

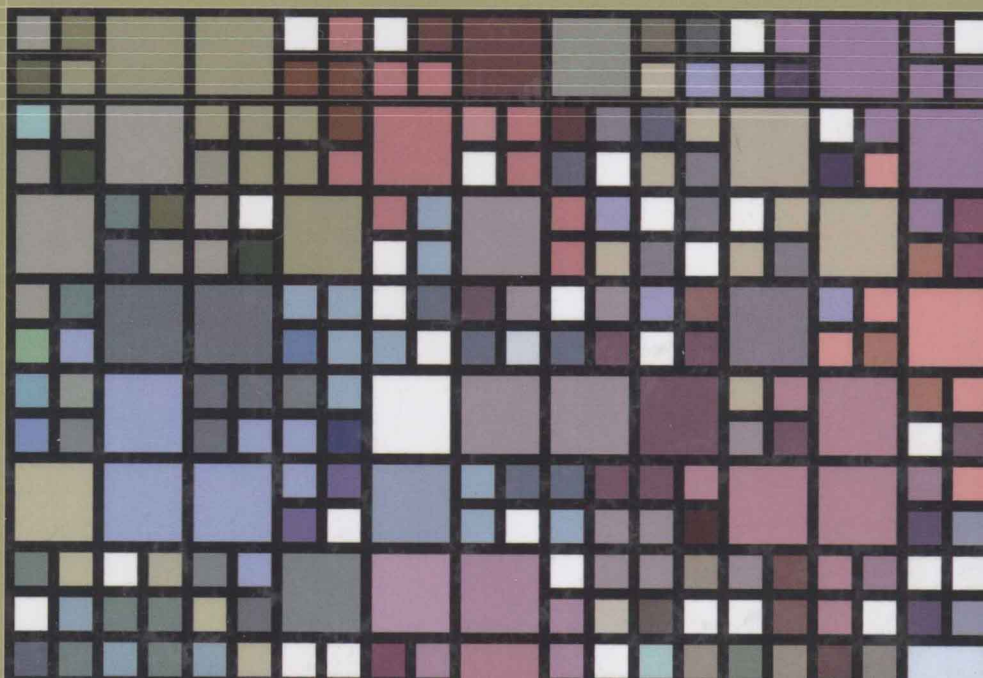
Studies in
Fiscal Federalism and State-local Finance



State and Local Fiscal Policy

Thinking Outside the Box?

Edited by **Sally Wallace**



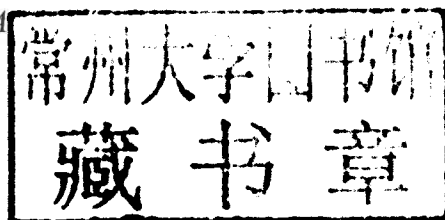
State and Local Fiscal Policy

Thinking Outside the Box?

Edited by

Sally Wallace

Georgia State University, USA



STUDIES IN FISCAL FEDERALISM AND STATE-LOCAL
FINANCE

Edward Elgar

Cheltenham, UK • Northampton, MA, USA

© Sally Wallace 2010

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical or photocopying, recording, or otherwise without the prior permission of the publisher.

Published by
Edward Elgar Publishing Limited
The Lypiatts
15 Lansdown Road
Cheltenham
Glos GL50 2JA
UK

Edward Elgar Publishing, Inc.
William Pratt House
9 Dewey Court
Northampton
Massachusetts 01060
USA

A catalogue record for this book
is available from the British Library

Library of Congress Control Number: 2009937773



ISBN 978 1 84844 424 9

Printed and bound by MPG Books Group, UK

State and Local Fiscal Policy

STUDIES IN FISCAL FEDERALISM AND STATE-LOCAL FINANCE

Series Editor: Wallace E. Oates, *Professor of Economics, University of Maryland, College Park and University Fellow, Resources for the Future, USA*

This important series is designed to make a significant contribution to the development of the principles and practices of state-local finance. It includes both theoretical and empirical work. International in scope, it addresses issues of current and future concern in both East and West and in developed and developing countries.

The main purpose of the series is to create a forum for the publication of high-quality work and to show how economic analysis can make a contribution to understanding the role of local finance in fiscal federalism in the twenty-first century.

Titles in the series include:

Competition in the Provision of Local Public Goods

Single Function Jurisdictions and Individual Choice

Alexandra Petermann Reifschneider

Decentralization in Asia and Latin America

Towards a Comparative Interdisciplinary Perspective

Edited by Paul Smoke, Eduardo J. Gómez and George E. Peterson

The Politics and Economics of Regional Transfers

Decentralization, Interregional Redistribution and Income Convergence

Fabio Padovano

Fiscal Reform in Spain

Accomplishments and Challenges

Edited by Jorge Martínez-Vázquez and José Félix Sanz-Sanz

Fiscal Federalism and Political Decentralization

Lessons from Spain, Germany and Canada

Edited by Núria Bosch and José M. Durán

The Theory and Practice of Local Government Reform

Edited by Brian E. Dollery and Lorenzo Robotti

The Political Economy of Financing Scottish Government

Considering a New Constitutional Settlement for Scotland

C. Paul Hallwood and Ronald MacDonald

Does Decentralization Enhance Service Delivery and Poverty Reduction?

