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THE ONGOING EVOLUTION OF STATE REVENUE SYSTEMS

WILLIAM F. FOX*

I. INTRODUCTION

Economists often evaluate revenue systems using a series of criteria, including fairness, revenues, economic effects, administrative costs, and political and legal constraints. Each characteristic is important in the development of a good tax system, but designing revenue systems that provide sufficient funding over the long-term without the need for frequent rate increases is the most significant challenge facing state governments during the next decade. Thus, significant weight should be placed on the revenue goal during tax reform discussions. States may differ in their decision on the appropriate size of government, with some preferring relatively large and others relatively small governments. Regardless of this decision, the revenue system must be designed to generate sufficient revenues to finance the appropriate level of government so that rate changes are not necessary to maintain the chosen size. Establishing what are sufficient revenues is not a decision that can be measured during a single year but instead must be evaluated in a dynamic context, meaning the revenues must be sufficient not only in the current year but also in the years to come.

The concept of sufficient revenue must be viewed in a dynamic framework because most service delivery is an ongoing process that is broken into years for accounting and political convenience and not because there is a corresponding beginning and ending to the services. The problems associated with not having a revenue system to properly finance government in coming years is much more likely to create fiscal stress or inadequate service delivery than any problems resulting from shortfalls (or excessive revenues) in the current year. In other words, fiscal stress is much more likely to be the result of an accumulation of problems over a number of years than the outcome of a single year of difficulties. The frequent focus on current-year funding reflects political shortsightedness. Given the difficulty of enacting policy changes, the ability of the fiscal structure to finance government over time is a greater

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concern than the ability in the current year. Thus, sufficient revenue is best thought of as existing when revenue growth matches the growth in expenditures that is required to maintain the level of services that a state chooses to deliver.¹

The size of government, likely best measured as a percentage of the economy, will differ among states based on the taste for public services and other factors. The growth in revenues, however, should be determined not by decisions on how large government should be, but by the annual increases in the costs of delivering those services that government has chosen to provide. The growth in revenues should only vary (in a long-term sense) if an explicit decision is made to increase or decrease the size of government. Thus, the long-term expenditure growth relative to the economy should be similar across states, with differences occurring only to the extent that the growth in expenditures varies because of the state-specific mix of services provided or the rate of state economic growth, or because a decision is made to increase or decrease the size of government.

No simple answer exists to the question of how fast government spending should be expected to rise. A reasonable expectation is that revenues should rise at approximately the same rate as the economy (perhaps measured by personal income), which means that state government would stay a constant share of the economy unless an explicit decision is made to decrease or increase the size of government. Through the Taxpayer Bill of Rights ("TABOR"), Colorado has chosen to limit spending from revenue growth to no faster than the combination of inflation plus population change, which when compounded over a number of years will significantly reduce state government as a share of the economy.² There are several reasons why the Colorado growth rate may be unduly limiting. First, choosing an appropriate inflation rate for state government is difficult. A consumer-based inflation measure, such as the consumer price index, or a broad economic measure, such as the gross domestic product deflator, likely fails to measure the inflation confronting state governments. States are particularly affected by

¹. Stability of tax revenue sources can also be an appropriate goal, but a properly sized rainy-day fund can be developed to equate the flow of revenues and expenditures over the business cycle. Thus, the growth in both expenditures and revenues is best evaluated over the long-term, say a business cycle, rather than the annual growth, which is determined by a series of short-term, often cyclical factors. Still, stability may be necessary to the extent that it is not politically feasible to build the required rainy-day funds.

². See COLO. CONST. art. 10, § 20. Colorado’s structure imposes several other limitations that will cause expenditure growth to be too slow. First, the constraint placed by population and inflation is always compared to the previous year, so long-term revenue growth will fall below this sum if the growth in any year fails to reach the constraint. Second, annual revenues are limited to a 6% growth rate.
recent health care cost inflation because their expenditures are very heavily weighted towards health care (Medicaid, employee fringe benefits, and other health department costs).

Second, an increase in expenditures at the rate of inflation plus population growth will result in a long-term decrease in a state's ability to deliver services. Consider the case in which K-12 education, states' largest expenditure item, rises at the sum of these two factors. Expenditure growth at this level allows states to maintain a constant pupil-teacher ratio and to increase expenditures at the same rate as inflation. In other words, education spending would be constant in real, per pupil terms, assuming that pupils grow at the same rate as the population. Teachers would be able to receive a raise equal to the rate of inflation if the pupil-teacher ratio is held constant, and schools would be able to continue buying the same items each year. However, teachers would receive raises that are lower than the average in the private sector because the private-sector raises are approximately equal to inflation plus productivity gains. Over time, the quality of people choosing careers in education and the people who stay in education will be diminished by the decline in their relative wages, which suggests that the quality of education should ultimately fall. Thus, education expenditures must rise faster than inflation plus population change if the quality of education services is to be held constant. Similar arguments can be made for many other public services as well.

Economic forces are lessening states' control over their tax systems, magnifying the problem of creating sufficient revenue systems. Much of this Article is a description of the forces that are changing the ways in which states tax and that are compelling state revenue systems to continue evolving with the changing economic structure, shifting behavior of people and businesses, and rising mobility. The remainder of the Article is divided into three parts. Part II addresses states' fiscal performance in recent years followed by a section on the Wisconsin state tax structure. Part III examines the reasons why state tax revenues have been, and likely will continue, to rise less rapidly than the benchmark identified here. Finally, the Article concludes with an analysis of four options that states should consider to maintain their revenue.

II. STATE FISCAL PERFORMANCE

Selecting the appropriate revenue instruments, structuring them correctly, and putting the necessary weight on each source are key steps to designing a

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3. Note that the argument refers only to changes in relative teacher salaries as they exist today, without reference to whether current teacher salaries are (or should be) higher or lower than those paid to individuals with the same education and skill levels.
properly performing revenue structure. State revenue elasticity is the revenue-weighted average of individual tax elasticities, so it is necessary to evaluate the revenue performance of the individual taxes to understand how the system will grow. States can select certain slow-growing tax instruments as long as the necessary set of fast-growing instruments is chosen as well.

