To: Members of the Subcommittee on Health of the House Subcommittee on Energy and Commerce
From: Robert Tannenwald, Director and Vice President, NEPPC
Re: State Fiscal Relief—Protecting Health Coverage in an Economic Downturn
Date: July 22, 2008

Summary

The fiscal condition of the states is weak. The latest official statistical snapshot of their fiscal condition was taken in the first quarter of calendar year 2008, three quarters into the last fiscal year for most states. Fiscal year-to-date tax revenues in that quarter were only 2.6 percent about their year-ago level. Given sharp rises in the costs of delivering public services, that translates into about a 3 percent revenue drop in inflation-adjusted terms. Revenue growth has been slowing with each passing quarter.

The nationwide turmoil in housing markets, soaring energy prices, and falling employment have combined to hit sales tax collections especially hard. While income tax growth has been stronger, it should weaken soon if history is any guide. Much of the variation in this tax source over the past decade has been driven by the stock market. The bull market that fueled robust income tax growth in recent years has given way to a bear market that is likely to slow or possibly even shrink income tax collections in coming quarters.

Compounding the fiscal challenges posed by current economic conditions are long-term trends that have eroded state tax bases and intensified demand for their services. The long-running transition from a goods to a service economy has slowed growth in sales tax bases, since services are difficult to tax both politically and administratively. Higher energy prices are probably here to stay for a long time, boosting state and local costs and siphoning dollars away from taxable sales. Intensifying competition for jobs and industry has locked state and local governments into a bidding war, diverting public resources from other uses. Tax planners have become increasingly aggressive in sheltering their clients from tax liabilities. Public infrastructure badly needs repair and modernization. The demand for improvement in educational outcomes is stronger than ever. And the cost of health care continues to soar.

Despite these challenges, inflation-adjusted state and local spending per capita has *fallen* during the past five years. But such simplistic indicators are not much help in judging the degree to which state and local governments have spent too much or too little. In making such a judgment, nothing can

substitute for a careful evaluation of the conditions confronting state and local governments that, through no fault of their own, compel them to spend more per unit of service delivered, augment the array of services they must provide, erode their traditional tax bases, and complicate tax enforcement.

Testimony

Thank you for the opportunity to testify before you this afternoon. For the record, I am a vice president of the Federal Reserve Bank of Boston, where I have worked for 26 years. I am director of the Bank's New England Public Policy Center. I have published extensively in the field of state and local public finance and have counseled many state and local officials and their advisors on issues concerning public finance. I have served as research director or member of five different state tax task forces convened within the New England region. I am immediate past president of the National Tax Association, widely considered to be the nation's foremost organization of tax professionals dedicated to advancing the theory and practice of public finance.

I will assess fiscal conditions in the nation's state and local sector and discuss factors, both short-term and long-term, that are complicating state and local governments' task of balancing their budgets while providing adequate services.

The views expressed in this testimony are my own. They do not necessarily represent those of the Federal Reserve Bank of Boston or the Board of Governors of the Federal Reserve System.

Current Fiscal Conditions in the Nation's State and Local Sector:

Recent growth in state tax revenues has been weak.

Three quarters of the way into state fiscal year 2008 (FY2008), state tax receipts were only 2.6 percent above their FY2007 level for the corresponding period (Figure 1). In the third quarter of FY2008, which ended on March 31, tax collections grew by only 1.4 percent on a year-over-year basis. The rate of growth in state tax revenues has not been this slow in five years.[1]

The cost of delivering state and local services has been increasing rapidly. As a result, in inflation-adjusted terms, state tax revenues have fallen steeply.

The implicit state and local price deflator, estimated by the U.S. Bureau of Economic Analysis, tracks the cost to state and local governments of delivering a "unit" of public services. According to this measure, state and local costs increased at an annualized rate of 6.1 percent during the first three quarters of FY2008. The comparable rate of growth for the first quarter of calendar year 2008 (CY2008:Q1) was 7.4 percent. When adjusted for these rising costs, state tax receipts shrank over the first three quarters of FY2008 by 3 percent relative to the comparable year-to-date level for FY2007 (Figure 2). In CY2008:Q1, inflation-adjusted state tax revenues were 4.5 percent below their year-ago level. Over the past three quarters, the state and local implicit price deflator has risen at almost twice the rate of the deflator for the federal government, and at almost three times the rate of inflation for the whole economy.[2]

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[1] U.S. Census Bureau. Data for the last quarter of the FY2008 are not yet available.
[2] U.S. Bureau of Economic Analysis, National Income and Product Accounts.

