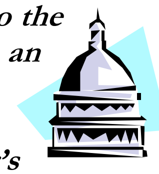
EASING THE STATE BUDGET SQUEEZE

Marianne Hill

States across the nation are being squeezed financially during the worst fiscal crisis in years. According to the National Association of State Budget Officers (NASBO), at least 37 states made cuts to budgets enacted for FY2002 – the largest number of states and the largest budget cuts ever (totaling more than $12 billion). Mississippi was among those states making cuts. The $11 billion FY2002 budget adopted by the Mississippi Legislature in 2001 was based on projections that included a 3.7% increase in net General Fund receipts. During the course of the fiscal year, however, the estimate of General Fund receipts was reduced by over $100 million, and corresponding budget cuts were made. At the end of FY2002, actual General Fund receipts stood 2.1% lower than in the previous fiscal year.



FY2003 was off to an even rockier start than FY2002 nationwide. According to the National Conference of State Legislators (NCSL), states had addressed an estimated $49 billion shortfall when crafting their FY2003 budgets, but now face additional cuts of at least $18 billion despite their caution. In addition, NCLS projects a $68.5 billion shortfall in FY2004. Standard and Poor's anticipates an even greater overall budget gap in FY2004, claiming that "it could exceed an aggregate $100 billion".

The short-term crisis is aggravated by the fact that most states are faced with underlying long-term structural imbalances. Expenditures have been rising steeply, led by the rapidly increasing cost of health care programs, while at the same time the tax bases of some major taxes have been shrinking.[1] Sales tax bases have eroded as the economy has become more service-oriented, and generous exemptions, deductions and other provisions have reduced markedly the ability of states to tax corporate income (Multistate Tax Commission 2003). The budget squeeze has been exacerbated by new homeland security measures, the recession and the decline in the stock market. While revenues have slowed, expenditures have continued to rise, often covered by one-time measures or rising debt levels. Although this fiscal crisis will ease with a return to more upbeat news on the economic front, an upswing in the economy will not suffice to eliminate the shortfalls anticipated. As a result, states have been forced to re-examine revenue sources and obligations.

The budget squeeze here is similar to that faced by many states. Between FY1997 and FY2002, despite the economic downturn and slowing tax revenue growth, state expenditures in Mississippi increased at an average annual rate of 9.2%. The expenditure category with the most rapid increase over this period was debt service, while the largest single expenditure category -- Medicaid/ Health & Welfare – had the second-highest average annual growth rate at 11%. Although state receipts from all sources grew sufficiently to finance these expenditures, the composition of these receipts changed noticeably, with an increased reliance on bond issues and other nontax sources. Tax collections grew substantially slower than expenditures. Every expenditure category except public works and higher education, as shown in Table 1, had an average annual growth rate in excess of 4.6%, which was the

Table 1. **GROWTH RATES OF MISSISSIPPI GENERAL AND SPECIAL FUND EXPENDITURES FY1997-2002**

Expenditure Catetory	Total Expenditure FY2002 ($millions)	Average Annual Increase FY1997-2002
Medicaid, Health and Welfare	$3,659.8	11.0%
Public Education	2,151.6	6.3
Public Works	1,103.0	4.0
Debt Service	1,054.2	64.2
Local Assistance	850.7	5.0
Higher Education	669.5	4.3
Corrections and Justice	328.2	7.2
Other	1,422.3	7.1
TOTAL Governmental	**11,239.3**	**9.2**
Total, Governmental and Nongovernmental	$12,301.5	12.0%

Note: The $11.2 billion of total governmental expenditures includes some expenditures outside of the FY2002 State Budget of $11.0 billion, such as expenses for special projects approved by the legislature financed by bonds or notes. Nongovernmental expenditure refers to similar spending on nongovernmental projects e.g. certain Nissan-related projects.

SOURCE: Mississippi Institutions of Higher Learning, Center for Policy Research and Planning, *Fiscal Summary*, January 2003.

growth rate of gross Tax Commission collections.

Current Revenue Sources

The sources of state revenues, which can be divided into General Fund and Special Fund revenues, are shown in Table 2. State General Fund revenues come almost entirely from taxes, fees and other charges. Sales and income taxes are the two largest individual revenue generators for the General Fund. FY2002 State-source Special Fund revenues come not only from diversions from the sales and use taxes ($0.8 billion), but also, for example, from the gasoline tax ($0.4 billion), from licenses, fees & permits ($0.4 billion) and court settlements ($0.2 billion). Federal-source Special Funds amounted to $3.7 billion in FY2002, providing almost 30% of state revenues. (Notice that Tax Commission collections go to both the General Fund and some Special Funds.)

