The Tax Landscape Is Changing

Five commonsense reforms for an increasingly mobile economy
Where Do We Go from Here?

It’s been a fast-paced three years in state tax policy. A potent combination of large surpluses, high inflation, sensitivity to greater economic mobility, and a desire for greater fairness (under sometimes competing definitions) led lawmakers across the country to implement substantial tax changes, often in the form of rate cuts.

Sky-high revenues enabled many states to trim rates without offsets, and a simple rate reduction is often more attractive—certainly “simpler”—than improvements to tax structure. But that takes nothing away from the importance of structural reform.

In fact, that’s often where states can get the most bang for their buck.

And in an era of enhanced mobility, where tax competition matters more than ever, an out-of-date tax code just won’t do. Lawmakers should modernize their tax codes to position their states for success in a rapidly changing economic landscape. This booklet highlights five tax reforms that most states could undertake to grow their economies and position themselves for success.

In the subsequent pages, we summarize how states can:

1. Drop largely unenforced requirements that penalize workplace flexibility
2. Eliminate a common tax provision that penalizes in-state investment
3. Prevent unlegislated inflation-linked income tax increases
4. Dramatically reduce small business tax compliance costs at a trivial cost to government
5. Protect homeowners from soaring property tax bills without breaking the system

Interested? Read on. Have questions? Flip to the end, where you’ll find ways to reach us. Our policy experts are always happy to assist policymakers and are just a phone call or email away.
Improving Tax Treatment of Remote and Flexible Work

How States Can Drop Underenforced Requirements That Penalize Workplace Flexibility

How long should you have to work in a state before you owe income taxes there? A month? A week? A day? A minute?

In the majority of states with income taxes, as trivial an act as reading a work email while on personal travel can create an obligation to file income taxes in that state. Compliance is low, making scofflaws out of otherwise honest taxpayers. Enforcement efforts are rare—and arbitrary. And even if the taxpayer did file, processing the return could cost more than it generates for the treasury. Why are we doing this?

The rise of remote and hybrid work arrangements has exacerbated an existing problem: when workers cross state lines, their tax situation quickly becomes complex. Someone traveling for work or pleasure, who does even a modicum of work while on the road, may be required to file taxes in that state. An employee in a hybrid work situation, who sometimes works from their office in one state, and sometimes from their home in another, must keep track of where they worked for tax withholding and remittance purposes. And remote workers can subject their employers to a wide range of additional business taxes, which in extreme cases can exceed the entire salary of the remote employee. It’s time for state tax codes to adapt.

Consider the traveling worker. If she spends a day working in another state and pays income tax there, she can claim a credit against taxes owed to her home state. It depends on which state’s taxes are higher, but often this means that total tax liability is unchanged. The real cost is in compliance. A typical employee working one day out of state might owe less
than $10 and offset the entire amount against their home-state taxes, but adding an additional state return on popular tax filing software costs $60—plus a lot of hassle.

Meanwhile, a company allowing an employee to work remotely in another state can find itself with nexus (meaning a sufficient connection for taxation) for state and local business license taxes and might face double taxation under general business taxes. To avoid unpleasant surprises, many businesses only allow their remote employees to work from states with taxpayer-friendly policies or where they already do business.

States should adopt a 30-day “mobile workforce” filing threshold for nonresidents and consider entering into reciprocity agreements with neighboring states which stipulate that employees living in one state but working (some or all of the time) in another only owe in their home state. This is far less complex for employees, employers, and state revenue officials alike, and it may even be a wash for state coffers: while losing out on collecting taxes from those just passing through, widespread adoption of such laws would also mean crediting fewer residents for taxes paid to other states. And lawmakers should scrutinize their tax codes to make sure that existing laws aren’t discouraging businesses from letting their remote employees move in. A reformed system is simpler, fairer, and long overdue.

Resources:

https://taxfoundation.org/mobility/

https://taxfoundation.org/reciprocity/
Adopting Permanent Full Expensing

How States Can Eliminate a Common Tax Provision That Penalizes In-State Investment

Corporations are generally taxed on their profits, not their expenses. But there’s one glaring exception to that rule: capital investment.

States dedicate considerable resources to encouraging in-state investment. Governors and economic development agencies aggressively court businesses and dangle large (and often economically inefficient) financial incentives. And yet in most states, the corporate tax code has a built-in bias against investment, treating it differently than almost every other business expense.

Because corporate income taxes are intended to fall on net income, there are deductions for most business expenses—compensation, cost of goods, and so on—and subtracting those from gross income yields the business’s net income: its profits. But whereas other expenses can be deducted the year in which they are incurred, capital investment must be deducted over time, according to depreciation schedules. Given inflation and the time value of money, businesses not only face a substantial additional upfront cost, but worse, they are never fully made whole.

