University of Michigan Journal of Law Reform

Volume 55

2022

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Recommended Citation

David Gamage, Darien Shanske, Gladriel Shobe & Adam Thimmesch, *Weathering State and Local Budget Storms: Fiscal Federalism with an Uncooperative Congress*, 55 U. MICH. J. L. REFORM 309 (2021).
Available at: https://repository.law.umich.edu/mjlr/vol55/iss2/3

https://doi.org/10.36646/mjlr.55.2.weathering

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WEATHERING STATE AND LOCAL BUDGET STORMS: FISCAL FEDERALISM WITH AN UNCOOPERATIVE CONGRESS

David Gamage, Darien Shanske, Gladriel Shobe & Adam Thimmesch*

ABSTRACT

Throughout most of 2020, state and local governments faced severe budget crises as a result of the COVID-19 pandemic. Increased demand for state welfare services and rising state expenses related to controlling the spread of COVID-19 stretched state and local budgets to their breaking points. At the same time, layoffs, business closures, and social distancing measures reduced states' primary sources of tax revenues. The traditional practice of American fiscal federalism is for the federal government to step in to provide aid during a national emergency of this magnitude, because state and local governments lack the federal government's monetary and fiscal powers. But during the 2020 national emergency, the majority coalition in control of Congress was skeptical of this traditional practice, leaving federal aid limited and insufficient.

Late in the day, and after a change of Presidents and in partisan control of the Senate, the federal government did eventually step in to provide substantial aid to state and local governments at the beginning of 2021. But, during 2020, it was not at all clear that this would occur. Regardless, due to heightened partisan polarization and related factors, it seems highly likely that future national emergencies will occur during times in which the federal government is again controlled by a majority coalition skeptical of the federal government's traditional role of providing aid to state and local governments during downturns.

This Article thus proposes a series of innovative state tax reform measures and other related reform proposals for modernizing states' outdated tax bases and crisis-proofing American institutions of fiscal federalism. These proposals were initially designed as reforms to mitigate the harmful state and local budget consequences of the COVID-19 pandemic. But a central role of legal scholarship should be to develop law reform solutions for legislatures and for other policymakers to prepare for future emergencies when those solutions may be urgently needed. To that end, this Article elaborates on and memorializes proposals initially developed for the 2020 crises, so that these proposals might be further developed to be ready as potential responses for future crises in which the federal government might once again prove unwilling to act sufficiently.

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INTRODUCTION

Periodic state and local budget crises are a fact of modern economic life.[1] In the American system of fiscal federalism, states and localities

1. *See, e.g.*, Ruth Mason, *Delegating Up: State Conformity with the Federal Tax Base*, 62 DUKE. L.J. 1267, 1308 (2013) ("Although most states have rainy-day funds to help them navigate economic downturns, these funds are often insufficient to cover gaps. Because they cannot deficit spend, . . . [i]f a state is unable to raise taxes to maintain revenue, it must cut spending."); David

are at the forefront of providing basic government services, but they do so without possessing the monetary or financial powers of the federal government.[2] This design has worked well enough in ordinary times, and traditionally in national emergencies (at least since the 1930s), the federal government took the lead in providing the additional funds needed to weather crises.[3] In more recent decades, however, one of the two major political parties has become increasingly averse to the federal government providing financial support to state and local governments, even during national emergencies.[4]

This raises questions about how state and local governments should cope during major economic crises that occur while Congress is controlled by a majority coalition unwilling to provide sufficient federal aid. The recent COVID-19 pandemic and resulting economic crises especially brought these questions to the forefront. Throughout most of 2020, the pandemic simultaneously increased demands on state and local services while also dramatically reducing state and local tax revenues—a perfect storm creating extreme financial pressures for state and local governments.[5] States evaluated many ways to close their budget gaps, including tax increases, social service cuts, and layoffs.[6]

Gamage, *Preventing State Budget Crises: Managing the Fiscal Volatility Problem*, 98 CALIF. L. REV. 749, 749 (2010) ("State governments have been on a fiscal rollercoaster in recent years.").

2. *See generally* David Gamage & Darien Shanske, *Tax Cannibalization and Fiscal Federalism in the United States*, 111 NW. UNIV. L. REV. 295, 302–03 (2017); David A. Super, *Rethinking Fiscal Federalism*, 118 HARV. L. REV. 2544, 2551–61 (2005).

3. Super, *supra* note 2, at 2575–76. Super explains how the "[t]he New Deal amended our implicit fiscal constitution by recognizing a new federal responsibility to provide countercyclical assistance" and then laments how support for this "role [of the federal government] has been under fire since the Reagan Administration." *Id.*

4. *See, e.g.*, Amy Liu & Mark Muro, *Republicans Should Care About State and Local Financial Relief in This Crisis*, HILL (Dec. 7, 2020, 2:00 PM), https://thehill.com/opinion/finance/529052-republicans-should-care-about-state-and-local-financial-relief-in-this-crisis [https://perma.cc/L9ZS-2RS7] (discussing and criticizing "resistance to state and local aid from Republicans"); *National Governors Association Outlines Need for 'Additional and Immediate' Fiscal Assistance to States*, NAT'L GOVERNORS ASS'N (Apr. 11, 2020), https://www.nga.org/news/press-releases/national-governors-association-outlines-need-for-additional-and-immediate-fiscal-assistance-to-states/ [https://perma.cc/8RYH-QZ4Q] (criticizing Congress in April 2020 for not providing sufficient aid); *see also* David Scott Louk & David Gamage, *Preventing Government Shutdowns: Designing Default Rules for Budgets*, 86 U. COLO. L. REV. 181, 185, 203 (2015) (discussing the "new fiscal politics" and the "rise of conservative anti-tax ideology" more generally); David Gamage, *Comments on Daniel Shaviro's Tax Reform Implications of the Risk of a U.S. Budget Catastrophe*, 50 U. LOUISVILLE L. REV. 599, 599–600 (2012) (discussing how the rise of anti-tax ideology in the Republican party now obstructs bipartisan compromises in regard to fiscal policy of the sort that was common in the 1980s and prior).

5. *See* Gladriel Shobe, David Gamage, Daniel J. Hemel, Ruth Mason & Darien Shanske, *Introducing Project SAFE (State Action in Fiscal Emergencies)*, TAX NOTES STATE (Apr. 27, 2020), https://www.taxnotes.com/featured-analysis/introducing-project-safe-state-action-fiscal-emergencies/2020/04/23/2cfvf [https://perma.cc/T5T9-NNK7]. This Article is a compilation and elaboration of policy recommendations and analysis developed by the authors through their work on Project SAFE, major portions of which have previously been written up in draft form in blog posts and published as short essays in Tax Notes State. *Id.*

6. *Id.*

Layoffs were, of course, one of the quickest ways for state and local jurisdictions to save money, and layoffs indeed occurred in great numbers across the country.[7] This is especially troublesome because layoffs and cuts to services exacerbate economic crises by taking money and support out of the economy just when it is needed most. Even worse, these cuts come at the worst possible time for the state employees who lose their jobs and for the rising number of state residents who depend on public services.

Anticipating that federal assistance would be insufficient in 2020, this Article's authors, along with others across the country, launched and participated in Project SAFE (State Actions in Fiscal Emergencies), an academic effort to help states mitigate the 2020 fiscal crises by providing research-backed policy recommendations.[8] This Article grows out of that work.

As this Article goes to press, partisan control of both Congress and the Presidency have switched, and substantial federal aid has been provided to states and localities. But there is every reason to expect that the future will bring new economic crises at times when the majority coalition in control of Congress is unwilling to provide much in the way of federal aid. This Article thus explains and memorializes the most important research and policy reform conclusions that the authors developed through their work on Project SAFE. In this way, we hope that this Article will spur further academic research on how state and local governments can respond to future economic crises in the absence of sufficient federal aid. We further hope that this Article will inspire academic research on how federal and state institutions can be improved, to hopefully prevent these problems from reoccurring in the future, or at least to mitigate the harmful consequences if they do.[9]

As a general matter, we argue that states should take a multipronged approach to emergencies. First, states should not respond to fiscal crises by imposing costs on those who can least afford it. Second, states should not give up revenue through automatic, or poorly considered, conformity with the kinds of changes to federal tax law that often accompanies crises, such as bonus depreciation. Third, rather than conform with money-losing federal tax provisions, states should consider whether or not there are ways to conform with federal law in strategic revenue-raising ways that are also consistent with good tax policy. An example of such a reform in the current context would be

7. *See* Patricia Cohen, *In Blue States and Red, Pandemic Upends Public Services and Jobs*, N.Y. TIMES (Dec. 4, 2020), https://www.nytimes.com/2020/12/04/business/economy/state-local-finances.html [https://perma.cc/C8DG-FML8].

8. Shobe et al., *supra* note 5.

9. For examples of the sort of research that we hope to inspire more of, see, e.g., Galle & Stark, *Beyond Bailouts: Federal Supports for State Rainy Day Funds*, 97 IND. L.J. 599 (2012); Gamage, *supra* note 1.

imposing a surcharge on the regressive tax break given by IRC 199A (the so-called pass through deduction) at the federal level.[10] Fourth, states should make changes to their tax systems that are already long overdue. For instance, states should broaden their sales tax base to account for changes in the economy and better reflect modern consumption patterns. Fifth, states should leverage any new revenue-raising reforms through borrowing so that they can have the revenue they need to get through the crisis. Sixth, states should explore federal tools and institutions other than Congress when looking for support. As such, we consider how the Federal Reserve might be able to expand its lending to states to alleviate state-level economic crises.[11]

Part I of this Article starts with an introduction to the immense fiscal pressures that states faced during 2020 and the insufficient congressional responses to those problems. Parts II through V explain a variety of proposed approaches for states to best respond to problems of this sort. Part II focuses on state corporate income tax reforms, Part III focuses on state personal income tax and wealth tax reforms, Part IV focuses on state sales tax reforms, and Part V focuses on ways in which states can borrow needed funds. Part VI then analyzes another source of potential relief for states: the Federal Reserve. Although states and localities generally eschewed the help offered by the Federal Reserve throughout 2020,[12] we explain how restructuring the existing loan program for states could be helpful in the future.

I. BACKGROUND

Throughout most of 2020, the COVID-19 pandemic sharply increased demand for state and local services and dramatically reduced state and local tax revenues. States depend primarily on income and sales tax revenue to fund state services such as education, healthcare, and public welfare programs, all of which experienced increased costs

10. I.R.C. § 199A.

11. Another example would be, in effect, to borrow from the federal government through reform of state unemployment insurance systems. *See generally* Brian D. Galle, David Gamage, Erin Scharff & Darien Shanske, *States Should Quickly Reform Unemployment Insurance*, TAX NOTES STATE (May 4, 2020), https://www.repository.law.indiana.edu/cgi/viewcontent.cgi?article=3893&context=facpub [https://perma.cc/X82K-5ZLD].

12. *See* Alan Rappeport & Jeanna Smialek, *Clash over Municipal Loan Program Delays Stimulus Report*, N.Y. TIMES (Oct. 10, 2020), https://www.nytimes.com/2020/10/09/business/congress-municipal-loan-oversight-coronavirus.html. [https://perma.cc/7N3N-PX8A] ("While it has been expanded several times to make more borrowers eligible, the program offers loans at relatively high interest rates, making it an expensive option for all but the hardest-hit states and localities. So far, only Illinois and the Metropolitan Transportation Authority, which operates New York City's subway system, have used it.").

because of the pandemic.[13] Yet, at the same time, income tax revenue plummeted because of the rise in unemployment.[14] Sales tax revenue, which generates about one third of state own-source revenue,[15] similarly declined due to closures of nonessential businesses and social distancing restrictions that prevented most retailers from operating at full capacity.[16]

As state revenue collapsed, state expenses swung in the opposite direction. Over forty percent of states' expenditures go to public welfare programs, such as Medicaid, Temporary Assistance for Needy Families, and Supplemental Security Income, which are funded by a mix of state and federal dollars.[17] Enrollments in, and state expenses related to, these programs rose during the pandemic.[18] States also help fund K-12 and higher education.[19] State education expenses similarly rose due to costs related to mitigating the spread of COVID-19 in schools, thereby further straining state budgets.[20]

Estimates indicated that states and localities would face shortfalls of at least $330 billion over two years during the pandemic.[21] These estimates represented massive shortfalls, especially in light of the expiration of federal aid programs and rising pandemic-related state

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13. *See* Shobe et al., *supra* note 5.

14. *See* Michael Leachman & Elizabeth McNichol, *Pandemic's Impact on State Revenues Less Than Earlier Expected but Still Severe*, CTR. ON BUDGET & POL'Y PRIORITIES (Oct. 20, 2020), https://www.cbpp.org/research/state-budget-and-tax/pandemics-impact-on-state-revenues-less-than-earlier-expected-but [https://perma.cc/F46F-GZDU] (showing estimates by Moody's Analytics of shortfalls totaling $450 billion to $650 billion and explaining their own estimates of shortfalls totaling $480 billion to $620 billion, all over a two year period); Kate Davidson & David Harrison, *Coronavirus-Hit State Budgets Create a Drag on U.S. Recovery*, WALL ST. J. (Aug. 12, 2020), https://www.wsj.com/articles/coronavirus-hit-state-budgets-create-a-drag-on-u-s-recovery-11597224600 [https://perma.cc/HCV6-TKDV].

15. *See The State of State (and Local) Tax Policy*, TAX POL'Y CTR. (May 2020), https://www.taxpolicycenter.org/sites/default/files/briefing-book/specific_state_and_local_taxes_1.pdf [https://perma.cc/ZAV4-QK6E].

16. Lucy Dadayn, *The COVID-19 Effect: State Sales Tax Receipts Shrank $6 Billion in May*, TAX POL'Y CTR. (July 14, 2020), https://www.taxpolicycenter.org/taxvox/covid-19-effect-state-sales-tax-receipts-shrank-6-billion-may [https://perma.cc/3DSC-KVEK].

17. *State and Local Expenditures*, URB. INST. (Feb. 3, 2020), https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/state-and-local-backgrounders/state-and-local-expenditures [https://perma.cc/68C7-KBAE].

18. *See, e.g.*, Sarah Kliff, *Medicaid Enrollment Surpassed 80 Million, a Record, During the Pandemic*, N.Y. TIMES (June 21, 2021), https://www.nytimes.com/2021/06/21/upshot/medicaid-enrollment-surpassed-80-million-a-record-during-the-pandemic.html [https://perma.cc/V5CR-EDW9].

19. Melanie Hanson, *U.S. Public Education Spending Statistics*, EDUC. DATA INITIATIVE (Aug. 2, 2021), https://educationdata.org/public-education-spending-statistics [https://perma.cc/5UN9-L96Y] (reporting that state and local governments provide about 92% of education funding).

20. *See, e.g.*, Ketra L. Rice, Gabrielle F. Miller, Fátima Coronado & Martin I. Meltzer, *Estimated Resource Costs for Implementation of CDC's Recommended COVID-19 Mitigation Strategies in PreKindergarten Through Grade 12 Public Schools—United States, 2020–21 School Year*, CTRS. FOR DISEASE CONTROL & PREVENTION (Dec. 18, 2020), https://www.cdc.gov/mmwr/volumes/69/wr/mm6950e1.htm [https://perma.cc/8FE3-6QF8].

21. *See* sources cited *supra* note 14.

expenses.[22] These shortfalls were especially problematic for states, because state governments operate under balanced budget requirements.[23] These balanced budget requirements almost uniformly require states to balance their projected expenditures and revenues, preventing states from deficit spending in times of economic downturn.[24] Thus, during a recession, almost all states need to either cut costs or bring in more revenue, through increased state taxes or federal aid. In contrast, the federal government regularly spends more than its revenues, especially in times of recession, without violating any constitutional or statutory rules.[25]

The federal government *did* act to an extent throughout 2020 to provide some aid to state and local governments. However, that federal aid came primarily in the form of earmarked funds to mitigate states' increased expenditures, not unrestricted aid to help with state tax revenue shortfalls. Specifically, on March 18, 2020, in the early days of the pandemic and in light of increased state Medicaid expenditures to treat COVID-19, the Families First Coronavirus Response Act provided that the federal government would temporarily increase its share of Medicaid expenses by 6.2 percentage points, decreasing states' Medicaid expenditures.[26] Within days, it became apparent that the federal government needed to take additional action, and on March 27, 2020, Congress passed the Coronavirus Aid, Relief, and Economic Security (CARES) Act.[27] The $2.2 trillion act—which included the Paycheck Protection Program (PPP), $1,200 direct stimulus payments, and enhanced unemployment insurance—provided $150 billion in state

22. The pandemic's impact on state budgets has varied, with the pandemic having a more significant impact on some states' revenues than others'. *See State Tax Revenue During COVID-19 Pandemic*, URB. INST., https://www.urban.org/sites/default/files/2020/12/08/staterevenuesummaryduringpandemic.pdf [https://perma.cc/NX5J-UFBD].

23. Because states generally operate under balanced budget requirements, borrowing against future revenue is restricted as a mechanism for managing shortfalls in states' general budgets. *See* David Gamage, *Preventing State Budget Crises: Managing the Fiscal Volatility Problem*, 98 CALIF. L. REV. 749, 754–68 (2010) (discussing the fiscal volatility problem and the nature and implications of state balanced budget constraints).

24. *See Briefing Book, The State of State (and Local) Tax Policy*, TAX POL'Y CTR., https://www.taxpolicycenter.org/briefing-book/what-are-state-balanced-budget-requirements-and-how-do-they-work [https://perma.cc/3KNF-E2W7].

25. *See* Jim Zarroli, *$3.1 Trillion: Pandemic Spending Drives the Federal Budget Deficit to a Record*, NPR (Oct. 16, 2020, 3:08 PM), https://www.npr.org/sections/coronavirus-live-updates/2020/10/16/924582156/-3-1-trillion-pandemic-spending-drives-the-federal-budget-deficit-to-a-record#:~:text=%243.1%20Trillion%3A%20Pandemic%20Spending%20Drives%20The%20Federal%20Budget%20Deficit%20To%20A%20Record&text=Patrick%20Semansky%2FAP-,The%20government%20shortfall%20for%20the%20fiscal%20year%20that%20just%20ended,size%20of%20the%20U.S.%20economy [https://perma.cc/UN2L-BNV6].

26. Families First Coronavirus Response Act, Pub. L. No. 116-127, § 6008, 134 Stat. 178 (2020).

27. Coronavirus Aid, Relief, and Economic Security (CARES) Act, Pub. L. No. 116-136, § 601, 134 Stat. 281 (2020).

and local aid.[28] States and certain localities could use the funds for "necessary expenditures" incurred prior to December 31, 2020, that (i) resulted from the COVID-19 public-health crisis, and (ii) were not accounted for in the state or local government's most recent budget.[29] The intent behind these restrictions was to earmark the funds for state expenditures that increased as a result of the pandemic, thus preventing states from using the funds for budget issues caused by declines in state revenue.[30] Therefore, in addition to the fact that $150 billion was not nearly enough to fill state budget gaps, states were not permitted to use the funds to ameliorate their drop in tax revenue.[31] The CARES Act also provided up to $454 billion in loans to states, local governments, and private businesses, but the program was underutilized due to restrictions on states' use of the funds.[32]

Immediately after Congress passed the CARES Act, the leaders of both political parties insisted that additional economic relief was necessary.[33] However, other than a small bill that provided additional funding for the PPP, Congress sat at a political impasse for most of 2020 and could not reach an agreement on a follow-up bill,[34] with the

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28. *Id.* §§ 1102, 2201, 5001(a).

