

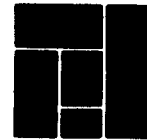
**Fiscal Affairs of State and Local  
Governments in Nevada**

**I. Executive Summary**



**November 1988**

**THE URBAN INSTITUTE**



***Price Waterhouse***





FINAL REPORT

A STUDY OF THE FISCAL AFFAIRS  
OF STATE AND LOCAL GOVERNMENTS  
IN NEVADA

Carson City, Nevada  
November 18, 1988

The Urban Institute  
Price Waterhouse



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## EXECUTIVE SUMMARY

### INTRODUCTION

The single most important theme that frames the next several hundred pages of discussion and analysis of Nevada's tax and intergovernmental system is that the system reflects the history and character of Nevada's people.

The fiscal arrangements here are not the result of an arcane and detached compilation of legal technicalities and bureaucratic regulations, but are statements about relationships among the people of Nevada and between the people and their governments.

That state and local fiscal arrangements reflect the people's character has been evident from at least the beginning of Nevada's "modern" era when Shoshones and Washos joined the Paiutes to select Chief Winnemucca as their single authority for dealing with the first fur traders and trailblazers.

Soon to follow that would be a series of events, many of which were centered on fiscal issues that would shape Nevada's state and local relationships as we see them today. One of the key acts of the first Territorial Legislature (1861) was the establishment of toll roads in order to facilitate the state's development. The first attempt to draft a Constitution (1863) for the State of Nevada was rejected by the voters over the issues of taxation. Following Statehood (1864) came the Bullion Tax War between the Bonanza mining company, Storey County, and the State.

The Silverite dominated Legislature (1890s) fought proposals for property tax equalization. And, when the 1931 gambling bill was approved, Sparks city officials assessed heavy fees on slot machines and other gambling devices in an obvious attempt to discourage the growth of gaming.

The New Deal created an enormous growth of federal expenditures in the State, in part for the purpose of developing much of the infrastructure that Nevadans still rely upon in their daily lives. And, in the Post War era as the state's character changed from rural to urban and the gaming sector matured, many of Nevada's present day fiscal arrangements got their beginning.

No present day discussion of the character of the Nevada people would be adequate unless it included issues such as the proper tax treatment of the State's extractive industries, the relationship between tax policy and the state's economic development goals, the state's fiscal conservatism as reflected in the electorate's strong anti-income tax sentiment, and the desire on the part of policymakers to hold down property tax burdens.

## **PURPOSE AND SCOPE**

### **Need For A Study**

In keeping with this theme regarding the relationship between the Nevada character and its fiscal arrangements, this Report provides a systematic and detailed analysis and evaluation of state and local tax and intergovernmental fiscal relationships.

A comprehensive discussion is needed for two reasons. First, periodically one should take a close look at state and local fiscal arrangements to learn just how well the system is operating as a whole. Over time, as laws are enacted to address specific short run concerns, the result can be a building up of a system that is overlapping or even contradictory in its use of policy tools, unnecessarily complex, and patchworked in a manner that thwarts the accomplishment of originally intended objectives. As discussed below, this is certainly the case with respect to Nevada's state-local relationship.

Second, it is important to provide policymakers with an analysis that addresses how well the fiscal system is likely to function in the context of the state's demographic and economic trends. The task of designing a fiscal system that meets the economic needs of the people is made much easier if that system tends to automatically flow with and capture the benefits of the national and even world trends that are beyond the control of any single state.

### Policy Directions

When the Legislature commissioned this study, it asked that the Final Report include a set of policy recommendations that would guide Nevada fiscal through the next decade and into the twenty first century.

As will become evident in both this Executive Summary and from a reading of the entire Report, a series of specific recommendations--some sweeping and others minor--have been made.

But Nevada needs options as well as recommendations. And, along with these options should come a discussion regarding the policy tradeoffs among alternative fiscal paths that Nevadans will want to consider in the years ahead. The economic and fiscal analysis provided in this report has much to contribute toward the promotion of a rational fiscal policy of which Nevadans can be proud. But there is also a line--though, not a well defined one--beyond which the analyst can no longer prescribe the "correct" policy or mix of policies. To use a metaphor that is appropriate to Nevada, the job of the analyst is to define the policy mesa, often having to be satisfied with warning political leaders where the cliffs are rather than where may be the "best" point to stand.

It is for these reasons--to provide a discussion of options as well as recommendations and to warn about the edge of the mesa--that the issue-by-issue discussion below is framed in terms of "policy directions" and not just "recommendations."

## CRITERIA FOR JUDGING A REVENUE SYSTEM

Debate on fiscal policy seldom makes clear the basis for selecting one revenue source over another. Several factors may be at work to discourage explicit statements--e.g., lack of data as to the economic effects of a tax; uncertainty as to who will bear the tax "burden"; and the complexity and multiplicity of tax effects. Nevertheless, when a subnational (state/local) government makes the political decision to use one tax form rather than another or to use some more intensively than others, there is a need to have a set of criteria by which to make policy choices. The following are those generally accepted criteria by which the Nevada fiscal system may be evaluated.

### o REVENUE PRODUCTIVITY

The state-local tax system must produce revenues that are adequate to finance an agreed upon flow of public services over time. The system should balance the tradeoffs between responsiveness to changes in economic growth (elasticity) and stability during periods of economic downturn.

