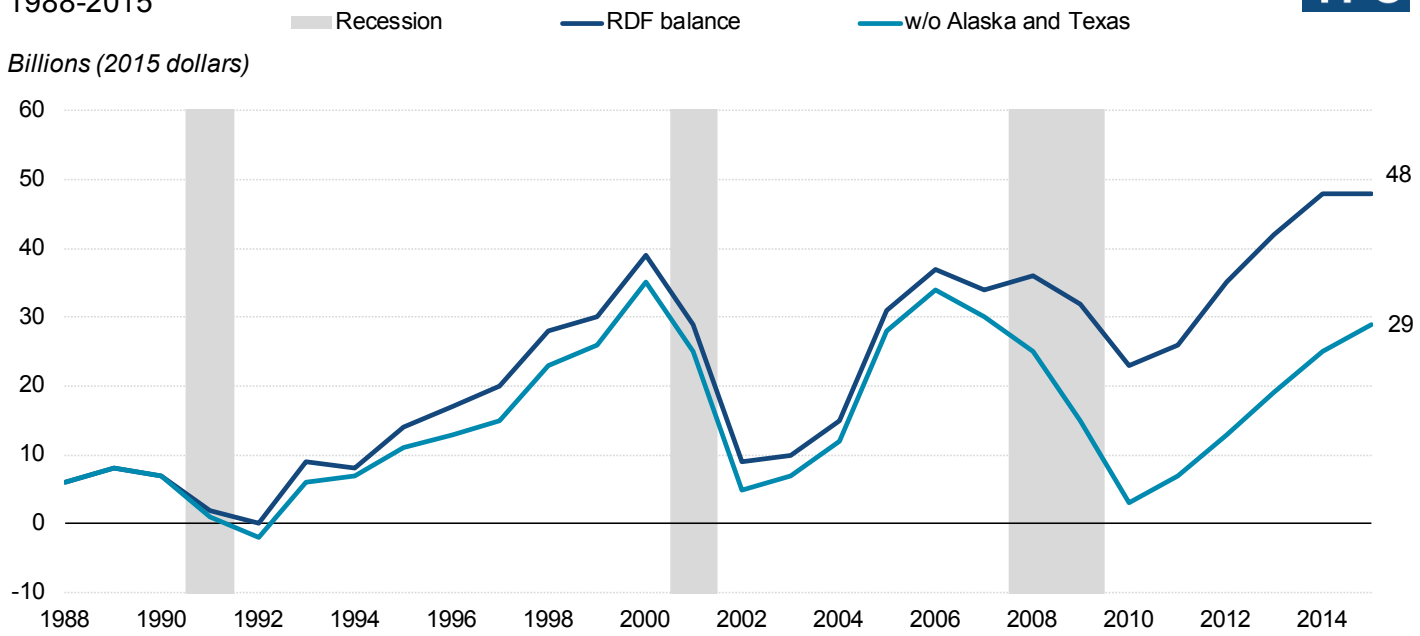
Q. What are state rainy day funds, and how do they work?

A. Budget stabilization funds allow states to set aside surplus revenue for times of unexpected revenue shortfall or budget deficit. Every state but Arkansas, Kansas, and Montana has some type of rainy day fund.

FIGURE 1

Rainy Day Fund Balance
1988-2015



Sources: National Association of State Budget Officers; Bureau of Labor Statistics for CPI.

The State of State (and Local) Tax Policy

What are state rainy day funds and how do they work?

SOURCES OF FUNDING

How rainy day funds (RDFs) are funded varies state to state (table 1). Most allow some or all year-end surplus to flow to the RDF. Other states require specified set-asides every year until the fund reaches its cap. A few states replenish with specific appropriations as part of the budget process. Finally, some RDFs have dedicated sources of revenue. Natural resource–rich states dedicate a portion of revenue from extraction to various reserve funds. Recently, California and Massachusetts dedicated a portion of capital gains tax revenue to RDFs.

TABLE 1

Rainy Day Fund Funding Mechanisms

Funding mechanism	States
Year end surplus deposited in RDF	Alaska, Delaware, Georgia, Iowa, Kentucky, Maryland, Massachusetts, Mississippi, New Hampshire, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma
Portion of year end surplus deposited in RDF	Louisiana, Maine, Minnesota, Nevada, New Jersey, Pennsylvania, Texas, Utah, West Virginia, Wisconsin
Automatic deposit - certain percentage of revenues or appropriations	Alabama, California, Colorado, Connecticut, District of Columbia, Florida, Hawaii, Missouri, Rhode Island, South Carolina, Tennessee, Vermont, Washington
Deposit triggered by revenue growth	Arizona, Idaho, Indiana, Nebraska
Other	Illinois, Michigan, Oregon, South Dakota, Virginia, Wyoming
No RDF	Arkansas, Kansas[a], Montana

Source: National Association of State Budget Officers.
(a) Although Kansas enacted a budget stabilization fund in 2016, the state has not yet established a mechanism to fund it.

