Pandemic Dos And Don'ts Of State Tax Policy: SALT In Review

Law360 (May 1, 2020, 1:41 PM EDT) — The novel coronavirus pandemic presents state and local governments with a conundrum like no other. They face significant revenue shortfalls and massive budget deficits. States will have to raise taxes, reduce spending or some combination of the two. On the spending side, states are unlikely to cut spending on health care during a pandemic. They may reduce or delay spending on education and transportation. They will attack waste, fraud and abuse, but there is not a lot of money there. Most states will not be able to resolve this financial crisis by cutting spending.

Most public finance experts I have spoken to think states will have to raise taxes. Part of the quandary is in determining how to do that. This public financial crisis may be different. The fundamentals of the economy before the pandemic were strong. There is a strong possibility that the economy will rebound once the public health risks dissipate. Some types of taxes will deter the economic recovery, but others will have a less deleterious effect. Here is what states should and should not do to deal with likely shortfalls in 2020 and 2021.

Policies to Avoid

Many politicians in states needing money are instinctively drawn to bad tax policy. Certain taxes will curb the recovery. Those policies should be avoided.

First, wherever possible, states should refrain from taxing business entities to close the budget gaps. Business taxation takes many forms, but the two most harmful in the current environment are corporate income and gross receipts taxes. Corporate income taxes are generally ineffective and inefficient ways to raise revenue. They have never raised much revenue, even in years with booming economies. The tax has never raised more than 5% of state tax revenue, and it has raised a much lower percentage of total revenue. Interstate and international competition and a plethora of planning opportunities keep corporate tax revenue in check.

Moreover, research shows that the state corporate income tax falls to an extent on labor in the form of higher wages and on consumers as higher prices. To be sure, the tax falls on shareholders in the form of lower returns. But taxing labor and consumption at a time of high unemployment and dismal retail sales is an unattractive option.

Some states will be tempted to join a handful of states and adopt a gross receipts tax. Virtually all public finance experts consider gross receipts taxes unsound policy choices. Such a tax is inevitably passed on to the consumers as higher prices. The ultimate result is lower consumption. Furthermore, the tax is not tied to profits. Struggling companies, and there will be many in the wake of the crisis, will be subject to tax.

The gross receipts tax falls hardest on businesses with high volume and low margins. The retail industry, along with many other consumer facing-businesses, has thin margins. Thus this tax will likely hit the segments of the economy that have been affected most during the economic downturn.

Gross receipts taxes are unsound policy choices; they are particularly unsound during a recession.

Second, states should avoid calls to levy state-level wealth taxes to pay for public COVID-19 costs. The argument is that the very wealthy have weathered the economic downturn better than the rest of the country. That is true, of course. But placing a tax on the value of assets cannot be effectively accomplished at the state level. Few countries place taxes on wealth, and subnational governments cannot impose such taxes. They are simply too difficult to administer and enforce. Most assets held by the wealthy are intangible. Identifying assets and calculating wealth is difficult. Furthermore, there are too many opportunities for people to avoid the tax. The wealthy will move assets or just move.

Third, states should avoid general sales tax increases. During past recessions, states have often raised sales tax rates to close budget gaps. Because the sales tax falls broadly on consumption, states should resist pursuing such policies. As malls and stores closed across the country, personal consumption fell significantly. The economy will need people to shop again. Broad-based sales taxes are generally sound ways to raise revenue, but they curb consumption. States should not impose taxes that will effectively lower buying. A sales tax rate increase could raise substantial amounts of revenue, but the cost of curtailing consumer spending – a prolonged economic downturn – is not worth that revenue.

Here Is What to Do

States will quickly exhaust their nontax options for balancing their budgets. States will spend rainy day funds. They will make short-term budget cuts: hiring freezes, furloughs and delayed spending. State and local governments may or may not get additional federal aid. Most states, though, will need to raise additional revenue over the next two years to balance their budgets.

The first thing states needing money should do is temporarily increase the top tax rates on high-income residents. In the 41 states with broad-based personal income taxes, this would be the fairest and most effective way to raise revenue. The personal income tax has many advantages. Two of the most important, for purposes of this discussion, are fairness and the ability to raise large amounts of revenue quickly in an improving economy.

