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T E S T I M O N Y

State Fiscal Trends and the Federal Role

Testimony to the Subcommittee on Commercial and Administrative Law, Committee on the Judiciary, U.S. House of Representatives

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Mr. Chairman and Members of the Subcommittee:

Good morning. I'm Robert Ward, of the Nelson A. Rockefeller Institute of Government in Albany, New York. The Institute is the public policy research arm of the State University of New York, based at the University at Albany. We are honored to be invited to speak with you today.

My testimony will focus primarily on the current picture and projected outlook for state and local government finances, particularly those of the states. Choices made in your committee can influence the ability of states to raise tax revenue. The fiscal environment influences states' need to raise revenue or to make offsetting spending cuts. In my closing comments, I will suggest the potential for broader thinking about the role of the federal government in shaping tax policy at the state level.

I will start with the current conditions that we see in states across the country. The Rockefeller Institute has maintained a special focus on research in this area for the past 20 years. State leaders right now face budget choices that are more difficult than any since the Great Depression. Those difficulties are caused by a combination of two things: Revenues that have fallen sharply for

more than a year now, and expenditure patterns that drive increases substantially higher than the rate of inflation unless policymakers act to reduce the baseline trends.

Since 1991, the Rockefeller Institute has reported each quarter on recent trends in state tax collections. During the recent national economic downturn, we have issued more frequent updates to allow more timely and more detailed analysis of the challenges facing the states. We are issuing our latest report, by my colleagues Donald J. Boyd and Lucy Dadayan, Friday morning. The report examines state tax collections during the final quarter of 2009 and the first two months of 2010, and offers some forward-looking observations regarding the remainder of 2010 and the years thereafter.

Recent Trends

Calendar 2009 was the worst on record in terms of the decline in overall state tax collections, with an overall drop of 11 percent from calendar 2008. During the fourth quarter of 2009, overall state tax revenues declined by 4.2 percent, compared to the same quarter a year earlier. (We generally compare one reporting period to the same period in the preceding year because of seasonal variation in state tax collections.) This was the fifth consecutive quarter in which state revenues showed a decline.

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Compared to two years ago, tax revenues during the final quarter of 2009 were down by 8.6 percent. Over the past two decades, before the last national recession, state tax revenues averaged annual, year-over-year increases in the range of 5 to 5.5 percent. In normal times, then, the last two years could have been expected to produce an overall tax revenue increase of 10 percent or more. Combined with the actual decline mentioned above, states have seen revenue drop by more than 18 percent relative to recent historic norms. The current decline in overall state tax collections is more than twice as deep as in the previous recession, which itself brought declines from historically high levels of revenue.

Another way to assess the current revenue picture is to adjust collections for inflation. Using this measure, state tax revenues are currently at roughly the same level as they were in both 2000 and 2004 (revenues declined, especially after adjusting for inflation, during and after the 2001 recession.) In other words, after accounting for inflation, state tax revenue is at about the same level as 10 years ago, although the nation's population has increased by approximately 10 percent during that period. Like the weakness in economic conditions over the past two years, revenue declines have hit every state.

Preliminary data for January and February, from 45 states, show continued weakness into the current calendar year. The data we have been able to obtain thus far show overall state tax revenues in the first two months of 2010 down by 2.2 percent from a year earlier. It appears likely that, when full quarterly data for all

the states are available several weeks from now, we will be reporting a sixth straight quarter of revenue decline.

The good news is that the declines are not as sharp as they were a year ago. Recent data show an unmistakable improvement in the national economy. Employment has stabilized in recent months and retail sales are now increasing on a month-to-month basis. These are among the most important determinants of trends in state tax revenue, with employment and wage levels influencing collections from personal income taxes and consumer sales driving revenue from sales taxes. Just as the national economy has shown at least some initial signs of recovery, so too with state revenues. In the report we are issuing Friday morning, nine states showed growth in tax revenues, with North Carolina and New Hampshire leading the way at 9.9 and 5.7 percent, respectively. Revenue increases in some states will come largely as a result of previously enacted tax increases, but there is underlying improvement as well.

Tax revenues for local governments – counties, municipal entities, and school districts – continue to show steady if modest growth for the nation as a whole, largely because of the stability inherent in the property tax. But there is great variation underlying this national average. Many cities, especially large ones with volatile tax structures more like those of states, face great distress. Localities that rely heavily on the property tax face declines if they reassess properties in a way that allows market value declines to be reflected quickly in assessed values.

