

# The Federal Role in State Tax Reform

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This paper considers the federal government's role in the design of state tax systems and asks what policy changes might be warranted so as to more effectively advance the federal interest in state tax reform. It begins with four observations and then asks a question. The four observations are as follows:

1. The federal government has an interest in minimizing the frequency and severity of state fiscal crises.
2. One of the key factors underlying state fiscal crises is revenue volatility.
3. The degree of revenue volatility that states experience is a function (in part) of tax mix—i.e., some tax structures are more volatile than others.
4. State tax mix is a function (in part) of federal policies and those policies, as presently designed, generally favor the adoption of volatile state tax systems.

The question that follows from these observations is: should the federal government play a more direct and proactive role in the design of state tax systems so as to minimize fiscal crises and promote the long-term fiscal sustainability of state and local governments? From that question several additional lines of inquiry naturally ensue. If a greater federal role in state tax reform is warranted, what sort of “intergovernmental tax policy” should the federal government adopt? What principles should motivate the design of an intergovernmental tax policy? What specific changes to existing law might be most warranted and feasible?

The role of the federal government in state and local taxation is not a new concern among tax policy analysts. Economists and legal scholars have developed an extensive literature examining various aspects of intergovernmental fiscal relations.<sup>1</sup> For the most part, however, this literature has addressed discrete aspects of federal policy, such as the deductibility of state and local taxes for purposes of the federal income tax,<sup>2</sup> federal legislation regarding the

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<sup>1</sup> These matters fall generally within the rubric of “fiscal federalism,” though that term captures a much larger set of concerns. For a basic overview of the issues and problems in this area, see Richard M. Bird, *Fiscal Federalism* in THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 151 (1999).

<sup>2</sup> See, e.g., Julie Berry Cullen and Roger H. Gordon, *Deductibility of State and Local Taxes: Is there a case for continuing this tax expenditure?* (draft manuscript) (July 11, 2008); Brian Galle, *Federal Fairness to State Taxpayers: Irrationality, Unfunded mandates, and the ‘SALT’ Deduction*, 106 MICH. L. REV. 805 (2008); Louis Kaplow, *Fiscal Federalism and the Deductibility of State and Local Taxes Under the Federal Income Tax*, 82 VA. L. REV. 413 (1996); Gilbert Metcalf, *Assessing the Federal Deduction for State and Local Tax Payments*, Draft NBER Manuscript (May 6, 2008); Kirk J. Stark, *Fiscal Federalism*

scope of state corporate income taxes,<sup>3</sup> or federal limitations on the imposition of state sales taxes on internet and mail order transactions.<sup>4</sup> This paper comes at the issue from a somewhat different perspective. Rather than focusing on a particular aspect of current law and asking how, if at all, federal policy should change vis-à-vis that discrete policy area, the paper begins with an articulation of a “federal interest” in state tax reform and then evaluates current law according to the extent to which it advances that interest. The hope is to frame the question of the federal role in state tax reform somewhat more broadly and to prompt consideration of questions such as: “What is the federal government’s current ‘policy’ with respect to state and local taxes?” and “How, if at all, should that policy be reformulated?”

With the demise of the Advisory Commission on Intergovernmental Relations (ACIR) in the mid-1990s,<sup>5</sup> this broader, more holistic framework for thinking about U.S. intergovernmental fiscal relations seems to have played less of a role in the formulation of federal policies in this area. There has been little effort in recent years to develop any sense of what set of rules, policies and institutions might work to ensure an effective and efficient “intergovernmental tax policy.” Instead, federal decisions impacting state and local tax policy are ad hoc and uncoordinated.<sup>6</sup> For example, despite the fact that state income tax policy is largely driven by federal law, Congress regularly adopts changes to the Internal Revenue Code with little or no consideration of the fiscal consequences for state and local governments. Another set of federal rules emerges from the decentralized adjudicatory process relating to constitutional (and sometimes statutory) limitations on state taxing authority. This is a relatively arcane area of law with potentially significant consequences for state and local governments; yet there is no effort at the federal level to anticipate, direct or influence the development of these rules, despite the plenary power of Congress to do so.<sup>7</sup> When Congress does get involved, proposed legislation affecting state and local taxes typically prompts intense interest-group lobbying, with state and local governments represented by the Federation of Tax Administrators (FTA), the U.S. Conference of Mayors (USCM), the National Conference of

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*and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 UCLA L. REV. 1389 (2004).

<sup>3</sup> These limitations are set forth in a federal statute, P.L. 86-272. At various points Congress has considered a “modernized” version of P.L. 86-272 via the Business Activities Tax Simplification Act.

<sup>4</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992); Streamlined Sales Tax Project.

<sup>5</sup> Bruce D. McDowell, *Advisory Commission on Intergovernmental Relations in 1996: The End of an Era*, 27 PUBLIUS 111 (1997)

<sup>6</sup> Daniel Patrick Moynihan on the dissolution of the ACIR: “...the ACIR does important, if largely unheralded, work. And we stand on the brink of terminating it. This is a mistake which we will regret...without the ACIR, our knowledge of important matters will never be anything more than meager. The action we are about to take will harm our capacity to govern effectively.” *See Id.* at 127.

<sup>7</sup> U.S. CONSTITUTION, ARTICLE I, SECTION 8, CLAUSE 3.

State Legislatures (NCSL), and the National Governors Association (NGA), and taxpayer concerns advanced by organizations such as the Council on State Taxation (COST).<sup>8</sup>

In other words, what often seems to be lacking in the ongoing policy discourse is a framework for thinking about the overall direction of U.S. intergovernmental fiscal relations. The result has been a series of ad hoc policy decisions that, when viewed together, seem to lack much policy justification aside from inertia, path dependence, or simply “that’s just how we do it.” This paper represents a modest and preliminary effort to resurrect a broader ACIR-type policy discourse regarding key aspects of U.S. fiscal federalism.<sup>9</sup>

The paper is divided into three parts.

Part I begins with a more detailed discussion of the “four observations” listed above. It attempts to articulate the federal interest in minimizing state fiscal crises; the role of revenue volatility in exacerbating state fiscal crises; and the effects of tax structure on revenue volatility. The basic theme in Part I is that through its ad hoc treatment and general neglect of questions of intergovernmental fiscal relations the federal government has stumbled into a situation where it is unwittingly promoting outcomes that are directly counter to its own best interest.

Part II relates the recent California experience with tax reform and how that experience illustrates the dynamics described in Part I. As the nation’s poster child for subnational fiscal turmoil, California offers a useful lens through which to view the current fiscal crisis, the often adverse effects of relying on a highly volatile state revenue structure, and the substantial constraints and limitations involved in attempting to fundamentally reform a state tax system. The overall picture that emerges from a close examination of the (as yet unsuccessful) California experience with tax reform is, not surprisingly, not a pretty one, suggesting that meaningful subnational tax reform, if it is to occur, will likely need to involve some significant federal reforms.

Part III considers options for federal reform, asking how current federal policies might be reformulated to more effectively advance the federal policy objectives spelled out in Part I. The specific frame here is to imagine an explicit “intergovernmental tax policy”—i.e., a set of federal rules and institutions designed to encourage state and local governments to adopt a particular tax structure. The main question taken up in Part III is not so much *whether* to

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<sup>8</sup> R. Allen Hays, *Intergovernmental Lobbying: Toward an Understanding of Issue Priorities*, 44 WESTERN POLITICAL QUARTERLY 1081, 1084-1086 (1991) (overview of key lobbying organizations representing general purpose state and local governments in Congress).

<sup>9</sup> Examples of recent scholarship in the same vein include William F. Fox, *The Ongoing Evolution of State Revenue Systems*, 88 MARQUETTE L. REV. 19 (2004); Jane G. Gravelle & Jennifer Gravelle, *How Federal Policymakers Account for the Concerns of State and Local Governments in the Formulation of Federal Tax Policy*, NAT’L TAX J. 631 (2007); ; John Swain & William Fox, *The Federal Role in State Taxation: A Normative Approach* NAT’L TAX J. (September 2007); Kathryn L. Moore, *State and Local Taxation: When Will Congress Intervene?*, 23 J. LEG. 171 (1997); David Wildasin, *Preemption: Federal Statutory Intervention in State Taxation*, NAT’L TAX J. (September 2007).

adopt such a policy (current law already has these effects), but rather what changes might be warranted to advance more effectively the federal interest in state tax reform.

