NEVADA POLICY RESEARCH INSTITUTE

analysis

One Sound State, Once Again

Comprehensive fiscal reforms to again make Nevada strong, prosperous and free

by Geoffrey Lawrence

Executive Summary

In the middle of the Great Depression, while other states suffered shortfalls and communities used scrip rather than actual currency, the State of Nevada ran a budget surplus. It lasted into the mid-1940s.

Proud of the Silver State's unique fiscal situation, state and business leaders launched a nationwide promotional campaign intended to attract wealthy investors to the state. The "One Sound State" project advertised Nevada as a state with "no income tax, no inheritance tax, no sales tax, no tax on intangibles, but with a balanced budget and a surplus."

By 1939, the state surplus was so large that the property tax rate — raised by the 1937 legislature — was cut by 20 percent. The *San Francisco Chronicle* editorialized, "Unbelievable, but it is true. These people just do not belong in the United States."

Today the State of California is again issuing scrip — called "registered warrants" now — and Nevada clearly needs a new model for fiscal rectitude.

The state's current legislative leadership, however — operating as the Interim Finance Committee — has already signaled its intent to ignore the state's need for comprehensive fiscal reform and instead simply pursue a quantum increase in the state tax burden, while billing it as a comprehensive review of the state revenue structure. Like each of its predecessors over the last 20 years, however, this legislature's tax study was structured to ignore genuine fiscal reform issues and instead merely provide cover for lawmakers out to transfer private-sector resources to the powerful, organized, tax-consuming groups that get them elected.

Nevertheless, Nevada seriously needs genuine, revenue-neutral fiscal reforms, and this report seeks to fill that vacuum. It analyzes the actual volatility of Nevada's current taxes — and the taxes lawmakers keep signaling they want. It covers important tax-related issues, such as achieving economic efficiency and tax equity, while reducing compliance costs as well as tax-induced distortions in economic behavior. And it reveals why comprehensive fiscal reforms for Nevada should include:

- Eliminating the modified business tax;
- Eliminating the insurance premium tax;
- Broadening the sales tax base and reducing the statewide sales tax to 3.5 percent;
- Implementing priority-based budgeting; and
- Implementing spending controls that limit state spending growth to the rate of inflation plus population increase.

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Background

A great deal of uncertainty surrounds the Nevada Legislature as it heads toward the 2011 regular session. Amid an economic recession of historic dimensions that has seen the state's unemployment rate climb above 13 percent,[1] state tax revenues have proven much lower than lawmakers desired. As such, state legislators — in concert with every household and business in Nevada — will face serious constraints as they plan for the 2011-13 budget cycle.

In recognition of current economic uncertainties, the 2009 legislature passed Senate Concurrent Resolution 37,[2] calling for a comprehensive examination of the state tax structure. Significant controversy surrounded this decision, however. SCR 37 not only directed the Interim Finance Committee[3] — a legislative creation widely acknowledged to be of dubious constitutionality — to conduct yet another in a long train of reviews of Nevada's "revenue structure," but it also directed the IFC "to provide long-term stabilization of revenue."

No legislative committee, much less the IFC, has the legal authority to itself "provide stabilization of revenue" for Nevada. Yet the overreaching language of the resolution was consistent with the ambitions reflected behind it. Indeed, a passing remark from Assemblyman Bernie Anderson, during a meeting of an IFC subcommittee, may have candidly given the game away. "We don't have money," he said. "That's the reason we're doing the study."[4] Thus, far beyond examining volatility within the tax structure in order to find methods of reducing such volatility, SCR 37 also explicitly directed the Interim Finance Committee to "review proposals for broad-based taxes" and to develop quality-of-life goals for all Nevadans.

Those goals — for the next five, 10 and 20 years — were to issue from a "Nevada Vision Stakeholder Group" that the IFC would appoint. The goals they were to identify would necessarily be goals to be achieved collectively through an expansion in the size and cost of government.[5] Finally, the IFC directed its contractor for the tax study to take these suggestions for new spending and come up with tax proposals to fund them within recommendations for changes to the state revenue structure.

Viewing this exercise as an unnecessary and disingenuous use of tax dollars, Governor Jim Gibbons responded by vetoing Senate Bill 143, which would have provided $500,000 in funding to hire a consultant for the tax study. The governor's veto was never overridden by the legislature, meaning that the initiative should have been dead, according to the prescribed constitutional process. Soon after, however, Senator Bill Raggio indicated that the Interim Finance Committee would use contingency funds to finance the study, irrespective of the governor's veto.[6]

In September 2009, the Interim Finance Committee made Raggio's scheme official by issuing a request for proposals from prospective contractors to do the tax study and asked the State Board of Examiners to approve up to $500,000 to finance the project.[7] The Board of Examiners, which consists of the governor, the secretary of state and the attorney general, approved the request — the attorney general and secretary of state overriding the vote of the governor.

This scheme to fund the tax study — with its end-run around the gubernatorial veto of Senate Bill 143 — is itself of questionable constitutional validity. The Interim Finance Committee's contingency fund is designated for allocation to Executive Branch agencies for specific, limited purposes, such as utility cost overruns. However, the actions taken by Interim Finance Committee members to circumvent the gubernatorial veto indicate that the contingency fund now functions as little more than a legislative slush fund.[8]

Having secured financing for the proposed tax study through dubious means, Interim Finance Committee members set about the process of selecting a consultant to perform the study and also began soliciting nominations for representatives to the Nevada Vision Stakeholder Group. The committee received eight responses to its request for proposals to perform the tax study that ranged in price from $32,200 to $909,861. The Committee voted to select Moody's Analytics to perform the study at a cost of $253,000.

In all, 85 nominations were received for individuals wishing to participate on the Nevada Vision Stakeholder Group. The Interim Finance Committee elected to restrict the number of voting members to 19, but decided to allow six members to participate as alternates. After much debate on the Subcommittee to Review Nominations,[9] and at the insistence of Interim Finance Committee Chair Steven Horsford, committee members also voted to appoint Robert Lang of Brookings Mountain West as the non-voting chair of the group. Also a newly installed UNLV sociology professor, Lang would wield significant influence by leading the discussions.

Each of the 19 voting members of the Nevada Vision Stakeholder Group was selected to specifically represent one of the five major areas of state government spending: Education, Health and Human Services, Public Safety, Transportation, and Business and Industry. Moreover, most of the individuals[10] selected for the group are public employees, public employee union representatives or representatives of organizations that receive tax dollars — all of whom would benefit directly from higher taxes and increased state spending.[11] As such, it appears that the structure of the Nevada Vision Stakeholder Group was intentionally engineered by lawmakers to produce a predetermined set of policy recommendations.[12]

Volatility and the Tax-and-Spend Cycle

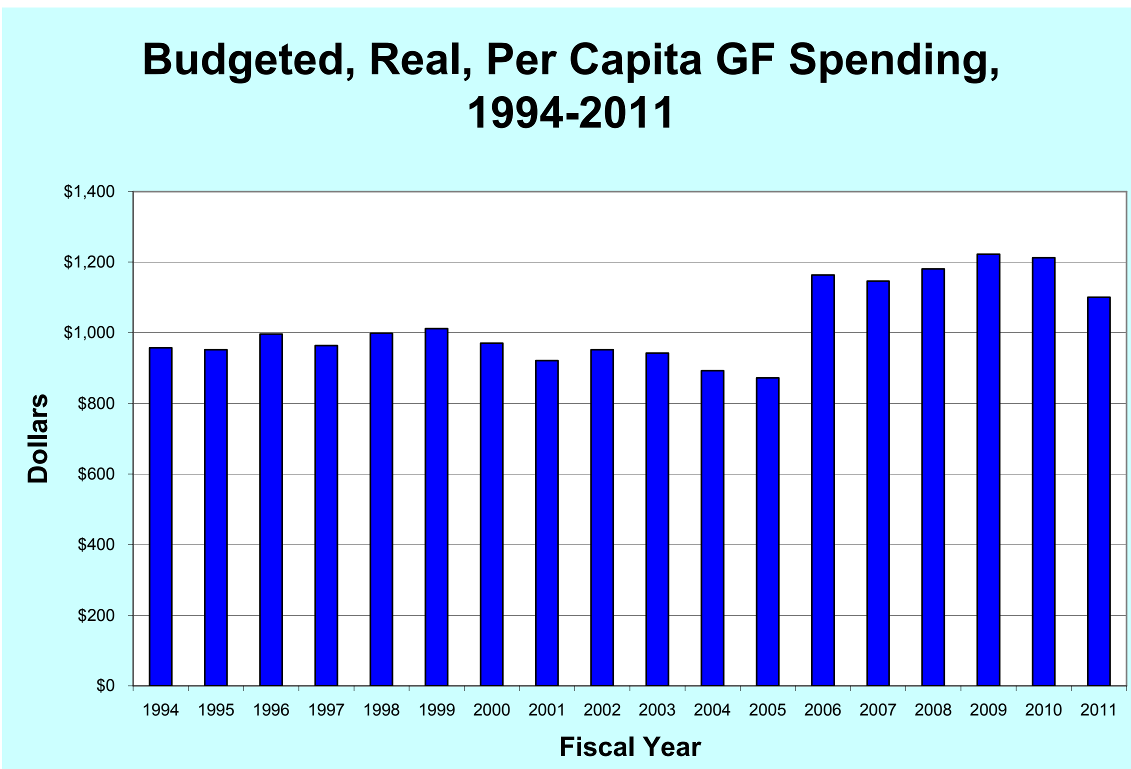
Notwithstanding the problematic processes and doubtful constitutionality of IFC actions described above, volatility of tax revenue is a genuine problem for all states and entirely worthy of study. Over the past decade, fluctuations in tax revenues have been a contributing factor in the significant growth, in both size and cost, of state government. When revenues have exceeded expectations, Nevada lawmakers have typically responded to that excess with an enthusiasm for new government spending. Then, having failed to provide for the inevitability of future downward fluctuations in revenues, they routinely proclaim the need for increasingly higher tax rates when revenue growth does not keep up with the new and higher level of state spending.[13]

This phenomenon has been demonstrated quite recently. In the wake of the 2001 recession, Nevada lawmakers entered the 2003 legislative session unsatisfied with the rate of growth in General Fund revenues and responded by passing a then-record $833 million tax increase. (During fiscal year 2003, General Fund revenues grew 4.2 percent while expenditures grew by

4.7 percent, and Nevada personal income grew by 5.3 percent.) The 2003 tax hike package created several new revenue streams, including the modified business tax, the real property transfer tax and the bank branch excise tax as well as increases in the cigarette tax, the liquor tax, the gaming tax and business license fees.

