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# THE FEDERAL ROLE IN STATE TAX REFORM

*Kirk J. Stark*[*]

*During the most recent economic downturn, state and local governments have experienced fiscal imbalances of a magnitude not seen since the Great Depression. The principal cause of the current state fiscal crisis is the profound macroeconomic shock of 2008–2009. Yet macroeconomic conditions alone cannot explain the historic decline in state tax receipts over the past few years. As various commentators have noted, state tax structures developed over the past century have become hyper-sensitive to cyclical variability in the economy, with tax receipts exhibiting greater volatility than warranted by changes in underlying economic conditions. This article considers the federal government's role in promoting the adoption of volatile state tax structures. Through various inducements and limitations embedded in federal law, the federal government has stacked the deck in favor of state revenue volatility, unwittingly exacerbating the subnational fiscal crises that it is then called upon to mitigate through bailouts and general fiscal relief. If the federal government is interested in reducing the likelihood and severity of future state fiscal crises, it should consider changes to federal law that would eliminate the current bias in favor of volatile state tax systems. The article considers various options for reforming the federal government's policy toward state taxes, ranging from a more neutral federal stance toward state tax design to policies that would explicitly favor the adoption of more stable revenue sources by state and local governments.*

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## I. INTRODUCTION

This article considers the federal government's role in the design of state tax systems and asks what policy changes might be warranted to more effectively advance the federal interest in minimizing state fiscal crises. 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.[1] 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,[2] federal legislation regarding the scope of state corporate income taxes,[3] or federal limitations on the imposition of state sales taxes on internet and mail order transactions.[4] This article

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[1] 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*, THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 127 (Joseph J. Cordes, Robert D. Ebel & Jane G. Gravelle eds., 1999).

[2] *See*, *e.g.*, 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); Kirk J. Stark, *Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 UCLA L. REV. 1389 (2004); Gilbert E. Metcalf, *Assessing the Federal Deduction for State and Local Tax Payments* (Nat'l Bureau of Econ. Research, Working Paper No. 14023, 2008); Julie Berry Cullen & Roger H. Gordon, Deductibility of State and Local Taxes: Is There a Case for Continuing this Tax Expenditure? (July 11, 2008) (unpublished manuscript, *available at* http://dss.ucsd.edu/~jbcullen/research/deductibility.pdf).

[3] These limitations are set forth in a federal statute, Public Law 86-272. Act of Sept. 14, 1959, Pub. L. No. 86-272, 73 Stat. 555. At various points, Congress has considered a "modernized" version of Public Law 86-272. Business Activity Tax Simplification Act of 2009, H.R. 1083, 111th Cong. § 2 (2009).

[4] Quill Corp. v. North Dakota, 504 U.S. 298 (1992); STREAMLINED SALES TAX

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 article begins with the observation that the federal government has an interest in state fiscal health 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 certain questions. For example, what is the federal government's current "policy" with respect to state and local taxes? How, if at all, should that policy be reformulated?

With the demise of the Advisory Commission on Intergovernmental Relations (ACIR) in the mid-1990s,[5] 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 on the part of the federal government in recent years to develop rules, policies, and institutions to ensure an effective and efficient "intergovernmental tax policy." Instead, federal decisions impacting state and local tax policy are ad hoc and uncoordinated.[6] 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 (Code) with little or no consideration of the fiscal consequences for state and local governments. Another set of federal rules relevant to subnational governments 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.[7]

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GOVERNING BOARD, INC., STREAMLINED SALES AND USE TAX AGREEMENT (2010), http://www.streamlinedsalestax.org/uploads/downloads/Archive/SSUTA/SSUTA%20As%20Amended%208-17-10.pdf.

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

[6] *See id.* at 127 (Daniel Patrick Moynihan on the dissolution of the ACIR: "[T]he 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.").

[7] U.S. CONST., art. I, § 8, cl. 3.

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 State Legislatures (NCSL), and the National Governors Association (NGA), and taxpayer concerns advanced by organizations such as the Council on State Taxation (COST).[8] Too often, debates in Congress over intergovernmental tax matters center exclusively on the concerns of these interest groups with little regard for developing a framework for thinking about the overall direction of federal policy.[9] The result has been a series of ad hoc policy decisions that, when viewed together, seem to lack much justification aside from inertia, path dependence, or simply "that's just how we do it." This article represents a modest and preliminary effort to resurrect a broader ACIR-type policy discourse regarding key aspects of U.S. fiscal federalism.[10]

The article 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 unwittingly backed into a set of

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[8] *See* R. Allen Hays, *Intergovernmental Lobbying: Toward an Understanding of Issue Priorities*, 44 W. POL. Q. 1081, 1084–86 (1991) (providing an overview of key lobbying organizations representing general purpose state and local governments in Congress).

[9] An example of interest group influence within a broader framework of policy objectives is the Tax Reform Act of 1986. There was no shortage of interest group lobbying in the months and years leading up to that legislation. At the same time, however, the parameters of debate were fundamentally cabined by the overarching policy principles of base broadening and lower rates. *See* JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM (1987).

[10] Examples of recent scholarship in the same vein include: William F. Fox & John A. Swain, *The Federal Role in State Taxation: A Normative Approach,* 60 NAT'L TAX J. 611 (2007); William F. Fox, *The Ongoing Evolution of State Revenue Systems*, 88 MARQ. 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*, 60 NAT'L TAX J. 631 (2007); Kathryn L. Moore, *Local Taxation: When Will Congress Intervene?*, 23 J. LEGIS. 171 (1997); Avid E. Wildasin, *Pre-Emption: Federal Statutory Intervention in State Taxation*, 60 NAT'L TAX J. 649 (2007).

policies that promote outcomes 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 storyline that emerges from a close analysis of the California experience is that meaningful state tax reform, if it is to occur, will likely require changes in federal law.

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 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 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 minimizing state fiscal crises.

