Federal Tax Restructuring and State and Local Governments: An Introduction to the Issues and the Literature

MICHAEL MAZEROV,* DAN R. BUCKS,** AND
MULTISTATE TAX COMMISSION***

The course of events in both the second session of the 104th Congress and the 1996 presidential campaign has significantly reduced the likelihood that a major restructuring of the federal tax system will be initiated in 1997. House Ways and Means Committee Chair Bill Archer—arguably the single individual with the greatest control over whether and when a serious effort to overhaul the federal tax system

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* Michael Mazerov has been a member of the Multistate Tax Commission staff since 1989, as Director of Policy Research and, currently, Director of Information. Previously, he was a public finance analyst with the national headquarters of the American Federation of State, County and Municipal Employees. He holds a B.A. in Economics and Government from Oberlin College and a Masters in Public and Private Management from Yale School of Management.

** Dan R. Bucks has served as Executive Director of the Multistate Tax Commission since 1988. Previously, he was Deputy Director of the Montana Department of Revenue. He has also worked in South Dakota state government and as a staff member of the National Conference of State Legislatures. Mr. Bucks earned a B.A. degree in Economics from Grinnell College, studied Economics at the graduate level at Johns Hopkins University, and received an M.P.A. degree from the University of Montana.

*** Any opinions offered in this introductory Article are the authors' own and should not be interpreted as official positions of the Multistate Tax Commission or any of its member states.

goes forward—has recently acknowledged that marking up legislation in 1997 is no longer feasible:

> [S]uch a massive undertaking is going to have to have broad consensus and bipartisan support within this country. That consensus is not there yet, because the information is not yet there.
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> . . . [U]ltimately the president needs to be convinced this is the right thing . . . .
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> Clearly, we are going to have to resolve differences within the Republican Party before we are going to be able to complete a structural replacement of the income tax . . . .[1]

The delay in Congress' timetable is a welcome development for those who appreciate how far-reaching the impact of substituting a comprehensive consumption tax for the existing federal personal and corporate income taxes would be on state and local tax systems and fiscal capacity. In no other area is the information gap that Representative Archer referred to more evident than with respect to the effect of major federal tax changes on our system of federalism. Failure to appreciate and to address the effects of federal tax restructuring on state and local governments could undermine not only one of its primary goals—administrative simplification—but also the current thrust of federal domestic policy-making generally: devolution of substantial service responsibility to states and localities.

I. THE SIGNIFICANCE OF STATE RELIANCE ON THE FEDERAL INCOME TAX "INFRASTRUCTURE"

We have been actively writing and speaking on this subject for more than a year and a half. The testimony of the Multistate Tax Commission submitted to the House Ways and Means Committee on May 1, 1996, which follows this introduction, encapsulates our analysis. It emphasizes what seems to us to be the most superficially obvious and, at the same time, the least appreciated impact on state and local tax systems of substituting any contemplated version of a consumption tax for the existing federal personal and corporate income taxes: the effective repeal of *state* personal and/or corporate income taxes as well. In adopting a federal starting point for the calculation of these taxes—as virtually all of them do—states have chosen to rely on the full range of Internal Revenue Service activities that are required to administer both taxes in an effective and equitable manner. These activities include developing regulations to define items of taxable income and allowable deductions,

1. John Godfrey, *Archer Outlines 1997 Tax Agenda*, 73 TAX NOTES, 11, 11-12 (Oct. 7, 1996).

requiring their reporting to federal authorities (information that is either simultaneously reported to or shared with the states), auditing a significant sample of taxpayers (particularly under the corporate tax), and, if need be, pursuing disputable issues through the courts. No state could cost effectively preserve a traditional personal or corporate income tax in the absence of the federal administrative and legal infrastructure comprised of the IRS and the Internal Revenue Code.

Beyond practical issues of cost lie fundamental questions of law. It seems highly unlikely that states would be able to compel companies, over which they lack personal jurisdiction, to report income they provide to the state's residents. Therefore, if Company A does not purposefully direct commercial activity to State B, State B cannot likely require Company A to report dividends or interest it pays to Mr. C, one of State B's residents. Indeed, State B cannot compel reporting of Mr. C's taxable wages if they are earned outside of State B. Absent mandatory reporting of income to the federal government, it cannot be effectively taxed at the state level—at least not without a level of state auditing that would be unacceptable for both political and fiscal reasons.

Now, as the Commission's testimony makes clear, there *are* significant differences among the various consumption tax proposals in the degree to which they render infeasible the maintenance of either existing state personal and corporate income taxes or broad-based substitutes for them. For example, the Nunn-Domenici "unlimited savings allowance (USA) tax"[2] would permit states to preserve a traditional ability-to-pay-based personal income tax, because income from capital would continue to be reported.[3] Both the USA tax and the various "flat tax" bills[4] based on the Hall-Rabushka proposal[5] would permit states to substitute a broad-based, apportioned, "subtraction-method" value-added tax for their existing corporate income taxes. (In this regard, the significance of the

2. S. 722, 104th Cong., 1st Sess. (1995).

3. However, see the discussion in the Multistate Tax Commission Testimony to the House Ways and Means Committee on the "source taxation" problem created under the USA tax by the heightened incentives it would provide for individuals to retire to states not taxing consumed income. Dan R. Bucks, *Federal Tax Restructuring: Perils and Possibilities for the States; Testimony to the House Ways and Means Committee of the U.S. House of Representatives, May 1, 1996*, 33 SAN DIEGO L. REV. 1468 (1996) [hereinafter Bucks, *MTC Testimony*].

