



**THE NELSON A.
ROCKEFELLER
INSTITUTE
OF GOVERNMENT**

Session: Fiscal Sustainability Issues & Options

-- Discussant comments --

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Selected points from papers

	McGranahan & Mattoon	Dye & Merriman	Franco
Fiscal sustainability issues examined	Cyclicalities of state tax systems and changes in cyclicalities over time	Development of long-term state fiscal projection systems	Long-term fiscal sustainability projections and mechanisms as practiced in the EU
Technical conclusions	<p>Post-1998 state gov't tax revenue became more responsive to the economy. Local did not.</p> <p>Increased sensitivity of income tax is primary cause.</p> <p>Income-tax sensitivity-increase was broad-based across states, and related to income inequality and investment income; degree of sensitivity-increase related somewhat to state size (+) and to changes in state policy (-).</p>	<p>Under default model assumptions, IL faces structural budget gap.</p> <p>Longer term (2020-2030) AAGR: PI grows +3.4%; Revenue grows faster than PI (+4.4%) but expenditure grows much faster (+5.3%). Health care costs (Medicaid, employee health) are major expenditure drivers. (True of GAO model, too.)</p> <p>Budget gaps under model assumptions are \$15b (2008\$) by 2020, \$29b by 2030.</p>	<p>Fiscal rules, monitoring, and enforcement mechanisms needed. Intuitive definition of sustainability: avoid bankruptcy. But hard to operationalize. Whatever is operationalized is hard to enforce.</p> <p>Technical assumptions about the future (e.g., health care expenditures driven by population aging) not necessarily supported by historical experience (many other reasons for historical health expenditure increases). Change in initial position (current crisis) can cause huge changes in projected outyear gaps.</p> <p>Ageing-related expenditures will create fiscal pressure in most EU nations, especially for pensions and health care; also, LTC. Sustainability requires cuts in non-ageing-related expenditures or increases in revenue.</p>
Policy lessons, suggestions & advice	<p>States need to adapt to, or compensate for, increased cyclicalities of income taxes.</p> <p>Examples: (a) raise taxes in recessions, (b) make income tax structure (or other taxes) less cyclical, (c) asset sales and other non-recurring revenue, (d) rainy day funds, (e) "smooth" (cut) expenditures in recessions, (f) run deficits, (g) federal help</p>	<p>Unless policies change <i>growth rates</i> of spending or revenue, not just levels, they will not solve the structural deficit.</p> <p><u>Model projections are not forecasts - annual budget decisionmaking will close near-term gaps</u></p> <p>Greater model disaggregation could lead to improved estimates.</p> <p>Same approach could be applied to other states, or even applied en masse to all 50</p>	<p>EMU framework does appear to have an effect - has led to (or been followed by) nation-specific fiscal rules.</p> <p>Appears to make long-term issues more-prominent in fiscal debates (albeit relatively little interest by policymakers)</p> <p>Many technical improvements possible.</p> <p>Many institutional improvements possible.</p>

Sustainability projections: conceptual issues

- What should we be projecting: Current law? Current services? Current policy? Current behavior & trends? Something else? Depends on purpose? And time horizon? (Also see technical comments)
- Examples:
 - Debt service: If we use current schedule, that is current law, but are we assuming no new debt issuances? That's probably not current policy. Infrastructure policy implications?
 - Education: If we project based on historical relationship between spending and PI, isn't that a behavioral relationship? And if it yields significant increases in real per-pupil spending, is that current services? Current policy? Or a prediction of future policy? Can we say that a state faces future budget gaps, if the cause is projected increases in real per-pupil spending?
 - EU nations & old-age pensions: Should they assume the indexation structures that are in law? Or constant real pensions per retiree? Constant relation between pensions and current-worker wages? (And what *do* they assume?) Fiscal sustainability vs. social sustainability.
 - State gov't pensions: Assumptions about plan funding?
 - OPEB: Assume pay as you go? Actuarially required contributions? Something else?
 - Revenue: should it be projected based on constant law (e.g., current tax structure)? Or as percentage of GDP, implicitly assuming law will be changed to keep revenue policy, broadly defined, constant? Does time horizon influence this choice?

