MINUTES OF THE
SENATE COMMITTEE ON REVENUE

Seventy-sixth Session
March 24, 2011

The Senate Committee on Revenue was called to order by Chair Sheila Leslie at 1:08 p.m. on Thursday, March 24, 2011, in Room 2134 of the Legislative Building, Carson City, Nevada. Exhibit A is the Agenda. Exhibit B is the Attendance Roster. All exhibits are available and on file in the Research Library of the Legislative Counsel Bureau.

COMMITTEE MEMBERS PRESENT:

Senator Sheila Leslie, Chair
Senator Steven A. Horsford, Vice Chair
Senator Michael A. Schneider
Senator Moises (Mo) Denis
Senator Mike McGinness
Senator Joseph (Joe) P. Hardy
Senator Elizabeth Halseth

STAFF MEMBERS PRESENT:

Russell Guindon, Principal Deputy Fiscal Analyst
Joe Reel, Deputy Fiscal Analyst
Brenda Erdoes, Legislative Counsel
Gayle Rankin, Committee Secretary

OTHERS PRESENT:

Matthew N. Murray, Ph.D., Professor of Economics and Associate Director, Center for Business and Economic Research, University of Tennessee, Knoxville
Jeremy Aguero, Principal Analyst, Applied Analysis
Guy S. Hobbs, Hobbs, Ong and Associates, Inc.

CHAIR LESLIE:
We have several presentations today. We are going to start with Professor Matthew Murray, who is a professor of Economics at the University of Tennessee, Knoxville. He will be addressing the Committee with a presentation entitled "Structurally Unbalanced, Cyclical and Structural Deficits in

Nevada" (Exhibit C). This meeting is being videoconferenced to the University of Tennessee, Knoxville.

MATTHEW N. MURRAY, PH.D. (Professor of Economics and Associate Director, Center for Business and Economic Research, University of Tennessee, Knoxville):

In the last couple of years, we have gone through the longest and most serious economic downturn since the Great Depression. That is the bad news. The good news is the economy is starting to recover. There are signs of economic growth in most states, including some signs of growth in Nevada. Unfortunately, for many states like Nevada, it will be a long road to recovery. Economic growth is not expected to be as robust in the coming years as the path of economic growth we have experienced in the first decade of the twenty-first century. It will be a difficult time to bring the budget in balance, not only in the near term, but there will also be long-term issues to confront with your Nevada State budget.

Page 2, Exhibit C, shows the background and team effort. I am in the Economics Department and also the Center for Business and Economic Research. We do a wide range of economic research and fiscal research for the State on both the spending and revenue side of the budget, economic forecasting, revenue forecasting, special studies on the education budget and welfare. The work I do is focused on state and local government finance issues. Our report is a team effort including Rob Lang, Director, University of Nevada, Las Vegas, Brookings Mountain West; Mark Muro, Washington Director, Brookings Mountain West and Tom Rex, Arizona State University. Mr. Rex developed the numerical estimates of the Structural Deficits in Nevada.

We went to press with the report at the end of 2010. Some of the information is dated and the economy and fiscal affairs have transitioned, but the overall theme of the report remains one that shows these states with large fiscal and structural imbalances. This will create a significant fiscal hardship for years.

Page, 3, Exhibit C, shows the distinction between a cyclical deficit and structural deficit. This is a complicated process and problem because Nevada does not include these measures of your deficit in a budget document. Some states such as California and Indiana look at their structural deficit, but most states do not. There are two definitions. A cyclical deficit is defined as a shortfall or a decline in revenue relative to expenditures during an economic recession or contraction. A structural deficit is defined as a permanent shortfall in revenue relative to expenditures once you have accounted for that cyclical performance of the economy. As an example, in the early part of 2000, the economy was moving along and state budgets were beginning to show signs of a fiscal surplus because of the improvement in economic conditions and revenue performance. The structural deficit is a deficit that arises from tax cuts or from permanent increases in spending that use up the surplus that emerged earlier. When you go into an economic downturn, revenues decline because of the recession and reduced tax receipts, and you also have pressures on the expenditure side of the state budget. These imbalances are aggravated by the structural deficit. This structural deficit never goes away. It is hidden during periods of economic health, and it comes back and surfaces during an economic downturn. The consequences of a structural deficit are many. It aggravates the problem you are dealing with in Nevada as you try to bring your budget back into alignment. It can lead to higher increases of taxes and sharper cuts in expenditures than if you were only dealing with a cyclical shortfall in revenues.

It can lead to poor decision-making because policy makers find themselves in a crisis environment. The State of Arizona sold its state capitol building and supreme court building, arranging a leaseback agreement to produce revenues to bring the budget in alignment—but creating a long-term expenditure requirement to maintain the lease payment.

DR. MURRAY:
The State of New York was challenged with meeting its pension fund contribution in 2010 and borrowed from the same pension fund to meet its pension fund obligation. We are engaging in short-term fixes that do not fundamentally resolve our budget problems; they push them down the road. Nevada has not gone that route. Nevada has used one-time monies and fund sweeps, but your state has not engaged in the same degree of gimmicks as many other states have. All of these fiscal problems can create problems—in service delivery, the stability of your economy, the stability of the fiscal system—and hamper your business climate. In a recent report from Moody's, the State of Nevada saw its bond rating downgraded as a result of the same factors I am talking about today. That bond rating downgrade will end up costing the State of Nevada more in borrowing costs in the years ahead. This is sending a signal to the world outside Nevada that you have serious problems that are not fully resolved.

