THE STATE BUDGET: CURVES IN THE ROAD AHEAD

Marianne Hill, Ph.D.

Curves, potholes, downhill slopes or uphill battles – what's in the road ahead for the state budget?

State revenue shortfalls are a virtual certainty this fiscal year, with budget cuts already in progress for FY2009. FY2010 will also be a challenge. There are three reasons why Mississippi should be concerned, not only about revenues during the next two years, but also beyond.

- First, 40% to 50% of the state budget has been funded by federal dollars since FY2005. Sometime after FY2010, when Katrina-related federal funds are all spent, this share will return to earlier levels of about 33%. The tax revenues generated by Katrina-related spending from all sources will also be ending near the same time, increasing the squeeze on the budget.
- Second, it is almost inevitable that during the coming decade there will be much slower growth in federal funding of current programs in the states, as Congress takes aim at the staggering U.S. debt. This could be done through using block grants to substitute for a variety of programs, through increasing matching funds requirements in programs such as Medicaid, and in other ways. New programs in health care and infrastructure will make up for much, or even most, of this funding loss, but many current programs will likely either have to downsize or find new funding sources.
- Third, there is yet another source of budgetary pressure: Mississippi, unfortunately, has experienced a slowdown in the growth rates of its major revenue sources over the last twenty years pre-Katrina. (Pre-Katrina trends are emphasized because the billions of dollars flowing to the state post-Katrina boosted revenues in ways that are not sustainable.) This slowdown pushed the growth rate of state revenues below that of income. This slow revenue growth will make it more difficult to find funds to prevent cutbacks in programs whose federal dollars drop.

If federal funds were to shrink as a percentage of gross state product, what would happen to Mississippi's fiscal position?

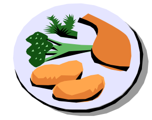
By law, the state budget must be balanced, and if federal special funds in the state budget were to shrink, so would state expenditures. The state would find it difficult to make up for a loss of federal funding, given recent trends in tax collections. Looking at the ten pre-Katrina years of FY1995 to FY2005, we see that state governmental expenditures rose 95%, but general fund receipts grew a much slower 50% and state-source special funds 68%, while Federal-source special funds rose a tremendous 117%. Incomes in the state, in comparison, rose at a relatively moderate 61%. (State tax-supported debt, a source of special funds, grew from 2% of personal income to 4.8%, and authorized but un-issued state debt also increased.[1])

Table 10 in the historical appendix shows Tax Commission transfers to the General Fund, and Table 11 shows total state expenditures by category, from FY1997 to FY2007.

How serious would a drop in federal funding be?

About 50% of the state budget of $17.6 billion in FY2009 is being financed directly by federal funds, with $8.5 billion going to such areas as Medicaid ($2.4 billion), the Mississippi Development Authority ($2.4 billion), Department of Transportation ($0.6 billion), Human Services ($0.6 billion), education ($0.6 billion), employment security ($0.2 billion), disaster relief ($0.9 billion), public health ($0.1 billion) and others. (In pre-Katrina FY2005, 39% of the state budget was financed by federal funds). State-source funds financed the remaining 50% of this year's budget.[2]

In addition to funding much of the state budget, federal funds also go directly to individuals through social security, Medicare, food stamps, child nutrition and more. In total, over $26 billion in federal funds flowed to the state in pre-Katrina FY2005, an amount equal to a third of that year's total $78.2 billion output (gross state product or GSP); post-Katrina, federal flows to Mississippi in FY2006 rose to $42.3 billion, or 52% of GSP.



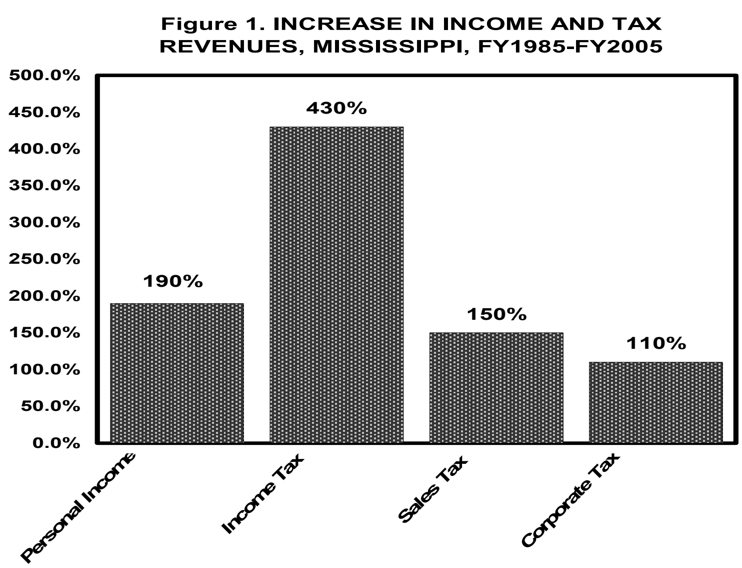
As a result, income levels in Mississippi are highly dependent on federal funds, both those going to the state budget and those going to individuals. In FY2005, Mississippi ranked fourth-highest in the nation in terms of dollars received ($1.77) for each dollar it sent to D.C.