Growth in local tax revenues, although faster than that of state revenues, has also decelerated markedly. Local tax revenues were up by 4.1 percent in the first three quarters of FY2008 on a year-over-year basis. CY2008:Q1 receipts were up only 2.6 percent relative to CY2007:Q1.[3] While showing stronger growth than state tax receipts, local collections have also not kept pace with the rising cost of service provision.

States have turned to deep reserves built up over the past several years.
According to the National Association of State Budget Officers (NASBO) and the National Governors Association (NGA), state governments had built up reserves equal to 11.5 percent of state spending by the end of FY2006, the highest percentage since 1979, the year that NASBO and NGA began to track this statistic. NASBO and NGA estimate that by the end of FY2008 these reserves were 8 percent of state spending.[4]

In a spring survey conducted by the National Conference of State Legislatures, budget officials in several states reported large projected deficits for FY2009, even assuming no increase in state service levels. Twenty-three states projected deficits, ten in excess of 5 percent of general fund spending, and five in excess of 10 percent of such spending. Reports are still coming in concerning how states resolved these imbalances in crafting their budgets for the current state fiscal year, which began in most states on July 1. On the other hand, energy-producing states are generally doing well, enjoying robust revenue growth and projected surpluses.[5]

Cyclical Economic Factors Exacerbating Fiscal Stress in the State and Local Sector

While no set of factors neatly explains the fiscal woes of every state and municipality, some recent economic developments have exacerbated the fiscal stress on the state and local sector.

The sharp contraction in housing has cut into the base of the sales and property taxes, two of the three most important sources of state and local tax revenue.

The nation's housing sector is in the midst of a severe contraction. From CY2007:Q1 to CY2008:Q1, nationwide residential investment fell by 21 percent,[6] home sales declined by 22 percent,[7] and residential housing values declined by 14 percent.[8]

Housing's difficulties have played a large role in dampening growth in revenues from state sales and gross receipts taxes. In FY2007, this source accounted for almost one third of state tax revenues. Over the first three quarters of FY2008, receipts from these taxes were only 1.5 percent above their level in the corresponding period of FY2007 (Figure 3). These receipts grew only 0.4 of a percent in CY2008:Q1 on a year-over-year basis.

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[3] U.S. Census Bureau.
[4] National Governors Association and National Association of State Budget Officers, *The Fiscal Survey of the States,* June 2008.
[5] National Conference of State Legislatures, *State Budget Update*, April 2008.
[6] U.S. Bureau of Economic Analysis, National Income and Product Accounts.
[7] National Association of Realtors.
[8] Case-Shiller Home Price Index.

Housing exerts such a big effect on sales tax collections because consumer durables and construction materials account for a disproportionately large fraction of sales tax bases. Purchases of big-ticket items and building materials are strongly affected by the pace of housing sales and construction. When a house is sold, the buyer often purchases new appliances and makes other improvements. When a house is built, contractors pay sales tax on the construction materials they acquire and the appliances they install.

Plummeting housing values have further curtailed consumer spending, as households become more cautious in the face of slowing wealth accumulation or declining net worth. Falling residential values have also cut into the bases of property taxes, which account for 75 – 80 percent of local taxes. Local governments have yet to feel the full brunt of shrinking home values, since tax assessors tend to revalue property with a lag. Furthermore, nonresidential property values have remained strong relative to their residential counterparts, although their growth has slowed, too. The bases of property taxes could come under further pressure if housing prices continue to decline, a likely scenario in the near term.

The rising price of energy has further curtailed consumption of taxable goods and services, as households devote a rising share of their budgets to gasoline, electricity, and home heating oil.

The recent decline in the value of stocks is beginning to slow growth in state personal income tax receipts.