4. *See, e.g.*, S. 1050, 104th Cong., 1st Sess. (1995); S. 488, 104th Cong., 1st Sess. (1995); H.R. 2060, 104th Cong., 1st Sess. (1995).

5. *See* ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (2d ed. 1995).

U.S. Supreme Court's decision in *Trinova Corp. v. Michigan Dept. of Treasury*,[6] upholding the apportionability of the Michigan "single business tax," cannot be overstated.) On the other hand, the wholesale substitution of a *transactional* consumption tax (such as a European "credit-invoice" value-added tax or the national retail sales tax[7]) for the federal personal/corporate income tax structure would, in our judgment, leave states no choice but to repeal their corporate personal income taxes as well. (That is, unless Congress affirmatively chose to preserve state income taxation by requiring continued reporting of profits, wages, personal income from capital ownership, etc.)

We remain convinced that the most significant implications for state and local tax systems of federal tax restructuring flow from its effects on the administrative and legal infrastructure that would (or would not) be available to states following enactment. Although this view is admittedly debatable, we would urge state tax officials to continue placing primary emphasis on these administrative issues—if for no other reason than that so many federal policy-makers "inside the Beltway" seem incapable of recognizing them.

The most glaring example of an inability to "see the forest for the trees" is provided by a Joint Committee on Taxation (JCT) study, *Impact on State and Local Governments and Tax-Exempt Organizations of Replacing the Federal Income Tax*,[8] prepared for the hearing to which the Commission submitted the testimony reprinted in this Symposium.[9] After correctly noting that "[b]ecause most of the states that collect individual and corporate income taxes model their state income tax systems after the Federal income tax system, any significant restructuring of the Federal income tax system could have considerable corollary implications for such states," the JCT simply observed that "the elimination of a Federal income tax and replacement with a consumption-based tax would entail a considerable increase in the complexity and expense of administering a state income tax system."[10] While devoting seventeen full pages to an analysis of the implications of federal tax restructuring for the implicit federal subsidy afforded by the tax exemption for interest on state and local government debt,[11] the JCT apparently did not regard the "expense of administering a state income

6. 498 U.S. 358 (1991).
7. H.R. 3039, 104th Cong., 2d Sess. (1996).
8. STAFF OF JOINT COMM. ON TAXATION, 104TH CONG., 2D SESS., REPORT ON IMPACT ON STATE AND LOCAL GOVERNMENTS AND TAX-EXEMPT ORGANIZATIONS OF REPLACING THE FEDERAL INCOME TAX (Joint Comm. Print 1996).
9. Bucks, *MTC Testimony*, *supra* note 3.
10. STAFF OF JOINT COMM. ON TAXATION, *supra* note 8, at 70.
11. *Id.* at 84-100.

tax system" in the absence of analogous federal taxes—let alone the fundamental feasibility of doing so—as an issue worthy of even a sentence! When it turned its attention to the complete replacement of the federal income tax by a national retail sales tax, the JCT seemed to view adapting to a new, broader sales tax base as the states' most significant problem.[12] Readers will search the JCT report in vain for an analysis of whether states could maintain income taxes in the complete absence of a federal income tax and, if not, of the *federal* government's ability to administer a twenty percent retail sales tax in an environment in which states and localities would need to raise their combined sales tax rates to approximately the fifteen percent level to replace their personal and corporate income taxes.

II. THE OTHER MAJOR ISSUES FOR STATES AND LOCALITIES

The narrowing of state and local tax policy choices, relative to those currently available, is a thread joining all of the major proposals for federal tax restructuring. However, it is not the only effect on states and localities of enacting a federal consumption tax. Two years into the current discussion there is, finally, a rich literature on this topic. Rather than attempt to discuss or pass judgment on issues that have already been thoroughly analyzed by others, we will simply summarize five other major implications for state and local taxation and fiscal capacity that have been identified and refer readers to articles that focus on these issues:

(1) To varying degrees, federal consumption taxes may subject state and local governments themselves to direct federal taxation.[13] Theoretical justifications exist for taxing state and local governments either as collective consumers (e.g., of the value of goods and services to build roads, police cars, and even the personal services provided by their employees) or as producers of public services.[14] The administrative and political infeasibility of adding a federal sales tax or VAT to state and local tax bills makes it more likely that such governments would be charged sales tax or VAT on their purchases. Under the flat tax, state

12. *Id.* at 71.
13. The most in-depth discussion of these issues may be found in STAFF OF JOINT COMM. ON TAXATION, *supra* note 10, at 49-70.
14. *Id.* at 52-58.

and local governments would be subject to direct taxation on the value of fringe benefits provided to their employees.[15] Either approach would make it more difficult for state and local governments to achieve balanced budgets with existing revenue levels.[16]

(2) Certain possible macroeconomic effects of federal tax restructuring could have significant impacts on state and local government revenue-raising capacity.[17] While these effects are a matter of considerable dispute among economists, they nonetheless warrant consideration in any thorough analysis of the implications for state and local governments of implementing a federal consumption tax. Three major issues are most commonly discussed.