### o SIMPLICITY

As a tax or set of taxes increases in its complexity, the cost borne by the taxpayer (individuals and institutions alike) in keeping records, computing and filing tax returns, and undergoing audits increases. Another result of complexity is that taxpayer understanding of the fiscal system decreases, a matter of serious concern in a democracy.

One way to accomplish tax simplicity and thereby both reduce taxpayer compliance costs and enhance the

public's understanding of the fiscal structure is to broaden tax bases--i.e., examine those taxes that are particularly cumbersome and consider whether the many exceptions or complexities are warranted.

- o **EQUITY**

Few questions of public finance are more obviously judgmental--and therefore political--than the question of "who should pay." Nevertheless, tax equity is a proper concern in economic analysis and must be addressed as objectively as possible. For our purposes here, there are two types of equity concepts that can be distinguished: "horizontal" and "vertical."

Horizontal equity requires the equal tax treatment of persons in equal circumstances ("equal treatment of equals").

Vertical equity deals with the "fairness" of the distribution of tax liabilities among persons not in similar circumstances. Here, the most commonly used index is income, and discussions of vertical equity usually focus on the distribution of the burden of a tax structure. Tax structures (or individual taxes) may be "progressive" (tax burden varies directly with income), "regressive" (tax burden and incomes are inversely related), or "proportional" (no change in tax burden as income changes).

- o **COMPETITIVENESS**

If a state and its localities (a) levy taxes at "too high" a level relative to other jurisdictions, (b) structure certain taxes so as to discriminate against

particular economic activities or transactions and/or (c) create a tax system characterized by a high degree of uncertainty, the result may be to discourage investment and, thus, job development within the state. If it is determined that for one of these reasons the state's tax structure is discouraging investment and thus the type of development that residents of the state obviously care about, then reassessment of the state's tax structure is in order.

o **ECONOMIC NEUTRALITY (EFFICIENCY)**

Neutrality in taxation requires that taxes accomplish certain intended objectives, but beyond this they should minimize interference with private economic decisions. Special emphasis must be placed on the word "intended." Sometimes a government deliberately chooses to raise some prices through taxation and thus discourage a particular activity.

o **INTERGOVERNMENTAL NEUTRALITY**

The revenue structure can have a powerful influence upon the relationship between the State and its local governments. Both the type of devices used to generate public funds as well as the constraints placed on local taxing authorities to levy "own source" revenues will influence Nevada's political structure. Using the analogy to the criteria of economic neutrality discussed above, the goal here is to design a tax system that minimizes unintended interference with respect to Nevada's intergovernmental arrangements.



- o ADMINISTRATIVE FEASIBILITY

Another basis commonly advanced for choosing among tax alternatives is the ease or difficulty, and costliness or cheapness, of collecting any levy in a reasonably uniform way. Other things being equal, it is preferable to choose taxes that are easy to administer.

It is important to recognize that in selecting or modifying one tax or set of taxes versus the alternatives, it is inevitable that tradeoffs will have to be made among the criteria. For example, the reason the property tax is so important to local governments is that it is levied on an immovable base, and thus uniquely addresses the problems subnational governments have as a result of the openness of the economies in which they operate. As a consequence the tax not only produces a reliable means for financing local services, but also permits local governments (counties, cities, special districts) a degree of fiscal independence from higher levels of government. One tradeoff to increased reliance on the tax is that it tends to be regressive across income classes.

In short, there is no perfect tax or tax structure. The task of the policymaker is to find the least undesirable alternatives for financing Nevada's public sector.

### The Themes of the Report

As a result of the analysis that has been carried out, the following four themes emerge with respect to the Nevada's state and local fiscal affairs. The reasons for their selection will become evident in the remainder of this discussion.

- o The system produces revenues that are currently adequate to meet the expenditure requirements of the State's General Fund as defined by current policy.

However, beginning in the mid-1990s an adjustment of revenues and/or expenditures on the order of 5 to 10 percent of General Fund Revenues will be required to just finance the current scope and quality of services. A thorough analysis of economic and demographic trends was made to assess the ability of the current tax structure to continue to pay for the scope and quality of current services over the period from 1988 to 2010. The conclusion is that barring any unexpected shocks to the Nevada economy such as a serious recession, the State will not experience a "budget gap" until the mid 1990s. Accordingly, unless Nevada citizens wish to substantially expand the size of the State's budget in order to upgrade the quality of public services, no new major General Fund revenues are required at this time.

- o Nevada's state-local fiscal arrangements need to go through a thorough "sorting out" process. The intergovernmental system is so overly complex and overlapping that there is no clear definition of accountability for the fiscal actions at either the state or local level. The system is characterized by state control and increasing state encroachment on the property tax, which is the mainstay of local finance. As a result, local governments are too limited in their flexibility to address the changing service demands of their residents. The lack of flexibility, in turn, raises important concerns regarding the ability of residents to assign the political responsibility for fiscal decisions.
- o The state and local tax system is unfair. When taken as a whole, the state and local revenue system fails to meet the test of horizontal equity and, especially, the test of vertical equity. Moreover, although there

are ways to address the horizontal equity concern within the structure of the existing fiscal system, there is at present no tool in the Nevada fiscal system designed to even out the tax burden across income classes.

- o The system has undesirable built-in institutional rigidities. Because of Constitutional constraints, earmarking of some revenues, and tight restrictions on local governments, Nevada is poorly positioned to confront unforeseen future developments. Such existing constraints should be removed and future calls for them rejected.

