

The Effect of Tax Reform on State and Local Governments

The comments below, prepared by the Joint Venture Tax Policy Group, were submitted to the House Ways & Means Committee for inclusion in the printed record of their hearing held May 1, 1996 on the impact of fundamental tax reform on state and local governments and tax-exempt entities. The comments focus only on state and local government considerations and issues. The comments are intended to *list* areas for which Congress must interact with state and local legislators and tax administrators in order for effective reform of the federal tax system to occur.

Drafting

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Factors Relevant to State and Local Governments That Must Be Included in The Federal Tax Reform Debate

State and local taxes are intertwined with federal taxes in a number of ways and it would not be possible for effective federal tax reform to occur without consideration of state and local tax implications. For example, one of the key goals touted for reform of the federal tax system is simplification. However, because most state income tax systems have some basis in the federal income tax structure, if states do not or cannot conform to federal changes, the goal of simplification will not be obtained for most taxpayers. This and other concerns that we believe must be included in the federal tax reform debate are listed and briefly explained below.

State and local governments rely on various federal income tax features:

State and local governments have come to rely on a large number of features of the federal income tax system. Repeal of any of these features could adversely impact state and local governments. Also, should the federal income tax system be repealed and replaced with another type of tax, state and local governments would need some amount of lead time to be able to set up their own systems or make other adjustments. Some of the areas of state and local government reliance include:

- 1) *State income tax conformity to federal income tax.* Most states with an income tax system in place rely on the federal income tax law in defining their own rules, in drafting state tax forms, and in their use of federal reporting forms, such as W-2s and 1099s. In addition, many states rely on the results of federal income tax examinations to make adjustments to state income tax returns. A recent Joint Committee on Taxation report notes the following

conformity information from the U.S. Advisory Commission on Intergovernmental Relations:¹

States with income taxes based on federal adjusted gross income (27):

Arizona, California, Connecticut, Delaware, District of Columbia, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Missouri, Montana, Nebraska, New Mexico, New York, Ohio, Oklahoma, Oregon, Virginia, West Virginia, Wisconsin.

States with income taxes based on federal taxable income (7):

Colorado, Hawaii, Idaho, Minnesota, North Carolina, South Carolina, Utah.

States with income taxes calculated as a percentage of federal tax liability (3):

North Dakota, Rhode Island, Vermont.

States that only tax certain interest and dividends (2):

New Hampshire, Tennessee.

States that do not conform to federal income taxes (5):

Alabama, Arkansas, Mississippi, New Jersey, Pennsylvania.

States without an income tax (7):

Alaska, Florida, Nevada, South Dakota, Texas, Washington, Wyoming.

- 2) *Exclusion of interest on state and local bonds.* State and local governments have relied on the tax advantage provided for state and local bonds under the federal income tax which excludes interest from such bonds from federal income taxation.² (See further discussion later.)
- 3) *Tax benefits of home ownership.* State and local governments have relied on the federal tax benefits provided to individuals who own a principal residence, namely the home mortgage interest and property tax itemized deductions. These benefits likely affect the value of homes. Any decline to the value of homes from a change in the federal income tax rules could have a negative impact on state and local government revenues from the resulting decline in the property tax base.
- 4) *Tax benefits of charitable giving.* All levels of government derive some amount of benefit from services performed by charitable organizations. Without these organizations, governments would likely have to provide these services. A study should be conducted on the impact to each level of government from the elimination of the deduction for charitable contributions (as would occur under the consumption tax proposals³). This study should focus on whether the levels of charitable giving under the current tax rules would be adversely affected under the consumption tax proposals.
- 5) *Consumption taxes are the domain of state and local governments.* State and local sales and use taxes are the major consumption taxes in the U.S. today. In 1994, such taxes represented

¹Joint Committee on Taxation, *Selected Materials Relating to the Federal Tax System Under Present Law and Various Alternative Tax Systems*, (JCS-1-96), March 14, 1996, page 82.

² The exclusion for interest on state and local bonds has been part of the federal income tax law from the beginning, having been enacted as part of the Revenue Act of 1913.

