

# Pre-Emption: Federal Statutory Intervention in State Taxation

***Abstract** - This paper examines the implications of federal statutory restrictions on state government taxing powers. Such pre-emption can prevent states from pursuing policies that are best adapted to their economic circumstances and objectives, inefficiently constraining decentralized state tax policymaking. States policy choices may, however, harm the efficient operation of the US federation as a whole; in such cases, the "visible hand" of federal pre-emption may lead to improved policy outcomes. Existing and proposed statutes that regulate state taxation of retail sales, retirement savings distributions, and corporation income illustrate the potential advantages and disadvantages of pre-emption.*

## INTRODUCTION

The extent to which subnational governments can independently choose their fiscal (and other) policies is a critical issue in any federation. In the United States, state governments enjoy a high but not unlimited degree of discretion in choosing their tax policies. For instance, although many states have elected to impose taxes on retail sales, personal income, and corporation income, others have not. Different states define taxable personal income, corporate income, and retail sales in different ways and subject these bases to taxation at different rates. The tax policies chosen by counties, municipalities, school districts, and other local governments vary substantially among and within states. These and other variations in state and local tax policies show that subnational governments in the United States possess substantial fiscal autonomy. These governments are not, however, completely free to pursue whatever tax policies they wish. In particular, state tax policies, and the tax policies of their subsidiary local governments, must respect fundamental constraints imposed by the US Constitution, as interpreted by the courts. Furthermore, state taxes are sometimes also constrained by federal statutes. The objective of the present paper is to examine such federal statutory "pre-emption" of state taxation in general and to discuss some important specific instances in which current or proposed federal statutes do (or may in the future) affect state tax policies.

To start the discussion, the second section provides a concise overview of existing federal statutes that regulate state tax

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policies. It also explains some of the ways in which state tax policies are affected by non-statutory controls, including constitutional constraints. The third section discusses pre-emption within the context of the economic analysis of federalism, comparing it with some of the alternative forms of control over state taxation outlined in the second section. The fourth section analyzes the role of pre-emption in three important specific areas of state tax policy: retail sales taxation of remote vendors, the taxation of tax-sheltered retirement distributions under state personal income taxes, and limitations on the powers of the states to tax the incomes of corporations not located within their boundaries. The fifth section provides a brief summary and conclusion.

#### CONSTRAINTS ON SUBNATIONAL TAXING POWERS IN THE US FEDERATION

The taxing powers of state governments are subject to a number of important constraints. Some of the most fundamental of these derive from the Constitution. Others are the result of federal legislation. States may also act voluntarily to restrict their taxes, for example by coordinating their policies with other states.

The Commerce Clause (Article 1, Section 8) authorizes Congress to regulate interstate commerce. As interpreted by the courts, the Commerce Clause also means that states cannot “regulate” or interfere with interstate commerce. The precise meaning of this “negative” or “dormant” commerce clause is the subject of continuing controversy, as illustrated recently by the case of *DaimlerChrysler v. Cuno*, but generally it is widely understood to preclude explicit tariffs on interstate

trade and other state policies that would similarly undermine free trade among the states.<sup>1</sup> In addition to the Commerce Clause, the exercise of state taxing powers must also respect other constitutional requirements, including the right of due process guaranteed by the Fifth Amendment.

While the Constitution places some limits on state policies, it may also grant significant policy authority to the states, even if only implicitly. It may do so, first, through the imposition of limits on the powers of the federal government, potentially leaving some scope for the exercise of state authority. Other constitutional provisions also appear to make at least some allowance for nontrivial state powers. In particular, the Tenth Amendment grants some rather ill-defined residual authority “to the states respectively, or to the people.” Although judicial interpretations of the Commerce Clause, the Preamble (establishing the union of the states in order to “promote the general welfare”), and other constitutional provisions have diluted this residual authority over time, there nevertheless seems to be a general “presumption of innocence” with respect to state and local taxation, in the sense that “what is not prohibited is allowed.” In practice, the states enjoy considerable “rate autonomy” in that they may freely raise or lower the rates of constitutionally permissible taxes, at least within wide boundaries. Furthermore, they possess significant “base autonomy” in that they may elect or decline to utilize specific types of taxes (on retail sales, whether tangible or intangible, on business incomes, on real and personal property, on fuels, on vehicles, and so forth). Like the federal government, they may generally define tax bases as they wish, as illustrated by

<sup>1</sup> See 126 S. Ct. 1854 (2006). In this case, it was argued that the state of Ohio and the city of Toledo should not be permitted to use tax policy to encourage investment by DaimlerChrysler in a new plant. The Supreme Court ultimately dismissed this particular case on technical grounds, but the fundamental issue seems likely to arise again in future litigation. See Enrich (forthcoming) for a legal analysis of the issues in *Cuno*.

the many state-specific adjustments that are commonly made to federal adjusted gross income when determining taxable income for state personal income tax purposes. The states may also obtain revenues from a wide variety of nontax sources. Indistinct though its boundaries may be, the residual taxing authority of the states granted by the Constitution evidently accommodates nontrivial diversity in state and local revenue structures.

