**RESPONSE**

# How States Risk Their Own Fiscal Stability

*Karen O. Green*[*]

State governments rely on a variety of sources to support spending, including federal grants and tax collections. Typically states raise most of their revenue by imposing a broad range of taxes on personal and corporate incomes, general consumption, and specifically targeted product sales such as fuel, cigarettes, and alcohol.[1] Some states rich in natural resources also generate substantial revenue from the exploitation of those resources.[2] Within these taxation schemes, tax rates vary significantly.[3] However, a small number of states have structured their taxation schemes to wholly eliminate income taxation, general consumption taxes, or both.[4] The decision of some states to eliminate one of these primary taxes has led other states to reconsider their own tax structures in order to achieve a more attractive taxation climate for businesses, industries, or retirees.[5]

The desire of states to attract those individual taxpayers and businesses having the ability to migrate to a more favorable tax climate must be balanced with the need for a stable flow of revenue to insure the state's fiscal integrity. Concerns about the fiscal soundness of states have been heightened by the downtown in the economy and the financial crisis of 2008.[6] It would be difficult to have missed the barrage of commentaries in the media on the fiscal crisis in state governments and the particular focus on the budget woes of California and New York.[7]

What then can state legislators learn from Professor Herwig Schlunk's article *Why Every State Should Have an Income Tax (and a Retail Sales Tax, Too)*?[8] Fortunately, quite a lot. Professor Schlunk makes the case for a balanced system of state taxation employing both income taxes and broad based consumption (sales) taxes in order to produce stable tax revenue over time. He argues that only a balanced system, which includes both income taxes and general sales taxes, will yield a

---

[*] Professor of Law and Mississippi Defense Lawyers Lecturer-in-Law, University of Mississippi School of Law.

[1] Gerald Prante, *Where Do State and Local Governments Get Their Tax Revenue?*, TAX FOUNDATION, Oct. 9, 2009, http://www.taxfoundation.org/publications/show/25301.html.

[2] These states include Alaska and Wyoming.

[3] TAX FOUNDATION, 2008 FACTS & FIGURES tbls.14-19 (2008). For example, states sales tax rates in 2007 ranged from 2.9% in Colorado to 7.25% in California. The highest individual income tax rate in 2008 was 10%, imposed in California on taxable incomes in excess of $1,000,000. In contrast, the state of Illinois imposed a low flat rate of 3% on federal adjusted gross income (with modifications).

[4] Those states imposing no tax on individual incomes include Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. Those imposing no general sales tax are Alaska, Delaware, Montana, New Hampshire, and Oregon. *Id*. at tbls.14, 18.

[5] ARTHUR B. LAFFER & STEPHEN MOORE, RICH STATES POOR STATES 51-54 (2007).

[6] In the second quarter of 2009, state income tax collections were down 27.5% and sales tax collections were down 9.5%, according to the New York Times. Michael Cooper, *States Lag in Recovery, Report Finds*, N.Y. TIMES, Oct. 15, 2009, *available at* httpp://www. nytimes.com/2009/10/15/us/15states.html?_r=1. *See also* Lucy Dadayan & Donald J. Boyd, *Recession or No Recession, State Tax Revenues Remain Negative*, 78 STATE REVENUE REPORT 1-7, (Jan. 2010).

[7] *Escape from New York*, WALL ST. J., Oct. 28, 2009, at A22; *A California Quake*, Wall Street J., Sept. 30, 2009, at A22.

[8] 78 MISS. L.J. 637 (2009).

stable flow of revenue over time given the ability of taxpayers to strategically migrate to the state having the more favorable structure in terms of costs (taxation) and benefits (spending).