The changing composition of state revenue sources is indicated in the last column of Table 2. The two fastest-growing categories of receipts are listed under Special Funds - Other Receipts. Proceeds of bond issues grew at an average annual rate of 68.9% between FY1997 and FY2002, and transfers from various state funds to Special Funds (including to the new Budget Contingency Fund), grew 22.1% annually.[2] [The Budget Contingency Fund, created in 2001, has become an important source of funds for several programs including the Adequate Education Program. It is funded by transfers from agencies ranging from the Department of Transportation to the Workers' Compensation Commission.] Federal funds going to Special Funds –

Table 2. **GROWTH RATES OF REVENUE SOURCES FOR MISSISSIPPI, FY1997-2002**

Revenue Sources	Total FY2002 Receipts (millions $)	Average Annual Increase FY1997-2002
General Fund, Net Collections		
Tax Commission Transfers[1]	$ 3,299.4	3.8%
Other[2]	$ 71.2	-4.7%
Special Funds, Governmental Receipts		
State Sources[3]	$ 2,768.9	8.5%
Federal Sources[4]	$ 3,736.9	10.1%
Special Funds, Other Receipts		
Proceeds of bond issues[5]	$ 1,093.7	68.9%
Transfers from other funds[6]	$ 1,419.9	22.1%
Other (Revenue Codes 47001 to 49960)[7]	$ 496.9	14.6%
TOTAL	**$ 12,676.5**	**9.6%**

[1]Includes all Tax Commission collections transferred to the general fund.

[2]Includes revenues received from the Highway Safety Patrol, interest on investments and other general fund collections.

[3]State source governmental receipts here include sales and use tax diverted to cities, Education Enhancement fund and other purposes ($0.8 billion), gasoline tax ($0.4 billion), licenses, fees (including gaming fees) and permits ($0.4 billion), charges for sales and services ($0.3 billion), court assessments/settlements ($0.2 billion) and other sources including interest on investments. Excluding court settlements (which include the Tobacco Settlement), the average growth of this category was 6.1%.

[4]Federal funds for Medicaid, the Department of Education, and other programs are in this category.

[5]These bond issues finance activities that may not be included in the state budget, though they must be approved by the Legislature, e.g. the bonds that will be issued to meet needs related to the Nissan plant. Bonds typically finance projects spanning several years, so receipts any given year will not match expenditures that year.

[6]These transfers include transfers to the Budget Contingency Fund, set up in 2001. See Note 2 at the end of the article.

[7]Various sources including gross sales of alcoholic beverages ($0.2 billion), Medicaid refunds ($0.1 billion), and MPACT contract receipts.

Note: The state budget for FY2002 was $11.0 billion, but additional expenditures, e.g. for Nissan-related projects, are also undertaken by the state. Tax Commission transfers to the General Fund financed 30% of the FY2002 state budget, federal source funds about 32%, and other special funds the rest.

SOURCE: Mississippi Center for Policy Research and Planning, *Fiscal Summary* , January 2002. Mississippi Department of Finance and Administration, *Comprehensive Annual Financial Report 2002,* and unpublished data.

Governmental Receipts grew 10.1%, with the largest single program being Medicaid.[3]

At the same time, the growth rate of gross collections by the Tax Commission averaged only 4.6% over this period, far below the growth rate of expenditures. Table 3 provides a break-down of Tax Commission collections by tax category. The most rapidly growing category during the FY1997-FY2002 period was gaming taxes and fees, at 8.3%, followed by the individual income tax at 6.6%. Sales tax revenues increased by 4.9%, except that the use tax, which is primarily sales tax on the user of property acquired from outside the state, dropped 0.1%. Corporate taxes increased only 0.3%. (Corporate taxes are a combination of corporate income taxes, which dropped 1.5% even before allowance for tax credits, and corporate franchise taxes, which increased just enough to offset this drop.) The gasoline tax, which is diverted to Special Funds earmarked for transportation, grew 2.7%.

The slow growth of Tax Commission collections, the primary source of recurring state funds, means that the growth rate of expenditures must slow, given that, in the long-run, the other two major sources of state funds, loans and transfers to special funds, must be financed by taxes and fees. (The growth rate of federal funds to the state, the only other major revenue source, is expected to fall due to the rising federal deficit.) Even should tax revenue growth exceed 5.0% in FY2004, the state will be hard-pressed to repay loans, to replenish earmarked funds that have shrunk, and at the same time to continue to meet legislated and federally-mandated commitments.

Mississippi is doing somewhat better this fiscal year than last, with Tax Commission tax transfers to the General Fund up 0.7% through May, compared to the first eleven months of FY2002. Nonetheless, the handwriting is on the wall: Mississippi needs to re-examine its revenues and expenditures. If the state wishes to continue funding its current programs at current service levels, it will need new revenue sources. If the state opts to reduce costs, it will need to cut or restructure programs.

