

The Federal Role in State Taxation: A Normative Approach

Abstract - Federal intervention in state taxation is normatively supportable when state tax policies generate negative externalities or result in excessive compliance burdens. States usually do not have sufficient incentive to cooperate to eliminate these distortions, and state cooperative cartels tend to break down over time. Although the national government can in principle correct for these defects, it similarly lacks the incentive in many instances to adopt efficiency-enhancing corrective measures. One promising approach is efforts such as the International Fuel Tax Agreement or the Streamlined Sales Tax Project, which reinforce (or seek to reinforce) state cooperative initiatives with federal mandates or incentives.

INTRODUCTION

States have considerable flexibility under the U.S. Constitution for imposing the taxes they choose. Generally, states are free to levy taxes without consideration of how other states are affected or without constraints imposed by the federal government, with two major exceptions. First, state taxes cannot run afoul of the dormant (or negative) Commerce Clause, as developed and interpreted by the U.S. Supreme Court. Second, Congress is constitutionally granted affirmative authority under the Commerce Clause to regulate interstate commerce, and it obtains most of its capacity to influence state taxes directly through this lever.¹

This arrangement has allowed states access to the resources necessary to finance their service responsibilities and the autonomy to tax based on local factors. Federal intervention has been relatively modest, as the dormant Commerce Clause has been interpreted to give states wide latitude in developing tax policy, and Congress has generally been reluctant to exercise its affirmative Commerce Clause powers in the area of state taxation. The question arises, therefore, as to whether the very modest level of federal restraints and interventions is sufficient to prevent subnational taxing arrangements from generating perverse economic effects, such as might occur with tax havens and some other forms of tax competi-

William F. Fox

Center for Business
& Economic Research,
College of Business
Administration,
The University of
Tennessee, Knoxville,
TN 37996-4334

John A. Swain

Rogers College of Law,
The University of
Arizona, Tucson, AZ
85721-0176

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¹ There are other constitutional limits on state taxation. See, generally, Hellerstein and Hellerstein (1998).

tion.² If these federal limits have not been effective, or have been counterproductive, then the advisability of additional and/or modified federal interventions merits consideration.

This paper seeks to analyze the case for federal intervention in state taxation and to identify specific instances where interventions may be appropriate. We also evaluate several existing federal interventions to determine whether they are consistent with the criteria we identify for federal government involvement and whether the specific policies are likely to achieve the expectations.

The role that the federal government should play in controlling/enabling state/local government revenue generation depends on the goals that are chosen. A number of goals could be envisioned, including such esoteric values as states rights, autonomy and local control. Without reaching any conclusion on these or other goals, we take the simple view that the federal role is to increase *national* economic efficiency and, thus, federal intervention may be justified in cases where efficiency could be enhanced. We also acknowledge, however, that there may be sound political or constitutional reasons why the federal government should not intervene even if there are possible efficiency gains from the intervention.

Although we do not focus on it in this paper, we do note that the federal government is not without other tools that could be used to offset negative state tax externalities. The grant system, for example, is an option for offsetting negative horizontal (state-to-state) effects, as described by Inman and Rubinfeld (1996).³ Significant restructuring of grants would be necessary, however, and the overall magnitude of grants would likely need

to be much larger than those currently imposed to offset some of the effects. The federal government could also structure national taxes to offset vertical externalities that can arise between the federal and state governments. Additional tools include deductibility and credits against federal taxes for state and local taxes paid, and so forth.

A very legitimate question arises: Will the federal government act to make state/local tax behavior more efficient or simply follow political pressures that are no more likely to make state/local taxes more efficient than if the governments were left free to design their policies independently (including pursuing cooperative measures independent of federal intervention). Certainly a case can be made that enhanced efficiency has seldom been the driving force behind federal legislation related to state/local taxation. Accordingly, we briefly examine whether federal policies are likely to encourage efficiency, as well as consider implementation strategies that might increase the probability of achieving salutary outcomes. Our primary focus, however, is on the narrower question of how appropriately set policy would make taxation in the federal context more efficient.

WHY FISCAL FEDERALISM?

The Economic Functions of Government

An extensive literature has developed regarding the economic justifications for a devolved/decentralized system of government. Richard Musgrave's (1959) seminal work is often cited as the foundation for thinking on the relative roles that different levels of government should play in a federal system. He divided government

² These effects might become increasingly problematic with economic globalization (see Bruce, Deskins and Fox (2007), who find that the responsiveness of corporations to taxes is growing).

³ Egger, Koethenbuenger, and Smart (2007) find that equalization grants lessen the extent of tax competition between German municipalities.

into the stabilization, distribution and allocation functions, and argued that the first two should be primarily at the national level.⁴ This leaves allocative efficiency as the primary economic justification for a federal system of government. Even when allocative efficiency is considered, certain services, such as national defense, are best delivered at the national level because the benefits of uniform national consumption and internalizing consumption and political externalities exceed the costs (see Epple and Nechyba (2004)).⁵ Provision of many other services by subnational governments is frequently efficiency enhancing because service levels can be differentiated according to local demands and diseconomies of large scale can be avoided. This is consistent with what is often termed the subsidiarity principle, which argues that services should be delivered at the closest possible level to service recipients. Of course, decisions on what is the closest possible level must be made after consideration of various factors, including the economies of scale/size (see Fox and Gurley (2006)) and externalities associated with service delivery.

Other reasons for devolved systems of government have also been asserted, though often not in a tight conceptual framework. For example, subnational governments have been justified as laboratories for experimentation on good government and based on a belief that government at local levels better hears the citizenry.

Tiebout and Taxes

The justifications for federalism and subnational governments have generally

been developed on the service delivery/expenditure side of government. Seldom has a case been made that state/local tax collection is more efficient than national collection, although the Tiebout model merits exploration in this regard.

Tiebout (1956) spawned a significant and continuing literature on the efficiency gains that result if a system of local governments proxies private market operation. The literature identifies the conditions under which efficiency can be attained as local consumers obtain the services they demand at minimum cost by voting with their feet. Service demands in these models are generally financed with a form of user fee that charges consumers a marginal price for services.

