Approved: May 5, 2010
Date

MINUTES OF THE SENATE WAYS AND MEANS COMMITTEE

The meeting was called to order by Chairman Jay Emler at 10:30 a.m. on April 30, 2010, in Room 548-S of the Capitol.

All members were present.

Committee staff present:
- Alan Conroy, Kansas Legislative Research Department
- J. G. Scott, Kansas Legislative Research Department
- Michael Steiner, Kansas Legislative Research Department
- Chris Courtwright, Kansas Legislative Research Department
- Cody Gorges, Kansas Legislative Research Department
- Aaron Klaassen, Kansas Legislative Research Department
- Jonathan Tang, Kansas Legislative Research Department
- Jarod Waltner, Kansas Legislative Research Department
- Jill Wolters, Office of the Revisor of Statutes
- Daniel Yoza, Office of the Revisor of Statutes
- Gordon Self, Office of the Revisor of Statutes
- Scott Wells, Office of the Revisor of Statutes
- Melinda Gaul, Chief of Staff
- Shirley Jepson, Committee Assistant
- James Fisher, Intern

Conferees appearing before the Committee:
- Joan Wagnon, Secretary, Department of Revenue
- Allie Devine, Kansas Livestock Association (KLA)

Others attending:
- See attached list.

Introduce of Legislation

Senator Emler moved to introduce legislation concerning the secretary of corrections; relating to inmate access to information containing personally identifying information (RS# 2165). The motion was seconded by Senator Lee. Motion carried on a voice vote.

Revenue Enhancement Package

Alan Conroy, Legislative Research Department, presented an overview of the following reports:
- Senate Appropriations Bill - Senate Substitute for HB XXXX (Omega 2) Reflects Committee actions on April 29, 2010 (Attachment 1).
- FY 2011 Senate Ways and Means Committee Recommendations, EXCLUDING Tax Increases, as of April 29, 2010 (Attachment 2).

Chris Courtwright, Legislative Research Department, reviewed the Chairman's proposal for a Tax Enhancement Package originally presented on April 21, 2010 (Attachment 3) and a revised proposal dated April 30, 2010 (Attachment 4). Mr. Courtwright indicated that $417.2 million is the current dollar amount needed to bring the State General Fund to zero on June 30, 2011.

The Committee voiced concern with the total amount funding that has been diverted from the State Highway Fund to the State General Fund (SGF).

A report on the Comprehensive Transportation Program (CTP) & Estimates based on FY 2010 and FY 2011 Governor's recommendations, State General Fund Revenue Adjustments for the period FY 1999 thru FY 2011 was distributed to the Committee (Attachment 5).

The Committee also voiced concern with the proposal to opt out of the IRS Section 199 Domestic Production Deduction and add this amount to the SGF (Attachment 6).

Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

Minutes of the Senate Ways and Means Committee at 10:30 a.m. on April 30, 2010, in Room 548-S of the Capitol.

The meeting was recessed at 10:00 a.m. and reconvened at 11:45 a.m.

Senator Vratil moved to accept the Chairman's Revenue Enhancement Proposal No. 2 dated April 30, 2011, for a total SGF revenue enhancement package of $417.211 million and recommend the legislation for favorable passage. The motion was seconded by Senator McGinn.

Senator Lee made a substitute motion to amend the Chairman's Revenue Enhancement Proposal No. 2 dated April 30, 2011, by reducing the Food Sales Tax Refund Program for the SGF by $4.0 million to $6.9 million and adding the $4.0 million to the State Highway Fund for a total of $21.0 million and recommend the legislation for favorable passage. The motion was seconded by Senator Umbarger. Motion carried on a voice vote.

Senator Apple moved to add language to the sales tax component to exclude construction contracts signed prior to July 1, 2010, from the 1 % sales tax increase. The motion was seconded by Senator Masterson. The motion was withdrawn.

Joan Wagnon, Secretary, Department of Revenue, stated that the action of the Apple motion would be very difficult to implement. The action would create a problem with reporting more than one tax rate within the same quarter.

Senator Taddiken moved to remove the provisions of the IRS Section 199 Domestic Production from the Revenue Enhancement Proposal dated April 30, 2011. The motion was seconded by Senator Masterson. Motion failed on a 4-8 vote.

Responding to questions from the Committee, Allie Devine, Kansas Livestock Association, stated that after further review, the Association has determined that the Add-Back of IRS Section 199 Domestic Production Deduction would have little effect on the state's livestock industry.

Senator Kultala moved to continue the 30 percent one-time inventory tax at the wholesale level and 30 percent on the amount paid at the wholesale level for retail establishments. The motion was seconded by Senator Kelly. Motion failed on a voice vote.

Senator Vratil moved to remove the contents of **HB 2360**, insert the language of the Chairman's Revenue Enhancement Proposal dated April 30, 2010, as amended by the Lee motion, allow for technical corrections as necessary for **Senate Substitute for HB 2360** and recommend **S Sub for HB 2360** favorable for passage. The motion was seconded by Senator Kelly. The motion carried on a 7-4 vote. Senators Masterson, Taddiken, Schodorf and Apple requested to be recorded as voting "no".

Adjournment

The next meeting is scheduled for 10:00 a.m. on May 1, 2010.

The meeting was adjourned at 12:45 p.m.

Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

SENATE WAYS AND MEANS COMMITTEE
GUEST LIST
DATE: __April 30, 2010_____

NAME	REPRESENTING
Kent Eckman	KW
Nancy Zogleman	Polsinelli
Marilyn Jacobson	Dept of Adm
Rob Johnson	Federico Consulting
Julie Thomas	DOB
Rachel Whitten	Kansas Reporter.org
John Donley	KS Lvsk. Assn
Chuck Heckert	Heckert Construction Co
Mike Crow	KS Asphalt Pavement Assoc
Terry Heidner	KDOT
Lindsey Douglas	KDOT
Reed Davis	KDOT
[illegible]	SRS
[illegible] Woods	SRS
[illegible] Reccht	Gaches Braden
Ron Gaches	GBA
Stan Ahlerich	TFI
Jennifer Bruning	OP Chamber
Bernie Koch	Ks. Economic Progress Council
Bill Brady	C.S.
LARRY BERG	MIDWEST ENERGY
Doug Smith	Pinegar, Smith & Associates
Jim Moag	Spirit AeroSystems

Mitz. McFatrich — KABC
Robin Clements / DCCCA Youthville
MA Hellebust — TFKC
Tracy Russell — ACA
Marlee Carpenter — KSCPA
Holly Smith — Kansas Libery
Kim Fowler — Judicial Branch
Mary Jane Stankiewicz — KGFA - KARA

