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Fall 1985, Vol. 11, No. 4

Intergovernmental PERSPECTIVE

SCHEDULES A&B (Form 1040)
Department of the Treasury Internal Revenue Service

Schedule A—Itemized Dec
(Schedule B is on back)
▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B

Name(s) as shown on Form 1040

Medical and Dental Expenses
(Do not include expenses reimbursed or paid by others.)

1 Prescription medicines and drugs; and insulin
2 a Doctors, dentists, nurses, hospitals, insurance premiums you paid for medical and dental care, etc.
b Transportation and lodging
c Other (list—include hearing aids, dentures, eyeglass
3 Add lines 1 through 2c, and write the total here

Taxes You Paid
6 State and local income taxes
7 Real estate taxes
8 a General sales tax (see sales tax tables in instruction booklet)
b General sales tax on motor vehicles
9 Other taxes (list—include personal property taxes) ▶
10 Add the amounts on lines 6 through 9. Write the total here. Total taxes ▶

11 a Home mo... interest you paid to financial institutions
b Home mor... interest you paid to individuals (show that person's nam... address) ▶

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TO DEDUCT OR NOT TO DEDUCT?

That is the question.

Special:
1983 RTS ESTIMATES

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(December 1985)

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Staff
John Shannon
Executive Director and Kestnbaum Fellow

Lawrence Hunter
Research Director

Robert Gleason
Director of Communications and Publications

Jane Roberts
Susannah Calkins
Co-Editors

Cover Design: Baskin and Associates

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ACIR News

Commission Approves Report on Garcia Case Implications

The U.S. Supreme Court's decision in *Garcia v. San Antonio Metropolitan Transit Authority* has prompted considerable discussion and controversy within the intergovernmental community during the past year. Although amendments to the *Fair Labor Standards Act* have been approved by the Congress to help ameliorate the fiscal impact of the Court's decision, fundamental federalism questions remain which go well-beyond the immediate fiscal and budgetary effects. Central to these concerns is whether state autonomy has been sacrificed to national expedience.

In response to *Garcia,* ACIR conducted a series of three regional hearings during the fall of 1985, and at its December meeting, approved publication of a staff information report on the implications of the decision. The staff analysis explores the broad constitutional context of *Garcia* in an effort to learn what, if anything, has gone wrong in the workings of the constitutional system with respect to the maintenance of federalism. The report concludes by discussing a range of state responses (including litigation, greater influence in the national legislative process, and resistance), as well as amending the U.S. Constitution to address such issues as explicit criteria for determining the limits of congressional power vis-a-vis the states, restructuring the national political process, and prohibitions against congressional action which displace state powers.

President Appoints Tennessee Deputy Speaker to ACIR

John T. Bragg, the Deputy Speaker of the Tennessee House of Representatives, has been appointed by President Reagan to be a member of the U.S. Advisory Commission on Intergovernmental Relations.

First elected in 1964 from the 48th House district, he has chaired the Finance, Ways and Means Committee since 1973. He is the Immediate Past President of the National Conference of State Legislatures.

Representative Bragg was appointed to a two-year term on the Commission. He is also Vice Chairman of the Tennessee Advisory Commission on Intergovernmental Relations.

A former newspaper publisher and printing executive, Bragg now serves as a full-time "part-time" Tennessee legislator. He is a graduate and distinguished alumnus of Middle Tennessee State University, and resides in Murfreesboro.

ACIR Recommends Turnback of Federal Programs and Tax Sources to States and Localities

Noting that decentralization is an enduring value in the American system of government, the Advisory Commission on Intergovernmental Relations has recommended that consideration be given to turning back selected federal government programs to states and localities, along with the tax sources to finance them.

While emphasizing that this is just one of several mechanisms for streamlining the federal system, the Commission defined a turnback package as legislation that would simultaneously repeal federal aid programs and relinquish tax bases (such as excises on alcohol, tobacco and gasoline). States would then be in a position to levy these taxes, and use the revenues to fund the programs at the state and local level.

The Commission did not recommend any specific legislation. However, included with the report are three possible ways the federal government could give serious consideration to turnbacks. Each package would return federal excise taxes to the states while the federal government recedes from a variety of programs in such areas as criminal justice, education, medical assistance, natural resources, transportation, economic development, and wastewater treatment.

In addition, the Commission adopted a national interest test that lays out criteria for assigning which programs should remain national and which should go back to the states.

The Commission further recommended that any turnback package be based on the following principles:

- The legislation should provide for an adequate transition period to allow state and local governments to adjust to the new environment of increased political decentralization.
- It should include an adequate pass-through of state funds to local governments during the transition period.
- There should be a mechanism during the transition period to facilitate any state legislative or constitutional changes necessary to adjust the political and fiscal relationship between states and their local governments.

The three turnback packages included in the information report involve $10 billion, $18 billion, and $21 billion in programmatic authority, and would respectively replace 98%, 84%, and 88% of the revenues in excise taxes. However, the recommendation directs the ACIR staff to develop alternative packages at the request of interested parties.

The Commission's recommendation, on a 12 to 3 vote, was made at

its December 4 quarterly meeting in Washington, D.C. The three Commissioners voting against the recommendation indicated that they will file a formal dissent.

President Announces ACIR Reappointments

President Reagan has reappointed Robert B. Hawkins, Jr. as Chairman and Sandra R. Smoley as a member of the U.S. Advisory Commission on Intergovernmental Relations.

Hawkins is President of the Sequoia Institute, a Sacramento-based organization encouraging effective local self-government within the federal system. From 1971 to 1974, he served in Governor Reagan's Administration, first as director of the California Office of Economic Opportunity, and then as Chairman of the Governor's Task Force on Local Government Reform. Before joining the Sequoia Institute in 1980, he was the State-Local Program Coordinator for the Smithsonian Institution's Woodrow Wilson International Center, and a visiting research fellow at the Hoover Institute in Palo Alto. Dr. Hawkins graduated from San Francisco State College (B.S., 1965) and the University of Washington (Ph.D., 1969).

Smoley represents the Third District on the Sacramento County Board of Supervisors. First elected in 1972, she was re-elected in 1976, 1980 and 1984, and has been chairman of the Board three times. In 1978, she served as President of the County Supervisors Association of California, and in 1983-84, she was President of the National Association of Counties. Supervisor Smoley graduated from the University of Iowa (B.S., 1959).

ACIR Hearing on Welfare Reform

ACIR will convene a public hearing on welfare reform issues on February 5 in Washington, D.C.. The hearing is being held in preparation for the next Commission meeting in April. At that time, Commissioners will reconsider the long-standing ACIR recommendation that calls on the national government to assume complete financial responsibility for AFDC and Medicaid-a position adopted in 1969. In 1980, ACIR reaffirmed the recommendation and made it the linchpin of a "sorting out" plan designed to streamline the cumbersome federal aid system. Under that "big swap" proposal, ACIR urged the national government to zero out financial support for many of its categorical aid programs to states in order to pay for a federal takeover of AFDC and Medicaid.

At least two considerations have prompted the Commission to reconsider the welfare sorting out issue. For decades, deep philosophical conflicts as well as cost considerations have effectively blocked all efforts to have the national government assume virtually complete responsibility for funding both the income support and health care of the poor. Moreover, there appears to be little likelihood that such a sweeping change can be effected in the next several years. Thus, the cause of welfare reform might be better served by urging the enactment of less sweeping changes where there is agreement than by advocating far-reaching changes which lack widespread support and offer little promise of early enactment.

The budget squeeze that is forcing the federal government to pull back along the state-local aid front stands out as a second reason for taking a new look at the ACIR position. The federal aid retreat inevitably raises painful sorting out issues and questions of national priority.

Witnesses will be asked to address a wide range of questions during the hearing, including:

- Do you agree with the view that, at least for the next several years, deep philosophical differences as well as cost considerations will continue to block efforts to nationalize the financing of AFDC and Medicaid? Do you see any possibility of moving the welfare reform issue off dead center by finding at least a limited area of consensus?
- If the ACIR big swap proposal is not feasible, do you see any prospects for limited swaps in which the national government would assume greater financial responsibility for certain parts of the Medicaid program in return for the "turnback" of responsibility in other federal aid areas?
- Regardless of whether responsibility for financing or administration of the welfare system is reallocated in some way within the federal system, is a greater emphasis on "workfare" desirable? How might it be implemented?
- In any welfare system that is not entirely nationalized, should the federal government provide states with relatively low fiscal capacity some form of "fiscal safety net" for the purposes of assisting them in meeting the needs of their welfare recipient population and in coping with major federal aid cutbacks?
- How could means-tested programs be better targeted to that portion of the population below the poverty line?

Spotlight on the New York State-Local Commission

Paul D. Moore
Executive Director
New York Commission

Created by statute in 1981, the New York Commission on State-Local Relations was directed to recommend ways of designing changes in the system of state aid to local governments in order to foster the most effective use of state and local resources, while preserving the fiscal integrity of both state and local governments. Specifically, the Commission was asked to study four interrelated issues: the state's system of aid to localities; the division of state and local responsibilities for providing services; state mandates; and state limits on the taxing and borrowing abilities of local governments.

The bipartisan Commission is composed of ten legislators: three members of the Senate appointed by the Temporary President; three members of the Assembly appointed by the Speaker; two members of the Senate appointed by the minority leader; and two members of the Assembly appointed by the minority leader.

The Commission operates with a three member "executive committee" to ensure continuing policy direction to staff during periods when the full legislature is not in session. The executive committee is composed of the chairman, the vice chairman and the executive director. The director, who heads a staff of eight, administers an annual budget of $450,000.

General Approach

Commission operations follow three central principles basic to the Legislature's intent. First is the commitment to a working partnership with municipal leaders. That partnership provides both the opportunity for joint policymaking, and requires all participants to accept a degree of responsibility for the results.

Second, the Commission seeks to make direct contributions to the solution of current problems, based on demonstrably workable ideas. This requires available resources to be directed to those areas of mutual concern where the potential for state legislative action is at a maximum.

The third principle requires the Commission to foster and support efficient and effective local services within the context of "home rule." Continuation of that policy requires that changes in the existing state-local organizational and fiscal systems by made only after careful examination—and that such examination include the participation of local government officials.

As a means of establishing appropriate channels of communication with local government associations, the Commission established a "working group." Its membership includes representation from the statewide associations that represent the interests of New York's 62 counties, 62 cities, 932 towns, 557 villages, and 735 school districts. The working group reviews and comments on research plans and products (including proposed legislation), Commission reports, conferences, and a host of other program activities.

Commission members and staff also participate in programs, seminars, workshops, and conferences sponsored by these associations and other government and nonprofit organizations active in the field of state-local relations.

Accomplishments

The Commission's early efforts were designed to provide channels facilitating in-depth consideration of all viewpoints and options affecting state-local policymaking. Accordingly, during this phase of the Commission's history, emphasis was placed on conferences, policy-neutral reports, and establishing coordinating mechanisms with local government representatives.

One conference focused on the state's fiscal system and another on the service delivery structure. Each helped to establish the direction of the Commision's early research and "working partnership" mechanisms with local governments. Proceedings from the conference on New York's fiscal system constituted the Commission's first major publication. Other major policy-neutral reports looked at New York's system of state aid and the division of responsibilities between the state and its local governments for the provision of basic services.

Concurrent with these research efforts, the Commission also began development of the computerized model of all federal and state aid programs operating in New York. The Intergovernmental Aid Information and Simulation System (IAISS) consists of three separate modules. The first is a detailed description of each and every program, including: authorizing legislation and eligibility requirements, type of aid program (e.g., formula driven, reimbursement with ceiling, etc.) and an agency contact. The second module provides a detailed accounting of the disbursements from these programs to each unit of local government. The third module allows simulating the impacts of changes in both the level of funding and the percentage of program costs funded by federal, state and local governments. This system is now operational, and is being used to explore state-level block grant opportunities in New York.

More recent research efforts completed by the Commission have focused directly on forming policy

options for consideration by the Legislature. The Commission's report on *New York's Limits on Local Taxing the Borrowing Powers,* for instance, suggested constitutional changes, statutory enactments, and administrative reforms that would lessen the negative impacts associated with current limits.

Perhaps the Commission's most visible accomplishment to date was enactment of *Chapters 69 and 70, New York Laws of 1985,* which provided a multi-year increase in the amount of general purpose aid distributed to local governments. This major legislative enactment made substantive changes in the formula distributing general purpose aid, and provided the first major increase in such funding since 1980. Credibility gained by the Commission from its working partnership with New York's local government representatives was instrumental in helping shape this legislation.

The Commission also has developed and introduced legislation to promote intermunicipal cooperation and stimulate innovative ideas for service delivery. The statement of legislative intent declares:

> "in order to facilitate an orderly and cooperative examination and realignment of governmental services, through a process that is consistent with the home rule principle, the Legislature declares the purpose and intent of this legislation is the encouragement and promotion of cooperative efforts designed to improve the service delivery system through local initiatives rather than state mandates."

To help achieve this purpose, the legislation provides for a five-year program of state grants to pay the major part of costs of both conducting feasibility studies and implementing programs. Monies appropriated would be used to provide 75% (with a maximum of $75,000) of the approved costs for a study to determine the administrative and economic feasibility of proposed cost effectiveness programs, and up to 75% (with a maximum of $150,000) of the approved first-year costs to implement such programs.

Other Activities

The Commission annually prepares a summary of the Governor's budget initiatives relating to state-local relations. This summary includes a description of all proposals which may have a major impact, whether fiscal or structural in nature. It is an information report, without evaluations or recommendations from Commission staff, and is distributed to Commission members and the legislative fiscal committees.

The Commission also is active on a national level with respect to federal intergovernmental policies and the development of information channels among the 24 states which have agencies concerned with state-local relations. The Commission was honored, in fact, to host a meeting of these agencies in Albany last September (see discussion below.)

Current Workplan

Since its inception, the Commission has developed annual workplans which parallel the four areas of concern identified by the Legislature. The current 1985-86 Commission workplan for each of the four areas is summarized below:

State's System of Aid

- Install the Intergovernmental Aid Information and Simulation System (IAISS) model of all federal and state aid programs operating in New York.
- Develop a catalogue of state and federal aid programs distributing money to New York's local governments (to be generated by the IAISS).
- Explore the possibility of long-term structural changes in state general purpose aid based on, and as a follow-up to, a new two-year "transition program" of increased aid.

Division of State and Local Responsibilities

- Initiate a two-year project with Cornell University to assemble a detailed compilation of the actual services being delivered by New York's local governments, how the service is produced, and the sources of funding for each, and whether or not the service is perceived as mandated by the state.
- Continue its function-by-function review of government services to help identify the proper division of responsibility between the state and its local governments. The first two efforts are focusing on highway and police services.

State Mandates on Local Governments

- Include as part of the Cornell study of actual services provided by local governments, questions relating to local perceptions of state-imposed service mandates
- Include as part of the functional analysis of policy and highway services, discussion of areas where state-imposed mandates are an issue.
- Introduce legislation providing state grants to promote and encourage intergovernmental cooperation in solving

PRESENT AND FORMER NEW YORK MEMBERS

Present	Former
From the Assembly:	
Dennis T. Gorski, Chairman	James W. McCabe, Sr.
Mary M. McPhillips	Thomas P. Morahan
Richard H. Miller	Dale E. Rath
Frank G. Talomie, Sr.	Gail S. Shaffer
Lewis J. Yevoli	John B. Sheffer, II
From the Senate:	
James H. Donovan, Vice Chairman	Charles D. Cook
Nancy Larraine Hoffmann	Fred J. Eckert
Anthony M. Masiello	Linda Winikow
Jess J. Present	
Caesar Trunzo	

problems as an alternative approach to state-mandated solutions.

