STATE TAXATION: THE IMPACT OF CONGRESSIONAL LEGISLATION ON STATE AND LOCAL GOVERNMENT REVENUES

HEARING

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COMMERCIAL AND ADMINISTRATIVE LAW

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STATE TAXATION: THE IMPACT OF CONGRESSIONAL LEGISLATION ON STATE AND LOCAL GOVERNMENT REVENUES

THURSDAY, APRIL 15, 2010

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 11:04 a.m., in room 2141, Rayburn House Office Building, the Honorable Steve Cohen (Chairman of the Subcommittee) presiding.

Present: Representatives Cohen, Watt, Maffei, Johnson, Scott, Chu, Franks, Coble, Jordan, and Issa.

Staff present: (Majority) Norberto Salinas, Counsel; Adam Russell, Professional Staff Member; and Stewart Jeffries, Minority Counsel.

Mr. COHEN. This hearing of the Committee on the Judiciary, Subcommittee on Commercial and Administrative Law will now come to order.

Without objection, the Chair will be authorized to declare a recess of the hearing.

I will now recognize myself for a short statement.

Today's hearing focuses both on the current fiscal situation of state and local governments, what impact tax legislation for this Subcommittee would have on state and local revenues. The effect of the current economic climate has been widespread.

Consumers have closed their pocketbooks and cut back on nonessential spending. Businesses have delayed investments in new technologies, or have resorted to laying off their employees. And with declining tax receipts due to lower payrolls, real estate, property values, and consumer spending, state and local governments have had to consider cutting spending, raising taxes, or a combination of both to balance their budgets.

Yet, the economy is improving. We see great support in the economy from the ARRA and other areas, which shows that the economy is making a turn. And the Dow, of course, has gone over 11,000. So, happy days will be here again.

While governors and mayors and city councils must make difficult decisions to stay in the black, a discussion on the current fiscal plight of state and local governments is not complete without discussing what role, if any, Congress has in the affairs of state and local governments.

Obviously, we have had a role in the last year or 2, for we have kept all state and local governments afloat with the ARRA. Congress has a responsibility to review state tax policies and determine whether those policies burden interstate commerce—specifically, we must examine the legislative proposals that have been introduced, and consider whether they would either restrict or expand the ability of states to tax certain activities or taxpayers. There must be a balance between protecting the authority of state and local governments to tax, while providing taxpayers with certainty and fair tax policies.

I thank the witnesses for appearing today, and I look forward to their testimony.

I now recognize my colleague from Arizona, Mr. Franks, the distinguished Ranking Member of the Subcommittee, for his opening remarks.

Mr. FRANKS. Well, thank you, Mr. Chairman. Thank you for calling this third general-oversight hearing on state taxation.

You know, in February, this Subcommittee held a hearing on when states can constitutionally impose taxes on businesses, individuals, and transactions. And, last month, the Subcommittee was supposed to learn how those states divided up that tax authority. And I know that a hearing had to be postponed because of conflicts on the floor. And I am hoping that that can be rescheduled in the near future.

As witnesses may be aware, I am a cosponsor of several state-tax related measures. And I encourage the Chairman of this Subcommittee to move the markup on those bills as soon as it is possible or practical. But that said, I am a bit of a reluctant cosponsor of state-tax related measures, because I am such a strong believer in the 10th Amendment, and in states' rights.

That amendment reads, "The power is not delegated to the United States by the Constitution, nor prohibited to it by the—nor prohibited by it to the states, are reserved to the states respectively, or to the people."

I remember that the founders created a Federal Government with limited powers. However, I also believe that some of those tax bills are necessary to ensure the flow of interstate commerce. And that, of course, is definitely one of the powers that the Constitution granted to Congress.

So, for my friends in state government, I have a straightforward question: When is it a good time for Congress to regulate in this area? Time and again, states and localities have come to Congress saying that they cannot afford for Congress to cut their revenues. And I understand that. I mean, when—this is said when states have coffers that are full, and certainly now, when they are empty.

Given that we know that we cannot tax our way to prosperity—or at least we pretend to know that—I want to know when it is a good time for Congress to assist states in making some much-needed tax reforms. Perhaps, just as importantly, what are the key principles that Congress should keep in mind when legislating in this area.

And so I look forward to hearing from our witnesses on these and other questions. And with that, Mr. Chairman, I yield back the balance of my time.

Mr. COHEN. Thank you, Mr. Franks.

We are going to recognize two of our Members here, who have particular desires. And we are going to ask them to limit their remarks to 2 minutes, so that we can get concluded before the Holocaust Memorial service in the Rotunda begins.

First, I would like to recognize the gentleman from Georgia, Chairman of the Subcommittee on the Anti-Trust, Mr. Johnson.

Mr. JOHNSON. Thank you, Mr. Chairman, for holding this important hearing on state taxation today. Today, it takes me back probably about 45, 50 years ago—and I would watch as my daddy would come home on April 15th. And he would lay all these receipts and things like that out on the table. And he would leave the house around a quarter to 12 to go to the post office to file the tax return. And so this is the anniversary of the time to do that. And I guess it is only fitting that we hold a hearing on state taxation today.

Today, we will examine the impact of congressional legislation on state and local governments. This hearing will give us the opportunity to examine the pending legislative proposals before this Subcommittee regarding state taxation.

The recession has severely affected state and local governments and their residents. State and local governments are forced to make tough decisions regarding their budgets. They are faced with laying off worker, making cuts to education, police and fire departments. We need to provide a solution for our constituents. That is why I have introduced H.R. 2010, the Mobile Workforce State Income Tax Fairness and Simplification Act.

This legislation provides for a uniform, fair, and easily administered law that would ensure that the correct amount of taxes are withheld and paid to the states, without the undue burden that the current system places on employees and employers. The Mobile Workforce Bill does not relieve any employee from paying state income taxes imposed by his or her state of residence. Therefore, the resident state of the short-term traveling employee will not be affected by this legislation.

From a national perspective, the Mobile Workforce Bill will vastly simplify the patchwork of existing inconsistent and confusing state rules. It would also reduce administrative costs to states, and lessen compliance burdens on consumers.

I thank the Chairman for holding this hearing, and I look forward to hearing from our witnesses today. And like Ranking Member Franks, I would love to bring H.R. 2010 to our Subcommittee as soon as possible, as practical, as Mr. Franks said.

Mr. COHEN. Thank you, Mr. Johnson.

Now, I would like to recognize Ms. Chu from California, who has a long history in state government.

Ms. CHU. Thank you, Mr. Chair.

I would like to thank the state and local government officials who have taken time to speak with us today about this very important issue.

Before becoming a member of the California Congressional Delegation, I was a chair of the California Board of Equalization, which is the elected taxation board for the state. And as such, I know how devastating the loss of tax revenue can be to local and state government.

I am particularly concerned about the damaging effects of the recent economic downturn on state and local government budgets. Over the past few years, these entities have been squeezed from both directions by shrinking tax rolls and increasing demands for public services.

As the testimony today demonstrates, the crisis is far from over. And as Members of Congress, we must do everything we can to help our state and local governments weather this storm, and must not be tempted to cut off the vital revenue streams that keep these government entities afloat.

I look forward to your testimony, and to working together with you on solutions for the future.

Mr. COHEN. Thank you, Ms. Chu. I appreciate your and Mr. Johnson's accepting the brevity of our remarks.

Now, I would like to thank our witnesses for appearing today, and any other Members of the Committee that want to make a statement can have it included in the record.

I would like to introduce our first panel. And thank you for participating in today's hearing. Without objection, your written statements will be placed in the record. And we would ask that you limit your oral remarks to 5 minutes.

We have got a little system there of lights. And when it gets yellow, it means you have got a minute to go. Green means you are in the first four. It doesn't stand for Vermont. It just means green, 4 minutes; yellow doesn't mean cheese—it means you have got 1 minute to go; and red—you are over it. It has nothing to do with red states. So that is where we go.

After each witness has made his testimony, each Subcommittee Member will be permitted to ask a question. We get 5-minute limits as well.

Our first witness is Governor James H. Douglas. Governor Douglas was elected to the Vermont House of Representatives in 1972. He spent his entire life in government, an admirable thing to have done. He became assistant majority leader in his second term and majority leader in his third term, at the tender age of 25.

Governor Douglas retired from the legislature in 1979, and became a top aide to then-Governor Richard Snelling. 1980, he was elected secretary of state. He held that post until 1993. His service to the people of Vermont continued with his election to state treasurer in 1994. And, then, in 2002, he successfully was a candidate for governor; reelected on 2-year terms through the current time, which would be 8 years of four terms.

He served as president of the Council of State Governments, and he is the new chairman of the National Governor's Association. We thank you for appearing here, Mr. Governor, and look forward to your testimony.

TESTIMONY OF THE HONORABLE JIM DOUGLAS, GOVERNOR, STATE OF VERMONT, ON BEHALF OF THE NATIONAL GOVERNORS ASSOCIATION

Governor DOUGLAS. Thank you very much, Mr. Chairman. I, first of all, should say that Judge Whitley is a CPA. And he would be happy to file an extension for any member who needs it, before the end of the day.

I am honored to be here on behalf of the Nation's governors. And I want to thank you for the opportunity to address the Subcommittee. I appreciate the fact you are taking time to examine how the state's fiscal situation relates to legislation before your Subcommittee and the full Committee.

As you know, economists have declared the national recession over, but for those who are still unemployed, or who have lost their homes, it is clear that, as a Nation, we have a long way to go. The situation remains poor for states. As governors, we are working with our legislatures to set budgets for 2011 and, in some cases, 2012.

What we are finding is that, from a state-fiscal standpoint, the worst is yet to come. To put it in perspective, it is important to review what states have been through, and examine what lies ahead. As you know, states must balance their budgets. So when revenues fall, states must cut services or increase revenues to make up the difference. Both actions can slow recovery.

Beginning with the last calendar quarter of 2008, state tax revenues plummeted for five consecutive quarters. Because of those declines, 43 states cut $31 billion from state budgets in 2009, and 36 states cut another $55 billion for the current year. These are cuts made after budgets were approved—budgets that were conservative to begin with. They also involve cuts to programs governors fight hard to preserve, like K through 12 education and public safety. In other words, everything is on the table.

In my own state, revenues are $25 million below their 2006 levels, and a staggering $113 million below where they were at the height of the economic bubble 2 years ago. We face a fiscal year 2011 shortfall of about $154 million. That is 14 percent of our general fund budget.

With revenues not expected to return to their pre-recession levels until 2013, our fiscal crisis extends far beyond today. Without sustainable reductions, the shortfall for fiscal 2012 will balloon to over $250 million. That is more than we spend on economic development, environmental protection, public safety and higher education combined.

Unfortunately, the road ahead doesn't look much better. NGA and the National Association of State Budget Officers recently surveyed states for information on their fiscal situations. They found that for fiscal 2010, states closed $90 billion in budget gaps, and have $19 billion more to close. And even after reducing revenue estimates, states' 2011 budget gaps stand at more than $55 billion, followed by another $61 billion the following year. So the total budget gaps over a 3-fiscal-year period—about $136 billion.

The reason these facts are important for the Subcommittee is that your jurisdiction over state tax issues provides you with unique authority to impact the speed of states' recoveries. Simply put, governors ask that the Committee take no action that would undermine the ability or authority of states to develop and manage our fiscal systems. Governors steadfastly believe that decisions about state revenue systems and state taxation should be made by elected officials in the states, and Federal action should favor the preservation of states' sovereignty over that of preemption.

As the Committee considers whether to take up legislation regarding state taxation, governors encourage you to review all proposals in light of these principles. First, do no harm. Legislation dealing with state taxing authority shouldn't undermine existing state revenue streams. Second, preserve flexibility. State fiscal crisis is forcing all governors and legislators to ask fundamental questions about the role of government. These will lead to changes at the state level that could have long-term positive effects on the delivery of services, modernizing revenue systems and holding government accountable. State reform efforts should not be hurt by Federal legislation that restricts states' authority to act.

Third, be clear. Federal legislation should be clear to limit the need for expensive and time-consuming legislation. Finally, find the win-win. The goal of all legislation should be to find a balance that improves the standing of all stakeholders.

Congress, through its authority under the Commerce Clause, has brought authority to regulate state taxation. The key question, though, is not whether Congress can regulate state taxation, but whether and when Congress should.

For governors, the answer stems from the basic principles of federalism. We believe that the ability of states to develop and manage our fiscal systems is a core element of sovereignty; one that should not be interfered with unless absolutely necessary to preserve interstate commerce.

So I thank you for the opportunity to be here and testify on behalf of the Nation's governors. And I look forward to working with the Subcommittee as you consider these important questions for the people we serve.

[The prepared statement of Mr. Douglas follows:]

PREPARED STATEMENT OF THE HONORABLE JIM DOUGLAS

Testimony of Vermont Governor Jim Douglas
Chair, National Governors Association

Before the House Judiciary Committee
Subcommittee on Commercial and Administrative Law
U.S. House of Representatives

State Taxation: The Impact of Congressional Legislation on State and Local Government Revenues

April 15, 2010

Chairman Cohen, Ranking Member Franks, and members of the Subcommittee, thank you for inviting me to testify today. On behalf of the nation's governors and the residents of my home state of Vermont, I appreciate you holding this hearing to explore the fiscal condition of states and the effect Congressional action can have on our fiscal health.

The bottom line is this: decisions about state revenue systems and state taxation should be made by elected officials in the states. This principle is particularly important now as states are working to emerge from a recession that has reduced state revenues to pre-2006 levels. Unlike the federal government, states must balance their budgets. This requires states to make up for lost or decreased revenues by either cutting services and spending or raising revenues. Both actions, cutting services or raising taxes, can slow recovery. As this committee, and Congress as a whole, considers legislation to spur the economy, create jobs or promote competitiveness, it should do so with an eye towards the critical role states play in promoting recovery. More specifically, legislation that would impact state taxes or taxing authority should adhere to the principles of "do no harm," preserve flexibility, be clear and find the win-win so that states may continue to manage their fiscal futures.

Fiscal Condition of States

The fiscal condition of states started deteriorating rapidly when the recession began at the end of 2007. In fact, repeatedly since the downturn started, states have had to lower revenue projections and make spending adjustments to meet balanced budget requirements. Governors in most states are in the process of finalizing or have just completed their budgets for fiscal year 2011, and in some cases 2012. What these budgets show is that from a state fiscal standpoint, the worst is yet to come.

Previous downturns have demonstrated that the worst budget years for a state are the two years immediately after the national recession is declared over. This lag occurs because state revenues continue to decline and state expenditures for safety net programs continue to rise until after unemployment levels peak. However, unlike the recession earlier this decade, states' recovery from the current recession may be prolonged, with most economists projecting a slow and potentially jobless national recovery. Moreover, even when recovery begins, states will continue to struggle because they will need to replenish retiree pension and health care trust funds and finance maintenance, technology, and infrastructure investments that were deferred during the crisis. They will also need to rebuild contingency or rainy day funds and both implement and eventually pay a portion of the Medicaid expansion under national health care reform. Taken together, these facts mean that many states will not fully recover from this recession until much later this decade.

The Current Situation – The recent national economic downturn started in December 2007 and likely ended around September 2009, making it the deepest and longest downturn since the Great Depression. The slowdown directly affected state tax collections, which according to the Rockefeller Institute declined for five consecutive quarters beginning in the last quarter of calendar year 2008 and extending through all of 2009, with reductions of 3.9, 11.6, 16.4, 10.9 and 4.1 percent respectively. These findings are consistent with the NGA/NASBO *Fiscal Survey of States* estimate that state revenues declined 7.5 percent in fiscal year (FY) 2009, which for most states ended June 30, 2009.

Similarly, Medicaid spending, which accounts for about 22 percent of state budgets, averaged 7.9 percent growth in FY 2009, its highest rate since the end of the last downturn six years ago. Medicaid enrollment is also spiking, with projected growth of 6.6 percent in FY 2010 compared with 5.4 percent in 2009.

What these falling revenues and increasing expenditures create are budget gaps – holes in state budgets that must be reconciled to meet balanced budget requirements.
The *Fiscal Survey of States* shows states closed budget gaps of $72.7 billion in FY 2009 and $89.8 billion in FY 2010. This includes tax and fee increases of $23.9 billion in 2010. Even with cuts and tax increases, states continue to experience new budget shortfalls including more than $18.9 billion remaining for FY 2010, $55 billion projected for 2011 and $61 billion projected for 2012. All told, the combined remaining budget gaps that must be filled for 2010 through 2012 equal $136 billion.

For fiscal year 2011, Vermont faces a shortfall of approximately $154 million – roughly 14% out of a General Fund budget of approximately $1.1 billion. In just over a year, more than 10,000 jobs have been lost and last year median family income fell nearly $2,000 from the year before. Although Vermont's unemployment rate is among the lowest in the nation, our workforce is shrinking and too many are underemployed. As a result, state revenues are $25 million below 2006 levels and a staggering $113 million below where they were at the height of the economic bubble in 2008.

While Vermonters have found it harder to pay the bills, our General Fund programs have seen unsustainable increases and new pressures. Demand for human services will grow by $50 million, pension contributions are projected to increase by $29 million, and $75 million in federal recovery funds relied on for this year will no longer be available. With revenues not expected to return to pre-recession levels until 2013, our fiscal crisis extends far beyond today. Without sustainable reductions, the fiscal 2012 shortfall will balloon to over a quarter billion dollars – more than we spend on economic development, environmental protection, public safety, and higher education combined.

Governors are making and have already made tough but necessary decisions to address these daunting challenges, including streamlining services, cutting programs, and reducing the state workforce. In Vermont, we are getting close to the end of our legislative session and we're debating controversial but necessary proposals such as alternatives to incarceration for non-violent offenders, and I'm fighting hard to resist legislative proposals to increase taxes on struggling manufacturers.

The American Recovery and Reinvestment Act (ARRA) – State fiscal conditions would have been worse if not for the passage of ARRA. Of the $787 billion in ARRA funds, about $246 billion came to or through states in more than 40 programs. Most important, the $87 billion in Medicaid funds and the $48 billion in state stabilization funds were flexible and allowed states to offset some planned budget cuts and tax increases. Specifically, the Medicaid funds allowed states greater flexibility to manage state funds allocated for Medicaid while the stabilization funds targeted help for elementary, secondary, and higher education, which represents about one-third of state spending.

Without these funds, state budget cuts and tax increases would have been much more draconian. In fact, given the ongoing fiscal problems in states, 47 governors recently signed a letter supporting a two-quarter extension of ARRA's enhanced FMAP funding. Such an extension would help states avoid some cuts or tax increases that would otherwise be necessary to balance 2011 budgets.

My own state of Vermont has received more $700 million dollars in Recovery Act dollars; $500 million of which was paid out before December 31, 2009 and helped support more than 2,000 jobs.

<u>The Recovery Period</u> – While there is still uncertainty regarding the shape of the recovery, there is a growing consensus that it will be slow. Numerous studies project that state revenues will likely not recover until 2014 or 2015. A recent forecast by Mark Zandi at Economy.com showed that the national unemployment rate, which straddled 5.5 percent during 2001–2007, will not attain that level again until 2014. Similarly, Zandi's latest forecast indicated that state revenues will not return to the 2008 level in real terms until FY 2013.

<u>Deferred Investments</u> – Even when recovery begins in the 2014–2015 period, states will be faced with a huge "over-hang" in needs and will have to accelerate payments into their retiree pension and health care trust funds, as well as fund deferred maintenance and technology and infrastructure investments. They will also have to rebuild contingency or rainy day funds. All of these needs were postponed or deferred during the 2009–2011 period and will have to be made up toward the end of the decade. According to a 2007 Pew Center on the States report, states have an outstanding liability of about $2.73 trillion in employee retirement, health, and other benefits coming due over the next several decades, of which more than $1 trillion is unfunded.

What all of this means is states will continue to struggle over the rest of this decade because of the combination of the length and depth of this economic downturn, the projected slow recovery, and the additional Medicaid responsibilities. Even after states begin to see the light, they will face the "over-hang" of unmet needs accumulated during the downturn. With states having entered the recession in 2008, revenue shortfalls persisting into 2014, and a need to backfill deferred investments into core state functions, states will need maximum flexibility to manage their fiscal systems in order to fully emerge from the current recession.

Principles for federal legislation related to state taxation

Governors believe federal action should favor the preservation of state sovereignty when legislating or regulating activity in the states. This is particularly true when it comes to actions that affect the ability of states to manage their revenue systems. The independent ability of states to develop and manage their own revenue systems is a basic tenet of our federal system. Therefore, the federal government should avoid legislation and regulations that would serve to preempt or prohibit, either directly or indirectly, sources of state revenues or state taxation methods that are otherwise constitutional.

Since adoption of the U.S. Constitution, Congress has generally respected state sovereignty with regard to state taxes. Unfortunately, that trend has begun to change over the last few years as Congress has increasingly restricted the rights of states to determine their own tax structure. Recent legislative examples include the moratorium on the taxation of charges for Internet access, prohibiting the taxation of nonresident pension income, and the accelerated elimination of the state estate tax credit.

As this committee considers whether to take up legislation related to state taxation, governors encourage the committee to review all proposals in light of the following principles:

- Do no harm: Legislation dealing with state taxing authority should not disproportionately reduce existing state revenues. This principle is especially important at a time when states are cutting core services to meet balanced budget requirements. Federal unfunded mandates or limits on state authority will only exacerbate the fiscal problems states currently face.

- Preserve flexibility: The fiscal crisis is forcing all governors and states to ask fundamental questions about the role of government. These questions will lead to changes at the state level that could have long-term, positive effects on the delivery of services, modernizing revenue systems and holding government accountable. States should not be hindered in their pursuit of these reforms by federal legislation that restricts a states authority to act.

- Be clear: Federal legislation, especially in the context of state taxation, should be clear to limit ambiguity or the need for expensive and time-consuming legislation.

- Find the win-win: The goal of all legislation should be to find a balance that improves the standing of all stakeholders. Especially in times such as these where states are struggling with unprecedented budget gaps, Congress should only consider legislation related to state taxation or state taxing authority that is beneficial to all stakeholders.

Conclusion:

Congress, through its authority under the Commerce Clause of the U.S. Constitution, has broad authority to regulate state taxation. The key questions are when and how should that authority be used. Governors believe that the ability of states to develop and manage their fiscal systems is a core element of sovereignty – one that should not be interfered with unless absolutely necessary to preserve interstate commerce. The current fiscal condition of states underscores this basic principle and should heighten Congressional consideration of the impact proposed legislation could have on states.

Thank you for the opportunity to testify before you today. On behalf of my fellow governors, I look forward to working with you and would be happy to take any questions.

Mr. COHEN. Thank you, Governor Douglas. I appreciate your remarks and finishing before the red light came. You are the first person, I think, in the entire time I have been in Congress, that has ever done that—particularly, members.

Our second witness is Judge B. Glen Whitley. He is a judge in Tarrant County, Texas—aka, Fort Worth, I guess—of course, selected to the—Tarrant County commissioner in 1996, and elected to the chief executive position as county judge in 2006; presides over the commissioner's court in the county of 1.8 million residents in the heart of the Nation's fourth largest metropolitan center, with great art museums.

Judge Whitley was elected first vice president of the National Association of Counties, NACo, of which I was a member in 1978 to 1980, on July 28, 2009, and became president-elect in this year, 2010.

Thank you, Judge Whitley. Begin your testimony.

TESTIMONY OF THE HONORABLE B. GLEN WHITLEY, COUNTY JUDGE, TARRANT COUNTY, TX, ON BEHALF OF THE NATIONAL ASSOCIATION OF COUNTIES

Judge WHITLEY. Thank you, Mr. Chairman, and Ranking Members of the Committee—and Members of the Committee. I am pleased to provide testimony today on behalf of America's 3,068 counties; and thank you for holding this hearing to discuss the impact of Federal legislation on local government revenues.

While Federal legislation can have a positive impact on local government revenue streams, it can also cause just the opposite. Unlike the Federal Government, local governments must balance their budgets, which is not an easy thing to do in today's financial climate. According to an October 2009 NACo survey, 56 percent of the counties report that they will start their fiscal year with budget shortfalls of up to $10 million; 47 percent of the counties report that those shortfalls will increase after the start of the fiscal year. And a whopping 82 percent of the counties state that the anticipated shortfalls are even greater into the next fiscal year.

This is why the imposition of unfunded mandates and the preemption of local taxing authority can have such a negative impact on local government. We strongly urge Congress, as it takes further action to spur our economy and create badly needed jobs, that it carefully considers the role of local governments play in our economic rebirth, and not take actions that would adversely affect county budgets and revenue streams.

Traditionally, counties perform state-mandated duties, which include assessment of property, record-keeping, maintenance of rural roads, administration of election and judicial functions, and safety-net services. Today, counties are moving rapidly into other areas, undertaking programs related to child welfare, consumer protection, economic development, employment training, planning and zoning, water quality—just to name a few.

It is important that Congress recognize that not all counties tax and spend in identical fashions, and that Congress creates a slippery slope when it removes the linkage between tax flexibility and services delivered.

Preemption of local taxing authority is a major concern of local governments. Preemption dictates policy implementation of traditional county responsibilities and functions; undermines the concept of federalism; and is contrary to the constitutional framework underlying Federal, state, and local relations. Federal preemption of local taxing authority should not be initiated unless there is an overriding issue of national importance.

Further preemption must not be undertaken if its fiscal impact on local governments has not been evaluated closely and openly in a public forum. For example, hotel taxing authority is under attack by online hotel operators such as Expedia and Travelocity. Local governments use hotel taxes in various ways. In some locales, the revenues are funneled to the general fund to help provide badly needed community services to the residents. Some locales use revenues to promote tourism, while others use these funds to pay for voter-approved convention centers, sports arenas and other public buildings.

It would be unconscionable during our current financial crisis for Congress to even consider the possibility of granting online travel companies preferential tax treatment at the expense of county budgets. State and local governments lose billions of dollars annually because of the inability of taxing authorities to collect from remote sellers.