29. *Id.* § 601(d).

30. Letter from Mark R. Warner et al., U.S. Senators and Members of Congress, to Steven Mnuchin, Sec'y of the Treas. (Apr. 7, 2020), https://www.kaine.senate.gov/imo/media/doc/2020%20-%20Letter%20to%20Mnuchin%20on%20Relief%20Fund_Final.pdf [https://perma.cc/FLD4-2SQ2] ("Unbudgeted costs can also come in the form of unexpected and precipitous revenue declines . . . . Inhibiting the use of Coronavirus Relief Funds to address revenue shortfalls is likely to lead to cuts in services and programs that otherwise can mitigate the indirect impact of COVID-19 at the state and local level; that will only make the health and economic crises worse."); Greg Allen, *For Counties, The Coronavirus Brings Major Budget Problems*, NPR (Apr. 8, 2020), https://www.npr.org/sections/coronavirus-live-updates/2020/04/08/830186999/for-counties-the-coronavirus-brings-major-budget-problems [https://perma.cc/SS73-E9U4] ("The biggest challenge we have is the way the law was written. We cannot be reimbursed for lost revenue.") (quoting Matt Chase, Exec. Dir., Nat'l Ass'n of Cntys.).

31. *See* Leachman & McNichol, *supra* note 14; Leachman, *To Support Education, Congress Should Provide Substantial Fiscal Relief to States and Localities*, CTR. ON BUDGET & POL'Y PRIORITIES (June 15, 2020), https://www.cbpp.org/research/state-budget-and-tax/to-support-education-congress-should-provide-substantial-fiscal [https://perma.cc/69FW-95M9] ("The federal aid provided so far can close roughly $100 billion of those gaps, leaving states $515 billion short."); Letter from Director Phillip L. Swagel, Dir. of Cong. Budget Off., to John Yarmuth, Chairman, House Comm. on Budget Regarding Answers to Questions Related to Fed. Funding for State and Loc. Gov'ts (May 13, 2020), https://www.cbo.gov/system/files/2020-05/56360-CBO-Schakowsky-response.pdf [https://perma.cc/H7FW-K7JG].

32. Coronavirus Aid, Relief, and Economic Security (CARES) Act, Pub. L. No. 116-136, § 4003(b), 134 Stat. 281 (2020). The Fed used $35 billion of this $454 billion as an equity contribution to launch a $500 billion lending program for states and larger localities. Press Release, U.S. Fed. Rsrv. Bd., Municipal Liquidity Facility (Apr. 27, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200811a1.pdf [https://perma.cc/NKU2-SKML].

33. *See* Jacob Pramuk, *Pelosi and Schumer Push for Emergency Coronavirus Bill with at Least $500 Billion More in Aid*, CNBC (Apr. 8, 2020), https://www.cnbc.com/2020/04/08/coronavirus-updates-pelosi-and-schumer-call-for-congress-relief-bill.html [https://perma.cc/FF46-ZK8C].

34. In May 2020, House Democrats passed a $3 trillion CARES 2 bill. The HEROES Act, H.R. 6800, 116th Cong. (2020). The Senate Republicans later proposed a narrow relief bill, which failed to

size and scope of state and local aid one of the primary sources of contention.[35] Eventually, Congress passed the Consolidated Appropriations Act of 2021. This act, among many other things, provided targeted aid for programs that require state funding, including funding for K-12 education, higher education, transit and state transportation, vaccine procurement and distribution, and emergency rental assistance.[36] It also gave states an additional year to spend aid received under the CARES Act, though many jurisdictions had already spent most of their portion of those funds.[37]

The prospects for federal aid changed quite dramatically once President Biden took office in 2021 and the Democratic party gained control of the Senate while retaining control of the House. Indeed, the American Rescue Plan Act of 2021 was signed into law on March 11, 2021.[38] The American Rescue Plan provided $219.8 billion for states, territories, and tribal governments, and $130.2 billion for metropolitan cities, municipalities, and counties.[39]

Nevertheless, future state and local governments may need to cope with another economic downturn while Congress or the Presidency is again controlled by a majority coalition unwilling to provide substantial federal aid. During recessions, states have historically balanced their budgets primarily by reducing spending rather than raising taxes.[40] But

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pass the Senate. Sarah Hansen, *Where Is the Senate GOP's $1 Trillion HEALS Act? Here's What We Know About the Mysteriously Splintered Proposal*, FORBES (July 28, 2020), https://www.forbes.com/sites/sarahhansen/2020/07/28/where-is-the-senate-gops-1-trillion-heals-act-heres-what-we-know-about-the-mysteriously-splintered-proposal/?sh=7e99bfaf4c96 [https://perma.cc/TNR4-RW26].

35. *See* Jim Tankersley & Emily Cochrane, *Biden Faces Challenge as Congress Drops State Aid to Secure Stimulus*, N.Y. TIMES (Dec. 17, 2020), https://www.nytimes.com/2020/12/17/business/stimulus-state-local-aid.html [https://perma.cc/JM6H-7Z8T]; Kristina Petersen & Andrew Duehren, *Coronavirus Stimulus Talks with White House at Impasse*, WALL ST. J. (Oct. 11, 2020), https://www.wsj.com/articles/house-speaker-pelosi-says-coronavirus-aid-talks-remain-at-impasse-11602428344 [https://perma.cc/QX4H-M9RP]; Andrew Duehren & Kate Davidson, *State-Aid Disagreement Proves Big Hurdle for Coronavirus Talks*, WALL ST. J. (Aug. 14, 2020), https://www.wsj.com/articles/house-speaker-pelosi-says-coronavirus-aid-talks-remain-at-impasse-11602428344 [https://perma.cc/XDR3-TYKL].

36. *See* Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, 134 Stat. 1182 (2020); Wendy Briggs & Shauna Woody-Coussens, *How the 2021 Consolidated Appropriations Act Can Help State & Local Governments*, BKD (Jan. 26, 2021), https://www.bkd.com/alert-article/2021/01/how-2021-consolidated-appropriations-act-can-help-state-local-governments [https://perma.cc/KH7E-ZTES] .

37. *See* GRANT A. DRIESSEN, CONG. RSCH. SERV., R46298, GENERAL STATE AND LOCAL FISCAL ASSISTANCE AND COVID-19: BACKGROUND AND AVAILABLE DATA 6–8 (2021), https://crsreports.congress.gov/product/pdf/R/R46298.

38. American Rescue Plan Act of 2021, Pub. L. No. 117-2, 135 Stat. 4.

39. *Id.* § 9901.

40. During the Great Recession, forty states implemented tax or fee increases, though those tax increases were relatively small compared with state budget cuts. *See* Tracy Gordon, *State and Local Budgets and the Great Recession*, BROOKINGS INST. (Dec. 31, 2012), https://www.brookings.edu/articles/state-and-local-budgets-and-the-great-recession/ [https://perma.cc/B4D2-9ZR9] ("Despite its severity, states relied less on revenue increases as a solution in the recent downturn. Although tax and fee increases in fiscal year 2009–2010 were the highest on record ($23.9 billion), this was in nominal terms and not as a percentage of prior year collections.").

these cuts tend to slow economic recovery and shrink states' safety nets for vulnerable residents just when state services are needed most.[41] Despite the harmful ramifications of budget cuts during a recession, states responded to the 2020 recession in much the same way as they had to previous recessions: by reducing spending, including for education and other essential state services.[42] The following Parts thus propose and analyze several ways for states to increase their tax revenues, thereby reducing the harmful consequences of state budget cuts to education, health, safety, and other important services.

In our view, the federal government should continue to fulfill its traditional role by providing states and localities with substantial aid during national emergencies, and the arguments against providing such aid, including the claim that states have somehow been profligate, generally do not stand up to scrutiny.[43] Absent sufficient federal aid, state and local governments, which generally operate under balanced budget constraints, tend to respond to economic downturns with sweeping cuts that can deepen the recession and reduce services when they are most needed.[44] Although we are not against states also pursuing smaller cost-cutting measures like hiring freezes, states should consider that many revenue-raising tools are available. Rather

41. *See id.*; David Cooper, *Without Federal Aid, Many State and Local Governments Could Make the Same Budget Cuts That Hampered the Last Economic Recovery*, ECON. POL'Y INST.: WORKING ECONS. BLOG (May 27, 2020), https://www.epi.org/blog/without-federal-aid-many-state-and-local-governments-could-make-the-same-budget-cuts-that-hampered-the-last-economic-recovery [https://perma.cc/XEM9-NVS8].

42. *See State Actions to Close Budget Shortfalls in Response to COVID-19*, NAT'L CONF. OF STATE LEGISLATURES (Jan. 11, 2021), https://www.ncsl.org/research/fiscal-policy/state-actions-to-close-budget-shortfalls-in-response-to-covid-19.aspx [https://perma.cc/FD5K-7V5E] (providing data on state budgetary responses to COVID-19 which show approximately half of states have cut education funding despite the increase in COVID-related costs borne by schools) [hereinafter NCLS]; Michael A. DiNapoli, Jr., *Making School Budgets Whole and Equitable During and After COVID-19*, LEARNING POL'Y INST. (July 17, 2020), https://learningpolicyinstitute.org/blog/covid-making-school-budgets-whole-and-equitable [https://perma.cc/RJS7-RV6G]. Although a handful of states proposed or enacted tax increases since the start of the pandemic, states primarily closed their 2020 revenue shortfalls through budget cuts. *See* David Harrison, *State, Local Governments Slashed Spending After COVID. Next Year Could Be Worse*, WALL ST. J. (Nov. 29, 2020), https://www.wsj.com/articles/state-local-governments-slashed-spending-after-covid-next-year-could-be-worse-11606669200 [https://perma.cc/RH24-Q33Z].

43. *See, e.g.*, Neil H. Buchanan, *Disaster Relief to States and Cities Is Both Right and Good: Part 1 of 2*, VERDICT (May 14, 2020), https://verdict.justia.com/2020/05/14/disaster-relief-to-states-and-cities-is-both-right-and-good-part-1-of-2 [https://perma.cc/G37V-VYD6]; Neil H. Buchanan, *Disaster Relief to States and Cities Is Both Right and Good: Part 2 of 2*, VERDICT (May 18, 2020), https://verdict.justia.com/2020/05/18/disaster-relief-to-states-and-cities-is-both-right-and-good-part-2-of-2 [https://perma.cc/EP2A-GY86]; Richard C. Auxier, *McConnell's Attempt to Blame States for COVID-19 Budget Shortfalls Is Wrong and Dangerous*, TAX POL'Y CTR. (Apr. 24, 2020), https://www.taxpolicycenter.org/taxvox/mcconnells-attempt-blame-states-covid-19-budget-shortfalls-wrong-and-dangerous [https://perma.cc/FDX3-PSWV].

44. *See* Gordon, *supra* note 40; Cooper, *supra* note 41; NCLS, *supra* note 42; DiNapoli, *supra* note 42; Harrison, *supra* note 42; *see also* Amanda Albright, *States, Cities Cut Payrolls by Nearly 1 Million over Shutdown*, BLOOMBERG (May 8, 2020), https://www.bloomberg.com/news/articles/2020-05-08/states-cities-cut-payrolls-by-nearly-1-million-over-shutdown [https://perma.cc/7FHR-VNCD].

than make deep cuts, it would be better to raise taxes on those who can afford to pay.[45]

During an economic downturn and absent sufficient federal aid, because states face balanced budget constraints, the fact of a recession is not an argument against raising taxes.[46] States and localities should prioritize raising tax revenues from those who can best pay over slashing services needed by those who cannot afford to lose them (or their jobs), especially because many of those services play important roles in preventing further harm to state economies.[47] It is also the case that states likely can, and should, borrow to a greater extent than they currently do. The following Parts discuss proposed reforms in four major areas: state corporate income tax, state personal income tax, state sales tax, and state borrowing practices.

II. STATE CORPORATE INCOME TAX REFORMS

We propose in this Part a number of reforms to state corporate income taxes.[48] Before proceeding, though, we recognize that a skeptic might note that state corporate income taxes represent only about 3 percent of state tax revenues, or about $45 billion per year.[49] To put this in perspective, the initial estimates of states' increased revenue needs caused by the recent COVID-19 economic crises were well over $100 billion annually.[50] We thus fully acknowledge that the corporate income tax reforms we propose in this Part would not lead to a doubling or tripling in corporate income tax collection. Nevertheless, the reforms we propose in this Part have the potential to address at least significant portions of states' revenue needs. For instance, moving to worldwide

45. Gamage, *supra* note 1, at 772–91; *see also* David Gamage & Darien Shanske, *States Should Consider Partial Wealth Tax Reforms*, 96 TAX NOTES STATE 859, 859–61 (2020).

46. *See* Gamage, *supra* note 1, at 772–91; Carolina Vargas, *Massachusetts Economists Push for Higher Taxes Amid Pandemic*, TAX NOTES TODAY STATE (May 28, 2020).

47. *See* Gamage, *supra* note 1; Vargas, *supra* note 46.

48. Although we specifically focus on the state corporate income tax in this Part, many of our proposals apply to the taxation of business income more broadly (i.e., strategically decoupling from the tax cuts provided in the Tax Cuts and Jobs Act of 2017 and in the CARES Act) and will apply equally to states' taxation of business income by sole proprietors and pass-through entities.

Portions of this Part consist of revised and elaborated reforms first proposed in: Darien Shanske, Reuven S. Avi-Yonah & David Gamage, *Reforming State Corporate Income Taxes Can Yield Billions*, MEDIUM (May 13, 2020), https://medium.com/whatever-source-derived/reforming-state-corporate-income-taxes-can-yield-the-states-billions-5a79f3d22f9b [https://perma.cc/59YM-WCU4].

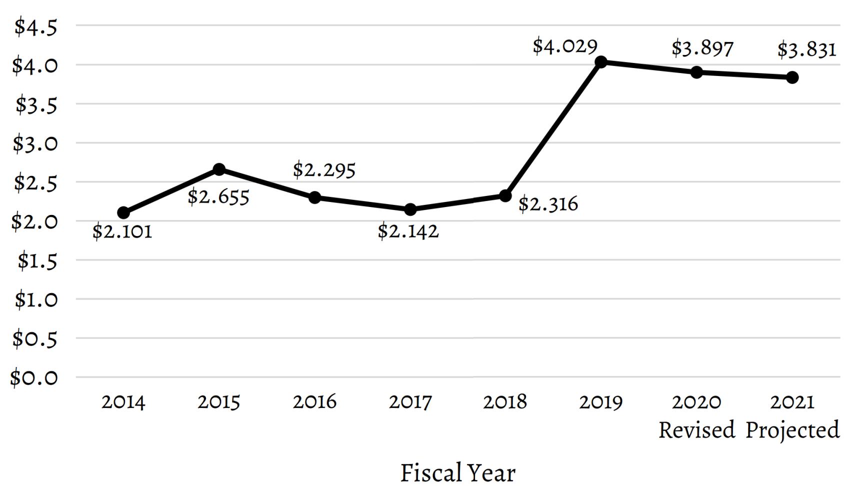
49. U.S. CENSUS BUREAU, 2017 STATE & LOCAL GOVERNMENT FINANCE HISTORICAL DATASETS AND TABLES, https://www.census.gov/data/datasets/2017/econ/local/public-use-datasets.html [https://perma.cc/2DK9-4MCE] (Oct. 8, 2021) (under the "2017 State & Local Government" heading, choose the file labeled "U.S. Summary & Alabama and Mississippi"; the amount is calculated from Table 1 in that file).

50. *See* Leachman & McNichol, *supra* note 14; Davidson & Harrison, *supra* note 14.

combination has been reasonably estimated to have the potential to raise about $17 billion per year.[51] That is a significant amount even on its own. Several of the other reforms below are of similar magnitude.

To be sure, recession conditions might suppress some of these revenue projections—but maybe not by much, given that many firms remain quite profitable. Further, once states put these reforms in place, not only will state revenues bounce back faster during future economic recoveries, but also state governments may be able to borrow against these anticipated future revenues to meet immediate revenue needs during a downturn.[52] That the numbers here can be large should not be too surprising; the yield of the state corporate income tax has fallen sharply over the last few decades, even relative to the decline in federal corporate income taxes.[53] In a sense, the reforms we propose would serve to partially restore the state corporate income tax bases to their prior levels. For those still skeptical, here is another—albeit noisy—data point regarding the money that most states have left on the table, from New Jersey's experience:

FIGURE 1. NEW JERSEY'S CORPORATE BUSINESS TAX (IN BILLIONS)[54]



51. Richard Phillips & Nathan Proctor, *A Simple Fix for a $17 Billion Loophole: How States Can Reclaim Revenue Lost to Tax Havens*, INST. ON TAXATION & ECONOMIC POL'Y (Jan. 17, 2019), https://Itep.Org/A-Simple-Fix-For-A-17-Billion-Loophole/ [https://perma.cc/W9SQ-5K3X].

52. *See infra* Part V.

53. *See, e.g.*, Michael Mazerov, *NCSL Task Force on State and Local Taxation, Legislators: Don't Feel Guilty about Taxing GILTI*, CTR. ON BUDGET & POL'Y PRIORITIES, at 5 (2018), http://www.ncsl.org/Portals/1/Documents/Taskforces/GILTI.pdf [https://perma.cc/RL2E-8QUJ].

54. STATE OF NEW JERSEY, SUMMARY OF BUDGET RECOMMENDATIONS FOR THE FISCAL YEAR 2021: BUDGET IN BRIEF 42–44 (2020), https://www.state.nj.us/treasury/omb/publications/21bib/BIB.pdf [https://perma.cc/F2KC-6GQ2]. Corporate business tax does not include energy tax.

This chart demonstrates extraordinary growth in New Jersey's corporate income tax after it passed several sensible reforms: in 2018, the state conformed to the global intangible low-taxed income regime under the federal Tax Cuts and Jobs Act of 2017 (TCJA), taxed 5% of the repatriation, moved to combined reporting (for 2019), and imposed a 2.5% corporate income tax surcharge for 2018 and 2019 (1.5% for 2020–21).[55] To be sure, the actual 2020 numbers might be lower because of the pandemic, and any number of other factors bespeak caution in extrapolating too far from one state's experience. Nevertheless, this chart indicates that—consistent with other data, some of which we discuss below—the state corporate income tax can be reformed in sensible ways that yield significant revenue. It is not a good thing, in our view, that states have let their corporate income taxes wither when there is so much to be gained from straightforward reforms. States should broaden their corporate tax bases, period; in a crisis, however, the failure to do what should have already been done represents an opportunity. States need only engage in some ordinary good tax housekeeping to revive their corporate income taxes.

Critically, the corporate tax should be part of the mix because it is, at least in part, a progressive tax.[56] As discussed earlier, those hardest hit by crises are typically at the bottom of the income distribution. Though there is certainly a case to be made for raising money somewhat regressively in order to spend it progressively, we should not start with such taxes if there is other low-hanging fruit.

The reforms we propose, in a thumbnail sketch, are as follows:

A. Shift to mandatory worldwide combination.[57] Multinational corporations are still shifting domestic profits abroad.[58] States can counter this by (reasonably) including these foreign subsidiaries in their corporate tax base.

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55. Assemb. B. 4202, 218th Leg., Reg. Sess. (N.J. 2018).