## II. FOUR OBSERVATIONS

As noted at the outset, this article 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.[11] This can be

[11] *See* Randal C. Archibold, *Schwarzenegger Presses U.S. for More Aid for Needy California*, N.Y. TIMES, Dec. 24, 2009, at A12; Shane Goldmacher and Evan Halper, *Schwarzenegger to Seek Federal Help for California Budget*, L.A. TIMES, Dec. 23, 2009, at A1; Marc Lifsher and Evan Halper, *State May Need to Ask U.S. for $7-Billion Loan*, L.A. TIMES, Oct. 3, 2008, at A1 .

seen most clearly in the two most recent recessions — the 2001 recession and the December 2007 to June 2009 recession[12] — during which Congress enacted legislation providing substantial fiscal relief to the states. In May 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.[13] In February 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.[14]

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.[15] The softening of subnational budget constraints is an ever-present danger of fiscal federalism. The problem is one of moral hazard. To the extent that state and local governments expect the federal government to provide fiscal relief during the next economic crisis, the incentive for fiscal discipline is diminished. Throughout the world, examples abound of federations that suffered the effects of soft

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[12] *See* NAT'L BUREAU OF ECON. RESEARCH, *US Business Cycle Expansions and Contractions*, Sept. 20, 2010, http://www.nber.org/cycles/US_Business_Cycle_Expansions_and_Contractions_20100920.pdf.

[13] Federal Medical Assistance Payment (FMAP) is the formula used to determine the amount of federal assistance to the states for purposes of the Medicaid program.

[14] IRIS J. LAV, NICHOLAS JOHNSON & ELIZABETH MCNICHOL, CTR. ON BUDGET & POLICY PRIORITIES, ADDITIONAL FEDERAL FISCAL RELIEF NEEDED TO HELP STATES ADDRESS RECESSION'S IMPACT (2010), http://www.cbpp.org/files/11-11-09stim.pdf.

[15] 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. János Kornai, *The Soft Budget Constraint Syndrome and the Global Financial Crisis*, 39 KYKLOS 3 (1986).

subnational budget constraints.[16]

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. To be sure, there are several mechanisms by which state and local governments can and do shift fiscal costs onto outsiders.[17] For the most part, however, the U.S. state and local sector has enjoyed a reputation for fiscal responsibility throughout the history of the republic.[18] 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 1870s, the federal government made no effort to step in to satisfy bondholder claims.[19] 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

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[16] For a useful cross-country analysis, see Lili Liu & Michael Waibel, Subnational Insolvency: Cross-Country Experiences and Lessons (World Bank, Working Paper No. 4496, 2008).

[17] 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 nonresidents. 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*, *in* THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 408 (Joseph J. Cordes, Robert D. Ebel & Jane Gravelle, eds., 2d ed. 2005); Mary N. Gade & Lee C. Adkins, *Tax Exporting and State Revenue Structures*, 43 NAT'L TAX J. 39 (1990). Another method of exporting the tax burden to nonresidents is through the federal income tax deduction for state and local taxes. I.R.C. § 164. *See* Gilbert Metcalf, *Tax Exporting, Federal Deductibility, and State Tax Structure*, 12 J. POL'Y ANALYSIS & MGMT. 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.

[18] 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 ST. J., Mar. 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, Feb. 9, 2010, *available at* http://blogs.pe.com/politics/2010/02/fiorina-state-should-keep-bank.html.

[19] Robert P. Inman, Local Fiscal Discipline in U.S. Federalism, 20–25 (Oct. 2000) (unpublished manuscript), *available at* http://www1.worldbank.org/publicsector/LearningProgram/Decentralization/usa.pdf.

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. . ."[20] 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 may be premature 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 softens the obligation that state and local governments face to keep their fiscal houses in 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.'"[21] Other commentators have called for a more comprehensive federal "rescue" of the states in the form of advances that would be charged against future federal transfers.[22] This type of action, though perhaps warranted in the short-term to avert catastrophe, must be evaluated against the risk of eroding the incentives for subnational fiscal discipline over the long run. An important object 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

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[20] *Id.* at 32.

[21] Mary Williams Walsh, *State Debt Woes Grow Too Big to Camouflage*, N.Y. TIMES, Mar. 29, 2010, at A1.

[22] Christopher Edley, Jr., *Let Treasury Rescue the States*, N.Y. TIMES, July 7, 2010.

state and local governments increase during a recession.[23] For example, state Medicaid expenditures increased significantly during the most recent recession, with an additional 3.7 million seeking program benefits in 2009 alone.[24] 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 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 countercyclical policy, the federal government may wish to adopt certain policies design to minimize the likelihood of future fiscal crises.[25] In other words, it is in the federal government's interest to minimize, to the extent possible, having state and local governments in budget crisis 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.[26] 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 — prompting demands for federal assistance. In other words, volatility played two separate and equally

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[23] *See* NAT'L CONFERENCE OF STATE LEGISLATURES, STATE BUDGET UPDATE: MARCH 2010 1, 7–8, http://ncsl.org/default.aspx?tabid=20157 (describing spending overruns, particularly with regard to Medicaid programs, for Fiscal Year 2010).

[24] Kevin Sack, *Recession Drove Many to Medicaid Last Year*, N.Y. TIMES, Sept. 30, 2010, at A16; s*ee also* THE HENRY J. KAISER FAMILY FOUNDATION, KAISER COMMISSION ON MEDICAID FACTS, *Medicaid Enrollment: December 2009 Data Snapshot* (2010), *available at* http://www.kff.org/medicaid/upload/8050-02.pdf).

[25] *See* Glenn Follette, Andrea Kusko & Byron Lutz, *State and Local Finances and the Macroeconomy: The High-Employment Budget and Fiscal Impetus*, 61 NAT'L TAX J. 531 (2008); Edward M. Gramlich, *Stimulating the Macro Economy Through State and Local Governments*, 69 AM. ECON. REV. 180 (1979).

[26] *See*, *e.g.*, BRIAN T. STENSON, ROCKEFELLER INST. OF GOV'T, GOVERNORS' BUDGETS REFLECTS STRONG REVENUE GROWTH (2006), *available at* http://www.rockinst.org/pdf/government_finance/200602governors'_budgets_reflect_strong_revenue_growth.pdf (describing proposals for tax cuts and spending increases in Arizona, California, Connecticut, Maryland, and Massachusetts).

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 demands, 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, such as rising expenditure obligations, constitutional tax limitations, and balanced budget requirements. 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.[27] 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. Indeed, there are convincing arguments in favor of revenue volatility. To the extent that government tax receipts fluctuate with changes in the economy, rising during periods of strong economic growth and declining as the economy slows, tax policy moderates the impact of the business cycle on private households.[28] The argument, as Auerbach notes, "is that the government is in a better position than private households and businesses to weather fluctuations in income, because it has better access to capital markets."[29] Under this view, revenue volatility shouldn't be avoided. If anything, revenue volatility should be embraced as an appropriate shifting of financial risk to the party more capable of handling that risk. Thus, rather than acting to reduce revenue volatility, governments should instead plan around it by establishing rainy day

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[27] *See*, *e.g.*, William F. Fox, *Three Characteristics of Tax Structures Have Contributed to the Current State Fiscal Crises*, 29 ST. TAX NOTES 375, 375 (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 M. Poterba, *State Reponses to Fiscal Crises: The Effects of Budgetary Institutions and Politics*, 102 J. POL. ECON. 799 (1994).