The further bad news for state governments is that most states are not yet enjoying actual growth in tax collections – rather, in most cases, the declines in the most recent quarter are smaller than those we saw previously. During the second quarter of 2009, for example, the overall decline in tax revenues was above 16 percent, compared to the year-prior level. That makes the fourth quarter's decline of 4.2 percent appear much less damaging. Yet it is important to keep in mind that, because the downturn in revenue has been going on for more than a year, we are now talking about reductions from already depressed levels. The rate of decline is moderating, however, and we may be approaching the bottom.

Looking forward, we project more troubling news for states.

The Outlook

Looking forward, we project more troubling news for states. Based on trends in capital gains and other factors, there is significant risk that income-tax revenues in April and May will fall relative to the already weakened level of a year ago. We do not expect much strengthening during the remainder of this year, based on the relatively poor outlook for employment and general economic activity. Nor does the picture brighten dramatically when we look ahead to 2011 and the years immediately following. Even if the economic recovery is as rapid as those from prior recessions, it would likely take state tax revenue several years to recover to its previous peak. With the expected slow recovery from this recession, it is likely to take longer.

At some point, history indicates, the economy will recover – and tax revenues will strengthen as well. Even so, over the next several years state budgets will face difficulty as federal stimulus aid goes away and as temporary solutions adopted in peak crisis years fade away. And the longer-term outlook for state and local government finances is clouded by significant problems on the expenditure side of the budget.

The Government Accountability Office (GAO) projects that, without policy changes, the overall operating balance for states and localities will fall significantly below historical averages within the coming decade, indicating what GAO describes as "increasing fiscal stress." GAO researchers predict that various cost increases, particularly for Medicaid and payments for employee and retiree health benefits, will present increasingly troublesome issues for states and localities. Mismatches between revenues and expenditures are predicted to grow steadily at least until the middle of this century, according to GAO.

Closing those projected gaps would require policy changes to produce savings equal to a 15 percent overall tax increase or a 13 percent reduction in spending financed by nonfederal revenues, according to GAO. Such numbers may not appear monumental at first. They should be viewed, however, in the light of difficulties that states and localities encounter when they try to restrain spending or generate new revenue. Even much smaller spending reductions from trendline increases, or proposals for smaller tax increases, tend to generate controversy and sharp criticism of elected officials. Achieving cost-efficiencies or revenue increases of such magnitude across all 50 states would represent extraordinary fiscal change.

Understanding State Fiscal Systems

As Congress considers the potential impact of federal legislation on state and local government revenues, it may be useful to start with an understanding of the current structure of state and local revenue systems.

As the table below shows, the largest single tax source for states is the category the Census Bureau defines as sales and gross receipts taxes. This includes general sales taxes as well as selective sales taxes on public utility bills, automotive fuel, tobacco products, alcoholic beverages, and other items. If we omit those selective sales taxes, the general sales tax is roughly equal to the personal income tax in overall importance to states, around 26 percent of own-source revenues. For the states, sales

Selected Taxes As Proportion of State/Local Governments' Own-Source Revenue, 2007

	States	Local Governments	State & Local Total
Sales/gross receipts taxes	34%	10%	24%
Personal income taxes	26%	3%	16%
Property taxes	1%	44%	21%
Corporate income taxes	5%	1%	3%
Other taxes	7%	4%	6%
Nontax revenue	*26%*	*38%*	*31%*

Rockefeller Institute calculations from Census Bureau data; totals may not add to 100% due to rounding

and income taxes are by far the most important single sources of revenue.

In 2007, the latest year for which we can obtain comprehensive data for both state and local governments, states' general revenue from their own sources was just over $1 trillion. Sales, income, and other taxes made up roughly three-quarters of that total. Tuition at public universities, hospital revenues, income from lotteries and other gambling activities, were among the major sources of nontax revenue.

For local governments, including school districts, property taxes are by far the dominant source of income, providing more than four in every 10 dollars of own-source revenue. Sales taxes are also important for local governments, while taxes on personal and corporate income are much less meaningful than they are for states.

These figures represent a snapshot of one year, including all the states and all local governments. Obviously, there is great variation among the states. In 2009, personal-and corporate income taxes made up 77 percent of total tax revenue in Oregon, more than 60 percent of tax revenue in Massachusetts and New York, and more than half of such revenue in an additional half-dozen states. At the same time, six states had no broad-based income tax at all.

One ramification of the increasing reliance on income taxes is a heightened risk of volatility in states' revenue streams.

