

University of Montana

ScholarWorks at University of Montana

Graduate Student Theses, Dissertations, &
Professional Papers

Graduate School

1993

Tax reform in Montana.

Mike Foster

The University of Montana

Follow this and additional works at: <https://scholarworks.umt.edu/etd>

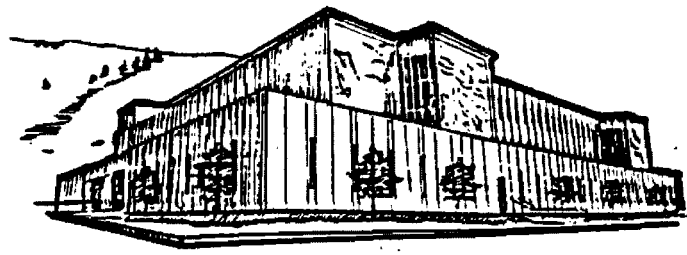
Let us know how access to this document benefits you.

Recommended Citation

Foster, Mike, "Tax reform in Montana." (1993). *Graduate Student Theses, Dissertations, & Professional Papers*. 8483.

<https://scholarworks.umt.edu/etd/8483>

This Thesis is brought to you for free and open access by the Graduate School at ScholarWorks at University of Montana. It has been accepted for inclusion in Graduate Student Theses, Dissertations, & Professional Papers by an authorized administrator of ScholarWorks at University of Montana. For more information, please contact scholarworks@mso.umt.edu.



Maureen and Mike
MANSFIELD LIBRARY

Copying allowed as provided under provisions
of the Fair Use Section of the U.S.
COPYRIGHT LAW, 1976.

Any copying for commercial purposes
or financial gain may be undertaken only
with the author's written consent.

University of
Montana

"TAX REFORM IN MONTANA"

Professional Paper

by Mike Foster

April, 1993

Presented in partial fulfillment of the requirements

for the degree of

Master of Public Administration

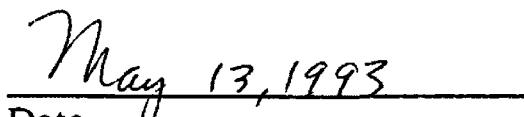
University of Montana

1993

Approved by


Chairman, Board of Examiners


Dean, Graduate School


Date

UMI Number: EP39284

All rights reserved

INFORMATION TO ALL USERS

The quality of this reproduction is dependent upon the quality of the copy submitted.

In the unlikely event that the author did not send a complete manuscript and there are missing pages, these will be noted. Also, if material had to be removed, a note will indicate the deletion.



UMI EP39284

Published by ProQuest LLC (2013). Copyright in the Dissertation held by the Author.

Microform Edition © ProQuest LLC.

All rights reserved. This work is protected against unauthorized copying under Title 17, United States Code



ProQuest LLC.
789 East Eisenhower Parkway
P.O. Box 1346
Ann Arbor, MI 48106 - 1346

21-93

"TAX REFORM IN MONTANA"

by Mike Foster

April, 1993

TABLE OF CONTENTS

		<u>Page</u>
Chapter 1	- INTRODUCTION	1
Chapter 2	- TAX POLICY	5
Chapter 3	- CRITERIA IN JUDGING A TAX SYSTEM	9
Part 1	- Adequacy and Stability of Revenue	10
Part 2	- Equity	14
Part 3	- Economic Neutrality/Efficiency	20
Part 4	- Simplicity of Compliance and Administration	23
Part 5	- Conclusion	26
Chapter 4	- TYPES OF TAXES AND COMPARISON WITH OTHER STATES	27
Part 1	- Property Tax	27
Part 2	- Individual/Personal Income Taxes	29
Part 3	- Corporation Income Taxes	36
Part 4	- General Sales Tax	42
Part 5	- Excise Taxes	44
Part 6	- Value-Added Tax	44

TABLE OF CONTENTS (Cont'd)

		<u>Page</u>
Chapter 5	- TAX REFORM IN 1993	49
Part 1	- Budget Deficit	49
Part 2	- Sales Tax and Other Options	51
Part 3	- Racicot vs. Bradley Tax Plan	52
Part 4	- 1993 Legislative Session	57
Chapter 6	- TAX REFORM AND PUBLIC ADMINISTRATION	58
Chapter 7	- CONCLUSION	69
BIBLIOGRAPHY		73

"TAX REFORM IN MONTANA"

by Mike Foster

April, 1993

LIST OF TABLES

<u>Title</u>	<u>Page</u>
State and Local Taxes in Montana as Share of Income for Family of Four, 1991	19
Personal Income Tax Collections as a Share of Total State Tax Collections, 1990	30
State Individual Income Tax Rates as of June 1991	32
Montana 1991 Taxable Income Brackets Indexed for Inflation	34
Percentage Distribution of State Tax Revenue, FY 1989 and FY 1990, Montana and U.S. Average	38
Corporation Income Tax Characteristics of Montana and Surrounding States	40

Chapter 1

INTRODUCTION

The matter to be addressed in this paper is tax reform in Montana. The major goal is to examine this widely debated issue from a theoretical, a political, and a public administration perspective. The discussion will include tax policy, criteria for judging a tax system, types of taxes, a comparison of tax systems in Montana and other states, tax reform prospects in 1993, the state's budget crisis, the Racicot vs. Bradley sales tax plans, the proper role of public administrators, and the effects of tax reform on the field of public administration in Montana.

Tax reform has been a popular topic in Montana for several years, and the question of whether or not Montana should adopt a sales tax has been hotly argued for at least 20 years. On two different occasions during that time period, the state's voters have turned down proposals to initiate a sales tax.

Of all the issues in the 1992 election, tax reform is widely regarded as the primary focus of voter decision making. In an unusual situation, the 1992 election featured two candidates for governor running on a pledge of tax reform, with both plans including a sales tax. Several legislative candidates ran on a similar platform.

The voters favored Marc Racicot for governor, a Republican who had held the position of Attorney General since 1988. He defeated veteran Democrat legislator Dorothy Bradley, an attorney from Bozeman. The 1992 election also provided a notable surprise in that the Republicans unexpectedly gained control of the Montana House of Representatives by a margin of 53-47. During the 1991 legislative session, the Democrats had held a strong majority of 61-39, but a net

change of 14 seats provided the newly elected Republican governor with a friendly majority in the House. In the Senate, interestingly, the trend was reversed as the Democrat majority moved from a margin of 28-22 to 30-20.

The make-up of the 1991 legislature caused there to be little movement in working toward any tax reform package, especially one that would include a sales tax. The Democrats who controlled both the Senate and the House in 1991 espoused a generally liberal philosophy in deciding policy, and many were plainspoken in their adamant opposition to a sales tax, regardless of its inclusion in any tax reform package. Even after the June 1992 Primary Election when the Democrats elected a governor candidate who actively supported a sales tax, many Democrat legislative leaders continued to be cynical about the chances of a sales tax passing.

With a Republican governor and a Republican majority in the House of Representatives in 1993, a dramatic shift in direction is likely to occur. However, the dynamics of the formula become fairly complicated when the Democrat-controlled Senate is considered. The Senate will have the ability to dismantle all Republican proposals, if they so desire, including tax reform. The end result could be the political gridlock that haunted the 1991 and 1992 legislative sessions due to having a Democrat legislature and a Republican governor, neither of whom would compromise their positions.

The interplay between Governor Racicot and the legislature will be critical in determining whether the end result will be success through cooperation or failure through gridlock. The fate of tax reform and a sales tax for Montana in the 1993

legislative session lies largely with the approach taken by the legislative leaders and the newly elected governor. Friendly rhetoric will soon melt away when the hard issues, such as tax reform and sales tax, surface forcing the major players to deal with the challenge of cooperation or division.

In order to construct a prudent tax reform plan, its architects must be cautious and alert in testing the proposal, including any tax relief components for income and property taxes, against generally accepted criteria for long-term tax policy. In developing, examining, and applying those criteria, attention must also be paid to tax systems and rates in other, especially nearby, states so that competitiveness in attracting and retaining businesses and individuals can be achieved.

Much of the emphasis has been on the revenue side of the equation. However, especially considering Montana's massive budget deficit estimated at exceeding \$300 million, it is expected that the levels of state government spending will also be addressed in tax reform. During his campaign for governor, Marc Racicot pledged to cut spending drastically as part of his tax reform plan in order to develop a long-term balanced budget. If no cuts are made in the budget, then alternate sources of revenue besides a sales tax must be found, and reductions in property and income taxes will become much less likely to occur.

While the elected executive and legislative officials wrestle with the politics of tax reform, the public administrators of Montana will be faced with many related decisions and problems. What effects will tax reform have on the budgeting process?

With a projected budget deficit of perhaps \$300 million, what role and approach should public administrators play in seeking appropriations? Should they be active advocates for their programs, or should they enthusiastically present areas and programs ripe for budget cuts, or should they take a neutral position? How can public administrators balance the virtues of efficiency and effectiveness in carrying out their programs under tight budgetary constraints? What role and approach should public administrators take in the process of prioritizing programs in preparation for eventual elimination of programs? Finally, what enduring effects will the policies of Governor Racicot and the 1993 legislative session have on the field of public administration in Montana?

This paper will begin by examining the issue of fair tax policy and how it relates to tax reform. The next step will be to discuss the criteria in judging a tax system in order to understand the various considerations that should be made in developing a balanced and fair tax reform plan. An explanation of the different types of taxes (property, income, sales, excise, and value-added) and a comparison of Montana's current tax system to those in other states will follow. The next section will address the political factors affecting tax reform in 1993, including the huge budget deficit and the major tax reform plans presented during the 1992 campaign. The paper's final section will address tax reform as it will likely affect public administrators and the field of public administration in Montana. The conclusion will attempt to recap the need for comprehensive and fair tax reform in Montana by emphasizing the necessity of thoughtful cooperation.

Chapter 2

TAX POLICY

Despite general consensus across political lines and among several interested groups on the need for comprehensive tax reform in Montana, actual changes in state and local tax policy have often been difficult to achieve not only in Montana, but other states as well. One of the problems, of course, in putting together a tax reform package is that the goals of each plan's architects are oftentimes quite diverse.

People and institutions advocate tax reform for a variety of admirable reasons: fairness, simplicity, funding enhancement, revenue diversification and stability, and economic development. These goals for tax reform can generate conflict between, for example, tax fairness and economic development. For instance, the tax reform plan of the Montana Association of Counties (MACO), the bill for which will be sponsored by Senator Waterman for consideration during the 1993 legislative session, was recently unveiled, and it understandably advocates using new tax revenues to increase funding for county governments.¹ In the view of MACO, their plan promotes tax fairness, but how will the Montana Chamber of Commerce, for instance, judge its effect on economic development in Montana?

¹Senator Mignon Waterman on behalf of the Montana Association of Counties, "Montana Tax Reform Act of 1993," (Helena, Montana: September 25, 1992).

The Citizens for Tax Justice fairly recently issued a report² charging that state and local tax structures around the country are regressive, and that lower- and middle-income persons pay disproportionately more in taxes than do the wealthy. The report calls for more reliance on progressive income taxes and less on consumption taxes. However, in disagreeing with the report, one might claim that most Americans prefer lower taxes and state policies that leave economic decisions in their hands. Philosophical disagreements such as these often give tax reform high marks in rhetoric but low marks in actual implementation.

As a result, tax reform is a complicated issue and difficult to achieve. A general understanding of taxation as well as an analysis and evaluation of a state's tax structure are important components in determining appropriate direction of tax reform measures. This section of the paper does not address tax reform, but rather outlines some basic principles related to state and local taxation policy and then describes the major state and local taxes levied in the United States.