SENATE WAYS AND MEANS COMMITTEE
GUEST LIST
DATE: __April 30, 2010_____

NAME	REPRESENTING
Wayne Bollig	KCVA
[illegible]	KCVA
Martha [illegible] Smith	KMHA
[illegible]	KLRD
Shannon Jones	SILCK
[illegible]	SKIL
Judith Gaar	Capitol Advantage
[illegible]	capitol advantage
Mike Murray	Capitol Advantage
Randall Hardy	KS Contractors Assn
Jake Klaver	"
Rebecca Rice	Kansas Beer Wholesalers Assn
Amy Campbell	KS Assoc. of Beverage Retailers
Matt Hickam	Kensinger & Hickam
Mick Urban	ONEOK, Inc.
Mark Chesney	MO/KS Concrete Pipe Assoc.
Berend Koops	Hein Law Firm
Craig Kaberline	K4A
Gary George	Olathe School District
Suzanne Wikle	KS Action for Children
Cynthia Smith	SCL Health System
Dick Koerth	KDWP
[illegible]	KCSL

Kevin Keatley — KAC
Kevin Carr — KTEC
Leslie Kaufman — Ks Co-op Council
Christy Caldwell — Topeka Chamber
Sandra Braden — Hallmark

SENATE WAYS AND MEANS COMMITTEE
GUEST LIST
DATE: __April 30, 2010_____

NAME	REPRESENTING
Mark Boranyak	Capitol Strategies
Doug Mays	Mays & Associates
[illegible]	WBD, PA.
Tim Heffel	IMA
[illegible]	Dustrol Inc.
[illegible]	[illegible]
Patrick Hurley	Economic Lifelines
Sean Tomb	Budget
[illegible]	DoB
Kevin Morris	Coca-Cola Bottling
John Peterson	Capitol Strategies
Mark Desetti	KNEA
Mark Tallman	KASB
Martin Hawver	Hawver's Capitol Report
Bud Burke	Issues Mgmt
Travis Lowe	Little Gov't Relations
Mike Hammond	Assoc. of CMHCs
Kent Beisner	Kansas Chamber
Kent Eckles	KS Chamber of Commerce
Larry R Baer	LKM
David R. Corbin	KDOR
Jane Carter	KOSE
RJ Wilson	KOSE

J.P. Small — Koch Industries
Erik Wisner — KNA
Carrie Ann Brown — Wine Institute
Hannah Sanders — Richard Cram KDOR
Andrew Payne — KHPA
Washburn Law Student

Senate Appropriations Bill - Senate Substitute for HB XXXX (Omega 2)

(Reflects Senate Committee Adjustments for FY 2010, FY 2011, FY 2012, FY 2013, FY 2014, FY 2015, FY 2016, and FY 2017)

Agency/Item	*State General Fund*	*All Other Funds*	*All Funds*	*FTEs*
FY 2011				
Secretary of State				
2. Add $435,000, all from special revenue funds (various fee funds), for FY 2011 to allow the agency to expend up to $435,000 for publication of two proposed constitutional amendments (2010 SCR 1614, currently in Conference Committee, which creates a Budget Stabilization Fund and a Debt Prepayment Fund, and 2010 SCR 1622, currently in the second House, which would delete mental illness as a disqualification for voting.)	0	435,000	435,000	0.0
Agency Subtotal	*$0*	*$435,000*	*$435,000*	*0.0*
Judicial Branch				
2. Delete $2.5 million, all from the State General Fund, to reduce judicial operations for FY 2011.	(2,469,434)	0	(2,469,434)	0.0
Agency Subtotal	*($2,469,434)*	*$0*	*($2,469,434)*	*0.0*
Dept. of Health and Environment - Health				
4. Add $105,537, all from the State General Fund, for the Cerebral Palsy Posture Seating program for FY 2011. This restores the funding which the agency indicated would be eliminated for the Cerebral Palsy Posture Seating program as the result of the Senate Committee's recommended FY 2011 State General Fund reductions.	105,537	0	105,537	0.0
6. Add $373,032, all from the State General Fund, for the Infants and Toddlers program for FY 2011. The funding is intended to offset funding reduced from the Children's Initiatives Fund for the program.	373,032	0	373,032	0.0
Agency Subtotal	*$478,569*	*$0*	*$478,569*	*0.0*
Department on Aging				
5. Add language that specifies any expansion of the Home and Community Based Services-Frail Elderly waiver program for the telehealth pilot study by 500 telehealth monitor units for fiscal year 2011 and be distributed geographically statewide. In addition, if legislation which authorizes an annual, uniform assessment per licensed bed, referred to as a quality care assessment, on each skilled nursing care facility, is passed by the legislature during the 2010 regular session and enacted into law, no such funds collected by such assessment shall be expended for any telehealth program.	0	0	0	0.0
Agency Subtotal	*$0*	*$0*	*$0*	*0.0*
Social and Rehabilitation Services				
13. Add $225,964, all from the State General Fund, for Early Head Start for FY 2011. The funding is intended to offset funding reduced from the Chilldren's Initiatives Fund for the program.	225,964	0	225,964	0.0
Agency Subtotal	*$225,964*	*$0*	*$225,964*	*0.0*
Board of Regents				
2. Delete $6.4 million, all from the State General Fund, from the Postsecondary Education Operating Grant for FY 2011.	(6,400,000)	0	(6,400,000)	0.0
Agency Subtotal	*($6,400,000)*	*$0*	*($6,400,000)*	*0.0*
Department of Education				
5. Delete $12.8 million, all from the State General Fund, for KPERS-School employer contributions savings for FY 2011 based on lower than anticipated salary increases and number of school employees.	(12,800,000)	0	(12,800,000)	0.0
Agency Subtotal	*($12,800,000)*	*$0*	*($12,800,000)*	*0.0*
State Conservation Commission				
4. Add language that authorizes the agency to expend existing funds for installation of an alternative, less expensive, public water supply solution for Washington County Rural Water District No. 1 for FY 2011.	0	0	0	0.0
Agency Subtotal	*$0*	*$0*	*$0*	*0.0*
Kansas Department of Transportation				
5. Add language transferring $44.3 million from the State Highway Fund to the State General Fund, this would capture FY 2011 savings for $86.5 million in preservation projects that were not let as part of GBA No. 1, Item 5 for FY 2010.	0	0	0	0.0
Agency Subtotal	*$0*			