The income tax has become more important to states over time. In 1975, individual income taxes represented about 24 percent of total state tax revenues. That proportion rose to 30 percent in the mid-1980s. In 2009, the personal income tax provided 34 percent of total state tax revenues. (This proportion is higher than the income tax's previously mentioned 26 percent share of states' own-source revenues; that broader category includes significant nontax revenue.)

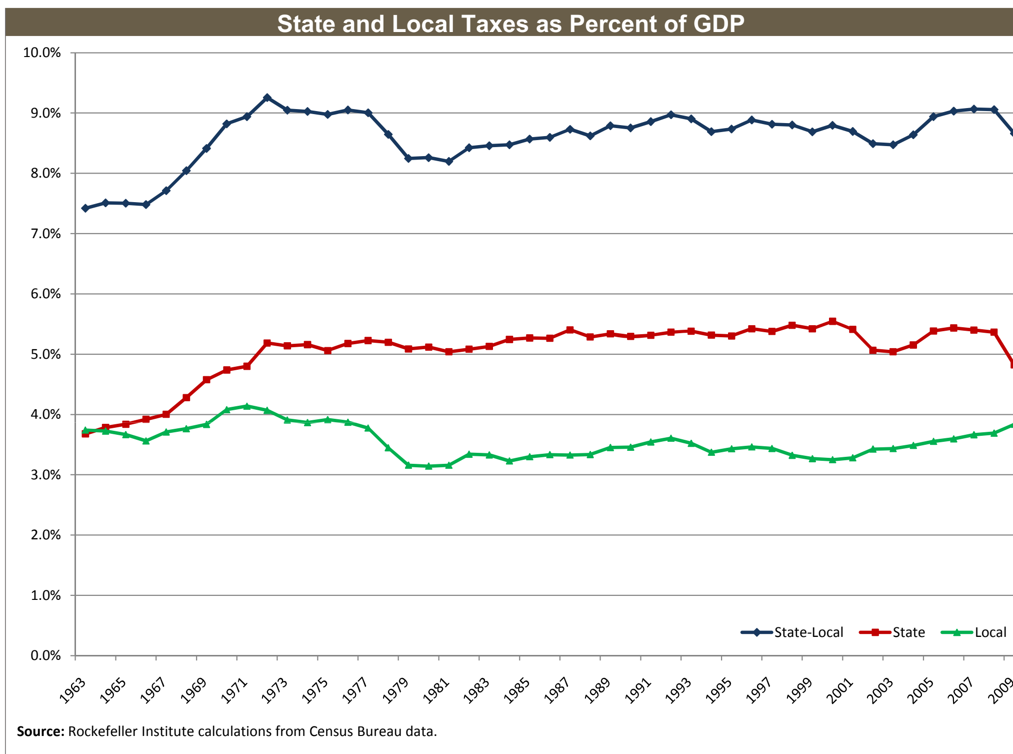
The corporate income tax has declined modestly as a contributor to state tax revenues – from around 8 percent in the mid-1970s to 6 percent in 2009. Motor fuel taxes have fallen from more than 10 percent of the total in 1975, to 5 percent in 2009.

One ramification of the increasing reliance on income taxes is a heightened risk of volatility in states' revenue streams. Economists from the Federal Reserve Bank of Chicago have concluded that "Greater reliance on the income tax and increases in the more volatile sources of income such as capital gains, have made state revenues more responsive to the business cycle since 1998."[1] We have seen the downside of such volatility over the past 12 to 18 months, as income-tax revenues to states have plummeted and states that are highly dependent on capital gains have seen particularly significant declines in overall tax revenue.

Moving from percentages of overall revenue to dollars, state tax collections have shown strong growth over time, even when we include fluctuations during and after major economic slowdowns. From around $80 billion in 1975, overall revenues rose to $715 billion in fiscal 2009. That increase represents growth of more than 100 percent, after adjusting for inflation.

Some of the issues that the Congress and this subcommittee may address, in relation to state and local taxes, arise from varying perspectives over the level of taxation and the adequacy of resources for public services. Observers differ, of course, in perspectives as to whether taxes – including those imposed by states and localities – are too high, too low, or just about right.

It may be worth noting that, measured as a proportion of the nation's economic activity, the total burden of state and local taxes has remained remarkably constant for the past 20 years, and has fluctuated relatively little over the past 40 years. The graph on this page shows state, local, and combined state-local tax revenues as a proportion of gross domestic product back to 1963. Using this measure, the level of state taxation rose significantly – by more than a third – from the early 1960s to the early 1970s. State taxes represented 3.7 percent of GDP in 1963, and surpassed 5 percent a decade later. Taxes imposed by local governments and school districts were essentially equal to those imposed by states in the early 1960s, and by this measure have held relatively constant over time – with some ups and downs. The size of the nation's economy has grown significantly during this period, so a roughly constant proportion of economic activity indicates significant growth in state and local revenues over time.