How strong has Mississippi's tax effort been? Is there a structural deficit?

Mississippi ranks 16th among the states in terms of tax effort, according to Hovey (2007), citing a study that applied national average tax rates to each state's tax base. Mississippi raised 1% more than representative tax rates would net here. At the same time, Hovey also reports that Mississippi has one of the most serious structural deficits, ranking 47th among the states. According to Hovey's definition, a structural deficit exists if there is a projected budget shortfall in 2013, under the assumption that current programs are maintained at current levels. Mississippi's shortfall, under this assumption, was 9.8% of baseline revenues. Every state had some shortfall, however, with 5.7% being the national average.

What have been recent trends among the state's major taxes?

Among the three major taxes (the "big three") which together account for about 83% of total revenues – the sales tax, the personal income tax and the corporate income tax – only one, the personal income tax, has grown as rapidly as income. While the growth rate of taxes from the "big three" outpaced the growth of personal income from FY1985 to FY1995, aided in part by an increase in the sales tax rate, this was not true of the following decade.



SOURCE: Center for Policy Research and Planning, November 2008.

Figure 1 shows the growth of each from 1985 to 2005. While personal income rose 190% over this period, growth of personal income tax revenues was even greater at 430%. The sales tax and corporate income tax rose less rapidly than income. The FY1995 to FY2005 period displays a similar trend, with the growth of the sales tax (49%) and the corporate income tax (37%) lagging that of personal income (60%), although the personal income tax did well (70% growth). These rates are all slower than those characterizing the FY1985-FY1995 period: sales tax, 68%; corporate income tax, 53%; personal income tax, 212%; and personal incomes, 80%. (As incomes rise, persons who before paid no income tax begin to have tax liabilities and those paying at the lower tax brackets move to upper tax brackets. This "bracket creep" explains much of the rapid growth in the income tax.)

Figures 2a to 2c illustrate an emerging problem: the growth rates of both the personal income tax and the corporate income tax have been declining over the past two decades, as the graphs of the five-year moving averages for each show. (Again, the rise after FY2005 is due to the inflow of Katrina-related billions.) If this long-term trend holds, the growth rate of the big-three tax revenues will lag the growth of personal income by even more in the future.[3]

This means that more than minor tweaking of these three taxes would be needed if Mississippi wants revenues from these taxes to grow in line with the growth of income.

Can you talk a bit about what's happening with individual taxes, starting with the sales tax?

The erosion of the sales tax base is a national problem. In 1959, 40% of consumer expenditures in the U.S. were on services, but by 2000 that percentage had increased to 58%. Some of the most rapidly growing service expenditures are not subject to the sales tax, including medical care and education. (*Survey of Current Business*, 3/01). Overall, about 50% of consumer expenditures in the South currently are on items that would not be subject to the sales tax in Mississippi, including mortgage and rental payments, health care, education, credit finance charges, pensions, charity, child care, insurance (although there is an insurance premium tax), city services, taxes, and gasoline (the gasoline tax does not go to the General Fund).

However, Mississippi has managed to counter the erosion of its sales tax base by including several services in that base – for example, internet services, cellular phone services, amusements and contract construction. (Internet sales, which are of growing importance, are not subject to the sales tax unless the firm has a store located in the state.) Mississippi ranks number one in the nation in the number of services subject to sales tax (Hovey 2007).

The state sales tax does not apply only to consumer purchases: it is also levied on many business to business transactions, such as sales of electricity to commercial firms and sales of building and heavy construction contractual services. This strengthens the tax base, and many of these business transactions have risen rapidly in recent years. The share in sales tax revenues of "contracting" and "public utilities", for example, rose from 13% in FY1998 to 20% in FY2005. Business to business sales may account for more than 20% of sales tax revenues at this point.[4]

What about the future of the sales tax? As income levels rise, will the trend change?