³ Only the USA tax proposal continues the charitable contribution deduction, but only for individuals; S. 722, 104th Congress, 1st Session, §8 and §11.

33% of the state government tax collections for the 50 states combined.⁴ A benefit to state and local governments of relying to some extent on a consumption tax is that it can offset the inability to use the income tax as the sole revenue source (this is particularly important when federal income tax rates are high). A change from an income tax to a consumption tax at the federal level would limit revenue choices for state and local governments.

State and local government financing concerns:

State and local governments could be financially impacted by federal tax reform in the following ways.

- 1) *New costs for state and local governments.* Some of the current tax proposals will subject state and local governments (and the federal government) to new tax burdens. For example, under the Arney flat tax, governments (and tax-exempt entities) would be subject to tax at 17% (20% for the first two years) on fringe benefits provided to employees. A report by the California Franchise Tax Board concluded that the annual cost of this tax could be about \$375 million for the State of California and about \$2.2 billion for local governments in California.⁵ The Gibbons subtraction method value-added tax (VAT) proposal does not suggest any exemptions for governments.⁶ Similarly, H.R. 3039, the National Retail Sales Tax proposal, does not suggest any special exemptions for governments.⁷ State and local governments would likely have to raise taxes on their own residents and/or reduce the level of government services in order to deal with these new tax burdens.

- 2) *Government bond market.* The National League of Cities (NLC) estimates that the removal of the exemption for interest on municipal bonds could cause an increase in capital improvement and borrowing costs of up to 30%.⁸ The California Franchise Tax Board estimates that if the interest rate on municipal bonds increased by one-half of a percentage point due to removal of the federal exclusion for interest, the increased first-year debt service cost to California state and local governments would be about \$100 million.⁹ How would state and local governments deal with such an outcome? How might the federal government offer an alternative means of support for such financing?

⁴ U.S. Census Bureau, <http://www.census.gov/>, under Government data; the 33% figure excludes sales taxes collected directly by local governments. Data for 1992 show that general sales taxes represented 10.8% of tax revenues for federal, state and local governments combined and 23.6% of tax revenues for state and local governments combined. Source: U.S. Dept. of Commerce, *Statistical Abstract of the United States 1995*, 115th Ed., Table No. 475. All Governments - Detailed Finances: 1992.

⁵ California Franchise Tax Board - Economics and Statistical Research Bureau, *The Impact of the Flat Tax on California*, December 1995, pages 63-64; based on an assumed 22.9% tax rate.

⁶ "Sales of goods and services to governments would be included in the system. Governments should not be exempt from the tax for their sales of goods and services." Congressman Gibbons, *The Value-Added Tax - A Revenue System for America's Future*, March 27, 1996, page 11.

⁷ "Nothing in this subtitle shall be construed to exempt any Federal, State, or local governmental unit or political subdivision from paying any tax imposed by this subtitle on any sale, purchase, use, consumption or enjoyment by such a unit." H.R. 3039, 104th Congress, 2d Session, §3(a).

⁸ NLC, *Nation's Cities Weekly*, January 22, 1996.

⁹ FTB Report, *supra*, page 63.

While replacement of the federal income tax with a consumption tax could lead to improved savings and economic growth, further study is needed as to how this potential benefit compares to the potential increased capital costs that state and local governments could face under the consumption tax proposals.

"Ripple" impacts to state and local governments from federal tax reform:

State and local governments could also be impacted indirectly by various changes in the federal income tax law.