### I. Four Observations

As noted at the outset, this paper is motivated by four basic observations about state fiscal policy, each of which has special salience given the current (and future) fiscal circumstances of U.S. federal, state and local governments. Each of these observations is discussed below.

#### A. *The Federal Interest in Minimizing State Fiscal Crises*

There are at least three reasons why the federal government has an interest in minimizing the frequency and severity of state fiscal crises. First, and most obviously, state fiscal crises trigger demands for federal resources to provide fiscal relief to the states.<sup>10</sup> This can be seen most clearly in the two most recent recessions, the 2001 recession and the 2007-present recession, during which Congress has enacted legislation providing substantial fiscal relief to the states. In 2003, as part of the Jobs and Growth Tax Relief and Reconciliation Act (JGTRRA 2003), Congress appropriated \$20 billion in state fiscal relief, which was delivered via an “Enhanced FMAP” as well as general fiscal relief.<sup>11</sup> In 2009, through the American Recovery Reconstruction Act (ARRA 2009), Congress once again provided state fiscal relief, this time on a significantly larger scale. Two vehicles were used to deliver these resources: (1) \$81.7 billion was appropriated for funding of an Enhanced FMAP for Medicaid (though these amounts are widely regarded as “largely available for fiscal relief”), and (2) \$53.6 billion for the State Fiscal Stabilization Fund. Of the latter amount, \$48.3 billion is regarded as “largely available for fiscal relief.” In its December 2009 “State and Local Update” report, Goldman Sachs noted that “state and local budget gaps continue to persist.” As a result, “talk of extending the state and local components of ARRA has surfaced in Washington.” As of March 2010, it appears that there is continued pressure on Congress to provide additional fiscal relief for the states.<sup>12</sup>

Second, the increased use of federal fiscal relief in response to state fiscal crises raises a more general concern about a potential softening of the budget constraint that state and local governments face.<sup>13</sup> The softening of subnational budget constraints is an ever-present dan-

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<sup>10</sup> March Lifsher and Evan Halper, *State May Need to ask U.S. for \$7-billion Loan*, LOS ANGELES TIMES (October 3, 2008); Shane Goldmacher and Evan Halper, *Schwarzenegger to Seek Federal Help for California Budget*, LOS ANGELES TIMES (December 23, 2009); Randal C. Archibold, *Schwarzenegger Presses U.S. for More Aid for Needy California*, NEW YORK TIMES (December 23, 2009).

<sup>11</sup> FMAP = Federal Medical Assistance Payment. This is the formula used to determine the amount of federal assistance to the states for purposes of the Medicaid program.

<sup>12</sup> Iris J. Lav, Nicholas Johnson, and Elizabeth McNichol, *Additional Federal Fiscal Relief Needed to Help States Address Recession’s Impact*, CENTER ON BUDGET AND POLICY PRIORITIES (March 1, 2010).

<sup>13</sup> When costs are shifted to outsiders, the state is said to face a “soft” budget constraint and the efficiency of public sector resource allocations is compromised. Janos Kornai, *The Soft Budget Constraint*, 39 KYKLOS 3 (1986).

ger of fiscal federalism. Among the world's federations, the United States stands out for its (relative) success in enforcing a hard budget constraint on state and local governments. While there are no doubt several mechanisms by which state and local governments can shift fiscal costs onto outsiders,<sup>14</sup> for the most part the U.S. state and local sector has enjoyed a reputation for fiscal responsibility throughout the history of the republic.<sup>15</sup> A key turning point in the development of this reputation was the refusal of the federal government to bail out the states after numerous bond defaults in the early 1840's. Similarly, when several Southern states repudiated their debts in the 1870's, the federal government made no effort to step in to satisfy bondholder claims.<sup>16</sup> These decisions both provided credible evidence of the U.S. government's commitment to a no-bailout strategy and prompted states to adopt constitutionally-based balanced budget requirements and debt limitations. As Inman explains: "On most dimensions, the U.S. performance has been a success. Most local governments live within their means. Widespread fiscal crises, when they occur, depend on unique and generally rare events..."<sup>17</sup> The result has been a tradition of fiscal self-sufficiency among the U.S. states that stands in sharp contrast to the experience in many of the world's other federations where the notion of a hard budget constraint for subnational governments is merely aspirational.

While it is still too soon to draw strong inferences about a general softening of the U.S. state/local budget constraint, the recent experience of substantial federal assistance to state and local governments to backfill budgetary shortfalls does not bode well for the future of U.S. fiscal federalism. The availability of substantial federal relief during times of fiscal crisis reduces the incentive that state and local governments face to keep their fiscal houses in

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<sup>14</sup> There are various strategies available to subnational governments to accomplish this result. The most direct means is through the use of taxes that "export" the cost of public goods to non-residents. State taxes on gaming (e.g., Nevada), hotels (e.g., Hawaii, Florida) and natural resources (e.g., Alaska, Texas) are commonly cited examples of tax exporting undertaken by the U.S. states. See Donald Phares, *Tax Exportation*, ENCYCLOPEDIA OF TAXATION AND TAX POLICY 408-(Joseph J. Cordes, Robert D. Ebel, Jane Gravelle, editors) (Urban Institute 2008); Mary Gade and Lee Adkins, *Tax Exporting and State Revenue Structures*, 43 NAT'L TAX J. 39 (1990). Another method of exporting the tax burden to non-residents is through the federal income tax deduction for state and local taxes. 26 U.S.C § 164 (2010). See Gilbert Metcalf, *Tax Exporting, Federal Deductibility, and State Tax Structure*, 12 J. POLICY ANALYSIS AND MANAGEMENT 109 (1993). Intergovernmental fiscal assistance has a similar effect by shifting the cost of local public goods to the federal budget. State reliance on these strategies weakens the link between taxing and spending decisions, potentially eroding fiscal discipline and "softening" the budget constraint that subnational governments face.

<sup>15</sup> There are of course exceptions, including most notably New York City, Orange County, etc... One option available to municipalities, but not state governments, is to file for bankruptcy under Chapter 9 of the federal bankruptcy code. See Steven Greenhut, *Vallejo's Painful Lessons in Municipal Bankruptcy*, WALL STREET JOURNAL (March 26, 2010). Republican candidate for the U.S. Senate, Carly Fiorina, recently suggested that the State of California should consider filing for bankruptcy. See Duane W. Gang, *Fiorina: State Should Keep Bankruptcy as Option*, THE PRESS-ENTERPRISE (February 9, 2010).

<sup>16</sup> Robert P. Inman, *Local Fiscal Discipline in U.S. Federalism* 20-25 (2000).

<sup>17</sup> *Id.* at 34.

order. The risk is that, despite state constitutional provisions requiring a balanced budget, states will pursue *de facto* deficit spending and simply offload the costs to the federal government during the next fiscal crisis. To date, most federal assistance to the states has not had an explicit “bailout” frame, proceeding instead under the guise of general fiscal relief. A more severe crisis, however, could easily prompt emergency federal intervention. As economist Kenneth Rogoff recently noted, “[i]f we ran into a situation where one state got into trouble, they’d be bailed out six ways from Tuesday.”<sup>18</sup> Such action, though perhaps warranted in the short-term to avert catastrophe, risks eroding the incentives for fiscal discipline over the long run. To avoid this possibility, an important consideration in the design of U.S. intergovernmental fiscal policy going forward should be to minimize the likelihood of future demands for state fiscal relief during economic downturns.

Third, fiscal crises compromise the ability of state and local governments to serve a useful countercyclical function during economic downturns. It is well recognized that service demands on state and local governments increase during a recession. Yet the existence of a fiscal crisis necessarily impairs state and local governments’ ability to meet those service demands; in fact, fiscal crises may prompt exactly the opposite strategy—i.e., a reduction in state and local services. In order to preserve the ability of state and local governments to play a constructive role in stimulating the macro-economy, it is advisable going forward to minimize the likelihood of future fiscal crises.<sup>19</sup> In other words, it is in the federal government’s interest to minimize, to the extent possible, having state and local governments in budget repair mode during the next economic downturn.