[28] *See* Yair Listokin, *Stabilizing the Economy Through the Income Tax Code*, 123 TAX NOTES 1575 (2009).

[29] Alan Auerbach, *California's Future Tax System*, 2 CAL. J. POL. & POL'Y 1, 13 (2010).

funds large enough to enable them to weather the effects of an economic downturn on state and local tax receipts.[30]

Unfortunately, recent experience suggests that even the most ambitious rainy day fund may not forestall fiscal crisis if the downturn is sufficiently severe. Zahradnik reports that during the boom years of the 1990s states 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."[31] Despite this planning, he concludes, "deficits during the downturn were five times the amount states had accumulated."[32] Similarly, Dye and Merriman conclude that "[i]t would take extremely large rainy day fund balances to fully smooth the effect of revenue fluctuations . . . on expenditures."[33] 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 during 2001 to 2002. The Government Finance Officers Association recommends that states maintain a minimum level of reserves totaling 15% of annual expenditures.[34] As a matter of practical political reality, it is extremely unlikely that state and local governments are going to be able to establish rainy day funds of this magnitude.

More fundamentally, the question addressed in this article is not whether state and local governments should adopt more prudent budgetary practices, like establishing larger rainy day funds — clearly they should. Rather, the question addressed here is how the federal government should respond, given that states have failed to establish rainy day funds. One possible policy response is to devise ad hoc quasi-bailouts via periodic enhancements to the Medicaid FMAP formula. This is the strategy that the federal government has followed in recent years, though as discussed above this approach, if followed repeatedly, may give rise to troubling incentive effects to the extent

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[30] 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: Managing the Fiscal Volatility Problem*, 98 CAL. L. REV. 749, 766 (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").

[31] ROBERT ZAHRADNIK, CTR. ON BUDGET & POLICY PRIORITIES, RAINY DAY FUNDS: OPPORTUNITIES FOR REFORM (2005), *available at* http://www.cbpp.org/files/3-9-05sfp.pdf; *see also* Gamage, *supra* note 30, at 763–64.

[32] ZAHRADNIK, *supra* note 31, at 1.

[33] Richard F. Dye & David F. Merriman, *State Revenue Stability: Alternative Conceptualizations*, 2004 ANN. CONF. TAX'N PROC. 258, 268.

[34] ZAHRADNIK, *supra* note 31, at 1.

that an expectation of federal assistance discourages states from adopting prudent budgetary practices. Another option might be direct federal encouragement of rainy day funds via subsidies or matching grants — something like an IRA but for states. The alternative discussed herein is whether the federal government may have a role to play in encouraging states to adopt tax structures that minimize the likelihood of fiscal crisis and the concomitant demands for federal fiscal relief during economic downturns.

### *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.[35] More generally, a state's demographic characteristics, including factors such as age composition and income distribution, are also likely to influence the volatility of state tax receipts over the business cycle.

Beyond these factors, researchers who study revenue volatility attempt to identify how the composition of the state tax base impacts fiscal stability. This literature generally considers both long-run effects (trend growth rate) and short-run effects (cyclical variability). With regard to long-run effects, the issue is essentially the extent that different tax bases are responsive to the growth in income over time.[36] 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

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[35] *See, e.g.*, DONALD J. BOYD, ROCKEFELLER INST. OF GOV'T, WHAT WILL HAPPEN TO STATE GOVERNMENT FINANCES IN A RECESSION? 13 (2008), *available at* http://www.rockinst.org/pdf/government_finance/2008-01-30-what_will_happen_to_state_government_finances_in_a_recession.pdf (comparing regional impact of 1990–91 recession, which was concentrated more on the coasts, with the 2001 recession, which was more widespread).

[36] 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.

the short-run cyclical variability of alternative state tax bases. In other words, how does state 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 influence the cyclical variability of tax receipts.

States differ greatly in the composition of their tax bases. Looking at the nation as a whole, almost 90% of total state tax revenue comes from sales and income taxes. States collect 30.8% of their total tax revenue from general sales taxes and another 15% from selective sales taxes. As for income taxes, 35.6% of state taxes come from individual income taxes with another 6.5% from corporate income taxes.[37] 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")[38] derives 29.4% of its tax revenue from general sales taxes and 37.3% from individual income taxes. At the extremes, however, are states like Florida, which derives 81.7% of its taxes from sales taxes (general and selective combined), and Oregon, which derives 74.9% of its taxes from income taxes (individual and corporate combined).[39] When local governments are factored into the analysis, the property tax emerges as an important source of revenue. For all states combined, property taxes account for just over 21% of general revenue from own sources.[40] Some states, like New Hampshire (42.5%), collect a large share of total revenue from property taxes, while others, like Alabama (9.5%), rely on property taxes to a much lesser extent.[41]

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 vary depending upon the data used and the

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[37] The remaining 12.1% of state taxes come from miscellaneous charges and license taxes.

[38] Stephen Ohlemacher, *Analysis Ranks Illinois Most Average State*, ASSOCIATED PRESS, May 17, 2007, *available at* http://thesouthern.com/news/article_a697be25-baf2-56c6-87c4-5428d10590de.html.

[39] State-specific breakdowns are set forth in the Appendix.

[40] U.S. CENSUS BUREAU, STATE AND LOCAL GOVERNMENT FINANCES BY LEVEL OF GOVERNMENT AND BY STATE: 2007-08 (TABLE 1), *available at* http://www2.census.gov/govs /estimate/08slsstab1a.xls.

[41] *Id.*

techniques employed for estimating variability. Dye and McGuire find that the variability of sales taxes depends significantly on the scope of the tax base.[42] 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 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 taxes vary significantly more over the business cycle than either the individual income tax or the retail sales tax.[43]

More recent work in this area has emphasized the difficulty of drawing strong conclusions about the relative variability of alternative taxes. For example, Dye notes 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."[44] Similarly, Bruce, Fox, and Tuttle (2006) conclude that "neither the personal income tax nor the sales tax emerges as the universally more volatile tax."[45] 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."[46] 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.