- 1) *Adverse effects of a proposal that is not revenue neutral.* If a new federal tax system is not revenue neutral, but instead does not raise as much revenue as the income tax, budget deficits and the national debt would increase. This can negatively impact the states by reducing the amount of federal funds provided to state and local governments and increasing interest rates for everyone.
- 2) *Impact from removal of federal incentives that benefit state and local governments.* Under most reform proposals, special deductions and credits, such as the targeted jobs tax credit and enterprise zone benefits, would be eliminated. While the direct benefits of these incentives are to taxpayers, state and local governments are indirect beneficiaries of them and could be adversely impacted by their removal.¹⁰
- 3) *Impact of removal of deduction for fringe benefits.* Under the consumption tax proposals, businesses could no longer deduct fringe benefits provided to employees. One possible reaction to this change is that businesses may eliminate or reduce the fringe benefits, such as health insurance, that they provide to workers.¹¹ If workers do not or cannot obtain their own health insurance, local governments are likely to see their health care costs, such as at county hospitals and clinics, increase.
- 4) *Impact on tax evasion from some proposed federal tax reforms.* One of the current federal proposals is to replace the federal income tax with a national retail sales tax of 15%.¹² For the 46 states and the District of Columbia that currently have sales and use taxes,¹³ adding a federal level sales tax on top of the state and local taxes would lead to combined rates of 20% or more in many states. At such a high rate, evasion is more likely and would adversely affect not only federal tax collections, but also state and local tax collections. Some tax administrators and researchers have suggested that at sales tax rates of 10% and above, evasion becomes more attractive.¹⁴

¹⁰ This potential problem has already been noted by the NLC in *Nation's Cities Weekly*, January 22, 1996.

¹¹ The Arney proposal maintains a business deduction for employee wages, but not fringe benefits. Under such a regime, businesses might be encouraged to eliminate fringe benefits, but to replace all or part of that cost with increased wages for its workers. However, unless workers can and do use the extra wage income to purchase health insurance, the impact noted here would still occur.

¹² Under the sales tax proposal, H.R. 3039, the *effective* tax rate is about 17.6% because the stated rate of 15% is applied to the tax-inclusive price for taxable property and services. H.R. 3039, *supra*, §1(a) and §21(b).

¹³ Delaware, Montana, New Hampshire and Oregon do not have a sales tax. Alaska does not have a sales tax at the state level, but it is used at the local level. Due and Mikesell, *Sales Taxation - State and Local Structure and Administration*, 2d ed., Urban Institute Press, 1994, page 3.

¹⁴ Tait, *Value Added Tax - International Practice and Problems*, International Monetary Fund, 1988, page 18. Mr. Tait suggests that at a sales tax rate of 10%, evasion is "more attractive, and at 15 - 20 percent, becomes extremely

5) *Impact of tax reform on industries that are not "winners" under reform proposals.* Tax reform will create winners and losers. That is, some taxpayers will see their tax liabilities go down while others will face increases. State and local governments that have a higher proportion of "losers" in their jurisdiction will likely suffer ripple effects of declines in business and tax collections, and possibly job losses. For example, a 1995 report by the California Franchise Tax Board noted that C corporations in all industries would face a tax increase under a flat tax (using a flat tax rate of 22.9%). The report noted that services, trade, construction and mining would fare worse under the flat tax than other industries.¹⁵

Factors affecting whether or not states can or should conform to federal changes:

The federal tax reform debate should also consider whether states can and should conform to any federal changes. If states do not or cannot conform, some of the goals touted for federal reform will not occur. For example, if states do not conform to a new federal tax system, simplification will not be achieved for most taxpayers. This scenario would certainly raise the question of whether the federal government should have even gone through the difficult and risky effort of changing its tax system. Also, if state and local governments are considering any reforms of their own tax systems, it may be more efficient and beneficial to taxpayers if the reforms at all government levels were coordinated. Some of the specific factors to consider in the area of state conformity to federal changes include the following.