Tax revenues in the average state have grown more slowly than the economy during the past decade, even without excluding the effects of tax rate changes from the data.\(^4\) Table 1 sets forth selected tax elasticities calculated for Wisconsin and the United States from 1992–2002.

**Table 1: Selected Tax Elasticities, Wisconsin and the United States, 1992 to 2002**

<table>
<thead>
<tr>
<th>Tax</th>
<th>Wisconsin</th>
<th>U.S.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>0.91</td>
<td>0.92</td>
</tr>
<tr>
<td>General Sales</td>
<td>1.08</td>
<td>0.96</td>
</tr>
<tr>
<td>Selective Sales</td>
<td>0.85</td>
<td>0.75</td>
</tr>
<tr>
<td>Individual Income</td>
<td>0.89</td>
<td>1.09</td>
</tr>
<tr>
<td>Corporate</td>
<td>0.35</td>
<td>0.38</td>
</tr>
</tbody>
</table>

Between 1992 and 2002,\(^5\) tax revenues rose only 91% as fast as the economy, owing mostly to slow growth in corporate income and selective sales taxes. Economists term the rate of growth of tax revenues divided by the rate of growth of state personal income a "revenue elasticity."\(^6\) An elasticity greater than one means tax revenues grow faster than the economy, an elasticity of one means that revenues grow at the same rate as the economy, and an elasticity below one means that tax revenues grow more slowly than the economy. The elasticity lower than one resulted in revenues falling from 6.36% of personal income in 1992 to 6.09% in 2002. Thus, state

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4. A mixture of rate increases and decreases occurred during the 1990s. The sales tax had the strongest pattern of rate increases, with 19 states raising and 5 decreasing their rate. The corporate income tax was more even, with 9 states increasing and 9 decreasing their rate, though the rate increases were on average larger than the rate decreases. There was a slight downward trend in the individual income tax rate, with nine states increasing their rate (partly because Connecticut added the tax) and 12 decreasing their rate.

5. These years are approximately similar points in the business cycle, both falling shortly after the end of the recession. Nonetheless, the slower rebound in revenues during the latter business cycle may lead to a downward bias in the elasticity calculations.

6. The growth in revenues not adjusted for rate changes is often termed buoyancy rather than elasticity.
governments would have raised nearly $1.5 billion (out of $533.4 billion in actual 2002 collections) more in 2002 if the same share of personal income were collected as in 1992.\(^7\)

Revenue elasticity calculations normally measure only the relationship between revenues at the endpoints, but revenue patterns during the intervening years are also important to overall state revenue conditions. Revenue growth was very strong during many of the interim years, meaning that state fiscal conditions were better than the elasticities suggest. From 1992 to 2000, states in total generated $131 billion in collections above the amount they would have raised if tax revenues remained at the same share of personal income as in 1992.\(^8\) Properly structured rainy-day funds would have retained these revenues for dealing with the shortfalls of 2001 through 2003 and would have significantly softened the state revenue "crisis" of 2001 to 2003.

The specific taxes performed very differently over this time period. The individual income tax grew somewhat faster than the economy, even after the significant declines in tax revenues during 2001 and 2002.\(^9\) The sales tax, on the other hand, grew a little slower than the national economy during this same time period. The corporate income tax and selective sales taxes (primarily taxes on motor fuels, tobacco products, and alcohol) have increased very slowly.

State funding challenges are exacerbated by the high degree of revenue volatility. For example, states experienced widely different revenue growth during the past 15 years. Figure 1 shows that the 1990s began with a recession and the accompanying slow revenue growth. This was followed, after a lag, by strong growth during most of the 1990s, particularly during the late 1990s. Beginning in 2001, states experienced their slowest revenue growth period during at least the past three decades and suffered the first year of actual revenue decline (2002) in their modern history. In fact, total state tax revenue was lower in 2003 than in 2000.

\(^7\) The percent of income paid in taxes varies from year to year, so defining a baseline is difficult, but 1992 represents a relatively low baseline year.

\(^8\) William F. Fox, Three Characteristics of Tax Structures Have Contributed to the Current State Fiscal Crises, ST. TAX NOTES 375, 376 (Aug. 2003).

\(^9\) Tax revenues grew much more slowly than the economy when 2003 is used as the endpoint, owing to the very weak revenue performance during the past three years.
The revenue pattern of 2001 to 2003 does not by itself mean that the long-term tax performance has been altered. Instead, the volatility that it demonstrates emphasizes the importance of examining tax structures based on long-term performance and using rainy-day funds to counterbalance the annual fluctuations. Still, the very different annual performance of state tax revenue during the past decade makes it difficult to discern the underlying pattern of state revenue growth and whether the underlying pattern has been altered.

III. WISCONSIN’S TAX STRUCTURE

Figure 2\textsuperscript{10} establishes that Wisconsin’s combined state and local government tax liabilities as a share of personal income are 5th highest among U.S. states and the District of Columbia and 9th highest in per capita terms.\textsuperscript{11}

\textsuperscript{10} U.S. BUREAU OF THE CENSUS AND BUREAU OF ECONOMIC ANALYSIS.
\textsuperscript{11} State and local governments are combined for cross-state comparisons to account for differences in the relative responsibilities assigned to state versus local governments.
State government alone ranks a little lower at 12th and 11th, respectively. Wisconsin's revenue elasticity was similar to the rest of the country's from 1992 to 2002. Wisconsin, like many other states, could have established a sizeable rainy-day fund if the revenues in excess of those necessary to maintain revenues as a constant share of personal income had been deposited in the rainy-day fund. Thus, Wisconsin generated $4.3 billion more in total tax revenue between 1992 and 2000 than was necessary to maintain spending at the 1992 level. Approximately $2.6 billion of this surplus would have been spent in 2001 through 2003 if the same level of spending relative to the economy had been maintained through these 3 years. It is important to see these calculations as indicative of a pattern that Wisconsin could have taken, and not as a precise recommendation because the specific calculations are dependent on the year used as the base.