#### B. *The Role of Revenue Volatility in State Fiscal Crises*

There is a growing consensus among commentators and policymakers regarding the adverse effects of revenue volatility on state and local budgeting. In the years preceding the two most recent recessions, state and local tax revenues surged, permitting an expansion of government services and tax cuts. These boom-year fiscal policies generated (political) expectations regarding the level of services and taxes going forward. With the onset of each recession, however, state and local governments faced yawning gaps between expenditure levels and tax receipts (thus prompting demands for federal assistance). In other words, volatility played two separate and equally important roles in creating the conditions for fiscal crisis—surging tax receipts during the boom years stimulated demand for new programs and tax cuts, while plunging tax receipts during the bust years made continued satisfaction of those demands impossible. The implicit counterfactual here is that more stable revenue levels across time would have translated into more consistent and realistic public service de-

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<sup>18</sup> Mary Williams Walsh, *State Debt Woes Grow Too Big to Camouflage*, NEW YORK TIMES (March 29, 2010).

<sup>19</sup> Edward M. Gramlich, Stimulating the Macro Economy Through State and Local Governments, 69 AMERICAN ECONOMIC REVIEW 180 (1979); Glenn Follette, Andrea Kusko, and Byron Lutz, State and Local Finances and the Macroeconomy: The High-Employment Budget and Fiscal Impetus, 61 NAT’L TAX JOURNAL 531 (September 2008).

mands, thereby minimizing the likelihood of (or at least reducing the severity of) budget imbalance in the down cycle.

Of course revenue volatility alone is not responsible for state fiscal crises. There are numerous variables at work—rising expenditure obligations, constitutional tax limitations, balanced budget requirements, etc... Expert commentary in this area emphasizes the importance of all of these factors in exposing states to the risk of severe budget imbalance during economic downturns.<sup>20</sup> Revenue volatility plays an independent role, however, especially insofar as unsustainable baseline outlays are established during periods of robust economic growth.

It bears noting that revenue volatility is not inherently problematic. To the extent that government tax receipts fluctuate with changes in the economy, rising during boom years and declining as the economy slows, tax policy moderates the impact of the business cycle on private households. This salutary moderating effect shouldn't necessarily be discouraged. Ideally, the government should establish its tax policy in accordance with principles of sound public finance (e.g., fairness, efficiency, administrability) and establish prudent budgeting practices to deal with any resulting revenue volatility. When private households experience substantial year-over-year income volatility, the customary response is to plan around that volatility—by saving and borrowing to smooth the availability of resources over time—rather than making drastic budgetary shifts in response to cash flows. It is perfectly valid to assert that state and local governments should do the same. In other words, state policymakers certainly bear some, perhaps even all, of the blame for not establishing adequate rainy day funds to weather the effects of an economic downturn on state and local tax receipts.<sup>21</sup> That being said, recent experience suggests that even the most ambitious/conservative rainy day fund may not forestall fiscal crisis if the downturn is sufficient severe. Zahradnik reports that during the boom years of the 1990s accumulated “reserves equivalent to 10.4 percent of a year’s expenditures, far more than they had on hand in either of the previous two downturns.”<sup>22</sup> Despite this planning, he concludes, “deficits during the downturn were five times the amount states had accumulated.”<sup>23</sup> Similarly, Dye and Merriman conclude that “it would

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<sup>20</sup> See, e.g., William F. Fox, *Three Characteristics of Tax Structures Have Contributed to the Current State Fiscal Crisis*, STATE TAX NOTES (August 4, 2003) (noting that there “is no single cause of the state fiscal crises” and that the “requirement that states balance their budgets combined with relatively rapid expenditure growth, the specific characteristics of their tax structures, and poor long-term fiscal planning have conspired to leave states in very difficult fiscal straits.”); James Poterba, *State Responses to Fiscal Crises: The Effects of Budgetary Institutions and Politics*, 102 JOURNAL OF POLITICAL ECONOMY 799 (1994).

<sup>21</sup> This is not to suggest that states do not already use rainy day funds—they do. For a discussion, see David Gamage, *Preventing State Budget Crises: Redefining ‘Tax Cuts’ and ‘Tax Hikes’*, 98 CA. L. REV. \_\_\_ (forthcoming 2010) (noting that “most states do indeed save some of their surplus revenues in ‘rainy day funds’” but that they “fall far short from adequately financing these funds.” (p14).

<sup>22</sup> Robert Zahradnik, *Rainy Day Funds: Opportunities for Reform*, CENTER ON BUDGET AND POLICY PRIORITIES (March 9, 2005); see also Gamage, *supra* note XX, at 15-16.

<sup>23</sup> Zahradnik, p1.

take extremely large rainy day fund balances to fully smooth the effect of revenue fluctuations...on expenditures.”<sup>24</sup> Based on this experience, it appears that even a rainy day fund of the magnitude accumulated during the boom years of the 1990s is not up to the task of covering shortfalls such as those experienced in 2001-2002. The Government Finance Officers Association recommends that states maintain a minimum level of reserves totaling 15 percent of annual expenditures.<sup>25</sup>

More fundamentally, the question addressed in this paper is not “who to blame” for revenue shortfalls experienced during economic downturns but rather whether or not the federal government might have an interest in minimizing the adverse effects of state fiscal crises. Thus, while the arguments for more robust and effective rainy day funds may be persuasive, the federal government must attend to its own best interests regardless of whether or not the state’s have engaged in sound fiscal planning.

### *C. Revenue Volatility and State Tax Mix*

Short-term revenue volatility is not uniform across all states. Some of the variation is attributable to regional or local differences in the nature of economic activity. A state that relies heavily on the financial services industry, for example, is likely to experience revenue cycles quite different from those observed in states that depend more on manufacturing or agriculture. In part because of these differences, business cycles do not have uniform nationwide effects, a point driven home by the uneven effects of recent recessions in different parts of the country.<sup>26</sup> More generally, a state’s demographic characteristics, including factors such as age composition and income distribution, are also likely to have some influence on the volatility of state tax receipts over the business cycle.

Beyond these factors, researchers who have studied revenue volatility have attempted to identify how the composition of the state tax base impacts fiscal stability. This literature has generally considered both long-run effects (trend growth rate) and short-run effects (cyclical variability). With regard to long-run effects, the question is essentially the extent to which different tax bases are responsive to the growth in income over time.<sup>27</sup> This is an important topic with potentially significant implications for the long-term fiscal sustainability of state and local governments; however, my focus here is on that aspect of the literature discussing the short-run cyclical variability of alternative state tax bases. In other words, how does state

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<sup>24</sup> Richard F. Dye & David F. Merriman, *State Revenue Stability: Alternative Conceptualizations*, NATIONAL TAX ASSOCIATION PROCEEDINGS, 97<sup>TH</sup> ANNUAL CONFERENCE 258, 268 (2004).

<sup>25</sup> *Id.*

<sup>26</sup> *See, e.g.*, Donald J. Boyd, *What Will Happen to State Government Finances in a Recession?*, ROCKEFELLER INSTITUTE FISCAL REPORT 13 (January 30, 2008) (comparing regional impact of 1990-91 recession, which was concentrated more on the coasts, and the 2001 recession, which was more widespread).

<sup>27</sup> Earlier contributions to the volatility literature had conflated the analysis of long-run and short-run trends, relying on a single statistic (income elasticity) and assuming that a buoyant growth trend over the long-run also meant short-run cyclical variability. This approach partly explains the conventional view that long-run growth in the tax base generally meant more cyclical variability.

tax mix influence the revenue volatility that states experience over the business cycle? We might expect individual income taxes to respond differently to changes in economic activity than corporate income taxes or retail sales taxes. Moreover, cross-state variations in the design of these taxes, such as the inclusion of food in the retail sales tax base or the degree of progressivity in the individual income tax, might also be expected to influence the variability of tax receipts over the business cycle.