- 1) *Potential double consumption tax for states.* If a state were to abolish its income/franchise tax system in response to repeal of the federal income tax and adopt a version of the new federal consumption tax in its place, most states would then have two consumption tax systems in place - the new one and the sales tax. Most of the current federal proposals call for some type of a subtraction method VAT which, in effect, is a mechanism for collecting a sales and use tax. If a state were to have a subtraction method VAT *and* a sales tax, it would have increased the regressivity of its overall tax system, have duplicative, but separate tax systems, and would have eliminated one possible form of relief, namely, exemptions and credits available through the income tax system (an income tax system also helps to identify who is a "low-income" taxpayer).
- 2) *Potential for increased regressivity of the tax system.* One benefit of an income tax at the state level is that it helps to offset the regressivity of the state's sales tax. If a state were to conform to a federal consumption tax, that benefit would be lost and a new mechanism would likely be needed at the state and local level to alleviate the regressivity of the tax system on low-income taxpayers. The likelihood of increased regressivity of the tax system and the need for a new mechanism to alleviate it could be a factor that discourages states from conforming to a new federal consumption tax. However, states that chose to maintain their income tax systems to alleviate regressivity would face obstacles, including the non-existence of information returns, such as Forms 1099 to report investment income, because they would be eliminated under a federal consumption tax.

tempting." Also see: General Accounting Office (GAO), *State Tax Officials Have Concerns About a Federal Consumption Tax*, GAO/GGD-90-50, March 1990, page 40; and Joint Economic Committee (JEC), *Consequences of Replacing Federal Taxes With a Sales Tax*, August 1995, page 8.

¹⁵ California Franchise Tax Board - Economics and Statistical Research Bureau, *The Impact of the Flat Tax on California*, December 1995, pages 59 - 60.

3) *Differing state tax mixes.* States have different tax mixes which can affect whether or not they can or should conform to a new federal tax system. This factor also means that states have differing concerns with federal tax law changes. For example, if a state currently has no income tax, its citizens will have no need to pressure the state to conform its system to a new federal tax system. Thus, in considering state government concerns in the federal tax reform debate, some state concerns must be considered at the individual state levels, not just under a broad category of concerns affecting all states similarly. The following chart illustrates how the mix of taxes can vary among states.

State government tax collections for all 50 states combined and selected states -1994

Type of tax	(in millions of dollars)							
	All 50 states ³	%	Calif.	%	New York	%	Texas	%
Property taxes	\$8,386	2.2	\$3,000	6.0	\$0	0	\$0	0
General sales tax	\$123,298	33.0	\$16,872	34.0	\$6,365	19.4	\$9,926	51.0
Selective sales tax ¹	\$62,540	16.7	\$4,594	9.2	\$5,231	15.9	\$5,941	30.5
License taxes ²	\$24,203	6.5	\$2,471	5.0	\$941	2.9	\$2,526	13.0
Individual income tax	\$117,726	31.5	\$17,548	35.3	\$16,034	48.9	\$0	0
Corporate income tax	\$25,498	6.8	\$4,633	9.3	\$3,120	9.5	\$0	0
Death and gift	\$5,042	1.4	531	1.1	\$799	2.4	\$153	0.8
Documentary & Stock transfer	\$2,539	0.7	\$0	0	\$327	1.0	\$0	0
Severance	\$4,298	1.1	\$46	0.1	\$0	0	\$919	4.7
Other	\$279	0.1	\$0	0	\$0	0	\$0	0
Total	\$373,809	100	\$49,695	100	\$32,817	100	\$19,465	100

¹ Includes alcoholic beverage, amusement, insurance premium, motor fuels, pari-mutuel, public utilities and tobacco sales taxes.

² Includes alcoholic beverage, amusement, corporation, hunting & fishing, motor vehicle, motor vehicle operators, public utility and occupation & business licenses.

³ Excludes the District of Columbia and local governments; thus, taxes that are collected at the local level, such as perhaps, property taxes, are not included in the chart.

Note: The chart does not reflect wage assessments for retirement and social insurance programs and unemployment compensation taxes.

Source: U.S. Census Bureau, <http://www.census.gov/>, under Government data.

4) *Possible pressure from taxpayers for conformity.* If the federal government were to replace the income tax system with a simpler system, individuals in states with income tax systems that conformed to the repealed federal income tax would likely put pressure on state legislators to repeal the state income tax. Because it may not be in the best interests of the state to conform, if state legislators are not able to convince taxpayers of that fact, taxpayer revolt could lead states to make difficult changes. On the other hand, if state legislators are able to convince their citizens that conformity would not be good for the state, a backlash against the federal tax law change could result when taxpayers realize that their compliance burdens have actually increased (because their federal and state filing obligations are now quite different).

