California Commission on Tax Policy in the New Economy

Sacramento
January 29, 2002

Proceedings

JANUARY 29, 2002; SACRAMENTO

How the Internet Affects the Board of Equalization
Honorable John Chiang - Chair, California Board of Equalization

Tangible and Intangible Taxable Property
Mike Brownell - Multi-state Technical Legal Coordinator, Franchise Tax Board

√The Shifting Tax Base From Tangible Goods to Services and E-commerce and its Effect on State Revenues
Alan Auerbach, Ph.D. - Chair, Department of Economics, UC Berkeley

The Changing Economy in California and its Impact on Tax Revenues
Terri Sexton, Ph.D. - Associate Director, Center for State and Local Taxation
UC Davis Chair, Department of Economics, CSU Sacramento

√Dos and Don'ts of Tax Policy for the New Economy
√The Nuttiness of State and Local Taxes — And the Nuttiness of Responses Thereto
Charles M^{c}Lure, Ph.D. - Senior Fellow, Hoover Institution, Stanford University

Bagley-Keene Open Meeting Act
Kathryn Doi - Chief Counsel, Counsel to the Secretary, Technology, Trade and Commerce Agency

MEETING MINUTES
California Commission on Tax Policy in the New Economy
State Capitol Room 126
Sacramento, California
January 29, 2002
2:00 PM

Commissioners Present

- William J. Rosendahl, Chair
- Lenny Goldberg
- Lawrence Carr
- Glenn Rossman
- Sean O. Burton
- William Weintraub
- Bill Dombrowski
- Marilyn C. Brewer
- Scott Peters

Members Absent

None

Ex-Officio Members Present

- The Honorable John Chiang (Chair, Board of Equalization)
- The Honorable Jack Scott (Chair, Senate Committee on Revenue and Taxation)
- Brian Toman (Chief Counsel, Franchise Tax Board), for Gerald Goldberg
- Marcy Jo Mandel (Deputy State Controller, Taxation), for the Honorable Kathleen Connell (State Controller)
- **C**onnie Squires (Program Budget Manager, Department of Finance), for Tim Gage
- Maria Bondonno (Staff Counsel for Governmental Affairs, Public Utilities Commission), for Loretta Lynch
- Kimberly Bott (Assembly Committee on Revenue and Taxation), for the Honorable Ellen Corbett

Call to Order

Welcome Remarks

Mr. Rosendahl welcomed everyone to the first Commission meeting. The Honorable John Vasconcellos and the Honorable Jack Scott also provided some welcome remarks. They both commented on what a challenge and an honor it will be for the Commissioners to serve over the course of the next couple years.

INTRODUCTION OF MEMBERS

Overview of Statute (SB 1933) and History of Legislation

Mr. Rosendahl read the contents of the legislation. He made special note to emphasize that the Commission will work to get all the stakeholders and the public involved in the meetings.

Expert Presentations

Series of experts discussed tax policy, specifically in relation to the impact of Internet and other forms of electronic technology on various types of taxes.

The Honorable John Chiang, Chair of the Board of Equalization

Mr. Chiang commented on how the Internet has affected the Board of Equalization (BOE). The BOE has a new way of providing services and are now required to adjust their enforcement efforts to ensure that all sellers are on a level playing field. Mr. Chiang cited the 1992 Quill vs. North Dakota case in reference to the issue of nexus. Mr. Chiang also cited California's Nexus Statute Sec. 6203C2. Mr. Chiang noted that the growth in online sales has required the BOE to give more focus to e-commerce, but in the context of the existing nexus statute, as opposed to challenging the Quill decision. He also noted that the BOE has several upcoming cases in its investigative unit and referred to the Borders Online case. Mr. Chiang mentioned that his office is fully empowered and willing to assist the Commission to the fullest extent possible.

Mr. Goldberg inquired whether California is participating in the Streamlined Sales Tax Project (SSTP). Mr. Chiang noted that although the BOE has decided not to participate in SSTP, California is still actively working with other federal and interstate projects.

Mike Brownell, Multi-state Technical Coordinator for Legal with the Franchise Tax Board

Mr. Brownell mentioned that there is little controversy in the determination of what is "income," with respect to the New Economy. He believes that most of the issues are with sourcing-based principles. Mr. Brownell cited the Uniform Division of Income for Tax Purposes Act (UDITPA) and provided a description of UDITPA's components. He expresses that the single largest problem with California's tax system is the sales factor. Mr. Brownell noted that it is not clear what constitutes tangible taxable property. E-commerce is intangible property. Using examples, he cited the rules for intangibles. Mr. Brownell also noted that "no-where income" is a problem, as it creates equity problems. He mentioned that if California looks at a more market-oriented rule, the state will have to work in conjunction with other states, but it would be up to UDITPA to complete the examination. However, nexus will still be an issue, as physical presence is required.

Mr. Peters inquired what vehicles exist for these cooperative efforts. Mr. Brownell noted a few existing projects and organizations including the Federation of Tax Administrators, the Multi-State Tax Commission, the UCC, and the NCCSL.

Mr. Goldberg inquired how much "no-where income" exists that should be ascribed to California. He also asked how often the apportionment percentage sums to more than 100%. Mr. Brownell stated that he does not know how much "no-where income" exists, but mentioned that in order to figure out how often the apportionment sums to greater than 100%, one would add up states' fractions and compare them to the federal total.

Ms. Brewer asked if states can solve "no-where income" issues or is it a federal issue. Mr. Brownell responded that there are a few options. 1) States can band together. 2) States can resolve the issues on an individual level, which they historically do. 3) The laws can be imposed at the federal-level. Ms. Brewer asked for clarification on the term "bricks and mortar," which Mr. Brownell defined as a business with a physical presence.

Mr. Rossman asked for opinion on a single sales factor weighting approach. Mr. Brownell felt it could multiply the current problems.

Mr. Weintraub inquired whether there are international issues related to the apportionment issues. Mr. Brownell commented that apportionment works on worldwide income, and federal policy affects the "no-where income" issues in an international context.

Mr. Rosendahl asked where the federal government is on these issues. Mr. Brownell responded that it is a swirling issue and Congress recently extended the Internet Moratorium to 2003. To his knowledge, there is no current activity.

Alan J Auerbach, Robert D. Burch Professor of Economics and Law, Director of the Burch Center for Tax Policy and Public Finance, and Chair of the Department of Economics at the University of California, Berkeley

Dr. Auerbach highlighted several important issues for the Commission to think about. In reference to a handout he provided, Dr. Auerbach spoke about the trends in revenue over the last decade at the state-level. In particular, he emphasized California's increase in income tax and decrease in sales tax percentages. Dr. Auerbach presented some causes of the trend, including the fact that income tax is more subject to business cycles and California has a progressive income tax. Dr. Auerbach stated that since the Internet bubble burst, the lack of income at the top causes a sharp decline in state revenue. The sales tax revenue is falling because the share of sales subject to tax is falling. Dr. Auerbach referred to the decline in the percentage of tangible goods in overall sales, as services represent 60% of household consumption. Services are exempt from tax. Dr. Auerbach proposed that the growth in services is a more important factor right now quantitatively than E-commerce.

Dr. Auerbach stated that a good sales tax has the largest base possible in order to have equity. He also remarked that sales tax should be on consumption, and therefore, business-to-business tax should not exist, in order to limit the cascading effect. Dr. Auerbach presented a number of problems confronting sales tax reform: 1) any

adjustment always results in someone paying more, and 2) multi-state tax issues. In summary, Dr. Auerbach stated that California relies on income tax more heavily than other states and that to keep sales tax viable, it needs to be reformed.

Mr. Weintraub inquired whether any states have taxed services. Dr. Auerbach commented that there are some failed attempts, not really any successes. Mr. Weintraub asked if the suggestion is to tax services, which Dr. Auerbach replied that if one were to design a system from scratch, yes. Mr. Weintraub asked for some clarification on the rational for exempting business-to-business transactions and how many transactions are already exempt.

Mr. Goldberg commented that there might be enforcement issues in determining business-to-business and service transactions.

Terri A. Sexton, Chair of the Department of Economics with CSU Sacramento and Associate Director of the Center for State and Local Taxation at UC Davis

Dr. Sexton commented on four areas: sales and use tax, land use and development issues, property tax, and telecommunications taxes.

Dr. Sexton recommended that the Commission take a look at Florida's failed attempt at taxing services. Dr. Sexton referred to a survey that found 161 different services that are taxed in the U.S., and of those, California only taxes 15. Dr. Sexton stated that of bigger issue is to look at the sales tax base, as California has moved from a manufacturing-based to a service-based economy.

Dr. Sexton also commented on the reliance of local government on sales tax as a source of revenue that may be affecting land use and development. She stated that regional revenue sharing shouldn't just involve the sales tax. Dr. Sexton remarked that there is a need to look at the property tax base and property tax allocation. She presented the problem of a city with high sales tax revenue per capita and low property tax revenue per capita.

Dr. Sexton then commented that she would like to see an examination of state vs. local assessment in all industries that the state assesses compete with companies that are locally assessed, and she would also like to see an examination of the change in property ownership rules.

Dr. Sexton referenced a University of California, Davis study being conducted on telecommunications taxes. She stated there is a convergence trend in telecommunications and gave examples. Dr. Sexton stated that California's tax system hasn't kept pace with the technology and there is ambiguity and inequity in the implementation of the laws. She stated that unequal treatment is generating inefficiency costs, and that a poor tax system will have implications on the growth of industry. Dr. Sexton commented that California's telecommunications tax system is more complex than other states.' She urged the Commission to define the term "telecommunication" as there is no definition in the state statutes.

Mr. Chiang asked for clarification on the suggestion of looking at state vs. local assessment. Dr. Sexton commented that some companies are state assessed annually, based on market value while others are assessed locally, based on Proposition 13 issues.

Mr. Goldberg recommended that the Commission work with Dr. Sexton and have her present her research in a future meeting. Mr. Goldberg asked if there are areas of telecommunications that are more heavily taxed than others. Dr. Sexton replied that it is too soon for conclusions, but she plans to have the report ready by July.

Mr. Peters asked if Dr. Sexton has reached any conclusions on broadening regional revenue sharing beyond sales taxes. Dr. Sexton remarked that one of her previous studies on property tax allocation concluded that some cities are fast growing but receive too little in property taxes. As a result, they have turned to retail to compensate for the lower property tax revenue. She suggested the Commission look at not just sales tax but also property tax.

Mr. Rossman inquired if Dr. Sexton is aware of any studies that look at the tax burden a citizen faces. Dr. Sexton commented that she is not aware of any comprehensive studies. Mr. Goldberg recommended the Legislative Analyst's Office be invited to a future meeting to present this issue.

Charles E. M^{c}Lure Jr., Senior Fellow at the Hoover Institution at Stanford University

A copy of Dr. M^{c}Lure's presentation is pasted below:

"I urge the Commission to begin its deliberations with a clear picture of the features of a conceptually ideal tax system, not because I think the ideal can be fully achieved, but because in designing tax policy it helps to aim at the target, instead of elsewhere. The Internet and the advent of electronic commerce do not alter the attributes of a sound tax system. I comment primarily on the sales tax, because it most needs to be reformed.

An ideal sales tax would exhibit four features:

> *Equal taxation of all consumption spending by households. This is required to avoid distorting consumers' choices among products, to simplify compliance and administration, and to allow a given amount of revenue to be raised with the lowest possible tax rates.*
>
> *No taxation of sales to business. This is required to avoid distorting choices of the production-distribution process, to simplify compliance and administration, and — of crucial importance — to avoid imposing an unnecessary burden on California producers who are attempting to compete (in either California or external markets) with producers from outside the state. (The value added taxes imposed by the 15 members of the European Union and more than 100 other countries were designed explicitly to achieve this objective, by allowing*

businesses a credit for taxes paid on their purchases.) Contrary to what some may think, taxes on business inputs generally cannot be exported to purchasers in other states.

Equal taxation of sales by local merchants and out-of-state vendors. This is required to prevent placing local merchants at a competitive disadvantage, relative to out-of-state (remote) vendors. It also avoids favoritism toward those who buy from remote vendors. For reasons to be explained below, California cannot achieve this objective acting alone.

Simplification. Simplification is desirable to reduce the compliance burden on vendors and the administrative burden of the state tax administration and, as explained below, is required for taxation of sales by remote vendors.