However, by fiscal year 2004, the growth in General Fund revenues (31.7 percent) was once again far outpacing the growth in state personal income (10.7 percent) and especially the growth in U.S. personal income (4.8 percent). Moreover, Economic Forum projections during the 2005 legislative session indicated to lawmakers that General Fund revenues would continue to grow by 15.8 percent during the 2005-07 budget cycle,[14] including more than $1 billion in revenues resulting from the 2003 tax hike package.[15]

Lawmakers eagerly responded to this explosion in revenue growth by growing expenditures even faster. Budgeted expenditures grew by 51.3 percent between the 2003-05 and the 2005-07 budget cycles. This new spending went to expansions of the Millennium Scholarship Program and the class-size reduction program, expansion of full-day kindergarten in Clark County and various "pork" projects around the state.[16]



The net result of the 2005 spending binge was to increase inflation-adjusted, per capita budgeted state spending by more than 30 percent — a new, higher level of per capita spending that has remained in place ever since.[17] In fact, in order to maintain the new, higher level of spending despite the onset of economic recession, the 2009 legislature raised the total state tax burden by 19.1 percent entering the 2009-11 budget cycle.[18] This included: a doubling of the business license fee, a doubling of the modified business tax, a raise in the statewide sales tax rate of 0.35

percent, and an adjustment of the depreciation schedule for motor vehicle registration designed to generate additional revenue from the "governmental services" tax.

What this tax-and-spend cycle makes clear is that revenue reforms that would temper the upward fluctuation in tax revenues during periods of economic expansion could aid in controlling government growth within the Silver State. It could moderate calls for tax increases during recessionary periods. Hence, reducing revenue volatility can be a key component of a larger strategy to control tax-and-spend cycles.

Seeking Stability

The first step in reducing revenue volatility is to determine the actual level of volatility in the state's current revenue structure. The analysis should highlight the specific degrees of volatility associated with each major tax instrument. Only with such an analysis can one begin to make educated recommendations for how to mitigate volatility in the overall revenue structure.

It is unrealistic to presume the possibility of achieving some tax structure that is completely immune to variations in revenue. Every tax instrument is attached to a specific economic activity. As the volume of the activity being taxed increases or decreases, so also will the revenues generated from the tax on that activity. More specifically, in periods of economic recession, during which the economic activities being taxed are likely to occur less frequently, total tax revenue generated from those activities will also decline.

When calculating quantitative values for volatility, economists are concerned with whether tax revenues rise or decline *faster* than overall economic growth. It is important to remember that values indicating relative stability do not imply that revenues do not fluctuate, only that they fluctuate less violently than the rate of economic growth.

Economists use a measure for determining volatility called "short-run elasticity." This measure is used to compute a numeric value representing the level of volatility by examining the rate at which revenues from a particular tax instrument respond to changes in aggregate personal income (which represent fluctuations in the business cycle).

In most cases, the economist must ensure that the geographic boundaries for the data being evaluated are in compliance — meaning that changes in Nevada tax revenues would be measured against changes in Nevada personal income. However, because Nevada's tourism-driven economy is also sensitive to changes in national and even worldwide personal income, it is appropriate to evaluate changes in Nevada tax revenues against changes in both state personal income and national personal income.

Recent Notable Studies

Recent attempts to evaluate the volatility of Nevada's tax structure were undertaken in separate studies commissioned by the Nevada Development Authority[19] and the Las Vegas Chamber of Commerce.[20] Both of these studies found Nevada's tax structure, contrary to conventional wisdom, to be relatively stable when compared to other states. The Chamber study, for example, finds that Nevada ranks ninth among the states in terms of per capita revenue stability.

The Nevada Development Authority goes more into depth in its analysis, calculating short-run elasticity estimates for each of the major tax instruments used in Nevada. The findings indicate the majority of tax instruments employed in Nevada are highly stable with regard to in-state personal income, but are more sensitive to changes in national personal income. This is reflective of Nevada's tourism-driven economy and indicates that fluctuations in the national business cycle have a strong impact on the volume of taxed economic activity occurring in the state. Changes to in-state personal income manifest themselves less prominently in volume of taxed behavior.

The NDA study's major findings are reproduced here:

Table 1: Volatility Levels of Major Tax Instruments

Tax Instrument	Short-Run Elasticity (NV Personal Income)	Short-Run Elasticity (U.S. Personal Income)
Taxable Gaming Revenues	0.499	0.947
Sales & Use Taxes	0.950	1.797
Modified Business Tax	0.964	1.188
Insurance Premium Tax	0.430*	1.016*
Property Tax	1.024	1.734
Alcoholic Beverage Tax	1.020*	1.050*
Amusement Tax	0.576	0.692
Tobacco Product Tax	0.621*	1.829
Motor Fuels Tax	-0.557*	-0.587*

*Less statistical probability; indicating that variability is likely not associated with the business cycle.

An elasticity value of *less than one* indicates that the volume of the taxed behavior changes more slowly than personal income, or that the tax instrument is relatively *stable*. Elasticity values *higher than one* indicate that the volume of the taxed behavior changes more quickly than personal income, or that the tax instrument is relatively *volatile*. A negative sign indicates an inverse relationship, or that the taxed behavior occurs more frequently as personal income levels decline, and vice versa.

These findings turn the conventional wisdom on its head. They show that the most stable tax sources in Nevada are those that are typically blamed for contributing to volatility, including: gaming, amusement (a proxy for the live entertainment tax) and alcoholic beverage taxes. Meanwhile, among the most volatile tax sources are property, tobacco and sales taxes. As the study's authors note, the insurance premium tax does not display a strong relationship to changes in the business cycle because consumers are statutorily compelled to purchase insurance no matter their income level.[21]

There are, however, important limitations to both the Chamber study and the Nevada Development Authority study that deserve consideration. First, both studies use state tax revenue data as reported by the U.S. Census Bureau. The Census data is helpful because it groups the tax instruments employed by different states into similar categories to allow for easy cross-state comparison. However, this strength is also a weakness in that many of the unique tax instruments employed in Nevada do not fit well into the general categories constructed by the Census and this skews the quality of the data.

Second, while these two studies represent the most recent assessments of tax revenue volatility for the Silver State, the data range examined only extends to the end of fiscal year 2007. Thus, any potential long-term changes in the relationship between state tax revenues and the business cycle that have appeared since the onset of recession in the second quarter of fiscal year 2008[22] are not included in the analyses.

Updating the Findings

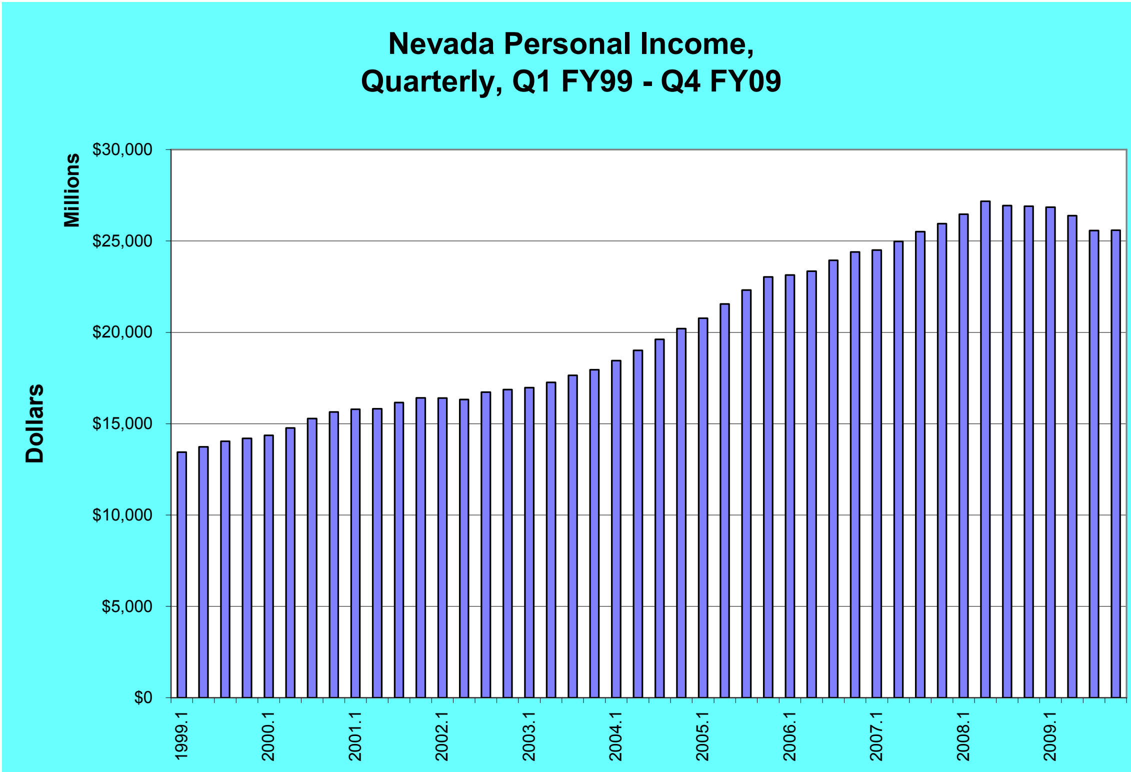
To address these concerns, this analysis examines a range of data beginning with fiscal year 1999 and extending to the close of fiscal year 2009 for all major tax instruments reported to the Nevada Department of Taxation[23] and the Nevada Gaming Control Board.[24] These data are reported on a monthly or quarterly basis for most tax instruments, which broadens the number of data points included in the range.

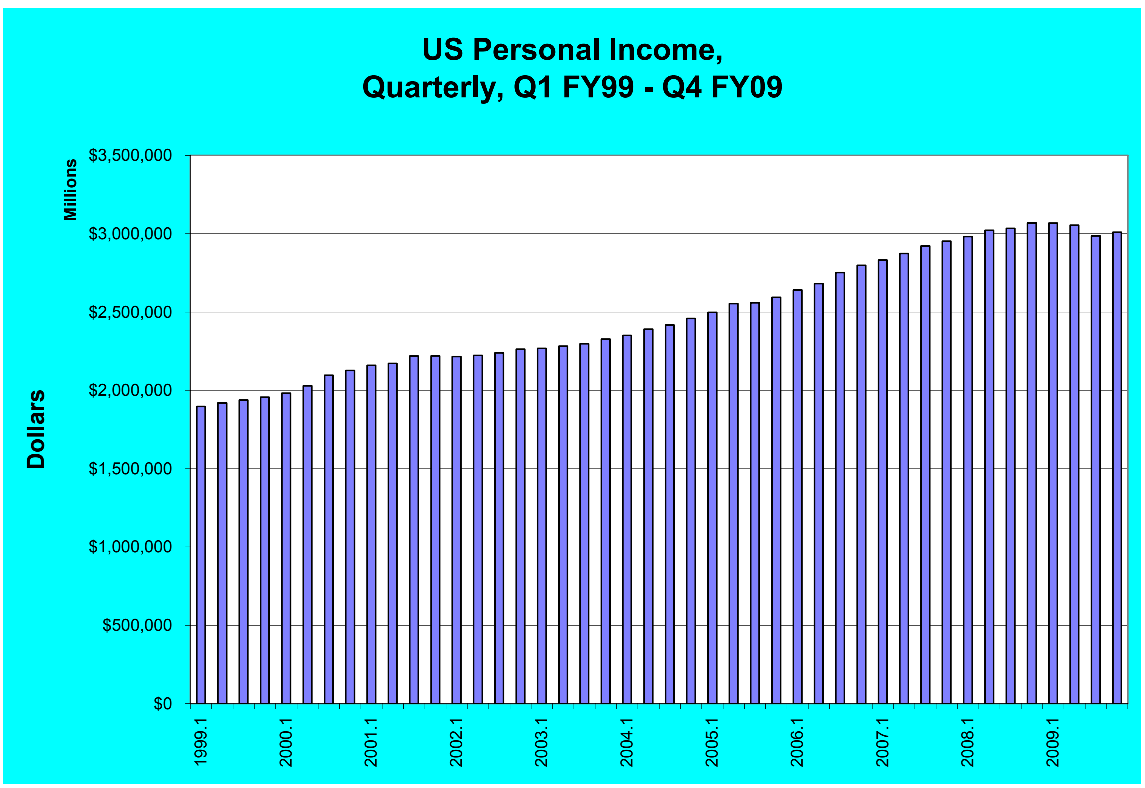
Pulling the data directly from the state agencies not only allows for the inclusion of the most recent data available, it also addresses the qualitative concerns that arise from using the Census data. A drawback of this approach is that, while it will allow for the most current and accurate calculation of short-run elasticity values, it will not allow for an easy cross-state comparison. However, such comparisons are unnecessary for accomplishing the end goal of this analysis, which is to provide recommendations for minimizing volatility in the overall state tax structure.

