



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

# Challenges in State-Local Revenues (set in fiscal context)

**States' Long-Term Budget  
Gaps: Are There Any  
Solutions?  
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# Why care about outyears?

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- Better decisions than year-at-a-time budgeting:
  - Don't adopt that policy if you can't afford it over the longer term
  - Policy options that cost money now but save money later can become rational in a multi-year environment
  - Some gimmicks become less attractive
- Potentially more stability and efficiency in gov't operations
  - don't start a policy, then stop, then restart
- Potentially more stability for citizens and business community (service & tax expectations)
- Creates opportunities for intergenerational fairness (Should our kids pay for unfunded compensation packages we gave to our university professors and police officers and ...? OPEB)

# Time horizons and planning

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- Short term:
  - Next week, next month, rest of this fiscal year
  - Next fiscal year or biennium *if* it's budgetmaking time
  - The main approach to state budgeting
- Medium term (3-5 years):
  - A lot of states do economic projections, or demographic projections; about 18 do budget-year + 3 years (or more) revenue projections; some do expenditure projections
  - Very few do multi-year financial *projections* showing gaps or surpluses. NYS does it well. But little evidence that projections influence policy.
  - Unaware of any stringent multi-year *plans*
- Longer term (6-50 years):
  - GAO 50-year simulations and projections for state-local sector
  - Dye & Merriman developmental work in IL (Fiscal Futures Project, IGPA, U. Ill.) – about 25 years
  - Some state demographic projections
  - A few consultant studies (e.g., Hovey for NEA; Rock Inst for NCHEMS)
  - Selected aspects of state budgets or financial statements reflect longer term projections: debt service; pension contributions; OPEB liability estimates

# Perspective on magnitude

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- The near term swamps the longer term
  - Near-term state budget gaps:
    - State budget gaps for 2010 are about 1.3% of GDP (\$180b gaps, \$14.4 trillion GDP). These gaps appeared in span of 1-2 years.
    - IL: 2010 gap about 2% of state GDP
    - NY: projected gap for 2013 about 1.5% of state GDP
    - These gaps are not just cyclical – but cycle plays a major role
  - Longer-term state or state-local gaps:
    - GAO projections for SLG sector: gaps that increase by about 1% (or less) of GDP per decade (GAO-08-317, GAO-09-210T, GAO-09-320R), absent intervening corrective action
    - Preliminary projections for IL suggest gaps of 2% of state GDP accumulate over a decade, absent intervening action
    - There will be intervening action (states can't budget like the feds)
- State-local longer-term gaps dwarfed by federal longer-term gaps: under current policies federal deficit could rise to more than 11% of GDP by 2030, and to more than 20% by 2050
- State-local K-12 education spending increased by 1.0% of GDP in 1950s and by an additional 1.0% in 1960s, as gov'ts paid for baby-boomer education. Solution was primarily on the revenue side. Much of the challenge ahead is related to health care for aging boomers...

# What causes these gaps?

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- Cyclical/short-term: revenue volatility
  - Sharp revenue declines by far the biggest reason. State tax systems have become more cyclical (e.g., Mattoon & McGranahan)
  - Medicaid, pensions also contribute to stress, but with lags and to lesser degree (e.g., Holahan & Garrett)
  - And of course, year-at-a-time budgeting led states to treat cyclical surges as revenue to support recurring spending
- Longer term: health-care-led expenditure growth
  - GAO: “Rapidly rising health costs drive long-term state and local sector fiscal difficulties”; taxes grow at about the rate of the economy. Non-health spending grows more slowly than economy
  - Dye & Merriman exploratory work: Revenue grows about 1% faster than personal income (annual average), but expenditures grow 1.8% faster than income. Expenditures driven by rapid growth in Medicaid.

# Lessons from fiscal scene-setting

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- Getting medium-term projections that are *used in policy-making* is hard but important
  - 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.” With these attitudes, are 20 or 50-year projections running before we crawl? Would 3-5 year projections, with a planning element, have greater policy impact given annual-balance budgeting?
  - What, if any, institutional and legal arrangements would encourage the annual budget decisionmaking process to consider outyear implications of current decisions?
- Revenue solutions to longer-term budget problems should not exacerbate short-term volatility
- Longer-term fiscal problems appear driven more by expenditures than revenue. (Doesn’t mean that solutions cannot be on revenue side. In any event, state revenue structures have many longer-term problems. But not all are related to sustainability.)