For the most part the implications for sales tax policy are obvious:

Expand the sales tax base to include all sales to households, including sales of digital content and currently untaxed services.

Expand the exemption of sales to business to exempt all such sales.

Simplify the sales tax. Comprehensive taxation of all sales to households and exemption of all sales to business would contribute significantly to simplification, by eliminating the need to distinguish between taxed and exempt sales. It would allow the tax base to be summarized in two simple sentences:

"If it is sold to consumers, tax it."
"If it is sold to business, exempt it."

The final implication of the ideal system requires a bit of explanation. Because of the complexity of the "system" of sales and use taxes imposed by the 45 sales tax states (and the District of Columbia), the U.S. Supreme Court has ruled (in the Quill case) that a state can impose a duty to collect use tax only on vendors who have a physical presence in the state. The Congress, acting pursuant to the Commerce Clause of the Constitution, or the Supreme Court could overturn this ruling. But much greater uniformity in the laws of the sales tax states is likely to be required in order to gain either Congressional or judicial approval of an extended duty for remote vendors to collect use tax. This leads to the fourth implication for state sales tax policy:

California should participate fully as a voting member in the Simplified Sales Tax Project, an on-going effort by 39 of the 45 sales-tax states (35 as voting participants and 4 as non-voting observers) to simplify state sales and use taxes.

California's failure to participate in the SSTP as a voting member is inexcusable.

Some may object to the suggestion that remote vendors, including those engaged in electronic commerce, should collect the same tax as local merchants. If remote vendors do not collect tax, the reasoning goes, they will have a competitive

advantage over local vendors and that will be good for Silicon Valley and for California. But let's examine the argument more closely.

First, whether remote vendors must collect tax on business-to-business sales, by far the predominance of e-commerce sales, is essentially irrelevant. In the conceptually ideal system there would be no tax on these sales, so the question would vanish. Under the system that actually exists, tax is collected on most taxable sales remote vendors make to business, as well as on taxable sales in-state vendors make to either business or consumers; the exception involves remote sales to small businesses willing to risk being found on audit to have evaded the use tax. Thus only tax on the sales remote vendors make to consumers is actually at stake.

Under current law, many sales to consumers would be exempt; even if remote vendors had an expanded duty to collect use tax, there would be no tax to collect. So it is only tax on taxable sales remote vendors make to consumers — all such sales to consumers in the conceptually ideal tax — that are really at issue. Here the question is one of basic fairness and economic good sense. It is not fair or sensible to place local merchants at a competitive disadvantage, by allowing remote vendors to exploit the California market without collecting the tax that local merchants must collect. And a policy that artificially encourages shipment of individual packages to homes, instead of boxes to stores, does not make economic sense. Nor, for that matter, does a policy that artificially encourages on-line delivery of digital content. Sales taxation should be neutral.

All states use "apportionment" formulas to determine the share of the income of multi-state corporations they will tax. Traditionally such formulas have accorded equal weight to payroll, property, and sales. In recent years, in an effort to stimulate local production, many states have shifted to double-weighting sales or even using only sales to apportion income. The point is that payroll and property reflect the origin of production, and sales represent its destination. By shifting from the traditional formula to one that places less weight on payroll and property and more on sales, destination-based taxation replaces origin-based taxation.

I would make several comments about this shift. First, the formula used to apportion income should be one that reflects where corporate income is earned. It does not seem that the "sales-only" formula (or even one that double-weights sales) does that. Second, if the objective is to encourage local production, the place to start is to eliminate the sales tax on sales to business, which has no place in a well-designed sales tax. Third, sales only apportionment can entail substantial loss of revenue. Producers located primarily in California but selling nationwide would pay less tax. This revenue loss need not be compensated by increased revenue from out-of-state vendors selling into California, since a federal law (P.L. 86-272) prohibits imposition of state income tax on corporations that only make sales in a state. More generally, if the objective is to reduce

the corporate income tax, which is probably a good idea, that should be done directly, not by double-weighting sales."

Mr. Goldberg asked what his suggestion is for taxes on housing. Dr. M^{c}Lure replied that housing is a difficult issue and that, in principle, one would include the original purchase price of the house in the sales tax base. Mr. Goldberg asked if that, in effect, would be a transfer tax, which Dr. M^{c}Lure replied that it is just on the first sale. Mr. Goldberg asked whether medical would be included as well. Dr. M^{c}Lure commented that one may want to exclude this, but states should decide this together, along with food, clothing and drugs.

Mr. Weintraub asked whether there are negative reasons against taxing services. Dr. M^{c}Lure stated that there are not any. He provided the Commission with a brief overview of the history of the sales tax. Dr. M^{c}Lure stated that the sales tax was created in the U.S. when mostly goods were sold and taxing services was perceived as taxing labor. Dr. M^{c}Lure compared the United States' history to the creation of Europe's V.A.T. Dr. M^{c}Lure commented on how Europe's system is more uniform. Dr. M^{c}Lure stated that the U.S. does not have any constitutional forum to bring uniformity, but SSTP is the best effort.

Mr. Burton asked if California decided to tax services and exclude business-to-business transactions what would happen to the tax base. Dr. M^{c}Lure commented that it may increase a little, but it would probably balance out.

Mr. Weintraub asked if the suggestion is to exclude business services, which Dr. M^{c}Lure confirmed. He stated it would help California's companies stay competitive.

Mr. Peters inquired if Dr. M^{c}Lure had any thoughts on quantifying potential for fraud. Dr. M^{c}Lure replied that he did not think the fraud would be significant.

Mr. Goldberg asked if there are any states that exempt all businesses' purchases. Dr. M^{c}Lure stated there are none to his knowledge.

Mr. Rossman commented that, from a competitiveness viewpoint, California is driving people out of the state, to which Dr. M^{c}Lure responded that exempting business-to-business transactions would be the first step in addressing this.

Discussion of Next Steps, including Meeting Schedule

Mr. Rosendahl suggested four working groups, to be voted on in the next meeting.

Mr. Rosendahl suggested that the first submission of the report to the Legislature and the Governor at the end of the year should present the available options, while the final report could provide the recommendations.

Mr. Rosendahl also stated that all Commissioners should feel free to share their points of view and expertise.

There was a brief discussion of what the scope of work should be, which was tabled for the next meeting.

Briefing on Bagley-Keene Open Meeting Act

Kathryn Doi, Chief Counsel/Counsel to the Secretary with the Technology, Trade and Commerce Agency reviewed some important procedures, including the Bagley-Keene Open Meeting Act.

Public Comment

A suggestion was made to put together a website so the public can submit comments to the Commissioners.

Adjournment

Alan J Auerbach Presentation

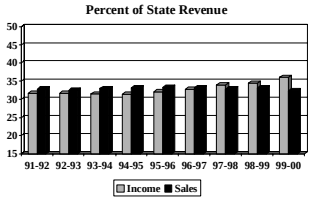
Slide 1

Tax Policy in the New Economy

Alan J. Auerbach
University of California, Berkeley
January 29, 2002

Slide 2

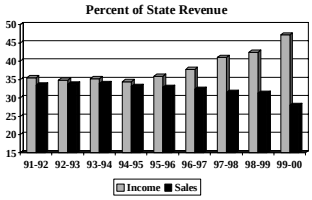
Trends in Revenue, All US States



Source: US Census Bureau

Slide 3

Trends in Revenue Shares, CA



Source: US Census Bureau

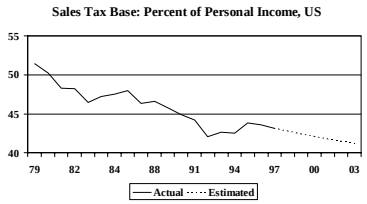
Slide 4

What's Behind the Trends?

* Income is more responsive to the business cycle than sales.
* Income has (had?) been rising faster at the top, and California's income tax is very progressive.
* The share of sales subject to tax has been falling.

Slide 5

The Falling Sales Tax Base



Source: Bruce and Fox, National Tax Journal, 12/2000

Slide 6

Reasons for the Decline in the Sales Tax Base

* Increases in exemptions.
* The shift from goods to services; services are now about 60 percent of household consumption.
* Remote sales (including the internet).
* **The shift from goods to services is most important to date, but remote sales are an issue for the future.**

Slide 7

Questions to Consider

* How to reform California's tax system, given its current state and recent trends? In particular, how to deal with electronic commerce?
* How to avoid, or reduce, revenue swings induced by economic fluctuations?

Slide 8

Elements of a Good Sales Tax

* As broad a sales tax base as possible, including services, to avoid unnecessary distortions to economic decisions.
* Not an effective tool for implementing tax progressivity.
* **California's sales tax base is narrower than the US average, relative to personal income (40% vs. 44% in 1996).**

Slide 9

Elements of a Good Sales Tax (continued)

* Tax consumption, rather than production.
* Tax should exempt **all** purchases by business, both intermediate and final.
* **But scarcely half of CA sales taxes come from consumers (53% in 1989, vs. 59% for US.** [Ring, National Tax Journal, 3/99]

Slide 10

Problems Confronting Sales Tax Reform

* Broadening and rationalizing the sales tax base will shift the burden of taxation among groups.
* Broadening the sales tax base to cover remote sales requires federal action.

Slide 11

Dealing with Revenue Uncertainty

* Fluctuating taxes can act as an "automatic stabilizer," but best done at federal level.
* A shift to more stable revenue source--for example, the sales tax-- can reduce the magnitude of the problem.
* Develop methods of smoothing tax and expenditure changes; don't earmark all increases in surplus immediately for tax cuts or expenditure increases.

Slide 12

Conclusions

* California relies more on the income tax than other states; in the long run, this may make sense if sales tax is not reformed, but revenue fluctuations must be faced.
* Sales tax must be reformed to keep it viable. Electronic commerce is just one of the issues that must be confronted.

Dos and Don'ts of Tax Policy for the New Economy

Charles E. M^{c}Lure, Jr.
Hoover Institution
Stanford University

A presentation to the
Commission on Tax Policy in the New Economy
January 29, 2002
Sacramento, CA

I. INTRODUCTION

I urge the Commission to begin it deliberations with a clear picture of the features of a conceptually ideal tax system, not because I think the ideal can be achieved, but because in designing tax policy it helps to aim at the target, instead of elsewhere. You will find that the Internet and the advent of electronic commerce do not alter the attributes of a sound tax system. I comment primarily on the sales tax, because it most needs to be reformed.

II. SALES TAX POLICY

A. FEATURES OF AN IDEAL SALES TAX

An ideal sales tax would exhibit four features:[1]

- Equal taxation of all consumption spending by households. This is required to avoid distorting consumers' choices among products, to simplify compliance and administration, and to allow a given amount of revenue to be raised with the lowest possible tax rates.
- No taxation of sales to business. This is required to avoid distorting choices of the production-distribution process, to simplify compliance and administration, and — of crucial importance — to avoid imposing an unnecessary burden on California producers who are attempting to compete (in either California or external markets) with producers from outside the state. (The value added taxes imposed by the 15 members of the European Union and more than 100 other countries were designed explicitly to achieve this objective, by allowing businesses a credit for taxes paid on their purchases.)
- Equal taxation of sales by local merchants and out-of-state vendors. This is required to prevent placing local merchants at a competitive disadvantage, relative to out-of-state (remote) vendors. It also avoids favoritism toward those who buy from remote vendors.

  For reasons to be explained below, California cannot achieve this objective acting alone.
- Simplification. Simplification is desirable to reduce the compliance burden on vendors and the administrative burden of the state tax administration and, as explained below, is required for taxation of sales by remote vendors.

B. IMPLICATIONS FOR SALES TAX POLICY

For the most part the implications for sales tax policy are obvious:

- Expand the sales tax base to include all sales to households, including sales of digital content and currently untaxed services.
- Expand the exemption of sales to business to exempt all such sales.
- Simplify the sales tax. Comprehensive taxation of all sales to households and exemption of all sales to business would contribute significantly to simplification, by eliminating the need to distinguishing between taxed and exempt sales. It would allow the tax base to be summarized in two simple sentences:
    - "If it is sold to consumers, tax it."
    - "If it is sold to business, exempt it."