Taxes can generally be defined as a compulsory contribution exacted by a government for public purposes. The basic purpose of taxation at the state and local level is to raise revenue for governmental expenditures. Indeed, taxes in general may be thought of as payments for benefits received by the public for governmental services. People would be unlikely to support a governmental program if they did

²Citizens for Tax Justice, A Far Cry from Fair: CTJ's Guide to State Tax Reform, (Washington, D.C.: Citizens for Tax Justice, April 1991).

not benefit, at least indirectly, from the program. However, to allocate the tax burden based on benefits received by any one individual would be impractical. The benefits of governmental services are usually received by groups rather than by individuals. That appears to be the primary justification for governmental activity. Society generally regards the provision of such services as schools, prisons, welfare, and national defense as desirable collective undertakings through government. In addition, tax payments, unlike user fees, do not give rise to specific services in return and do not constitute an exchange in the usual economic sense. Because public expenditures may redistribute wealth, the level and incidence of public expenditures should also be taken into account.

Administrative costs are the costs to government for levying and collecting taxes. Administrative costs will vary from tax to tax and by the complexity of the tax. For instance, an income tax is typically more costly to administer than a sales tax; a narrow-based sales tax is usually more costly than a broad-based sales tax.

Compliance costs are the costs incurred by the taxpayer both in time and money to keep the necessary records and actually pay the tax. Because of the complexity of personal income taxes, compliance costs for this tax can be high. Obviously, the cost for some taxpayers will be higher than for others depending on whether the taxpayer itemizes deductions and on whether the taxpayer uses an accountant or lawyer to prepare the return. While compliance may be costly to the taxpayer it is justified by a more equitable outcome.

Although issues such as who should bear the burden of taxation and who, in fact, does bear the burden may be of secondary concern when taxes are imposed to finance or increase government services, they are important policy considerations nonetheless. These issues may be resolved in part by the standards of equity and good government held by the dominant political organizations and individuals. The common thread underlying these issues of taxation seems to be the notion of tax fairness.

In democratic societies, there appears to be largely universal agreement that everyone should bear his or her "fair share" for the cost of government. There is, however, no general agreement on how "fair share" should be defined, except perhaps the old saying, "Don't tax me, and don't tax thee; tax the feller behind the tree."

Chapter 3

CRITERIA IN JUDGING A TAX SYSTEM

In a study aimed at evaluating all aspects of state and local taxation, the Texas Select Committee on Tax Equity identified nine criteria for judging a "good" tax system: adequacy of revenue, equity, efficiency, stability, economic competitiveness, simplicity, balance, breadth of tax base, and intergovernmental linkages.

Based on that analysis, the Texas Select Committee collapsed the criteria into four broad categories:

- 1.) **Adequacy of Revenue.** A "good" tax system should produce adequate revenue to fund governmental services in a stable and predictable manner. The tax system should make use of a wide variety of revenue sources with the widest possible bases.
- 2.) **Equity.** A "good" tax system should be fair, both to individual citizens and to businesses operating in the state.
- 3.) **Economic Efficiency.** A "good" tax system should not unnecessarily or unintentionally interfere with private economic decisions. It should be competitive with the tax systems used in other states, but it should not rely heavily on tax incentives that favor certain businesses or industries to the exclusion of others.

- 4.) **Simplicity.** A "good" tax system should be as simple as possible to administer for both the taxpayer and the tax collector.³

Perhaps a summary of these criteria would be that effective tax reform involves policies that remove exemptions or deductions or grant new ones and changes that make the tax system more balanced or more stable, easier to administer, easier to comply with, easier to understand, less regressive, more supportive of economic development, or more neutral.

For purposes of this paper, this section will briefly describe the following criteria that may be used to evaluate state and local tax systems: adequacy and stability of revenue; equity; economic efficiency (or neutrality) and tax competitiveness; and simplicity. These criteria will be discussed primarily from a conceptual perspective and may be considered in further exploration and development of technical analyses of Montana's state and local tax structure.

Part 1 - Adequacy and Stability of Revenue

According to the criteria identified by the Texas Select Committee on Tax Equity, the first requirement of a tax system is to raise the required revenue to support the activities of government. The tax system should have the capacity, allowing for normal fluctuations, to provide a stable and predictable source of revenue for a given level of governmental services without the constant need for

³Texas Select Committee on Tax Equity, Rethinking Texas Taxes: Final Report of the Select Committee on Tax Equity, Vol. 1, January, 1989, Austin, Texas, pp. 29-30.

revisions in the tax base or tax rates. The other side of the adequacy criterion is that the tax structure should not generate more revenue than is required to meet government obligations.

The revenue adequacy criterion appears to be a reasonable tax policy goal, given some accepted level of public expenditure. The appropriate level of public expenditure, however, is a judgment that is resolved through the political process, and this judgment may change over time. Depending on the dominant view of the desired level of government activity as represented in expenditure patterns, the expression of the revenue adequacy criterion may ebb and flow between the extreme ends of the political spectrum. At one extreme is the view that tax revenue should grow more slowly than the economy. This objective requires elected officials to vote on higher taxes for larger public expenditures, thus ensuring political accountability for increased taxes related to increased expenditures.⁴ Reliance on property taxes, sales taxes, and user fees are expressions of this view of revenue adequacy. The indexation of personal income taxes is another expression of this view.

At the other extreme is the view that tax revenue should grow at a faster pace than the economy, thus ensuring revenue for perceived social needs while minimizing the political risk of explicitly imposing higher taxes.⁵ A tax structure that relies

⁴John Shannon, "State Revenue Diversification - The Search for Balance," in The Quest for Balance in State-Local Revenue Structures, Ed. by Frederick D. Stocker (Cambridge, Mass.: Lincoln Institute of Land Policy, 1987) p. 20.

⁵Ibid., p. 20.

heavily on a steeply graduated progressive income tax is the preferred method of taxation for this view because a progressive tax tends to grow more rapidly than the economy.

The adequacy of tax revenue is often analyzed in terms of its responsiveness to changes in the economy, usually personal income. The traditional method of measuring the responsiveness of tax revenue relative to changes in personal income over time is the income elasticity of tax revenue. Income elasticity of tax revenue is the ratio of the percentage change in tax revenue to a corresponding percentage change in personal income between two time periods. If a tax source grows more slowly than personal income, it is "inelastic;" if it grows faster than personal income, it is "elastic." In other words, the elasticity of tax revenue is the measure of the growth in revenue relative to growth in the economy, usually in terms of personal income growth. An elastic tax tends to grow faster than personal income, while an inelastic tax tends to increase more slowly than personal income.

For a given tax rate and tax base, progressive income taxes are the most responsive to income growth. That is, personal income tax revenue tends to grow at a faster rate than personal income as individuals move into higher income tax brackets as a result of economic growth or inflation. Property tax revenue tends to grow more slowly than personal income, while sales taxes, depending on the base, may grow at about the same rate as personal income. The more responsive a tax is to changes in personal income, the less stable it is. Thus, a decline in personal

income will result in a correspondingly greater decline in tax revenue from a highly responsive tax (e.g., the personal income tax).

Another approach to evaluating the stability of a tax is to examine changes in revenue collections through economic cycles of expansion and contraction. Corporate profits, and hence corporate income taxes, are extremely sensitive to economic fluctuations. This sensitivity justifies the reluctance by state governments to rely heavily on the corporate income tax. The individual income tax is the next most sensitive to economic fluctuations, and property taxes and sales and excise taxes appear the least sensitive to economic cycles.⁶ Using the business cycle to analyze the adequacy or stability of revenue may be a more reliable method than using the income elasticity of tax revenue because it better accounts for economic reality than does simply looking at income trends. The income elasticity approach might provide misleading information about the growth in revenue from the personal income tax. Even in a recession, for instance, personal income tends to rise because of pay increases for persons who remain at work. Individuals and businesses, however, alter their economic behavior in a recession, either by choice or of necessity. A delay in the purchase of "big ticket" consumer durable goods or capital equipment is one example of that changed behavior. Such changes in behavior may have a negative effect on tax collections that may be greater than would be expected

⁶Helen F. Ladd and Dana Weist, "General Sales Tax," in State and Local Finance for the 1990's: A Case Study of Arizona, Ed. by Therese J. McGuire and Dana Wolfe Naimark (Tempe, Arizona: School of Public Affairs, Arizona State University, 1986), p. 133.

from simply analyzing changes in personal income. Conversely, in an expansion, individuals and businesses may alter their behavior to an extent that tax collections may be greater than would be expected from changes in personal income.

With respect to planning budgets and developing expenditure policies, state and local governments may want a smooth and predictable growth in tax revenues that roughly corresponds to growth in personal income or to an anticipated rate of growth in expenditure levels. A reliable revenue source or sources would also be desirable if the demand for state and local government services increases with income. The "taste" for public goods and services, however, may be more strongly related to other variables (such as population size and composition) and to distinct preferences within a state.

Part 2 - Equity

A second criterion in evaluating a "good" tax system is equity. The equity criterion involves the policy question of how tax burdens should be apportioned among individuals within the state.

There are two concepts associated with the equity criterion: the benefits received principle and the ability-to-pay principle. The benefits received principle states that those who enjoy the benefits of goods and services provided by government should bear the burden of taxation in proportion to the amount of benefits received. As the measure of equity, this principle links the expenditure and revenue sides of the budget and also links tax burdens with benefits derived from

government. The benefits received principle is a theoretical concept that has limited applicability in the formulation of general tax policy. The principle is usually invoked when identifying certain groups of taxpayers who benefit from certain governmental services but who should not be recipients of a taxpayer subsidy.⁷

The alternative concept is the ability-to-pay principle. Under this principle, the amount of taxes or level of tax burden should be related to an individual's ability to pay based on economic well-being. Taxation under the ability-to-pay principle implies both horizontal and vertical equity. Horizontal equity is rooted in the principle of equal treatment under the law.⁸ That is, persons of roughly equal economic capacity should pay approximately the same amount in taxes. The related concept of vertical equity implies that persons with greater economic capacity should pay more taxes. Vertical equity can be measured in terms of whether the tax is progressive, proportional, or regressive according to whether payments rise, are constant, or fall as a proportion of income as income rises.

Vertical equity may be analyzed in terms of the incidence or burden of a tax. Tax burden relates to the reduction in family income or purchasing power caused by paying taxes. Tax burden studies attempt to determine the distribution of taxes, both

⁷John Wicks, et al., "An Integrated Tax Structure for Montana," in Montana Taxation Task Force Papers, prepared for members of the Subcommittee on Taxation, (Helena, Montana, 1966).

⁸Richard A. Musgrave, Public Finance in a Democratic Society, Vol. 1, (New York: New York University Press, 1986), p. 261.

direct and indirect, according to income class or group. The tax burden is measured by the percentage of family or household income that is devoted to taxes. That percentage figure is referred to as the effective tax rate. Tax burden analyses employ a variety of assumptions about tax shifting and incidence, allocation of taxes by income group or class, and the appropriate household income base. Although a discussion of the models used in tax burden studies is beyond the scope of this paper, for a discussion of the historical development of tax burden and an analysis of the models used, see Who Pays State and Local Taxes by Donald Phares, published in 1980.

The final incidence of business taxes, for example, is an important consideration in tax burden studies. Businesses do not pay taxes in the economic sense; that is, business taxes are ultimately paid by individuals as indirect taxes. Business taxes may be shifted forward to consumers in the form of higher prices, or such taxes may be shifted backward to workers in the form of lower wages or to stockholders in the form of lower dividends. There is no general agreement on the direction or magnitude of tax shifting by business. Thus, the allocation of business taxes to individuals often depends on the judgment of the analyst.

