1. Introduction and overview

Sally Wallace

The period since 1990 has presented a new set of challenges and opportunities for public finances in the USA. Demographic trends have put substantial pressure on non-discretionary public expenditures such as health care, legal challenges have put pressure on education financing, and aging infrastructure continues to call for more federal, state and local investment. Policy changes at the federal level such as changes in income tax policy affect states tied to the federal income tax, and revised and new mandates for issues such as water and air quality reduce state and local governments’ fiscal ‘space’. Control over many of these challenges is beyond the bailiwick of state and local governments, but dealing with their repercussions on public finances is a central job of state and local governments. Dealing with these forces has arguably become increasingly difficult due to domestic and international competition for economic development and the politics associated with holding down local taxes such as the property tax.

The economic downturn of the early 2000s and the 2008 recession underscore the volatility of the economic landscape facing state and local governments. Because of the overarching landscape of pressures outside their control and difficult economic times, state and local governments are more hard-pressed than ever to find creative solutions to long-term financing issues. How can state and local governments cope? Is there room for more tax revenue at the subnational level? Do states need to reduce expenditures? Are there means of creative financing out there? These questions and more were the focus of a conference sponsored by the Fiscal Research Center of the Andrew Young School of Policy Studies, Georgia State University, in May 2008. The conference brought together state and local public finance scholars and practitioners to share their research and experiences regarding state and local governments’ use (or potential use) of ‘out of the box’, or novel, new public finance mechanisms to deal with the demographic, economic and political pressures facing them. The conference participants presented original work that asked whether state and local governments have ‘gone outside the box’ to deal with the strains on
current public finances – or whether they have gotten along by adhering to
the status quo. Some of the papers looked toward the future by analyzing
the applicability of out of the box policies for the future.

Brought together in this volume, the chapters and comments by discus-
sants provide an extensive landscape of state and local fiscal policy today
and for the future. The chapters thereby provide students and policy-
makers with evaluations of actual practices and analysis of potential
policy changes for the future – made by well-known scholars in the area of
state and local public finance.

Part I of the book provides insight into the major state and local policy
challenges and why and how states have become creative in their response.
In Chapter 2, Ronald Fisher posits six ‘headliner’ challenges to state and
local fiscal policy: health care costs and provision; assessment, produc-
tivity and accountability in education; privatization of higher education
and related issues of access; corrections and public safety; resurgence of
the property tax revolt; and the expectation that economic development
is a primary objective or responsibility of state–local government. Fisher
provides data and analysis to demonstrate the magnitude of the growth
in public health care costs and points out that the complications of health
care as a social issue merit a federal–state–local policy discussion regarding
the reform of financing. Fisher points out three other expenditure-related
issues likely to be problematic for state and local governments: the need
for real advances in achievement in education; the increased private cost of
higher education; and the need for re-evaluation of ‘policy and approach’
to criminal justice. In addition, he notes that the continued attack on
property taxes will further constrain local government choices as they deal
with demographic and economic pressures. Finally, Fisher highlights the
potential damage done to state and local choices by the focus of state and
local economic development policy. In conclusion, he calls for more prac-
tical research in areas that focus on these larger issues in state and local
budgets to help governments overcome these challenges.

Chapter 3 by Robert Tannenwald, Jennifer Weiner and Igor Popov
presents two alternative explanations of state policy-makers’ increasing
creativity: ‘alienation’ and ‘tax obsolescence’. The alienation hypothesis
holds that as the economic status of the average American has stagnated
and state and local spending has increased, there has been a voter back-
lash against ‘big government’ and additional tax hikes. The obsolescence
hypothesis is one that has been uttered by many public finance economists
– state and local tax polices simply do not fit today’s economy. As a result,
the growth in tax revenues has not mirrored the economic growth of the
nation. Tannenwald et al. support these main hypotheses by presenting
data demonstrating the reluctance of governments to increase tax rates for
corporate and individual income and sales taxes over the last 20 years. They also show us data on the increasing disparities in income distribution and lack of public confidence in government. However, they also point out that spending did not decrease over the same period of time – thereby increasing the pressure for new levels of creativity in state budgets in this millennium.