The final implication of the ideal system requires a bit of explanation. Because of the complexity of the "system" of sales and use taxes imposed by the 45 sales tax states (and the District of Columbia), the US Supreme Court has ruled (in the *Quill* case) that a state can impose a duty to collect use tax only on vendors who have a physical presence in the state.[2] The Congress, acting pursuant to the Commerce Clause of the Constitution, or the Court could overturn this ruling. But much greater uniformity in the laws of the sales tax states is likely to be required in order to gain either Congressional or judicial approval of an expended duty for remote vendors to collect use tax. This leads to the fourth implication for state sales tax policy:

- California should participate fully as a voting member in the Simplified Sales Tax Project, an on-going effort by 38 of the 45 sales-tax states (32 as voting participants and 6 as nonvoting observers) to simplify state sales and use taxes.[3]

California's failure to participate in the SSTP is inexcusable.

C. A COMMENT ON THE TAXATION OF ELECTRONIC COMMERCE

Some may object to the suggestion that remote vendors, including those engaged in electronic commerce, should collect the same tax as local merchants. If remote vendors do not collect tax, the reasoning goes, they will have a competitive advantage over local vendors and that will be good for Silicon Valley and for California. But let's examine the argument more closely.[4]

First, whether remote vendors must collect tax on business-to-business sales, by far the predominance of e-commerce sales, is essentially irrelevant. In the conceptually ideal system there would be no tax on these sales, so the question would vanish. Under the system that actually exists, tax is collected on most taxable sales remote vendors make to business, as well as on taxable sales in-state vendors make to either business or consumers; the exception involves remote sales to small businesses willing to risk being found on audit to have evaded the use tax. Thus only tax on the sales remote vendors make to consumers is actually at stake.

Under current law, many sales to consumers would be exempt; even if remote vendors had an expanded duty to collect use tax, there would be no tax to collect. So it is only tax on taxable sales remote vendors make to consumers — all such sales to consumers in the conceptually ideal tax — that are really at issue. Here the question is one of basic fairness and economic good sense.[5] It is not fair or sensible to place local merchants at a competitive advantage, by allowing remote vendors to exploit the California market without collecting the tax that local merchants must collect. And a policy that artificially encourages shipment of individual packages to homes, instead of boxes to stores, does not make economic sense.

III. A QUICK COMMENT ON THE "SALES-ONLY" APPORTIONMENT FORMULA

All states use "apportionment" formulas to determine the share of the income of multi-state corporations they will tax. Traditionally such formulas have accorded equal weight to payroll, property, and sales. In recent years, in an effort to stimulate local production, many states have shifted to double weighting sales or even using only sales to apportion income. The point is that payroll and property reflect the origin of production and sales represents its destination. By shifting from the traditional formula to one that places less weight on payroll and property and more on sales, destination-based taxation replaces origin-based taxation.

I would make several comments about this shift. First, the formula used to apportion income should be one that reflects where corporate income is earned. It does not seem that the "sales-only" formula (or even one that double-weights sales) does that. Second, if the objective is to encourage local production, the place to start is to eliminate the sales tax on sales to business, which has no place in a well-designed sales tax. Third, sales only apportionment can entail substantial loss of revenue. Producers located primarily in California but selling nationwide would pay less tax. This revenue loss need not be compensated by increased revenue from out-of-state vendors selling into California, since a federal law (P.L. 86-272) prohibits imposition of state income tax on corporations that only make sales in a state. More generally, if the objective is to reduce the corporate income tax, which is probably a good idea, that should be done directly, not by double-weighting sales.

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M^{c}Lure, Jr., Charles E., "The Taxation of Electronic Commerce Background and Proposal," in *Public Policy and the Internet Privacy, Taxes and Contracts*, Nicholas Imparato, editor (Stanford, CA: Hoover Institution Press, 2000), pp. 49-113.

M^{c}Lure, Jr., Charles E., "SSTP: Out of the Great Swamp, But Whither? A Plea to Rationalize the State Sales Tax," Keynote Address to the Inaugural Meeting of the Implementing States of the Simplified Sales Tax Project, Salt Lake City, November 28, 2001, *State Tax Notes*, December 31. 2001, pp. 1077-85.

M[c]Lure, Charles E., Jr., "Taxing Electronic Commerce: Legal, Economic, Administrative, and Political Issues," presented at the Annual Meeting of the Association of American Law Schools, San Francisco, January 5, 2001, forthcoming in The Urban Lawyer.

Rosen, Arthur R., and Susan K. Haffield, "The Streamlined Sales Tax Likely to Affect All American Businesses," State Tax Notes, Vol. 22, No. 14 (December 31, 2001), pp. 1087-95.

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[1]Time requires that this presentation be brief. I have presented this line of argument in greater detail elsewhere; see, for example, M[c]Lure (2001), which also contains references to supporting literature. I omit many possible qualifications, such as the possibility of exempting prescription drugs and not exempting luxury automobiles (and, of course, disguised consumer goods) bought for business use.

[2]The use tax is imposed on the in-state use of goods bought outside the state. It is imposed at the same rate as the sales tax and is intended to compensate for the constitutional inability to collect sales tax on such goods. Although the tax is the legal liability of the purchaser, it is generally ignored and cannot be collected economically (except on goods such as automobiles that must be registered to be used in the state), unless the vendor collects it.

[3]The SSTP, in the words of its Executive Summary: is an effort created by state governments, with input from local governments and the private sector, to simplify and modernize sales and use tax collection and administration. The Project's proposals will incorporate uniform definitions within tax bases, simplified audit and administrative procedures, and emerging technologies to substantially reduce the burdens of tax collection. The Streamlined Sales Tax System is focused on improving sales and use tax administration systems for both Main Street and remote sellers for all types of commerce. See M[c]Lure (forthcoming) and Rosen and Haffield (2000) for descriptions and analyses of the SSTP.

[4]This brief discussion can only scratch the surface of this fascinating and complicated topic. For more detailed analyses see M[c]Lure (2000) and (2001) and references provided there.

[5]For refutation of some of the fallacious arguments made in favor of exempting electronic commerce, see M[c]Lure (2000).

Special Report / Viewpoint

The Nuttiness of State and Local Taxes — And the Nuttiness of Responses Thereto

by Charles E. M^cLure Jr.

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I. INTRODUCTION

Many key elements of state and local taxes can only be described as nutty.[1] Some nutty provisions may reflect the economic reality or the state of knowledge of economics that prevailed when the taxes were first enacted — or, of course, they may simply reflect the political realities of the time.[2] Changes in economic reality and our understanding of the economic effects of unwise tax policy are sometimes reflected in improved tax policy.[3] But policy response in the United States — when it has occurred — has often exhibited further nuttiness. Some of the nuttiness of the policy response to prior nuttiness can reasonably be interpreted as attempts to overcome the legacy of nutty policy, without eliminating the nuttiness directly, through fundamental reform.

The next section contains a short summary of key points in the theory of tax assignment, which will be useful as background for the ensuing discussion of sales taxes, income taxes, and tax incentives. It also describes briefly the constitutional setting in which tax assignment occurs in the United States, as that setting conditions achievement of the previously identified tenets of tax assignment. Sections III and IV describe some of the nutty aspects of state sales and use taxes and of state corporate income taxes, respectively. Section V suggests that the tax incentives states provide to attract economic activity, while nutty in a world free from other nutty policies, may not be so nutty in actuality and provide indirect evidence of the general nuttiness of state and local tax policy.[4]

II. TAX ASSIGNMENT: A SHORT COURSE

The theory of tax assignment provides important lessons for the design of state and local taxes. Two aspects of that theory are worth emphasis here: the role of benefit-related taxes and the importance of compliance and administration in the rational design of a decentralized system of taxation.[5]

A. THE ROLE OF BENEFIT-RELATED TAXES

The theory of tax assignment is rooted in the theory of fiscal federalism, in which subnational fiscal autonomy plays a crucial role. The theory of tax assignment suggests that, to the extent possible, subnational governments should rely on taxes that reflect the benefits of public services.[6] Benefit taxation has an advantage similar to that of using market prices to determine what is produced and who pays for it: it promotes economic efficiency. (Many would argue that benefit taxation is also fair, but others might disagree; fairness is not essential to the case for benefit taxation.)

Taxes on business that do not reflect benefits of public services provided to the taxpayer should be avoided.

Aside from the use of taxes on motor fuels to pay for the construction and maintenance of roads and highways, it is difficult to design taxes that are closely related to benefits of public services.[7] But the benefit principle does, none the less, yield some fairly straightforward lessons for the design of subnational taxes. The following are especially relevant for current purposes:[8]

- Taxes on business that do not reflect benefits of public services provided to the taxpayer should be avoided. These include sales taxes on business purchases and corporate income taxes,[9] as well as taxes on business property that exceed benefits provided. Besides distorting production decisions, such taxes make a state an economically less attractive place to do business.
- Sales taxes should be levied primarily on a destination basis, not an origin basis — that is, by jurisdictions where consumption occurs, rather than where production occurs. The idea is that people consume public services predominantly where they consume private products, not where they produce them. Moreover, origin-based taxes that do not reflect benefits of public services distort the location of economic activity, making the taxing state less attractive to business. This principle means that products imported into the state should be taxed like those produced within the state and that exports from the state should not betaxed.[10]
- Individual income taxes should be levied by the state where the taxpayer lives (that is, on the basis of residence), not where the taxpayer works (on the basis of source). The argument is similar to that for destination-based sales taxes; people consume public services primarily where they live, not where they work. This implies that income taxes, which can relatively easily be based on residence, if individuals file tax returns to comply with a national income tax, are likely to be conceptually preferable to payroll taxes, which are commonly levied at the place of employment.[11] Highly graduated rates have no place in individual income taxes levied by subnational governments, as they are not likely to reflect benefits received and they encourage emigration from high tax states. This line of argument figures only marginally in what follows, which devotes little further attention to individual income taxes and none to payroll taxes.

- Tax competition among states can be beneficial, by protecting taxpayers from the tendency of politicians to levy taxes that exceed benefits provided to taxpayers.[12]
- Economic efficiency in government, as well as fairness, demands that subnational taxes not be exported to residents of other jurisdictions, unless they reflect benefits provided to nonresidents. (Residents of jurisdictions that are able to export taxes do not pay the full cost of the public services they receive and thus may demand an excessive amount of services.)

B. Compliance and Administration

Inconsistencies in the way different states impose a given tax can render tax administration and compliance needlessly complicated and costly, and it may create unacceptable inequities and economic distortions. The U.S. Supreme Court has implicitly recognized this important principle. In the *National Bellas Hess* decision (386 U.S. 753, 1967), the Court ruled that, due in large part to the complexity caused by the lack of uniformity of state sales taxes, a state can require a remote (out-of-of-state) vendor to collect its use tax (a substitute for the sales tax that is levied on the in-state "use" of a product bought outside the state) only if the vendor has a physical presence in the state.[13] This principle implies that certain aspects of subnational taxation should be coordinated, in order to facilitate administration and compliance and avoid inequities and distortions.[14]

Desirable aspects of uniformity include, *inter alia*, the definition of the tax base, means of dividing the tax base among states, the legal framework, and administrative procedures. *There is generally no persuasive case for requiring uniformity of tax rates*, which eliminates subnational fiscal autonomy, as well as any possibility of tax competition, without much affecting complexity. See, however, the discussion of local sales and use taxes below.

C. The Constitutional Setting

In some nations, either the constitution or national legislation prescribes the taxing powers of subnational governments in considerable detail. Where this occurs, as in South Africa and the members of the former Soviet Union, subnational governments may have relatively little latitude in choosing the tax policies they pursue. It is especially important to get tax assignment "right" if it cannot easily be changed, for example, because it is prescribed in the constitution.

The U.S. Constitution is essentially silent on tax assignment; about all that is required is that state taxes not contravene the Due Process, Commerce, or Equal Protection clauses.[15] This leaves to the courts, particularly the U.S. Supreme Court, the task of deciding whether individual state laws and practices are constitutional. The Constitution also provides that the Congress can, in its exercise of the power to regulate commerce, impose greater restrictions on the taxing powers of the states. The U.S. Supreme Court has made it clear that Congress likewise has ample power to relax the restrictions that the Court has effectively imposed on the states through its interpretation of the Commerce Clause — a

point of current significance in light of state efforts to seek reversal through Congress of the physical presence rule of *National Bellas Hess and Quill* described above and discussed below.