Source: Rockefeller Institute calculations from Census Bureau data.

It is difficult to apply any comparison of taxation levels without prompting debates as to which measure, if any, is most appropriate. Most state policymakers will testify that rising demand for state expenditures in education, health care, public protection, and other areas has meant continuing budgetary challenges despite the significant gains in revenue over time. Clearly, cost inflation in health care – a major driver of state expenditures – has outpaced general inflation for many years. Governors, legislatures and voters have also made policy choices to implement major programmatic and staffing expansion in education, health care, and other areas.

In good times, states tend to use higher-than-normal revenues to expand spending commitments at the same time they enact reductions in taxes. The common result is that, when revenues return to normal growth or go into decline, baseline spending requirements often exceed revenues from existing tax laws. States then must make some major changes in spending or revenues, or a larger number of smaller changes, to achieve budgetary balance. Often, the solution lies in some mix of one or two major changes and a number of smaller adjustments. And states also patch budget gaps with temporary fixes in the hope — with some justification in history — that sharp revenue growth during recovery will fill gaps left when patches fall out.

Even smaller adjustments can be politically controversial, or may require steps that many citizens and policymakers consider undesirable. We need not focus on the list of such actions that have been taken in just the past year or are under consideration now – I know you are aware that they include cuts in many services for the needy; closing of parks, libraries, and schools; and increases in taxes, fees, and revenues from state-sanctioned gambling. In many cases, these controversial or undesired steps provide only a marginal difference in an overall budget of many billions of dollars. The fact that they are undertaken despite public opposition and potential political risk to elected officials indicates the difficulty that states face in balancing budgets in the twenty-first century.

Perhaps it is time for broader thinking about the fiscal relationships between Washington and the states.

Concluding Observations

All of which is to say that, as Congress considers any action that may influence state and local government revenues, you are right to invest careful study and consideration before doing so. Even seemingly small differences in revenues and costs can matter – to state officials who are struggling to balance budgets, to those who depend on vital services, and to state and local taxpayers.

I will briefly touch on one other issue of interest to the subcommittee. The subcommittee has devoted a previous hearing to the topic of sales tax application to remote vendors. The Rockefeller Institute does not advocate on tax or other issues. I raise this topic only to observe that, in addition to the technical and policy questions inherent in taxation of, and collection of tax on, remote sales, there is a broader question: Should federal policy emphasize the benefits of interstate differences, including tax competition among jurisdictions? Or should national policy focus on the benefits to be obtained from greater uniformity among the states? To some extent, at least, these are questions of political or social values, rather than of technical policy points.

The flow of shared power within our federalist system of government sometimes moves in the direction of greater national authority, other times toward more power for the states, and sometimes in both directions, across varied policy areas,

simultaneously. The United States is currently moving extensive authority over health care to the national level — but giving states responsibility for implementing this national policy, a task complicated by their volatile fiscal systems. For several decades, and increasingly over the past 10 years, Washington has taken on greater policy responsibility in education, as well. Education and health care represent the largest areas of expenditure for states. There are other major areas of state concern, such as transportation and public welfare, where federal policy decisions and funding play enormously important roles.

With regard to state taxation, Congress and the federal courts have stepped into policy-setting or policy-shaping roles in selected and often narrow areas, generally with relatively little attention to the overall structure of state and local tax systems. Perhaps it is time for broader thinking and analysis, within the boundaries that the Constitution provides. Beyond the fiscal challenges to states that I mentioned earlier, we are all well aware that the federal government faces its own major budgetary concerns in the years and decades ahead. Thoughtful observers are starting to talk about significant restructuring of governmental finance at both the national and subnational levels. Whether one's favored solutions involve more revenue sources such as a value-added tax, or new restraints on health care and other spending – or a combination of both approaches – the complex array of fiscal relationships between Washington and the states will be an important subtext of any serious debate, as it should be because states implement many of the most important policies the federal government adopts. Debate there will be. The question is how we may best inform it.

Endnotes

1 Richard Mattoon and Leslie McGranahan, "Revenue Bubbles and Structural Deficits: What's a State to Do?" Federal Reserve Bank of Chicago Working Paper No. 2008-15, November 1, 2008.