First, some economists assert that elimination of current tax preferences for owner-occupied housing (principally the mortgage interest and property tax deductions) would result, at least in the short term, in a significant drop in home values. Because owner-occupied homes represent a major share of local property tax bases, this could lead to a reduction in local property tax revenues in the absence of offsetting tax rate increases. (It should be kept in mind that many local governments are subject to legal limitations on their authority to raise property tax rates.)

Second, because the hallmark of consumption taxation is the elimination of taxation on the return to new investment, some economists assert that the value of *existing* investments could drop significantly. (A fierce debate rages as to whether transition rules should be adopted to help preserve the relative value of the existing capital stock.) Just as in the case of home values, a drop in the value of existing farms, rental housing, and commercial and industrial real estate and equipment could have a significant downward impact on local property tax bases and tax collections.

Third, the wholesale shift of the federal tax system from taxation of income to taxation of consumption could lead to a significant decrease in national consumer expenditures and a corresponding increase in the national savings rate. (Achieving this result is, of course, one of the

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15. *Id.* at 34.

16. A study by the staff of the California Franchise Tax Board has estimated that this provision of the flat tax would cost California and its local governments $2.6 billion annually. Economics and Statistical Research Bureau, Cal. Franchise Tax Bd., The Impact of the Flat Tax on California, at 64 (1995).

17. The most thorough discussion of these issues may be found in Gerald E. Auten & Eric J. Toder, Federal Consumption Tax Proposals and the States, The Sales Tax in the 21st Century (William F. Fox & Matthew Murray eds.) (manuscript on file with author); and DOUGLAS HOLTZ-EAKIN, CONSUMPTION-BASED TAX REFORM AND THE STATE-LOCAL SECTOR 476-77 (1996).

principal objectives of advocates of a federal consumption tax.) Given the substantial reliance of state and local governments on consumption taxation (sales and excise taxes account for thirty-five percent of state and local tax revenues and twenty-five percent of own-source revenues),[18] a significant nationwide drop in consumption could reduce state and local revenues in the absence of offsetting tax rate increases or base-broadening.

(3) All of the major proposals for federal consumption taxes would eliminate the remaining ability of individuals to deduct state and local income and property taxes in determining their federal tax liability. (The USA tax and the flat tax do not permit such deductions in calculating their respective household-level taxes; the national retail sales tax and a credit-invoice VAT would, of course, eliminate household tax filing entirely). As was exhaustively discussed during the debate on eliminating state and local tax deductibility that occurred during development of the Tax Reform Act of 1986, eliminating deductibility increases the effective "tax price" of state and local services.[19] The possibly attendant affects that expert observers have identified[20] include: (a) immediate taxpayer pressures for reduction in state and local taxes and spending; (b) greater taxpayer resistance to tax increases that may be sought in the future; (c) taxpayer resistance to state and local tax and spending policies that tend to redistribute income or tax burdens from upper income segments of the population to lower income segments (since upper income taxpayers are most likely to itemize state and local tax deductions on their federal returns and therefore experience a tax increase resulting from the elimination of deductibility); and (d)

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18. U.S. Bureau of the Census, Series GB/92-5, Government Finances: 1991-92, at 7 (1996).

19. *See* U.S. ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, REPORT A-97, STRENGTHENING THE FEDERAL REVENUE SYSTEM: IMPLICATIONS FOR STATE AND LOCAL TAXING AND BORROWING 37-66 (1984); Gilbert E. Metcalf, *Tax Exporting, Federal Deductibility, and the Tax Structure*, 12 J. OF POL'Y ANALYSIS & MGMT. 109 (1993); Martin S. Feldstein & Gilbert E. Metcalf, *The Effect of Federal Tax Deductibility on State and Local Taxes and Spending*, 95 J. OF POL. ECON. 710 (1987).

20. Again, we wish to emphasize that we are not attempting to evaluate the accuracy of these predictions or taking a position on their desirability. Many economists who would agree with the predictions believe the outcomes are desirable, that is, that federal tax policy should not shield state and local taxpayers from the full "tax price" of state and local services because it leads to economically inefficient levels of demand for such services. *See generally* Metcalf, *supra* note 19; Feldstein & Metcalf, *supra* note 19.

pressures to shift the burden of state and local taxes away from household taxes and toward business taxes (since under most federal consumption tax proposals businesses may continue to deduct state and local taxes as ordinary business expenses).