The Tiebout model has been extended and evaluated broadly, as discussed in Epple and Nechyba (2004). While the Tiebout framework offers many keen insights and helpful approaches to understanding local service delivery, it is difficult to make the case that state/local governments rely heavily on benefit charges. Explicit benefit charges generate a relatively small share of state and local government funding in the U.S. For example, charges and fees raised 14.4 percent of total state and 26.2 percent of total local government own-source revenue in 2004.⁶ Other taxes, such as the property tax, are sometimes seen as benefit charges, but there is considerable disagreement about the extent to which this is true.⁷ Further, no counterpart system of benefit taxes exists at the state level (with a few possible exceptions, such as higher education tuition). Thus, in the absence of a system of user fees, the efficiency gains that can be obtained through delivery

⁴ Of course, there continues to be discussion about the degree to which stabilization and distribution should be entirely national functions. For example, see Fox and Murray (1997).

⁵ See Oates (1972).

⁶ See http://www.census.gov/govs/estimate/0400ussl_1.html.

⁷ An excellent point-counter point perspective on the property tax as a benefit tax versus as a tax on capital can be found in Fischel (2001) and Zodrow (2001b). Also, see Zodrow (2001a).

of services through a federal system of government might be at least partly offset by the extra costs of generating revenues at the subnational level. As we explore in the following section, generating the resources to finance state and local service delivery is likely, in fact, to impose additional costs and lessen the efficiency gains from decentralization.

BASIS FOR FEDERAL INTERVENTION

Subnational taxation engenders a series of horizontal and vertical externalities that can impose additional burdens on the economy. Horizontal externalities refer to the effects that taxation by one government has on other governments at the same level, and vertical externalities refer to the effects that taxation by a government at one level has on governments above or below it. Additionally, the geographic or economic size of states may be insufficient to achieve scale economies in tax collection, and so federal participation or cooperative arrangements between states may allow lower administrative costs. Further, there may be economic savings on the compliance side if some degree of uniformity can be achieved. In short, the potential for lowering the costs of assessing, administering and complying with taxes offers the primary justification for federal intervention in state and local taxation. This section addresses each area where federal intervention could lower the national costs of taxation.

Efficiency Costs of Subnational Taxation

Academic work points in two directions: One thread suggests that a subnational tax and expenditure system could be efficiency enhancing and another suggests that it expands the efficiency losses from taxation. The former argues that horizontal competition between governments could restrain Leviathan effects and make the overall system more

efficient. The notion is that competition for economic actors could restrain expansive tax policies and result in government that is closer to constituent demands. The second focuses on efficiency effects of tax incentives at the central versus subnational level, and observes that subnational taxation encourages taxation that is too low on mobile capital and creates other incentives that can result in inefficient tax and expenditure policies. This paper focuses on the second literature in order to investigate whether national policy could limit the efficiency losses from imposing some taxes at the subnational level.

A wide literature addresses how the horizontal externalities that arise across state governments and the vertical externalities that occur between governments at different levels in a federal structure alter behavior in ways that would not occur if all revenue were raised by a welfare maximizing central government. These effects can change tax rates that governments would choose, particularly on mobile activity, relative to those imposed by an efficient single government structure. This literature generally concludes that tax rates will be too low and the size of government too small, particularly as a result of tax competition. Correcting for these externalities is an important function for the national government since states have neither the incentive nor the capacity to correct for these effects individually (see Wildasin (1989)).

Inman and Rubinfeld (1996) summarize six horizontal effects that develop from decentralized taxation and reduce efficiency relative to an efficient, centralized system. Some form of national intervention would be necessary to correct for each of these if the costs are to be averted. All six are described here, but the emphasis in the broader literature tends to be on two of the six: tax competition and the effects of state taxation on base mobility and tax exporting. First, Inman and Rubinfeld describe the tendency to tax export as the

decision-making coalition in a community pays only part of the tax cost, with the remainder paid by non-residents and the disenfranchised. The tendency is to overtax sources where such tax exporting is possible. Concern over tax exporting is an important reason for a federal role in limiting the effect of taxes on interstate commerce. Second, state taxes may be more regressive than would result from a national tax system, to the extent that higher-income people are more mobile than lower-income individuals and that state governments set tax rates to limit mobility.

Third, states may engage in not-in-my-backyard taxation by tending to overtax socially desirable activity that imposes negative externalities in the local community. Fourth, state governments ignore the benefits that other governments receive when their taxes cause economic activity to flow out. The result is a tendency to undertax the mobile activity as each government sets rates while only considering its own base. In other words, tax competition lowers tax rates on mobile activity. Fifth, state government taxes alter factor prices and these effects on other governments are ignored. Sixth, the cost of inputs used heavily in the production of public services rises as a government taxes more, and this raises the costs for other governments.

Vertical externalities ensue when two levels of government choose to tax the same base. Each tends to ignore the effect on the other's revenues when tax rate increases narrow the joint base (Keen, 1998). The likely effect is for vertical externalities to lead to excessive taxation of common bases. For example, taxation of capital by both the national and state governments probably results in excessive taxation of capital.

The incentives to overtax that arise from vertical externalities tend to offset, at least to some extent, the incentives created by horizontal externalities to undertax

mobile activity. Whether the net effect is overtaxation or undertaxation depends on the responsiveness of bases to various taxes. Horizontal effects dominate and the combined rates are too low if bases are sufficiently mobile across state governments (Keen and Kotsogiannis, 2002). Vertical externalities dominate and the combined tax rates are too high if the aggregate national tax base is responsive enough to the state taxes, that is, if the total national base shrinks significantly in response to imposition of taxes by the states. Vertical externalities might also tend to dominate if the national and state governments are Leviathan in their objectives (Keen and Kotsogiannis, 2003).

A corollary to the above discussion is that the states, as with other generators of externalities, have limited incentives to correct for these externalities individually. States could negotiate a cooperative solution to correct for externalities, but the costs of negotiation can be very high and individual states will have incentives to break the cartel. For example, some states would want to operate as tax havens even if others cooperated (as occurs with international tax behavior). On the other hand, states may individually have incentives to cooperate in areas where they can achieve cost savings, such as from economies of scale in administration. But, even in these cases, states may be apprehensive about sacrificing autonomy in the name of cost savings, particularly since the cost savings may be difficult to identify in advance. Again, the conclusion is that some form of corrective federal intervention may be necessary in these instances.