In addition to the fundamental limitations imposed by the Constitution, state taxing powers are constrained by federal legislation. The Federation of Tax Administrators (FTA) (2005) provides a convenient inventory of federal statutes regulating state taxation, identifying 28 separate laws that prohibit or restrain certain specific types of state taxation. These statutes are quite diverse, but most can be characterized as pertaining to tax situations involving either “horizontal” (interstate) or “vertical” (federal/state) intergovernmental fiscal interactions.

The “horizontal” category includes statutes that affect the power of states to tax individuals or businesses whose activities have some multi-state dimension. Several statutes govern state taxing powers for businesses or workers involved in interstate transportation or communications. For example, some of these statutes prohibit state sales/gross receipts or per-head taxes on businesses or consumers in airline, rail, and bus transportation. Others insure that the incomes of transportation workers, whose duties may take them to several different states in the normal course of their employment, may be taxed only in their states of residence. All of these statutes have the effect of limiting the ability of states to impose taxes on activities directly involved in or closely related to interstate trade. The 1998 Federal Internet Tax Freedom Act (ITFA) and its successor, the 2004 Internet Tax Nondiscrimination Act (ITNA), prohibit state governments from taxing internet

access. Since internet access facilitates interstate (and global) communication, these laws can be viewed in part as attempts to prevent states from imposing taxes that could interfere with such communication and with the interstate commerce that it may spawn.

Other federal statutes apply more generally to economic activities involving interstate commerce, rather than to specific industries linked closely to such commerce. For example, Public Law 104-95, enacted in 1996, prevents states from imposing taxes on pension distributions and other deferred compensation received by former residents, such as households that move to other states upon retirement. In the realm of corporate income taxation, Public Law 86-272, passed in 1959, prevents a state from imposing taxes on the income of a corporation if its only connection with the state is that it sells *tangible* products there or solicits such sales. These two statutes are discussed in more detail in the fourth section below.

In addition to statutes that affect state taxation of multistate activities, there are laws that constrain their taxing authority with respect to federal government resources and policies. Several of these “vertical” pre-emptions limit the powers of states to tax personnel connected with the federal government. For example, the incomes of personnel on a military base are subject to tax in their states of residence. Other statutes limit the power of states to tax members of Congress or of federal employees generally, the activities of government enterprises, and Federal Reserve Banks. Sometimes these laws provide for exemption from state taxation, whereas in other cases they impose uniformity or non-discrimination requirements that insure that federal employees are not subjected to differentially high taxation. Another federal statute prohibits states from collecting sales taxes on food purchased using Food Stamps. This statute insures that state taxes cannot impinge

upon and possibly interfere with this federally financed program.

Whereas the Constitution and federal statutes may place limits on state taxes, states may also relinquish taxing powers voluntarily through participation in agreements with other states. The Multistate Tax Compact (MTC) illustrates how such agreements can provide policy coordination mechanisms for the states when they so desire. The MTC, established in 1967, came into effect upon its adoption by seven states, and it has by now a total of 47 participating states.<sup>2</sup> Through the work of its Multistate Tax Commission, it facilitates common approaches to tax policy and administration, for example by promoting the familiar three-factor apportionment formula in the taxation of the income of multistate corporations. Because participation in the MTC is voluntary, it does not restrict state tax policies as strictly as federal statutes or the Constitution. As discussed in the next section, voluntary arrangements have both advantages and disadvantages relative to more binding forms of control over state tax policies.

Although the present paper focuses on federal statutes that affect state tax policies, it is worth bearing in mind that state constitutions and statutes define and regulate the taxing powers of local governments. Limitations on local property taxation, of which Proposition 13 in California is a famous example, are found in many states. Local governments

in some states are authorized to collect taxes on the earnings of workers and on the profits of corporate and noncorporate businesses, whereas such taxes may not be permitted in other states.<sup>3</sup> In general, states may grant localities as much or as little "rate" and "base" autonomy as they wish—always subject, however, to oversight by the courts. Indeed, judicial interventions in local taxation can be extremely significant; in many cases, court decisions have mandated state legislative action leading to major restructuring of school finance systems. In one notable instance, a Missouri school finance case (*Missouri v. Jenkins*) led to a federal judicial override of state constitutional limitations on local property tax rates, found to be incompatible with the court's desired remedies for deficiencies in local schools (O'Leary and Wise, 1991). As evidenced by the rich literature on the impacts of property tax limitations, state limitations on local taxes (and the court decisions that in some cases may have brought about these limitations) may have far-reaching and possibly unanticipated consequences, affecting not only local expenditures but also the division of financing and expenditure responsibilities between states and localities (Silva and Sonstelie, 1995).