State Limits on Local Borrowing and Taxing Powers

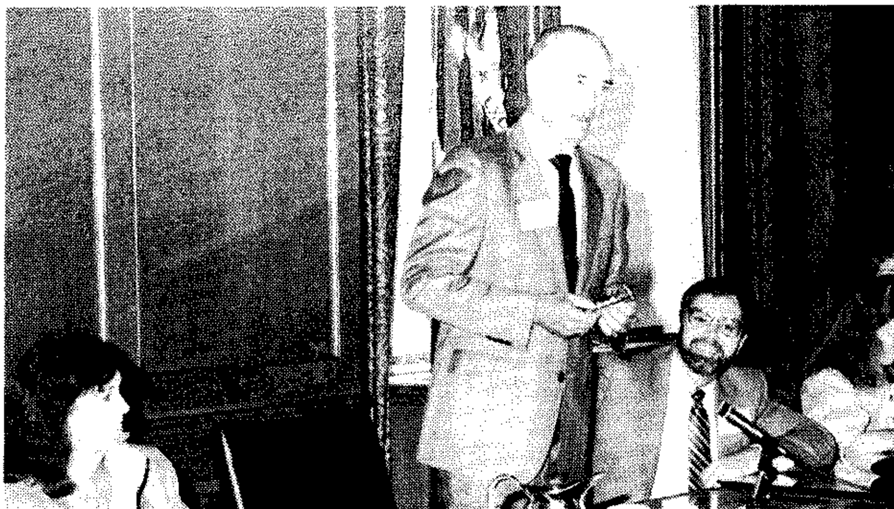
- Provide follow-up to the Commission's 1983 report entitled *New York's Limits on Local Taxing and Borrowing Powers: A Time for Change.*

The Year Ahead

The Commission is positioned to provide continuing leadership in New York's effort to respond to the significant forces of change resulting from new federalism initiatives and other fiscal, social and economic pressures.

Structurally, the Commission is an arm of the legislature designed to focus on broad, long-term policy issues. The necessity for this kind of strategic planning unit derives from the fact that state-local relations are a continuous function, and by the heavy pressure on every legislature to deal with immediate problems. In New York, that pressure is embodied in the annual introduction of some 15,000 bills that result in some 1,000 final enactments. In past decades, this pressure has resulted in piecemeal legislation dealing with individual aspects of state-local relations without adequate consideration of effects on the entire system. Providing a framework for all affected parties to participate in designing policies appropriate to proper development of the whole system, the Commission has the potential of identifying policy options which can properly shape future development.

STATE PANELS MEET IN ALBANY



New York State Senator James H. Donovan, vice chairman of New York's Commission on State-Local Relations (standing) welcomes participants at the Albany state ACIRs conference. Seated (left to right) are Lois Pohl from Missouri, and the New York commission staff director, Paul Moore, and Denise Lord from Maine.

Policy problems facing states in key areas of intergovernmental relations occupied center stage in Albany, New York on September 26 and 27, as the New York commission hosted a national meeting convened by and for state-local ACIRs. The purpose of the meeting was to institutionalize exchanges between state ACIRs on the range of complex intergovernmental issues faced by state and local governments, and to enhance mutual understanding of the immediate issues on which the resources of the national and state-level ACIRs are focused. The presentations and discussions identified the further development of state fiscal aid to municipalities and the enhancement of state-local service delivery effectiveness and efficiency as major areas of interest.

Representatives from 15 of the 24 states which now have an intergovernmental relations agency, as well as from the "parent" U.S. agency, exchanged their views on such timely subjects as:

- improved methods of measuring local fiscal capacity;
- new data bases and computer software to support intergovernmental policy analysis;
- analytic frameworks for examining service delivery structures to sort out the proper division of responsibility between state and local governments; and
- designs for state general purpose aid formulas, and the implications of the possible loss of federal revenue sharing.

The varied backgrounds of those attending, coupled with the striking differences among the states' intergovernmental relations systems, produced a valuable exchange of ideas. One area of continuing widespread fiscal concern and discussion was the impact of the cost of state mandates on localities operating in a "home rule" environment. Another was the nationwide dilemma created by the explosion in the cost of government liability insurance coverage.

The meeting produced several tangible results. An extensive exchange of reports and studies between states was organized. In addition, copies of all state ACIR reports will be filed with the national ACIR as a special repository for intergovernmental research. A quite useful and very welcome "gift" was mady by the U.S. ACIR to all state agencies, consisting of Census Bureau government finance data entered on floppy discs pre-formatted for use with personal computer spreadsheets. Up-to-date estimates on amounts of federal aid, by program, that each state could expect to receive in the current federal fiscal year also was provided, along with a demonstration of newly-developed software especially effective at incorporating word processing with the manipulation of multiple data bases. Finally, participants were given a demonstration of a computer model of all state and federal aid programs being used by the New York commission to formulate various types of policy options.

The Albany meeting was a direct outgrowth of the national ACIR's sponsorship of an annual state counterparts conference as part of its spring meeting program. Several states have expressed interest in hosting the next such state-sponsored meeting, and that topic will certainly be discussed at the April 1986 meeting of the U.S. ACIR in Chicago.

Deductibility

Since the first federal income tax was designed in 1913, individuals who itemize deductions have been permitted to deduct certain state and local taxes from the income they report for federal income tax purposes. Initially, all state and local taxes were deductible. In 1964, the deductions for automobile and drivers' licenses and selective excises were eliminated. In 1978, the Congress eliminated the deduction for gasoline taxes when it became clear that a subsidy for gasoline consumption was counter to federal energy policy. At present, deductions are allowed for:

- state and local real property taxes
- state and local personal property taxes
- state and local income taxes
- state and local general sales taxes.

According to U.S. Treasury estimates, about $27.7 billion in federal revenues were foregone in 1984 because of the tax deductibility provision. On a nationwide basis, more than half (52%) of the benefits are gained from deducting income taxes; real estate taxes account for 31% of the total; and general sales taxes account for 13%.

Although the immediate benefits of deductibility go to the individual taxpayer, it is important to state and local governments because for itemizing taxpayers, deductibility reduces the cost of state and local services. Thus, deductibility makes it possible for state and local governments to raise more revenue at a lower cost to their taxpayers. However, the benefits of deductibility to itemizing taxpayers and to state and local governments are divided unevenly among the states, depending upon income levels, tax levels, and the mix of tax sources.

The various tax reform proposals which have been debated treat the deductibility of state and local taxes differently. The Bradley-Gephardt plan disallows deductions for general sales and personal property taxes and reduces the value of real property and income tax deductions because all taxpayers would take these deductions against a 14% marginal tax rate. The Kemp-Kasten proposal disallows all but deductions for real property taxes. The first Treasury proposal and the President's tax proposals would completely disallow deduction of all state and local non-business taxes. In striking contrast, the House approved version of tax reform allows deductibility of all currently deductible state and local taxes.

It is clear that the battle over the elimination of deductibility is far from over. As the debate now moves to the Senate, many possible paths to compromise have been pointed out. There is first the possibility of eliminating the deductibility of certain state and local taxes, but retaining it for others; i.e., eliminate the deduction for sales and personal property taxes, but retain the deductibility privilege for income and residential property. Another possibility is to continue deductibility for all currently deductible taxes, but limit the amount by allowing it against the lowest marginal tax bracket (the Bradley-Gephardt approach). Among the other possibilities which have been suggested are setting a general floor so that only deductions over a specified amount (such as 1% of adjusted gross income) are allowable; setting a general ceiling (such as allowing deductions exceeding 6.5% of adjusted gross income); or disallowing a specified proportion of the current deduction. The effect of each proposal upon the individual states differs depending upon the level of taxpayers' incomes in the state, state tax levels, and the mix of state (and local) taxes in the state.

To deduct, or not to deduct, that is the question.

When the States Gave the Income Tax to the Federal Government

Bob Gleason

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census enumeration.

The Sixteenth Amendment
to the Constitution
Ratified February, 1913

Having just been authorized by the states' ratification of the Sixteenth Amendment, in July 1913 the 63rd Congress enacted the first permanent federal income tax. "All good citizens will willingly and cheerfully support and sustain this, the fairest and cheapest of all taxes," predicted the chairman of the House Ways and Means Committee.

Perhaps he exaggerated in saying that *all* citizens were cheerful; but 97% were. The new tax would apply only to the 3% of the population with annual earnings over $3,000 ($4,000 for a married couple)—roughly the equivalent of $80,000 in 1985 household income. In addition, the wealthy were overwhelmingly concentrated in a handful of northern industrial states.

And therein lay the crux of the debate over ratification of the Sixteenth Amendment. Which citizens would be forced to pay? In which states would they reside? And what would be the effect on the states' abilities to control their revenue sources? They are arguments which reverberate in the current debate over tax reform.

This issue of *Intergovernmental Perspective* examines the issue of deductibility of state and local taxes from federal income taxes. In the following two articles, Pennsylvania Secretary of Revenue James Scheiner takes a position in support of eliminating this provision of the tax code, and Gerald Miller, Executive Director of the National Association of State Budget Officers, offers arguments in opposition.

While this deduction is only a part—albeit a very significant part—of the complex modern federal income tax, it is instructive to review it in the context of the debate over constitutional authorization of the federal income tax that took place in the state legislatures some 75-odd years ago. Like today, there was the philosophical question of state sovereignty. Distinct, but similar to today, there was the pragmatic question of how citizens of each state would be affected. Whereas the issue of deductibility pits *high-tax* states against *low-tax* states, the "money" issue pervading the debate over ratification of the Sixteenth Amendment pitted the *high-income* states (whose citizens would pay more tax) against the *low-income* states.

Throughout the half-century succeeding the Civil War, a broad-based coalition of progressives, agrarians, and labor sought to institutionalize the income tax as part of the national government's revenue system. Their design was to shift away from those taxes based on consumption (tariffs and excises) to those based on an "ability to pay." This was the ideological mega issue—the desire to redistribute income and foster a more egalitarian society. Columbia University economics professor Edwin Seligman denounced taxes based on "the things men eat and wear." The Democratic platform of 1912 said the tariff was "the principal cause of the unequal distribution of wealth; it is a system of taxation which makes the rich richer and the poor poorer." Miller expresses one modern manifestation of this sentiment when he states: "The deductibility provision reaffirms that redistribution of income is primarily a national [as opposed to state or local] interest, as it should be." Yet, if redistribution is the goal, then counters Scheiner, deductibility makes the federal income tax less progressive.

Ideologically opposed to the income tax—particularly a progressive one—were those who felt that income redistribution was a violation of property rights. In a 1880 article for the *North American Review* titled "The Communism of a Discriminating Income-Tax," David A. Wells, a special commissioner of U.S. revenues after the Civil War, condemned a narrow-based and progressive tax. U.S. Representative, and future President, James Garfield said there was "just as much right to demand that the rich men of this country shall give all their income, and a bonus besides, as to demand that they shall pay twice as much per dollar as others pay." These sentiments, too, have their modern—if less alarmed—adherents.

Though temporary, the nation's first income tax had been adopted to help finance the Civil War. Of pertinence to today's debate, it passed the Congress over

objections that citizens already paying customs and excise duties would now be subject to double taxation—an issue addressed by Scheiner as it relates to the deductibility of state and local taxes. The Civil War legislation was declared constitutional after it expired, but proponents failed in attempts to resurrect it. In 1894, however, a modest income tax was included in a tariff reform act. This time, in the case of *Pollock v. Farmers' Loan and Trust Company,* the Supreme Court ruled the income tax unconstitutional. While the Court's decision, and subsequent legislative maneuverings, are fascinating in and of themselves, it is only important to note here that they propelled the Congress to propose the Sixteenth Amendment in 1909. The phrase "without apportionment among the several states, and without regard to any census or enumeration" was specifically designed to overturn the majority's holding in *Pollock.*

With the advent of the ratification process, the issue of federal income tax imposition moved to the state legislatures. As with the current debate over deductibility and other tax matters, views concerning the impact on the states' inherent rights were heard from disparate voices. Virginia House of Delegates Speaker Richard E. Byrd said: ". . . I do not hesitate to say that the adoption of this amendment will be such a surrender to imperialism that has not been seen since the northern states in their blindness forced the Fourteenth and Fifteenth Amendments upon the entire sisterhood of the Commonwealth. I am not willing by any voluntary act to give up revenue which the State of Virginia herself needs . . ." U.S. Senator George F. Hoar of Massachusetts said: "I am opposed to the income tax, first, because it is a class of taxation which, except during the extremity of a great war, always has been and always ought to be left to the States." And, from a wide range of state policymakers there were arguments that revenues were needed by the states to provide services—the basic emphasis of Miller's article.

The true political issue, however, was one of regionalism. Much more so than today, there was a wide disparity of wealth among the states, and particularly among the regions. In the non-rich states of the West and South the rallying cry for ratification was "only the rich will pay." It was generally understood that the tax would only be levied on the top three to five percent of income recipients.

The West

The Populist movement, and the antagonism of the West toward the East, caused ratification in those states west of the Mississippi to be basically *pro forma.* Also, it was a region of the country that openly sought federal aid for development. With the proceeds of an income tax filling the federal treasury, it was thought that aid would be more readily available. But those tax dollars would not originate in the West. The region had a relatively even distribution of income and very few wealthy persons. It had only 12 people with incomes in excess of $1 million, and only 666 who made over $100,000 per annum. The economic base was agriculture, and home on the range, the income tax would not be a discouraging word.

With the exception of Utah (where it was ratified in the senate, but not in the house), the Amendment won easy ratification in all western states. Utah was a Republican stronghold with some political allies in the East, but much more importantly, the Amendment was opposed by the Mormon Church. Not only did the church have extensive holdings, but its members remained angry at the federal government for sending troops in the 1890s to eliminate polygamy.

The South

In the South, states' rights and regional sentiments collided to form an inconsistent philosophy. With bitterness still lingering over the Civil War and Reconstruction, there was certainly little propensity to give the Northern-dominated federal government more taxing authority. Some said it was a plot to give additional benefits to Union veterans. Some, such as the Speaker of the Florida House, favored the tax but wanted revenues returned to the states.

These impulses would be suppressed, for the reality was that the South was poor. National per capita income was $1,165 in 1910; in the South it was $509. Only 1.1% of the population made over $5,000, and only three one-hundredths of one percent made over $10,000. Just five Southerners made over $1 million per annum, and only 214 over $100,000.

"Because none of us here have $4,000 incomes, somebody else will have to pay the tax," said a University of Arkansas professor. The chairman of the Mississippi House Judiciary Committee said: "We are not particularly concerned in this matter, as there are only a small number of people in Mississippi who have incomes worth taxing." Also the South, like the West, wanted to pave the way for lower tariffs.

While senators in the South tended to be less favorably inclined than lower house members (senators were richer and thus potential taxpayers), all the states of the old Confederacy, except Virginia and Florida, ratified the Amendment. Virginia held to the state sovereignty issue. In Florida, the house passed the Amendment overwhelmingly, but the senate was able to defeat it.

The Northeast/Midwest

The affluent North was supposed to be the opponents' stopper. Because the Amendment needed three quarters of the states to ratify, a solid rejection by the mostly industrial Northeast and Midwest would have killed it.

It is important to keep in mind the Amendment's phrase "from whatever source derived." That meant not only wages, but "unearned income" as well. Overwhelmingly, this was concentrated in the Northeast/Midwest. Sixty percent of all interest income, and 70% of all income from dividends, were derived by residents of this region. It also contained 189 of the 206 people with incomes in excess of $1 million, and 85% of all those earning $100,000 or more yearly. Indeed, when the 1913 tax went into effect, residents of New York, Pennsylvania, Ohio, Massachusetts and Illinois paid nearly 70% of all taxes collected.

This should have boded ill for the Amendment's chances in the region's legislative chambers. But between congressional adoption in 1909 and final ratification in 1913, an upheaval took place in American politics. During the period 1908 to 1912, Democrats

captured governorships in Ohio, Illinois, New Jersey, Massachusetts, Indiana, Maine and Connecticut. In legislative chambers, Democrats and progressive Republicans formed coalitions. While in many cases these newly-elected officials had won office for other reasons, they also had a proclivity toward taxation based on ability to pay. Thus, the Amendment's consideration had fortunate timing. In the end, only Pennsylvania, Connecticut and Rhode Island failed to ratify.