56. The incidence of the corporate income tax is an enduring mystery, but the common assumption is that it is roughly progressive—that is, that it falls at least substantially on the owners of capital as opposed to workers. *See, e.g.*, Edward G. Fox, *Does Capital Bear the U.S. Corporate Tax After All? New Evidence from Corporate Tax Returns*, 17 J. EMPIRICAL LEGAL STUD. 71, 72 (2020); David Gamage & John R. Brooks, *Tax Now or Tax Never: Political Optionality and the Case for Current-Assessment Tax Reform* 25 (Indiana Legal Stud. Rsch. Paper No. 437, 2021), https://ssrn.com/abstract=3801164 ("[M]ost analysts consider [the corporate income tax] to be at least somewhat progressive.").

57. For further development of this argument, see generally Darien Shanske, *White Paper on Eliminating the Water's Edge Election and Moving to Mandatory Worldwide Combined Reporting*, 89 TAX NOTES STATE 1181 (2018).

58. *See infra* Section II.A.

B. Conform to GILTI.[59] The TCJA made a half-hearted attempt to combat income shifting. Though moving to worldwide combination would be better, conforming to GILTI at the state level is the minimum measure that a state should take.

C. Strategically decouple.[60] The TCJA and the CARES Act provided a wide range of corporate tax cuts from which states should consider decoupling.

D. Income tax surcharge.[61] A handful of major corporations will likely be very profitable over the next few years. States should add a temporary income tax surcharge to tax some of these profits.

E. Suspend some tax credits. States have been generous in giving large corporations credits reducing their corporate income tax.[62] Credits of this magnitude were probably never prudent, but given the current crises, it is a particularly apt time to suspend these credits.

F. Reform the sales factor. States generally divide the income of multijurisdictional corporations based on their share of a corporation's sales.[63] Some taxpayers have become skilled at manipulating the location of sales, but there are ways to make the formula harder to game.

G. Expand the corporate income tax to include all large businesses. For decades, there has been a shift to the use of noncorporate business entities.[64] It has never made sense that only corporations pay taxes at the entity level. This should be corrected.

H. Other reforms. States should, at times, strategically conform to federal tax changes, such as repatriation.

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59. For further development of this argument, see generally Darien Shanske & David Gamage, *Why States Should Tax the GILTI*, 91 STATE TAX NOTES 751, 751–54 (2019); Darien Shanske & David Gamage, *Why States Can Tax the GILTI*, 91 STATE TAX NOTES 967, 967–70 (2019); Darien Shanske & David Gamage, *States Should Conform to GILTI, Part 3: Elevator Pitch and Q&A*, 94 TAX NOTES STATE 121, 121–24 (2019).

60. These proposals were first presented in shorter form in: Darien Shanske, Adam Thimmesch, & David Gamage, *Strategic Nonconformity, State Corporate Income Taxes, and the TCJA: Part II*, 97 TAX NOTES STATE 123, 123–25 (2020).

61. The proposals offered in this Section and the three that follow were first presented in Shanske et al., *supra* note 48.

62. *See infra* Section II.E.

63. Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159 (1983).

64. William F. Fox & LeAnn Luna, *Do Limited Liability Companies Explain Declining State Corporate Tax Revenues?*, 33 PUB. FIN. REV. 690, 715–16 (2005).

A. *Mandatory Worldwide Combination*

States have long confronted the problem of how to tax the income of a multistate business. In general, as a matter of constitutional law, each state can tax only income generated in the state,[65] but how does one calculate that for an integrated multistate business like a railroad or Apple? If one asks a taxpayer to determine the state in which an integrated multistate business generated income, that taxpayer will naturally argue that most of the business's income is generated in a low-tax or no-tax state.

States arrived at an especially effective solution to this problem. Instead of asking a multistate business to divide up its income, some states ask the business to report all of its income, including income nominally earned abroad, and then apportion some of the income to each state by means of a formula.[66] The most common modern formula uses the percentage of sales within a state because, among other reasons, the location of a firm's customers is more fixed than a firm's other assets.[67] So how much of Apple's total income is generated in a given state under this system? The answer is the same percentage as the percentage of Apple's sales within that state.

Note that this method—mandatory worldwide combination—eliminates the incentive to shift income to a low-tax jurisdiction. It does not matter where the income is nominally earned because it all goes in the same pot and is multiplied by the usual formula (percentage of sales) to apportion the income.[68]

The U.S. Supreme Court has upheld mandatory worldwide combination twice.[69] After the first win for the states, in 1983,[70] U.S. trading partners pressured the federal government, which in turn pressured the states, not to use mandatory worldwide combination. The states capitulated and offered—and still offer—multinational corporations what is called a "water's-edge" election, which, for the most part, allows corporations *not* to combine income earned abroad.[71] That is, as to which income of a multinational is domestic and which foreign, the water's edge election allows a corporation to force the state

65. *See, e.g.*, *Franchise Tax Bd.*, 463 U.S. 159.

66. *Id.*

67. Darien Shanske, *A New Theory of the State Corporate Income Tax: The State Corporate Income Tax as Retail Sales Tax Complement*, 66 TAX L. REV. 305, 312–14 (2013); *State Apportionment of Corporate Income*, FED'N OF TAX ADM'RS (Jan. 2021), https://www.taxadmin.org/assets/docs/Research/Rates/apport.pdf [https://perma.cc/J3SS-7869].

68. *See generally* JEROME HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ch. 8 (2020) (discussing the apportionment of corporate income for purposes of the state income tax).

69. Barclays Bank PLC v. Franchise Tax Bd. of Cal., 512 U.S. 298, 321–31 (1994); *Franchise Tax Bd.*, 463 U.S. at 196.

70. *Franchise Tax Bd.*, 463 U.S. at 196.

71. Shanske, *supra* note 57, at 181–82.

to accept its accounting. Naturally, the availability of a water's-edge election encourages multinational corporations to shift income abroad to escape state taxation. Eliminating this election could therefore allow states to tax a substantial portion of the income that multinational corporations continue to shift to low-tax jurisdictions. As noted above, one respected estimate is that states could raise about $17 billion through moving to worldwide combination.[72]

B. *Conforming to GILTI*

Global Intangible Low-Taxed Income (GILTI) is a category of income added to the federal tax code by the TCJA.[73] GILTI is income nominally earned by the foreign subsidiary of a U.S. corporation that federal tax law deems to have been earned someplace else, such as the United States.[74] In other words, by means of a formula, the federal corporate income tax uses GILTI to combat the same income-shifting problem that is targeted by worldwide combination.

Though there is some complexity, all a state with a corporate income tax has to do is subject GILTI to state corporate tax, and then that state would also be combatting income stripping. The state can then use the same formula that it would ordinarily use to divide up the income of a multinational corporation.[75]

A state cannot conform to GILTI and adopt worldwide combination; the two are substitutes because both are attempts to ferret out shifted income. A state could offer taxpayers a choice between the two. Between worldwide and GILTI, worldwide is better from the state's perspective because it simply includes all the income of a multinational corporation without the intrusion of the complicated federal formula for picking out suspect income. That said, conforming to GILTI may be easier politically (and, arguably, administratively), as it requires little more than adding a sentence to the state corporate income tax code that the state is conforming to a provision of the federal tax law meant to combat income shifting. This conformity could raise a lot of revenue; the Penn Wharton Budget Model estimates $382 billion in total GILTI for 2020.[76] If states were to follow the federal government and tax half of GILTI, and do so at a 5% rate, then the taxes would yield almost $10

72. Phillips & Proctor, *supra* note 51.

73. I.R.C. § 951A.

74. *See id.*

75. *See generally* Darien Shanske, *How the States Can Tax Shifted Corporate Profits: An Application of Strategic Conformity*, 94 S. CALIF. L. REV. 251 (2021) (discussing the various complexities).

76. *Global Intangible Low-Taxed Income, 2020–2030: Estimates for the U.S. and Massachusetts*, PENN WHARTON UNIV. OF PA. BUDGET MODEL (Feb. 25, 2020), https://budgetmodel.wharton.upenn.edu/estimates/2020/2/25/gilti-2020-2030-us-ma [https://perma.cc/FQ5Z-F983].

billion annually. To be sure, this is an estimate—and a pre-pandemic estimate at that, like all the estimates we provide. That said, broadening the base in this way is sound tax policy. The ensuant revenue will remain substantial even during a recession given that some firms, quite possibly with a lot of GILTI, are likely to remain profitable.[77] Note that President Biden has proposed changing the structure of GILTI in various ways. Most of these reforms would not affect how states should conform to GILTI, but some might, and so GILTI conformity may require modulation based on events at the federal level.[78]

C. *Strategically Decouple from Federal Tax Cuts*

States generally piggyback on the federal tax code for purposes of their own tax laws.[79] In this Section, we suggest that states take a closer look at that practice and strategically decouple from a series of tax cuts enacted in recent years. Specifically, we suggest that states strongly consider decoupling from the TCJA's full expensing provision under Section 168(k) and from the CARES Act's expanded corporate interest deductions and net operating loss provisions. We argue that states should decouple from these specific provisions and similar provisions that might one day be passed in response to future crises.

1. Full Expensing

Section 168(k) currently allows taxpayers a 100% deduction for most business equipment and machinery purchases.[80] That full-expensing section is generally defended as either a supply-side stimulus or a preferential step toward a cash-flow based tax.[81] Full expensing at the state level is inappropriate under either rationale, especially during the COVID-19 fiscal crises.

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77. A related—and complementary—way to expand the corporate tax base through conformity would be to also conform to Subpart F, I.R.C. § 952. For discussion of Subpart F and many more issues involved in GILTI conformity, see Shanske, *supra* note 67.

78. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2022 REVENUE PROPOSALS 4–6 (2021), https://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf [https://perma.cc/FQ5Z-F983] (providing proposals to reform GILTI, including elimination of deemed ten percent normal rate of return).

79. *See e.g.*, Amy B. Monahan, *State Individual Income Tax Conformity in Practice: Evidence from the Tax Cuts & Jobs Act*, 11 COLUM. J. TAX L. 57, 61–64 (2019); Mason, *supra* note 1, at 1274–79.

80. I.R.C. § 168(k).

81. *See e.g.*, Erica York, *Reviewing the Benefits of Full Expensing for the Post-Pandemic Economic Recovery*, TAX FOUND. (Apr. 27, 2020), https://taxfoundation.org/benefits-of-full-immediate-expensing/[https://perma.cc/RX3N-NYDS].

First, as we have noted throughout this Article, states are not in a good position to provide economic stimulus to businesses in times of fiscal distress. That is the type of assistance that should come from the federal government. This point bears repeating: the right question is not whether, all things equal, a state-level tax break would help businesses right now—of course it would. But those dollars must come from somewhere, given state balanced-budget rules. Thus, the right question is whether a relatively small amount of state tax relief is a better use of funds than making cuts to vital services during a recession and pandemic, especially when the federal government has already provided relief.

Second, the general economic case for full expensing is uncertain and controversial[82]—especially in a world in which Section 179 of the Tax Code gives smaller firms full expensing already.[83] Additionally, although adopting full expensing might move a state closer to what some consider a normatively superior tax base,[84] states cannot achieve that goal with full expensing in isolation. The existing state corporate income tax deviates from a cash-flow tax by both excluding borrowed funds from income and including those amounts in an asset's depreciable tax basis while also allowing for interest deductions for the funds used to purchase assets that are fully expensed.[85] Full expensing alone is a costly, partial move toward a cash-flow tax. It is unwise for states to adopt full expensing as a step toward a complete restructuring of their tax systems without undergoing that complete restructuring altogether. Partial reforms can result in negative tax rates on capital investments and the concomitant encouragement of investments that would not be undertaken absent that tax benefit.[86] It is especially

82. *See generally*, Lily L. Batchelder, *Accounting for Behavioral Considerations in Business Tax Reform: The Case of Expensing* (Jan. 24, 2017) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2904885; Steve Wamhoff & Richard Phillips, *The Failure of Expensing and Other Depreciation Tax Breaks*, INST. ON TAX'N & ECON. POL'Y (Nov. 19, 2018), https://itep.org/the-failure-of-expensing-and-other-depreciation-tax-breaks/ [https://perma.cc/8RLB-CLDA]; *cf.* Anna Tyger, *New Evidence on the Benefits of Full Expensing*, TAX FOUND. (Aug. 15, 2019), https://taxfoundation.org/benefits-of-full-expensing/ [https://perma.cc/ZK7B-8QY8] (making the economic case for full expensing).

83. Tax Code § 179 allows certain taxpayers the option of deducting certain expenses that would otherwise be capitalized, but the provision is available only up to a limit and for taxpayers whose otherwise eligible expenses are limited in amount. *See* I.R.C. § 179 (providing these conditions). In contrast, § 168(k) allows full expensing for eligible expenses without limit. *See* I.R.C. § 168(k).

84. *See e.g.*, Christopher H. Hanna, *Tax Theories and Tax Reform*, 59 SMU L. REV. 435, 439–45 (2006).

85. *See* Joseph M. Dodge, *Toward Income Tax Accounting Consistency: Eliminating Accrual, Depreciation, and the Existing Tax Treatment of Borrowing*, 18 FLA. TAX REV. 1, 15 (2015) (discussing these features of the Tax Code).

86. *See* Hanna, *supra* note 84, at 451 ("[E]xpensing coupled with an interest deduction on debt-financed investments yields an effective tax rate of less than zero.").

foolish to engage in such a restructuring during ongoing crises if the transition would result in even less revenue.

If states want to move toward a corporate tax base compatible with full expensing, then we recommend (at a minimum) that they disallow all interest payment deductions as part of their corporate tax bases. But seeing as successfully enacting this would require much broader, more involved reform than just decoupling from § 168(k), decoupling from § 168(k) is the easiest and most straightforward path for states to follow during their budget crises.

More ambitiously, and as an extension of the foregoing logic, it would also be prudent for states to go further and consider decoupling from the accelerated depreciation generally allowed under § 168—at least absent or until broader reform efforts consider the alternative of ending interest payment deductions and possibly including debt financing in the tax base. Again, a depreciation allowance that would more closely track economic depreciation is justifiable within states' current systems as a matter of income tax principle and would help them meet their revenue needs.

2. Net Interest Deduction Limitation

Related to this discussion are the net interest limitations contained in the TCJA and the CARES Act's modifications to those rules. The TCJA introduced § 163(j), which limited business interest deductions to thirty percent of a taxpayer's adjusted taxable income.[87] The CARES Act loosened that limitation in a couple of ways. First, it raised the threshold percentage from thirty to fifty percent.[88] Second, for purposes of tax reporting for 2020, the bill modified § 163(j) by allowing taxpayers to use their 2019—rather than 2020—adjusted taxable income for making their limitation calculations.[89]

The TCJA's business interest limitation was enacted in conjunction with its full-expensing allowance in § 168(k). And while neither the conference report nor the JCT Bluebook explained why that provision was enacted, the U.S. Senate Finance Committee did discuss that limitation in a section on cost recovery.[90] Some therefore view the business interest limitation as a sort of quid pro quo for full

87. I.R.C. § 163(j)(1)(B).

88. Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, § 2306, 134 Stat. 358 (2020).

89. *Id.*

90. *See, e.g.*, U.S. S. COMM. ON FINANCE, 115TH CONG., TAX CUTS AND JOBS ACT: CHAIRMAN'S MARK SECTION-BY-SECTION SUMMARY (2017), https://www.finance.senate.gov/imo/media/doc/11.19.17%20Section%20by%20Section%20—%20FINAL1.pdf [https://perma.cc/C3DQ-6YCQ].

expensing—a way of discouraging "excessive debt financing" of assets that could be fully expensed.[91]

But the business interest limitation of § 163(j) is neither directly tied to nor fully accounts for § 168(k). Section 163(j) limits interest deductions,[92] but it does not prevent businesses from deducting interest on debts incurred to purchased assets that are fully expensed under § 168(k). That is highly problematic as a matter of tax policy.[93] Section 163(j) is even further limited because it does not apply to all taxpayers. Exempt from the limits are businesses whose average annual gross receipts over an applicable three-year period do not exceed $25 million.[94] Thus, it is reasonable for states to evaluate their business interest limitation independently from their depreciation allowances after the TCJA and CARES Act.

Pre-CARES Act, states were in two camps: those that conformed to § 163(j), and those that did not—which means that non-conforming groups allowed interest deductions without the § 163(j) limitation.[95] Conformity with the CARES Act for these latter groups would obviously mean two different things: an expansion of the interest deduction for previously conforming states, and a contraction for the others.

States that did not previously conform to § 163(j) and limit business interest deductions might want to consider that change. Quite simply, the calculus for states is very different now than it was even immediately after the TCJA was enacted. Limiting an interest deduction for a limited subset of highly leveraged firms is likely preferable to cutting funding for critical state services. States must be concerned with overall welfare rather than focused on only the negative impact that a limited interest deduction might have on particular firms.

States that conformed to § 163(j) prior to the CARES Act should have decoupled from the CARES Act's changes to that limitation—and more generally, states should consider decoupling from similar deduction expansions in future fiscal emergencies. Many businesses undoubtedly

91. *See, e.g.*, Karl A. Frieden & Stephanie T. Do, *State Tax Conformity to Key Taxpayer-Favorable Provisions in the CARES Act*, 96 TAX NOTES STATE 303, 306 (2020); Jared Walczak, *Ranking State Tax Competitiveness After Wayfair and the TCJA*, 94 TAX NOTES STATE 413, 417 (2019) ("[The business interest limitation] was intended to eliminate the bias in favor of debt financing over equity financing in the federal code.").

92. I.R.C. § 163(j)(1)(B).

93. There is no room in the existing income tax—which both excludes borrowed funds from income and includes those amounts in an asset's depreciable tax basis—for any interest deduction for funds used to purchase assets that are fully expensed. *See, e.g.*, Calvin H. Johnson, *Tax Shelter Gain: The Mismatch of Debt and Supply Side Depreciation*, 61 TEX. L. REV. 1013, 1018 (1983); Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575, 1609 (1979).

94. I.R.C. §§ 163(j)(3), 448(c).

95. *See* Richard C. Byrd, Stephen J. Madden, Jeffrey M. Raney & John T.M. Whiteman, *State Responses to the Tax Cuts and Jobs Act: An Analysis from Indiana and Missouri*, 58 WASH. U. J.L. & POL'Y 231, 257–59 (2019) (discussing differing state responses).

need cash in such desperate times, and many also need to incur additional debt to manage shortfalls caused by emergencies. Expanded deductions certainly help those companies, and some argued for CARES Act conformity on that ground.[96] But the problem with expanding the state business interest deduction to aid struggling firms was two-fold. First, states were not in a position to provide stimulus funding to firms during the pandemic. Second, there was little fit between expanding the interest deduction and providing relief to firms that were struggling because of COVID-19.

The interest limitation of § 163(j) applies to only a select group of firms, and expanding that limit would reverse the modest inroads that the TCJA made into the debt preference in the U.S. Tax Code.[97] States choosing to expand the limit would be providing a targeted tax cut to an unknown group of taxpayers to the detriment of the known community in the state. No change in the tax laws can be viewed in isolation from the state's overall mission and goals. In light of these considerations, states should not conform to the CARES Act changes to the business interest limitation, and states that previously decoupled from § 163(j) should consider adopting that provision now.

3. NOL Changes

Before the TCJA, the federal tax code allowed taxpayers to carry net operating losses (NOLs) back for two tax years and to carry them forward for twenty years.[98] The TCJA eliminated taxpayers' ability to carry back their NOLs but allowed an unlimited carryforward.[99] The Act also limited taxpayers' use of NOLs in any given year to 80% of their taxable income.[100] These provisions served both to raise revenue for offsetting the TCJA's revenue reductions and to prevent taxpayers from using losses incurred in post-TCJA years to offset income earned under the old 35% corporate tax rate.