State control over local taxation is not examined further here, but this subject warrants further research attention. As the above brief remarks show, judicial and statutory controls over the fiscal policies of local governments pervade the U.S. fed-

<sup>2</sup> The MTC was established partly in order to forestall federal legislation, which would likely have restricted state corporation income taxes more severely than PL86-272 (Multistate Tax Commission, 1969). It seems to have succeeded in this respect, although recent proposed federal legislation, discussed further in the fourth section below, reopens the issue. The interplay between Supreme Court rulings on corporate taxation, federal legislative proposals, and the states that culminated in the founding of the MTC is discussed in Anonymous (1968).

<sup>3</sup> Local taxation varies by state. Kentucky's system provides an interesting illustration. In addition to property taxes, many but not all localities are permitted tax wage income and business net income, at rates that vary within specific limits, depending on the size and type of jurisdiction. Taxes on property insurance premiums are an important revenue source for some localities. Property tax rates can vary among localities, but a state law limits the annual rate of growth of property tax revenues for most localities. Proposed reforms of this system would necessitate a combination of state legislation and amendments to the state constitution. These and other intricacies are discussed in detail in the report of a recent Task Force on Local Taxation (see Wildasin (2007)).

eral system and are by no means confined to federal government control over state government policies. Systematic study of state–local statutory and constitutional fiscal regulation could shed significant light on the general federalism issue of higher–level government control over lower–level government fiscal policies.

#### THE PROS AND CONS OF POLICY AUTONOMY IN A FEDERATION

Constitutional constraints, federal legislation, and voluntary interstate agreements are alternative mechanisms that limit state government policymaking autonomy. Such restrictions have potential advantages as well as potential disadvantages. As discussed in the literature of fiscal federalism, decentralized policymaking in a federal system offers the potential for more efficient policy choices than those that would be chosen by “central planners” or higher–level governments.<sup>4</sup> In brief, the potential economic advantages and disadvantages of fiscal decentralization are not dissimilar to those of economic decentralization in general. Decentralized decisionmakers assess the benefits and costs of their actions in the light of the specialized information at their disposal, not necessarily available to higher–level decisionmaking units, and are motivated by the relatively narrowly focused interests to whom they are responsible rather than by a more diffuse responsibility to “society at large.” When state and local government decisionmakers formulate fiscal and other policies, they are expected to be relatively highly attentive to the benefits and costs that those policies entail for the constituencies to which they are responsible, a focus that can lead to improved efficiency of decisionmaking from the viewpoint of

society as a whole when the social benefits and costs of these policies are closely congruent with the benefits and costs to the residents of these states and localities. Decentralized decisionmaking may be relatively inefficient, however, when lower–level decisions generate significant costs and benefits for the broader society. In such cases, constraints on subnational government policy autonomy may enhance the overall efficiency of the federal system. As a classic illustration, state government interference with the free flow of interstate commerce, prohibited by the Commerce clause, could damage the national “common market” within which households and firms carry out their economic activities.

These basic considerations provide a framework for assessing the potential advantages and disadvantages of federal statutory controls over state tax policies. In cases where there is little reason to expect a state’s policies to produce important consequences beyond its boundaries, whether favorable or unfavorable, the fundamental rationale for federal intervention is weak. When state policies produce significant external benefits or costs, on the other hand, corrective interventions may be useful. Note, however, that corrective actions need not entail federal pre–emption of state taxes or, indeed, any *federal* action at all. Formal and informal cooperative agreements among states provide one way in which socially beneficial or harmful policies may be encouraged or discouraged without any federal action at all. These agreements may be viewed as the federalism equivalents of Coasian negotiations and bargaining to internalize externalities (Coase, 1960).

Of course, as recognized by Coase, bargaining is a costly process, perhaps so much so that advantageous bargains

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<sup>4</sup> See Oates (1972) for a classic treatment. See Wildasin (2006, forthcoming) for concise and nontechnical discussions of some basic themes of fiscal federalism research as well as references to other works that survey some of the large and rapidly growing literature in this field.

sometimes cannot be struck. For instance, an interstate agreement to simplify the administration of sales taxes by limiting the number of commodity categories subject to exemptions or other special treatment and by establishing shared definitions of the commodities that fall into these categories could ease administrative and enforcement burdens throughout an entire federation. Arriving at such an agreement may be infeasible, however, if states haggle endlessly over fine distinctions of comparatively slight importance. In such instances, federal action may be needed to induce the states to adhere to a new and more efficient policy.