Federal legislation which would permit the collection of these taxes has not been introduced in the 111th Congress. Although NACo supports efforts to reduce the complexity of state and local sales-and-use-tax laws, tax simplification should not be used by the Federal Government to undermine county-government taxing authority and revenue streams.

NACo has long supported communication, tax reform, and simplification. But any changed must treat like services alike, and must allow for an increase in tax revenues as the service or industry grows. Tax simplification vehicles such as any legislation that would implement the streamlined sales-and-use-tax agreement should not be used as a means to undermine local-government finances, while at the same time, granting preferential treatment to special interests.

This is why NACo is concerned with Sale Tax Fairness Act, which would impose a 5-year moratorium on new discriminatory taxes on mobile-service providers and property. Moratoriums harm local governments' ability to reform their tax systems, and are especially troubling for local jurisdictions that rely on wireless taxes. It is inescapable that Federal legislation have both a positive and negative impact on local-government revenues.

County governments urge Congress, when it considers tax and revenue-related legislation, to avoid preempting local tax authority, preserve local budgeting flexibility, and resist imposing unfunded Federal mandates.

On behalf of NACo and the Nation's counties, I would like to thank you for the opportunity to testify before you, and look forward to working with you, and would be happy to answer any questions.

[The prepared statement of Judge Whitley follows:]

PREPARED STATEMENT OF THE HONORABLE B. GLEN WHITLEY

Testimony of Tarrant County, Texas Judge B. Glen Whitley
President-elect, National Association of Counties

Before the U.S. House of Representatives
Subcommittee on Commercial and Administrative Law

"State Taxation – The Impact of Congressional Legislation on State and Local Government Revenues"

April 15, 2010

Chairman Cohen, Ranking Member Franks, and members of the House Subcommittee on Commercial and Administrative Law:

My name is B. Glen Whitley. I am the Tarrant County, Texas Judge and President-elect of the National Association of Counties (NACo). NACo is the only national organization that represents county governments in the United States. Founded in 1935 – and celebrating its 75th Anniversary this year – NACo provides essential services to the nation's 3,068 counties. NACo advances issues with a unified voice before the federal government, improves the public's understanding of county government, assists counties in finding and sharing innovative solutions through education and research, and provides value-added services to save counties and taxpayers money.

I am pleased to provide testimony today on behalf of America's counties and thank you for holding this hearing to discuss the impact of federal legislation on local government revenues.

No one can seriously question the impact that federal legislation can have on the financial health of local governments. For example, consider the passage of the American Recovery and Reinvestment Act (ARRA) in early 2009. With its combination of federal tax cuts, expansion of unemployment and other benefits, and increased spending for education, health care, and infrastructure, the $787 billion bill surely helped to lessen the devastating impact on local governments caused by the worse economic downturn since the Great Depression.

I would be remiss not to mention the Build America Bonds programs, which was part of ARRA. These bonds have proven to be an effective financing option for local governments. The program has increased the market for local government debt by expanding the pool of potential market investors, including pension funds. To date, there have been over 1,000 issuances of Build America Bonds worth over $90 billion. According to a Treasury Department analysis, state and local governments stand to save $12.3 billion from bonds issued during the program's first year. If you're looking for an example of how federal legislation impacts state and local government revenues, this is it.

<u>County Budgets</u>

But while federal legislation can have a positive impact on local government revenue streams, it can also cause just the opposite. Unlike the federal government, local governments must balance their budgets, which is not an easy thing to do in today's financial climate. According to an October 2009 NACo survey, 56% of counties report that they will start their fiscal year with projected shortfalls of up to $10 million; 47% of counties report that those shortfalls will increase after the start of the fiscal year. And a whopping 82% of counties state that they anticipate shortfalls into the next fiscal year.

In balancing their budgets, county officials must have every available option on the table. Budgeting flexibility and the ability to respond to constituent needs are of paramount importance in the budgeting process. According to our survey, counties are responding to budget shortfalls in various ways. Sixty percent of counties report they are delaying purchases and repairs; 49%

report imposing hiring freezes; 54% of the counties are delaying capital investments; and 44% are using their rainy day/reserve funds.

This is why the imposition of unfunded mandates and the preemption of local taxing authority can have such a negative impact on local government finances. And this is why we strongly urge Congress, as it takes further action to spur our economy and create badly needed jobs, that it carefully considers the role that local governments play in our economic rebirth and not take actions that would further adversely affect county budgets and revenue streams.

Traditionally, counties performed state-mandated duties, which included assessment of property, record keeping (e.g., property and vital statistics), maintenance of rural roads, administration of election and judicial functions, and poor relief. Today, counties are moving rapidly into other areas, undertaking programs relating to child welfare, consumer protection, economic development, employment/training, planning and zoning, and water quality, to name just a few.

Service delivery responsibilities, however, vary widely among counties. For most, construction and maintaining local roads is one of their prime duties. North Carolina counties, however, have no responsibilities in this area. Wide variations also exist in the social service responsibilities and the types of utility services (e.g., water supply) provided by county governments.

That disparity is clearly demonstrated by a review of individual states and the percentage (of total expenditures) their counties spent on various services. For instance, according to the most recent census data, counties in Virginia spent 55% of their total expenditures on educational services (including library services) in FY 2001-02. New Hampshire counties spent 67% on public welfare services in the same fiscal year. South Dakota counties spent 35% of their budget on transportation services for FY 2001-02, and Maine spent 56% of its budget on public safety that year.

It is important that Congress recognize that not all counties tax and spend in identical fashions and that Congress creates a "slippery slope" when it removes the linkage between tax flexibility and services delivered.

Preemption

Preemption of local taxing authority is a major concern of local governments. Preemption works to dictate policy implementation of traditional county responsibilities and functions, undermines the concept of federalism, and is contrary to the constitutional framework underlying federal, state, and local relations. Federal preemption of local taxing authority should not be initiated unless there is an overriding issue of national importance. Furthermore, preemption must not be undertaken until its fiscal impact on local governments has been evaluated closely and openly in a public forum.

For example, hotel taxing authority is under attack by online hotel operators, such as Expedia and Travelocity. Local governments use hotel taxes in various ways. In some localities, the revenues are funneled into the general fund to help provide badly needed community services to our residents. Some localities use the revenues to promote tourism. And some municipalities use these funds to pay for voter-approved convention centers, sports arenas, and other public buildings. It would be unconscionable during this current financial crisis for Congress to even consider the possibility of granting the online travel companies preferential tax treatment at the expense of county budgets.

Unfunded Mandates

Fifteen years ago last month, Congress passed and President Clinton signed the Unfunded Mandates Act of 1995. Strongly supported by NACo, the purpose of the Act was to curb the practice of imposing federal mandates on state and local governments without adequate funding and without full Congressional consideration that such mandates could displace other essential governmental priorities. But despite the good intentions of the Act, opposition to unfunded mandates remains a key legislative priority of NACo. The federal government must fully fund all costs incurred by county governments with complying with federal mandates.

Streamlined Sales and Use Tax

State and local governments lose billions of dollars annually because of the inability of taxing authorities to collect taxes from remote sellers. Federal legislation, which would permit the collection of these taxes, has not been introduced in the 111th Congress. Although NACo supports efforts to reduce the complexity of state and local sales and use tax laws, tax simplification should not be used as a means by the federal government to undermine county government taxing authority and revenue streams. Of major concern to local governments is the proposed inclusion of telecommunications taxes in federal streamlined tax legislation. NACo opposes any efforts to preempt or modify local government taxing authority over telecommunications taxes without our express agreement. Further, any changes must be revenue neutral and technology agnostic.

Telecom Tax Reform

NACo has long supported communications tax reform and simplification. But any changes must be revenue neutral to the locality, must treat like services alike, and must allow for an increase in tax revenues as the service or industry grows. Tax simplification vehicles, such as any legislation that would implement the Streamlined Sales and Use Tax Agreement, should not be used as a means to undermine local government finances, while at the same time granting preferential tax treatment to special interests.

This is why NACo is concerned with the Cell Tax Fairness Act (H.R. 1521 and S. 1192), which would impose a 5-year moratorium on new "discriminatory" taxes on mobile services, providers, and property. Moratoriums harm local governments' ability to reform their tax systems, and are especially troubling for local jurisdictions that rely on wireless taxes.

Conclusion

It is inescapable that federal legislation can have both a positive and negative impact on local government revenues. County governments urge Congress, when it considers tax and revenue related legislation, to: 1) avoid preempting local taxing authority; 2) preserve local budgeting flexibility; and 3) resist imposing unfunded federal mandates.

On behalf of NACo and our nation's counties, I would like to thank you for the opportunity to testify before you today. I look forward to working with you and would be happy to answer any questions.

Mr. COHEN. Thank you. That was perfect. The red light just went on. I appreciate it.

We will now begin questioning. And I will start.

One of the issues that has been raised for many industries is that industries have asked Congress to give them protections from state and local taxes. We have heard from the hotel industry. We have heard from the car-rental industry. We have heard from satellite-television groups, Internet-access providers, and others.

Many of them have stories, charts, and whatever, on how this affects their business. And they argue that they are Federal concerns because of interstate commerce. You know, I know, in my state, that we have used car-rental taxes to help fund sports arenas. And we have used hotel taxes to do it.

And I know when I go out of state and I rent a car, and they charge me high taxes to pay for their stadiums and arenas, it bothers me. I am not too upset when we do ours, but I am upset when they do theirs—"Don't tax me. Do tax that guy behind the tree—"

And, Governor, first, I would like your thoughts. Is it really fair to gore your tourists to fund your facilities?

Governor DOUGLAS. Well, first of all, we use our car-rental tax receipts to maintain and improve our roads and bridges so that folks can drive those rental cars on them—an appropriate use, I would suggest, of—of that source of revenue. Tourism is the second biggest part of our GDP. We welcome people to Vermont. We encourage people to come. Some of our ski areas are still open, by the way, and we hope that you will take advantage of that.

So we don't want to do anything that would give tourists a bad experience, or discourage them from coming again. But it seems to me that states ought to make those decisions for themselves. And if a tourist is disappointed in the use of a tax revenue for a particular purpose, then perhaps that tourist might choose to go somewhere else in the future.

The question is——

Mr. COHEN. Where are they going to see foliage like that?

Governor DOUGLAS. Well, that is why we are using car-rental revenues for the right purpose.

You are our best cheerleader, Mr. Chairman. Thank you.

I think, in the context of the fiscal crisis that states are facing, we—we have to maintain the flexibility to solve their problems as states see fit. The decisions that governors and legislators are making all across this country are profound. The 14 percent budget gap that we are working to fill in Vermont now is prodigious. We have negotiated a pay cut with our state employees. We have negotiated pension cuts for our public-school teachers. We have closed welcome centers—well, maybe that is not good for tourists.

We have limited some of the—corrections to population, which is obviously controversial. But we have to make tough decisions in order to stay within those budgetary parameters. So what we are asking for is to maintain that flexibility.

As I indicated in my remarks, we respect and recognize the role of the Congress to tax where it affects interstate commerce, but we ought to be able to work together and find a win-win outcome so that we can do what is right for the people we represent.

Mr. COHEN. And Governor, let me ask you this—and I am just kind of guessing. I may be wrong. But you are kind of, I think, a moderate, and kind of tend to be kind of more pro-business, maybe, in some areas. Do you think arguments that businesses make about the undue burden on interstate commerce to have any merit?

Governor DOUGLAS. Well, I understand he interest in uniformity; the ease with compliance, when it is on a national basis. But I come back to Congressman Franks' eloquent quotation of the 10th Amendment, and would urge the Congress to respect the prerogative of the state to determine their own destiny from a budgeting and tax standpoint.

I think that is critical as we wrestle with the challenges I have mentioned. We have got one city in our state, Mr. Chairman, that is literally having a debate about whether to maintain its police department or its fire department. It is that serious, because of the fiscal crisis that that community is facing, and that many are, across the country.

So I am suggesting that the Congress ought not to tie the hands of state and local government, but work with us to find a system that benefits us all.

Mr. COHEN. Thank you, Governor. Knowing the wonderful state that you are from, I would think they would—probably the fire department—police themselves, I think.

Governor DOUGLAS. We do have a low crime rate. Thank you.

Mr. COHEN. Judge Whitley, you have seen benefits, I imagine, to your county, from the American Recovery and Reinvestment Act. If that act weren't passed, what would have happened to your county in terms of the personnel that you employ, and programs?

Judge WHITLEY. You know, we have some summer training funds that we did—that was a very successful program. We have been fairly fortunate in my particular county, from a county's perspective, because of some—our recent gas finds. The Barnett Shale have helped us tremendously.

But I will tell you that the city of Fort Worth laid off close to 100 folks last year. And their budget deficit this year is far worse than it was last year—the same with the city of Arlington. So they are looking at some real problems. And at the same time, they did get some benefit.

A lot of the local budgets within Texas are pretty much arrived at locally. We get very little benefit from the state, when it comes back to taking care of our budgets; so most of our budgets come through sales-and-use tax or through property tax. And that is why it is very important that, as we try to figure out how we are going to put that budget together—that we have as many, and as flexible of options as possible.

Mr. COHEN. Thank you, Judge.

My time has expired. I will recognize Mr. Jordan, from the state of Ohio.

Mr. JORDAN. Thank you, Mr. Chairman.

Let me start with just some kind of broad concepts and questions, if I could.

Do you, as a governor and a county official—do you think that taxes can get so high that—I mean, I guess I would ask: Do you agree that the—with the idea that taxing can get so high that we actually hurt economic growth, don't foster job creation and, thereby, actually decrease revenues that come in, and—to provide the services and goods and things that you want to do?

Governor DOUGLAS. I agreeing completely.

In fact, last year, our legislature imposed some tax increases over my veto. And lo and behold, greater revenues haven't been realized because of it, for the reason that you cited, Congressman.

Mr. JORDAN. Governor——

Judge WHITLEY. I guess I would say that, yes, most definitely, it can get too high. But I will absolutely guarantee you, before I look at any tax increase or any additional fee, or anything along that line—I know that I am going to have to go back to my voters and respond and answer, and be held accountable for that.

The problem that we have so often is that we get unfunded mandates, both from you——

Mr. JORDAN. I agree with that.

Judge WHITLEY [continuing]. And from the state.

And so once you begin trying to limit what we can do from a revenue-generation—without limiting what we have to do to be—for the most part, county government is the implementer of Federal and state——

Mr. JORDAN. No, well said. Well said.

Let me ask you two other broad questions. I never thought I would see this day, but it is being talked about a lot here in Congress and across the country—a value-added tax. You know, in America—I mean, I can't believe it is being considered, on top of all the other taxes we currently have, and on top of all the taxes that have been put in place, frankly, over the last year—many of them impacting the middle class.

Your thoughts on what that tax would do to economic growth, economic activity, and how it would impact you as a county, and you as a state?

Judge WHITLEY. I am not sure I know the answer to that. At this point, it is a concept that is, as you indicated, Congressman, being discussed more broadly now. And I guess we shouldn't rule anything out summarily. But the principle that ought to be applied is the one you articulated.

We ought to find a way to move all of our states and counties and localities toward greater prosperity; to encourage entrepreneurship; to put more people back to work, to support the services of government through greater economic activity and revenue-generation, rather than raising tax burdens.

So I guess, in this fiscal climate, we shouldn't say no to anything at the outset. But we should gain some information from the experience of other nations that have done it, and then decide where to go.

Mr. JORDAN. Governor, I am curious—well, look the counties talk is a little bit—as a general statement, do you believe Americans are overtaxed or under-taxed right now—if you had to say one or the other?

Governor DOUGLAS. Well, I would argue that the tax burden is quite high. According to a recent report, Vermonters bear the second-highest burden in America of state taxes per capita. And that is something that I continue to try to reduce. But the principle that I outlined in my remarks, and would suggest again, is that states ought to be given the flexibility to make their own decisions and, in fact, their own mistakes.

Judge WHITLEY. As a CPA, it may surprise you a little bit to hear me say that I really believe we have got to move away from the taxing system that we currently have. I have to send my employees to an 8-hour training session just to figure out how to depreciate this table for tax purposes.

Mr. JORDAN. Yes.

Judge WHITLEY. So it is absolutely ridiculous—the complications that we have moved ourselves into. I guess, also, I would say that, if you look to some sort of a value-added—I mean, you have got a lot of things. It is regressive. So you are going to have to look at some means by which to move some of that—the dollars actually being paid back to those at the lower-income levels. But you also avoid the—for the most part, the people who fail to file; the people who are making income and who are not paying or not filing a tax return.

Mr. JORDAN. Yes.

I mean, look, I happen to think the value-added tax is a terrible idea; and particularly, when you try to impose it on top of all the ridiculous tax burden and complex tax system we have today.

Let me ask one final thing, because I am down to my last 30 seconds. This was also in the news just last week: Do you think it is healthy for a Nation to have 47 percent of the citizens not paying income tax—not paying into the system? Now, they pay payroll tax and other things. But do you think that is healthy for our culture; healthy for our society; healthy for our great country?

Judge WHITLEY. As one of the 53 percent who had to write a check today, no.

Governor DOUGLAS. Well, interestingly, in the recent health-care debate, one of the principles was everybody had to pay. But that is not true in our system of income taxation.

Mr. JORDAN. Thank you, Mr. Chairman. I yield back.

Mr. COHEN. Thank you.

Mr. Johnson, you are recognized. And if you would like to ask if it would be better if our society didn't have this big gap between the rich and the poor, where everybody did pay—if you could do that——

Mr. JOHNSON. Well, I was just getting ready to mount a vicious attack on those who are well-healed and find all kinds of loopholes to utilize so that they don't have to pay taxes. And we have been on a tax-cutting binge since 1980. And during that time, the tax system has become so complex that even my daddy—he would have to start about 10—15 days early to get his taxes squared away. And, for me, I have to have someone else do my taxes, because I don't want to end up pulling my hair out.

But I will say that, with respect to state and local governments, I am very attuned to the fact that the Federal Government has established a habit of imposing mandates without funding, on state and local governments. And I am also particularly affected by how state legislatures impose the mandates upon local government. And the fact is local government does not have any option to be able to shift responsibility for certain expenses to another entity. And so the buck stops with local government.

I want to congratulate you, Mr. Whitley, for your recent election as chair of NACo. I was a member of that organization up until

2006, when I started campaigning for this office. And I was also Budget Committee chair for DeKalb County. That county is now upwards of $80 million shortfall.

And, by the way, we are one of two counties in Georgia that relies upon a sales tax, as opposed to property tax, for county operations. And our school board, which still relies on property taxes, is—is laying off power professionals and closing schools because of a roughly $55 million reduction in the amount of income that they are receiving—the amount of revenue that they are receiving.

And everyone feels like we are paying too much in taxes. But I will tell you, one of the counties that I represent partially—people got so riled up about a millage increase that there was a mass rally right there at the commission meeting. And it forced the commission to back off of a plan to raise the millage rate. And when those same people found out that it was affecting the operation of their library system, and when they found out that police and fire protection was being adversely affected, then they changed course and went back to the county commission. And, as a result, the millage rate was increased so that those services did not have to be cut.

And those are the things that we are straddled with in our state government—a shortfall that continues to escalate at unprecedented numbers, causing lots of layoffs, early retirements, and this kind of thing.

I am very sensitive to state and local governments, when it comes to unfunded mandates and—but I do want to say that—Governor Douglas, there has never been a instance where all states have enacted a uniform tax law. They have gone as far—group states—agreeing to model uniform tax laws; but a minority of those states have enacted the various model laws.

So H.R. 2010—which has the approval of 49 of 50 state-revenue collectors—would be the first, should it pass. Do you think that mobile workers and their employers would benefit from a uniform act?

Governor DOUGLAS. The National Governors Association hasn't taken a formal position on that proposal, Congressman Johnson. But we would be willing to engage in those discussions with you and your colleagues. We all have that phenomenon of people living in one state and working in another. We are next door to New Hampshire—that has no personal income tax. And so folks come across the state line, work in Vermont, and we have the benefit of their income-tax payments. And, obviously, it is quite prodigious of the New York metropolitan area.

So I think it is an issue that is worth discussion. And we would be happy to be a part of that.

Mr. JOHNSON. Thank you.

Mr. COHEN. Thank you, Mr. Johnson.

I now recognize the Ranking Member, Mr. Franks, for 5 minutes.

Mr. FRANKS. Well, thank you, Mr. Chairman. Thank you for your indulgence here.

Gentlemen, thank you for being here.

Governor Douglas, you know, I used to be in state government. And I really do sincerely identify with the challenges of state government. It seems like the Federal Government is always placing unfunded mandates or something that just complicates state governments' lives to the extent that it is maddening. And I just wish, you know, you could know how much I do identify with that. So, please grant me diplomatic immunity here, with any of these questions, if you would.

At the end of your written testimony, you set forth a number of principles that Congress should consider when enacting state-tax legislation. I know there have been a number of legislative proposals put forth in the last few years, as you know—the Business Activity Simplification Act, the Cell Tax Fairness Act, the Mobile Workforce Act—to name three.

And do any of these bills, in your judgment, or the other state-tax bills that may be out there, satisfy your principles as a state governor, or—that would merit NGA support?

Governor DOUGLAS. Most of them, I would not be enthusiastic about, frankly, Congressman Franks. The one area where we would like to see the Congress consider action is the Streamlined Sales Tax. In order to be fair to the merchants on Main Street in our communities, we want to make sure that they are not placed at a competitive disadvantage by untaxed transactions over the Net.

So 18 states now are full, participating members. Six other are part way toward being a part of that compact. And we would like to see the Congress embrace that in order to have a fair system of taxation in that area.

But most of the other proposals, frankly, would work to the detriment of states, in my view, to either collect revenues, or impose restrictions that would limit the ability of states to have the flexibility to design their own tax structure. So I would urge the Subcommittee to be cautious in proceeding with most of the bills that are pending.

Mr. FRANKS. Well, your testimony establishes that the current economic crisis has, you know, been a burden on states. And I think somebody would have to be living on the moon to not realize that.

I live in Arizona, which is close. But the reality is that it has been a profound challenge for the states. And I do understand that. So I guess the question I would ask is: It does, in spite of that, seem that states or cities or counties really never have a time when they think it is okay for us to do this.

And so I want to ask you to predict the future. But can you give me an example, in the last 20 years, when states would have considered it acceptable, from a budgetary standpoint, for Congress to pass a tax-related law?

Governor DOUGLAS. Well, first of all, I have a son who lives in Arizona. So I get firsthand reports on the fiscal and economic challenges of your state. And there——

Mr. FRANKS. So you know I speak the truth——

Governor DOUGLAS. Indeed.

I don't know. I am trying to think of an example. Obviously, the Federal Government has imposed certain telecommunications taxes over the recent past. And there may be some legitimate justification for some of them. But I think, as a general proposition, since states have to balance their budgets on an annual basis, especially in this climate, we ought to respectfully limit the involvement of the Federal Government in tying their hands, so that they can design structures that are best for their constituents.

And sometimes, those decisions won't be advantageous, as I suggested earlier. But that is the laboratory of democracy——

Mr. FRANKS. Sure.

Governor DOUGLAS [continuing]. That we need to let states pursue.

Mr. FRANKS. Well, you know, the ironic part, of course, here, is I—everything you are saying resonates in my own heart, because you—it makes a lot of sense to me. The challenge, of course, is that when one state does—overtaxes here, then it impacts another state. And, then, we are called upon to have some sort of, you know, effort to try to maintain commerce through the states. And it makes it kind of difficult.

So let me just ask you a final question. Say, with respect to the Sale Fairness Tax Act, of which I am a—I am a cosponsor of that bill—the national average tax rate that consumers pay for wireless services—15.2 percent. But consumers in some states, as you know, pay over 20 percent in taxes and fees. And I guess I would just ask you: Is there a point—or what point does the tax rate on a competitive good or service—you know, that can be bought from interstate situations—is there a time when it becomes exorbitant?

Governor DOUGLAS. Well, I guess, a couple of thoughts in response to that question—first of all, the bill uses the term "discriminatory," and there will probably be a lot of debate over what constitutes a discriminatory tax. And that is why I think the best policy is to reserve that to the states.

I am sensitive to your comment about states' developing a level of taxation that is excessive; but, to some extent, I think that can be self-correcting. It is no secret back home that I believe we have a—a tax level that is quite high—as I mentioned, second only to Alaska, in terms of per-capita taxation.

And because our income tax is so high, we have seen an exodus of well-to-do residents to other states, where the burden is less. So I am urging our legislature to reduce that burden so we can be more competitive. And I hope other legislative bodies will do the same, when the burden gets too high.

Mr. FRANKS. Well, thank you, Governor. You are a very compelling witness. Thank you very much.

Mr. JOHNSON. [Presiding.] Thank you.

Next, we will have questions from Congresswoman Chu.

Ms. CHU. Governor Douglas, your association, the National Governors Association, along with the Congressional Budget Office and other analysts have estimated that the passage of the Business Activity Tax, H.R. 1083, would cumulatively cost states between $1 billion and $6.6 billion annually. Of course, it is because it would expand the Federal prohibition against state taxation of interstate commerce.

Well, what does that amount mean to you, and what kind of impact would that have on the states?

Governor DOUGLAS. I have seen some different calculations, but they are in that range, Congresswoman Chu. I have seen some as high as $8 billion; but in that order of magnitude.

It is hard to know what the impact is on an individual state. It depends on its own structure of taxation. But I return to the principle that I outlined in my opening remarks—that we ought not to tie the hands of states, especially when we are confronting cumulative shortfalls of $136 billion over the next couple of fiscal years.

States are really struggling. I know Members of the Subcommittee are well aware of that. But I want to make sure I put an exclamation point on that comment, because this is such an extraordinary time. And the challenges are so profound.

We have, cumulatively, $1 trillion worth of unfunded pension liabilities in state pension systems as well. And as governors are laying off employees, cutting back on things that we feel strongly about—environmental protection, K-through-12 education, higher ed, vital human services—we need to have a tax structure that doesn't tie our hands, and gives states flexibility through this difficult period.