Senate Ways & Means Cmte
Date 4-30-2010
Attachment 1

Agency/Item	State General Fund	All Other Funds	All Funds	FTEs
State Employee Pay				
2. Delete $12.0 million, including $10.0 million from the State General Fund, to implement a moratorium on employer contributions to the KPERS Group Insurance Reserve Fund, or Death and Disability Fund, for April, May, and June 2011 and transfer $2.0 million from special revenue funds to the State General Fund for FY 2011.	(10,074,327)	(1,973,855)	(12,048,182)	0.0
Agency Subtotal	*($10,074,327)*	*($1,973,855)*	*($12,048,182)*	*0.0*
TOTAL: FY 2011	**($31,039,228)**	**($1,538,855)**	**($32,578,083)**	**0.0**

1-2

Senate Ways & Means Cmte
Date 4-30-2010
Attachment 2

FY 2011 Senate Ways and Means Committee Recommendations, EXCLUDING Tax Increases

Senate Ways and Means Committee Recommendations as of April 29, 2010 (Senate Sub. for HB 2631)

Adjusted for April State General Fund Consensus Revenue Estimate

STATUS OF THE STATE GENERAL FUND
FY 2010-FY 2012
(In Millions)

	Senate Ways and Means Committee FY 2010	Senate Ways and Means Committee FY 2011	Estimated FY 2012
Beginning Balance	$ 49.7	$ -	$ -
Receipts (April, 2010 Consensus Revenue Estimate)	5,254.3	5,094.7	5,640.0 *
Governor's Other Revenue Adjustments (adjust transfers; continue KDOT transfer, etc.)	-	274.6	-
NO Governor's Recommended Sales/Use Tax Increase - 5.3% to 6.3%	-	-	-
NO Governor's Recommended Cigarette and Tobacco Product Tax Increase**	-	-	-
Senate Ways and Means Committee Revenue Adjustments (Senate Sub. for HB 2631)	20.1	45.9	-
Total Available Revenue	$ 5,324.1	$ 5,415.2	$ 5,640.0
Expenditures ***	6,144.3	6,088.9	6,210.3
Federal Economic Stimulus Legislation	(530.7)	(257.9)	-
Subtotal - Expenditures	5,613.6	5,831.0	6,210.3
Less Governor's Allotments and Net Other Adjustments	(159.2)	-	-
Senate Ways and Means Committee Adjustments (Senate Sub. for HB 2631)	(37.5)	(90.2)	-
Expenditures Adjusted for a Zero Ending Balance	**(92.8)**	**(325.6)**	**(570.3)**
Total Adjusted Expenditures	5,324.1	5,415.2	5,640.0
Ending Balance	$ -	$ -	$ -
Ending Balance as a Percentage of Expenditures	0.0%	0.0%	0.0%
Adjusted Receipts in Excess of Unadjusted Expenditures	**$ (92.8)**	**$ (325.6)**	**$ (570.3)**
Two-Year Sum of SGF Ending Balance (FY 2010 and FY 2011)		**$ (418.4)**	

*) Assumes 4.0 percent growth in tax receipts.

**) Excludes Governor's recommended cigarette tax increase from $0.79 to $1.34 per pack; tobacco product tax increase from 10 percent to 40 percent.

***) FY 2012 expenditures include replacing federal economic stimulus funds; KPERS employer contribution increase; human services caseloads; special education increase and state employee undermarket salary adjustment.

Senate Ways & Means Cmte
Date 4-30-2010
Attachment 3

Proposal for Ways and Means Committee Consideration

($ in millions)

	Sales/Use Tax Increase to 6.3% on 7/1/10; 11.403% of all receipts SHF, balance SGF; Rate Falls to 5.6% on 7/1/13 with SHF Getting All of Additional 0.3% above 5.3%			liquor enforce tax incr from 8% to 12%	liq drink tax to 15% assuming enf tax increase, too	cigarette increase 55 cents per pack (to 1.34) 7/1/2010	tob prod tax incr from 10% to 40% wholesale 7/1/2010	total package	total package	
	sgf	shf	total	7/1/2010	7/1/2010	sgf	sgf	sgf	shf	
FY 2011	$322.290	$21.796	$344.086	$23.010	$12.450	$49.424	$13.710	$420.884	$21.796	$442.680
FY 2012	$365.667	$22.837	$388.504	$24.772	$13.300	$41.568	$15.610	$460.917	$22.837	$483.754
FY 2013	$378.466	$23.636	$402.102	$26.259	$13.820	$39.905	$16.130	$474.580	$23.636	$498.216
FY 2014	$30.428	$132.985	$163.413	$27.834	$14.350	$38.309	$16.660	$127.581	$132.985	$260.566
FY 2015	0	$142.145	$142.145	$29.504	$14.910	$36.777	$17.210	$98.401	$142.145	$240.546
5-yr total	$1,096.851	$343.399	$1,440.250	$131.379	$68.830	$205.983	$79.320	$1,582.363	$343.399	$1,925.762

Other Issues Added to SB 516

* Moist snuff provisions from SB 413 with rate at $0.34 per ounce.

* Requirement that stamps and meter imprints be affixed in manner "reasonably intended" to preserve serial number legibility.

Senate Ways & Means Cmte
Date 4-30-2010
Attachment 4

Proposal for Ways and Means Consideration -- April 30

($ in millions)

	Sales/Use Tax Increase to 6.3% on 6/1/10; Approx $21m in add'l rev due to June 1; All but $17m to SGF for FY 2011-13; $17m to SHF in FY 2011-13. Rate falls to 5.6% on 7/1/13 with SHF getting all above 5.3%			Diversion of Sales Tax Revenue for Intermodal Utility Purch	Expand FS Rebate Program to 35k and incr refund amts to 45/90	Require Add-Back of IRS Section 199 Domestic Production Deduction	cigarette increase 55 cents per pack (to 1.34) 7/1/2010	tob prod tax incr from 10% to 40% wholesale 7/1/2010	total package	total package	
	sgf	shf	total	sgf	sgf	sgf	sgf	sgf	sgf	shf	
FY 2011	$348.000	$17.000	$365.000	-$0.023	-$10.900	$17.000	$49.424	$13.710	$417.211	$17.000	
FY 2012	$371.504	$17.000	$388.504	-$0.083	-$11.445	$17.000	$41.568	$15.610	$434.154	$17.000	
FY 2013	$385.102	$17.000	$402.102	-$0.208	-$12.017	$17.000	$39.905	$16.130	$445.912	$17.000	$462.912
FY 2014	$30.428	$132.985	$163.413	-$0.387	-$12.618	$17.000	$38.309	$16.660	$89.392	$132.985	$222.377
FY 2015	0	$142.145	$142.145	-$0.538	-$13.249	$17.000	$36.777	$17.210	$57.200	$142.145	$199.345
5-yr total	$1,135.034	$326.130	$1,461.164	-$1.239	-$60.229	$85.000	$205.983	$79.320	$1,443.869	$326.130	$1,769.999

Other Issues Added to Legislation

* Requirement that stamps and meter imprints be affixed in manner "reasonably intended" to preserve serial number legibility.