Among recent studies, at least two have provided estimates of state and local tax burdens. One is a study conducted by the Tax Foundation (TF) in 1989.⁹ The

⁹Tax Foundation, Tax Burden by Income Class, 1986-1987, (Washington, D.C.: Tax Foundation, 1989).

purpose of the TF study was to provide a detailed nationwide analysis of the distributional impact of federal, state, and local taxes. The other study was conducted by the Citizens for Tax Justice (CTJ).¹⁰ The primary purpose of the CTJ study was to estimate the impact, by state, of major state and local taxes.

Both studies show that personal income taxes are the most progressive element of the state and local tax structure. The CTJ study shows that the personal income tax is progressive throughout the income spectrum, while the TF study indicates that personal income taxes tend to be proportional for income classes \$40,000-\$49,000 and above.

According to the CTJ analysis, the tax burden of the corporation income tax is generally proportional for incomes up to \$82,000 but slightly progressive after that. The CTJ study assumes that the corporate income tax is borne by owners of capital in the form of lower dividends.

The TF study, on the other hand, shows that the corporate income tax imposes a greater burden on low income families than on middle income families. The tax burden, however, tends to be progressive at the higher income levels. The TF study assumes that half the corporate income tax is shifted forward to consumers as higher prices and half to owners of capital as lower dividends. Thus, the corporation income tax is regressive for lower income families because consumption

¹⁰Citizens for Tax Justice, A Far Cry from Fair: CTJ's Guide to State Tax Reform, (Washington, D.C.: Citizens for Tax Justice, April 1991).

expenditures take a greater proportion of their family income; whereas the tax is progressive for upper income families because dividend income is more concentrated in these income groups.

As might be expected, both studies show that sales taxes and excise taxes are regressive throughout the income spectrum. The TF study shows that excise taxes impose a greater burden on families at every income level than is shown by the CTJ study.

The analyses of property tax burdens exhibit somewhat divergent trends. The CTJ study shows that property taxes are regressive throughout the entire income scale. The TF study shows that the property tax is regressive at lower income levels, proportional in the middle income range, and progressive in the upper income levels.

Each study shows slightly different results in the total tax burden of the major taxes. According to the CTJ study, the state and local tax structure is regressive throughout the income spectrum, while the TF study indicates that the tax structure is regressive until the highest income level is reached. Both studies, however, show virtually identical disparity between the tax burden borne by the lowest income class or group and by the highest income class or group.

Although the results of the two studies exhibit some similar equity patterns by type of tax, they are not strictly comparable because of differences in purpose, methodology and assumptions, data sources, and year analyzed. Some differences have already been noted.

Table: State and Local Taxes in Montana as Share of Income for Family of Four, 1991

Family Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	Next 1%
Average Income	\$8,900	\$21,300	\$31,700	\$43,300	\$66,600	\$139,600	\$708,200
Personal Income Taxes	0.4%	1.9%	2.4%	2.9%	3.5%	4.6%	5.0%
Corporate Income Taxes	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%	0.4%
Property Taxes	3.3%	3.5%	3.5%	3.5%	3.1%	2.3%	1.4%
Sales Taxes	0.4%	0.3%	0.2%	0.2%	0.2%	0.1%	0.1%
Excise Taxes	2.9%	1.6%	1.3%	1.0%	0.8%	0.5%	0.1%
Total Taxes	7.1%	7.4%	7.4%	7.6%	7.6%	7.7%	7.0%
Federal Offset Deduction	0.0%	-0.2%	-0.3%	-0.6%	-1.7%	-2.0%	-1.7%
Total After Offset	7.1%	7.2%	7.2%	7.0%	5.9%	5.7%	5.3%

Source: Replicated From Citizens for Tax Justice

The above table shows CTJ estimates of the tax burden on a family of four in Montana in 1991. The total tax burden in Montana before the federal offset deduction indicates a generally proportional state and local tax structure. A

progressive income tax and the absence of a sales tax account for much of the proportionality of Montana's tax burden. The federal offset deduction appears to make the Montana tax structure slightly regressive in the highest income quintile.

Although revenue adequacy and tax equity are separate policy issues, they are linked. Property taxes and sales taxes (typically regressive taxes) tend to grow more slowly than personal income, and tax policies that reduce the regressivity of the tax structure are likely to lead to enhanced revenue growth.

Part 3 - Economic Neutrality/Efficiency

Economic neutrality is a third criterion for evaluating a "good" tax structure. Under normal conditions, competitive markets provide an efficient allocation of scarce resources. Economic efficiency in competitive markets is distorted if taxation policies unintentionally affect business decisions on price and output, consumer decisions on consumption patterns, or individual decisions on whether or not to work.¹¹ A specific sales or excise tax has the effect of raising the price of the product taxed. As a result, consumers will tend to purchase less of the taxed item and more of an untaxed item. For example, a selective excise tax on soda pop may cause consumers to purchase less soda pop and more of untaxed beverages (e.g., tea or juice). If that happens, the tax is economically inefficient because it alters economic choices.

¹¹Final Report of the Pennsylvania Tax Commission, Richard M. Cyert, Chairman, (Pittsburgh: Carnegie-Mellon University, March 1981), p. 12.

The same analysis may be applied to a general sales tax. For example, a sales tax that exempts services favors consumers with preferences for services. As a result, there may be a shift from consumer goods to consumer services. Furthermore, spending patterns differ by family preferences within income groups so that a sales tax that exempts services imposes differential tax burdens among families with equal tax-bearing capacity¹², thus violating the principle of horizontal equity.

A personal income tax structure characterized by relatively high marginal tax rates may discourage individuals from working and encourage more leisure. Similarly, relatively high rates of taxation on the wealth of businesses may discourage capital accumulation or may encourage a business to relocate to a state where tax policies are perceived as more favorable. On the other hand, economic neutrality is enhanced if competing firms face the same effective tax rates measured against a common base.¹³

A tax structure that is competitive with other states is a criterion often considered in relation to economic neutrality. A state's tax structure is often equated with the "business climate" of the state. Proponents of economic development often compare the "pro-business" tax policies of surrounding states and use the comparison as justification for changing the state's tax policy or for obtaining a tax concession.

¹²John L. Mikesell, "General Sales Tax", in Reforming State Tax Systems, Ed. Steven D. Gold (Denver: National Conference of State Legislatures, 1986), p. 212.

¹³Robert P. Strauss, "Business Taxes," in Reforming State Tax Systems, (Denver: National Conference of State Legislatures, 1986), p. 236.

A good example in Montana is the ongoing debate over the proper level of coal severance tax in order to be competitive with Wyoming's coal industry.

Some studies analyzing the effects of business taxation have generally concluded that differences in state tax levels and tax incentives have little or no impact on a firm's location decisions. In a fairly recent report on taxation and expenditure policies in Montana,¹⁴ Beattie and Young reiterate this point by noting that until recently, most economic studies showed that state and local taxes were relatively insignificant factors in business location decisions. They point out, however, that more recent research may suggest otherwise. They describe a study by Benson and Johnson¹⁵ that focuses on the measurement of relative tax rates among states. According to this study, existing differentials in tax rates between states are not so great as to cause widespread changes in location. Changes in location would occur when tax policies in one state are significantly altered relative to other states. However, the general immobility of business property usually precludes an immediate response to such changes in tax policy.

Obviously, many factors other than tax policy affect economic activity and business location decisions. Labor costs and other factor inputs - geography, access

¹⁴Bruce R. Beattie and Douglas J. Young, Montana Taxation and Expenditure: Issues and Options, (Bozeman, Montana: Montana State University, July 1988).

¹⁵Bruce L. Benson and Ronald N. Johnson, "The Lagged Impact of State and Local Taxes on Economic Behavior," in Economic Inquiry, vol. 24, 1986, pp. 389-401. Cited in Beattie and Young, Montana Taxation and Expenditures: Issues and Options, (Bozeman, Montana: Montana State University, July 1988).

to markets, regulatory policies, "quality-of-life," and general economic conditions - may all be relatively more important than tax considerations in business location decisions. In addition, companies with a major capital commitment to a state may prefer higher taxes if those taxes enhance the infrastructure within the state and increase the level of public services.

Regardless of the evidence of whether tax policies relating to business influence business decisions, state legislatures often appear eager to grant concessions. Ideally, states should develop some procedure to measure the effectiveness of tax concessions as an economic development tool. Until there is some mechanism to do this, business tax policy may be influenced more by demagoguery and misinformation than facts empirical data.

Part 4 - Simplicity of Compliance and Administration

Few would disagree that a tax system should be easy for taxpayers to understand and for government to administer. Beyond that, simplicity is neither easily defined nor easily measured. A tax that was "simple" in the sense of being easy to determine may conflict with other tax policy goals. For example, a head tax may be the easiest tax to comply with and to administer. However, a head tax would be unrelated to a taxpayer's ability to pay and would not provide adequate revenue growth. Similarly, a gross receipts tax would be simpler to calculate and easier to administer than a net income tax, but it would conflict with the concept of horizontal equity.

Many states, including Montana, conform their personal income taxes and corporation taxes to federal income tax laws. Although federal income tax laws are extremely complex, conformity at the state level accomplishes the following: (1) makes a state tax return easier to complete; (2) requires only one set of books; (3) eliminates the need for separate determinations of factual and legal questions; and (4) reduces the costs of administration.¹⁶ Total conformity with federal taxes may further enhance simplicity but would severely limit flexibility in implementing state tax policy objectives.

There is an inherent complexity in determining taxable income for corporations that operate in more than one state. A state can only tax corporate income that is attributable to the state, and state tax administrators must be able to determine the amount of a corporation's federal income that is taxable to the state.

The property tax is probably the most difficult tax to administer and to understand and is frequently the target of taxpayer protests. There are many reasons that the property tax is perceived as unfair. Perhaps the most significant is the apparent capriciousness of assessed values. Taxpayers become upset when they discover that their property is valued higher (and the resulting tax bill is higher) than the property of their neighbors. Whether the difference is justified or not, the fact of the difference leads to an inherent mistrust of the property tax.

¹⁶Richard D. Pomp, "Simplicity and Complexity of a State Tax System," in Reforming State Tax Systems, (Denver: National Conference of State Legislatures, 1986), p. 122.

In Montana, the property tax classification system adds to the complexity, confusion, and mistrust of the tax. During the June 1989 Special Session and the 52nd Legislative Session, the Montana Legislature simplified the property tax structure by reducing from 20 to 12 the total number of property classes. Similar reductions have occurred in the past. In 1978, there were 20 different property classes; in 1983, there were 12 property classes; in 1985, sixteen; and in 1987, twenty. These vacillations cause taxpayers to speculate about the Legislature's commitment to tax fairness and simplicity.

Part 5 - Conclusion

There are many criteria that may be used to evaluate a tax system. This paper has highlighted a few of the commonly considered criteria of a "good" tax system: adequacy and stability of tax revenue; equity; economic neutrality (or efficiency) and tax competitiveness; and simplicity.

None of the desirable features of a tax system can be fully realized in any practical sense. Prayers at the altar of tax equity or the altar of tax competitiveness may often go unanswered. Their imperfect achievement can only be obtained through tradeoffs in the political system.

Among citizens and policymakers in the United States, it is probably true that tax fairness may be the most important goal for any tax system. However, the concept of tax equity involves value judgments. The diversity in state and local tax structures, including policy preferences for one particular tax over another, indicates

that no consensus has yet been agreed upon in determining the most equitable tax system. In addition, social and other policy goals figure into the development of any state and local tax structure. The question for policymakers is how to strike a balance between competing goals.

Chapter 4

TYPES OF TAXES AND COMPARISON WITH OTHER STATES

The major taxes levied by state and local governments are the property tax, the income tax, the sales tax, and to a much lesser extent selective excise taxes, including motor fuels taxes and motor vehicle license taxes. This section will examine these various types of taxes.