There is considerable variation in the composition of tax bases among the U.S. states. Looking at the nation as a whole, almost 90 percent total state tax revenue comes from sales and income taxes. States collect 30.8 percent of their total tax revenue from general sales taxes and another 15 percent from selective sales taxes. As for income taxes, 35.6 percent of state taxes comes from individual income taxes with another 6.5 percent from corporate income taxes.<sup>28</sup> Most states rely on some mix of sales and income taxes. For example, Ohio (in an apparent effort to displace Illinois as the “most average state”),<sup>29</sup> derives 29.4 percent of its tax revenue from general sales taxes and 37.3 percent from individual income taxes. At the extreme, however, are states like Florida, which derives 81.7 percent of its taxes from sales taxes (general and selective combined), and Oregon, which derives 74.9 percent of its taxes from income taxes (individual and corporate combined). State-specific breakdowns are set forth in the Appendix.

Not surprisingly given the states’ predominant reliance on sales and income taxes, the economic literature on revenue volatility has focused principally on the question of the relative stability of these two taxes. The findings have varied depending upon the data used and the techniques employed for estimating variability. Dye and McGuire (1991) find that the variability of sales taxes depends significantly on the scope of the tax base.<sup>30</sup> Generally speaking, a narrow sales tax base will exhibit greater short-run variability than a broader base, and certain components of the base (e.g., food for home consumption, recreation services) tend to exert a stabilizing influence on tax receipts. On the other hand, certain aspects of the sales tax base (e.g., inclusion of motor vehicle fuels) tend to introduce greater variability. As for income taxes, Dye and McGuire emphasize the importance of progressivity as an influence on revenue volatility. On balance, states with more steeply progressive marginal tax rates exhibit greater cyclical variability in income tax receipts than do states with flat-rate income taxes. Results reported by Sobel and Holcombe (1996) are generally consistent with these conclusions, though unlike Dye and McGuire these authors estimate short-run elasticities for corporate taxable income as well, confirming the intuition that state corporate income

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<sup>28</sup> The remaining 12.1 percent of state taxes come from miscellaneous charges and license taxes.

<sup>29</sup> Stephen Ohlemacher, *Analysis Ranks Illinois Most Average State*, ASSOCIATED PRESS (May 17, 2007).

<sup>30</sup> Richard F. Dye & Therese J. McGuire, *Growth and Variability of State Individual Income and General Sales Taxes*, 44 NATIONAL TAX JOURNAL 55 (1991).

taxes vary significantly more over the business cycle than either the individual income tax or the retail sales tax.<sup>31</sup>

More recent work in this area has focused on the difficulty of drawing strong conclusions about the relative variability of alternative taxes. For example, Dye (2004) emphasizes that there is “too much cross-state variation in cycles, in tax structures, and in estimated elasticities to draw any easy conclusions from multi-state data.”<sup>32</sup> Similarly, Bruce, Fox, and Tuttle (2006) conclude that “neither the personal income tax nor the sales tax emerges as the universally more volatile tax.”<sup>33</sup> Although “income elasticities are generally larger for the income tax in both the long-run and the short-run,” the authors also note that “the sales tax can actually be the more volatile tax in certain situations.”<sup>34</sup> One intriguing result from the Bruce, Fox, and Tuttle research is that short-run elasticities for both the sales tax and the income tax are asymmetric around the overall trend rate. That is, during periods of strong economic growth, such as the 1990s, the short-run elasticities for both taxes are higher than during periods of below-average growth.

On balance, therefore, it is hard to say anything absolutely definitive regarding the relative volatility of individual income taxes and retail sales taxes. Which tax is more variable across the business cycle is a function of state-specific circumstances and the characteristics of the business cycle under examination. That said, there does seem to be a general consensus regarding certain features of specific tax bases, including the following:

- (1) corporate income taxes are among the most volatile of all state taxes;<sup>35</sup>
- (2) broad-based personal consumption tax less volatile than narrow base (e.g., inclusion of food in the sales tax base generally makes the tax more stable over the business cycle);<sup>36</sup>

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<sup>31</sup> Russell S. Sobel & Randall G. Holcombe, *Measuring the Growth and Variability of Tax Bases over the Business Cycle*, 49 NATIONAL TAX JOURNAL 535 (December 1996).

<sup>32</sup> Richard F. Dye, *State Revenue Cyclicalities*, 57 NATIONAL TAX JOURNAL 133 (March 2004).

<sup>33</sup> Donald Bruce, William F. Fox, M.H. Tuttle, *Tax Base Elasticities: A Multi-State Analysis of Long-Run and Short-Run Dynamics*, 73 SOUTHERN ECONOMIC JOURNAL 315 (2006).

<sup>34</sup> *Id.* at 338.

<sup>35</sup> (page 68 of 10<sup>th</sup> district paper); (Sobel/Holcombe); introduction of state tax credits likely to make CIT more volatile (GSU paper, page 5)

<sup>36</sup> Dye and McGuire (1991); Dye (2004); R. Alison Felix, *The Growth and volatility of State Tax Revenue Sources in the Tenth District*, FEDERAL RESERVE BANK OF KANSAS CITY 65-66 (2008). Most states (31 total) exempt food purchased for home consumption from the sales tax base, while several others either tax groceries at a lower rate or offer some form of tax credit or rebate to low-income households to offset the effects taxing groceries. Only two states—Alabama and Mississippi—tax groceries in full without any credit or rebate. Center on Budget and Policy Priorities, *Which States Tax the Sale of Food for Home Consumption in 2009?*, (November 4, 2009).

- (3) taxes on nonwage sources of income (capital gains, interest, dividends) generally exhibit greater volatility than wages;<sup>37</sup> and
- (4) the more progressive tax the tax system, the more volatile.<sup>38</sup>

#### *D. The Federal Influence Over State Tax Mix*

There are several mechanisms by which federal law currently influences the design and architecture of state and local tax systems. Together these mechanisms can be viewed as the federal government's current "intergovernmental tax policy"—that is, the collection of federal policies, rules and institutions that establish incentives for the design of state and local tax systems.

*Federal-State Base Conformity.* Perhaps the most obvious (yet little discussed) federal "inducement" for the design of state and local tax systems is the fact that Congress has established an elaborate and detailed legal framework for certain taxes—including, most notably, the individual and corporate income taxes—but not for others.<sup>39</sup> The very existence of the Internal Revenue Code, Treasury regulations, IRS administrative guidance, and federal judicial case law provides an almost irresistible incentive for the states to adopt individual and corporate income taxes. At first blush, the availability of the federal income tax base as a starting point in calculating state tax liability is an unqualified benefit. Clearly there are economies of scale that make state reliance on the federal system efficient. Aside from the substantive law itself, the Internal Revenue Service partners with state revenue agencies to enhance compliance through, for example, the exchange of taxpayer data.<sup>40</sup> To start a state tax system from scratch, without taking advantage of the existing federal legal and administrative apparatus already available would be foolhardy to say the least.

At the same time, however, it must be recognized that there are potentially significant costs associated with having states piggyback on the federal income tax. It is clear that some of the most volatile state revenue sources are those upon which states rely by virtue of piggybacking on the federal income tax. For example, as noted above Sobel and Holcombe

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<sup>37</sup> Dye (2004) at 142; Donald J. Boyd and Lucy Dadayan, *State Tax Revenue Falling Sharply in Fourth Quarter, Early Data Show*, NELSON A. ROCKEFELLER INSTITUTE OF GOVERNMENT 15 (January 2009).

<sup>38</sup> Rockefeller Institute; revenue reports

<sup>39</sup> Ruth Mason, *Federalism and the Taxing Power*, \_\_ CALIFORNIA L. REV. 46-49 (Forthcoming 2010) (discussing federal-state tax base conformity and noting that "[l]ittle attention has been paid in the federalism literature to this automatic (or semi-automatic mirroring of federal fiscal policy in state fiscal policy).