(4) All major proposals for a federal consumption tax either reduce (in the case of the USA tax) or eliminate (all others) the implicit federal subsidy afforded by the federal tax exemption for interest paid on state and local government borrowings.[21] Again, the ultimate impact of eliminating this subsidy on the interest cost of state and local government is a matter of debate among economists; it depends critically on the impact on interest rates, generally, of shifting to a federal consumption tax (which is itself a matter of debate). Any increase in the interest costs of state and local governments is significant, since collectively they paid $65 billion in interest in FY92, and these costs equaled eight percent of their own-source revenues.[22]

(5) Federal adoption of a transactional consumption tax (either a national retail sales tax or a credit-invoice VAT) would raise a host of issues for existing state and local sales taxes quite apart from all of those previously discussed.[23] In one way or another, the issues revolve around competition between, and coordination of, the federal and state/local taxes. Some impacts on state and local sales taxation that have been postulated include: (a) "crowding out" of the state and local sales tax base by the federal tax, e.g., political pressure for immediate reductions in state and local sales taxes or against future increases, because voters have a limited tolerance for taxation of any particular base; (b) political pressure brought by the business community (which of course must collect transactional taxes) for either mandatory conformity of the state and local sales tax base to the federal base or elimination of state/local sales taxes entirely and substitution of revenue sharing; and (c) a similar issue of tax base definition autonomy, and an additional issue of the adequacy of federal reimbursement of state costs, if states were either to be mandated or given the option to administer a

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21. STAFF OF JOINT COMM. ON TAXATION, *supra* note 8, at 84-100. *See also Hearing on the Impact on State and Local Governments and Tax-Exempt Entities of Replacing the Federal Income Tax Before the House Comm. on Ways & Means*, 104th Cong., 2d Sess. (1996) (various written submissions of state and local government organizations). Again, we are not taking a position on the appropriateness of such a subsidy from a public policy standpoint.

22. U.S. BUREAU OF THE CENSUS, *supra* note 18, at 6-7.

23. U.S. ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, *supra* note 19, at 93-99; Charles E. McLure, Jr., *State and Local Implications of a Federal Value Added Tax*, 38 TAX NOTES 1517 (March 28, 1988); Alan Schenk, *Choosing the Form of a Federal Value-Added Tax: Implications for State and Local Retail Sales Taxes*, 22 CAP. U. L. REV. 291, 311-18 (1993).

federal transactional tax for the federal government. Other experts have stressed that numerous positive benefits could flow from the states' administration of a federal transactional consumption tax.[24]

III. CONCLUSION

While they have received relatively little serious attention to date, we believe that the potential impacts on state and local government should be viewed by Congress as among the two or three most important issues it must study as it explores restructuring the federal tax system over the next several years. Some of the potential impacts discussed in this introduction, and the Commission testimony that follows, may be inherent in substituting a theoretically pure consumption tax for our current federal personal and corporate income taxes. However, Congress has the power to diverge from theoretical purity in pursuit of other, arguably legitimate, public policy goals (e.g., to preserve tax incentives for owner-occupied housing, as Senator Spector proposed in his version of the flat tax). Congress also has the power to take other steps to mitigate the impact of these proposals on states and localities (e.g., to maintain a structure of mandatory reporting to the federal government of personal income from capital ownership, so that states would have the option of continuing traditional income taxes even if the federal government itself adopted a flat tax).

We hope that the analysis and references to other writings offered here will be useful to state and local officials, private practitioners, and those who believe that a vital state and local public sector is an essential element of a productive American economy. We hope that they will be motivated to educate members of Congress about the fundamental significance, for our federal system, of the decisions regarding the federal tax system that they may soon be making.

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24. *See* Ernest J. Dronenburg, SAFCT: State Administered Federal Consumption Tax: The Case for State Administration of a Federal Tax (Nov. 20, 1995) (paper prepared for the New York University Annual State and Local Taxation Conference, on file with author); John A. Miller, *State Administration of a National Sales Tax: A New Opportunity for Cooperative Federalism*, 9 VA. TAX REV. 243 (1989).

APPENDIX A

TESTIMONY TO THE WAYS AND MEANS COMMITTEE OF THE U.S. HOUSE OF REPRESENTATIVES MAY 1, 1996 FEDERAL TAX RESTRUCTURING: PERILS AND POSSIBILITIES FOR THE STATES

DAN R. BUCKS, EXECUTIVE DIRECTOR,
MULTISTATE TAX COMMISSION

An historic debate is developing over the nature of the federal tax system. Several national leaders are seeking to replace federal income taxes with consumption or other taxes that shift the tax burden away from capital income. Each of these proposals will affect state fiscal systems in fundamental ways.

The central irony of the emerging debate is that while the federal government is transferring expenditure responsibility to the states, most of the major tax changes would effectively reduce the tax policy choices available to states. State officials need to be engaged in this discussion to preserve the vitality of federalism.