Part 1 - Property Tax

The property tax is an ancient form of taxation and has historically been a major source of revenue in the United States. However, with the advent of other types of taxes at the national and state levels, property taxation has become primarily a local government tax.

Property taxes are levies on tangible property including personal property and land and improvements, and to a much lesser extent on intangible property. The tax bill under the property tax is determined by multiplying the tax rate times the property's market value. Since property, especially real property, is sold infrequently, the value is usually determined by assessment or appraisal by a public official.

Property may be taxed uniformly or under a classification system. Under a uniform taxation system, all property, real and personal, is assessed at market value and is subject to the same statutory tax rate. Under a classification system, different tax rates (the amount of tax as a percentage of market value) are established for different types or "classes" of property. The classification system assigns every

taxable piece of property to a particular class of property and establishes interclass differentials.¹⁷

From an equity viewpoint, there is a question of whether the value of a particular piece of property is a good measure of the ability-to-pay. The value of a person's property may be indicative of benefits received for certain public services such as public education and public safety. On the other hand, the value of property may not reflect benefits received for other governmental services and the value of a person's property may not be closely related to income. Also the property owner may face relatively high tax burdens in relation to the level or quality of services provided.

There is a tendency for property values to be capitalized to reflect tax liability and the level of government services. Capitalization refers to the adjustment in the price of an asset that takes into account the stream of future benefits and costs associated with ownership of the asset. The market value of property may be higher in an area where there are high levels of desirable public services. People are likely willing to pay more for housing in these areas and the value of the amenities of the public services are capitalized into higher market values. Conversely, the market value of property may be lower in areas where tax liabilities are high but without offsetting high levels of public services.

¹⁷John H. Bowman, "Real Property Classification," in State and Local Finance for the 1990's: A Case Study of Arizona, Ed. by Therese J. McGuire and Dana Wolf Naimark (Tempe, Arizona: School of Public Affairs, Arizona State University), p. 426.

In 1986, the Montana electorate, apparently disgruntled with rapidly escalating property (and perhaps other) taxes and the perception of inordinately high property tax burdens, passed the ballot measure Initiative 105. That initiative provided that property taxes were to be frozen at their 1986 level until such time in the future when the Montana legislature would provide for comprehensive tax reform that would include a plan designed to reduce property tax burdens, while at the same time providing revenue levels sufficient to fund future state and local government needs.¹⁸

Part 2 - Individual/Personal Income Taxes

The personal income tax, which is largely a creature of the twentieth century, is the single largest source of state tax revenue in Montana and exists in all but seven states (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming). Because of the importance of the personal income tax to the state's revenue structure, it has often been the object of tax reform efforts. During the last three regular legislative sessions, several proposals have been introduced to revise the way personal income is taxed. These proposals have included taxing income based on a percentage of federal liability, changing the tax base to federal taxable income, revising the rate structure, and limiting the deduction for federal taxes. These proposals have been introduced to enhance tax equity, to reduce administrative and

¹⁸Larry Finch, "The Value-Added Tax: An Alternative Approach to Comprehensive Tax Reform in Montana," (Helena, Montana: Office of Research and Information, Montana Department of Revenue, September 1992), p. 1.

compliance costs, to improve the state's business climate, and, perhaps secondarily, to increase state tax revenue.¹⁹

Reliance on the personal income tax varies substantially among the states. The table below shows the percentage of personal income taxes to total state tax revenue in Montana and 12 surrounding states in 1990.

Table: Personal Income Tax Collections as a Share of Total State Tax Collections, 1990		
State	Income Tax Collections (Thousands of Dollars)	Income Tax as a Percent of Total
Arizona	\$1,063,804	24.3%
Colorado	1,341,695	43.7%
Idaho	403,461	35.4%
Minnesota	2,876,636	42.2%
Montana	279,643	32.6%
Nevada	-0-	-0-
New Mexico	360,971	17.9%
North Dakota	105,687	15.6%
Oregon	1,826,646	65.6%
South Dakota	-0-	-0-
Utah	646,830	36.6%
Washington	-0-	-0-
Wyoming	-0-	-0-
United States	96,076,243	32.0%

Source: U.S. Bureau of the Census, State Government Tax Collections: 1990, (Washington, D.C.: U.S. Government Printing Office, 1991).

¹⁹Conversation with Denis Adams, Director of the Montana Department of Revenue, September 1992.

Four of the seven states without a personal income tax are within the comparison region. Oregon clearly relies extremely heavily on personal income taxes, and Colorado and Minnesota rank next highest on the table. The reliance on personal income taxes in Montana, at 32.6 percent, is about the same as in the nation as a whole.

Total tax collections do not provide a meaningful comparison between states because of differences in population and economic capacity (as measured by personal income). Interstate tax comparisons, however, can be made by using per capita collections or by using collections relative to personal income of the state. On the basis of income tax revenue per capita and per thousand dollars of personal income in fiscal year 1990, Montana ranked sixth among the nine comparison states with an individual income tax and ranked 26th in the nation as a whole. Per capita income tax collections in Montana were 90 percent of the U.S. average.²⁰

Measuring taxes relative to personal income provides a more accurate estimate of a state's relative tax burden than do per capita levels. For example, tax collections per thousand dollars of personal income indicate the relationship between tax levels and economic activity within the state. Using this measure, Montana, a relatively low-income state, appears to devote an average share of personal income to personal income taxes.

²⁰U.S. Bureau of the Census, State Government Tax Collections: 1990, (Washington D.C.: U.S. Government Printing Office, August 1991), p. 44.

The table below compares tax rates and taxable income bracket amounts for those states within the comparison region that impose a personal income tax. The table shows considerable variability in tax rates and bracket amounts. North Dakota and Montana have the highest top marginal tax rate of any state in the region at 12 percent and 11 percent respectively. The lowest bracket amount ranges from \$1,000 in Idaho to \$20,000 in Arizona, while the highest bracket amount ranges from \$5,000 in Oregon to \$300,000 in Arizona. Montana appears to be on the low end of these scales. The number of income tax brackets also varies considerably among the states.

The table also shows whether federal income taxes are deductible. Montana and North Dakota are the only states in the region that allow full deductibility of federal income taxes. Oregon and Utah limit the deduction.

Table: State Individual Income Tax Rates as of June 1991						
	Lowest Bracket Rate	To Taxable Income of	Highest Bracket Rate	To Taxable Income of	Number of Brackets	Federal Inc. Tax Deduct.
Arizona	3.8%	\$20,000	7%	\$300,000	5	No
Colorado	5% of federal taxable income				NA	No
Idaho	2%	1,000	8.2%	20,000	8	No
Minnesota	6%	19,910	8.5%	79,120	3	No
Montana	2%	1,600	11%	57,600	10	Yes
New Mexico	1.8%	5,200	8.5%	41,600	7	No
North Dakota	2.67%	3,000	12%	50,000	8	Yes
Oregon	5%	2,000	9%	5,000	3	Limited
Utah	2.55%	1,500	7.2%	7,500	6	Limited

Source: Montana Department of Revenue

The above table is presented for illustrative purposes only. By itself, the information contained in the table has limited value for making interstate tax comparisons because of differences in such factors as the tax base, allowable deductions, the level of personal exemption deductions or credits, and the filing status of the taxpayer. However, there is certainly some value in observing the differences in tax systems.

Under a graduated progressive income tax structure, inflation causes unlegislated increases in the real burden of the income tax (commonly referred to as "bracket creep"). One way to alleviate bracket creep is to index the taxable income bracket amounts to inflation.

In November, 1980, Montana voters approved an initiative to index personal income taxes to inflation. Under the initiative, an inflation factor is applied to the income tax brackets, personal exemptions, the standard deduction, and the minimum filing requirements. The inflation factor is determined for each tax year by dividing the Consumer Price Index for June 1980 by the Consumer Price Index for June of the tax year.

The table below shows taxable income for each income tax bracket in nominal and inflation-adjusted amounts for tax year 1991. Under indexing, the lowest marginal tax rate (2 percent) is applied to taxable income between \$0 and \$1,600, while the highest marginal tax rate (11 percent) is applied to taxable income in excess of \$57,600.

Since 1980, the maximum amount in each bracket has increased by more than 60 percent. As a result, individuals face lower marginal tax rates than they otherwise would without indexing. For example, an individual with taxable income of \$23,000 without indexing would face a 10 percent marginal tax rate; with indexing, the marginal tax rate is 8 percent.

Table: Montana 1991 Taxable Income Brackets Indexed for Inflation		
Nominal Taxable Income (\$)	1991 Indexed Taxable Income (\$)	Income Tax Rates
0-1,000	0-1,600	2%
1,001-2,000	1,601-3,300	3%
2,001-4,000	3,301-6,600	4%
4,001-6,000	6,601-9,900	5%
6,001-8,000	9,901-13,200	6%
8,001-10,000	13,201-16,400	7%
10,001-14,000	16,401-23,000	8%
14,001-20,000	23,001-32,900	9%
20,001-35,000	32,901-57,600	10%
35,001 +	57,601 +	11%

Source: Montana Department of Revenue

Montana's personal income tax structure is similar to that of many states in the computation of taxable income. While the state's income tax structure was somewhat regressive in higher income brackets prior to federal tax reform in the 1980's, it now appears to be fairly progressive throughout the income scale. On the average, state income tax collections have grown at a faster rate than personal

income, although indexing has reduced the disparity. Even though Montana has one of the highest top marginal tax rates in the nation, personal income taxes do not appear to take a disproportionate share of personal income when compared to the rest of the nation.

The use of personal exemptions and increasing marginal tax rates tend to make the income tax progressive. Marginal tax rates, however, do not necessarily indicate the degree of progressivity of the tax. So-called tax loopholes can offset the progressivity implied in marginal tax rates. Conversely, progressivity in the income tax structure can be maintained with personal exemptions and a single tax rate. One way to determine the progressivity of the income tax is to examine effective tax rates, or tax liabilities as a percentage of adjusted gross income.

Changes to the existing personal income tax structure could be accomplished in a variety of ways, from tinkering with the existing structure to a major overhaul. Repeal of or limits to indexing and federal deductibility and revisions to the tax rates are examples of tinkering with the existing system. A tax structure based on federal taxable income or based on federal tax liability is an example of a major overhaul. In changing the existing structure, decisionmakers will have to choose among a variety of priorities, including the revenue needs of the state, the distributional effects of the tax, the economic impacts, and simplicity.

Part 3 - Corporation Income Taxes

Montana is 1 of 44 states and the District of Columbia that taxes the net income of corporations. Michigan, Nevada, South Dakota, Texas, Washington, and Wyoming do not tax corporations on the basis of net income. Taxes on corporate net income differ significantly among the states in terms of tax rates, methods of apportionment, and definitions of the taxable unit and taxable income. In general, net income is determined by subtracting external purchases and internal costs from gross receipts.²¹ This section reviews the rationale for taxing corporate net income, analyzes the Montana corporation income tax structure, describes the level of corporate income tax collections, and compares the Montana tax structure with that of other states.

There are two major rationales for taxing the net income of corporations. The first is to protect the individual income tax base by including certain corporate source income, such as retained earnings, in the corporation tax base. If corporate income were not taxed, shareholders could hide income within the corporation. The corporate income tax is, however, an imperfect means of getting at this source of income. The tax on retained earnings could cause vertical inequities among shareholders because the rate structure faced by the corporation may be unrelated to the circumstances of the potential taxpayer. Horizontal inequities arise because

²¹Robert P. Strauss, "Business Taxes" in Reforming State Tax Systems, Ed. Steven D. Gold (Denver: National Conference of State Legislatures, 1986), p. 233.

corporate source income is taxed differently than other sources of income. In addition, shareholders would be subject to double taxation when dividends are paid. Finally, if the corporation tax is not paid by shareholders but is shifted to workers (through lower wages) or consumers (through higher prices), both horizontal and vertical inequities may arise.