Sustainability projections: gap numbers

	American states	United States (federal budget)	European Union
Cyclical budget gaps	Cyclical state gov't gaps of about 1.3% of GDP in 2010 (about \$180b counting initially projected gaps plus midyear gaps - CBPP), up from near-zero in 2008. (Plus unknown but smaller local gov't gaps.) IL state gov't budget gap in 2010 was about 2% of GDP	Deficit rose from 3.2% of GDP in 2008 to 10% in 2009, a nearly 7 % point increase	Deficit rose from 0.8% of GDP in 2007 to about 6-7% in 2009 and 2010 -- increase of 5-6 % points (EC Oct 2009)
Longer-term annual budget gaps	IL: state gov't gap rises to \$15b (2008\$) in 2020 and to \$29b in 2030, from perhaps \$2b in 2008. This is 2.4% and 4.6% of 2008 IL GDP, respectively.	Under current policies (as opposed to law), falls from 2009 to about 5% of GDP, then rises dramatically to more than 11% by 2030 and more than 20% by 2050. Debt held by public rises dramatically	
	GAO (GAO-08-317 January 2008, GAO-09-320R January 2009): Absent policy changes (such as annual budget-balancing), state-local gaps appear to rise from about 1+% of GDP in 2010 to somewhat less than 2% by 2020, about 2.5% by 2030, and 3.5% by 2040		
Rate of "accretion" in longer-term gaps	IL "rate of accretion" in annual gaps (if unchecked) is about 0.2% of GDP per year. That is, each year is just a little bit worse than the year before. By contrast, year to year change in cyclical gap was about 10x as large. But structural gap keeps worsening, year after year, absent policy changes.	US annual deficit, absent policies to reduce deficit, appears to worsen by about 0.5% of GDP per year.	
Adjustment mechanisms	Relatively strict annual budget balance requirement. Even when rules are stretched and twisted, revenue and expenditures are pulled closer together.	Political process and budget rules. Successive years of deficits are possible so that gaps can grow dramatically.	Stability and Growth Pact, to extent enforceable and enforced

Do (or can) sustainability projections matter?

- Overheard at a state budget officers meeting: “If my state’s legislature thinks ahead to next week, that’s long-term planning.” Also overheard: “Why would I publish outyear gaps? They’ll just attack me.” Are 20 or 50-year projections running before we crawl? Would 3 or 5 year projections have greater policy impact given annual-balance budgeting?
- And why do we care? What’s wrong with year-at-a-time budgeting? (Good to articulate the reasons.)
- What’s the bigger threat to state gov’t fiscal sustainability - cyclical volatility, or structural gaps? (Especially given increase in state tax sensitivity to business cycle per M&M?) When 10-year-out structural gaps are about as large as single-year cyclical gaps, can we expect states to focus on them?
- What, if any, institutional and legal arrangements would encourage the annual budget decisionmaking process to consider outyear implications of current decisions? (Year 20, Year 10, or even 3 or 2.) Are there lessons from the EU? Is there a role for the federal gov’t in stabilizing or shoring up state finances, or in encouraging multi-year projections and planning, as it pushes new health care responsibilities on states?

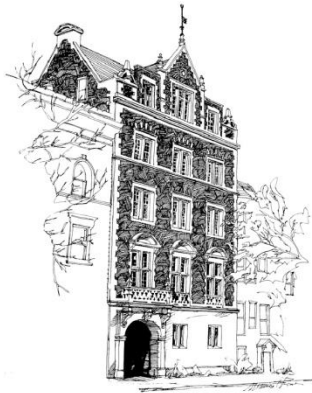
Technical comments & questions

Technical comments: McGranahan & Mattoon

- The aggregate equations, when reflecting investment income, appear to enter %change but not account for level. One thing that made 2001-02 so bad for states was that not only did investment income decline dramatically in % terms, but it fell from a very great height (after many years of rapid growth). Might be able to restructure the regressions to capture this, which might accentuate (for good reasons) the estimated impact of changes in investment income.
- The finding (p.19) that Q1 is important probably is not related to return filing (most of which affects Q2) but rather to wage changes due largely to bonuses paid to executives and investment bankers and the like, which are paid disproportionately in Q1. There was a big falloff in the 2001 recession after the dot.com bust. There was another – and bigger – falloff in 2009Q1 (outside model period but still worth mentioning as it had a lot to do w/2009 Jan-Apr revenue decline noted on p.22). For US as a whole 2009Q1 QCEW wages show an astounding 6.1% decline driven by 20.2% decline in finance/insurance. Especially pronounced in finance-sector states (e.g., total wages down 15.6% year on year in NY, driven by 36.2% finance/insurance decline). These are nominal numbers and outside historical experience.
- Statement p.21 that revenue crash in 2001 recession should not have been unexpected might be too strong: paper notes 16% drop in S&P500 and 47% in NASDAQ corresponded to 47% capital gains drop in 2001. But 10% S&P500 *drop* in 2000 corresponded to 16.6% *increase* in capital gains. Gains are hard to forecast in part because they reflect discrete decisions of taxpayers that are based upon not just market conditions but economic conditions, transaction costs, and current and expected tax rates. States knew they would fall but were not sure how far or when. A crash was reasonably predictable, but timing and magnitude were much harder to predict.

Technical comments: Dye & Merriman

- Models appear to have a mix of constant-policy and policy-change-behavioral assumptions (is this a correct interpretation?)
 - Revenue: appears largely constant policy, but excise taxes (other) grow 6.5+% per year. Can excise taxes grow faster than PI without policy changes? (Perhaps structure of IL excises allows this?)
 - Spending: some relations appear to be constant policy (pensions), some constant law (debt service), and some behavioral (5.3% K-12 education growth suggests significantly rising per-pupil expenditures?)
- Medicaid, if driven by historical relation to PI, does not account for aging of the population and rising nursing home costs? (But is pretty growthy nonetheless)
- What do pension contribution assumptions say about funding ratios for pension plan?
- Are federal funds really likely to grow 6+% per year in 2% inflation environment (Medicaid, yes, but other?)
- Treatment of OPEB?



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