State Tax Notes: Professor, you have worked on a variety of tax issues at the local, state, and federal levels of government. I would like to start with local taxation. Will the property tax remain the primary source of revenue for local governments?

Strauss: There's a saying in baseball that the best glove is an old glove. In fiscal matters it could well be, at least in the United States, that the tax we know the best and perhaps dislike the most, the property tax, is one that we know we can live with because we have lived with it in the past. This is circular reasoning; however, much of what passes for fiscal discourse these days is of this nature I'm afraid.

The more interesting issue surrounding the property tax, I think, is what local government should be to use it. It's been now almost twenty years since federal policy has involved the aggressive devolution of responsibility from Washington back to the states. But I can't think of any state which has taken upon itself to examine organizational issues of local government. Such an inquiry would not only entail an examination of the type of local finance, but also the functional responsibilities of various tiers of local government as well as their geographic boundaries and rules governing the process by which tax and indebtedness changes would be adopted.

Even when the relationship between local school districts and the property tax has been aggressively reviewed, I can't think of a state which changed the boundaries of its school districts, or made politically independent those schools which had been politically dependent, or vice versa. This has been a hot issue for educational finance many years ago.

With a few exceptions, state aid to public education has drifted downwards in the 1990's as measured by state aid as a percentage of total school spending. So do-it-yourself federalism has entailed relying increasingly on the local property tax for local finance.

Unless radical new revenue sources come from afar or outside local finance, it seems that the property tax will remain the mainstay of municipal and school finance.

Regrettably, we know far less than we used to about the quality of the property tax or its burden on household vs. business property. The Census bureau has not for eighteen years systematically measured the quality of residential, commercial, and industrial assessment practices. Hopefully, in this new millennia the federal government will take its statistical responsibilities, which are actually in the U.S. Code, more seriously, and we will begin to know just how well the property tax is administered.

State Tax Notes: Is the local option sales tax a viable alternative?

Strauss: I'm not a big fan of the local option sales tax because of the cascading which it entails, because of the diversion which it encourages, and especially because of its lack of political transparency. It hides the true costs of government, and is difficult to administer.

State Tax Notes: I know you have done much work on local income taxes. Are they a viable alternative to the property tax?

Strauss: I like the local income tax when the base is identical to the state personal income tax base, and when the range of tax rates is relatively modest. However, I find the argument for such an ability to pay source of revenue to be most compelling for schools, then counties which are financing human services, and lastly for some municipal services.
State Tax Notes: You have led or worked on several state tax reform commissions. What does it take to successfully reform a revenue system?

Strauss: Keep in mind that defining "success" can be itself problematical since some define tax reform as tax reduction, while others define tax reform as reallocating tax burden, if not tax incidence, in accordance with various normative principles.

I was gratified that Pennsylvania in the 1980's eliminated much of the ambiguity over one of its business tax bases, historically the "actual value" of the Capital Stock and Franchise Tax base, through the adoption of a valuation scheme that was much more transparent. The valuation scheme had been initially worked out by several academics (Jack Ochs from the University of Pittsburgh and myself) who supported the work of the 1981 Pennsylvania Tax Commission and who convinced diverse members of the business community that clarity could be accomplished. Key to its final reform was having in place in the Pennsylvania Department of Revenue a corporate tax model that I helped initially to organize and which was viewed as credible.

Once the basic ideas were in print, and a reliable revenue estimating mechanism was in place, the political process was enabled to find a workable statutory compromise. That isn't to say that there was not some fairly significant horse-trading during the subsequent legislative process; however, the basic ideas were generated by some independent minds, broadly agreed to by various stake-holders in the business community, and then promulgated through publication of the report.

In West Virginia, the elimination of the cascading Business and Occupation Tax, which I was very much involved in, was due to not only the above factors being at work (good data, an independent analysis and broad agreement by diverse stakeholders in the business community), but also a serious fiscal problem whose short-term solution was traded for a long-run solution.

Knowing prior tax history can be very important. I talked extensively with Professor Jim Papke of Purdue about his earlier experiences of trying to slay the B&O Monster, and concluded that it was much easier for a recalcitrant Governor (Arch Moore) to fire a consultant (Professor Papke), than fire an out-of-state University. Papke found that his value added tax, initially endorsed by Gov. Moore, and passed by the WV House and Senate, somehow ran afoul of Gov. Moore upon second consideration, and he simply vetoed it, and prematurely terminated Papke's contract.