The second rationale for taxation of corporations is the benefits-received principle. Corporations receive many services from state and local governments. Net income, however, is perhaps a poor measure of the value of services provided. Obviously, corporations with no net income are not taxed (or taxed minimally) for services. To the extent that a benefit tax is appropriate for corporations, other tax bases may better reflect the value of services received. For example, real and personal property would reflect the value of such services as police and fire protection and improvements to infrastructure. Other taxes, such as a value-added tax or a gross receipts tax, may be better proxies for benefits received. Under value-added taxes or gross receipts taxes, businesses, whether profitable or unprofitable, would be required to pay for services.²²

Montana first levied a tax on the earnings of corporations in 1917, and the current rate is 6.75 percent of net income. Corporate profits, and hence corporate income taxes, are very sensitive to economic fluctuations. Between 1982 and 1990,

²² Minnesota Tax Study Commission, Final Report of the Minnesota Tax Study Commission: Findings and Recommendations, Vol. 1 (St. Paul: Butterworth Legal Publishers, 1986), pp. 199-200.

corporation income tax collections exhibited the volatility normally associated with this tax. The back-to-back economic recessions of 1980 and 1982, the ups and downs of the natural resource industries, and changes in federal corporate income tax law all have contributed to the swings in Montana corporation income tax collections.

The table below compares the percentage distribution of corporation income taxes with other taxes levied by the state and with the United States as a whole. Corporation income taxes account for less than 10 percent of total tax collections both in Montana and in the nation as a whole. In 1989, corporation taxes were slightly less significant in Montana than in the United States, and in 1990, the reverse was true.

Table: Percentage Distribution of State Tax Revenue, FY 1989 and FY 1990, Montana and U.S. Average				
	<u>Montana</u>		<u>U.S. Average</u>	
	1989	1990	1989	1990
Individual Income Tax	36.5%	32.6%	31.2%	32.0%
Corporate Income Tax	7.7%	9.4%	8.4%	7.2%
Sales Taxes	24.6%	21.3%	48.7%	48.9%
General Sales	-0-	-0-	32.9%	33.2%
Selective Sales	24.6%	21.3%	15.8%	15.8%
License Taxes	11.0%	10.7%	6.2%	6.3%
Severance Taxes	11.7%	11.2%	1.5%	1.6%
Other Taxes	8.5%	14.8%	4.0%	4.0%

Source: Montana Department of Revenue and U.S. Bureau of the Census, State Government Tax Collections, 1989 and 1990.

It is not unusual for state corporate income taxes to be paid by multistate firms. In Montana, the percentage of corporate income taxes paid by multistate firms varies from year to year. Typically, 100 corporations pay about 50 percent of the corporation income tax in Montana. Of those corporations, 70 to 80 percent are multistate firms.²³

The table below compares the corporate income tax rates and the relative share of corporation income taxes for Montana and eight surrounding states. As the table shows, six of the comparison states (including Montana) impose a flat tax rate on corporate income, while Colorado, New Mexico, and North Dakota have graduated structures. In 1990, the corporation income tax contributed 9.4 percent of total state tax revenue collections in Montana. As the table shows, Montana relied more heavily on the corporation income tax than did any of the comparison states in 1990.

²³ Montana Department of Revenue.

Table: Corporation Income Tax Characteristics of Montana and Surrounding States				
	Range of Rates	Minimum Taxable Income for Top Bracket	FY 90 Percent of Total Tax Revenue	FY 90 Percent of Personal Income
Arizona	9.3%	All	4.1%	0.32%
Colorado	5.0-5.5% (2)	\$50,001	4.2%	0.21%
Idaho	8.0%	All	6.4%	0.51%
Minnesota	9.8%	All	7.1%	0.62%
Montana	6.75%	All	9.4%	0.71%
New Mexico	4.8-7.6% (3)	\$1,000,001 +	3.1%	0.31%
North Dakota	3.0-10.5% (6)	\$50,001 +	6.9%	0.52%
Oregon	6.6%	All	5.3%	0.33%
Utah	5.0%	All	5.3%	0.42%

Source: Montana Department of Revenue

Although Montana appears to be somewhat more reliant on the corporation income tax as a source of tax revenue, interstate differences in the corporate income tax base, tax rates, credits, and the inherent instability of corporation income tax collections account for some of the major differences shown in the above tables. However, the information presented indicates that corporation income taxes in Montana appear to be fairly stable.

The corporation net income tax is a relatively minor component of Montana's tax revenue structure. However, the imposition of the tax protects the personal income tax base by including income that would otherwise escape taxation. The

corporation income tax appears to be relatively more important in Montana than in other states, and it takes a slightly higher share of state personal income than it does in the nation as a whole. Finally, the data shown indicates that the statutory tax rate appears comparable to other states.

It is difficult to evaluate the equity of the corporation income tax because the final incidence of the tax is not known. Regardless of who pays the tax, whether shareholders, workers, or consumers, vertical and horizontal inequities may arise. The tax is also justified on the benefits-received principle, but net income is a poor measure of benefit taxes.

The corporation income tax is a convenient revenue-raising source, but it is inherently unstable because of the cyclical nature of the tax. The instability of the tax is compounded by net operating loss carrybacks and carryforwards. Because of these factors, it is difficult to accurately forecast tax revenue from this particular source.

Despite its weaknesses, the corporation income tax is a familiar and generally accepted form of taxation. Changes to the existing corporation income tax structure, however, could be accomplished in a variety of ways. A graduated rate schedule, for example, could be imposed. Depending on its structure, a graduated system could increase revenue, but it could exacerbate the inherent inequities of the tax. The imposition of an alternative minimum tax or the elimination of carryover provisions for net operating losses could reduce some of the revenue instability.

A more radical alternative would be to eliminate the current structure and adopt a new method of taxation, such as a value-added tax. There are several advantages to a value-added tax. First, the tax would be imposed on all business activity regardless of the legal form of organization (sole proprietorship, partnership, or corporation). As such, the imposition of a value-added tax would reflect more closely the concept of a benefits tax. Because the tax base is so much broader under a value-added tax, the tax rate may be much lower than under a net income tax. As a tax on business activity rather than on profits, the value-added tax is a relatively stable revenue source. A significant disadvantage of the tax is that it does not resolve the vertical and horizontal equity problems inherent in the corporation net income tax. Also, its applicability in a state that is only somewhat industrialized, such as Montana, is somewhat questionable considering that the only state with a value-added tax is Michigan, a highly industrialized state that can export the tax largely through car sales across the nation and around the world.

Part 4 - General Sales Taxes

Sales taxes are of more recent vintage than income taxes. Mississippi first imposed the tax in 1932, followed by 26 states between 1933 and 1938. Declining revenues from other sources, particularly the income tax, rising costs for relief programs, and participation in federal programs during the depression led many states to adopt the sales tax in the 1930's. Forty-five states and the District of Columbia now impose general sales taxes. Five states, Alaska, Delaware, New

Hampshire, Montana, and Oregon do not have a general sales tax. In 1989, general sales taxes accounted for 24 percent of all state and local tax revenue and for 33 percent of all state government tax revenue.²⁴

General sales taxes are taxes on consumer purchases but usually include business purchases as well. In most states, sales taxes may be typified as general sales taxes on tangible personal property and selective excise taxes on service transactions. In an attempt to reduce the regressive features of sales taxes, many states have narrowed the tax base by exempting such items as food, prescription drugs, utilities, goods subject to excise taxes, and other items that are politically attractive to exempt from the tax. The base narrowing, however, has generally led to higher statutory rates and increased administrative and compliance costs. Exemptions tend to favor consumers with heavy expenditures in these transactions. For example, the exclusion of services from the tax base discriminates against consumer preferences for goods.²⁵

The question of whether or not Montana should adopt a general sales tax has been a matter of hot political debate since at least the 1960's. Once again, the issue will come to the forefront during the 1993 legislative session as Montana's newly elected governor, Marc Racicot, is expected to present a tax reform package that will

²⁴John F. Due and John L. Mikesell, Sales Taxation: State and Local Structure and Administration (Baltimore: Johns Hopkins University Press, 1983), p. 2.

²⁵John L. Mikesell, "General Sales Tax", in Reforming State Tax Systems, (Denver: National Conference of State Legislatures, 1986), p. 226.

include a 4 percent general sales tax. This will be discussed more extensively later in this paper.

Part 5 - Excise Taxes

Selective excise taxes are levies on the sale of particular goods or services apart from a general sales tax. With the exception of motor fuels taxes, they are typically minor components of a state's revenue structure. At the state level, selective excise taxes generally include user charges and consumption taxes. Motor vehicle taxes and gasoline taxes are the most common examples of a charge for the use of goods and services provided by government. These taxes are correlated with the use of roads and embody the benefits received principle. Consumption taxes (often called "sin taxes") are levied on goods that society regards as perhaps somewhat undesirable, such as cigarette and alcohol taxes. An additional rationale for consumption taxes is that they internalize the costs to society that may occur as a result of using the product.

Excise taxes tend to be regressive and are often thought to be unfair on the ability-to-pay criterion. If excise taxes are a source of general fund revenue, they may be inequitable. However, they may not be unfair if they are levied as user charges, as is the case for most motor fuels taxes.

Part 6 - Value-Added Tax

A value-added tax (VAT) is a single, flat-rate tax that is applied to all business activity within a taxing jurisdiction, regardless of whether the form of ownership is

a corporation, partnership, or sole proprietorship. All forms of business are taxed on the basis of the value they add to the economy. Because the tax applies to all business activity, the tax base is very large, relative to other forms of taxation, which allows for a relatively low tax rate. In fact, one type of value-added tax has the same theoretical tax base as the general retail sales tax.

Generally, value-added taxation has been used only at the national level, most notably in Europe and Mexico. Currently, Michigan is the only state that has adopted a value-added tax, but this tax either has been or is being considered by several other states.

For an individual firm, value added can be thought of as the difference between what the firm receives in revenue when it sells its product(s) and what it costs that firm to purchase the materials (or goods and services) that went into producing that product. This difference is the "value added" by the production process. In accounting terms, value added can be described as follows: Value Added = Revenue - Total Cost of Materials. Under the value-added tax concept, each individual firm would compute its value added as its tax base and apply the tax rate to that value to determine tax liability.²⁶

In practice, every seller in the commercial chain collects the tax from the buyer and remits it to the state. The buyer then collects the tax on subsequent sales and

²⁶ Larry Finch, "The Value-Added Tax: An Alternative Approach to Comprehensive Tax Reform in Montana" (Helena, Montana: Office of Research and Information, Montana Department of Revenue, September 1992), p. 3.

is allowed a credit for the taxes paid to the previous seller. The ultimate consumer is not entitled to a credit and, in theory, bears the entire tax burden (incidence).

For example, if a consumer finds a screwdriver in a hardware store with the shelf price marked at \$5.00, then that is the amount required to purchase the tool. The total VAT amount from all levels of production will already be included in the shelf sale price of the item.

Alternatively, if a sales tax is in place rather than a VAT, the customer would purchase the same screwdriver for a shelf price theoretically lower than the shelf price under a VAT system. The sales tax would then be applied at the counter so that the total price paid by the customer would equal \$5.00, the same overall price as under a VAT. (Interestingly, since Michigan also has a general sales tax along with a VAT, the ultimate purchase price would be \$5.00 plus an additional sales tax amount.)