To analyze this question, Professor Schlunk creates a simple model on state taxation and spending for exploring the impact of strategic migration, using three hypothetical states, one imposing income tax only, a second imposing general sales tax only, and a third adopting a combined income tax and sales tax structure. He illustrates the effects on a state's fiscal health in three examples. His initial model, which assumes that the cost of goods and services do not vary over time, is designed so that each state produces sufficient tax revenue to yield exactly the amount needed to pay for goods and services provided to income producers and consumers, regardless of the taxpayer's decision to spend now or invest and spend later.[9] The model thus suggests that states might expect stable revenue regardless of the type of taxation chosen to fund the state's spending.[10] However, the model is altered to illustrate that, where the cost of goods and services provided varies over time, the effect can be a budget surplus (overcharging of the taxpayer) in the income-tax-only state or a budget deficit (undercharging of the taxpayer) in the sales-tax-only state.[11] Thus, the model holds that only in the state adopting a combined income and sales tax structure will revenue and spending continue to match.

A more marked difference is illustrated in his third example in which each state is assumed to be populated by two taxpayers. The first taxpayer initially generates income, then invests and spends later, while the second taxpayer initially borrows to spend and generates income later to repay the borrowed funds. The model now illustrates that, within an income tax only structure, wealth is transferred from the income-generating taxpayer to the consumer; within a sales tax only structure, wealth moves from the consumer to the income-generating taxpayer.[12]

Assuming that taxpayers are mobile, Professor Schlunk concludes that taxpayers may migrate to the state yielding the most favorable cost/benefit given the taxpayer's characteristics as a net income producer, a net consumer, or neither.[13] He then modifies his model to illustrate how each of these individual taxpayers might move strategically to obtain the largest amount of goods and services (spending) for the least amount of costs (taxation).[14] The resulting composition of the population in each of the three states after two waves of migration starkly supports Professor Schlunk's conclusion that "a lingering effect of a state's attempt to impose asymmetric taxes is that such state attracts disproportionate numbers of individuals who disproportionately benefit from its asymmetric tax structure."[15]

---

[9] *Id*. at 649-51. The model assumes a 3% interest rate for investment by the taxpayer or government over a period of 23.5 years.
[10] *Id*. at 652.
[11] *Id*. at 652-55. The model assumes tax rates are reduced over time.
[12] *Id*. at 655-57.
[13] His model examines the behavior of three taxpayers: an average taxpayer (earns the average income and consumes the average amount); a net income producer (earns 10% more income than average and consumes 10% less than average); and a net consumer (earns 10% less than average and consumes 10% more than average).
[14] *Id*. at 657-68.
[15] *Id*. at 667.

Clearly, there are complicating factors that may reduce the benefits of a taxpayer's decision to migrate for tax and spending benefits not addressed in Professor Schlunk's model. The article examines some of these in the context of a comparison between the tax and spending characteristics of Tennessee,[16] a state relying primarily on consumption based taxes, with the balanced approaches of income and sales taxation in Kentucky and Georgia.[17] Specifically looking at the benefits of increased state spending through federal grants, the federal subsidy for certain state taxes through the federal income tax deduction,[18] and the effects of local government taxation and spending, Professor Schlunk finds little impact from these factors on the predictions of his general model.[19] Therefore, he concludes that income-generating taxpayers will likely migrate to Tennessee, while consumers (such as retirees) will likely favor Kentucky or Georgia.[20]

If Professor Schlunk is correct in concluding that only states having both an income tax and a general sales tax can expect stability in revenue flows, why then do some states continue to consider elimination of state income tax? Undoubtedly, states want to position themselves as offering the most attractive climate for businesses and industries in terms of a variety of factors including taxation. Indeed, organizations such as the Tax Foundation[21] and economic experts such as Arthur Laffer advocate reduction or elimination of the income tax.[22] The basis for their position is that the loss of this tax revenue due to tax cuts will be recouped many times over through capital investment in the state and the creation of jobs. In turn, per capital incomes will increase and demand for goods and services will grow. Thus, in the end, the state's revenue will increase as a consequence of the reduction or elimination of income taxes.[23]