In my case, some 20+ years later, with Moore again governor, I made sure that the project was through Carnegie-Mellon for a fixed period of time. Arch found that the new system of business taxes, which I had devised, was very popular, and signed the bill. However, he showed his pique by not paying the University for 9 months.

I was finally able to get the executive branch to honor its contractual agreement. What the Speaker of the House and chair of the Ways and Means Committee could not get the governor to do, I was able to. It actually was quite simple; I threatened the Governor's office with an interview on TV in the Capitol. I would explain that the reason my wife and I were unable to purchase a bed for our son, who had outgrown his crib, was because Governor Moore refused to pay CMU for work performed. They paid within 48 hours.

I should also credit CMU President Dick Cyert for showing understanding, patience and support. He thought Moore's conduct was outrageous, and that my solution to encourage him to pay was both effective and funny.

There aren't many university presidents today, I'm afraid; who would support their professor's public policy undertakings, especially at public universities, at the risk of engaging an elected official's
displeasure. More often than not they try to ingratiate themselves to politicians by simply providing political cover or pandering.

**State Tax Notes:** You conducted a study of the State of Washington's revenue system and recommended adoption of an income tax. Why do you think that recommendation was never adopted?

**Strauss:** Don't forget that when I was invited to work with Washington, they were in the midst of *Tyler Pipe* (aka *National Can*) which was a follow up to *Armco vs. Hardesty*. At risk was something like 40% of the annual state budget were the Washington B&O Tax to fall. Washington was littered with failed personal and corporate income tax reform proposals that had failed various public referenda. In Washington there were serious constitutional constraints on the type of income tax they could have, and a very suspicious electorate, especially East of the Cascades, which did not want a more elastic revenue machine in Olympia at the disposition of liberal legislators from West of the Cascades.

The basic task I faced was to figure out a replacement system of personal and business income taxes should the US Supreme Court deal Washington a fiscal nightmare. The thinking was that, were the fiscal death star to plunge into Washington, there were reasonable odds that the electorate would finally ok a constitutional amendment which would render personal and corporate income taxes, along the lines in most states, permissible.

The Court's decision was relatively benign, so the income tax option was never taken to the public for referenda, let alone considered by the Washington House or Senate. Moreover, they quickly enacted a prospective fix in the form of a credit, which is still being litigated. Since the state continues to prosper and has added a new industry to its economy, personal computer software, on top of aerospace and wood products, it really has not had to think about changing its system of gross receipts taxation.

Texas has moved reasonably close to a corporate income tax by the way the franchise tax base is defined, but stayed very far afield from a personal income tax. Tennessee has a difficult constitutional hurdle to overcome; Connecticut is really the only state within recent memory to adopt a personal income tax and overcome various political inhibitions.

**State Tax Notes:** The conventional view says that states cannot impose progressive taxes because high-income citizens will migrate to states with more attractive tax climates. Do you subscribe to this view? Can states impose progressive taxes?

**Strauss:** The question at the outset is how progressive is progressive? Are we talking about 7 vs. 5%, or 12 vs. 5%? My sense is that the relative disparity in top personal income tax rates, especially among nearby or contiguous states, has diminished over time. Musgrave has made a normative argument that progression, or more properly income redistribution, is more properly a national rather than state responsibility. Reschovsky and Chernick have examined the empirics of this.

There is another dimension to this sort of debate, and that has to do with measuring the fisc on a net basis --- this takes into account not only taxes sacrificed, but also benefits received. We know from the study of property taxes, that capitalization of taxes can not be viewed in isolation from the services provided. I hasten to add that this not easy to measure. But I do believe, in the case of personal and business taxes that when confidence in the services being provided (as well as the fairness in administration of the tax) is high, then relocation is far less likely.

**State Tax Notes:** You have done much work on corporate income taxes as well. Can the state corporate income tax be saved? Should it be saved?

**Strauss:** My work in WV and Washington led me to the conclusion, long ago, that state corporate income taxes are far more voluntary than compulsory. Multistate corporations have many vehicles available to
represent beneficially where their income is earned, and the states are at a constant disadvantage trying to take issue with this. Some years ago I did a back of the envelope calculation which showed that something like 1/3 of corporate source income sort of disappeared from state business tax bases, and I attributed this to both the skill of corporate tax professionals, and the high quality of our institutions of higher education where they got their initial education. I’m not sure just how funny state tax administrators thought this was.