On the plus side, analyzing the most current data available gives us the best opportunity of understanding recent shifts in economic behavior and how those shifts have impacted state tax revenues.

Economic recessions occur as previously malinvested capital is redirected, effecting a change in the economy's structure of production. Often, recessions are also associated with shifts in inter-temporal consumer preferences as well, meaning that individuals begin choosing to save, rather than consume, a higher proportion of their income. These changes, taken together, can vastly alter the composition of economic activity occurring within a state.

As all tax instruments are attached to particular forms of economic activity, any substantial change in the proportional composition of the state economy can dramatically impact the performance of the overall tax structure. Indeed, it is for this reason that any recommendations for revenue reform should be informed by an analysis that includes the most recent data available.


Nevada Personal Income,
Quarterly, Q1 FY99 - Q4 FY09
Millions
Dollars
$30,000
$25,000
$20,000
$15,000
$10,000
$5,000
$0
1999.1
2000.1
2001.1
2002.1
2003.1
2004.1
2005.1
2006.1
2007.1
2008.1
2009.1


US Personal Income,
Quarterly, Q1 FY99 - Q4 FY09
Millions
Dollars
$3,500,000
$3,000,000
$2,500,000
$2,000,000
$1,500,000
$1,000,000
$500,000
$0
1999.1
2000.1
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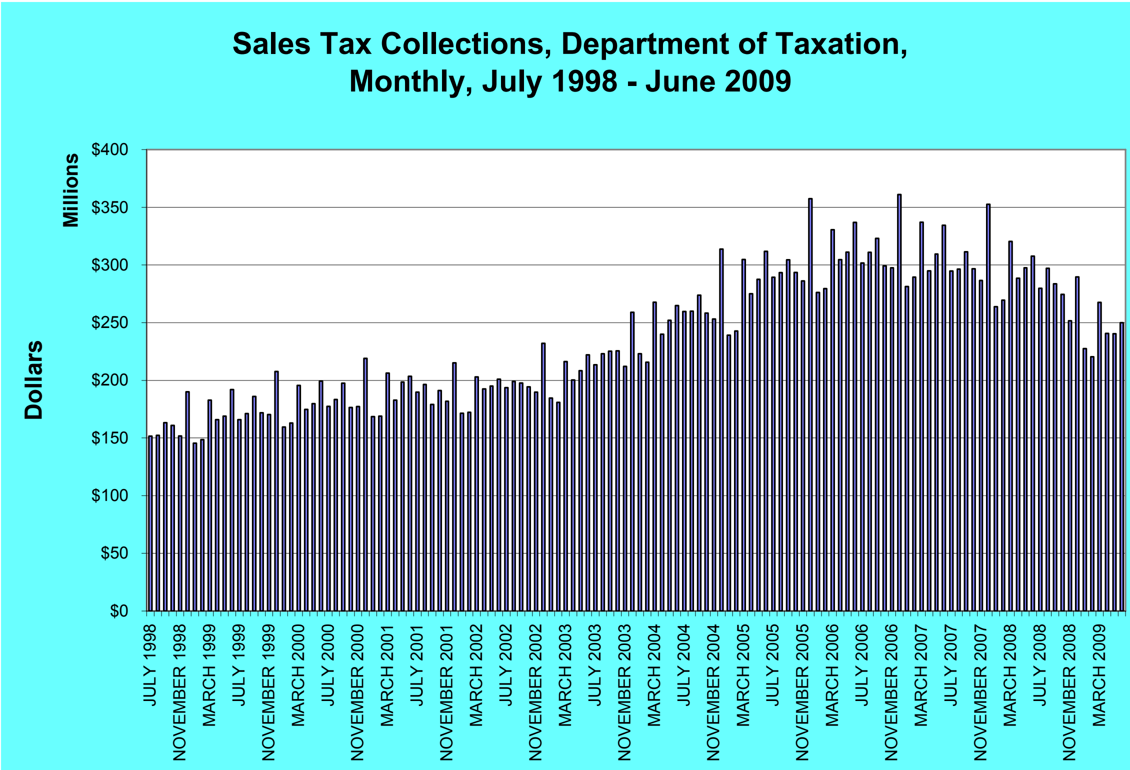
2006.1
2007.1
2008.1
2009.1


Sales Tax Collections, Department of Taxation,
Monthly, July 1998 - June 2009
Millions
Dollars
$400
$350
$300
$250
$200
$150
$100
$50
$0
JULY 1998
NOVEMBER 1998
MARCH 1999
JULY 1999
NOVEMBER 1999
MARCH 2000
JULY 2000
NOVEMBER 2000
MARCH 2001
JULY 2001
NOVEMBER 2001
MARCH 2002
JULY 2002
NOVEMBER 2002
MARCH 2003
JULY 2003
NOVEMBER 2003
MARCH 2004
JULY 2004
NOVEMBER 2004
MARCH 2005
JULY 2005
NOVEMBER 2005
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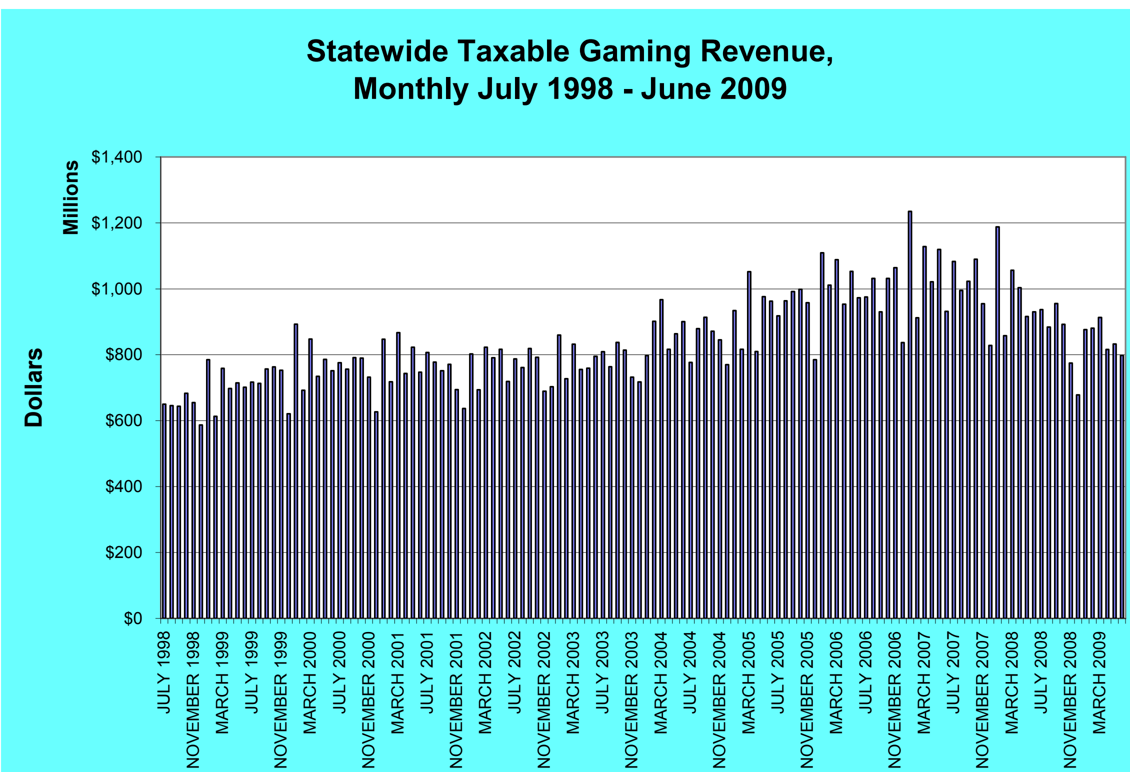
JULY 2007
NOVEMBER 2007
MARCH 2008
JULY 2008
NOVEMBER 2008
MARCH 2009


Statewide Taxable Gaming Revenue,
Monthly July 1998 - June 2009
Millions
Dollars
$1,400
$1,200
$1,000
$800
$600
$400
$200
$0
JULY 1998
NOVEMBER 1998
MARCH 1999
JULY 1999
NOVEMBER 1999
MARCH 2000
JULY 2000
NOVEMBER 2000
MARCH 2001
JULY 2001
NOVEMBER 2001
MARCH 2002
JULY 2002
NOVEMBER 2002
MARCH 2003
JULY 2003
NOVEMBER 2003
MARCH 2004
JULY 2004
NOVEMBER 2004
MARCH 2005
JULY 2005
NOVEMBER 2005
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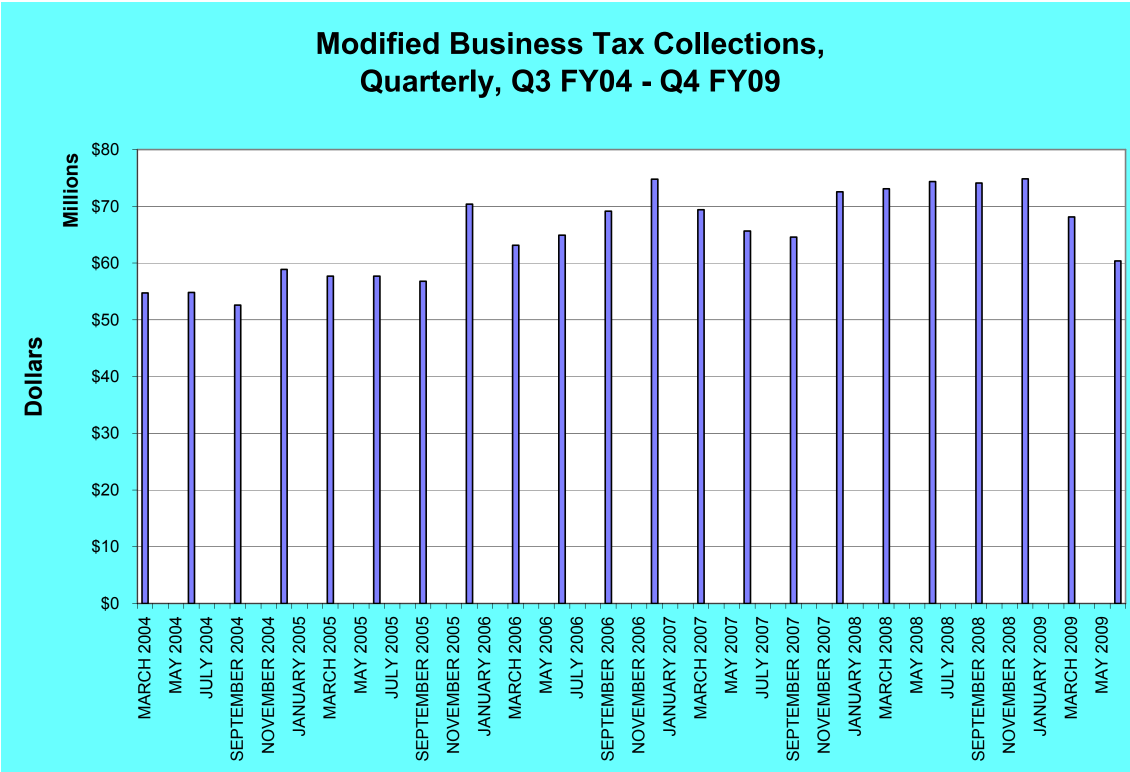
NOVEMBER 2007
MARCH 2008
JULY 2008
NOVEMBER 2008
MARCH 2009