* Intermodal revenue diversion provisions.

Senate Ways & Means Cmte
Date 4-30-2010
Attachment 5

Comprehensive Transportation Program (CTP) & Estimates based on FY 2010 and FY 2011 Governor's recommendations
State General Fund Revenue Adjustments

(In Thousands)

	I			II		III			IV	V		VI	
	1	2	3	4	5	6			7	8			
($000)	Sales Tax Demand Transfer			Sales & Compensating Use Tax		State General Fund (SGF) Loans			SGF CTP Bond Payments	Transfers from the State Highway Fund (SHF)			
FY	Proposed (Sales Tax) Transfer	SGF (Sales Tax) Transfer	Difference (2-1)	Actual S&C Tax	Increase In S&C	SGF Loans	Loan Repayments	Delayed/ Unpaid	TOTAL (P + I)	Commerce Fair Fares	Highway Patrol SGF Transfer	Gov. Rec. Reduction & Transfers	TOTAL Transfers
1999	$ 106,119	$ 87,899	$ (18,220)	$ 85,889	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
2000	107,910	62,240	(45,670)	88,598	-	-	-	-	-	-	-	-	-
2001	109,744	51,709	(58,035)	89,241	-	-	-	-	-	-	-	-	-
2002	138,261	94,288	(43,973)	91,611	-	(94,609)	-	(94,609)	-	-	-	-	-
2003	170,070	-	(170,070)	89,369	-	-	-	(94,609)	-	-	(2,249)	-	(2,249)
2004	179,519	-	(179,519)	90,276	-	(30,597)	-	(125,206)	-	-	-	-	-
2005	180,486	-	(180,486)	93,471	-	-	-	(125,206)	-	-	(35,092)	-	(35,092)
2006	190,213	-	(190,213)	99,069	-	-	-	(125,206)	-	-	(34,515)	-	(34,515)
2007	196,774	-	(196,774)	158,559	60,953	-	32,517	(92,689)	10,426	(5,000)	(30,207)	-	(35,207)
2008	187,869	-	(187,869)	273,446	186,682	-	30,896	(61,793)	16,150	(5,000)	(30,405)	-	(35,405)
2009	185,899	-	(185,899)	268,877	173,112	-	-	(61,793)	-	(5,000)	(37,179)	-	(42,179)
Est. 2010				258,040				(61,793)	-	(5,000)	(36,245)	(133,789)	(175,034)
Est. 2011				268,524				(61,793)	-	(5,000)	(36,210)	(105,000)	(146,210)
1999-2011 TOTAL	$ 1,752,864	$ 296,136	$ (1,456,728)	$ 1,954,970	$ 420,747	$ (125,206)	$ 63,413	$ (61,793)	$ 26,576	$ (25,000)	$ (242,102)	$ (238,789)	$ (505,891)

($000) FY	(2+4+7) RECEIPTS TOTAL
1999	$ 173,788
2000	150,839
2001	140,949
2002	185,899
2003	89,369
2004	90,276
2005	93,471
2006	99,069
2007	168,986
2008	289,596
2009	268,877
Est. 2010	258,040
Est. 2011	268,524
1999-2011 RECEIPTS	$ 2,277,683

($000) FY	(3+5+6+7+8) NET TOTAL
1999	$ (18,220)
2000	(45,670)
2001	(58,035)
2002	(138,582)
2003	(172,319)
2004	(210,116)
2005	(215,578)
2006	(224,728)
2007	(128,085)
2008	10,454
2009	(54,966)
Est. 2010	(175,034)
Est. 2011	(146,210)
1999-2011 NET TOTAL	$ (1,577,088)

I. The 2002 Legislature eliminated the FY 2003 Sales Tax demand transfer, the 2003 Legislature eliminated the FY 2004 Sales Tax demand transfer, and the 2004 Legislature eliminated Sales Tax demand transfers for the remainder of the CTP.

II. Prior to FY 2007 the Sales and Compensating Use Tax was 0.25 percent, in 2007 it was increased to 0.38 percent, and then increased again in FY 2008 to 0.65 percent, and continues at that level.

III. A total of $125.2 million was "borrowed" from the State Highway Fund with arrangement to pay back by from FY 2007 to FY 2010 (includes the 2002 Legislature transfer equal to the FY 2002 sales tax transfer, the 2003 Legislatures transfer to finance a portion of the Department of Revenue's Division of Vehicles, and the 2004 Legislature transfer to finance Highway Patrol State General Fund operations). The first two repayments were made in FY 2007 and FY 2008. As part of the 2009 Session, the FY 2009 payment of $30.9 million was delayed until FY 2011, and the FY 2010 payment of $30.9 million was eliminated. The Governor's FY 2011 recommendation calls for the elimination of the FY 2009 payment that was delayed to FY 2011.

IV. The 2004 Legislature authorized the issuance of $210.0 million in State General Fund backed bonds, which appear in the Department of Administration's (DOA) budget. The 2009 Legislature transferred $25.3 million, all from the State Highway Fund, to the State General Fund to reimburse the State General Fund for FY 2009 and FY 2010 Comprehensive Transportation Plan (CTP) bond payments (Interest and Principal in FY 2009, and Interest in FY 2010 as the Principal portion was part of the bond restructuring). The Governor's FY 2011 recommendation includes the continued transfer of $25.0 million to reimburse the State General Fund for bond payments.

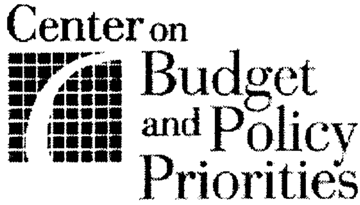
V. Transfers from the State Highway Fund include: (1) Affordable Airfare Fund: 2006 House Substitute for Senate Bill 475 created the State Affordable Airfare Fund in the Department of Commerce, funded through a transfer of $5.0 million from the State Highway Fund annually from FY 2007 to FY 2011. (2) The State Highway Fund transfer to the State General Fund to finance Highway Patrol operations.