## MAJOR FINDINGS AND POLICY DIRECTIONS

A reading of all three remaining parts of this report is required in order to get a full presentation of the findings, recommendations, and policy directions of this study. Here are the highlights:

### The Background Conditions

#### The Nevada Economy

##### Findings

1. The service industries, led by tourism and gaming, are a dominant force in Nevada's economy. Service-producing industries accounted for 87 percent of total Nevada employment in 1986.
2. The Nevada economy is gradually diversifying. Since 1979, Nevada has outperformed the nation in manufacturing, mining, wholesale trade and business,

health, engineering and architectural services. However, growth in these industries starts from a small base so that progress toward diversification should not be overstated.

3. The Nevada economy is not recession proof. Employment fell more sharply in Nevada than the U.S. during the 1981-82 recession.
4. Job creation in Nevada has outpaced the nation during the current recovery and expansion phase of the business cycle.
5. Nevada's rapid population growth has continued into the 1980s. The state's average annual growth rate of 4 percent since 1980 was the third highest among the states and was four times the national average.
6. Approximately one-third of migration to and from Nevada was from California in 1986. However, more than half of the net migration to Nevada has come from regions east of the Rocky Mountains, especially the Midwest. The growth of Nevada population in the future will depend in part upon the state's ability to continue to attract people from these areas.
7. The proportion of the population over 65 and under the age of 6 increased more rapidly in Nevada than in the U.S. during the 1980s. These trends have important implication for increases in school enrollments and long-term care costs.

## The Fiscal Process

### Findings

1. Broad constitutional provisions relating to tax law--such as the Nevada uniformity clause that calls for a "uniform and equal rate" of tax in any one jurisdiction--are necessary.
2. Amending the Constitution is, as intended, a slow and cumbersome process. This is particularly true for Nevada in which the minimum practical duration for the amendment process is 31 months.
3. The representative form of democracy should be relied upon for making tax policy. Through a process of research, analysis, and public debate, elected officials can design tax policies that effectively deal with changing conditions.
4. Writing specific tax law in the Constitution reduces needed policy flexibility and, as is evident in Nevada with respect to the sales tax, often leads to consequences that were not intended by even the proponents of an amendment.

### Policy Directions

Constitutional prohibitions relating to specific taxes should be removed. Further use of the Constitution for writing specific tax law, including the current effort to prohibit a personal income tax, should be avoided.

## The Long-Term Outlook (General Fund Projections)

### Findings

1. In part because of strong revenue growth in 1988, the long-term projection begins with the general fund in a positive position. However, the most probable (baseline) scenario indicates that expenditures, as defined by current policies, will exceed current law revenues beginning in the mid-Nineties. The peak revenue shortfall is projected to be in excess of 6 percent of total general fund revenues.
2. The baseline scenario projects continued healthy growth in the Nevada tourism industry but at a somewhat moderate pace as compared to the rapid growth rates experienced during the Seventies.
3. Growth in elementary and secondary education, prisons, and medical assistance expenditures are major factors leading to the projected budgetary imbalance.
4. The recession alternative indicates that a budgetary imbalance would be experienced sooner if a recession occurs in the next few years.
5. Under the optimistic scenario in which the tourism sector continues to expand rapidly, revenues from the current structure are just adequate to meet current services needs over the next twenty years.
6. Under the pessimistic scenario in which another competitor emerges in casino gambling, the budgetary imbalance is approximately 10 percent of total revenues in the worst year.

## Policy Implications

1. The most probable general fund forecast indicates a need to either increase taxes to maintain the current level of services or reduce the current services spending level beginning in the mid-Nineties. The magnitude of the required fiscal adjustment is on the order of 5 to 10 percent of total general fund revenues.
2. Although no short-term budgetary projection is presented in this analysis, the potential for a budgetary imbalance under the recession scenario is a strong affirmation of the current fiscal management policy in Nevada of maintaining a sizeable budget balance.
3. The baseline projections included in this report are not intended as a judgment of the appropriateness of current state expenditure policies. This analysis only defines the amount of revenue required to finance the current scope and quality of services. Revenue needs will ultimately reflect the decisions of Nevada citizens and their elected officials about the scope and quality of public services that they are willing to pay for in the future.

## Fiscal Comparisons

### Findings

1. When compared to other states in terms of the relationship between its potential fiscal capacity and its actual tax effort, Nevada has fiscal room to maneuver. When ranked with the other states, Nevada

is next to last in tax effort. This low effort is due in part to a high capacity in the export industries.

2. In recent years, Nevada has moved from a position of a less than average degree of centralization (state control of the fiscal system) to above average centralization.
3. Because Nevada is unique among the states with respect to its economic base, the use of state-by-state rankings of fiscal aggregates is in most cases an inappropriate mechanism for judging this State's fiscal circumstances.

### Policy Implications

The purpose of fiscal comparisons is to provide an initial idea of how one state compares in terms of fiscal behavior vis-a-vis other states. While these comparisons are easy to calculate, they have several weaknesses. They say nothing about equity, fail to account for tax exporting, ignore differences in the quality of public services among the states, and, when viewed in isolation, say little or nothing about the relationship between jobs and taxes. Accordingly, although it is useful to present these numbers, they serve only as crude indicators of fiscal behavior. Thus, no recommendations can or should be drawn from them.