So the impact of that particular proposal is a little less than some of the other initiatives that we have seen; but in the cumulative sense, can be quite serious, especially when states are facing budget shortfalls of that magnitude.

Ms. CHU. Let me bring up another thorny issue, which is auction sites, like EBay, which offer entrepreneurs a great opportunity to bring home some extra money, or get their small business off the ground. On the other hand, much of this commerce has not produced tax revenue, even if those products are sold within the same state. And, then, there are the myriad of tax regulations that are different from across the states.

What can we do to address this problem, and should there be different tax standards for online sellers that make a certain amount of profit in a state, or complete a certain amount of business in a state?

Governor DOUGLAS. Well, I think the streamlined-sales-tax project would be an important step forward to capture some of the revenue that is lost from online transactions. There are about 1,000 companies nationwide that voluntarily participate now, and collect those revenues, and distribute them to the states, and so the lost amount that we have been estimating has come down somewhat. But it is still on the order of magnitude of $12 billion a year. So I think that would be an important first step that would be very helpful for the Subcommittee to consider.

Judge WHITLEY. You know, I would add on that, I guess, that we are—if you don't have level playing fields, you are really going to hurt your Main Street businesses—your small businesses back home. And with technology today, I just refuse to accept that the programs can't be developed that will take into account the complexity, or what a particular local area tax rate is. When Google can look at my home from its satellites, then I have an idea that there is a program out there that can figure out what my tax rate is in Tarrant County.

Ms. CHU. I appreciate that.

Now, Judge Whitley, I know you indicated that NACo supports, yet opposes some of the language in the streamlined sales-and-use tax legislation. I was wondering what the governors' position was.

Are the positions of support and opposition along the same lines, or what? What are the differences?

Governor DOUGLAS. I haven't seen the NACo policy, Congresswoman Chu, but the Governors are concerned about those provisions that suggest compensation to local companies. We think that that ought not to be a part of what, ultimately, is passed. So I think we may be on on the same page, there.

Ms. CHU. Okay. Thank you. I yield back.

Mr. JOHNSON. Thank you.

Next questioner will be my friend, the Ranking Member of the Courts and Competition Policy Subcommittee, which I Chair, Mr. Howard Coble.

Mr. COBLE. Thank you, Mr. Chairman.

Governor—good to have you and the judge with us.

Governor, I have come in back and forth, because of—so I may ask that—this may be repetitive. But is the Green Mountain State the only state that does not have an amendment or a statute to require a budget to be balanced?

Governor DOUGLAS. That is correct.

Mr. COBLE. How, Governor, has that impacted your ability to either cut spending on the one hand, or raise taxes on the other?

Governor DOUGLAS. We like to think, Congressman Coble, that Vermonters don't need that constitutional imperative—we are so responsible and thrifty.

Mr. COBLE. I can see why you are the governor, Governor.

Governor DOUGLAS. And, in fact, we are rated AAA by both Moody's and Fitch. So I think the fiscal responsibility that we have been able to achieve has been comparable to that of other states, even though we are the only one, as you noted, without a requirement—either constitutional or statutory—to have a balanced budget.

Mr. COBLE. And that speaks of self-discipline. I think that is noteworthy.

Now, Governor, are you here on behalf of the National Governors Association?

Now, of the other state groups, such as the National Conference of State Legislatures, has expressed support for the Streamlined Sales Tax Agreement, and the Main Street Fairness Act. I noticed, however, that your testimony was silent on that. Do you want to comment one way or the other about that?

Governor DOUGLAS. I did refer to that in response to a question. We do support, as an association, the streamlined-sales-tax project. Vermont is one of 18 states that is a full-fledged member of that effort now. And I believe, as Judge Whitley and I have suggested, that it is only a matter of fairness to those vendors—those retailers in our states and counties and communities who are faced with unfair competition through online transactions.

So we are strong supporters of that, and hope that the Subcommittee can take it up.

Mr. COBLE. Thank you, sir.

Judge, your written testimony singles out telecommunications providers as entities that should not receive special treatment. You specifically mentioned the telecommunication provision in the Streamlined Sales Tax Agreement, and the Cell Tax Fairness Act; yet, telecommunications providers would argue that they should—that they shoulder a disproportionate burden of state and local taxes.

Is there any reason why NACo's views—strike that. Is there any reason why NACo views telecommunication's taxes, in particular, to be sacrosanct, or holy?

Judge WHITLEY. Now, I don't know that. I think that there is.

What we look at—I can tell you, especially, in Texas, and in Tarrant County, with regards to the cell phones, and with regards to the taxes on that—it goes back to our emergency services—our 911. We are making tremendous changes, and investing a tremendous amount of money in the technology that will allow us to be able to identify where that cell phone is calling from. And if it was just a land line, there wouldn't be that problem.

So most of the fees—when we look at fees, we don't normally just stick fees on there, and then use those—the fees coming from—like the telecommunications arena—for other areas of general revenue or general budget. We are pretty well looking for it for a user-type fee.

When we get to something that is going to be kind of general, we go back to our property tax. But our citizens get pretty testy when we start putting a whole lot of property tax in there to do things which they consider to be better paid for with user fees.

Mr. COBLE. I got you.

But, now, Governor, or—is either you or the judge familiar—I mentioned it in passing—the Sales Tax Fairness Act—are you all familiar with that?

What do you say in response to that bill?

Governor DOUGLAS. I assume that is the legislation that was referred to by some other Members earlier. Is that the proposed moratorium that is proposed?

Mr. COBLE. Well, it prohibits states or local governments from imposing any new discriminatory taxes on mobile services, et cetera.

Governor DOUGLAS. Yes, right. I suggested that the National Governors Association does not support that initiative, Congressman Coble. We really believe that there ought to be maximum flexibility for states to make their own determinations, and that that ought to not be approved.

Mr. COBLE. Thank you, Governor.

Judge?

Judge WHITLEY. Same way with NACo. You know, again, when you start applying moratoriums, then you really tie our hands with regards to tax reform, and with regards to expenditures that, a lot of times, we are required to make.

Mr. COBLE. Thank you both for being here.

Thank you, Mr. Chairman. I yield back.

Mr. JOHNSON. Thank you, Mr. Coble.

Next, we will have questions from Congressman Scott, Chair of the Crime Subcommittee of the Judiciary Committee.

Mr. SCOTT. Thank you.

And, thank you, Mr. Chairman.

You know, we have—we are in a situation where all of the states and all of the counties are suffering from a financial decline, and are looking for revenue whenever they can get it. And one way is to encroach on other states to get some of their tax revenue. It has the added advantage of—you are increasing taxes, but not on anybody that actually votes for you. And so there is a great incentive during these times to kind of expand your tax base.

Governor Douglas, if you expand your tax base and start taxing, essentially, out-of-state residents, do the out-of-state residents get a tax credit in their home state, necessarily, for the taxes they pay in your state?

Governor DOUGLAS. That is probably a function of the tax laws in their individual states, but I think, in many cases, they do.

We are very sensitive to the point that you have raised, Congressman Scott, because we rely on tourism as a major part of our economy. And I don't want to take steps that would be discouraging to people to come and visit. And, also, we have a lot of second-homeowners and business property that is owned by non-residents. And so I am concerned about the burden of property taxation and not making that too high, so that it is not competitive either.

So I think your point is well taken that tax policy ought to be, first, as low as possible to meet the legitimate needs of government; and, secondly, balanced in a way that doesn't put any class of taxpayers at a disadvantage.

Mr. SCOTT. Well, yes, but in those cases, you have indicated the tax is actually applied to something that is clearly going on in Vermont. Some of these schemes that are taxing people for things where you are really kind of stretching a little bit, and getting people back in the home—the Internet, where you don't really have a physical presence in Vermont, and getting some activity going on in Vermont, and getting that kind of tax—those kind of taxes.

But if you pay those taxes, the question is whether you get a tax credit, or whether you are essentially getting taxed in your home state for the business activity, and in the out-of-state tax—you are being taxed twice for the same activity—can that happen?

Governor DOUGLAS. Well, I don't know about the tax laws of all the other states. We don't do that in Vermont. In fact, there was a case on a motor-vehicle tax that went all the way to the United States Supreme Court to make sure that Vermonters don't pay double tax on their motor-vehicle-registration taxes.

Look, both of my sons, at one point, had some income in other states while they were residents of Vermont. And we don't provide a system of double taxation. But I, honestly, don't know what the laws of other states are.

Mr. SCOTT. Well, if there is no double taxation, then the $8 billion impact would not be an overall impact, it would be kind of a shifting of where you pay the taxes, not how much taxes are paid.

Governor DOUGLAS. Yes, it is hard to estimate what the impact would be. I guess the essence of my testimony is that there ought to be flexibility for states to make their decisions, and not have an imposition by the Congress on what has traditionally been the prerogative of state and local government.

Mr. SCOTT. Well, if you are only going to pay a certain amount of tax, then the question is: Who gets it? So——

Judge WHITLEY. But I think the question, in some cases, is they are not paying any tax at all.

Mr. SCOTT. Well, that takes place over—to a large extent, on Internet sales.

What would you suggest as the appropriate thing to do with Internet sales, in light of the fact that the seller really has no way to individually calculate, even by zip code, what the tax rate is in the state, county, town, and whatever subdivision—business subdivision there may be—what the appropriate tax would be?

Judge WHITLEY. I believe that, with technology as it is today, that, as I stated earlier—I believe that the technology exists to be able to take it to the zip code and determine exactly what I pay in Hurst, Texas, in the form of school—no, those are property taxes. The sales tax would simply be the city and the state. And it would be 8.25 percent.

You know, if I am going to buy something in Hurst, Texas, out of my home, then that sales tax that I would pay if I bought that in Hurst, Texas, is going to take care of the fire and the police, and all the services that I get——

Mr. SCOTT. And you ought to pay the same tax if it is shipped in?

Judge WHITLEY. Yes, because I am still going to—when the fire and the——

Mr. SCOTT. You don't see a complication about the calculation of the tax. What about physical presence in an area—when you try to tax someone for an activity for which there is no physical presence?

Judge WHITLEY. I don't know that I—I think, if we are talking about—I guess the point of purchase, is what I am suggesting, is where the tax should apply, and not necessarily the point of the sale. Whether they have—you know, whether whoever someone I am purchasing something from has a presence in Hurst, Texas or not, the fact is I am buying it. Coming to Hurst, Texas—eventually, whatever is there, the police are going to—if it gets stolen, I am going to call the police and report it stolen in Hurst, Texas.

Mr. SCOTT. I think the next panel might address this, but there is some—I know we have had some problems with truckers going up the New Jersey Turnpike and, essentially getting kidnapped because they were going through New Jersey with their shipment, when that was about the only activity they had. New Jersey was trying to assess a tax on the contents.

But we will deal with that on the next panel.

Mr. JOHNSON. The gentleman's time has expired.

I want to thank you both for your testimony. And you may both be excused.

And, as you depart, the second panel can assume the positions that you now occupy.

Judge WHITLEY. Thank you very much.

Governor DOUGLAS. Thank you, Mr. Chairman.

Mr. JOHNSON. Thank you all for participating in today's hearing. And you are under the same instructions as the previous panel.

Our first witness on this panel is Mr. Robert Ward. He is the deputy director of the Nelson A. Rockefeller Institute, and heads the institute's State and Local Government Finance Research. He has studied and written about New York state government for more than 20 years as a newspaper reporter and editor, as assistant to the chairman of the Assembly Ways and Means Committee, and as director of research for the Public Policy Institute of New

York State, the research affiliate of the Business Council of New York State.

He is also the author of "New York State Government," published by the institute in 2002, and revised in 2006. His work on state finances includes leading the institute's recent research into gambling revenues for states, and a study of long-term changes in the property tax in New York state.

Mr. Ward, welcome; and please begin your testimony. And I will introduce you all as we get to you.

TESTIMONY OF ROBERT B. WARD, DEPUTY DIRECTOR, NELSON A. ROCKEFELLER INSTITUTE OF GOVERNMENT

Mr. WARD. Thank you very much, Mr. Chairman. And it is an honor to be invited to speak with you today.

I would like to say a special hello to Congressman Maffei, from my home state of New York.

But it is an honor to speak with all the Members of the Subcommittee.

My testimony will focus on essentially three things. And I will limit my oral testimony. First, I will talk a little bit about the current picture for states. We are about to release, tomorrow morning, our latest look at state tax collections from around the country. I will also touch briefly on the long-term trends in state-and-local tax revenues. And I will close with some suggestions for broader thinking about the role of the Federal Government in shaping fiscal policy at the state level.

As I mentioned, the report that we will be releasing tomorrow morning shows that calendar 2009 was the worst year on record in terms of decline in overall state-tax collections, with an overall drop of 11 percent from calendar year 2008. The fourth quarter of 2009 brought the fifth consecutive quarter in which state revenues showed a decline. We now have preliminary data in hand for about half of the first quarter of 2010, and it appears likely that that quarter will represent a sixth-straight quarter of year-over-year decline.

Broadening the picture just a little bit—if we compare these numbers to 2 years ago, tax revenues during the final quarter of 2009 were down by 8.6 percent through that same quarter in 2007.

Over the past two decades, before the last national recession, state-tax revenues have averaged annual year-over-year increases in the range of 5 percent to 5.5 percent. So in normal times, the last 2 years could have been expected to produce an overall tax-revenue increase of something in the range of 10 percent or more.

When we combine that with the actual decline that I have mentioned, states have seen revenue drop by more than 18 percent over those 2 years, relative to recent historic norms. The current decline in overall state-tax collections is more than twice as deep as in the previous recession, which itself brought declines from historically high levels of revenue.

After accounting for inflation, state-tax revenue is essentially at the same level as it was 10 years ago, although the Nation's population has increased by approximately 10 percent during that period. In my written testimony, I have some discussion of the outlook. I will simply say here that looking immediately ahead, we think that there is significant risk that income-tax revenues in April and May will fall relative to the already weakened level of a year ago.

And, echoing some of the comments in Governor Douglas' prepared testimony, we do not expect much strengthening during the remainder of this year; and, of course, we know that there are enormous fiscal challenges for states in the years ahead.

Some reflections on longer-term trends—the income tax has become much more important to states over time. And one ramification of this is a heightened risk of volatility in states' revenue streams. Economists from the Federal Reserve Bank of Chicago have concluded that greater reliance on the income tax and increases in the more volatile sources of income, such as capital gains, have made state revenues more responsive to the business cycle since 1998.

We have seen the downside of such volatility over the past 12 to 18 months in New York and in other states, as income-tax revenues have plummeted, and states that are highly dependent on capital gains have seen particularly significant declines in overall tax revenue.

Many of the issues that the Congress considers relating to state and local taxes reflect varying perceptions over the burden of taxation, and the adequacy of resources for public services. In that context, it may be worth noting that, measured as a proportion of the Nation's economic activity, the total burden of state and local taxes has remained remarkably constant for the last 20 years.

And there is a chart in my prepared testimony showing that. As a matter of fact, there has been relatively little change over the past 40 years. And, perhaps, that is worth keeping in mind as we now enter a period at the national level, where we are looking at significant changes in the overall fiscal relationship between Washington and the states.

On that point, Congress and the Federal courts have stepped in to policy-setting or policy-shaping roles, in selected, and often narrow, areas, generally, with relatively little attention to the overall structure of state and local tax systems. Perhaps it is time for broader thinking and analysis within the boundaries that the Constitution provides.

Beyond the fiscal challenges to states that I mentioned earlier, we are all well aware that the Federal Government faces its own major budgetary concerns in the years and decades ahead. Whether one's favored solutions to the challenges facing both the national and state governments—whether those favored solutions involve more revenue sources such as a value-added tax, or new restraints on health-care and other spending, or some combination, the complex array of fiscal relationships between Washington and the states will be an important subtext of any serious debate.

Mr. JOHNSON. And, Mr. Ward, if you could, sum——

Mr. WARD. I will simply sum up by saying that there will be debate about the—ongoing and significant debate—about the relationship between Washington and the states. The question is how we may best inform that debate.

[The prepared statement of Mr. Ward follows:]

PREPARED STATEMENT OF ROBERT B. WARD

THE NELSON A.
ROCKEFELLER
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State University of New York

April 15, 2010

T E S T I M O N Y

State Fiscal Trends and the Federal Role

Testimony to the Subcommittee on Commercial and Administrative Law, Committee on the Judiciary, U.S. House of Representatives

Robert B. Ward
Deputy Director/Director of Fiscal Studies
The Nelson A. Rockefeller Institute of Government

Mr. Chairman and Members of the Subcommittee:

Good morning. I'm Robert Ward, of the Nelson A. Rockefeller Institute of Government in Albany, New York. The Institute is the public policy research arm of the State University of New York, based at the University at Albany. We are honored to be invited to speak with you today.

My testimony will focus primarily on the current picture and projected outlook for state and local government finances, particularly those of the states. Choices made in your committee can influence the ability of states to raise tax revenue. The fiscal environment influences states' need to raise revenue or to make offsetting spending cuts. In my closing comments, I will suggest the potential for broader thinking about the role of the federal government in shaping tax policy at the state level.

I will start with the current conditions that we see in states across the country. The Rockefeller Institute has maintained a special focus on research in this area for the past 20 years. State leaders right now face budget choices that are more difficult than any since the Great Depression. Those difficulties are caused by a combination of two things: Revenues that have fallen sharply for

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more than a year now, and expenditure patterns that drive increases substantially higher than the rate of inflation unless policymakers act to reduce the baseline trends.

Since 1991, the Rockefeller Institute has reported each quarter on recent trends in state tax collections. During the recent national economic downturn, we have issued more frequent updates to allow more timely and more detailed analysis of the challenges facing the states. We are issuing our latest report, by my colleagues Donald J. Boyd and Lucy Dadayan, Friday morning. The report examines state tax collections during the final quarter of 2009 and the first two months of 2010, and offers some forward-looking observations regarding the remainder of 2010 and the years thereafter.

Recent Trends

Calendar 2009 was the worst on record in terms of the decline in overall state tax collections, with an overall drop of 11 percent from calendar 2008. During the fourth quarter of 2009, overall state tax revenues declined by 4.2 percent, compared to the same quarter a year earlier. (We generally compare one reporting period to the same period in the preceding year because of seasonal variation in state tax collections.) This was the fifth consecutive quarter in which state revenues showed a decline.

After accounting for inflation, state tax revenue is at about the same level as 10 years ago.

Compared to two years ago, tax revenues during the final quarter of 2009 were down by 8.6 percent. Over the past two decades, before the last national recession, state tax revenues averaged annual, year-over-year increases in the range of 5 to 5.5 percent. In normal times, then, the last two years could have been expected to produce an overall tax revenue increase of 10 percent or more. Combined with the actual decline mentioned above, states have seen revenue drop by more than 18 percent relative to recent historic norms. The current decline in overall state tax collections is more than twice as deep as in the previous recession, which itself brought declines from historically high levels of revenue.

Another way to assess the current revenue picture is to adjust collections for inflation. Using this measure, state tax revenues are currently at roughly the same level as they were in both 2000 and 2004 (revenues declined, especially after adjusting for inflation, during and after the 2001 recession.) In other words, after accounting for inflation, state tax revenue is at about the same level as 10 years ago, although the nation's population has increased by approximately 10 percent during that period. Like the weakness in economic conditions over the past two years, revenue declines have hit every state.

Preliminary data for January and February, from 45 states, show continued weakness into the current calendar year. The data we have been able to obtain thus far show overall state tax revenues in the first two months of 2010 down by 2.2 percent from a year earlier. It appears likely that, when full quarterly data for all the states are available several weeks from now, we will be reporting a sixth straight quarter of revenue decline.

The good news is that the declines are not as sharp as they were a year ago. Recent data show an unmistakable improvement in the national economy. Employment has stabilized in recent months and retail sales are now increasing on a month-to-month basis. These are among the most important determinants of trends in state tax revenue, with employment and wage levels influencing collections from personal income taxes and consumer sales driving revenue from sales taxes. Just as the national economy has shown at least some initial signs of recovery, so too with state revenues. In the report we are issuing Friday morning, nine states showed growth in tax revenues, with North Carolina and New Hampshire leading the way at 9.9 and 5.7 percent, respectively. Revenue increases in some states will come largely as a result of previously enacted tax increases, but there is underlying improvement as well.

Tax revenues for local governments – counties, municipal entities, and school districts – continue to show steady if modest growth for the nation as a whole, largely because of the stability inherent in the property tax. But there is great variation underlying this national average. Many cities, especially large ones with volatile tax structures more like those of states, face great distress. Localities that rely heavily on the property tax face declines if they reassess properties in a way that allows market value declines to be reflected quickly in assessed values.

Looking forward, we project more troubling news for states.

The further bad news for state governments is that most states are not yet enjoying actual growth in tax collections – rather, in most cases, the declines in the most recent quarter are smaller than those we saw previously. During the second quarter of 2009, for example, the overall decline in tax revenues was above 16 percent, compared to the year-prior level. That makes the fourth quarter's decline of 4.2 percent appear much less damaging. Yet it is important to keep in mind that, because the downturn in revenue has been going on for more than a year, we are now talking about reductions from already depressed levels. The rate of decline is moderating, however, and we may be approaching the bottom.

The Outlook

Looking forward, we project more troubling news for states. Based on trends in capital gains and other factors, there is significant risk that income-tax revenues in April and May will fall relative to the already weakened level of a year ago. We do not expect much strengthening during the remainder of this year, based on the relatively poor outlook for employment and general economic activity. Nor does the picture brighten dramatically when we look ahead to 2011 and the years immediately following. Even if the economic recovery is as rapid as those from prior recessions, it would likely take state tax revenue several years to recover to its previous peak. With the expected slow recovery from this recession, it is likely to take longer.

At some point, history indicates, the economy will recover – and tax revenues will strengthen as well. Even so, over the next several years state budgets will face difficulty as federal stimulus aid goes away and as temporary solutions adopted in peak crisis years fade away. And the longer-term outlook for state and local government finances is clouded by significant problems on the expenditure side of the budget.

The Government Accountability Office (GAO) projects that, without policy changes, the overall operating balance for states and localities will fall significantly below historical averages within the coming decade, indicating what GAO describes as "increasing fiscal stress." GAO researchers predict that various cost increases, particularly for Medicaid and payments for employee and retiree health benefits, will present increasingly troublesome issues for states and localities. Mismatches between revenues and expenditures are predicted to grow steadily at least until the middle of this century, according to GAO.

Closing those projected gaps would require policy changes to produce savings equal to a 15 percent overall tax increase or a 13 percent reduction in spending financed by nonfederal revenues, according to GAO. Such numbers may not appear monumental at first. They should be viewed, however, in the light of difficulties that states and localities encounter when they try to restrain spending or generate new revenue. Even much smaller spending reductions from trendline increases, or proposals for smaller tax increases, tend to generate controversy and sharp criticism of elected officials. Achieving cost-efficiencies or revenue increases of such magnitude across all 50 states would represent extraordinary fiscal change.

Understanding State Fiscal Systems

As Congress considers the potential impact of federal legislation on state and local government revenues, it may be useful to start with an understanding of the current structure of state and local revenue systems.

As the table below shows, the largest single tax source for states is the category the Census Bureau defines as sales and gross receipts taxes. This includes general sales taxes as well as selective sales taxes on public utility bills, automotive fuel, tobacco products, alcoholic beverages, and other items. If we omit those selective sales taxes, the general sales tax is roughly equal to the personal income tax in overall importance to states, around 26 percent of own-source revenues. For the states, sales

Selected Taxes As Proportion of State/Local Governments' Own-Source Revenue, 2007

	States	Local Governments	State & Local Total
Sales/gross receipts taxes	34%	10%	24%
Personal income taxes	26%	3%	16%
Property taxes	1%	44%	21%
Corporate income taxes	5%	1%	3%
Other taxes	7%	4%	6%
Nontax revenue	*26%*	*38%*	*31%*

Rockefeller Institute calculations from Census Bureau data; totals may not add to 100% due to rounding and income taxes are by far the most important single sources of revenue.

In 2007, the latest year for which we can obtain comprehensive data for both state and local governments, states' general revenue from their own sources was just over $1 trillion. Sales, income, and other taxes made up roughly three-quarters of that total. Tuition at public universities, hospital revenues, income from lotteries and other gambling activities, were among the major sources of nontax revenue.

For local governments, including school districts, property taxes are by far the dominant source of income, providing more than four in every 10 dollars of own-source revenue. Sales taxes are also important for local governments, while taxes on personal and corporate income are much less meaningful than they are for states.

These figures represent a snapshot of one year, including all the states and all local governments. Obviously, there is great variation among the states. In 2009, personal-and corporate income taxes made up 77 percent of total tax revenue in Oregon, more than 60 percent of tax revenue in Massachusetts and New York, and more than half of such revenue in an additional half-dozen states. At the same time, six states had no broad-based income tax at all.

One ramification of the increasing reliance on income taxes is a heightened risk of volatility in states' revenue streams.

The income tax has become more important to states over time. In 1975, individual income taxes represented about 24 percent of total state tax revenues. That proportion rose to 30 percent in the mid-1980s. In 2009, the personal income tax provided 34 percent of total state tax revenues. (This proportion is higher than the income tax's previously mentioned 26 percent share of states' own-source revenues; that broader category includes significant nontax revenue.)

The corporate income tax has declined modestly as a contributor to state tax revenues – from around 8 percent in the mid-1970s to 6 percent in 2009. Motor fuel taxes have fallen from more than 10 percent of the total in 1975, to 5 percent in 2009.