Modified Business Tax Collections,
Quarterly, Q3 FY04 - Q4 FY09
Dollars
Millions
$80
$70
$60
$50
$40
$30
$20
$10
$0
MARCH 2004
MAY 2004
JULY 2004
SEPTEMBER 2004
NOVEMBER 2004
JANUARY 2005
MARCH 2005
MAY 2005
JULY 2005
SEPTEMBER 2005
NOVEMBER 2005
JANUARY 2006
MARCH 2006
MAY 2006
JULY 2006
SEPTEMBER 2006
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SEPTEMBER 2007
NOVEMBER 2007
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MARCH 2008
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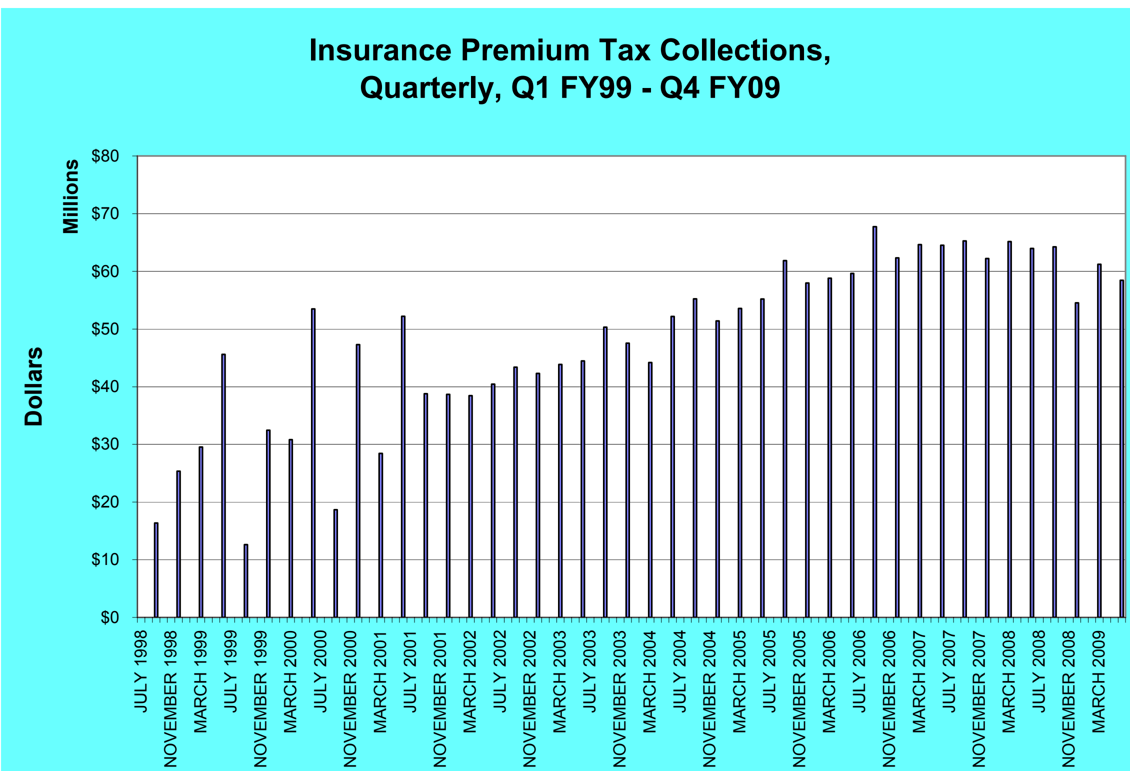
JULY 2008
SEPTEMBER 2008
NOVEMBER 2008
JANUARY 2009
MARCH 2009
MAY 2009


Insurance Premium Tax Collections,
Quarterly, Q1 FY99 - Q4 FY09
Dollars
Millions
$80
$70
$60
$50
$40
$30
$20
$10
$0
JULY 1998
NOVEMBER 1998
MARCH 1999
JULY 1999
NOVEMBER 1999
MARCH 2000
JULY 2000
NOVEMBER 2000
MARCH 2001
JULY 2001
NOVEMBER 2001
MARCH 2002
JULY 2002
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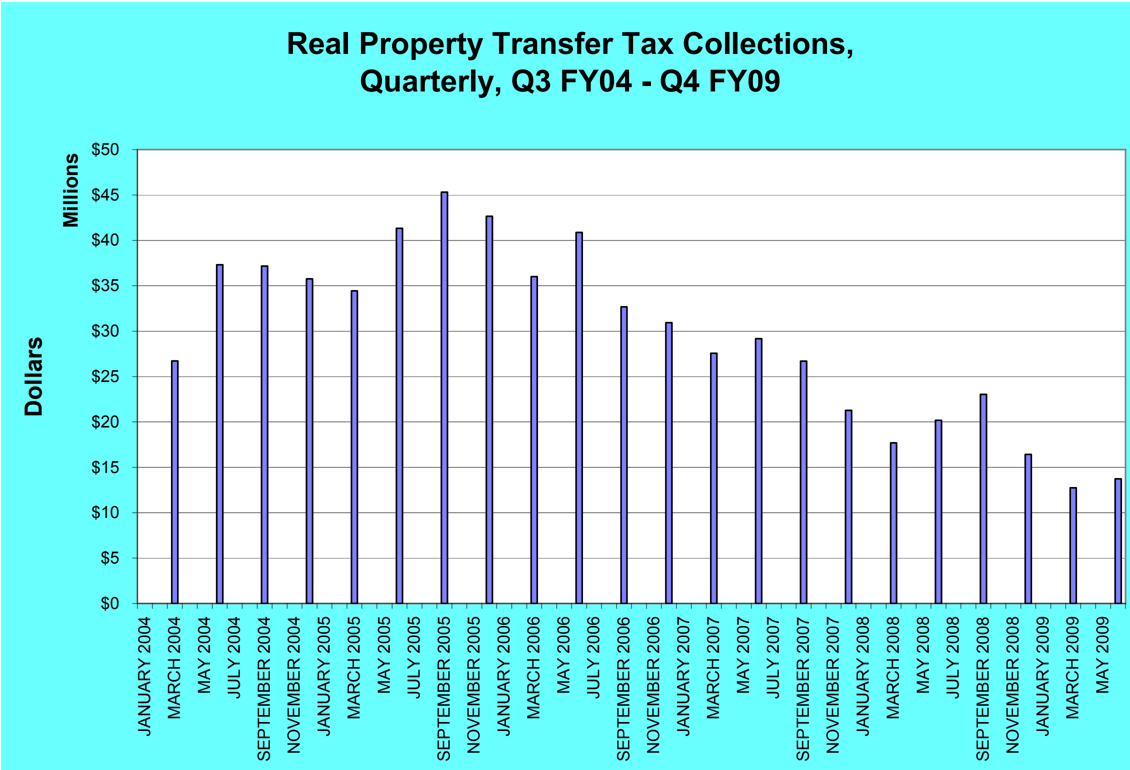
NOVEMBER 2008
MARCH 2009


Real Property Transfer Tax Collections,
Quarterly, Q3 FY04 - Q4 FY09
Dollars
Millions
$50
$45
$40
$35
$30
$25
$20
$15
$10
$5
$0
JANUARY 2004
MARCH 2004
MAY 2004
JULY 2004
SEPTEMBER 2004
NOVEMBER 2004
JANUARY 2005
MARCH 2005
MAY 2005
JULY 2005
SEPTEMBER 2005
NOVEMBER 2005
JANUARY 2006
MARCH 2006
MAY 2006
JULY 2006
SEPTEMBER 2006
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SEPTEMBER 2007
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MARCH 2008
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JULY 2008
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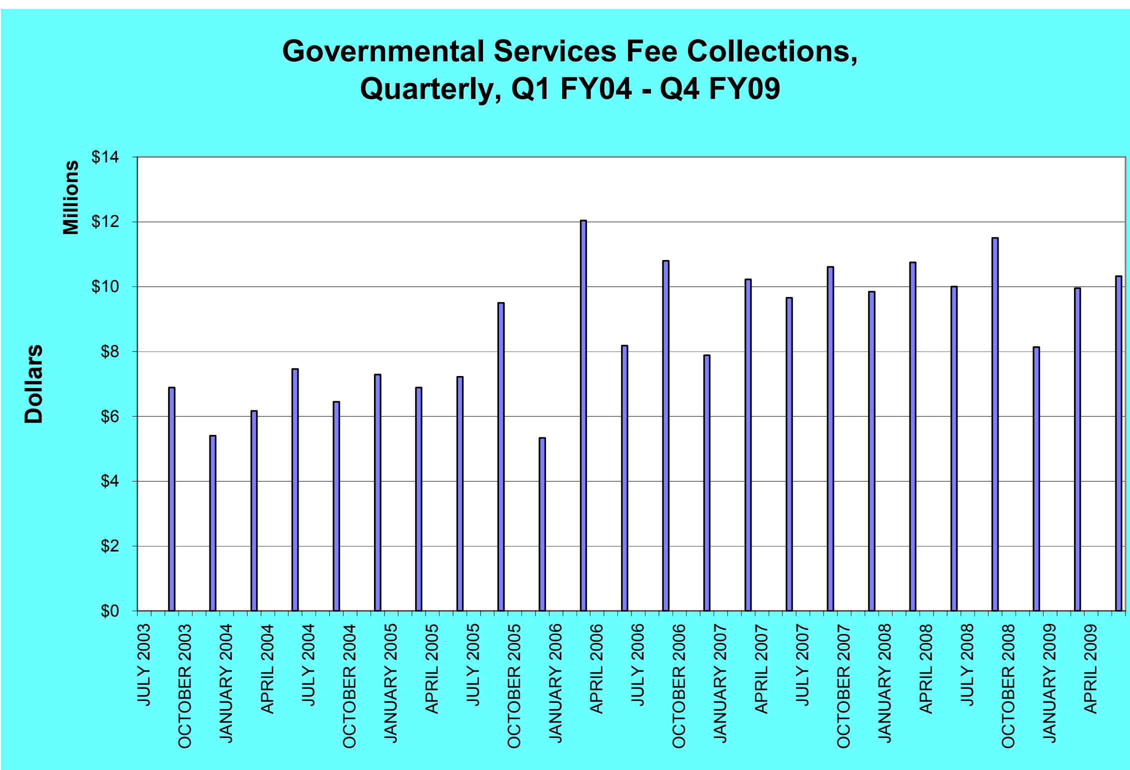
JANUARY 2009
MARCH 2009
MAY 2009