Viewed in a broad perspective, the fiscal disparity among the states influenced the ratification debate in all three regions. This reality exists today over the issue of state and local tax deductibility and can be found in both the Scheiner and Miller articles. While Scheiner states that "the richest 20% of U.S. taxpayers get 83% of the money from deductibility," Miller contends that "eliminating deductibility would increase the cost to the taxpayer of needed government services in higher tax areas, creating an incentive for the more affluent taxpayers in the higher tax areas to move." Another theme that recurs is the wide diversity in aggregate state tax burdens. As reliance on the progressive income tax causes Washington's revenue collections to be disproportionate among the states, the issue of one state exporting taxes to other states is also raised in both articles: Scheiner says that because of deductibility, "every time a state or local government raises its own taxes, taxpayers from the rest of America end up paying a greater share of the federal tax burden," while Miller counters that "a state rich in a natural resource can tax the natural resource [and pass it on to] citizens in other states—thus relying less on taxes assessed on individuals such as the [state] income and sales taxes."

On February 13, 1913 Wyoming became the 36th—and requisite—state to ratify the Sixteenth Amendment. On February 25, the U.S. Secretary of State reported ratification, and by that July, the nation had an income tax.

"Obviously the national government has now entered the field of direct taxation hitherto reserved in ordinary times for the exclusive use of the states," wrote Harvard Professor Charles J. Bullock. "This is not in itself objectionable," he said, "but it raises important questions concerning the proper division in the field and the coordination of the two systems of taxation." There are echoes of this in Miller's quotation from a recent letter to Treasury Secretary James Baker from state and local officials: "Since all levels of government utilize the same tax base to provide essential governmental services in the most cost-effective manner, we hold joint responsibility to our citizens to be able to sit together as equal partners to discuss alternatives to the issues and problems on the table before us."

Yet, for all the years of debate and litigation preceding the ratification of the Sixteenth Amendment, the actual tax bill that emerged in 1913 was exceedingly modest. For the 3% of population crossing the earnings threshold ($3,000 for an individual and $4,000 for a married couple) the rate was 1%. The tax may have been progressive, but only slightly so. A surtax of an additional 1% became effective after $20,000, and was graduated up to 7% for incomes over $500,000—the upper stratosphere of early 20th Century wealth.

Nevertheless, even those incredibly low rates—by today's standards—were of concern to Professor Bullock. He called the maximum rates "clearly excessive," contending that, "as the experience of all countries shows . . . the limit of safety for income taxation is probably ten percent." Because the federal government had now set a 7% marginal tax rate, "the United States had appropriated seventy percent of the total possible proceeds of direct taxation on large incomes," Professor Bullock calculated. He concluded that: "Congress has acted with a total disregard of the interests of the states, and apparently on the assumption that only the claims of the federal treasury require consideration."

Ironically, both Scheiner and Miller can claim support for their positions in Professor Bullock's contention: Scheiner, when he says that tax reform's "goal of lower marginal rates is extremely important to sound tax administration," and Miller, when he says that the state and local "tax revolt movement, which began in the 1970s, was really a reaction to the combined tax burdens of federal, state and local governments."

To be sure, many changes have occurred in the income tax since 1913—from its universalization during World War II (as late as 1939, only 5% of the wealthiest individuals paid any tax), to the elimination of deductibility of certain state and local taxes as noted by Scheiner, and eventually to the current labyrinth of exemptions, deductions and loopholes. But just as surely, we are revisiting many of the pragmatic and philosophical arguments that took place in state legislatures three-quarters of a century ago. True, the pragmatic conflict has shifted from *high-income* vs. *low-income* states to *high-tax* vs. *low-tax* states, but even here there is overlap. Many of the high-tax states are also the high-income states whose citizens may well be better off by trading in deductibility for lower rates—another point that Scheiner makes in his article.

Furthermore, as tax reform moves through the Congress, some are urging that the package be supplemented with a value added tax—a complicated form of national sales tax eventually paid by the consumer. Not only would this have the national government entering a new field of taxation previously reserved for the states, it would also—as with tariffs and excises—revert at least some of the national government's revenues to a levy based on consumption.

These are the sounds and rhythm of 1913 ragtime played 1980s style. As Scott Joplin's music from the period has been rediscovered, it seems we are likewise hearing some of the same federalism refrains that sounded when the states gave Washington the authority to directly tax individual incomes.

Bob Gleason is ACIR Director of Communications and Publications.

Federal Deductibility of State and Local Taxes: Fact and Fiction

James I. Scheiner

Many state and local governments have had a knee-jerk, negative reaction to the proposal to trade federal deductibility of state and local taxes for lower federal rates and higher personal deductions. This is unfortunate, because the trade-in of federal deductibility would benefit the vast majority of taxpayers. Why, then, have many state and local officials taken a position contrary to the interests of their constituents? To answer this question, we must examine and debunk seven fictions surrounding the federal deductibility issue.

FICTION: The President's tax plan will take away federal deductibility, thereby **increasing** taxes for most Americans.

FACT: The President's tax plan will trade federal deductibility for lower tax rates and almost double the personal exemptions, thereby **decreasing** taxes for most Americans.

No itemizing taxpayer wants to **lose** any deduction. When phrased in this way, the federal deductibility issue is bound to be unpopular. But this phrasing misstates the President's tax proposal. What is being proposed is a $36 billion trade-in, swapping federal deductibility for lower marginal rates and almost double the personal exemptions. This is a good trade-in for three reasons.

First, if most American taxpayers put pen to paper, they'd find out that they'd pay less federal tax after the trade-in. While we have not seen a definitive study that isolates the distributional impacts of just the state and local trade-in, we know that 60% of taxpayers who do not itemize certainly benefit, because they get no direct benefit from deductibility. Of the 40% who do itemize, many, if not most, would pay less tax with lower marginal rates and almost double the personal exemption.

Second, the goal of lower marginal rates is extremely important to sound tax administration. The root cause of the alarming increase in federal tax non-compliance is high marginal rates. Reducing marginal rates will reduce the attractiveness of all tax shelters and will encourage voluntary compliance. Pennsylvania provides a case study of tax compliance under low marginal rates. Pennsylvania has a low, flat-rate personal income tax, dropping back to a 2.2% rate on January 1, 1986. Almost 80% of the tax's $2.7 billion annual yield is collected through employer withholding. The state's Revenue Department runs an extensive series of computer cross-matches to search for personal income tax non-filers and under-remitters. These cross-matches show a remarkable degree of compliance among Pennsylvania's five million taxpayers.

Third, the goal of almost doubling the personal exemption is strongly pro-family. The President's proposal begins with a $2,000 personal exemption for 1986, then indexes this exemption for inflation. This feature, plus an increased earned income credit, would insure that any family below the poverty threshold would not pay a federal income tax. Under current law, a family of four begins to pay the federal tax at $9,575 of income; the President's proposal would increase this tax-free income level to $12,798.[1]

No doubt, Americans would prefer lower marginal rates, a higher personal deduction, and the preservation of state and local tax deductibility too. Of the three features, however, most Americans, including government officials, would admit that federal deductibility is the least important.

FICTION: Federal deductibility is a tax break that predominantly benefits the middle class.

FACT: The richest 20% of U.S. taxpayers get 83% of the money from deductibility.

According to *The President's Tax Proposals*, more than 30 million families, or 33% of the U.S. total, made some use of state and local deductibility in 1983.[2] Testimony by Virginia Governor Charles Robb before a U.S. Senate committee sets the percentage now itemizing deductions for state and local taxes at 41%.[3]

Clearly, millions of families use state and local deductibility. But who gets the lion's share of benefits? An Advisory Commission on Intergovernmental Relations' (ACIR) draft working paper, "Federal Income

Tax Deductibility of State and Local Taxes," sheds light on this subject.[4] Information provided to supplement a table in the study shows that the richest 20% of American taxpayers pay two-thirds of the federal taxes, but get **five-sixths** of the tax savings from state and local deductibility (see Table 1). Almost half the benefits of state and local deductibility go to just 5% of taxpayers. That leaves only one dollar out of every six in tax savings for the remaining 80% of taxpayers.

Federal deductibility of state and local taxes is highly regressive. With a tax impact estimated at $36 billion in 1985, federal deductibility may be the most regressive single feature of the federal tax code on an absolute-dollar basis.[5] If Congress enacted a $36 billion income transfer program, transferring five-sixths of the dollars to the richest 20% of U.S. taxpayers, there would be a tremendous outcry about the program's inequity. Yet, that is precisely what the tax expenditure of federal deductibility accomplishes.

FICTION: Federal deductibility prevents "double taxation" of income, and "double taxation" is inherently wrong.

FACT: The majority of states tax income paid for federal and local taxes, resulting in the same "double taxation" that is opposed at the federal level.

While imposing a "tax on a tax" sounds as if it is inherently wrong, it is in fact an accepted practice of state, local and federal governments. For example, state and local governments would have to exempt federal excise taxes on cigarettes, liquor and motor fuels from sales taxes to eliminate "taxes on taxes." In the personal income tax area, 28 states—including the populous states of California, New York, Pennsylvania, Illinois and Ohio—apply a tax to personal income **without** deducting federal taxes paid (see Table 2). A state income tax deduction for local income taxes paid is more prevalent, with 22 states providing some type of deduction, although eight states (including California, New York and Pennsylvania) do not. Why, then, must the **federal** government provide a deduction for state and local taxes paid particularly when many state governments do not reciprocate?

The majority of federal taxpayers do not itemize, and do not get any benefits from state and local tax deductiblity.[6] Attempting to preserve this deduction for a minority of taxpayers by using a double-taxation argument is clearly spurious, particularly from those government jurisdictions which impose their own double taxation.

FICTION: State and local governments will have to sharply curtail services were federal deductibility lost.

FACT: Most of the 30 state governments which are coupled to federally-defined income will raise more money at their same rates due to the base-broadening effect of the

Table 1

PERCENT OF FEDERAL TAX SAVINGS FROM TAX DEDUCTIBILITY COMPARED TO INCOME TAX LIABILITY BY ADJUSTED GROSS INCOME (AGI) CLASS, 1982

Size of 1982 AGI ($1,000)	Percent of Total Taxpayers[a]		Percent of Total Tax Liability		Percent of State/ Local Deductibility Savings	
Under 5	18.8%		.23%		.03%	
5-10	17.9%		2.32%		.37%	
10-15	15.0%		5.42%		1.41%	
15-20	11.0%		7.04%		2.72%	
20-25	9.2%		8.69%		5.12%	
25-30	8.0%		10.04%		7.85%	
30-50	15.3%		30.64%		36.47%	
50-100	3.9%		18.20%		27.03%	
100-200	0.6%	20%	7.82%	66%	9.75%	83%
200-500	0.1%		5.06%		5.10%	
500-1,000	0.02%		1.88%		1.73%	
1,000+	0.01%		2.66%		2.41%	
TOTAL	(b)		100.00%		100.00%	

Source: ACIR calculations based on Office of Tax Analysis, Office of the Secretary of the Treasury, "Tabulations from the 1982 Statistics of Income File for the Fiscal Relations Study," December 12, 1984, Table 3.

[a] ACIR computations.

[b] Total of 99.83% due to rounding errors.

Table 2

STATE INCOME TAX COMPARISON
FEDERAL INCOME TAX AND SELECTIVE LOCAL TAX DEDUCTIBILITY

50 States and the District of Columbia	*Personal Income Tax*	*Federal Income Tax Deductible*	*Local Income or Occupation Tax Deductible*[3]
Alabama	X	X	X
Alaska			N/A
Arizona	X	X	X
Arkansas	X		[5]
California	X		
Colorado	X	X	
Connecticut	X[1]		[5]
Delaware	X	X[2]	X
District of Columbia	X		N/A
Florida			N/A
Georgia	X		[5]
Hawaii	X		
Idaho	X		X
Illinois	X		X
Indiana	X		X
Iowa	X	X	X
Kansas	X	X[2]	
Kentucky	X	X[2]	X
Louisiana	X	X	[5]
Maine	X		X
Maryland	X		
Massachusetts	X		X
Michigan	X		X[6]
Minnesota	X	X	[5]
Mississippi	X		X
Missouri	X	X	X
Montana	X	X	X
Nebraska	X		X
Nevada			N/A
New Hampshire	X[1]		[5]
New Jersey	X		
New Mexico	X		X
New York	X		
North Carolina	X		[5]
North Dakota	X	X[3]	[5]
Ohio	X		X
Oklahoma	X	X[4]	X
Oregon	X	X[2]	X
Pennsylvania	X		
Rhode Island	X		X
South Carolina	X	X[2]	[5]
South Dakota			N/A
Tennessee	X[1]		[5]
Texas			N/A
Utah	X	X	[5]
Vermont	X		X
Virginia	X		[5]
Washington			N/A
West Virginia	X		[5]
Wisconsin	X		X
Wyoming			N/A
TOTALS	44	16	22

[1]The tax applies only to interest and dividend income.
[2]Deductions limited.
[3]Only if state's long form is filed.
[4]A full deduction for accrued federal income taxes is allowed with use of optional rate schedules.
[5]No local income or occupation taxes are imposed in addition to the state personal income tax.
[6]A partial credit is allowed for city income taxes paid.

SOURCES: Compiled by the Pennsylvania Department of Revenue from *CCH State Tax Review*, December 11, 1984.
A phone survey of state tax administrators, November 19, 1985.

President's tax plan; most other state and local governments will face relatively minor adjustments under the President's tax plan.

State and local governments are understandably wary about federal tax reform. Federal taxes are tied in a variety of ways to state and local taxes.

The Advisory Commission on Intergovernmental Relations is studying federal-state linkages, with deSeve Economics authoring "A Description of the Linkages Between the Federal and the States Personal Income Tax Codes" for ACIR.[7] Review of the April 1985 draft of this report indicates that the major problem facing many states under the President's tax plan will be how much to **lower** tax rates. Unless those states which are coupled to federally-defined income **lower** rates, they will be awash in extra tax money due to the base-broadening effects of the President's plan.

The predominant direct impact of the President's plan, therefore, is to generate substantially more money for many state governments, or provide them with an opportunity to lower tax rates. Beyond that, the fiscal effects on state and local governments are open to considerable conjecture. This is particularly true for federal deductibility of state and local taxes. The ACIR federal deductibility study has a section, appropriately entitled "Role of Fiscal Illusion," that discusses the tenuousness of taxpayer behavioral assumptions behind the fiscal impact analysis.[8] With acceptance of these tenuous assumptions, the study concludes:

> "Our current best estimate is that eliminating tax deductions would mean that over the next five to ten years state and local governments would be pressed to cut spending, relative to what it would be otherwise, by about 2 to 3%. Because state and local spending has been growing by about 7% per year since 1980, the adjustment to the elimination of deductibility would come about through a reduction in the growth of state/local spending; elimination of tax deductibility would not cause an absolute drop in the level of state and local spending."[9]

Even this projection of a 2–3% lesser growth rate in state-local spending runs counter to empirical evidence. After the 1981 federal tax cut, the state-local tax deduction was worth less to the federal itemizer, but there is no evidence that this change has been a factor in any state or local government's spending since 1981. After the 1979 gasoline shortage, the Congress repealed federal deductibility of state gasoline taxes, amid cries that state legislatures would react by cutting taxes and, thereby, highway expenditures. In fact, the opposite occurred, with 44 states raising gasoline taxes subsequent to 1979, in response to the clear need for highway programs. In Pennsylvania, the loss of federal deductibility for gasoline taxes was never a factor—not even a miniscule factor—in gas tax debates.

Many state governments know that the President's tax plan will generate substantial new tax money at current rates, but this fact is a secret well-kept by public officials. Yet, the dubious proposition that loss of federal deductibility of state and local taxes will force a curtailment of government services has been trumpeted all across America by some of these same public officials.