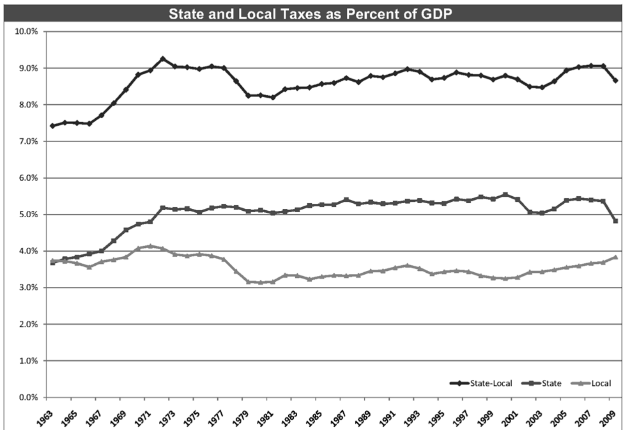
One ramification of the increasing reliance on income taxes is a heightened risk of volatility in states' revenue streams. Economists from the Federal Reserve Bank of Chicago have concluded that "Greater reliance on the income tax and increases in the more volatile sources of income such as capital gains, have made state revenues more responsive to the business cycle since 1998."[1] We have seen the downside of such volatility over the past 12 to 18 months, as income-tax revenues to states have plummeted and states that are highly dependent on capital gains have seen particularly significant declines in overall tax revenue.

Moving from percentages of overall revenue to dollars, state tax collections have shown strong growth over time, even when we include fluctuations during and after major economic slowdowns. From around $80 billion in 1975, overall revenues rose to $715 billion in fiscal 2009. That increase represents growth of more than 100 percent, after adjusting for inflation.

Some of the issues that the Congress and this subcommittee may address, in relation to state and local taxes, arise from varying perspectives over the level of taxation and the adequacy of resources for public services. Observers differ, of course, in perspectives as to whether taxes – including those imposed by states and localities – are too high, too low, or just about right.

It may be worth noting that, measured as a proportion of the nation's economic activity, the total burden of state and local taxes has remained remarkably constant for the past 20 years, and has fluctuated relatively little over the past 40 years. The graph on this page shows state, local, and combined state-local tax revenues as a proportion of gross domestic product back to 1963. Using this measure, the level of state taxation rose significantly – by more than a third – from the early 1960s to the early 1970s. State taxes represented 3.7 percent of GDP in 1963, and surpassed 5 percent a decade later. Taxes imposed by local governments and school districts were essentially equal to those imposed by states in the early 1960s, and by this measure have held relatively constant over time – with some ups and downs. The size of the nation's economy has grown significantly during this period, so a roughly constant proportion of economic activity indicates significant growth in state and local revenues over time.

State and Local Taxes as Percent of GDP



Source: Rockefeller Institute calculations from Census Bureau data.

It is difficult to apply any comparison of taxation levels without prompting debates as to which measure, if any, is most appropriate. Most state policymakers will testify that rising demand for state expenditures in education, health care, public protection, and other areas has meant continuing budgetary challenges despite the significant gains in revenue over time. Clearly, cost inflation in health care – a major driver of state expenditures – has outpaced general inflation for many years. Governors, legislatures and voters have also made policy choices to implement major programmatic and staffing expansion in education, health care, and other areas.

In good times, states tend to use higher-than-normal revenues to expand spending commitments at the same time they enact reductions in taxes. The common result is that, when revenues return to normal growth or go into decline, baseline spending requirements often exceed revenues from existing tax laws. States then must make some major changes in spending or revenues, or a larger number of smaller changes, to achieve budgetary balance. Often, the solution lies in some mix of one or two major changes and a number of smaller adjustments. And states also patch budget gaps with temporary fixes in the hope — with some justification in history — that sharp revenue growth during recovery will fill gaps left when patches fall out.

Even smaller adjustments can be politically controversial, or may require steps that many citizens and policymakers consider undesirable. We need not focus on the list of such actions that have been taken in just the past year or are under consideration now – I know you are aware that they include cuts in many services for the needy; closing of parks, libraries, and schools; and increases in taxes, fees, and revenues from state-sanctioned gambling. In many cases, these controversial or undesired steps provide only a marginal difference in an overall budget of many billions of dollars. The fact that they are undertaken despite public opposition and potential political risk to elected officials indicates the difficulty that states face in balancing budgets in the twenty-first century.

Perhaps it is time for broader thinking about the fiscal relationships between Washington and the states.

Concluding Observations

All of which is to say that, as Congress considers any action that may influence state and local government revenues, you are right to invest careful study and consideration before doing so. Even seemingly small differences in revenues and costs can matter – to state officials who are struggling to balance budgets, to those who depend on vital services, and to state and local taxpayers.

I will briefly touch on one other issue of interest to the subcommittee. The subcommittee has devoted a previous hearing to the topic of sales tax application to remote vendors. The Rockefeller Institute does not advocate on tax or other issues. I raise this topic only to observe that, in addition to the technical and policy questions inherent in taxation of, and collection of tax on, remote sales, there is a broader question: Should federal policy emphasize the benefits of interstate differences, including tax competition among jurisdictions? Or should national policy focus on the benefits to be obtained from greater uniformity among the states? To some extent, at least, these are questions of political or social values, rather than of technical policy points.

The flow of shared power within our federalist system of government sometimes moves in the direction of greater national authority, other times toward more power for the states, and sometimes in both directions, across varied policy areas, simultaneously. The United States is currently moving extensive authority over health care to the national level — but giving states responsibility for implementing this national policy, a task complicated by their volatile fiscal systems. For several decades, and increasingly over the past 10 years, Washington has taken on greater policy responsibility in education, as well. Education and health care represent the largest areas of expenditure for states. There are other major areas of state concern, such as transportation and public welfare, where federal policy decisions and funding play enormously important roles.

With regard to state taxation, Congress and the federal courts have stepped into policy-setting or policy-shaping roles in selected and often narrow areas, generally with relatively little attention to the overall structure of state and local tax systems. Perhaps it is time for broader thinking and analysis, within the boundaries that the Constitution provides. Beyond the fiscal challenges to states that I mentioned earlier, we are all well aware that the federal government faces its own major budgetary concerns in the years and decades ahead. Thoughtful observers are starting to talk about significant restructuring of governmental finance at both the national and subnational levels. Whether one's favored solutions involve more revenue sources such as a value-added tax, or new restraints on health care and other spending – or a combination of both approaches – the complex array of fiscal relationships between Washington and the states will be an important subtext of any serious debate, as it should be because states implement many of the most important policies the federal government adopts. Debate there will be. The question is how we may best inform it.

Endnotes

1 Richard Mattoon and Leslie McGranahan, "Revenue Bubbles and Structural Deficits: What's a State to Do?" Federal Reserve Bank of Chicago Working Paper No. 2008-15, November 1, 2008.

Mr. JOHNSON. Thank you, sir.

Next, we will hear from Mr. Joseph Henchman. He is a constitutional attorney and policy analyst, who supervises the Tax Foundation's state policy and legal programs. His analysis of state-tax trends and tax-law developments has been featured in several publications, and in court decisions and testimony at the Federal and state levels.

Before joining the Tax Foundation in 2005, Mr. Henchman previously worked in the historic 2003 California Recall Election as press-policy aide to gubernatorial candidate and interned with the Office of D.C. attorney general, Citizens against Government Waste, and University of California Outreach in the Central Valley.

Thank you, Mr. Henchman. Please begin your testimony.

TESTIMONY OF JOSEPH HENCHMAN, TAX COUNSEL AND DIRECTOR OF STATE PROJECTS, TAX FOUNDATION

Mr. HENCHMAN. Thank you, Mr. Chairman; Mr. Ranking Member; and Members of the Subcommittee.

I appreciate the opportunity to testify today on the role of Congress in ensuring that state taxation does not do harm to the national economy. This is not a new issue. One of the reasons we have a constitution is because of states' impulse to do death with a thousand cuts to the national economy through their tax policy.

As Professor Daniel Shaviro put it, "Perceived tax exportation is a valuable political tool for state legislators, permitting them to claim that they provide government services for free." Frowning on these divisive and destructive practices, the founders inserted several constitutional provisions empowering Congress and the courts to restrain state tax power. And for over a century and a half, states' power of taxation stopped at their border and did not extend to interstate commerce.

That changed in the 1977 Complete Auto decision, where the U.S. Supreme Court permitted states to tax interstate commerce if the tax met a four-part test. The most relevant one of today is nexus. Nexus survives as a restraint on state tax power, although it is now under attack.

First, there is the state corporate income tax. It is a dying tax, killed off by thousands of credits, deductions, abatements and incentive packages. Corporations are able to plan their way out of the corporate income tax, resulting in significant compliance and administrative costs, compared to other revenue sources.

The beggar-thy-neighbor policy adopted by states of apportionment formula games, mercantilist film and incentive-credit programs, destructive gross-receipts taxes, and corporate welfare are the reason for the collapse of this tax as a revenue source. But rather than fix those problems, the push has been, by some states, to reach across state lines and out of their borders with the nebulous concept of economic nexus. A uniform physical-presence standard would limit these destructive state efforts to export tax burdens, and they will decrease transaction costs for the interstate business activity.

For sales taxes, the adoption of sales taxes in the 1930's was quickly followed by use taxes to discourage consumers from buying goods in lower-tax states. Use taxes seek to equalize tax burden for the tax on transactions occurring in other states—essentially a protectionist measure. But judicial decisions have barred states from forcing non-physically-present individuals and businesses to collect their use taxes. These decisions are premised both on the geographic limit of state powers, and on the difficulty of complying with over 8,000 constantly changing sales taxes, with different bases, different rates, different exemptions; and, contrary to popular belief, not aligned with nine-digit or even five-digit zip codes.

Brick-and-mortar retailers claim unfairness. They must collect sales taxes while their online and out-of-state competitors do not. Of course, the proposal on the table is to impose a greater obligation on out-of-state and online businesses, forcing them to collect thousands of different sales taxes, while brick-and-mortar retailers need to track and collect only one.

For the income tax, nearly half the states require non-resident employees to set up individual income-tax withholding for their first day of travel into the state. Sixteen more states also require withholding after a certain point—and that is just withholding, not the obligation to file a return or pay taxes.

A few years ago, we at the Tax Foundation got a call from a woman in Ohio. Her son was a soccer goalie, and he had earned $28,000 doing that. And spread across this woman's kitchen table were 10 state income-tax returns, divvying up the tax on $28,000. States are becoming more aggressive in this regard, with non-resident income taxes, hunting down schedules via Twitter, demanding travel vouchers; generally imposing a colossal compliance burden that is a net national-revenue wash, transferring tax dollars from low-tax, low-expense states to the states with the highest tax burdens.

The states are hurting, it is true. But they aren't entirely innocent in that predicament. I want to echo Mr. Ward, who emphasized that those states that rely heavily on volatile revenue sources such as taxes on capital gains and taxes on high-income earners are those states that are hurting the most. I should also note that state fiscal pain does not justify beggar-thy-neighbor policies that impose significant compliance burdens and deadweight losses on the national economy. State power to tax should not extend to everything, everywhere. Simplification should be something that everyone embraces, and is not a partisan issue.

As Chief Justice Marshall said, "The power to tax is the power to destroy," and state tax overreaching can destroy.

As a country, we have gone from the artisan to Amazon.com. But the sophistication of technology does not override the timeless constitutional principles designed to restrain states from burdening interstate commerce and imposing uncertainty on the national economy.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Henchman follows:]

PREPARED STATEMENT OF JOSEPH HENCHMAN

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The Role of Congress in State Tax Legislation: Ensuring that State Taxation Does Not Do Harm to the National Economy

Joseph Henchman
Tax Counsel & Director of State Projects
Tax Foundation

Hearing on "State Taxation: The Impact of Congressional Legislation on State and Local Government Revenues"

Before the U.S. House Committee on the Judiciary, Subcommittee on Commercial and Administrative Law

April 15, 2010

Mr. Chairman, Ranking Member Franks, and Members of the Subcommittee:

I appreciate the opportunity to testify today on the role of Congress in ensuring that state taxation does not do harm to the national economy.

This is not a new issue. One of the reasons we have a Constitution is because of states' impulse to do death-with-a-thousand-cuts to the national economy through their tax policy.[1] As Professor Daniel Shaviro put it, "Perceived tax exportation is a valuable political tool for state legislators, permitting them to claim that they provide government services for free."[2]

Frowning on these divisive and destructive practices, the Founders inserted constitutional provisions empowering Congress and the courts[3] to restrain state tax power.[4] For over a

1 *See, e.g.*, *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 224 (1824) (Johnson, J., concurring) ("[States' power over commerce,] guided by inexperience and jealousy, began to show itself in iniquitous laws and impolitic measures . . ., destructive to the harmony of the states, and fatal to their commercial interests abroad. This was the immediate cause, that led to the forming of a convention."); 1 STORY CONST § 497 ("[T]here is wisdom and policy in restraining the states themselves from the exercise of [taxation] injuriously to the interests of each other. A petty warfare of regulation is thus prevented, which would rouse resentments, and create dissensions, to the ruin of the harmony and amity of the states."); Statement of Gouverneur Morris, SUPPLEMENT TO MAX FARRAND'S THE RECORDS OF THE FEDERAL CONVENTION OF 1787 at 360 ("These local concerns ought not to impede the general interest. There is great weight in the argument, that the exporting States will tax the produce of their uncommercial neigbors.").

2 Daniel Shaviro, "An Economic and Political Look at Federalism in Taxation," 90 Mich. L. Rev. 895, 957 (1992).

3 The power of the federal courts to act when Congress is silent is inferred as an implication of the Commerce Clause, a doctrine often referred to as the "dormant" or "negative" Commerce Clause. *See, e.g.*, *Willson v. The Black Bird Creek Marsh Co.*, 27 U.S. 245 (1829).

century and a half, states' power of taxation stopped at their border and did not extend to interstate commerce.[5]

That changed in the 1977 *Complete Auto* decision, where the Supreme Court permitted states to tax interstate commerce if the tax met a four-part test:[6]

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[4] *See* U.S. CONST. art. I, § 8, cl. 3 (Interstate Commerce Clause); U.S. CONST. art. I, § 10, cl. 2 (Import-Export Clause); U.S. CONST. art. IV, § 2, cl. 1 (Privileges and Immunities Clause); U.S. CONST., amend. XIV, § 1 (Privileges or Immunities Clause).

The Commerce Clause prohibits states from imposing a tax on activity out-of-state while leaving identical activity in-state untaxed. *See Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318 (1977) (invalidating a New York tax imposed solely on activity out-of-state while leaving identical activity in-state untaxed); *Westinghouse Elec. Co. v. Tully*, 466 U.S. 388 (1984) (invalidating a New York scheme exempting activity in-state while simultaneously imposed a tax on identical activity out-of-state); *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984) (invalidating a Hawaii tax imposed on a category of products but exempting activity in-state); *Am. Trucking Ass'n v. Scheiner*, 483 U.S. 266 (1987) (invalidating a Pennsylvania scheme imposing fees on all trucks while reducing other taxes for trucks in-state only); *New Energy Co. v. Limbach*, 486 U.S. 269 (1988) (invalidating an Ohio tax credit to all ethanol producers but disallowed for non-Ohio producers); *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994) (invalidating a Massachusetts general tax on dairy producers where the revenue was then distributed to domestic dairy producers); *Camps/Newfound/Owatanna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997) (invalidating Maine's denial of the general charitable deduction to organizations that primarily serve non-Maine residents). *But see Dep't. of Revenue of Ky. v. Davis*, 553 U.S. 328 (2008) (upholding Kentucky's exclusion from tax of interest earned from its state bonds, but not other states bonds, on the grounds that Kentucky is acting as a market participant no different from any other bond issuer).

The Import-Export Clause prohibits states from penalizing activity that crosses state lines, particularly imports. *See, e.g., Michelin Corp. v. Wages*, 423 U.S. 276, 295 (1976) (stating that the Import-Export Clause prohibits import taxes that "create special protective tariffs or particular preferences for certain domestic goods….").

The Privileges and Immunities Clause of Article IV and the Privileges or Immunities Clause of the Fourteenth Amendment protects the right of citizens to cross state lines in pursuit of an honest living. *See, e.g., United Bldg. & Constr. Trades v. Mayor*, 465 U.S. 208, 219 (1984) (identifying "pursuit of a common calling" as a privilege of citizenship protected by the Constitution); *Saenz v. Roe*, 526 U.S. 489 (1999) (invalidating a law that did not restrict state travel *per se* but discouraged the crossing of state lines with a punitive and discriminatory law); *id.* at 511 (Rehnquist, J., dissenting) ("The right to travel clearly embraces the right to go from one place to another, and prohibits States from impeding the free passage of citizens); Erwin Chemerinsky, CONSTITUTIONAL LAW 450 (2d ed. 2002) ("The vast majority of cases under the [Article IV] privileges and immunities clause involve states discriminating against out-of-staters with regard to their ability to earn a livelihood.").

[5] *See, e.g., Freeman v. Hewit*, 329 U.S. 249, 252-53 (1946) ("A State is … precluded from taking any action which may fairly be deemed to have the effect of impeding the free flow of trade between States"); *Leloup v. Port of Mobile*, 127 U.S. 640, 648 (1888) ("No State hast he right to lay a tax on interstate commerce in any form.").

[6] *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). The case came about after a series of cases in the 1950s and 1960s where the Court treated essentially identical taxes differently based on "magic words" in the statute. For example, an annual license tax imposed on the in-state gross receipts of an out-of-state company was invalidated as discriminating against interstate commerce, but an otherwise identical franchise tax on in-state going concern value, measured by gross receipts, was upheld as valid. *Compare Ry. Express Agency v. Virginia*, 347 U.S. 359 (1954) (*"Railway Express I"*) *and* Ry. *Express Agency v. Virginia*, 358 U.S. 434 (1959) (*"Railway Express II"*).

- **Nexus**: there has to be a sufficient connection between the state and the taxpayer.
- **Fair Apportionment**: the state cannot tax beyond its fair share of the taxpayer's income
- **Nondiscrimination**: the state must not burden out-of-state taxpayers while exempting in-state taxpayers
- **Fairly Related:** the tax must be fairly related to services provided to the taxpayer.

The test is well-formulated but much of it is ignored today.

On apportionment, states have drifted away from a once-uniform rule, with successive rounds of states' grabbing revenue from other states (see table) through modified formulas, throwback rules, and combined reporting.[7]

Regarding nondiscrimination, states and localities put hefty taxes on rental cars and hotel rooms used primarily by out-of-state residents,[8] and taxes designed to be stealth and punitive on certain products, such as telecommunications.[9]

And regarding taxes being fairly related to services, it's assumed today that any tax is fairly related, even though only residents benefit from most state and local spending.[10]

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[7] *See* Chris Atkins, "A Twentieth Century Tax in the Twenty-First Century: Understanding State Corporate Tax Systems," TAX FOUNDATION BACKGROUND PAPER NO. 49 (Sep. 2005) at 6-9 ("Apportionment: How Much of the Pie Can You Eat?")

[8] *See, e.g.*, Joseph Henchman, "Cities Pursue Discriminatory Taxation of Online Travel Services: Real Motivation is to Shift Tax Burdens to Nonresidents; Result is Harm to Interstate Commerce," TAX FOUNDATION SPECIAL REPORT NO. 175 (Feb. 2010), http://www.taxfoundation.org/publications/show/25786.html; Andrew Chamberlain, "The Case Against Special Rental Car Excise Taxes," *Tax Policy Blog* (Apr. 18, 2006), http://www.taxfoundation.org/blog/show/1440.html.

[9] *See, e.g.*, Joseph Henchman, "States Target Cell Phones for a Stealth, Burdensome Tax," TAX FOUNDATION FISCAL FACT NO. 116 (Jan. 18, 2008), http://www.taxfoundation.org/research/show/22881.html ("State and local governments should not single out one product for stealth tax increases, as they are doing with cell phones. Such actions distort market decisions, violating the sound-tax-policy principle of neutrality. Cell phone users are often overtaxed relative to consumers of other goods, and at risk of double taxation. Finally, the wide number of taxing authorities and the wide variety in rates makes tracking problematic and burdensome.").

[10] *See, e.g.*, *Goldberg v. Sweet*, 488 U.S. 252, 266-67 (1989) ("The purpose of this test is to ensure that a State's tax burden is not placed upon persons who do not benefit from services provided by the State. Appellants would severely limit this test by focusing solely on those services which Illinois provides to telecommunications equipment located within the State. We cannot accept this view. The tax which may be imposed on a particular interstate transaction need not be limited to the cost of the services incurred by the State on account of that particular activity.").

STATE APPORTIONMENT FORMULAS: ONCE UNIFORM, NOW NOT

State	Kept Uniform Rule?	Formula	Statute
Alabama	Yes	Evenly weighted three-factor formula.	Alabama Code §40-27-1(IV)(9)
Alaska	Yes	Evenly weighted three-factor formula.	Alaska Stat. §43.19.010(IV)(9)
Arizona	No	Three-factor formula with double-weighted sales factor or enhanced sales factor formula 80-10-10 (sales, property, payroll).	Ariz. Rev. Stat. §43-1139(A), Form 120, Instructions
Arkansas	No	Three-factor formula with double-weighted sales factor.	Ark. Code. Ann. §26-51-709
California	No	Three-factor formula with double-weighted sales factor.	Cal. Rev. & Tax Code §25128(a), Cal. Rev. & Tax Code §25128.5
Colorado	No	One-factor sales formula.	Colo. Rev. Stat. §39-22-303(2)(b), Colo. Rev. Stat. §24-60-1301(IV)(9)
Connecticut	No	Single-factor gross receipts formula for income other than that derived from the sale or use of tangible personal or real property, and three-factor formula with double-weighted sales factor for income derived from the sale or use of tangible personal or real property. Three-factor formula with double-weighted sales factor for income derived from the manufacture, sale, or use of tangible personal or real property.	Conn. Gen. Stat. §12-218(b) and (c)
Delaware	Yes	Evenly weighted three-factor formula.	Del. Code Ann. tit. 30, §1903(b)(6)
Florida	No	Three-factor formula with double-weighted sales factor.	Fla. Stat. ch. 220.15(1)
Georgia	No	One-factor sales formula.	Ga. Code Ann. §48-7-31(d)
Hawaii	Yes	Evenly weighted three-factor formula.	Haw. Rev. Stat. §255-1(IV)(9)
Idaho	No	Three-factor formula with double-weighted sales factor.	Idaho Code §63-3027(i)(1)
Illinois	No	One-factor sales formula.	35 ILCS 5/304(h)(3)
Indiana	No	Three-factor formula 90-5-5 (sales, property, payroll).	Ind. Code §6-3-2-2(b)
Iowa	No	One-factor sales formula.	Iowa Code §422.33(2)(b)
Kansas	Yes	Evenly weighted three-factor formula.	Kan. Stat. Ann. §79-3279(b)(1)
Kentucky	No	Three-factor formula with double-weighted sales factor.	Ky. Rev. Stat. Ann. §141.120(8)
Louisiana	Yes	Evenly weighted three-factor formula for corporations without a specified formula (i.e., businesses other than manufacturing, merchandising, transportation, or services, etc).	La. Rev. Stat. Ann. §47:287.95(F)(2)
Maine	No	One-factor sales formula.	Me. Rev. Stat. Ann. tit. 36, §5211(8)
Maryland	No	Three-factor formula with double-weighted sales factor and a one-factor sales formula for manufacturers.	Md. Code Ann. §10-402(c)(1) and (2)
Massachusetts	No	Three-factor sales formula with double-weighted sales factor.	Mass. Gen. Laws ch. 63, §38(c)
Michigan	No	One-factor sales formula for purposes of computing Michigan Business Tax (MBT).	Mich. Comp. Laws §208.45(a)(1), Mich. Comp.

			Laws §208.1301(2), Mich. Comp. Laws §208.1303(1)
Minnesota	No	Three-factor formula 87-6.5-6.5 (sales-property-payroll).	Minn. Stat. §290.191(2)
Mississippi	Varies	No general apportionment formula. One-factor sales formula for taxpayers that are not required to use a designated apportionment formula based on specific type or line of in-state business activity.	Miss. Reg. 35.III.8.06(II)(B), Unofficial Tax Commission guidance
Missouri	Yes	Evenly-weighted three-factor formula or optional one-factor sales formula for corporations other than certain public utilities and transportation companies.	Mo. Rev. Stat. §32.200(IV)(9), Mo. Rev. Stat. §143.451.2
Montana	Yes	Evenly weighted three-factor formula.	Mont. Code Ann. §15-31-305
Nebraska	No	One-factor sales formula.	Neb. Rev. Stat. §77-2734.05(1)
New Hampshire	No	Three-factor formula with double-weighted sales factor.	N.H. Rev. Stat. Ann. §77-A:3(II)(a)
New Jersey	No	Three-factor formula with double-weighted sales factor.	N.J. Stat. Ann. §54:10A-6
New Mexico	Yes	Evenly weighted three-factor formula.	N.M. Stat. Ann. §7-4-10(A)
New York	No	One-factor receipts formula.	N.Y. Reg. Sec. 4-2.2(b)
North Carolina	No	Three-factor formula with double-weighted sales factor.	N.C. Gen. Stat. §105-130.4(i)
North Dakota	Yes	Evenly weighted three-factor formula.	N.D. Cent. Code §57-38.1-09
Ohio	N/A	For purposes of the commercial activity tax, the state has specific rules describing how gross receipts are sitused to the state.	Ohio Rev. Code Ann. §5733.05(B)(2)
Oklahoma	Varies	Evenly weighted three-factor formula; corporations meeting investment criteria may double-weight the sales factor.	Okla. Stat. tit. 68, §2358(A)(5)
Oregon	No	One-factor sales formula.	Or. Rev. Stat. §314.650(1)
Pennsylvania	No	Three-factor formula 90-5-5 (sales, property, payroll).	72 P.S. §7401(3)2(a)(9)(A)
Rhode Island	Yes	Evenly weighted three-factor formula.	R.I. Gen. Laws §44-11-14(a)
South Carolina	No	Three-factor formula with double-weighted sales or optional one-factor sales formula for manufacturers, sellers, distributors and renters oftangible property.	S.C. Code Ann. §12-6-2250, S.C. Code Ann. §12-6-2290, Form 1120SC Instructions, C Corporation Income Tax Return
Tennessee	No	Three-factor formula with double-weighted sales factor.	Tenn. Code Ann. §67-4-2012(a)
Texas	N/A	One-factor gross receipts formula.	Tex. Tax Code Ann. §171.105(a), Tex. Tax Code Ann. §171.106(a)
Utah	Varies	Evenly weighted three-factor formula, unless election is made to use apportionment formula with double weighted sales factor.	Utah Code Ann. §59-7-302, Utah Code Ann. §59-7-311, Utah Admin. Code R865-6F-8
Vermont	No	Three-factor formula with double-weighted sales factor.	Vt. Stat. Ann. tit 32, §5833(a)
Virginia	No	Three-factor formula with double-weighted sales factor.	Va. Code. Ann. §58.1-408
West Virginia	No	Three-factor formula with double-weighted sales factor.	W. Va. Code §11-24-7(c)
Wisconsin	No	One-factor sales formula.	Wis. Stat. §71.25(6)(a)
District of Columbia	Yes	Evenly weighted three-factor formula.	D.C. Code Ann. §47-1810.02(d)

Source: Commerce Clearinghouse; Tax Foundation.