Economies of Scale and Administrative and Compliance Costs

As a general proposition, administration and compliance costs would probably be lower if all taxes were administered nationally. Compliance costs almost surely would be lower if taxpayers were required

only to remit returns to and be audited by a single revenue service. Further, the myriad of definitional differences between the national and the state tax structures and across states would disappear, thereby lowering compliance costs. Administrative costs would also fall if size economies result from tax collection across wider geographic areas and if scale economies exist from handling larger numbers of returns. Further, scope economies could result from collecting multiple taxes. Administrative savings would not result if there were significant diseconomies of large size and scope. Hildreth, Murray and Sjoquist (2005) discussed the limited literature on administration and compliance. They observe that compliance costs are likely to be higher without harmonization across the states but were able to find relatively little evidence to confirm this assertion. They also conclude that the earlier literature found that administrative and compliance savings from national collection of taxes were not sufficient to justify tax collection by a single agency.

National collection of state/local taxes entails two large disadvantages. First, states would lose autonomy and almost surely would have little or no control over their tax bases if the federal government were to collect all taxes, though the system could be designed so that states could alter their revenues to some extent through tax rates (including a zero rate on some bases). Second, the federal government has a greater incentive to collect taxes for its own use than for state purposes. Quite simply, the IRS would be more responsive to the institutions that set its budgets, wages, staffing and so forth than to agencies that are mere recipients of the revenues it collects. The federal government or the IRS could retain a share of state revenues to defray collection costs, but this share is unlikely to dramatically

change the incentive structure. As a result, state and local taxes may not be efficiently collected at the national level.

Significant administrative and compliance savings could potentially result from administrative assistance and cooperation between governments if the balance between the advantages and disadvantages of a single tax administration leads to the conclusion that each should control its own tax administration. There might also be efficiency gains from cooperation in collecting taxes to the extent that uncoordinated collection is less efficient and the differential efficiencies across states inject additional distortions into taxpayer behavior. These cooperative approaches to limiting administration costs are the focus here.

National influence over tax bases may be justifiable because of compliance savings that result if multistate businesses are subject to uniform treatment across the nation. Further, common bases would reduce or eliminate the chance that activity, and particularly multistate activity, is either taxed more than once or not at all.⁸ Theoretical research in the spirit of Kanbur and Keen (1993) has not investigated whether uniform bases are theoretically preferred, but it seems likely that the compliance savings are sufficient to justify substantially common bases, at least for taxes where much of the compliance is done by multistate firms, such as the sales and corporate income taxes. Common bases would still allow states to vary their revenues as needed through rate differentiation.

The availability of federal bases as a starting point for state definitions is a less aggressive approach for creating common bases and is followed by most states for the personal and corporate income taxes. But state divergence from federal bases appears to be a growing phenomenon.

⁸ There are substantial questions regarding federal ability to achieve uniform bases and administration, even if a decision was made to do so. See Dennen and Bissondial (2005) for some of the issues that arise.

State adoption of federal definitions would appear to be more effective if the federal government altered bases only infrequently and did so only after consideration of effects on states. Frequent federal changes enhance the likelihood that states will decouple and thereby limit the compliance advantages.

IN WHAT AREAS SHOULD THE FEDERAL GOVERNMENT SEEK TO AFFECT STATE TAXATION

The Five State Tax Functions

The state tax function can be decomposed into five components: base definition, rate, designation of taxpayers, administration, and revenue ownership. States must decide the set of taxes to impose and the specific definitions of these bases. A related but separable decision is determining the set of taxpayers to whom the taxes apply. In addition, the specific rate(s) must be selected and the means to administer the taxes decided upon. Revenue ownership refers to which government receives the revenues for funding services.

Each federal intervention is ultimately aimed at one or more of these components, and the degree to which the federal government intervenes determines which level of government actually has power over the tax. Ownership of the revenue at the state or local level is the minimum standard for revenues to be considered as a state or local source. Taxes where the states own the revenues but control none of the other four elements might be best thought of as grants apportioned based on the situs of tax collection. At the other extreme, state and local governments have complete control and independence if the federal government has no influence over any of

the other four elements. The more likely scenarios are somewhere in between, with some federal and some state role. From a normative perspective, the challenge is to determine the appropriate federal role, starting with the initial assumption that state and local governments own the revenue.⁹

Forms of Federal Interventions

Federal interventions involving these five elements can take many forms and will be illustrated here with some examples. It can be limitations on the rates or bases that are levied. It can be enabling legislation that overrides a dormant Commerce Clause prohibition, such as if the Congress permitted states to require remote vendors to collect sales and use taxes (a taxpayer designation intervention). It can be by providing base definitions that states voluntarily adopt to serve as a starting point for determining state bases. The federal government could also intervene by offering to collect taxes for state governments (as with the personal income tax) or by cooperating with states in collection activities. In the extreme, the federal government can deny state access to a tax base altogether, as has occurred with Internet access (Internet Tax Freedom Act, Pub. L. No. 105-277) and air travel (49 U.S.C.A. § 40116). With regard to air travel, the federal government chose to appropriate the base to itself, thereby taking ownership (I.R.C. § 4261).

Some forms of federal intervention may be targeted at broad state tax structures rather than one of the five elements of the tax system. For example, deductibility of personal income and property taxes lower the costs of these taxes without directly targeting the base or the rate. Examples of federal influence over revenue ownership

⁹ It is important to keep in mind that this part of the discussion is focused on the federal role from an economic perspective, and not in the context of any Constitutional limitations that might exist.

can be found as well. The credit for state estate taxes effectively shifted ownership of the revenues from the federal to the state governments.

Justifications for Federal Interventions as Applied to Different Components of State Taxes

The justifications for efficient federal interventions discussed above likely have different applications across the various components of the tax decision. Thus, the specific form of intervention must be carefully designed to achieve the federal objective. For example, the theoretical literatures on horizontal externalities and tax competition and on vertical externalities tend to focus on competition through tax rates. The notion is that tax competition can be limited through control over the tax rate. Federal limitations over transaction tax rates or restrictions on the use of tax concessions are examples that could be imposed. The optimal form of federal control need not be uniform rates or structures. For example, Kanbur and Keen (1993) demonstrate that minimum tax rates are a preferred limitation over uniform rates for transactions taxes. Unfortunately, it is very unlikely that the federal government has sufficient information on the extent of horizontal externalities or the degree to which these are offset by the vertical externalities to determine what federal interventions would result in a more efficient state tax system or a more efficient combined federal and state structure.