It will, but most likely not for the better. As real incomes rise, a higher percentage of income goes to savings and investment, as Figure 3 shows. When income growth is concentrated in the top income groups, the percentage of the increase in income spent on items subject to the sales tax drops rapidly. This was the case in Mississippi in the years just prior to 2005. Even when income growth is more broadly distributed, consumers still tend to spend more on items not subject to the sales tax as incomes rise, such as education, retirement accounts, medical and financial services.

Figure 2a. Five-Year Moving Average of Growth Rates

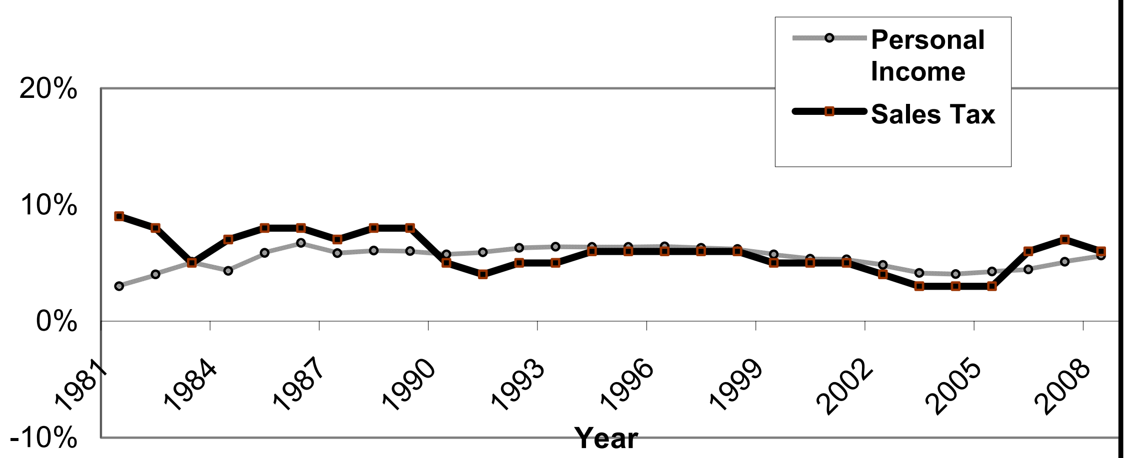


Figure 2b. Five-Year Moving Average of Growth Rates

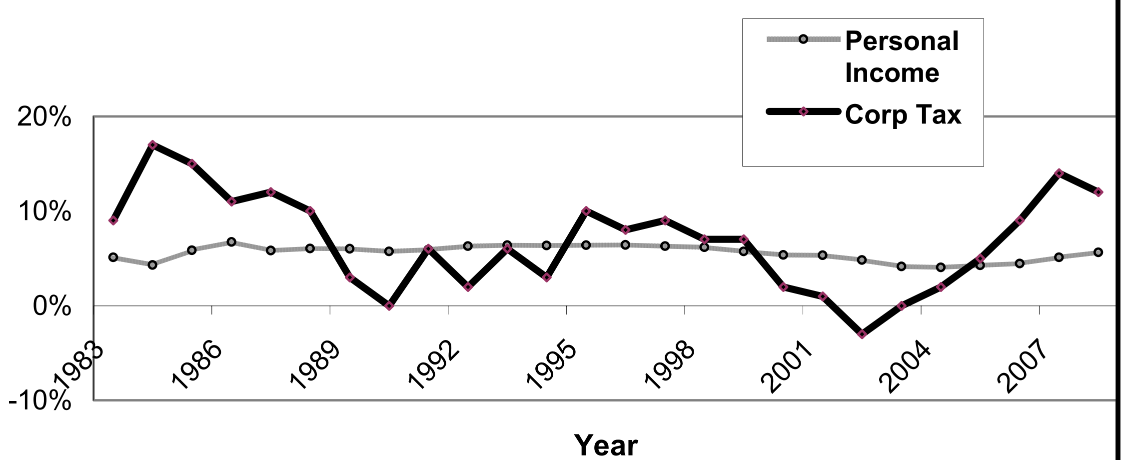
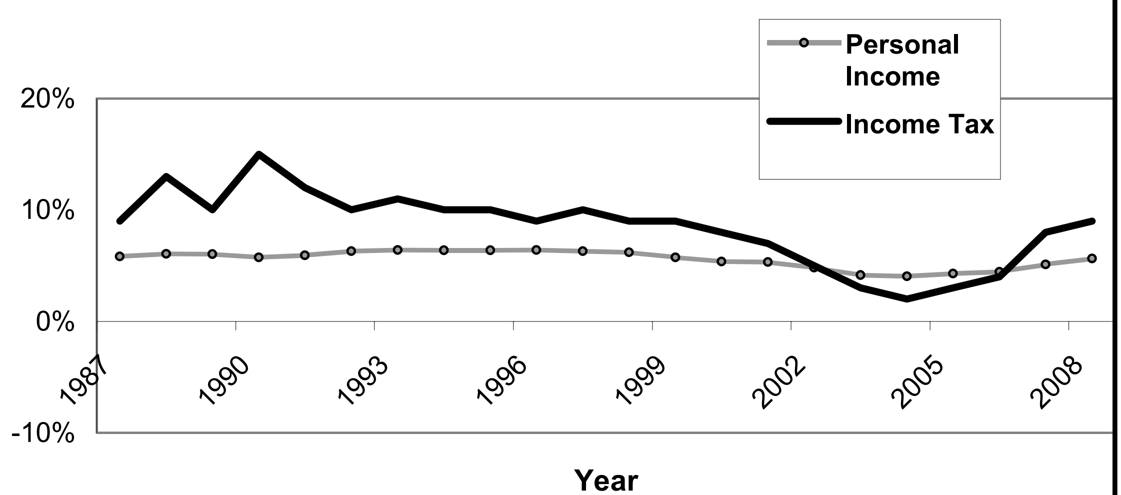
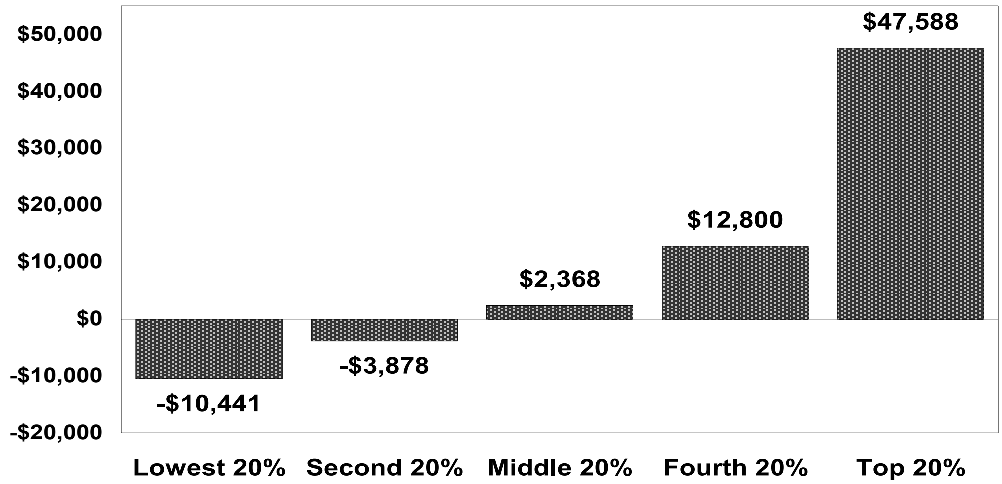


Figure 2c. Five-Year Moving Average of Growth Rates



SOURCE: Mississippi Center for Policy Research and Planning, November 2008.

Figure 3. U.S. FAMILY SAVINGS & INVESTMENT BY QUINTILES, 2006



SOURCE: U.S. Bureau of Labor Statistics, Consumer Expenditure Survey, 2006.

How can we raise revenues from the sales tax?

At 7%, Mississippi's state sales tax rate is the highest in the nation, although many states allow cities to charge an additional local sales tax as well, so that in nine states sales tax revenues as a percentage of personal incomes is higher than in Mississippi (Hovey 2007). In FY2004, Mississippians paid an average of $1,191 in sales taxes per person (if we include use taxes, taxes on beer, wine, tobacco and liquor), compared to $366 in income taxes (Hovey 2007). There are strong arguments both in terms of efficiency and of equity against raising the sales tax rate further.