### Earmarking Tax Revenues

#### Findings

1. Nevada is notable for its unusually heavy use of earmarking of tax revenues--the practice of reserving revenues from certain sources for particular



expenditures. Indeed, Nevada earmarks more than half of all its state collected revenues--a rate that is two and a half times the national average.

2. The practice of earmarking tax revenues for specific expenditure purposes has merit if it meets a clear "benefits" test--i.e., if it can be shown that there is a direct and strong relationship between the proceeds of the tax and the benefits derived from the particular expenditure.
3. In Nevada, this test is generally satisfied with respect to its use of Special Revenue Funds, including the dedication of motor vehicle and motor fuel tax revenues to a special Highway Fund. In all other cases--including earmarking the cigarette tax for counties, the slot tax and estate taxes for education, and the alcoholic beverage tax revenues for counties and cities as well as alcohol and drug rehabilitation--the test is not met.
4. Of the earmarked revenues, the most significant are the use of the local share of the retail sales tax for general support of local governments--i.e., the local school tax (1.5%), Basic City-County Relief Tax (0.5%), and the Supplemental City-County Relief Tax (1.75%). In fact, if these taxes were not earmarked, then Nevada would be an average earmarking state.
5. A close examination of Nevada's earmarking suggests that, in general, it (a) hampers effective budget control; (b) removes certain expenditures from the systematic review accorded other types of expenditures--a review that promotes fiscal as well as political accountability in a democratic system; and (c) may

result in a "shell game" whereby policymakers often feel that once a revenue has been earmarked, they are absolved from further responsibility to appropriate additional general funds to the program.

### Policy Directions

The state should avoid earmarking except in cases where the benefits test is met. In order to accomplish this with respect to the general sales tax, a Constitutional change will be required.

### Tourism

#### Findings

1. A healthy tourist (visitor) industry is enormously important to the Nevada economy. In 1986, for example, the industry accounted for
  - o 45 percent of total earnings in the state,
  - o 65 percent of total full time equivalent jobs,
  - o Nearly 55 percent of direct general fund revenues and 44 percent of direct total revenues.
2. Despite its great importance, the gaming-dominated industry is beginning to become somewhat less important to the state's economy as the state slowly diversifies its economic base.
3. Although difficult to estimate, the available data suggests that competition from Atlantic City has had little long term impact on the Nevada market.

Similarly, although there is some anecdotal evidence that the California lottery may have initially diverted some gamblers away from Nevada when it began its 1985 operations, there is no evidence of significant effects at present.

4. The types of visitors who travel to enjoy the amenities of Nevada tend to be highly sensitive to national economic conditions (reducing their travel as the economy slows). However, the demand for Nevada vacations is not very sensitive to changes in the cost of travel.

### Tax Policy and Economic Development

#### Findings

1. Nevada has the lowest general business taxes of fifteen states whose overall business tax burdens were analyzed. The analysis covered all of the Western states plus New Jersey and Florida.
2. For five manufacturing and wholesaling industries, the average state-local tax burden equalled 8.0 percent of pretax income. Nevada's overall business tax burden of 3.8 percent was less than half of the fifteen state average and was also well below California's average burden of 7.3 percent.
3. This low business tax ranking was due to low property taxes as well as to the absence of a corporate income tax. Business property taxes in Nevada were the second lowest of the fifteen states.

## Policy Implications

1. The multistate business tax analysis indicates that Nevada business taxes could be increased somewhat without jeopardizing the state's competitive position. If the legislature decides that additional revenue is needed, a general business tax could be designed to be compatible with the state's economic development strategy of diversification.
2. However, careful analysis of the tax burden implications of alternatives is necessary to maintain some competitive tax advantage.

## State Assistance to Local Governments

## Findings

### The Overview

1. Nevada's decision making process regarding the state and local system is among the most centralized in the nation.
2. There is great diversity among Nevada localities in the level and growth of population, per capita income, assessed value per capita, and other dimensions such as topography and economic base.
3. Between 1977 and 1986 own-source revenues for the state government and for school districts have been growing more rapidly than for states and school districts nationally, while the opposite is true for cities and counties.

4. As a source of local revenues in Nevada, except for school districts, the property tax:
- o is a less important source of local revenue in Nevada than it is nationally;
  - o is a less important source of local revenue in Nevada than in most of the neighboring states;
  - o has been falling in relative importance nationally and in Nevada for the last 25 years;
  - o is decreasing in real per capita terms in Nevada compared to the national average.

#### **The Property Tax Structure**

5. With respect to structure, the Nevada property tax:
- o is consistent with both the benefits-received and ability-to-pay principles;
  - o is levied on a base that is becoming narrower as various forms of personal property and some real property are exempted from taxation;
  - o is less regressive than previously thought; although it is still slightly regressive in the lowest four deciles of household income, proportional through the next four deciles, and slightly progressive over the last two deciles.

6. With respect to the issue of property tax relief:

- o there are a variety of direct and indirect mechanisms for providing for tax relief, ranging from the use of indirect policies such as the substitution of other revenues for the tax (e.g., the goal of the tax shift) to more direct tools such as tax credits targeted to low income households (e.g., the "circuit breaker");
- o the state's circuit breaker should not be targeted to the elderly; rather it should be targeted to low income taxpayers regardless of age.