The CARES Act modified these rules again. Under the new law, corporations are allowed to carry back losses incurred in tax years ending after December 31, 2017, and before January 1, 2021, for five years.[101] The TCJA's 80% limitation is also suspended for tax years

96. *See* Frieden & Do, *supra* note 91, at 305.
97. Robert E. Holo, Jasmine N. Hay & William J. Smolinski, *Not So Fast: 163(j), 245A, and Leverage in the Post-TCJA World*, 128 YALE L.J.F. 383, 383–89 (2018).
98. I.R.C. § 172(b)(1)(A)(ii)(I) (2016) (amended 2017).
99. § 172(b)(1).
100. § 172(a)(2).
101. § 172(b)(1)(D).

beginning before January 1, 2021.[102] The CARES Act did not eliminate the TCJA's indefinite carryforward.

If one is solely focused on getting taxpayers cash in any way possible during a recession, these expansions obviously work—for some. The NOL expansion allows taxpayers to carry back losses unburdened by an 80% limit. In a world where the tax year is used just for administrative convenience, an unlimited carryback may also make sense. A taxpayer who earns a profit in Year 1 and loses it in Year 2 has, on net, earned nothing. A carryback recognizes the oddities that result from adopting reporting periods for tax purposes.

Again, however, states have more to consider than simply getting companies cash in any way possible. As with the aforementioned net interest limitation modification, merely pointing out that some companies would benefit from expanded net operating loss utilization does not justify this policy change. States should again consider the overall cost and distributional aspects of that expansion and whether the state could better help its residents and businesses through other means. States, again, cannot be in charge of stimulus funding during a recession. Firms must look to the federal government for that support.

Notably, most states already decouple from the federal NOL rules in one way or another, and most do not allow any NOL carryback.[103] NOL carrybacks at the state level raise difficult issues regarding the amount and source of the losses for taxpayers operating in multiple states. Either the calculations are imprecise or the administrative burden is incredibly high.[104] States that use state-specific calculations for precision purposes already use NOL calculations independent from the federal amounts, so conformity becomes a matter of state tax and economic policy rather than one of harmonization with the federal government.

An unlimited NOL provision might make more sense at the state level than at the federal level if states' tax rates have remained unchanged. But states have other policy considerations—as evidenced by their current NOL practices—and their tax codes do not necessarily reflect good tax policy at every turn. For example, every state with an income tax conforms to the federal step-up in basis at death,[105] and states offer a wide variety of targeted tax breaks for particular

102. § 172(a)(1).

103. *See* Frieden & Do, *supra* note 91, at 308; *see also* HELLERSTEIN & HELLERSTEIN, *supra* note 68, at § 7.16.

104. HELLERSTEIN & HELLERSTEIN, *supra* note 68, § 7.16[1]; Katherine Loughead, *State Conformity to Federal Pandemic-Related Tax Provisions in CARES and ARPA*, TAX FOUND. (Apr. 1, 2021), https://taxfoundation.org/state-conformity-cares-act-unemployment/ [https://perma.cc/KY8R-DZAQ].

105. *See* I.R.C. § 1014(a) (providing that the tax basis of property that is inherited is generally the property's fair market value at the time of the prior owner's death).

industries or taxpayers.[106] It is just reality that states' tax bases reflect political and economic considerations that go beyond pure tax policy.[107] In the NOL context, states have erred on the side of more limited NOL use than is allowed under federal law, so the question is whether they should have changed course in the midst of the pandemic.

We obviously cannot consider each idiosyncrasy in states' budgets or tax bases, but it seems clear that conformity as pure stimulus would be overbroad. The CARES Act's NOL expansions apply to losses incurred well before this pandemic,[108] so the changes are not tied to pandemic losses. NOL expansions would also obviously work to get cash into the hands of affected corporations. But that does not mean that conformity makes sense for states as a method of relief. Every taxpayer would benefit in the form of additional funds, but that was true before this pandemic as well. States must prioritize, and they likely cannot afford this type of nontargeted relief.

D. *Temporary Corporate Income Tax Surcharge*

Many businesses suffered losses during the recession. A few prospered. It is not imposing a moral judgment to suggest that businesses that do relatively well should pay more in taxes to offset the increased budgetary costs of the downturn. Put concretely, we may be grateful to Amazon for its delivery service, but it still seems appropriate to tax it on its profits in order to help main street businesses. It might be particularly appealing to tax a firm that is profiting during the recession on its "excess" profits,[109] but designing and implementing a new tax would be a heavy administrative lift for a state during a pandemic.

Fortunately, the regular corporate income tax is already something of an excess profits tax, to the extent that by definition it will tax only profitable firms, and those firms are likely to be less common during a downturn. As for those few profitable firms, a temporarily higher corporate income tax rate would reflect that putting a greater share of profits toward the common good is especially urgent. For instance,

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106. HELLERSTEIN & HELLERSTEIN, *supra* note 68, § 4.14[3][b][v] ("[V]irtually every state with an income tax offers a credit for investing in particular types of facilities, hiring a specified number of new employees, or spending a certain amount of money in the state on particular activities.").

107. *See, e.g.*, *id.*

108. *Supra* notes 101–02 and accompanying text.

109. Reuven S. Avi-Yonah, *It's Time to Revive the Excess Profits Tax*, AM. PROSPECT (Mar. 27, 2020), https://prospect.org/coronavirus/its-time-to-revive-the-excess-profits-tax/ [https://perma.cc/D34Q-LWWK]; Reuven S. Avi-Yonah, *Taxes in the Time of Coronavirus: Is It Time to Revive the Excess Profits Tax?* (Univ. of Mich. Pub. L. Rsch. Paper No. 671, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3560806.

suppose that a state were to adopt a 3% corporate income tax surcharge for three years. This could raise some extra revenues in the depths of a recession from those most able to pay. This surcharge could be imposed only above a threshold, so as to apply only to larger businesses that are unlikely to face serious liquidity problems, and with respect to which the corporate income tax can also serve antitrust-related goals. That is, if one believes that the most profitable firms (and thus the ones paying most of the corporate income tax surcharge) are so profitable because they are earning supernormal profits,[110] there is an extra reason to tax these profits to the extent one believes that these firms' monopoly power imposes costs on the rest of us.[111]

E. *Suspension (or Capping) of Some Corporate Tax Credits and Deductions*

States offer a multitude of tax credits. The consensus is that these do little to encourage economic development,[112] but this is not the place to fight that battle. What we want to emphasize is that some tax credits have grown so large that they could dramatically reduce the value of these suggested reforms. Our principal example is state R&D credits, at least in some states.[113] These are expensive, costing California alone almost $2 billion annually.[114] Depending on the year, that is as high as twenty percent of all that California collects in corporate income tax.[115] Even worse, R&D credits in some states, again, like California, which has a particularly generous credit structure, can be stockpiled. It is likely that many of the taxpayers shifting profits have also been stockpiling credits; there were $11 billion in credits stockpiled in California in 2009, likely concentrated in the very profitable industries, such as pharmaceuticals, that would likely pay more in tax under the

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110. *See generally* Fox, *supra* note 56.

111. Reuven S. Avi-Yonah & Lior Frank, *Antitrust and the Corporate Tax: Why We Need Progressive Corporate Tax Rates*, 167 TAX NOTES FED. 1199, 1199–201 (2020). Note that pairing progressive tax rates with a state corporate tax base that has been successfully broadened through moving to worldwide consolidation or conforming to GILTI would be a sensible permanent reform.

112. David Gamage & Darien Shanske, *Tax Cannibalization and State Government Tax Incentive Programs*, 82 STATE TAX NOTES 197, 199 n.13 (2016).

113. LEGISLATIVE ANALYST'S OFFICE, CURRENT STATE R&D TAX CREDITS 2 (2011), https://lao.ca.gov/handouts/Econ/2011/Current_State_R_D_12_5_11.pdf [https://perma.cc/6G6D-LG7J] (analyzing California's R&D and credit) [hereinafter LAO]. For a survey of R&D credits in states in the north east, see Heather Poole, *Selected States R&D Tax Credits*, https://www.cga.ct.gov/2015/rpt/2015-R-0209.htm [https://perma.cc/6A4L].

114. CAL. DEP'T OF FIN., TAX EXPENDITURE REPORT: 2019–20, at 8, https://www.dof.ca.gov/Forecasting/Economics/Tax_Expenditure_Reports/documents/Tax_ExpenditureReport_2019-20_B.pdf [https://perma.cc/9T9M-FLNA].

115. *See State Government Tax Collections, Corporation Net Income Taxes in California*, FRED https://fred.stlouisfed.org/series/CACORPINCTX (last visited Feb. 18, 2022) (reporting that California collected about $10 billion in corporate tax in 2017 and $14 billion in 2019).

other corporate reforms.[116] It is estimated that a shift to worldwide combination could net California almost $3 billion annually,[117] but this would not amount to much during a crisis if the most profitable firms use their $10+ billion stockpile of credits to negate the tax.

We hope that a time will come to reconsider state R&D credits and other credits.[118] But, as with the temporary surcharge we propose, states must be able to tax the actors with greater ability to pay during an economic downturn. R&D credits should thus be suspended, for, say, a few years or some other rough estimate during a recession.

F. *Reform the Sales Factor*

As noted earlier,[119] states have shifted to dividing up the income of a multinational corporation by using a formula based on the percentage of sales in a state. This approach has turned out to be expensive. For example, in 2014–15, the last available year for which data were collected, California estimated that it loses almost $1 billion per year[120] because of this formulaic shift—roughly ten percent of its total corporate income tax collection.[121] How can that be? California is a big market state, after all. One likely reason is that taxpayers have gotten very good at gaming the sales factor.[122] Reforming the sales factor could therefore raise a lot of revenue, especially if some of the other reforms we discuss are also adopted. We propose two reforms below.[123]

First, the law of the sales factor should be refined to apportion a sale to its ultimate destination in all cases, including sales of tangible personal property. States generally permit sales to be located where a middleman—e.g., a wholesaler—takes title to the goods.[124] The problem with this rule is that it encourages taxpayers to sell to intermediaries in low-tax jurisdictions. Reforming the rule to apportion a sale to its

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116. *See* LAO, *supra* note 113, at 5–6.

117. *See* Philips & Proctor, *supra* note 51.

118. In fairness, state-level R&D credits have been shown to have some effect at attracting more research activity, but at the expense of other states. *See, e.g.*, Daniel J. Wilson, *Beggar Thy Neighbor? The In-State, Out-Of-State, and Aggregate Effects of R&D Tax Credits*, 91 REV. ECON. & STAT. 431 (2009).

119. *See supra* Section II.A (discussion of mandatory worldwide combination).

120. CAL. DEP'T OF FIN., TAX EXPENDITURE REPORT: 2014–15, at 7 tbl.2, https://www.dof.ca.gov/Forecasting/Economics/Tax_Expenditure_Reports/documents/TER_9_15_2014.pdf [https://perma.cc/S5TB-TJV8] (showing an estimated loss of $890 million).

121. *See supra* note 115.

122. Darien Shanske, *Expanding State Fiscal Capacity, Part I: Combining an Entity-Level Consumption Tax, Improved Sales Factor Apportionment, and a Tax on a Federal Windfall (the QBI Deduction)*, 22 FLA. TAX REV. 448, 487–99 (2019).

123. *See* Reuven S. Avi-Yonah & Kimberly A. Clausing, *Toward a 21st-Century International Tax Regime*, 95 TAX NOTES INT'L 839, 846–47 (2019); Shanske, *supra* note 122, at 487–99.

124. *See* Shanske, *supra* note 122, at 497–98.

ultimate destination would be actionable; a corporation could look to information it retains in the usual course of business, because surely businesses generally know where their customers are. If the corporation does not have this information and cannot obtain it from its wholesalers, then it could use any reasonable method, including population, to fill in the gaps.

A second reform we propose to the sales factor is for corporations to be required to submit an accounting of where they would locate all their sales using the method they have used for the state in question. Corporations should also report where they are reporting sales to other states with the single sales factor. It might not seem odd to a California auditor, for instance, if California's sales factor for a corporation was only eight percent—so a bit below the state's share of U.S. GDP[125]—but it would rightfully raise alarm bells if the disclosure of this method revealed a ten percent sales factor for Nevada, which has less than one percent of U.S. GDP, or for the Cayman Islands. How could such small jurisdictions absorb such a high proportion of the sales of a large multinational corporation?

G. *Expand the Corporate Income Tax to All Entities*

There has been a shift away from the corporate form over the last few decades; prominent commentators link the shift to the decline in the productivity of the state corporate income tax.[126] In any event, it does not make much sense for two large businesses to be subject to different tax regimes solely because one is a corporation and the other is not. The tax system should be neutral as to different decisions regarding business organization. One possible objection is that we would not want to pull millions of small businesses into the corporate tax regime. That concern is valid, as such businesses often are not C corporations. Yet the corporate tax could be extended to just the largest noncorporate businesses with little loss of revenue.[127] This is another example of a change that could yield significant revenue, especially as the economy improves. This is not an abstract proposal, as Texas'

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125. *See* Katharina Buchholz, *Which States Are Contributing the Most to U.S. GDP?*, STATISTA (Apr. 12, 2021), https://www.statista.com/chart/9358/us-gdp-by-state-and-region/ [https://perma.cc/9V5U-PEBJ].

126. Fox & Luna, *supra* note 64, at 715–16.

127. Matthew J. Knittel & Susan C. Nelson, *How Would Small Business Owners Fare Under a Business Entity Tax?*, 64 NAT'L TAX J. 949, 974 (2011) ("Using a $10 million gross income and deduction test, we find that 99 percent of the entities deemed a business (54 percent of total filers) are also a small business, and they reported 18 percent of total business income and 16 percent of net business income for tax year 2007.").

franchise (margin) tax is imposed on all business entities,[128] except those with revenue below a certain threshold (about $1 million).[129]

H. *Other Reforms: Strategic Conformity*

States should be on the lookout for other kinds of opportunities. For example, sometimes the federal government changes the tax law in ways that states do not automatically conform to but that they *should* conform to. A significant example of this involved repatriation.[130]

Under the U.S. international tax law regime that ended in 2018 with the TCJA, the United States—at least nominally—sought to tax the profits of multinational corporations on the basis of their worldwide income.[131] At the same time, the regime permitted U.S.-based multinationals to defer payment of tax on profits earned overseas until that money was brought home.[132] Until a foreign subsidiary repatriated its profits to its U.S. parent, the profits were not subject to U.S. tax.[133] Naturally, large multinational corporations left a lot of money—over $2 trillion—stashed abroad.[134]

Much of that money represented profits that were substantively earned in the United States by virtue of the contributions made by U.S. workers and consumers, and that would have been taxed in the U.S. if not for the increasing allure of shifting profits.[135] The TCJA deemed all the deferred income repatriated and subject to tax.[136] But it then applied special low tax rates to these profits, effectively exempting most of the profits from tax.[137] Most state corporate income taxes were not set up to recoup this loss, because they did not conform to this new provision of the Code or were otherwise not set up to tax this kind of income.[138]

128. TEX. TAX CODE ANN. § 171.0002 (West 2021).

129. § 171.002(d)(2).

130. For a more in-depth version of this argument, see Darien Shanske & David Gamage, *Why (and How) States Should Tax the Repatriation*, STATE TAX NOTES 317, 317 (2018).

131. For a brief introduction to the U.S. approach to taxing companies with international operations, see Susan C. Morse, *International Cooperation and the 2017 Act*, 128 YALE L.J.F. 362, 363–66 (2018).

132. *Id.*

133. *Id.*

134. Jeff Sommer, *A Stranded $2 Trillion Overseas Stash Gets Closer to Coming Home*, N.Y. TIMES (Nov. 4, 2016), https://www.nytimes.com/2016/11/06/your-money/strategies-corporate-cash-repatriation-bipartisan-consensuss.html [https://perma.cc/H3QH-5BTB].

135. Harry Grubert, *Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales, Are Being Globalized*, 65 NAT'L TAX J. 247, 247 (2012).

136. I.R.C. § 965(a).

137. I.R.C. § 965(c).

138. Jared Walczak & Erica York, *GILTI and Other Conformity Issues Still Loom for States in 2020*, TAX FOUND. (Dec. 19, 2019), https://taxfoundation.org/gilti-state-conformity-issues-loom-in-2020/#Repat [https://perma.cc/5PKR-L3NA].

Amazingly, states still did not act to recoup the loss even at the depths of the crisis.[139] We hope that states will be quicker to embrace easy, progressive, and sound solutions like taxing repatriation the next time around.

III. State Personal Income Tax and Wealth Tax Reforms

During a fiscal emergency like the COVID-19 pandemic, states should focus on raising revenue from their most fortunate residents to ensure the health, safety, and welfare of the entire community.[140] In that vein, we suggest that states consider modifying their personal income tax rate structures to make these taxes more progressive—rather than (say) tinkering with personal exemptions or standard deductions. That recommendation especially applies to the nine states that impose flat-rate income taxes.[141] Those states should impose graduated rates, at least for a limited period (for instance, as temporary high-income surcharges).

States that already have graduated rate structures should look to either adding brackets or raising the tax rates for those in the highest brackets. That recommendation applies with special force to the many states with graduated structures that are effectively flat. For example, the top bracket in many states kicks in once an individual has over $20,000 of taxable income.[142] Those structures are progressive in name only. And while those states may not be willing to abandon their overall economic or political goals underlying those effectively flat-rate structures, they should ask for more from their millionaires than from their entry-level schoolteachers during a global pandemic or other severe crisis. High-income taxpayers received the bulk of the tax cuts from the TCJA[143] and have greater capacity to shoulder the state tax burden. Again, at a minimum, temporary surcharges on the highest-

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139. Karl A. Frieden & Erica S. Kenney, *Eureka Not! California CIT Reform Is Ill-Conceived, Punitive and Mistimed*¸ TAXNOTES (May 24, 2021), https://www.taxnotes.com/tax-notes-international/corporate-taxation/eureka-not-california-cit-reform-ill-conceived-punitive-and-mistimed/2021/05/24/60lsy [https://perma.cc/FL5L-3ZTW].

140. This Part restates and builds upon reforms that were first proposed in Adam Thimmesch, Darien Shanske & David Gamage, *Strategic Nonconformity to the TCJA, Part I: Personal Income Taxes,* STATE TAX NOTES 1, 17 (2020).

141. Federation of Tax Administrators, *State Individual Income Tax Rates*, TAXADMIN.ORG (Feb. 2021), https://www.taxadmin.org/assets/docs/Research/Rates/ind_inc.pdf [https://perma.cc/5G7H-GZN5].

142. Katherine Loughead, *State Individual Income Tax Rates and Brackets for 2020*, TAX FOUND. (Feb. 4, 2020), https://taxfoundation.org/state-individual-income-tax-rates-and-brackets-for-2020/ [https://perma.cc/EE8N-FLCQ].

143. Jennifer Bird-Pollan, *Revising the Tax Law: The TCJA and Its Place in the History of Tax Reform*, 45 OHIO N.U. L. REV. 501, 523–24 (2019) ("On the distributional side, most commentators agree that the large majority of the benefit of the tax cuts enacted under the TCJA will accrue to higher-income and wealthy taxpayers.").

income state taxpayers could help state governments endure the coming fiscal storms.

Worth underscoring here is the tautology that an income tax is a tax on income. Suppose someone in the restaurant business earned a high income in tax years 2018 and 2019, and thus profited handsomely from the TCJA. In 2020 this taxpayer earned much less because of the pandemic. Adding a new higher bracket or two will have little or no effect on them while they are down, although they might well need to pay more when their earnings have been restored.