This Article reviews three major variants of consumption taxes advocated by various Members of Congress:

- the national retail sales tax (NRST) introduced by Representatives Dan Schaefer (R-CO), Billy Tauzin (D-LA) and Dick Chrysler (R-MI). (This bill is House Bill 3039).[1] Senator Richard Lugar (R-IN) has also advocated a national sales tax, although he has not yet introduced legislation;
- the flat tax proposed by Representative Richard Armey (R-TX) and Senator Richard Shelby (R-AL) and a variant thereof introduced by Senator Arlen Specter (R-PA). (These bills are House Bill 2060,[2] Senate Bill 1050,[3] and Senate Bill 488,[4] respectively); and

1. H.R. 3039, 104th Cong., 2d Sess. (1996).
2. H.R. 2060, 104th Cong., 1st Sess. (1995).
3. S. 1050. 104th Cong., 1st Sess. (1995).
4. S. 488, 104th Cong., 1st Sess. (1995).

- the unlimited savings allowance (USA) tax introduced by Senators Sam Nunn (D-GA) and Pete Domenici (R-NM). (This bill is Senate Bill 722).[5]

A transactional value-added tax (VAT) is also discussed because its impact on states closely parallels the proposed National Retail Sales Tax. However, although proposals for such a VAT have been introduced in the 104th Congress, they are discussed only briefly because they have not been proposed as a substitute for the existing federal personal and corporate income taxes.[6] Finally, a fifth proposal, by Representative Richard Gephardt, is not reviewed here because it does not propose major changes in federal taxation of business.

Each of the plans discussed here is intended to improve the U.S. savings rate by shifting the burden of taxation to consumption and by providing direct or indirect incentives for investment and savings. Because each of the proposals takes a different form, they will affect state tax systems in different ways. Nonetheless, with respect to state taxation, the proposals share a common characteristic: *Compared to current circumstances, all of the proposals would leave the states with fewer tax policy choices.*

The current structure of federal and state tax systems combines consumption taxes—state sales taxes—with "ability to pay" taxes—federal, state, and local income taxes. If the federal government moves to a consumption tax, it will be difficult, if not impossible, for states to maintain "ability to pay" income taxes in their revenue mix.

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5. S. 722, 104th Cong., 1st Sess. (1995). Senator Jeff Bingaman (D-NM) has also advocated substituting the Boren-Danforth Business Activities Tax (BAT), a "subtraction-method" value-added tax, for the existing corporate income tax. See Scrambling to Pay the Bills: Building Allies for America's Working Families, February 28, 1996, pp. 17-19. Most of the observations made here regarding the business-level tax embodied in the Nunn-Domenici USA plan apply with equal force to the Boren-Danforth BAT. The Boren-Danforth BAT was proposed in the Comprehensive Tax Restructuring and Simplification Act of 1994, S. 2160, 103d Cong., 2d Sess. (1994). Note: Subsequent to the Ways and Means Committee Hearing, Representative Sam Gibbons (D-FL), introduced H.R. 4050, 104th Cong., 2d Sess. (1996), the "Revenue Restructuring Act of 1996." H.R. 4050 also proposes a subtraction-method valued-added tax, in this case as a substitute for federal personal and corporate income taxes and Social Security and Medicare taxes.

6. See the VATs proposed in the Deficit and Debt Reduction and Health Care Financing Act of 1995 introduced as S. 237, 104th Cong., 1st Sess. (1995), by Senator Ernest Hollings (D-SC) and in the National Health Insurance Act introduced as H.R. 16, 104th Cong., 1st Sess. (1995), by Representative John Dingell (D-MI).

Administering a state individual or corporation income tax without a federal tax would be extremely difficult, if not impossible, for nearly all states. To a large degree, states currently rely on federal income tax definitions of income, expense, and other relevant items and begin state tax computations from a federal starting point. In addition, states rely extensively on federal audit and compliance programs for their own purposes and are reliant as well on federal information reporting and withholding rules for their own administration. Without this infrastructure, it is unlikely that states would be able to administer an income tax without substantial additional capacity and without additional complexity to taxpayers. They may also run into constitutional issues that would prevent effective administration, especially with respect to requiring information reporting by out-of-state corporations. Ultimately, these constitutional issues may prove to be the greatest barrier to continued state use of income taxes in the absence of a federal income tax. Thus, the proposed federal tax changes will narrow the diversity of tax policies available to the states, and the entire federal/state fiscal system will shift to various forms of consumption taxes.

I. THE FEDERALISM IMPACTS—BRIEFLY

Space does not allow for a full discussion of the impact of each proposal on our system of federalism. This high-level assessment of the three major plans demonstrates, however, that the impacts are significant and vary somewhat among them.

(1) *National Retail Sales Tax.* Replacing the federal income tax with a single transactional tax, such as the Schaefer/Tauzin/Chrysler NRST or a Euro-VAT, will also require that states shift in large part to such a tax. As noted above, it seems unlikely in the extreme that a state could effectively maintain and administer an income tax in the absence of a federal counterpart. Thus, a primary federalism impact of these transaction tax proposals is that states would no longer have the option of including ability-to-pay income taxes in their tax mix.