VI. Governor's Recommended expenditure reduction and transfers to the State General Fund from the State Highway Fund include:

{FY 2010} <1> $80.0 million captured through reductions and existing State Highway Fund balance (recommended to the Legislature as part of the 2009 July and November allotments); <2> $25.3 million to reimburse the State General Fund for debt service principal and interest payments on CTP bonds (as part of 2009 Senate Substitute for House Bill 2373); <3> $28.0 million captured through additional project letting reductions (recommended as part of the Governor's "Budget Balancing Plan" announced March 5, 2010).

{FY 2011} <1> $80.0 million captured through recommended reductions and existing State Highway Fund balance; <2> $25.0 million to reimburse the State General Fund for debt service principal and interest payments on CTP bonds.

CTP = Comprehensive Transportation Plan
SGF = State General Fund
P + I = Principal and Interest
SHF = State Highway Fund



States Can Opt Out of the Costly and Ineffective “Domestic Production Deduction” Corporate Tax Break

By Nicholas Johnson and Ashali Singham

Updated January 14, 2010

Over the past year, state revenue collections have dropped dramatically, creating large budget gaps for many states. A contributor to this fiscal crisis in many states is a relatively new and rapidly growing corporate tax break — one that in most states never even received a vote in the state legislature but nonetheless is costing states hundreds of millions of dollars each year.

Related Areas of Research
State Budget and Tax
Federal-State Issues
Taxes

The federal government created this tax break, known as the “domestic production deduction,” in 2004. Since most states base their own tax codes on the federal tax code, the tax break was carried over into many states without specific legislative scrutiny or a vote. Now it is costing not only the federal government but also 25 states a large, and growing, amount of money. By 2011, it will cost these states over $500 million per year.

The deduction — enacted as Section 199 of the federal Internal Revenue Code — allows companies to claim a tax deduction based on profits from “qualified production activities,” a sweeping category that goes well beyond manufacturing to include such diverse activities as food production, filmmaking, and utilities — a substantial share of states' corporate income tax base.

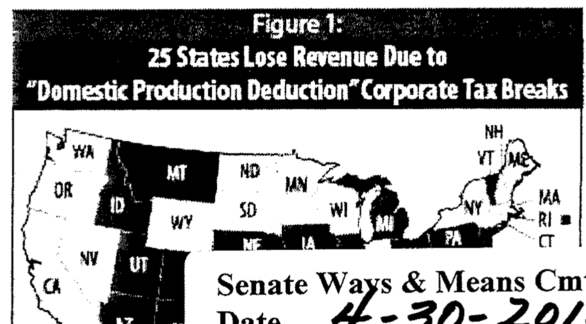
The revenue loss to states that still allow the deduction will increase steeply this year because of how the federal credit is designed. Initially, the cost was relatively modest because the deduction was limited to 3 percent of qualifying income. As of January 1, 2007, the percentage rate rose to 6 percent. The final increase to 9 percent takes effect in the 2010 tax year. Federal estimates suggest that allowing this deduction will reduce the revenue yield of corporate taxes by roughly 3.1 percent in 2011 and also reduce individual income taxes somewhat.

States are not required to allow this deduction. Since 2008, Connecticut, New York, Wisconsin, and the District of Columbia have joined 18 other states in disallowing the deduction and thereby reducing their current budget shortfalls and benefitting their states' economies. But another 25 states continue to permit it. (Four states lack personal and corporate income taxes and so are unaffected.) If they continue to do so, a conservative estimate suggests the tax break will cost those states almost $505 million in 2011. (These estimates are based on current levels of corporate profits.) [1]

There is no good reason why states should accept such revenue losses.

The deduction is unlikely to protect or create jobs within the state, because multi-state corporations can claim the deduction for out-of-state “production activity” just as they can for in-state activity.
The deduction provides little or no help to businesses that are

Figure 1:
25 States Lose Revenue Due to “Domestic Production Deduction” Corporate Tax Breaks

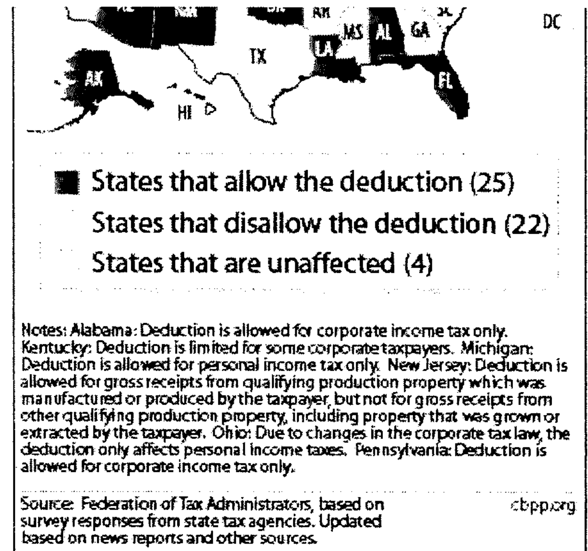


Senate Ways & Means Cmte
Date 4-30-2010
Attachment 6

struggling in the current downturn, since only profitable firms have taxable income for it to offset.

The deduction is heavily slanted towards large corporations. In 2006, 94 percent of the deduction taken under the corporate income tax was claimed by the 0.4 percent of firms with over $100 million apiece in assets. Many of these large firms are multi-state corporations and may invest little or nothing in the state granting the tax break.

Most importantly, given the large cuts most states are making in education, healthcare, and almost all other areas of spending, it makes little sense for them to be *growing* such a large new tax break. Maintaining the tax break would mean states would have to cut more elsewhere, and the jobs lost due to such cuts would almost certainly exceed any jobs created by maintaining this costly and inefficient deduction.



Decoupling from the domestic production deduction, as 22 states have already shown, is simple to enact and inexpensive to administer. [2] It can be done by adding a single sentence to state tax law requiring corporations to add back the deducted amount to their taxable income and a single line to state tax forms.

Indeed, decoupling might even spare a state entanglement in the extensive administrative and legal action that may occur in coming years. The Internal Revenue Service has stated that the provision is complex and difficult for taxpayers to understand. It also has noted that it could be subject to abuse. States that conform to the federal provision risk becoming involved with these difficult and time-consuming enforcement issues.

The Federal Domestic Production Deduction Is Costing States Hundreds of Millions of Dollars per Year — And Its Cost Is Rising

The domestic production deduction allows businesses to deduct — and hence pay no taxes on — a portion of their profits attributable to a broad range of "qualified production activities."[3] Three percent of this income was deductible in 2005 and 2006; 6 percent is deductible in 2007, 2008, and 2009; and 9 percent is deductible in 2010 and years thereafter.