What about expanding the base? As we saw, the percentage of consumer and business expenditures that are subject to the sales tax is likely to shrink over the coming years, if the base isn't continually expanded. But, bottom line, there is limited room for expanding the base, except in the area of business to business transactions and perhaps internet sales. It is true that some current exemptions can be eliminated, more services may be added, and sales taxes can also be raised on specific products to encourage activities such as recycling or to discourage certain behaviors, such as smoking. This could postpone a further slowdown in revenue growth.

Issues of equity and efficiency should be at the center of decisions made regarding sales taxes – especially given the disproportionate weight sales taxes hold in the state. Sales tax revenue accounts for 54% of Mississippi's state and local revenues from sales, individual income and property taxes, compared to an average of 40% in the U.S. as a whole (Hovey 2007).

Increasing taxes on business to business transactions could have negative effects. Would businesses that purchase products and services locally be unfairly disadvantaged relative to others who obtain such items in-house or from other states?

Taxing health care, educational services, and similar services not now subject to the sales tax would make them even less affordable to families, most of whom are already hard-pressed to pay for

GROSS STATE PRODUCT: THE STATE'S ECONOMIC BASE

Three taxes are the major source of general fund revenues. The sales tax accounted for 42% of total Tax Commission transfers to the general fund in 2006; the personal income tax, 31%; and the corporate income tax, 10%. These taxes can be compared to the state's economic base. As shown in the pie chart, the state's gross domestic product from the income side (or value-added) is broken into: wages & salaries, 45%; labor benefits, 12%; gross operating surplus (GOS), 35% (private industry, 33% and government, 2%); and certain taxes on production, 8% (not income taxes). See note below on GOS. In some countries, a tax on value-added is the primary revenue source.

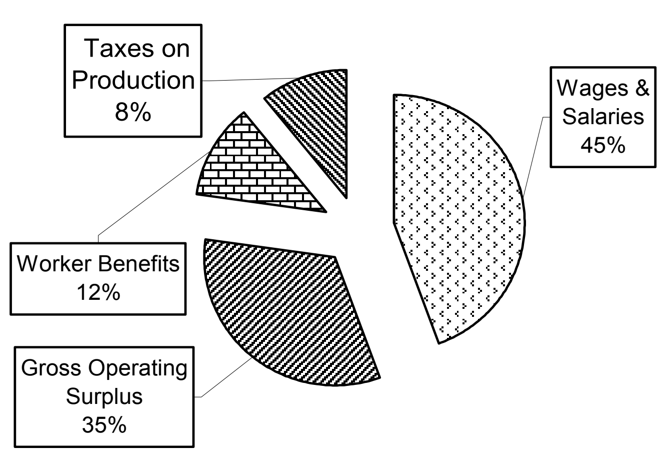
Even though some of the sales tax is paid by businesses and some of the personal income tax by small businesses (proprietorships), individuals provide considerably more of general fund revenues than do corporations and businesses directly -- more than their share in state income. Businesses deduct their costs of production in calculating their net income; the deductions allowed individuals for the cost of living are much less.

Exactly what is a fair tax burden for individuals versus businesses is not a question that requires resolution. Rather the question to be considered is the following – which individuals, and which businesses, are not paying a fair share in relation to the needs of the state?

Note. The gross operating surplus (GOS) includes pre-tax profits, capital consumption (depreciation), net interest payments and some taxes (not on income), but does not include the cost of inputs used in production. The definition of the Bureau of Economic Analysis (www.bea.gov) is that GOS consists of:

1.Business income of private domestic enterprises (corporate profits before tax with inventory valuation adjustment and without capital consumption adjustment, proprietors' income with inventory valuation adjustment and without capital consumption adjustment, rental income of persons without capital consumption adjustment); 2. Net interest and miscellaneous payments; 3. Business current transfer payments (net); 4. Capital consumption allowances; 5. Consumption of fixed capital of government, households, and institutions; 6. Current surplus (or deficit) of government enterprises. Gross operating surplus differs from the formerly used property-type income component because it includes all nontax liabilities except special assessments and it excludes subsidies.

MISSISSIPPI GROSS STATE PRODUCT: THE INCOME SIDE



SOURCE: U. S. Bureau of Economic Analysis.

these items. A reduction in spending on education and health care by low- and middle-income families would likely hurt not only those families, but also the long-term growth of the state.

You said the personal income tax has a high growth rate. Won't that help?