Nexus survives as a restraint on state power, although it is now under attack.

Corporate Income Tax

First there's the state corporate income tax. It's a dying tax, killed off by thousands of credits, deductions, abatements, and incentive packages. In the late 1970s during the time of the *Complete Auto* case, the tax raised nearly 10% of state tax revenue; today it's hovering around 6% (see table). Corporations try to plan their way out of it, resulting in serious compliance and administrative costs compared to other revenue sources.[11]

THE DYING STATE CORPORATE INCOME TAX: NATIONWIDE COLLECTIONS AS A PERCENTAGE OF TOTAL STATE TAX REVENUE AND AS A PERCENTAGE OF TOTAL STATE REVENUES

	% of Tax	% of Total
1977	9.1%	4.5%
1978	9.5%	4.8%
1979	9.7%	4.9%
1980	9.7%	4.8%
1981	9.4%	4.6%
1982	8.6%	4.2%
1983	7.7%	3.7%
1984	7.9%	3.9%
1985	8.2%	4.0%
1986	8.1%	3.8%
1987	8.3%	4.0%
1988	8.2%	4.0%
1989	8.4%	4.1%
1990	7.2%	3.4%
1991	6.6%	3.1%
1992	6.6%	2.9%
1993	6.8%	3.0%

	% of Tax	% of Total
1994	6.9%	3.1%
1995	7.3%	3.2%
1996	7.0%	3.0%
1997	6.9%	3.0%
1998	6.6%	2.8%
1999	6.2%	2.7%
2000	6.0%	2.6%
2001	5.7%	2.7%
2002	4.7%	2.3%
2003	5.2%	2.2%
2004	5.1%	1.9%
2005	5.9%	2.4%
2006	6.7%	2.7%
2007	7.0%	2.6%
2008	6.5%	3.0%
2009	6.1%	N/A

Source: US Census; Tax Foundation.

[11] *See, e.g.*, Organization for Economic Cooperation and Development, "Tax and Economic Growth," ECONOMICS DEPARTMENT WORKING PAPER NO. 620 (Jul. 11, 2008) ("[C]orporate taxes are found to be most harmful for growth, followed by personal income taxes, and then consumption taxes."); David Brunori, STATE TAX POLICY at 84 (2004) ("In many cases, the amount of time and resources devoted to the [state corporate income] tax outweighs its financial contribution to the states."); Richard Pomp, "The Future of the State Corporate Income Tax: Reflections (and Confession) of a Tax Lawyer," *in* THE FUTURE OF STATE TAXATION (David Brunori ed. 1998); J. Dwight Evans, "The Approaching State Corporate Income Tax Crisis," TAX FOUNDATION BACKGROUND PAPER NO. 14 (Sep. 1995), http://www.taxfoundation.org/research/show/570.html; Joel Slemrod & Marsha Blumenthal, "The Income Tax Compliance Cost of Big Business," TAX FOUNDATION SPECIAL ACADEMIC PAPER (Nov. 1993), http://www.taxfoundation.org/publications/show/639.html;

The beggar-thy-neighbor policies of apportionment formula games, mercantilist film and investment credit programs,[12] destructive gross receipts taxes,[13] and corporate welfare[14] are the reason for the collapse of this tax as a revenue source. But rather than fix those problems, the push by some states has been to reach across state lines with the nebulous concept of "economic nexus."[15]

A uniform physical presence standard would limit these destructive state efforts to export tax burdens and will decrease transaction costs for interstate business activity.[16]

Sales Tax

Sales taxes were first adopted by states in the 1930s, quickly followed by "use" taxes to discourage consumers from buying goods in lower-tax states. Use taxes seek to equalize tax burdens with a tax on transactions occurring in other states -- essentially a protectionist measure.[17]

But judicial decisions have barred states from forcing non-physically present individuals and businesses to collect their use taxes.[18] These decisions are premised both on the geographic

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[12] *See* Will Luther, "Movie Production Incentives: Blockbuster Support for Lackluster Policy," TAX FOUNDATION SPECIAL REPORT NO. 173 (Jan. 2010), http://www.taxfoundation.org/publications/show/25706.html.

[13] *See* Andrew Chamberlain & Patrick Fleenor, "Tax Pyramiding: The Economic Consequences of Gross Receipts Taxes," TAX FOUNDATION SPECIAL REPORT NO. 147 (Dec. 2006), http://www.taxfoundation.org/research/show/2061.html.

[14] *See, e.g.*, Melvin L. Burstein & Arthur J. Rolnick, "Congress Should End the Economic War Among the States," FEDERAL RESERVE BANK OF MINNEAPOLIS 1994 ANNUAL REPORT 9 (1):3-19 (urging a congressional end to states "using financial incentives to induce companies to locate, stay, or expand in the state.").

[15] *See, e.g.*, Joseph Henchman, *Why the Quill Physical Presence Rule Shouldn't Go the Way of Personal Jurisdiction*, 46 STATE TAX NOTES 387 (Nov. 5, 2007), http://www.taxfoundation.org/commentary/show/22785.html ("Abandoning the physical presence rule in *International Shoe* led to confusion and uncertainty, resulting in an area of law in which no one is sure what the rules are. Abandoning the *Quill* physical presence rule would result in the same.... First, applying geography-based income taxes or geography-based sales taxes with a standard unconstrained by geography risks multiple taxation and burdensome compliance costs.... Second, simply imposing the existing taxation regime on e-commerce would burden e-commerce more than bricks-and-mortar businesses.... Third, there is a high likelihood that e-commerce would become subject to multiple taxation under an economic nexus standard.... Fourth, how far in space and time economic nexus can go remains undetermined.... Fifth, adopting an economic nexus standard would unsettle expectations and threaten retroactive application of taxes, endangering economic investments.... Overturning the present standard without being sure about what replaces it will repeat the mistake made by the progeny of *International Shoe*.").

[16] *Id.*

[17] *See, e.g.*, Joseph Henchman, "'Amazon Tax' Laws Signal Business Unfriendliness and Will Worsen Short-Term Budget Problems," TAX FOUNDATION SPECIAL REPORT NO. 176 (Mar. 8, 2010), http://www.taxfoundation.org/publications/show/25949.html, *citing Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937).

[18] *See, e.g.*, *Quill Corp. v. North Dakota*, 504 U.S. 298, 313 (1992) ("[Nexus] limit[s] the reach of State taxing authority so as to ensure that State taxation does not unduly burden interstate commerce."); *id.* at n. 6 ("North Dakota's use tax illustrates well how a state tax might unduly burden

limit of state powers and on the difficulty of complying with over 8,000 constantly changing sales taxes, with different bases, rates, and exemptions, and contrary to popular belief, are not aligned with even 9-digit or even 5-digit zip codes.[19]

Brick-and-mortar retailers claim unfairness: they must collect sales tax while their online and out-of-state competitors don't. Of course, the proposal on the table is to impose a *greater* obligation on out-of-state and online businesses, forcing them to collect thousands of different sales taxes, while brick-and-mortar retailers need to track and collect only one.[20]

We have the Streamlined Sales Tax Project (SSTP), an effort to simplify and harmonize state sales taxes in the hope that Congress or the Supreme Court will permit states to impose use tax collection obligations on out-of-state companies.[21] While the SSTP has made notable progress on uniform definitions, meaningful efforts to simplify have been avoided.[22] The SSTP's work is far from finished.

We have "Amazon taxes" that expand nexus even further than previous cases.[23] These taxes have actually reduced revenues in states that have adopted them and are considered by most to be unconstitutional.[24]

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interstate commerce."); *National Bellas Hess, Inc. v. Dep't of Revenue of State of Ill.*, 386 U.S. 753, 759-60 (1967) ("If Illinois can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes. The many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose "a fair share of the cost of the local government.").

[19] *See, e.g.*, Joseph Henchman, Testimony to the Maryland Legislature on the Streamlined Sales Tax Project (Feb. 18, 2009), http://www.taxfoundation.org/research/show/24346.html ("At [the SSTP] New Orleans meeting in July 2008, for instance, I asked if any effort was being made to reduce the number of sales taxing jurisdictions, and/or to align them with 5-digit zip codes. 'No and no,' was the short but honest answer.").

[20] *See, e.g.*, Joseph Henchman, "'Amazon Tax' Laws Signal Business Unfriendliness and Will Worsen Short-Term Budget Problems," TAX FOUNDATION SPECIAL REPORT NO. 176 (Mar. 8, 2010), http://www.taxfoundation.org/publications/show/25949.html.

[21] *See, e.g.*, Joseph Henchman, Testimony to the Maryland Legislature on the Streamlined Sales Tax Project (Feb. 18, 2009), http://www.taxfoundation.org/research/show/24346.html, *citing* Joseph Henchman, "Nearly 8,000 Sales Taxes and 2 Fur Taxes: Reasons Why the Streamlined Sales Tax Project Shouldn't Be Quick to Declare Victory," *Tax Policy Blog* (Jul. 28, 2008), http://www.taxfoundation.org/blog/show/23423.html.

[22] *Id.*

[23] *See, e.g.*, Joseph Henchman, "'Amazon Tax' Laws Signal Business Unfriendliness and Will Worsen Short-Term Budget Problems," TAX FOUNDATION SPECIAL REPORT NO. 176 (Mar. 8, 2010), http://www.taxfoundation.org/publications/show/25949.html ("New York relied on two U.S. Supreme Court cases, *Scripto, Inc. v. Carson* and *Tyler Pipe Indus. v. Washington Dep't of Revenue*, where in-state independent persons were so necessary and significant in establishing and maintaining the out-of-state company's market in the state that the companies were deemed to be present in the state. These 'attributional nexus' cases have been described by the Supreme Court itself as the "furthest extension" of nexus.... New York's law is an unprecedented expansion of state taxing authority. The affiliates are responsible for only 1.5% of Amazon.com's sales in New York, and there is no evidence that the affiliates even target New Yorkers (they operate via websites, available

Individual Income Tax

Half the states require nonresident employees to set up individual income tax withholding for their *first* day of travel into the state.[25] Sixteen more states also require withholding after a certain point. And that's just withholding, not the obligation to file a return or pay taxes.[26]

A few years ago, we got a call from a woman in Ohio. Her son was a soccer goalie and he had earned $28,000. Spread across this woman's kitchen table were 10 state income tax returns, divvying up the tax on $28k. States are becoming more aggressive with nonresident income taxes, hunting schedules via Twitter, demanding travel vouchers, generally imposing a colossal compliance burden that is a net revenue wash, transferring tax dollars from low-tax, low-expense states to the states with the highest tax burdens.[27]

Conclusion

The states are hurting, it is true. They aren't entirely innocent in that predicament.[28] But state fiscal pain does not justify beggar-thy-neighbor policies that impose significant compliance and deadweight losses on the national economy. State power to tax should not extend to everything everywhere. Simplification should be something everyone embraces. As Chief Justice Marshall said, "The power to tax is the power to destroy."[29] And state tax overreaching can destroy.

As a country we have gone from the artisan to Amazon.com. But the sophistication of technology does not override the timeless constitutional principles designed to restrain states from burdening interstate commerce and imposing uncertainty on the national economy.[30]

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worldwide). The affiliates neither engage in direct solicitation nor provide any crucial sales support for Amazon.com in the state.").

[24] *See, e.g.*, Joseph Henchman, "'Amazon Tax' Laws Signal Business Unfriendliness and Will Worsen Short-Term Budget Problems," TAX FOUNDATION SPECIAL REPORT NO. 176 (Mar. 8, 2010), http://www.taxfoundation.org/publications/show/25949.html.

[25] *See* Council on State Taxation, "Nonresident Personal Income Tax Withholding."

[26] *Id.*

[27] *See* David Hoffman & Scott A. Hodge, "Nonresident State and Local Income Taxes in the United States," TAX FOUNDATION SPECIAL REPORT NO. 130 (Jul. 1, 2004), http://www.taxfoundation.org/research/show/94.html.

[28] *See, e.g.*, Joseph Henchman, "State Budget Shortfalls Present a Tax Reform Opportunity," TAX FOUNDATION SPECIAL REPORT NO. 164 at 9 (Feb. 2009), http://www.taxfoundation.org/research/show/24321.html ("Those states hardest hit by the recession are those that relied the most heavily on capital gains, high-income earners, and corporate profits… Revenue from [these tax sources] does spike during times of economic boom, but it plummets during a bust. States without spending controls get into trouble by assuming for spending purposes that the years of revenue windfall will continue.").

[29] *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 431 (1819).

[30] *See, e.g.*, Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 902 (1992) ("Today's more integrated national economy presents far greater opportunities than existed in 1787 for states in effect to reach across their borders and tax nonconsenting nonbeneficiaries.").

Mr. JOHNSON. Thank you, Mr. Henchman.

Next, we will hear from Ms. Kerry Korpi, our final witness.

Ms. Korpi is director of the Department of Research and Collective Bargaining Services for the American Federation of State, County and Municipal Employees, a union of 1.6 million working and retired public-service workers. The department provides assistance to AFSCME affiliates on a variety of issues, including public-sector budgets and finance, and health and pension benefits.

Ms. Korpi has worked for AFSCME at its Washington, D.C. headquarters, and in various field assignments since 1982.

Welcome, Ms. Korpi, and please begin.

TESTIMONY OF KERRY KORPI, DIRECTOR OF RESEARCH AND COLLECTIVE BARGAINING SERVICES, AMERICAN FEDERATION OF STATE, COUNTY AND MUNICIPAL EMPLOYEES

Ms. KORPI. Thank you, Mr. Chairman and Members of the Committee, for holding this hearing, and for inviting me to testify——

Mr. JOHNSON. And would you turn that microphone on right there, and pull it a little closer to you?

Mr. HENCHMAN. It is on. I don't think it is working.

Ms. KORPI. Can you hear me?

Mr. JOHNSON. Maybe we could switch microphones.

Ms. KORPI. This works?

Mr. JOHNSON. Yes.

Ms. KORPI. There we go.

Mr. JOHNSON. Yes. Thank you.

Ms. KORPI. Thank you for holding this hearing, and for inviting me to testify on behalf of AFSCME's 1.6 million members. We represent public-service workers around the country, in jobs "from accountants to zookeepers," as we say, and everything in between.

You have got my written testimony, so rather than repeat that, let me speak to this topic from the perspective of our members and the people that they serve.

We have heard a lot about the recent couple of difficult years. Back in the years 2002 to 2005, we were seeing a fiscal crisis in state and local governments that, at that time, was the worst that I had seen in my years at AFSCME. And, little did we know then, it would be nothing compared to what we are seeing now.

In the last couple of years, our members have experienced layoffs, furloughs, wage freezes, wage cuts, and we expect more fiscal trouble in the next 2 fiscal years. This certainly puts a strain on our members, but also puts serious strains on the public services and the people that they work for. The demand for food stamps, unemployment insurance, employment services, TANF, Medicaid, the need for child-welfare services, have all increased dramatically in this downturn. And systems that were stretched before this crisis have reached a breaking point.

And the role of other public services in a bad economy may not be quite as obvious, but they are just as important—public safety, parks and recreation; libraries have become a place where people search for jobs. And they are closing and shortening hours and putting a lot of people at real hardship. So when we talk about taxes, I think it is important to remember what those taxes pay for.

What we are also seeing are major policy changes enacted as a result of the budget crisis. In some states, there are fewer school days. As Governor Douglas mentioned, several states are releasing inmates en mass early, before they serve their sentences. Now, these policies certainly shouldn't be set in stone, and there is room to debate them. But we probably shouldn't just change them because we have run out of money.

In addition to making budget cuts, states are biting the bullet and raising taxes by some $32 billion recently. But state and local governments are running out of options for dealing with the continuing budget problems.

The American Recovery and Reinvestment Act was tremendously helpful. It closed some 30 percent to 40 percent of the deficits that states expect from 2009 to 2012. And we thank the House and the Senate for passing the $26 billion extension of FMAP, and we urge you to quickly reconcile the two versions of the bill so that these can get to states.

We also urge you to continue recovery funding for schools. There was funding included in the Jobs for Main Street Act, passed by the House, and also in representative George Miller's Local Jobs for America Act, which we strongly support as well.

And I want to join other speakers in strongly urging you not to restrict state's options at this critical time. There is a temptation in Congress and in states to use state-tax systems to protect particular industries, particular new or emerging industries, so that they can grow and thrive. And while that intention may be good and admirable, the result is many state-tax systems that we're good in the 1930's are completely inadequate for the 21st century. And it means that state-tax systems capture less and less economic activity over time, and those sectors that are taxed foot the bill.

So in closing, we urge you to do what only the Federal Government can do, and continue to provide relief so that states and local governments can provide the services we need to get our economy on track. And we also urge you to allow them the flexibility to do what they can do to get their own budgets back on stable footing. And thank you again for calling this hearing, and for inviting me here.

[The prepared statement of Ms. Korpi follows:]

PREPARED STATEMENT OF KERRY KORPI

Testimony of Kerry Korpi
Director of Research and Collective Bargaining Services
of the
American Federation of State, County and Municipal Employees
before the
Subcommittee on Commercial and Administrative Law
Committee on Judiciary
U.S. House of Representatives
on
State Taxation – The Impact of Congressional Legislation on State and Local Government Revenues
April 15, 2010

Mr. Chairman and Members of the Committee, my name is Kerry Korpi. I am the Director of Research and Collective Bargaining Services at the American Federation of State, County and Municipal Employees (AFSCME). As the representative of 1.6 million working and retired public service employees, AFSCME is all too familiar with the topic of your hearing – State Taxation – The Impact of Congressional Legislation on State and Local Government Revenues.

It's been a rough couple of years for public services. In fact, it's been a pretty rough decade. The economic downturn and fiscal crisis we experienced from 2002-2005 was, at that time, the worst we had seen in decades. State shortfalls totaled $250 billion over that period.

Little did we know that those numbers would pale in comparison with the problems we're now experiencing. Forty-eight states faced shortfalls, averaging 29% of their budgets, in fiscal year (FY) 2010. State shortfalls in FY 2009 and 2010 totaled over $300 billion. Another $300 billion in shortfalls is projected for FY 2011 and 2012.[1]

Some may blame "out of control" state spending for this problem. This is not the case. Unlike the federal government, every state except Vermont is required by constitution or statute to balance its budget. While states can and most do borrow for capital expenses, such as new roads and schools, they do this by selling bonds to investors, which states must then repay over a period of time with interest. In fact, state spending never fully recovered from the 2001 recession. By FY 2008, state spending reached 4.8% of GDP which was still below the pre-recession peak of just over 5% in FY 2001.[2] And, as we all know, there have been major cuts since 2008.

The problem is clearly an unprecedented drop in state revenues. State revenues dropped in every quarter of 2009 in relation to the corresponding quarter of the prior year. In the January-March 2009 quarter, state tax revenues dropped by 11.6%. This was the largest drop in 50 years of recorded data. The April-June quarter saw an even worse state revenue drop of 16.4%. This was followed by a 10.9% revenue drop in the July-September quarter and finally a

[1] Center on Budget and Policy Priorities.
[2] State Expenditure Growth Slowing; Center on Budget and Policy Priorities, July 31, 2007.

4.1% drop in the last quarter of 2009. Combined with a 3.9% revenue decline in the fourth quarter of 2008, this period marks an unprecedented five straight quarters of revenue declines for state government.[3]

At the same time, the economy is creating skyrocketing demand for the safety net services that states provide. According to the Centers for Medicare and Medicaid Services' figures for June 2009, there was a nationwide increase of 3.3 million individuals enrolled in Medicaid since June 2008. This is the biggest one year increase in enrollment in the program's 45 year history. The story for the Supplemental Nutrition Assistance Program (SNAP, formerly Food Stamps) is similar. The SNAP program saw an increase of 7.2 million individuals from January 2009 to January 2010. As of January 2010, 12.8% of the U.S. population was receiving food stamps.[4] Nationally there has been a 10% increase in the number of families receiving cash assistance since the start of the recession.[5]

Instead of staffing up to meet this demand, at least 42 states have cut spending, some by a substantial amount. In the 18 months between August 2008 and February 2010, 192,000 state and local government jobs were lost.[6] That doesn't include the furloughs that states and local governments around the country are imposing on our members. AFSCME members have taken as many as 24 days of furlough in a year, representing a cut in pay of over 9%. The combination of job reductions and unprecedented furloughs has created increased danger and stress for state and local government workers. Correction and mental health facilities that were chronically understaffed prior to the recession are now dangerously understaffed. Caseworkers now have caseloads that rise into the hundreds and potholes that developed during this long winter will take longer to repair.

At the same time, states understand that simply cutting their way out of this problem is more harmful to economic recovery than a balanced approach. Thirty-three states have increased taxes, increasing state revenues by a net of almost $30 billion.[7] And while there is ample information about state finances, cities are also experiencing unprecedented problems, which are less well-documented and receive less attention. We represent members in many of our largest cities, and many of those had lost jobs, housing, stock and much of their tax base before the current Great Recession. Research by the National League of Cities estimates that the municipal sector will face shortfalls of between $56 and $83 billion from 2010-2012. Over 90% of cities responding to a survey in 2009 reported making cuts that year and over 80% expected to make further cuts in 2010. This is the worst outlook the report has found in 24 years.[8]

Congressional legislation has had a tremendous impact in mitigating the damage caused by these shortfalls. As I mentioned, states must balance their budgets, so only Congress can take the action needed to avert fiscal disaster. The $225 billion provided for state fiscal relief by the

[3] The Nelson A. Rockefeller Institute of Government, State Revenue Flash Report, February 23, 2010. The Nelson A. Rockefeller Institute of Government, "Recession, Recovery, and State and Local Finances" by Donald J. Boyd, January 28, 2010.
[4] Food Resource and Action Center, Source USDA.
[5] Center on Law and Social Policy.
[6] Center on Budget and Policy Priorities.
[7] Center on Budget and Policy Priorities.
[8] National League of Cities, Research Brief, December 2009.

American Recovery and Reinvestment Act (Recovery Act) covered an estimated 30-40% of state shortfalls from FY 2009-FY 2012. The Recovery Act was a big success in our opinion. It did what it was supposed to do: save and create jobs. It immediately provided help to cash-strapped states and local governments so they could avoid job cuts and service reductions. In addition to increased Medicaid funding to the states, it increased funding for other health needs, school districts, child care, employment and training, child support enforcement, road and bridge modernization, public transit, Clean Water and Drinking Water State Revolving Funds, the Community Development Block Grant (CDBG) and Community Services Block Grant (CSBG), public housing, Temporary Assistance for Needy Families (TANF) Emergency Contingency Fund and Supplemental Grants, the SNAP program, Community Oriented Policing Services (COPS), and the Byrne JAG grant program. All of these programs and services were in dire need.

But Recovery Act funds will essentially dry up at the end of this year. We thank the House and the Senate for passing the $26 billion six-month extension of enhanced federal Medicaid payments to the states and urge you to swiftly reconcile the two bills so that relief can get to the states.

We also urge you to continue Recovery Act funding for schools, which was also included in the House-passed Jobs for Main Street Act. Without new assistance, more than 300,000 education jobs will be lost in the coming year. Additional education assistance which will greatly help states and local school districts is also included in Representative George Miller's bill, The Local Jobs for America Act (H.R. 4812), that would create or save a million local government and non-profit jobs. AFSCME strongly supports this legislation, which will continue the economic recovery that has started to take hold.

AFSCME historically has expressed concerns about and opposed legislation that preempts the taxing authority of state and local governments. For example, AFSCME opposes the "Business Activity Tax Simplification Act" (BATSA), H.R.1083. Estimates from the Congressional Budget Office (2006), National Governors Association (2005), and other analysts suggest BATSA would cumulatively cost states $1 billion - $6.6 billion annually. In 2008, New York State estimated BATSA would cost as much as $650 million in annual revenue in the short term. We oppose this legislation in coalition with the National Governors Association, National League of Cities, U.S. Conference of Mayors, National Association of Counties, Federation of Tax Administrators, Center on Budget and Policy Priorities, and other labor unions.

I would note that other similar legislation to preempt state and local taxing authority would benefit large telecommunications firms, rental car companies, and other industries and sectors. It's not surprising that most corporations and entire industries prefer to pay less in taxes. But where would this stop? Enacting any such legislation merely encourages others to lobby for their own tax breaks. Worse, it shifts costs to other businesses and individuals by forcing states and localities to either reduce services or increase their taxes. AFSCME is opposed to any legislation that unfairly infringes upon the authority of state and local government to make decisions necessary to fund services. Rather than create new special interest tax breaks that affect state and local government, we feel strongly that Congress should support state and local government efforts to collect taxes rightly owed and to generate revenues needed to fund the services that allow individuals and communities to prosper.

Finally, also on the horizon is the National Commission on Fiscal Responsibility and Reform. That Commission has been appointed and is to vote on a report no later than December 1, 2010. Its charge is to propose recommendations to balance the federal budget, excluding interest payments on the debt, by 2015, and to propose recommendations to address the growth of entitlement spending and the projected gap between federal revenues and expenditures.