Federal inducements to the states take several different forms. Constitutional constraints are the most durable and inflexible of these. Pre-emptive federal statutes, though legally binding upon the states, can be amended or removed with much greater ease than constitutional constraints and can provide much more specific policy guidance than broad constitutional principles. Federal fiscal inducements, such as intergovernmental transfers, offer still another means through which state government policymaking can be influenced. Although intergovernmental transfers are not often viewed as mechanisms through which state tax policies are “regulated,” transfer programs certainly may affect the levels and types of taxes chosen by recipient governments. In particular, formula-based grants that depend upon the “tax effort” or “tax capacity” of the recipient government create quite explicit incentives to alter tax policies.

Federal statutory restrictions on state taxes, thus, are one mechanism among many through which imperfect decentralized tax policymaking by state governments can potentially be improved. Along a spectrum that ranges from the least-coercive mechanisms, notably voluntary interstate agreements, at one end, to the most powerful of all mecha-

nisms, constitutional constraints, at the other end, pre-emptive federal statutes occupy a middle ground. In cases where state-level policy choices produce significant spillover effects but the costs of coordination among the states are high, statutes may help the states to realize policy outcomes that are socially preferred but not attainable through the operation of the “invisible hand” of purely decentralized policymaking. Federal statutes can impose costs of their own, however, since they may produce policies that do not reflect the heterogeneous benefits and costs of policies in different states—the usual potential drawback associated with centralized policymaking. For this reason, federal pre-emption may be of greater value when it takes the form, as it typically does, of general procedural specifications (e.g., avoidance of double taxation, or general exemptions for classes of taxpayers) rather than detailed specifications of state tax policies (e.g., income tax rates cannot exceed 15 percent, or must be at least five percent). The latter, highly detailed policy specifications would destroy important features of state fiscal policy autonomy and would limit interstate variation in policies in response to the unique assessments of benefits and costs in individual states. Poorly designed and overly restrictive federal statutes can do more harm than good.

Constitutional constraints on state powers may also facilitate socially preferred outcomes. However, the stakes are much higher in this context, since the Constitution is much more difficult to amend than federal statutes. The consequences of policy errors at the constitutional level are highly durable. The same is true, though to a somewhat lesser degree, of judicial decisions based on constitutional interpretations. In general, these can only be altered by explicit constitutional amendments or by the slow process of revision of judicial opinion through sequences of litigation that sometimes culminate in

important new constitutional interpretations. Constitutional constraints like the Commerce Clause provide durable commitments to fundamental principles and, thus, may be of immense value. Constitutional provisions that provide (or are interpreted to provide) detailed policy specifications risk the loss of benefits from decentralized policymaking and the imposition of the costs associated with policy centralization in the same way as federal statutes, only to a greater and more persistent degree.

To summarize, then, federal statutes may be most beneficial when they help states to solve coordination problems, enabling them to achieve desired policy outcomes that are not attainable either through completely decentralized policymaking or through voluntary cooperation among the states. Such statutes limit the policy autonomy of states, however, and, thus, can interfere with the potential gains from decentralized policymaking. The costs of federal statutory constraints that prescribe state tax policies in highly specific detail are likely to be much greater than those that reserve significant policy discretion for the states so that they can continue to adapt policies in response to ever-changing local conditions. By comparison with statutory interventions, constitutional constraints and their judicial interpretations entail still greater departures from decentralized policy autonomy.

These brief observations are intended merely to provide an overall perspective for the analysis of federal pre-emption of state tax policy. By no means do they provide a complete normative foundation for the formulation or evaluation of such pre-emptive statutes. Rather, they are intended to convey some insights from the economics of fiscal federalism that can contribute to a better understanding not only of the normative foundations for federal pre-emptions but of the use of such pre-emptions in practice. Let us

now consider some specific instances of such statutes.

## STATE TAXATION OF CONSUMPTION AND INCOME

This section discusses three important cases in which state taxing powers depend importantly on constitutional or legislative constraints. The first case concerns state taxation of sales by out-of-state vendors to in-state purchasers. The second case concerns the taxation of distributions from pensions and other forms of retirement savings under state personal income taxes. The third case concerns state taxation of the income of out-of-state corporations. In each case, federal statutes with important consequences for state tax policy have been enacted or are under consideration.