The possibility that taxpayers will pressure states *not* to conform should also be considered, particularly under a plan such as the national retail sales tax where the federal government would want the states to conform and to administer the federal tax. Under H.R. 3039, the national retail sales tax proposal, a tax of 15% is levied on gross payments for the use, consumption or enjoyment of taxable property or services. Gross payments are defined as the product of the pre-tax factor and the price of the goods or services. The pre-tax factor is 1 divided by 1 less the federal rate of 15% *and* the state tax rate if it is imposed in conformity with the federal system. Under this calculation, if a state has a conforming sales tax, its citizens will pay a higher federal tax rate.¹⁶ Under these circumstances, consumers will *not* want their state to conform. This would be in opposition to what the federal government desires. These types of concerns must be addressed during the tax reform debate.

- 5) *State reliance on a diverse tax mix.* States may not find it in their best interests to conform to the extent they rely on a diverse tax mix to provide steady and predictable revenues. Property, sales and income taxes behave differently at various stages of the business cycle and under various economic conditions. This fact can be important to states in balancing state budgets on a yearly basis.
- 6) *Transition time.* States that want to conform to federal changes may need more time to get ready than the federal government needs.¹⁷ Also, due to differences in fiscal years between the federal government and most state governments, transitional periods may need special coordination in order to prevent confusion for taxpayers, possible abuses by taxpayers and needlessly complex federal-state tax reconciliations by taxpayers.

Concerns of state and local taxpayers:

- 1) *Updating of P.L. 86-272.* If the federal government replaces its income tax system with a consumption tax and all or some states conform, businesses would likely want to see P.L. 86-272 updated to include the new tax (such as a subtraction method VAT) in order to retain interstate protections provided by P.L. 86-272.

P.L. 86-272 (15 U.S.C. §381)¹⁸ enacted in 1959, provides the minimum standards that must be met in order for one state to tax the operations of a foreign (out-of-state) business. The law

¹⁶ For example, assume that H.R. 3039 is enacted and an individual purchases a \$20,000 car in a non-conforming state. The federal sales tax owed on this purchase would be $15\% \times [1 \div (1 - .15)] \times \$20,000 = \$3,529$. Now assume that the individual lives in a conforming state with a rate of 7%. The federal sales tax calculation now becomes: $15\% \times [1 \div (1 - .15 - .07)] \times \$20,000 = \$3,846$. Thus, the federal tax liability has increased by \$317 if the individual resides in a state that conforms its tax system to the federal sales tax.

¹⁷ For example, states may need more time to enact legislation, train tax personnel, change computer systems, and make a revenue estimate in order to set a tax rate. The availability of personnel and resources may not be equivalent at the state level to what it is at the federal level; and to some extent, the federal government has obtained a "head start" in the reform process.

¹⁸ 15 U.S.C. §381 Imposition of net income tax

(a) Minimum standards. No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after the date of the enactment of this Act, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

prohibits a state from taxing a foreign business's net income derived from activities within the state if the activities consist merely of solicitation of orders that are approved, filled and shipped from outside the state. This law only applies to *net income taxes* and transactions involving the sale of tangible personal property. Whether the protections of P.L. 86-272 apply to a VAT has already been tested in *Gillette Co. v. Dept. of Treasury*¹⁹ which involved Michigan's single business tax (SBT), a form of addition method VAT. The court held that because the SBT was neither a tax imposed on net income nor a tax measured by net income, P.L. 86-272 did not apply to the tax. Thus, whether Michigan could subject an out-of-state taxpayer to the SBT had to be determined under the Due Process and Commerce Clause provisions of the U.S. Constitution. Because some or all states might consider conforming to a new federal tax, revision of P.L. 86-272 should be included in the federal debate.