The deduction is broad in its scope and therefore costly in its fiscal impact. Although the deduction is often described as a tax break for manufacturing activities, it is actually much less targeted. In fact, deductible income can be any profits (that is, receipts minus costs) that a business can attribute to a broad range of activities, including:

food processing (but not retail food sales),
software development,
filmmaking,
mining and oil extraction,
publishing,
electricity/natural gas production, and
construction.

Even firms outside these industries benefit. Virtually every sector of the economy has seen its taxes cut by this tax break, including firms whose primary business is retail sales, financial services, and entertainment.[4] Overall, business tax returns for 2006 claimed that about 29 percent of all corporate taxable income qualified for the deduction.[5] (See Table 1.)

TABLE 1: EXTENT TO WHICH DIFFERENT INDUSTRIES CLAIM Domestic Production Deduction Against Corporate Income Tax

The domestic production deduction affects states because states generally conform their tax codes to the federal Internal Revenue Code. For personal income taxes, most states use "taxable income" or "adjusted gross income" as calculated for

Amount of

6-2

federal tax purposes as the starting point for their own income tax calculations. Similarly, most states begin their corporate income tax calculations with federal "taxable income" from the federal corporate tax form. Therefore, when federal legislation narrows the definition of taxable or adjusted gross income, taxpayers report less income and states typically see a decline in revenue. .

To understand how this deduction affects state income taxes, consider a hypothetical corporation with $10 million in "domestic production" income, located in a state with a 5 percent corporate income tax rate. For 2010, 9 percent of that income is deductible — meaning the corporation gets to claim $900,000 of profits as tax-free income. At a tax rate of 5 percent, the corporation gets a tax break worth $45,000.

Not surprisingly, such a broadly available tax break carries a heavy fiscal cost. The Joint Committee on Taxation (JCT), which estimates federal revenue impacts for Congress, projects that the Section 199 provision will cost the federal government $11.6 billion in 2011 — about 3.1 percent of projected federal revenue from corporate income taxes plus another 0.2 percent of projected revenue from personal income taxes. [6]

States face losses of comparable magnitude. In fiscal year 2011 and thereafter, when the deduction is in full effect, it is likely to cost conforming states almost $505 million a year. State-by-state amounts are shown in Table 2; the Appendix explains how these figures were calculated. [7]

The cost of the deduction could be even higher depending on exactly how it is utilized over time, given the likelihood that corporate tax accountants are devising new ways of exploiting it. The deduction has been widely derided by tax policy experts as an incentive for corporations to engage in complicated new accounting schemes solely for the purposes of reducing tax liability. Economist Kimberly Clausing, an expert on taxation of international firms, wrote at the time of the deduction's 2004 passage:

The bill [will] create compliance and enforcement difficulties as firms [will] have incentives to characterize as much income as possible as production income. For instance, firms [will] have an incentive to make those divisions subject to favorable tax treatment more profitable than those that do not receive such treatment. By shifting paper profits among divisions, firms can reduce their overall tax liability. [8]

For the Internal Revenue Service, which is already short on resources, limiting the creativity of the bookkeeping will pose major challenges. [9]

States Can Decouple from the Section 199 Domestic Production Deduction

States are not required to accept revenue losses from the domestic production deduction. As of January 2010, 21 states plus the District of Columbia have "decoupled," disallowing the deduction on state tax returns. Connecticut and Wisconsin decoupled in 2009; New York and the District of Columbia decoupled in 2008. Arkansas, California, Georgia, Hawaii, Indiana, Maine, Maryland,

Massachusetts, Minnesota, Mississippi, New Hampshire, North Carolina, North Dakota, Oregon, South Carolina, Tennessee, Texas, and West Virginia are also disallowing the deduction, according to a survey by the Federation of Tax Administrators and information from state tax departments. [10]

Most of those states still conform to most other provisions of federal tax law, including other changes adopted by Congress at the same time that Section 199 was enacted. One change to federal law enacted in 2004 to which most states conform phases out the protection of certain "extraterritorial income" from foreign exports, protection that the World Trade Organization has said is illegal under international law. States generally also have conformed to the 2004 elimination of some costly and inappropriate tax shelters. But conforming to those other provisions does not require conformity to Section 199, nor do the merits of the other provisions enacted at the same time make conformity to Section 199 good state policy.

6-3

TABLE 2: APPROXIMATE REVENUE LOSS IN STATES THAT STILL ALLOW THE DOMESTIC PRODUCTION DEDUCTION

State	Annual Revenue Loss in 2011 (in millions of dollars)	State	Annual Revenue Loss in 2011 (in millions of dollars)
Alabama	$15	Missouri	$20
Alaska	11	Montana	6
Arizona	21	Nebraska	9
Colorado	20	New Jersey	N/A
Delaware	7	New Mexico	6
Florida	55	Ohio	23
Idaho	7	Oklahoma	15
Illinois	103	Pennsylvania	53
Iowa	12	Rhode Island	5
Kansas	17	Utah	11
Kentucky	4	Vermont	4
Louisiana	25	Virginia	41
Michigan	15	TOTAL	505

Domestic Production Deduction Was Created Without State Action and Without Consideration of Cost to States

In most of the 25 states that are losing revenue from the domestic production deduction, legislatures never voted to adopt the tax break. Most of those states have "rolling conformity" to the federal tax code, meaning that state tax law is defined by current federal law, so tax changes are incorporated without any action by the state. Therefore, when the federal government in 2004 enacted the deduction, it became part of state law automatically. The remaining states have "fixed-date conformity," meaning that state law is tied to federal law as of a fixed date, and that date is updated periodically; these updates typically occur as a matter of course and without consideration of specific federal changes involved. The delayed phase-in of the deduction made scrutiny by state lawmakers especially unlikely. The full fiscal impact was delayed until 2010, which at the time of enactment was well outside states' budget windows (which typically extend only one or two years into the future).

The federal government also did not explicitly consider the tax break's cost to states. Federal lawmakers are required by law to consider the impact of tax cuts on federal revenue, but almost never give formal consideration to the impact on state revenue. [11]

In short, the *federal* government passed legislation that altered *state* tax law, costing states hundreds of millions of dollars. The change took effect without either federal or state lawmakers considering the cost to states.

Disallowing the Domestic Production Deduction Is Good Economic and Fiscal

6-4

Policy

The domestic production deduction was depicted in some accounts at the time of its enactment as important aid for struggling industries and as a draw for manufacturing jobs. State conformity to the deduction is unlikely to achieve these goals. Furthermore, the economic downturn means states have more pressing uses for scarce funds than a subsidy for profitable corporations.

