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State Taxation: The Impact of Congressional Legislation on State and Local Government Revenues

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Chairman Cohen, Ranking Member Franks, and members of the Subcommittee, thank you for inviting me to testify today. On behalf of the nation's governors and the residents of my home state of Vermont, I appreciate you holding this hearing to explore the fiscal condition of states and the effect Congressional action can have on our fiscal health.

The bottom line is this: decisions about state revenue systems and state taxation should be made by elected officials in the states. This principle is particularly important now as states are working to emerge from a recession that has reduced state revenues to pre-2006 levels. Unlike the federal government, states must balance their budgets. This requires states to make up for lost or decreased revenues by either cutting services and spending or raising revenues. Both actions, cutting services or raising taxes, can slow recovery. As this committee, and Congress as a whole, considers legislation to spur the economy, create jobs or promote competitiveness, it should do so with an eye towards the critical role states play in promoting recovery. More specifically, legislation that would impact state taxes or taxing authority should adhere to the principles of "do no harm," preserve flexibility, be clear and find the win-win so that states may continue to manage their fiscal futures.

Fiscal Condition of States

The fiscal condition of states started deteriorating rapidly when the recession began at the end of 2007. In fact, repeatedly since the downturn started, states have had to lower revenue projections and make spending adjustments to meet balanced budget requirements. Governors in most states are in the process of finalizing or have just completed their budgets for fiscal year 2011, and in some cases 2012. What these budgets show is that from a state fiscal standpoint, the worst is yet to come.

Previous downturns have demonstrated that the worst budget years for a state are the two years immediately after the national recession is declared over. This lag occurs because state revenues continue to decline and state expenditures for safety net programs continue to rise until after unemployment levels peak. However, unlike the recession earlier this decade, states' recovery from the current recession may be prolonged, with most economists projecting a slow and potentially jobless national recovery. Moreover, even when recovery begins, states will continue to struggle because they will need to replenish retiree pension and health care trust funds and finance maintenance, technology, and infrastructure investments that were deferred during the crisis. They will also need to rebuild contingency or rainy day funds and both implement and eventually pay a portion of the Medicaid expansion under national health care reform. Taken together, these facts mean that many states will not fully recover from this recession until much later this decade.

<u>The Current Situation</u> – The recent national economic downturn started in December 2007 and likely ended around September 2009, making it the deepest and longest downturn since the Great Depression. The slowdown directly affected state tax collections, which according to the Rockefeller Institute declined for five consecutive quarters beginning in the last quarter of calendar year 2008 and extending through all of 2009, with reductions of 3.9, 11.6, 16.4, 10.9 and 4.1 percent respectively. These findings are consistent with the NGA/NASBO *Fiscal Survey of States* estimate that state revenues declined 7.5 percent in fiscal year (FY) 2009, which for most states ended June 30, 2009.

Similarly, Medicaid spending, which accounts for about 22 percent of state budgets, averaged 7.9 percent growth in FY 2009, its highest rate since the end of the last downturn six years ago. Medicaid enrollment is also spiking, with projected growth of 6.6 percent in FY 2010 compared with 5.4 percent in 2009.

What these falling revenues and increasing expenditures create are budget gaps – holes in state budgets that must be reconciled to meet balanced budget requirements.
The *Fiscal Survey of States* shows states closed budget gaps of $72.7 billion in FY 2009 and $89.8 billion in FY 2010. This includes tax and fee increases of $23.9 billion in 2010. Even with cuts and tax increases, states continue to experience new budget shortfalls including more than $18.9 billion remaining for FY 2010, $55 billion projected for 2011 and $61 billion projected for 2012. All told, the combined remaining budget gaps that must be filled for 2010 through 2012 equal $136 billion.

For fiscal year 2011, Vermont faces a shortfall of approximately $154 million – roughly 14% out of a General Fund budget of approximately $1.1 billion. In just over a year, more than 10,000 jobs have been lost and last year median family income fell nearly $2,000 from the year before. Although Vermont's unemployment rate is among the lowest in the nation, our workforce is shrinking and too many are underemployed. As a result, state revenues are $25 million below 2006 levels and a staggering $113 million below where they were at the height of the economic bubble in 2008.

While Vermonters have found it harder to pay the bills, our General Fund programs have seen unsustainable increases and new pressures. Demand for human services will grow by $50 million, pension contributions are projected to increase by $29 million, and $75 million in federal recovery funds relied on for this year will no longer be available. With revenues not expected to return to pre-recession levels until 2013, our fiscal crisis extends far beyond today. Without sustainable reductions, the fiscal 2012 shortfall will balloon to over a quarter billion dollars – more than we spend on economic development, environmental protection, public safety, and higher education combined.

Governors are making and have already made tough but necessary decisions to address these daunting challenges, including streamlining services, cutting programs, and reducing the state workforce. In Vermont, we are getting close to the end of our legislative session and we're debating controversial but necessary proposals such as alternatives to incarceration for non-violent offenders, and I'm fighting hard to resist legislative proposals to increase taxes on struggling manufacturers.