Any state that changes its income and franchise taxes to a VAT (assuming that is what the federal government does), might also want to revisit apportionment formulas for determining what portion of a multistate company's taxable base is taxable in a particular state. The standard 3-factor apportionment formula (sales, property, and payroll) is used in Michigan for its SBT and the constitutionality of its use has been upheld by the U.S. Supreme Court.²⁰ However, should other states also replace net income taxes with a VAT, perhaps consideration should be given to what is the best apportionment technique to determine a multistate business's taxable business activity within a particular state. Alternatively, the new federal system may warrant that states consider whether it is most appropriate to apply the system on an origin or a destination basis and how this could be coordinated with the federal system such that simplification would be attained and business income would not be double taxed by the states. Again, time would be needed for this aspect of state taxation to be analyzed, debated and implemented.

The possible need to update P.L. 86-272 and revisit apportionment and/or sourcing standards is an area that will require discussion among state and federal governments, as well as businesses, and must be included in the federal tax reform debate.

2) *Can reform alleviate both federal and state tax burdens?* Much of the federal tax reform discussions to date have focused on the complexity of the federal income tax as a reason to change it. However, federal taxes are not the sole compliance burden faced by businesses. A survey conducted by researchers at the University of Michigan in 1993 noted the following "most frequent" suggestions from respondents for simplifying compliance:

- increase uniformity between federal and state rules
- eliminate, simplify and/or change the AMT rules
- increase book-tax conformity

(1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and

(2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

¹⁹ *Gillette Co. v. Dept. of Treasury*, 497 N.W.2d 595 (Mich. App. 1993), cert denied, 115 S.Ct. 779 (1995); also see *Guardian Industries Corp. v. Dept. of Treasury*, 499 N.W.2d 349 (Mich. App. 1993).

²⁰ *Trinova Corp. v. Michigan Dept. of Treasury*, 498 U.S. 358 (1991).

- a uniform formula for apportioning state taxes²¹

The current consumption tax proposals would only alleviate the AMT compliance burden for businesses. The suggestion to increase uniformity between federal and state rules cannot be met if states are not included in the federal tax reform debate. Also, state apportionment is not part of the current debate (although tax simplification *is* part of the debate).

To best address what would truly be simplification for businesses and individuals, the debate must include whether state and local governments can or should conform to the proposed new federal tax system, what are the true compliance concerns of business and individual taxpayers and how both federal and state compliance burdens can be alleviated in one reform effort.

Can state and local tax issues be included in the federal tax reform debate?

State and local governments presently face several taxation issues, such as nexus determinations, how to collect sales and use tax on purchases made by mail order or over the Internet from non-present retailers, how to deal with eroding tax bases, and increasing pressure to offer various business tax incentives. Many of these issues stem from changes in the economy, such as expansion of the services sector and decline of the manufacturing sector. In addition, changes in ways of doing business, and the increased importance of difficult to tax items, such as services and intangible assets, have made portions of federal, state and local tax systems outdated and sometimes, ineffective. While these are complex issues and situations, consideration of how federal tax reforms can or should help state and local governments address these areas would be a beneficial addition to the debate for all parties involved.

The federal debate should also consider the flat tax proposals that some states have already proposed, such as in California (ACA 29), Arizona (SB 1407) and Iowa (HF 2492). These proposals and the reaction of taxpayers to them and how they differ from each other and from federal proposals would be an interesting addition to the federal tax reform debate.

Perhaps the federal reform process should include creation of a model state tax act that would address state tax concerns and aid states that want to conform to the new federal system. Such a model would be helpful to states in calculating what a revenue neutral rate would be for them. It would also help taxpayers to more effectively evaluate the potential impact of tax reform at the federal and state levels.²²

Federalism:

Proposals to shift tax collection responsibility raise issues of federalism and the balance of power between federal and state governments. A proposal to require the states to collect a national sales tax, for example, could shift the balance of taxation power to the individual states and lead to

²¹ As reported in JCS-1-96, *supra*, page 77, based on study by Joel Slemrod and Marsha Blumenthal, "Income Tax Compliance Cost of Big Business," Univ. of Michigan Working Paper No. 93-11, 1993.