Although the theoretical literature seldom considers the other ways that tax competition may occur, world experience shows that state governments may engage in horizontal tax competition through means other than rates. Fox (2003) discusses the competition that occurs between the entities in Bosnia and Herzegovina through base defini-

tions and administrative practices. For example, states may choose to compete through the set of intermediate or final goods that are taxable under the sales tax. Alternatively, states may compete by deciding how rigorously to enforce taxes or how frequently to audit firms in certain industries. Thus, externalities may also offer a basis for federal intervention in these areas as well.

As described above, federal sway over state/local bases can potentially be justified not only by externalities but also by administrative and compliance benefits, and economies of scale in tax administration. Numerous examples exist of both active and passive federal cooperation (see Duncan and Luna (2007)). In a similar vein, the national government may have an interest in ensuring that states adopt a consistent set of rules for designating the entities that are taxable in each state to avoid either the possibility of multiple or too little taxation of some economic activities relative to others. Common nexus definitions may also lessen compliance costs for firms operating in multistate environments.

State Cooperative Efforts

States could voluntarily cooperate to achieve savings, particularly in areas with possible administrative and compliance gains. Hildreth, Murray and Sjoquist (2005) use a simple game theoretic model to demonstrate that in many circumstances states are not likely to voluntarily cooperate in policy design, but may be more likely to cooperate in small structural changes that lower business compliance costs. The Streamlined Sales Tax Project's (SSTP) approach of developing common definitions but allowing states to vary the specific set of taxable activities and tax rates is a voluntary attempt to balance state autonomy with a mechanism that lowers administration and compliance costs.

The SSTP and Uniform Division of Income for Tax Purposes Act (UDITPA) are cooperative means between the states of enhancing base uniformity, but these agreements effectively operate as cartels and can break down, as the incentives facing individual governments differ from those facing the nation as a whole. The UDITPA agreement has been slowly eroding as states engage in efforts to stimulate in-state production. Cooperative action within the SSTP has been motivated at least in part by the carrot of potential revenues that could be gained as a result of positive federal action that would allow states to require remote vendors to collect sales taxes. These experiences are certainly suggestive that some federal influence is likely to be an effective means of movement towards more uniform bases.

EVALUATION OF EXISTING FEDERAL INTERVENTIONS

As already noted, the federal government has intervened in state taxation in a variety of ways. Here we evaluate some of the major interventions in light of the normative criteria developed above.

The Dormant Commerce Clause

Under the Commerce Clause of the United States Constitution, Congress has near-plenary authority to regulate state taxation of interstate commerce. Further, even in the absence of federal legislation, the so-called dormant (or negative) Commerce Clause has been interpreted to give courts the authority to strike down state tax rules that unduly burden interstate commerce. Thus, although not commonly thought of as an intervention, the dormant Commerce Clause is the federal government's primary default mechanism for regulating state taxation, and may properly be characterized as an intervention as compared to an environment in which state taxation were not subject to any federal control.

In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), the Supreme Court interpreted the dormant Commerce Clause to provide that a state tax must be (1) assessed only against taxpayers with a substantial nexus with the state; (2) fairly apportioned; (3) non-discriminatory (against interstate commerce); and (4) fairly related to the services provided by the state. Taken at face value, these four rules would earn high normative marks. Requiring substantial nexus with the taxpayer, for example, would prevent taxing authorities from chasing *de minimis* sources of revenue and would protect remote taxpayers from burdensome compliance obligations not justified by the taxpayer's connection with the state. The fair apportionment requirement would prevent double taxation, while leaving states with enough taxing authority to avoid situations of under taxation. The prohibition against discrimination against interstate commerce would go far in preventing tax exportation and promoting horizontal neutrality among taxpayers. Finally, the requirement that a tax be fairly related to services provided by the state would seem to promote the benefit principle, which has particular appeal at the subnational level in an open economy, especially when applied to the taxation of businesses (Oakland and Testa, 1996).

In actual application, however, these four tests have served mainly to establish minimum thresholds of acceptability rather than to promote a normative state and local tax regime. In the context of corporate income taxes, for example, the Supreme Court has merely required that a state's apportionment formula not be "inherently" arbitrary (*Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 121 (1920)) or, at best, that it "reflect a reasonable sense of how income is generated" (*Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983)). Under such a forgiving standard, non-uniform apportionment formulae have proliferated,

resulting in over- and under-taxation of corporate income in the aggregate. Similarly, the Court has expressly rejected the notion that the requirement that a state tax be fairly related to the services provided by a state is an embodiment of the benefits principle in an economic sense. Rather, the fairly related test has been interpreted as being akin to the requirement that there be some minimum connection—a substantial nexus—between the taxpayer (or the subject of the tax) and the state (see *Commonwealth Edison v. Montana*, 453 U.S. 609 (1981)).

The Court has shown more teeth in interpreting the anti-discrimination requirement. Indeed, the Court has vigilantly struck down statutes that are facially discriminatory. For example, in *Associated Industries of Missouri v. Lohman*, 511 U.S. 641 (1994), a state statute that required remote taxpayers to impose municipal use tax at a single rate was struck down because some municipal sales tax rates were lower than the surrogate rate, even though the aggregate amount of tax collected by out-of-state sellers would have been lower under the challenged regime.