FICTION: Federal deductibility of state and local taxes is no different from disaster relief or any other federal program in that some localities and states get more from the program than others.

FACT: Federal deductibility is fundamentally different from other federal programs. Each state and local government, by raising its own taxes, has the power to increase federal tax expenditures without any control exercised by the Congress.

Every time a state or local government raises its own taxes, taxpayers from the rest of America end up paying a greater share of the federal tax burden. This is the perverse result of federal deductibility, that links hundreds of thousands of state and local tax decisions to the federal system.

Some public officials have used "merit-want" arguments to justify this tax linkage. H. Louis Stettler, III, the Maryland budget secretary, is quoted as follows: "There is a big difference between providing food to needy children and the three martini lunch; between providing transportation to public schools and 'business trips' to the Superbowl."[10] The notion that governments can spend money "better" than private industry flies in the face of conventional wisdom about comparative efficiency.

In Pennsylvania, the Thornburgh Administration has achieved substantial savings in government operating costs while improving public services. For example, since 1978 the state Revenue Department reduced its payroll by almost 30%, while quadrupling collections of delinquent taxes and providing faster, more accurate customer service. The Pennsylvania Transportation Department has 2,500 fewer employees than it did seven years ago, yet highway repairs and construction activities are at historic highs. Despite staff increases for priority areas such as environmental protection and prisons, the Thornburgh Administration has trimmed the overall state payroll by 12,000—about 12%. Pennsylvania now ranks last among the 50 states in the ratio of state employees per 100,000 population. The Thornburgh Administration has achieved an average of $200 million per year in cost reduction savings through initiatives in such areas as state cars, printing, postage, and office and process automation.

With these successes, Pennsylvania could make a claim to be at or near "efficiency frontiers" in all its operations. Yet, the Thornburgh Administration continues to identify and achieve additional efficiencies. Many state and local governments join Pennsylvania in candidly acknowledging that there is room for greater efficiency in government. Given this environment, why should taxpayers in one jurisdiction, via the federal tax code, help subsidize state and local government spending elsewhere?

FICTION: State and local governments are bearing the brunt of federal tax reform, with deductibility of state and local taxes repre-

senting 11% of total tax expenditures, but about 75% of base-broadening under the Treasury proposals.

FACT: State and local governments do not directly pay any federal income taxes, and they get a relatively small indirect benefit from state and local tax deductibility.

The U.S. Treasury Department estimates that, if state and local tax deductibility were eliminated, state and local governments would react by cutting back expenditures by about $6 billion.[11] But the price that is paid for this indirect assistance to state and local governments, which amounts to just 1½% of total state-local expenditures, is a $36 billion tax loss to the federal government. Given these figures, it would appear that the benefits of state and local tax deductibility to governments pale beside the benefits to America's richest taxpayers.

As a revenue sharing progam, state and local tax deductibility is highly inefficient. Yet, many state and local officials defend deductibility on just this basis, arguing against its trade-in for lower tax rates and higher exemptions.

State and local officials from high-tax jurisdictions have been particularly vocal, raising fears that affluent taxpayers will flee from high-tax to low-tax areas, and that tax wars will be spawned. These fears are being exaggerated. Taxes are not the dominant factor in where people and businesses choose to locate. If they were, high-tax jurisdictions would not be participating as fully as they are in the nation's economic recovery. Further, state government itself can compensate for the differential impacts of trading in state and local tax deductibility on the various localities within that state. Regarding the specter of tax wars, if they mean increased competition to more efficiently deliver high quality state and local government services, most taxpayers would say: "Bring them on."

FICTION: Federal deductibility of state and local taxes has been a principle of fiscal federalism, unchanged since the 1913 federal income tax code.

FACT: The Congress has eliminated a number of state and local tax deductions, and after 72 years, remaining deductions need reevaluation on their merits.

In 1943, the Congress eliminated the deductions for certain state and local excise taxes. Then, in 1964, the deduction ended for state and local taxes on tobacco, alcohol, and vehicle registration and operator license fees. Since gasoline tax deductions ended in1979, sales, income and property taxes are the only deductions left.

Thus, federal deductibility of state and local taxes is not an all-or-nothing proposition. The Internal Revenue Service administers the sales tax deduction through an imprecise table that bears little relationship to taxpayers' sales tax expenditures. While, in theory, federal deductibility of sales taxes could benefit less affluent families, in fact these very same families do not itemize deductions and, therefore, do not get a penny from this federal exemption.

If compromise is necessary on this issue, federal deductibility of state and local personal income and property taxes could be phased out over time or could be limited to the rate of the lowest tax bracket, as in the Bradley-Gephardt proposal. Treating state and local taxes like catastrophic losses, by allowing deductions above some minimum, is a particularly unattractive alternative. There is no rational basis for comparing state and local taxes to unexpected medical bills or casualty losses. Allowing deductions for only those taxpayers in the nation's highest tax jurisdictions creates an incentive for certain state and local governments to spend more and economize less.

Unlike certain other tax exemptions recently legislated by the Congress, federal deductibility of state and local taxes makes no pretense of promoting capital investment or economic growth. As a $36 billion tax expenditure, that redistributes 83% of the money to the richest 20% of U.S. taxpayers, state and local tax deductibility should be "on the table" for tax reform. State and local officials have a responsibility to provide the Congress with facts—not fictions—to support the deliberations on this subject.

FOOTNOTES

1 U.S. Government Printing Office, **The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity,** May 1985.
2 *Ibid.*, p. 67.
3 "Statement of the Honorable Charles S. Robb, Governor of Virginia, before the Subcommittee on Intergovernmental Relations, Committee on Governmental Affairs, United States Senate, on State and Local Tax Deductibility," June 26, 1985, p. 5.
4 ACIR draft working paper, "Federal Income Tax Deductibility of State and Local Taxes," Advisory Commission on Intergovernmental Relations, April 1985.
5 ACIR, *op. cit.*, p. 15.
6 U.S. Government Printing Office, *op. cit.*, p. 62.
7 deSeve Economics, "A Description of the Linkages Between the Federal and the State's Personal Income Tax Codes," submitted to the Advisory Commission on Intergovernmental Relations, April 30, 1985 (draft).
8 ACIR, *op. cit.*, pp. 29-32.
9 *Ibid.*, p.i., Executive Summary.
10 Chalmers, Jr., Douglas A. S., "Tax Reform Divides States, **State Government News,** July 1985, p. 14.
11 Rafuse, Dr. Robert, U.S. Treasury official, in a presentation at the National Tax Administrators-Tax Institute of America Conference, Denver, CO, October 14, 1985.

James I. Scheiner is Secretary of Revenue for the Commonwealth of Pennsylvania.

Repeal of Tax Deductibility: Bad Rx for Federalism

Gerald H. Miller

Something is fundamentally wrong with intergovernmental fiscal relations in this country. Federal officials seem to view state and local government as just another "interest group" rather than an equal partner in our federal system. The volume of deferred and emergency needs that must be addressed by state and local governments has been well-documented from education to health care, to infrastructure, to the homeless, to corrections. Federal fiscal and monetary policy should be geared to assisting state and local governments in meeting these needs.

The views of state and local elected officials were clearly stated in a recent letter to Secretary of Treasury James Baker transmitting their perspective on current issues in federalism. The letter stated:

> "Since all levels of government utilize the same tax base to provide essential governmental services in the most cost-effective manner, we hold a joint responsibility to our citizens to be able to sit together as equal partners to discuss alternatives to the issues and problems on the table before us. Our view is that the Treasury Department is a partner with state and local governments on behalf of the people, not an outside agency that grudgingly 'subsidizes' our governments. The only way that resolution of key domestic issues can be realized is by a constructive relationship among state, local, and federal governments."[1]

Discussion of federal tax reform should always attempt to analyze how change will affect state and local governments and their ability to deliver needed services. It is within this context that I will analyze the current efforts to "reform" the federal tax system.

One of the major provisions of the Reagan Administration's proposed individual income tax reform plan is the repeal of the deductibility of state and local taxes. This policy change is estimated to increase federal revenues by approximately $40 billion per year by the end of the decade. An option recently considered by the House Committee on Ways and Means would eliminate over three-fourths of the value of this deduction and result in extremely large interstate differentials.

Obviously, the elimination of deductibility is a course neither to be taken lightly nor to be casually deleted from the federal tax code. The consequences of eliminating tax deductibility are many, complex and far reaching. One point I think we can all agree on is that the elimination of deductibility of state and local taxes cannot help state and local government. This negative impact will be manifested in a number of ways.

Higher Prices for State and Local Government Services

One of the important ways that this deduction helps maintain a fiscal balance between the different levels of government is that it effectively lowers the relative prices of services provided by state and local governments. For example, a taxpayer with a state tax liability of $1,000 and a marginal federal income tax rate of 30% can use deductibility to reduce the net state tax liability by $300. Therefore, this taxpayer's net state tax liability of $700 actually provides governmental services worth $1,000.

One major factor that will keep taxes from increasing is the continued existence of the "tax revolt" sentiment among taxpayers. The tax revolt movement, that began in the 1970s, was really a reaction to the combined tax burdens of federal, state and local governments; but because taxpayers have more direct access to state and local governments, the brunt of the tax revolt was felt by those governments first. The tax revolt resulted in tax rollbacks and/or spending and taxing limitations in 35 states.

The revolt is by no means dead today. For example, two years ago, two Michigan state senators were recalled because they voted for a temporary income tax increase during the midst of the severe economic recession. That marked the first time in Michigan's history that an elected state official was recalled from office. Given this situation on taxes, it is very clear that the increase in the price of services that would occur if deductibility were eliminated would not be offset by a direct increase in state and local tax burdens. It therefore follows that over time it would result in a decrease in state and local government services.

The degree to which state and local governments in the aggregate would be forced to cut spending is currently being debated, with some estimates as high as 21%. The U.S. Treasury Department estimates these spending cuts to be in excess of $6 billion—not a trivial number.[2]

The tax revolt sentiment, the reduction of federal assistance to state and local governments, and the shifting of additional responsibilities to state and local governments are already placing extraordinary burdens on the budgets of state and local governments. The elimination of deductibility would only make a bad situation worse.

Greater Fiscal Disparities

Deductibility also helps narrow the unavoidable interstate, intrastate and regional tax differentials. Tax levels vary in different parts of the country for a number of reasons. For instance, a state rich in a natural resource can tax that natural resource and export the tax to citizens in other states—thus relying less on taxes assessed on individuals such as income and sales taxes.

Moreover, complete elimination of tax deductibility would substantially increase the competitive tax advantage that the non-income tax states and the low income tax states now enjoy over the high income tax states. When I refer to tax competition I am focusing on upper income taxpayers—the people who are frequently the most "footloose" and the most influential in deciding where investments are going to be made.

In order to meet growing social needs, an older industrial city whose economic base is deteriorating likely will need a higher level of taxes on individuals to meet the increasing service demands within the city. Deductibility can help reduce the tax differentials that unavoidably arise between central cities and their surrounding suburbs within a state. Conversely, eliminating deductibility would increase the cost of needed government services in the higher tax area, creating an incentive for the more affluent taxpayers in the higher tax area to move. The less well-off—the elderly and the poor—would have much less opportunity to relocate.

Complete elimination of deductibility would substantially increase the competitive tax advantage that many low tax suburban jurisdictions now enjoy over their central city neighbors. It would tend to reinforce all of the other factors working in our urban society that are pushing the upper income families out of the central cities and into suburbia.

Without deductibility, the economic base of certain areas (particularly large cities) would be adversely affected and therefore the problems that already exist would be exacerbated. This is an important point that bears repeating: The problems that create tax differentials, be they poverty or some other social factor, would not vanish if deductibility were eliminated. These problems would still need to be addressed and, as already noted, state and local governments would be less able to cope.

In short, the 50 states of the Union and the tens of thousands of local governments do not enter that competitive arena on an equal footing. Some governments are carrying heavy welfare burdens while others take a relatively narrow view of their social responsibilities. Some jurisdictions are blessed with energy resources so they do not have to levy an income tax—such as Alaska and Texas.

Program Cuts Likely

At the very time when the federal government is expecting state and local governments to take on more of the public service responsibilities which it is shedding, the modification of the deductibility provision will decrease state and local governments' willingness and ability to respond with increased spending in the areas of health care, education and social services for the poor.

In terms of the way in which this country organizes its public sector, the modification of the deductibility of state and local taxes will reduce the ability of those governments to experiment within the public policy arena and diminish the significance of state and local choice in the development of public policy. In terms of the way in which state and local governments respond to the service needs of their citizens, the series of bad news mentioned above, capped by the repeal of the deductibility provision, highlights the fiscal disparities among state and local governments and makes state-local service pick-up of federal programs even more unlikely.

Distortions of State-Local Tax Structure

Deductibility also provides an incentive to state and local governments to use more progressive taxes to raise the revenue to finance needed public services. The more progressive the tax, the more the burden of the tax will fall on those persons most likely to itemize deductions and therefore lower the effective price of the services provided by the state or local government. Redistribution of income is an inevitable outcome of the state-local fiscal system. The deductibility provision reaffirms that redistribution of income is primarily a national interest, as it should be. Its repeal pushes the redistribution function away from the federal government toward state and local governments where it should not be. The end result will be that the nation steps away from its redistribution obligations.

Eliminating deductibility would not only eliminate the incentive to use more progressive taxes, but it would also create new incentives to rely more on user fees and other regressive revenue sources, and it would encourage the use of taxes on business. Because state and local taxes on business would still be deductible at the federal level as a business expense, there definitely would be an incentive to place more of the state-local tax burden on businesses—particularly on corporations. This is an important point that should not be overlooked or underestimated by the business community, and an action that would shrink the federal revenue gain relative to gains assuming no changes in state and local revenue systems.

Martin Feldstein, former chairman of the President's Council of Economic Advisers and currently a professor of economics at Harvard University, addressed this issue in a recent commentary for *The Wall Street Journal* entitled "A Tax-Reform Mirage." Feldstein observed: "If the deductibility of personal income, sales and property taxes were eliminated, states and cities would increase their reliance on business taxes and fees. . . . The net effect of eliminating deductibility therefore would be to shift a portion of the finance of state and local governments from individuals—where

each dollar of state and local tax payment has a relatively small impact on federal tax receipts—to corporations where those same state and local tax payments have a much larger impact on federal tax revenue. If eliminating deductibility causes a large enough shift from personal taxes to business levies, the Treasury actually would lose money by eliminating deductibility."[3]

To support this view, he cited statistical evidence that suggests a much different revenue outcome than that offered by Treasury should deductibility be eliminated or otherwise changed.

> "I recently completed a study at the National Bureau of Economic Research that indicates that the current differences among states in the proportion of taxpayers who itemize and in the average tax rate of itemizers has an important effect on the way that states and local governments finance their spending. The statistical estimates imply that eliminating deductibility would cause enough of a shift in the mix of state and local revenue sources to cut the Treasury's prospective revenue gain by more than half. Although there are, of course, many complexities in interpreting the statistical evidence, the clear implication is that the federal revenue effect of eliminating the deductibility of state and local taxes is uncertain at best."

In concluding, Feldstein observed: ". . . I suspect that the principal reason it (deductibility) is being considered is that it looks like the only way to raise substantial tax revenue with which to finance reductions in personal tax rates. Unfortunately, that is a fiscal illusion on which it would be reckless to rely."

The "Subsidy" Issue

As is clear from the above discussion, the repeal of the deductibility of state and local taxes will have a negative impact on the ability of state and local government to deliver needed services. However, before concluding the case we need to briefly examine the view put forth by many that tax deductibility is an inefficient subsidy. Noto and Zimmerman, using a price elasticity of $-.5$, argue that the increase in state and local expenditures caused by deductibility amounts to only 60 cents per dollar of loss to the federal treasury.[4] Because the federal government has the option of giving the dollar to state and local government directly, say through General Revenue Sharing, Noto and Zimmerman conclude that deductibility is an inefficient mechanism for stimulating state and local spending. The recently-released U.S. Treasury study comes to the same conclusion that tax deductibility is an inefficient subsidy.