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[42] Richard F. Dye & Therese J. McGuire, *Growth and Variability of State Individual Income and General Sales Taxes*, 44 NAT'L TAX J. 55 (1991).

[43] Russell S. Sobel & Randall G. Holcombe, *Measuring the Growth and Variability of Tax Bases Over the Business Cycle*, 49 NAT'L TAX J. 535 (1996).

[44] Richard F. Dye, *State Revenue Cyclicality*, 57 NAT'L TAX J. 133 (2004).

[45] Donald Bruce, William F. Fox & M.H. Tuttle, *Tax Base Elasticities: A Multi-State Analysis of Long-Run and Short-Run Dynamics*, 73 S. ECON. J. 315, 338 (2006).

[46] *Id.*

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 is 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;[47]

(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);[48]

(3) taxes on nonwage sources of income (capital gains, interest, dividends) generally exhibit far greater volatility than wages;[49] and

(4) the more progressive tax the tax system, the more volatile;[50]

(5) property taxes tend to be more stable than sales and income taxes.[51]

Put differently, if a state wished to maximize the cyclical

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[47] R. Alison Felix, *The Growth and Volatility of State Tax Revenue Sources in the Tenth District*, ECON. REV. (KAN. CITY), June 22, 2008, at 63, 68; Sobel & Holcombe, *supra* note 43, at 544; Laura Wheeler, *Corporate Tax Revenue Buoyancy*, 2009 FISCAL RES. CENTER POL'Y BRIEF 196, at 5 (introduction of state tax credits likely to make CIT more volatile).

[48] Dye & McGuire, *supra* note 37, at 58–59; Dye, *supra* note 39, at 140; Felix, *supra* note 47, at 65–66. Most states (thirty-one 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 of taxing groceries. Only two states — Alabama and Mississippi — tax groceries in full without any credit or rebate. CTR. ON BUDGET & POLICY PRIORITIES, WHICH STATES TAX THE SALE OF FOOD FOR HOME CONSUMPTION IN 2009? (2009), *available at* http://www.cbpp.org/cms/index. cfm?fa=view&id=1230.

[49] Dye, *supra* note 39, at 143; DONALD J. BOYD & LUCY DADAYAN, ROCKEFELLER INST. OF GOV'T, STATE TAX REVENUE FALLING SHARPLY IN FOURTH QUARTER, EARLY DATA SHOW 11 (2009), *available at* http://www.rockinst.org/pdf/government_finance/state_revenue_report/2009-01-16-(74)-state_revenue_report_tax_revenue_falling_sharply.pdf.

[50] BOYD & DADAYAN, *supra* note 49, at 15; *see* Felix, *supra* note 47, at 76 (noting that "[s]tructures that are more progressive . . . will experience faster growth and more volatility in revenue" and that Colorado, with a flat rate income tax, exhibited less volatility than other states with progressive income taxes).

[51] Yilin Hou & Jason S. Seligman, *LOST Stability? Consumption Taxes and the Cyclical Variability of State and Local Revenues*, (John Glenn Sch. of Pub. Affairs Working Paper Series, Sept. 2010).

variability of its tax receipts, it would do well to rely heavily on progressive income taxes (especially taxes on nonwage sources of income), corporate income taxes, and sales taxes with a relatively narrow base. Likewise, a volatility-maximizing state would minimize reliance on property taxes and broad-based, flat-rate household consumption taxes. As we will see in the following section, federal law generally favors the adoption of volatile state tax structures.

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

As a general rule, state and local governments decide for themselves how to raise revenue to fund government services. Nevertheless, there are several mechanisms by which federal law may, directly or indirectly, influence the design of state and local tax systems. Roughly speaking, these federal policies can be thought of as either *inducements* (i.e., policies that reduce the cost of relying on a particular revenue source) or *limitations* (i.e., policies that limit the ability of state and local governments to use a particular revenue source). In combination, these mechanisms can be viewed as the federal government's "intergovernmental tax policy" — that is, the collection of policies, rules, and institutions that establish incentives for the design of state and local tax systems.

#### 1. Incentives for Conformity with the Federal Tax System

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.[52] The very existence of the Code, Treasury Regulations, IRS administrative guidance, and federal judicial case law creates an almost irresistible incentive for the states to adopt individual and corporate income taxes. 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 (Service) partners with state revenue agencies to enhance compliance through,

[52] Ruth Mason, *Federalism and the Taxing Power*, 99 CAL. L. REV. (Forthcoming 2011) (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").

for example, the exchange of taxpayer data.[53] These benefits substantially reduce the cost of relying on individual and corporate income taxes relative to other taxes lacking such a ready-made administrative framework. While clearly not a decisive factor in every case (e.g., note that states such as Florida and Texas have chosen not to adopt income taxes), the benefits of conforming to federal law are unmistakable.

At the same time, however, there are potentially significant costs associated with having states piggyback on the federal income tax. Taxes that might be suitable for use by a central level of government are not necessarily appropriate for use by state or local governments.[54] 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 show that state corporate taxable income exhibits significantly greater variability over the business cycle than all other major state revenue sources.[55] 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 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

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[53] 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 U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-45, TAX ADMINISTRATION: IRS NEEDS TO STRENGTHEN ITS APPROACH FOR EVALUATING THE SRFMI DATA-SHARING PILOT PROGRAM, 4 (2008).

[54] For the classic treatment of this "tax assignment" question, see Richard Musgrave, *Who Should Tax, Where, and What?*, in TAX ASSIGNMENT IN FEDERAL COUNTRIES 6–10 (Charles E. McLure Jr. ed., 1983); *see also* Richard Bird, *Rethinking Subnational Taxes: a New Look at Tax Assignment*4-9 (Int'l Monetary Fund, Working Paper No. 99/165, 1999), *available at* http://www.imf.org/external/pubs/ft/wp/1999/wp99165.pdf.

[55] Sobel & Holcombe, *supra* note 43, at 543 (Table 2).

gains in the federal income tax base, along with the realization rule that has been long embedded in federal law,[56] 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.[57] 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.[58]

2. Subsidies for Selective Taxes 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.[59] 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 unmistakable. 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).[60] By carving out a benefit for some but not all state and local taxes, the SALT deduction

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[56] Eisner v. Macomber, 252 U.S. 189, 211 (1921).

[57] ELIZABETH G. HILL, REVENUE VOLATILITY IN CALIFORNIA 12 (California Legislative Analyst's Office 2005); *see also* Mac Taylor, Legislative Analyst, Cal. Legislative Analyst's Office Perspectives on California's Revenue Structure 160 (Jan. 22, 2009) (noting that with respect to volatility in California tax receipts, "Capital Gains Are the Main Story.").