<sup>40</sup> Specific programs include the Governmental Liaison Data Exchange Program (GLDEP-general taxpayer data sharing), the Questionable Employment Tax Program (QETP-sharing related to employee-independent contractor questions), and the Abusive Tax Avoidance Transactions program (ATAT-sharing related to tax shelter audits). In addition, there is a new information sharing pilot program, the State Reverse File Match Initiative (SRFMI). For a discussion, see *Tax Administration: IRS Needs to Strengthen Its Approach for Evaluating the SRFMI Data-Sharing Pilot Program*, UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE (November 2008).

show that state corporate taxable income exhibits significantly greater variability over the business cycle than all other major state revenue sources.<sup>41</sup> The bottom line is not that states should abandon state corporate income taxes; they are a commonsense and logical source of revenue given the existence of the federal income tax. Nevertheless, it should be recognized that the availability of the federal tax base is not an unalloyed benefit; the volatility cost associated with reliance on corporate income taxes that must be balanced against the benefits of relying on the federal base.

A similar analysis holds with respect to the individual income tax, especially as it applies to nonwage sources of income. Generally speaking, capital gains and other nonwage sources of income exhibit substantially greater volatility than wages. The inclusion of capital gains in the federal income tax base, along with the realization rule that has been long embedded in federal law,<sup>42</sup> virtually guarantees that states with an individual income tax are going to experience substantial revenue volatility as a result of their decision to piggyback on the federal income tax. This is especially true for those states, like California, that rely on the federal base and the federal realization rule, but tax capital gains income at the same rate as all other types of income.<sup>43</sup> In a report issued in 2005, the California Legislative Analyst's Office noted that "the most important factor in recent years [accounting for California's relatively high degree of revenue volatility] is the extraordinary boom and bust in stock market-related revenues from stock options and capital gains" and that "PIT revenues from these two sources jumped from about \$2 billion in 1995-96 to a peak of \$17 billion in 2000-01, before plunging to about \$5 billion in 2002-03.

*Inducements via Deductibility.* Another incentive established by federal law is the differential treatment of alternative tax sources within the federal income tax deduction for state and local taxes.<sup>44</sup> Here again the federal policy was not specifically designed with an eye toward influencing the composition of state and local tax systems, but the incentives for the state fiscal architect are unmistakably clear. In calculating their taxable income for purposes of the federal income tax, individuals who itemize their deductions are allowed to claim a deduction for (1) state and local real property taxes, (2) state and local personal property taxes (e.g., car taxes), and (3) state and local income taxes, or, at the taxpayer's election, state and local general sales taxes in lieu of state and local income taxes. This latter provision was added to the law in 2004 primarily for the benefit of taxpayers that live in states without an individual income tax (e.g., Florida, Texas).<sup>45</sup> By carving out a benefit for some but not all

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<sup>41</sup> Russell S. Sobel & Randall G. Holcombe, *Measuring the Growth and Variability of Tax Bases Over the Business Cycle*, 49 NAT'L TAX J. 535, 543 (1996) (Table 2).

<sup>42</sup> *Eisner v. Macomber*, 252 U.S. 189 (1921).

<sup>43</sup> Elizabeth G. Hill, Legislative Analyst, *Revenue Volatility in California* (January 2005); see also Mac Taylor, Legislative Analyst, *Perspectives on the State's Revenue Structure: Presentation to Commission on the 21<sup>st</sup> Century Economy* 5 (January 22, 2009) (noting that with respect to volatility in California tax receipts, "Capital Gains Are the Main Story.").

<sup>44</sup> 26 U.S.C. §164 (2010).

<sup>45</sup> 26 U.S.C. §164(b)(5) (2010) (as amended by the American Jobs Creation Act of 2004).

state and local taxes, the SALT deduction establishes clear price effects favoring the adoption of, say, income taxes over sales taxes.

Perhaps even more important than the thumb that section 164 puts on the scale in favor of some taxes over others is the fact that a larger subsidy is made available to high-income taxpayers. There are two reasons for this. First, the SALT deduction is available only to those taxpayers who itemize their deductions, which typically means that only higher-income households will benefit from the deduction.<sup>46</sup> Second, because the subsidy is made available via a deduction from income (rather than, for example, a credit), its value to the taxpayer is a function of the itemizing taxpayer's marginal tax rate. In a system of progressive marginal tax rates, this means that those taxpayers with the highest levels of taxable will enjoy the largest benefit from the SALT deduction. For example, consider two taxpayers, X and Y, each of whom has paid \$10,000 in state income taxes. Assuming that X's marginal tax rate is 15 percent, the value of the SALT deduction to her will be \$1,500. However, Y—who let's assume faces a federal marginal tax rate of 35 percent—will enjoy a federal SALT benefit of \$3,500. All else equal, state and local governments will have an incentive to design their tax systems so as to take maximum advantage of the SALT subsidy, which suggests a strong price effect in favor of a more progressive tax system. Generally speaking, states that concentrate their tax burdens on high-income households are likely to experience greater income tax volatility than those with less progressive tax systems. Here again then we see that federal law offers an inducement for states to adopt a relatively volatile state tax structure.

The continuing influence of the section 164 price effects just described is somewhat in a state of flux. For purposes of the alternative minimum tax (AMT)—a parallel system designed to ensure that taxpayers claiming certain tax preferences pay at least some minimum amount of tax—state and local taxes are *not* deductible. In recent years, the AMT has grown in significance as more and more higher and even middle-income households have become AMT taxpayers. Given the non-deductibility of state and local taxes under the AMT, one might view its increasing significance as a *de facto* gradual repeal of the SALT subsidy (an outcome I favor). It is worth noting, however, that many higher income taxpayers (especially those with large amounts of income subject to the current top marginal rate of 35 percent) actually “blow through” the AMT and thus “regain” the marginal benefit of the SALT deduction—(this is true for President and Mrs. Obama, for example). In addition, assuming that the Bush tax cuts expire on schedule and the two pre-2001 top marginal tax rates (of 36 and 39.6 percent) are reintroduced, a significant number of taxpayers currently subject to the AMT will revert to the regular income tax and thus once again enjoy the marginal benefit of the SALT deduction.

Beyond subsidizing the particular list of specifically enumerated taxes, section 164 can also be viewed as “penalizing” (or at least “discouraging”) the adoption of taxes for which no

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<sup>46</sup> Note, however, that there is a temporary above-the-line deduction for property taxes, up to a maximum of \$500 for singles and \$1,000 for married individuals filing a joint return.

federal income tax deduction is available. The most obvious example of such a tax, following the amendments introduced via the Tax Reform Act of 1986, is the general retail sales tax. With the exception of section 164(b)(5) (discussed above), section 164 does not generally allow a deduction for state or local retail sales taxes. On balance, therefore, the federal subsidy disfavors greater state reliance on sales taxes, which, generally speaking, tend to exhibit less volatility than income taxes.<sup>47</sup>

*Federal Statutory Limitations.* Beyond the two major categories of federal “inducements” just described, there are also various specific provisions in federal law that limit state taxing authority. Foremost among these is Public Law 86-272, legislation enacted in 1959 largely in response to the U.S. Supreme Court’s decision in *Northwestern States Portland Cement v. Minnesota*.<sup>48</sup> In that decision, the Supreme Court rejected a commerce clause challenge against the imposition of a state corporate income tax on an out-of-state corporation whose sole activity in the state consisted of small number of sales representatives who solicited orders for the purchase of the corporation’s products. Looking back more than a half-century, it is hard to appreciate the significance of the Court’s decision, but it bears noting that the case prompted a front-page article in the *New York Times* with the headlines, “High Court Backs Wide State Right to Tax Business.”<sup>49</sup> According to the *Times* account, Justice Felix Frankfurter penned a “vigorous” dissent and announced from the bench that, “Very few cases have been before this court of such import to national-state relations and the economy of this country.”<sup>50</sup> The decision prompted sufficient alarm in the halls of Congress that it mobilized support for the enactment of P.L. 86-272. That law, which was intended as a temporary stop-gap measure but did not incorporate a sunset provision, continues in full force today and may be fairly regarded as a key feature of current U.S. intergovernmental tax policy. To the extent that P.L. 86-272 can be viewed as cabining the scope of state corporate income taxes, it might be regarded as a stability-enhancing feature of federal law. On the other hand, P.L. 86-272 has prompted some states to adopt so-called “throwback” and “throwout” rules that have the effect of shifting income that goes untaxed in the state of destination to the state of origin.<sup>51</sup>

[KJS note: discuss other statutory limitations on state taxing power].