Governmental Services Fee Collections,
Quarterly, Q1 FY04 - Q4 FY09
Dollars
Millions
$14
$12
$10
$8
$6
$4
$2
$0
JULY 2003
OCTOBER 2003
JANUARY 2004
APRIL 2004
JULY 2004
OCTOBER 2004
JANUARY 2005
APRIL 2005
JULY 2005
OCTOBER 2005
JANUARY 2006
APRIL 2006
JULY 2006
OCTOBER 2006
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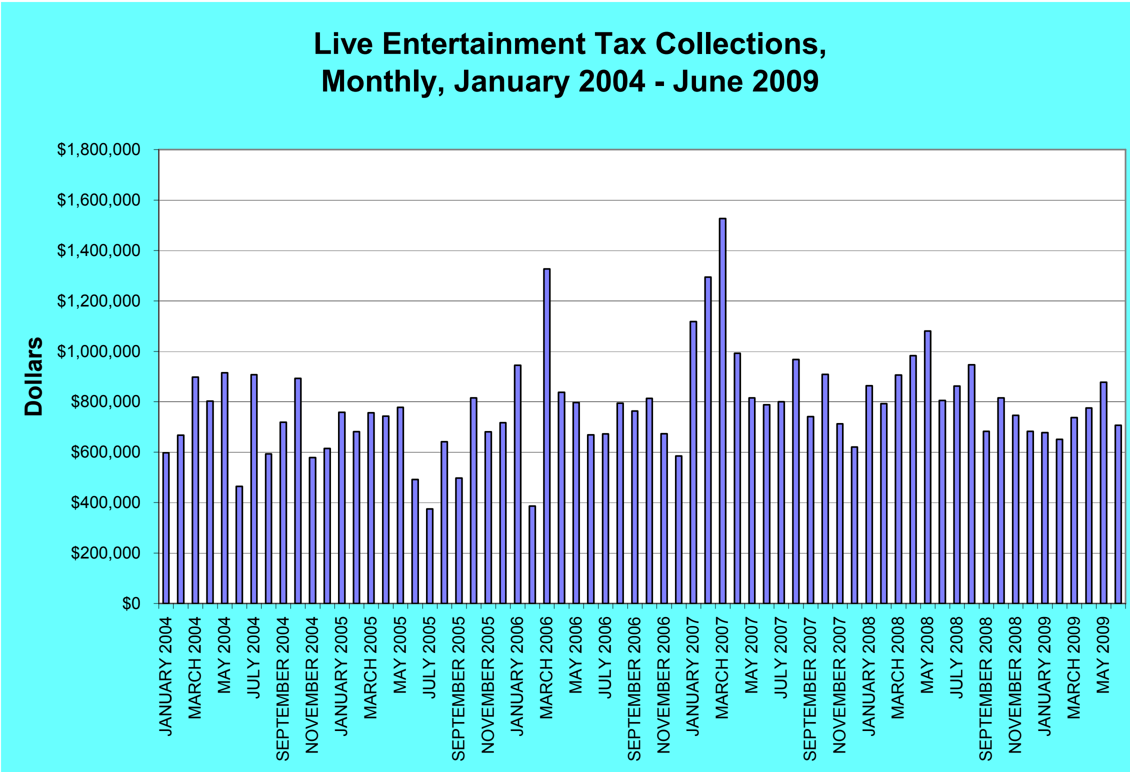
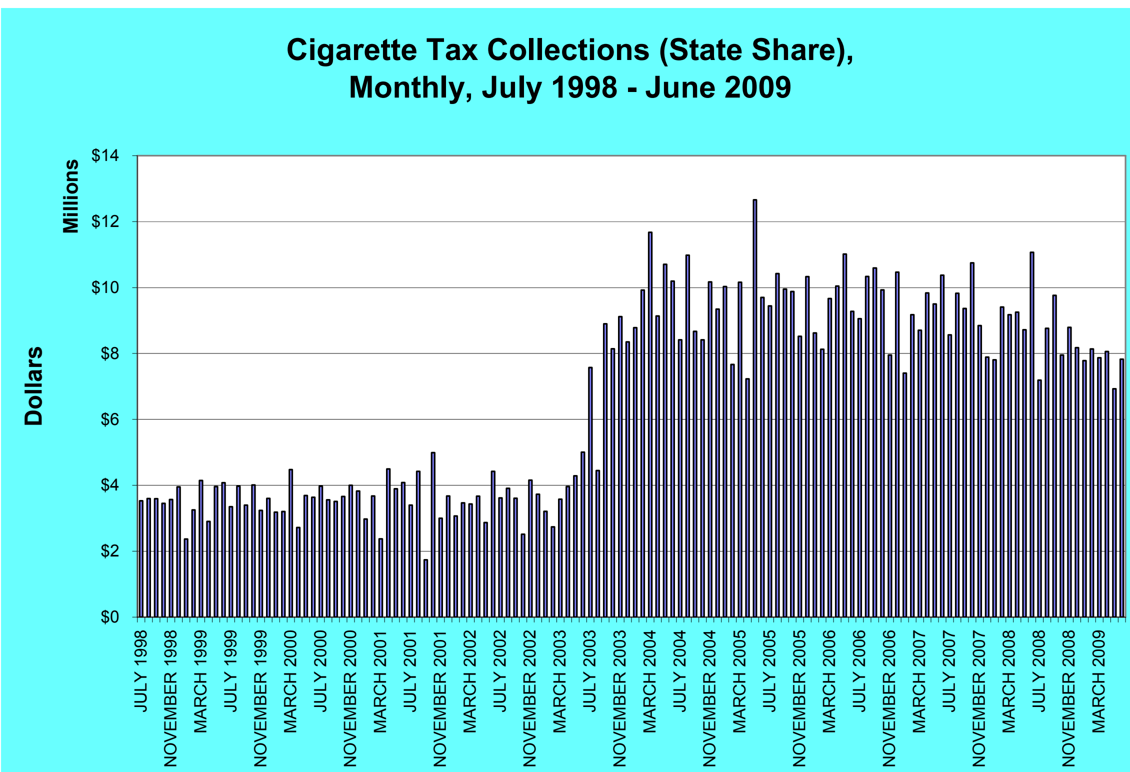
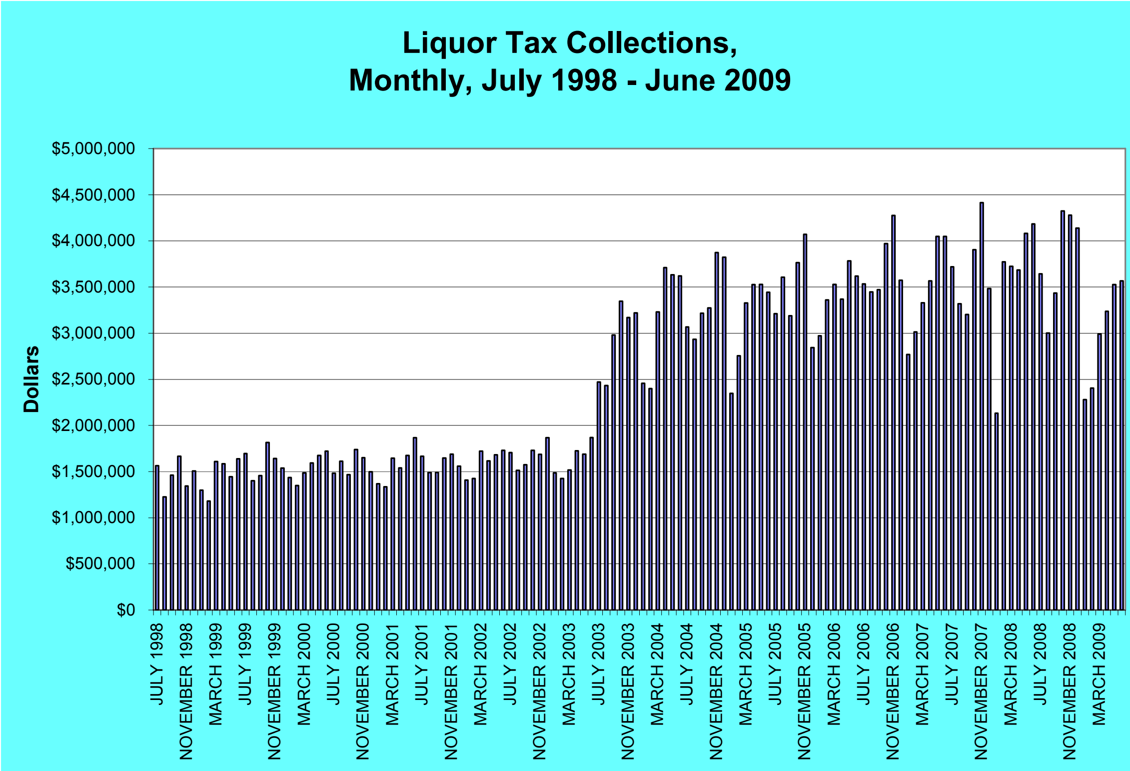
JANUARY 2009
APRIL 2009





*Revenue increase beginning in FY 2004 reflects a 128.6 percent increase in the tax rate enacted by the 2003 legislature.



*Revenue increase beginning in FY 2004 reflects a 75 percent increase in the tax rate enacted by the 2003 legislature.

The results of this volatility analysis are presented here:

Table 2: Volatility Levels of Major Tax Instruments, FY99-FY09

Tax Instrument	Short-Run Elasticity (NV Personal Income)	Short-Run Elasticity (U.S. Personal Income)
Taxable Gaming Revenues	0.595	1.949
Sales & Use Taxes	1.031	2.211
Modified Business Tax	1.731	2.270
Insurance Premium Tax	1.193*	1.538*
Real Property Transfer Tax	-1.070**	-1.103**
Liquor Tax	0.639	1.706
Cigarette Tax	0.305	1.204
Live Entertainment Tax	1.409	1.883
Governmental Services Tax	2.146*	1.297*

*Less statistical probability; indicating that variability is likely not associated with the business cycle.
**Declining sales in the real estate market preceded the decline in the overall economy, creating the statistical illusion that revenues from this tax instrument are counter-cyclical.

Again, contrary to conventional wisdom, these findings confirm that gaming taxes continue to be among the state's more stable revenue sources.