USE OF FUNDS

In most states, the RDF is dedicated to closing fiscal gaps in the current year or maintaining gov-ernment spending when revenues are projected to decline. However, some states use funds only for specific purposes. For example, Colorado's fund can only be used to cover shortfalls caused by natural disasters.

The means of access varies; some states allow transfers from the RDF to be included in normal appropriations bills, while others require an emergency declaration or a super-majority (three-fifths or two-thirds) of the legislature to make a transfer. Several states also allow the RDF to be used to cover short-term cash flow gaps. Funds are transferred to the general fund and must be paid back by the end of the fiscal year.

The State of State (and Local) Tax Policy

What are state rainy day funds and how do they work?

CAPS

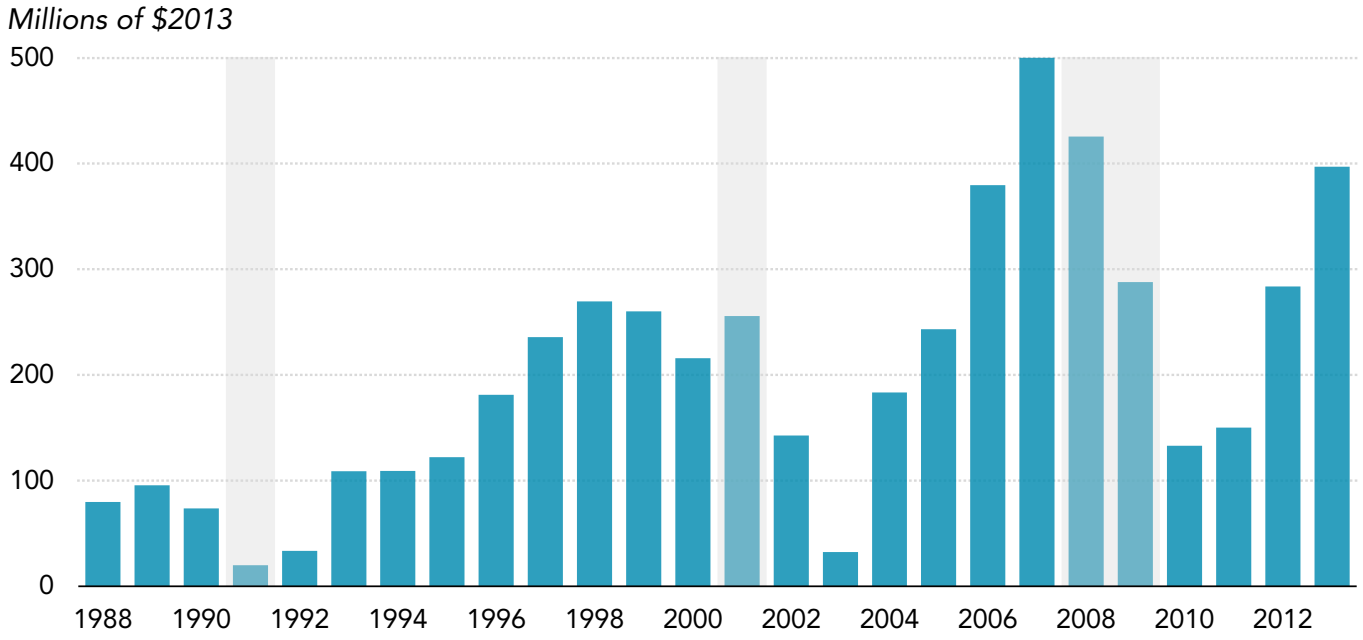
Twenty-five states cap the balances of their funds. The cap is either a percentage of revenue or expenditure. Most states that fund RDFs with operating surpluses stop transfers once the cap has been reached. But a few redirect surpluses to other funds for special projects or taxpayer relief. New Mexico, for example, has a "cascading" fund balance. The operating reserve is capped at 8 percent, and any excess goes to the tax stabilization reserve. This reserve is also capped, and its excess flows to the taxpayer dividend fund. Other states have separate reserve funds for educa-tion or Medicaid spending designed to cover shortfalls in these vital programs.

MITIGATING FISCAL CRISIS

An economic downturn can cause significant fiscal stress for states because without changes in policy, revenues decline even as demands on programs such as unemployment insurance and Medicaid increase. Savings in rainy day funds help them weather a fiscal downturn with fewer expenditure cuts. The median balance of state RDFs declined significantly after the last three recessions and then built back up (figure 3).