Individual Wisconsin taxes performed differently from the national norms across the past decade. The sales tax elasticity has been much higher and the individual income tax elasticity much lower than the national norm. This pattern is consistent with econometric-based estimates of Wisconsin tax elasticities. The long-run Wisconsin sales tax elasticity is higher and the income tax elasticity is lower than the average state. Several characteristics of Wisconsin's tax system work to lower the income tax elasticity, including a

high-income threshold for the highest marginal tax bracket, a modest degree of progressivity (a comparison of the relative relationship between the lowest and highest marginal rate), and the existence of a low income tax credit. There is also evidence that the annual Wisconsin elasticities are highly volatile, being near zero for both taxes in bad times and very large in good times. Among other implications, the volatility of elasticities suggests that tax revenues should begin growing relatively rapidly during the next 12 to 24 months, at the latest.

Wisconsin’s state tax structure is focused relatively more on personal income taxes and relatively less on all other tax categories than is the average state’s structure (see Figure 3). The heavy concentration is achieved without unusually high income tax rates, since Wisconsin’s maximum 6.75% rate is 17th highest among the states with progressive taxation. The relatively low income tax elasticity causes Wisconsin’s overall tax elasticity to be low even though the income tax provides a high percentage of tax revenues.

**Figure 3: Percentage Distribution of U.S. and Wisconsin State Tax Collections, 2003**

<table>
<thead>
<tr>
<th>States Generally</th>
<th>Wisconsin</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Property</strong></td>
<td><strong>Sales</strong></td>
</tr>
<tr>
<td>Other</td>
<td>10.0%</td>
</tr>
<tr>
<td>Corporate</td>
<td>5.2%</td>
</tr>
<tr>
<td>Individual Income</td>
<td>33.3%</td>
</tr>
<tr>
<td>Selective Sales</td>
<td>16.0%</td>
</tr>
</tbody>
</table>

14. *Id.* at 19–20.
15. *Id.* at 31.
IV. STATE REVENUE OUTLOOK

A. Causes of State Fiscal Difficulties

Analysis of past tax growth is much like analysis of past stock portfolio performance—it is not necessarily an indicator of future performance. Still, analysis of past patterns, combined with an understanding of the underlying determinants of these revenue trends, can signal the likely future direction of revenues. In assessing the probable revenue pattern, the focus here is on how the tax base responds to economic growth so that it is possible to assess revenue patterns from the existing legislated tax structure. No significant attempt is made to assess how states may legislatively respond in terms of tax rates, but the ongoing pattern of legislated base changes is discussed.

The individual income tax is the main hope for a tax that will rise rapidly relative to the economy and potentially offset the slower growth of other revenue sources. The individual income tax’s revenue growth in the average state has been very robust. It is estimated that for every state with both personal income and sales taxes, the personal income tax grows much faster relative to the economy than the sales tax (the income tax elasticity is larger than the sales tax elasticity) and the income tax grows faster than the economy (the elasticity is greater than one). The rapid income-tax growth path is probably one important reason why income tax rates have been decreased in recent years. Unfortunately, income-tax growth is prone to be erratic, as has been seen during the past several years, but over the long-term it performs well.

States are their own greatest risk in terms of future income tax revenue growth. Long-term income tax performance is likely to remain relatively strong but will weaken in coming years relative to the past 30 years as states feel pressure to lower rates and narrow the base. Pressures will exist to lower income tax rates, as has already been occurring, and to flatten the individual income tax schedule. A key reason is that rising population mobility makes it increasingly difficult to tax higher income people heavily because of the greater avoidance/evasion possibilities that they enjoy. The problem is compounded by lower federal marginal rates combined with the phase out of deductibility, which raise the cost of state taxes and increase the

17. See Multi-State Analysis, supra note 13, at 11–12.
19. States will also feel strong political and economic pressure to lessen inheritance taxes on high-income individuals.
incentives for high-income people to engage in tax planning. High-income people are apparently already using similar avoidance techniques to those described below for corporations in order to lower their tax burdens. Today, 35 states and the District of Columbia use progressive tax rates, though in states like Kentucky, the rates are proportional over much of the income range. Wisconsin imposes progressive rates, with only 5 states levying their highest marginal rate at a greater threshold than Wisconsin.

Base narrowing, such as for nonlabor and pension income, will also receive considerable attention. The focus will be on the more mobile forms of income, and particularly those sources that are not tied to the local labor market. Thus, the personal income tax will increasingly look more like a wage tax. The other major state tax sources are expected to remain inelastic—grow relatively slowly—during coming years. Weak growth in selective sales taxes is easily understood from the tax structure choice. The bases for these taxes, which are primarily levied on tobacco, alcohol, and motor fuel products, are frequently determined by the quantity of consumption, such as packs of cigarettes, gallons of gasoline, and gallons of alcohol. Thus, revenue growth is slow because quantity rather than value serves as the tax base and because consumption of these items has grown relatively slowly in recent years. The next Section provides a detailed examination of the sources of slow growth in sales and corporate income taxes.

B. Underlying Causes of Slow Sales and Corporate Income Tax Growth

An important and less understood issue is why sales and corporate income taxes are performing weaker than might have been expected. The obvious answer is that the revenues have grown poorly because the tax bases are growing more slowly than the economy. The corporate income and sales tax bases have been narrowing as a share of the economy for many years, and the net effect is slow revenue growth. Figure 4 illustrates the long-term movement of the sales tax base relative to personal income, using personal income as a broad indicator of overall economic activity.

Figure 5 demonstrates the movement of the state corporate income tax base relative to total corporate profits, as measured for national income accounting purposes.