Like sales and gross receipts taxes, the personal income tax accounts for about one-third of state tax revenues, although the degree to which states rely on it varies greatly. While growth in income tax receipts has slowed nationwide in recent quarters, in CY2008:Q1 they stood 3.2 percent higher than their value four quarters earlier.

Over the past decade, the volatility of state income tax revenues has increased sharply (Figure 4), mostly reflecting increased volatility in the value of equities. Capital gains and stock-related sources of income, such as stock options, have grown as a percentage of total state taxable income. The correlation between personal income tax collections and stock values has increased accordingly. State income tax revenues soared during the late 1990s and the year 2000 in tandem with the run-up in the value of equities, only to plummet in 2002 when stocks retreated sharply. State income tax receipts could be on a similar roller coaster ride now. The performance of income tax collections in CY2008:Q2 will be especially telling, since this quarter included April 15, the tax filing deadline.

Long-term fiscal challenges facing state and local governmental tax systems

While these challenges are many and varied, some of the most prominent include:

The shift in both consumption and production from goods to services.
Over the past several decades, the nation's mix of both consumption and production has shifted steadily away from goods towards services. This shift has diminished the revenue productivity of state and local sales taxes, since the taxation of services is difficult for both political and administrative reasons. Furthermore, intermediate purchases, which account for roughly 40 percent of state sales tax receipts, have shrunk in value relative to Gross Domestic Product, further eroding

sales tax bases. An increasing share of these transactions takes place overseas, beyond the jurisdiction of state sales tax officials.

The rising share of business and household purchases transacted electronically.
While in principle electronic commerce transacted across state lines is taxable under state use taxes, in practice, the taxation of such purchases is difficult to enforce. Moreover, in light of recent court decisions, attempting to collect taxes on such commerce from sellers located in a state other than the customer's state of residence is illegal. As e-commerce has grown as a share of total sales, expansion of sales tax bases has been constrained accordingly.

Intensifying inter-jurisdictional economic competition and increasingly aggressive efforts at tax avoidance.
As firms have become increasingly mobile and the geographic scope of many markets has become global, state and local governments find themselves under increasing pressure to keep taxes low and to enter into bidding wars for businesses by offering generous tax incentives, loans, supportive firm-specific infrastructure, and training programs at local vocational schools colleges, and universities. Competition among states and municipalities can enhance operational efficiency and induce governments to grow their jurisdictions' economies. Some have argued, however, that competition has become so intense that state and local governments have been locked into a "zero-sum" or "negative sum" game, in which all the players either gain nothing or lose in the long run. None is willing to quit, however, unless everyone agrees to do so. Meanwhile, the revenue foregone on tax incentives and spending devoted to recruitment and retention of business detract from the provision of other services that constituents need and want.

In addition, the expanding geographic scope of economic markets and increasing complexity of corporations' organizational arrangements have created new opportunities for avoidance of state and local taxes. Sophisticated tax planners have taken advantage of these opportunities. Partially as a result, state and local corporate income taxes as a percentage of pre-tax profits have declined over the past 30 years (Figure 5). Some states have enacted laws and regulations in recent years that have attempted to curb tax avoidance practices.