The Court professes to be equally vigilant in forbidding subtler form of discrimination. Thus, in recent years it has struck down a number of state tax incentive schemes “with rhetoric so sweeping as to cast a constitutional cloud over all state tax incentives” (Hellerstein and Hellerstein, 1998; ¶ 14.13[2][b]). This cloud, however, seems to have done little to chill the enthusiasm for state and local tax incentive legislation. This reflects the legal and practical reality that simply because an incentive scheme may be unconstitutional in theory does not mean that there will be a party sufficiently motivated and with sufficient legal standing to challenge the offending measure in

court. Moreover, even if all potentially discriminatory schemes could receive judicial attention, there is a significant and understandable reluctance on the part of the Court to engage in the kind of economic analysis necessary to show that subtler schemes discriminate against interstate commerce, and many such schemes may pass constitutional muster even if shown to be economically discriminatory. For example, high levels of facially neutral taxation of in-state natural resources—or hotel rooms—might be discriminatory in fact, but have not been held to violate the Commerce Clause under current doctrine. It has generally taken congressional legislation to level the field when this game is played.¹⁰

Interestingly, court action in the U.S. has focused on preventing states from imposing heavier taxes on non-resident activity so that interstate commerce is not discouraged. In principle, however, the economic distortions of tax differentials are the same regardless of whether the instate activity is favored or disfavored. But no action seeks to ensure that interstate commerce is unaffected when the tax liabilities of instate firms are greater than those of remote firms. Such distortions can arise from P.L. 86-272, which can be exploited to ensure that firms operating in a single state market face higher corporate tax burdens than those selling across state lines. States’ inability to require remote firms to collect sales and use taxes creates similar effects. This places states in a very difficult position. They can choose either to collect no revenues from the taxes or to impose the tax and disadvantage domestic firms.

Finally, we come to the Court’s interpretation of the substantial nexus requirement. As noted, one might expect this requirement to establish a reasonable *de minimis* floor beneath which the costs of

¹⁰ For an example of a Congressional anti-discrimination intervention, see the discussion below of the 4-Rs Act.

compliance exceed the benefits of taxation. With regard to sales and use taxes, however, the Court in *Quill Corp. v. North Dakota*, 504 US 298 (1992), adopted a formalistic physical presence standard rather than endorsing a standard guided by a taxpayer's economic connections with a state. As a result, a substantial volume of sales to consumers within a state effectively escapes taxation, with the economically distortive results that one would expect to flow from the *de facto* subsidization of remote selling. As noted above, this is a constitutional rule that compels states either to discriminate against residents (as compared to non-physically present sellers) or to abandon the sales and use tax altogether.¹¹ Although the *Quill* ruling applied only to sales and use taxes, it has given rise to question of whether the physical presence test also applies to other state taxes. Although a number of state courts have held that physical presence is not required for other taxes, the question can only be resolved definitively by the Supreme Court or Congressional action. This uncertainty has increased both the compliance and enforcement costs associated with these other taxes.

Thus, the *Quill* court's implementation of the substantial nexus requirement deviates from our general view that the Commerce Clause sets minimum standards of behavior that in some instances might require supplemental federal legislation. Instead, it goes too far, suggesting another reason for Congressional intervention: enabling states to do what they otherwise could not do under existing Commerce Clause doctrine.¹²

Our criticism of the *Quill* decision is tempered for two reasons. First, the *Quill* court deliberately designed its opinion

to both allow and encourage Congressional intervention on the nexus question. Second, *Quill* itself could be viewed as an implicit and arguably salutary incentive-based (carrot and stick) intervention by the federal judiciary. The stick, of course, is the physical presence test, and the carrot is the decision's implication that the physical-presence test might be "repealed" if the predicate for the *Quill* decision—compliance burdens—were reduced. Indeed, the Streamlined Sales Tax Project (whose major goal is compliance-burden reduction) was formed a mere eight years after the 1992 *Quill* decision, and predecessor cooperative efforts began as early as 1997.¹³

In summary, the dormant Commerce Clause is in most cases a blunt instrument for offsetting inefficiencies of state taxation, and as a result is likely to do a weak job of creating a more efficient tax system. It at best provides a minimum level of protection against overreaching and discriminatory state tax policies, and at its worst has prompted a nexus rule that discriminates in favor of interstate transactions and against local ones. It would not be appropriate, however, to expect more of the dormant Commerce Clause or the federal judiciary. The regulation of state tax policy unquestionably requires the consideration and balancing of a host of economic, political, and social factors, an exercise better suited for the legislative branch of government. It is to those interventions that we now turn.

P.L. 86-272

P.L. 86-272 has been described as "[t]he most important piece of legislation that Congress has enacted limiting the states'

¹¹ Theoretically, the in-state consumer is liable for the tax, but this rule is seldom enforced against individual consumers.

¹² For an example of this genre of intervention, see the discussion below of the Mobile Telecommunications Sourcing Act.

¹³ Perhaps the earliest concerted effort to address these issues was the National Tax Association's Communications and Electronic Commerce Tax Project, which convened in early 1997.

power to tax interstate business” (Hellerstein and Hellerstein, 1998; ¶ 6.16). It is a taxpayer designation rule intervention, providing that a state may not enforce a net income tax against a business whose in-state activities are limited to solicitation (even though the business has earned in-state income). P.L. 86-272 has been widely criticized on tax policy grounds. It has the effect of excluding otherwise taxable income from the tax base, thus violating principals of equity and neutrality. Moreover, it encourages tax planning and the associated economic inefficiencies. For example, it encourages firms to artificially minimize their activities in market states. Curiously, its protection is limited to sellers of tangible personal property, resulting in the non-neutral treatment of service businesses as compared with businesses selling tangible items.

The historical context of P.L. 86-272 and related congressional activity sheds some light on the practical and political realities of federal intervention in state tax policy. P.L. 86-272 itself was a response to a federal judicial intervention. In 1959, the Supreme Court ruled in *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, that there was no Commerce Clause bar to the imposition of a non-discriminatory, fairly apportioned net income tax on interstate businesses. States immediately responded to this liberalization of the dormant Commerce Clause doctrine by amending their tax codes, and Congress with equal speed adopted P.L. 86-272, reacting to business community complaints about the far-reaching consequences of the court’s decision. It was intended as a temporary measure, allowing Congress time to more thoroughly study the problem.

Soon thereafter, there were extensive Congressional hearings addressing the impact of state taxation on interstate commerce, and emanating from those hearings (among other things) was a proposal to require states to adopt a two-factor

(payroll and property) uniform income tax apportionment formula. Fearing congressional intervention, the states quickly moved to form the Multistate Tax Compact, and by the late 1960s, UDITPA (or UDITPA-like apportionment formulas) had been adopted by a majority of the states. Thus, federal legislation mandating a uniform apportionment formula was never enacted, presumably because the states had addressed the problem through the widespread adoption of UDITPA. P.L. 86-272, however, was never repealed.