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<sup>47</sup> In addition, it is worth noting that since 1979, federal law has disfavored state reliance on gasoline taxes. The Revenue Act of 1978 (P.L. 95-600, § 111(a), 92 Stat. 2763, 2777 (1978)), Congress repealed the deduction for state gasoline taxes.

<sup>48</sup> *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959).

<sup>49</sup> Anthony Lewis, *High Court Backs Wide State Right to Tax Business*, *New York Times*, p. 1 (February 25, 1959).

<sup>50</sup> *Id.*

<sup>51</sup> Margaret C. Wilson, *Apportionment Apoplexy: Throwback, Throwout, or Just Throw Up Your Hands*, TAX EXECUTIVE (July 1, 2005); Institute on Taxation and Economic Policy, “*Nowhere Income*” and the *Throwback Rule*, TALKING TAXES, POLICY BRIEF #39 (2008).

*“Quasi-Statutory” Judicial Limitations.* Where Congress has chosen not to act to limit state taxing powers, often times the Supreme Court has acted instead. Beginning with the 1824 decision in *Gibbons v. Ogden*,<sup>52</sup> the U.S. Supreme Court has taken it upon itself to police state regulations that it views as encroaching upon the plenary power of Congress to regulate interstate commerce. Under the Court’s “dormant” commerce clause jurisprudence, states are generally prohibited from imposing taxes (or tax collection obligations) unless the state can show that (1) it has a “substantial nexus” with the taxpayer, (2) the tax is non-discriminatory (vis-à-vis intrastate and interstate activities), (3) the tax is “fairly apportioned”, and (4) the tax bears a “fair relation” to the services provided by the state. These four “prongs” come from the Court’s landmark decision in *Complete Auto* (1977), which established the modern framework for the resolution of dormant commerce clause disputes in the area of state and local taxation.

The U.S. Supreme Court’s dormant commerce clause jurisprudence can be viewed as a set of “quasi-statutory” limitations on state taxing authority. There is of course no actual federal “statute” setting forth these limitations; however, the rules have the same legal force as a federal statute and like a statute may be repealed or amended by Congress at any time. Thus, it seems appropriate to think of these judicially-articulated rules as a set of additional federal limitations (in the same way we think of P.L. 86-272). By far the most significant quasi-statutory rule arising out of the Supreme Court’s dormant commerce clause jurisprudence is the ruling in *Quill Corporation v. North Dakota* in 1992.<sup>53</sup> *Quill* extended the rule of the Court’s 1967’s decision in *National Bellas Hess* that a state may not collect sales taxes on an out-of-state firm whose only connection with the state is through the U.S. mail or common carrier.<sup>54</sup> The practical effect of this rule has been to carve out an area of tax-free consumption via mail-order or internet purchases. Viewed as a key component to the overall U.S. intergovernmental tax policy, this rule is best understood as the central federal obstacle to the adoption by the states of a broad-based personal consumption tax. To be sure, there are numerous other flaws in the design of state retail sales taxes that prevent the tax from deserving recognition as a broad-based tax on household consumption—the widespread taxation of business inputs and the general exclusion from the base of personal services are two main examples. Still, as long as the *Quill* rule stands, state retail sales taxes will remain nothing more than a weak imitation of a consumption tax.

To summarize, the basic picture that emerges from a review of the foregoing is this: under current law, the federal government generally *favors* the adoption of state individual and

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<sup>52</sup> *Gibbons v. Ogden*, (1824)

<sup>53</sup> *Quill v. North Dakota* (1992).

<sup>54</sup> More precisely, the *Quill* decision prohibits the state from imposing a use tax collection obligation on an out-of-state vendor whose only connection with the state is through the U.S. mail or common carrier. The “use tax” is a complementary tax to the standard retail sales tax and applies to items that are purchased in one state but then consumed in another. There is no question regarding the constitutionality of the substantive use tax liability on the in-state consumer; the question of *Quill* is instead whether the vendor can be made to collect that use tax on the state’s behalf.

corporate income taxes (by virtue of both the administrative benefits associated with base conformity and the price effects associated with federal income tax deductibility) and to a lesser degree property taxes (where there are no base conformity benefits but there is a positive price effect due to deductibility). In addition, federal law currently *disfavors* the adoption of general sales taxes (by virtue of the lack of any base conformity benefits and the usual lack of any price effects from deductibility). As for the distribution of tax burdens among income classes, federal law currently gives states an incentive to concentrate the tax burden on those individuals who are best positioned to take advantage of federal subsidies made available through income tax deductibility. Thus, all else equal, states should *favor* the use of deductible taxes imposed on federal itemizers (subject to the AMT caveat described above), as well as taxes on high-income taxpayers who likely face the highest federal marginal tax rates.

[KJS Note: discuss other miscellaneous taxes, such as estate taxes, state gasoline taxes...]

As noted in Section C above, studies on state revenue volatility do not support strong, definitive claims regarding the relative volatility of income versus sales taxes. Income taxes are generally more volatile, but under certain circumstances (e.g., comparing a flat rate wage tax to a narrowly applied sales tax) sales taxes can exhibit greater variability. On the other hand, there appears to be a general consensus that state reliance on corporate income taxes and the nonwage component of individual income taxes is likely to result in considerable revenue volatility over the business cycle. Income tax revenues derived from the labor income base appear to exhibit less volatility, though the extent of that volatility is likely to vary depending upon the distribution of income within the state (the more top-heavy, the more volatile) as well as the progressivity of the state's personal income tax (the more progressive, the more volatile).

Current federal law can be viewed as contributing to state revenue volatility in several respects. First, the inclusion of corporate income and nonwage personal income in the federal base offers up an easy, almost irresistible tax base for state governments. Second, the general federal preference for more progressive tax systems (because of the differential value of deductibility) likely contributes to the volatility of state revenue. Third, federal rules relating to the taxation of internet and mail-order sales generally inhibits the development of broad-based personal consumption taxes in the states. Thus, in combination it appears that federal law generally favors the adoption of tax structures that contribute to—perhaps even exacerbate—revenue volatility.

## II. Implications for State Tax Reform—the California Experience

Whether or not one agrees with the foregoing description of the federal government's existing implicit "intergovernmental tax policy" and regardless of how one feels about the need for a reorientation of federal law in this area, it should be clear that current law places significant obstacles in the path of states wanting to alter their tax mix in favor of a less volatile combination of revenue instruments. Given the general gravitational pull in favor of base conformity with the federal income tax, the dominant price effects of federal income tax de-

ductibility, the federal limitations on expansion of the sales tax base, and the lack of federal administrative support or incentives for alternative revenue instruments, it would seem to require an act of heroic fiscal innovation for state policymakers to branch out beyond the conventional taxes upon which states have relied for decades. Throw in a little path dependence, political inertia, and general adherence to the principle that the only good tax is an old tax, and it's not too hard to see why the states—acting on their own, without federal intervention—are not likely to stray too far from the status quo.