Action — and inaction — by the Court and the Congress has shaped state tax policy in important ways. As noted above, the U.S. Supreme Court has ruled twice that the current sales tax is so complex that states cannot require remote vendors to collect use taxes unless they have a physical presence in the state. This restriction may yet lead the states to simplify their sales taxes, in hopes of convincing either the Court or the Congress to allow them to require remote vendors to collect use tax. However, the states have not followed this course during the 35 years that have passed since *National Bella Hess* was decided; see the next section.[16] The Court has not taken a similar stand with regard to state corporate income taxes, instead allowing the states wide latitude in taxation. These taxes exhibit a stunning array of complexity and inconsistency, some of which is described in Section IV.

The federal government has enacted legislation that limits state sovereignty in both the sales and corporate income tax areas. The Internet Tax Freedom Act, enacted in 1998 and extended for two years in 2001, bans taxes on Internet access and multiple and discriminatory taxes on electronic commerce. It has little practical effect on the taxation of remote sales of tangible goods, because the *Quill* decision effectively prohibits taxation of much remote commerce and there is little desire to impose multiple or discriminatory taxes on e-commerce. There is, however, a risk that the exemption of Internet access will be interpreted so broadly that most digital content will also be exempt, even if the provider has a physical presence in the taxing state.[17]

Public Law 86-272, enacted in 1959, provides that a state cannot impose its income tax on a firm whose only activity in the state is solicitation for the sale of tangible products. This legislation was a specific response to the U.S. Supreme Court's decision in *Northwestern States Portland Cement Co. v. Minnesota,* 458 U.S. 450 (1959), which, for the first time, explicitly authorized the states to impose apportioned net income taxes on "interstate commerce." It can be interpreted either as a legislative substitute for the *National Bellas Hess/Quill* decisions in the income tax area or simply as the result of pure political power. In either event, when combined with common features of state tax corporate income taxes, it creates ludicrous results; see Section IV.

III. THE NUTTINESS OF STATE SALES AND USE TAXES

This section describes principles of sound sales tax policy, actual sales tax practices and the problems they create, and implications for policy.[18]

A. PRINCIPLES OF SOUND SALES TAX POLICY

A fair and neutral system. A conceptually sound sales tax that is consistent with the principles of tax assignment outlined above would exhibit the following characteristics:[19]

- All consumption would be taxed.
- No sales to business would be taxed.20

- Exports would not be taxed.
- Sales by remote (out-of-state) vendors would be taxed like sales by local vendors (subject to *de minimis* rules to be considered below).

Such a system would be fair and economically neutral.[21] It would not discriminate between types of consumption, between ways of organizing production and distribution, or between local and remote vendors. It would not distort the location of economic activity. Nor would it discriminate between consumers who buy products that are subject to light and heavy taxation, as all products sold to consumers would be taxed the same.

There should be enough simplicity that it is not unreasonable to require remote vendors to collect use tax if their sales in a state exceed a de minimis *amount.*

Administrative features. There should be enough simplicity— which means interstate uniformity — that it is not unreasonable to require remote vendors to collect use tax if their sales in a state[22] exceed a *de minimis* amount. Ideally there would be enough uniformity that a merchant in one state could easily comply with the sales and use tax of another state if it knew the laws of its own state, plus the destination of the sale and the tax rate of the other state.[23] To achieve this objective, uniformity is required, *inter alia,* in:

- the tax base;
- definitions of products;
- rules for "sourcing" (determining the destination of)sales;
- exemption of purchases by business;
- statutes, regulations, and interpretations; and
- administrative procedures, including "one-stop" registration for all states.[24]

Local jurisdictions within any state (and thus in all states) would follow the state definitions, legal frameworks, and procedures, and states would collect local taxes as surcharges on state taxes. Uniformity of state tax rates would not be required; indeed, as indicated above, state power to set tax rates is required for the exercise of fiscal autonomy. Diversity of local rates is considered below.

Nexus should depend on having either *a substantial physical presence or a non-*de minimis *amount of sales in a state.*

Nexus (duty to collect tax) should depend on having *either* a substantial physical presence or a non-*de minimis* amount of sales in a state, not merely on having a physical presence, as it does under *Quill*.[25] This two-pronged test of nexus deserves comment. First, it would make no sense to force remote vendors that make only a small amount of sales in a state to collect tax. Thus the sales prong of the nexus test should depend on having non-*de minimis* sales in a state. Given the degree of uniformity inherent in the proposed system, the sales threshold could beset quite low. Second, the physical presence test of *Quill* would be modified by the addition of the word "substantial." This

would prevent remote vendors that have only an insubstantial physical presence and make only *de minimis* sales in a state from being forced to collect tax.[26] Finally, realistic vendor discounts would relieve the compliance burden of small firms, which is especially heavy.

Interaction between economic neutrality and simplicity. The economically neutral system described earlier would have the simplest possible tax base — or at least the simplest tax base that makes sense.[27] It could be described in two sentences:

- If a household buys it, it is taxable;
- If a business buys it, it is exempt.

These rules allow focus to shift from the nature of the product to the nature of the purchaser. Whereas the former distinction is inevitably problematic, the latter is ordinarily straightforward. (There is, of course, some possibility of abuse by those who falsely characterize the purpose of purchases.)*Inevitable problems of local sales taxes.* The imposition of sales and use taxes by local governments inevitably creates problems. (The same problems exist at the state level, but ordinarily in much attenuated form.) First, remote vendors will experience compliance problems in:

- "sourcing" the sale to its destination;
- applying the proper tax rate(s); and
- channeling revenue to the right jurisdiction(s).

Note that solving the second problem, by requiring a single tax rate for remote sales made in a state, would not solve the other two problems, which are closely related. Second, even if compliance problems can be overcome for remote commerce, the use of sales taxes by jurisdictions within a major metropolitan area can create other problems, because of cross-border shopping (making purchases in a jurisdiction other than that of residence):

- The exporting of taxes to nonresidents is unfair and distorts the price of local public services in the jurisdiction that exports taxes.
- Revenue does not go to jurisdictions of residence, which provide most public services provided by local governments.
- Local governments engage in unhealthy tax competition to attract stores and shopping malls that generate revenues from sales tax that is exported to households who live in other jurisdictions.[28]

These inevitable problems lead some to conclude that local sales taxes should be avoided.[29] This issue is considered further below.

B. THE NUTTINESS OF ACTUAL SALES TAXES

Extant sales taxes violate all the principles of sound tax policy stated above, with the adverse consequences indicated.[30]

- Much consumption, especially of services, is nottaxed.[31]
  - This distorts consumer choices and creates inequity among consumers.
  - The regressivity of the tax system is increased, because services are consumed disproportionately by the more affluent.
  - Tax rates must be higher than otherwise, to raise a given amount of revenue.
- Many sales to business are taxed.[32]
  - This distorts business decisions on production and distribution.
  - Part of the cost of government is concealed.
- An origin-based element of taxation is interjected into the destination-based sales tax system.
  - Inputs employed in production for export are taxed.
  - There is a disincentive to produce in states that tax business purchases.
  - Producers in those states are disadvantaged, relative to foreign producers, in both foreign and domestic markets.
- There is substantial complexity because of the lack of uniformity in:[33]
  - tax bases;
  - definitions of products;
  - exemptions of business purchases;
  - legal frameworks; and
  - administrative procedures.
  - Also, states do not exempt *de minimis* sales or provide realistic vendors' discounts.
- Local taxes are the source of much additional complexity.
  - It is necessary to "source" sales to local jurisdictions, apply the appropriate tax rate, and channel the revenue to the proper jurisdiction.
  - Local tax bases deviate from state bases in some states.
  - Local governments in some states administer their own taxes.
- Because of complexity, the U.S. Supreme Court has ruled that states can impose a duty to collect use tax only on vendors with a physical presence in the state (*National Bellas Hess* and *Quill* decisions).
  - This violates the destination principle.
  - This discriminates against "Main Street" merchants and their customers.
  - It leads to loss of revenue (or higher rates to raise a given amount of revenue).

C. Eliminating Nuttiness: Implications for Policy

The needed reforms. Some of the implications for policy are relatively straightforward. In order to eliminate nuttiness, it is necessary to:

- eliminate exemptions for consumer purchasers;
- exempt all business purchases;
- simplify the sales tax system by creating greater uniformity; and
- modify the physical presence test of nexus as suggested above.

The problem of local use taxes. As noted earlier, local sales taxes pose especially difficult problems. The proposal to eliminate local sales taxes and replace them with local income taxes seems hopelessly unrealistic. Not only are local sales taxes an important source of revenue for many local governments, revenues from them have been pledged to service bonds (e.g., for sports stadiums).[34]

Local taxes could be simplified in various ways, particularly in the few states that deviate dramatically from the conceptual ideal. As a bare minimum, state and local taxes in a given state should be levied on the same tax base and states should collect local taxes. Beyond that, it should be possible to devise ways to reduce compliance costs for remote vendors, for example, by combining realistic *de minimis* rules and vendor discounts with a "technological fix" that would allow sales to be traced to the locality of buyers.[35]

State and local taxes in a given state should be levied on the same tax base and states should collect local taxes.

Requiring one use tax rate per state (combined with sales tax rates of local choosing and state allocation of use tax revenues among localities based on a formula, rather than attribution of individual sales by remote vendors to particular localities) would greatly simplify compliance for remote vendors, but would require congressional approval (because interstate sales would be taxed more heavily than sales by local merchants in jurisdictions with sales tax rates below the uniform use tax rate). One use tax rate per state would produce relatively little simplification if remote vendors were required to source sales and channel revenues to local jurisdictions.

D. CAN A STATE 'GO IT ALONE' IN FIXING ITS SALES TAX?

The inability to require collection of use taxes on sales by remote vendors — and the complexity that underlies it — is currently the most vexing problem of sales taxation. If the states are to require vendors who lack an in-state physical presence to collect use tax, the Congress or the U.S. Supreme Court must override the *Quill* decision. This, in turn, is almost certain to require drastic simplification of the state sales tax "system." Because simplicity requires greater uniformity, no single state acting alone can achieve it. Rather, simplification requires the concerted effort of all the sales tax states — or at least enough of them to convince the Supreme Court or the Congress to reverse the *Quill* decision and allow those states to require remote vendors to collect use tax for them. This is a tall order because the complexity of the sales tax "system" is the evolutionary product of the independent actions of 45 states and the District of Columbia.

By comparison, any state could act unilaterally to rationalize its sales tax in the other ways mentioned. That is, a single state could extend the tax to services and other consumer products that are currently exempt and could exempt all sales to business. The second of these would have the salutary effect of removing a cost that impedes the ability of in-state firms to compete in both foreign and domestic markets, including the market of the taxing state, but it would have an enormous negative impact on revenues, unless rates were raised dramatically.

Some might decry the elimination of taxes on sales to business as a "race-to-the-bottom," using the pejorative term often employed to describe tax competition.[36] But this form of tax competition is *good* tax competition, because the bottom— complete exemption of sales to business — is precisely what makes sense, both for the individual state and for the nation.[37] Moreover, if the legislatures and governors of all the states, acting independently, were to eliminate sales tax on all sales to business the result would be a substantial simplification of the entire system. State-by-state rules concerning what is exempt if bought by businesses (when engaged in particular activities) could be replaced by a single rule, and a single uniform tax exemption certificate could be used to implement the rule: "if a business buys it, it is exempt." One of the enduring mysteries is why business interests have not pressed for this reform, which has, in effect, been in place in Europe since the 1960s.

Because simplicity requires greater uniformity, no single state acting alone can achieve it.

In theory the same type of state-specific action could also lead to a definition of the tax base that would be uniform across the nation, and therefore simple to implement: "If a consumer buys it, it is taxable." Realism suggests, however, that this reform is even less likely to result from the unilateral action of individual states. Whereas there should be powerful forces advocating elimination of tax on sales to business, there is no similar natural constituency for taxing all consumption — and plenty of constituencies that would oppose it.

E. A DIGRESSION ON TAX EXPORTING

Some may argue that it would be illogical for a state to eliminate taxation of business inputs because this component of the sales tax is exported to nonresidents of the state. This may be good politics, but it is nutty economics.[38] Standard economic analysis indicates that a tax on business inputs, like any tax on production, will be reflected in higher prices only to the extent that the state dominates the relevant market for itsproducts.[39] Because few, if any states dominate important out of-state markets for their products, exporting of sales and use taxes on business inputs is highly unlikely. Such taxes are more likely to be borne locally, by reducing wages and land rents.