Table 3. **GROWTH RATES OF MISSISSIPPI GROSS COLLECTIONS, MAJOR TAXES AND TOTAL STATE TAX COMMISSION FY1997-FY2002**

	Total FY2002 (millions $)	**Average Annual Growth FY1997-FY2002**
Sales Tax	$2,156.4	4.9%
Individual Income Tax	1,297.4	6.6%
Corporate Income Tax[1] (before credits)	192.6	-1.5%
Corporate Franchise Tax[1] (before credits)	123.0	5.4%
(Total Corporate Tax (after credits))[1]	(296.2)	(0.3%)
Use Tax	204.5	-0.1%
Gaming Taxes and Fees	327.2	8.3%
Other	964.3	3.4%
TOTAL[2]	**$5,246.0**	**4.6%**

[1]Figures from the corporate income and franchise taxes shown here are before tax credits are deducted. After credits, the average annual growth rate of the corporate income and franchise tax, which is a combined tax, was 0.3%, and the total collected in FY2002 was $296.2 million.

[2]$1,946.6 million of this total was diverted to Special Funds, including the Education Enhancement Fund, payments to cities, municipalities and counties, and other diversions.

SOURCE: Mississippi State Tax Commission and calculations by the author.

On the Expenditure Side: Increasing Government Efficiency

There is always room for increasing the efficiency of state government. This, however, requires analysis of current programs. Performance-based budgeting (PBB), which was begun in Mississippi in 1994, was to provide performance evaluations that could guide changes that would improve efficiency. PBB called for gathering data on an agency's effectiveness to measure its success in improving outcomes. Less successful programs would yield to more successful ones with the same objectives. Programs duplicating services would be consolidated, or at least coordinated.

Since 1994, under PBB, state agencies here have been required to develop five-year plans with goals and a means of achieving those goals. However, agency performance reports typically emphasize measures of program output rather than measurements of program outcomes. For instance, a report on a training program might cite the number of persons trained, but not the kinds of jobs obtained by those trainees. This is a nationwide problem. If a training program is aimed at reducing poverty or raising incomes, the success of the program can only be judged if information on trainee incomes before and after training is provided. If little or no progress is made in addressing the root problem that an agency is tackling, e.g. low incomes, expenditure levels of that agency may remain high without generating additional tax dollars, and the size of the problem may increase.[4] A more effective implementation of PBB would aid in reducing costs and improving outcomes.

The growing debt service burden is also worthy of mention before turning to the revenue side. The cost of incentives packages used to support businesses in the state has grown rapidly in recent years, due in large part to the provisions of the Advantage Mississippi Initiative legislation, designed to lure Nissan. In addition to Nissan, Howard Industries and Northrop Grumman have also received special incentives, and more companies in the state are also likely to request such subsidies. While those companies receiving such incentives will view them in a positive light, those not receiving any may see such incentives as biased.

One approach to reducing revenues lost through tax breaks that have accumulated over the years is to levy a surcharge on corporate tax incentives (NASBO mentions as an example a 20% surcharge on tax breaks qualified for under business incentive programs). Tying tax incentives to outcomes and monitoring company performance more closely are also reforms being implemented in some states. In any case there are many other means of supporting business investment and maintaining a competitive business environment. Incentive packages have their place, but expenditures on well-designed projects leading to urban renewal, joint business-university ventures or compre-hensive adult education programs, for example, have the potential for equal or greater economic impact than direct business subsidies and tax breaks.

Equity and Efficiency: Basic Principles of Taxation

There are two principles normally used when evaluating the structure of taxes and fees in an economy: equity and efficiency. These principles can be used to guide the reform or restructuring of taxes and fees.

1. Equity -- be fair. What this means is by no means obvious. For example, it may seem fair that everyone pays the same 7% sales tax on a quart of orange juice, but it would seem less fair for both millionaires and families below the poverty line to pay the same dollar amount in income taxes. Overall, two basic principles used in determining the equity of a tax system are: 1) the tax burdens on persons in similar circumstances should be similar, and 2) persons with greater ability to pay should pay more. It should also be kept in mind that a tax system must be considered as a whole when judging its equity.

2. Be efficient. The most efficient taxes will have relatively low administrative and compliance costs and will generate stable income that grows as rapidly as the economy. Efficient taxes will minimize the discouragement or distortion of beneficial economic activities.

How do Mississippi taxes currently rate in the areas of equity and efficiency?