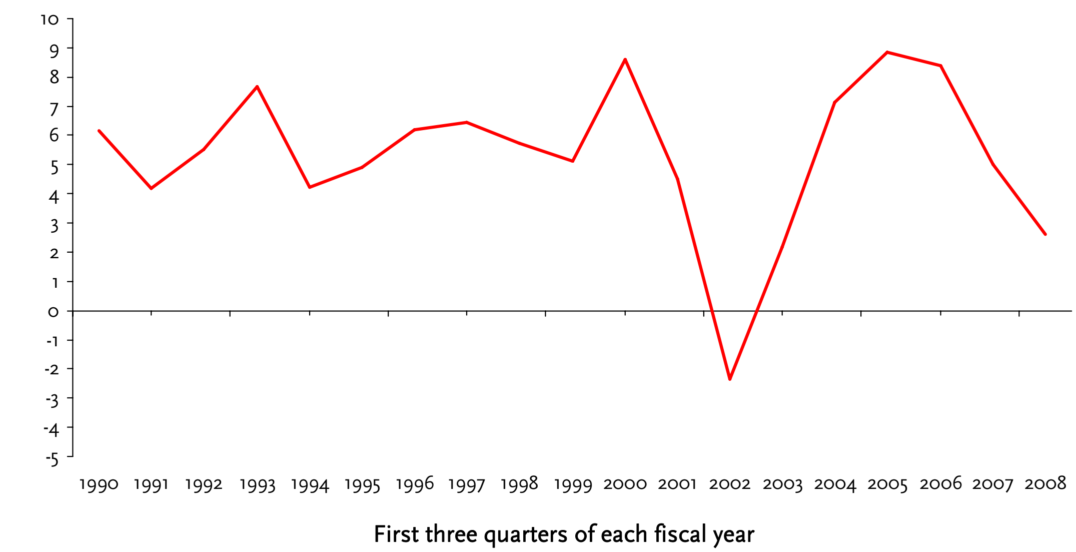
Have State and Local Governments Been Spending "Excessively"?
It has been argued that state and local governments, though faced with formidable fiscal challenges, are still at least partially responsible for their own fiscal problems by spending excessively. One frequently cited indicator designed to gauge this degree of excess is the extent to which the rate of inflation-adjusted growth in state and local spending has exceeded the rate of growth in the nation's population. The implicit underlying premise of this indicator is that the need for state and local public services increases only with population, regardless of its composition in terms of age, household size, and income distribution, and regardless of the severity of such challenges confronting state and local governments as deteriorating infrastructure, environmental pollution, and the constitutional requirement to adequately educate the nation's school-aged children. In the past, analysts have focused on the period from 1990 to 2002. During that period, inflation-adjusted per capita total state and local spending, as measured in the National Income and Product Accounts, grew at an annualized rate of about 1.75 percent per year. However, this was a period during which

the share of the nation's population accounted for by children between the ages of 5 and 18 grew substantially, a factor increasing demand for local educational services. From 2002 until 2007, by contrast, inflation-adjusted state and local spending grew more slowly than the population. During this period, real per capita state and local spending fell at an annualized rate of 0.5 percent.

Another frequently cited statistic to gauge the fiscal prudence of state and local governments is the extent to which their inflation-adjusted rate of growth exceeds that of the federal government. Again, in the 1990 – 2002 period, the federal government's spending grew considerably more slowly than that of state and local governments, primarily because defense spending fell sharply with the demise of the Soviet Union. By contrast, from 2002-2007, inflation-adjusted spending grew far more slowly than its federal counterpart, in part because of the nation's military efforts in Afghanistan and Iraq.

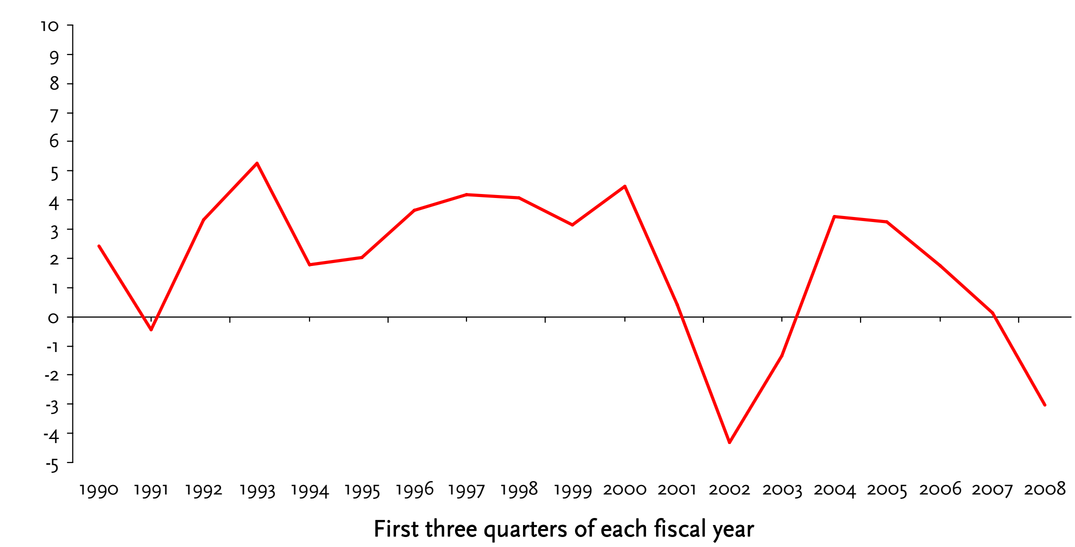
Neither of these statistics is especially helpful in gauging excess because they do not take into account the particular fiscal needs and stresses operating on each level of government. No simple ratio or number can take the place of a careful assessment of such needs and stresses in evaluating the adequacy or profligacy of government spending.