**The Tax Shift and SCCRT**

7. The Supplemental City/County Relief Tax and the tax shift initiative highlight the need for identifying and debating the tradeoffs inherent in the setting of tax policy. The program:

- o has been successful in holding down property taxes;
- o is not well correlated with any measure of fiscal need, effort, or capacity;
- o shifts the control of local revenue policies from the locally elected officials to the state legislature (with an especially important role for the Interim Finance Committee) and the Nevada Tax Commission;
- o fails to provide the flexibility originally intended regarding the provisions to override the

limits on local governments imposed by the SCCRT and the limits on charges and fees. It is unreasonable to expect the Legislature and its Interim Finance Committee to grasp the full range of local priorities. Moreover, the costs associated with the override process limits the ability of local officials to respond to legitimate changing needs of their communities;

- o because of the limited options it provides, tends to penalize most localities that have the most limited fiscal capacity.

#### Policy Directions

The property tax structure and system of direct property tax relief can be improved by :

- o assessing all property annually at 100 percent of full market value;
- o targeting tax relief to families of low income; not on the basis of age or some other non-economic criterion;
- o adopting a "truth-in-taxation" or full disclosure law whereby officials are required to fully disclose the change in effective rates of the property tax and then hold public hearings prior to voting a change in the effective tax rate.

While there is a legitimate state objective in the limiting of local property taxes and limiting the growth of state and local spending, it is important create a system that allows for local flexibility and discretion so that officials in Nevada's

240 local governments are better able to respond to the diverse needs and circumstances of the local citizenry. Components of this reform of the intergovernmental system include:

- o state establishment of an overall limit on the amount of revenues a locality may raise from all types of own-source revenues (e.g., taxes, fees, charges, licenses). These limits should be permitted to automatically rise as factors that influence expenditures (e.g., inflation, population, and other measures of growth) rise. Local voter processes for overrides of even this automatic growth should be provided;
- o repeal of the SCCRT distribution formula;
- o freeing up the sales tax revenues from the statewide rate for state General Fund use, one of the uses of which will be to create a formula-driven state to local aid program based on factors of fiscal need, effort, and revenue capacity. It should also be recognized that the state-local aid structure may require providing some minimum level of state support through an unrestricted lump sum grant;
- o granting the option to general purpose local governments to enact some levels of non-property taxes (e.g. on taxable sales). If approved, this policy should be accompanied by a minimum state grant to localities with severely restricted tax bases;
- o elimination of state imposed limits on beneficiary fees and charges.



## THE STATE REVENUE SYSTEM

### Gaming

#### Findings

1. Nevada casinos dominate the U.S. gaming industry. There are 32 large casinos compared to 9 in Atlantic City.
2. There has been a significant change in the composition of the gaming mix as slot games have become an increasingly important source of casino revenue. Pit revenue (e.g., blackjack and craps) accounts for about 41 percent of total casino revenues compared to 55 percent from the slots.
3. The country's two largest casino states, Nevada and New Jersey, take a similar approach to the taxation of the industry in that each relies quite heavily on some form of gross receipts taxation. In terms of total burden, however, New Jersey's (Atlantic City) taxes are much higher. For the small casino (annual revenues of about \$10 million), all taxes are 32 percent higher than in Nevada (Las Vegas).
4. The general impression that over the long run the burden of casino taxes falls largely on non-residents is correct. Overall, about 85 percent of gaming taxes are "exported" to tourists. The remainder of the tax is borne by those who work in, sell supplies to, and/or own the casino operations. There is some evidence, however, that residents are accounting for a larger share of the gaming revenues as slots increase in popularity.

5. Nevada is not at a competitive disadvantage because of high casino taxes.

#### Policy Directions

1. Although this study finds that the Nevada casino industry has a lower burden than its New Jersey competitor, that fact does not mean that Nevada should turn only to gaming taxes for increased revenues. Although Atlantic City is not a competitive threat--at least not as presently structured--gaming like any business must compete with other activities for capital. The solution is to continue to look toward that industry for revenue growth (and certainly not cut its tax load), but this should be done with a degree of caution.
2. Despite their rather special nature, gaming taxes should be judged against the same criteria of good tax policy as are other revenue sources. Thus, the annual gaming license tax should be considered a candidate for state general fund use.
3. In view of the growing relative importance of slot revenues and the trend toward higher value games (e.g., dollar slots), the State should consider replacing per machine taxes with gross receipts taxes. Since it is easier to evade a gross receipts tax on slots than a per machine tax, this change should be accompanied by increased spending on tax enforcement.

## Lottery

### Findings

1. At present, Nevada is one of 24 states that does not employ a state lottery as a tool for financing public sector activities.
2. The often used argument that the adoption of a state run lottery in Nevada would reduce casino gaming is not supported by the analysis contained in this report. Indeed, just the opposite is found: lotteries and casino gaming may be complementary.
3. Regardless of how popular state run lotteries are becoming (there is little doubt that they contribute to the overall revenue stream of a government), the lottery fails both the equity and efficiency tests of a good tax system.

### Policy Direction

Because it fails the test of equity and has a limited revenue raising potential, there is no need for a state-run lottery.