### *Sales and Use Taxation*

Increased utilization of internet-based technologies for retail sales has focused new attention on state sales and use taxation. The US Supreme Court, in *Quill Corp. vs. North Dakota* (1992), held that states could impose sales taxes only on vendors physically present within their jurisdictions. This determination left states with the second-best alternative of relying on use taxes, imposed on purchasers, to tax mail-order and other interstate transactions. The increased convenience of such transactions afforded by new technologies gives rise to the potential for substantial losses of sales tax revenues. Some version of a "Streamlined Sales and Use Tax Act" (see McLure and Hellerstein (2004)) may offer the states an opportunity to tax sales more efficiently by providing explicit Congressional authorization for the imposition of state sales taxes on interstate transactions. At present, a number of states have joined the Streamlined Sales and Use Tax Agreement (SSUTA), a multi-state compact that aims to establish

a workable framework for the enforcement of sales taxes on remote vendors. As of January 2007, 15 states (with a combined population of about 57 million residents) were full members of this compact and another six (total population of 24 million) were associate members, a level of participation that indicates substantial but less-than-unanimous state interest in this initiative (NCSL, 2007). Under the terms of this agreement, states establish low-cost administrative mechanisms through which taxes are collected on remote vendors at rates and with remittances corresponding the states in which purchasers are located, that is, on a destination basis.

There are several potential benefits to the states from adherence to such an agreement. Perhaps of greatest interest to state policymakers, such cooperation might allow states to obtain additional revenues by taxing transactions that presently escape taxation. From the viewpoint of policy evaluation, this is actually a somewhat secondary consideration, since the extra revenues could instead be obtained by raising tax rates on the existing sales and use tax bases or from other sources, just as any additional revenues that may be obtained from state cooperation in sales tax administration can be offset through the reverse of these actions. More important, from a policy viewpoint, is the effect of such an initiative on the efficiency and distributional effects of state sales taxes. The key potential benefit arises from avoidance of the distortions of economic behavior resulting from different effective rates of sales and use taxation. At present, this effective tax differential (attributable to low rates of use-tax compliance) provides households

and firms with fiscal incentives to shift transactions, otherwise subject to sales taxation, to forms that are subject to use taxes. These fiscal incentives do not reflect underlying economic benefits and costs and, thus, produce economic inefficiencies. In addition, in order to simplify compliance and administration of sales taxes, the SSUTA aims to establish convenient technologies that would allow vendors to apply and remit appropriate taxes on sales to dispersed purchasers, potentially reducing the costs of sales tax administration in general. From a distributional viewpoint, successful implementation of a SSUTA would reduce the horizontal inequities that presently arise from differences in effective rates of sales and use taxes.

The emergence of the SSUTA illustrates the interplay between different institutions in the US federation. The Constitution, as interpreted by the Supreme Court in *Quill*, dictates that state taxing powers are limited in important respects. The states, through voluntary cooperation, may arrive at a mutual adjustment of their historically diverse sales tax regimes (including the local sales taxes that many states permit), which would facilitate the establishment of a nationwide sales tax administration mechanism that obviates the distortions arising from differentials in effective sales and use tax rates. Congressional action would apparently be required to implement any such agreement, since it would authorize the states to enforce tax collections on transactions involving remote purchases.<sup>5</sup> Indeed, Congressional action could authorize state taxation of transactions involving remote vendors even in the absence of any such prior interstate agreement.

<sup>5</sup> Rather than attempt to tax every transaction at the rate required by the destination jurisdiction, states could impose origin-based taxes on all transactions and then remit a portion of the revenues to other states, pursuant to a voluntary interstate compact (presumably based on reciprocity arrangements). Such a tax might not violate any constitutional constraints, but many economists would prefer a system of destination-based sales taxes because they would more closely approximate a consumption tax.



However, the search for sales tax simplifications agreeable to all or many states, as embodied in the current or possible future versions of the SSUTA, promises to lower the administrative and enforcement costs that have figured prominently in Supreme Court decisions concerned with the burdens imposed by state taxes on interstate commerce. Interestingly, proposed Congressional legislation—e.g., the Sales Tax Fairness and Simplification Act (S.2152) and the Streamlined Sales Tax Simplification Act (S.2153), introduced in the 109<sup>th</sup> Congress—would enable the implementation of the SSUTA provided that sufficiently many states enter into the agreement. Such provisions in effect make the Congress into a “delegated enforcer” of state government policies, highlighting the role of Congress as a coordination mechanism for the states, as discussed in the third section.