Page 4, Exhibit C, shows the structural deficit can surface from three sources. The first is your fiscal system. The fiscal system includes your system of taxation rates and bases, expenditure obligations in different spending programs and provides for rules that affect your fiscal decision-making. You have a two-thirds supermajority requirement on both sides of the Legislature, Assembly and Senate. That represents a constraint on your ability to make fiscal policy decisions. The fiscal structure and the rules that determine the processes on how you make your decisions are affected by demographic and economic trends that ripple through on the spending side and the tax side of the budget. In Nevada, the sales tax base relies heavily on tangible goods and tends to exempt a wide array of consumer services. Consumer services have been a growing share of household consumption for decades. If there is not a policy change, the revenue performance of your sales tax erodes over time. We may be in fiscal balance one year, but because of the erosion of the sales tax base over time, we will be imbalanced in other years.

Demographic trends, such as the growing school age population can put pressures on the kindergarten through Grade 12 (K-12) education system. A growing elderly population can put rising pressures on public health delivery service cost as well as the health care insurance programs you provide for your State government employees.

Political decision-making and voter initiatives can also influence the structural deficit. Political decision-making has much to do with the origin of a structural deficit. During periods of economic growth, the State of California expands government service delivery programs which increases expenditure requirements. This is not sustainable in the long term. During periods of economic growth and economic downturns, the State of Arizona chose to cut taxes significantly without commensurate cuts to the spending side of the budget. In both of those instances, those policies have contributed to growing structural deficits in California and Arizona.

Page 5, Exhibit C, shows the estimates of the structural deficit and the cyclical deficits for California and the three intermountain states included in the analysis. The structural deficits in California and Arizona are especially pronounced for the reasons I just gave you. During the 1970s, 1990s and part of the first decade of the twenty-first century, California increased government spending—without the commensurate increase in taxes to fund those permanent increases in spending over the ups and downs of the business cycle—and created a structural deficit. In Arizona, they have cut taxes year in and year out for a couple of decades without the same reductions in spending. Permanent tax reductions without permanent spending reductions are the primary source of the structural imbalance in Arizona.

Colorado's situation is unique because of the Taxpayer's Bill of Rights and the ratchet effect associated with the Taxpayer's Bill of Rights. Over the course of business, this cycle tends to bring overall government spending down, leading to a smaller state government as a share of the private sector economy, for example, state government revenues and expenditures as a share of the gross domestic product or personal income. Colorado has been able to avoid large structural deficits, but they have done so at the cost of compromising their ability to fund important public services, in particular education services in K-12 and higher education which represent investments in people and the state economy that make both more productive over the long run.

Nevada's structural imbalance for 2011 is small in comparison to the other states. The reason for the small structural deficits is we have raised a number of taxes—such as the Modified Business Tax and sales tax—and fees that have helped shore up fiscal affairs. Because of our fiscal structure and the economy, the structural deficit may loom larger in the future.

SENATOR HORSFORD:
Are you aware that the revenue raised starting in 2009 is due to sunset? What would that do to the structural deficit?

DR. MURRAY:
It is my understanding we are talking about as much as $1 billion in revenue in the form of temporary tax increases. At the end of June, that revenue will no longer be available. That is one of the factors that is going to aggravate the fiscal situation in Nevada. Your economy is not rebounding rapidly enough to make up for that loss in revenue. Compounding the problem from that loss is the loss of fiscal stimulus funds from the federal government. You are looking at a double crisis as you move into fiscal year (FY) 2012 and FY 2013 because of loss of temporary revenue and federal funds and the lack of a robust recovery in the private sector economy.

CHAIR LESLIE:
Did you factor the sunsets into this analysis?

DR. MURRAY:
Our analysis stops in FY 2011. We did not project the numbers going forward. That will aggravate the fiscal situation in the years ahead.

Page 6, Exhibit C, shows a chart. Look at the period after the recession of 2001. If you look at the expenditure line, you can see the expenditure line drifted up which reflects the dramatic growth in the state population. Nevada's population grew more strongly than any other state in the Country during the first decade of the twenty-first century. That has contributed to the upward pressure on spending growth across your state budget, including expensive expenditure programs such as K-12 education. You can see what happened to revenues on the heels of that recession. The recession brought down tourism and gaming activity. A rebound from the recession began to restore revenues, and there were also some tax increases in 2004. You can see the surplus between revenues and expenditures during a short period in the first decade of the twenty-first century before the recession kicked in, where revenue performance weakened and expenditure demands on the budget increased. That is part of the surplus I have mentioned previously. A surplus is needed over the long term to fund the fiscal shortfall during an economic downturn. Had that surplus been put in your fund to stabilize the operation of State Government (Rainy Day Fund) you would still be dealing with a difficult budget situation, but you would have substantially more money in your Rainy Day Fund to temper the decline in spending and reduce the pressure for tax rate increases.

SENATOR HORSFORD:
Are you aware of efforts by other states with the policy they have set to put those funds in a reserve not including the rainy day fund?