## The General Sales and Use Tax

### Findings

1. Although Nevada relies quite heavily on the sales tax as a generator of state and local government revenues, it does so by relying on a relatively narrow tax base. In order to get its sales tax revenues (36 percent of state general fund revenues and 20 percent of state

plus local general revenues in 1986), it utilizes one of the highest statutory tax rates (5.75 percent) in the nation. Nevada's rate is not out-of-line with combined state-local rates.

2. Of the total sales tax revenue generated in Nevada, approximately two-thirds are earmarked for local government (county, city, and/or school district)--the result of a historical accident due to the interplay between the tax law and the state Constitution.
3. Because of the unusually "open" nature of Nevada economy i.e., the presence on any one day of a large number of non-residents spending in the state--when it comes to the sales tax, Nevadans have tended to promote the goals of revenue productivity and exporting of the tax burden over those of horizontal equity and stability for the resident population.
4. In terms of the initial burden of the sales tax, the analysis in this report shows that:
  - o 35 percent of the sales tax is paid by Nevada residents in their roles as retail consumers of taxable goods and services;
  - o 28 percent of the retail sales tax is directly paid by visitors; and
  - o 37 percent is collected from other sources--primarily by business firms in their purchase of taxable items that are used in their operations.
5. Of the portion of the sales tax that is borne by Nevada resident consumers, the distribution is clearly

regressive. That is, the burden increases as family incomes decrease. In view of the fact that there are other regressively distributed taxes in the state and virtually no progressively distributed levies (the one percent tax on hotels and lodging being perhaps the only important exception), the net effect of the Nevada system is one that is among the most vertically unfair tax systems in the nation.

### Policy Directions

In order to promote simultaneously the goals of revenue stability and horizontal equity, as well as of vertical fairness across income groups, it is recommended

- o For horizontal equity and stability: Broaden, on a revenue neutral basis, the general sales tax base to fully include hotels and lodging, food for home consumption, drugs, household fuels and other utilities (including telephone service), services to persons (e.g., dry cleaning, beauty and barber shops) and newspapers. Because this combination will broaden the base of the tax by approximately 70 percent, the tax rate may be substantially reduced (net of any other adjustments) to about 3.3 percent.
- o For vertical equity: In order to achieve vertical equity, the state should enact a variable vanishing sales tax credit (such as is now used in eight other states) designed to target special tax relief to low income residents. In order to offset the added regressivity of this tax base expansion as it affects low and middle income families, the credit will entail a cost of approximately \$40 million. Accordingly, the

net gain of this package is approximately \$322 million. That translates into a new tax rate of 3.6 percent.

In making this recommendation it is explicitly recognized that the most difficult tradeoff between the gain of stability vs. a worsening of vertical equity is associated with an extension of the tax base to food and drugs. Even if repeal of the food and drug exemption is rejected by the Legislature, the low income credit adjustment should still be instituted. If at some point the state were to adopt a progressive personal income tax, the credit may become redundant.

### Alcohol and Tobacco Taxation

#### Findings

1. Alcohol and tobacco provide classic examples of products for which there is a relatively inelastic demand. That is as price rises (e.g. due to a tax), the quantity demanded tends to fall proportionately less than the price change. As a result these taxes contribute to the stability of a revenue system.
2. Although the total dollar amount of tax collections derived from the sale of alcoholic beverages and cigarettes has increased over the past 20 years, the percent contribution of each of these taxes to total state revenues has fallen dramatically.
3. In a state with a significant flow of goods and services across its borders (e.g., as between California and Nevada), if one of these states gets too far out ahead of its neighbor in excise taxation, the result may be significant illegal bootlegging of products across state lines. This result was most

likely to occur between California, which had taxed cigarettes at 10 cents per pack compared to 17 cents in Nevada. But, as the result of a November 1988 California initiative pushing that state's rate to 35 cents and an Oregon rate of 27 cents per pack, the bootlegging problem is minimized.

4. Moving away from a per unit tax approach such as Nevada now applies to both alcohol and cigarettes and towards an ad valorem approach would enhance both the revenue productivity and horizontal equity of the Nevada tax system. It will also tend to reduce the cost of tax compliance.
5. Revenue productivity would similarly be enhanced by the adoption of an annual indexing of the per unit taxes (i.e. annual increase equal to the change in the consumer price index). Indexing does not, however, promote horizontal equity (neutrality).

#### Policy Directions

1. Tax cigarettes on an ad valorem basis at the same rate that other tobacco products are taxed.
2. In view of the recent developments in California (an increase in the tax from 10¢ per pack to 35¢ per pack), raise the Nevada tax to an ad valorem equivalent of approximately 30¢.
3. In lieu of adopting an ad valorem approach, raise the tax on cigarettes to approximately 30¢ per pack and then index the tax for the annual rate of change in the consumer price index.

4. Tax all alcohol products on an ad valorem basis using the same rate for all products no matter what their alcoholic content.
5. Remove all earmarking of alcohol and cigarette taxes and turn the revenues over to the state general fund.

### Highway Taxation

#### Findings

1. At present, Nevada relies almost completely on user fees to support the State highway system. Fuel taxes, registration fees, and fees paid by motor carriers comprise the bulk of revenues paid into the State Highway Fund.
2. The revenue share contributed by owners of the two principal vehicle classes-basic (cars, pickups, and light trucks) and heavy (trucks over 10,000 lbs. gross weight)-matches fairly closely the share of highway construction, repair, maintenance and administrative costs they impose. In other words, the State's highway funding system is equitable across vehicle classes.
3. Recent increases in fuel taxes, registration fees, and motor carrier mileage fees, coupled with increases in vehicle registrations and miles travelled, have produced large increases in State Highway Fund revenues. State gasoline tax increases also have meant increased intergovernmental aid to counties and cities for the support of the local roadway network.
4. Despite the increased revenues from fees paid by motorists, only about half the total amount identified



by the Nevada Department of Transportation as needed for highway improvements over the next ten years will be available. A financing gap of similar magnitude can be expected for identified local roadway needs.