It should be noted that the SSUTA by no means establishes an “economically satisfactory” sales tax regime, even if it does address some of the administrative problems that arise under current policy. In particular, retail sales taxes are generally quite poor approximations to destination-based consumption taxes. On the one hand, their tax bases are *too inclusive*, in that they tax many intermediate-goods transactions. As Ring (1999) has shown, the states differ widely in the proportion of sales tax revenues derived from taxation of sales to consumers. This figure is as high as 89 percent in West Virginia, but as low as 28 percent in Hawaii, averaging 59 percent for the nation as a whole. (The wide interstate variation in this respect is one important indicator of the extent of state revenue autonomy, and also of the hurdles to be surmounted if states are to achieve significant “base harmoniza-

tion,” a reform that would likely facilitate Congressional action in support of an initiative such as the SSUTA.) For the nation as a whole, then, it appears that more than one-third of sales tax revenue derives from transactions that would not be taxed under a consumption tax. On the other hand, state sales tax bases are *not inclusive enough*, viewed from the perspective of consumption taxation. Exemptions for food and clothing are widespread and well known. Just as importantly, especially in an economy with a growing service sector, expenditures on health, education, financial, and other services provided to households are also often exempt from sales taxation.<sup>6</sup> (Business services *should* be exempt from retail sales taxes that are intended to tax consumption, since these services are intermediate inputs, not final consumption.) For both of these reasons, retail sales taxes are far from ideal taxes from an efficiency perspective. Indeed, as noted below, state personal income taxes may approximate a tax on final consumption better than existing retail sales taxes do.

### *State Taxation of Pension Incomes*

As is well known, personal income taxes, as they are implemented in practice, are not taxes on true economic income. Instead, they are “hybrids” of income taxes and consumption taxes. A consumption tax differs from an income tax in that it taxes the uses of income, at the time that it is consumed, rather than the sources of income as it accrues. Federal and state tax treatment of the income from retirement savings, capital gains, and other types of income produces a tax system that diverges substantially from a true income tax and that corresponds in important

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<sup>6</sup> Many personal services (lawn and garden care, laundry, personal grooming) avoid sales taxation but should, of course, be taxed as part of personal consumption. The exemption of services complementary to the sale of taxed tangible goods—automobile repair, for instance—creates incentives for tax avoidance through pricing distortions (reduced prices for taxable “parts” and increased prices for untaxed “labor”).

ways to a personal consumption tax. In particular, when households elect to save a portion of their earnings using tax-sheltered retirement savings in IRAs, 401(k)s, and other similar accounts, the return on their savings within these accounts is not subject to tax until the assets within the accounts are distributed upon retirement. This means that the economic income arising from the return to capital in these accounts escapes taxation. Similarly, employer contributions to employee pension plans as well as the return on these contributions are not subject to tax until they are distributed at retirement. Since the proceeds of these distributions finance retirement consumption, the taxation of distributions from tax-sheltered savings and pension accounts effectively shifts the personal income tax away from a tax on all sources of income to a tax on the uses of income when consumed, that is, to a consumption tax. The taxation of capital gains on a realization basis offers similar opportunities for households to opt out of a tax on economic income and into a tax on consumption. By electing to defer realization of capital gains until the proceeds from asset sales are needed in order to finance current spending, households are again able effectively to convert the "income" tax to a tax on consumption expenditures.

These features of current federal and state personal income tax systems do not result in true or "pure" personal consumption taxation, since there are limits on the amount of nonwage income that can be sheltered from taxation as it accrues. Furthermore, early distributions from sheltered accounts are often subject to penalties, making them unattractive instruments for non-retirement savings. Consequently, a significant amount of nonwage income is taxed as it accrues,

and to this extent the personal income tax diverges from a consumption tax and more closely approximates a true income tax. Existing federal and state income taxes are, thus, "hybrids" of income and consumption taxes.

The interstate mobility of households over the life cycle adds an interesting aspect to the question of consumption taxation at the state level. Suppose that a household earns wage income when residing and working in one state, say state A, directing a portion of this income into tax-sheltered retirement savings accounts. Suppose that the household moves to a different state B upon retirement and then receives distributions from its retirement savings accounts. This household's life-cycle consumption is now spread across two states. Assuming that both states impose taxes on personal income, the question arises as to whether distributions from retirement accounts "should" be taxed in A or B. If these distributions are taxed by state A, then its personal income tax base is the lifetime consumption of households that reside and earn wages there early in the life cycle. If retirement distributions are taxed in state B instead, then state A's personal income tax allows it to tax consumption early in the household's life cycle, while state B's personal income tax base includes the household's retirement consumption expenditures. These two alternatives may be referred to as "source based" and "residence based" taxation of distributions from sheltered accounts, and they result in source-based and residence-based consumption taxation, respectively.<sup>7</sup>

Needless to say, this simple illustrative example abstracts from many nontrivial complications, including the possibility that households may reside in several different states at different stages of the