A. *Taxing the QBI Windfalls*

There exists a more specific way in which state governments should consider reforming their personal income taxes, so as to claw back some of the windfall given to high earners by the TCJA: states could affirmatively tax their residents' "QBI windfalls."[144] The twenty percent qualified business income (QBI) deduction of § 199A was one of the more questionable provisions in the TCJA[145] and served largely to retain a consistent tax rate differential for taxpayers who earned income through investments in corporations and through pass-through entities.[146] It is unclear why maintaining this arbitrary rate distinction is a preferred policy goal. In any event, the TCJA did not completely accomplish that goal. The QBI deduction is not available to all taxpayers and is subject to a variety of conditions and phaseouts.[147]

The QBI deduction is also highly regressive and distortionary. The Joint Committee on Taxation estimated that more than three-fourths of the benefit would go to those earning $200,000 and above.[148] Those with earnings above $1 million received nearly half the benefit.[149] The deduction is also expensive, projected to cost about $40 billion in 2018.[150] Thus, even taxing away half the benefit would raise about as much as shifting to mandatory worldwide combination.

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144. Shanske, *supra* note 122.

145. Daniel Shaviro, *Evaluating the New U.S. Pass-Through Rules*, 1 BRITISH TAX REV. 49, 52–53 (2018).

146. Michael S. Knoll, *The TCJA and the Questionable Incentive to Incorporate*, STATE TAX NOTES, 977, 977 (2019).

147. *E.g.*, I.R.C. § 199A(b)(3), (c)–(e).

148. JOINT COMMITTEE ON TAXATION, JCX-32-18, TABLES RELATED TO THE FEDERAL TAX SYSTEM AS IN EFFECT 2017 THROUGH 2026, at tbl.3 (Apr. 23, 2018), https://www.jct.gov/publications/2018/jcx-32-18/ [https://perma.cc/Y6PF-SL9A].

149. *Id.*

150. *Id.*

Almost no states conformed to the QBI deduction for purposes of their own personal income taxes,[151] and for good reason. The dubious policy reason given for this change at the federal level did not apply at the state level given the lack of state corporate tax rate changes. States that have not yet decoupled from the § 199A deduction should do so. We also think that states should go further and affirmatively tax their residents' QBI windfalls.[152] The § 199A deduction granted to residents saves them from paying federal income tax on up to 20% of their earnings.[153] That windfall thus increased those residents' taxpaying capacities and represents a pool of funds that states could access in a progressive way to help the entirety of their populations.[154]

Our proposal is not to tax the QBI benefit retroactively; only current and future beneficiaries would pay the tax. Further, we propose clawing back the benefit only at higher-income levels. Again, the idea is that those who can pay more should pay more in an emergency, and they should pay out of their ill-conceived federal windfall.

B. *Strategically Decoupling from Federal Tax Cuts*

We considered strategic decoupling in our discussion of the corporate income tax above,[155] but it is also important for states to strategically decouple from federal tax changes that negatively impact their personal income tax codes as well. That decoupling would include many of the same provisions that affected the corporate income tax, due to the reporting of business income from pass-through business entities on personal income-tax returns. For example, states should consider decoupling from the expansion of the NOL rules in the CARES Act for purposes of both of their corporate and personal income taxes. One provision in the CARES Act was particularly problematic for state personal income taxes alone—the Act's retroactive expansion to the deductibility of "excess business losses."[156] We advise states to decouple from that change as well.

151. *See* Jared Walczak, *Tax Foundation Analyzes State Tax Codes Following Federal Reform*, 91 STATE TAX NOTES, 579, 597 (2019) (discussing how few states would be impacted by the federal deduction).

152. For more on this proposal, see Shanske, *supra* note 122.

153. I.R.C. § 199A(a).

154. *See* GARY GUENTHER, CONG. RSCH. SERV., R46650, SECTION 199A DEDUCTION: ECONOMIC EFFECTS AND POLICY OPTIONS 12 (2021), https://sgp.fas.org/crs/misc/R46650.pdf [https://perma.cc/QHN7-NRDE].

155. *See supra* Section II.D.

156. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 11012(a), 131 Stat. 2054.

One of the TCJA's revenue raisers was a new limitation on high-income earners' ability to deduct so-called "excess business losses."[157] Excess business losses are losses from a trade or business that exceed the sum of the taxpayer's income from trade or business activity *and* another $250,000, or $500,000 in the case of a taxpayer filing jointly with a spouse.[158] Disallowed losses are carried forward to future years, so the limitation is effectively a timing provision.[159] The CARES Act changed this limitation retroactively and deferred its application until tax years beginning after December 31, 2020.[160] The result was a significant, and retroactive, loss of revenue for states.[161]

The TCJA's change to the excess business loss rules presented the worst of state tax conformity. The change was retroactive. Its effects were targeted at high-income taxpayers.[162] It applied in the middle of a pandemic when states were ill-equipped to study its effects. And the cut was not even targeted at taxpayers with demonstrated need.[163] Perhaps one could make an argument for liberalization of the excess business loss limitation for taxpayers with 2020 losses—though we think even that argument would be strained—but allowing taxpayers relief without any regard to their 2020 position makes no sense for states. It should go without saying that it makes even less sense for states to add state-tax relief to the much larger federal tax break offered to those impacted by this change.

For these reasons, states would be well advised to decouple from, or refuse to conform to, the CARES Act's modification of the excess business loss rules. States should also review other federal tax changes that impact their personal income taxes and strategically decouple to protect both the amount and distribution of their state personal income tax collections. Most broadly, examples like that of excess business losses indicate that states should generally consider moving away from

157. I.R.C. § 461(l).

158. *Id.* at (l)(3).

159. *Id.* at (l)(2)

160. Coronavirus Aid, Relief, and Economic Security (CARES) Act, Pub. L. No. 116-136, § 2304(a), (b)(3), 134 Stat. 313 (2020).

161. *See* Michael Mazerov, *First, Do No Harm: States Can Preserve Revenue by Decoupling from CARES Act Tax Breaks for Business Losses*, CTR. ON BUDGET & POL'Y PRIORITIES (Jan. 4, 2021), https://www.cbpp.org/research/state-budget-and-tax/first-do-no-harm-states-can-preserve-revenue-by-decoupling-from-cares [https://perma.cc/3H4C-LHUV] (providing estimates of state revenue losses from this change in law).

162. Clint Wallace, *The Troubling Case of the Unlimited Pass-Through Deduction: Section 2304 of the CARES Act*, U. CHI. L. REV. ONLINE (June 29, 2020), https://lawreviewblog.uchicago.edu/2020/06/29/cares-2304-wallace/ [https://perma.cc/K2BF-WLDA].

163. The retroactive nature of the CARES Act's modification meant that taxpayers with losses prior to the COVID-19 pandemic would benefit even if they were doing fine, or particularly well, in 2020. Relief was available to all taxpayers who had excess business losses in 2018 or in 2019.

fixed conformity to federal tax law such that the default is that their tax systems do not blindly follow federal choices.[164]

C. *State Wealth Tax or Deemed Realization Tax Reforms*

More ambitiously, we also urge states to consider wealth tax or deemed realization tax reforms, at least temporarily, to raise needed revenue to weather budget crises.[165] At least two promising options could be designed and implemented sufficiently quickly (at least in some states) to make good policy responses to budget crises.

First, absent administrative constraints, the best solution is a one-time wealth tax on state residents—which is backward-looking in that the approach would tax wealth accumulated previously. Hence, it is less subject to tax-gaming and other detrimental taxpayer responses. Such a wealth tax should be designed with a large exemption, so that the tax would only apply to the wealthiest, who are generally better positioned to weather the downturn as compared to others—especially the beneficiaries of major state spending programs.[166]

Of course, administrative constraints complicate this story. States currently lack a general wealth tax, and it is unlikely to be feasible for them to design and implement a major new tax quickly. Moreover, some states face legal prohibitions against general taxes on wealth; for instance, article XVI, section 3, of the New York State Constitution states that "[i]ntangible personal property shall not be taxed ad valorem nor shall any excise tax be levied solely because of the ownership or possession thereof, except that the income therefrom may be taken into consideration in computing any excise tax measured by income generally." Thus, because such a large share of wealth consists of intangible personal property (chiefly in the form of financial assets such as stocks and bonds), any meaningful New York wealth tax would likely require a constitutional amendment.

Nevertheless, these barriers leave open at least two promising reform options. The first is a new statewide real property tax with a large exemption level (or circuit-breaker) so that only the wealthiest residents or businesses would be subject to it. Such a new tax (or surtax) could piggyback on the existing administrative valuations for real property taxes, and thus could be designed and implemented quickly.

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164. *See generally* Mason, *supra* note 1. Or states should even consider having their own tax systems. *See* Monahan, *supra* note 79.

165. The proposal provided in this Section was previously explored in Gamage & Shanske, *supra* note 45, at 859.

166. Daniel Markovits has made a similar proposal at the federal level. *See* Daniel Markovits, *A Wealth Tax Is the Logical Way to Support Coronavirus Relief*, N.Y. TIMES (Apr. 21, 2020), https://www.nytimes.com/2020/04/21/opinion/coronavirus-wealth-tax.html [https://perma.cc/ELP7-CW3Z].

Needless to say, this would only be a quick option in states without constitutional limits on property tax rates or other legal and administrative barriers. In any case, this proposal could be designed and implemented as a temporary measure, meant for raising the revenue needed to weather an economic downturn.

The second option is a new tax or deemed realization measure on the stock of unrealized capital gains. This could be done in several possible ways. For instance, the new tax could consist of a deemed realization of a percentage (for example, fifty percent) of unrealized gains that would then immediately be taxed at the state's income tax rates, with an exemption so that this new levy would apply to only the wealthiest taxpayers. This option would be more difficult to design and implement and would likely need to rely substantially on self-reported appraisals—backed by auditing and penalties—for valuation purposes. But the revenue potential should still be reasonably large, and because so much wealth is constituted by publicly traded securities, neither self-assessment nor auditing ought to be prohibitively onerous.[167]

By taxing these unrealized gains now, states would in effect be accelerating what would otherwise have been future tax payments (at least in theory, as in practice much of unrealized gains are never realized or recognized because of provisions like stepped-up basis upon death). This is appropriate, because the effect of taxing unrealized gains during a downturn would be to at least partially counteract the fiscal volatility roller coaster by moving revenues to when they are needed most. In a sense, then, one might think of the current nontaxation of unrealized capital gains as a sort of emergency rainy day fund that states should now tap.

It could be argued that either of these partial wealth tax reform proposals (which we explained earlier) could cause liquidity problems, even for the wealthy. Therefore, as a matter of design, the tax could permit a payment schedule, much like the deemed repatriation in the Tax Cuts and Jobs Act.[168] Such a schedule should contain a reasonable

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167. Mark Gergen estimates that seventy-three percent of the total value of income-producing assets are publicly traded securities. Mark Gergen, *How to Tax Capital*, 70 TAX L. REV. 1, 22 (2016). It might also be possible to design screening mechanisms that would use tax frictions to deter wasteful tax planning without imposing excess costs on taxpayers not engaged in such wasteful tax planning. *See* David Gamage, *A Way Forward for Tax Law and Economics? A Response to Osofsky's 'Frictions, Screening, and Tax Law Design,'* 61 BUFFALO L. REV. 189, 190 (2014) ("Incorporating the analysis of screening mechanisms into the design of tax frictions, then, has the potential to improve the tax law's ability to deter wasteful tax planning while imposing lower costs on regular business transactions."). *See generally* Leigh Osofsky, *Who's Naughty and Who's Nice? Frictions, Screening, and Tax Law Design*, 61 BUFFALO. L. REV. 1059 (2013) (explaining such screening mechanisms).

168. 26 U.S.C. § 965(h).

interest rate because states should consider borrowing against this stream of income to pay for immediate needs.

Another possible objection to a tax of either type is that the wealthy might simply leave the state. There is significant economics literature on these issues.[169] We read this literature as implying that migrations from so-called high tax states have *so far* not represented a phenomenon that should overly trouble states considering more progressive taxation.[170] Regardless of how one reads the literature as to ongoing income taxes, our proposed tax measures represent a one-time tax on previously accumulated wealth or gains. Thus, there should be a minimal behavioral response.

These taxes are not only broadly progressive and efficient, but they also could be designed to address deeper issues of inequality. Income and wealth inequality have become increasingly pressing issues at both the federal and state levels. Accordingly, recent Pew Research Center polling reveals that six in ten U.S. adults believe that there is too much inequality in the country today, and 84% of those who see inequality as a problem believe that the government should increase taxes on the wealthy.[171] Yet states and the federal government do a very poor job of taxing the true economic income of the very wealthy.[172] For the top 0.1% of taxpayers, whose incomes derive primarily from the returns on owning wealth (rather than from salary or wages), structural features of state and federal income taxes make these taxes "so porous as to be largely symbolic."[173] Thus, other relatively progressive reforms we have discussed, such as reforming personal income taxes, will not be progressive at the very top of the income distribution if not paired with a wealth or deemed realization tax.

In that light, either option—a new statewide property surtax on the very wealthy or a new statewide tax on the unrealized capital gains of the wealthy—would help ameliorate the lack of effective taxation of the very rich. There is good reason to impose these taxes at any time, but during a pandemic and recession, these tax reform proposals are clearly

169. *See generally*, Cristobal Young, Charles Varner, Ithai Z. Lurie & Richard Prisinzano, *Millionaire Migration and Taxation of the Elite: Evidence from Administrative Data*, 81 AM. SOCIO. REV. 421 (2016); Joshua Rauh & Ryan J. Shyu, *Behavioral Responses to State Income Taxation of High Earners: Evidence from California* (Nat'l Bureau of Econ. Rsch., Working Paper No. 26349, 2019).

170. For example, we are not considering what would happen if states imposed much higher tax rates than they currently do.

171. Juliana Menasce Horowitz, *Most Americans Say There Is Too Much Economic Inequality in the U.S., but Fewer than Half Call It a Top Priority*, PEW RSCH. CTR. (Jan. 9, 2020), https://www.pewresearch.org/social-trends/2020/01/09/most-americans-say-there-is-too-much-economic-inequality-in-the-u-s-but-fewer-than-half-call-it-a-top-priority/ [https://perma.cc/QZ4G-Q47R].

172. *See* David Gamage, *Five Key Research Findings on Wealth Taxation for the Super Rich* (July 27, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3427827.

173. *Id.* (citing Edward J. McCaffery, *The Death of the Income Tax (or, the Rise of America's Universal Wage Tax)* 2 (USC Gould Sch. of L. Ctr. for L. & Soc. Sci., Working Paper No. 18-25, 2019)).

well advised. Recall, when the federal government fails to act sufficiently, there is a zero-sum game at hand. Either states and localities must cut vital services, thereby prolonging the recession, or they avert these cuts by raising tax revenues.

IV. STATE SALES TAX REFORMS

Raising sales tax rates would be regressive and is not a good reform option for coping with economic crises.[174] However, states should consider expanding their sales tax bases to include services. There are many reasons why states should consider this, the most pressing of which is that taxing services would significantly increase revenue in most states.[175] For example, when Utah attempted to expand its retail sales tax base to include all services by default in 2019, state auditors estimated the bill would bring in an additional $230 million in revenue in 2020.[176] In 2017, Illinois estimated that it could bring in an additional $1.2 to $3 billion per year if it taxed the same services that Iowa taxed (which taxes a relatively broad range of services).[177] North Carolina, which passed legislation that added several services to its tax base in 2016, estimated that the change brought in at least $84.8 million in sales tax revenue in the first year.[178] Since each state includes a different mix

174. The proposals in this Part were first provided in two prior essays: Gladriel Shobe, Grace Stephenson Nielsen, Darien Shanske & David Gamage, *Why States Should Consider Expanding Sales Taxes to Services, Part 1*, 98 STATE TAX NOTES 1349 (Dec. 21, 2020); Grace Stephenson Nielsen, Gladriel Shobe, Darien Shanske & David Gamage, *How States Should Consider Expanding Sales Taxes to Services, Part 2*, STATE TAX NOTES 45 (Jan. 4, 2021).

175. The state-level revenue projections in this Part are descriptive—they reflect estimates for proposed or enacted state tax packages—rather than normative and prescriptive. They may therefore include tax revenue from items that policymakers and scholars generally agree should not be included in the base. This is especially problematic for business inputs, which currently comprise around 40% of most states' tax bases. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 68, § 12.03.

176. Fiscal Note, H.B. 441, 63d Leg., Gen. Sess. (Utah 2019), https://le.utah.gov/~2019/bills/static/HB0441.html [https://perma.cc/X7P6-YMWR] (on the right-hand side of the webpage under "Related Documents," choose the file labeled "Fiscal Note").

177. Keith Staats, *A Tax on Services?*, ILL. CPA SOC'Y: INSIGHT, TAX DECODED (Spring 2017), https://www.icpas.org/information/copy-desk/insight/article/spring-2017/a-tax-on-services [https://perma.cc/U52M-PUJZ]. Many other states have provided similar revenue estimates. For example, Connecticut, which already added certain services to its sales tax base in 2012, could raise an additional $730 million to $1.5 billion by expanding its sales tax to include more services. *See* Derek Thomas, *Revenue Options Are Key to Addressing Budget Shortfalls and Supporting Thriving Communities*, CONN. VOICES FOR CHILD. (Jan. 2017), https://ctvoices.org/wp-content/uploads/2017/05/Revenue-Options-2017-FINAL-updated.pdf [https://perma.cc/DPW7-VK8Z].

178. *See* H.B. 1030, 2016–2017 Gen. Assemb., Reg. Sess. (N.C. 2016), https://www.ncleg.gov/documentsites/committees/House2015-24/2016%20Session/06-07-16/Summary%20of%20Senate%20Finance%20Package%20in%20Senate%20Budget.pdf [https://perma.cc/9AXV-BFQB]; *NC Adds Sales Tax to Services*, BGW CPA, https://www.trustbgw.com/blog/2016/03/01/nc-begins-taxing-services [https://perma.cc/H7HM-MFUL]; *see also* Jared Walczak, *Enhancing Tax Competitiveness in Connecticut*,

of transactions in its sales tax base, economists and policy makers have found it difficult to make concrete projections about how much revenue a broad services tax would raise if all states were to add consumer services to their tax bases. At least one estimate, though, places the potential "annual, nationwide revenue yield from taxing all services purchased by households" in the tens of billions.[179]

Beyond the revenue potential, taxing services makes substantive policy sense, too. First, expanding the base would help modernize state sales taxes.[180] When states first adopted sales taxes, the purpose was to capture consumer spending.[181] At that time, consumers spent much more on goods than services, so states were able to tax the majority of consumer spending by taxing the sale of goods (and excluding all but a few services).[182] Since the mid-twentieth century, consumer spending has shifted toward services and away from goods.[183] Sales of goods may have been a workable, albeit imperfect, sales tax base in the past when services expenditures were not as high as they are today.[184] Today,

TAX FOUND. (July 31, 2018), https://taxfoundation.org/connecticut-tax-competitiveness/#_ftnref32 [https://perma.cc/KSG5-DG7V].