It will. The personal income tax is a good revenue raiser. The growth rate of revenues from the personal income is the highest of the three major taxes (sales, personal income and corporate income). And, as Figure 2c shows, the moving average growth rate of the personal income tax exceeded that of personal income for most of the period shown. But the distinct downward trend is a clear concern. (Again, we consider the recent post-Katrina upturn unsustainable.)

Another factor to keep in mind is that there appears to be agreement that exemptions and deductions to the income tax should be increased. Inflation has greatly reduced the real value of those exemptions and deductions, which in many cases remain at 1990 levels or lower.[5] This means that now even families living below the poverty line must pay income taxes in several cases. The Governor's Tax Commission has recommended increasing exemptions and deductions. However, it should be kept in mind that this would result in an appreciable drop in revenues, if not accompanied by an additional tax bracket with a higher rate or perhaps an alternative minimum tax. Currently, the highest personal income tax rate is 5% and the lowest, 3%. The 3% tax rate applies to the first \$5,000 of taxable income; 4% to the next \$5,000; and 5% to taxable income above \$10,000.[6] (Twenty-seven states had a top income bracket above 5% in 2006 (Hovey 2007).)

What about the corporate income tax? Are corporations paying their fair share of taxes?

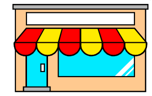
A good question, and one that states have been considering for some time. Better enforcement of existing tax regulations would substantially increase collections and this has become a key concern of the states. The Multistate Tax Commission, with which most states are affiliated, reported in a 2003 study that large, multistate corporations avoided as much as \$7.1 billion in state corporate taxes in FY2001, due to such tactics as shifting their reported profits from high-tax states to low-tax states.

To combat this particular problem, over 20 states now use "combined reporting". Combined reporting requires a multi-state corporation to add together the profits of all its subsidiaries, regardless of their location, into one report. This report, then, provides each state with information needed to levy the appropriate tax, based on their individual tax provisions. The Governor's Tax Study Commission recommends that Mississippi consider changing to combined reporting after further study. (The Institute on Taxation and Economic Policy (2008) and Tax Justice Digest (6/27/08) provide more information on combined reporting.)

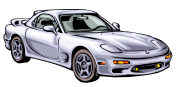
Combined reporting would also make it more difficult to avoid reporting income altogether: one study of 252 large corporation found that in 2003 these companies on average failed to include two-thirds of their actual U.S. pretax profits on their state tax returns (McIntyre 2005). For example, in a related study, McIntyre (2007) found that Wal-Mart reported \$77.4 billion in pretax profits to its shareholders but paid state income taxes on about half that sum.

Should we cut back on tax breaks for corporations?

Mississippi needs to be competitive with other states, and it is, both in terms of the tax rate on net corporate income over \$10,000 -- which is 5% compared to the 6.1% U.S. average -- and also in terms of tax incentives offered to firms locating here. However, in Mississippi as elsewhere, there are differences in the effective rate among firms. Large manufacturers, for example, are eligible for many tax breaks not available to other firms. The reason is that they bring in investment dollars from out-of-state, create large numbers of high-paying jobs through sales to out-of-state customers, and also generate jobs among suppliers. By contrast, retailers, for example, typically generate their income through sales within the state and may reduce employment at competing stores. They, then, have a much smaller net positive impact.



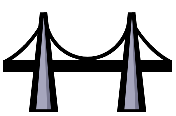
Tax breaks need to be continually monitored to ensure that the benefits of tax incentives outweigh the costs to the state, and to ensure that businesses are treated fairly. Locally-owned businesses and businesses with an out-of-state customer base are of special concern. If the return to the state from the investment in a certain tax break is not as great as expected, there is an argument for levying a surcharge on that tax break – the National Association of State Budget Officers (2002) mentions a 20% surcharge on tax breaks qualified for under business incentive programs.



In Mississippi, hundreds of millions of dollars are being spent to lure automakers to the state. Take the case of Toyota. In addition to benefiting from state expenditures of $326 million for infrastructure, job training and more, Toyota is eligible for income tax exemptions, reduced taxes in other areas, and may receive rebates on state personal income taxes withheld on payrolls, sales and use taxes on equipment used to build vehicles, and contractor taxes on the plant's construction. The rebates on personal income taxes collected alone will be in the millions of dollars.[7] Such tax reductions require on-going scrutiny.

So, if we need more revenues, where do we start?