20. See State Individual Income Taxes, supra note 16. This total includes Rhode Island, which accepts the federal progressivity by setting the state tax liability as a percentage of the federal tax liability.

21. See id.
Total corporate income is a broad gauge of the base that states are seeking to tax. The effective corporate tax rate (revenues divided by profits) fell by about 35% since 1991, though the effective rate may have risen again in 2003.\textsuperscript{22} Figures 4 and 5 both evidence the general pattern of a base that is falling relative to the economy. The 5 underlying causes of slow growth in these two taxes are similar, including state-legislated base-narrowing,

\textsuperscript{22} Based on the quarterly revenue data that are available from the Bureau of the Census.
difficulties in taxing multistate activity, federal policy changes, consumer behavior changes, and greater tax sheltering. This Section addresses each of these causes.

1. Legislated Base-Narrowing

Both the sales and the corporate income taxes have been subject to significant base-narrowing through policy decisions made in state capitols. Recent examples of legislated sales tax base-narrowing include decisions to exempt food, prescription and nonprescription drugs, and business machinery, and to grant sales tax holidays. Twenty-nine states (including the District of Columbia) now exempt food and 4 others impose a lower tax rate on food than the general sales tax rate. With the exception of Illinois, all sales taxing states have traditionally exempted prescription drugs, and there are now 12 states (including the District of Columbia) that exempt at least some nonprescription drugs and one imposes a lower rate on nonprescription drugs. Minimal base expansions have to some extent offset the policy-based exemptions, but the overall effect has been for legislation to significantly reduce the base.

Sales tax holidays are a particularly recent form of base erosion. New York offered the first sales tax holiday in 1997, and 12 states (including the District of Columbia) granted sales tax holidays in 2004. Eleven of the 12 states provided a tax holiday on clothing (often with the holiday applying to a maximum value per item), 6 on computers, and 7 on school supplies. The holidays often are for 2 to 3 days, but a few states had 7-day holidays in 2004. Tax holidays are one of the most obvious examples where good tax policy and political benefits point in opposite directions. Tax holidays are a very poor idea when compared against a standard of good tax policy, but it

24. Id.
25. Most base-broadening discussions have focused on expanding the taxation of services. Both Florida and Massachusetts enacted significant expansions of the base to services during the past 20 years. However, the Florida legislation was in effect for about 6 months. William F. Fox & Matthew Murray, Economic Aspects of Taxing Services, 41 NAT'L TAX J. 19, 21 (1988); see also Fed'n of Tax Admin., SALES TAXATION OF SERVICES, UPDATE 1 (1997), at http://www.taxadmin.org/fta/pub/services/services.html (providing a listing of the existing extent of service taxation in states). The Massachusetts legislation was never implemented. Texas also enacted some substantial expansion to services.
27. Id.
28. Id.
29. Richard R. Hawkins & John L. Mikesell, Six Reasons to Hate Your Sales Tax Holiday, St.
has proven politically difficult to argue against a holiday from paying taxes unless a fiscal crisis exists.

Wisconsin's sales tax base is only about 43% of personal income, where the sales tax base divided by personal income measures sales tax base breadth.\(^{30}\) The breadth of Wisconsin's sales tax base is below the median state (tied for 27th among the sales taxing states).\(^{31}\) Still, the issue in base erosion is not the breadth per se, but how the breadth has been changing in response to legislated policy and other factors. Wisconsin does not appear to have selectively narrowed the sales tax base as much in recent years as many states because it has not granted sales tax holidays, newly exempted food, or provided an exemption for nonprescription drugs. Nonetheless, as described below, other factors are also causing base erosion.

Legislation in many states has narrowed the corporate tax base both as the outcome of planned state strategies and because of unintended consequences of statutes that were passed for other reasons. Increasing the weight on the sales factor has been one means where state tax decisions were expected to narrow the base, though in principle, changing the weights could modify the base in any direction. Wisconsin is one of 24 states that double-weight the sales factor in the corporate income tax apportionment formula.\(^{32}\) Eight states place more than 50% weight on the sales factor.

The creation of limited liability companies ("LLCs") and limited liability partnerships ("LLPs") during the 1990s,\(^{33}\) which was generally expected to provide limited liability for owners of small businesses, has become an unintended means of narrowing the base in many states.\(^{34}\) LLCs have reduced state tax revenues in part because states did not modernize their tax legislation to accommodate the new form of business entity, apparently because states presumed that individuals subject to the personal income tax would own LLCs, so that the income would be passed through and taxed at the individual level. In fact, the formation of single-member LLCs by large corporations has become an effective means of tax planning, an issue discussed further below. Income earned by an LLC owned by a single out-of-state member may be


\(^{31}\) Id.


\(^{33}\) Two states, Florida and Wyoming, had LLC legislation in place prior to 1990.

taxable under a state’s corporate income tax, but there are legitimate questions regarding whether a company with no presence other than owning another company that has nexus can be subjected to a state’s corporate income tax.\(^3\)

Also, states often apply tax structures differently to LLCs. For example, Kentucky does not impose the corporate franchise tax on LLCs (some other states do this as well) and allows LLCs to apportion income using a single factor sales formula.

The justifications for legislated narrowing of both tax bases have also been similar. In some cases the base-narrowing represents good tax policy and in others it does not. Indeed, in some cases, legislation is necessary to conform the tax structure to the intended tax base. For example, sales tax exemptions for manufacturing equipment have been provided (or subjected to lower tax rates) by many states during the past 15 years, and this represents movement to a more conceptually appealing tax structure. Still, the effect of the exemptions is to erode the tax base and slow revenue growth.