1. **Equity**. Do families with higher incomes pay a higher percentage of their income in taxes than do families with lower incomes? A tax system that has this characteristic is called progressive. If higher income families pay a lower percentage of their income in taxes, the tax system is called regressive. Of the three major taxes in most states – the property tax, the sales tax and the individual income tax -- only the income tax is a progressive tax. Table 4 shows state and local taxes as a percent of family income in 2002 in Mississippi and in the U.S., for the five income quintiles. Families in the lowest fifth of the state pay only about 0.2% of their income in state income taxes, while families in the top fifth pay more than 2.4%, with the top 1% paying 4%. The U.S. income tax is similarly progressive.

The burden of the property tax in Mississippi, also shown in the table, is the greatest for those in the second quintile, who find that 2.9% of their income goes toward this tax. (The homestead exemption has reduced the relative burden of the property tax on lowest-income families.) Sales taxes and excise taxes on tobacco, alcoholic beverages and gasoline hit the bottom quintile hardest at both the state and national level, absorbing about 8% of family income. The sales tax on groceries and other basic needs is a regressive feature of the sales tax. Many states, including several Southern states (State Policy Reports 11/02), have opted to eliminate the sales tax on groceries.

Overall, families in the lowest 20% of the income distribution in Mississippi pay about 10% of their incomes in taxes, families in the second 20% pay 11.5%, and after that, as incomes rise, the tax burden drops, with families in the top 1% paying 5.3% of their income in taxes. The situation in the U.S. as a whole is not much different: families in the low and middle-income brackets have the highest tax rates overall.

Another question that must be asked in assessing tax equity is this: do families in similar circumstances face similar tax burdens?

Table 4. **STATE AND LOCAL TAXES AS PERCENT OF FAMILY INCOME IN 2002 MISSISSIPPI AND U.S. (Nonelderly Taxpayers)**

Family Income Group	Sales and Excise Taxes		Property Taxes		Income Taxes		TOTAL[1] Individual State and Local Taxes/Income	
	MS	US	MS	US	MS	US	MS	US
Lowest 20%	8.1%	7.8%	1.7%	3.1%	0.2%	0.6%	10.0%	11.4%
MS Average $7,000								
US Average $9,300								
Second 20%	8.0	6.4	2.9	2.3	0.6	1.6	11.5	10.3
MS Average $15,100								
US Average $19,700								
Middle 20%	6.9	5.1	1.6	2.5	1.2	2.3	9.7	9.6
MS Average $24,100								
US Average $31,900								
Fourth 20%	5.4	4.1	1.4	2.6	2.0	2.7	8.6	8.8
MS Average $40,400								
US Average $52,500								
Top 20%[2]								
Next 15%	4.3	3.1	1.8	2.6	2.4	3.2	8.0	7.7
Next 4%	2.7	2.0	1.8	2.3	3.1	3.8	6.6	6.5
Top 1%	1.3	1.1	1.5	1.4	4.0	4.8	5.3	5.2

[1]These totals include tax offsets due to federal deductions, which reduce the overall tax burden.

[2]Average income for top 20% was not provided. For bottom 15% of top 20%, the average income in Mississippi was $69,000, for the next 4% $131,000, and for the top 1%, $509,000. For the U.S., the corresponding numbers are $95,300, $202,300 and $1,080,900.00

This difference in average incomes affects how this table should be interpreted. Note that the average income level in the bottom quintile in Mississippi is $7,000, compared to $9,300 for the U.S. A Mississippi family with a $9,300 income could well be paying 11.4% of that income in state and local taxes--the same rate as for the U.S.

SOURCE: Institute on Taxation and Economic Policy Report, *Who Pays State and Local Taxes* , *2002,* at www.itepnet.org.

Given the differing needs of families at the same income level, and the limits on exemptions and deductions available, some inequality in tax burdens is inevitable. Also, some families will benefit more directly from government expenditures than others -- for example, from government expenditures on education – which further complicates comparison among families. As a general rule, tax exemptions and deductions should routinely be re-examined, as there is inevitably room for improvement.

2. **Efficiency**. The sales tax, property tax and individual income tax have low costs of collection and administration relative to the revenues they bring to the state. However, in recent years, as consumer expenditures shift more towards services, sales tax revenues have failed to keep pace with overall expenditure growth. Individual income tax revenues, on the other hand, have grown more rapidly than personal income, as taxpayers move into higher income tax brackets over time, and on average have outpaced expenditures.

(During a recession, if taxpayers move to lower income brackets, this multiplier effect can be a disadvantage.)

All taxes have some negative effects on efficiency that cannot be totally avoided, but these effects should be estimated and kept in mind when changing the tax structure. For example, a higher sales tax here than in other states puts businesses here at a competitive disadvantage in attracting customers from out-of-state. A sales tax on goods but not on services tends to place goods producers at a disadvantage relative to service producers. A tax on property favors non-property forms of investments. Taxes that discourage investment in areas critical to the future of the state, such as education and training, should be particularly avoided.