Here we have both an explicit federal intervention (P.L. 86-272) and a state cooperative effort (UDITPA). In hindsight, we see that the congressional intervention promoted an undesirable tax policy, while the state cooperative effort (spurred by the threat of Congressional intervention) had much to commend it. The differences in effect may be in part because P.L. 86-272 addresses concerns about tax exporting and the need for a *de minimis* nexus rule by eliminating a broad class of taxpayers, and, as with the *Quill* physical presence test, is a very blunt instrument for doing so. UDITPA, on the other hand, adopts a much more nuanced approach (formula apportionment). The UDITPA cartel in the absence of federal intervention and support, however, has ultimately broken down, as states have moved away from a uniform three-factor formula to various non-uniform super weightings of the sales factor. While it is dangerous to draw too strong of a conclusion from our one sample of history, a plausible approach to the *form* of federal intervention would be to draw on both the coercive power of the federal government and the wisdom of the states (i.e., their experience with state tax administration and their sensitivity to state needs and concerns) when trying to guide policy in a normative direction.

The streamlined sales tax movement illustrates this dual approach. Motivated by the Supreme Court’s decision in *Quill*, nearly all states convened to draft the

Streamlined Sales and Use Tax Agreement (SSUTA), which has been implemented in full by 15 member states. The major focus of SSUTA is to reduce the kinds of compliance burdens highlighted by the *Quill* court. It is generally acknowledged, however, that without the adoption of federal legislation that either makes streamlining mandatory and or repeals the *Quill* physical presence test as a reward for compliance with the streamlined system, the streamlined sales tax cartel risks breaking down in the longer run, much as has occurred with *UDITPA*.

THE 4-Rs ACT AND SIMILAR FEDERAL INTERVENTIONS

The Rail Revitalization and Regulatory Reform Act of 1976 (4-R Act) prohibits states from taxing railroad property at a higher rate (whether by means of assessment practices, assessment ratios, or tax rates) than other commercial and industrial property in the same assessment jurisdiction (49 U.S.C. § 11501(b)). Congress extended similar protection to motor carriers in 1980 (49 U.S.C. § 14502), and to air carriers in 1982 (49 U.S.C. § 40116). These interventions might be classified as either targeted rate or base interventions. Partial rate intervention is probably most descriptive, because the ultimate intent of these federal interventions is to prevent the application of a discriminatory property tax rate to the property of interstate carriers.

Though limited in scope, these interventions undoubtedly have the salutary effect of barring states from the (previously) widespread practice of attempting to export a portion of the property tax burden onto interstate carriers, which has perverse consequences for the size of state government and for capital used

in these industries. Interstate carriers are easy targets for tax exportation, because although the capital involved is quintessentially mobile, transportation routes are geographically and economically immobile and captive.

Various counterarguments might be launched against this intervention. For example, it could be argued that the benefits principle supports heavier property taxation of interstate carriers. We suspect, however, that empirical analysis might support the opposite proposition,¹⁴ and this argument is otherwise belied by the motivations that underlay the discriminatory practices that preceded these federal interventions. One might also quibble with the details. For example, should there be parity with residential and agricultural property as well? Are there other classes of immobile property, or “not-in-my-back-yard” (NIMBY) property, that also should be protected? We will not delve into these details here, except to note that the federal government indeed has intervened in several other captive taxpayer situations.¹⁵

Two broad conclusions can be drawn from the 4-Rs Act and related interventions. First, federal intervention may be justified where there is relatively captive economic activity that is subject to discriminatory tax policies that generate negative externalities. Second, as we previously observed, it is unlikely that states will act alone or in concert to correct policies that generate negative externalities unless such cooperation also brings a greater benefit to the state. From the vantage point of each individual state, correction of this type of externality (an excessive toll on interstate carriers) may not generate such a countervailing benefit, because exporting taxes through interstate carriers and simultaneously importing

¹⁴ This analysis would need to consider fuel and other taxes paid by these carriers.

¹⁵ Examples include energy tax discrimination (15 U.S.C. § 391) and bus tickets (49 U.S.C. § 14505) (complete preemption).

taxes imposed by other states on these carriers is a non-transparent means of generating revenues that can offer important political benefits in the states. Also, states that are able to benefit differentially (such as states with large geographic areas and small populations) have little incentive to reach agreements that eliminate these benefits in the interest of enhancing national economic efficiency.

The Internet Tax Freedom Act (ITFA) and Similar Non-Tax Policy Preemptions

Boiled down to its essentials, ITFA (1) codifies (and arguably expands) the physical-presence nexus test as applied to e-commerce and (2) exempts Internet access charges from state taxation.¹⁶ We have already addressed the infirmities of the physical-presence test, and so we focus here on the base intervention aspect of ITFA—the exclusion of Internet access from the consumption tax base.

McLure and Hellerstein (2004) conclude that the case for the ITFA intervention is weak. They identify two principled arguments for exempting Internet access: (a) that the Internet creates external benefits not reflected in the price, and (b) that a tax exemption “helps bridge the digital divide” between poor non-users and affluent users. Regarding external benefits, they consider whether the “network effects” of expanding Internet usage might justify a tax subsidy, but conclude that this and related infant industry arguments are “ludicrous” in view of the widespread and global levels of Internet usage. With regard to the distributional benefits of subsidizing Internet access by low-income households, they observe that an across-the-board exemption (for rich and poor alike) is an extremely costly method of pursuing such a distributional

policy, and because a disproportionate number of Internet users are relatively affluent, the desired distributional effect would not be achieved in any event.

We note in passing that there are other occasions in which Congress has preempted state taxation for non-tax policy purposes. For example, the Employee Retirement Income Security Act (ERISA) preempts state taxes affecting employee benefit plans. This base intervention is normatively supportable as facilitating the federal non-tax policy goals of encouraging employee benefits and retirement savings and planning. The merits of this federal policy objective are beyond the scope of our analysis here. Still, we can observe that another normative justification for federal intervention in state policy is to allow the federal government to effectively speak with one voice in pursuing federal non-tax policy objectives. But, extreme care must be taken when using tax policy to achieve non-tax objectives because a series of unintended consequences is likely to result. For example, the ITFA could result in inefficient bundling of cable and Internet services to avoid imposition of the sales tax. Nevertheless, each particular intervention is subject to evaluation on its own merits.