However, other economists, such as Professor Oakland of Tulane University, have attempted to point out certain flaws in the Noto and Zimmerman argument.[5] He argues that it is not necessarily the case that tax deductibility will stimulate state and local spending by less than a program such as General Revenue Sharing. Indeed, theoretical considerations suggest that the opposite may be true. In any event, the evidence is not sufficiently clear-cut to conclude that tax deductibility is an inefficient form of subsidy to state and local governments. This is not to say that there are not grant mechanisms that could more efficiently stimulate particular forms of state and local expenditures. But with respect to stimulating state and local expenditures in general, tax deductibility is not inherently inefficient.

No matter how you come out on this debate, it is irrelevant to the tax policy discussion facing us today. The reasons for this should be very clear in that I have not seen any federal public finance policymaker putting forth any realistic alternative grant mechanism to the repeal of deductibility. Therefore, those who wish to make the inefficiency (alternative) argument should clearly identify and explain the negative impact that the repeal will have on state and local government unless there is an alternative grant mechanism proposed.

An Acceptable Alternative?

One alternative that could help remove deductibility from the options being considered for federal tax reform was recently suggested by Professor George Break and I quote ". . . its (deductibility) significance and equity could be improved by removing it from the official list of federal tax expenditures, thereby recognizing its basic structural functions, and by moving it 'above the line' into the category of 'adjustments to income,' thereby making it available to all federal income taxpayers."[6]

Until federal tax policy officials are willing to address the fact that the elimination of the deduction for state and local taxes will have a negative impact on the ability of state and local governments to deliver needed services, responsible state and local officials will continue to vigorously oppose any effort to repeal or modify the present provision of tax deductibility.

FOOTNOTES

[1] Letter signed by Jane Maroney on behalf of the State-Local Advisory Group, September, 1985.

[2] U.S. Department of Treasury, **Federal-State-Local Fiscal Relations,** Report to the President and Congress, September, 1985, pp. IX., 21.

[3] **The Wall Street Journal,** November 20, 1985.

[4] Nonna Noto and Dennis Zimmerman, **Limiting State-Local Tax Deductibility in Exchange for Increased General Revenue Sharing: An Analysis of the Economic Effect,** Congressional Research Service, The Library of Congress, June 2, 1983, p. 10.

[5] See testimony of William H. Oakland before the Joint Economic Committee, May 29, 1985.

[6] See George F. Break, "Commentary," in **American Domestic Priorities: An Economic Appraisal** (University of California Press, 1985), John M. Quigley and Daniel R. Rubinfeld (eds.), pp. 78-79.

Gerald H. Miller is Executive Director of the National Association of State Budget Officers.

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The Measurement of State-Local Fiscal Capacity and the 1983 Representative Tax System Estimates

Carol E. Cohen

and

Robert B. Lucke

The Advisory Commission on Intergovernmental Relations (ACIR) has been involved for over 20 years in the debate surrounding the measurement of state-local fiscal capacity. While at first glance the choice of a measure of fiscal capacity may appear to be a methodological issue of interest only to a small group of economists, it actually has important intergovernmental implications. Besides being of intrinsic interest to federal, state and local policymakers, fiscal capacity measures are employed in federal formulas distributing billions of dollars annually to states and their localities. The choice of measures, each with its own theoretical and practical justifications, affects this distribution. And with the recent cutbacks in federal aid, the distribution of these funds has taken on even greater importance.

The two best-known instruments which currently exist for measuring fiscal capacity are per capita income and the Representative Tax System (RTS). Per capita income, published by the U.S. Bureau of the Census, is the measure now used in federal formulas seeking to achieve a degree of fiscal equalization by incorporating a measure of fiscal capacity. Per capita income is used in the distribution formulas for over a dozen programs, including General Revenue Sharing, Medicaid, Aid to Families with Dependent Children (AFDC), Community Development, Vocational Education, and several other social service programs.

The RTS estimates, the major alternative to per capita income, were first published by ACIR in 1962, and annual estimates have been produced since 1979. The RTS provides a unique form of disaggregated tax base, tax capacity, and tax utilization data that is extremely valuable to state and local policymakers.

What Should Fiscal Capacity Measure?

The choice between per capita income and the RTS hinges as much on the definition of fiscal capacity as on the theoretical and practical characteristics of the measures themselves. There is no disagreement that a good measure of fiscal capacity should be hypothetical and standard across all states; that is, it should not depend on any individual state's **actual** tax choices, but rather on its **potential** ability to raise taxes. Furthermore, it should be comprehensive in whatever it is trying to measure. But what exactly should it measure?

One school of thought holds that fiscal capacity should measure the resources which are generated from all economic activity and available to support both public and private spending, regardless of whether governments actually tax that activity or not. Per capita income is included in this category of measures which attempt to estimate the underlying economic resources from which taxes theoretically can be raised to support the state-local sector. The U.S. Bureau of Economic Analysis' recent efforts to measure gross state product would also fit into this category.

An alternative view is that a measure of fiscal capacity should reflect the ability to raise revenues for

public purposes from sources governments actually **can** and **do** tax. The RTS illustrates this latter approach because it is designed to measure the potential revenue of each state if all of them used the same "representative" tax system. The system is based on 26 commonly used tax bases and national average tax rates.

The Choices: Per Capita Income and the RTS

Per capita income measures all of the income that is received by a state's residents and is available to purchase all goods and services (divided by the number of residents). The measure has achieved wide acceptance and use because it is conceptually simple and readily available. It is calculated annually by the Bureau of the Census.

However, per capita income has several deficiencies. As a measure of economic activity, it is not comprehensive; it does not include accrued income from sources such as the non-dividend portion of corporate income nor does it include changes in net worth (e.g. unrealized gains on property). As a measure of fiscal capacity, per capita income bears some relationship to the ability to raise public revenues, but it does not provide a direct measure of actual tax sources. Importantly, by measuring the income of **residents** of a state, per capita income fails to account for tax exportation—the ability of a state to collect taxes from nonresidents. The ability to export taxes depends, for example, on how much of a state's tax base lies in industries which can pass on taxes (such as severance taxes) to nonresidents, and on the amount of taxes (such as sales or hotel/motel taxes in tourist areas) a state receives which are paid directly by nonresidents. Whenever there is tax exporting, there is also tax *importing*. By failing to account for these factors, per capita income results in the relative over- and understatement of fiscal capacity.

The RTS measures the absolute and per capita amount of revenue that each state would raise if it applied a uniform set of tax rates (national averages) to a common set of 26 tax bases. Because the same tax rates are used for every state, the RTS implicitly measures the underlying bases creating the differential taxing capacities of the states.

By using 26 tax bases, the RTS automatically is a more comprehensive measure of fiscal capacity than per capita income, that uses only one taxable source (income) in its calculation. The RTS bases its calculation of capacity on such major sources of revenue as the property tax (that accounted for 31.4% of all state-local tax revenue in 1983), the sales tax (22.8%), the corporate income tax (5.0%), and 23 other taxes, rather than on the income tax alone (19.4%). And because the RTS employs a representative system of actual taxes, including those likely to be exported, it captures the extent of tax exportation. The RTS does not provide information on the final incidence of taxes, only on the total amount of state revenue—from residents and nonresidents—that could be collected from each tax.

Some Advantages of the RTS

There are two important advantages to employing the RTS measure rather than per capita income. First, the advantage of the RTS over per capita income in incorporating tax exportation (the *major* difference) is extremely important because of the difficulty of measuring exportation directly. With the high oil prices experienced in the late 1970s and into the 1980s translating into increased nonresident tax revenues for oil-rich states, the divergence between the per capita income and RTS measures of fiscal capacity becomes particularly apparent. As **Table 1** demonstrates, by failing to account for tax exportation, per capita income seriously understates the tax capacity of states which have high tax exporting opportunities due to mineral wealth (such as Alaska) or tourism (such as Nevada). By understating the tax capacity of some states, the per capita income measure creates a relative overstatement of the tax capacity of others. A full state-by-state comparison of the two measures is presented in **Table 2.**

Table 1

Comparison of 1983 RTS and Per Capita Income (PCI) Indices for Selected States

State	1983 RTS Index	1983 Per Capita Income Index	Percentage Point Difference Between RTS and PCI Indices
Alaska	272	147	+125
Wyoming	182	102	+ 80
Nevada	147	107	+ 40
Texas	124	100	+ 24
Oklahoma	115	94	+ 21
New Mexico	108	83	+ 25
Louisiana	107	88	+ 19
Montana	105	85	+ 20

Source: ACIR Staff Compilation

In addition to the increased accuracy and sophistication provided by its incorporation of tax exportation, the RTS also is more sensitive than per capita income to changes in fiscal capacity. Economic changes which affect state tax bases, and hence fiscal conditions, are reflected more quickly and strongly by the RTS than by the per capita income measure. (These changes, as reflected by the RTS estimates, are discussed in detail below.) At times when federal policymakers may wish to provide countercyclical fiscal assistance, the RTS can do a better job than per capita income of quickly pointing up changes in fiscal capacity.

Some Criticisms

Despite its advantages over per capita income, the RTS is not without its shortcomings. Some critics claim that it is too complex to calculate and understand, and that the data requirements are too great. However, ACIR's annual calculation of the RTS for the United States and Canada's implementation of an RTS would

Table 2
1983 RTS and Per Capita Income Indices

State	*RTS*	*Per Capita Income*
New England		
Connecticut	124	128
Maine	90	84
Massachusetts	107	114
New Hampshire	108	123
Rhode Island	86	100
Vermont	94	86
Mideast		
Delaware	118	109
Washington, DC	117	135
Maryland	99	111
New Jersey	112	121
New York	95	111
Pennsylvania	88	92
Great Lakes		
Illinois	98	106
Indiana	86	90
Michigan	90	98
Ohio	89	96
Wisconsin	87	97
Plains		
Iowa	91	92
Kansas	102	105
Minnesota	97	102
Missouri	89	94
Nebraska	101	96
North Dakota	111	100
South Dakota	87	84
Southeast		
Alabama	75	79
Arkansas	78	77
Florida	104	99
Georgia	87	89
Kentucky	79	81
Louisiana	107	88
Mississippi	68	69
North Carolina	87	84
South Carolina	76	79
Tennessee	89	82
Virginia	96	84
West Virginia	87	79
Southwest		
Arizona	97	71
New Mexico	108	83
Oklahoma	115	94
Texas	124	100
Rocky Mountain		
Colorado	122	110
Idaho	83	82
Montana	105	85
Utah	82	77
Wyoming	182	102
Far West		
California	119	114
Nevada	147	107
Oregon	95	92
Washington	101	104
Alaska	272	147
Hawaii	114	104
U.S. Average	100	100

Source: ACIR Staff Computation

seem to belie the notion that the RTS is technically or politically infeasible.* Indeed, the strength of the RTS is that, because it is based on the real world, it provides a sophisticated measure of fiscal capacity, yet does so in a manner that has a great deal of intuitive appeal.

A second set of criticisms, relating to such matters as the RTS's inclusion of consumption bases (e.g. sales, property) and the exclusion of an adjustment for tax exportation via the deductibility of state and local taxes on the federal income tax, stem from efforts to impose a comprehensive income approach on the RTS, and reflect philosophical rather than technical differences with the RTS. Taken as whole, the RTS is a self-contained approach to measuring fiscal capacity based on the actual tax bases that determine capacity.

In addition, a number of technical criticisms have been levied at the RTS. These include the assertions that it is not comprehensive because it excludes certain revenues such as user fees and rents and royalties; that applying average rates for severance taxes is not appropriate; and that the interaction effect between tax rates and tax bases interferes with the accurate measurement and capacity.

The ACIR has experimented with the RTS and measured the impact of making adjustments in response to these technical criticisms. Generally, it has found that the RTS methodology is quite flexible and adaptable to change. Under alternative assumptions, the RTS results change very little for most states, illustrating the robustness of the RTS method.

Recent Trends

The 1983 RTS capacity estimates reflect the underlying currents flowing through the economy. The estimates are for a year in which the economy experienced the beginnings of a strong recovery from the deep recession of 1982. The changes in the estimates of many state tax capacities betwen 1982 and 1983 were large, reflecting the sensitivity of the RTS method to changes in state economic conditions.

The recovery was not shared equally among the states. The states with the largest capacity growth between 1982 and 1983 are generally in the Northeast; these states include Connecticut (+7 points), Massachusetts (+6 points), New Hampshire (+8 points), Maine (+6 points), and New Jersey (+6 points). These states have prospered from the recovery more than other states. This is due in large part to the large expansion in high-tech industries in the region, and in Massachusetts in particular. Another state relying heavily on high-tech industries—California—also had its capacity increase (by 3 points) over 1982.

The states which have benefited least or failed to share in the recent economic recovery are primarily the energy-producing states. Alaska (−40 points), Wyoming (−19 points), Oklahoma (−11 points), and New Mexico (−7 points) had the biggest reductions in their capacities. These states are all large energy producers

* **Editor's Note:** The Canadian RTS has its roots in a 1940 Royal Commission report and in an equalization program based on a "mini RTS" (limited to three taxes) introduced in 1957. In 1967, the RTS was expanded to 16 elements, including all provincial taxes on income, consumption, property and natural resource rents, and various licenses, fees and service charges. Today, the Canadian RTS is comprised of 39 tax, license and fee categories.

and have felt the effects of a soft world oil market through lower prices for their oil and gas production, and through reduced exploration and drilling activity in their states. Between 1982 and 1983, the price refiners paid for crude oil declined about 9% in nominal terms, and about 12% in real terms. In Wyoming and Oklahoma, per capita income (in nominal dollars) actually declined between 1982 and 1983.

Coal producing states also have suffered from lower energy prices. Montana (–5 points), West Virginia (–5 points), North Dakota (–4 points) and Kentucky (–3 points) are all major coal producers that experienced significant capacity declines between 1982 and 1983. Between 1982 and 1983, the real price of coal declined by 8%. The strong value of the dollar has also hurt these states by reducing coal exports; U.S. exports of coal fell by 27% between 1982 and 1983. In 1982, coal exports were 13% of domestic production; in 1983, exports were about 10% of production.

The farm states also have been hurt by the high value of the dollar that makes exports less competitive abroad. Iowa (–5 points), Kansas (–4 points), and Minnesota (–2 points) have seen their tax capacities continue to erode. Between 1982 and 1983, U.S. farm income declined (in nominal terms) by 20%; farm income of the Plains states fell by 34%.

The recovery in the automobile industry has somewhat helped the Midwestern states keep their heads above water. Although the industry earned record profits in 1983, this was not enough to increase the capacities of Michigan, Indiana and Ohio—all three experienced declines of 3 points. Slow or no growth in other manufacturing industries worked to offset gains made in the automobile industry. As a result, these states did not keep up with the rest of the Nation's recovery.

The non-energy southern states remained about even with their 1982 standings. Mississippi (68), Alabama (74), and South Carolina (75) remain the fiscally poorest states and experienced only minor changes in their relative capacities. North Carolina experienced a significant gain of five points (from 82 to 87), largely due to across-the-board increases in most sectors. Virginia (rising from 94 to 96) continued its long-run trend toward the national mean of 100.

The overall changes between 1982 and 1983 reflect basic changes in the national economy. The large federal budget deficits have strengthened the dollar, thereby making U.S. exports less competitive abroad and hurting industries (and the states that rely on those industries) which are major exporters or who compete in U.S. markets against foreign producers. These trends are apparent for sectors such as farming, mining, and durable goods manufacturing. As already mentioned above, soft world energy markets have played a major role in the capacity declines of energy-producing states.