179. *See* MICHAEL MAZEROV, CTR. ON BUDGET & POL'Y PRIORITIES, EXPANDING SALES TAXATION OF SERVICES: OPTIONS AND ISSUES iii, 4 (2009), https://www.cbpp.org/sites/default/files/atoms/files/8-10-09sfp.pdf [https://perma.cc/7UYK-2Y5W] (estimating $87 billion and granting exemptions for certain household essentials); *FTA Survey of Services Taxation – Update*, FED'N OF TAX ADM'RS (July–Aug. 2017), https://www.taxadmin.org/btn-0817_services [https://perma.cc/EA2H-9DHU] (noting that although many states tax services like hotels, event admissions, utilities, and repair services, only a small minority of states tax personal and professional services that make up the majority of service transactions).

180. *E.g.*, Michael Leachman, *Four Ways to Modernize State Sales Taxes*, CTR. ON BUDGET & POL'Y PRIORITIES (July 9, 2013), https://www.cbpp.org/blog/four-ways-to-modernize-state-sales-taxes [https://perma.cc/AB82-CLYM]. The recent Supreme Court decision in *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018) allows states to require businesses to collect and remit state sales tax on internet purchases. The *Wayfair* decision helped bring state sales tax regimes into the twenty-first century, but it represents just one piece of the "modernization" puzzle. *See generally* David Gamage, Darien Shanske & Adam Thimmesch, *Taxing E-Commerce in the Post-Wayfair World*, 58 WASH. UNIV. J.L. & POL'Y 71 (2019) (discusing the *Wayfair* case and its implications); David Gamage & Devin J. Heckman, *A Better Way Forward for State Taxation of E-Commerce*, 92 B.U. L. REV. 483 (2012) (discussing the problems with state taxation of e-commerce prior to the *Wayfair* decision).

181. Kirk J. Stark, *The Uneasy Case for Extending the Sales Tax to Services*, 30 FLA. STATE UNIV. L. REV. 435, 440–41 (2003).

182. *See* Robert Tannenwald, *Are State and Local Revenue Systems Becoming Obsolete?*, 4 NEW ENG. ECON. REV. 27, 31 (2001) (describing administrability concerns for taxing service transactions); HELLERSTEIN & HELLERSTEIN, *supra* note 68, § 12.05 ("When state legislatures first enacted general sales taxes during the 1930s, they confined the tax base largely to sales of tangible personal property, with taxation of services limited to utility services and admission fees.").

183. Jonathan J. Church, *Explaining the 30-Year Shift in Consumer Expenditures from Commodities to Services, 1982–2012*, BUREAU OF LAB. STATS. (Apr. 2014), https://www.bls.gov/opub/mlr/2014/article/explaining-the-shift-in-consumer-expenditures.htm [https://perma.cc/ZX38-3WKT] (showing that since around 1990, Americans have spent more on services than on commodities).

184. BUREAU OF ECON. ANALYSIS, U.S. DEP'T OF COM., NATIONAL INCOME AND PRODUCT ACCOUNTS, NIPA TABLES, SECTION 1 – DOMESTIC PRODUCT AND INCOME, tbl.1.1.5 (Dec. 22, 2021), https://apps.bea.gov/iTable/iTable.cfm?ReqID=19&step=4&isuri=1&1921=flatfiles#reqid=19&step=4&isuri=1&1921=flatfiles.

however, services account for sixty-nine percent of consumer spending.[185] Put simply, most state sales taxes are based on the economy not as it is today, but as it existed nearly a century ago.

It is further worth noting that the U.S. tax system as a whole, considering both the state and federal levels, dramatically undertaxes spending as compared to every other developed nation.[186] This is because every other developed nation raises a large portion of its overall revenues from a value-added tax (VAT).[187] By contrast, the U.S. federal government levies neither a VAT nor any substantial tax on spending, and U.S. state governments' sales taxes are much smaller in both scope and magnitude as compared to other nations' VATs.[188]

Second, a tax on services could help eliminate the current arbitrary distinctions between closely related consumer goods and services, which may distort consumer choices by artificially making service transactions less expensive.[189] For example, if purchasing a lawnmower with a useful life of four years and hiring a lawn care service over that same time period each cost $400 before sales tax, and only the purchase of the lawnmower is taxable, the fact that the purchase of the lawnmower is taxed makes it more expensive relative to the cost of the lawn care service.

A general maxim of tax policy is that broad-based taxes are superior at minimizing economic distortions.[190] Expanding state sales taxes to include services would broaden the base of these taxes and enhance their efficiency. Indeed, the arbitrary sales tax distinction between goods and services results in higher taxes on goods because the items that remain in the tax base must bear the full brunt of the sales tax revenue burden.[191] Adding services to their sales tax base gives states

185. *Id.*

186. *See, e.g.*, Ajay K. Mehrotra, *The Myth of the "Overtaxed" American and the VAT that Never Was*, 2 MOD. AM. HIST. 97, 97–98 (2019); Andrea Louise Campbell, *America the Undertaxed*, 91 FOREIGN AFFS. 99, 99–100 (2012).

187. Mehrotra, *supra* note 186; Campbell, *supra* note 186.

188. Campbell, *supra* note 186.

189. Alan R. Romero, *Including Legal Services in State Sales Taxes*, 29 HARV. J. ON LEGIS. 280, 286 (1992); Stark, *supra* note 181, at 448.

190. *See, e.g.*, Shahira ElBogdady, *The Inefficiency of Targeted Tax Policies*, JOINT ECON. COMM. REPUBLICANS (Apr. 1997), https://www.jec.senate.gov/public/_cache/files/fe2eafaa-f355-462f-b515-15ad4a8f5e74/the-inefficiency-of-targeted-tax-policies-april-1997.pdf [https://perma.cc/YJ6A-ZSL7]; David Gamage, *How Should Governments Promote Distributive Justice?: A Framework for Analyzing the Optimal Choice of Tax Instruments*, 68 TAX L. REV. 1, 20 (2014) (describing this "general prescription" as the "tax-smoothing principle"); David Gamage, *The Case for Taxing (All of) Labor Income, Consumption, Capital Income, and Wealth*, 68 TAX L. REV. 355, 381 n.85 (2015) ("[T]he tax-smoothing principle has been called 'the broad base rule.'").

191. For example, Illinois ranks forty-third in the United States for the breadth of its sales tax base, but thirteenth for its sales tax rate. CHI. METRO. AGENCY FOR PLAN., THE BENEFITS OF ADDING MORE SERVICES TO ILLINOIS' SALES TAX BASE 3 (2019), https://www.cmap.illinois.gov/documents/10180/986064/Benefits+of+adding+more+services+to+IL+sales+tax+base.pdf/98029a31-c167-689f-2b6c-2367c8239a6e [https://perma.cc/5ER7-6UEW].

the option to lower their overall average sales tax rates (perhaps after state finances have recovered from the economic effects of the pandemic), which reduces the price for goods and services that are already subject to sales tax without reducing overall sales tax revenue.[192]

Of course, all consumption taxes raise significant design concerns. First, business inputs should generally remain untaxed.[193] When business inputs are taxed, businesses raise retail prices to cover sales taxes paid on transactions during production, a concept often referred to as "tax pyramiding" (i.e., a tax on a tax).[194] This is especially problematic in the sales tax context where there may be many levels involved in production processes. To address this problem, states need to implement credits, deductions, or exclusions for business-to-business purchases so that services can be incorporated into the sales tax base without exacerbating concerns related to tax pyramiding.

Another potential concern is that sales taxes (like other consumption taxes) are generally considered regressive because they are imposed at a flat rate, and lower-income taxpayers spend a greater proportion of their income on goods and services.[195] Yet this concern is likely to be more than offset by the progressivity of how revenues are spent. Because most of the major categories of state spending benefit low-income populations, the overall result of funding incremental spending or preventing cuts through an expanded sales tax base would be, in fact, progressive.[196]

A. *Which Services to Tax*

If states decide to expand their sales tax bases to include more services, they will need to determine which services to bring under the sales tax umbrella. Services can be divided into roughly three categories: services consumed primarily by businesses, services

192. HELLERSTEIN & HELLERSTEIN, *supra* note 68, § 12.05.

193. For example, most countries that use a VAT also follow the "credit-invoice method" to make intermediate business transactions taxable but creditable. *Briefing Book: How Would a VAT Be Collected?*, TAX POL'Y CTR., https://www.taxpolicycenter.org/briefing-book/how-would-vat-be-collected [https://perma.cc/3MQ4-AYA9]. This means "there are no net taxes on sales between registered VAT businesses," and only "the full value of the final sale to the consumer bears tax." *Id.*

194. *See, e.g.*, Michele E. Hendrix & George R. Zodrow, *Sales Taxation of Services: An Economic Perspective*, 30 FLA. STATE UNIV. L. REV. 411, 416 (2003); MAZEROV, *supra* note 179, at 25–26 ("pyramiding"); Shanske, *supra* note 122, at 465–66.

195. *See, e.g.*, Elaine S. Povich, *Why States Are Struggling to Tax Services*, PEW RSCH. CTR. (June 27, 2017), https://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2017/06/27/why-states-are-struggling-to-tax-services [perma.cc/G4VN-33R6].

196. *See* Gladriel Shobe, *Disaggregating the State and Local Tax Deduction*, 35 VA. TAX REV. 327, 334 (2016).

consumed primarily by households, and services consumed by both businesses and households.

Economists generally agree that, in order to avoid "tax pyramiding," states should not tax business-to-business transactions when "the same goods or services are taxed multiple times" along the production process.[197] Furthermore, taxing business inputs distorts the allocation of resources by incentivizing businesses to provide those services in-house, even if those services could be produced more efficiently by a third party.[198] Therefore, states that choose to expand their sales tax bases should proceed cautiously with respect to services consumed primarily by businesses.[199] States would also be well advised to consider adding a credit, deduction, or exemption for business-to-business sales rather than trying to exclude categories of services from sales tax bases. But if politics or other obstacles prevent the adoption of such a credit, deduction, or exemption, then it may be prudent to partially or fully exempt services primarily consumed by businesses.

By contrast, policy makers generally support taxing services consumed by households.[200] The purpose of a sales tax is to tax personal consumption, and the consumption of services by households, such as lawn care services for a home or the services of a personal trainer, is a form of personal consumption. According to a survey by the Federation of Tax Administrators, although a handful of states tax more than 100 services (e.g., Hawaii and New Mexico tax 167 and 164 services respectively), most states tax far fewer.[201] Many of those untaxed services are consumed primarily by individuals, including household

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197. *See* Robert J. Cline, John L. Mikesell, Thomas S. Neubig & Andrew D. Phillips, *Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services*, 35 STATE TAX NOTES 457 (2005). *See generally* JARED WALCZAK, TAX FOUND., 2020 STATE BUSINESS TAX CLIMATE INDEX 35–36 (2019), https://files.taxfoundation.org/20191021155857/2020-State-Business-Tax-Climate-Index-PDF.pdf [perma.cc/XB4F-PGVP] (scoring states based on their tax systems and giving the worst sales tax scores to states that tax the most business inputs).

198. Despite the arguments against imposing sales taxes on business inputs, states collect an average of 42% of their sales tax revenue from business inputs. *See* KARL FRIEDEN & FRED NICELY, COUNCIL ON STATE TAXATION, THE BEST AND WORST OF STATE SALES TAX SYSTEMS 9 (2018), https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/the-best-and-worst-of-state-sales-tax-systems-august-17-2018-final.pdf [perma.cc/RG62-PBXA].

199. It is worth noting that although states should avoid expanding the number of business-to-business services in their tax base, business inputs currently make up a significant portion of many states' sales tax base. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 68, § 12.03 ("[B]usiness inputs in fact make up a healthy portion of most states' sales tax bases. Indeed, most nationwide studies conclude that business inputs as a share of the sales-tax base average about 40 percent for forty-five states and the District of Columbia.").

200. *See, e.g.*, MAZEROV, *supra* note 179, at 29–30.

201. *See FTA Survey of Services Taxation – Update*, *supra* note 179, at 1.

storage, dating services, gyms, tanning and hair salons, and personal instruction (like golf lessons or fitness coaching).[202]

The third category of services includes services consumed by both businesses and households. This category is obviously more complicated because states would need to find ways to capture personal, but not business, consumption of these services. For all three categories, the best way to accomplish this goal is by granting deductions for intermediate business transactions or by reforming the current system of business-to-business credits, rather than trying to exclude categories of services from sales tax bases, since these services are often (but not always) consumed by businesses.

B. *Mechanics of Expanding the Sales Tax Base*

Over the last thirty-five years, many state legislatures have proposed expanding their sales tax bases to broadly capture services.[203] Many have failed. For example, Utah and Maryland legislators proposed significantly expanding their sales tax bases to include more services, in 2019 and 2020 respectively, but the local business communities mobilized against and defeated the proposals.[204] Similarly, when Michigan tried to tax a long list of enumerated services in 2007, "widespread public opposition" caused the state legislature to repeal the tax on the day it was scheduled to go into effect.[205] Additional examples

202. *See id.*; *see also* Nicole Kaeding, *Sales Tax Base Broadening: Right-Sizing a State Sales Tax*, TAX FOUND., at tbl.3 (Oct. 24, 2017), https://taxfoundation.org/sales-tax-base-broadening [perma.cc/25YQ-UUGK]; MAZEROV, *supra* note 179, at 38–43.

203. *See, e.g.*, FLA. STAT. § 212.059 (1987), *repealed by* 1988 Fla. Laws 19; S.J.R. 938, 34th Gen. Assemb., Reg. Sess. (Fla. 2002) (never passed); MASS. GEN. LAWS. ch. 64H, §§ 1–33 (1991), *amended and partially repealed by* 1991 Mass. Acts 4; MASS. GEN. LAWS. ch. 64H, § 1 (2013) (amending the sales tax to include "computer system design services"), *repealed by* 2013 Mass. Acts ch. 95; 2007 Mich. Pub. Acts 92, *repealed by* H.B. 5408, 94th Leg., Reg. Sess. (Mich. 2007); *see also, e.g.*, INDIANA FISCAL POLICY INSTITUTE, SALES TAXATION OF SERVICES IN INDIANA: CONCEPTS AND ISSUES 6–7 (2009), http://www.indianafiscal.org/Resources/Documents/Sales-Taxation-Services-Indiana.pdf [perma.cc/TQ28-KJS4] (describing unsuccessful attempts to expand service taxes in Florida, Massachusetts, Maryland, and Michigan, but noting New Jersey's successful but significantly more narrow expansion of taxable services).

204. H.B. 441, 63d Leg., Gen. Sess. (Utah 2019) (bill not passed); *see, e.g.*, Lisa Riley Roche, *Despite Business Backlash, Utah's Tax Reform Bill Headed to House Floor*, DESERET NEWS (Mar. 1, 2019), https://www.ksl.com/article/46502054/despite-business-backlash-utahs-tax-reform-bill-headed-to-house-floor [perma.cc/ENE5-TB2S]; Pamela Wood, *Maryland Lawmakers Defeat Sales Tax Expansion That Was Pitched as Way to Pay State's Share of Kirwan Education Improvements*, BALT. SUN (Mar. 5, 2020), https://www.baltimoresun.com/politics/bs-md-pol-ga-no-sales-tax-20200305-au3kz74nivfcbelxkuiquz2bj4-story.html [perma.cc/M6M4-WUXQ]; Ovetta Wiggins, *5,000 Emails in 3 Hours: Blast of Opposition to Md. Bill Expanding Sales Tax*, WASH. POST (Mar. 2, 2020), https://www.washingtonpost.com/local/md-politics/business-owners-blast-house-democrats-plan-to-extend-sales-tax-to-services-in-maryland/2020/03/02/2fc678a2-5cab-11ea-b29b-9db42f7803a7_story.html [perma.cc/9X4E-9XVH].

205. Monica Davey, *States Seeking Cash Hope to Expand Taxes to Services*, N.Y. TIMES (Mar. 27, 2010), https://www.nytimes.com/2010/03/28/us/28taxes.html [https://perma.cc/ADT3-SVAR]; 2007 Mich.

of states that have proposed, but failed to pass, legislation that would have added services to their sales tax base include Florida (1987 and again in 2002), Massachusetts (1991), Nebraska (2013), Ohio (2013), Louisiana (2013), Minnesota (2013), and Pennsylvania (2015).[206]

In contrast, several states and the District of Columbia have successfully expanded their sales tax bases over the past decade. For example, Connecticut increased the number of services in its sales tax base from 85 to 99, the District of Columbia expanded its services tax base from 75 to 91, North Carolina increased its list of taxable services from 36 to 62, and Kentucky added an additional 17 services in 2018.[207] Health clubs, home maintenance services, automotive repair, car washes, parking lots, storage, carpet cleaning, and bowling alleys were among the many services added to these jurisdictions' tax bases.[208] These examples show that although expanding a state's tax base to include services may be politically difficult, it is still possible.

Why have some states been able to successfully expand their sales tax bases to include services while others have failed? Many factors determine whether a bill is successful. For example, states' current sales taxes often capture goods (like auto parts) but not adjacent services (like mechanics' services), which can create economic distortions by treating closely related transactions differently.[209] When state legislatures add new items to the sales tax base, additions that reduce distinctions between closely related transactions may prove more politically feasible and easier to administer, in part because they likely affect vendors who are already collecting and remitting sales tax.

Another factor that appears to affect the outcome is whether the proposed legislation taxes business inputs. States that include business-to-business service transactions in their proposed bills provoke strong opposition from the states' business communities, who argue that the proposed legislation will result in tax pyramiding.[210] For

Pub. Acts 93 (adding a long list of both consumer and business services to Michigan's use tax base by adding § 3(d)), *repealed by* 2007 Mich. Pub. Acts 145.

206. *See* ANDREW PHILLIPS & MUATH IBAID, THE IMPACT OF IMPOSING SALES TAXES ON BUSINESS INPUTS 16 (2019), https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/1903-3073001_cost-ey-sales-tax-on-business-inputs-study_final-5-16.pdf [perma.cc/8MKR-9683]; *see also* MASS. GEN. LAWS. ch. 64H, §§ 1–33, *amended and partially repealed by* 1991 Mass. Acts 4; Samuel B. Bruskin & Kathleen King Parker, *State Sales Taxes on Services: Massachusetts as a Case Study*, 54 TAX LAW 49 (1991) (detailing and analyzing Massachusetts's attempt to tax a long list of services); FLA. STAT. § 212.059 , *repealed by* 1988 Fla. Laws 19; S.J.R. 938 (never passed); Vicki L. Weber, *Florida's Fleeting Sales Tax on Services*, 15 FLA. STATE U. L. REV. 613 (1987).

207. *See FTA Survey of Services Taxation – Update*, *supra* note 179; CHI. METRO. AGENCY FOR PLAN., *supra* note 191, at 6.

208. *See FTA Survey of Services Taxation – Update*, *supra* note 179.

209. *See* Shobe et al., *supra* note 174, at 1352–53.

210. PHILLIPS & IBAID, *supra* note 206, at 18 ("[E]ach of these proposals failed, in large part due to opposition from the business community. Generally, the policy objections were not to the

example, Michigan's proposed legislation faced strong opposition because it would have captured many services used primarily by businesses: management, scientific, and technical consulting; office administration; merchandise warehousing and storage; and industrial and graphic design.[211] Proposed legislation in Florida, Louisiana, Massachusetts, Minnesota, Nebraska, Ohio, and Utah faced similar defeats after their respective business communities argued that the bills would have taxed business inputs.[212] In contrast, jurisdictions that have successfully added services to their tax base have primarily added personal services, not business inputs.[213] Although those jurisdictions received pushback from certain interest groups, such as health clubs, they also received support from policy makers who argued that the bills targeted personal consumption and were thus grounded in sound tax policy.[214] Therefore, while there are certainly many factors that affect the outcome of any proposed bill, it appears that legislation that avoids taxing business-to-business transactions is more likely to pass.