Mobile Telecommunications Sourcing Act

With the support of both the telecommunications industry and the states, Congress recently adopted the Mobile Telecommunications Sourcing Act (MTSA) (4 U.S.C. § 116). The MTSA allows states to tax all mobile telecommunications services provided that calls are sourced to the customer’s “primary place of use,” which is usually the billing address. A state

¹⁶ IFTA was originally adopted as a temporary moratorium in 1998, but has been twice extended, most recently through November 2007, by Pub. L. No. 108-435 (2004). IFTA also prohibits taxes that discriminate against the Internet.

may not tax mobile telecommunication services unless it follows this federally imposed sourcing rule.

The impetus for this base intervention was the difficulty of administering a system under which mobile calls could only be taxed, as a matter of dormant Commerce Clause jurisprudence, in a state in which the customer's billing address was located *and* from which or to which a call was made.¹⁷ Under this system, for example, a business traveler from State A making a call from State B to State C would not be taxed at all. Further administrative difficulties arose from having to source on a call-by-call basis, particularly when the customer might be paying a flat fee for the service.

This is another example of an incentive-based (carrot and stick) intervention. The carrot is that states are authorized to impose a tax on some transactions that might otherwise escape taxation as a result of dormant Commerce Clause jurisprudence. The stick (which comes close to a mandate) is that they must follow the federally mandated sourcing rules to impose *any tax at all* on these services. The federal intervention was necessary because states, acting on their own, could not overrule the relevant dormant Commerce Clause rule. This appears to be an excellent example of positive, efficiency-enhancing federal intervention. The blunt instrument of the dormant Commerce Clause was likely to lead to differential taxation within the broadly defined communications industry, causing the industry to develop, at least in part, around the ability to tax and not as a result of motivations generated by demand and cost. The resulting federal legislation blended compliance cost concerns with the broader efficiency

aspects of taxation to achieve a reasonably effective outcome.¹⁸

Absent the dormant Commerce Clause bar, it is quite possible that federal intervention might not have been necessary and states might have cooperated in finding a common solution incorporating normatively desirable uniform sourcing rules, assuming that a MTSA-type rule would be relatively revenue neutral¹⁹ and ease the costs of administration. Although much narrower in scope, the MTSA parallels the proposed streamlined sales tax federal intervention, whereby the Congress would "repeal" the existing dormant Commerce Clause bar to state taxation of remote sales in exchange for state participation in the streamlined system.

International Fuel Tax Agreement

The contiguous 48 states and ten Canadian provinces currently are signatories to the International Fuel Tax Agreement (IFTA). IFTA establishes a uniform apportionment and collection mechanism for motor-fuel taxes imposed on motor carriers. IFTA began in 1983 as a cooperative effort among three states out of which developed, through the National Governors Association, a Model Base State Fuel Use Tax Reporting Agreement, to which 16 had subscribed by 1990. Congress then intervened in 1991 by prohibiting states from enforcing fuel-use taxes not in conformity with IFTA. Though it addresses a relatively narrow and discrete tax, IFTA is broad in coverage, imposing a uniform base and apportionment method, a uniform taxpayer definition, and a uniform system of administration (under which taxpayers report to a single base jurisdiction that subsequently makes reconciling

¹⁷ This was the practical result of the Supreme Court's holding in *Goldberg v. Sweet*, 488 U.S. 252 (1989).

¹⁸ Hellerstein and McLure (2004) normatively explore the MTSA in greater detail and concur that it was a desirable federal intervention.

¹⁹ In a world in which all calls could have been taxed. In fact the MTSA enhances aggregate tax revenues because, prior to its enactment, the dormant Commerce Clause blocked the taxation of some calls.

distributions among the member jurisdictions). The individual states retain control over revenues and rates (including exemptions).

Denison and Facer (2005) identify a number of tax policy benefits of IFTA-like arrangements. Most notably, economies of scale and the benefits of administrative and compliance simplification are realized. In addition, neutrality objectives are realized to the extent that interstate cooperation minimizes tax avoidance and compliance costs. At the same time, retention of state control over rates and exemptions allows states to pursue revenue adequacy as well as equity objectives. Finally, although accountability can be enhanced through the delegation of enforcement responsibilities—making the enforcement of a tax more efficient, fair, and transparent—they caution that cooperative agreements like IFTA may need to reserve ultimate audit responsibility to the individual states in circumstances when the state has a legitimate concern about fraud and abuse.

Along with normatively evaluating the IFTA regime, Denison and Facer also consider the empirical lessons that might be learned about the preconditions for successful state tax coordination. First, there was a substantial consensus regarding both the base, the apportionment of the base, and the definition of qualifying taxpayers. Second, the base jurisdiction concept through which the net tax liability is reported to a single jurisdiction (which then reconciles the balances among the member jurisdictions) reduced compliance and administrative costs for both taxpayers and taxing authorities. Notwithstanding these benefits, however, they conclude that federal intervention

may have been essential to getting the full participation of the 48 contiguous states, as well as to achieving such participation so quickly.²⁰

THE FUTURE OF FEDERAL INTERVENTIONS

In this section we evaluate several possible future federal interventions. We then conclude with a cautionary note regarding the risks of pursuing state tax efficiency goals at the national level.

The Streamlined Sales Tax

We have alluded throughout this paper to the streamlined sales tax as an example of a cooperative undertaking among the states with generally salutary effects.²¹ Its immediate goal is to relieve administrative and compliance burdens while at the same time preserving the existing (and varied) tax bases within each state. The SSTP does not address all horizontal externality issues, but seeks to enhance state efforts to levy a destination based sales tax, which will lessen tax induced distortions between domestic and remote sales and reduce the potential for tax competition. A destination-based consumption tax (in its normative form) is generally not amenable to tax competition (Kanbur and Keen, 1993).

The longer-term goal of streamlining, however, is to induce a federal intervention, specifically, Congressional authorization for streamlined states to collect tax from remote vendors, thereby allowing states to enforce destination taxation. Such an intervention would implicate the tax function of taxpayer identification, and also would serve to undo the perverse

²⁰ Still, Denison and Faber note that ten of the provinces of Canada elected to join IFTA without a similar Canadian federal directive.