DR. MURRAY:
We do not know or have detail because there is not standard reporting. The National Association of State Budget Officers collects uniform data across the state on formal rainy day funds, and most all states have a rainy day fund. Those can be monitored, but we know very little about local government rainy day funds and idle reserves that might be available within state agencies and their various budgets. When the bond rating agencies begin coming back into the states to talk about the fiscal affairs of the state, they are going to push for much larger rainy day funds. The general rule prior to the recession was to have a rainy day fund around 10 percent of your general fund revenues and

expenditures. We will see a push for a number as high as 20 percent or 30 percent of general fund expenditures.

On Page 7, Exhibit C, is a series of bar charts that show the deterioration in the fiscal situation in terms of the deficit in Nevada. Starting in 2007, you had a cyclical surplus. The recession did not start until December 2007 when the economy was still performing well and the health of state government was in reasonably good shape. In 2007, the estimates show this embedded structural deficit. While the cyclical deficit grew because of policy changes enacted by the State Legislature, the structural deficit began to decline with the passage of time. The text in the middle of this page says, "Underlying shifts in the economy threaten to nullify recent progress in reducing the state's structural deficit." For the balance of the presentation, I will review this. I have already mentioned the temporary tax increases go away at the end of June and the stimulus funds go away at the end of the current fiscal year for the state.

Page 8, Exhibit C, shows what you know and know very painfully. The economic situation in Nevada has stabilized. There are signs of some improvement in economic growth. The unemployment rate fell from 14.9 percent to 14.2 percent. This remains very elevated but is an improvement in the unemployment rate. A publication called *State Policy Reports* came out in December 2010 with an index that placed the State of Nevada fiftieth across the states in economic momentum for the fourth quarter of last year. Nevada was fiftieth in personal income and employment growth with the highest unemployment rate in the Nation last year. Despite weak economic conditions, Nevada will continue to be a draw to the population around the Country and the world because of your climate and relatively low property values. That growing population will continue to put pressures on the spending side of the budget, but you will not likely see the same return to revenue growth like you saw during the first decade of the twenty-first century.

From a fiscal perspective, Page 9, Exhibit C, shows the way your fiscal structure is established and the way it interacts with the economy as a whole. Nearly two-thirds of your revenues come from transactions of some form. Many of these transactions are on the part of visitors and nonresidents of Nevada and include sales and use tax, gaming and casino taxes and room tax. You have diminished flexibility from a fiscal perspective because both sides of your Legislature require a supermajority for a tax increase. You have a constitutionally constrained sales tax rate, and you have a constitutional prohibition against corporate and personal income taxes. This is part of the fiscal environment in the earlier chart, identifying some of the sources of a structural deficit. These sources are good from a fiscal discipline perspective in good economic and fiscal times. They can strain you during times of fiscal decline and poor fiscal health as you try to bring your budget into alignment.

Page 10, Exhibit C, shows how this fiscal system will interact with your economy which is disproportionally oriented on the tourism sector. We show the share of State gross domestic product (GDP) which is the broadest measure of economic activity for a state or a national economy. Over 40 percent of the GDP is coming from leisure, hospitality, real estate and the construction sector. Your economic portfolio has one stock in it, and that is the Gaming industry. That concentrated portfolio makes you subject to the volatility of an economic downturn along with long-term structural changes and patterns in economic performance.

SENATOR HORSFORD:
You indicated we have a constitutional prohibition on corporate income tax. It is on personal income, not on corporate income. We are one of five states that does not have a corporate income tax.

In the good years of economic growth in the gaming and construction sectors, we had a tremendous boom and those two sectors made up our GDP in the state budget. Gaming is not going down further, but neither it nor the construction industry will grow at the rate it did over the past two decades. What would the GDP have to be in other sectors and through personal contributions in order for us to sustain the growth we saw from construction and gaming?

DR. MURRAY:
I cannot give you a precise number because I have not run numbers like that. You are absolutely right. The gaming sector is not likely to rebound like it did during the first decade of the twenty-first century. There are fundamental shifts in gaming activity, the rise of Internet gaming and a different pattern and consumer benefitting from gaming activity. You will not see that surge in gaming activity. The residential housing sector along with commercial property is depressed. We have very high vacancy rates and continued downward pressure on values which will put long-term downward pressure on property tax revenues. A lack of growth in spending means you will not see the resurgence

to growth in sales and use tax. All the building materials that go into construction of a home, the home furnishings and building materials that go into commercial property are sales taxable. You will not see that bubble anytime in the foreseeable future. Through this entire decade, you could see construction activity perform poorly and likewise affect your state sales and use tax and Real Property Transfer Tax. I cannot precisely answer what needs to happen outside the gaming sector. You do not want to give up on the gaming sector. It is still an important component of your economy, but you do need to diversify. Unfortunately, diversification does not come at the turn of a corner. Diversification has to come through long-term planning. It is absolutely essential you begin making those investments today to reap the benefits of those investments for years ahead.

SENATOR HORSFORD:
We rely on tourism to determine our basic needs as residents in Nevada. There is this feeling we have relied on it so heavily that our own future is at risk. My kid’s education is not as strong because the tourists are not coming to contribute to this tax base. I want to ask again if there is something we should put in place structurally as we try to diversify the economy? I realize that gaming and sales from construction cannot sustain our basic needs, and those of us in major businesses in the state may have to pay our share to do so. We have relied on others for too long.