# Tax policy principles

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- A few commonly accepted principles:
  - Adequacy – stability over the shorter term, sufficiency over the longer term
  - Equity – horizontal, vertical
  - Minimize economic distortion, responsive to economic competition – Repeat: “broad base, low rates” ...
  - Easy to comply with and administer
- Principles often conflict with each other (but sometimes go together)
- Adequacy: the most important principle with respect to fiscal sustainability

# Top three short-term adequacy issues

1. Volatility
2. Volatility
3. Volatility

# Longer-term adequacy issues

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- A common thesis: Longer term trends are conspiring against revenue structures
  - Continued movement toward production and consumption of services
  - Technology and globalization making “place” less relevant
  - Demographics, especially aging of the population

# Result: many revenue adequacy issues

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- Hard to determine which are most significant
- Two known, quantitatively important issues:
  - Collection of taxes related to remote vendors
  - Sales taxation of services
- Other contenders in some quarters (see Sjoquist-edited book; Lav et al.; Augustine-edited book; Brunori book)
  - Erosion of corporate income taxes (policy, globalization)
  - Possible erosion of property taxes due to shift to services, aging population
  - Possible slowing of personal income tax revenue due to state failures to tax retirement income of an aging population
  - Possible slowing of sales tax due to different consumption patterns of an aging population
  - Limitations on property tax growth resulting from acquisition-value taxation
  - Sales tax erosion due to legislated exemptions
  - Fiscal rules limiting revenue growth
- Wild card: What will happen if feds move toward consumption-based tax?

# The sales tax and e-commerce: problem

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- Bruce, Fox, and Luna (2009) estimate SLG sales & use tax losses related to e-commerce
  - Will reach \$11.4b by 2012 – an increase of about \$4-5b from 5 years earlier
  - Total loss related to remote sellers (not just e-commerce) and concomitant potential gain could be much larger
  - The 5-year growth in annual e-commerce loss (i.e., continuing erosion) is about 1.5+% of SLG sales tax revenue, about 0.4% of total taxes, and 0.03% of GDP
  - Potential gains from full taxation (stop erosion plus restore base), for e-commerce and other remote sales, would be several times as large

# The sales tax and e-commerce: solutions

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- Action by individual states on their own: “Amazon”-type laws (NY, RI, NC; other attempts)
- Collective action by states – Streamlined Sales and Use Tax Agreement – simplification, plus voluntary compliance (and amnesties)
- Federal action – Congress has authority under Commerce Clause to grant states authority to collect from remote sellers even if no physical presence (perhaps for SSUTA states)

# The sales tax and services: problem

- Consumption and production moving away from manufacturing, toward services
- State and local sales taxes typically are asymmetric in treatment of goods and services: (a) imposing tax on goods, with specific exemptions, and (b) exempting services, with specific exceptions
- Failure to capture growth related to services

# The sales tax and services: solutions

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- In general, it is practical (technically, legally, if not always politically) to expand sales tax base to services purchased primarily by households
- This is one of those rare cases where improving adequacy goes well with other principles – making tax fairer, potentially less volatile, easier to comply with, and less distorting
- Some of the larger services tend to be motor vehicle repairs, landscaping, and various rentals. Recent enactments have raised sales tax revenue by as much as 4-5%; much greater expansion is possible.

# Related issues

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- In addition to correcting known problems of erosion, states and localities have options for raising revenue, and revenue growth, to support growing spending demands
- In general, they should move in direction of broad base, low rates. Examples include:
  - Adding food to sales tax base, perhaps with income tax credit (e.g., HI, ID, KS, OK, SD)
  - Expand base of income tax (eliminate itemized deductions)
  - Reduce/eliminate property tax exemptions and abatements
  - Possibly move toward consumption taxation

# Concluding remarks

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- Personally, I believe short-term volatility issues are a greater threat to states' abilities to finance services than longer-term erosion. Wild swings in revenue, coupled with balanced budget requirements and myopia, can lead to sharp cuts in services with stable/rising demand. These numbers are large. Revenue stability is underappreciated.
- Among the longer-term problems, collection of sales/use tax related to remote sellers, and sales taxation of services, are demonstrably large and real issues of tax erosion. The former is tractable and, I believe, likely to be solved. The latter is extremely difficult politically.
- In addition, states have many (politically unpalatable) options for making revenue systems more efficient (broader bases, possibly lower rates) if they choose to raise additional revenue

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