<sup>7</sup> Of course, it is possible that both states could try to tax retirement distributions, resulting in double taxation. A possible solution to the double-taxation problem would be for states to offer credits for taxes paid to other states, as in fact was generally the case prior to the passage of PL104-85, which has obviated the issue.

life cycle and may face graduated and time-varying income tax rates in different states. It serves, however, to show that the tax treatment of retirement distributions on a source or destination basis has important implications for state personal income taxation. Both types of taxation have some economic virtues. Source-based taxation allows states (state A in the example) to tax a household's lifetime consumption if it earns wage income there when young and takes advantage of opportunities to shelter a portion of this income from current income taxation. State-level taxes on lifetime consumption may be viewed as desirable on equity grounds, and, if so, the principle of horizontal equity might be interpreted to require that lifetime tax burdens be fixed independently of the state in which consumption occurs. Under this principle, residence-based taxation would be undesirable because it would result in unequal lifetime state income tax burdens for households that remain in one state for their entire lifetimes as compared with other households that relocate at some point in the life cycle, thereby exiting the personal income tax system of the previous state(s) of residence and entering the system of their new state(s) of residence. The implementation and even the conceptual justification for this horizontal equity argument for source-based consumption taxation appears to be quite problematic, however, when applied to households that reside in several different states during the pre-retirement portion of the life cycle.

Destination-based consumption taxation might be preferable to source-based taxation on efficiency grounds, insofar as households (including retirees) impose public-service provision costs on the states where they reside. Location-contingent taxes, such as a destination-based consumption tax, can enhance locational efficiency by serving as indirect congestion tolls when governments provide congestible public goods.<sup>8</sup>

PL 104-85, passed in 1996, has decided this issue of state taxation in favor of the residence principle. Prior to the passage of this law, states had the option of imposing income taxes on distributions from the retirement accounts of former residents and some 16 states did so, at least in principle.<sup>9</sup> By declaring that states may only tax such distributions on a residence basis, this statute has clarified how states may exercise some of their taxing powers, obviating potential constitutional and other legal disputes regarding double taxation and nexus. It also obviates the difficult administrative issues that arise, under the source principle, for individuals who reside in multiple states during their working lifetimes. By settling on the residence principle, the statute equips states that attract older residents with an important policy instrument with which to finance the public services that these households demand, even as it limits the ability of states to impose taxes on their working populations. This is an important policy distinction in an economy with a

<sup>8</sup> In general, neither a residence-based nor a source-based consumption tax is a perfect congestion toll. If the cost of public service provision is highly dependent on the level of employment within a state, employment-based taxes like a source-based consumption tax or taxes on earnings or payrolls might be preferable to residence-based consumption taxes or possibly retail sales taxes. Many public services, however, depend principally on the size of the population being served rather than on the level of employment, in which case a residence-based consumption tax is likely to be a better implicit congestion toll. This is especially true for congestible public services consumed disproportionately by the elderly, such as nursing-home care.

<sup>9</sup> See the report of the House Committee on the Judiciary (1995) for discussion of the policy background of PL104-85. The report notes (p. 3) that "One State in particular, California, ... aggressively sought to tax annuity payments made to retirees who have moved elsewhere." "Elsewhere," in this context, includes Nevada, a state with no income tax—a problematic situation from the viewpoint of source-based consumption taxation but quite acceptable from the residence perspective.

rapidly aging population and growing amounts of wealth held in tax sheltered accounts. The availability of this tax instrument permits states to shift the burden of government finance to the elderly, if desired. Competition for older workers under these circumstances may result in state-expenditure, regulatory, and other policies that are more favorable to older residents with significant amounts of accumulated tax-sheltered savings.

### *Corporation Income Taxation*

In 1959, the Supreme Court (*Northwestern States Portland Cement Co. v. Minnesota*) determined that a state could impose income taxes on a corporation if it solicited sales there, irrespective of whether it engaged in any production activities, owned any property, or employed workers in the state. Within months, Congress passed PL 86-272, which prohibits a state from levying such taxes on a corporation if it is only involved in the solicitation of sales for *tangible* products within the state and if such sales are filled by deliveries from outside the state. This law, thus, allows a corporation to sell its tangible products in a state without exposure to the state's corporation income tax.