From both technical and policy perspectives, state corporate income taxes are hard to justify. Geographic attribution is a mess, and the three factor formula is no longer widely adhered to by the states. Just as the incidence of the federal corporate income tax remains in academic dispute, the same can be said of the state corporate income tax. Few academics fully appreciate how important pension fund ownership of corporate stock is in reaching any kind of conclusion about burden let alone incidence.

**State Tax Notes:** Most public finance experts identify electronic commerce as the single biggest challenge facing state tax systems. I have a few questions on this topic. How do you assess the work of the National Tax Association Project on the Taxation of Electronic Commerce?

**Strauss:** As you know, I was a member of the NTA project, and, while it did not reach agreement on what might be a set of tax policies for the near and medium term, a very readable, fair, and comprehensive document came out of the process. I wrote about this in STN last October, and concluded it turned out better than I expected.

**State Tax Notes:** How do you assess the work of the Federal Advisory Commission on Electronic Commerce?

**Strauss:** ACEC turned out as I expected, gridlocked, but had more rancor surrounding it than I expected. Having factions suing each other in federal court is unheralded as far as I can recall.

I recall on two occasions lecturing both industry and government factions at NTA meetings that the NTA project was a far better forum to work out matters than a National Commission. Nobody responded from either the business or government side. Since many of the business representatives were not actually taxpayers per se, but people retained to represent particular business taxpayers, they actually benefited from multiple forums. More billable time so to speak. Those from business and government associations also probably found the prospects of more travel to be on net desirable.

I do think the NTA report was much better than the ACEC report.

**State Tax Notes:** There has been a debate in the pages of *State Tax Notes* between those who still maintain that without reforms, electronic commerce will costs the states substantial amounts of revenue and those who think those claims are overstated. What are your views on this debate?

**Strauss:** Recently Professor John Mikesell wrote in *State Tax Notes* that sales and use taxes were no longer the most important revenue source for states, and personal income taxes have eclipsed it. I think a combination of decelerating use tax collections, legislative proclivities to give in to exemption requests, and some pressure from E-commerce are at work. Professor Bill Fox has an interesting paper, earlier this year, which shows a basis for there to be serious concerns about erosion due to E-commerce.

The Cline and Neubig paper is, by their own admission, based on somewhat dated information. As Harley Duncan pointed out, the real question has to do with the future.

Once bandwidth gets to households, then I think there will be an explosion of Ecommerce, and the traditional sales and use tax will be in real trouble.
**State Tax Notes:** You signed the "Appeal for Fair and Equal Taxation of Electronic Commerce." Can you remind our readers why you think electronic commerce should not be exempt from taxation?

**Strauss:** Some months ago I debated a representative of the Cato Institute by telephone hookup for public radio in Philadelphia.

I made two points which seem to put everything together, besides the obvious equity argument that functionally equivalent economic events should be taxed the same. That is something Andy Grove of Intel told the Joint Economic Committee last week, by the way.

The first obvious point is that customers owe the use tax under current law everywhere, but don't pay it because they "forget" or simply engage in tax arbitrage. So, when we talk about figuring out a way for remote vendors to collect and remit, we are asking them to help perform basically a ministerial function for their customers. I don't think it is such an enormous matter when viewed from this vantage point.

The second obvious point is that the reason we impose the tax on where customers live (the destination principle) is to have them pay for public services they enjoy that have to be financed. The reason for taxes is to pay for needed public services. If one form of commerce is given a free ride, then revenues must be obtained from another form of commerce. This raises equity and efficiency flags.

Use tax exemption of remote electronic commerce is just another manifestation of what has been festering since *Bella Hess* and now *Quill,* and which Congress so far has failed to address legislatively.

At a NTA project meeting last year, I remember asking Ellen Fishbein of AOL if AOL collected and remitted sales tax from its Virginia customers. She politely told me that AOL obeyed the law. I was heartened by that, and am confident that one rate per state can be administered, especially with a vendor's discount, by AOL or any other internet vendor which is competent enough to run a web site or have one run on its behalf.