Professor Schlunk agrees that, in some situations, imposing income tax on certain residents is inappropriate. State spending may not benefit a particular taxpayer's production of income. This is particularly true for a passive investor whose assets are not located within his state of residence. Passive investors, holding corporate stock and/or corporate debt instruments, are effectively taxed though corporate income taxes in the state(s) in which the corporation is located or does business. The author's position here may account for the fact that retirees may be both in-migrators and out-migrators in states relying more heavily on income taxes. Professor Schlunk points out that retirees who are passive investors are more likely to migrate out of these states while retirees without assets,

---

[16] Individual income taxes are imposed only on dividends and interest income. In contrast, Tennessee imposes a general sales tax of 7%, which is among the highest rates of state sales taxation. TAX FOUNDATION, *supra* note 3, tbls.14, 18.
[17] Georgia and Kentucky impose general sales tax at the rates of 4% and 6%, respectively. Both impose a broadly applicable income tax at graduated rates of up to 6%. *Id*.
[18] I.R.C. §164 (a)(3) (2008). The federal income tax benefit flowing from the deduction of state income taxes may be reduced or eliminated under other provisions of the code including the alternative minimum tax. *Id*. §§ 55, 56.
[19] Schlunk, *supra* note 8, at 671-87.
[20] *Id*.
[21] The Tax Foundation publishes an annual report with an index ranking for states based on each state's individual ranking in the areas of corporate income and individual income taxation, sales and use taxation, unemployment taxation, and property taxes. *See* Curtis Dubay & Chris Atkins, *2008 State Business Tax Climate Index*, 57 BACKGROUND PAPER 1 (Oct. 2007).
[22] LAFFER & MOORE, *supra* note 5, at 30-38.
[23] *See* Barry W. Poulson & Jules Gordon Kaplan, *State Income Taxes and Economic Growth*, 28 CATO J. 53 (2008). The authors find that lower marginal rates of state taxation were associated with higher rates of economic growth over the period of 1964 to 2004.

thus having little taxable income, are more likely to migrate into these states.[24] However, there may be another reason for migration by retirees into states relying heavily on income taxes. The vast majority of states exempt at least some portion of retirement income, including payments from Social Security, public pensions, private pensions, and 401(k) or similar plans.[25] These exemptions, like tax credits and tax rebates for business and industry, are designed to attract retirees to migrate into a state.

Professor Schlunk does not base his case for a combined income and sales tax system of taxation on the idea that a balanced system in and of itself will produce a more stable flow of revenue.[26] Indeed, however, this may be the more important question for examination. Ultimately, a state must determine what structure will likely produce the most stable system for generating revenue. This structure must change over time to produce an equitable division of the tax burden and such structure may not resemble that of the past or the present. For example, states already face challenges in the proper application of the sales tax given the evolution of our economy from a manufacturing based economy to a services economy and the growth of sales conducted over the internet.[27] Despite these challenges, we should not lose sight of an important point in the article about the role of taxation in creating economic opportunities and its resulting benefits to a state and its residents. Efficient state spending allows taxpayers to produce more income and buy more goods, since state expenditures provide benefits that would be more costly if provided by the taxpayer himself. Thus, there is a net benefit to income producers and consumers from having these services provided by the state and funded through equitable taxation on both groups of taxpayers.[28] How a state achieves equitable taxation and a stable flow of revenue will be the formidable challenge.

[24] Schlunk, *supra* note 8, at 701-03.

[25] AARP PUBLIC POLICY INST., STATE TAXATION OF SOCIAL SECURITY AND PENSIONS IN 2006 8-15 (Nov. 2007).

[26] Schlunk, *supra* note 8, at 639. An interesting study looked at the volatility of revenues in the context of Georgia's local sales tax option which permits local governments to replace a portion of property taxes with local sales taxes, concluding that local sales taxes are associated with increases in the volatility of revenues in the short-run. Yilin Hou & Jason S. Seligman, *LOST Stability? Consumption Taxes and the Cyclical Volatility of State and Local Revenue* (Nov. 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1029697.

[27] *See* Kirk Stark, *Florida Services Tax: The Uneasy Case for Extending the Sales Tax to Services*, 30 FLA. ST. U. L. REV. 435 (2003).

[28] Schlunk, *supra* note 8, at 641-45.