The obsolescence hypothesis is supported in the chapter by exploring the following trends: the intensification of interjurisdictional competition; the shift in the nation’s mix of production and consumption from goods to services; the proliferation of electronic commerce; and the tendency of state courts to invalidate the local property tax as the principal means of financing public primary and secondary education. The chapter summarizes by pointing out that future pressures – less buoyancy to the property tax and a tough federal budget deficit – may reduce state–local tax policy creativity and call for good old-fashioned tax increases to deal with the pressures from 2009 forward.

David Sjoquist presents an interesting tax counterfactual in Part II, Chapter 4. What do states without an income tax do? How do they raise revenue – or do they simply make do with less? To provide insights into these questions, Sjoquist selects a sample of income tax states and compares a number of fiscal characteristics between the no-income tax states with that sample. He carefully decomposes the various possible differences including expenditures per capita, grants, composition of revenue and relative state versus local revenue. Excluding Alaska, the no-income tax states carry a higher sales tax burden than the income tax states – other tax burdens are similar between the two groups.

Chapter 4 ends with an interesting hypothetical: if an income tax state eliminated their income tax, what changes would have to occur to other components of the revenue structure to keep the state finances whole? This exercise uses the state of Washington as the no-income tax example, and calculates changes in the revenue necessary for the average income tax state to obtain Washington’s revenue structure. The changes are substantial (measured as dollars per capita) – state property taxes would have to increase by over 1000 percent on average (the largest percentage change) and state general sales and gross receipts taxes would have to increase by over $600 per person to attain Washington’s revenue distribution. It is questionable as to whether income tax states would be willing to make such changes – or whether there is much public sentiment for eliminating the state income tax regime.

Robert Wassmer (Chapter 5) takes a look at the impact of California’s Proposition 13 on the state and local revenue structure in California. Since Proposition 13 was instituted, property taxes as a share of state and local tax revenue in California have fallen from 26 percent to 13 percent.
The state is now in the lower quartile in terms of property tax reliance. Wassmer asks how California has coped with the reduction in property tax reliance and what state and local governments might do in the future to cope with property tax limitations.

Between 1977–78 and 2005–06, total state and local revenue in California increased relative to the US average as a share of personal income and on a per capita basis. According to Wassmer, a large share of the increase in state and local revenue in California came from an increase in personal income tax revenues. Because of the concentration of personal income tax revenues from high-income taxpayers, Wassmer points out a potential instability in the share of income tax revenues from the capital income attributed to individuals at higher income levels. He points out that until recently, the general growth of the economy masked some of the fiscal stress accompanying the change in the composition of revenue.

Accompanying the revenue shifts post-Proposition 13, the state’s education spending per student fell from the top five in the nation to 33rd. Wassmer argues that further financing and school expenditure initiatives have severely restricted state and local government budget discretion in the state. The budget crisis of 2007–09 in an environment of decreased budgetary flexibility has led to a number of proposed solutions, including revising the budget process and revenue reform to move to a more stable revenue structure (such as a less progressive income tax and a significant state-level property tax). Wassmer suggests there are other alternatives and offers us an ‘out of the box’ solution involving the use of a cap-and-trade agreement to enable companies to reach the state’s greenhouse gas emissions goals. In this case, the state could benefit by retaining a portion of the revenue earned from auction sale of initial allocations.

The two chapters in Part III of the book look at alternative forms of state income taxation. Rork and Wheeler (Chapter 6) focus on alternative corporate income tax forms and Wallace (Chapter 7) focuses on the potential of an integrated income tax. In Chapter 6, the authors analyze the implications of moving from factor apportionment corporate income taxes to a gross receipts tax (GRT) at the state level. Gross receipts taxes have gained in popularity, evidenced by the adoption of the GRT in four states since 2002 (joining Washington). Using micro-level corporate data for Georgia, the authors analyze the impacts of moving from a standard state corporate income tax to a GRT.