The recent experience in California with the tax reform recommendations made by the state's Commission on the Twenty-first Century Economy (COTCE) illustrate the many hurdles that state tax reformer face. COTCE was a bipartisan commission consisting of 14 members, half of whom were appointed by Governor Schwarzenegger (a Republican) and half by the legislative leadership (Speaker Pro Tem Darrell Steinberg and Assembly Speaker Karen Bass—both Democrats). The hope was that the Commission would identify a set of tax reforms that would serve the state well in the highly competitive, globalized service-based economy of the twenty-first century. In addition, revenue volatility was a major concern of several, though certainly not all, members of the Commission. After several months of hearings, 9 of the Commission's 14 members (6 Republicans and 3 Democrats) endorsed a final report that that was submitted to Governor Schwarzenegger in late September 2009.<sup>55</sup>

The centerpiece of the COTCE recommendations was a proposal for a new tax that the Commission called a "business net receipts tax" (BNRT). The tax was loosely modeled on a tax that had been enacted in Michigan in 2007 (the Michigan Business Tax) and seems to have drawn some inspiration from the recent experience in a few states with gross receipts taxes (e.g., the Ohio "Commercial Activities Tax" and the Texas "Margins Tax"). Along with gross receipts taxes more generally, these other taxes in Michigan, Texas and Ohio have been the subject of some criticism along the lines of the old European "turnover" taxes that predated the introduction of the value-added tax in the 1960s. Any tax based on gross receipts suffers from a "pyramiding" problem to the extent that non-retail receipts are included in the base. The widespread criticism of gross receipts taxes on this point seems to have had some role in motivating the Commission's recommendation for a *net* receipts tax that would allow firms to deduct all payments made to other firms. In effect, the BNRT as proposed was a type of subtraction-method value-added tax in that it sought to tax each firm on the market value of the goods/services it produced, less amounts paid to other firms. The tax would apply to any firm having "economic nexus" with the State of California (i.e., sales above a certain threshold would be a sufficient statutory basis for the imposition of the tax, even if the firm had no physical presence in the state). In addition, the net receipts base of those firms doing business both within and without California would be apportioned on the basis of the ratio of the firm's California sales to its nationwide sales (or global sales, in the event of a firm's water's edge election).

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<sup>55</sup> See Final Report of the Commission on the 21<sup>st</sup> Century Economy (September 2009) (at [www.cotce.ca.gov](http://www.cotce.ca.gov)).

The intent of the Commission—or at least those Commissioners who endorsed the Commission’s final report—was to propose a set of tax reforms that would be revenue-neutral and reduce revenue volatility in the State’s General Fund.<sup>56</sup> The reduction in revenue volatility was to be accomplished through a substantial reduction (and flattening) of the individual income tax rates, a complete repeal of the state’s corporate income tax, and a partial repeal of the general retail sales tax (the state portion of the RST was to be repealed with local sales taxes remaining). The remaining state tax structure would thus consist primarily of a reformed and reduced income tax and the BNRT. The overall incidence of the proposed package would be more regressive than current law; but the hope was that the resulting reduction in volatility would put the state’s finances on a firmer footing and thus be worth the cost. Although there has been no official action taken on the COTCE recommendations in the California legislature, it has been widely observed that the package was “dead on arrival” due to the joint opposition of business (which generally disliked the uncertainty of the BNRT) and labor (which generally opposed reducing the progressivity of the state’s tax system).

The California tax reform experience provides concrete evidence of the difficulty that state tax reformers face in attempting to design a less volatile tax structure in the face of existing federal policies in this area. Several points deserve mention. First, and most significantly, there is simply no federal support for the adoption of a tax such as the BNRT. Unlike the corporate income tax, the BNRT would come with its own legal and administrative complexities that could not be avoided through reliance on an existing federal structure. In fact, federal law is arguably *hostile* to the adoption of BNRT-type taxes insofar as current federal limitations (including the *Quill* holding and P.L. 86-272) could be construed to apply to such a tax and thus limit the enforcement of the economic nexus standard the Commission had proposed.<sup>57</sup> Second, and related, the Commission’s proposed repeal of the state corporate income tax is subject to the criticism that the state is giving up on a tax for which a substantial federal administrative infrastructure is already in place. Despite the (many many) faults of the state corporate income tax, it is hard to argue that the state should jettison a tax for which so much of administrative apparatus is already baked into the system. Third, the Commis-

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<sup>56</sup> The idea behind making the package revenue-neutral was to ensure that the package could be adopted by the legislature by simple majority since it would not be a tax increase requiring a two-thirds majority within the meaning of Article XIII A of the California Constitution.

<sup>57</sup> In effect, the Commission was attempting to “thread the needle” between the dormant commerce clause restrictions of *Quill* and the federal statutory restrictions of P.L. 86-272. The former expressly applies to state sales and use taxes and could possibly also apply to consumption-type taxes such as the BNRT. The Commission secured an opinion from lawyers at the California Franchise Tax Board to the effect that the *Quill* physical presence rule “should” not apply to the BNRT. If the BNRT is not a consumption tax, however (and thus not subject to *Quill*), the state could face the alternative argument that it is a net income tax and thus subject to the restrictions of P.L. 86-272. Here again, however, the FTB opinion took the view that P.L. 86-272 would not apply since the tax was not a tax on “net income.” The point here is not to comment on the merit of these legal conclusions but rather to point out how these two important federal limitations—one from the Supreme Court, the other from Congress—set the basic parameters for how much volatility-reducing state fiscal innovation is possible.

sion's recommendation for a reduced reliance on the individual income tax, which might well be an advisable course of action for a state wishing to reduce overall revenue volatility, is subject to the criticism that the state would be shifting tax liabilities away from those who are best positioned to benefit from the federal subsidy of section 164 (again, subject to the AMT caveat).

[KJS Note: expand/recap COTCE experience & federal obstacles to consumption tax].

### III. A Question (and Options for Reform)

To recap: it seems that the federal government has a strong interest in reducing the frequency and severity of state fiscal crises. Doing so enables it to minimize future bailout claims and promotes adherence of state and local governments to a hard budget constraint, a critical objective in intergovernmental fiscal relations. There are reasons to believe that revenue volatility is an important contributor to state fiscal crises and that volatility depends in large part of the particular mix of taxes used by the state. Rather than discouraging reliance on volatile revenue sources, however, current federal law generally favors the adoption of tax systems that generate revenue volatility. This raises a natural question: should the federal government play a more direct and proactive role in the design of state tax systems so as to minimize fiscal crises and promote the long-term fiscal sustainability of state and local governments?

Answering this question requires some attention to the normative desiderata of an "inter-governmental tax policy." What values/principles/norms should animate such a policy? There is a general consensus in the public finance literature regarding the normative goals of taxation in general. While many differ about how to accomplish these goals or the relative weight that should be given to them, most commentators agree that sound tax policy requires attention to the competing goals of fairness, efficiency, and administrability.<sup>58</sup> The same can be said for tax policy at the state and local level. Though the multijurisdictional setting introduces new variables, such as interjurisdictional competition and the possibility of taxpayer exit, most analysts agree that state and local tax policy should reflect a similar emphasis on fairness, efficiency and administrability norms.<sup>59</sup> Once we start thinking about tax policy across vertical tiers of government, however, the normative calculus begins to change.

As a first cut, one might assume that the same normative rationales underlying federal tax reform (i.e., fairness, efficiency, administrability) should play a similar role in the formula-

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<sup>58</sup> See, e.g., Government Accountability Office, *Understanding the Tax Reform Debate: Background, Criteria and Questions*, GAO-05-1009SP (September 2005) (available at <http://www.gao.gov/new.items/d051009sp.pdf>).

<sup>59</sup> In the state/local tax context, the National Conference of State Legislators has produced a well-known list of "Principles of a High-Quality State Revenue System." This list includes nine separate principles, most of which fall within the categories of fairness, efficiency and administrability. See National Conference of State Legislators, *Principles of a High-Quality State Revenue System* (4<sup>th</sup> Edition, June 2001) (updated June 2007) (available at <http://204.131.235.67/programs/fiscal/fp-phqsr.htm>).

tion of an intergovernmental tax policy. However, a strong countervailing principle—federal respect for state sovereignty and fiscal autonomy—counsels against active federal interference with state and local tax systems, especially on sensitive political questions such as the distribution of tax burdens among income classes. It is not clear, for example, that federal law should either encourage or discourage the adoption of progressive state and local tax systems. Similarly, one might argue that the breadth of the sales tax base (including questions such as the inclusion of food for home consumption in the base) should be a matter left to state discretion. At the same time, however, respect for state fiscal autonomy should not be (and indeed *has not been*) an absolute principle. Without purporting to resolve the precise balance between respect for state fiscal autonomy and other values, I offer the following preliminary thoughts on options for reform that might serve the interest in reducing state revenue volatility.