State legislatures will need to determine whether to expand their sales tax bases by switching from an "incremental" approach to a "comprehensive" approach. Most states take an incremental approach to taxing services, meaning they exempt services from sales tax by default and then specifically subject certain services to sales tax by state statute.[215] In contrast, other states—including Hawaii, New Mexico,

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expansion and modernization of the sales tax base to include the growing services sector, but to doing so without limiting the base expansion to household services.").

211. 2007 Mich. Pub. Acts 93 (incorporating specific industry codes from the 2002 North American Industry Classification System (NAICS 2002) by reference, including NAICS 2002 codes 5416, 5611, 4931, and 5414).

212. *See* PHILLIPS & IBAID, *supra* note 206, at 16; Weber, *supra* note 206, at 626, 628 (explaining that under the 1987 Florida law, all services purchased by nearly all businesses would be subject to sales tax); Hendrix & Zodrow, *supra* note 194, at 427 (stating that the 2007 Florida proposal would have expanded the tax base to include many business-to-business transactions); H.B. 441, 63d Leg., Gen. Sess. (Utah 2019) (exempting manufacturing, wholesale trade, and most financial services, but providing no exemption for legal, accounting, and most architectural and engineering services). Massachusetts's 1991 law would have taxed professional services like legal, accounting, engineering, and architectural services *only* when provided to businesses, not individual consumers. 1990 Mass. Acts 209 (defining many "services" for consumption tax purposes to include services *only* if "provided to businesses").

213. *See FTA Survey of Services Taxation – Update*, *supra* note 179.

214. *See, e.g.*, Joseph Bishop-Henchman, *Vida Fitness Spreads Half-Truths About DC Tax Cut Bill*, TAX FOUND. (May 30, 2014), https://taxfoundation.org/vida-fitness-spreads-half-truths-about-dc-tax-cut-bill [perma.cc/65VK-2CBK].

215. Typically, those states' retail sales tax regimes capture all sales of tangible personal property by default unless expressly exempted and then include a list of taxable services in the statutory definition of "retail sale." *See, e.g.*, WASH. REV. CODE § 82.04.050(1)(a) (2017) ("'Sale at retail' or 'retail sale' means every sale of tangible personal property."); *Id.* § 82.04.050(2)(a)–(e) (2017) ("'[R]etail sale' includes the sale of . . . labor and services rendered in respect to: . . . The installing, repairing, cleaning, altering, imprinting, or improving of tangible personal property of or for consumers, . . . cleaning, fumigating, razing, or moving of existing buildings, . . . [a]utomobile towing," etc.).

South Dakota, and West Virginia—take a comprehensive approach by taxing all services by default and then granting exemptions, such as exemptions for business-to-business transactions and essential services.[216]

Although the comprehensive approach naturally captures more services in a state's sales tax base, seemingly making it the most attractive option for capturing a broad range of services, only South Dakota has successfully switched from an incremental to a comprehensive approach.[217] Every other state's attempt to make this switch has been defeated, in large part because the business community has argued that a comprehensive approach sweeps a large number of business inputs into the tax base.[218] Thus, it may well be that an incremental approach is more politically achievable than aiming for a more ambitious, comprehensive one. For guidance on navigating the political obstacles, state governments might look to jurisdictions that have successfully implemented the incremental approach, like Connecticut, Kentucky, North Carolina, and the District of Columbia.[219]

V. STATE BORROWING

We remain mindful that the tax reform proposals suggested above, despite all of their merit, might not be enough, even if there is substantial federal support, and especially if there is not.[220] Indeed, given the variety of taxes states currently employ, the diversity in state economies, and the different conditions of various state budgets, some shortfalls seem very likely, at least in some states. And it is important to remember here that it will likely fall to states in many instances to shore

216. Hawaii, New Mexico, and South Dakota impose gross receipts taxes on businesses that provide services. HAW. REV. STAT. § 273-13 (2021) (4% tax on "gross proceeds of sales, or gross income" of service businesses); N.M. STAT. ANN. §§ 7-9-3.5(1) & 7-9-4 (2021) ("[G]ross receipts is imposed on any person engaging in business in New Mexico," where "'gross receipts' means the total amount of money or the value of other consideration received from selling property . . . or from performing services."); S.D. CODIFIED LAWS §§ 10-45-2, 10-45-4, 10-45-4.1, & 10-45-5 (2021) (taxing "gross receipts of all sales of tangible personal property" and gross receipts from "engaging or continuing in the practice of any business . . . unless the service is specifically exempt"); S.D. CODIFIED LAWS § 10-45-12.1 (2021) (expressly exempting healthcare, education, and local transportation (except for limousines!)). Although the tax is paid by businesses, not the consumer, the end result—a consumption tax on services—is the same, since businesses will pass the gross receipts tax costs on to consumers through higher prices. West Virginia includes services in its retail sales tax base, but it exempts all professional services. *See* W. VA. CODE §§ 11-15-2 & 11-15-3 (2021).

217. *See* MAZEROV, *supra* note 179, at viii.

218. *See* PHILLIPS & IBAID, *supra* note 206.

219. *See FTA Survey of Services Taxation – Update*, *supra* note 179.

220. See Darien Shanske & David Gamage, *The Case for State Borrowing as a Response to the Current Crises*, 97 TAX NOTES STATE 1137 (2020), for a prior version of the proposal in this Part.

up *local* finances. Thus, if the effects of an economic crisis are not to fall upon those most vulnerable, states (and localities) need tools beyond raising revenues in the short, or even long, term.

In most crises, it seems reasonable to surmise that in, say, three years, state and local finances will be looking a lot better, even without new taxes. Even so, state revenues will likely look even better still in three years if they do not eat their seed corn now by reducing funding for vital services. Consider that if states worked on five-year budget cycles, a budget planner would be well advised to borrow from later in that cycle to pay for necessary expenses now, at the nadir. Thus, the basic idea is that states should smooth their taxing and spending by borrowing from a better future to sustain the challenging present. To ensure that there will be more revenue in the future, states should improve their revenue systems now—and, as we have discussed, there is much to improve. Because there is so much to upgrade, putting into place a suite of revenue enhancements now might unlock substantial streams of revenue that could be securitized.

This is a different proposal than simply borrowing without reform, because borrowing without putting into place new revenue can be hamstrung by one of two problems. First, the amount borrowed could be too small. In that case, there is little harm done to the state's future revenue, but it has done little to address the enormous current crises. On the other hand, a state could look to borrow on a scale sufficient to mitigate a crisis, but this level of borrowing could place a large burden on the state down the road without new revenues.[221] To be specific about securitizing revenue, suppose California put into place our proposal to broaden its corporate income tax base by shifting to mandatory worldwide combination.[222] In better times, this was estimated to raise $2 billion per year,[223] a roughly twenty percent increase in state corporate income tax revenues. Suppose California securitized ten percent of its corporate income tax base—an estimated $1 billion per year—for twenty years at a five percent rate. That would be worth about $12 billion to California right now,[224] which is about 85% of the $14 billion that the state was hoping the federal government

221. A recent Center on Budget and Public Priorities report makes this point very persuasively. *See* Michael Mazerov & Elizabeth McNichol, *State Borrowing No Substitute for Additional Direct Aid to Help States Weather COVID Downturn*, CTR. ON BUDGET & POL'Y PRIORITIES 1 (June 29, 2020), https://www.cbpp.org/sites/default/files/atoms/files/6-29-20sfp.pdf [https://perma.cc/65RX-5VN9].

222. *See supra* Section II. A.

223. *See* Phillips & Proctor, *supra* note 51, at 2.

224. Given the time value of money (5% in this example), $12 billion is how much a 20-year stream of $1 billion payments is worth now.

would provide to head off deep cuts in the spring of 2020.[225] The cost of federal funds at the time was closer to one percent for a borrowing for twenty years—so if the Fed were to purchase these bonds, as we argue below that it should,[226] then California could have raised $17 billion through this expedient. Note that before the onset of COVID-19, California was running a surplus without this reform.[227] Even if it were to raise fifty percent less than expected, the state's net fiscal position when the recession ends would still be the same as had been expected before the crisis and this borrowing.[228]

But we do not mean to be overly prescriptive about the need for pairing new revenue with borrowing. First, the future crises in revenue might be even worse if states allow their economies to contract too much in the present. Second, states like California that had been running a surplus can roughly borrow from future surpluses. Third, states like New Jersey have recently implemented many smart corporate income tax reforms with favorable results.[229] It would be odd that only those states that have still not made common-sense reforms should borrow. Fourth, states can always raise taxes later, and the politics of doing so might be different during a recovery. In the end, however, it would be better for new borrowings to be paired with new revenue. One compromise would be to put in place tax increases that would only kick in as the economy expands or when revenues come in too far below what is needed.

A. *What About Borrowing Limitation Rules?*

Special debt rules have been part of American public finance for almost two centuries, and for good reason: it is tempting for current generations, especially politicians, to saddle the future with debt. States incurred huge debts in the 1830s building infrastructure (such as

225. Nicole Nixon, *Newsom, California Lawmakers Agree to Budget Deal That Avoids Cuts to Health and Social Services*, CAPRADIO (June 22, 2020), https://www.capradio.org/articles/2020/06/22/facing-54-billion-deficit-newsom-and-california-lawmakers-agree-to-budget-deal/ [https://perma.cc/2UVA-HZDZ].

226. *See* Darien Shanske & David Gamage, *How the Federal Reserve Should Help States and Localities Right Now*, 96 TAX NOTES STATE 765, 766 (2020).

227. John Myers, *Coronavirus Threatens to Wipe out California's $21-Billion Surplus. And It Could Get Worse*, L.A. TIMES (Mar. 25, 2020), https://www.latimes.com/california/story/2020-03-25/california-20-billion-budget-reserve-may-get-wiped-out-by-coronavirus-crisis [https://perma.cc/QG3W-NNZU].

228. Note that California did not borrow, but cut instead. *See* STATE OF CALIFORNIA, GOVERNOR'S BUDGET SUMMARY—2021–22, http://www.ebudget.ca.gov/2021-22/pdf/BudgetSummary/Introduction.pdf [https://perma.cc/T7JQ-GANB]. As it turns out, state revenue did not collapse and so the cutting was unnecessary, but that does not weaken the case for borrowing.

229. *See* STATE OF NEW JERSEY, SUMMARY OF BUDGET RECOMMENDATIONS FOR THE FISCAL YEAR 2021: BUDGET IN BRIEF 42–44 (2020), https://www.state.nj.us/treasury/omb/publications/21bib/BIB.pdf [https://perma.cc/F2KC-6GQ2].

canals), and many of these projects ended up in the red when the economy turned.[230] This experience of states facing default and near-default led to special constitutional rules about incurring debt.[231]

But to review that history and the associated rationales for borrowing limits is to understand why at least some crises, such as the pandemic, are different. The current generation is not trying to saddle the future with a speculative white elephant, but rather attempting to ensure that the future generation is given schooling and other services at least roughly comparable to what was being provided before the pandemic. States could hardly have socked away $500 billion in case of a pandemic. And in fact, as already noted, many states entered into this crisis with a reasonable level of budgetary reserves, despite being seared by the Great Recession.[232] So how can this sort of borrowing work? Can a stream of future tax revenue actually be sold in this way (that is, used to back borrowing in advance of when those future tax revenues are raised)? Yes, and indeed, there is a long history of financing new development projects through, in effect, selling the speculative increase in tax revenue that the development is expected to generate. This is called tax increment financing.[233]

And there are even more interesting models. For instance, states and localities sold their right to revenue from the giant settlement with the tobacco industry even though it was unclear how much revenue that settlement would bring.[234] Those bonds contained features to manage

230. Isabel Rodríguez-Tejedo & John Joseph Wallis, *Fiscal Institutions and Fiscal Crises*, *in* WHEN STATES GO BROKE 23 (Peter Conti-Brown & David A. Skeel eds., 2012); Richard Briffault, *Foreword: The Disfavored Constitution*, 34 RUTGERS L.J. 907, 947–49 (2003) [hereinafter Briffault, *Disfavored*].

231. *See, e.g.*, Rodríguez-Tejedo & Wallis, *supra* note 230, at 23; Briffault, *Disfavored*, *supra* note 230. There is also a more theoretical case favoring maintaining special budget rules for limiting debt financing, which we suspect has played a key role in the continuation of these special rules after their historical origin. This case is based on concerns that absent such special rules the costs of debt financing might not be sufficiently politically salient, and that subnational governments might act irresponsibly thinking they could count on bailouts from the federal government. *See, e.g.*, David Gamage, *On the Future of Tax Salience Scholarship: Operative Mechanisms and Limiting Factors*, 41 FLA. STATE U. L. REV. 173, 179 (2013) ("The costs of deficit financing may be less politically salient than the costs of financing through current taxes."); David Gamage & Darien Shanske, *Three Essays on Tax Salience: Market Salience and Political Salience,* 65 TAX L. REV. 19, 44–45 (2011) ("[M]any scholars appear to believe that deficit financing reduces the political salience of taxation, and there is some suggestive empirical support for this hypothesis, as well as a great deal of anecdotal support."); David Gamage & Darien Shanske, *The Trouble with Tax Increase Limitations*, 6 ALBANY GOV'T L. REV. 50, 63 (2012) ("Hard budget constraints at the subnational level are generally deemed essential for the proper functioning of fiscal federalism. Without these constraints, subnational governments have little incentive to live within their means because they can count on bailouts from the central government.").

232. Auxier, *supra* note 43.

233. *E.g.*, Richard Briffault, *The Most Popular Tool: Tax Increment Financing and the Political Economy of Local Government*, 77 U. CHI. L. REV. 65 (2010).

234. E. Matthew Quigley, *Securitizing Tobacco Settlements: The Basics, the Benefits, the Risks*, FED. RSRV. BANK OF BOSTON (2002), https://www.bostonfed.org/-/media/Documents/neff/tobacco.pdf [https://perma.cc/BQ9K-J2NP].

the uncertainty in future revenues,[235] and any issued coronavirus deficit bonds could do likewise.[236]

B. *But Doesn't State Constitutional Law Forbid General Deficit Spending?*

Even if state borrowing is a good idea, we still must consider the potential obstacles posed by balanced budget rules in state constitutions. Our first response is that, in some states, either amending the constitution or putting a constitutionally authorized borrowing proposal on the ballot for voter approval is not that difficult.[237] Each state should consider holding these votes or elections to authorize borrowing under its rules. The rationale for state borrowing is compelling and should carry the day in those votes or elections.

Of course, we appreciate that (for various reasons) holding votes or elections might not be appealing or possible in some states. But all is not necessarily lost. State rules prohibiting borrowing without an election have long been found by the courts to have important exceptions. We think our proposed borrowing can fit under several of these exceptions, although any state pursuing our approach would have to carefully consider its own specific case law. Here, we can only speak in broad strokes.

As to available exceptions, we will review two because we think the rationales for the legal rules track our policy arguments reasonably well. Some other exceptions might be available as well and could be justified on similar policy grounds.[238]

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235. *See id.*; *see also* Steve Hong, Allen Davis & Stephanie Larosiliere, *Tobacco Bonds: An Unfiltered Look at a Unique Municipal Asset Class*, INVESCO (Jan. 8, 2018), https://apinstitutional.invesco.com/dam/jcr:bf426594-66ce-4a2a-bcd9-26b69bf88626/IFI_20180202_Tobacco-bonds-An-unfiltered-look-at-a-unique-municipal-asset-class-by-Invesco-Fixed-Income.pdf [https://perma.cc/7YM3-KA73] (providing a somewhat recedent discussion of the market).

236. One important feature would be to permit a special redemption option if the federal government does step up. Other important features could include "turbo redemption" if revenues come in more quickly than expected, or lengthening the term of the borrowing if revenues come in more slowly.

237. California is an example of both. *See* CAL. CONST. art. XVI, §1; *id.* art. XVIII, §§ 1, 33. For a survey of the states, see ROBERT S. AMDURSKY, CLAYTON P. GILLETTE & G. ALLEN BASS, MUNICIPAL DEBT FINANCING LAW § 4.2 (2d ed. 2013); ADVISORY COUNCIL ON INTERGOVERNMENTAL RELS., FISCAL DISCIPLINE IN THE FEDERAL SYSTEM: NATIONAL REFORM AND THE EXPERIENCE OF THE STATES, WASHINGTON, D.C. (1987).

238. If a state court has upheld the "subject to appropriation" exception, then it would be straightforward for a legislature to use this exception, because all it requires is that the debt not be secured by a promise to repay. *See* Briffault, *Disfavored*, *supra* note 230, at 920–25. There is also the different, more widespread contingent obligation exception, which requires that the borrowing occur in the form of a lease. *Id.* at 919–20. One issue with this exception is that it is unlikely to raise enough revenue because the state would raise revenue by selling property and then leasing it back. Note that Arizona used such a structure during the Great Recession. *See* Peter Carbonara, *Cash-*

First, there is the cash flow borrowing exception. Here is a classic example: property taxes are typically collected in one or two lump sums by local governments. Should a county be able to borrow at the nadir of its cash flow until it gets its second installment of property tax receipts? Courts in every state we know of say that it can.[239] As we explained, the borrowing we are envisioning is also a cash flow borrowing, albeit over a longer cycle. Thus, so long as the overall structure is reasonable and does not put future taxpayers at any greater risk, we think the sort of borrowing we propose should also fit within this cash flow borrowing exception.

Second, there is the special fund exception.[240] Under this exception, if all that investors are promised is a specific revenue stream—and no more—then those borrowings are not considered to trigger the election requirement or other state constitutional bars against deficit spending because the government's general taxing power is not being promised. This exception is common, but state courts have also varied on whether they interpret it broadly or narrowly. The narrow version of the exception potentially requires that the borrowing be secured only by funds that would not have existed if not for the borrowing—say, by using only toll revenues to pay for a bridge.[241] The broader version of the exception focuses on the separateness of the revenue stream rather than the nexus with the project.[242] Generally, prominent commentators have considered the narrow interpretation of the exception more favorably than have the courts.[243]

Though we would not endorse the broader view in every case, we think the narrow view is unduly restrictive. To go back to the beginning, the classic debt problems that ended in trouble in the 1830s involved states backing up the debt of private entities—such as a railroad—with the taxing power of the state. To simplify, states helped secure cheaper financing for the railroads by acting, in effect, as their

Hungry States Are Putting Buildings on the Block, N.Y. TIMES (May 4, 2010), https://www.nytimes.com/2010/05/05/realestate/commercial/05states.html [https://perma.cc/N9TU-H364].

239. *See* AMDURSKY ET AL., *supra* note 237, § 4.4. During the Great Depression, the California Supreme Court even upheld issuing claims on future revenue that were not likely to be repaid until after the then-current two-year budget period. Riley v. Johnson, 58 P.2d 631 (Cal. 1936).

240. AMDURSKY ET AL., *supra* note 237, § 4.5; Briffault, *Disfavored*, *supra* note 230, at 918–19.

241. *See* AMDURSKY ET AL., *supra* note 237, § 4.6; *see also* City of Trinidad v. Haxby, 315 P.2d 204 (Colo. 1957).

242. *See* AMDURSKY ET AL., *supra* note 237, § 4.5 (citing cases disapprovingly such as Moses v. Meier, 35 P.2d 981 (Or. 1934)).