Rork and Wheeler do a good job of providing us with the basics regarding how a GRT works in most states. As a broad-based tax on receipts, it is a potentially powerful revenue engine and relatively simple from a tax administration standpoint. However, as they point out, it may be criticized on the basis of its turnover nature – whereby the tax gets embedded and...
passed forward in multiple-stage production processes. They provide us with an interesting empirical analysis of the change in the concentration of tax payments among firms from moving a state’s corporate income tax to a gross receipts tax (adjusting the GRT tax rates so that there is no net revenue change and using a one-factor apportionment formula as an intermediate step). Using a panel micro data file of more than 90,000 state corporate income tax returns, they simulate the impacts of a GRT in Georgia. They find that there is little change in the concentration of tax payments moving from a state corporate income tax to a GRT.

In Chapter 7, Wallace develops an empirical analysis of the revenue impact of moving a state income tax system (corporate and individual) to a consumption tax. With a proliferation of federal consumption tax proposals in the US and their increased use around the world, it is natural to ask whether a ‘true’ consumption tax is feasible for a US state. The objective of this chapter’s analysis is to demonstrate how a conventional income tax system could be converted to a flat rate consumption tax in a US state under a revenue-neutral scenario. Wallace uses data for Georgia to decompose the revenue impacts of the main changes need to move a standard income tax system to a consumption-based tax system. As she points out, there are some major revenue swings; the loss of itemized deductions and personal exemptions will be burdensome to all taxpayers and may be particularly so to low-income taxpayers. Taxing fringe benefits and eliminating tax benefits for retirement contribution increase revenue, but at a high political cost. However, she demonstrates that there are reasonable ways to estimate the impacts of such a change and, in the case of Georgia, some of the distributional implications of the change can be offset with an overall rate reduction.

The final section of the book, Part IV, contains two chapters that highlight the budgetary aspects of state and local governments’ fiscal choices. In Chapter 8, Katherine Willoughby examines state government leaders in ‘structural balance’ as determined by the Government Performance Project (GPP). Structural balance is the ability of government to support ongoing expenditures with ongoing revenues, and consideration is given to tax structures, countercyclical devices, financial management strategies and various fiscal ratios. The research uses information generated by the most recent iteration of the GPP 50-state survey, conducted in 2007. Willoughby first provides an overview of the current fiscal condition of state governments and relays the concerns of current governors regarding reaching and maintaining structural balance. She includes a helpful accounting of the GPP methodology and criteria used to measure state budget and financial management. Using the GPP results, she assesses the characteristics of strong states (those with structural balance) as well as states that are not in as positive a budget balance position.
Willoughby identifies nine state governments as leaders in reaching and maintaining structural balance and finds that there are some characteristics that define these states that could provide useful examples to other states. On the revenue side, these states are characterized as follows: they did not transfer earmarked funds into the general fund, increase short-term borrowing, draw down budget stabilization or contingency funds or accelerate tax payments. Additionally, on the expenditure side, these states did not use hiring or program increase freezes but they were more likely to require employees to contribute additionally toward health benefits and to implement privatization initiatives.

In Chapter 9, Daniel Mullins brings the tax and expenditure limitation (TEL) information and debate up to date. Mullins argues that while TELs have been around for more than 100 years, the TELs since the 1970s have brought in more rigorous constraints to state and local fiscal policy. He also demonstrates that the impact of TELs increases over time, so that it becomes difficult to analyze the impact of any one TEL policy given that often many have come before.

Mullins provides a great deal of detail on the types of TELs that have been passed since 1990. He also summarizes the literature on why we have this continued passage of TELs. Various explanations abound, including ‘runaway’ property taxes, mistrust of government and a demand for increased efficiency in government. The impacts of the TELs also vary. Mullins summarizes a wide-ranging literature, and suggests that TELs have little effect on the overall size of the state and local public sector and have decreased the use of local broad-based taxes (specifically property taxes), have expanded the fiscal role for state governments, and have altered the composition of the local public sector, increasing the use of special districts (special purpose districts designed to meet specific needs of the local population including security, sanitation, and recreational services). The chapter provides a large amount of specific and timely data on TELs.

Finally, in Chapter 10, Bert Waisanen brings together the lessons learned from the individual chapters to draw conclusions regarding the future of state and local tax and expenditure policy.