The reason why some don't favor such new obligations to collect and remit has to do with their own financial self-interest. There's nothing wrong with their wanting more money, of course, but one should not view that sort of thing as morally compelling or reflecting good tax policy concerns. It's just about money.

**State Tax Notes:** What would Bob Strauss do to solve the problem electronic commerce poses for the states?

**Strauss:** I have a rather simple yet dramatic solution, but it will take a political coalition of governments and traditional business to get it enacted. It's contained in my testimony before Congress last month, and which was published in *State Tax Notes* on May 28:

1) Enact into the Internal Revenue Code a definition of a "qualified sales and use tax base."

2) Create in the IRS an office which monitors state sales and use taxes.

3) If any state adopts as its sales and use tax base the qualified sales and use tax base, then any federal taxpayer selling into the such state with such a qualified sales and use tax would be subject to a new, federal excise of 10% UNLESS the vendor collected and remitted the use tax at the ONE rate the state chose.

A qualified sales and use tax would not pertain to any local sales and use tax, and, in the best of possible worlds, the qualified sales and use tax base would be based on just final household consumption. Further, the Congress would never enact its own retail sales tax.
The states would lose control of the definition of the tax base, get use taxes finally collected and remitted, and would retain control over the rate of taxation. Business would get the hoped for simplification and the end to cascading.

I do not think the states are capable in my lifetime to reach agreement themselves on a uniform base or model statute, and would lack the authority to ensure that the use taxes were collected. The above mechanism would get the job done without raising any nexus issues.

Much would depend on how good a job Congress did in fashioning a qualified sales and use tax base. Putting it in the Internal Revenue Code will make it very hard to change, and thus create some certainty which has been lacking in the sales and use tax area. By not relying on it themselves, Congress might take the high road and fashion a final consumption tax base. They did it in Russia, so maybe the tax committees of Congress can do it here.

State Tax Notes: You have been in this business a long time. What has been the single biggest development in the state tax field during your career?

Strauss: I have noticed several changes. First, compared to 30 years ago, there seems to be a lot less civility in the tax policy process at any level of government. Government, and government services, which is why we have taxes, is routinely demonized. I regret this, and find it distasteful.

Let me give you an example. At a NTA Project meeting, one very high priced lawyer, who shall go unnamed, took a swing at me while I was on a pay telephone during a break, after I had publicly questioned one of his arguments in open session.

That never happened to me before in other settings. And this was just a project not actual legislation that was under discussion. For the record, I ignored him and endured the pain of having been struck.

Second, and related to the first matter, is the fact that as a result of much greater competition in product markets, companies are far more anxious to tax-minimize than before, and engage in whatever it takes to accomplish this. This has been predictable of course.

Third, there has been an explosion in the for-profit tax advising business, which has been used to advocate policy for short-term tax advantage.

I used to think that the explosion of tax policy shops in the accounting firms was the most important change in the way professionals are involved in taxation; however, when I read the Ways and Means Committee report on the 1932 manufacturer's excise tax, I noted that the Managing Partner of Price Waterhouse openly disputed the Joint Committee's revenue estimates, and that, as a result, the tax rate was increased to reach the desired revenue level. This was before feedback or supply side analysis was available or fashionable.

Fourth, the availability of immense amounts of socio-economic data, and statistical, modeling, and simulation software in very convenient forms, has meant that anybody can engage in tax policy advice and hyperbole. Everybody can now do revenue estimates that appear plausible. This probably has forced government to upgrade its analytical capabilities. Unfortunately, the basic research that underlies measurement and also behavioral theory has not kept apace with these innovations. Our statistical processes are likely behind at the federal and state levels.

Fifth, there has been a decline in federal and state legislative interest in fiscal federalism.
Some years ago I was rummaging around the Treasury library (before the great fire), and came upon a series of documents related to Treasury's studies during WWII about fiscal federalism. I had the pleasure of taking a seminar in public finance from Professor Harold Groves at Wisconsin the last year he taught it. Groves was a natural resources socialist who took advantage of federal tax shelters. He told us, “I don’t like them, but I’m not stupid.” As you know, he led the commission set up by Treasury Secretary Morganthau to think hard about how our federal (national, state, local) system should be financed.