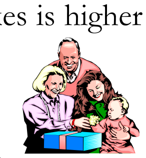
There is no easy answer, but it is important to keep in mind the principles of equity, stability and efficiency. It makes sense to start with examining the three major taxes, as we did above. There are also other taxes and alternative means of revenue-raising. For example, fees can be increased on government-supported services, such as those of the Department of Environmental Quality or of regulatory agencies; similarly, fees and fines imposed to discourage or penalize certain kinds of behavior can be raised, or introduced (such as a carbon-emissions tax or fines for hiring undocumented workers); and user fees on such state-owned assets as roads can be increased (many states are introducing new toll roads and bridges). The state can demand refunds with interest from contractors who fail to provide products and services for which they have been paid, and so on. More state auditors can be hired to reduce tax avoidance. But, in the end, it would be very difficult to generate the needed revenues, from such sources, and changes in the three major taxes will likely remain the major source of new funds. See Hill (2003) for a further discussion of alternative means of raising revenues.



How do we ensure that any changes in our tax system are fair?

Equity calls for ensuring that individuals and businesses at the same income level pay similar taxes; and that those with higher incomes pay higher taxes. Equity can also mean that those who benefit from a particular service pay more than those who do not (the benefit principle).

The personal income tax is generally considered to be more equitable than the sales tax, since it is a progressive tax – that is, the percentage of income that a household pays in income taxes is higher for high-income families than it is for low-income families. Currently, families in the lowest 20% income group pay about 10% of their average income (pre-assistance) in state and local taxes, but only 0.2% of their income goes to the state income tax. Families in the top 20%, with an adjusted average income of $123,284, pay an average of $7,220 or 5.9% of their income to state and local governments, with 2.6% going to the state income tax.



Families in the same tax bracket pay comparable taxes, although there is room to improve equity in terms of deductions, exemptions, tax brackets and tax rates. The corporate income tax is also a progressive tax; and, here as well, there is room for improving equity in the treatment of different firms.

The sales tax, in contrast, is regressive, that is, lower income families pay a higher percentage of their income in sales and excise taxes (8%) than do higher income families. Mississippians in the middle 20% of the income distribution, for example, paid an average of 6.9% of their adjusted income, and those in the top 1% paid 1.3%.

Mississippi ranks 14th among the states in the progressivity of its major state and local taxes (which include sales, property and income taxes). Efficiency must also be considered when discussing tax reform: when taxes are high relative to those of other states, there can be a loss of earning capacity as firms and individuals choose to relocate.

Explain efficiency a bit more.

Taxes affect behavior. They can make or break business deals. A tax of a few cents on the dollar can make the difference between profit or loss for companies. Out-of-state companies who are potential customers for Mississippi products would probably buy those products elsewhere if they had to pay our 7% sales tax. That is why manufactured goods and other items produced here but delivered out-of-state are exempt from the state sales tax.

Taxes also affect individual behavior. Retirees are attracted to states with lower taxes on retirement income (in Mississippi, retirement income is not subject to the income tax – the state foregoes over $200 million per year in revenues due to this exemption).

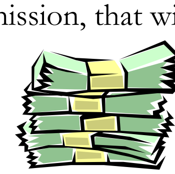
Taxes are inefficient when they cause changes in behavior in ways that reduce output and incomes in undesirable ways. Some inefficiencies are inevitable – taxing income but not leisure can discourage work. It does seem clear, though, that any large differences in the tax burdens of businesses and individuals at similar income levels should be examined to ensure that these differences are desirable.

Are there other considerations?

Stability is a key consideration, as is ease of collection. The sales tax is a more stable revenue source than either the personal or corporate income tax, which fluctuate with the swings in the economy, and it is more straight-forward and easy to collect.

Will improving equity and efficiency generate more revenues at the same time?

This is an early consideration of groups, such the Governor's Tax Reform Commission, that wish to improve the tax system. (This Commission has revenue-neutrality as a goal.) It is generally easier to recommend cuts in tax rates and increases in exemptions and deductions, than it is to end existing tax breaks or to raise taxes on some groups to equalize the burden between groups. This is a common problem in tax reform efforts, one that makes even revenue-neutrality a challenge. Estimates of the impact on revenues of all proposed changes are essential. In the case of Mississippi, this is especially important in light of the unfavorable pre-Katrina trends in the state's major taxes, and the likelihood of budget revenue shortfalls in the future, if the state wishes to maintain current levels of service.