There are various methods of calculating the VAT tax base, but this paper will not explore their complexities. The important feature is that all methods result in the same tax base. There are also many combinations allowing for several different types of VAT, but this paper will only discuss the end result of applying a common approach of this sort of taxation with administrative ease.

The amount of revenue that a VAT would raise in Montana depends on several factors, including the type of VAT implemented, the tax rate, and any special exemptions, credits, or other provisions that act to reduce the base. Estimates of the

revenue generating potential from a VAT are calculated by examining the state-level theoretical tax base associated with a VAT.

In 1990, revenue from a 4% VAT would have generated about \$379 million in Montana before any consideration of practical or political reductions in the tax base. This represents estimated revenue as measured under the broadest possible consumption type VAT. Clearly, revenue would be less than this amount in the wake of administrative and political considerations that in all likelihood would act to reduce the tax base. This estimated revenue amount is very close to recent estimates of revenue that would be generated under a general retail sales tax. Sales tax revenue in Montana under the broadest of all possible sales tax bases has been estimated at \$377 for tax year 1990, which is quite comparable to the VAT estimate above.²⁷

An alternative method to gauge the revenue potential from a value-added tax is to compare the size of Montana's economy with that of Michigan and relate that comparison to revenue generated under Michigan's VAT. This approach indicates a Michigan-type VAT would have generated about \$126 million in Montana in 1990, using the Michigan tax rate of 2.35%. Based on the Michigan experience, a 4 percent VAT would have raised for Montana between \$292 million and \$356 million in 1990 (using both a narrow and broad tax base).²⁸

²⁷ Ibid., pp.12-13.

²⁸ Ibid., pp. 13-14.

The above estimates provide a rough approximation of the revenue potential from a Montana VAT. The approach is necessarily simplistic due to the absence of the data necessary to conduct a more sophisticated analysis. Nevertheless, the above estimates indicate that the VAT has the potential to rival Montana's currently largest source of revenue, the individual income tax, and Montana's potentially new source of revenue, the general sales tax, in revenue generation.

Of fundamental concern to policymakers is the impact of tax changes on various sectors of the economy. An examination of the possible impact a VAT would have on Montana's 50 largest corporate taxpayers shows that, at a 4 percent rate, a VAT would have generated over twice the revenue generated under current law over the period 1988-1990. In 1988, the Montana corporate income tax rate of 6.75 percent generated about \$22 million compared to a calculated VAT revenue generation of about \$54 million. Similar figures for 1989 are \$25 million compared to \$53 million, and 1990 figures show \$22 million versus \$49 million from a VAT.

The revenue-neutral VAT tax rate for these corporations would have been about 1.77 percent over the three year period. In other words, to insure that the top 50 corporations would pay no additional tax as a group under the VAT, the rate for all businesses could be no higher than 1.77 percent. This would reduce revenue from a broad-based VAT from around \$356 million, as discussed above, to about \$158 million.²⁹ In this perspective, some of the trade-offs become apparent.

²⁹ Ibid., pp. 15-16.

Chapter 5

TAX REFORM IN 1993

Comprehensive tax reform has been a major issue facing the state of Montana for at least the past six years (since the passage of I-105 in 1986 freezing property taxes) and probably for the past two or three decades. The apparent need for comprehensive tax reform seems to stem from three different sources: a mandate from the electorate, a deteriorating fiscal system, and a perceived poor business climate.

The state's current tax structure is often cited as one of the principal reasons why the state consistently receives low marks in studies and surveys ranking state business climates. Montana is often ranked among the worst states in this regard. Particularly troublesome to analysts of state business climates is Montana's absence of a general retail sales tax, the relatively high tax rates on business personal property, and the relatively high top marginal personal income tax rate.

Part 1 - Budget Deficit

The state legislature has been struggling to find an appropriate means of funding an ever growing structural budget deficit. In six of the past nine years, state general fund and school equalization account revenues have failed to keep pace with spending, notwithstanding several across-the-board spending reductions initiated by

current and past administrations and legislatures.³⁰ Revenue shortages forced two special legislative sessions to be held in 1992 alone. Recent estimates have placed the state's structural deficit as high as \$200-\$350 million by July 1, 1995.³¹

In fact, on November 20, 1992, in his report to the Legislative Revenue Oversight Committee, Terry Johnson, Principal Fiscal Analyst in the Office of the Legislative Fiscal Analyst, stated that the projected state budget deficit on January 1, 1993, would be approximately \$200 million. In calculating that level of deficit, Mr. Johnson included no increases in funding for any state programs. In other words, if the 1993 legislature desires simply to maintain government services at their current level, existing taxes must be increased substantially or a new and sizeable source of revenue must be found immediately. Otherwise, drastic cuts or a combination of cuts and revenue increases must be implemented.

Obviously, the deficit problem is a serious one that will not simply disappear with the addition of retired newcomers in the Flathead, Gallatin, and Bitterroot Valleys. To address recent budget crises, the legislature has been wont to apply "band-aids" to supply one-time cash infusions and accounting gimmicks to reduce the hemorrhaging in the short term. As Representative Bob Gilbert of Sidney said

³⁰ Office of the Legislative Fiscal Analyst, "The Montana Historical Revenue and Expenditure Report, Fiscal Years 1979 through 1991," (Helena, Montana: Office of the Legislative Fiscal Analyst, June 1992).

³¹ Office of the Legislative Fiscal Analyst, "Appropriations Report, 1993 Biennium, July 1992 Special Session," (Helena, Montana: Office of the Legislative Fiscal Analyst, July 1992).

during the second special legislative session of 1992, "Folks, the band-aid box is empty, and the wounds haven't stopped bleeding yet; in fact, they continue to get worse. It's time for the Montana Legislature to take a hard look at our state's budget and address tax reform in a responsible manner."

Part 2 - Sales Tax and Other Options

All of the past and current proposals for comprehensive tax reform that have received serious attention by the legislature attempt to rectify Montana's fiscal dilemma through a combination of property tax and income tax relief, funded through the enactment of a general retail sales tax. Proposals of this nature have been discussed extensively since the 1987 legislative session. Indeed, in the 1992 election year, both the Republican and Democrat gubernatorial candidates endorsed a general sales tax as a means by which to provide comprehensive tax reform and additional revenue to fund state and local governments.

Invariably, however, reform proposals that rely on a general sales tax include provisions requiring final approval of the tax through the referendum process. Historically, proposals for a general sales tax that have been voted on by the electorate have met with failure in Montana. While there is speculation that a majority of voters now recognize the need for a general sales tax in Montana, particularly evidenced by the voters' selections in the race for Governor in the June 1992 Primary election, there remains the strong possibility that such a referendum would not be approved.

There has been little in the way of alternative proposals for comprehensive tax reform in the absence of a general sales tax. Politically, it is unlikely that existing taxes could be raised enough to fund the structural deficit, especially considering that one of the major purposes of the current plans for comprehensive tax reform is to provide relief in existing income and property taxes. In addition, the ongoing depressed economic climate in the natural resources industries makes it unlikely that taxes could be raised significantly in that sector.

The only alternative to sales tax drawing much interest from legislators is the value-added tax (VAT), discussed fairly extensively above. The only state using a VAT is Michigan, which also has a sales tax. In many ways, a VAT is quite similar to a sales tax, but it is being viewed in some political circles as preferable to a sales tax merely because it has a different name. Since consumers in theory ultimately pay the VAT when purchasing a product, as is also the case with a sales tax, the VAT carries the baggage of potentially being a highly regressive tax, particularly harmful to low-income individuals. If a VAT were instituted in Montana as part of a tax reform plan, the type and level of accompanying tax relief afforded to property and income tax would likely be different than a tax reform plan with a sales tax. However, until a specific proposal surfaces, those details will remain unknowns.

Part 3 - Racicot vs. Bradley Tax Plan

The dynamics in the race for the office of Governor in Montana in 1992 were both unusual and fascinating. On the Democrat side, a veteran legislator from

Bozeman, Dorothy Bradley came out early and immediately embraced tax reform with the center piece of her plan being the implementation of a 4 percent general sales tax. Ms. Bradley faced much criticism from her two more "traditional" Democrat opponents in the Primary battle, who both predictably opposed the sales tax altogether, and from some interest groups generally recognized as Democrat loyalists (e.g., AFL-CIO). Despite quite vocal challenges within her own political party in opposition to a sales tax, Ms. Bradley won the June Primary election and used the momentum of her impressive victory to bring her former adversaries in the Democrat Party into her camp. Ms. Bradley, along with her tax reform plan containing a sales tax, were catapulted into a favored position to win the November election.

On the Republican side, the expected suddenly became the unexpected when Governor Stan Stephens suffered a physical ailment soon after the end of the first special legislative session in January 1992 that caused him to back out of his race for re-election. Stepping forward was Attorney General Marc Racicot who quickly put together a campaign team and easily won the Primary election in June. Although his victory in June was by a sizeable margin, the lack of time in preparing specific proposals for public analysis put him in the position as the underdog in the fall.

Eventually, Mr. Racicot put forward his tax reform plan, which also included a 4 percent sales tax, and touted it as the centerpiece of his platform. The stage was then set for the public to decide which candidate, Bradley or Racicot, presented a

tax reform plan most closely aligned with individuals' views of taxation and the role of government in their lives. In the end, Racicot rallied and won the race by a small margin. A brief look at their tax reform plans is worthwhile before examining the 1993 legislative session.

As mentioned above, both plans featured a 4 percent general sales tax as a way to diversify the tax base and to provide a "level playing field" for all taxpayers. Their position was that a sales tax will clear the way for Montana to reduce income and property (including business equipment) taxes to levels more competitive with other states. They theorized that the changes would greatly aid in repairing the state's economy by creating a friendlier environment for business, resulting in job growth. Also, both candidates saw a sales tax as a way for the government to capture some money from tourists and part-time residents for services they currently get for free, such as police protection.

The amount of revenue raised from the sales tax was similar for both plans. Bradley projected collections of about \$340 million in the first year, and Racicot estimated his sales tax would net about \$325 million. Both plans called for a mandatory vote of the public on whether or not to adopt a sales tax, following approval of a specific proposal by the legislature. Racicot favored a special election in February 1993 while the legislature is in session or, alternately, in June 1993, with the tax going into effect eight or nine months later. Bradley targeted a special election in June 1993 with the sales tax going into effect on July 1, 1994. Her ballot

proposal would also include a non-sales tax option (higher income and property taxes). Racicot supported a constitutional cap on the sales tax rate level. Both plans exempted such items as food, medical services, prescription drugs, and agricultural products.³²

The big differences in the plans centered around what would be done with the money from the sales tax. Both advocated using some of the pot to reduce income and property taxes. Racicot's plan included total tax relief of \$202 million, while Bradley's plan allowed a lower level of tax relief at \$138 million, a difference in total tax relief of \$64 million.

In income tax relief, Bradley proposed a \$19 million annual reduction by making state income tax an unspecified flat percentage of the federal tax and by eliminating the tax for families with an annual income of less than \$13,000. Racicot, on the other hand, offered \$53 million of annual income tax relief by replacing current income tax rates with a progressive 6 percent flat tax based on a taxpayer's federal adjusted gross income.

For property tax, Racicot's plan provided \$109 million relief a year on homes (\$60 million) and business equipment (\$49 million). Homeowners would be allowed to deduct the first \$20,000 of market value of their homes on their property taxes. For business equipment, he advocated dropping the property tax rate from 9 percent

³² Tribune Staff, "Racicot, Bradley Tax Plans," (Great Falls, Montana: Great Falls Tribune, October 18, 1992), p. 1B.

to 4.5 percent (\$36 million savings) and completely eliminating the tax on furniture and fixtures (\$13 million in annual relief).³³

Bradley's plan, which provided \$87 million in annual property tax relief, was similar in approach but differed in degree. She would allow homeowners to deduct the first \$15,000 of home market value on property taxes, resulting in annual savings of \$50 million. The business equipment tax rate would be reduced from the current level of 9 percent to 6 percent, saving \$24 million per year. The tax on furniture and fixtures would also be eliminated, saving \$13 million annually.