The downward trend in some states was matched (by definition) by increased capacity in other states. Lower prices for imported intermediate goods—especially oil—have enhanced the competitiveness of industries using these goods. This is especially the case for firms which are not subject to international competitive pressures but whose markets are primarily domestic. Other sectors producing goods not subject to major international competition, such as retail and wholesale trade services (e.g., medical, legal, hotel), public utilities, and defense contractors also fared quite well in the recovery.

1975–83 Trends

The ACIR's initial research on RTS in the 1960s and 1970s has now become an ongoing effort. As such, annual estimates on a generally consistent basis from year-to-year are now available for 1975, 1977, and 1979 through 1982. These estimates provide an interesting backdrop for analyzing the capacity trends over the last several years.

The Energy States. The RTS has shown the large energy booms in the producing states in 1979 to 1981 turning into an energy bust in recent years. For example, during the 1977–79 period, the tax capacity of Texas went from 112 to 117, and peaked at 132 in 1981. Since then, the state's capacity has declined to 124 in 1983. Texas is somewhat diversified in its economic base, so the swings related to energy were not nearly as large as other more energy-dependent states such as Alaska and Wyoming.

The Alaska case is special because of its large energy base and relatively small populations. In 1975, the state's tax capacity was 158. Although the Alaskan pipeline had not been completed, the state's capacity was buoyed by the massive construction investment in the state. In 1979 (after completion of the pipeline), the state's capacity shot up to 217, and further rose to a high of 324 in 1981. This large surge in tax capacity points out one of the primary flaws in the per capita income measure of capacity. Even though the state's coffers were overflowing with oil revenues in these years, the per capita income measure showed only a modest change, rising from 134 to 142 during the 1979–81 period. In fact, based on the per capita income measure, Alaska's capacity was highest in 1977 (at 157), before North Slope oil started to flow.

That the RTS and per capita income would produce such diverse results is not surprising. The per capita income measure treats all forms of economic activity in the same way: a dollar paid to construction workers is "worth" the same amount to the state (in the form of fiscal capacity) as a dollar earned from selling crude oil. On the other hand, the RTS weights different types of activity according to what the average (or representative) state actually taxes. If states tax oil and gas production at high rates, oil and gas production is weighted more heavily; similarly, if they tax income at low rates, income is assigned a low weight. That the same dollar of economic activity should be weighted differently makes intuitive sense: states are likely to tax immobile activities (e.g. oil and gas production) at higher rates than footloose activities (e.g. construction workers income). The fiscal advantage given to a state by tax bases which are relatively immobile, compared to other states, is not recognized in the per capita income approach to capacity measurement.

Other energy states also have experienced the same kind of ups and downs as Alaska. For example, Louisiana was at 97 in 1977, climbed to 117 in 1981, and has since retreated to 107. Oklahoma grew from 101 in 1977 to 127 in 1981, and has since declined to 115. The major coal-producing states have gone through the same cycle, although with less severity. West Virginia

rose from 90 in 1977 to 94 in 1980, but is now down to 87. Wyoming—a large producer of oil, gas and coal—grew from 154 in 1977 to 216 in 1981, and has now backed down to 182.

In 1983, the energy cycle had yet to reach its trough. Energy prices were weaker in 1984, and have continued to decline in 1985 in real terms. This suggests that the tax capacities of energy states are likely to show continued declines for 1984 and 1985.

The Non-Energy States. In contrast to the energy states, the capacities of the New England states appear to be on the rise. For example, Massachusetts was at 96 in 1975, declined to 93 in 1979, and has risen since then to 107 in 1983. Similarly, Connecticut has risen from 110 in 1975 to 124 in 1983. Maine was at 84 in 1975, fell to a low of 79 in 1981, but has now grown to 90. The recession of the early 1980s did not hit these states as hard as the rest of the Nation, so their capacities did not decline relative to other states. In recent years, as these states have moved from dependence on an old mill town economy to a more high-tech orientation, their fiscal health has grown concurrently.

Over the 1977–1982 period, the Great Lakes states and the Plains states have seen their capacities seriously eroded. For example, since 1977 Illinois has seen its capacity fall from 112 to 98; Michian's capacity has declined from 103 to 90; and Iowa's capacity has fallen from 105 to 91. These states have felt the full brunt of the decline in the durable goods manufacturing and agricultural sectors. Not only did they experience the severe economic downturn of 1981–1982, but the high value of the dollar in international markets has prevented them from sharing in the economic recovery to the same extent as other states.

On the Pacific Coast, California has seen its capacity fluctuate over the 1975-1983 period. In 1975, the state's capacity was 110; since then, it has risen to 119. The boom in high-tech industries, as well as in defense contracting, fueled the latest rise in capacity. However, the current downturn in the semiconductor industry, as well as some reduction in defense spending, may tend to reverse this growth in 1984 and 1985. California's northern neighbor Oregon has seen its capacity steadily decline since 1977, from 104 to 95. Most of this decline is likely attributable to the state's weak lumber industry. Washington's capacity has remained fairly constant at about the national mean since 1975.

RTS Regional Disparities and Per Capita Income

During the period when energy prices were rising rapidly (1979 to 1981), the geographic distribution of tax capacity favored the western energy-producing states at the expense of the northeastern states. Virtually all western states—except those without significant energy production—had tax capacities above their per capita income ratings. Conversely, all northeastern states had capacities below their per capita income. This geographic disparity was viewed by some as an "inherent" bias of the RTS against the western states. Certainly, if the estimates of tax capacity had been used instead of per capita income in federal grant formulas, a significant shift in federal funds from the West to the East would have occurred in those years.

The situation has changed, and should continue to change. Several northeastern states now have tax capacities in excess of their per capita income ratings. These include Maine, Vermont, New Hampshire, and Delaware. The shortfall between tax capacity and per capita income in some other northeastern states also has declined significantly. For example, the tax capacity for Massachusetts was 11 points below its per capita income rating in 1979 and 1981; it is now 7 points below. The differences between tax capacity and per capita income are shown for the New England states in **Table 3.**

Table 3
Difference Between Tax Capacity and Per Capita Income Indices for the New England States, 1979 to 1983

State	1979	1981	1983
Connecticut	−9	−12	−4
Maine	0	−3	6
Massachussetts	−11	−11	−7
New Hampshire	1	−2	5
Rhode Island	−11	−7	−14
Vermont	1	−2	8

Source: ACIR Staff Compilation

These changes are mirrored by opposite changes in many western states: the gap between their tax capacity and per capita income also is shrinking. The end result of these recent changes is that the charge of "regional bias" in the RTS is less sustainable. Furthermore, any shift in federal grants that would result from switching from per capita income to the RTS is likely to be substantially less now than in the 1979–1981 period. Lastly, to the extent that these trends continue, the regional disparities between tax capacity and per capita income should be further reduced.

Long-Term Trends in Fiscal Disparities

Over the 1975 to 1981 period, the tax capacity indices showed growing disparities among the states in their revenue-raising capacities. Since then, this trend has reversed itself, although disparities remain greater than in the years before 1981.

The "population-weighted standard deviation" of the tax capacity indices is a summary measure of the dispersion among state tax capacities around the national average of 100. In 1975, the standard deviation was 10.4; in 1977, it was slightly higher at 11.4. As energy prices rose and revenues started flowing into the coffers of the energy-producing states, this index rose to 13.7 in 1979, 15.7 in 1980, and peaked at 18.5 in 1981. These changes reflect the large rise in world oil prices in 1979 and 1980, as well as the decontrol of oil prices in 1981 and phased decontrol of natural gas prices. Disparities remained about the same in 1982, and declined to 16.8 in 1983. As a result of further weakening in energy markets, the 1984 and 1985 estimates should show a continued decline in state disparities.

The RTS tax capacity indices for selected years between 1967 and 1983 are contained in **Table 4.**

Table 4

RTS TAX CAPACITY INDICES FOR 1983 AND SELECTED PRIOR YEARS

State	1983	1982	1981	1980	1979	1977	1975	1967
New England								
Connecticut	124	117	110	112	109	112	110	117
Maine	90	84	79	80	80	82	84	81
Massachusetts	107	101	96	96	93	95	98	98
New Hampshire	108	100	95	97	96	102	102	110
Rhode Island	86	81	80	84	84	87	88	91
Vermont	94	89	84	84	85	93	94	88
Mideast								
Delaware	118	115	111	111	110	120	124	123
Washington, DC	117	115	111	111	110	123	118	121
Maryland	99	100	98	99	99	101	101	101
New Jersey	112	106	105	105	102	106	109	107
New York	95	92	89	90	89	94	98	108
Pennsylvania	88	89	90	93	93	99	98	91
Great Lakes								
Illinois	98	99	104	108	112	112	112	114
Indiana	86	89	91	92	98	100	98	99
Michigan	90	93	96	97	104	103	101	104
Ohio	89	92	94	97	101	104	104	100
Wisconsin	87	87	91	95	100	99	98	94
Plains								
Iowa	91	96	102	105	108	105	106	104
Kansas	102	106	109	109	109	105	109	105
Minnesota	97	99	100	102	105	100	97	95
Missouri	89	91	92	94	97	96	96	97
Nebraska	101	97	97	97	100	101	106	110
North Dakota	111	115	123	108	109	99	101	92
South Dakota	87	87	86	90	95	91	94	91
Southeast								
Alabama	75	74	74	76	76	77	77	70
Arkansas	78	79	82	79	77	78	78	77
Florida	104	104	101	100	100	101	102	104
Georgia	87	84	81	82	81	84	86	80
Kentucky	79	82	82	83	85	83	85	80
Louisiana	107	113	117	109	104	99	97	94
Mississippi	68	71	72	69	70	70	70	64
North Carolina	87	82	80	80	82	83	85	78
South Carolina	76	74	75	75	76	77	77	64
Tennessee	89	77	79	79	81	83	84	78
Virginia	96	94	94	95	93	91	93	86
West Virginia	87	92	90	94	92	90	89	75
Southwest								
Arizona	97	96	89	89	91	89	92	95
New Mexico	108	115	114	107	103	98	97	94
Oklahoma	115	126	127	117	108	101	98	102
Texas	124	130	132	124	117	112	111	98
Rocky Mountain								
Colorado	122	121	113	113	110	107	106	104
Idaho	83	86	87	87	91	88	89	91
Montana	105	110	114	112	113	103	103	105
Utah	82	86	86	86	87	88	86	87
Wyoming	182	201	216	196	173	154	154	141
Far West								
California	119	116	115	117	116	114	110	124
Nevada	147	151	148	154	154	148	145	171
Oregon	95	99	99	103	106	104	100	106
Washington	101	102	99	103	103	100	98	112
Alaska	272	313	324	260	217	158	155	99
Hawaii	114	117	105	107	103	107	109	99
U.S. Average	100	100	100	100	100	100	100	100
Standard Deviation[1]	16.8	18.3	18.5	15.7	13.7	11.4	10.4	14.6

[1]Population weighted

Source: ACIR staff compilation

The Case for a More Comprehensive Measure of Fiscal Capacity

Although the trend toward lower fiscal disparities lessens the urgency of providing redistributive fiscal assistance to state and local governments, there remains a strong case for using tax capacity instead of per capita income in federal grant formulas. In an era of fiscal austerity at the federal level, it is important that the limited fiscal assistance provided by the federal government be targeted to those states with the lowest ability to raise revenues on their own. Using the RTS—or some other more comprehensive index of capacity than per capita income—could improve the cost effectiveness of federal grants in reducing fiscal disparities among the states.

The tendency toward equalization is slow. In the short-run, there often are shocks to the economic system which may have large effects on the bases of state economies. The aforementioned rise and fall of energy prices, as well as the international standing of the dollar, are likely to favor some states relative to others. These shocks are unforeseen events that provide gains (and impose losses) on states which happen to be in the right (or wrong) place at the right (or wrong) time. In the short-run, these shocks can lead to large disparities among the states; over the long-term, the economies of the states adjust to the shocks and return to their long-run equalization path.

Does the national government have a role in providing assistance to offset fiscal disparities? To the extent that the federal government provides fiscal equalization assistance to the states, it may ease the effect of economic shocks, thereby offsetting some of the gains and losses. Government assistance may, however, impede the economy's adjustment to these shocks, and this possible cost must be balanced against the goal of offsetting fiscal disparities.

If this analysis is correct, the disparities among the states are short-term in nature and will be equalized over the long-run. But, as Lord Keynes reminded us, in the long-run we are all dead.

Carol E. Cohen is a research associate with the Public Affairs Research Council of Louisiana, Inc. Robert B. Lucke is a tax analyst at the Congressional Budget Office. Both served as ACIR Fellows. The views expressed here are those of the authors, and do not necessarily reflect the policies of their respective organizations.

A Special Report

Taxing the Catalogue Buyer: Playing Fair in Interstate Commerce?

Holley H. Ulbrich

It is possible to shield interstate commerce from undue state tax burdens without causing serious taxes losses for state governments? This tough balancing question confronted the Advisory Commission on Intergovernmental Relations as it sought to resolve a long-standing conflict over the taxation of out-of-state mail order sales.

The Commission has been considering the problems involved in the taxation of mail order sales since its March 1985 meeting when it held the first of two hearings on the subject. At its September meeting, the Commission voted 11 to 5 to recommend that the Congress enact legislation enabling states to enforce tax collection on sales and use taxes on out-of-state mail order sales. In order to ease compliance burdens on small firms operating in multiple jurisdictions, the Commission recommendation included a *de minimis* rule that would exempt vendors with sales below a specified threshold amount determined by the Congress, but not less than $12.5 million in gross sales, and a provision for a single non-discriminatory tax rate.

The Controversy

Problems relating to the taxation of out-of-state mail order sales have resulted in a controversy between state tax administrators and out-of-state mail order houses. The managers of the mail order house contend that they should not be required to collect taxes on goods and services sold in those states where their only business presence consists of the distribution of sales catalogues or other advertising materials because they receive little or no benefit from programs financed by state and local taxes. Moreover, they argue that a congressional directive that would force out-of-state mail order houses to collect the sales/use tax for all of the states and for thousands of local sales tax jurisdictions would impose heavy collection costs on them—an undue burden on interestate commerce.

In 1967, the Supreme Court, in the *National Bellas Hess v. Illinois Department of Revenue* decision, supported their contention by ruling that states could not require out-of-state mail order firms to collect state sales/use taxes if their business presence in the state was limited to distributing sales catalogues or other forms of advertising.

On the other hand, tax administrators claim that the mail order industry has not cooperated with the states by either collecting the tax or providing the state with the transaction data needed to bill customers for the tax. Thus, they argue, this situation provides out-of-state vendors with an apparent competitive advantage (4.5% nationwide) over the millions of in-state merchants throughout the United States who cannot legally avoid the collection of state and local sales and use taxes—a situation that undermines the fairness and equity of state-local tax systems.

State tax administrators also emphasize that this out-of-state mail order problem will worsen because many factors are now contributing to the substantial growth in mail order sales—the use of television advertising, "800" telephone numbers for placing orders, and other technological innovations such as the use of home computers for shopping and purchasing. Most state tax administrators favor remedial congressional legislation that would negate *National Bellas Hess* by requiring out-of-state vendors to collect the use tax from their customers and remit it to the state revenue department.

The Problem: How to Enforce Sales/Use Tax Collection?

State tax authorities are becoming increasingly concerned about their inability to collect the sales/use tax in a growing number of cases in which their residents purchase goods from out-of-state mail order firms. Their enforcement concern is illustrated by the following hypothetical example in which three Wisconsin consumers purchased camping equipment for $1000.

Consumer A buys at a local retail store where the firm collects $50 in Wisconsin *sales taxes* and remits to Madison.

Consumer B orders from the Sears, Roebuck catalogue headquarters in Chicago. Because Sears also has outlets in Wisconsin (and hence a business presence), that firm collects and remits $50 in *use taxes*.

Consumer C buys from a catalogue seller in Maine that has no business location or facilities in Wisconsin. He pays neither a sales nor a use tax.