243. To be clear, prominent commentators seem more skeptical of a broad reading, while courts seem split or even tend to favor the broader analysis. *See, e.g.*, AMDURSKY ET AL., *supra* note 237, §§ 4.5–.6 (collecting cases, expressing doubt about broader interpretation of exception); Briffault, *Disfavored*, *supra* note 230, at 919 ("The cases are not always consistent, but the trend has been to loosen the nexus required between the project financed by the bond and the revenues committed to paying off the obligation in order to justify avoidance of the debt limitations.").

"rich uncle" and guaranteeing the loan.[244] If the project succeeded, disproportionate benefits would flow to some narrow interest groups. Failure, however, would be borne by the whole state.

This blending of public and private was why the debt limitation rules were typically accompanied by constitutional provisions regarding public purpose, gift of public funds, subscription of stock, etc.[245] This is also why circumventing debt limitations through privatization is problematic in ways that resonate with the historical problem these provisions were designed to solve.[246]

A revenue bond using securitized general tax revenue—even new tax revenue, which is what we propose as ideal—is also a burden on taxpayers, but it is a cabined liability in time and amount. Importantly, our proposals do not involve taxpayers taking on unknown risks, much less unknown risks based on speculative projects particularly likely to benefit a powerful few.

Indeed, to the extent that taxpayers get money now, while bondholders have to wait to see how much revenue tax increases yield, taxpayers have shifted risk from themselves to the investors, effectively the opposite of the classic problematic financings of the nineteenth century.[247]

It is true that the financings we propose could balkanize the general tax base, and there are good reasons to be concerned with this practice. But this was not the primary target of the debt limitation provisions, and we think courts should be wary of constitutionalizing this concern. This is because there is also an argument that earmarking taxes does not destroy a tax base, but rather preserves it because voters or interest groups will protect a tax with clear benefits or beneficiaries.[248] We are not taking sides on the earmarking debate; our primary concern is to argue that courts should also refrain from taking sides absent a clear mandate. To fully fit within our argument and the law (in some jurisdictions), it might be necessary for states to securitize *new* revenue in this way.

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244. *See supra* notes 230–31 and accompanying text.

245. *See* Briffault, *Disfavored*, *supra* note 230, at 913–15.

246. *See* Julie Roin, *Privatization and the Sale of Tax Revenues*, 85 MINN. L. REV. 1965, 2001–21 (2011).

247. Amdursky, Gillette and Bass see the issue of who bears the risk as central to the question of whether a debt is constrained by the debt limitation rules. AMDURSKY ET AL., *supra* note 237, § 4.1.

248. *See* Susannah Camic Tahk, *Public Choice Theory & Earmarked Taxes*, 68 TAX L. REV. 755 (2015).

C. *Do State Constitutional Limits Even Apply in an 'Emergency'?*

Some state debt limitation rules apply "except in case of war to repel invasion or suppress insurrection."[249] This martial language may be more accommodating than it could seem at first glance.

At the broadest level, the exceptions, which invoke exigent circumstances, indicate an understanding that borrowing in response to an emergency is not subject to the same political process concerns as the speculative financings of the nineteenth century. Thus, courts in a state with an exception of this kind have a textual warrant for the proposition that debt limitation rules were not meant to prevent borrowing in case of emergency. This could be a useful complement to some other exception (e.g., cash flow or special fund).

In at least one state, there is no need to use the emergency language as a complement. In New Jersey, this debt limitation provision grants an exception for "act[s] of God," so borrowing in response to the pandemic would seem to be plainly permitted.[250] Appropriately, the New Jersey Legislature approved an almost $10 billion borrowing authorization.[251] The statute was challenged, but the New Jersey Supreme Court unanimously upheld the law.[252]

In states with only the narrower insurrection/invasion-type language, the legislature could still argue that no other exception is needed. These provisions are appropriately interpreted by appeal to the canon of *ejusdem generis*—i.e., these are the types of emergencies that suspend the usual rule—rather than that of *expressio unius*, which would limit the emergencies to those named in the state constitution.[253] This makes sense: Why would the authors of the state constitution except emergency spending to treat the victims of a war but not the victims of a pandemic?

At least a few state courts have interpreted their provisions broadly in roughly this manner. For example, the Washington Supreme Court upheld a bond issue for unemployment relief in the midst of the Great Depression.[254] The court reasoned that mass unemployment had caused signs of insurrection, and that the Legislature's determination that an "incipient" insurrection existed was conclusive "unless, giving effect to every presumption in its favor, the court can say that such legislative

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249. *See, e.g.*, CAL. CONST. art. XVI, § 1; *see also* AMDURSKY ET AL., *supra* note 237, § 4.4.

250. N.J. CONST. art. VIII, § 2, para. 3.

251. *See* Samantha Marcus, *Murphy Can Borrow up to $9.9B During Pandemic, N.J. Supreme Court Rules*, NJ.COM (Aug. 12, 2020, 5:04 PM), https://www.nj.com/coronavirus/2020/08/murphy-can-borrow-up-to-99b-during-pandemic-nj-supreme-court-rules.html [https://perma.cc/224U-KQ89].

252. *Id.*

253. *See* 2A SUTHERLAND STATUTORY CONSTRUCTION §§ 47:17, 47:23 (Norman J. Singer & J.D. Shambie Singer eds., 7th ed. 2021).

254. *See* State *ex rel.* Hamilton v. Martin, 23 P.2d 1 (Wash. 1933).

declaration, on its face, is . . . dissimulation."[255] The California Supreme Court found the issue of whether an insurrection existed to be a political question and permitted borrowing in connection with bonuses to Civil War soldiers[256] and the financing of a railroad.[257] The California bonus provision was made during the Civil War.[258] Several state supreme courts upheld borrowing for bonus provisions for soldiers made after World War I.[259]

If a state does plan to use any of these exceptions, it would be prudent to also create a fast-tracked procedure so that courts can hear any possible legal objections quickly. Of course, this proposal is inferior to the federal government stepping in to do its job adequately.[260] However, if the only other feasible choice is imposing severe cuts to needed spending programs, we consider borrowing of the sort proposed here to be the far superior option.

VI. THE POTENTIAL FOR ASSISTANCE FROM THE FEDERAL RESERVE

As noted previously, the CARES Act provided funds for up to $454 billion in loans to states, local governments, and private businesses.[261] The Federal Reserve used $35 billion of that $454 billion as an equity contribution to launch a $500 billion lending program for states and larger localities.[262] That number was appropriate, as the National Governors Association had estimated at the time that states would need $500 billion, but the program was also significantly underutilized due to restrictions on how funds could be used.[263] We think that Congress should have given the Federal Reserve a bigger role or that the Federal Reserve could have, and should have, taken on such a role itself.[264]

255. *See id.* at 4.

256. *See* Franklin v. State Bd. of Exam'rs, 23 Cal. 173, 175–76 (1863).

257. *See* People *ex rel.* McCullough v. Pacheco, 27 Cal. 175, 223–24 (1865).

258. *Hamilton*, 23 P.2d 1.

259. *See, e.g.*, State *ex rel.* Griffith v. Davis, 213 P. 171 (Kan. 1923).

260. Note that this is the second crisis of the twenty-first century in which the federal government has failed in this way; thus, the question of whether states should have more formal backup plans is one to revisit. *See* Jared Bernstein & Ben Spielberg, *Preparing for the Next Recession: Lessons from the American Recovery and Reinvestment Act*, CTR. ON BUDGET & POL'Y PRIORITIES (Mar. 21, 2016), https://www.cbpp.org/research/economy/preparing-for-the-next-recession-lessons-from-the-american-recovery-and [perma.cc/8A3V-88VM].

261. *See* CARES Act, Pub. L. No. 116-136, 4003(b), 134 Stat. 313 (2020).

262. *See* Shobe et al., *supra* note 5; BD. OF GOVERNORS OF THE FED. RSRV. SYSTEM, MUNICIPAL LIQUIDITY FACILITY TERM SHEET (2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200811a1.pdf [https://perma.cc/UD4X-BCPE].

263. *See* Rappeport & Smialek, *supra* note 12.

264. See Darien Shanske & David Gamage, *How the Federal Reserve Should Help States and Localities Right Now*, 96 TAX NOTES STATE 765 (2020), for a prior version of the proposal in this Part.

The CARES Act gave the Federal Reserve the capacity to lend $500 billion to states and localities; this was the Municipal Liquidity Facility.[265] The notes the Fed could purchase could be "tax anticipation notes (TANs), tax and revenue anticipation notes (TRANs), bond anticipation notes (BANs), . . . and other similar short-term notes issued by Eligible Issuers," but the notes could not mature later than thirty-six months from the date of issuance.[266] One major problem with this design was that three years is too short of a time frame; states will need to be able to pay back these loans over a much longer term if they are to meaningfully help in preventing dramatic, harmful budget cuts. After all, this is a once-in-a-century crisis. Therefore, the core of our proposal is that the Fed should have extended loans (or notes purchased) for a longer term and at a reasonably low rate—say a twenty-year term at the federal government's cost of funds, which was about one percent in April 2020.[267] Note that prominent economists such as Ben Bernanke have endorsed using monetary policy to shore up demand under extreme circumstances.[268] In this case, and as we have explained earlier, the Federal Reserve would not be creating new demand in the economy so much as preventing its needless destruction.

We should acknowledge that our expertise is in tax law and public finance, not banking law or the powers of the Federal Reserve. Nevertheless, with that caveat, our understanding is that the Federal Reserve does have the power to make such loans under current law, though with two complications. Before we get to the complications, we should note that Congress can and should change the law.[269] Though there is surely danger in over-entanglement between states and the Fed, there is also risk to under-entanglement. If the Fed has found creative ways to keep major private businesses afloat, then it should be permitted to do the same for states during emergencies.

The complications under current law are important if one assumes that Congress will have trouble acting sufficiently on its own, therefore leaving a big vacuum for the Fed to fill. We think that states should be

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265. *See* CARES Act § 4003(b).

266. BD. OF GOVERNORS OF THE FED. RSRV. SYSTEM, *supra* note 262.

267. U.S. TREASURY DEP'T, DAILY TREASURY YIELD CURVE RATES (2020), https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2020 [perma.cc/3KW7-7FL4].

268. Adair Turner, Inst. for New Econ. Thinking, The Case for Monetary Finance—An Essentially Political Issue at the International Monetary Fund 16th Jacques Polak Research Conference (Nov. 5, 2015), https://www.imf.org/external/np/res/seminars/2015/arc/pdf/Turner_pres.pdf [https://perma.cc/8CUW-TWM7]; Ben S. Bernanke, *What Tools Does the Fed Have Left? Part 3: Helicopter Money*, BROOKINGS INST., (Apr. 16, 2016), https://www.brookings.edu/blog/benbernanke/2016/04/11/what-tools-does-the-fed-have-left-part-3-helicopter-money/ [https://perma.cc/D62W-8T3V].

269. Note that § 110801 of the HEROES Act did propose such a change. HEROES Act, H.R. 6800, 116th Cong., § 110801 (2020).

prepared to work with the Fed to craft creative solutions in the face of a future crisis. As to the Municipal Liquidity Facility, the Fed derived its authority from § 13(3) of the Federal Reserve Act.[270] There is nothing in § 13 that directly dictates that the loans must be short term. However, § 13 was revised by the Dodd-Frank Wall Street Reform and Consumer Protection Act to require more transparency and accountability. Of particular importance, the Federal Reserve "may not establish any program or facility under this paragraph without the prior approval of the Secretary of the Treasury."[271] Accordingly, the current short-term program was approved by the Secretary of the Treasury.[272] Thus, for the reasons outlined earlier, the Secretary of the Treasury may approve a longer-term lending program. The Secretary of the Treasury was not inclined to do so during the last crisis. Again, this could be a recurring problem.

We believe the Federal Reserve could use its powers under § 14 of the Federal Reserve Act even without the express approval of the Secretary of the Treasury[273]—because the Federal Reserve's power under § 14 does not require approval from the secretary. There is, however, a significant limitation: Under § 14, the notes cannot have longer than a six-month maturity.[274] But how much of a limitation is this really? Could the Federal Reserve commit to permitting states the option to roll over their debts during the crisis and for a fixed, but significant period thereafter (again, say twenty years)?[275] Once the crisis was over, states could only roll over a decreasing amount of principal each period. The steadily declining amount of the reduction could function as a kind of amortization schedule. The Federal Reserve could even have upfront rules as to the amount of debt it would be willing to purchase from a state or locality based on the size of the projected deficits compared with a recent historical baseline. That seems like a reasonable safeguard as a matter of both politics and fiscal federalism.

270. Codified at 12 U.S.C. § 343(3); U.S. Fed. Rsrv. Bd., *supra* note 32.

271. § 343(3)(B)(iv).

272. *See* U.S. Fed. Rsrv. Bd., *supra* note 32.

273. *See* 12 U.S.C. § 355(1).

274. *Id.*

275. We do not know of any instances of the Fed using its power in this way and, to be sure, this proposal works around the text's prohibition on the Fed simply purchasing long-term debt. That said, our understanding of the legislative intent behind this prohibition is that it was meant to protect the liquidity of the Federal Reserve. *Banking and Currency: Hearings Before the Comm. on Banking and Currency U.S. Senate, Vol. I*, 63d Cong. 698 (1913) (statement of Andrew J. Frame). That is, the concern was that the Fed would tie up too much of its firepower in illiquid assets if it purchased long-term state and local bonds. Leaving aside the cogency of this concern as to the current Fed, the need for the Fed to positively act to rollover the debt protects the Fed in the unlikely event of a credit crunch.

After all, this program should not be about bailing out underfunded pension programs.[276]

Federal law already has at least two models for what this calculation might look like: one from the law of tax exempt bonds and one from the application of the American Rescue Plan Act (ARPA). First, states and localities regularly borrow for cash flow purposes, but if they were to borrow too much, this would turn their borrowing into an arbitrage bond or would require rebate of the arbitrage. Accordingly, federal tax law delves into the definition of a cumulative cash flow deficit.[277] States and localities have cash flow deficits because their revenue (taxes) often arrives in lumps, while government spending is more smooth. States and localities can borrow to cover such deficits.

Even more helpful is a formula recently developed by the Treasury in connection with Section 9901(c)(2)(A) of ARPA.[278] This provision forbids "[a] State or territory [from using funds provided under ARPA] to either directly or indirectly offset a reduction in the net tax revenue of such State or territory."[279] In order to enforce this rule, the Treasury needs to assess how much ARPA funding can be properly used to restore state (and local) funding and, to do that, the Treasury developed a formula to determine the deficit caused by the pandemic.[280]

These two examples of rules will not translate perfectly to the context we discuss here, but they should at least provide a neutral baseline with which to begin. They certainly demonstrate that crafting such rules can be done reasonably, and, in the case of ARPA, quickly.

We think that states, contrary to common belief, could act quickly to borrow from a well-designed federal program. It would be better for both states and the federal government to develop a more formal mechanism, but what is in place now can work well enough if actually used.

Would our proposal be proper on federalism grounds? Some have expressed concerns that the federal government should not bail out "profligate" states.[281] However, we do not think those concerns are well placed, for at least three reasons. First, as an empirical matter, this is simply not a true description of how many states entered the current

276. *See* Mary Williams Walsh, *Illinois Seeks a Bailout from Congress for Pensions and Cities*, N.Y. TIMES (Apr. 17, 2020), https://www.nytimes.com/2020/04/17/business/dealbook/illinois-pension-coronavirus.html [https://perma.cc/Q67L-CS2G].

277. *See* I.R.C. § 148(f)(4)(B)(iii)(II).

278. American Rescue Plan Act, Pub. L. No. 117-2, 135 Stat. 4.

279. *Id.*

280. 31 C.F.R. § 35.6(d)(2) (2021) (definition of "a reduction in a recipient's general revenue").

281. Andrew Desiderio, *McConnell Pushes 'Bankruptcy Route' as Local Governments Struggle*, POLITICO (Apr. 22, 2020, 2:40 PM), https://www.politico.com/news/2020/04/22/mitch-mcconnell-bankruptcy-route-201008 [https://perma.cc/S8SK-VCHP].

crisis,[282] and we suspect that will be true for the next crisis as well. Second, these are meant to be emergency measures. It is possible to designate aid to state and local governments that helps them through the current crisis, takes into account federal aid, and does not bail out past mistakes.

Third, and more fundamentally, our empirical starting point is that the system of American federalism is far from operating as it should. It is entirely consistent with the theory of federalism that the federal government should use its superior financial firepower during national economic downturns. It has always been a theoretical weakness of our federalist system that states, which have balanced budget constraints—as prescribed by fiscal federalism theory—are also tasked with partially financing enormous countercyclical expenses for Medicaid and unemployment insurance—which is not what theory prescribes.[283] The problems with this arrangement were clear enough during the Great Recession,[284] but this pandemic made them even more glaring. It is convoluted for the federal government to, in effect, lend money to states to pay for their share of Medicaid, rather than federal government directly paying for Medicaid. But it is better than not having vital services paid for at all. Perhaps this system could be (somewhat) justified on the grounds that it encourages state and local fiscal effort and/or probity, but providing loans based on structural deficits will not undermine these incentives.

CONCLUSION

States are responsible for providing many of our most basic, fundamental government services, and yet they are hobbled in their ability to respond to economic crises due to balanced budget rules—absent sufficient federal aid. During the heart of the pandemic-induced crises in 2020, Congress was controlled by a majority coalition suspicious of the traditional practices of American fiscal federalism whereby the federal government steps in during emergencies. Although the specifics of the crises probably will not reoccur in exactly the same way, it seems highly likely that there will be future national

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282. *See* Auxier, *supra* note 43.

283. *See, e.g.*, RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 569–70 (1989); MEDICAID & CHIP PAYMENT & ACCESS COMM'N, ISSUE BRIEF: CONSIDERATIONS FOR COUNTERCYCLICAL FINANCING ADJUSTMENTS IN MEDICAID 1 (2020), https://www.macpac.gov/wpcontent/uploads/2020/06/Considerations-for-Countercyclical-Financing-Adjustments-in-Medicaid.pdf [https://perma.cc/8M4V-JDCW]; David Super, *supra* note 2, at 2587.

284. JARED BERNSTEIN & BEN SPIELBERG, CTR. ON BUDGET & POL'Y PRIORITIES, PREPARING FOR THE NEXT RECESSION: LESSONS FROM THE AMERICAN RECOVERY AND REINVESTMENT ACT (2016), https://www.cbpp.org/sites/default/files/atoms/files/3-21-16econ.pdf [https://perma.cc/LDY2-P33S].

emergencies during periods when the federal government is controlled by a coalition unwilling to provide sufficient assistance to state and local governments.

Moreover, although each recession is different, history suggests that state spending and the related provision of basic government services will suffer long after the pandemic-induced recession. The federal government eventually provided significant support to individuals, businesses, and to state governments, but it took a long time and very nearly did not provide sufficient support to keep basic services afloat. Therefore, before they confront the next crisis, states should make strategic tax reforms and expand their borrowing capacity to help them weather the storm. Further, many of these reforms, like expanding the state sales tax base, make good sense independently of preparing for the next crisis. In this Article, we propose a number of innovative ways for states to raise additional revenue, so as to resolve budget shortfalls without cutting funding for necessary state services.

A central role for legal academic scholarship should be to develop law-reform solutions for legislatures and for other policymakers in advance of emergencies when those solutions may be urgently needed. This Article aims to fill that role with respect to state and local budget emergencies, both directly, by offering solutions for current crises and for possible future crises, and also less directly, by hopefully inspiring further research and scholarship on developing better solutions and proposals for reforming our fiscal federalism institutions so that they may better handle future crises.