Concerning deficit reduction or elimination, Racicot's plan allocated \$77 million per year to reduce the projected budget shortfall, while Bradley proposed \$100 million for that purpose. In rebates, Bradley proposed \$32 million for low-income people, while Racicot targeted \$40 million to low-income people, renters, and retirees. Racicot agreed that cities and counties should have the authority to ask their voters for a 1 percent local sales tax (beyond the 4 percent state sales tax), but Bradley included no provision in her plan for a local option sales tax.

One of the major differences between the two plans, which no doubt was an important factor in voters' minds, was in the area of new spending. Racicot proposed no new spending, and, in fact advocated \$40 million per year in state budget cutbacks, but did intend to set aside \$45 million in sales tax proceeds to create a reserve fund to help the state deal with future shortfalls. Bradley supported

³³ *Ibid.*, p. 1.

\$102 million in new state expenditures on existing programs in education, human services, and parks.³⁴

Part 4 - 1993 Legislative Session

Now the stage is set for the 1993 Montana Legislature to address comprehensive tax reform. Republican Marc Racicot will be sitting in the Governor's seat, and his tax reform plan will surely be placed before the lawmakers for their consideration. Governor Racicot's plan will presumably have a friendly welcome in the Republican-controlled House of Representatives, but the Senate, controlled by Democrats by a wide margin, could be a much different situation.

Democrats in Montana have traditionally opposed a sales tax, largely because of the negative effects its inherent regressivity has on fixed and low income folks. Therefore, many strong foes of a tax reform plan touting a sales tax are likely to exert strong effort to derail any such proposal reaching the Senate. In order to avoid the specter of a sales tax, perhaps the Democrats will offer a value-added tax (VAT) as part of their own tax reform plan that will eliminate the deficit and provide a new, large source of tax revenue.

³⁴ Ibid., p. 4.

Chapter 6

TAX REFORM AND PUBLIC ADMINISTRATION

The field of Public Administration in general and public administrators in particular are faced with interesting questions and challenges in analyzing tax reform and determining the proper role and position that the academic field and the practicing professionals should be taking while the issue is being debated and ultimately decided. During this time of budget shortfalls in Montana (and in many other states across the United States), what role should public administrators and Public Administration be playing, and what positions should they be taking? Should administrators be staunchly defending and guarding their programs from the budget axe in the legislature? Should they be attempting to expand their programs? Should they be prioritizing their programs and putting forward ideas for elimination of entire programs and cost savings? Should they be actively promoting a sales tax or a VAT? Should they stand on the sidelines and hope for survival? How should the field of Public Administration be adjusting its theories and principles to reflect an era of extremely tight budgets?

There are also concerns about tax reform of a mostly mechanical nature that should be of interest to public administrators, but they are secondary in comparison to matters regarding possible reductions in employee levels, inadequate (or worse) program funding levels, and struggling to sustain organizational operations. Matters such as how to implement a sales tax from an administrative view or how to adjust

program funding mechanisms under tax reform are important for those directly involved, but there is typically adequate information from, for instance, other states who have previously gone through similar changes. Therefore, these matters will not be the subject of discussion in this paper.

Regardless of the method used in the budgeting process, the days of agency administrators coming before the legislature with a somewhat padded budget, including requests for additional FTE's and extraordinary capital purchases are truly gone. The state of Montana is on the verge of being "broke," not having even nearly enough revenue to fund existing programs at current levels (as discussed in the above related section). Without the approval of a tax reform plan during the 1993 legislative session that includes a new and sizeable source of revenue, there could be massive employee layoffs and the termination or suspension of many state programs.

Public administrators would be wise to recognize the reality of this situation and to play a constructive role as the legislature and administration work to structure government to maximize public benefit with fewer dollars. If Dorothy Bradley had been elected Governor, public administrators could have breathed a sigh of relief knowing that over \$100 million from the proposed sales tax would have been infused into the state budget as new spending. However, Marc Racicot in the Governor's chair is reality, and he proposes that government spending will actually be reduced by \$40 million per year. Obviously, every public administrator faces exposure for budget cuts and potential loss of jobs and programs.

This is a relatively new environment having frustrating and challenging factors and circumstances to which public administrators must adjust and quickly find the best approach. If an administrator stands idly by while the legislature decides his/her personal fate along with the future of the programs being administered, a rationale will likely soon be developed targeting this individual and program as nonessential.

The decision facing the 1993 legislature is whether to make permanent cuts by eliminating programs or to make across-the-board cuts leaving programs mostly intact or to structure a combination of the two. The point is there will be cuts one way or another. There are definite dangers for an administrator to advocate across-the-board cuts in an attempt to save programs and jobs in hopes that the revenue picture will become bright in a few years and full funding can be restored. The effectiveness of a program having only a large enough budget to cover pared down administrative costs would be severely harmed. Staff morale could easily become a serious problem.³⁵ Another problem for an administrator to cope with under shoe-string funding is the strong likelihood of loss of experienced professionals (engineers, accountants, economists, etc.), again adversely affecting a program's effectiveness and organizational morale.

Considering that the downsizing of state government appears imminent, "survival of the fittest" may become the new motto of public administrators, and only

³⁵ Donald A. Schon, The Reflective Practitioner: How Professionals Think in Action, (New York: Basic Books, Inc., 1983), p. 337.

those who are best prepared for the battle will literally continue to exist, while others will be forced to move on to other activities. The "reflective practitioner" discussed in the book by the same name, written by Donald A. Schon, would likely rally his "clients" behind the value of the program, stressing to each client the advantages of the program's continued existence.³⁶ Of course, the same rationale would apply in convincing politicians at various governmental levels and interested taxpayers of the high value of the organization's program.

The first step in the Racicot plan to reduce government spending by \$40 million per year is to prioritize existing programs. That process will be crucial to the survival of public administrators and programs. A program administrator would be best served to become a fierce and extremely vocal advocate of the program. Hard decisions will be made, and administrative neutrality could easily be interpreted as indifference to continued operation of a particular program.

Anthony Downs, in his book Inside Bureaucracy, discusses the different types of administrators - climbers, conservers, and mixed-motive officials. Downs describes climbers as people who constantly seek to maximize and increase their own power, income, and prestige through such techniques as job promotion, self-aggrandizement, or jumping from one organization to another. Conservers, who are not as ambitious as climbers, seek to maximize their security and convenience by holding on to the present condition with the least amount of effort possible. Mixed-motive officials

³⁶ Ibid., pp. 290-297.

seek policy goals connected with the public interest and are motivated by altruistic loyalty to the program or the cause being addressed. Administrators generally lean toward one of the three types described.

Considering the survival circumstances public administrators will likely be facing during the 1993 legislative session, the mixed-motive officials will probably be most successful. Climbers may be too interested in themselves rather than the programs they administer, and conservers simply may not be able to adjust to a drastic change in the status quo. However, mixed-motive officials will be both able to embrace dramatic change and to meet the challenge of justifying the continued existence of the program addressing the policy goals they are passionately pursuing. Their desire for the continuation of a program will be motivated by idealism, in a sense, as much as self-interest, whereas the concerns of both climbers and conservers would center around their own personal needs.

According to Downs, there are three variations of mixed-motive officials, all of which are highly motivated to pursue the public interest. "Zealots," "advocates," and "statesmen" all have qualities essential in convincing decision makers of the importance of their programs. Their names fairly well describe their traits, and each serves a highly useful purpose in aggressively seeking what best suits their organizations. Their loyalties to the program and strong belief in pursuit of the public interest will serve well as they fight for high prioritization of the program and adequate funding of operations. Also, they are likely to encourage goal diversity

within their organizations to generate expansionary forces adding to the power of their organizations.³⁷

In his essay "Bureaucracy," Max Weber spelled out the characteristics of bureaucracy and administrators.³⁸ Mr. Weber's description of public administration under model and involatile circumstances do not anticipate the modern dilemma of fighting for continued survival and adequate funding of operations. A public administrator seeking help in figuring out the best approach in presenting a case to the legislature that his/her program or agency deserves adequate funding may not find much solace in reading Weber's writings. He provided an impressive framework for organizing and operating a bureaucracy, but the budgetary circumstances of today exceed the limits of his recommendations.

Perhaps Herbert Kaufman more adequately addresses this situation in "Administrative Decentralization and Political Power" when he says, "...[T]he administrative history of our governmental machinery can be construed as a succession of shifts..., each brought about by a change in emphasis among three values: representativeness, politically neutral competence, and executive

³⁷ Anthony Downs, Inside Bureaucracy, (Boston: Little, Brown and Company, 1967), pp. 92-111.

³⁸ Max Weber, From Max Weber: Essays in Sociology, by H. Gerth and C. Wright Mills, (Oxford University Press, Inc., 1946). Found in Classics of Public Administration, by Jay M. Shafritz and Albert C. Hyde (Pacific Grove, California: Brooks/Cole Publishing Company, 1987), pp. 50-55.

leadership."³⁹ The point he makes is that traditional modes of representation before decision makers and of administrative leadership may no longer suffice. In order to survive, an organization will have to be well organized with a broad spectrum of strong support for its continued existence, and its leaders will have to be aggressive advocates of the public interest being served by the program.

Actually, this will be a good test for those public administrators who adhere to the "social equity" approach promoted by H. George Frederickson. He advocates going beyond the classic description of public administration as the efficient, economical, and coordinated management of services by adding social equity as a goal worth pursuing. Since the followers of Frederickson have not been acting in a neutral manner by being committed to both good management and social equity (generally striving to improve the quality of life for all) as values, they might actually have developed close ties with clients that will ease the task of rallying these groups behind the program and organization.⁴⁰

This approach is consistent with the theory that the bureaucracy is the most representative entity in government and can serve as a valid source of public

³⁹ Herbert Kaufman, "Administrative Decentralization and Political Power," Public Administration Review, (Vol. 29, January-February 1969), pp. 3-15. Found in Classics of Public Administration, by Jay M. Shafritz and Albert C. Hyde, (Pacific Grove, California: Brooks/Cole Publishing Company, 1987), pp. 389-390.

⁴⁰ H. George Frederickson, "Toward a New Public Administration," from Toward a New Public Administration: The Minnowbrook Perspective, (Chandler Publishing Company, 1971). Found in Classics of Public Administration, by Jay M. Shafritz and Albert C. Hyde, (Pacific Grove, California: Brooks/Cole Publishing Company, 1987), pp. 424-434.

sentiment before the legislature, as advocated by Krislov and Rosenbloom.⁴¹ A public administrator using this theory can make the argument before the legislature that he/she has spoken directly with and is actually speaking on behalf of the legislators' own constituents, who have shown definite preference for the continuation of the program in question.

Even for those programs that survive, the administrators will have to learn quickly how to do more with the same amount of, or less, resources. The conflict between effectiveness and efficiency in providing services is certainly a reality, but public administrators should view this situation as a challenge that must be met directly with innovation and energy. Performing tasks for society at a high level of quality with limited or reduced resources will become increasingly difficult, and public administrators must adopt to this new environment.