Figure 1
State Tax Receipts



Source: U.S. Census Bureau.

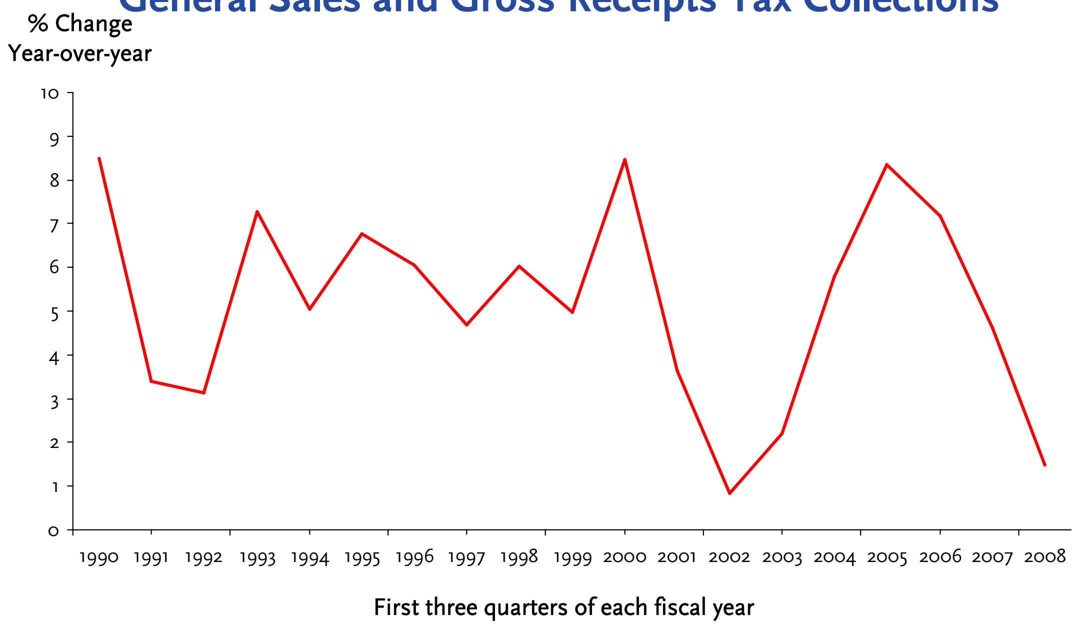
Figure 2
Inflation-Adjusted State Tax Receipts



Note: State tax receipts are adjusted for inflation using the implicit price deflator for state and local government purchases.