The Advisory Commission for Intergovernmental Relations was a result of this thinking in the 1940’s and 1950’s. In the 1990’s, with another sea change in national responsibilities, we witnessed the eclipse of the ACIR, and the removal of any forum for discussion of how we ought to finance ourselves in the 21st century. The parallel between the end of WWII, and the fall of the Berlin wall and end of the Cold War seems very clear, but our capacity to think about and debate the implications for our fiscal system seems to have regressed. I find this very worrisome.

State Tax Notes: What will the state tax system look like in twenty years?

Strauss: If one looks carefully at the history of taxation over the centuries, one finds that, while commerce has changed through innovation and technology, our ingenuity to find ways to support the monarchy, dictatorship, or democracy's taste for public services (or the capacity to wage war) has not changed that much. There have been property taxes, excise taxes and even income taxes for literally centuries. Technology has improved the ability of the tax collector to collect and cross check, of course, but the subject of taxation, be it wealth, the transaction, the buyer or seller, the business or employee, has always been a fair target for taxation.

The arguments about economic distortions and vertical and horizontal equity issues can also be found back through the ages, although not as clearly stated as they are today.

As long as various kinds of balanced budget requirements remain in state constitutions, it's hard to imagine how state and local governments can move away from their portfolios of revenue streams. Diversity in structure helps balance out economic fluctuations in tax revenues, and also has the political advantage of hiding the true costs of government. I may argue in favor of transparency; however, it will be a rare elected official who actually tells his electorate how much he or she is taking directly and indirectly from them.

There are large economic forces that may readily change the mixture of state and local spending, but they will have a smaller effect on the composition of taxes used to finance these services. Those forces are demography and the growth in the electronic economy.

The combination of an aging population and falling family size will affect the nature of federal and state service responsibilities. Communication technology makes location less important than ever before in many lines of work. The increased competition in our economy which results from a world of spot auctions and instantaneous price comparisons will make it more difficult for governments to differ dramatically in terms of effective rates of any sort of taxation.

One can see the effects of this increased competition in the private sector filtering through to public sector activities: governments are using MuniAuction.com to sell bonds, and FreeMarkets.com to buy commodities. These are both Pittsburgh based companies I hasten to point out. Communications technology is being exploited by governments to improve the quality of "service" to its customers in a myriad of settings, from on-line payment of water bills to electronic filing of tax returns.

The next big revolution in the state and local sector, that I foresee within 2-3 years, is the explosion of distance education not only in higher education, but more importantly in k-12. A highly unionized system of public education, built on the automobile assembly model, will be centrally challenged by an
inexpensive system of individualized instruction in which the personalized computer tutor will be available through local cable and phone companies.

Were this form of home schooling to take over 20 to 30% of the public education market in say 5 to 7 years, at a fraction of the per pupil cost of the current model of public education, it's easy to imagine that public willingness to support the costs of public education could diminish radically. My guess is that this new model of k-12 education would be largely a private alternative to public schools, and would therefore receive little public monies. It would be a fee-based system and that could cause a change in the composition of education finance because so much of it would be essentially privatized.

If you think this is pie in the sky you need to go look at the learning gains achieved by cognitive tutors that run on relatively cheap personal computers.

One can already see this happening in the area of telecommunications skills. The reason CISCO is investing in such online training activities (the CISCO Academies) in the public schools is because the schools themselves have not been relevant to generating the skills CISCO is having such difficulty buying. The next step in this process will be for CISCO to simply give away the training on the Internet, and independently certify skill levels. Public education will likely not "get it," and increasingly parents and kids will bypass traditional training institutions to get specific and general labor market skills.

Once the entertainment industry realizes they can make oodles of money when they join with the communications industry to do general education skills such as mathematics, reading and writing, you may well find billions being invested in such interactive, intelligent curricula rather than in movies.

This sort of dramatic change in how education functions would not necessarily alter the composition of finance as much as who is providing the service. Government in the form of school districts (teachers and administrators) and indirectly schools of education would be the losers. As best I can see, the traditional education establishment is clueless about this possibility. If elected officials conclude they can cut taxes because education gets privatized in this manner, especially if learning outcomes are better, I think the regulatory battles trying to stop this revolution will be won by the tax-cutters.

So, while I foresee sea changes in what state and local government delivers, and foresee increased competition among governments to keep rates comparable, I think their having to balance budgets will force them to maintain their current portfolio of revenue sources.