*Options for Reforming/Repealing Deductibility.* First, and most obviously, it may be advisable to reform or repeal the deduction for state and local taxes. Because the deduction as currently crafted favors the adoption of progressive income taxes, it arguably contributes to the problem of state revenue volatility. One policy option, taking into account the growing significance of the AMT, is to simply “let the AMT run its course” or, alternatively, incorporate into the regular income tax the AMT’s treatment of state/local taxes. This is in effect what is being proposed by the recent Wyden/Gregg legislation. Apart from outright repeal, other options include converting the deduction to a flat-rate credit (so as to strip out the differential subsidy for high income taxpayers) or to convert the deduction to an above-the-line rather than itemized deduction. More ambitiously, one could imagine a state/local tax credit regime in which the credit percentage varies depending on the tax. Thus, from the perspective of reducing revenue volatility, it might make sense to provide a larger federal subsidy for property taxes, broad-based sales taxes, or wage income taxes. A lower or zero federal subsidy might be more suitable for state taxes on nonwage sources of income.

*Options for Centralizing Particularly Volatile Tax Bases.* In other work, I have taken the position that state corporate income taxes should be replaced by a single federal corporate income tax.<sup>60</sup> This is the standard view from the fiscal federalism literature on tax assignment; mobile tax bases should generally be assigned to higher levels of government. The volatility effects of including corporate income taxes in state tax portfolios further support their assignment to the federal government.<sup>61</sup> A similar argument might be made for individual income taxes on nonwage income. To be sure, the notion of prohibiting the states from taxing capital gains, interest or dividend income might face constitutional challenges as an impermissible abrogation of state taxing powers.<sup>62</sup> To the extent that such legal challenges have

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<sup>60</sup> Kirk J. Stark, *The Quiet Revolution in U.S. Subnational Corporate Income Taxation*, BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION, (reprinted in STATE TAX NOTES (March 4, 2002)).

<sup>61</sup> *But see* Michael Fatale, *Federalism and State Business Activity Nexus: Revisiting Public Law 86-272*, STATE TAX NOTES (June 3, 2002); Michael McIntyre, *Thoughts on the Future of the State Corporate Income Tax*, STATE TAX NOTES (September 23, 2002).

<sup>62</sup> *Id.*

merit, Congress would need to use alternative mechanisms for ensuring de facto centralization.

*Options for Reducing the Cost of Relying on Alternative Tax Bases.* As noted above, the Internal Revenue Code exerts a powerful gravitational pull on state tax systems by providing a ready-made system of legal rules and administrative apparatus for individual and corporate income taxes. It will not be possible to replicate these effects for other taxes unless the federal government undertakes fundamental tax reform. However, it may be possible to adopt certain micro-reforms that move in the direction of reducing the cost of relying on alternative tax bases. For example, one might imagine federal assistance for a broad-based retail sales tax built on uniform federal base specifications (perhaps working from the efforts already undertaken through the SSTEP). Alternatively, one could imagine the federal government taking on a greater administrative role in the design and administration of local property taxes. At first blush this may seem to be a sharp departure from the long tradition of local reliance (and non-interference by the federal government) in property taxation; on the other hand, there are almost certainly some efficiencies and economies of scale to be derived by consideration of such a project.

*Options for Facilitating the Adoption of Personal Consumption Taxes.*—what types of federal reforms might facilitate the adoption of subnational consumption taxes? (CVAT, VI-VAT, Dual VAT; etc...).<sup>63</sup>

*Objections, Costs, and Counterarguments* (with particular emphasis on the question of preserving state fiscal sovereignty...)

#### IV. Conclusion: Reimagining U.S. Fiscal Federalism

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<sup>63</sup> McLure; Bird; etc... Michael Keen, *VIVAT, CVAT, and All That: New Forms of Value-Added Tax for Federal Systems*, IMF WORKING PAPER (2000).

**Composition of State Tax Bases: 2008**

(Major Tax Sources as Percentage of Total Taxes)

	<b>General Sales Tax</b>	<b>Selective Sales Tax</b>	<b>Individual Income Tax</b>	<b>Corporate Income Tax</b>	<b>Other</b>
UNITED STATES	30.8%	15.0%	35.6%	6.5%	12.1%
Alabama	25.2%	23.7%	33.9%	5.8%	11.4%
Alaska	0.0%	3.3%	0.0%	11.7%	85.0%
Arizona	46.9%	12.5%	24.9%	5.7%	10.0%
Arkansas	37.3%	12.9%	31.1%	4.5%	14.1%
California	27.2%	6.7%	47.5%	10.1%	8.5%
Colorado	24.0%	12.5%	52.7%	5.3%	5.5%
Connecticut	23.8%	15.0%	52.4%	4.0%	4.9%
Delaware	0.0%	16.5%	34.4%	10.5%	38.6%
Florida	60.0%	21.7%	0.0%	6.2%	12.1%
Georgia	31.9%	10.4%	48.6%	5.2%	3.9%
Hawaii	50.9%	13.3%	30.0%	2.0%	3.8%
Idaho	36.9%	10.8%	39.4%	5.2%	7.7%
Illinois	24.9%	23.6%	32.4%	9.8%	9.4%
Indiana	38.5%	16.5%	32.4%	6.1%	6.5%
Iowa	26.7%	16.2%	41.3%	5.0%	10.7%
Kansas	31.6%	11.5%	41.1%	7.4%	8.3%
Kentucky	28.6%	18.3%	34.6%	5.3%	13.1%
Louisiana	31.4%	18.9%	28.8%	6.4%	14.5%
Maine	29.1%	17.4%	39.3%	5.0%	9.1%
Maryland	23.9%	15.9%	44.2%	4.7%	11.4%
Massachusetts	18.7%	8.9%	57.0%	10.0%	5.4%
Michigan	33.2%	14.9%	29.0%	7.2%	15.7%
Minnesota	24.8%	15.7%	42.5%	5.7%	11.3%
Mississippi	46.3%	16.2%	22.9%	5.7%	8.9%
Missouri	29.4%	14.1%	46.7%	3.5%	6.3%
Montana	0.0%	22.1%	35.4%	6.6%	35.9%
Nebraska	36.3%	11.9%	40.8%	5.5%	5.5%
Nevada	50.3%	30.3%	0.0%	0.0%	19.4%
New Hampshire	0.0%	35.1%	5.2%	27.2%	32.4%
New Jersey	29.1%	11.8%	41.2%	9.2%	8.7%
New Mexico	34.5%	12.6%	21.5%	6.3%	25.1%
New York	17.3%	13.5%	55.9%	7.7%	5.5%
North Carolina	23.1%	16.1%	48.3%	5.3%	7.2%
North Dakota	22.9%	14.8%	13.7%	7.0%	41.5%
Ohio	29.8%	18.5%	37.3%	2.9%	11.5%
Oklahoma	24.7%	11.1%	32.9%	4.2%	27.1%
Oregon	0.0%	10.4%	68.3%	6.6%	14.7%
Pennsylvania	27.6%	20.0%	32.4%	6.8%	13.1%
Rhode Island	30.7%	19.3%	39.5%	5.3%	5.2%
South Carolina	36.1%	14.5%	39.5%	3.8%	6.1%
South Dakota	55.4%	25.7%	0.0%	5.3%	13.6%
Tennessee	59.2%	15.4%	2.5%	8.7%	14.1%
Texas	48.5%	26.2%	0.0%	0.0%	25.3%
Utah	33.0%	11.4%	43.6%	6.6%	5.3%
Vermont	13.3%	20.3%	24.5%	3.3%	38.6%
Virginia	19.9%	13.2%	54.9%	4.3%	7.7%
Washington	63.2%	17.0%	0.0%	0.0%	19.8%
West Virginia	22.7%	23.7%	31.1%	11.0%	11.4%
Wisconsin	28.3%	13.6%	44.0%	5.7%	8.4%
Wyoming	34.3%	6.2%	0.0%	0.0%	59.5%

Source: U.S. Census Bureau, Census of Governments, 2008 Annual Survey of State Government Finances.