A state-level domestic production deduction creates little incentive for corporations to create or protect jobs within that state. Firms can claim the domestic production deduction for profits from *all* qualifying domestic activities — meaning activities that occur *anywhere* within the United States. As a result, a multi-state firm can claim the deduction in a conforming state for production activities in any state, not just the state where the firm is filing. Thus states have no guarantee that firms claiming the deduction have a single employee working in a qualifying industry in that state.[12]

The deduction provides little help to struggling businesses, since only profitable ones can use it. The domestic production deduction has been justified as assistance for struggling industries and protection for threatened jobs, but it is poorly designed for these goals. The reason is the amount of the deduction is tied to a firm's qualifying profits, and the value of the deduction (like that of all deductions) is limited by a firm's total profits. As a result, only profitable businesses can claim the deduction, and more profitable businesses benefit more. The deduction takes no account of the number of people a business employs.

This structure — favoring profitable businesses, excluding unprofitable ones, and ignoring employment — makes the deduction particularly ineffective at protecting jobs. Money-losing firms considering layoffs receive little or no benefit. Highly profitable firms benefit disproportionately whether or not they are creating jobs.

The deduction favors large corporations over small businesses. The domestic production deduction has been praised as a boon to small business, but IRS statistics suggest otherwise. Among 2006 corporate income tax returns, 94 percent of the deduction was claimed by the 0.4 percent of firms with assets over $100 million. [13] Many of these large firms are multi-state corporations and may invest little or none of the benefit in the state granting the tax break.[14]

State revenues lost to the deduction could be better spent on other priorities. Almost every state now faces fiscal distress, buffeted by a slowing economy, rising unemployment, and the housing crisis. [15] Unlike the federal government, states must balance their budgets each year. Many states have passed or are considering budget cuts, actions that may worsen the economic slowdown.[16] Within this context, corporate tax breaks — especially those costing states hundreds of millions of dollars per year — need to be carefully examined. The high cost of conforming to the domestic production deduction could be better spent on maintaining key spending priorities or on closing budget deficits.

Decoupling from Section 199 Is Administratively Feasible and May Protect State from Future Complications

From an administrative perspective, decoupling from the domestic production deduction is straightforward. It requires a simple statutory change, is simple to comply with, and does not interfere with state conformity to other federal provisions.

As a statutory matter, decoupling can be accomplished by adding a single sentence to state tax law disallowing the deduction. Compliance is equally simple: corporations just add back the deducted amount to their taxable income.

Decoupling does create some minor administrative difficulties for states, but it is possible that the administrative challenges of failing to decouple would be even greater. State revenue departments, along with the IRS, could well find themselves involved in extensive legal action as the courts try to resolve the exact limits to the deduction and prevent abuse.

In a letter to Congress discussing the pending legislation that included the domestic production provision, on October 7, 2004, IRS Commissioner Mark W. Everson wrote:

Many businesses, particularly small businesses, will find it difficult to understand and comply with these complex new rules,

6-5

which will affect not only the computation of a taxpayer's regular tax liability but also its alternative minimum tax liability. It will be difficult, if not impossible, for the IRS to craft simplified provisions tailored to small businesses or other taxpayers....

Taxpayers will be required to devote substantial additional resources to meeting their tax responsibilities, including not only employees and outside tax advisers, but also recordkeeping and systems modification resources. The resulting costs will reduce significantly the benefits of the proposal. Some small businesses may find that the additional costs outweigh the benefits, particularly during the initial phase-in period....

It will be necessary to devote significant audit resources to administering the new deduction. This will be due not only to the novelty of the rule but also to the benefits that are provided to "production activities" over other aspects of a taxpayer's business. Taxpayers naturally will classify everything possible as production activities. Audits, particularly those involving integrated businesses, will have to focus on classification and the allocation of income and costs. Significant additional IRS resources will be needed to administer the provision to avoid diverting resources from other compliance issues (such as tax shelters)....

Finally, for all of the reasons discussed above, we anticipate a significant increase in controversies between taxpayers and the IRS. This will increase the number of IRS appeals cases and litigated tax cases.[17]

It remains too early to tell whether Everson's prediction will come true. The deduction is fully phasing in this year, and it can take five years or longer for a tax case to come to trial, meaning that any excessively creative tax accounting related to the tax year 2010 may not become public until 2015 or later.

Appendix: Calculating the Impact of the Domestic Production Deduction

The state estimates in this paper represent an approximation of the impact of the domestic production deduction on state tax revenues.

The first step in the estimating process was to use the estimates of the Joint Committee on Taxation (JCT) on the impact of the deduction on corporate and personal income tax revenues in federal fiscal year 2011.[18] These figures were divided by the Congressional Budget Office's (CBO) projections of actual corporate and personal income tax revenues for 2011. These calculations yielded estimates that the deduction would reduce corporate tax revenues by 3.1 percent in 2011. Personal income tax revenues would be reduced by about 0.2 percent in 2011.

This process was repeated based on projections issued by the Office of Management and Budget, which are much higher. [19] The OMB projections indicate that when fully implemented, the domestic production deduction will reduce corporate tax revenues by about 4.4 percent in 2011. Personal income tax revenues would fall by about 0.3 percent in 2011. However, the JCT/CBO estimates appear to more closely match the 2006 tax return data.

The third step was to multiply those percentage rates by the latest available corporate and personal income tax collections figures for each state, as reported by the U.S. Census Bureau.[20]

The spreadsheet used to generate these estimates is available upon request from Ashali Singham at singham@cbpp.org.

A number of state revenue departments and state fiscal offices have developed their own estimates of the cost of the deduction for one or more fiscal years, and in some cases these may be more reliable.[21] For instance, a state may have its own data on the types of industries that pay taxes, and may find that a higher or lower share of taxable income is likely to be eligible for the deduction. In addition, states may choose not to use the JCT or OMB estimates as a starting point, but rather generate their own estimates based on state-level data on production activities. Finally, given the volatility of these taxes over the last year and their unpredictability in the coming years, state analysts may want to adjust the estimates in this paper according to their own state's revenue forecasts, simply by multiplying forecast corporate tax revenue by 3.1 percent and personal income tax revenue by 0.2 percent. In order to show comparable data representing a single methodology and timeframe, Table 2 includes only estimates based on the Center's methodology.[22]

6-6

End Notes:

[1] These estimates are based on forecasts by the Joint Tax Committee. The Office of Management and Budget forecasts higher losses due to the domestic production deduction. For further discussion of estimating techniques, see the Appendix.