F. SO WHAT'S HAPPENING?

Forty-two of the 45 sales tax states and the District of Columbia are currently involved in the Streamlined Sales Tax Project (SSTP), 37 as voting participants and 5 as nonvoting observers. The three sales tax states that are not participating in the SSTP (Colorado, New Mexico, and Hawaii) are relatively unimportant economically. California, Connecticut, Georgia, Idaho, and New York are participating, but not as voting members.

The avowed purpose of the SSTP is to "develop measures to design, test and implement a sales and use tax system that radically simplifies sales and use tax."[40] The objective is to

gain congressional or judicial approval of an expanded duty for remote vendors to collect use taxes.[41] Thus far 31 states have adopted some form of the SSTP legislation and legislation has been introduced in four more; two of the voting states have yet to introduce legislation.[42]

The SSTP's efforts at simplification involve only some of the components of an ideal sales tax identified earlier, including uniform definitions of broad categories of products (from which each state could construct its own tax base, by choosing whether to tax or exempt the category); the same state and local tax bases in a given state (with the exception of a few large easily taxed items); state administration of local taxes; uniform rules for "sourcing" sales; electronic exemption certificates; and one-stop registration.[43] Uniformity would not extend to such crucial issues as the definition of the tax base, the treatment of sales to business, much of the legal framework, or many administrative procedures. Thus the objective stated earlier, "that a merchant in one state could easily comply with the sales and use tax of another state if it knew the laws of its own state, plus the destination of the sale and the tax rate of the other state," would not be achieved.

If the SSTP is successful, in that complexity is substantially reduced and the physical presence test of nexus is eliminated, the result will be a significant reduction in nuttiness. But achieving greater economic neutrality (by eliminating tax on business purchases and taxing all consumption uniformly) plays no part in the project's agenda, although it may — or may not — eventually occur as a by-product of attempts to simplify the system. If not, the system will still be nutty.

IV. THE NUTTINESS OF STATE CORPORATE INCOME TAXES

As noted in Section II, state corporate income taxes are inconsistent with the theory of tax assignment. There is no need to discuss further the basic nuttiness of their existence.[44] However, it is useful to discuss the nuttiness of the way the states implement the tax, given that it exists.[45]

A. DESIGNING A SENSIBLE STATE CORPORATE INCOME TAX

A sensible system of state corporate income taxes would exhibit several characteristics.[46]

Formula apportionment. The states do not attempt to implement geographic separate accounting, under which a corporation operating in more than one state would attempt to isolate the income originating in each, based on separate books of account for each state. (At least *that* nutty choice is avoided.) Economic interdependence between parts of the corporation operating in various states would doom such an effort. Moreover, taxpayers could manipulate transfer prices to shift income out of high-tax states. Finally, geographic separate accounting would be onerous for taxpayers because they would not undertake it for internal business reasons. Rather, the states use formulas to apportion the income of multistate corporations among the states where they operate. Apportionment is based on the ratios of in-state to total quantities of various *apportionment factors*. Payroll, property, and sales are by far the most commonly used apportionment factors,

presumably because they were once thought to reflect where income originates.[47] These three factors were traditionally given equal weight. While one might reasonably quibble about the choice of factors and the weights placed on them, this seems like a generally sensible way to apportion income.

Unitary combination. Essentially the same problems that would plague geographic separate accounting (economic interdependence between members of the group and the possibility of manipulating transfer prices, including those for intra-group financing) arise in attempting to isolate the income of each member of a corporate group operating in more than one state. (On the other hand, separate corporations do keep separate books.) To overcome these problems, some states (most notably California) "combine" the activities of affiliated corporations deemed to be engaged in a "unitary" business. Under unitary combination transactions between members of the group (for example, sales, royalties, interest payments, and dividends) are ignored and the income of the group is apportioned on the basis of the apportionment factors of the group. Again, this approach seems sensible.

If the SSTP is successful, in that complexity is substantially reduced and the physical presence test of nexus is eliminated, the result will be a significant reduction in nuttiness.

A sensible nexus standard. It would be appropriate to have a nexus threshold that would eliminate the need to file tax returns for firms whose (otherwise) taxable income in a given state fell below that threshold. The only sensible economic interpretation of formula apportionment is that the factors in the apportionment formula are intended to reflect where income would be fixed. This implies that taxable nexus should depend on the in-state presence of non-*de minimis* amounts of one or more of the factors in the apportionment formula, as well as a non-*de minimis* amount of apportionable income. In particular, if payroll, property, and sales were used to apportion the income of multistate firms and a firm had both a non-*deminimis* amount of apportionable income and a non-*de minimis* amount of sales in a state, it should be deemed to have nexus for income tax purposes, even if it had neither payroll nor property in the state. (It would, of course, be deemed to havenexus if it had non-*de minimis* amounts of either of these factors, as well as non-*de minimis* apportionable income.) If a corporation (or corporate group) had only *de minimis* amounts of all the factors in a given state, it would be appropriate to distribute the profits that would otherwise escape taxation among the states where the corporation had nexus. This could be achieved by omitting these *de minimis* amounts from the denominators of the various factors in the apportionment formula.

Uniformit. Like the conceptually ideal sales tax, a sensible system of state corporate income taxes would exhibit considerable uniformity across states, *inter alia*, in these respects:

- a uniform definition of taxable income based on the definition for federal tax purposes;
- uniform treatment of affiliated firms;
- a uniform apportionment formula;

- uniform definitions of apportionment factors; and
- a uniform nexus standard.

Should corporate tax rates be uniform? There would seem to be no more reason to demand uniformity for corporate income tax rates than for sales tax rates. Indeed, it was argued above that tax competition has salutary effects. Of course, in this case tax competition might lead to a "race to the bottom"— a result that is unlikely for destination-based sales taxes. But, as with the sales tax on business inputs, that is exactly where the theory of tax assignment tells us we should be!

B. THE NUTTINESS OF ACTUAL STATE CORPORATE INCOME TAXES

To be mutually consistent, the income taxes of the various states must be uniform, except in the choice of tax rates.[48] Lack of uniformity would create gaps and overlaps in the tax bases of the various states. In actuality, the U.S. Supreme Court does not require that state corporate income tax laws be uniform or mutually consistent. The Court accords the states wide latitude in corporate income taxation, and the Congress generally has chosen not to exercise its powers under the Commerce Clause to limit that latitude, except as noted above. A state need only employ a methodology (for example, for apportioning income) that, considered by itself, passes judicial muster under the four-pronged test stated in *Complete Auto Transit*, 430 U.S. 274(1977): substantial nexus; fair apportionment; nondiscrimination; and fair relation to services provided by the state.[49]

To be mutually consistent, the income taxes of the various states must be uniform, except in the choice of tax rates.

Two tests of fairness the Court has used are "internal consistency" and "external consistency." The first of these means only that a state's methodology, if applied by all states, would result in no more than all income being taxed.[50] The second requires that "the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated."[51] Methodologies employed by various states can be quite different, and yet pass both of these tests. Because there are many inconsistencies in the ways the various states actually impose their income taxes, the system is complex and there are gaps and overlaps in taxation. The following formula used to calculate the taxable income a state apportions to itself shows clearly the latitude for gaps and overlaps:

$$T_i = I\,[\langle_w(W_i/W) + \langle_p(P_i/P) + \langle_s(S_i/S)],$$

where:

T_i is taxable income in state i;
I is the company's apportionable income;
$\langle_w$, $\langle_p$, and $\langle_s$ are the fractional weights assigned to payroll, property, and sales;
W_i, P_i, and S_i are payroll, property, and sales in state i; and
W, P, and S are total payroll, property, and sales.

The definition and measurement of the payroll factor is the only part of the right-hand side of this formula that is relatively consistent from state-to-state; virtually everything else is up for grabs. Moreover, states differ in whether they require or allow unitary combination and if so, how they define a unitarybusiness.[52] In short, the system is nutty.

Putting P.L. 86-272, sales-only apportionment, and lack of unitary combination together is especially nutty.

State corporation income taxes exhibit nuttiness, *inter alia*: in the nexus standard (P.L. 86-272) imposed by the U.S. Congress, in the distinction between business and nonbusiness income, in the lack of consistency of apportionment formulas across states, in a recent trend to use only sales to apportion income among states, in the failure of many states to require unitary combination, in the lack of consistency across states in the definition of a unitary business, in the tax treatment of dividends, and in a nexus test based on the presence of intangible assets in a state. Putting P.L. 86-272, sales-only apportionment, and lack of unitary combination together is especiallynutty.[53]

P.L. 86-272. As noted at the beginning of this section, a sensible nexus standard would be based on whether a corporation has more than a *de minimis* amount of at least one apportionment factor in a state, plus the existence of non-*de minimis* amounts of apportionable income. By comparison, P.L. 86-272prohibits state taxation of the income of corporations whose only activity in a state is the solicitation of sales of tangible personal property; this is true even if the state employs sales as an apportionment factor and no matter how great the firm's sales in the state. This implies that if a firm falls within the safe harbor of P.L. 86-272 a state is precluded from taxing the profits that its formula (and the formula used by the state of origin of the sales) would apportion to it.[54] P.L. 86-272 should be replaced with the nexus standard stated above, but only if there is enough simplification — which implies substantial uniformity across states — that complexity would be dramatically reduced.

The business/nonbusiness income distinction. States distinguish between business income, which is apportionable, and nonbusiness income, which is allocated to a specific state, commonly the state of commercial domicile. The distinction is generally based on UDITPA, which provides (section 1(a):

> "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible or intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

UDITPA further provides (section 1(a): "'Nonbusiness income' means all income other than business income."

Hellerstein (2001) has written cogently of this distinction:

> The law pertaining to the business-nonbusiness income distinction is a mess. Courts have divided over the question whether the distinction contains a single transactional test or both a transactional and a functional test; they have divided over the meaning of the functional test; and they have divided over the proper

> treatment of the same transaction. The causes of this disarray in the law governing the business-nonbusiness income distinction are twofold. First, the provision at the source of the controversy — the business income definition of the Uniform Division of Income for Tax Purposes Act (UDITPA) — is hardly a model of draftsmanship.[55] Second, and more importantly, there is no clear policy objective underlying the business-nonbusiness income distinction, apart from the constitutional limits on apportionability. . . . Because courts have no underlying normative principle to guide their decision making, their opinions have led to widely— some might say wildly — different conclusions.

The result is, of course, the potential for both over taxation and under taxation — the latter possibility heightened by tax planning. If this distinction is to be retained, perhaps it should, as Hellerstein and others have argued, be based simply on whether income is constitutionally apportionable; only income that cannot be apportioned would be allocated.[56]

Inconsistent apportionment formulas. In a mutually consistent system of state corporate income taxes all states would use the same apportionment formula.[57] In fact, the states differ dramatically in the apportionment formulas they use. Moreover, even if two states use ostensibly identical apportionment formulas, there may be gaps and overlaps in their tax bases because they may not define apportionment factors identically (and, of course, there may be other differences). For example, although sales are commonly attributed to the state of destination, most states — but not all — effectively attribute sales of intangibles to the state of origin.[58]

"Sales-only" apportionment. There has been a recent trend for states using the traditional equally weighted three-factor apportionment formula to reduce the weight on payroll and property and increase the weight on sales. Only 12 states still use the equally weighted three-factor formula that was long the standard; 24 double-weight sales, 7 use the sales-only formula, and 3 accord sales a weight between 50 and 100 percent.[59] Given that the majority of income tax states used the equally weighted formula for many years, one might reasonably ask why this shift in weights is occurring?

It would be ludicrous, at best, to suggest that the sales-only apportionment formula reflects where income originates better then the three-factor formula.[60] Does anyone seriously believe that only sales — which are determined on a destination-basis— accurately reflects where income is earned in the oil industry? Would that have been equally true during the energy crisis, when oil companies were making above-normal profits? Should a firm attribute no more income to a state where it has oil wells and refineries than to other states where it has the same amount of sales?[61] If Washington had an income tax, would Boeing's or Microsoft's sales in Washington accurately reflect the fraction of income those companies earn in that state? The suggestion is nutty, whether applied to these or to other industries. If only sales are used to apportion income, taxation is not likely to be rationally related to where income originates.