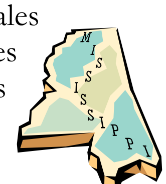
Alternatives For Raising Revenues

The National Conference of State Legislators (NCSL) regularly reports on measures taken by states to close their revenue gaps. NCSL notes that several states have increased their taxes on cigarettes, while others have broadened their sales tax to include more services. A few have increased their corporate income tax. In its December report, the National Association of State Budget Officers listed several other options that states are using to close the gap between spending and revenues. Some options that could apply to Mississippi are considered below.

Sales Tax. At 7% since 1992, Mississippi already has the highest state sales tax rate in the nation, matched only by Rhode Island. Eighteen states, however, have local sales taxes which are high enough to push their overall average rate, including both state and local rates, above Mississippi's 7% average (State Policy Reports 11/02). (Mississippi also has a 1% tax on tourist-related sales in some cities.) Overall, the sales tax places a burden on both producers and consumers of goods that are taxed, in comparison to their non-taxed, or lower-taxed, competitors.

There are strong arguments against raising the sales tax rate to more than 7%. An increase in the state sales tax would increase the burden on low-income families disproportionately, and would hurt the competitive position of many businesses in the state, particularly those whose customers have the alternative of making their purchases out-of-state, e.g. via the internet. There are a few special tax exemptions or reduced rates that could be changed or eliminated, e.g. the exemption for some nonprofit organizations or for sales of coffins, but the benefits of these exemptions may outweigh their costs to the state. A list of tax exemptions and reduced rates, along with estimates of the impact on state revenues, can be found in the *Annual Tax Expenditure Report*, published by this office.

It should also be noted that sales via the internet are currently not subject to the sales tax, due to federal regulations. Many states are lobbying for this to change. One low sales tax rate, common to all states, would be more business-friendly (and more enforceable) than a myriad of rates, but this requires a rethinking of federal-state and inter-state relations.



A broadening of the sales tax base to include more services would be feasible and perhaps desirable. The sales tax applies to all goods sold, unless specifically exempted, where- as only specified services are taxed (see Mississippi Code Section 27-65-23). A 1996 study by the Federation of Tax Administrators found that of 164 categories of services, the typical state only taxed 56. Mississippi rated much better than the average, taxing 70 categories (*State Policy Reports*, 11/02, Vol. 20(22)). However, Mississippi does not tax most professional

Table 5. **PERCENTAGE OF STATE AND LOCAL MAJOR TAX REVENUE FROM EACH MAJOR TAX AND NATIONAL RANK, SELECTED STATES**

Fiscal Year 2000

State	**From Property Tax**	**Rank**	**From Sales Tax**	**Rank**	**From Income Tax**	**Rank**
Alabama	16.6	48	56.7	9	26.7	29
Arkansas	17.9	47	54.8	12	27.3	27
Georgia	27.5	36	43.1	20	29.5	18
Kentucky	19.4	45	41.6	22	38.9	5
Louisiana	18.2	46	65.2	4	16.6	40
Mississippi	**25.8**	**39**	**56.5**	**10**	**17.8**	**39**
North Carolina	24.2	41	37.9	26	37.9	6
South Carolina	31.1	28	40.4	23	28.4	23
Tennessee	27.8	35	70.5	2	1.7	43
National Average	**32.4%**		**40.2%**		**27.4%**	

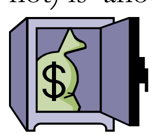
SOURCE: *State Policy Reports*, Vol. 20, No. 21, November 2002, p. 18.

services, and while some construction-related services are taxed, others such as carpentry are not. Taxing more business services is a possibility, although this would tend to favor large companies able to provide these services in-house. However, there is considerable revenue potential.

Residential utilities are also exempted, and one possible change would be to impose a tax/surcharge on energy use which exceeds a specified base amount per household. Commercial utilities are taxed, although the tax is lower for manufacturing facilities, at 1 ½%. Taxes, other than the sales tax, related to emissions might be preferable since taxes on emissions would not only raise revenue but would have the effect of reducing pollution and encouraging a shift to cleaner energy sources. See further discussion below.

Individual Income Tax

Nationally, income taxes provide 27.4% of total revenue from major state and local taxes, as shown in Table 5. In Mississippi, the percentage is 17.8%. The argument for seeking additional revenues through the individual income tax is strong if there is agreement that more revenue is needed. In fact, if equity were the prime consideration, the individual income tax would be the prime candidate for a rate increase or a base-broadening, since it is the tax most closely linked to the ability to pay. The fact that state income taxes paid are deductible from income for purposes of the federal income tax (whereas sales taxes are not) is another plus for this alternative.