[58] Hill, *supra* note 57, at 8.

[59] I.R.C § 164.

[60] I.R.C. §164(b)(5) (as amended by the American Jobs Creation Act of 2004).

establishes clear price effects favoring the adoption of, say, income taxes over sales taxes.

Perhaps even more important than the thumb that § 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.[61] 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 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. All else equal, state and local governments will have an incentive to design their tax systems to take maximum advantage of the SALT subsidy, which suggests a strong price effect in favor of a more progressive tax system. Empirical studies have shown that the federal deduction for state and local taxes exerts a substantial influence on subnational progressivity.[62] When combined with the insight that states with more progressive tax systems generally experience greater income tax volatility than those with less progressive tax systems, it becomes apparent that federal law, as currently structured, offers an inducement for states to adopt a relatively volatile state tax structure.

On the question of deductibility of state and local taxes, one further point deserves mention. The continuing influence of the § 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.[63] In recent years, the AMT has grown in significance as

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[61] Statutory rates for taxable year 2010 range from 10 percent to 35 percent. I.R.C. § 1. Using 2004 data, Cullen and Gordon estimate that itemizers faced an average marginal tax rate of approximately 26 percent. *See* Julie Berry Cullen & Roger H. Gordon, Deductibility of State and Local Taxes: Is There a Case for Continuing this Tax Expenditure? 7 (July 11, 2008) (working paper, *available at* http://dss.ucsd.edu/~jbcullen/research/deductibility.pdf). Regarding non-itemizers, note 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. I.R.C. §§ 63(c)(1)(C), 63(c)(7)(b).

[62] *See*, *e.g.*, Howard Chernick, *On the Determinants of Subnational Tax Progressivity in the U.S.*, 58 NAT'L TAX J. 93, 108 (2005).

[63] *See* I.R.C. § 56(b)(1)(A)(ii).

more and more high- and even middle-income households have become AMT taxpayers.[64] 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.[65] 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 benefit from the SALT deduction.[66]

Beyond subsidizing the particular list of specifically enumerated taxes, § 164 can also be viewed as "penalizing" (or at least "discouraging") the adoption of taxes for which no 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 § 164(b)(5) (discussed above), § 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 tends to exhibit less volatility than income taxes.[67]

### 3. Federal Statutory Limitations on State Tax Reform

Beyond the two major categories of federal "inducements" just

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[64] Tax Policy Center, *Table T09-0385: Aggregate AMT Projections and Recent History 1970-2020*, http://www.taxpolicycenter.org/numbers/Content/PDF/T09-0385.pdf.

[65] This is the case, for example, for America's First Family. On their 2009 federal income tax return, President and Mrs. Obama claimed state and local tax deductions on Schedule A in the amount of $186,910 and owed no alternative minimum tax, for section164 federal subsidy of roughly $65,000 (i.e., $186,910 * 35%). *See* President Obama's Complete 2010 Return, http://www.whitehouse.gov/sites/default/files/president-obama-2010-complete-return.pdf.

[66] *See* Tax Policy Center, *Table T10-0106: Aggregate AMT Projections, 2009-2020, http://www.taxpolicycenter.org/numbers/Content/PDF/T10-0106.pdf* (rows marked "Current Law" show a significant drop-off in AMT in 2011 as compared to 2010).

[67] In addition, it is worth noting that since 1979, federal law has disfavored state reliance on gasoline taxes. The Revenue Act of 1978, Pub. L. No. 95-600, § 111(a), 92 Stat. 2763, 2777, Congress repealed the deduction for state gasoline taxes.

described, there are also various specific provisions in federal law that limit state taxing authority. Foremost among these is Public Law 86-272, which was enacted in 1959 largely in response to the U.S. Supreme Court's decision in *Northwestern States Portland Cement v. Minnesota*.[68] 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 headline, "High Court Backs Wide State Right to Tax Business."[69] According to the *Times*'s 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."[70]

The *Northwestern States-Portland Cement* decision prompted sufficient alarm in the halls of Congress that it mobilized support for the enactment of Pub. 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 Pub. L. 86-272 can be viewed as limiting the scope of state corporate income taxes, it might be regarded as a stability-enhancing feature of federal law. On the other hand, Pub. 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.[71] To the extent that such provisions have the intended effect of allowing states to tax income that would otherwise go untaxed, Pub. L. 86-272's overall impact would be to shift rather than reduce state corporate income tax revenues.[72]

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[68] Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959).

[69] Anthony Lewis, *High Court Backs Wide State Right to Tax Business*, N.Y. TIMES, Feb. 25, 1959, at 1.

[70] *Id*.

[71] Margaret C. Wilson, *Apportionment Apoplexy: Throwback, Throwout, or Just Throw Up Your Hands*, 57 TAX EXEC. 357, (July 1, 2005); INST. ON TAX'N AND ECON. POL'Y, TALKING TAXES: "NOWHERE INCOME" AND THE THROWBACK RULE (2008).

[72] For a discussion of the effect of throwback rules where some states employ them while others do not, see William F. Fox & Matthew N. Murray, *How Should a*

Perhaps more significantly, ambiguities in the scope of Pub. L. 86-272 have raised questions regarding the validity of state tax reforms that might otherwise have the effect of stabilizing state business tax receipts. Here the question is which state business taxes should be regarded as a "net income taxes" within the meaning of Pub. L. 86-272. While a tax labeled as a "net income tax" and designed with typical income-tax features would plainly fall within the scope of the main federal limitation, other taxes — such as gross receipts taxes or modified "net" receipts taxes — have a less certain status. In part to resolve these uncertainties, some have proposed "modernizing" Pub. L. 86-272 to give it a broader reach.[73] The so-called "Business Activities Tax Simplification Act" (BATSA) would amend Pub. L. 86-272 by, among other things, extending the statutory limitation to all "business activity taxes." As discussed in further detail below,[74] ambiguities in the scope of Pub. L. 86-272, as well as the possibility of new BATSA-type legislation, was one of the reasons that California's proposed "Business Net Receipts Tax" (intended as a modified value-added tax) was regarded as dead on arrival when presented to the legislature.

4. Federal Judicial Limitations on State Tax Reform

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*,[75] 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 1977 decision in *Complete Auto*, which established the modern framework for the resolution of dormant commerce

*Subnational Corporate Income Tax on Multistate Businesses Be Structured?*, 58 NAT'L TAX J. 139, 153–55 (2005).

