



**The  
Nelson A.  
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Government**

# **'Nutcracker Effect': The Fiscal Outlook For States**

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# Overview

- ❖ State tax revenues are weakening at the same time costs are rising sharply: the classic ‘nutcracker’ effect
- ❖ Local tax revenue – including school taxes – is stronger so far, but also faltering
- ❖ A new concern: Purchasing power of the tax dollar
- ❖ Beyond the dollars and cents: How will we measure what results we’re getting in our schools?

# The state revenue picture

- ❖ Rockefeller Institute's latest survey shows state tax revenue rose only 2.3% from 4<sup>th</sup> quarter 2006-2007
- ❖ That was the worst performance in almost five years
- ❖ After adjusting for legislated tax changes and inflation, real state tax revenue was down 4.3% -- also the weakest since early 2003
- ❖ Census data differ somewhat, but show same trend

# Tax revenue gains (losses) by region

	PIT	Sales tax	Total
New England	8.2%	5.1%	3.9%
Mid-Atlantic	7.5	2.3	3.0
Great Lakes	5.8	4.5	3.8
Plains	7.4	2.9	5.7
Southeast	3.6	(0.9)	(1.4)
Southwest	(12.4)	3.6	5.5
Rocky Mountains	10.3	4.9	8.4
Far West	(2.9)	0.9	1.0
<b>U.S. average</b>	<b>3.8%</b>	<b>1.9%</b>	<b>2.3%</b>

Source: Rockefeller Institute of Government

# The mix of taxes matters a lot

## Increase/decline in combined state-local tax revenues, 4<sup>th</sup> Quarter, 2006-2007

	Change in revenues	Total revenues, nationwide
Personal income tax	5.0%	\$356 billion
Corporate income tax	(10.0%)	\$12 billion
Property tax	6.8%	\$153 billion
Sales/gross receipts tax	3.7%	\$77 billion
Total	4.9%	\$356 billion

Source: U.S. Census Bureau; Rockefeller Institute calculations

## Mix of state tax revenues (share of total), selected states, FY 2007

	PIT	Sales	Corporate inc.	Property
California	46.5%	35.2%	9.7%	2.0%
Florida	0	77.0	6.8	0.1
Illinois	31.9	48.5	9.9	0.2%
Indiana	32.7	55.0	7.0	0
Michigan	27.0	48.6	7.5	9.7
New York	54.7	30.9	8.6	0
Ohio	40.4	45.2	5.3	0.1
<b>U.S. average</b>	<b>35.4%</b>	<b>46.1%</b>	<b>7.1%</b>	<b>1.6%</b>

# What about local revenues?

- ❖ States differ in the proportion of school funding generated locally – more than 50% in Colorado, Connecticut, Florida, Illinois, Maryland, Massachusetts, Nebraska, New Hampshire, New Jersey, Ohio, Pennsylvania, Rhode Island, S. Dakota, Texas, Virginia (U.S. average is 44.4%)
- ❖ Local share is lowest in Hawaii, Vermont, New Mexico, Arkansas (source: Census Bureau)

# Where will state, local taxes go next?

- ❖ Tell me where the economy is going, and I'll answer!
- ❖ Prospects for both state and local revenues are troubling

## Prospects for states

- ❖ Capital gains have been high, driving lots of tax revenue, and that's not likely to continue – bad news for states that rely heavily on personal income taxes
- ❖ Wage growth has slowed – also bad for income tax
- ❖ Retail sales are also slowing – bad for sales tax
- ❖ Strong resistance to tax increases, and emerging opposition to expansion of gambling revenue

# Prospects for property tax revenue

- ❖ Property tax revenue is much more stable than the income tax, sales tax or corporate income tax – outright declines are unusual
- ❖ But falling property values translate into reduced assessments (with some lag) – and a stagnant economy means little growth in the tax base

# Demographic trends and school finance

- ❖ As the population ages, the three major sources of education revenue – income, property and sales taxes – are all affected in negative ways
- ❖ Average incomes fall; exemptions increase; retired folks spend less on housing, cars, travel, clothing
- ❖ Northeast states are adding older residents while school-age population falls; some other states see increases in 65+ population (source: Ron Snell/NCSL)

# What's going on with spending?

- ❖ Everyone wants to provide pre-K and other programs, but cost inflation may get in the way by depleting the purchasing power of each tax dollar
- ❖ Inflation in 2007 was over 6% for state and local government services, compared to 3.6% overall
- ❖ Page 11 of the Rockefeller Institute's *State Revenue Report* shows the new gap between state/local cost inflation, and inflation overall

## What's up with spending? (cont.)

- ❖ States and localities are paying lots more for diesel fuel and other petroleum-related products (including construction), with no gain in value: that's inflation.
- ❖ And employee benefit costs are rising, with little or no gain in educational value.
- ❖ Bottom line: The purchasing power of each tax dollar is diminished. **Schools have three choices: raise taxes, cut services, or find cost-efficiencies.**

# Beyond the dollars and cents

- ❖ What are the results? How do we measure results?
- ❖ States vary widely in standards and measures of proficiency – but no one wants federal control here
- ❖ Rockefeller Institute is leading a national discussion of models for an intergovernmental agency that could set education standards and improve testing
- ❖ Forthcoming articles by Lynn Olson and others



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