The point must be emphasized that Consumer C is legally liable for the payment of the Wisconsin use tax on the equipment he purchased and had sent into the state. The only issue is how to best enforce the sales/use tax law.

Sales and use taxes are levied on the final purchaser but collected primarily through the vendor. For in-state sales, the fact that the sales tax normally rests on the purchaser, but is collected by the vendor, presents no serious problems. For many interstate sales, the state also is able to collect a use tax through one of the following methods:

1) If the vendor has an adequate nexus (i.e., business location or other identifiable linkage that meets the nexus test—warehouses, retail outlets, sales staff, offices, service facilities, etc.) in the state, the state is able to require that the firm collect either a sales or use tax, usually the later.

2) Out-of-state purchases of automobiles are usually subject to the collection of sales or use taxes because the purchaser must pay it to register the vehicle in the state.

3) At least part of the use tax on business purchases from out-of-state vendors can be collected from the business purchaser through normal channels (monthly or quarterly sales tax returns) or on an audit by state tax authorities if the purchaser is registered for sales tax purposes.

4) Reciprocal collection cooperative agreements provide some enforcement of the use tax collection, although this is the least common method.

Purchases on which use taxes are most likely to escape collection include mail order and direct marketing interstate sales, border sales, and some part of taxable business-to-business sales. It is the first of these categories, and some parts of the third category, which are the concern of the ACIR study.

Because of the enormous diversity in state sales and use taxes, it is difficult to generalize about the nature, coverage and other aspects of these taxes. Most states that enacted sales taxes (taxes on purchases) followed them shortly thereafter with a use tax, the main purpose of which was to tax purchases made in other jurisdictions by residents of the state. Typically, the use tax is a tax on "the enjoyment of that which is purchased" when the purchase would, in the absence of jurisdictional problems, be subject to the sales tax. While there is no meaningful economic distinction between sales and use taxes as commonly defined, the courts have held them to be different in terms of the vendor's collection obligation.

State and Local Revenue Losses

States and local governments have become increasingly dependent on sales and use taxes; they constituted 24% of all tax revenues for state and local government in 1982, up 19% since 1967, the year of the *National Bellas Hess* decision. From 1979-85, the number of local jurisdictions levying sales and use taxes grew by 22% from 5,448 to 6,668. In addition, 26 states had higher sales tax rates in 1985 than they had in 1980, while only one state had a lower rate.

As the volume of mail order sales rises, revenue losses to state and local governments from uncollected taxes has been rising. The ACIR study estimates that in 1985 state-local revenue losses ranged from $1.4 to $1.5 billion (see Table 1). These estimates were adjusted for exempt items and make other necessary corrections. Even after allowing for vendors which meet the linkage test in multiple states, and providing for the exclusion of some sellers by a *de minimis* rule exempting firms below a specified sales threshold, additional state and local sales and use tax revenues in excess of $1 billion would be well within the realm of possibility if states and localities were able to collect the taxes owed. As the mail order industry continues to grow, the revenues will increase even more.

Compliance Costs: The Business Side of the Story

Firms not now obligated to collect the tax rest their economic arguments against collection requirements primarily on compliance costs. If local as well as state use taxes are to be collected (both are collected by mail order firms meeting current nexus standards), there are about 6,700 jurisdictions to deal with; even for state taxes alone, or a combined state-local tax, there are 46 jurisdictions. In addition to rate differences, exempt items and buyers vary greatly from state-to-state. This is a particular problem for sales in states exempting purchases of food and clothing, or to potentially exempt buyers (e.g., charitable organizations), or to business firms.

Mail order firms argue that an adequate determination of the sales tax is more difficult without the physical presence of the customer to resolve borderline cases of exemptions. The mail order *customer* who pays cash must determine the amount of tax to add to his payment. The growing volume of credit purchases presents a much less serious problem, because the mail order *firm* determines the tax owed.

Compliance costs appear to be a particularly serious problem for the numerous small firms who do not make the bulk of the sales in mail order and direct marketing. The definition of "small" is a critical component of any proposed legislation. For example, one Philadelphia firm that sells sales and use tax computer software estimates that annual sales of $5 million would be a threshold level for use of their product, a measure that ties size to use of cost-saving tax compliance tech-

Table 1
Estimated State Revenue Loss From Mail Order and Direct Marketing Sales, 1985

State	Allocated by Sears', Ward's and Penney's Sales (in thousands of dollars)	Allocated by Personal Income
Alabama	$ 4360	$ 18840
Arizona	16540	19990
Arkansas	41610	10830
California	104580	209500
Colorado	8900	15010
Connecticut	10340	34470
DC	1440	7630
Florida	39930	63250
Georgia	35930	22900
Hawaii	420	6320
Idaho	11650	4770
Illinois	61020	89260
Indiana	30320	36730
Iowa	20790	16240
Kansas	23050	11590
Kentucky	52680	21350
Louisiana	38700	23270
Maine	13030	5540
Maryland	23840	35410
Massachusetts	8960	34350
Michigan	39780	42790
Minnesota	33240	30170
Mississippi	44720	16240
Missouri	44060	28600
Nebraska	12130	6210
Nevada	10520	6530
New Jersey	16940	58090
New Mexico	22530	8180
New York	47440	122940
North Carolina	62740	30380
North Dakota	10310	3850
Ohio	38180	61960
Oklahoma	27530	14240
Pennsylvania	50160	76610
Rhode Island	890	6050
South Carolina	29710	18810
South Dakota	7870	3510
Tennessee	72580	36860
Texas	101020	97410
Utah	10050	10240
Vermont	7980	2620
Virginia	36840	27660
Washington	61030	49130
West Virginia	38160	11000
Wisconsin	29860	27330
Wyoming	4860	1960

U.S. Total: $1,409,000 to $1,487,000 (thousands)

Source: ACIR staff computations

nology. The Small Business Administration (SBA) develops size standards for various industries which define maximum sales levels below which firms are eligible for the services of the SBA. For mail order firms, the 1984 SBA threshold sales volume was set at $12.5 million.

Large firms are more likely to meet the business presence test in more than one jurisdiction and therefore have greater familiarity with complying with multiple sales and use tax requirements than smaller firms. Few firms, however, are presently involved in collecting taxes for a large number of states. A rough measure of those who meet the nexus requirement in more than one state is the number of multi-establishment firms. Census data indicate that in 1982, only 18 of 5,858 firms which list mail order as their primary classification operated five or more establishments. No comparable data are available for firms whose secondary industrial classification is mail order.

The Options

In September, the Commission considered four alternatives relating to the collection of sales and use taxes on out-of-state mail order sales. The Commission recommended enactment of federal legislation to enable states to require the collection of use taxes on interstate mail order sales without reference to nexus requirements. It favored enabling federal legislation because of the serious drawbacks to be found in each of the three other options it considered:

- to affirm the status quo;
- to encourage state-initiated litigation to overturn *National Bellas Hess;* and
- to recommend Congressional legislation providing for a direct federal tax on mail order sales across state lines.

The Commission found affirmation of the status quo unsatisfactory because the problems caused by the existing situation are too serious to be ignored. Enforcement problems plague state tax administrators, who have no way of assessing or collecting use taxes on many mail order purchases coming into their state. Because of these problems in collecting sales and use taxes on mail order sales, state tax administrators find that the integrity of their tax bases is being undermined, and that severe damage has been done to the perceived equity of their tax systems. In-state merchants feel that they are placed in an unfair competitive position compared to many out-of-state mail order houses who do not collect sales/use taxes.

The Commission also rejected the alternative that states actively pursue litigation intended to modify or overturn the nexus standards established in the *National Bellas Hess* case, and if successful, then implement collection of use taxes on interstate mail order sales through multistate cooperative agreements. This option was found to be unsatisfactory because litigation addresses the problem in a piecemeal fashion, requiring a long series of court decisions to resolve the issues involved; the litigation process has no possibility of addressing the political-administrative problems involved in taxing mail order sales, such as compliance costs or the multiplicity of state-local tax rates; and even successful litigation cannot resolve most enforcement problems.

The Commission also was presented with a third alternative—to recommend enactment of federal legislation imposing a national mail order sales tax at a single rate on all sales to customers outside the state in which the mail order firm is located. Although the relative simplicity and minimal compliance costs for the seller are attractive, the Commission could not endorse a direct federal tax because it would represent a major federal intrusion into state taxing authority. It also would impose sales and use taxes on mail order sales in states which do not presently levy such taxes on in-state sales, putting mail order houses at a competitive disadvantage in those states.

The Commission chose to recommend corrective federal legislation negating the *National Bellas Hess* decision, thereby enabling states which have sales and use taxes to enforce use tax collection. This solution offers the most direct and comprehensive resolution of the competitive fairness, tax revenue, and compliance costs issues without requiring drastic federal intervention. Federal legislation would define nexus standards (the degree of business presence needed to require collection of the use tax) clearly and uniformly in all situations at the same time.

In sharp contrast to a judicial solution of the problem, Congressional action could weigh a broader business presence standard against legitimate business concerns about compliance costs and protection for small firms. Business interest in a *de minimis* rule, uniform state-local rates, and amnesty for prior taxes could be addressed in legislation. All of the economic issues—tax revenues, competitive fairness, and compliance costs—could be resolved through appropriate legislation.

Legislation also could address the current problem of enforcement. State officials feel that a central issue is the uniform enforcement of a clearly established use tax liability in order to promote tax fairness, as well as to prevent further erosion of the sales and use tax revenue base. The sales and use tax is the only broad-based tax that is primarily—if not exclusively—available for state government since property taxes are primarily local, and the federal government makes intensive use of the individual income tax. Thus, its perceived fairness and the integrity of its sales base should be safeguarded.

Congressional action at this time would be a particularly appropriate instance of intergovernmental comity because it would assist states in collecting revenues owed to them at a time when grants from the federal government to states and localities are being cut, and there is a prospect of further grant reductions and devolution of responsibilities.

Critics may argue that corrective federal legislation would reverse a long-standing decision of the Supreme Court. They point to a legal disagreement as to whether it is possible for the Congress to overrule the *National Bellas Hess* decision. However, the Supreme Court decision in *National Bellas Hess* invited congressional action. If the action taken by the Congress is felt by some to be inappropriate, it can be tested through subsequent litigation.

Both proponents and critics of federal legislation overturning the *National Bellas Hess* decision recognize that resorting to a federal legislative solution in-

volves a risk of restoring the linkage in Congressional action between state corporate income taxes and sales and use taxes. The legislative process may not be costless to state revenue officials. To put the issue more bluntly, the price that states may have to pay for Congressional help in extending the reach of their sales and use taxes may be some real constriction on state jurisdictional reach in the corporate income tax area. However, the sales and use tax is a much more significant revenue source for most states than the corporate income tax, and the prospective tax revenue losses from proposed changes in the latter are far outweighed by the potential revenue gains from being able to collect a use tax on interstate mail order sales.

ACIR Recommendation

The Commission recommended that Congress enact legislation that would negate the Supreme Court's *National Bellas Hess* decision by requiring mail order vendors to collect a state's use tax on interstate sales delivered in that state, if the mail order vendor engages in regular or systematic solicitation of sales in that state through catalogues, advertising or other means. Recognizing that the requirement that a use tax be collected can result in substantial compliance costs and enforcement problems, the Commission further recommended the addition of *de minimis* provisions, a provision for a single state-local rate, and an amnesty provision for back taxes.

Exemption of Small Mail Order Firms from Use Tax Collection Requirements. Empirical evidence indicates that the cost of complying with the requirement that use taxes be collected on out-of-state mail order sales is highest for small firms which have great difficulty in keeping abreast of the rates and exemptions applying to the 45 states and about 6,700 local governments which impose sales and use taxes. These firms are frequently too small to be able to afford the computerized equipment which would make the task feasible. Even from the standpoint of the state tax administrator, it is cost effective to exempt small firms and thereby reduce the state's costs in collecting small sums from a large number of out-of-state vendors. While there are a large number of firms in the mail order segment of retail sales, a small number of large firms generate most of the sales volume. Thus, tax revenues could be collected on a large proportion of mail order sales by having tax collectors deal with a relatively small number of registered sellers. The Commission recommended that legislation should contain a *de minimis* rule, exempting vendors whose national sales and/or sales in the destination state are below a specified threshold amount.

While the Commission recommended that the *de minimis* exemption should be determined by the Congress, it suggested that the national level should not be less than $12.5 million indexed annually to the Consumer Price Index to account for inflation. The Commission chose the figure of $12.5 million because the Small Business Administration considers firms in the mail order industry eligible for assistance if their 1984 gross sales are below that level; thus, this level is the accepted government standard for defining a small business in the mail order industry. Although figures are not available to indicate the number of firms which would be exempt at the $12.5 million level, information indicates that only 3.8% of the firms with mail order as their primary or secondary industry classification would be required to collect the tax if the *de minimis* exemption were set at $10 million. At the $12.5 million level, the percentage of firms subject to collection requirements would be somewhat lower.

While objections have been raised about the exemption of small firms on the grounds that small in-state firms enjoy no such sales tax exemption, in many of the states imposing sales and use taxes, the compliance cost burdens for small in-state firms are eased by allowances which cover some part of the collection cost. A useful supplement or alternative to a *de minimis* rule could be to require all states to provide an allowance for collection of interstate sales and use taxes.

Single rate provision. The Commission recommendation also provides another way of easing the cost of compliance for mail order firms—a single tax rate for each state. It is time-consuming and costly for a mail order house to be required to determine tax rates for purchases in every sales tax jurisdiction in the United States—as many as 45 state rates, and about 6,700 local rates are potentially involved.

The Commission recommendation attempts to ease this burden by providing that in states in which there are local sales and use taxes, that state should determine a non-discriminatory single rate: either the state rate only, or a combined state and local rate that the seller may elect to charge in lieu of charging the combined state and local rates for each involved jurisdiction. This provision would reduce the number of rates facing a multistate firm to a maximum of 46.

Admittedly, the process of determining a combined state-local rate is difficult in those states where local rates are nonuniform and the use of local sales taxes is limited to certain jurisdictions. It might be preferable to limit use tax collection to the state tax. There is strong precedent for excluding local use taxes from federal legislation because they are not currently enforced on in-state purchase—a purchase made in City A in Ohio with no local sales tax would not be assessed for a local use in the purchaser's home City B when the item is brought home. On the other hand, much potential tax revenue may be lost by excluding local taxes. For example, New York City has a local rate that is higher than the state rate, and a significant volume of mail order sales can be presumed to be made to the residents of that city.

Amnesty. The Commission's recommendation for an amnesty provision is designed to protect firms from indeterminate liabilities for back taxes. It would be particularly important for small firms if the proprietor wished to sell the firm or issue stock or debt. The provision would free mail order firms from the spectre of an indeterminate contingent liability for sale or use taxes on past sales.

Summary

The Commission's recommendation for dealing with the problems posed by the mail order issue seeks to strike a balance between two conflicting and perennial concerns of our federal system—the maintenance of a

free flow of interstate commerce and the retention of strong and equitable state revenue systems. In response to interstate commerce concerns, the Commission required safeguards designed to minimize the compliance burden on out-of-state mail order firms. In protecting the integrity of state revenue systems, the recommendation enables the states to collect more than 70% of the estimated $1.5 billion which currently escape sales taxation, while exempting some 6,000 mail order firms nationwide.

In the judgment of the majority of the Commission, only carefully crafted Congressional action can both negate the *National Bellas Hess* decision *and* achieve a delicate—but essential—balance.

Holley H. Ulbrich is a professor of economics at Clemson University. She was the primary author of the ACIR mail order study.

Editor's Note: The following dissent to the mail order sales recommendation, adopted by the Commission on September 20, 1985, has been filed by Chairman Hawkins and Commissioners Brock, Dwight, Rothschild and Sununu. Commissioner Meese is filing a separate dissent.