With all income taxes repealed, a single tax base—consumption—would be used to finance the majority of federal and state services and a substantial share of local services. No other major industrialized country relies to such a high degree on transactional consumption taxes; instead they typically mix consumption and ability-to-pay income taxes much as the states do now.[7]

7. This heavy reliance is likely to lead to higher rates than some envision. The 15% rate included in the Schaefer/Tauzin/Chrysler NRST does not acknowledge the need of states to find a replacement for their income tax receipts. After accounting for the

The limits on policy choices would be especially dramatic in the five states that do not now levy a state sales tax: Alaska, Delaware, Montana, New Hampshire, and Oregon. Sales taxes are a divisive issue in these states, and indeed Montana and Oregon voters have specifically rejected such taxes in referenda on several occasions. Yet, under an NRST or a Euro-VAT, these states would likely have to abandon their traditional reliance on income taxes. The impact on these states highlights in the extreme the constraints placed on the policy choices of all states under a shift to a federal transactional consumption tax.

An NRST or a Euro-VAT would also raise the key federalism issue of the autonomy allowed states to define the bases (and perhaps rates) of state sales taxes or VATs. Admirably, the Schaefer/Tauzin/Chrysler NRST leaves states free to retain their own sales taxes and opt-out of administering the federal tax. Whether such a dual system would be politically sustainable in the long run is open to question, however. It seems likely that the American business community would apply intense pressure for mandatory consolidation, and it is true that a consolidated federal-state tax would be easier to administer for taxpayers and tax administrators alike.

However, consolidation of the two levels of taxation would mean that Congress would control the structure of state retail sales taxes. And, given that these proposals may compel states to abandon income taxes, the result is congressional control of the major share of the general fund revenues of most states. This control could even theoretically lead over time to congressional earmarking or restraining of the uses of state revenues. *If the NRST or Euro-VAT leads to states losing the authority to determine tax policy for themselves, the balance of power in our federal system will shift profoundly in favor of the national government.*

Others may argue that the loss of autonomy in tax policy will be outweighed by the efficiency benefits to the national economy arising from a common national tax. Proponents could also argue that states will enjoy the revenue benefits of Congress enacting a tax base that is broader than most states have been able to adopt on their own. Whether

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need to replace state income taxes, plus the likelihood that the final tax base will be narrower than the pure consumption base used to calculate the 15% rate, the final combined federal-state-local tax rate necessary to raise revenues equal to federal and state income taxes, plus current state and local sales taxes, would be in the 30% to 40% range. Similarly, the rate for a Euro-VAT would likely be much higher than its advocates anticipate.

the federal base would remain immune over time to the inevitable process of exemptions and special exceptions is yet to be seen, however.[8]

There is also no assurance that Congress, after gaining control of the federal and state tax base, will retain the benefits of national uniformity. Indeed, Congress has prohibited states from taxing certain "government-sponsored enterprises," such as "Fannie-Mae," while continuing to subject such enterprises to federal income taxation.

The stakes in this debate between economic efficiency and political autonomy are very high for the states. The authority to determine tax policy is a core element of sovereignty. With that power comes the independence to set expenditure priorities. Ultimately, the combination of the repeal of federal income taxes and mandated conformity to a federal transactional tax would make states much more dependent on the federal government.

Space does not permit a discussion of all the important issues raised for states in the context of a National Retail Sales Tax. The proposal for states to administer the Schaefer/Tauzin/Chrysler National Retail Sales Tax deserves serious consideration.[9] State administration likely ensures greater attention to details important to states as well as to issues of national importance. State administration might also provide a means of resolving the use tax nexus issue; interstate sales would be taxed under a national sales tax, and it would make little sense to have the states administer a federal tax on such sales while remaining effectively powerless to tax them themselves.

(2) *Nunn-Domenici USA Plan.* The tax plan proposed by Senators Nunn and Domenici combines a "federalism friendly" operational (Michigan-style) VAT with a consumed income tax that has the potential to divide the states.

At the business tax level, Nunn-Domenici propose a subtraction-method VAT that would be administered like an income tax. Such a tax

8. Moreover, it is not certain that a federal NRST base that will (presumably) include most household purchases of services will necessarily be appreciably larger than existing state sales tax bases. States currently tax significant amounts of business inputs, which will be exempted under a national sales tax because taxing them at rates as high as 15-20% would lead to significant economic distortions. The expansion of the state sales tax base to include household services may not do much more than compensate states for the loss of the sales tax base comprised of such business inputs.

9. A member of the California State Board of Equalization (the agency charged with responsibility for administering that state's sales tax) has set forth a detailed proposal for state administration of a national sales tax. See Ernest J. Dronenburg, Jr., "SAFCT: State Administered Federal Consumption Tax: The Case for State Administration of a Federal Tax," paper prepared for the New York University Annual State and Local Taxation Conference, November 30, 1995.

is "federalism-friendly" because states could readily "piggyback" on what would be a robust, broad-based tax. States could simply transport their current apportionment formulas from the corporate income tax arena to the new operational VAT. Michigan's experience—especially with the U.S. Supreme Court's approval of apportioning an operational VAT in *Trinova Corp. v. Michigan Dept. of Treasury*[10]—serves as a model for other states. New Hampshire as well now has several years of experience with administering an operational VAT.