Fortunately, there’s a fix. It’s called “full expensing,” and it allows businesses to deduct the full amount of qualifying capital investment from taxable income in the year the investment was made. This policy was adopted at the federal level in 2017, but it phases out unless extended by Congress. In fact, that phaseout has already begun. Fifteen states conform to federal treatment, meaning they’ve had this pro-growth policy in place but are now winding it down. Another two states have made full expensing permanent, regardless of what the federal government does. They deserve to have company.
Full expensing boosts long-run productivity, economic output, and incomes primarily because investments that were not profitable under long-term depreciation rules become profitable under full expensing. Workers are impeded from reaching their full earning potential when capital formation is hindered. Greater capital investment correlates with both greater worker productivity and higher wages. That’s why states so aggressively pursue it through other channels.

In an increasingly mobile economy, states that make in-state investment more attractive will have a leg up on their peers. In an economy characterized by high inflation and supply chain shortages, states also need to be aware of provisions in their tax codes that exacerbate the effect of inflation or create a feedback loop that contributes to even more inflation.

States that subject capital to lengthy and incomplete cost recovery drive up the cost of investment and lead to malinvestment. They put a thumb on the scale in favor of expenses that can be written off immediately, such as labor, advertising, or supplies. They discourage the sort of long-term capital investment that can boost productivity, expand production, and have a necessary complementarity with labor. Making full expensing permanent can help curb inflation by setting the conditions for businesses to address the production side of the problem where too much money is chasing too few goods.

Right now, states are offering with one hand what they’re taking away with another. There’s a better, simpler way, and it’s permanent full expensing.

**Resources:**

https://taxfoundation.org/state-expensing/
Inflation hits taxpayers in the pocketbook twice: their purchasing power goes down and their effective tax rate goes up. They are the victims of what is known as “bracket creep,” where higher marginal rates begin applying to a larger share of taxpayers’ income—even if it hasn’t increased in real terms. Unindexed tax codes impose a hidden, unlegislated tax increase precisely when consumers are struggling the most.

When a state’s individual income tax brackets are not inflation-adjusted, bracket creep occurs, exposing more of a person’s income to higher marginal rates due to inflation rather than higher real earnings. And when a state’s standard deduction and personal exemption are left unindexed, their nominal value might remain constant for years, but their real value diminishes over time.

Imagine, for instance, a Delaware resident who made $60,000 in taxable income in 2019 and makes $71,000 in 2023. Due to inflation, she has not seen an increase in real income: her $71,000 in 2023 has about the same purchasing power as her $60,000 in 2019. But since her state’s income tax brackets are not inflation-indexed, whereas her top marginal rate was previously 5.55 percent (on income between $25,000 and $60,000), she now has $11,000 taxed at the higher rate of 6.6 percent. Her tax bill has risen by $726 even though her purchasing power has remained constant.

States began implementing policies to eliminate these unlegislated tax increases in the 1970s, during the “Stagflation” era, but many have yet to finish the job—and some never began. The recent experience with a new round of high inflation accentuates the need for these cost-of-living adjustments in state tax codes, a modernizing effort that can help states preserve their tax competitiveness over time.
Forty-one states and the District of Columbia tax wage income, while New Hampshire taxes just interest and dividend income and Washington taxes just capital gains income. Of these, 15 states and the District of Columbia fail to adjust their brackets for inflation, 10 states fail to adjust their standard deduction (if they have one), and 19 have an unindexed personal or dependent exemption or credit. In addition to these states, California and Oregon do not fully index their top brackets, while Arkansas caps its inflation adjustments at 3 percent annually.

Inflation also boosts sales and excise tax collections because consumers are forced to spend a greater share of their income in a high-inflation environment. States pocket more consumption tax revenue at times when money is tight for consumers. Is it necessary for them to run with unlegislated income tax increases too?

Notably, many states inflation-adjust their motor fuel taxes, ensuring that the government does not generate less revenue in real terms over time due to inflation. Taxpayers themselves deserve the same consideration.

Resources:

https://taxfoundation.org/state-indexing/
Implementing Property Tax Levy Limits

How States Can Keep Property Taxes in Check Without Distorting Property Markets

Housing has gotten more expensive. By a lot. Single-family homes are selling for upwards of 40 percent more than they were pre-pandemic, and in many cases, that means a 40 percent larger property tax bill. Unsurprisingly, homeowners across the country are clamoring for relief.

They have a point. Inflation affects governments too, and the cost of providing the services that property taxes fund has gotten more expensive, but not 40 percent more expensive. Homeowners aren't getting 40 percent more government or 40 percent better government, so they're right to be upset about paying 40 percent more for it.

State lawmakers across the country want to deliver for homeowners, but let's face it: providing property tax relief is hard. It's never easy for state lawmakers to deliver on reforms to what is overwhelmingly a local tax, and most of the tools available to state legislators—backfilling local revenue or imposing assessment limits, for instance—distort property markets, create perverse incentives, shift burdens unfairly, or stop working after a few years.

But lawmakers can't just throw up their hands and say the problem is intractable. Again, we're talking tax hikes of 40 percent!

The good news is that there's at least one tool available to lawmakers that doesn't come with all that baggage. The best way to keep property tax burdens in check is to adopt levy (or revenue) limits, not assessment or rate limits.