FIGURE 2

Median Balance of Rainy Day Funds
1988-2013



Source: NASBO Survey of State Finances, various years.

The State of State (and Local) Tax Policy

What are state rainy day funsd and how do they work?

Capping the amount in the RDF is a sensible approach to preventing the unnecessary build-up of restricted funds, but the cap has to be set appropriately. The rule of thumb had been 5 percent of expenditures, but the Great Recession has made states reconsider. Only 5 of the 25 states with caps top out at 5 percent or less. The Government Finance Officers Association recommends two months of expenditures, or about 16 percent, though only four states had RDF balances above 16 percent at the end of 2013, and all were natural resource–rich states (Alaska, North Dakota, West Virginia, and Wyoming).

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Q. What are tax and expenditure limits?

A. Tax and expenditure limits (TELs) restrict the growth of government revenues or spending by either capping them at fixed dollar amount or limiting their growth rate to match increases in population, inflation, personal income, or some combination of those factors. As of 2015, 28 states had at least one TEL.

DESIGNING TAX AND EXPENDITURE LIMITS

Spending versus revenue limits

Limits can be placed on revenue, appropriations, or both. Many states, for example, have a mechanism in place to restrict the growth of property taxes, but this is more often a restraint imposed by the state on local governments. Typically, states limit the ability to appropriate or spend funds rather than limit revenue collected. In 2015, 26 states imposed limits on their own government spending. By contrast, only two limited revenue; these two also capped spending.

Mechanism

The means used to limit spending and revenue varies. The limit can either be a cap on growth or a restriction on the level. The most common formula restricts expenditure growth to the pace of personal income. But some states include population and inflation growth in the formula. And others restrict expenditures to a level determined by a formula, such as a set percentage of personal income.

Idaho, for example, limits expenditures to 5.33 percent of state personal income, there-by allowing expenditures to grow at the same rate as personal income. Another method is to restrict expenditures to a percentage of projected revenue, maintaining a cushion in case revenues fall short of the projection.

What are tax and expenditure limits?

Stringency

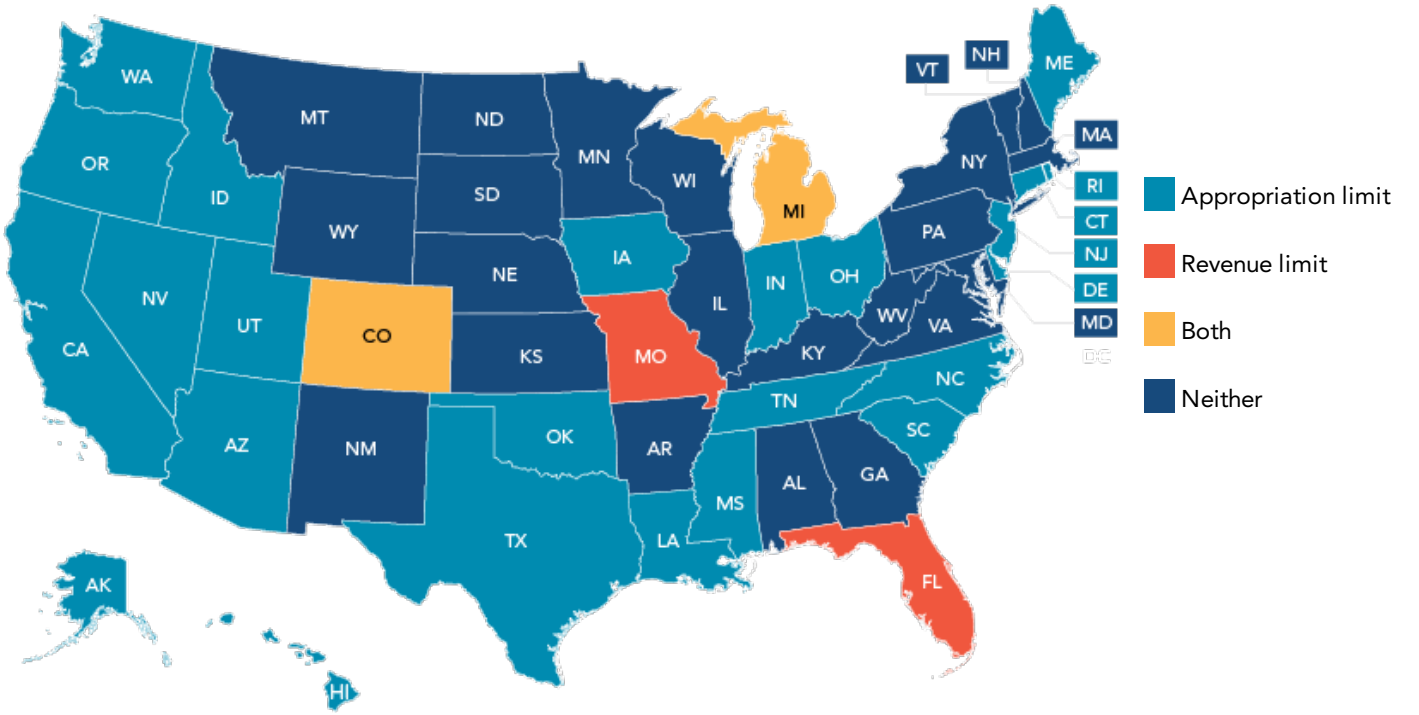
In general, TELs set in state constitutions are more difficult to change or override than statutory TELs. By the same token, TELs imposed directly by voters rather than legislators are more restrictive (New 2010).