²¹ Although streamlining might be criticized for not attempting to implement fundamental sales tax reform (for example, by extending the tax to all consumption and excluding business inputs from the base) (McLure and Hellerstein, 2004)).

efficiency effect of the *Quill* physical-presence test, which is to compel states choosing to impose a sales tax to discriminate against *instate* vendors. The streamlined sales tax is undoubtedly a monumental step in the right tax policy direction.

As we suggested earlier, though styled as a state cooperative effort, the lure of federal intervention is in all likelihood what has made streamlining possible. Although one can imagine a world suggested by the International Fuel Tax Agreement (which in the end also benefited from federal intervention) in which states voluntarily cooperate to adopt various uniform and streamlined procedures to facilitate tax administration and compliance, the Streamlined Sales and Use Tax Agreement goes beyond those relatively cost-free measures by requiring that states adopt certain uniform definitions, relax exemption certification standards, and so on. Indeed, it is telling that the streamlining movement stalls whenever it addresses matters with substantive revenue implications, such as the definition of “digital property.”²² The most plausible explanation for the success, to date, of streamlining is that the states have been highly motivated by the fear that electronic commerce would devastate state sales tax revenues and by the hope that a federal intervention would authorize states to compel remote sellers to collect tax. Even in this environment, however, less than 50 percent of the states are SSUTA members, and nearly all of the most populous states remain holdouts. In short, it is doubtful that streamlining could have achieved the limited success it has without the promise of federal intervention, and if such intervention is not forthcoming, the streamlining cartel

risks breaking down or becoming much more limited in scope.

Business Activity Tax Nexus Legislation

Proposals to extend the protections of P.L. 86-272 to services and other types of activity have been introduced in Congress in recent years. Our criticisms of P.L. 86-272 apply equally to these proposals: they would have the effect of excluding otherwise taxable income from the tax base, thus violating the neutrality principle and encouraging tax planning and associated economic inefficiencies. Legislation requesting that Congress extend nexus protection is generally motivated by taxpayer complaints about compliance burdens caused by uncoordinated tax systems. The answer to these complaints is prudent tax coordination reform—such as that which occurred under IFTA and is occurring under the streamlined sales tax—rather than adoption of measures that further exacerbate inefficiencies. Even if tax coordination reform is not achieved, a nexus standard that adopts thresholds that mirror the factors (generally, sales, property and payroll) that are used to apportion income to the states would be more sensible, if even the compliance burdens of an uncoordinated system supported relatively high thresholds. Indeed, the Multistate Tax Commission (MTC) has proposed such a factor nexus standard,²³ and there is no reason in principle why it should not be considered during the upcoming UDITPA reform process, which we next discuss.²⁴

UDITPA Reform

The National Conference of Commissioners on Uniform Laws (NCCUSL) has

²² In theory, states may choose to tax or not tax defined items, but as a practical matter the scope of definitions will affect revenues, as state must choose to either completely tax or not tax a defined item, rather than adopt their own definitional parameters.

²³ The MTC’s factor nexus proposal can be found on the model legislation page of its website, www.mtc.gov.

²⁴ UDITPA does not currently address nexus standards.

resolved to form a study committee to consider revisions to UDITPA, now in its 50th anniversary and sorely in need of revision.²⁵ Although the drafting of uniform laws is a state cooperative effort, the question may (and arguably should) arise during or after the completion of this process as to whether federal intervention would be necessary or useful to prod states to adopt a newly revised UDITPA. As we have noted, there was little state interest in adopting UDITPA until the Congress threatened to impose a uniform apportionment formula on the states (that varied from the UDITPA formula), and it would not be unreasonable to expect the same pattern to emerge again. While states undoubtedly will be reluctant to cede control of business income allocation and apportionment to Congress, weighing in favor of a post-UDITPA revision Congressional intervention is that the uniform laws process is deliberative one, employing numerous checks and balances. In addition, it is a process that will be driven by the states and others with a high level of experience and expertise in state taxation. Thus, the end product might reflect more collective wisdom than that which might be embodied in a measure that is developed solely through the Congressional legislative process.

CONCLUSION

Horizontal and vertical externalities and savings from lower cost administration and compliance offer substantial justification for national intervention in state/local taxation. These arguments for federal influence over state/local taxation are based on the presumption

that national interventions are intended to enhance efficiency. But, other streams of research, such as those found in public choice, argue that the national government does not have incentives to either tax efficiently or undertake efficiency-enhancing corrective actions. The benchmark created by Inman and Rubinfeld is not one of a national government as it would actually operate, but instead is a theoretical construct of efficient, welfare-maximizing centralized taxation. The actual national government confronting a set of political incentives and seeking to tax activity that is also internationally mobile, such as capital, will itself be less efficient than the prototype.²⁶ Further, the national system is less likely to be confronted with the competitive forces that might constrain Leviathan effects and tend to hold tax rates on mobile activity in check while restraining the size of government. The national government can in principle correct for the externalities, but there is plenty of reason to believe that it would fail to create a structure that actually corrects for the externalities as opposed to dealing with their political implications. Thus, we recognize that the decentralized system, with limited national controls, is not necessarily worse than the actual national taxing system that could replace the U.S. federal system or the state/local system that would result from a much heavier national hand.

The experience to date provides mixed evidence on whether federal interventions can be expected to enhance efficiency. The IFTA and MTSA suggest that good interventions are possible, but P.L. 86-272 and the failure thus far to act on the streamlined sales tax indicate that federal

²⁵ This uniform laws project is still in its formative stage and in all likelihood will take several years to be completed. Weissman (2007) offers a critical analysis of the Multistate Tax Commission's rationale for seeking a revision of UDITPA. The substance of UDITPA reform is beyond the scope of this paper.

²⁶ See Keen and Kotsogiannis (2002, 2003) for discussion of some inefficiencies in national government behavior.

responses can be perverse or missing in key areas. Overall, the experiences suggest that effective federal intervention is possible when the broad constituencies are in agreement that the problems need to be fixed, which seems more possible with narrower areas of taxation, such as motor fuels or mobile communications. The experiences are less encouraging across broader areas of taxation, such as corporate and sales tax nexus issues, where broad consensus may not be possible but the need for federal intervention is significant.

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