The Nunn-Domenici operational VAT would also benefit states by reducing problems created under the corporate income tax by the artificial shifting of income overseas via transfer pricing. The Nunn-Domenici plan alleviates the transfer pricing problem because export sales are exempt from the tax and import purchases are taxed. (In technical terms, it is a "border-adjusted" VAT.)

While the business tax portion of the Nunn-Domenici plan is workable from a federalism perspective, the individual consumed income tax may be a different matter.[11] The "source tax" issue that arose in conjunction with pensions, IRAs and other tax-deferred retirement income would be magnified under the USA plan.[12] A person could add to savings and receive a deduction while a resident of a consumed income tax state, but then retire to a low-rate or non-income tax state.[13] The incentive to retire to such a state would greatly increase relative to the current situation because the exemption (or low rate) would apply not only to pension benefits but to all savings vehicles.

States could de-couple from the USA savings deduction without creating severe administrative complications. However, there would likely be significant political difficulties in eliminating at the state level a federal tax deduction that would be popular with individuals who have significant savings.

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10. 498 U.S. 358 (1991).

11. Under the proposal, the individual tax base would be equal to income from wages, interest, capital gains, and dividends, less net additions to savings.

12. Congress recently preempted the authority of states to tax, under the source principle, IRS-qualified pension and certain other deferred compensation benefits paid to former residents. See Act of January 6, 1996, Pub. L. No. 104-95, 109 Stat. 979 (1996).

13. The issue will be exacerbated to the degree that individuals are able to borrow funds, up to certain limits under the USA plan, to increase their savings deduction.

A federalism advantage of the USA plan is that it does not interfere with the operation of state sales taxes. A federalism disadvantage is that states may find it difficult to retain a traditional "ability-to-pay" income tax. However, that difficulty appears to be more political than technical or administrative, since interest, dividend, and capital gain income would continue to be reported to and audited by the federal government.

(3) *Armey-Shelby and Specter Flat Taxes.* These plans aim at the goal of corporate tax integration, whereby all income is theoretically taxed only once. There is no taxation of consumed wage income twice as there is under the USA plan,[14] and there is no taxation of corporate business profits twice as is commonly alleged in the current system. Business profits and employee fringe benefits (except pensions) are taxed at the business entity level. Wages, salaries, and pension benefits are taxed at the individual level. Senator Specter's plan would allow for the deduction of home mortgage interest and charitable contributions; the Armey/Shelby flat tax would not.

States could readily piggyback on the business operational VAT contained in both these flat tax plans, just as they could in the USA plan. Unlike the USA plan, however, transfer pricing remains a problem because the Armey/Shelby and Specter flat taxes do not qualify as "border adjustable" taxes. Hence, export sales are taxable, and import purchases are deductible as business inputs. Therefore, the same incentives to under-price exports to related foreign parties and to overprice imports from related foreign suppliers exist as under the current corporate income tax. Moreover, without the "backstop" of taxation of repatriated dividends, income once shifted overseas by U.S. multinational corporations is removed from the U.S. tax base forever. Allowing global enterprises to shift income through transfer pricing is a major federal policy failure, and under these flat tax proposals it becomes even more important to solve this problem. On the other hand, the reduction of tax rates under the flat tax relative to the current corporate income tax may decrease the incentive for artificial income shifting somewhat.

The individual tax proposed in the Armey/Shelby and Specter flat tax proposals is designed in a manner that would make it difficult to impossible for states to retain a traditional individual income tax, which includes interest, dividends, and capital gains in the base. The administrative infrastructure for the taxation of these types of income would no

14. Consumed wages are taxed at the individual level under the USA tax, and, because they are not deductible from the business tax base, they are effectively taxed at that level as well.

longer exist because of the elimination of the information reporting on these items. States that prefer a traditional income tax as a part of their fiscal mix would effectively no longer have that choice.[15] On the other hand, as with the USA plan, a federalism benefit of the flat tax plans is that states could retain their sales taxes without inherent federal interference.

II. POSSIBILITIES

While major change in the federal tax system will present challenges to states and localities, it may also produce an opportunity to improve the operation of tax systems at all levels of government. Such improvements would likely require coordination and cooperation between federal, state, and local governments. State officials should be full partners with federal officials in exploring such potential improvements.

Interstate compacts between Congress and participating states should be explored as the mechanism most consistent with federalism for mitigating potential adverse impacts on the states from federal tax changes and for maximizing the benefits of coordination among federal, state, and local taxes.[16] Interstate compacts, freely entered into by states, could forestall congressional imposition of tax policy on the states. At the same time, interstate compacts provide a means of voluntarily harmonizing otherwise separate and potentially disparate tax policies. Compacts are especially called for if the federal government

15. This narrowing of tax policy choices for the states might be potentially mitigated were Congress to empower states with the ability to require income information reporting by out-of-state companies or to continue to collect the information and share it with states on a cost-reimbursement basis. States, in turn, could cooperate through an interstate compact that would provide a basic, uniform legal structure for state income taxes. Such an approach would be consistent with federalism and would avoid forcing all the states into a "one size fits all" tax system controlled only by Congress. Beyond supporting principles of federalism, the federal interest in preserving a state option for income taxation (even if not used at the federal level) would be to prevent the rate of federal consumption taxes from being so high that they produce their own forms of economic distortion and incentives for evasion.