Under assessment limits (think California Prop 13), an artificial cap is imposed on increases in any given property's assessed value. The conditions under which the assessed value catches up with actual market value varies by state,
but typical triggers are a substantial improvement to the property (renovations or additions), a change in use, or a sale or transfer.

Under assessment limits, empty nesters who have owned their home for decades may pay only a fraction of what their newlywed neighbors pay, even if their home is worth less. Assessment limits lock people into their current homes (that older couples might otherwise want to downsize), shift burdens to newer or younger homeowners, and discourage owners from making otherwise desirable renovations. They do their job—keeping people from being priced out of their homes through rising property tax burdens—at the cost of introducing substantial distortions and inequities into the tax system.

Levy limits, by contrast, use actual market values, but roll back everyone’s rates when assessed values rise too rapidly. They typically account for inflation plus an allowable annual growth factor and exclude new property from the calculations (after all, governments should generate more tax revenue if there are additional homes or businesses). But—subject to voter override—they limit the overall amount of additional revenue the property tax can raise just because home values increase.

Under a levy limit, if assessed values soar like they have in recent years, no one fiddles with the assessments or locks some assessments in place while new homeowners are forced to suffer. Instead, everyone’s rates are automatically reduced to offset some of the assessed value increase. It’s simpler, more equitable, and it doesn’t put a thumb on the scale in favor of some homeowners at the expense of others.

Resources:

https://taxfoundation.org/property-limits/
Enacting a *De Minimis* Exemption for Tangible Personal Property Taxes

How States Can Dramatically Reduce Small Business Costs with Trivial Revenue Losses

Imagine you could eliminate an onerous tax regime for 75 percent of your state’s businesses at a minimal cost. That’s what Rhode Island did this year when it enacted a $50,000 exemption for property taxes on business machinery, equipment, and other tangible property, and what other states have done in prior years.

Unlike the taxation of real property, tangible personal property (TPP) taxes are poor policy, as they penalize investments in business growth and productivity. But what makes these taxes particularly egregious is the deadweight losses they create. For many businesses, the actual tax liability is modest, but compliance costs are high. Businesses must catalog all their machinery, equipment, fixtures, and other tangible property, tracking acquisition dates, costs, and depreciation. It’s a lot of work, frequently for very little revenue to local governments.

In Connecticut, a 2015 study concluded that a $10,000 exemption would exempt 46 percent of all businesses while reducing property tax collections by a trifling 0.014 percent, and even a $200,000 exemption—which would eliminate taxation for 89 percent of businesses—would only reduce property tax collections by a small fraction of a percent. When Indiana raised its exemption from $20,000 to $40,000, the statewide fiscal impact was only $4 million even though it eliminated filing obligations for 28,000 businesses.

Currently, 13 states exempt most or all tangible personal property from taxation, including Wisconsin, which repealed what remained of its TPP tax through a bipartisan push earlier this year. Some other states have *de minimis* exemptions, eliminating the burden of compliance for smaller businesses. Ideally,
states would eliminate TPP taxes altogether, but if that’s not possible, an exemption that takes smaller businesses off the rolls is a good first step.

Crucially, the exemption must eliminate any need to file, not just wipe out liability on property up to a certain threshold. Under, for instance, a $100,000 threshold, most sole proprietors and many other small businesses could safely skip the process entirely, eliminating the deadweight loss that comes with high taxpayer compliance costs.

But the problem goes beyond just compliance costs. Taxes levied on tangible personal property are, in effect, assessed on capital. This creates economic distortions as it incentivizes firms to alter investment choices or relocate entirely to avoid compliance and remittance burdens. It discourages investment in replacement equipment, inducing businesses to get by with old and inefficient (but fully depreciated) machinery and equipment longer because replacements would incur new tax burdens.

Tangible personal property taxes used to apply to personal and business property alike—your sofa, your silverware, and your bedroom set in addition to a business’s computers, office furniture, vehicles, and machinery. Taxes on your home goods disappeared long ago. It’s time for states to eliminate—or at least curtail the burden of—this badly outdated tax.

**Resources:**

https://taxfoundation.org/tpp/
Connect with the Tax Foundation’s State Team

Consider Us Your Resource on State and Local Tax Policy Issues

Serving as a free resource to state policymakers is at the core of our mission on the Tax Foundation’s state team. Our tax policy experts regularly meet with lawmakers, testify before state legislatures, and field questions from policymakers in all 50 states. We’d be delighted to answer your tax policy questions, supply our analysis, or point you to helpful resources.

You can find contact information for each member of our team, along with a list of states each of us covers, at www.taxfoundation.org/state-tax-resources/

There, you’ll also find links to some of our most popular publications and tools, like Facts & Figures, the State Business Tax Climate Index, our free six-video State Tax Policy Boot Camp series, and primers and studies on some of the most pressing tax policy issues confronting state lawmakers.

We look forward to hearing from you!

Best regards,

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