DR. MURRAY:
You have relied on the interest of others in gaming and tourism to determine your economic and fiscal health. Now is an opportunity to take control of your own destiny by thinking about ways to diversify your economy with a tax system that is not heavily reliant on tourism. In the near term, you will continue to rely on the fate of gaming and tourism because that is the foundation of your economy. There are still some things you can do. Grow the Rainy Day Fund to a higher level and expand your sales and use tax base to include services that are largely untaxed today. Pursue a broader sales and use tax base. This is a problem when economic activity remains depressed and you do not have vibrant economic growth that translates into vibrant fiscal or revenue growth. The key strategy for Nevada is to focus strategically on a long-term direction for the economy. Design a tax system consistent with that diversified economy and put your future in your own hands as opposed to the hands of visitors to Nevada.

Page 11, Exhibit C, presents the broad recommendations. Lawmakers should begin by improving the quality of fiscal policy-making by broadening, balancing, and diversifying the tax base and the revenue stream. Improve budget processes and information-sharing with the public and within the Legislature.

Page 12, Exhibit C, shows some of the points of improved fiscal policy-making. Commit to a balanced approach. Your budget does not exist in a vacuum. Taxes and government expenditures do not exist in a vacuum. Your budget serves a purpose to complement private sector economic activity and to provide assistance to needy families. It contributes to your economy by supporting infrastructure investments such as transportation infrastructure that facilitates commerce. Your budget supports education that makes people more productive and makes businesses in Nevada more productive. Taxes are a burden. No one would question that. A budget reflects both a tax side that is burdensome and an expenditure side that helps people and businesses. That needs to be identified and recognized when dealing with difficult budget problems. When we argue for a balanced approach, we are arguing that both revenue increases need to be considered along with tax cuts. You cannot reasonably bring your budget into alignment in Nevada solely by cuts and expenditures or solely by increases in taxes. Those decisions need to be made strategically. They need to be based not on where Nevada wants to take its budget but where Nevada wants to take its economy in the years ahead. A balance of taxes and expenditures is the goal.

The next is broadening the sales and use tax base. You exempt food and a range of services, including repair, installation, laundry and veterinary. Some of those are small in scale and would contribute little to revenue; others would contribute substantial amounts of revenue to the tax base. With a narrowly based economy, broadening of the tax base will help, but absent economic diversification, broadening of the sales and use tax base is not a solution by itself. Local governments need to have control and influence over their own futures. Economists such as I are strong advocates of assigning much expenditure obligation and revenue-raising capacity to the local government level where there is the greatest degree of accountability between the local electorate and elected officials. We often know our elected officials at the local level. We typically do not know our elected officials at the state level.

As I have already mentioned, Rainy Day Fund balances are too low in Nevada and most other states. Rainy Day Fund balances need to be enhanced at the state level and encouraged at the local level. Then protect those funds. Do not sweep those rainy day funds away at the local level. Give the local governments authority, control and the responsibility to meet the service needs demanded of them by the local electorate.

Page 13, Exhibit C, explains better budget processes and information-sharing. I have been surprised at how little the American public knows about the federal budget, despite the severe and acute deficit problem, and our State budgets. The Public Policy Institute of California surveyed the electorate and wanted to know if the electorate could identify the largest spending program in the state. The majority identified corrections. Corrections is the fourth largest spending program in California. Only 16 percent identified K-12 education as the largest expenditure category. It is difficult to make sound decisions when the electorate does not have good information. Good budget processes and information-sharing within government and with the public is essential. I want to emphasize the importance of a strategic plan that will help you make the decisions on the budget. If you have a strategic plan in place to deal with your economy, that plan can be a reference point for making recommendations regarding possible tax increases—as unattractive as they are during an economic downturn—as well as any spending cuts, which are also unattractive during poor economic times.

DR. MURRAY:
Nevada has a biennial budget process. That is not what we are referring to here with multiyear budgeting. We are looking at long-term budgeting that may go out five or ten years. We want a budget process that goes beyond the election cycle of currently elected officials. It puts the burden on them. Information about what we think our expenditure commitments will be five years from now is shared with the public. What will K-12 look like? The numbers will be precise. I do economic forecasting, and our center does revenue forecasting. We forecast our unemployment insurance trust fund balance, and we typically miss the mark. It is a useful exercise to go through because it engages people. You are all engaged in the same kind of dialogue about what if: What if we do have a recession? What if this does not happen? The long-range crystal ball thinking about your budget helps you think about the "what ifs" and the consequences of alternative "what ifs."

Report budgets and fiscal data in a transparent manner. When we were putting together this report, one of the things I do when I look at states from afar is go to publications from the National Association of State Budget Officers. It is good information and is uniform across the states. Of the four states we looked at in this process, Nevada is the most problematic. It was difficult to acquire information on current spending cuts, cuts that have been implemented and cuts being proposed. It was difficult getting good timely data on tax increases and the temporary tax increases we have talked about. That lack of information creates uncertainty, anxiety and distrust on the part of the electorate and does not allow them to support informed decision-making on the part of their elected officials.