²² Such a model need not be created by Congress; it might instead be written through a combined effort of the various organizations that presently exist that represent state and local governments. Several of these organizations are noted in the next section of this comment letter.

federal-state conflicts. Under such a system, the federal government would depend on states to remit their "national" tax revenues. What remedies would exist if a state withheld its revenues to compel the federal government to modify some federal policy, or if the federal government was not in favor of some technique used by a state in administering the tax? Conversely, if a tax reform proposal involved federal collection of state revenues, would state governments lose their independence in tax administration and adjudication matters? Similarly, would removal of the current income tax rules, in light of the fact that the majority of states rely on some portion of these rules, be equivalent to the federal government imposing its new system on the states? Again, what is the appropriate division between federal and state governments with respect to taxes?

The tax reform debate should include a study of the appropriate balance between federal, state and local governments in enacting and administering taxes, as well as the role of the judiciary. For example, where states act as collectors of a federal sales tax, in which courts should disputes be handled? The tax reform debate should involve a constitutional discussion of federalism and taxation, how to balance this issue with taxpayer desires for simplification (such as increased uniformity between federal and state rules), and how changes in the economy and the nature of business transactions that have occurred since the federal income tax was adopted in 1913²³ impact the balance of taxation matters between each level of government.

Existing Input From State and Local Tax Administrators and Legislatures

In 1990, the GAO conducted a survey of state tax administrators to gather their views on a federal consumption tax. This data should be updated and included in the debate. This study found that 81% of state policymakers opposed a federal retail sales tax and 68% opposed a VAT. Instead, most favored using existing tax systems to reduce the federal budget deficit.²⁴ Per the report:

Policymakers are concerned that a federal consumption tax could (1) limit the states' ability to raise additional revenue from state sales taxes, (2) pressure the states to alter their tax bases to conform with the federal tax base, and (3) confuse taxpayers about the distinction between state and federal consumption taxes.²⁵

In addition, the National League of Cities has adopted an action agenda dealing with federal tax reform issues. A key concern of the NLC is the lack of attention being given to local government concerns in the federal debate. The 1996 Action Agenda adopted by the NLC Board of Directors in March 1996 states that they support:

- a system based on ability to pay;
- keeping the income tax as the primary federal tax base;
- the deductibility of state and local taxes;
- keeping municipal bond interest exempt from tax;

²³ For example, our economy of today has a more global focus, as opposed to a local or national focus. Also, transactions have changed to a point where in many instances, borders are not transactionally important, such as for transactions involving the Internet and satellite transmissions.

²⁴ General Accounting Office, *Tax Policy: State Tax Officials Have Concerns About a Federal Consumption Tax*, GAO/GGD-90-50, March 21, 1990, page 31.

²⁵ GAO/GGD-90-50, *supra*, page 4.

- a federal tax system which produces sufficient revenues for ongoing government services;
- changing current rules that favor consumption over savings, rather than moving to a pure consumption tax;
- broadening the tax base; and
- "a phasing-in of any major tax changes and recognition of the interrelationship of the federal, state, and local tax systems."²⁶

Because the items on the NLC agenda are in conflict with most of the federal tax reform proposals, there is a clear need for open dialogue and debate on the difficult issues raised by federal tax reform and how they impact state and local governments.

Additionally, a report of the National Conference of State Legislatures discusses revenue and taxation issues and concerns presently faced by states. Information from this report should be useful in considering state and local tax systems and issues and how they might be hindered or helped in the process of reforming the federal tax system.²⁷

Conclusion

We encourage Congress to include the state and local government items listed above in the federal tax reform debate so that effective reform can occur for all taxpayers and all levels of governments and without unnecessary adverse impact to state and local governments.

²⁶ "1996 Action Agenda" of the National League of Cities, adopted March 9, 1996.

²⁷ *Financing State Government in the 1990s*, February 1994, ed. Snell, prepared by the staffs of the National Conference of State Legislatures, National Governors' Association, Federation of Tax Administrators, Multistate Tax Commission, and the National Association of State Budget Officers.