16. A resolution adopted by the Multistate Tax Commission at its 1995 annual meeting commits the Commission to "study[ing] and consider[ing] carefully the potential for state administration of coordinated national taxes, including the use of an interstate compact as a legal vehicle, consistent with preserving state authority within the federal system, for establishing a coordinated system of national taxation within States participating in the compact."

were to enter the field of *transactional* consumption taxation long relied upon by state governments as a major source of revenue.

States cannot afford to ignore the debate over the shape of the nation's tax system. All of the major proposals for federal change will constrain the tax choices available to the states to some degree. It is ironic that as states are being assigned more expenditure responsibilities, they may be left with fewer revenue choices. The choice that states can make now is to try to influence the decisions of Congress that will vitally affect their future tax authority and revenue systems.

APPENDIX B

MULTISTATE TAX COMMISSION RESOLUTION

IMPACTS ON STATE ADMINISTRATION OF PROPOSALS FOR MAJOR FEDERAL TAX CHANGES

WHEREAS, a number of announced candidates for President in the 1996 election and members of the congressional leadership in both parties have recently set forth detailed proposals or otherwise called for major changes in fundamental federal tax policies, and

WHEREAS, several of these proposals call for enactment at the federal level of a comprehensive transactional tax on consumption, which has heretofore been almost exclusively a major source of revenue for States and local governments, and

WHEREAS, enactment of such a tax would raise significant issues of coordination with existing state and local sales taxes, would likely lead to pressure to conform state and local sales taxes to the federal base, and could constrain the ability of state and local governments to retain the existing level of reliance on sales taxes or to achieve increases in sales taxes that might be judged necessary in the future, and

WHEREAS, at least one announced proposal for a comprehensive federal consumption tax contemplates its administration by the States on behalf of the federal government, and

WHEREAS, some proposals for enactment of a comprehensive transactional tax on consumption contemplate such a tax as a complete substitute for federal corporate and personal income taxes, and

WHEREAS, elimination of the federal corporate and personal income taxes would eliminate federal income tax legal frameworks, definitions, income information reporting, tax withholding and tax auditing upon which States depend critically for cost-effective enforcement of their own taxes and thereby raise critical issues concerning the cost and feasibility of instituting these requirements and activities at the state level, and

WHEREAS, other proposals for comprehensive reform of the federal personal income tax base, the substitution of a consumed-income tax for the personal income tax and the substitution of a business activities tax for the federal corporate income tax would, given widespread, conformity to federal tax bases, similarly lead to major transitional adjustments in state tax policy and administration, and

WHEREAS, some proposals for overhaul of the personal income tax raise issues unique to States, such as a potentially greater share of the consumed-income tax base becoming subject, not to deferred taxation at the time of consumption, but rather permanent exemption if consumed in a non-taxing State, and

WHEREAS, in sum, all of the major extant proposals for comprehensive federal tax reform have major implications for the ability of States to retain their current tax policies and systems of tax administration, and

WHEREAS, the proponents of these proposals have given virtually no indication that they are aware of their potential implications for States, and

WHEREAS, interstate compacts represent a partnership approach between Congress and the States that could be the means for coordinating overlapping federal and state taxes that is the most consistent with the balance of power within our federal system of government

NOW, THEREFORE, BE IT RESOLVED, that the Multistate Tax Commission respectfully calls upon the Congress of the United States to consider fully the potential impact on state tax policy prerogatives and state tax administration of all proposals for comprehensive tax reform that it may consider, to consult fully regarding these impacts with all relevant organizations of state officials, including the Multistate Tax Commission, prior to the mark-up of any such legislation, and to devote at least one hearing on any such piece of legislation to its potential impact on state taxation, and

BE IT FURTHER RESOLVED, that the staff of the Multistate Tax Commission will analyze all of the major proposals for comprehensive reform of the federal tax system that are offered during the next several years and advise the Member States with regard to their impact on the ability and cost to the States of retaining their current systems of taxation, and

BE IT FURTHER RESOLVED, that the Multistate Tax Commission will seek to coordinate and serve as a clearinghouse for research by Member State revenue agencies on the impacts of the various tax overhaul proposals, and

BE IT FURTHER RESOLVED, that the Multistate Tax Commission will work diligently to bring before the U.S. Congress and other state government organizations all information available to it concerning the impact of federal tax overhaul proposals on state taxation and to ensure that Congress considers these impacts in its consideration of these proposals, and

BE IT FURTHER RESOLVED, that the Multistate Tax Commission shall study and consider carefully the potential for state administration of coordinated national taxes, including the use of an interstate compact as a legal vehicle, consistent with preserving state authority within the federal system, for establishing a coordinated system of national taxation within States participating in the compact.

Adopted this 28th day of July, 1995, by the Multistate Tax Commission.

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