<u>The American Recovery and Reinvestment Act (ARRA)</u> – State fiscal conditions would have been worse if not for the passage of ARRA. Of the $787 billion in ARRA funds, about $246 billion came to or through states in more than 40 programs. Most important, the $87 billion in Medicaid funds and the $48 billion in state stabilization funds were flexible and allowed states to offset some planned budget cuts and tax increases. Specifically, the Medicaid funds allowed states greater flexibility to manage state funds allocated for Medicaid while the stabilization funds targeted help for elementary, secondary, and higher education, which represents about one-third of state spending.

Without these funds, state budget cuts and tax increases would have been much more draconian. In fact, given the ongoing fiscal problems in states, 47 governors recently signed a letter supporting a two-quarter extension of ARRA's enhanced FMAP funding. Such an extension would help states avoid some cuts or tax increases that would otherwise be necessary to balance 2011 budgets.

My own state of Vermont has received more $700 million dollars in Recovery Act dollars; $500 million of which was paid out before December 31, 2009 and helped support more than 2,000 jobs.

The Recovery Period – While there is still uncertainty regarding the shape of the recovery, there is a growing consensus that it will be slow. Numerous studies project that state revenues will likely not recover until 2014 or 2015. A recent forecast by Mark Zandi at Economy.com showed that the national unemployment rate, which straddled 5.5 percent during 2001–2007, will not attain that level again until 2014. Similarly, Zandi's latest forecast indicated that state revenues will not return to the 2008 level in real terms until FY 2013.

Deferred Investments – Even when recovery begins in the 2014–2015 period, states will be faced with a huge "over-hang" in needs and will have to accelerate payments into their retiree pension and health care trust funds, as well as fund deferred maintenance and technology and infrastructure investments. They will also have to rebuild contingency or rainy day funds. All of these needs were postponed or deferred during the 2009–2011 period and will have to be made up toward the end of the decade. According to a 2007 Pew Center on the States report, states have an outstanding liability of about $2.73 trillion in employee retirement, health, and other benefits coming due over the next several decades, of which more than $1 trillion is unfunded.

What all of this means is states will continue to struggle over the rest of this decade because of the combination of the length and depth of this economic downturn, the projected slow recovery, and the additional Medicaid responsibilities. Even after states begin to see the light, they will face the "over-hang" of unmet needs accumulated during the downturn. With states having entered the recession in 2008, revenue shortfalls persisting into 2014, and a need to backfill deferred investments into core state functions, states will need maximum flexibility to manage their fiscal systems in order to fully emerge from the current recession.

Principles for federal legislation related to state taxation

Governors believe federal action should favor the preservation of state sovereignty when legislating or regulating activity in the states. This is particularly true when it comes to actions that affect the ability of states to manage their revenue systems. The independent ability of states to develop and manage their own revenue systems is a basic tenet of our federal system. Therefore, the federal government should avoid legislation and regulations that would serve to preempt or prohibit, either directly or indirectly, sources of state revenues or state taxation methods that are otherwise constitutional.

Since adoption of the U.S. Constitution, Congress has generally respected state sovereignty with regard to state taxes. Unfortunately, that trend has begun to change over the last few years as Congress has increasingly restricted the rights of states to determine their own tax structure. Recent legislative examples include the moratorium on the taxation of charges for Internet access, prohibiting the taxation of nonresident pension income, and the accelerated elimination of the state estate tax credit.

As this committee considers whether to take up legislation related to state taxation, governors encourage the committee to review all proposals in light of the following principles:

- Do no harm: Legislation dealing with state taxing authority should not disproportionately reduce existing state revenues. This principle is especially important at a time when states are cutting core services to meet balanced budget requirements. Federal unfunded mandates or limits on state authority will only exacerbate the fiscal problems states currently face.

- Preserve flexibility: The fiscal crisis is forcing all governors and states to ask fundamental questions about the role of government. These questions will lead to changes at the state level that could have long-term, positive effects on the delivery of services, modernizing revenue systems and holding government accountable. States should not be hindered in their pursuit of these reforms by federal legislation that restricts a states authority to act.

- Be clear: Federal legislation, especially in the context of state taxation, should be clear to limit ambiguity or the need for expensive and time-consuming legislation.

- Find the win-win: The goal of all legislation should be to find a balance that improves the standing of all stakeholders. Especially in times such as these where states are struggling with unprecedented budget gaps, Congress should only consider legislation related to state taxation or state taxing authority that is beneficial to all stakeholders.

Conclusion:

Congress, through its authority under the Commerce Clause of the U.S. Constitution, has broad authority to regulate state taxation. The key questions are when and how should that authority be used. Governors believe that the ability of states to develop and manage their fiscal systems is a core element of sovereignty – one that should not be interfered with unless absolutely necessary to preserve interstate commerce. The current fiscal condition of states underscores this basic principle and should heighten Congressional consideration of the impact proposed legislation could have on states.

Thank you for the opportunity to testify before you today. On behalf of my fellow governors, I look forward to working with you and would be happy to take any questions.