We hope that the Commission approaches its charge the way we would urge any decision-making body to approach a problem – decide what our needs are and figure out how to pay for them. We are concerned that a focus on the growth in entitlement spending obscures the good that that spending does. Discussion of entitlement spending in the abstract does not take into account the retiree whose only retirement income is his or her Social Security payment that averages about $14,500 a year.

AFSCME members and the public services they provide are a valuable asset to the communities they serve. While the economy has started to improve, we still have a long way to go, especially at the state and local level. State and local governments still are going through an unprecedented and prolonged period of fiscal crisis, and further cuts will only slow economic recovery. While the Recovery Act has been very helpful in the short run, the depth and severity of the problem requires additional fiscal assistance, particularly to meet increased demands for services such as Medicaid and education.

We have an important opportunity to take a closer look at the role revenues play in keeping our communities and citizens safe and prosperous and I applaud the Chairman for calling this hearing. It's very important that any federal legislation that impacts state and local revenues takes into account the precarious financial position state and local governments are in at this time as well as the impact federal action may have on state and local sovereignty. We look forward to working with the committee as it proceeds.

Thank you for the opportunity to testify. I would be happy to answer any questions you may have.

Mr. JOHNSON. Thank you, Ms. Korpi.

Our final witness, Mr. Scott Pattison, serves as executive director of the National Association of State Budget Officers, NASBO, in Washington, D.C. Prior to coming to NASBO, Mr. Pattison served for 4 years as Virginia's state budget director. Previous to serving as state budget director, Mr. Pattison headed the Regulatory and Economic Analysis section of the Virginia Department of Planning and Budget. He also served in a variety of capacities in the Office of the Virginia attorney general, including as counsel.

Mr. Pattison began his career with the Federal Government, serving in several positions at the U.S. Federal Trade Commission in Washington, D.C., including as an attorney advisor. He also briefly ran a small non-profit focusing on consumer-protection issues.

Thank you, Mr. Pattison. And please proceed with your testimony, and welcome.

TESTIMONY OF SCOTT D. PATTISON, EXECUTIVE DIRECTOR, NATIONAL ASSOCIATION OF STATE BUDGET OFFICERS

Mr. PATTISON. Thank you, Mr. Chairman, and Members of the Subcommittee, for inviting me to testify today. I really appreciate it.

And speaking on behalf of the National Association of State Budget Officers, which was founded in 1945 and represents the budget and finance officers in the 50 states, as well as the territories: We collect an enormous amount of data about state fiscal conditions. And probably no surprise—I have to tell you that states are currently facing an unprecedented fiscal and economic situation.

Mr. Ward talked about the declines in revenue. We have found the worst situation since the Great Depression. For the first time ever, in the data we have collected over several decades, there are 2 years in a row of outright actual declines—real declines—in state year-over-year spending. We have never had that before. And I think it does demonstrate a very difficult time.

Unfortunately, I have to say, as Governor Douglas and others talked about, too—is we expect this to continue through fiscal 2013 for the states. There is a lag between the time of economic recovery and actual recovery for state governments. So it will take a while there.

Now, while there are efficiencies that come from tighter budgets, and some reforms, it is still important to note that states must balance their budgets, and they do not have the same flexibility and tools that national governments, like the Federal Government have, such as controlling the currency, to deal with their budget situations.

The other thing that I want to emphasize, which I think is so critical to remember, is the constraints that states have upon them, that makes it very difficult already to manage their finances. There are very significant state expenses, governed by Federal requirements such as regulations in Medicaid. There are formulas that have been put into place by states themselves, in terms of K-through-12 funding. There are court-ordered expenditures that sometimes can be hundreds of millions, if not in the billions. So there are a lot of constraints on the flexibility of states already.

And the reason that is important is that we do feel that any additional requirements, particularly during this 2- to 3-year period of unprecedented difficult fiscal times for states, are extremely problematic, and should be avoided.

Now, many states are spending considerably less now than they did even a few years ago. One of the most extreme examples is

Michigan, which is actually spending the amount now that they spent in 1996. There are a lot of states that are spending less now than they did 2, 3, 4 years ago. In other words, there is an outright actual decline in spending, even with the Recovery Act funds and other revenue increases that they have had to take on.

Now, states have had to work within these constraints. And many have attempted to do so. And I think one of the things that is important to remember, too, is that states do attempt to deal with this volatility with rainy-day funds. During the mid-2000's, they had rainy-day funds equaling 11 percent of their general funds. That is fairly significant. And they have really helped—these rainy-day funds, along with the Recovery Act funds—to prevent even further cuts and tax increases, despite the fact that there have been significant cuts, and significant tax increases during this period.

Therefore, given this unprecedented fiscal situation facing the states, and the fact we expect it to continue at least for another 2 years and, unfortunately, for some states like California, beyond that, we urge you to consider that any changes to Federal tax laws that limit the states' ability to have the flexibility to deal with this economic and fiscal crisis should be avoided; and, again, especially during this very unprecedented, difficult fiscal time for the states. Thank you.

[The prepared statement of Mr. Pattison follows:]

PREPARED STATEMENT OF SCOTT D. PATTISON

Testimony of

Scott D. Pattison

Executive Director, National Association of State Budget Officers (NASBO)

Before the

House Judiciary Committee

Subcommittee on Commercial and Administrative Law

U.S. House of Representatives

State Taxation: The Impact of Congressional Legislation on State and Local Government Revenues

April 15, 2010

10:00 a.m.

Chairman Cohen, Ranking Member Franks, and members of the Subcommittee, thank you for inviting me to testify today on behalf of the budget and finance officers of the nation's fifty states and its territories. The National Association of State Budget Officers (NASBO) was founded in 1945 and serves as the professional organization for all state budget officers. NASBO collects data and publishes numerous reports on state fiscal conditions.

States Contribute to the Economy and Safety Net

State and local governments are an important part of our nation's service delivery system and are critical to the nation's overall economic health. State and local governments account for over 14 percent of total U.S. employment and they contribute approximately 12 percent to our national gross domestic product (GDP) with over $2 trillion in operating and capital expenditures. The fiscal health of states is therefore critical to the economy.

States Facing Unprecedented Fiscal Crisis

States are currently facing an unprecedented and extremely difficult downturn in their revenues and expenditures, the worst since the Great Depression. States have experienced a significant slowdown in revenue collections and we fully expect that state fiscal conditions will improve at a much slower and gradual rate than the economy as a whole. States are expected to take up to several years after the recession has ended to fully recover.

Our data shows that during the last two fiscal years, state general fund expenditures have shown an unprecedented decline even with the assistance of the federal government through the American Recovery and Reinvestment Act (ARRA). For two consecutive years revenues and expenditures have decreased dramatically. Fiscal 2009 general fund expenditures declined 3.4 percent compared to fiscal 2008 levels and enacted budgets for fiscal 2010 show a 5.4 percent decrease in general fund expenditures. These decreases in general fund expenditures are the largest declines in the history of our data collection. Prior to 2009, actual state general fund spending had only declined one other time, in 1983, by 0.7 percent. Overall, more than half the states (28) enacted general fund budgets with negative spending growth in fiscal 2009, and over two-thirds of states (37) enacted fiscal 2010 budgets with general fund spending lower than the previous year.

Painful Cuts and Other Actions

Nearly every state faced difficult fiscal conditions these past two years and very few states have escaped significant budget gaps and shortfalls. In fiscal 2009, 43 states reduced enacted budgets by $31.3 billion, while at least 36 states so far this year have reduced expenditures by $55.7 billion, with more expected to further cut budgets. Many states are spending considerably less now than they did in 2008. For example, Michigan's general fund budget was $9.9 billion in 2008 and for 2010 their expenditures are $8.1 billion.

As a result of declining state fiscal conditions along with the requirement that they must balance their budgets, state officials have actively addressed budget gaps in fiscal 2009 and 2010. States are required to balance their budgets and do not have the same tools available to the federal government to deal with fiscal crises. States cannot run large operating deficits. To deal with their fiscal problems, states have taken a variety of actions. Many have relied on targeted budget cuts, while more than half enacted across-the-board cuts, and half the states used rainy day funds to reduce or eliminate budget gaps. Other common strategies include furloughs, layoffs, and reductions in local aid. In addition, some states have raised revenues. Enacted tax and fee changes are expected to result in $23.9 billion in additional revenue for fiscal 2010 budgets.

Financial Management Responsibility

Many state expenses are pre-determined by federal requirements such as those in Medicaid regulations and by state requirements such as K-12 education formulas or court ordered spending. States work to deal with their fiscal problems as responsibly as possible despite the enormous constraints on their ability to manage a very difficult economic and financial crisis. For example, total state reserves and balances—which include state "rainy day" funds—were built up during the years of economic growth in the middle part of the decade. For example, in fiscal 2006 states saved $69 billion or 11.5 percent of general fund expenditures. The reserves and balances have been used by most states recently to ameliorate the pain of cuts and tax increases necessary to balance their budgets. In fiscal 2009, balance levels declined to 4.8 percent of expenditures. However, I should note that removing Alaska and Texas from this aggregate total, which represents 44 percent of total balances, reveals that total balance levels for the remaining 48 states equal only 2.7 percent of general fund expenditures for fiscal 2009.

Spending at the State Level is Predominantly Education and Medicaid

I should also note that when the breakdown of state expenditures is analyzed, the bulk of state spending is in just two areas – Medicaid and education. These areas represent 62% or more of state general fund expenditures and half of total state expenditures. When you consider all other significant state expenditures such as transportation, corrections, public health and economic development must fit within just 38% of general fund expenditures, it shows how difficult it is to ensure a balanced budget without significant impacts to most areas of state government. Therefore, there are many constraints on state budgets and the lack of flexibility makes balancing the budget a difficult exercise. Some areas of the budget are protected by various federal statutory provisions and other important areas of the budget are disproportionately cut.

Flexibility is Critical

We expect austere state budgets for at least the next several years ensuring tough competition for state general funds. While good things come from tighter budgets such as improved efficiencies and opportunities for reforms, states will still need every tool possible to use at their disposal to manage their difficult fiscal situation.

Financial management is important for states and they need as much flexibility as possible to deal with the current fiscal crisis. State elected officials and their appointed senior management teams should be allowed as much latitude as possible to do what they believe is in the best interest of their citizens. They are already constrained by significant numbers of federal requirements and mandates. They are also constrained by balanced budget requirements. While not all of these constraints are necessarily problematic, it is important to recognize their existence.

Therefore, changes to federal tax laws that put additional requirements on states should be avoided, especially during this difficult and unprecedented fiscal period for states.

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Mr. JOHNSON. Thank you, sir.

And we will now begin with questioning, starting with myself, who I will recognize for 5 minutes.

Mr. Henchman, in your testimony, you state that, "Simplification should be something everyone embraces." Could you explain the hardships and burdens that are placed on everyday Americans when there is uncertainty with respect to income-tax liability? And can you explain how this uncertainty affects mobile workers?

Mr. HENCHMAN. Sure.

I think simplicity is something that is really striking, especially today. Today is the deadline for filing Federal income taxes. And just figuring out income taxes is an enormous burden. In my spare time, I help some of my friends with their income-tax returns. And in this area, there are a lot of people who move around. So there are people who live in one state, or move between different states. So having to file multiple state returns is—it is kind of common around here.

And it is starting to get more common as more states become more aggressive about collecting revenue. I mean, as we have learned from this panel and the one before it, states are doing anything they can to get cash in the door right now. And one way to do that is to hunt down the people that are in a state, and are not residents of the state, and hit them up for income taxes. And that is something that we are seeing.

In D.C., I heard of a business turned upside-down to get travel vouchers. Schedules are getting more common online. And states are making use of that technology, unless there is some Federal restraint put on it.

The catchword today seems to be "flexibility." The problem with that is that every state wants this revenue. And you can only divvy it up so many ways before you are really imposing enormous compliance costs, especially with the Mobile Workforce Bill, where if you add it all up, it is a net national revenue wash. So we have all of this paperwork and all of this record-keeping and all of this auditing, and states, on whole, get no additional revenue out of it.

Mr. JOHNSON. So this simplification in the Mobile Workforce Act, which has been proposed as H.R. 2010, would alleviate some of that compliance burden on the part of both states and employees.

Mr. HENCHMAN. The virtue of the bill, I think, is that it provides a uniform rule in which all states have to abide by. And uniform rules in that regard can assist in reducing complexity. People will be certain about where they can go, and what their taxes will be, and what the rules are. Right now, it is not.

I think the Council on State Taxation has put together a very good paper on what they—the best they can figure are—the rules are today, on people traveling around. I mean, I am sure everyone on the panel—and everyone on the Committee—Subcommittee—travels around a lot. I don't think anybody actually sets up withholding before they travel somewhere. Maybe some people file all the tax returns for every state they have spent more than a day in. I can't imagine many people do that.

But it is a potential revenue source for states. And, yes, they want the "flexibility" to go after that. And this bill might help address that.

Mr. JOHNSON. Thank you, sir.

Next, I will address a question to Ms. Korpi.

AFSCME represents 1.6 million working and retired public-service employees. Some of them would, I imagine, be employed by the city of Atlanta. And, on behalf of my colleague who had to depart this morning early, Chairman Cohen—I am sure that there are a lot of employees in his area as well—Memphis, Tennessee.

Have the state and local spending cuts affected public-service employees in Atlanta and in Memphis; and to what extent, if any?

Ms. KORPI. In virtually every city around the country—Can you hear me now?—we have seen serious problems. The problems hit first at the state level, frankly. And, then, as states started cutting aid to local governments, we have seen—in local governments as well. And as property values are reset, we expect those problems to continue.

The data on cities is not as comprehensive as the data on states, but certainly, anecdotally, in the city of Atlanta, in the city of Memphis, we have got members who have serious problems, who have been, you know, ask to sacrifice benefits, have been in discussions about wages and so on, and seeing public services cut as well.

Mr. JOHNSON. Thank you.

Next, we will have questions from Mr. Bobby Scott, from the great state of Virginia.

Mr. SCOTT. Thank you, Mr. Chairman.

All of the witnesses have talked, again, about the need for more revenue on a state and local basis. And with the reluctance, I guess—or decision—not to raise tax rates, you have got to go find more income to tax. And the best place is to smack out-of-state residents who don't vote.

Now, Mr. Henchman, you mentioned "net wash." What do you mean by that?

Mr. HENCHMAN. As far as I know, every state has a—gives a credit for taxes paid to other states. So, for instance if—I live in Virginia. I am a constituent. And if I work in New York and I have to file a New York income-tax return, I will be able to credit those taxes paid to New York from my Virginia return.

Mr. SCOTT. Will you credit the taxes, or would you shield that income from Virginia taxation?

Mr. HENCHMAN. Well——

Mr. SCOTT. That would——

Mr. HENCHMAN. It ends up doing both.

Mr. SCOTT. Well, it would end up doing both if the tax rate is the same. If one is a higher tax rate, it would have——

Mr. HENCHMAN. If the tax rate is the same, it would end up—it really wouldn't matter. But, of course, New York has a higher income-tax rate than Virginia does. So the result would be that New York would get more of the taxes than—than they deserve, in a way, because I would get a credit for all those taxes I paid to New York on my Virginia taxes.

Mr. SCOTT. Now, that is for the individual income tax.

Mr. HENCHMAN. Correct.

Mr. SCOTT. What about things like business-activity tax? Does the business get a local credit for the business-activity tax they pay somewhere else?

Mr. HENCHMAN. It depends, I think. I don't think the rules are as certain as they are on the individual income tax.

Mr. SCOTT. So——

Mr. HENCHMAN. And, often, it depends on whether a company has nexus. And even that can be disputed.

Mr. SCOTT. So that if one state gets very aggressive against out-of-state companies, kind of making up a nexus and assessing the tax, the business may not get a credit back at home.

Mr. HENCHMAN. I mean, that is a problem we see with both the individual and the corporate income tax. It is sort of a race to be the highest-tax, highest-burden state, because that is the one that gets to take from all of the other states.

Mr. SCOTT. Okay.

Internet sales—any of the witnesses—we have heard the last panel suggest that it is not difficult for the Internet seller to actually calculate all of the local different taxes—that there are programs that can calculate this. Is there any dispute about that on this panel?

Mr. HENCHMAN. I would dispute that. I work at the Tax Foundation, where one of our missions is to keep track of all of the different taxes that are in the United States. And we try to put them up on our website as a public service. And it is almost impossible to keep track of all of the different sales taxes.

And it is not so much a technological problem. I mean, you can create calculators, and if you feed the data into it, it would be fine; although, there is some issue of lining them up with zip codes, because most people know their five-digit zip code. Almost no one knows their nine-digit zip code. And of course, sales taxes aren't even aligned by that.

But the problem is essentially in states and localities constantly changing what is taxed and what the rate is, and little rate surcharges, because different things can be taxed under different state and local tax systems. So it can be very difficult to keep track of, especially for retailers, whose main goal is to run their business, not become tax experts, like the people testifying today.

Mr. SCOTT. Is it difficult to clarify exactly—just to clarify, to simplify, exactly where the income is earned, for the purpose of taxation?

Mr. HENCHMAN. It can be, because the main thing is who gets to tax it. If I, living in Virginia, buy something on the Internet, does Virginia get to tax it? Does the state where the person sold it to me get to tax it? Does the state that has the distribution center that sent it to me get to tax it? Does every state that the truck passes through get to tax it?

The Streamlined Sales Tax Project has developed some uniform rules associated with this, although I think they are still under discussion. But, of course, not every state is a member of that. And if you left it up to the states, every state would say they want a piece of it.

Mr. SCOTT. Well, would it be possible to leave it up to the states, to let them, by compact, decide who gets to tax, and let the Federal Government out of it?

Mr. HENCHMAN. Yes, Representative. That would be an option. It doesn't seem to be going anywhere any time soon, though.

Mr. SCOTT. Well, if we don't clarify it, you have got things like use taxes and business-activity taxes, where, based on what you said, it is possible for the same business activity to get taxed in two different states.

Mr. HENCHMAN. Correct.

Mr. SCOTT. So we have a reason to want to clarify that.

Thank you, Mr. Chairman.

Mr. JOHNSON. Thank you.

I would like to thank all of the witnesses for their testimony today. Without objection, Members will have 5 legislative days to submit any additional written questions, which we will forward to the witnesses, and ask that you answer as promptly as you can, to be made part of the record.

Without objection, the record will remain open for 5 legislative days for the submission of any other additional materials. Again, I thank everyone for their time and patience. This hearing of the Subcommittee on Commercial and Administrative Law is adjourned.

[Whereupon, at 12:40 p.m., the Subcommittee was adjourned.]

APPENDIX

Material Submitted for the Hearing Record

Prepared Statement of the Honorable John Conyers, Jr., a Representative in Congress from the State of Michigan, Chairman, Committee on the Judiciary, and Member, Subcommittee on Commercial and Administrative Law

Today's hearing focuses on the impact of federal legislation on State and local tax revenues. This hearing is particularly timely in light of the fact that today is also the deadline for taxpayers to file their federal tax returns.

During the current economic downturn, State and local governments have greatly suffered as a result of decreased tax revenues and the increased need for public services spending. Out of necessity, many have responded by cutting spending for programs as well as raising taxes and fees.

For example, my home State of Michigan, along with several other States, has resorted to furloughing employees in an effort to reduce expenditures.

Another example is the City of Los Angeles, which is considering temporarily closing its agencies two days a week. Nevada has cut its primary and higher education budget nearly 7%. And Mississippi—in an effort to reduce its expenditures for its prison systems—is making nonviolent offenders eligible early for parole.

Unfortunately, even these spending cuts may not fully stabilize the current financial situation of States and municipalities. Economists predict that State revenues will lag well behind the country's economic rebound.

This Committee has an interest in the current financial situation of State and local governments, especially those governments' tax policies that may affect interstate commerce.

The Subcommittee on Commercial and Administrative Law has conducted hearings over the past Congresses examining legislative proposals and general taxation concepts, including an oversight hearing last February that focused on defining nexus.

Accordingly, I welcome today's hearing, and find it to be particularly timely on Tax Day. As we hear testimony from today's witnesses, we should consider the following three points:

First, we should be cognizant of how the current economic situation affects our State and local governments.

Given the potential for our legislative proposals to limit the ability of State and local governments to determine how and whom to tax within each jurisdiction's borders, it is critical for Congress to understand the effects of pending and future legislative proposals not just on taxpayers, but also on State and local government revenues.

State and local governments depend on tax revenues to support programs, fund education and essential emergency services, and enhance transportation infrastructure.

Many States have laws that require them to balance their budgets. When tax revenues decline, as they continue to do so now in most States, because of lower employee payrolls, sales receipts, or property values, State governments must adapt. They must cut funding to programs, or raise taxes.

The current economic environment requires State officials to make tough decisions. We should be aware that State legislators and governors, local councils and mayors, have to decide where to cut spending and how much to raise taxes.

Second, we need to identify those legislative proposals before this Committee that restrict State and local governments' authority to tax and raise revenues and be aware of their impact on revenues. We also should consider legislation which would expand State and local governments' taxing authority, while not burdening interstate commerce.

With their revenues declining for the foreseeable future, State and local governments have had to make tough choices to spur economic growth while balancing their budgets.

My home State of Michigan has been hit especially hard as its tax base continues to dwindle. In response, Michigan has had to cut spending and tweak its tax policies just to stay afloat.

Our State and local governments have to create tax policies not only to pay for providing essential services, but also to spur economic development and promote job creation.

When Congress considers legislation that may restrict State tax authority, we should remember the impact that such restrictions have on the ability of State and local governments to provide essential services. We should consider targeted State taxation legislation to lessen the burden on interstate commerce, which encourages the free flow of commerce.

We should consider legislation introduced during the last Congress by Representative Delahunt, which would grant the authority of states to require remote sellers to remit use taxes. That legislation, setting tenets to be incorporated in the Streamlined Sales Tax Project, would establish a level playing field for brick and mortar retailers and electronic commerce retailers.

But most relevant to today's hearing, that legislation would bring in much needed revenue for states, which have seen their sales tax receipts dwindle when consumers move their purchase-making to the Internet, and avoid paying sales taxes.

The Supreme Court has weighed in on the issue of States' requiring remote sellers to remit use taxes. In 1992, in Quill Corp. v. North Dakota, the Court clearly left it to Congress to decide this issue. The Court stated: "Congress is now free to decide whether, when, and to what extent the States may burden interstate [commerce] with a duty to collect use taxes."

Congress should weigh in on this issue, especially in light of the current fiscal situation we find in the States.

Third, we should encourage State and local governments—together with the relevant taxpayers—to work jointly to establish competitively neutral tax policies. And we should be actively involved in these deliberations.

Competitively neutral tax policies would not burden interstate commerce; they would provide certainty and fairness, and foster business development. They would also encourage technological development and job creation.

I thank Chairman Cohen for holding this very important hearing, to help us as we consider the impact of legislative proposals on State and local governments.

PREPARED STATEMENT OF THE HONORABLE HENRY C. "HANK" JOHNSON, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF GEORGIA, AND MEMBER, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

Thank you, Mr. Chairman, for holding this important hearing on state taxation today. It is especially fitting as today is "Tax Day."

Today we will examine the impact of congressional legislation on state and local governments. This hearing will give us the opportunity to examine the pending legislative proposals before this Subcommittee regarding state taxation.

The recession has severely affected state and local governments and their residents. State and local governments are forced to make tough decisions regarding their budgets. They are faced with laying off workers, making cuts to education, police and fire departments.

We need to provide a solution for our constituents.

This is why I have introduced H.R. 2110, the Mobile Workforce State Income Tax Fairness and Simplification Act.

This legislation provides for a uniform, fair, and easily administered law that would ensure that the correct amount of tax is withheld and paid to the states without the undue burden that the current system places on employees and employers.

The Mobile Workforce bill does not relieve any employee from paying state income taxes imposed by his or her state of residence. Therefore, the resident state of the short-term traveling employee will not be affected by this legislation.

From a national perspective, the mobile workforce bill will vastly simplify the patchwork of existing inconsistent and confusing state rules. It would also reduce administrative costs to states and lessen compliance burdens on consumers.

I thank the chairman for holding this hearing, and I look forward to hearing from our witnesses today.

RESPONSE TO POST-HEARING QUESTIONS FROM THE HONORABLE JIM DOUGLAS, GOVERNOR, STATE OF VERMONT, ON BEHALF OF THE NATIONAL GOVERNORS ASSOCIATION

Responses from Governor Jim Douglas to the Honorable Steve Cohen, Chairman of the Subcommittee on Commercial and Administrative Law Hearing on State Taxation: The Impact of Congressional Legislation on State and Local Government Revenues

Questions from the Honorable Steve Cohen, Chairman

1. In response to several questions from Congressman Scott concerning tax credits and double taxation for business activities, you responded that you did not know about the tax laws of all of the other states. Now that you have had time to review the laws of the other states, please provide a more detailed response to Congressman Scott's questions about double taxation, taxing business activities, and tax credits.

Response:
Double taxation, (i.e., taxing the exact same income multiple times) is rare. In fact the U.S. Supreme Court has stated that the Constitution prevents a state from enacting a law, which if adopted by every state, would necessarily result in double-taxation. This "internal consistency" requirement, was set out in the landmark case Complete Auto Transit v. Brady, 430 U.S. 274 (1977).

In contrast with double-taxation, it is common for a portion of the multi-state tax base to go without the imposition of tax for one reason or another. One way that states prevent double taxation is through credits given for taxes paid to other states, as is the widespread practice in the individual income tax and sales tax areas. In addition, "apportionment" helps prevent duplicate taxation by dividing up taxable income among taxing jurisdictions based on the relevant factors that produced the income.

2. In response to a question from Congresswoman Chu and in a discussion with Congressman Coble, you indicated that the National Governors Association supports at least the concept of the streamlined sales and use tax legislation, but that you have concerns about portions of it. Please explain in detail about which portions NGA has concerns.