Some TELs prohibit lawmakers from evading the limit through unfunded mandates or transfers of program responsibility to local governments, but more often, the measure of a TEL's stringency is the ability of the governor and legislature to override the cap. Several states have what at first glance appear to be restrictive TELs, but those states only require simple legislative majorities to override, which is the same threshold for approving budgets. Six states—Alaska, California, Colorado, Missouri, South Carolina, and Texas—require popular votes to exceed the limits (figure 1).

FIGURE 1

Tax and Expenditure Limits by State

2015



Source: NASBO, 2015.
Notes: Delaware has been added and Illinois removed from source data. Alaska and Hawaii are not drawn to size.

There are also 14 states with legislative supermajority (usually three-fifths or two-thirds of the legislature) and voter approval requirements for new taxes. These requirements may pertain to all taxes or only to specific revenue sources, such as corporate or sales taxes. The most stringent revenue limits require that surplus revenues go back to tax-payers as rebates or be sequestered in rainy day funds. Oregon's "Kicker" rebate and Colorado's Taxpayer Bill of Rights (see box) are examples. Thirteen states require su-permajorities to increase taxes; Colorado requires a voter referendum.

TELs can also interact with other constraints. Knight (2000) found that states with both TELs and supermajority requirements to raise taxes had lower expenditures than states with just one constraint or the other. Poterba and Rueben (1999) found that TELs affect the costs of state borrowing in two ways: not surprisingly, spending limits lower the costs, and revenue limits increase them.

BACKGROUND

Most TELs emerged during the "tax revolt" of the late 1970s or the economic recession of the early 1990s. Although many of the best-known local property tax limits, such as California's Proposition 13 and Massachusetts's Proposition 2½, were adopted through citizen initiatives, most state TELs originated in their legislatures. As of 2015, legislatures had enacted 17 TELs, nine were passed as voter initiatives and two emerged from constitutional conventions.

Evidence on whether TELs limit state and local spending is mixed (Gordon 2008). Rue-ben (1996) found that specific details of the laws matter and that TELs requiring a legislative supermajority or popular vote to modify spending led to a 2 percent reduction in state general fund expenditures. However, those savings were offset in part by higher local spending. New (2010) found that TELs adopted through citizen referendum were more effective than those adopted by legislatures.

PROPERTY TAX LIMITS

Property tax limits constitute a special category because, in most cases, the limits are set by state governments but apply to local governments. Only four states—Connecticut, Hawaii, New Hampshire, and Vermont—do not limit property taxes. State restrictions can apply to the property, to the jurisdiction, or both. Rate limits impose maximum rates on jurisdictions (e.g., counties, municipalities, and school districts) and apply to properties. Limits on how much assessments can increase are typically applied to properties.

For example, Arizona limits combined state and local tax rates to a maximum of 1 percent; restricts governments' taxing authority to levy property taxes at 2 percent over the previous year; caps local government expenditure growth financed by property taxes to inflation and the growth in population; and limits residential property assessment to 10 percent growth.

Colorado's Taxpayer Bill of Rights (TABOR)

Colorado enacted a TABOR in 1992 that is arguably the nation's most restrictive TEL. The TABOR applies to all taxing districts in the state, and requires that voters directly approve all tax rate and property tax assessment increases as well as the imposition of new levies. The law also explicitly prohibits particular types of taxes.

The TABOR also limits general revenues to the previous year's revenues adjusted for population growth and inflation. All excess revenues must go back to Coloradans through tax reductions or cash rebates. Only voters can override these provisions or any other spending or revenue limits. However, in November 2005, Colorado voters did agree to suspend the revenue cap for five years. (McGuire and Rueben 2006).

The State of State (and Local) Tax Policy

What are tax and expenditure limits?

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