[2] Here and throughout this report, the District of Columbia is counted as a state.

[3] For this reason, the tax break is sometimes referred to as the qualified production activities income deduction, or QPAI.

[4] President Obama has proposed eliminating this tax break for oil and natural gas production. The Joint Committee on Taxation estimates that enacting this provision would save the federal government $536 million. Available at http://www.jct.gov/publications.html?func=startdown&id=3558.

[5] Calculated from IRS Statistics of Income data for tax year 2006.

[6] The Office of Management and Budget projects an even greater federal revenue loss — $16.9 billion by fiscal year 2011 — but IRS data on actual tax claims under the domestic production deduction suggest that the JCT estimates may be closer to the mark. See Appendix.

[7] Even more accurate estimates might be produced by considering the extent to which a state's predominant industries qualify for the deduction. A state with a high concentration of industries that have a high percentage of deductible income is likely to suffer even larger losses.

[8] Kimberly A. Clausing, *The American Jobs Creation Act of 2004: Creating Jobs for Accountants and Lawyers,* Urban-Brookings Tax Policy Center, December 2004.

[9] As Tom Ochsenschlager, vice president for taxation with the American Institute of Certified Public Accountants, told the trade journal *Tax Notes,* "It's a whole new skill that the IRS is going to have to bring to the table, and a whole new dimension to the audits" (quoted in Warren Rojas, "New Manufacturing Deduction Presents Many Open Questions," *Tax Notes*, October 18, 2004). Lengthy court battles are quite likely as corporations challenge IRS interpretations and enforcement actions. It is unclear how effective the IRS can be at limiting excessive Section 199 claims. As a recent IRS directive notes, "Due to the complexity of the law, there is the potential to spend substantial audit resources in an examination." See *Industry Director Directive on Domestic Production Deduction (DPD),* December 6, 2006, downloaded from http://www.irs.gov/businesses/article/0,,id=164979,00.html.

[10] Five states have partially decoupled from the domestic production deduction. Alabama allows the deduction for the corporate income tax, but does not allow it for those companies filing under the personal income tax. Michigan decoupled from the deduction for the corporate income tax, but maintains the deduction for the personal income tax. Kentucky and New Jersey have narrowed the definition of what qualifies for the domestic production deduction. Pennsylvania allows the deduction for businesses filing taxes under the corporate income tax code, but not for those filing under the personal income tax code.

[11] When Congress considers a bill to cut taxes, its Joint Committee on Taxation (JCT) calculates the cost to the federal government, and this information becomes part of the public debate. But JCT does not calculate the cost to the states whose taxes will be cut due to federal conformity. Since no state bill is under consideration, state fiscal offices seldom analyze the impact either.

[12] The actual value of a state's domestic production deduction to a corporation depends on several factors. The deduction applies to total taxable income, which is then "apportioned" to each state in which a corporation does business. The apportionment formula varies among states, but typically reflects the share of a corporation's payroll, property, and sales that occur in a given state. So a multi-state corporation's domestic production deduction equals its federal domestic production deduction multiplied by the relevant apportionment factor.

6-7

[13] CBPP calculations based on 2006 IRS data.

[14] These statistics cover only businesses that pay the corporate income tax, i.e., those governed by chapter 1, subchapter C of the Internal Revenue Code. Since the corporate income tax accounted for 72 percent of the deduction overall, these huge firms received at least 68 percent of the deduction's total value. The other 28 percent of the deduction was claimed against the personal income tax, which is paid by individual owners of S corporations, partnerships, and sole proprietorships. Data on the domestic production claimed by these firms is not available broken down by firm assets. These firms tend to be smaller on average. Even so, the benefit among firms exempt from the corporate income tax also seems to be skewed toward large firms. In 2007, among payers of the personal income tax, those with adjusted gross income over $5 million accounted for over 30 percent of the deduction.

[15] Elizabeth McNichol and Nicholas Johnson, "Recession Continues to Batter State Budgets; State Responses Could Slow Recovery," Center on Budget and Policy Priorities, updated December 23, 2009.

[16] Elizabeth McNichol and Nicholas Johnson, "Recession Continues to Batter State Budgets; State Responses Could Slow Recovery," Center on Budget and Policy Priorities, updated December 23, 2009.

[17] Congressional Record, October 11, 2004.

18] Joint Committee on Taxation, Estimates Of Federal Tax Expenditures For Fiscal Years 2009-2013, January 11, 2010, p.35. Available at http://www.jct.gov/publications.html?func=startdown&id=3642.

[19] Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2010,* p. 304. Available at http://www.whitehouse.gov/omb/budget/fy2010/assets/receipts.pdf.

[20] As noted above, the one exception is Kentucky, where the fiscal impact listed in the tax expenditure report was used.

[21] These estimates are typically released as part of a state tax expenditure report.

[22] The following estimates were produced by states. Some states also provided estimates for earlier years.

> **Arizona:** $13.76 million in fiscal year 2008. Arizona Department of Revenue, "Estimated Impact on State Revenues of Conformity to Provisions in the Working Families Tax Relief Act of 2004, and the American Jobs Creation Act of 2004," revised February 3, 2005, p. 3. This estimate was found using a method similar to the Center's and was based on JCT data, according to Department of Revenue staff.
>
> **Connecticut:** Connecticut estimated saving $27.5 million in fiscal year 2010 as a result of decoupling. Connecticut Office of Fiscal Analysis fiscal note for the 2010 and 2011 budget.
>
> **District of Columbia:** $6.28 million in fiscal year 2011. Mayor's FY 2009 Proposed Budget and Financial Plan. D.C. has decoupled.
>
> **Kentucky:** $3.5 million in fiscal year 2011. Governor's Office for Economic Analysis, "Commonwealth of Kentucky Tax Expenditure Analysis, Fiscal Years 2010-2012," p. 75. This estimate for revenue loss is classified under the personal income tax.
>
> **New York:** $56 million in fiscal year 2009. New York State Division of Budget and Department of Taxation and Finance, "Annual Report on New York State Tax Expenditures," January, 2008, p. 209. New York has since decoupled.
>
> **Pennsylvania:** $112 million in fiscal year 2009 and $136 million in fiscal year 2010, according to the state Department of Revenue.
>
> **Wisconsin:** $16.4 million in fiscal year 2008. Division of Executive Budget and Finance, Department of

6-8

Administration, and Division of Research and Policy, Department of Revenue, "Summary of Tax Exemption Devices," February 2009, p. 33. Estimate covers revenue loss through the corporate income tax only. Wisconsin has since decoupled.

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6-9