In many cases several explanations can be given for why transactions or income are granted exemption or special treatment. Enhancing economic development has been the primary argument for many exemptions, with states responding to pressures by businesses and local communities that certain tax structure changes would be important economic stimulants. Both sales and corporate income tax exemptions have often tended to focus on more mobile economic businesses and transactions. Thus, concessions, such as altering the weight on the sales factor in the corporate income tax formula, are only beneficial to multistate firms, based on the assumption that this type of investment is the most mobile. These schemes can lower the effective tax rate on the more mobile, often larger firms and still keep the tax in place on other firms. Imposing taxes on the least mobile activity is generally consistent with the optimal tax rules developed by economists, based on the notion that the excess burdens from taxation arise from distortions in behavior.\(^3\) Multistate firms, though, are at best a very rough proxy for the most mobile capital.

In some cases the exemptions are granted to broad classes of firms based on the expectation of stronger economic growth. Sales tax holidays, sales tax exemptions for manufacturing capital, and greater weight on the sales factor in the corporate income tax all have been justified as means to stimulate state economies and are generally available to wide groups of firms. Narrower

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exemptions by firm\textsuperscript{37} or area have also been granted because of perceived economic development gains. Firm-specific exemptions are frequently provided based on the argument that they are necessary to attract or retain a particular business. Concessions for specific geographic regions, such as enterprise zones, are often based on the hope that taxes can strengthen the local economy or raise incomes of people living in the area by attracting firms. Again, regardless of the type of exemption or concession, the net effect is to narrow the tax base. Even if these structural changes stimulate economic activity, the effects will be much less than the lost revenue so the tax base shrinks.\textsuperscript{38} Said differently, tax exemptions are not self-financing.

Improving fairness and simplicity have also been important arguments for base-narrowing. Sales tax exemptions for food and drugs and sales tax holidays have been justified on the basis of fairness. An obvious problem is that the consumption of nearly every commodity is regressive against current income, so these exemptions will not create a progressive sales tax. Further, the benefits are very poorly targeted to low-income people, making these exemptions very expensive means of assisting low-income individuals.

2. Federal Policy

Federal policy has also been an important factor in base-narrowing for both the sales and corporate income taxes. Nearly every state determines corporate taxable income by beginning with the federal definition of taxable income, making some adjustments, and apportioning the income into the state. As a result, federal policy decisions and administrative practices are very important to state corporate tax revenues. Federal action or inaction has also been key to the sales tax performance. These issues are addressed in this Section.

\textit{a. Federal Limitation of its Own Tax Bases}

Bonus depreciation that was enacted through the Job Creation and Worker Assistance Act ("JCWAA") in March 2002 and modified through the Jobs and Growth Tax Relief Reconciliation Act ("JCTRRA") in May 2003 is a good example of recent federal decisions that are expected to reduce state (and federal) corporate taxation. Many states have responded by decoupling

\textsuperscript{37} The specific firm may not be mentioned by name, but the statute is written such that only one firm can qualify for the special tax treatment.

from the bonus depreciation legislation, but decoupling from other federal legislation has been less frequent. As of December 2003, 17 states were allowing the bonus depreciation to at least some extent for state tax purposes and 22 states, including Wisconsin, had decoupled.\(^{39}\) Other states were not affected by the legislation for reasons such as they had adopted federal legislation as of a particular point in time and were not subject to federal base revisions.

Recent corporate scandals and poor federal corporate tax performance have attracted considerable attention to the accuracy of corporate tax reporting and whether corporate tax bases were properly reflecting business conditions. Corporate book income and federal corporate taxable income have been diverging in recent years, as illustrated by Jonathan Talisman during his tenure as Acting Assistant Secretary for Tax Policy of the Department of Treasury.\(^{40}\) He found that book income was approximately equal to taxable income in 1991 but had grown to be 40% greater by 1996.\(^{41}\) Interestingly, this deviation far exceeds any change in the federal taxable base relative to National Income and Product Accounts ("NIPA") profits, suggesting that NIPA profits are also diverging from book income. The federal effective tax rate was about the same at the beginning of the 1990s and in 2000.\(^{42}\) The failure to find large reductions in the effective federal rate suggests that the problem may be more an increasing overstatement of book income than an increasing understatement of taxable income. But revenues should have grown about 10% from the combined effect of the increase in federal revenues as the average state effective tax rate was falling (state tax revenues are deductible in calculation of federal taxes) and the nominal federal rate increase in 1993 (and there were some other base expansions such as longer lives for real property). This suggests that the federal base actually has fallen about 10% relative to profits.\(^{43}\)


\(^{41}\) Id. at 4.

\(^{42}\) Based on data for the mid-1990s, some had suggested a significant decline in the effective federal tax rate. However, the effective rate rose again at the end of the 1990s.

\(^{43}\) James Mackie III of the Office of Tax Analysis, U.S. Department of Treasury, correctly argues that changes in the effective tax rate can result from many factors, so this finding is at best a general indication of the pattern. See James B. Mackie III, The Puzzling Comeback of the Corporate Income Tax, 92 Nat’l Tax Ass’n Proc. 93 (2000). He decomposes the reasons why the average effective federal tax rate deviates from the nominal tax rate into effects from treatment of depreciation, S-corporations, losses, inflation, foreign source income, alternative minimum tax, and others. He finds that the relative importance of these factors changes over time. Id. at 99–101. Still, depreciation and S-corporations are the primary factors explaining why the effective rate is lower.
may include the check-the-box regulations, worldwide tax planning, and expatriation of U.S. corporations. Additional tax sheltering is another possible explanation for this decline. A 10% decline in the federal base is consistent with the shrinking federal base accounting for about 30% of the fall off in the state effective rate. Thus, other factors must account for most of the falling effective state corporate tax rate.