Educate citizens about fiscal implications, general budgeting of referenda, citizen's guides, pamphlets and booklets. The type of information the League of Women Voters around the Country share at election time about election and referenda issues is a good example.

Improve tax expenditure reporting. With the exception of Nevada, states in the region already have tax expenditure reports. I strongly recommend you look at the multiyear tax expenditure reports from Minnesota that are consistent with our focus on multiyear forward-looking budgeting. A tax expenditure is something we have chosen as a policy-making body. Not to tax services under the sales and use tax would represent a tax expenditure. Services have generally been exempt from your State sales and use tax. It is the choice on the part of your Legislature not to tax them. If you go to a state like Illinois that has a tax expenditure report, their report does not list revenue losses from the failure to tax services. Tax expenditure reports are an important complement to your overall budgeting process in information-sharing within state government and with the public.

CHAIR LESLIE:
Your presentation was interesting. You talked about Arizona selling their state buildings and leasing them back. You used that as an illustration of poor fiscal policy. We are looking at securitizing future insurance premium taxes. Would you put that in the same category of poor fiscal policy?

DR. MURRAY:
Securitization of that form needs to be looked at very hard. It is not something you would have considered during a time of economic and fiscal health. The fact you are looking at it now suggests you are looking for every possibility to close the budget gap. Budget and policy experts would say those are ill-advised

policies. You need the revenue today, but a household does not sell its house to generate cash to fund ongoing expenditures. It is not good fiscal policy. Take a very hard and cynical look at a policy like that.

CHAIR LESLIE:
Thank you. You were clear with your presentation, and we appreciate you spending so much of your day with the Nevada Legislature. We will go to our second presentation from Jeremy Aguero and Guy Hobbs.

JEREMY AGUERO (Principal Analyst, Applied Analysis):
I have provided you two documents today. The first of those documents is "Studies on Nevada's Tax Structure" (Exhibit D). This is what is on the screen and what I am going to review. The second document is published by Nevada Taxpayers Association *An Incomplete History of Nevada's Tax System* (Exhibit E, original is on file in the research library). We tried to get all the major changes that have happened to our tax structure as far back as we could go. A special thanks goes to the Nevada Taxpayers Association and the Legislative Counsel Bureau for all the documentation they gave us.

I would like to start with our review of historical tax studies. I will outline what has happened before, state some one-liners from recommendations with comments as need be and then turn it over to Mr. Hobbs to talk about the similarities and lessons learned from the tax studies.

I will start with the 1960 Zubrow Report titled *Financing State and Local Government in Nevada* on Page 2 of Exhibit D. We have been talking about these ideas for a long time, and you find many of the themes are much the same as the information you just heard from Dr. Murray. The 1960 Zubrow Report, created as a result of a 1959 legislative act included a 25-person Special Citizens Committee on Taxation and Fiscal Affairs and limited its recommendations to existing sources but included analysis of some new revenue sources. To put into perspective what the world was like in 1960, our state had 280,000 people. Our government employed 3,200 people. The General Fund was $25 million. We are going to talk about the problems and recommendations that are not that different from what we are talking about today. When you go back and read this report, they were still thinking about the Great Depression. We are still thinking about coming out of the downturn or the uptakes.

Page 3 of Exhibit D shows recommendations from that study. They include exempting household effects from the tax base and reducing the state levy to compensate local jurisdictions. That is a restructuring of our sales and use tax. In addition, they recommend exempting food and restaurant meals from the tax base to improve overall equity and to increase the tax on cigarettes and liquor, a common theme in every tax study done. They also suggest modifying and redistributing the County Table Tax and increasing the State gross gaming receipts tax scale from the existing 3 percent to a maximum of 5.5 percent to a recommended 3 percent to 7 percent.

Page 4 of Exhibit D shows The Lybrand Report in 1966, the second of the studies. Senate Concurrent Resolution No. 8 of the 12th Special Session created the need for this *Study of General Fund Revenues of the State of Nevada*, on page 4 of Exhibit D. It gave priority to gaming taxes and financial controls. In 1966, there were great concerns over our gaming industry and the organized crime influence in the gaming industry. There was concern that skimming was happening, and we were not collecting taxes that were due. This loomed over that tax study. In 1966, our population had grown to 419,000, whereas today, we are at 2.7 million. State revenues were $178 million with the General Fund growing to $52 million. A projected revenue shortfall of $9 million or 14 percent was anticipated to grow to $45 million or 35 percent by the time we got to 1976. An initiative petition was being circulated that would increase the gaming tax by 200 percent. Regulatory oversight was a big issue. Sales and gaming taxes make up the vast majority of State General Fund revenues, which is a recurring theme of what we saw in 1966.

Page 5 of Exhibit D shows the recommendations in that study. They included increasing licenses and fees and implementing the estate tax to allow for the state "pick up." The federal government allowed us to pick up a piece of that. Until 2005, those monies were going directly from that to education; the federal government fazed them out with the Bush tax cuts. Additional recommendations were to increase liquor taxes by 50 percent and cigarettes by 2 cents per pack and to increase the gaming percentage by 50 percent over the next eight years, 25 percent immediately. Also, the study recommended instituting a corporate income tax of 5 percent, escalating to 12.5 percent over eight years, and instituting a personal income tax of 1.25 percent going to 3 percent over eight years.