Five alternative changes in the income tax and the resulting impact on collections were considered in an article in the June 1991 issue of this *Review,* namely: 1) decreasing standard deductions; 2) decreasing the basic exemptions for each filing status; 3) decreasing all itemized deductions by 10% per tax return; 4) increasing tax bracket intervals and adding a higher bracket; and 5) decreasing itemized deductions by 10%, while increasing tax bracket intervals and adding a higher bracket. The last two alternatives had much greater revenue impact (on the order of $25 million in 1991) than the other three, and only families with adjusted gross incomes of over $50,000 paid an additional $50 or more in taxes. The same changes today would likely show a similar pattern, with higher income families accounting for most of additional revenue in the last two cases.

Another alternative would be to institute changes that would raise revenues by treating income from different sources more equally, e.g. wage & salary income and income from dividends or capital gains. While raising income taxes may discourage some income-earning activities, the effect is not likely to be great if the rate increase is kept in line with tax rates elsewhere.

Corporate Income and Franchise Taxes

Mississippi corporate taxes include both a corporate franchise tax (levied at $2.50 per $1,000 of capital equity in the state) and a corporate income tax. The two are filed on the same form and are typically reported together, under the label "corporate income tax". As Table 3 shows, over the FY1997-FY2002 period, corporate franchise tax obligations (pre- tax credits) grew at an average annual rate of 5.4%, while corporate income tax obligations (also pre- tax credits) decreased by 1.5% annually.[5] After deducting tax credits, corporate tax collections from both taxes were only $3.5 million higher in FY2002 than in FY1997. Without the franchise tax, collections would have dropped. The economy was close to recession in FY2002, which may account for the low collections in FY2002, but, in fact, throughout the 1990s, corporate tax collections have averaged a growth rate closer to that of the sales tax than to that of the individual income tax. By comparison, in the 1980s, the growth rate was much higher, averaging in the double-digits. The problem of an eroding corporate tax base is a national one (Multistate Tax Commission 2003).

While the argument for closing loopholes in the state corporate income tax may be strong, in practice his may be difficult. (See accompanying box "Corporate Income Taxes Lag.") In the past, the federal government and several states have instituted alternative minimum corporate income taxes as a means of overcoming declining growth rates. At the federal level, the alternative tax succeeded in increasing the effective corporate tax rate for a while, until new tax breaks were instituted in 1993 and 1997.

In Mississippi, the corporate franchise tax acts as a minimum corporate tax, although it is not levied on income. (Some corporations, however, may be exempted from most of this tax under the Advantage Mississippi program enacted in 2000.)[6] This tax, despite its low rate, is a stable revenue source whose earnings are approaching those of the corporate income tax. The rate hasn't been increased in decades. If the rate were increased with perhaps some portion made deductible against the income tax, the net effect would be to raise the minimum floor on a corporation's taxes.

This is generally a sound approach. When the rate of return on a capital investment is 10%, the 0.25% franchise tax amounts to an effective tax rate of 2.5% on returns. When the rate of return is low or negative, however, the 0.25% tax on capital raises some questions related to fairness and efficiency. These can be addressed in various ways. Some provision could be made for delaying the imposition of the franchise tax for an initial three years, if the company suffers a loss during that time. Or flexible payment schedules could be arranged.

CORPORATE INCOME TAX REVENUE LAGS

At the federal level, as well as at the state level, revenues from the corporate income tax have not kept pace with revenues from the individual income tax. Part of the explanation is that incentives often result in low effective tax rates, or even rebates, for the largest corporations.

For example, a study of 250 of the largest U.S. companies that reported positive profits every year from 1996 to 1998 found that 41 companies paid less than zero taxes in at least one year from 1996 to 1998, despite reporting a total of $25.8 billion in pretax U.S. profits. Among 24 companies receiving tax rebates in 1998 were MCI Worldcom ($112.6 million), Weyerhaeuser ($9.5 million), Northrop Grumman ($1.0 million), and Saks ($7.9 million), although all but Saks had reported profits in excess of $200 million. Over the three years, the tax rate for these companies was generally positive, but well below the statutory rate of 35%, e.g. for Northrop Grumman it was 5.2%, not including substantial deferred taxes.[7] Over a longer time period, the tax rate for any particular company may be higher than for one three-year period. In general, though, federal receipts from the corporate income tax have slowed. The average growth rate of federal receipts from the corporate income tax was 6.4% over the 1995-2000 period, compared to a 14% growth rate for the individual income tax. By contrast, over the 1985-1990 period growth of corporate income tax receipts, at 10.5% despite the 1990 recession, out-paced that of the individual income tax.