5. Nevada gasoline and diesel fuel taxes already are among the nation's highest. A doubling of vehicle registration and motor carrier fees would not produce the revenues needed if the state's identified funding gap is to be fully closed.

#### Recommendations

1. Nevada can be proud of its record in promoting a fair highway finance system. The balance struck between costs and revenues across vehicle classes, between heavy and basic vehicles, should be established as well within vehicle classes, based on place of registry and miles driven. One way of doing this is to require Nevada-based carriers to pay mileage fees, just as out-of-state carriers do.
2. If the state is committed to funding all or a portion of the unmet needs identified by the Nevada Department of Transportation, registration and motor carrier fee increases will be needed. These increases must be carefully applied, so as to sustain and even improve, the system of equitable contributions already in place.
3. Because of the state-wide importance of the local roadway network, portions of gasoline tax proceeds are distributed to counties based on area, population, miles driven, and road and street mileage. Augmented distributions should be hinged on local effort by

requiring counties to invoke the full local gasoline tax option prior to receipt of additional state aid.

4. To maintain the real buying power of current revenues in the face of highway construction and repair cost inflation and to bolster the productivity of the gasoline tax as increasing fuel economies erode per-vehicle revenues, the Legislature should adopt some form of indexing, or at least commit to approving, as a matter of state policy, compensatory fee increases.
5. Unless the state is willing to raise user fees to levels unequalled anywhere in the region to fund its identified highway need, some additional general fund support for highway improvements must be committed. This departure from the principle of user-financed infrastructure can be justified based on benefit spillovers; e.g., the employment opportunities sustained through the maintenance of a quality highway network.

#### Taxation of Mining

1. Gold production has surged from less than 300 thousand ounces in 1980 to approximately 2.7 million ounces in 1987. Although it is a relatively small part of the state's total employment base, mining is a key industry in a number of rural Nevada counties. Eighty percent of the gross revenue from mining was produced in just five counties in 1987--Eureka, Nye, Lander, Elko, and Humboldt.
2. Analysis of the gold mining industry suggests both opportunities and risks for the State of Nevada. North American production is increasing much more rapidly

than global production and Nevada is the dominant producer in the U.S. However, movements in the price of gold will be heavily influenced by political events and other factors that affect the value of gold as an investment hedge. Mining taxes are a relatively unstable source of revenue because of the unpredictability and volatility of gold prices.

3. The current net proceeds tax has the least adverse effect on production decisions, compared to alternative tax bases such as gross yield or volume of production. It distinguishes between highly profitable and marginal mines and encourages the mining of lower-grade deposits.
4. The Nevada net proceeds definition provides a relatively broad tax base, by disallowing a number of deductions that are permitted for federal income tax purposes. For illustrative purposes, a 5 percent net proceeds tax is estimated to raise \$35 million in 1989 (assuming a gold price of \$400).
5. The volatility of revenue flows is a disadvantage of the net proceeds base. The amount of net proceeds depends upon unstable prices as well as production costs and levels.

#### Policy Directions

1. The current net proceeds tax should be retained as the primary method of taxing mining.
2. Because of the instability of gold prices and mining tax revenues, only revenue generated by a floor price of gold should be used for recurring or operating

expenditures. The floor price assumption would be set to reflect a worst case price level prior to each budget period. Revenue generated in excess of the floor price amount would be allocated to a trust fund or used for one-time expenditures such as capital projects.

3. The net proceeds tax should be supplemented with a severance tax based upon gross yield in order to reduce revenue instability and to insure that all mines pay some tax to compensate for environmental impacts. However, net proceeds should continue to be the primary method of mining taxation.
4. Both state and local governments should share mining tax receipts. Some local share is justified due to the local impacts of mining. A state share is justified by the view that the mineral resources are part of a natural heritage and should benefit all of the citizens of the state. The state-local shares should be a legislative determination.

### Personal Income Tax

#### Findings

1. Nevada is one of seven states that has no personal income tax. For Nevada, a fundamental issue is whether a personal income tax should be enacted.
2. The personal income tax can be used to offset the regressive nature of other taxes, such as the sales and property taxes. Rebate mechanisms are direct devices for providing targeted tax relief to lower income taxpayers. Property tax relief circuit breakers and

income-adjusted sales tax rebates, as well as the personal income tax, can be used as tools for addressing regressivity concerns.

3. By its nature, the personal income tax is a major revenue source. A Nevada personal income tax with modest rates of around 3 percent would raise approximately \$350 million in fiscal year 1991. To put this in perspective, such an income tax yield would approximate one-half of total Nevada General Fund revenues.
4. Non-income tax states are distinctive in possessing large sectors that have tax exporting potential. Use of exported taxes is an attractive option if it is technically feasible and if it can be justified as offsetting social costs generated by out-of-state residents. Nevada residents currently pay low overall personal taxes in part because of the large contribution of gaming and tourist-related sales taxes to the state General Fund.