[73] Business Activity Tax Simplification Act of 2009, H.R. 1083, 111th Cong. § 2 (2009).

[74] Part III, *infra*.

[75] Gibbons v. Ogden, 22 U.S. 1 (1824).

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 Pub. 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.[76] *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.[77] The practical effect of this rule has been to carve out an area of tax-free consumption via mail-order or internet purchases. A key component to the overall U.S. intergovernmental tax policy, this rule is the federal obstacle to states adopting broad-based personal consumption taxes. Any state tax reformer hoping to adopt a European-style value-added tax or a broad-based retail sales tax that reaches all household consumption must contend with this fundamental legal hurdle standing in the way of such reform.[78] To be sure, there are numerous other flaws in the design of state retail sales taxes that prevent the tax from deserving recognized 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.

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[76] Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

[77] 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.

[78] Robert P. Strauss, *Federal Tax Mechanisms to Enable State Taxation of Final Consumption*: *Testimony Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 106th Cong. (2000), *available at* https://www.andrew.cmu.edu/user/rs9f/wm00b.pdf (noting the difficulties presented by *Bellas Hess* and *Quill* to a broad-based consumption tax).

5. Summary — Federal Ground Rules for State Tax Reform

To summarize, the basic picture is that under current law, the federal government generally *favors* the adoption of state *individual and 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). Additionally, 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.

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 general consensus that state reliance on corporate income taxes and the non-wage component of individual income taxes (principally investment income) 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 non-wage 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 inhibit the development of

broad-based personal consumption taxes in the states. In short, federal law generally favors the adoption of tax structures that contribute to — perhaps even exacerbate — revenue volatility.

## III. IMPLICATIONS FOR STATE TAX REFORM — THE CALIFORNIA EXPERIENCE

Whether or not one agrees with the preceding 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 deductibility, 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 that states have relied for decades. Once one factors in path dependence, political inertia, or simply general adherence to the principle that "the only good tax is an old tax," 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 reformers face. COTCE was a bipartisan commission consisting of fourteen members, half of whom were appointed by Governor Schwarzenegger (a Republican) and half by the legislative leadership (Speaker Pro Tem Darrell Steinberg and then 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, nine of the Commission's fourteen members (six Republicans and three Democrats) endorsed a final report that that was submitted to

Governor Schwarzenegger in late September 2009.[79]

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 an "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). Additionally, the net receipts base of those firms doing business both within and outside 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).

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.[80] 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 repeal with local sales

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[79] *See* COMM'N ON THE 21ST CENTURY ECON., FINAL REPORT (2009), *available at* http://www.cotce.ca.gov/documents/reports/documents/Commission_on_the_21st_Century_Economy-Final_Report.pdf.

[80] 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 XIIIA of the California Constitution.

taxes remaining). Had the Commission's recommendations been accepted, the remaining state tax structure would have consisted 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. Three specific 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. At a practical level, what this means for a state like California is that the state tax administrative agency — in California's case, the Franchise Tax Board — would have to build an entirely new legal and administrative apparatus from scratch. None of the efficiencies and economies of scale associated with the current regime would be available.

Second, adoption of the BNRT or similar reforms would likely trigger constitutional and statutory challenges based on the *Quill* holding and Pub. L. 86-272.[81] With regard to the *Quill* issue, out-of-state firms with no physical presence in California would almost certainly challenge the application of the BNRT's "economic nexus" provision on federal dormant commerce clause grounds. The resolution of this challenge would turn on whether the Supreme Court's *Quill* decision applies exclusively to sales and use taxes or should be extended to other taxes as well. While several state supreme courts have addressed this question, the U.S. Supreme Court has yet

[81] 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. Memorandum from the Cal. Franchise Tax Bd. to the Comm'n on the 21st Century Econ. 10 (Aug. 21, 2009) *available at* http://www.cotce.ca.gov/documents/correspondence/staff_and_commissioners/documents/FTB%20Analysis%20for%20COTCE%20-%208.21.09.pdf.

to weigh in on the matter. As for Pub. L. 86-272, the argument would be that the BNRT is a type of "net income tax" and thus cannot be imposed on out-of-state firms whose activities in the state do not exceed the statutory threshold of "mere solicitation."[82] In effect, the Commission was attempting to "thread the needle" between the dormant commerce clause restrictions of *Quill* and the federal statutory restrictions of Pub. L. 86-272 by contending that the BNRT was neither a sales/use tax (and thus *Quill* should not apply) nor a net income tax (and thus Pub. L. 86-272 should not apply). The point here is not to comment on the merit of these legal conclusions but rather to emphasize 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.

Third, the Commission'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 § 164. Recall that those taxpayers in the highest federal income tax brackets enjoy a federal subsidy of 35 cents for every dollar of taxes paid to state and local governments. By shifting the tax burden away from the income tax toward the BNRT, the overall federal subsidy for the state's taxes would necessarily decline.[83] Here again we see the influence of federal law — in this case the "inducement" of § 164 — narrowing the choice set that state lawmakers face in considering state tax reform proposals. A state wishing to maximize its federal subsidy under § 164 should (subject to the AMT caveat discussed above) shift its tax system away from non-deductible taxes and rely more heavily on deductible taxes on the highest income earners.[84]

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[82] CAL. FRANCHISE TAX BD., APPLICATION AND INTERPRETATION OF PUBLIC LAW 86-272 1 (2000), *available at* http://www.ftb.ca.gov/forms/misc/1050.pdf.

[83] Some members of the COTCE commission argued that because the BNRT would be deductible as a business expense by the firms paying it to the state, the proposed reform package would generate a "federal offset" of $6.8 billion. However, this conclusion ignored the fact that an increase in firms' (deductible) BNRT liability would result in a corresponding increase in firms' (taxable) revenues as prices are adjusted to reflect the tax liability. The Commission's flawed analysis is discussed in Steven M. Sheffrin, *Tax Reform Commissions in the Sweep of California's Fiscal History*, 37 HASTINGS CONST. L.Q. 662, 679–81 (2010).