MR. AGUERO:
On page 6 of Exhibit D is the 1988 Price Waterhouse/Urban Institute Report. This extensive report is referred to as the *Fiscal Affairs of State and Local Governments in Nevada* report. This legislative-commissioned study was comprehensive and well done. The analysis was edited by Robert Ebel who later went to work for the World Bank. The study was thoughtfully prepared and extensive. It was also posttax shift. The tax shift changed the way we distribute and collect money in Nevada between State and local governments. In 1988, our population was just over 1 million people. State employment was 500,000. Total State revenue was at $1.5 billion. Annual visitor volume had grown to 19 million people. Inflation was relatively low. In the late 1970s and the early 1980s, inflation was a huge issue. They were now dealing with a more-controlled inflationary environment.

Page 7, Exhibit D, lists a number of recommendations. Some of them are similar. One thing mentioned throughout their presentation was the constitutional limitations to our tax system. There is great danger in writing tax law into your constitution because you cannot change it. It becomes difficult, and flexibility is paramount in tax policy.

Avoid earmarking except in limited cases. With earmarking, the Legislature has little flexibility in the money's use.

Nevada should be careful to maintain a business tax advantage; however, the report concluded that business tax could be raised without jeopardizing the State's competitive position.

Property Tax relief measures should not be targeted to the elderly but rather to low-income taxpayers. If you are going to have tax relief, give it to the people who cannot pay based on some rational basis. Property should be assessed at 100 percent of market value. The land is taxed at full cash value, but the improvements are taxed at replacement cost. The idea was to have it taxed at 100 percent of market value so it would ebb and flow with the market value. This was never followed.

Tax system transparency should be increased. We have much better access to data today than then.

Make significant reforms to the intergovernmental revenue system in how we distribute revenues. There was long-standing concern about the State being dependent on gaming taxes and local governments being more dependent on property and sales and use taxes. That is not a perfect analogy. The State also has a vested interest in property taxes, but the gaming tax pays the majority of it to the State. There were concerns about whether that would create some degree of inequity over time.

Replace the per gaming machine, per unit tax with taxes based on gross receipts. There was concern throughout the study that many of our taxes are unit-based. We charge 1 cent per pack of cigarettes or 1 cent per gallon of gasoline. If the prices change, the taxes do not change. You are constantly left with some degree of structural shortfall.

We should not have a State lottery.

On a revenue-neutral basis, we should broaden the general sales and use tax base to include hotels and lodging, food for home consumption, drugs, household fuels and other utilities, services to persons and newspapers. To attain revenue neutrality, significantly reduce the State's sales and use tax rate and address the regress issue. The State should enact a "variable vanishing sales tax credit." This is a way to give lower-income consumers a tax credit for the sales and use tax they pay to make it more progressive and less regressive as a tax system.

Raise the cigarette tax to 30 cents per pack and index the tax to the annual rate of change in the consumer price index.

Page 8, Exhibit D, continues recommendations. Tax all alcohol products on an ad valorem basis. Liquor taxes today are based on units as opposed to prices.

Consider the use of mileage fees for classes of drivers. Our form of taxation that relates to roads and highways is not going to keep pace because it is unit-based. Local governments should be required to invoke the full gasoline tax.

Mines should continue to be principally taxed on Net Proceeds of Minerals Tax; due to the instability of the revenue source, reoccurring operations should only be funded by a floor price of gold. This is to use the same tax we have but find a baseline value of gold because it is going to go up and down. This money would not be used to fund reoccurring operations. Put it aside and create some type of endowment structure where we could live off the interest of those cyclical ups and downs. Net Proceeds of Minerals Tax should be supplemented with a severance tax based upon gross yield. This would add a second tax to the mining industry.

SENATOR HORSFORD:
Can you explain what you said about the severance tax being a supplement?

MR. AGUERO:
I am not an expert on severance tax, and I would have to see how it is structured in other states. Essentially, the idea of a severance tax is that you are severing an asset from the State that is nonrenewable in nature. There are states that have a second tax levy associated with the fact that the unit of a good being taken out of the state is gone forever.

SENATOR SCHNEIDER:
About 12 years ago, I had a bill to take the Net Proceeds of Minerals Tax and put it in a trust fund. We could only spend 75 percent of the interest of the trust fund. The other 25 percent of interest would go back into the trust fund plus all incoming mining revenue. If that had started in 1864, we would have had enough money in the trust fund to fund education fully. This is the way to go. It is a nonrenewable resource. The mining companies had a fit and came unglued. This is something we need to look at. This is not like the forestry business where in 50 or 100 years you have new trees to cut down. With mining, it is over when they take it out of the earth. It will never come back. We need to plan for the future.

CHAIR LESLIE:
From what you are telling us, this is the 1988 study. They were thinking along those lines then. There are similar recommendations in this study.

MR. AGUERO:
A lot of proposals have come up. Specific to this study? Yes, that was absolutely what was included.

Personal income tax would be overkill to address revenue shortfall and should only be considered as an option if the Legislature determines government services need to be increased.

They suggest the constitutional prohibition against income tax should be removed.