The Commission's recommendation in this report is one of short-sighted expedience for state governments. Regrettably, it harbors long-term erosion of state taxing authority, and is devoid of circumspection, consistency and constitutional soundness. We therefore dissent from this recommendation, and strongly believe that enactment of such legislation would violate the basic precepts of American federalism.

Lack of Circumspection. States should be acutely aware of the potential consequences of asking the Congress for help in tax collection. The price of legislation to extend the reach of the state sales tax collector may turn into constraints on the ability of the states to collect corporate income taxes.

For years, representatives of business firms have been urging the Congress to place a variety of restrictions on state use of corporate taxes. Perhaps the most notable example is the proposal to prohibit unitary taxation—a method by which all corporate profits are computed in determining taxes owed a state. In opposing a ban on this taxing method, state officials, particularly tax administrators, have quite properly defended the inherent right of states to use whatever method they believe fair in assessing the tax liabilities of corporations. The claim of business that unitary taxation is inefficient is regarded as secondary by those opposed to federal remedial legislation—a position supported by this Commission in a 1983 recommendation.

Yet in the Commission's deliberations on the recommendation in this report, many tax administrators informed us that they did not favor an alternative recommendation that would allow states to form compacts to collect sales taxes because it would not be efficient. Such a scheme, they said, would not work in all states and would be more costly to administer.

Have state officials—and the Commission majority who would normally defend state autonomy—transformed their thinking? Is efficiency now the most important consideration in tax policy? If so, then business has a point it may well make to the Congress: If one applies the standards of efficiency sought by tax administrators in interstate mail order sales, then one would think that the most cost efficient means of taxing corporations would be uniform standards enforceable in federal court.

Lack of Consistency. We are in fundamental agreement with one of the philosophical arguments underpinning the Commission's recommendation: that regardless of the merits of sales and use taxes in general, if a state or locality enacts such a tax through the democratic process then citizens of that jurisdiction should not be able to evade it through mail order pur-

chases. Yet, in its own recommendation, the majority ends up violating this principle.

By adopting a $12.5 million *de minimis* rule (only firms with annual sales over that amount be forced to comply) the majority "solved" the pragmatic problem of prohibitive compliance costs for small firms. Thereby did the majority also acknowledge that its recommendation is philosophically empty. If a citizen—who presumably derives the benefits of the revenues collected by his jurisdiction—should not be able to evade a sales tax by purchasing from a large mail order firm rather than from the local merchant, then neither should he be able to evade the tax by buying from a small mail order firm rather than a large one.

In a subtle but undeniable way, this recommendation would transform the sales tax from one levied on consumers to one also levied on out-of-state vendors—business and citizens who have no vote in that jurisdiction and derive no benefit from its spending. If it is true, as this recommendation implies, that local retail merchants are competitively disadvantaged because out-of-state vendors do not have to collect sales taxes, then the *de minimis* rule would place large mail order firms at a disadvantage to small firms. To remain competitive while still collecting the tax, large firms would have to lower their prices. In effect, they would be paying the tax out of their profits, not collecting it from the citizen-consumer who derives the benefits of his jurisdiction's spending.

Lack of Constitutional Soundness. By design, the U.S. Constitution gives states the widest possible latitude in taxing its own citizens, subject only to the restriction on the imposition of tariffs and the requirement that taxes not burden interstate commerce. Yet this recommendation asks Congress to determine the scope and authority of states with regard to their power to tax non-state sources of sales tax. If Congress can set standards for the collection of sales taxes in other states, using federal courts to settle disputes, then Congress may, at a later point, set uniform sales tax rates for the states.

Particularly objectionable in this recommendation is the provision for a single-rate for those states with local jurisdictions which also impose a sales tax. Mandating this, even for a limited purpose, represents an unprecedented intrusion into state-local fiscal relations. The national government has no authority under the U.S. Constitution to interfere with the taxing authority of localities. That is prescribed by each state, either through legislation or by the state's constitution. If Congress can dictate a single state-local sales tax rate, what is to prevent it from mandating other uniform rates on the grounds that such uniformity removes impediments to the free flow of interstate commerce?

In the 1985 case of *Garcia vs. San Antonio Metropolitan Transit Authority*, the Supreme Court held that the Congress of the United States had the right to determine the scope of state authority—in effect ruling that the political process protected the rights of the states, not the Constitution. Most of the members of this Commission, including the majority in this recommendation, are extremely adverse to that decision. Yet, defining the scope of state authority is precisely what this recommendation asks the Congress to do.

Those of us opposed to this recommendation believe that federalism is more than mere efficiency and administration. At its core it is about diversity while still maintaining unity. Our Constitution reserves a broad range of powers for states to undertake governmental activities of their own choosing, and at the same time provides mechanisms for states to solve problems jointly.

If states find that problems involved in taxation of out-of-state mail order sales escape solution by individual state action, we suggest that the appropriate remedy, consistent with federalist principles, would be to ask Congress for legislation authorizing state compacts to facilitate the collection of sales taxes. Such a remedy would encourage state problem solving, could facilitate speedy remedies in state courts, and would bypass the dangerous precedents involved in federal legislation which intrudes upon state taxing authority.

It is a Faustian bargain the Commission has struck. The new revenues look attractive today, especially to tax administrators and politicians who will not be around when payment—in the coin of authority—is demanded. To paraphrase a great American who understood Faustian bargains only too well, "those state and local officials who would give up a little authority to the national government in exchange for a little revenue, deserve neither revenue nor authority."

And Briefly: Books

Changing Public Attitudes on Governments and Taxes, 1985 (S-14) $3.00

At a time when many observers contend that the roles of federal, state and local governments have been dramatically altered, public opinion appears to have shifted very little according to the annual ACIR poll *Changing Public Attitudes on Governments and Taxes, 1985.*

With the exception of 1984, the federal government consistently has vied with local governments for first place in public esteem, with the edge usually going to the federal government, and state governments have placed third. This year, 32% of the respondents chose the federal government as the level from which they get the most for their money, while 31% said local, and 22% said state.

When asked what is the least fair tax, respondents assigned the following order: federal income tax (38%), local property tax (24%), state sales tax (16%), and state income tax (10%). This order of ranking has been consistent since 1979. Thus a paradox: while federal and local governments have consistently out-ranked state governments on the basis of giving more for the money, their primary revenue sources are viewed as the least fair. It is a phenomenon that has spanned four national administrations.

As in 1978, 1982 and 1984, the ACIR poll also addressed attitudes about the power of the federal government. This year, 31% felt the federal government had too much power, 27% felt that it had about the right amount, and 36% felt Washington should use its powers more vigorously.

This is the third year that the Gallup Organization has done the poll for ACIR. Findings are based on a personal interview survey conducted among a nationally representative sample of 1,528 men and women, 18 years of age and older, living in private households. Sampling tolerances for the survey are ± 3 percentage points at the 95% level of confidence.

Emerging Issues in American Federalism: Papers Prepared for ACIR's 25th Anniversary $5.00

Since 1959, ACIR has pursued its primary responsibility: proposing ways to improve the federal system which are based on research, analysis and deliberate consideration by individuals representing a broad spectrum. The Commission's 25th Anniversary—celebrated in 1984—provided a timely opportunity to give attention to past actions, and to place them in the context of contemporary and future issues confronting federalism.

Several events were undertaken during the year: a retreat in Annapolis (MD); a series of public hearings throughout the country; and a dinner at year's end to commemorate the contributions of the organization and its past commissioners. This volume contains the essence of the Annapolis program: papers presented by four distinguished scholars of federalism—Daniel Elazar, Paul Peterson, A. E. Dick Howard, and Harry Scheiber—and extended comments by Senator Richard Lugar (IN) and Alice Rivlin, the first director of the Congressional Budget Office and now with The Brookings Institution. Also included is the anniversary dinner keynote address given by nationally-known syndicated columnist Neal Peirce.

A companion volume summarizing the public hearings will be published in early 1986.

The States and Distressed Communities: Final Report (A-101) $5.00

ACIR, with assistance from the U.S. Department of Housing and Urban Development and the National Academy of Public Administration, undertook a multiyear monitoring project focusing on state policies and programs to assist distressed communities. The results of the 1980-83 effort are contained in *The States and Distressed Communities: Final Report.*

The study found that the focus in local government is shifting toward self-help. States and localities have taken many steps in this direction, and the Commission has called for more to be done. The findings are based on measures of actions taken in 20 specific areas from 1980-83 to expand local government capacities and meet community needs in the fields of housing, economic development, public works, neighborhood development, and local self-government. The areas include: housing mortgage revenue bonds, customized job training, industrial revenue bonds, state bond banks, community-based organizations, enterprise zones, tax increment financing, state aid, state assumption of welfare and education responsibilities, reimbursement for state mandates, and local home rule.

Based upon these findings, ACIR praises the positive trend toward decentralization and urges the states to redouble their efforts to revitalize local governments, to help those governments focus more effectively on solving problems of community distress, and to establish stronger state-local-private partnerships for economic growth. The Commission also advises the federal government to refrain from impeding such state and local efforts through regulatory mandates.

Intergovernmental Arrangements for Delivering Public Services: 1983 Update (A-103) $5.00

Intergovernmental contracts and agreements for service delivery and functional transfers have been used for years by many local governments. A 1983 survey by the International City Management Association and ACIR found that over half of all responding cities and counties contract with neighboring units for services. A similar number use joint service agreements. About 40% of the surveyed localities also have transferred one or more functions to another unit of government (state or local) since 1976.

These activities are analyzed in *Intergovernmental Arrangements for Delivering Public Services: 1983 Update.* The study also documents the expanding constitutional and statutory authority for using intergovernmental methods of service delivery.

As a result of the report's findings, the Commission urges states to encourage rather than inhibit interlocal contracting and cooperation, recommends that states authorize functional transfers among their political subdivisions, and advocates tht such authorization be broadened to include transfers to the state level as well. The Commission also recommends that states revise their laws authorizing interlocal contracting to eliminate any overly stringent procedures and conditions not essential to protecting the public interest.

Other Recent Releases:

Bankruptcies, Defaults, and Other Local Government Financial Emergencies (A-99)—$5.00

The States and Distressed Communities: State Programs to Aid Distressed Communities—Catalog of State Programs, 1983 (M-140)—$10.00

The Question of State Government Capability (A-98)—$10.00

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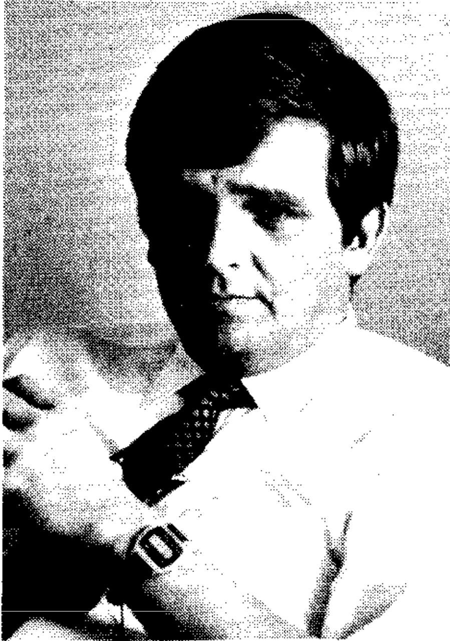
The Chairman's View



A decade ago, during the first year of the second Reagan Administration, the Supreme Court issued its now famous decision in *Garcia v. San Antonio Metropolitan Transit Authority*. Ten years later, the integrity of the federal system is still under siege, as evidenced by actions taken during the first session of the 104th Congress.

- Heeding the concerns of business leaders that the confusing and fragmented traffic laws of state and local governments were frustrating the free flow of commerce, the Congress ordered the Secretary of Transportation to draft uniform national standards. To assist in the effort, a 12-person advisory commission will be established. State and local governments will have three representatives.

- At the behest of the Secretary of Education, the Congress has finally adopted a workable set of national standards for teacher certification and pay. For national education groups, this will alleviate the inconvenience of decentralized planning.

- Finally, the Congress reluctantly decided that state and local governments must further help to reduce the continuing high deficits by implementing the *Clean Water Act* without financial assistance from Washington. The path was cleared for this action when the Supreme Court—in one more of a long string of decisions extending the dictum of *Garcia*—held that the Congress had the authority to regulate the actions of state and local governments, regardless of the presence of federal financial assistance.

Nevertheless, state and local elected officials thought 1995 was a pretty good year. Legislation that would have mandated man-hours for firemen died in committee. In a close floor vote, legislation was defeated that would require consolidation of local schools into regional systems for greater efficiency. And, while a revised bill is sure to be reintroduced, the President vetoed legislation that would have repealed all state and local sales taxes and replace them with a higher national value added tax.

Predicting the future is always fanciful, but thoughtful state and local leaders should think back ten years and ask themselves if they would have ever dreamed that any number of federal interventions would have occurred. The 55 mph speed limit? The 21 year-old drinking age? Interstate banking legislation?

In the last issue of *Intergovernmental Perspective,* ACIR examined the *Garcia* decision by offering two opposing viewpoints. Since that time, the Commission has conducted three regional hearings on the issue, and the staff has written an excellent working paper on the constitutional implications of the decision, as well as the federalism logic the Court has been following.

The staff paper begins by asserting that *Garcia* was consistent with a long history of Court decisions regarding the relationship between federal and state powers. In this contention, the case that *Garcia* overturned, *National League of Cities v. Usery,* was an anomaly. This is near heresy for those of us who saw *Usery* as the beginning of constitutional doctrine to give real meaning to the Tenth Amendment. Yet, I am convinced that the staff is right.

The Tenth Amendment reserves powers to the states that are not delegated to the national government. What is delegated to the national government, however, depends on the rest of the Constitution. And that's the catch. Because of the Commerce Clause, the Court has basically been unable to put limits on the reach of the Congress; because of the Necessary and Proper Clause, it has held most national legislation reasonable to protect health and safety. In short, since there are few other constraints on the Congress in the Constitution, the Court finds little, if any, justification for limiting the Congress. Thus, the majority's logic in *Garcia:* the scope of state authority must be determined by the political processes in the Congress.

Our regional hearings elicited considerable concern over the decision. Naturally, there was substantial interest concerning fiscal impact: the immediate effect of subjecting state and local governments to the *Fair Labor Standards Act* as it relates to overtime pay, and for which remedial legislation has since been enacted. Yet, the focus of the hearings was not on short-term solutions but on long-term impact. What emerged was most interesting.

Most participants agreed with the analysis in the staff working paper. But when it came to solutions, most felt the Congress should solve the problem; or that while a constitutional remedy was necessary, it was impractical. Since then, I have heard numerous comments to the effect that, "now that we have *Garcia* solved because of the legislation we can move on to more important issues;" or, "we cannot tamper with the Constitution, and must seek long-term solutions in the Congress." I would contend that most of these responses reaffirm the Court's dictum that state and local governments must look to the Congress for their authority.

In one sense, the Court is right. The question of federal-state relationships is a political issue. The critical nuance, however, is what type of political issue: congressional or constitutional?

If we answer that it is a question of congressional politics, several things become quite clear. First, state and local governments become nothing more than special interest groups who must play the lobbying game with the Congress. Some may recoil at this notion by contending that states and localities are somehow different, but the Court has ruled differently. Like any other special interest group, the authority of state and local governments is now determined by the Congress.

Another question state and local officials must ask themselves is how they can avoid the scenario outlined at the beginning of this article. How do they forestall increasing federal intervention? I believe that in the game of congressional politics they will ultimately fail in confining the reach of Washington. Since state and local governments do not have a vote for members of the Congress, where does their leverage come from?

Because of this reality, my contention is that the constructive alternative to congressional politics is to seek a constitutional remedy. Whether that takes the form of a new amendment, or further litigation, we need to build a consensus to alter the basic rules under which state and local officials are now forced to play. For, to reduce elected officials to one more lobby pleading before the Congress is indeed a sad notion, and it signals that public interest groups are no different than private interest groups.

Robert B. Hawkins, Jr.
Chairman

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