[84] A recent "tax swap" proposed by California Senate pro Tem Darrell Steinberg would do precisely this by reducing the state's reliance on retail sales taxes

Although the California legislature may still act on the COTCE proposals, perhaps by adopting some or all of the Commission's recommendations, on balance it appears that the reform project was not a success. Although one might criticize the Commission on various dimensions, much of the blame rests not with the Commission but rather with the federal government. Through its ad hoc intergovernmental tax policy of (1) providing administrative and enforcement support for income taxes but not other taxes, (2) restricting the scope of consumption taxes via the *Quill* decision, (3) limiting the reach of "net income taxes" through Pub. L. 86-272, and (4) providing greater federal tax subsidies for some state taxes than for others, the federal government has stacked the deck against volatility-reducing fiscal innovation. As a result, states wishing to adopt reforms that might stabilize revenue flows face an uphill battle. The next Part considers changes to federal law that would eliminate some of the current incentives for adopting a volatile tax structure.

## IV. A QUESTION — AND OPTIONS FOR REFORM

As noted in Part I, studies show that revenue volatility is partly a function of the particular mix of taxes used by the state and that certain features of state tax systems (e.g., greater progressivity, heavy reliance on corporate income taxes, narrow sales tax bases) predictably increase the short-term cyclicality of tax receipts. Yet rather than discouraging reliance on volatile revenue sources, current federal law generally favors the adoption of tax systems that exhibit significant revenue volatility. The result is a boom-bust cycle in state fiscal policy that fosters bailout demands, softening state budget constraints. This state of affairs prompts a natural question: should the federal government reconsider those policies that encourage state and local governments to adopt volatile tax structures? If so, what types of specific reforms might be most warranted? These questions go to the heart of the intergovernmental tax policy — that is, the set of federal policies and institutions bearing on the design of state and local tax systems.

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(a proposal also advanced by the COTCE commission) and increasing state income taxes and vehicle license fees, both of which are deductible for federal income tax purposes. *See* Kevin Yamamura, *Dems Propose a Tax Swap*, SACRAMENTO BEE, Aug. 4, 2010, at 1A.

### *A. Base Composition Neutrality as a Policy Norm*

As a first cut, one might assume that the same normative principles that underlie federal tax reform (i.e., fairness, efficiency, administrability) should guide the formulation of the federal government's policies toward state and local taxation. But, a strong countervailing principle — namely, 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 favor any particular distribution of state and local tax burdens. Whether a state decides to raise the revenue to fund its government services via progressive, regressive, or distributionally neutral taxation would seem to be a question more appropriately left to state political choice. Similarly, one might argue that questions such as the breadth of the sales tax base (including considerations such as whether to tax food for home consumption) should also be left to state discretion.

If we take seriously the fiscal sovereignty of state and local governments, then it would seem that current federal policies favoring the adoption of certain types of taxes over others are in tension with that principle. Under this view, the federal government should adopt a more deliberately agnostic perspective on state and local taxes, explicitly refusing to favor any particular set of subnational choices. We can think of such an approach as a policy of "base composition neutrality." Adherence to a principle of base composition neutrality might have both negative implications for federal policy (e.g., the federal government should not confer differential subsidies for different types of taxes) as well as positive implications (e.g., the federal government should strive to provide comparable administrative support for sales and property taxes as it provides for income taxes). The overarching principle is one of deference to, and respect for, the political choices of subnational governments.

### *B. Federal Policies for Reducing State Revenue Volatility*

Of course, respect for state fiscal autonomy should not be (and indeed *has not been*) an absolute principle. Departures from the principle of base composition neutrality are most warranted where there is a compelling federal interest at stake. To the extent that minimizing the risk of state fiscal crises is such a compelling interest, a case can be made that the federal government should encourage the adoption of state tax systems that reduce overall state revenue

volatility. Specific federal policies that would advance that objective are considered below.

*Reforming/Repealing the Deduction for State and Local Taxes.* Perhaps the most straightforward federal policy change recommended by the analysis above would be to reform or repeal the deduction for state and local taxes. Because the deduction favors the adoption of progressive income taxes, and such taxes have been implicated in the revenue volatility states experience, a rethinking of this longstanding subsidy would seem to be in order. Repealing the federal subsidy does not guarantee that state and local governments would reduce their reliance on more volatile revenue sources. In addition, it bears noting that outright repeal would also involve elimination of the deduction for property taxes — a relatively stable source of revenue. Nevertheless, unless state and local governments are wholly unresponsive to the price effects conferred by deductibility (and empirical studies suggest that they are in fact responsive to those effects), it is likely that repealing § 164 would result in a substitution away from currently favored taxes.[85]

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. Under a flat-rate credit, for example, taxpayers could be granted a credit equal to, say, 20 percent of total taxes paid to state and local governments. Such an approach would unhitch the value of the federal subsidy from the taxpayer's marginal tax rate and thereby reduce the incentive to concentrate the tax burden on those individuals capable of generating the largest federal subsidy. Converting the deduction from an itemized to an above-the-line deduction would have a less significant effect (because the relationship of the subsidy to the taxpayer's marginal tax rate would remain), though compared to current law a broader subset of federal taxpayers would benefit from the subsidy, which should have similar, though less significant, incentive effects on state tax design.

More ambitiously, one could imagine a state/local tax credit regime in which the credit percentage varies depending on the relative volatility of the tax. For example, based on the research discussed above, we know that property taxes are a relatively stable source of

[85] One means of accomplishing this result, without actually repealing § 164, would be simply to let the alternative minimum tax run its course. As noted above, state and local taxes are not deductible for purposes of the AMT. As a result, many individuals who live in high-tax states, such as California and New York, have already experienced a *de facto* repeal of the deduction for state and local taxes.

revenue for state and local governments. Income taxes, by contrast, tend to exhibit greater variability over the business cycle. In recognition of the relative volatility of these two taxes, Congress could enact a tax credit of 30 percent for property taxes and a tax credit of 10 percent for income taxes. Again, the aim is to engage in an explicit manipulation of the price effects with the hope that state and local governments would alter their tax structures in response. Such an overt favoring of one type of revenue instrument over another may sound foreign and oddly intrusive on states' fiscal sovereignty, though of course it is precisely the sort of regime that exists today. The most significant difference is that the current subsidy regime haphazardly imperils the federal government's interest in state and local fiscal stability, while the new regime would be designed to minimize state fiscal crises and the attendant demands for federal bailouts.

*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.[86] 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.[87] A similar argument might be made for individual income taxes on nonwage income — particularly capital gains. To be sure, the notion of prohibiting the states from taxing capital gains or other types of investment income might face constitutional challenges as an impermissible abrogation of state taxing powers.[88] To the extent that such legal challenges have merit, Congress would need to use alternative mechanisms for ensuring de facto centralization. For example, Congress could condition the receipt of certain federal grants to the states on their agreement to remove investment income from the personal income tax base. Alternatively, Congress could retain a federal subsidy for wage income taxes (either a deduction or a credit) but repeal the subsidy for state taxes on capital gains and other investment income.