However, these findings indicate some notable departures in the pattern of economic activity from the results of the previously cited studies that employed the older, standardized Census data. Including the current recessionary period in the range reveals that cigarette tax revenues are much less volatile than previous analyses have shown, while revenues from the modified business tax and the live entertainment tax are much more volatile.

Wide gaps between the short-run elasticity value with regard to Nevada personal income and the short-run elasticity value with regard to U.S. personal income indicate that the tax is levied on an activity that is sensitive to the volume of tourism. Where the gap is larger for a particular tax instrument, revenues generated by that instrument are relatively more sensitive to tourist volume. Nearly all of the tax instruments examined exhibit such a behavior, yet the most pronounced are, in descending order: the gaming tax, the sales and use tax, the liquor tax and the modified business tax.

It should be noted that the short-run elasticity values for the real property transfer tax may appear to indicate that the tax is counter-cyclical, meaning that it would generate higher revenues during recessions and fewer revenues during expansion periods. However, this is a statistical artifact created by the data range examined.

This tax instrument was created by the 2003 legislature and did not begin to collect revenue until the third quarter of fiscal year 2004 — at the height of the "bubble market" in real estate.[25] Because the decline in real estate sales preceded the decline in overall economic activity, the current range shows a decline in revenues from this tax instrument while personal income continued to grow at both the state and national levels. Hence, a qualitative review reveals the findings for this tax instrument to be a statistical anomaly.

A 'Broad-Based Business Tax'?

Although the legislature's Interim Finance Committee has commissioned its own review of the state revenue structure, the committee imposed constraints on that review that, even according to the Legislative Counsel Bureau, are likely to bias it. "The directions given to the contractor can influence their recommendations," noted LCB staffers last September, testifying before the IFC's Subcommittee to Conduct a Review of Nevada's Revenue Structure.

Within the language of SCR 37, the IFC directed its eventual contractor to "review proposals for broad-based business taxes," signaling that optimal methods of reducing volatility are not the study's priority.

If the language that IFC Chair Steven Horsford proposed in Senate Bill 432[26] during the 2009 legislative session is any indication, the specific tax instrument that Horsford would like to see current-contractor Moody's recommend is a corporate income tax.[27] As legislative staff testified to IFC subcommittee members, it is highly likely that Moody's will provide recommendations consistent with the desires Horsford has signaled.

However, any recommendation for a corporate income tax or similar tax instrument would run counter to the committee's purported purpose of reducing revenue volatility. Numerous studies have shown that corporate income taxes are one of the most volatile tax instruments used by states in this country. The Federal Reserve Bank of Kansas City recently calculated the national average short-run elasticity value for state corporate income taxes to be 2.61.[28] This means that, even after considering recent changes in economic behavior that have elevated the volatility measurement of some tax instruments in Nevada, *a corporate income tax would be much more volatile than any major tax instrument currently employed in the state.*

The reason is simple. During periods of economic expansion, businesses are able to generate profits and a portion of those profits are captured by a corporate income tax. However, during economic recession, many businesses fail to generate income and instead suffer losses. At that point, a corporate income tax generates no revenue at all.

Other revenue studies commissioned by the Nevada Legislature have previously reached similar conclusions about the volatile nature of a corporate income tax. The famed 1988 study by the Urban Institute and Price Waterhouse concludes that "a business profits tax adds to the instability of a state's revenue structure."[29]

One alternative that has been pushed forward is a corporate gross-receipts tax, which would force businesses to pay taxes to the state not only when they generate profits, but even when they incur losses. However, such an option would be nearly as volatile as a corporate income tax, since the additional financial burden imposed on firms would accelerate business closures. Thus, not only would the state be unable to collect revenue, but the uniquely perverse distortions caused by a gross-receipts tax would generate significantly higher unemployment.

A gross-receipts tax would also impose additional perverse distortions on economic behavior. First, a gross-receipts tax is a cascading tax. Because the tax is levied at every stage of production, it penalizes the production of complex goods that require multiple stages of production. The higher tax rates that would be assessed against more complex goods would distort consumer behavior away from optimal consumption patterns by introducing artificial price discrimination.

Second, the burdensome new accounting measures that a gross-receipts tax would require firms to adopt would inflict high compliance costs on private business. These new compliance costs would disadvantage small businesses to the benefit of larger businesses. In addition, the tax would accelerate vertical mergers as firms seek to consolidate the accounting function to reduce compliance costs. The result of these compounding dynamics would be less competition within the marketplace.

These two distortions would also accompany a further option that may be considered — a net-receipts tax, otherwise known as a value-added tax or VAT. However, there is a unique element to the VAT that would exacerbate unemployment beyond what would be seen under a corporate income or a gross-receipts tax. The VAT functions similarly to the gross-receipts tax in that it is levied on transactions at every stage of production. However, as the VAT is intended to only tax the value added during a specific stage of production, it allows firms to claim deductions for purchase receipts.[*]

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[*] Revenues generated through a VAT are expected to be less volatile than those generated through a corporate income or gross-receipts tax. However, the higher stability of this revenue structure would come at the expense of uniquely high unemployment rates.

As a result, firms attempting to limit tax liability have a strong preference for substituting capital equipment for labor beyond the point which economic fundamentals would justify. (The tax introduces an artificial distortion to the marginal rate of substitution.) Hence, the VAT causes over-mechanization and the dismissal of workers — leading to higher unemployment and lower wage rates.[30]

Any of these options for a "broad-based business tax" would intensify the economic challenges currently facing Nevada. If any of them is recommended to the 2011 legislature by the current Interim Finance Committee, it will signal that the true intent of committee members is to simply increase the volume of revenue regardless of volatility, unemployment or other concerns.

Important Reform Considerations

If the goal of the Interim Finance Committee is truly to reduce volatility in the revenue structure and establish sound policy, then its members will seriously consider the recommendations outlined here. The comprehensive fiscal reforms of which Nevada is in such dire need extend significantly beyond mere issues of revenue volatility.

Excess Burden

Tax policy has a direct impact on the rate and composition of economic activity. Prohibitively high tax rates levied on a specific activity discourage individuals from participating in that activity and, therefore, create a distortion in economic behavior. To the extent that such distortions divert resources such as labor and capital away from their highest-value use, there is an opportunity cost of wealth foregone and jobs not created.

Because governments are obligated to levy taxes in order to fund their operations, some level of wealth destruction is inevitable. However, poorly designed tax policy can distort the incentive structure to the point that wealth and jobs are needlessly destroyed. The key lesson here is that by adversely impacting investment and business decisions, poorly designed tax policy can impose an additional economic burden beyond the tax itself.[31]

It is therefore incumbent upon policymakers to ensure that state tax policy is designed to minimize the necessarily perverse impact on economic behavior that taxes impose. This can be done through two primary means: (1) creating a tax structure that does not punitively target specific activities and (2) limiting the overall tax burden.

Compliance Costs

Simplicity is another essential element of good tax policy. Tax policies that are complex or difficult to understand impose additional costs beyond the amount of taxes paid. Tax complexity requires businesses and individuals to devote thousands of hours to develop an understanding of the tax code and to ensure compliance. These are man-hours that cannot be spent on productive, wealth-creating tasks. Many businesses and individuals find themselves compelled to hire specialists at great cost in order to ensure compliance with the tax code.

The Tax Foundation has estimated that the complexity of the federal income tax, for instance, will cost Americans $368 billion in lost wealth in 2010 alone, just to ensure compliance.[32] That amounts to 22.8 percent of the total revenues collected by the tax.[33] Complex arrays of deductions and tax credits, stratified systems of income brackets that assess individuals at different rates and punitive taxes on "unearned income" all add to the complexity of a tax system.

While deductions and tax credits can be beneficial to businesses and individuals who qualify for them, they are primarily instruments used by policymakers to compel behaviors that may or may not be economically efficient. Often, their true impact is to force a higher tax burden onto actors who do not engage in the "correct" behavior while providing a financial reward to those who do. Good tax policy should minimize the distortions to economic decision-making and should not be used to purposefully manipulate behavior.

Equity

Tax policies that impose disproportionate burdens on different individuals are not only economically inefficient, but discriminatory tax burdens are inherently unjust. Good tax policy should avoid both horizontally and vertically discriminate structures. This is to say: Individuals in similar circumstances should face similar tax burdens (horizontal equity) and individuals at different places along the income scale should face roughly equal proportional tax rates (vertical equity).

Regressive tax structures place the burden of government on those who can least afford it by depriving lower-income individuals of a greater percentage of their income. In extreme circumstances, the higher tax burden can displace the individual's ability to purchase necessities such as food, housing or utilities.

Taxes on consumption activities typically have a regressive impact because lower-income individuals consume a larger percentage of their income. These include general sales taxes and special excise taxes such as those on liquor and cigarettes. This is not to say that these forms of taxation should not be included within the state revenue structure, but that simple and creative provisions should offset their regressive impact.

Overly progressive tax structures discriminately penalize high-income earners. High-income earners tend to save and invest a larger percentage of their income and these savings allow for the capital formation that is essential to economic growth. Capital formation provides the liquidity for businesses to invest in new technologies that improve labor productivity, which leads to increased wages for workers. Because progressive tax instruments impede savings and investment, they stifle the potential for economic growth, and this cost is borne by individuals at all points on the income scale.[34]

Taxes on wealth or income typically have a progressive impact where income taxes use stratified income brackets that are assessed at increased rates. Progressive tax instruments also include taxes that explicitly penalize savings and investment such as capital gains taxes and taxes on dividends. Fortunately, Nevada does not employ these destructive tax instruments, while personal income taxes are prohibited by the state constitution.

The progressive tax instruments employed in Nevada are taxes on wealth. These include the "governmental services" tax assessed against the value of registered vehicles within the state, as well as property taxes that are assessed primarily at the local government level. The relative virtue of these tax instruments is that they do not parlay into the destruction of wealth that is engendered by other progressive tax instruments such as capital gains taxes that directly penalize savings and investment.

Establishing an equitable tax structure does not require that all regressive and progressive tax instruments be eliminated. Indeed, this is impossible. An equitable tax structure, however, requires that the array of tax instruments employed be calibrated to result in a net non-income discriminatory impact. This can be accomplished through adjusting the proportional importance of each instrument and through some simple yet innovative techniques that will be outlined here.

Revenue Recommendations

Objectives

The objectives for policymakers in reforming the state revenue structure thus include four components: (1) reducing revenue volatility, (2) ensuring economic efficiency by minimizing tax-induced distortions in economic behavior, (3) minimizing compliance costs through simplicity of the revenue structure, and (4) ensuring vertical and horizontal tax equity.

Review of Previous Recommendations

Over the years, Nevada policymakers have received a wealth of tax policy recommendations from multiple revenue studies. Yet, many of the useful and positive recommendations made have been routinely ignored by lawmakers, whose primary concern has nearly always been collecting additional revenue and not meaningful reform. In doing so, Nevada lawmakers have displayed a willingness to discard recommendations from their own contractors when those recommendations have stood in the way of potential revenues.