The shift to sales-only apportionment is probably best attributed to an economic development objective. If a formula is used to apportion profits of a multistate enterprise

among the states where it operates, the state corporate income tax becomes, in effect, a tax on the apportionment factors in the formula (with an effective tax rate that depends on the corporation's nationwide profitability relative to the various factors, as well as the statutory tax rate), not a tax on income truly originating in the state.[62] Thus the shift from the three-factor formula to sales-only apportionment has the effect of converting the corporate income tax from a tax on payroll, property, and sales to a tax on only sales. Because the payroll and property factors reflect the origin of sales and the sales factor reflects the destination of sales, the shift to sales-only apportionment serves the economic development objective of shifting from reliance on origin-based taxation to reliance on destination-based taxation.

It is difficult to gainsay the objective of moving from origin based taxation to destination-based taxation; after all, Section II defended destination-based taxation as being more consistent with the benefit principle and less likely to distort the location of economic activity. But achieving destination-based taxation by changing the apportionment formula is a bizarre (nutty?) way of achieving this worthy objective. Moreover, it appears that sales-only apportionment violates international tradeagreements.[63] It would be far simpler, as well as more direct, transparent, and honest, simply to repeal the corporate income tax and raise the sales tax (or impose one anew). (One would hope, of course, that the sales tax has been reformed as suggested in Section III.)

If only sales are used to apportion income,taxation is not likely to be rationally relatedto where income originates.

Failure to combine unitary businesses. Many states use unitary combination to determine the income of entities they tax that are part of larger corporate groups. But a larger number employ separate company reporting, thus respecting the legal distinction between corporations for tax purposes.[64] Failure to require unitary combination is an open invitation to tax avoidance.[65] (Or — to the extent transfer prices are misstated — is it tax evasion?[66]) The advent of electronic commerce exacerbates the potential problems of economic interdependence and manipulation of transfer prices.[67] Moreover, if some states employ combination and some do not, the result is almost certain to be inequities and distortions, as well as complexity, even if there is no manipulation of transfer prices.

Diverse definitions of a "unitary business." Even those states that do provide for unitary combination — either by allowing it or requiring it — do not all employ the same definition of a unitary business. The U.S. Supreme Court has condoned this state of affairs, by stating (in *Container*, 463 U.S.159, 167 (1983)), " . . . the unitary business . . . is not . . .unitary: there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach." As with other elements of non-uniformity, this creates complexity, as well as inequities and distortions.

States should not tax dividends received by corporations.

Taxation of dividends. For the most part, the states followthe federal definition of income. To the extent that they do not, complexity occurs (and probably also distortions

and inequities); this is not discussed here, for the most part. But the tax treatment of dividends deserves consideration.[68]

States should not tax dividends received by corporations. The ostensible purpose of the corporate income tax is to tax income in the state where it originates. But the corporate income from which dividends are paid has already been subject to tax of the jurisdiction where it is earned (unless, of course, it is exempt or earned in jurisdictions that have no income tax). It should not be taxed again. The federal government recognizes this principle; it does not tax most dividends received from domestic subsidiaries. It taxes income from foreign subsidiaries,but allows a credit for foreign taxes paid, up to the amount of the domestic tax on the foreign-source income that is distributed — which produces a result that is generally similar to exemption.[69]

In states that employ unitary combination, dividends flowing between domestic affiliates engaged in a unitary business are eliminated from the calculation of profits. Most other dividends, including those received from foreign corporations, are taxed. Some dividends are attributed to the state of commercial domicile of the parent, but some states attempt to include dividends in the apportionable income of the parent. Whether they are constitutionally allowed to do this depends on whether the payer and payee corporations are engaged in a unitary business.[70] States that include dividends in apportionable income generally do not adjust their apportionment formulas to reflect the apportionment factors of the payer corporation. The varieties of ways dividends are taxed creates complexity, as well as inequities and economic distortions.

Geoffrey. States that do not provide for unitary combination are vulnerable to the manipulation of transfer prices to shift income out of their tax bases. This is especially problematical in the case of intangible assets, which are often the "crown jewels" of modern corporations.[71] Because there are generally no transactions with independent parties, there are no "comparable uncontrolled prices" against which to judge transfer prices for intangibles.

The Supreme Court of South Carolina upheld — and the U.S. Supreme Court refused to review — a decision that condoned the use of a novel theory of nexus: that the in-state presence of intangible assets creates nexus for income tax purposes. (The protection of P.L. 86-272 is limited to those who sell only tangible products.) Since then other states have asserted "*Geoffrey* nexus," but have not always been successful when challenged in court.

The result reached in *Geoffrey* may not be unreasonable, but the approach used to get there is nutty on several counts.[72] First, it seems ridiculous to apply different nexus standards for sellers of tangible and intangible products, and especially to provide greater nexus protection for sellers of tangible products than for sellers of intangible products. (While it might reasonably be argued that those selling intangible products may not know the location of their customers, the same cannot be said of those selling tangible products.) Second, to base nexus on the in-state presence of intangibles makes no sense

because intangibles often have no location.[73] Third, adoption of unitary combination would have made — and would make — assertion of *Geoffrey* nexus unnecessary.[74]

Exponential nuttiness: Putting P.L. 86-272, "sales-only" apportionment, and separate accounting together. Putting separate reporting, P.L. 86-272, and sales-only apportionment together is really nutty.[75] Consider first the simple case of a single firm that has substantial income.[76] Because of the interaction of P.L. 86-272 and sales-only apportionment, such a firm could have little or no tax liability in the state if it had either:

- substantial sales in the state but no physical presence(that is, no nexus) or
- a substantial physical and economic presence in a state, as indicated by payroll and property (and thus nexus), but minimal sales.

Both of these results are clearly nutty because a logical system of nexus and apportionment would attribute a substantial amount of income to the state.

Suppose now that the state allowed separate company reporting to be used for each legally separate entity. Under this regime the group could avoid paying taxes by lodging sales in affiliates that lack nexus. (Note that this ploy does not require the manipulation of transfer prices — only the separation of nexus and sales.) If the taxing state required unitary combination, this technique would not affect the group's tax liability.

C. ANOTHER DIGRESSION ON TAX EXPORTING

State corporate income taxes are no more likely to be exported in the long run than are sales taxes on business inputs. Because the former are, in effect, taxes on the factors in the apportionment formula, they can be expected to have roughly the same incidence as a set of taxes levied directly on thosefactors.[77] (The incidence would not be exactly the same because the effective tax rate depends on the nationwide profitability of the corporation, relative to the various factors. Taxes that are, in effect, high because profitability is high are less likely to be shifted than are taxes that are low.) Again, standard economic analysis suggests that neither the part of the corporate income tax that is related to sales to local businesses producing for outside markets nor the parts related to payroll and property can be exported to out-of-state consumers because of competition from out-of-state producers. (The part related to sales to local consumers would be borne by those consumers.) The part that is related to payrolls is likely to be borne by workers. The parts that are related to property and to sales to local businesses producing for outside markets would, all else equal, make the state an unattractive place to invest, and are thus likely to be borne by workers and perhaps owners of land. Again, expecting the tax to be exported may be good politics, but it is nutty economics. The dramatic recent shift to the sales-only apportionment formula suggests that policymakers are learning this lesson. If only they could see that the corporate income tax based on the sales-only apportionment formula is a nutty way to levy a sales tax!

D. YET ANOTHER DIGRESSION ON TAX INCIDENCE

The reader may be wondering why I assert that the incidence of a state corporation income tax is similar to that of a tax on the apportionment factors, when the conventional textbook analysis says that profits taxes reduce profits. There are several parts of the answer, some of which are not particularly relevant for current purposes. First, the conventional analysis is for a tax on economic profits, whereas the typical income tax applies to the return to equity investment, as well as to economic profits. Second, while even a tax on the return to equity capital may be borne by the owners of that capital in the short run, this is not likely in the long run. Because the return to equity capital constitutes a cost, a tax on it is more likely to be shifted. Third, and of greater relevance for the current discussion, we are dealing here — if only implicitly up to now — with a tax that is imposed by a single state, not by the states acting in concert. A tax levied by one state is likely to have effects that are very different from those of a nationwide tax.[78] Because investors have the option of investing outside the taxing state in order to avoid the tax, they are likely to continue investing in the state only if they can shift the tax.

Tax Taxes in other states should be of no more consequence than any other cost in other states.

In this analysis, it makes no difference that other states may have taxes that are as high as (or higher than) those under consideration; from the viewpoint of policymakers in the state in question taxes in other states should be of no more consequence than any other cost in other states over which they have no control, such as the weather. All things equal (including whatever taxes exist in other states), economic analysis says that taxes will have the effects indicated.

The recent shift of apportionment formulas described earlier suggests that this lesson is not lost on state policymakers. Lawmakers apparently recognize that they can improve the economic attractiveness of their state by shifting weight toward the sales factor, regardless of the weights used in other states. Similarly, in reacting to changes in apportionment factors made by states that compete with them for investments, they are implicitly acknowledging a belief that the unilateral actions of other states can be effective in attracting economic activity —and that they can act unilaterally to counteract that impact.[79]

The same reasoning is applicable to the effects of taxing business inputs under the sales tax. A state can improve its competitive position by exempting business inputs, whether or not other states tax business inputs.

E. CAN A STATE 'GO IT ALONE' IN FIXING ITS INCOME TAX?

As in the case of the sales tax, states could unilaterally overcome some of the defects of the state corporate income taxes. Perhaps most significantly, they could replace revenues from the corporate income tax with sales tax revenues. They could also adopt unitary combination and could thus avoid the need to assert *Geoffrey* nexus or to tax domestic

dividends. (They could also cease taxing foreign-source dividends, but are not likely to do so because of the loss of revenue.) They could revert to the three-factor apportionment formula, but are unlikely to do so unilaterally because of economic development concerns.

Tax incentives can also be interpreted as rational responses to the nuttiness of tax policy.

Only by acting together could the states eliminate the inconsistencies in their apportionment formulas and their definitions of a unitary business. They cannot repeal P.L. 86-272, whether acting individually or in concert. Indeed, unlike the *Quill* decision, not even the U.S. Supreme Court can override this statute, which the Congress enacted pursuant to the Commerce Clause. One might hope that substantial uniformity of state corporate income taxes could be achieved and, if it were, that Congress would approve a more rational nexus standard.[80]

V. TAX INCENTIVES: LOOKING FOR LOVE IN ALL THE WRONG PLACES

States provide a number of tax incentives in an attempt to attract economic activity. Some have criticized tax incentives as, *inter alia*, undermining the revenue of the states, failing to achieve their intended objectives, distorting the allocation of resources, and unconstitutionally interfering with interstate commerce.[81] While many of these criticisms are undoubtedly well-founded, tax incentives can also be interpreted as rational responses to the nuttiness of tax policy catalogued above. Even so, they are a nutty way to respond to the problem.

A. TYPES OF TAX INCENTIVES OFFERED BY STATES AND LOCALITIES

Among the forms tax incentives take are the following:[82]

- reductions in property taxes on business property;
- selective reductions in sales tax on business purchases;
- reductions in corporate income tax, via sales only apportionment; and
- incentives intended to attract generators of sales tax revenue (for example, regional shopping malls) to local jurisdictions.

B. THE TAXES BEING REDUCED DO NOT MAKE SENSE

The tax incentives identified above are consistent with the view that much in the present tax policy of state and local governments makes no sense:

- Business property should not bear more taxes than justified by the benefits of public services.
- Business inputs should not be subject to sales tax.
- States should not levy corporate income taxes.
- States should not levy origin-based income taxes.

- Assignment of sales taxes to local government is problematical.

C. TAXES THAT MAKE SENSE ARE NOT BEING REDUCED

By comparison, incentives are generally not being used to reduce taxes that do make sense:

- sales taxes on sales to consumers[83] and
- personal income taxes (except top progressive rates, which make little sense for state governments).

VI. CONCLUDING REMARKS

The message of sections III and IV is that there is much about the sales taxes and corporate income taxes imposed to finance state and local government that is nutty. The tax incentives mentioned in Section V provide evidence that policymakers are finally recognizing some of the adverse economic effects of nutty tax policy and are taking steps to reduce or eliminate these adverse effects. But the response to nutty tax policy is also nutty; it amounts to treating the symptoms, instead of the disease. Rather than eliminating the nuttiness directly, via fundamental reform that would move the systems closer to the conceptual ideal, state and local governments are adopting ad hoc measures that merely modify the deeply flawed systems. As John Mikesell (2001) has written concerning targeted sales tax exemptions for certain business purchases,"[R]ather than applaud these targeted exemptions we should recognize them as an index of the basic failure of the state's sales tax system and an indicator of how badly the state requires a fundamental restructuring of its tax."