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[86] Kirk J. Stark, *The Quiet Revolution in U.S. Subnational Corporate Income Taxation*, BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION, reprinted in ST. TAX NOTES (Mar. 4, 2002).

[87] *But see* Michael Fatale, *Federalism and State Business Activity Nexus: Revisiting Public Law 86-272,* ST. TAX NOTES (June 3, 2002); Michael McIntyre, *Thoughts on the Future of the State Corporate Income Tax*, ST. TAX NOTES (Sept. 23, 2002).

[88] *Id.*

It bears noting that these changes need not involve a reduction in the overall tax burden on investment income. Congress could impose a special surcharge on capital gains income, the proceeds of which would be earmarked for federal grants to the states. The object is not necessarily to reduce the tax burden on investment income, or even to reduce the volatility of tax payments. Rather, the idea is to shift the revenue volatility to the level of government that is better positioned to handle it.

*Administrative/Legal Support for Non-Income Taxes*. As noted above, the 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 Streamlined Sales Tax Project.[89] 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. A federal agency charged with developing state-of-the-art expertise on valuation techniques, compliance efforts, and other features of property tax administration might offer a useful counterweight to the benefits for income tax administration currently generated by the Service.

*Facilitating the Adoption of Broad-Based Consumption Taxes*. Finally, there are various reforms that the federal government might consider to facilitate the adoption of broad-based consumption taxes at the state and local level. Some of these reforms might involve improvements to the current retail sales tax. Most obviously, Congress could overturn the Supreme Court's decision in *Quill* and permit the imposition of a use tax collection obligation on out-of-state vendors. Aside from rendering moot the needless litigation between states and

[89] For an overview of the SSTP and its efforts at bringing greater uniformity to state and local retail sales taxes, see http://www.streamlinedsalestax.org/.

multistate firms over the scope of the Court's 1992 decision, such a move would enable the states to broaden their sales tax bases and lower the rates. As a general rule, a broader base with lower rates will exhibit less short-run volatility than a narrow base with higher rates. Another RST-related federal reform would be some sort of regime to "bribe" the states to tax food. Currently, only a handful of states include food for home consumption in their sales tax bases.[90] The rationale for exempting food from the sales tax is that doing so mitigates the regressivity of the tax. A superior approach for accomplishing this policy objective, while retaining the volatility-reducing benefits of taxing food, would be for the federal government to allow a per capita tax credit to residents of states that include food in the sales tax base. In effect, the federal government would be reimbursing households for the sales taxes paid on food, while also encouraging the adoption of more stable state tax structures.

Beyond the retail sales tax, there are other types of broad-based consumption taxes that would stabilize state and local revenues. Most notable among these is the value-added tax (VAT) in use in nearly every country except the United States. A few states have adopted or have considered adopting VAT-like taxes. The states of New Hampshire and Michigan have both adopted taxes that might plausibly be described as value-added taxes. In addition, as discussed above, California recently considered a proposal for a VAT-like tax called a "business net receipts tax." To date, the experience with subnational VAT-like taxes in the United States has not been successful. Much of the difficulty with such taxes arises from the serious issue of how to treat cross-border transactions. There is considerable experience with this issue in the international context, though the standard approach for handling cross-border transactions (i.e., border tax adjustments) is likely unworkable in a subnational setting due to the lack of border controls among states. In recent years, tax policy researchers have begun to develop various techniques for operating a VAT in a federalist setting.[91] However, these techniques require significant coordination between national and subnational governments. The point here is simply that state VATs are most likely unworkable, as well as inadvisable, in the absence of some sort of federal coordination effort. Thus, if the

[90] CTR. ON BUDGET & POLICY PRIORITIES, WHICH STATES TAX THE SALES OF FOOD FOR HOME CONSUMPTION IN 2009? (2009), http://www.cbpp.org/files/3-16-06sfp3.pdf.

[91] Michael Keen, *VIVAT, CVAT, and All That: New Forms of Value-Added Tax for Federal Systems* (IMF Working Paper, 2000).

federal government wishes to encourage the adoption of a broad-based household consumption tax other than the RST, doing so will likely require considerable federal oversight and coordination or, alternatively, adoption of a federal VAT.[92]

## V. CONCLUSION

The chief aim of this article has been to highlight the incentives under current federal law for the adoption of volatile state tax structures and the relationship between revenue volatility and state fiscal stress. To the extent that (1) federal law promotes state revenue volatility, (2) revenue volatility promotes fiscal stress, and (3) fiscal stress prompts demands for federal fiscal relief, the federal government may wish to reconsider its intergovernmental tax policy so as to break these linkages. Respect for state fiscal sovereignty would favor a more neutral federal policy toward state taxation, perhaps an explicit agnosticism regarding the composition of state and local tax bases. Reforms consistent with this approach might include repealing the deduction for state and local taxes, or reforming it to make the value of the subsidy invariant to the type of tax imposed.

Alternatively, a federal government interested in minimizing state fiscal crises may wish to eschew neutrality in favor of federal policies that promote the adoption of more crisis-resilient state revenue structures. Such an approach might involve differential subsidies depending upon the relative stability of different taxes. While the broad outlines of such an approach have been outlined above, the topic clearly requires further study. Of particular relevance to this line of inquiry is a consideration of how uniform federal rules would affect differently situated states. For example, might a federal policy designed to reduce revenue volatility in one state actually increase revenue volatility in another state? Another relevant factor for analysis is whether adoption of taxes with lower short-run variability might compromise the long-term growth prospects of state tax systems. The relationship between volatility and growth may vary from state to state, and any federal policy aimed at assisting states in identifying the optimal trade-off will require sensitivity to this heterogeneity among the states. Considerations such as these should inform the adoption of any intergovernmental tax policy, including the current ad hoc regime.

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[92] Charles E. McLure, Jr., *Coordinating State Sales Taxes with a Federal VAT: Opportunities, Risks, and Challenges*, ST. TAX NOTES (June 20, 2005).

# APPENDIX

TABLE 1. COMPOSITION OF STATE TAX BASES: 2008
*(Major Tax Sources as Percentage of Total Taxes)*

| | GENERAL SALES TAX | SELECTIVE SALES TAX | INDIVIDUAL INCOME TAX | CORPORATE INCOME TAX | OTHER |
|---|---|---|---|---|---|
| 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.