PL 86-272 implies a significant restriction on state taxing powers, all the more so as states have moved toward reliance on apportionment rules in which sales are the main determinant of the taxable share of corporate income. The fact that the statute mentions only *tangible* products presents a special complication, as it leaves open the possibility that states can tax the incomes of corporations that derive revenues from *intangibles*, such as royalties, even if they have no physical connection with the state. Indeed, the Supreme Court of South Carolina has specifically ruled that such taxes are permissible (*Geoffrey Inc. v. South Carolina Tax Commission*, 1993). The economic consequences of this asymmetric treatment of tangibles and intangibles are potentially

quite significant, although this complex issue cannot be thoroughly analyzed here (see Wildasin (2000, 2002), McLure and Hellerstein (2004), and references therein for further discussion). What is of particular interest for present purposes is the role of a pre-emptive federal statute. In this case, as in the sales tax case, a Supreme Court ruling had an important impact on state taxing powers. Whereas the Supreme Court imposed significant limitations on state sales taxation in *Quill*, it offered a seemingly expansive interpretation of state powers to tax corporation income in *Northwestern States*. In the latter case, Congress acted swiftly to exercise its own powers to regulate interstate commerce by enacting PL 86-272 and, thus, removing the taxing powers that the states were held by the Supreme Court to possess. Because this law referred specifically to tangible products, the current status of state taxing powers with respect to income derived from intangibles is open to dispute.

This matter could be clarified by further Supreme Court rulings, although such rulings could presumably be superseded by additional congressional action as happened in 1959 after the ruling on *Northwestern States*. Indeed, new legislation need not await further court rulings. As an example, the Business Activity Tax Simplification Act of 2003 (BATS) (McLure and Hellerstein, 2004) would have further restricted state taxing powers by limiting state corporation income taxes only to corporations that are physically present within their boundaries. Logically, legislation along these lines may be seen as a natural complement to PL 86-272: if revenues derived from the sale of tangible products do not alone make a corporation's income subject to tax within a state, it is seems anomalous for it to be taxable solely because it derives revenues from intangibles. On the other hand, logical consistency would also be served by the repeal of PL 86-272, so that states could tax the incomes of all corporations that derive

revenues from any sources at all, whether tangible or intangible. The scope of state corporation income taxation depends heavily on the resolution of these issues.

## CONCLUSION

As is clear from the illustrative cases discussed in the fourth section, federal statutes can have major impacts on state taxation. Sales, personal income, and corporation income taxes are three of the most important components of state tax structures. The ability of the states to utilize each of these taxes has been affected (or may soon be affected) in major ways by existing or proposed federal statutes. Federal pre-emption is, however, only one part of the institutional structure within which state tax systems must operate. Important court decisions have in some cases expanded and in some cases restrained the scope of state taxing powers. In some instances, court decisions have triggered contrary federal legislative action (PL86-272), while in other cases Congress has been willing to accept the impact of judicial rulings (*Quill*). Perhaps stimulated in some cases by judicial rulings and, in others, by Congressional inaction, states occasionally undertake important tax coordination initiatives on their own, as illustrated by the Multistate Tax Compact and the Streamlined Sales and Use Tax Agreement. Thus, the Constitution (as interpreted by the courts), federal legislation, interstate cooperative efforts, and independent state action interact continuously against the backdrop of economic and technological change to determine how state governments are financed. This is a very complex dynamic institutional process and, for students of federalism, a deeply interesting one.

Within this institutional context, federal statutes occupy a kind of middle ground. They control the taxing powers of the states with the force of law and, once enacted, their impact on the states is ines-

capable. Unlike constitutional constraints, however, these statutes can in principle be altered comparatively easily should circumstances arise in which Congress would wish to do so, and new statutes can be implemented with far greater ease than amendments to the constitution or, perhaps, revisions of judicial doctrines of constitutional interpretation. (The fact that PL86-272 has not been revised in nearly a half century attests to the fact that federal statutes may, nonetheless, be very durable.) On the other hand, federal legislation is much less flexible than cooperative agreements among the states, which can be altered without Congressional action and to which state adherence is discretionary. Voluntary compacts, thus, impose comparatively modest constraints on state tax policy. Such compacts would appear to be most useful to the states when they must deal with particularly complex problems under rapidly changing circumstances, that is, when the commitment to a rigidly fixed policy entails a high risk of policy error.

The literature of fiscal federalism has identified some of the important advantages and disadvantages of decentralized government policymaking in a federation. Federal statutory controls over state policymaking provide one means by which some of the disadvantages of decentralization may be avoided or minimized without undermining its advantages. Further detailed analysis of the benefits and costs of specific statutes, such as those described in the fourth section, would be of great interest from the viewpoint of normative policy evaluation. An equally interesting challenge for future research is to understand why and under what conditions Congress elects to intervene in state tax policy matters and when it instead steps into the background, allowing other institutions—the states themselves, acting independently or cooperatively, as well as the Constitution, as interpreted by the courts—to play more decisive roles. Many

contributions to the literature of fiscal federalism offer potential insight into this issue but, to the author's knowledge, it has not so far been the subject of systematic analysis by economists. Further investigation of this topic can shed important light on the development of policy in a complex and dynamic institutional context.

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