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[1] Over the years I have harped on many of the issues addressed in this paper; *see* the references provided. Listening to a panel on "Forms of State Taxation Within the United States" at the 55th Congress of the International Fiscal Association, held in San Francisco on October 3, 2001 — and witnessing the incredulity of foreign members of the audience — I was struck by the pervasive nuttiness of state and local tax policy.

[2] For a more general statement of the proposition that the theory and practice of tax assignment change with the times, *see* M^{c}Lure (2001a).

[3] For example, the value added taxes that members of the European Union(EU) began to impose in the late 1960s are substantially more sensible than the retail sales taxes (RSTs) that the states began to impose in the 1930s. The VAT was chosen with the express intent of avoiding the distortions that had characterized the turnover taxes they replaced — distortions not unlike some that characterize the state sales taxes — whereas the RSTs "just growed." The VAT did not exist when the states first began to impose the RST; *See* M^{c}Lure (2002a).

[4] In a long and thoughtful letter commenting on an earlier draft of this paper— which I tried unsuccessfully to convince him to publish simultaneously as a counterpoint — Michael Mazerov has reacted strongly to much of what I say here. The current version reflects some of his comments. Without trying to reflect Mazerov's viewpoint adequately, and accepting full blame for any inaccuracies, I would note the following additional comments that fall under the general heading of the political economy of tax reform:

- The tone of the paper will undermine efforts to motivate state policymakers to improve the system.
- In a democratic, federalist system, state policymakers might legitimately trade the economist's standard of economic efficiency for a political standard of equity.
- The paper fails to acknowledge the political reality facing policymakers, including;
  - The persuasive power of those who want less government and lower taxes;
  - The power of lobbyists bent on creating and protecting preferential tax treatment; and
  - The likely political reaction to a massive shift in tax burdens from business to households implied by a sales tax exemption for business inputs or elimination of state corporate income taxes.

• The paper does not acknowledge the enormous practical and political obstacles to developing and implementing uniform tax policies, including: – State budgetary restraints; and
– Business opposition to recommendations for greater uniformity.

[5] For a more complete exposition of the theory of tax assignment and references to other literature, *see* McLure (2000a).

My response, aside from generally agreeing that the points are well-taken, is simple: that reform would be difficult does not change the fact that the system is nutty, and not only in ways I have described. I leave it to others to examine the political economy explanations of why it is nutty, and likely to stay that way.

[6] The use of benefit taxation should also be sought at the national level. But the national government may also be assigned a role in income redistribution— a role that is not ordinarily assigned to subnational governments — that requires the use of taxes not related to benefits.

[7] Even the most carefully designed motor fuel taxes are inadequate for this task, even if we leave aside the problem of charging for congestion and pollution, because damage to roads and highways increases with weight more rapidly than with fuel consumption and the type of road. License taxes for trucks that are based on weight are also inadequate; unless the tax depends on the number of miles a truck travels (and on what type of road). Finally, fuel consumption may not be closely related to congestion, and consumption of a given amount of gasoline and of diesel fuel causes different amounts of damage to the environment. *See* Newbery (2002). Beneficiaries may also pay taxes for the provision of local services such as water, sewerage, and garbage collection. If such payments, whether called taxes or fees, do not depend on the actual amount of service used, they lack an essential characteristic of benefit taxes. Finally, in theory Social Security benefits could be linked directly to contributions, as are benefits in private defined-contribution pension schemes. In fact the relationship between benefits and contributions is commonly so weak that contributions are appropriately characterized as taxes, but not benefit taxes.

[8] Oakland and Testa (2000) reach consistent conclusions.

[9] The basic point is that most public services are provided to households, not to businesses. (Oakland and Testa, 1996, estimate that more than 86 percent of state and local expenditures are for services provided to households.) Beyond that, there is no reason to think that businesses require more public services because they purchase inputs, instead of producing the inputs themselves. Corporate income taxes are not likely to reflect benefits of public services because services are not provided only to businesses that are organized incorporate form, they are not likely to be provided only to corporations that are profitable, and they are not likely to increase in direct proportion to profits. Pogue (1998) provides an excellent discussion of the use of business taxes to charge for the costs imposed by business. He notes that it is equally important that costs incurred on behalf of business also not exceed business taxes. The design and administration of benefit-related taxes on business is extremely difficult and complicated and is well beyond the scope of this paper. An origin-based VAT might, in principle, be a reasonable way to charge for benefits provided to business. But both transactions-based VATs (employing the credit and subtraction methods) and addition-based VATs are fraught with difficulties that cannot be adequately discussed here. Transfer-pricing problems plague the former, and the problems of measuring corporate income that are discussed in Section IV below arise under the addition method.

[10] For ease of exposition much of what follows is couched in terms of state taxes. As with the point made immediately above, most of the reasoning is equally applicable — or even more applicable — (sometimes with slight alteration) to local taxes.

[11] This implies, of course, that the "wrong" state receives revenue if, as is common, the state of employment levies income tax and the state of residence gives credit for that tax. This practice reflects the ability of state of employment to levy the tax, not principle. Of course, the choice need not be all-or-nothing; residence-based income taxes intended to reflect benefits of public services provided to residents could be combined with employment-based payroll taxes intended to reflect benefits of public services provided to workers.

[12] Pogue (1998, p. 103) writes, "Any single state will find it difficult to tax mobile businesses more heavily than other states, *unless it also provides services that are sufficiently valuable to offset its relatively high taxes*. Tax competition will thus tend to reduce interstate differences in taxes on mobile businesses *that are not matched by differences in government-provided services* (emphasis added). He adds, however (p. 105), "Tax competition will likely push business taxes below the levels required to offset external and public service costs." Wilson (1999) and Zodrow (2001) provide comprehensive reviews of the literature on the

effects of tax competition, most of which assumes explicitly that benefit taxes are not available or are not chosen. For my own thoughts on tax competition, based on personal encounter with Leviathan, *see* M^{c}Lure (1986b).

[13] In affirming relevant aspects of this decision in *Quill* (504 U.S. 298,1992), the Court relied heavily on considerations of *stare decisis*, noting that a large and important industry had been built on the basis of the physical presence rule.

[14] Reflecting institutional and political realities in the United States, I consider only independent but coordinated state legislation and administration as means of reducing costs of compliance and administration. Another method of coordination that maintains the all-important ability of states (and localities) to choose tax rates involves state (local) surcharges levied on the state (local) share of the federal (state) tax base. Surcharges are most efficiently administered by the higher-level government. Moreover, it is virtually axiomatic that the tax bases of the federal (state) and state (local) governments should be virtually the same. Although surcharges are widely used for local income and sales taxes in the United States and for provincial income taxes in Canada, they cannot be employed for state sales taxes because of the lack of a federal sales tax. Moreover, a state surcharge on the federal income tax does not seem to be in the cards for the foreseeable future. Legislation enacted in 1976 that would have provided federal collection of state taxes was repealed because no state had taken advantage of it. Surcharges are to be distinguished from tax sharing, in which subnational governments merely receive a share of revenues collected from a tax levied by a higher level of government. Unlike surcharges, tax sharing allows no subnational autonomy over tax rates. The federal government of Australia shares VAT revenues with the states and Canada shares VAT revenues with three provinces.

[15] The Constitution explicitly forbids state imposition of import and export duties. However, due to the narrow but economically sensible construction that the U.S. Supreme Court has given the clause — effectively applying it only to taxes that discriminate against foreign imports or exports based on their country of origin or destination, *Michelin Tire Corp. v. Wages*, 423 U.S. 276 (1976) —the Import-Export Clause plays only a limited role in restraining state taxes. For a general discussion of these and other constitutional limitations on state taxation, *see* Hellerstein and Hellerstein (1998).

[16] It is important that in *Quill* the Court based its decision on the Commerce Clause, instead of the Due Process Clause. (The Court had not clearly indicated the precise constitutional basis of its decision in *National Bellas Hess*.) While the Congress has the constitutional power to regulate interstate commerce, and thus to overturn *Quill*, it does not have the power to authorize the states to deny due process. This may help explain state inaction; before *Quill*, it was not clear that Congress could legally overturn the physical presence test, even if the states simplified their sales taxes.

[17] *See* Mazerov (2001b).

[18] Because I have explained these propositions at length elsewhere, they are only stated here. *See* M^{c}Lure (1998a), (1998b), and (2000d). General statements of principle are stated in terms of "sales" taxation, ignoring the difference between sales and use taxes. (In the United States, sales taxes are levied only on sales actually made in the taxing state. Use taxes are levied on the "use" of taxed products purchased elsewhere and brought into the state. They are the legal liability of the purchaser, but a state can require a vendor to collect such taxes if the vendor has constitutional nexus with the state.) This distinction is respected in discussing actual and potential arrangements where necessary for clarity; meaning should ordinarily be clear from context.

[19] Mikesell (1998, p. 21) reaches the same conclusions regarding sales to households and to businesses: Seeing the sales tax as a uniform tax on household consumption provides a clear general template for sales tax structure. Household consumption purchases ought to be taxed, regardless of who the seller or purchaser is and regardless of the nature of the purchase; purchases of business inputs ought to be exempt, regardless of seller or purchaser and regardless of the nature of that purchase. In succeeding pages Mikesell explains the rationale for these rules and acknowledges the difficulty of taxing some services.

[20] One might reasonably make an exception for products easily diverted to personal use, such as restaurant meals, entertainment, and automobiles. It would be possible to utilize a system in which all sales of many "dual use" products such as computers are initially subject to tax, requiring the buyer to submit a claim for a refund of tax on purchases made for business purposes. This is, in essence the technique that underlies the credit-method VAT. Audits would be subject to the same uncertainty as federal income tax deductions for similar expenditures.

[21] Some may wonder why I stress economic neutrality, rather than "optimal taxation." For some of the reasons, *see* Slemrod (1990). Others may complain that such a tax would be regressive (that is, that it

would take a smaller percentage of a household's income, the greater its income). This concern should be addressed by a progressive federal income tax and transfer payments, not by sales tax exemptions, which are a blunt instrument for achieving income distribution objectives.

[22] By this, I mean "sales to customers located in a state." I am not concerned with such legal niceties as where the sale is deemed to occur, for example, where passage of title occurs.

[23] For the author's proposal, *see* M^{c}Lure (2000c).

[24] Uniformity is also required in numerous details that cannot be noted here, such as the treatment of bad debts, whether to include shipping and handling in the tax base, and conventions on rounding; *see* the proposals of the Streamlined Sales Tax Project, available at http://www.geocities.com/streamlined2000/.

[25] Whether the sales prong of the nexus test should be based on taxable sales, rather than total sales, deserves further consideration.

[26] It might be more sensible not to have a physical presence test. The word "substantial" invites uncertainty and litigation. If sales are not significant, not much revenue would be involved, whether or not the vendor has a physical presence in the state.

[27] A "turnover" tax that applied to all sales, including those for resale, would be simpler, but would badly distort decisions on production and distribution. The EU switched to the VAT in part to avoid these distortions.

[28] Unhealthy competition for cross-border shoppers can be distinguished from healthy competition for economic activity by the exporting of the tax to nonresidents of the taxing jurisdiction that occurs in the former case.

[29] *See* Varian (1999) and, for a different view, M^{c}Lure (2000d).

[30] For further description of these problems and references to other literature, *see* M^{c}Lure (1998a), (1998b), (2000c), and (2001c).

[31] Many observe that taxation of purchases of business inputs by service providers partly offsets the failure to tax services. This is true, but, (a) business inputs are a relatively small cost of providing most consumer services and (b)to the extent business services (for example, legal and accounting expenses)are taxed in this indirect way, the tax constitutes an unjustified cost.

[32] *See* Mikesell (2001) for a useful description of this aspect of the problem. Ring (1999) estimates that as much as 20 to 70 percent of sales tax revenues in various states comes from sales that are not made to households.

[33] Due and Mikesell (1994) describe interstate differences in tax bases. Cline and Neubig (2000) describe horror stories involving interstate differences. Sales tax holidays (temporary exemption of school supplies and selected items of children's clothing just prior to the start of the school year) are particularly nutty complications. M^{c}Lure (2001c) calls the current system a "Great Swamp."

[34] For further discussion, *see* M^{c}Lure (2000d).

[35] *See* the proposals of the Streamlined Sales Tax Project athttp://www.geocities.com/streamlined2000/.