States face problems with corporate income taxes that the federal government doesn't. The Multistate Tax Commission notes, "Many multistate companies can avoid fully reporting their income or can limit their tax payments by assigning income to jurisdictions other than the states where the income was earned. Thus, the corporate income tax has declined substantially both as a percent of corporate profits and as a share of state revenues." Since corporations can operate in several states, it is difficult to determine what percentage of a corporation's profit is due to its operations within a given state. There is not one national standard for determining how to allocate the income of a corporation between states. Various formulas are used, based on such factors as the size of payroll, amount of sales and value of property in the state. If a corporation claims that a certain percentage of its profits originated from operations in another state, that claim will be difficult to dispute.

Data available on taxes paid by industry group for corporations accounting for 80% of Mississippi corporate tax collections indicate that there may be a problem capturing the tax base of services-producing industries. The data show that, pre-tax credits, manufacturing corporations owed more in both income and franchise taxes in FY2002 than in FY1997, and that taxes paid fell less than one percent. However, the pre-credit income tax owed by corporations in services dropped 11%, although the number of firms identified as in this industry increased 25%. Post-credit corporate taxes in this industry remained stable only due to the franchise tax, which rose 47%. Similarly, pre-credit income taxes owed by wholesale and retail trade fell over both the FY1997-FY2000 period and the more troubled FY2000-FY2002 period. Again, only the increase in franchise tax obligations prevented the drop in collections from exceeding its actual average annual decrease of 3.4%.

The increase in tax credits claimed by industries is also striking, although this increase accounts for less than half of the fall in corporate income tax obligations. From FY1997 to FY2000, the value of credits claimed increased at an annual rate of 3.4%, and from FY2000 to FY2002, at 8.7%. Total credits claimed were $31.5 million in FY2002. Tax credits need to be periodically re-examined to ensure that they are carefully linked to the creation of future income, so that revenues lost in the short-term will be recouped.

Overall, the slowing growth of corporate income tax indicates the need for careful monitoring of this tax by the State Tax Commission. According to the *Mississippi Business Journal* (3/31/03), however, the Tax Commission has suffered cuts of about 5% in each of the past two years, and there are about 88 vacancies, including 22 auditing positions. With fewer staff than 10 years ago and close to twice as many filings, it may be difficult for the Commission to take on the tasks needed to reverse the downward trend in the growth rate of corporate taxes under the current tax code.

Environmental fee increases.

Fees and permits related to the environment and conservation have the result of both protecting the environment and of increasing state funds available for environmental regulation, conservation, and some health-related programs. They may also discourage industrial production that has high pollution costs. A 2002 study of the Performance Evaluation and Expenditure Review Committee provides a comprehensive review of state agency fees. Among the eight agencies listed with the greatest potential for increasing their receipts (by $1.0 million or more) is the Forestry Commission. According to the PEER report, the Commission could bring in $8.0 million more through fees related to fire control, land management, insect/disease control and orchard & nursery management. The Department of Environmental Quality also has the potential to bring in similar amounts through increasing fees, according to this report: Mississippi is the only state in the Southeast that does not charge a fee for a series of one-time permits related to pollution control (MAXIMUS 2001 and PEER 2002).

Environmental regulations are of increasing importance worldwide, used to reduce ecological damage.[8] It is worth noting that in its annual *Budget Options* report (3/03), the Congressional Budget Office lists several taxes related to the environment that it finds to have the potential for increasing federal revenues. Similar options could be put into place in Mississippi, and may be deductible against similar federal taxes in the future. REV-36 would institute a tax on sulfur dioxide emissions; REV-37 on nitrogen oxide emissions; and REV-38 looks at a gas guzzler tax.

A tax on the chemical and petroleum industries is proposed to fund environmental clean-ups.

Given the rural character of the state, hazardous emissions and pollution affect fewer persons here than elsewhere, but many Mississippi industries have sizeable hazardous waste by-products which adversely affect the environment. In fact, in 2001, Lee County led the nation in releases of recognized carcinogens into the air. A sound argument can be made for the imposition of taxes on hazardous emissions in Mississippi.

Some states also have initiatives directed specifically against greenhouse gases, which contribute to global warming and thus the rising sea levels in the 1990s.[9] These state initiatives against greenhouse gases include the following. New Jersey and other states penalize utilities that do not reduce carbon dioxide and other emissions according to a set timetable. California will require reduced emissions by new vehicles beginning 2009. Texas and other states require that a certain percentage of total electricity offered by utilities come from renewable sources. North Carolina has reached an agreement with Smithfield Foods (which owns 70% of the hog industry there) to fund a waste management center that will develop techniques that will eliminate open-air waste lagoons. Similar initiatives in Mississippi could provide funding for state programs related to conservation, transportation, energy, public health and the environment. Andrew Hoerner, of the Center for a Sustainable Economy, estimates that a comprehensive tax of $10 per ton of carbon content in fuels consumed would raise roughly $190 million in Mississippi.