Professor Mihir A. Desai sought to decompose the key factors in the growing spread of book income and federal taxable income, which is one cause of slow growth in corporate tax revenues. He focused on three main factors: accelerated depreciation, repatriation of foreign income, and nonqualified stock options. While being important determinants of the wedge between book and taxable income, these factors explained about only one-half of the difference. He attributed the additional gap to tax sheltering. He found that the three had differing effects over time, with accelerated depreciation being much more important in the 1980s and nonqualified stock options more important in the 1990s. Excess depreciation accounted for about two-thirds of the deviation during the 1980s, but for no more than one-fifth during the 1990s. Jerome R. Hellerstein and Walter Hellerstein note that the large increases in depreciation under the Accelerated Cost Recovery System ("ACRS") had a dramatic effect on state tax revenues in the early 1980s (and also the federal effective tax rate until 1984), causing many states to decouple their tax base from the federal base. However, most states conformed back to the federal base following the base-broadening effects of the Tax Reform Act of 1986.

The exercise of nonqualified stock options currently accounts for the largest share of the divergence (about one-half), after playing no role until

\[ldid\text{at 100. However, the treatment of losses raises the effective tax rate and inflation lowers it, and the role of each fell dramatically during the 1990s but in a somewhat offsetting manner.}\]

\[ldid\text{at 10.}\]

\[ldid\text{at 10.}\]

\[ldid\text{at 10.}\]
The exercise of stock options reduces corporate taxable income but not book income. Some states may not experience a revenue loss because the excess of the market over the strike price is taxable under the individual income tax. But a revenue loss can be expected in the 24 states where the maximum corporate rate is higher than the maximum individual rate and in the 9 states with no individual income tax. Reinvested earnings abroad are responsible for one-third or more of the simulated divergence. This can result either because foreign activity is growing rapidly or because of reduced repatriation of earnings.

Further, Professor Desai simulates book income using the same factors. He observes that simulated book income and actual book income, which were relatively close until 1993, have begun to diverge. Actual book income has been consistently greater than simulated book income, with the former being 26% greater than the latter by 1998. He undertakes regressions of book income on taxable income and finds results that are consistent with increased tax sheltering at low levels of income. He observes that lower probabilities that tax sheltering will be detected and lower perceived penalties if it is detected are explanations consistent with this pattern. Greater tax sheltering will probably also lower state tax revenues.

b. Federal Limitation of States’ Actions

Professors Charles McClure and Walter Hellerstein observe that the federal government can intervene in state taxation in three ways: prohibiting or limiting state use of existing authority, allowing states to tax in an area that was previously barred, or a combination of these two. The federal government has directly limited the breadth of states’ sales and corporate income tax bases in several areas. States have been prevented from imposing the sales tax on food-stamp purchases and on access to the Internet. The food-stamp limitation likely represents Congress’s intent to target relief to low-income individuals and to expand the purchasing power of food stamps. But, authority to determine progressivity (or extent of regressivity) of state taxes has normally remained with the states, and as noted above, most have

51. See DESAI, supra note 46, at Table 1.
52. No revenue loss exists if the stock options are viewed as legitimate compensation because they should be regarded as a deductible expense. However, failure to reflect the cost in book income creates an incentive to provide excess compensation that is further encouraged by the tax savings.
53. Actual book income is 63% greater in 1998 than actual taxable income using Professor Desai’s data.
54. See DESAI, supra note 46, at 24.
chosen to provide preferred treatment to food purchases.

Congress first passed the Internet Tax Freedom Act ("ITFA") in 1998 and extended the legislation for an additional 2 years in 2001. The ITFA prevented states from imposing discriminatory taxes on Internet-based transactions and precluded states from taxing access to the Internet, except for 10 states that were allowed to tax access through a grandfather clause. Only 6 of these states continue to tax access. The House of Representatives has passed a permanent extension of the ITFA and the Senate recently passed an extension of the legislation. Congress is likely to reach agreement on some version of the extension, with the only question being the specific form that it takes. Key issues that have slowed agreement on the final bill in Congress include whether the legislation will be permanent and how broadly the exemption for access will be construed. There are some major differences between the House and Senate versions. For example, the House version permanently extends the ITFA while the Senate version provides for only a four-year extension of the ITFA. Effects of direct preemption of Internet access on revenue have been relatively modest thus far, though some analysts believe that the House version of the ITFA would have dramatic effects on state telephone tax revenues. Specifically, the breadth issue getting most attention is whether Voice over the Internet Protocol ("VOIP") is access to the Internet and therefore should be exempted from state sales taxes under the new congressional legislation.

The omission of federal enabling policy has been more important for the sales tax than the commission of federal preemption, though this could change with the ITFA extension. Federal inactivity in enabling states to collect use taxes on remote transactions has a much larger implication for state tax collections (and local tax collections in 34 states) than explicit policy decisions by the states. This issue is addressed in detail below.

57. There is no relationship between taxation of Internet access and the propensity to go online. Donald Bruce et al., Has Internet Access Taxation Affected Internet Use? A Panel Data Analysis, PUB. FINANCE REV. 145 (Mar. 2004). They did find that sales taxation of computer purchases tended to lower decisions to go online. Id. at 143.
58. For example, Tennessee recently stopped collecting the tax on access after court rulings that Tennessee is unable to apply its existing telecommunications tax statutes to Internet access. Prodigy Services Corp. v. Johnson, 125 S.W.3d 413 (Tenn. Ct. App. 2003).
62. See id. at 671.
Congress has also limited states' ability to collect corporate income taxes through legislation such as Public Law 86-272,63 which prohibits a state from levying a net income tax on a business whose only contact with the state is to solicit for the sale of tangible personal property. This is not a new preemption of state tax collection, but firms may have become much more adept in recent years at arranging their corporate structure such that PL 86-272 can be used as an effective tax avoidance mechanism. Congress is considering legislation that would impose a physical presence nexus standard on the states with clearly articulated bright-line tests for when physical presence exists. This legislation would bring more certainty to state corporate income taxes but would also more tightly constrain states' ability to levy the tax.