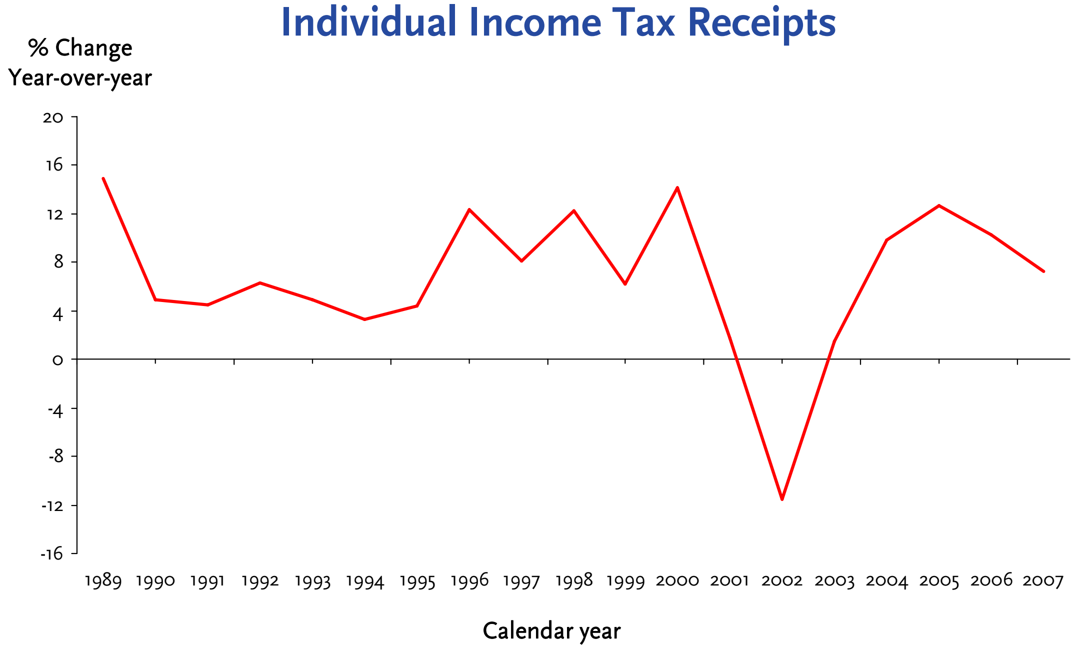
Sources: U.S. Census Bureau and
U.S. Bureau of Economic Analysis

Figure 3
General Sales and Gross Receipts Tax Collections



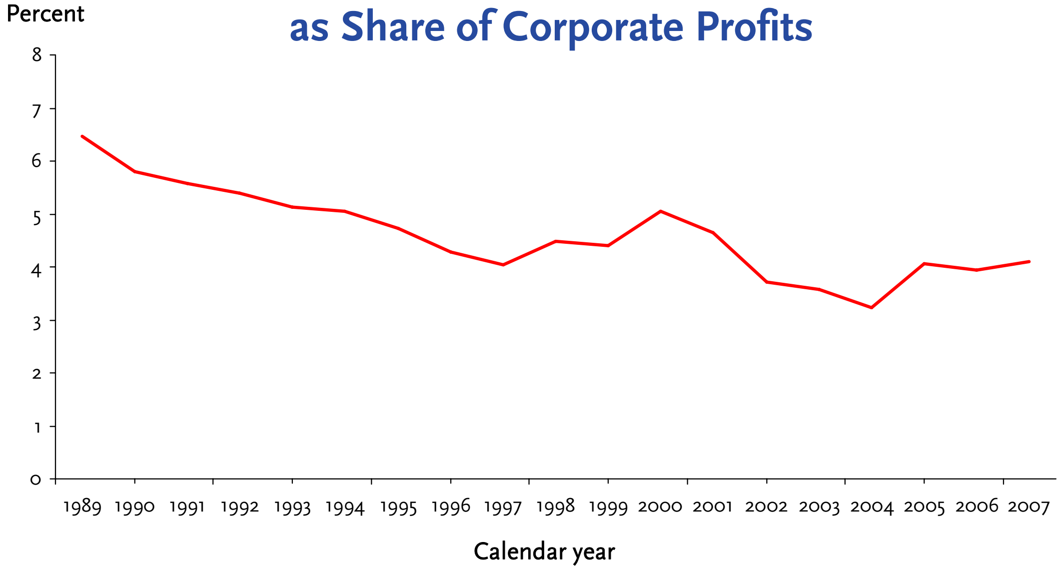
Source: U.S. Census Bureau.

Figure 4
Individual Income Tax Receipts



Source: U.S. Census Bureau.

Figure 5
State and Local Corporate Net Income Taxes as Share of Corporate Profits



Note: Corporate profits are before taxes and with inventory valuation and capital consumption adjustments.
Sources: U.S. Census Bureau and U.S. Bureau of Economic Analysis.