Lottery. During successive legislative sessions, Nevada lawmakers have devoted notable time to considering the creation of a state-run lottery to generate additional state revenues.[35] This has been done in direct conflict with recommendations made in 1988 by the Urban Institute and Price Waterhouse (hereafter known as the Price Waterhouse study or, simply, Price Waterhouse),[36] which say:

> Regardless of how popular state-run lotteries are becoming … the lottery fails both the equity and efficiency tests of a good tax system. Moreover, it has proven to be an unstable source of revenues over time.

> At present the state's private gaming interests have their own forms of lotteries (e.g. keno), and have the ability to create even more forms. Moreover, a state-run lottery fails every test of a "good" tax policy. In Nevada, gaming should be left to the private sector.[37]

Mining. A voter initiative is currently under way in Nevada that seeks to raise the tax burden on the mining industry by changing the industry's current net proceeds tax into a gross-receipts tax.[38] For the purposes of accomplishing the four-fold goal of revenue reform outlined above, such action should be avoided by lawmakers. As Price Waterhouse concludes:

> Mining taxes are a relatively unstable source of revenue because of the unpredictability and volatility of gold prices [Objective 1].[39]
>
> The current net proceeds tax has the least adverse effect on production decisions [Objective 2], compared to alternative tax bases such as gross yield or volume of production.[40]
>
> The Nevada net proceeds definition provides a relatively broad tax base by disallowing a number of deductions that are permitted for federal income tax purposes [Objective 3].[41]

The Price Waterhouse study makes a sensible recommendation with regard to minimizing the volatility associated with mining tax revenues:

> Because of the instability of gold prices and mining tax revenues, only revenue generated by a floor price of gold should be used for recurring or operating expenditures.[42]

Financial Institutions. Nevada currently employs a modified business tax rate of 2.0 percent of payroll against financial institutions, discriminating against that industry. Moreover, IFC Chair Steven Horsford has signaled an intent to further raise discriminatory taxes on financial institutions operating within the state.[43] Such an action would fly directly in the teeth of the Price Waterhouse recommendations:

> The principles relating to the treatment of general businesses should be applied to financial institutions. If the state does decide to adopt a general business tax, the financial sector should be broadly defined and included in the tax base. The apportionment formula should not discriminate against resident firms.[44]

Reform that Works

In order to accomplish the four goals of revenue reform, policymakers must find ways of substituting less volatile tax instruments for those that are relatively more volatile. The quantitative values determined above for the degree of volatility of each of the major tax instruments provide the information for this process.

These quantitative values reveal that, of tax instruments currently used in Nevada, the modified business tax is the most volatile. Hence, a primary objective of revenue reform should be to eliminate the modified business tax and replace the revenues generated by that instrument with a source that is less volatile.

Interestingly, the Price Waterhouse study suggests how to modify statewide sales and use taxes in a way that would improve not only revenue stability, but also horizontal equity:

> *For horizontal equity and stability:* Broaden, on a revenue neutral basis, the general sales tax base to include fully hotels and lodging, food for home consumption, prescription drugs, household fuels and other utilities (including telephone service), and services to persons (e.g. dry cleaning and beauty and barber shops).[45]

Broadening the base of the sales and use tax to include all consumption expenditures could conform with all four of the objectives for revenue reform outlined previously.

Revenue volatility. The bulk of consumption spending that would be newly incorporated into the tax base — spending on services, utilities, food for home consumption, etc. — are expenditures primarily made by in-state residents. At a value of 1.031, expected revenue volatility pertaining to this broadening of the tax base would closely mirror that of overall economic activity and be substantially lower than that of most major revenue streams currently employed in Nevada.

Minimizing economic distortions. Further, this broadening of the sales and use tax base would establish a uniform rate of taxation for all end-use transactions. The current, narrow tax base encourages individuals to substitute non-taxable consumption (such as hair care services) for taxable consumption (such as hair care products) that, all things being equal, they might otherwise prefer. Hence, a broadening of the tax base would induce fewer distortions in economic behavior than currently occur.

Minimizing compliance costs. A uniform tax rate for all end-use transactions would simplify the administration of the sales and use tax by easing the burden on vendors who are currently required to keep separate accountings for taxable and non-taxable goods. A broad and uniform tax rate would lower compliance costs substantially by allowing vendors to determine taxable income as a simple percentage of total receipts.

Ensuring tax equity. It is clear that a uniform sales and use tax would impose horizontal equity in the tax burden because vendors collecting a similar volume of total receipts would face similar tax burdens regardless of the nature of the transaction. What is less obvious is the impact that such a move would have on vertical equity. This analysis has highlighted the typically regressive impact of taxes on consumption. However, a key suggestion made by Price Waterhouse should be a starting point for establishing vertical equity within a consumption tax system:

> The state can provide a fixed or income-variable tax refund or credit for low-income taxpayers.[46]

Some observers may recognize this concept as the central component of more recent efforts at establishing a federal "fair tax."[47] The "fair tax" is designed explicitly to retain the relative benefits that a broad consumption tax would offer, in terms of the first three objectives of reform, while also mitigating the system's regressive impact.

Proposals for a federal "fair tax" would grant all individuals an automatic refund for taxes paid on an amount of presumed consumption expenditures equaling the federal poverty line. Once again, because the refund is uniform, the administration costs of such a program would be minimal. If Nevada were to institute such a program in tandem with a broadening of the sales and use tax base, policymakers would be able to realize all four objectives of reform.

Double Taxation

A broadening of the sales and use tax to encompass financial services, including insurance services, would create a unique tax burden on insurance providers who already are faced with the insurance premium tax.

Policymakers should note that the insurance premium tax fails two of the objectives of reform. The tax fails Objective 2 because it discriminately penalizes a specific activity and therefore can create distortions in economic behavior. It also fails the horizontal equity test of Objective 4 because it imposes substantially different tax burdens on firms in similar financial situations.

Hence, the most appropriate way of reconciling this double-taxation conundrum is to remove the insurance premium tax and instead apply the uniform sales and use tax to insurance services as would be done with all other services.

Establishing the rate

The Price Waterhouse study suggests that a broadening of the base of the sales and use tax in tandem with a tax refund for low-income taxpayers could be accomplished on a revenue-neutral basis at a statewide sales tax rate of 4.6 percent.[48] However, in the 20 years since that recommendation, the Silver State's economy has undergone important structural changes. In addition, a primary purpose of such a reform, according to this analysis, is to allow for the curtailment or elimination of relatively more volatile tax instruments. Hence, a determination of the appropriate tax rate must be recalculated to reflect these conditions.

Without a change from the current statewide sales tax rate of 6.5 percent,[†] a broadening of the sales and use tax base to include all end-use transactions would yield significant additional revenues. Because no reliable state-specific data source for consumption patterns is known to exist, this analysis uses total consumer expenditure data on a national level as a proxy for Nevada consumption patterns.

Applying data available from the U.S. Department of Commerce suggests that Nevada's current sales and use tax base includes only 33.19 percent of all consumer spending.[49] Therefore, absent a rate change, a broadening of the base to encompass all end-use transactions would roughly

[†] The current allocation of the statewide sales tax includes: 2 percent for the state General Fund, 2.25 percent in local school support taxes, 0.5 percent in basic city/county relief and 1.75 percent in supplemental city/county relief.

triple revenues.‡ Using actual collection data from FY09, this would have implied an additional estimated $5,401.4 million in revenues for that year.

It does not immediately follow, however, that a broadening of the tax base in this context would allow for a two-thirds reduction in the rate. Reform-minded policymakers must first account for two additional components. First, the additional cost of the proposed tax refunds must be included into the calculation. Based on 2009 data, that cost is estimated to be $1,154.7 million.[50] Second, the calculation must also include the cost of off-setting tax instruments that conflict with the four objectives of reform: namely, the modified business tax and the insurance premium tax.

Table 3 displays the projected revenues from each of these tax instruments for FY09 as released by the Nevada Economic Forum at its May 2009 meeting.[51]

Table 3: Revenue Projections from MBT and Insurance Premium Tax

Tax Instrument	*Projected GF Revenues, FY09*	*Projected Percentage of GF Revenues, FY09*
MBT (Non-Financial)	$264,203,000	9.60%
MBT (Financial)	$20,200,000	0.73%
Insurance Premium Tax	$235,395,500	8.55%
Total	*$519,798,500*	*18.88%*

Thus, the additional annual cost of the sales tax refund and the elimination of the modified business tax and insurance premium tax, based on FY09 data, is estimated to be $1,674.5 million. Therefore, a revenue-neutral tax reform would require a lowering of the statewide sales and use tax rate to offset $3,726.9 million in excess revenues.

To be clear, the sales and use tax breakdown will change substantially as a higher proportion of revenues are directed toward the state General Fund in order to off-set the elimination of the modified business tax and insurance premium tax. As the fiscal structure of revenues flowing to local governments and school districts would not be substantively impacted by this reform proposal, the rates on those taxes are simply recalibrated to reflect the same level of funding. Table 4 contains the new statewide sales tax rates and breakdown that would result from the revenue-neutral reform package outlined here.

Table 4: Recalibration of Statewide Sales and Use Tax Rates

Component	*Current Rate*§	*Reform Rate*
State General Fund	2.0%	2.03%
Local School Support Tax	2.25%	0.74%
Basic City/County Relief Tax	0.5%	0.17%
Supplemental City/County Relief Tax	1.75%	0.58%
Total Statewide Sales and Use Tax	*6.5%*	*3.52%*

‡ Although such a change in tax policy could alter consumption patterns, it would only induce more spending in the currently tax-disadvantaged sectors. Hence, while there may be a shift in the proportional importance of various sectors, total sales and use tax revenues are not anticipated to be greatly affected.

§ For fiscal years 2010 and 2011, the local school support tax rate has been temporarily raised to 2.60 percent. However, this rate is scheduled to revert to the long-term rate of 2.25 percent beginning in fiscal year 2012. This analysis accounts for the long-term rate.

Table 4 illustrates that even after considering the loss in revenue that would result from eliminating the modified business tax and insurance premium tax as well as the additional expenditure created through a universal sales tax refund for presumed expenditures equaling the federal poverty line, this reform proposal would still result in a sizable decrease in the statewide sales tax. After accounting for these changes, the additional revenue generated through a broadening of the tax base would allow for the statewide sales tax rate to decline by nearly 3 full percentage points.

In addition, the replacement of the modified business tax with sales tax revenues that are subject to a smaller short-run elasticity value would measurably temper volatility in the overall tax structure. Applying the short-run elasticity values derived for this analysis reveals that revenues generated through an expanded sales and use tax base would conservatively be 30.7 percent less volatile than the revenues they would replace.

Clearly, the proposal outlined here is a superior approach for stabilizing the state tax structure as well as for meeting the other three objectives of revenue reform than any proposal for implementing a corporate income or corporate gross-receipts tax.

Spending Recommendations

Comprehensive fiscal reform in Nevada should also complement reform of the revenue structure with fundamental reform of the spending structure. Spending reform in Nevada should be intended to further safeguard state taxpayers from the unpredictability of the state's notorious tax-and-spend cycles but should also ensure that the highest-priority goals of state government can be met in the most efficient and effective way possible. Reaching both of these demands will require the implementation of two policy tools: an alternative budgeting system and meaningful spending restraints.