Now that funding is clearly limited, public administrators should learn from the constructive aspects of the career of Robert Moses, who has been described as America's greatest builder in the country's greatest city, New York City. He handled politicians and budget problems incredibly and showed that aggressiveness and innovative tactics in public administration can effect positive results. As explained by Robert Caro in The Power Broker, Moses succeeded through careful analysis

⁴¹ Samuel Krislov and David H. Rosenbloom, "Representative Bureaucracy and the American Political System," from Representative Bureaucracy and the American Political System, (Praeger Publishers, 1981), pp. 21-26, 189-193. Found in Classics of Public Administration, by Jay M. Shafritz and Albert C. Hyde (Pacific Grove, California: Brooks/Cole Publishing Company, 1987), pp. 529-537.

before taking action and by looking for solutions creatively without bowing to the status quo.

Under these almost crisis conditions, an administrator should become introspective, beginning with a careful review of the organizational structure to insure that the people in charge at the various levels of bureaucracy truly are carrying out the goals of the organization and program being administered. Also, the administrator should examine personnel policies and management techniques to determine if productivity is being maximized. As Donald A. Schon says, "In general, the more an organization depends for its survival on innovation and adaptation to a changing environment, the more essential its interest in organizational learning."⁴² That statement clearly describes the challenge for public administrators during the 1993 legislative session, and these same administrators should be pursuing all potential avenues in finding cost savings and emphasizing streamlining without jeopardizing (or at least successfully minimizing) the effectiveness of a particular program.

If the administrator determines that management techniques and work atmosphere are not fostering self-motivation and employee satisfaction, then productivity has not been maximized and internal management changes are required. The administrator should begin with him/herself in making the necessary changes and

⁴² Donald A. Schon, The Reflective Practitioner: How Professionals Think in Action, (New York: Basic Books, Inc., 1983), p. 327.

then implement policies at all levels of the bureaucracy so that productivity will indeed be maximized.

Once the internal structure and motivational techniques are adjusted to more easily accomplish the goals of the organization, then the internal procedures should be carefully examined. Any outdated, duplicative, or unnecessary functions and tasks should be eliminated or modified to promote internal efficiency.

At this point, the administrator should be left with an organization that is performing at higher levels of productivity and efficiency without adversely affecting the effectiveness of the service provided. This is important because an administrator should always keep proper perspective that the role of the organization is to provide the service to the public in the best possible manner.

When going before the legislature, the administrator can demonstrate steps that have been taken to streamline the operation of the agency and increase the productivity of the employees, while not sacrificing the provision of service to the public. By establishing credibility with a client group, especially ones typically cynical of government programs, the administrator will set the stage for an improved likelihood of favorable treatment in the process of prioritizing programs and when requesting adequate funding to improve the effectiveness of providing the public with its service.

In order to succeed in this era of finite resources, an administrator must be proficient in the teachings of public administration in order to be aware of the

options available in managing an agency or program to find balance between effectiveness and efficiency. Without internal efficiency, the effectiveness of the organization suffers due to lack of legislative support. Without effectiveness, the organization is subject to harsh public criticism.

The conflict between effectiveness and efficiency will always be present, and administrators need constantly to be aware of the goals and the internal workings of the organization in order to keep these two opposing concepts in proper perspective and balance. As budgets become increasingly tighter and the public cries for more government services, success will come to well-informed, innovative, and aggressive administrators who not only understand this dynamic conflict, but who are also able to implement constructive changes needed to maintain equilibrium and a high enough priority status to continue functioning.

Chapter 7

CONCLUSION

After many years of debate and frustration, tax reform in Montana will take center stage during the 1993 legislative session. The major issue to be decided is whether or not to implement a general sales tax (or perhaps, alternatively, another new tax revenue source such as a value-added tax). The battle will no doubt be fierce, but without that piece of the tax reform puzzle, the whole concept is guaranteed to fail leaving Montana's budget and economic future in a dire predicament. The budget deficit is already at the \$200 million mark, and to ignore a potential new revenue source will require either massive tax increases, massive budget cuts, or some sort of combination of the two. Without tax relief, Montana's business climate is likely to continue to be perceived negatively hurting the state's ability to compete for economic development.

Regardless of the good intentions of all involved, because of the power split existing in the 1993 legislature, the result for tax reform in Montana in 1993 could be no progress caused from absolute political gridlock. The test for the parties and elected officials in power in their respective positions will be to seek compromise wherever it is mutually beneficial. As long as the tone throughout the session remains conciliatory and cooperative, then tax reform has a strong possibility of becoming a reality for Montana. If, however, lines are drawn in the sand, then Montanans will likely be forced to wait two more years for a plan that will address

the goals of adequately funding government programs, at whatever level is deemed appropriate (see the differences between the Racicot and Bradley tax reform plans discussed in the related section above), while eliminating the budget deficit for the long term.

If nothing constructive is done in the 1993 session, however, then the two year period between legislative sessions will be terribly difficult for all Montanans. Taxpayers will possibly be faced with increased levels of existing taxes. All government programs on the state and local level will be forced to make large-scale adjustments due to significantly reduced budgets. The reason is that the decision makers in the state of Montana over the past decade or so have heard the warnings from the fiscal experts saying, "Pay now or pay later," but they have chosen not to listen. Montana's revenue and accounting "band-aid box" is virtually empty, and the situation demands immediate attention. In the long-term, tax reform, including a new source of tax revenue and tax relief, are definitely in the best interests of both the payers and receivers of benefits from government programs.

Regarding the deliberations legislators must make in developing a comprehensive tax reform plan, the challenge is always to consider the "big picture" of desirable overall tax policy in judging individual tax proposals. For instance, would an excise tax of 5 cents on 12 ounce cans of pop for the purpose of funding state parks be considered "good" tax policy? To answer the question, each decision maker must weigh his/her particular political philosophy and the political winds "back

home" against the generally accepted criteria of "good" tax policy before voting aye or nay. The same is true in evaluating a comprehensive tax reform plan of the magnitude that will be proffered by Governor Racicot.

The role of public administrators in this process will also be extremely important. Programs will best be served by dynamic leaders who will be able to convince decision makers that a program deserves high priority ranking for survival and adequate funding for effective provision of service. Finding and communicating ways to maximize efficiency without affecting quality of service will be a big challenge, but the rewards (such as legislative recognition for the effort) may be quite tangible. The stakes will be high, and those who falter will potentially cause grave harm to respective organizations and programs.

The future of public administration will be dictated largely by respect for the past. Adapting to future conditions while not forsaking time honored principles will provide the necessary stability for long-term survival and success in administering government programs in an era of extremely tight budgets. Effectively administering programs while listening closely to the public voice will instill public confidence. Treating accountability and fiscal responsibility as high priorities will lead to credibility. Demonstrating concern for human development will foster economic growth and social equity. The future result will be a highly respected and dynamic public administration.

If tax reform does indeed become a reality for Montana, the hope is that it will be the product of compromise where all affected parties (executive branch, legislative branch, taxpayers, program beneficiaries, and public administrators) will be winners to the extent possible under the circumstances. If balance is not achieved, then undue suffering will result and the call will once again be soon heard across Montana that what the state really needs is a good plan for comprehensive tax reform.

"TAX REFORM IN MONTANA"
April, 1993

BIBLIOGRAPHY

Books

Downs, Anthony, Inside Bureaucracy. Boston: Little, Brown and Company, 1967

Due, John F. and Mikesell, John L., Sales Taxation: State and Local Structure and Administration. Baltimore: Johns Hopkins University Press, 1983

Frederickson, H. George, Toward a New Public Administration: The Minnowbrook Perspective. Chandler Publishing Company, 1971. Reprinted: Shafritz, Jay M., and Hyde, Albert C., Classics of Public Administration, Second Edition. Pacific Grove, California: Brooks/Cole Publishing Company, 1987

Kaufman, Herbert, "Administrative Decentralization and Political Power," Public Administration Review magazine, Vol. 29, January-February 1969, pp. 3-15. Reprinted: Shafritz, Jay M., and Hyde, Albert C., Classics of Public Administration, Second Edition. Pacific Grove, California: Brooks/Cole Publishing Company, 1987

Krislov, Samuel and Rosenbloom, David H., Representative Bureaucracy and the American Political System. Praeger Publishers, 1981

Musgrave, Richard, Public Finance in a Democratic Society, Vol. 1. New York: New York University Press, 1986

Schon, Donald, The Reflective Practitioner: How Professionals Think in Action. New York: Basic Books, Inc., 1983

Shannon, John, "State Revenue Diversification - The Search for Balance," from The Quest for Balance in State-Local Revenue Structures. Cambridge, Massachusetts: Lincoln Institute of Land Policy, 1987

Weber, Max, From Max Weber: Essays in Sociology. Oxford University Press, Inc., 1946

Magazines

Benson, Bruce L. and Johnson, Ronald N., "The Lagged Impact of State and Local Taxes on Economic Behavior," Economic Inquiry, vol. 24, 1986

Reports and Studies

Beattie, Bruce R. and Young, Douglas J., "Montana Taxation and Expenditure: Issues and Options," Bozeman, Montana: Montana State University, July 1988

Bowman, John H., "Real Property Classification," State and Local Finance for the 1990's: A Case Study of Arizona, Ed. by Therese J. McGuire and Dana Wolf Naimark. Tempe, Arizona: School of Public Affairs, Arizona State University, 1986

Citizens for Tax Justice, A Far Cry from Fair: CTJ's Guide to State Tax Reform. Washington, D.C.: Citizens for Tax Justice, April 1991

Cyert, Richard M., "Final Report of the Pennsylvania Tax Commission," Pittsburgh: Carnegie-Mellon University, March 1981

Finch, Larry, "The Value-Added Tax: An Alternative Approach to Comprehensive Tax Reform in Montana," Helena, Montana: Office of Research and Information, Montana Department of Revenue, September 1992

Great Falls Tribune Staff, "Racicot, Bradley Tax Plans." Great Falls, Montana: Great Falls Tribune, October 18, 1992

Ladd, Helen F. and Weist, Dana, "General Sales Tax," from State and Local Finance for the 1990's: A Case Study of Arizona. Tempe, Arizona: School of Public Affairs, Arizona State University, 1986

Mikesell, John L., "General Sales Tax," from Reforming State Tax Systems. Denver: National Conference of State Legislatures, 1986

Minnesota Tax Study Commission, "Final Report of the Minnesota Tax Study Commission: Findings and Recommendations," Vol. 1, St. Paul: Butterworth Legal Publishers, 1986

Office of Montana Legislative Fiscal Analyst, "The Montana Historical Revenue and Expenditure Report, Fiscal Years 1979 through 1991." Helena, Montana: Office of the Legislative Fiscal Analyst, June, 1992

Office of Montana Legislative Fiscal Analyst, "Appropriations Report, 1993 Biennium, July 1992 Special Session." Helena, Montana: Office of the Legislative Fiscal Analyst, June, 1992

Pomp, Richard D., "Simplicity and Complexity of a State Tax System," from Reforming State Tax Systems. Denver: National Conference of State Legislatures, 1986

Strauss, Robert P., "Business Taxes," Reforming State Systems. Denver, Colorado: National Conference of State Legislatures, 1986

Tax Foundation, Inc., Tax Burden by Income Class, 1986-1987. Washington, D.C.: Tax Foundation, 1989

Texas Select Committee on Tax Equity, "Rethinking Texas Taxes: Final Report of the Select Committee on Tax Equity," Vol. 1. Austin Texas, January 1989

U.S. Bureau of the Census, "State Government Tax Collections: 1990." Washington, D.C.: U.S. Government Printing Office, 1991

Waterman, Mignon, "Montana Tax Reform Act of 1993," Helena, Montana: Montana Association of Counties, 1992

Wicks, John, et. al., "An Integrated Tax Structure for Montana," Montana Taxation Task Force Papers, prepared for the members of the Subcommittee on Taxation. Helena, Montana, 1966

Miscellaneous

Bradley/Halligan campaign literature and related newspaper articles

Brochures from the Bureau of Business and Economics Research at the University of Montana