NOTES

1. Sources: Mississippi Fiscal Summary, January 2004 and January 2008, Figures D-1 and Appendix Tables 2 and 5. Moody's, State Median Incomes 2007. It is also worth noting that state bonds authorized but not issued have been growing rapidly and are making up some of the gap between revenues and budgeted expenditures. Authorized, un-issued bonds increased 69% from FY2002 to FY2007.

2. Federal funds to the state for Employment Security, Disaster Relief, Human Services, and the Mississippi Development Authority (which alone received $2.42 billion) were more than twice as high in FY2009 as they were in FY2003, due to the continuing post-Katrina reconstruction. Other categories receiving more than $100 million in federal funds include Medicaid (the single largest recipient at $2.43 billion), the State Department of Health, General Education, and the Department of Education, each of which experienced at least a 25% increase.

3. The growth of state expenditures over both periods was higher than that of taxes from the "big three" and also higher than that of personal income.

4. Four sales tax categories are dominated by business-related expenditures: machinery, equipment & supplies (includes industrial, farm & hospital equipment); lumber & building materials (lumber, plumbing, electrical, metal); public utility (about half, telephone charges and one-third, electricity to commercial business & industrial fuel purchases by utilities – if used to generate electricity exempt) ; and contracting (drilling and construction related). Data refer to FY2005.

Assuming all sales of "machinery, equipment & supplies" ($125 million in tax revenues on $2.3 b. of sales) and of "contracting" sales ($163 m. on $4.5 b. of sales) were to businesses, along with sales of electricity and gas for commercial use and fuels for manufacturing/industry ($60.3 m. on sales of $1.5 b.), we find a minimum of $348 million in tax revenues were due to sales to business or 14% of total sales tax revenues in FY2005.

If we include as well 10% of telephone and telegraph services, 50% of sales of lumber & building material sales and plumbing, heating & air conditioning materials, all neon & other signs, oil & gas field services, aircraft sales, 8% of hotel rooms and so on, the percentage of sales tax revenues due to sales to businesses would rise to 20% as a reasonable, back-of-the-envelope guess. (Manufacturing machinery is taxed at 1.5%, contracts at 3.5% tax rate, and electricity and gas for commercial use at a 7% rate.) The use tax, a tax on sales largely paid by business, grew very little from FY1995 to FY2005. It accounted for 5% of general fund transfers in FY2006 and 4% pre-Katrina.

5. Consumer prices are 65% higher in 2008 than they were in 1990. This means that a 1990 exemption of $2,000 would have to be $3,300 today to have the same effect on purchasing power.

The 2008 poverty threshold for an individual is an estimated $11,170 and for a family of four, $21,945. A married-couple family of four at this poverty income level would be paying taxes at Mississippi's 4% tax bracket, just below the 5%, if the family took only the standard deduction and exemption of $16,600.

6. Only 64% of Mississippians who filed a federal income tax return in 2006 owed any taxes; and of those who did owe tax, the bottom 60% paid only 15% of total Mississippi tax liabilities. The top 10% paid 61%. The average tax paid was $1,600 per return for the bottom 60% (adjusted gross income or AGI under $50,000) and for those with AGI from $100,000 to $200,000 the average federal income tax was $18,278. Similar data is not available on Mississippi's state income tax

returns, and an expansion of the research capacity of the State Tax Commission to provide such statistics would be useful to the state.

7. To lure the Toyota plant, the state offered $326 million in incentives with local government chipping in another $30 million. Most of the incentives, as detailed in Senate Bill 3215, will go to infrastructure ($162 million) and site preparation ($50 million). Another $84 million is for job training and an on-site training facility, plus $30 million to training for suppliers at two community colleges and the University of Mississippi. In addition, Toyota is eligible for income tax exemptions, reduced taxes in other areas, and may receive rebates on payroll taxes, sales and use taxes on equipment used to build vehicles, and contractor taxes on the plant's construction. These will add millions to the package.

For a complete list of incentives provided to Toyota, see Senate Bill 3215, regular session 2007, at www.ls.state.ms.us. A description of incentive packages is at www.mississippi.org. Under loan programs for business, see especially Mississippi Major Economic Impact Authority and under tax incentives, see Advantage Job Incentives Program. The advantage job program typically provides the firm with a rebate of a certain percentage of state personal income taxes withheld – if the annual average wage is at least 125% but less than 175% of the lesser of the average county or state wage, then the rebate is 80% of those withheld taxes (but no more than state personal income taxes actually paid by employees). The percentage may be as high as 90% or as low as 70%, depending on the average wage paid.

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