#### Policy Directions

1. The long-term projections included in this report indicate a projected revenue need for financing the current level of General Fund expenditures on the order of 5 to 10 percent of General Fund revenues. Unless it were set at a very low statutory rate, the income tax would be "overkill" in addressing a revenue need of that magnitude.
2. The case for a Nevada personal income tax at this time must rest on a judgment that the current level of services is inadequate and spending levels should be

significantly increased. That question requires a legislative determination and is outside the scope of this study.

3. The option to enact a personal income tax should not be foreclosed by constitutional prohibitions. Over the long term, unanticipated changes in economic conditions could result in either erosion of current revenue sources or heightened spending levels. Thus it is important for the legislature to retain the flexibility to consider the full range of potential revenue sources.

### General Business Taxation

#### Findings

1. Nevada, Alaska and Wyoming are the only states that do not impose a general business tax.
2. The most common form of state general business tax is the corporate income tax. Forty-five states levy a corporate income tax. In addition, Texas imposes a capital stock franchise tax and Michigan applies a modified value-added tax.
3. The appeal of an income tax base for a general business tax is that it avoids burdening firms that are in an unprofitable position. There are, however, two arguments against relying entirely upon a profits base. First, profits are volatile and a business profits tax adds to the instability of a state's revenue structure. Second, business operations receive public service benefits, such as transportation, sewer and water

facilities, and police and fire protection, even if they are not currently profitable.

4. The capital stock franchise tax is an alternative business tax that is imposed by twenty-nine states. The tax base can be defined as equity or invested capital (including long-term debt) as measured on the firm's balance sheet. Franchise taxes are more stable than profits taxes.

#### Policy Directions

1. If additional revenues are needed, a general business tax would be an appropriate revenue source. However, the level of taxation should be carefully designed so as not to entirely eliminate Nevada's competitive business tax advantage.
2. The preferred option would be a 3 percent business income tax combined with a 0.12 percent franchise tax on invested capital. This option would raise approximately \$70 million in FY 1991 and would be equivalent to a 5 percent corporate income tax. The advantage of this alternative is that the use of a franchise tax adds stability to the revenue structure.
3. If adopted, a general business tax should be imposed upon all businesses whether organized as corporations, partnerships, or sole proprietorships. If some exemption for small businesses is judged to be necessary, the policy should be defined in terms of the size of the business not its legal form.

## Telecommunications

1. With respect to the telecommunications industry, the future is arriving at a fantastic pace. There may be no other area in which the technology employed by an industry is developing so rapidly.
2. As the new technologies in voice, video, and data transmission converge with (and to a large extent precipitate) institutional (e.g., judicial) reform, the notion of "the telephone company" as a monopoly is fast disappearing. This is certainly true for inter-exchange (e.g., long distance) firms such as AT&T (90 percent of the Nevada market) and its competitors (there are 11 others sharing the other 10 percent of the market).
3. The state's local operating companies still hold considerable control over their assigned areas within the state (e.g. Central Telephone Co. in Clark County, Nevada Bell in Washoe), and therefore may justifiably be thought of as monopolies. The Legislature should be well aware, however, that operating companies are beginning to face an increasing amount of competition for some services.

## Policy Directions

1. Nevertheless, for inter-exchange carrier and operating company alike, it is important that the system be neutral with respect to taxation. That is, these firms should be taxed in the same manner as other business firms.



2. In order to promote efficiency in the tax system as it applies to telecommunications firms, the state should move to eliminate the sales taxation of equipment purchases (e.g., central office equipment) for local operating companies and long distance carriers. This will result in about a \$ 1.5 - \$2.0 million dollar revenue loss.
3. In order to promote horizontal equity in the general sales tax system, the retail sales tax should be applied to the retail telephone bill. This could generate as much as \$9 million per year in state general fund revenues.

### Financial Institutions

#### Findings

1. As was true for the telecommunications industry, the financial industry is experiencing rapid changes in technologies and the organizational relationships of its operations.
2. As Nevada enters the era of expanded interstate banking, it should consider the adoption of broad rules as to the definition of a what constitutes a "bank" and the reporting requirements that accompany such a broad application.

#### Policy Directions

The principles relating to the treatment of general businesses should be applied to financial institutions. If the State does decide to adopt a general business tax, the financial sector should be broadly defined and included in the tax base.

The apportionment formula should not discriminate against resident firms.

### Other Taxes

1. The (Pick-Up) Estate Tax: The state should maintain its policy of utilizing the pick-up of the federal estate tax credit. However, the provision should be removed from the Constitution and its earmarking for education abolished with the funds being placed in the State General Fund.
2. The Tax On Controlled Substances ("Grass Tax"). Now that the special tax on illegal drug sales has passed its major constitutional tests of due process and protection against self-incrimination in one test state (Minnesota, 1988), Nevada should move quickly to enforce its own tax on controlled substances. The Nevada Department of Taxation and the various state and local law enforcement agencies should meet to work out the mechanics of cooperation in the enforcement of the law.
3. Insurance Premiums. The coverage of the insurance premiums tax is broad (e.g., Blue Cross/Blue Shield and HMOs are included in the tax base) and a uniform rate is applied to all lines of insurance. This treatment achieves a degree of tax neutrality of insurance premiums that has eluded many other states. Accordingly, there is no need to restructure this tax.