[36] Enrich (1996) bemoans the "race to the bottom" in the somewhat different context of state tax incentives. *See also* Section V below.

[37] To see this, consider the analogous situation under the income tax. Few would argue that not all reasonable costs of business should be deductible.

[38] Like the equally nutty view, "If consumers are going to pay tax, business should pay tax, too."

[39] For a demonstration of this proposition, *see* M^{c}Lure (1981a). Note that domination of the market is necessary for tax exporting, but it is not sufficient; conditions of supply (the structure of costs) and demand also matter. If supply is inelastic or demand for the product is elastic, tax exporting will not occur, even if the state dominates the market. Taxes on business inputs may be exported to nonresident owners of corporate shares in the short run. In the long run because such taxes cannot be shifted and suppliers of capital will seek a higher return elsewhere, they are likely to divert economic activity to other states and/or depress wages and land values in the taxing state. One possible exception to the general rule involves long-term contracts that provide pass through of increases in costs, such as some coal contracts with generators of electricity.

[40] From the Project Mission; *see* http://www.geocities.com/streamlined2000/oprules.html.

[41] The National Governors' Association (NGA), in a description of "The Issue," available at http://www.nga.org/ nga/lobby-Issues/1,1169,D_1232,00.html, has explained, "the Governors adopted a policy to express their willingness to simplify their sales taxes with the expectation that, in exchange, the federal government would provide these states with the authority to require larger remote sellers, including

Internet vendors, to collect this sales tax for the states." *See also* NGA Policy StatementEC-12, available at : http://www.nga.org/nga/legislative-Update/1,1169,C_POLICY_POSITION^D_489,00.html.

[42] A map showing these breakdowns is available at http://www.nga.org/nga/salestax/1,1169,,00.html.

[43] As before, this list is not intended to be complete; *see also* note 24. Many of the reforms that are required to simplify the system are included in the SSTP proposals. *See* M^{c}Lure (2002b) for an early appraisal of the draft legislation and Rosen and Haffield (2001) for a more recent analysis.

[44] Actually the nuttiness of corporate income taxes goes well beyond violation of the tenets of tax assignment; these taxes make no sense even if levied by a national government, except (a) to "backstop" the individual income tax — by preventing the use of the corporate form to avoid paying taxes until income is distributed — and (b) to gain revenue that might otherwise go to the government of a foreign country where a multinational corporation is headquartered. *See also* M^{c}Lure (1975). Being much higher, the federal income tax is far more important than the state income tax as a backstop. During the past 50 years, the relation between the top federal tax rates on individual income and on corporate income has varied from 94:40 to near equality. Thus the corporate tax has been inadequate to backstop even the federal income tax during much of that period. Thus other provisions, such as those pertaining to personal holding companies and undistributed corporate profits, have been enacted.

[45] This section draws on ideas presented in greater detail in M^{c}Lure (2000b). It may be appropriate to warn the reader against what Michael Mazerov calls whiplash from reading the following: that states should not impose corporate income taxes; but if they do, they should follow certain principles, rather than letting the tax be gutted by enactment of nutty provisions; but if they follow these principles taxes may be computed to zero, which is where they belong. I find this an intellectually (and morally) respectable position, and (as I am sure Mazerov would agree) far better than favoring enactment of bad (nutty) policies as a way to get rid of bad taxes. Brunori (2002) advocates simply repealing state corporate income taxes, which he favors in principle, largely because they do not yield enough revenue to justify the administrative and compliance costs they entail. In a similar vein, Pomp has written (1998, p. 67), "If only we had known at the beginning of this century what we know now, perhaps the states would never have taken on the administration of a corporate income tax."

[46] I do not address the question of whether all income should be apportionable and the contours of the distinction between apportionable and allocable income, if that distinction is to be drawn, as these are issues about which I have not thought adequately. I am inclined to believe, however, that such a distinction has little merit. *See also* the discussion of business and nonbusiness income below.

[47] On the historical development of the state corporate income tax, including the evolution of formula apportionment, *see* Hellerstein and Hellerstein(1998), chapter 8, and Weiner (1992).

[48] Pomp (1998, p. 55) writes: "For a state corporate income tax to work properly, uniformity is essential . . . ."

[49] *See generally* Hellerstein and Hellerstein (1998).

[50] *See* Hellerstein (1988). Essentially, the "internal consistency" doctrine requires that a tax be such that, if implemented by every state, it would not bear more heavily on interstate than on intrastate enterprises.

[51] *Container*, 463 U.S. 159, 169 (1983).

[52] It is interesting to contrast this situation with current proposals for harmonization of corporate income taxes in the European Union. To get around the requirement for unanimity in tax matters found in the EU Treaty, a Member's adoption of whatever proposal is eventually put forward may be made optional. But it is generally (if implicitly) assumed that all members adopting the proposal would employ the same system to apportion income among the members. One of the leading proposals would also have a common definition of the tax base. The other — which I think is unlikely to be adopted— would utilize the definition of income in the country where the parent of the corporate group is resident. *See* Commission of the European Union (2001a) and (2001b).

[53] For a more detailed discussion of some of the issues discussed in this section, *see* Mazerov (2001a).

[54] In the situation just described the state where sales originate may use a "throwback" rule to apportion the income in question to itself. While such a rule may prevent the income from becoming "nowhere income," this is not a sensible solution to the problem. Moreover, 20 states do not have throwback rules. "Through-around," which is implicit in omitting *de minimis* amounts off actors from the denominators of apportionment factors, is more sensible.

[55] McIntyre, Mines, and Pomp (2001, p. 727) write in a similar vein: "Tax professionals fully understand . . . that the UDITPA definition of business income is not an exemplar of clarity and therefore has failed as an instrument of uniformity. It currently is an instrument of complexity, confusion, and wasteful

litigation." They explain this particular bit of nuttiness by noting that UDITPA merely codified existing practices. Whereas the distinction between business and nonbusiness income now offers opportunities for tax planning because some important states of commercial domicile do not tax much of the income that is allocated to them, it did not when UDITPA was adopted, becausesuch income ordinarily was taxed.

[56] *See* Hellerstein (2001) and McIntyre, Mines, and Pomp (2001).

[57] Pomp (1998, p. 55) writes: " . . . agreement on the apportionment formula is a key ingredient in attaining . . . uniformity."

[58] For further discussion of the treatment of intangibles, *see* Brownell(1997).

[59] These figures are from Mazerov (2001a), which contains qualifications to the descriptions for some states.

[60] Many years ago the U.S. Supreme Court suggested that income "may be defined as the gain derived from capital, from labor, or from both combined." *Eisner v. Macomber*, 252 U.S. 189, 207 (1920) (quoting *Doyle v. Mitchell Bros Co.*, 247 U.S. 179, 185 (1918) and *Stratton's Independence Ltd. v. Howbert*, 231 U.S. 399, 415 (1913)). While this statement is now regarded as an unduly narrow view of income, the notion that capital and labor should be entirely ignored in determining the sources of income is absurd on its face. Those who advocate state imposition of corporate income taxes on benefit grounds would presumably also find ludicrous the suggestion that corporations enjoy no public services where their employees and facilities are located.

[61] Munnell (1992), M^{c}Lure (1989), and Weiner (1996) have all opined that income in this industry is earned where the oil comes out of the ground.

[62] M^{c}Lure (1980) demonstrates this.

[63] *See* M^{c}Lure and Hellerstein (2002).

[64] No state uses geographic separate accounting to attribute income to a jurisdiction on a geographic basis without regard to formulary apportionment, except in unusual circumstances.

[65] Pomp (1998, p. 62) observes, "A state that does not require related corporations conducting a unitary business to file a combined report is at the mercy of its corporate taxpayers."

[66] It is useful to quote several authorities on the difficulty of implementing separate accounting based on the arm's length principle in the international sphere, which is arguably easier than for domestic transactions. More than a decade ago Ronald Pearlman, then chief of staff of the Joint Committee on Taxation of the U.S. Congress and former assistant secretary of the Treasury for Tax Policy said, "it is beyond my comprehension that section 482 is going to be administrable in the long run . . . . I just don't see how arm's length principles are going to be a viable way of apportioning income internationally . . . " (Pearlman, 1990, p. 284) Vito Tanzi, then head of the Fiscal Affairs department of the International Monetary Fund expressed similar views five years later: The arm's length criterion for establishing acceptable transfer prices has often proved ambiguous or not very helpful. It may not be too far-fetched to predict that in a technologically evolving world, the allocation of income by the use of transfer prices may be subject to increasing challenges and may thus become progressively more controversial. Other allocation principles based on formulas may acquire more legitimacy than now. (Tanzi, 1995, p. 139)

[67] Horner and Owens (1996) state, again in the context of using separate accounting to isolate the income of one part of a multinational enterprise: The speed, frequency, and integration of exchanges over the Internet and the development of private networks within MNEs will require an innovative approach in applying a separate transaction analysis. In terms of comparability, it becomes more difficult to determine what the transaction actually is, and even greater difficulties apply to finding a third party transaction about which enough is known to conclude that it is comparable. And transactions can be hard to discover and trace, particularly those which take place in private networks. The OECD guidelines direct a functional analysis to assess comparability, but with electronic commerce and private networks, it can be difficult to know who is doing what. Transfer pricing will increase in complexity, particularly if the MNE is purposefully attempting to shift income among related parties.

[68] This discussion draws on M^{c}Lure (1986a).

[69] Since foreign-source dividends are not taxed until repatriated, the result may be even more like exemption.

[70] *See generally* Hellerstein (1993).

[71] For further discussion, *see* M^{c}Lure (1997).

[72] For background facts and an in-depth analysis of the *Geoffrey* decision, including options open to the state, *see* Cowling (1996).

[73] In finding that an intangible had physical presence in New Mexico that satisfied the *National Bellas Hess/Quill* nexus standard for use tax, the New Mexico Court of Appeals declared that, when Kmart Corp. used the trademarks of its intangible holding company "in a highly visible and commercially purposeful fashion in New Mexico, it logically follows that those [trade]marks are physically present during their period of use." *Kmart Properties Inc. v. Taxation and Revenue Department of the State of New Mexico*, No. 21,140, Nov 27, 2001 (not yet officially reported); *petition for certiorari granted* 131N.M. 564, 40 P.3d 1008 (2002). Accordingly, the court held that New Mexico had jurisdiction over the out-of-state company that owned the trademarks. (For the full text of the New Mexico Court of Appeals' decision in *Kmart Properties*, see *Doc 2001-29956 (22 original pages)* or *2001 STT 233-18*.) Leaving aside the question of whether this ruling makes sense, one must ask about the location of other intangibles, such as technical know-how.

[74] Note, however, that intangibles also create problems for the application of formula apportionment; *see* Brownell (1997) and M^{c}Lure (1997.)

[75] The nuttiness of juxtaposing two other nutty ideas — by using only sales to apportion dividend income — also deserves comment. The result would, in effect, be a tax on in-state sales that depends on the ratio of dividends to nationwide sales. *See also* M^{c}Lure (1986a).

[76] For further discussion, *see* Pomp (1998, pp. 55-59).

[77] *See* M^{c}Lure (1981b).

[78] I show this for property taxes in M^{c}Lure (1977).

[79] That lawmakers believe that the choice of apportionment factors affects the location of corporate investment does not, of course, imply that it does so. Mazerov (2001a) argues that the choice of apportionment factors has little impact on location of economic activity. *See* Edmiston and Arze (2002) for references to recent literature.

[80] In 1957 the National Conference of Commissioners of Uniform State Laws (NCCUSL) formulated the Uniform Division of Income for Tax Purposes Act (UDITPA) in an effort to bring increased uniformity to state corporate income taxation. UDITPA speaks to many of the topics discussed here, but has become increasingly inadequate. Many recognize that it may be appropriate to review UDITPA to see whether and how it needs to be revised. A review of UDITPA is beyond the scope of this article. Of course, unless the states actually enact a model statute such as UDITPA (with few major modifications), it does not bring uniformity.

[81] For a critique of tax incentives, including comments on their effectiveness, and references, *see* Enrich (1996).

[82] This list it not intended to be complete. *See* Enrich (1996), Hellersteinand Coenen (1996), and Youngman (2001) for descriptions and analyses of tax incentives and further references.

[83] A notable exception is the use of sales tax holidays. As Cline and Neubig (2000) note, these particularly nutty provisions add incredible complexity to the system.