Response:
NGA is a strong supporter of the Streamlined Sales and use Tax Agreement and its objectives of simplifying sales and use taxes and leveling the playing field for in-state and out-of-state retailers. One key question for governors has been whether federal law should mandate that states pay compensation to retailers for collecting sales taxes. Currently less than half of all states pay some level of compensation for the collection of sales taxes. Governors have stated explicitly that any federal statute related to Streamlined should not dictate how states spend state tax dollars. Consequently, governors oppose having federal law dictate how states compensate retailers for collecting state sales taxes.

3. In Judge Whitley's written statement, he mentioned the success of the Build America Bonds programs. Please tell us your thoughts on the federal legislation, which was a part of President Obama's and this Congress's efforts to stimulate the economy in 2009, with passage of the American Recovery and Reinvestment Act. And what else can Congress do to positively impact state and local government revenues?

Response:
Prior to the passage of ARRA, states faced budget shortfalls for fiscal years 2009-2011 of over $250 billion dollars. ARRA directed more than $246 billion to or through states including funds to assist with Medicaid and sustain education spending. Unlike other stimulus packages that were often passed after the recession ended, ARRA's timing helped states avoid some revenue enhancements and cuts to services. Looking ahead, a majority of the funds flowing to and through states will be spent this year before dropping off sharply in 2011. Forty-seven governors sent a joint letter to Congress in February calling for ARRA's enhanced Medicaid match to be extended for an additional two quarters through the end of states' fiscal year 2011 as the best way to preserve jobs and help avoid tax increases or service cuts that could slow recovery.

4. Mr. Robert Ward, who is testified on the second panel at the hearing, posed a question in his written statement for Congress to consider when reviewing legislation affecting state taxation: "Should federal policy emphasize the benefits of interstate differences, including tax competition among the jurisdictions, or should national policy focus on the benefits to be obtained from greater uniformity among the states?" Please respond.

Response:
As I mentioned in my testimony, the position of governors with regard to any legislation affecting state taxation is that Congress should not interfere with the ability of states to develop and manage their fiscal systems unless absolutely necessary to preserve interstate commerce. The choice, therefore, is not between promoting difference and competition over uniformity, but whether the issue Congress seeks to address is of sufficient importance to override the principles of federalism and the sovereignty of states.

5. IBM has partnered with the State of New York to find delinquent taxpayers. The two have created the Optimizer, a system that uses predictive modeling software to identify delinquent taxpayers. The Optimizer apparently has exceeded expectations and is predicted to bring in an additional $100 million in revenue for New York over the next three years. Are other states taking similar steps to identify delinquent taxpayers and collecting unpaid taxes? If yes, what steps are they taking and how successful are these steps? How does such success impact state revenues and taxpayers?

Response:
States have long employed a number of mechanisms to identify delinquent or noncompliant individuals and businesses and ensure that taxes are enforced fairly and to their fullest extent. States use data provided from multiple sources including the Internal Revenue Service, other

state tax agencies, the state's own corporation registration databases, local government business license databases and construction licenses and permits. Most of the efforts to gather and analyze data are conducted in-house or within state government.

Indeed, indentifying delinquent or noncompliant taxpayers is a fundamental function of state tax agencies, which have developed experience and expertise in gauging how compliant certain populations of individuals or businesses are and where information can be found on potentially noncompliant taxpayers. For example, the IRS-State information sharing arrangement with respect to electronic information on individual income tax reporting has been in place for more than twenty years and through information sharing agreements between the states, states can now also share electronic information in virtually countless other areas. Without such sharing of information, it would be difficult if not impossible to enforce a number of state taxes including fuel taxes and tobacco taxes.

Some states have started to use software and service providers to "find" delinquent taxpayers. Massachusetts is a leading proponent of this kind of collection efforts. Recent news stories in the Wall Street Journal have noted that some states are even using social networking websites, such as Face Book and YouTube to find people that owe taxes and cannot be found using traditional methods. . I should note that every state has strict confidentiality statutes in the tax area which prohibit the disclosure of taxpayer provided or other private information and states must also comply with Internal Revenue Service requirements for the safeguarding of information if they are to be allowed to participate in information sharing. (The IRS conducts reviews of state tax agency databases and systems to ensure these requirements are being followed, as well.) By law, therefore, states are situated similarly to the IRS or other federal law enforcement agencies when it comes to privacy protections.

6. Broadband development is of national interest. But we need state and local authorities to assist in that development. Other than state and local governments lowering taxes or keeping taxes low on wireless services, what else can state and local governments do to encourage broadband development which would also not affect their current revenues?

Response:
Governors view broadband as an engine of economic development that can help attract businesses and provide educational and occupational opportunities. Governors as chief executive officers of the states are in a unique position to coordinate and partner with broadband providers and leverage resources to maximize opportunities that bring benefits to consumers and businesses.

All states have developed or updated state broadband plans to meet the access and deployment needs of the state using state funds leveraged with federal stimulus dollars. States continue to need access to federally-collected data submitted by broadband service providers to fully map broadband availability within their jurisdictions and assist in the development of the FCC's National Broadband Map due to Congress in February 2011.

In my own state of Vermont, we established the Vermont Telecommunications Authority to facilitate the establishment and delivery of mobile phone and internet access infrastructure and services for residents and businesses throughout the state. The authority is focused on unserved and underserved areas and an overall long term goal of broadband and mobile phone infrastructure throughout the state.

States also must continue to retain the authority to develop innovative communications solutions to encourage broadband deployment. Federal and state regulatory structures for the communications industry should enable private investment and promote competition to provide benefits and options to consumers and businesses and foster broadband development.

7. In his opening statement, Mr. Joseph Henchman described the state corporate income tax as "a dying tax, killed off by thousands of credits, deductions, abatements and incentive packages." Is his statement accurate, that corporations are able to skirt paying the tax, therefore leading to lower tax revenues for states? Would elimination of such credits, deductions, etc., lead to lower possibilities of further taxes which may affect interstate commerce? Please respond.

Response:
State corporate income tax provides a small percentage of the revenue states raise through taxes (around 6%). The tax has never provided a very significant percentage of tax revenue in most states, although a handful of states rely more on the tax than others.

Much like the federal tax code, states have used credits, deductions and other incentives to attract businesses to their states or encourage activities that benefit business development and state citizens. Removing these credits and deductions may increase tax revenues in the short run, but the benefits they were created to produce may be lost.

Two factors limiting collections of corporate income taxes are tax changes at the federal level and aggressive tax planning by corporations. Most states begin their tax computation using the federal definition of taxable income. Consequently, whenever the federal government enacts laws that benefit corporate taxpayers and lower federal coffers, state revenues are also reduced.

Most states also believe that recent declines in state corporate income tax revenues are due to aggressive tax planning by corporations to avoid taxation. States have taken actions to curb these tax planning strategies, but new planning techniques, some of which border on tax evasion, require ongoing vigilance by states.

RESPONSE TO POST-HEARING QUESTIONS FROM THE HONORABLE B. GLEN WHITLEY, COUNTY JUDGE, TARRANT COUNTY, TX, ON BEHALF OF THE NATIONAL ASSOCIATION OF COUNTIES

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on State Taxation: The Impact of Congressional Legislation on State and Local Government Revenues
April 15, 2010

The Honorable B. Glen Whitley, President-Elect, National Association of Counties

Questions from the Honorable Steve Cohen, Chairman

1. IBM has partnered with the State of New York to find delinquent taxpayers. The two have created the Optimizer, a system that uses predictive modeling software to identify delinquent taxpayers. The Optimizer apparently has exceeded expectations and is predicted to bring in an additional $100 million in revenue for New York over the next three years. Are local governments taking similar steps to identify delinquent taxpayers and collecting unpaid taxes? If yes, what steps are they taking and how successful are these steps? How does such success impact local revenues and taxpayers?

One of the biggest revenue sources for local governments is real property taxes. (In fact, only 14 states permit local governments to impose an income tax.) Most jurisdictions have processes in place that identify delinquent taxpayers and permit the option of filing of a tax lien against the real and personal property of the delinquent taxpayer.

In conjunction with existing tax collection options, local governments have long advocated the enactment of federal legislation that would amend the Internal Revenue Code of 1986 to permit the collection of local tax debts and court-ordered obligations in criminal and juvenile justice proceedings through the reduction of federal tax refunds. As a result, NACo strongly supports H.R. 3060 that would permit the collection of past-due, legally enforceable local government tax obligations to local governments through federal tax refund offsets. (A copy of NACo's letter of support is attached.)

NACo is also supportive of the Streamlined Sales and Use Tax Agreement, which would permit members states to collect sales and use taxes on remote sellers – taxes that, for the most part, are not currently collected from vendors or paid by consumers. However, as explained more fully below, NACo opposes efforts to include telecommunications taxes – above and beyond sales and use taxes – in the Agreement.

2. In your written statement and also alluded to in your opening statement, you indicated that NACo supports, yet opposes the Streamlined Sales and Use Tax legislation which was introduced during the 110th Congress. Many of us have been under the assumption that state and local governments wholeheartedly support the legislation. Please explain in detail.

While NACo is supportive of the Streamlined Sales and Use Tax project, it opposed legislation that was introduced in the 110th Congress due to the fact that the legislation included provisions that would have required wholesale revisions to state and local telecommunications tax laws. These provisions affected not only sales and use taxes, but also rights-of-fees, 911 fees, franchise fees, and so on – taxes and fees that were clearly beyond the original scope of the streamlined project.

However, NACo does support the current draft version of the Main Street Tax Fairness Act of 2010, which has yet to be introduced in the 111th Congress. The proposed legislation addresses only telecommunications sales and use taxes. (A copy of NACo's letter of support is attached.)

Various news articles have discussed the complexity of including a complete simplification of all telecommunications taxes in the Streamlined Agreement. Indeed, the Streamlined Sales Tax Governing Board has finally recognized the complexity of this issue and has recently put together a task force to examine the issue of telecommunications taxes in greater detail.

I would like to note that NACo does, in fact, favor simplifying telecommunications taxes as long as the vehicle used by the federal government to achieve same does not undermine county governments' ability to retain taxing authority and revenue streams. We believe that including such reform in the Streamlined Tax Agreement would do just this.

3. Mr. Robert Ward, who testified on the second panel at the hearing, raised an interesting question in his written statement for Congress to consider when reviewing legislation affecting state taxation: Should federal policy emphasize the benefits of interstate differences, including tax competition among the jurisdictions, or should national policy focus on the benefits to be obtained from greater uniformity among the states? Please respond.

NACo believes that counties, as political subdivisions of state government, but with closer relationships to the people, have a right and a responsibility to raise the necessary revenues, unhindered by federal impositions or restrictions, in order to finance critical basic public services of a wide variety, many of which are federally mandated. As such, it would be difficult for NACo to support the proposition that national tax policy should focus on greater tax uniformity among the states rather than appreciating the benefits of interstate differences.

A one-size-fits-all, uniform tax policy fails to recognize the legitimate taxing differences among state and local governments. Jurisdictions tailor their tax schemes based on the needs of the residents and the various taxing options available for use. Some states have no income tax; some jurisdictions depend heavily on property taxes rather than sales taxes; which jurisdictions impose hotel taxes, while others do not. Indeed, the challenges of trying to impose a uniform taxing scheme is evident by the difficulties the Streamlined Sale Tax project has had in attracting the membership of many states, including California and New York.

In times past, it may have been difficult to track and manage tax differences between jurisdictions, but in an era of massive data collection, instant communications and compatible databases, the argument that this is too difficult is spurious.

4. Many industries have requested that Congress grant them special protections from state and local taxes. We have heard from the hotel industry, the car rental industry, the satellite television industry, Internet access providers, and big businesses among several others. Many of them offer compelling stories, with statistics and charts to support their positions. And many of their concerns are arguably federal concerns because of interstate commerce. Please tell us why, when the issue is of federal importance, we should ignore their concerns.

NACo's opposition to these various proposals is evident in the question itself – these businesses are looking for "special protections" when, in fact, no such "protections" are necessary or justified. What these industries are looking for is simply for is preferential tax treatment at the expense of state and local governments, taxpayers, and others businesses.

For example, the cell phone industry claims that it is unfairly taxed, which hinders innovation, growth, and profitability. But as made clear in prior testimony presented to this Subcommittee, these claims are simply false. In the year 2000, wireless passed the 100 million device threshold. In December 2009, according to CTIA, there were 285.6 million devices. The facts do not support the claim.

Online travel companies (OTCs), such as Expedia, are seeking preemption from state and local taxation in large part because of pending litigation in many jurisdictions over their failure to submit hotels taxes they have collected from customers, but have failed to remit to the appropriate taxing authority. The hotel industry is aligned with state and local governments on this issue and opposes the efforts of the OTCs to carve out special tax exemptions.

Internet access providers are already exempt from state and local taxes through the Internet Tax Freedom Act, so any current complaints these companies may have as far as state and local taxing policies are perplexing. Local governments are specifically prohibited, in federal law, from taxing satellite providers.

Federal action should be limited to those situations where problems are of national scope. For example, the Internet Tax Freedom Act, which was signed into law in 1998, was designed to encourage the development of the Internet. Regional differences in how rental cars are taxed or 911 fees are imposed or whether a hotel tax should be imposed to help fund tourism are local issues – no national interests are at stake. Each state and local authority must be able to tailor its taxing scheme to the various resources available in each jurisdiction and how best to use those limited resources to serve their residents.

Association of Public Treasurers
Government Finance Officers Association
International City/County Management Association
National Association of Counties
National League of Cities
U.S. Conference of Mayors
Treasurers' Association of Virginia

June 12, 2009

The Honorable Jim Moran
U.S. House of Representatives
2239 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman Moran:

On behalf of our tens of thousands of members, we wish to thank you for introducing the *Federal Offset Program for Local Governments Act*. This legislation would allow certain types of delinquent local tax debt to be collected through the reduction of federal tax refunds. Providing local governments with access to these necessary and owed funds is important both in principle and for budgetary purposes.

Our organizations strongly support the *Federal Offset Program for Local Governments Act* and for many years have been calling for the expansion of the Federal Offset Program. The program was created to help states secure child support arrearages and was expanded to allow states to submit other delinquent claims against an individual's federal tax return. By expanding the program to include local government tax debts, thousands of cities, counties and town across the country would be able to retrieve hundreds of millions of dollars of lost revenues which are particularly needed during this economic downturn. Furthermore, as you noted, this legislation will also help protect honest taxpayers from having to pay for those who are evading payment of their outstanding tax obligations.

This legislation is an example of how federal, state and local governments can work well together. There are limited costs to the federal government associated with the bill, as states and the federal government would be compensated by the local government for the administrative burden. Furthermore, it assists efforts to close the "tax gap" for local governments.

We can not thank you enough for introducing this legislation and for your continued support to the local government community.

Sincerely,

Jim Bell, President, Association of Public Treasurers – U.S. and Canada, 937-415-2237
Susan Gaffney, Government Finance Officers Association, 202-393-8468
Alison Miller Richards, International City/County Management Association, 202-962-3569
Stephen Traylor, National Association of Counties, 202-942-4254
Lars Etzkorn, National League of Cities, 202-626-3173
Larry Jones, U.S. Conference of Mayors, 202-861-6709
Tara L. Thomas, President, Treasurers' Association of Virginia, 804-693-2141

NACO National Association of Counties
The Voice of America's Counties

National League of Cities

May 7, 2010

The Honorable Michael B. Enzi
United States Senate
379 Russell Senate Office Building
Washington, DC 20510

RE: **Main Street Tax Fairness Act of 2010**

Dear Senator Enzi,

The national associations representing local government officials would like to thank you for your leadership in attempting to modernize sales and use taxes through the introduction of the Main Street Tax Fairness Act of 2010.

This important legislation will respond to the changing nature of sales and use taxes, streamline their collection, and will help local governments to meet the service mandates for our citizens. Your willingness to take on this task after years of discussions, and your acknowledgement of the concerns of local government is greatly appreciated.

It has been a pleasure to work with you and your staff, especially Randi Reid, on this important legislation and we look forward to continuing to work with you towards the passage of this legislation.

Sincerely,

Larry E. Naake, Executive Director
National Association of Counties

Donald J. Borat, Executive Director
National League of Cities

Tom Cochran, CEO and Executive Director
United States Conference of Mayors

Jeffrey L. Esser, Executive Director
Government Finance Officers Association

POST-HEARING QUESTIONS SUBMITTED TO ROBERT B. WARD, DEPUTY DIRECTOR, NELSON A. ROCKEFELLER INSTITUTE OF GOVERNMENT*

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on State Taxation: The Impact of Congressional Legislation on State and Local Government Revenues
April 15, 2010

Robert Ward, Deputy Director, Rockefeller Institute of Government

Questions from the Honorable Steve Cohen, Chairman

1. **When can we expect a turnaround for state and local governments? In providing a response, please attach the report which you indicating you would be releasing shortly after the hearing, and briefly summarize the findings.**

2. **The supporters of many of the relevant state taxation bills would contend that the impetus behind their bills is to foster business development, create a level playing field within an industry, or even to lessen administrative burdens. Passing such legislation could arguably lead to increased state and local revenues when businesses can reinvest their tax savings into hiring more employees or buying more equipment. Would that assumption be correct?**

3. **In your written statement, you indicated that the GAO has projected "that without policy changes, the overall operating balance for states and localities will fall significantly below historical averages within the coming decade." Thus, closing projected gaps in state and local government budgets would require policy changes of an extraordinary magnitude across all 50 states, and the District of Columbia. Please explain in more detail. What would state and local government officials have to do? What happens if they do nothing?**

*At the time of the printing of this hearing record, the Subcommittee had not received a response to the questions submitted to this witness.

RESPONSE TO POST-HEARING QUESTIONS FROM JOSEPH HENCHMAN, TAX COUNSEL AND DIRECTOR OF STATE PROJECTS, TAX FOUNDATION

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on State Taxation: The Impact of Congressional Legislation on State and Local Government Revenues
April 15, 2010

Joseph Henchman, Tax Counsel and Director of State Projects, Tax Foundation

Questions from the Honorable Steve Cohen, Chairman

1. **In your written statement, you suggested that the states hardest hit by the recession are those that relied the most heavily on certain taxes. Assuming that your assertion is correct, what would you suggest to fill the revenue void for those states which have become most dependent upon the revenues from taxes on specific taxpayers and activities?**

States must decide two things when developing a tax system: (1) how much revenue it should raise, and (2) how it should raise it. Different states will answer differently; some adopt a high-tax, extensive-service model, while others prefer a low-tax, small-government model. Whichever way a state opts for the first question – important question though it is – states should raise their revenue in a way that promotes simplicity, neutrality, transparency, and stability.

Some tax policies are better than others in this regard. Broad-based sales taxes, flat income taxes on a broad base, and corporate taxes with few credits and deductions for particular industries can do less harm to long-term economic growth than narrow sales taxes, income taxes on high earners, numerous credits and deductions from a high corporate income tax, and capital gains taxes. Excise taxes, particular the gasoline tax, are among the most stable taxes. Property taxes, despite the bursting housing bubble, continue to rise and remain stable.

In our annual *State Business Tax Climate Index*, available at www.TaxFoundation.org, we rank each state on over 100 different tax policies that economic analysis has led us to conclude are either favorable or unfavorable.

This formula may not help in the short-term for a handful of states, such as California, Maryland, New Jersey, and Washington State. These states and a few others have expanded their spending commitments at a unsustainable rate, often by suggesting that someone else would pay for them (high income earners, corporations, out-of-staters, etc.). A correction of their overspending is likely the key to their fiscal recovery.

2. **You advocate for Congress to restrain the states from taxing certain activities which may burden interstate commerce. Ms. Kerry Korpi, who testified on the second panel at the hearing, contended in her written statement that if Congress enacts just one piece of legislation preempting the taxing authorities of state and local governments, such legislation would encourage others to lobby for tax breaks. She**

suggested that such tax breaks would shift costs to other businesses and individuals. Please respond.

If one assumes that the purpose of federal tax powers is to hand out favors to those with whom you empathize, Ms. Korpi's concern is a valid one. From my perspective, however, the purpose of Congress's power under the Commerce Clause is to restrain states from parochially harming the interstate economy. Federal pre-emption of discriminatory, intrusive, or aggressive state tax policies is both necessary and a proper role for the Congress.

Assuming that it becomes harder for states to export their tax burdens to non-residents, state finances would improve as it would require those who consumed state services to pay for them instead of passing costs off to others. Alternatively, if tax burdens are reduced to the level that residents are willing to pay for, a net reduction in taxes will occur, benefitting businesses and individuals.

Many states do not do this, of course. States have a natural inclination to avoid direct taxes on voting residents, preferring to hide taxes, mislabel them, or impose them on nonresidents or out-of-state companies. Individuals pay all taxes, whatever they are called, and taxes imposed in this matter result in less oversight and greater fiscal irresponsibility.

3. **In his written statement, Mr. Robert Ward, who testified on the second panel at the hearing, posed a question for Congress to consider when reviewing legislation affecting state taxation: "Should federal policy emphasize the benefits of interstate differences, including tax competition among the jurisdictions, or should national policy focus on the benefits to be obtained from greater uniformity among the states?" Please respond.**

Both. Justice Brandeis once wonderfully observed that the states are the "laboratories of democracy," and as I previously mentioned, states are free to pursue high-service or small-government models, or anything in between, and citizens are free to vote at the ballot box or with their feet. States also compete on proximity to raw materials or transportation centers, regulatory or legal structures, quality of education systems, and workforce skills, and proper tax competition is a legitimate end to allow states with a short-term deficiency in any of these areas to level the playing field. States can impose nondiscriminatory taxes on residents and set the rates at whatever they like without suggesting any constitutional implications.

There are good kinds of competition and bad kinds, however. The problems begin to arise when states begin taxing income, sales, or economic activity that crosses state lines. States naturally seek to grab more than their fair share, and are reluctant to collaborate on even the most mundane definitional or procedural rules. There is a role for Congress in curbing the states' worst excesses (such as discriminatory taxation against nonresidents) and encouraging uniformity in key areas involving multiple states (such as apportionment rules and nexus standards).

For example, common agreement on uniform division of income came about in the late 1950s only after Congress threatened to impose a rule that most states would have hated. (That uniformity has since withered away.)

4. **Many of the witnesses at the hearing mentioned the current plight of state and local governments. They provided studies which show that current trends still show that state and local governments will not see a complete turnaround for several more years. Some suggested that Congress's passing legislation, such as the Cell Tax Fairness Act or the Business Activity Tax Simplification Act, or other state taxation bills, would further impede the turnaround. Please respond.**

First, states are not innocent in their predicament, as I've mentioned; additional revenue will not begin to address the worst excesses in unfunded public pension plans, inflated employee compensation and staffing, overcommitted state budget resources, and unsustainable budget growth.

Second, the revenue at issue ranges from a few million dollars to tens of millions – more than I have on me – but ultimately a drop in the bucket in the state fiscal picture. The states will not live or die depending on the revenue from taxes on online travel companies. In some cases, such as occupancy taxes on online travel companies, any revenue a locality receives is a *windfall*, not less revenue from what they reasonably expect.

Third, and most importantly, the fact that any state relies on revenue from discriminatory taxes or policies that export tax burdens to nonresidents should not justify their continuation. Wrong is wrong, and the states that will be hurt in the short-term are those that currently do the most damage to their sister states and to the national economy.

RESPONSE TO POST-HEARING QUESTIONS FROM KERRY KORPI, DIRECTOR OF RESEARCH AND COLLECTIVE BARGAINING SERVICES, AMERICAN FEDERATION OF STATE, COUNTY AND MUNICIPAL EMPLOYEES

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on State Taxation: The Impact of Congressional Legislation on State and Local Government Revenues
April 15, 2010

Kerry Korpi, Director of Research and Collective Bargaining Services, AFSCME

Questions from the Honorable Steve Cohen, Chairman

1. **In his written statement, Mr. Joseph Henchman, who testified on the second panel at the hearing, advocated for Congress to restrain the states from taxing certain activities which may burden interstate commerce. Do you agree? Please explain your response.**

AFSCME does not agree with Mr. Henchman's position that Congress should restrain states from taxing certain activities which he alleges may burden interstate commerce. Current federal law preempts state and local taxes only with respect to internet access and travel by bus, train and plane. We oppose Congressional action that would place additional constraints on state taxation. Almost every state is required to balance its budget, and each state's tax system reflects the economic and political environment in which it operates. States are given tremendous responsibilities by the federal government and by their citizens. They need the flexibility to determine best how to meet those responsibilities.

2. **Mr. Henchman suggested that the states hardest hit by the recession are those that relied the most heavily on certain taxes. Are states over-reliant on certain taxes? Have they created tax policies which enhance the effects of an economic downturn? And if states have become over-reliant, what can they do to correct it?**

How deeply the recession affected any given state seems to be mainly a factor of that state's economy and political environment rather than its tax system. Until recently, states with economies based on commodities tended to be in better shape than those that rely on manufacturing, tourism or other industries. Likewise, states that have been somewhat dysfunctional politically have had difficulty making decisions that would mitigate budget problems. We do not see any correlation between reliance on certain taxes and the impact of the recession on states. As an example, look at Oregon and Washington. Oregon relies heavily on the income tax and does not have a sales tax. Washington relies heavily on the sales tax and does not have an income tax. Yet both states suffered severe budget shortfalls. If tax structure played a significant role in enhancing the effect of an economic downturn, then one of these states should have weathered the economic crisis better than the other. The fact is, the state budget crisis is a revenue crisis, driven by unprecedented drops in every category of revenues including personal income taxes, sales taxes and corporate taxes.

We do believe, however, that all states would benefit from updating and stabilizing their revenues. Most state sales tax systems were developed decades ago, and our economy has evolved since then from one based on goods to one based on services. State tax systems are capturing less economic activity as time passes, and those sectors of the economy that are taxed bear an unfair burden. We believe that sales taxes should be extended to many services and to remote sales.

We also believe that only the federal government can provide the kind of counter-cyclical relief that will lessen the impact of this recession and we strongly urge Congress to provide states with additional FMAP, to provide aid to schools (S. 3206) and to pass the jobs bill (H.R. 4812).