Severance Taxes. An annual privilege tax is assessed against oil and gas severed from the ground at the rate of 6% of the market value of the oil or gas at the point of production. There are exemptions, however, to encourage production. One of the questions to be asked is – does Mississippi wish to continue to forego tax dollars to encourage production now, or would it be preferable to remove exemptions and so conserve oil and gas for the future? All of the current exemptions, with the exception of enhanced oil recovery methods, marginal wells and carbon dioxide, do not apply if the average monthly sales price exceeds $20 per barrel for oil, or $2.50 per MCF for gas.

The enhanced recovery exemption reduces the tax to 3%, for those fields covered. The estimated tax loss for FY2003 was $2 million. Firms using three-dimensional seismic technology in connection with the drilling of oil or gas wells also enjoy reduced rates for five years. The cost to the state in FY2003 was estimated at $300,000, according to the *Annual Tax Expenditure Report*, November 2002.

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Notes

[1]Double-digit increases in health care costs have been a major contributor to the squeeze on state budgets, due largely to the rising price tag of the Medicaid program, but also due to the increasing cost of public health programs and of health benefits for state employees and retirees. In Mississippi every state dollar for Medicaid is matched by four federal dollars, but to draw down the almost $2.0 billion in federal funds in FY2003, the state had to spend $551.3 million. State dollars going to the program have grown from $287.0 million in FY1993 to $551.3 million in FY2003.
Clearly, then, cost containment measures could be beneficial in health care, and structural reform is on the national agenda in the case of Medicaid, the program subsidizing health care for low-income families and children. But crafting successful reform of the health care system will require time and investment on the front-end. It will not be the short-term solution to the current fiscal crisis.

[2]The Budget Contingency Fund was created under Senate Bill 2680 in 2001. Since that time, various funds have been transferred to this Fund, e.g. under House Bill 1036 signed in 2003, $250 million will be transferred to this Fund in FY2004 from the General Fund, the Department of Transportation, the School Ad Valorem Tax Reduction Fund, the DPS Emergency Telecommunications Standards and Training Board, the Mississippi Development Authority CAP Loan Program, the Workers' Compensation Commission and other sources. An annual cash management fee instituted in 2003 (levied on all state agencies that have special funds in the State Treasury that retain their interest and investment earnings) will also provide cash to this Fund in FY2004.

[3]Mississippi receives more federal dollars per dollar of federal taxes paid than all but two states, at $1.78 per dollar paid in FY2001. Table E-12 in Hovey and Hovey 2003.

[4]See *Performance Budgeting*, U.S. General Accounting Office report GAO-03-595T, or "Mississippi and the Evolution of Federal Devolution", *Mississippi Economic Review and Outlook*, June 1998.

[5]Most tax credits apply to corporate income taxes owed, but there are two credits (of lesser impact) specific to the franchise tax.

[6]In the summer of 2000, the Mississippi Legislature passed the Advantage Mississippi Initiative. This legislation included economic development incentives (Job Tax Credits and a Fee-in-lieu of Franchise Taxes) that can reduce or even eliminate a firm's corporate tax liability during the first five to ten years of operation in Mississippi. To read the legislation, go to www.ls.state.ms.us and click on Bill Status and then on 2000 Second Extraordinary Session.

[7]The full 64-page report, *Corporate Income Taxes in the 1990s*, is available at www.itepnet.org, website of the Institute on Taxation and Economic Policy in Washington, D.C. Information on individual companies, e.g. 10-K reports, is available from the Securities and Exchange Commission, at www.sec.gov.

The 1999 10-K report for Northrop Gumman refers to $1 billion in taxes that will eventually have to be paid.

[8]Typically, firms are required to apply for permits if the environment may be adversely impacted by their production activities. The release of hazardous pollutants into the air and water is regulated, enforceable by fines when limits are exceeded. Emission charges, which apply to all emissions, regardless of the quantity released, are also levied in some cases. (These charges are generally treated as a business expense for tax purposes.) Several states tax activities that deplete natural resources, as well as materials, such as bottles and cans, that are recyclable.

[9]Greenhouse gases are the byproducts of activities including industrialization, the use of fossil fuels and deforestation. Scientific experts on global climate are close to "a consensus that global warming is due mainly to the release of carbon dioxide and other greenhouse gases", as noted in State Policy Reports 20(22), November 200w. See also the Intergovernmental Panel on Climate Change and the Union of Concerned Scientists.

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