3. Remote and Multistate Activity

The rapidly increasing extent of multistate activity appears to have dramatically lowered state sales and corporate income tax bases by making it difficult for states to collect taxes on remote sales and by allowing firms greater opportunities to shift income to low- or no-tax states. Currently, precise numbers on the extent of remote sales are difficult to obtain, but some evidence exists. The U.S. Bureau of the Census reported that e-commerce transactions totaled $1159.5 billion in 2002.64 In addition, mail-order houses had sales of $82.3 billion in 2002, and this does not include the sales by firms that make mail-order sales through a bricks and mortar firm. Mail-order house sales grew very modestly between 1999 and 2002 but were lower in 2002 than in 2000.

Business-to-business transactions dominate e-commerce sales, representing 92% of e-commerce according to Forrester Research, Inc.65 The Census Bureau estimates that the retail portion of the activity, representing only 3.8% of total e-commerce (some consumer purchases will be in other categories such as wholesale purchases), rose by 58.7% between 2001 and 2003.66 Data on business-to-business transactions shows much slower growth than on retail transactions between 1998 and 2002, but no data are available for later years.

The United States Supreme Court ruled in Quill Corp. v. North Dakota67 that states could require collection of use taxes only by vendors with physical

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64. Author's calculations based on data at http://www.census.gov/eos/www/ebusiness614.htm.
65. See E-Commerce, supra note 30, at 1382.
This holding limits states’ ability to collect sales taxes on many of the multistate transactions. Donald Bruce and William F. Fox estimate that state and local governments lost an additional $15.5 billion in revenues in 2003 as a result of the advent and rapid growth in e-commerce and that the losses are growing. The losses in Wisconsin account for about 2.3% of the national total.

Every sales taxing state has a corresponding use tax requiring payment of the tax liability by the purchaser or user, a consideration brought into the Bruce and Fox analysis. However, use tax compliance is very weak, particularly by individuals. Approximately 19 states include a line on the individual income tax to allow residents an opportunity to easily report their use tax liabilities, but even these states collect little revenue through voluntary compliance. An informal survey conducted by the Federation of Tax Administrators several years ago found no state collecting as much as $2 million through this avenue. Business compliance with the use tax is better but still appears to be very poor by comparison with other taxes. For example, the state of Washington found 27.9% noncompliance for the use tax, by comparison with 1.3% for the sales tax and 1.5% for the business and occupations tax.

The Quill case was decided in part on Commerce Clause grounds that the compliance costs for multistate vendors exceed those for single state vendors and distort interstate commerce. Over the past several years, the states have undertaken the Streamlined Sales Tax Project (“SSTP”) in cooperation with the business community in an effort to find a mechanism through which vendors can be required to collect the use tax on remote transactions. The intent is to simplify sales and use tax compliance to the point that compliance burdens for remote and local vendors are similar and any effects on interstate commerce are eliminated. The National Governors Association reports that 20 states have passed legislation in compliance with the Streamlined Sales

68. Id. at 318.
70. See id. at 514.
71. NINA MANZI, USE TAX COLLECTION ON INCOME TAX RETURNS IN OTHER STATES, POLICY BRIEF, MINN. H.R. (2003).
Tax Agreement that grew out of the SSTP, though not all states may have fully complied with the agreement. Economists view the SSTP as an attempt to enforce a destination-based sales tax. The conventional wisdom has been that destination-based consumption taxes are less distorting than origin-based structures (which exist if remote sales cannot be taxed).

State corporate income tax planning occurs in a variety of ways, including by arranging transactions to take advantage of the preemption provided through PL 86-272 and by taking advantage of differences between state tax structures. Differences in nexus requirements, combined reporting statutes, and breadth of the taxable income base are some of the areas that firms can exploit to lessen their tax liabilities. The problem is complicated by the creation of LLC statutes without updating of the corporate tax statutes. The use of Delaware holding companies to transfer income out of states, which is available in part because Delaware does not tax the income from intangibles, is a frequently discussed mechanism to lessen tax burdens. Data are not available on the extent of state tax planning and how it is growing, but there seems to be consensus among analysts that it is expanding very rapidly.

4. Changes in Consumer Behavior

Changes in the components of consumption have been important to erosion of the sales tax base. A significant reduction in the portion of consumption devoted to goods and a corresponding increase in the portion devoted to services has narrowed the base because most services are not taxed. Table 2 illustrates that consumers spent 47.4% of their income on services in 1979 and this percentage had grown to 59.1% by 2002.

The extent of the erosion is lessened by the fact that about one-half of this growth was in medical services, which are taxed to a noticeable extent in only Hawaii and New Mexico. On the other hand, food is responsible for a nearly equal share of the decline in goods consumption, and food is also not taxable in many cases.

74. See The Streamlined Sales Tax Project Answers the Question . . . Is Orange Juice a Fruit or a Beverage?, at http://www.nga.org/nga/salestax/1,1169,00.html.
75. For example, the Texas legislation did not include destination-based sourcing for the local sales tax.
### Table 2: Personal Consumption Expenditures, 1979 and 2002

<table>
<thead>
<tr>
<th>Expenditure</th>
<th>1979 (Percent)</th>
<th>2002 (Percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Durable Goods</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Autos</td>
<td>5.9</td>
<td>5.2</td>
</tr>
<tr>
<td>Furniture and Household</td>
<td>5.2</td>
<td>4.4</td>
</tr>
<tr>
<td>Other Durables</td>
<td>2.4</td>
<td>2.4</td>
</tr>
<tr>
<td>Nondurable Goods</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Food and Beverage</td>
<td>20.3</td>
<td>14.1</td>
</tr>
<tr>
<td>Other Nondurables</td>
<td>18.8</td>
<td>14.9</td>
</tr>
<tr>
<td>Services</td>
<td>47.4</td>
<td>59.1</td>
</tr>
</tbody>
</table>

The behavioral changes have been fostered in part by new technologies and new products. Digitization, for example, has allowed the development of a new set of products that were not envisioned in state tax law and may not be taxable unless specifically enumerated in state statutes. Internet access in Tennessee is a good example, where the court denied the state efforts to apply the tax based on the telecommunications statutes. Also, the digitization process transforms goods from a tangible to an intangible format that can make some formerly taxable transactions not taxable. Some of these issues are being addressed within the streamlined sales tax agreement.