Priority-Based Budgeting

The leading cause behind the regular occurrence of proclaimed "budget shortfalls" within the Silver State is the flawed process by which the state develops its spending plan. The current, cost-plus model to state budgeting presumes that, in each successive budget cycle, allocations to state agencies should only grow and never contract — regardless of how the state's needs may change.

Called "Baseline Budgeting," this process simply carries forward all expenditures from the previous budget cycle and adds in new expenses to cover the costs of inflation, caseload growth and annual across-the-board employee pay raises that regularly range as high as 8.5 percent.[52] Once these new expenditures are added to the previous cycle's appropriation, the new, higher "baseline" figure is regarded as an entitlement. If tax revenues do not grow as quickly as the "baseline" calculation, lawmakers proclaim there is a "budget shortfall" that must be bridged with higher taxes.

At no point does current state law require a review of existing programs to determine whether agencies are meeting their goals and whether those goals even remain a priority for the state. Indeed, many state programs have never even identified the goals of their existence and how success in achieving those goals would be measured — as if their continuation is justified solely by their previous existence.

Without a systematic review process, lawmakers are regularly seen blindly funding ongoing and, in some cases, unjustified programs with no plan in place as to how expenditures might be reduced when the fundamentals require it. In fact, because there is no plan, when revenue growth fails to keep pace with the growth in the "baseline" amount, lawmakers typically resort to across-the-board spending adjustments, such as occurred in the recent 26th Special Session.[53] This penalizes highly effective and high-priority programs as much as ineffective or low-priority programs.

An alternative budgeting process could eliminate the automatic drive for perpetually expanding government that is incarnate in the baseline process. At the same time, any alternative process should provide lawmakers with a defined plan to finance their highest priorities even during periods when revenue growth is negative.

The approach developed by Governor Gary Locke of Washington in 2002 provides an excellent model upon which to reform the Silver State's budgeting process. Known alternatively as the Priorities of Government approach, Budgeting for Outcomes (BFO), Outcome-Based Budgeting or Priority-Based Budgeting, this approach combines the concepts of zero-based budgeting, competitive sourcing and performance contracting to ensure that citizens get the most "bang for their buck" out of their tax dollars.[54]

The BFO process sees the Executive Branch develop "results teams" tasked with the objective of developing the most cost-effective means for accomplishing legislatively determined priorities. The results teams identify individual functions that contribute to their assigned overall goal, such as "Improving Public Health," and solicit bids from vendors who might fulfill those functions. Because the bidding process allows state agencies, local governments, public employee unions, non-profit institutions and private enterprise to bid competitively for each contract, taxpayers can be assured that government services are being delivered at the lowest cost.

The process also ensures that the quality of services will improve as each contract incorporates at least three metrics that are used to gauge performance. Failure to meet performance standards can mean loss of the contract. In this way, the BFO process ensures that state funds are used to purchase meaningful, quantifiable *results* — and not merely to fund ongoing programs.[55]

Upon receiving bid proposals, results teams rank the proposals in order of cost-effectiveness at achieving the overall goal. Hence, when the budget is presented to the legislature, lawmakers do not have to micromanage how funds will be spent; they merely determine how much will be allocated toward specific policy areas in accord with their priorities. The spending plans designed by the results teams ensure that what money is spent in each policy area will be spent in the most cost-effective way possible.[56]

Using this process, the State of Washington was able to reduce state spending by $2 billion over the baseline approach while ensuring that funds were spent much more effectively. The success of BFO in Washington has since inspired Iowa, Michigan, South Carolina and Louisiana, as well as local governments across the country, to adopt similar approaches.[57] In fact, one of the 44 recommendations recently proposed by Nevada's bi-partisan Spending and Government Efficiency (SAGE) Commission is that "A method of establishing budget funding priorities based on different levels of expected revenues [such as a BFO approach], should be adopted.[58]"

It is clear that Nevada needs to move away from the current, flawed budgeting process toward one that works for its people.

Tax and Spending Control

Beyond the failures of the budgeting process itself, a primary reason why lawmakers have faced funding challenges in the 2009-11 budget cycle is because budgeted General Fund spending has increased by more than 30 percent on an inflation-adjusted, per person basis since the 2003-05 budget cycle. Had lawmakers maintained inflation-adjusted, per person spending levels from the 2003-05 budget cycle, they would have passed a $5.3 billion budget for the current cycle instead of the $6.9 billion budget that became law.[59]

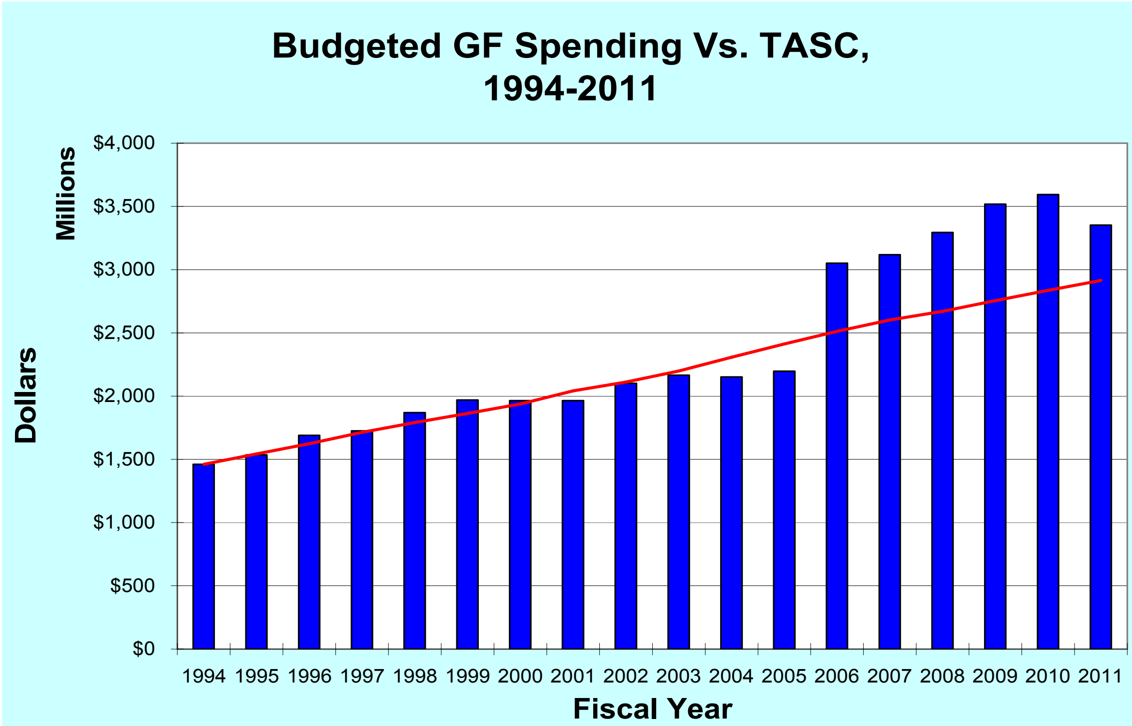
Simply put, lawmakers have tried to grow spending faster than revenues would allow and the additional spending is the root cause of present fiscal woes. Even after lawmakers made adjustments to the 2009-11 budget in the 26th Special Session to address a "shortfall" that resulted from their excess spending, lawmakers still plan to spend 25 percent more on an inflation-adjusted, per person basis than the 2003-05 budget.[60]

While tempering the volatility of revenue can help control the tax-and-spend pattern that has contributed to this rapid increase in government spending, the best restraint would result from meaningful spending controls. A provision similar in principle to the Tax and Spending Control (TASC) amendment that has been proposed for Nevada would be the most prudent means of accomplishing this.

A TASC-like provision would restrict the *growth* in government spending to the level of population growth plus inflation. The intent of such a provision is to protect taxpayers from rapidly accumulating government liabilities. It should further afford a sense of security and predictability with regard to the future tax burden they will face — thereby creating an economic environment hospitable to long-term planning and the investment which creates jobs and diversifies the economy.

TASC-like controls on spending would still allow lawmakers the flexibility to spend beyond normal restraints when voters agree. Indeed, one of the virtues of a TASC-like amendment is that such a provision would increase democratic accountability by giving voters greater control over the size and scope of government.[61]

Had TASC or a similar provision been in place in Nevada over the past decade, lawmakers would never have found themselves in their present fiscal predicament. A review of General Fund expenditures back to the mid-1990s quickly reveals that lawmakers would have largely stayed within TASC-like constraints, had they been in place, until the 2005 legislative session.



It has only been since the 2005 legislative session's spending binge that General Fund expenditures have clearly exceeded the TASC limits with regularity. Between fiscal years 2006 and 2011, lawmakers have outspent the theoretical TASC line (shown in the above chart) by a cumulative $3.64 billion.[62]

This recent trend demonstrates conclusively the need for immediate fiscal reform in Nevada and that reform should include meaningful spending restraints.

Conclusion

As lawmakers convene for the 2011 regular session, the debate over fiscal reform will be more emphatic than ever. Recommendations will likely urge the legislature to adopt a new "broad-based business tax," such as a corporate income tax.

While current Interim Finance Committee members feign concern over revenue volatility, this analysis has conclusively demonstrated through quantitative techniques that the tax ideas publicly favored by powerful members of the Interim Finance Committee would only exacerbate volatility. If lawmakers are truly concerned with reducing revenue volatility, they would take the comprehensive approach at fiscal reform that is outlined here.

Lawmakers should note that fiscal reform should include a restructuring of the revenue structure in order to achieve four primary objectives. These include: (1) reducing revenue volatility; (2) ensuring economic efficiency by minimizing tax-induced distortions in economic behavior; (3) minimizing compliance costs through simplicity of the revenue structure; and (4) ensuring vertical and horizontal tax equity.

The approach outlined here would enable lawmakers to achieve these goals by eliminating the modified business and insurance premium taxes, broadening the sales tax base, lowering the statewide sales tax rate to 3.5 percent and providing a direct tax refund to all Nevadans for presumed consumption expenditures equaling the federal poverty line.

In addition, if lawmakers are to pursue fiscal reform, it should include reform to the spending as well as the revenue side, by reforming the budget process and instituting TASC-like spending controls. Taken together, these two approaches will lead to a more stable and predictable fiscal structure for Nevada and will safeguard taxpayers from the unpredictability associated with tax-and-spend cycles.

Once upon a time, Nevada advertised itself to the rest of the country as "One Sound State." In a time of serious economic and fiscal pressures, enlightened lawmakers will position the state for a return to growth and prosperity by once again becoming One Sound State.

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Geoffrey Lawrence is a fiscal policy analyst at the Nevada Policy Research Institute and the author of *The 2009 Nevada Legislative Session Review & Report Card*, plus *Nevada's Freedom Budget 2009-2011: The Road to Recovery*

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The Nevada Policy Research Institute
3155 E. Patrick Lane
Suite 10
Las Vegas, Nevada 89120-3481

(702) 222-0642 ◆ Fax (702) 227-0927
www.npri.org ◆ office@npri.org

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