Edited by Ehtisham Ahmad and Giorgio Brosio

State and Local Fiscal Policy

Thinking Outside the Box?

Edited by Sally Wallace

Contributors

Don Bruce is Associate Professor in the Center for Business and Economic Research and the Department of Economics at the University of Tennessee, Knoxville.

Ronald C. Fisher is Professor of Economics, Michigan State University.

Mary Mathewes Kassis is Associate Professor of Economics, University of West Georgia.

Daniel R. Mullins is Associate Professor and Co-Director of the Center for Public Finance Research in the School of Public Affairs at American University. His PhD is from the Maxwell School of Citizenship and Public Affairs at Syracuse University.

Igor Popov was, at the time he contributed to this chapter, a senior economics major at Stanford University, interning with the New England Public Policy Center at the Federal Reserve Bank of Boston.

Jonathan Rork is Assistant Professor of Economics and Faculty Research Associate of the Fiscal Research Center, Andrew Young School of Policy Studies, Georgia State University.

Jason S. Seligman is Assistant Professor, John Glenn School of Public Affairs, Ohio State University.

David L. Sjoquist is Professor of Economics and Director, Fiscal Research Center, Andrew Young School of Policy Studies, Georgia State University.

William J. Smith is Assistant Professor of Economics, University of West Georgia.

Robert Tannenwald is the Vice President and Economist Director, New England Public Policy Center at the Federal Reserve Bank of Boston.

Kurt Thurmaier is Director and Professor of Public Administration in the Division of Public Administration at Northern Illinois University.

Bert Waisanen is a Program Principal for Fiscal Affairs at the National Conference of State Legislatures in Denver.

Sally Wallace is Professor of Economics and Associate Director, Fiscal

Research Center, Andrew Young School of Policy Studies, Georgia State University.

Robert W. Wassmer is Professor and Chairperson of the Department of Public Policy and Administration at California State University, Sacramento. At Sacramento State he also directs the Master's Program in Urban Land Development and is associate director of the Doctorate Program in Education Leadership and Policy.

Jennifer Weiner is policy analyst with the New England Public Policy Center, at the Federal Reserve Bank of Boston.

Laura Wheeler is Senior Research Associate, Fiscal Research Center, Andrew Young School of Policy Studies, Georgia State University.

Katherine Willoughby is Professor of Public Management and Policy, Andrew Young School of Policy Studies, Georgia State University.

Contents

<i>List of contributors</i>	vii
-----------------------------	-----

PART I THE PERFECT STORM?

1 Introduction and overview	3
<i>Sally Wallace</i>	
2 Major state–local policy challenges: outside-the-box solutions needed	9
<i>Ronald C. Fisher</i>	
3 Genesis of state–local creativity	28
<i>Robert Tannenwald, Jennifer Weiner and Igor Popov</i>	
Discussant comments: Mary Mathewes Kassis	58
Discussant comments: Jason S. Seligman	60

PART II HOW STATES COPE WITH ALTERNATIVE STRUCTURES

4 Going without an income tax: how do states do it?	67
<i>David L. Sjoquist</i>	
5 California’s state and local revenue structure after Proposition 13: is denial the appropriate way to cope?	98
<i>Robert W. Wassmer</i>	
Discussant comments: Don Bruce	125

PART III NEW FORMS OF TAXATION

6 An exploration of various corporate tax structures in Georgia: some effects of moving from three-factor apportionment of corporate income to a gross receipts tax	131
<i>Jonathan Rork and Laura Wheeler</i>	
7 Can Georgia move from income tax to consumption tax?	156
<i>Sally Wallace</i>	
Discussant comments: William J. Smith	173

PART IV EVALUATING STATE AND LOCAL
GOVERNMENT FINANCES AND BUDGETING

8	Reaching and maintaining structural balance: leaders in the states <i>Katherine Willoughby</i>	179
9	Fiscal limitations on local choice: the imposition and effects of local government tax and expenditure limitations <i>Daniel R. Mullins</i>	201
	Discussant comments: Kurt Thurmaier	266
10	Out-of-the-box conference: an epilogue <i>Bert Waisanen</i>	271
	<i>Index</i>	275

PART I

The perfect storm?

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 discussants 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, productivity 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 practical 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 backlash 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 policies 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.