5. Tax Planning

To some extent, businesses are able to plan both their sales and corporate tax liabilities within the United States. A number of analysts appear to believe that the extent of tax sheltering has grown dramatically in recent years and has been an important source of tax base erosion, as was discussed above for the federal corporate income tax.\(^{77}\)

Of course, tax planning is often enabled by some of the factors already discussed, including federal and state policy, multistate transactions, and multistate companies, so tax planning is not a completely independent source of erosion. For example, companies may be able to plan their sales tax liabilities by creating a separate corporate tax structure for bricks and mortar

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stores and for online sales. Some states, such as Arkansas, have sought to lessen the opportunity for such tax planning by asserting nexus over online companies that have the same name and other linkages to the bricks and mortar stores that have physical presence in the state. 78

Companies have many options for corporate tax planning including the use of LLCs, Delaware holding companies, exploiting P.L. 86-272, and others. In some cases the planning has been viewed as abusive, such as when a number of banks in California formed mutual funds in an effort to escape corporate income taxation. 79 But, determination of when a shelter is abusive is very much in the eye of the beholder. Thus, Professor Joel Slemrod has recently argued that the better term is tax selfishness because of the difficulty of distinguishing between avoidance and evasion. 80 States have attempted a number of policies to lessen the extent of tax planning, including required combined reporting, disallowing certain deductions between closely related companies (such as royalty payments and interest), developing alternative tax structures (such as a value-added tax), and imposing a minimum tax. Each of these policy fixes has advantages and disadvantages, but none will eliminate all forms of tax planning. Indeed, Professor James Hines, Jr. has argued that attempts by governments to eliminate tax planning may ultimately harm economic efficiency by inducing business to spend even more on identifying tax-planning techniques—resources that are ultimately lost to the economy. 81

V. CONCLUSION

The extremely weak state revenue picture of the past several years may bias downwards our perspective on how revenues have performed over the long-term. Still, the past 15 years' experience suggests that tax revenues, except for the personal income tax, will grow more slowly than the economy in the future. Most of the forces causing state tax revenue growth to slow are outside the states' control, and states will need to be increasingly creative to maintain their revenues in this evolving environment.

States appear to have four basic options. First, state government tax revenue as a share of personal income could be allowed to fall, meaning that at least the own-source-financing part of state government would become smaller. It is important to remember that state government revenues have

78. The California Franchise Tax Board has ruled that Borders and Borders.com are sufficiently related that Borders.com has nexus within existing California legislation.
81. See HINES, JR., supra note 44, at 2.
risen as a share of personal income over the past years, so the decline would not be relative to the long-term levels of state revenues. The consequences of lower revenues depend in part on whether state governments respond by reducing programs such as education and infrastructure (relative to the economy) or by decreasing programs such as Medicaid, corrections, and mental health programs.

Second, states could reduce their reliance on sales and corporate income taxes and increase their reliance on personal income, wage, and property taxes. The role played by various taxes has been changing over time, as evidenced by the rapid decline in the importance of selective sales taxes and the increasing role played by the individual income tax and, until recently, by the sales tax. 82 The personal income tax will rise as a share of total taxes even without direct state action because of the higher revenue elasticity. States may ultimately increase the income tax role more radically through policy decisions, such as higher rates. But, this would probably mean higher average rates, not more progressive rates. As described above, states’ ability to impose high rates on upper income individuals and on nonlabor income is being constrained by many of the same forces that limit corporate taxation. Further, states will be increasingly constrained in the level of taxation that businesses and individuals will accept. Vote-with-your-feet responses to taxation can be expected to expand as the costs of mobility fall. Thus, states will be forced to provide high-income people and businesses with services that they want if higher tax rates are to be imposed. These groups will not be easily available to subsidize services for others.

Third, states can transfer responsibilities to local governments or reduce the intergovernmental transfers to local governments. Local governments then have a similar set of options. One likely outcome is that local governments will rely more on the property tax, which effectively means that the property tax will to some extent substitute for state taxes. Options 2 and 3 together point to greater use of income/wage and property taxes and lesser reliance on other taxes. This is best seen as increased (at least relatively) taxation of less mobile bases (workers and property) and reduced taxation of more mobile bases (transactions and business profits).

Fourth, states can seek to fix their traditional taxes, and particularly the sales and corporate income taxes, to offset the weaknesses arising from the causes described above. The SSTP, discussions of broadening the sales tax

82. Sales taxes rose as a share of total state taxes from their advent in the early 1930s until 1996. They fell every year from 1996 through 2001 before rising in 2002 and 2003 in response to the dramatic fall in personal income tax revenues. A combination of more states adopting the tax and higher tax rates were the primary reasons for the growing role of sales taxes. The tax fell as a share of revenues when state rate increases became much less frequent.
base to services, and recent corporate tax legislation in states such as New Jersey are all examples of attempts to fix the problems. Combined reporting, entity level taxes on pass-through firms, and minimum taxes are all options being considered or legislated in some states. Unfortunately, states cannot fully legislate tax structures that overcome the problems. Federal legislation that enables (such as with the SSTP) or does not unduly limit states (such as in the business activity tax arena) is essential and federal policy must not tightly confine states. Perhaps more importantly, competitive pressures limit what states can do (or are willing to do) politically (such as adding unitary reporting and broadening the sales tax base to many services). States are unlikely to make aggressive forays into areas that are perceived to harm their economic climate. Further, tax reforms may be unable to deal effectively with issues relating to many multinational concerns, like services sold over the Internet from foreign companies and international payments to related companies.

In the end, most states will muddle through using a combination of these four options and a few states that are creative, foresightful, and politically courageous will design tax systems that best take advantage of the evolving economic and political structure. All else equal, the latter states will be in the strongest position in terms of stimulating economic development and generating the revenues necessary to fund essential public services.