3. **Please provide more concrete examples of how budget cuts by state and local governments have impacted taxpayers, members of AFSCME, and state and local governments.**

State have closed budget gaps totaling $110 billion in FY 2009, $200 billion in FY 2010 and are facing projected gaps of $260 billion in FY 2011 and 2012. While these is no comprehensive tally of local government or school district deficits, a December 2009 report by the National League of Cities projected municipal shortfalls totaling $56-$83 billion from 2010-2012. School districts around the country estimate that their shortfalls will lead to the layoffs of 100,000-300,000 staff in the coming school year.

According to the Center on Budget and Policy Priorities, thirty states plus the District of Columbia have already cut aid to K12 education. Twenty-five states plus DC have cut services to the elderly and disabled. Forty-one states have cut funding for higher education. States and local governments have eliminated 212,000 jobs since August 2008 but, since many states and local governments addressed budget problems using furloughs rather than layoffs, that does not begin to capture the impact of this budget crisis on our members and the public they serve. States have implemented furlough days ranging up to 36 in a year in California. Because of furlough days the school year will be shortened by 17 days in the State of Hawaii. Budget problems led Gov. Schwarzenegger to propose releasing 15,000 nonviolent offenders before their sentences were served. Kentucky released 2,000 inmates early, including some murderers. These are just some examples of the harmful effects of budget cuts.

At the same time demand for all safety net public services, including food stamps, unemployment insurance and Medicaid, has skyrocketed.

Representative Johnson asked at the hearing about conditions in Atlanta and Memphis.

Atlanta has long-term, serious problems in its watershed department, where about 40% of the general budget is needed to pay off debt and its bonds are rated just above junk status. City workers have been through three rounds of RIFs in the last year and the city is virtually shut down every Friday for furloughs. About 70 airport workers are slated to be laid off and, while layoffs have been averted in Fulton County so far, they are possible in the coming year. The Mayor's FY 2011 proposed budget is financed in part by some fee increases and by leasing the city jail to the county and selling City Hall East. It is not clear whether these financing mechanisms will be realized. If they are not, they will be further serious trouble.

In Memphis, cuts of $7.6 million were recently approved, and a gap of $1.4 million remains to be filled. Cuts included police and fire and the Mayor proposed to close some libraries and golf courses and to privatize sanitation. Fee increases and debt restructuring are on the table. Memphis schools face a shortfall that could lead to elimination of 584 positions and two furlough days. The school system is considering turning to more online learning and virtual schools.

We are seeing problems in cities throughout the country. The City of Harrisburg, PA is exploring bankruptcy. Baltimore, MD faces a gap of $121 million. Detroit, MI public schools will end this year with a deficit of $332 million and expect deficits until 2014. Philadelphia, PA faces a gap of $500-700 million over the next five year. The list goes on.

4. **In your written statement, you urged Congress to "support state and local government efforts to collect taxes rightly owed and to generate revenues needed to fund the services that allow individuals and communities to prosper." Please explain fully what Congress can do.**

Congress can pursue several different options to support state and local government efforts to collect taxes owed and to generate needed revenues.

First, Congress can strengthen enforcement of existing federal tax laws to ensure that corporate and individual taxpayers pay 100% of the taxes they owe. In the many state and local governments that directly link or piggyback their tax laws to the federal tax code, as taxpayers report more income on their federal tax returns, that would correspondingly generate more state and local government revenues.

One specific step Congress should take is to increase appropriations for IRS' enforcement activities, both with respect to tax collection personnel and to information systems. In recent years, there has been bipartisan support for this - both President George W. Bush and President Obama proposed it. In addition, Congress should work with the Administration on policies targeting IRS enforcement activities toward large corporations and the wealthiest taxpayers, which would be the most effective and efficient use of resources. Congress should also work to increase the audit rates for firms exceeding $250 million in assets, which in FY 2007 declined to all-time low of 26%.

Overall, Congress should work with Treasury to reduce the tax gap – estimated at up to $345 billion per year.

Second, Congress should enact legislation that helps state and local governments collect on local tax debts. For example, Congress should support the goals of H.R. 3060, which would amend the Internal Revenue Code of 1986 to allow certain local tax debts to be collected through the reduction of Federal tax refunds. The bill's sponsor, Rep. Jim Moran, estimates that this would bring in $65-$70 million in revenue for Virginia's localities during the first year.

Congress should also support the goals of the State Tax Administration Assistance Act, HR 2303. This would amend the Internal Revenue Code to permit a state to offset state income tax obligations owed by nonresidents against any federal income tax refunds due to such nonresidents if the state has a reciprocal agreement with the Secretary of the Treasury that allows an offset of federal income tax obligations against its own tax refunds.

Third, Congress should enact Streamlined Sales Tax legislation to simplify and increase the efficiency of collecting taxes. Congress should support the goals of the Sales Tax Fairness and Simplification Act, which is not yet introduced in the current 111th Congress.

Fourth, Congress could repeal Public Law 86-272, which prohibits states from imposing their corporate income taxes on sellers of tangible personal property who limit their activities in a state to "solicitation." It could substitute instead a nexus proposal developed by the Multistate Tax Commission that would allow states to impose their corporate income taxes on corporations that had property, payroll, OR sales in a state in excess of specified thresholds.

Fifth, Congress should enact a matching grant program to help fund state and local government technology and computer infrastructure that will enable these governments to collect taxes rightly owed. Like the federal government, states and local government face large tax gaps. Congress should enact legislation to adequately fund state and local government efforts to strengthen their tax collection systems.

RESPONSE TO POST-HEARING QUESTIONS FROM SCOTT D. PATTISON, EXECUTIVE DIRECTOR, NATIONAL ASSOCIATION OF STATE BUDGET OFFICERS

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on State Taxation: The Impact of Congressional Legislation on State and Local Government Revenues
April 15, 2010

Scott Pattison, Executive Director, National Association of State Budget Officers

Questions from the Honorable Steve Cohen, Chairman

1. **You stated in your written testimony that states are spending less now than they did in 2008, for obvious reasons. For example, Michigan's general fund budget was $9.9 billion in 2008, but only $8.1 billion in 2010. Please give us concrete examples of what this drop off of nearly two billion dollars means.**

Michigan has been required to make significant adjustments to maintain its balanced budget in light of the decline in its general fund budget of close to $2 billion from fiscal 2008 through fiscal 2010. Some of the actions that Michigan took to address budget gaps include closing 8 prisons, 10 correction camps, 6 residential care facilities, and a state hospital. Five departments have been eliminated and nearly 300 obsolete state boards and commissions have been trimmed. The state has also sold surplus property.

The state workforce has 17 percent fewer employees than it did in 2001 and employees have been subjected to furloughs (unpaid days off), increases in health premiums, deferred pay, and increased workloads. Other examples include actions by the Department of Corrections to lower prison population through its Michigan Prisoner Re-entry Initiative and changes adopted through the Legislative Commission on Government Efficiency.

2. **The supporters of many of the relevant state taxation bills would contend that the impetus behind their bills is to foster business development, create a level playing field within an industry, or even to lessen administrative burdens. Passing such legislation could arguably lead to increased state and local revenues when businesses can reinvest their tax savings into hiring more employees or buying more equipment. Would that assumption be correct?**

While the impact on state and local revenues may be affected by the relevant state taxation bills, states would be best served if allowed to develop and manage their fiscal systems. Congress, through its authority under the Commerce Clause of the U.S. Constitution, has broad authority to regulate state taxation. The key questions are how and when that authority should be used. Governors believe that the ability of states to develop and manage their fiscal systems is a core element of sovereignty – one that should not be interfered with unless absolutely necessary to preserve interstate commerce. The current extremely difficult fiscal condition of states underscores this basic principle and should heighten Congressional consideration of proposed legislation and the potential impact it could have on states.

3. **In Mr. Robert Ward's written statement, he indicated that the GAO has projected "that without policy changes, the overall operating balance for states and localities will fall significantly below historical averages within the coming decade." Thus, closing projected gaps in state and local government budgets would require policy changes of an extraordinary magnitude across all 50 states, and the District of Columbia. Do you agree? What would state and local government officials have to do to close the projected budget gaps?**

According to the GAO's March 2010 update on the *State and Local Governments' Fiscal Outlook,* the state and local government sector continues to face near and long-term fiscal challenges which grow over time. As noted by GAO, the sector's long-term fiscal position will steadily decline through 2060 absent any policy changes. The decline in the sector is primarily driven by the rise in health care costs.

We concur with the findings of GAO and note that we are currently witnessing significant adjustments that states are undertaking to maintain balanced budgets. The expectation is that states will continue to make adjustments with the forecast of a slow economic recovery period. As evidenced in the December 2009 *Fiscal Survey of States* publication, which was published in the middle of most states' fiscal 2010 budget year, forty-three states reduced their enacted budgets in fiscal 2009 by $31.3 billion while 36 states cut their fiscal 2010 expenditures by $55.7 billion.

As a result of declining state fiscal conditions, actions taken or planned in fiscal 2010 include 31 states using targeted cuts, 17 states using rainy day funds, 23 states using layoffs, and 16 states instituting furlough programs. Additionally, other actions taken or planned include twenty states reducing local aid, 13 states adding or increasing user fees, 12 states reducing employees' salaries, and 12 states reorganizing agencies to address budget shortfalls.

PREPARED STATEMENT OF THE DIRECT MARKETING ASSOCIATION

STATEMENT OF THE

DIRECT MARKETING ASSOCIATION

REGARDING THE

SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

U. S. HOUSE OF REPRESENTATIVES COMMITTEE ON JUDICIARY

HEARING ON

STATE TAXATION: THE IMPACT OF CONGRESSIONAL LEGISLATION ON STATE AND LOCAL GOVERNMENT REVENUES

APRIL 15, 2010

GERALD CERASALE
SENIOR VICE PRESIDENT, GOVERNMENT AFFAIRS
DIRECT MARKETING ASSOCIATION, INC.
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WASHINGTON, DC 20036
202-861-2423

I. INTRODUCTION

The Direct Marketing Association (DMA) thanks Chairman Cohen, Ranking Member Franks and members of the Subcommittee on Commercial and Administrative Law for this opportunity to present its views on the efforts of states to impose tax and tax collection obligations on retailers who are located outside of their states and who have no physical presence in that state. DMA is the leading global trade association of businesses and nonprofit organizations using and supporting direct marketing via channels including mail, telephone, direct TV, radio and the Internet,. Founded in 1917, the DMA currently has over 3,100 member companies across the United States and 53 foreign countries.

DMA would like to discuss specifically two tax initiatives that states are taking:

1. Requiring remote (out-of-state) sellers to become unpaid tax collectors for states under the Streamlined Sales and Use Tax Agreement (SSUTA); and,
2. Taxing business activity of remote (out-of-state) businesses.

II. STREAMLINED SALES AND USE TAX AGREEMENT

The U.S. Supreme Court in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), ruled that without specific authorization from the U.S. Congress, states could not impose tax collection burdens upon remote sellers that have no "physical presence" as this would interfere with interstate commerce. Moreover, if allowed by Congress, the myriad of state tax jurisdictions with resulting variance in rates, definitions, and audits would create a complex and administratively costly nationwide sales tax collection system. It is significant that these remote sellers' businesses do not receive police or fire protection from those states—they are not present in them. Their employees and their families do not receive educational or social services from those states—the businesses have no employees located in those states.

Governments, as well as businesses, face difficult financial decisions in these economic times. State legislatures have very difficult budget determinations and are looking at both cutting costs and increasing revenues. However, proponents of both the SSUTA and the advertising-based nexus tax have cited grossly exaggerated revenue estimates of uncollected sales and use taxes due to remote sales. In particular, proponents have cited a 2000 University of Tennessee study that includes unbelievable estimates as to the amount of the uncollected sales tax. The Tennessee study estimate for uncollected sales tax due to the Internet sales in 2006 was a whopping $45 billion nationally. While a revised Tennessee study lowered those estimates to $24 billion, even the revised estimates will not be realized.

It is important to note that the Tennessee study rests on a number of faulty assumptions and is not based on U.S. Government data. Further, the study's implication that states are "losing" a substantial portion of their sales tax revenues to electronic commerce is simply false. The vast majority of e-commerce transactions are not with consumers, but rather with businesses, and such business transactions almost always are subject to tax collection or direct payment of use taxes by the purchaser.

In contrast, the independent firm, Forrester Research, has estimated that the loss of tax revenue due to state residents not paying use taxes for remote sales is $3 billion nationwide—a fraction of the $24 billion estimated in the revised Tennessee study. A 2007 updated DMA-commissioned study, based on U.S. Commerce Department data, estimates that in 2006 uncollected sales tax nationally totaled $4.2 billion. There is no $24 billion pot of gold.

In light of the *Quill* decision, the states began a project to simplify the sales tax regimes that a remote seller would face if required to become the foreign state's tax collector. The SSUTA goal was to remove that complexity and create a 21st century, Internet-friendly tax regime to encourage economic growth throughout the national marketplace. However, the SSUTA has failed to either remove complexity or create that 21st century tax policy standard. To be blunt, the SSUTA is a document drafted by tax administrators, and, as might be expected, it has resulted in little in the way of tax simplification.

Specifically, the SSUTA:

- Has not reduced the number of sales tax jurisdictions in the Nation, which currently number over 7,000;
- Has not reduced the number of state and local sales tax rates;
- Has not reduced the number of audits to which an interstate seller would be subject (each state revenue department would still conduct its own independent audit);
- Has not established a long-promised uniform vendor compensation to cover the substantial cost of tax collection; or
- Has not established a single remittance procedure.

Moreover, the Governing Board of SSUTA has granted exceptions to its feeble simplification initiatives to win approval of the states. Recently, the Board granted an exception from the SSUTA-defined rule for Massachusetts when calculating the sales tax on articles of clothing over $100. SSUTA will continue to grant exceptions that will increase the complexity of sales tax collection. States are enacting sales tax holidays—some for all purchases under a capped price; others for specific products (such as hurricane preparedness) on a specific date. Those actions, while important for the state and its citizens, further complicate a nationwide sales tax collection regime. As you can see, tax collection has not been simplified since the inception of SSUTA. In fact, SSUTA is "streamlined" in name only.

To better appreciate the failings of the SSUTA, it is instructive to consider its history. The Streamlined Sales Tax Project was launched in 2000 on the heels of two earlier joint government/industry initiatives: the National Tax Association (NTA) Communications and Electronic Commerce Tax Project, and the Congressionally-established Advisory Commission on Electronic Commerce. Both projects had concluded that the existing state sales tax system was one of daunting complexity, and that true simplification would require sweeping reforms.

Perhaps most emblematic of the SSUTA's failure to achieve genuine sales tax reform was the early demise of the single-most important step toward simplification: the adoption of a single sales tax rate per state for all commerce (both over-the-counter sales and interstate sales). Had the SSUTA adopted this so-called "one rate per state" proposal, this single act could have eliminated the problem of merchant compliance with thousands of local tax jurisdictions with different tax rates.

To put this "one rate per state" issue in perspective, the United States is the only economically developed country in the world with a system of sub-state transaction taxes, not only for counties and municipalities, but also for school districts, transportation districts, sanitation districts, sports arena districts, and other local jurisdictions. In light of this wildly complex system, the adoption of the "one rate per state" standard was the *unanimous* recommendation of the NTA's E-Commerce Project (which included delegates of the National Conference of State Legislatures, National Governors Association, and US Conference of Mayors) and was in the majority report recommendation of the Congressional Advisory Commission.

Those failings increase the burden on out-of-state sellers. Being subject to 45 separate state audits requires a tax department. Those businesses would be required to have multiple state registrations and multiple remittance procedures. The cost stemming from tax collection would be passed to consumers, constituting an anti-stimulus at a time when our nation is working to stimulate the economy.

III. BUSINESS ACTIVITY TAXES

Broad imposition of business franchise, corporation net income, and gross receipts taxes (commonly called Business Activity Taxes) on small and mid-sized out-of-state remote direct marketers would constitute a tremendous new tax compliance burden. Currently, there are at least 3,300 separate state and local business activity taxes imposed by state and local governments and over 12,600 jurisdictions have the authority to collect such a tax. Just as the Supreme Court found in its *Quill* decision, precisely the same burdens created if sales and use tax obligations were imposed by the nation's over 7,000 sales and use tax jurisdictions would also result from allowing the thousands of state and local jurisdictions that have the authority to impose a business activity tax to extend their taxing authority across state borders to businesses with no stores, offices, factories or employees within their territories.

Despite assertions that business activity taxes do not appear to cause the same degree of compliance burdens as sales and use tax collection, the reality is that compliance with state income taxes and gross receipts taxes is extremely complicated and varies greatly from state to state. According to Gupta & Mills (*Does Disconformity In State Corporate Income Tax Systems Affect Compliance Cost Burdens?* 56 National Tax Journal 355, June 2003) 45 states, along with the District of Columbia, impose such a tax. States differ tremendously in how income is allocated and apportioned, in how the tax base is defined, in what tax rates apply and in a host of other issues.

States also have varying rules regarding reporting and filing procedures, including which corporations must file a return, whether related entities should file together or separately, what due dates apply for filing and remitting taxes, and whether federal extensions are accepted. Roughly half the states allow combined reporting, whereas and other half require or allow separate reporting by each entity within an affiliated group. Among the states that follow combined reporting of unitary businesses, there are dramatic differences regarding the level of combination.

Another cause of considerable complexity is the fact that the states have different rules for allocating and apportioning a multi-state corporation's income among the states in which it does business. Most states use a three-factor formula (i.e., sales, property and payroll) to apportion business income. Some states weigh all factors equally, other states double-weight the sales factor, and some states place even more emphasis on sales. Furthermore, while sales are typically assigned to a particular state based on a destination test, some states use a "throwback rule" that reassigns sales to the state of origin if the corporation is not taxable in the destination state. States also differ in their definitions of the tax base, with varying stances on what items of income and deduction are included in taxable income. States have different depreciation rules, rules for deduction of net operating losses, and the list goes on. Gupta & Mills found that non-uniformity among the states substantially increases corporations' compliance costs (even allowing for such factors as number of tax returns filed, firm size and other firm-specific control variables), and concluded that state income tax compliance costs are largely driven by complexity and disconformities.

Large companies with accounting staffs and outside consultants may be able to navigate successfully through the labyrinth of state income tax compliance, but smaller companies do not have the resources to meet these compliance obligations. Further, the differing apportionment standards among states place a business, especially a smaller company, at risk of duplicative over-taxation. This risk is increased by the fact that there is no centralized resource to which businesses can turn in determining, let alone meeting, their obligations.

Moreover, the prospect of challenging an incorrect assessment in a remote jurisdiction is daunting. For example, a small Vermont business sells gourmet food products, such as jams and maple sugar candy, over the Internet. With a good website and a great set of recipes, there is no limit to the national – or even international – markets this start-up business could reach. However, if one of New Mexico's 100-plus taxing municipalities issued an assessment against the company for a local gross receipts tax based on sales made to its citizens, and the Vermont business believed the measure of taxes was in error and challenges the assessment, it would have to hire local counsel familiar with local tax law, proceeding first through the administrative protest and, if unsuccessful, then through the judicial process. Furthermore, in many states, the business must pay the tax before it can challenge the assessment in state court; only then is it permitted to sue for a refund.

Such a procedure would be inordinately expensive for a small retailer, which would be left with little choice but to pay the tax and forget its objections. Faced with potentially hundreds of such practically incontestable assessments, the small Vermont food company could fall victim to "death by a thousand cuts."

IV. CONCLUSION

The bright-line physical presence test in *Quill* should remain for collection of sales and use taxes and should be implemented for business activity taxes. The burden of each on interstate commerce is large, and this is a time when our economy can ill afford such a burden.

Congress should not grant the States authority to expand business activity taxes or forced sales and use tax collection beyond their borders. Federalism does not work efficiently—or fairly—when a legislature attempts to export its tax laws across state borders. A system in which 50 state governments, and thousands of localities, impose their myriad sales and use tax regimes on businesses in each of the other 49 states would be chaotic, both as a matter of tax administration and business compliance. The end result of expanded nexus will be nothing less than a crazy quilt of non-uniform tax laws and compliance obligations that will further stagnate the consumer sector of the economy and aggravate an already grossly inefficient system of multi-state tax administration. The patchwork quilt of business activity taxes, rules, definitions, reporting, etc. will chill the one growing engine of our economy, Internet commerce, by burdening new start-up companies before they have the opportunity to grow.

DMA urges Congress to uphold the physical nexus standard of *Quill* rather than extending taxing authority of states to include the collection of sales and use tax beyond their borders collection.

PREPARED STATEMENT OF THE HONORABLE RONALD O. LOVERIDGE, PRESIDENT, NATIONAL LEAGUE OF CITIES, AND MAYOR, RIVERSIDE, CA

Statement for the Record
The Honorable Ronald O. Loveridge
National League of Cities, President
Mayor, Riverside, California

Before the House Judiciary Committee
Subcommittee on Commercial and Administrative Law
U.S. House of Representatives

State Taxation – The Impact of Congressional Legislation on State and Local Government Revenues

April 15, 2010

Good morning Chairman Cohen, Ranking Member Franks, and the other members of the Subcommittee on Commercial and Administrative Law. On behalf of the National League of Cities, I appreciate being able to present testimony on the interdependent economic health of each level of government – federal, state, and local. Certainly, each level of government has its own economic characteristics, but none stands alone. During these challenging times, only by recognizing our interdependence and by working together can we build and maintain strong hometowns.

While the federal economy may be approaching the late stages of the worst economic downturn since the Great Depression, local government budget tightening and spending cuts over the next several years will continue and may drag our nation's economic recovery. The municipal sector – as if all city budgets were totaled together – likely faces a combined, estimated shortfall of anywhere from $56 billion to $83 billion from 2010-2012. A deficit we must close, as local governments must balance their budgets.

Yet the fiscal pressures we are now addressing in cities is likely only the tip of our budget challenges, as to-date we've been addressing declines in income and sales tax receipts. A third source of revenue for cities, property tax collections, decline later in a downturn given the time it takes for real property assessments to be adjusted. Because most city tax revenue is collected only at a few specific points during the year, or over the course of several years in the case of property tax revenue, there is usually a time lag of 18 months to two years before economic shifts register their full impact on city fiscal conditions. This means that cities will be dealing with the downturn even after federal and state economies improve. For example, drawing upon city experiences in the past two recessions, the low point for the nation in those recessions came in 1991 and 2001 respectively. However, the low point for city revenues in both instances followed two later, in 1993 and 2002.

In most places, the local response to shrinking revenue has consisted of a predictable round of unfortunate but unavoidable layoffs, service cutbacks, and, in some cases, increasing fees and taxes. The vast majority of city fiscal officers report spending cuts in 2009 and expect further reductions in 2010 that will result in layoffs, delayed or canceled infrastructure projects, or cuts to public safety, libraries, parks and other municipal services. As the brunt of the economic crisis is faced by cities over the next 18 to 24 months, these sorts of responses will continue – and likely spread.

Right now, cities throughout the United States are addressing their budget pressures. For example:

- **Baltimore**: $127 million shortfall, likely resulting in a more layoffs and furloughs after already having eliminated more than 500 positions.
- **Bossier City, La.**: $6.5 million deficit in the city's current $50.3 million budget, resulting in proposed elimination of 117 out of 897 positions, including 80 police and fire positions.
- **Boston**: $130 million shortfall, resulting in layoffs of more than 500 municipal employees.
- **Cleveland**: $23 million shortfall, and the city estimates that for every $1 million about 20 general city employees or 12 police and firefighters would have to be laid off.
- **Denver**: $120 million shortfall, resulting in layoffs of 80 positions and early retirement of 322 city workers.
- **Los Angeles**: $98 million shortfall in 2009-10, $408 million in 2010-11, and predicting total shortfall near $1 billion by 2013; the city has already removed 2,400 positions from the city payroll through early retirement, furloughs and other workforce reductions.
- **Seattle**: $72 million budget shortfall, resulting in the elimination of 310 positions and the city using $25.4 million of a $30.6 million fiscal stabilization ("rainy day") fund.
- **Springfield, Ill.**: $8.5 to $12 million shortfall in next fiscal year, which would mean eliminating 136 to 192 positions.
- **Springfield, Mo.**: $13.7 million in budget cuts, resulting in four positions eliminated and furloughs of 158 employees.

Without help for hometowns, an ongoing local government fiscal crisis could well undercut the nation's recovery, which points to the need for both the federal and state governments to consider the health of local governments as you make fiscal policy decisions. Continuing local government layoffs and service cuts may be a significant drag on the nation's economy just as the $787 billion American Recovery and Reinvestment Act of 2009 winds down.

With the nation's unemployment rate still too high, there is a need for continued and expanded focus on creating jobs in our hometowns. As you know, job growth tends to lag economic growth, so unemployment challenges will remain present in communities around the country even as overall economic growth returns.

That is why I am pleased, Chairman Cohen, that you and other members of the Subcommittee have joined more than 125 of your colleagues in the House to co-sponsor the Local Jobs for America Act (H.R. 4812), which will direct $100 billion in assistance to help create and save jobs for those in the public and private sectors. The Local Jobs for America Act will provide our economy a shot in the arm by putting one million people to work in education, public safety, childcare, health care, education and transportation. These are essential services at the heart of the quality of life for our residents.

We need a partnership among all levels of government to ease the nation's fiscal crisis. Local governments are innovating. Yet, without help like the Local Jobs for America Act, city leaders will have to layoff more employees and cut essential services – retrenchments that will place a drag on our national recovery. For that reason both the national interest and the realities of American federalism call for a federal, state and local dialogue. In keeping with this spirit, our federal and state partners in government should pursue a variety of strategies to strengthen the intergovernmental partnership. These include: engaging more directly with each other to learn about the impact of national policies and programs on America's hometowns; supporting and promoting policy innovations at the local level; avoiding unfunded mandates and other policies that preempt local authority; and encouraging regional and inter-local collaboration.

By working together at all levels of government, we can safeguard a still-shaky recovery. A well-functioning intergovernmental system provides a framework for economic growth that also preserves important principles of freedom.

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