If additional revenues are needed, a general business tax would be an appropriate revenue source; however, caution should be given to preserving Nevada's competitive advantages as a low-business tax state. They offered an alternative which was a 3 percent business income tax with a 0.12 percent franchise tax on invested capital imposed on all businesses. This is something they thought would be a rationale from a business standpoint.

The State should eliminate the sales and use tax on equipment purchases for local telecommunications companies and long-distance carriers. Telecommunications was in its infancy in 1988. We have talked about the expansion of sales and use tax to include services. One of the services taxed in 44 states, but not in Nevada, is telecommunications such as cellular phone bills. Telecommunications was being contemplated in 1988, although they would not understand the full magnitude of its volume today. Sales and use tax should be applied to all phone bills.

Page 9, Exhibit D, continues recommendations. Financial Institutions should be taxed in a manner similar to other businesses and included in the tax base of any general business tax.

The State should maintain the estate tax pickup.

The *Study of Taxation in Nevada*, page 10, Exhibit D, resulted from Assembly Bill No. 801 of the 65th Session. Assemblyman Bob Price was chair of that committee, and the committee worked for about a year developing this report. These posttax-shift policy-related questions were important in our history.

In 1990, our population had grown to 1.2 million people. Our General Fund was $802 million. Statewide visitor volume was 22 million.

Page 11, Exhibit D, gives the recommendations. The distribution of formulas between State and local governments needs to change. Sales and use tax distribution factors should be adjusted for some rural counties. Discussion about the property tax assessment ratio being different between the counties led to a recommendation of between 32 percent and 36 percent. Today, that structure is at 35 percent. Elko County and Eureka County should be consolidated. The Nevada Constitution should be amended to allow for legislative approval of administrative regulations. Local governments should be allowed to establish toll roads and bridges. Certain businesses should be allowed to pay sales and use taxes directly to the State. The State should eliminate caps on property taxes other than the statutory ceiling of $3.64 per $100 of value. The State should require the Department of Taxation to develop uniform assessment standards and mandatory training of county assessors. Those processes have improved.

The State should establish an interim committee on taxation and others along this line to try and make the system work more efficiently. Page 12, Exhibit D, completes recommendations from this study. The property tax exemption should be reviewed.

Page 13, Exhibit D, has the next study: the 2002 *Analysis of Fiscal Policy in Nevada* by the Governor's Task Force on Tax Policy (Task Force). Mr. Hobbs was the chair of the Task Force created by Assembly Concurrent Resolution No. 1 of the 17th Special Session that required this group deliver recommendations that would broaden the tax base to reflect the diversity of the State's economy. There was recognition by the Legislature. Like all the tax studies done prior, our tax system was not reflecting our economy, and it needed to change. This study was performed in the wake of the tragedy of September 11, 2001 (9/11). I worked with Mr. Hobbs and helped staff the committee. We had questions on how we would recover because we had lost a million visitors after 9/11. Twenty-five thousand people lost their jobs within the first six months. There was a real question of how the United States was going to recover and how Nevada was going to recover.

In 2002, our state population was 2.21 million. It was starting to look like it does today. The rate of inflation was low. There were some concerns we may see a period of deflation.

MR. AGUERO:
The recommendations are on page 14 of Exhibit D. This committee spent a long time evaluating the magnitude of the problem to identify the solution. They looked at nontax alternatives to generate revenue at the front end.

They recommended considering electronic funds transfers, e-filing returns, credit card payments and other similar passive measures that will generate $25 million. We were not doing those things then. We are doing a lot of it now, and it has helped.

They also suggested implementing a state activity tax of 0.25 percent on all business receipts in excess of $350,000 per year. That is the gross receipts component of the Task Force report. There is no way the tax could more reflect the basis of the economy than that. The committee wanted to eliminate the impact on small businesses at $350,000 per year. The majority of businesses at that time would have been exempt. There were many things designed to bring the tax system current. We had gone through a period of extensive growth. Many of our taxes had never been adjusted to reflect inflation. The Business License Fee of $25 per employee per quarter was increased to $35 per employee per quarter to reflect inflation since it was first created.

Additionally, they recommended increasing all corporate filing fees by 50 percent, adjusting all liquor taxes by inflation up 89 percent from the last increase, doubling the cigarette tax from 35 cents to 70 cents, and implementing a property tax flex rate of 15 cents per $100 of assessed value.

The Task Force realized they could never design a perfect system. It would never stabilize where we could hit every ebb and flow. They designed a 15 cent per $100 of assessed value flex tax that would trigger at the point revenues come in under or over expectations. Those taxes would be reduced in order to maintain a leveling of the General Fund revenue for the State. It would be an alternative to the Rainy Day Fund.

They also recommended to consider increasing the slot tax fee on restricted licensees by 32 percent; instituting a broad-based admissions and amusements tax of 6.5 percent; expanding the sales and use tax base and lowering the tax rate; developing a lottery as part of a longer-term strategy; in light of the importance of expenditure accountability, exploring the formation of a similar task force to review expenditure reform; and implementing strategies to increase Nevada's relative allocation of federal funds. We were last in the United States in terms of federal funds coming to the State of Nevada on a per capita basis. We are still close to that today.