Those earning high incomes have largely escaped the harshest economic impacts of the pandemic. Higher-income taxpayers have been more likely to keep their jobs and to work remotely. It is the lower-income taxpayers who have suffered the brunt of the economic duress – those who work in restaurants, hotels, retail. A strong argument, a politically salable argument, can be made that those who have survived the economic downtown should be asked to contribute to the recovery.

The personal income tax can raise large amounts of revenue efficiently and effectively. Once the health risks abate, the economy will presumably rebound. The personal income tax is elastic, far more than any other state tax. A personal income tax increase on high-income taxpayers will raise substantial revenue in relatively short time.

The design of such a tax increase, which will vary from state to state, depends on many factors but mostly on actual revenue needs. The increase should fall only on the top earners. Some states may decide to impose a higher rate on annual income over $100,000; other states may choose a greater income threshold, say, $250,000.

It is crucial that the tax increase be temporary. Permanently raising taxes on the wealthy will not work practically or, in many states, politically. There must be an automatic sunset provision after one or two years. I am generally not in favor of high personal income taxes, but a temporary rate increase on those who have weathered this crisis the best is fair.

Raising income taxes is not an option in Texas, Florida, Nevada or other states with no levy on income. Yet these states, heavily dependent on sales taxes, also face large deficits. In oil- and gas-producing states, the crisis is aggravated by falling energy prices.

There are ways that sales-tax states can raise revenue without significantly curtailing the recovery. As noted, a general sales tax increase is not a good idea. The one area of consumption that has actually increased during the pandemic, however, is digital goods and services. Currently, 29 states tax digital goods and services in some manner. But definitions of what is taxed vary significantly. Some states tax these goods narrowly, some states have broad bases.

Sales taxation of digital goods and services is consistent with sound tax policy. The sales tax should fall on all final consumption. There is no tax or economic reason to tax a sweater or a toaster but exempt an e-book. Exempting digital goods results in greater sales tax burdens on other consumption, creating economic distortions. Most important, exempting digital goods and services results in a lot of lost revenue.

Although expanding the sales tax base to include digital goods is sound policy, states should be aware of legal and policy issues presented by such expansion. From a policy perspective, to the extent possible, business purchases of digital goods and services should be exempt because business inputs should never be subject to sales tax. Thus states should avoid policies such as those proposed in Maryland, Nebraska and New York, to target digital advertising services – purchases made exclusively by business. Legally, states should be careful not to run afoul of the Internet Tax Freedom Act , which prevents the taxing of digital goods when nondigital goods are not taxed.

Sales-tax states needing revenue should consider expanding the base to include more services. This is more difficult politically, particularly with respect to professional services. But like digital goods, personal consumption of services should be subject to sales tax. We are a service economy; exempting services from the tax base makes no sense. This is an issue long debated. We know the obstacles to taxing services. States should expand the sales tax to apply to all services, professional and nonprofessional, but should expressly limit those taxes to personal consumption. Most professional services are purchased by business entities; those services should be explicitly exempt from tax. This will raise less revenue, obviously. But it will also blunt some of the intense political opposition to sales taxes on professional services. Most states do not subject most services to sales tax. The current budget crisis should be a catalyst for changing that.

Finally, states should consider raising gas taxes. Since most states earmark gas taxes for transportation, an increase will not affect the overall budget. But there has never been a better time to increase the tax. Lower demand has caused oil prices and consequently gas prices to plummet. States are raising significantly less gas tax revenue. And while Americans are driving less, many transportation costs remain constant. With low gas prices, there is unlikely to be significant political opposition to fuel tax increases.

Conclusion

These proposals have the best chance to raise revenue without severely curbing an economic recovery. Political leaders, for now, should resist the temptation to use the tax laws to advance other goals. There will be proposals to give tax breaks to some industries. There will be attempts to address income inequality. There will be attempts to tax products that some think should not be consumed. The political focus, though, should be on balancing budgets while fostering economic recovery.

by David Brunori

David Brunori is a senior director at RSM US LLP in Washington, D.C., a research professor at The George Washington University and a regular contributor to Law360 Tax Authority.