Page 15, Exhibit D, wraps up recommendations from the Task Force by recommending the consideration of increasing investment in technology to make revenue collection and government services more efficient; because of the growing impact of unfunded mandates, limiting the extent to which responsibilities are passed down to local government in absence of program funding; monitoring the impact of all tax policies on economic development and small business; making all State agency fees and charges commensurate with the cost of actually providing the service; reviewing unit-based taxes as opposed to indexing taxes. We do not want to index every tax, but put them on a review so they are not going 15 or 20 years without adjustment; and increasing the investment in the Department of Taxation's audit and enforcement functions.

This ends the major tax studies. Turn to the chart on page 15, Exhibit D. There are a number of parts to the puzzle in trying to fashion good tax policy. We want something simple, equitable, uniform and transparent that generates money. Of all the items on this chart, the piece in red is ultimately the decider of what gets done and what does not. Political viability is why our tax system looks the way it does in absence of every recommendation made since 1960. It will guide what gets done. I do not want to suggest any of these recommendations are novel, whether it is from me offering them to you today or Mr. Zubrow offering them to you in 1960.

A gentleman by the name of Adam Smith, from 1776, gave some comments referenced in the Zubrow Report.

Adam Smith's comments on revenue system equity and revenue system transparency appear on page 16, Exhibit D. He addresses ease of compliance and cost of administration on page 17, Exhibit D.

I have provided summaries of the statements from each one of the reports on equity, stability and neutrality. I would like to turn this over to Mr. Hobbs to summarize some of those common themes and lessons learned in Nevada's tax cycle.

CHAIR LESLIE:
That is a great way to proceed.

GUY S. HOBBS (Hobbs, Ong and Associates, Inc.):
There was a lot of hard work with good intentions on the topic of taxation. We have learned through these various studies that much of what was contained in the last study, as far as modeling the State's fiscal system and identifying the problems, is true today. One of the things you heard Dr. Murray mention was that a tax expenditure report would be a useful tool for us to have. During the 2002 Governor's Task Force on Tax Policy meeting, a tax expenditure report was done. We produced a list of every identifiable revenue source.

We know from going through this tax structure that the State of Nevada does not emulate the economy of the State. This does not need to be studied again. Our economy has changed over the past 50 years. We have changed nationally from a goods-oriented economy to a service-oriented economy. Much of our tax law was put into place before the Zubrow Report in 1960. While our economy has continued to evolve, our fiscal structure has done little to evolve with it. Our tax structure continues to receive low marks in the areas of equity, reliability, sufficiency and those other key areas you saw in the presentation. Past predictions showing declines in per capita revenue and increases in per capita expenses and how those would lead to an imbalance between revenue and expenses over time have proven true. We have known for some time that certain revenue sources are weak. The sales and use tax base is extremely narrow. We apply it to tangible personal property purchased at the retail level. We exempt services and a number of those things that are tangible therein. At the end of the day, we are taxing a small fraction of the economic transactions that occur within our economy. That makes us susceptible to those items within that narrow band like construction, of which we are seeing evidence today, and car sales. It is not representative of our economy as a whole. Technological changes have led to more purchases on the Internet, and those are not taxed. Technology and cultural changes are working against us. We know the sales and use tax base has been eroding for years. We have done little other than add to the sales and use tax rate to deal with the problems with sales and use tax.

We know gaming tax has been declining over the last several years on an inflation-adjusted per capita basis. It will continue to decline. We also know the industry has been changing. Twenty years ago, if you looked at what visitors spent their money on, gaming was a very large piece of the pie chart. Today, it is a smaller piece because more emphasis is placed on lodging, shows, retail and other offerings to tourists than just getting them here for gaming. Gaming is being taxed the same way. That is something we have known for some time, and we continue to tax something in decline.

Our experience over the last four or five years should tell us the property tax revenue we once thought to be stable and predictable has lost its luster with the decline in property values and the passage of caps on residential and commercial properties. Even with a recovery in housing values, prices and assessments, because of those caps in place, recovery on the fiscal side would be stalled for years. We have added a new problem to the equation. It is still good to point out an enviable tax burden in Nevada. From a business attraction standpoint, our tax structure is still enviable. From a personal standpoint, the implied contract we have with people who move into the State, expecting a certain quality of services at a certain price, has been upheld. The State has tremendous capacity. Capacity also means opportunity. Looking at all the studies done, the conclusions I have laid out for you are those things common to nearly all of them.

CHAIR LESLIE:
That was a great summary. Questions from the Committee? I do not see any. Thank you for these great documents. They will be useful.

Is there any other business to come before the Committee? Is there any public comment? Seeing none, this meeting is adjourned at 2:29 p.m.

RESPECTFULLY SUBMITTED:

____
Gayle Rankin,
Committee Secretary

APPROVED BY:

____
Senator Sheila Leslie, Chair

DATE:_____________________________________

EXHIBITS			
Bill	**Exhibit**	**Witness / Agency**	**Description**
	A		Agenda
	B		Attendance Roster
	C	Matthew M. Murray	Structurally Unbalanced, Cyclical and Structural Deficits in Nevada
	D	Jeremy Aguero	Studies on Nevada's Tax Structure
	E	Jeremy Aguero	*An Incomplete History of Nevada's Tax System*