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Four Big Threats to State Finances Could Undermine Future U.S. Prosperity

By Nicholas Johnson and Michael Leachman

Without adequate revenues, states and localities cannot continue providing public services like education, health care, and infrastructure that lay the groundwork for a prosperous future. But state revenue systems face four serious challenges.

- **The most severe recession in seven decades blasted holes in state budgets from which they have yet to recover.** The recession of 2007-09 sharply reduced state revenues, causing budget shortfalls totaling well over half a trillion dollars.[1] Revenues have improved lately but remain about 6 percent below where they were five years ago, even as the number of people needing state services has grown. In addition, states need to replenish reserve funds diminished in the recession, such as "rainy day" budget reserves, pension funds for state workers, and unemployment trust funds. These factors make it very hard for states to reverse past budget cuts — let alone exploit new opportunities for cost-effective investments in areas like early education, job training, and new business incubation.

- **States' antiquated tax systems are ill-suited to raising adequate revenue in a 21st century economy.** States have not modernized their tax systems to keep pace with trends such the growth of the service sector and of e-commerce. Nearly half of total household purchases go for services, for example, yet only a few states apply their sales taxes to a broad array of services. States' failure to update their tax systems will take a growing toll on revenues and hence on their ability to finance the rising need for state-funded services in areas like education and health care.

- **The federal government, which provides about one-quarter of state and local revenues, is on track to make deep spending cuts that could hit states hard.** The 2011 Budget Control Act has already caused cuts in grant programs to states and will push federal funding for a wide range of state and local services — schools, water treatment, law enforcement, and

[1] Phil Oliff, Chris Mai, and Vincent Palacios, "States Continue to Feel Recession's Impact," Center on Budget and Policy Priorities, updated June 27, 2012, http://www.cbpp.org/cms/index.cfm?fa=view&id=711.

other areas — to its lowest level in four decades as a share of the economy.[2] Additional, automatic cuts ("sequestration") are scheduled to begin in March, causing over $6 billion in additional cuts in aid to states this year. Those are just the budget cuts that are already scheduled to occur (even though specific individual cuts have not been determined); there is substantial risk that future deficit-reduction legislation could impose still more cuts, especially if that legislation doesn't include substantial revenues.

- **Some state policymakers are pushing for large tax cuts that would further undermine state revenues, with potentially dramatic consequences for public services.** In five states governors and/or leading legislators have proposed complete repeal of the state income tax, which typically provides one-third to one-half of all state revenues. (No state other than oil-rich Alaska in the 1970s has ever repealed its income tax.) Less radical but still harmful tax cuts are on the table in a number of other states, as are rigid limitations on state budgeting.

States and localities educate the nation's children and build and repair its roads, bridges, airports, and public transit systems. They provide public safety, help the homeless, protect waterways from sewage contamination, provide job training, and much more. Many of these services are essential for the nation's long-term economic growth. If states can't perform them adequately, the country's long-term economic potential could diminish, and poverty and inequality could be more severe than they otherwise would be.

Some states likely will rise to the above challenges, protecting their schools, transportation networks, and other public services and modernizing their revenue systems for the long term. Some other states likely won't meet the challenge, choosing instead to accept depressed revenues and decaying public services as the "new normal." The country's future prosperity depends to a significant degree on the number of states that choose the first, more fruitful path.

Recession Seriously Damaged State Revenue Systems

The recession of 2007-09 sharply reduced state revenues (see Figure 1), causing budget shortfalls totaling well over half a trillion dollars.[3] States responded with large cuts in funding for schools and a wide range of other services: 35 states have cut K-12 school funding per student to below 2008 levels, after adjusting for inflation, and in about half of these states the cut has been more than 10 percent.[4] States have made even deeper cuts in funding for public universities and community colleges: nationwide, they spent 29 percent less per student in the 2011-12 school year than they did before the recession.[5]

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[2] The Budget Control Act caps apply to all non-defense discretionary state aid programs, except for federal funding for transportation projects.

[3] Phil Oliff, Chris Mai, and Vincent Palacios, "States Continue to Feel Recession's Impact," Center on Budget and Policy Priorities, updated June 27, 2012, http://www.cbpp.org/cms/index.cfm?fa=view&id=711.

[4] Phil Oliff, Chris Mai, and Michael Leachman, "New School Year Brings More Cuts in State Funding for Schools," Center on Budget and Policy Priorities, updated September 4, 2012, http://www.cbpp.org/cms/index.cfm?fa=view&id=3825.

[5] CBPP analysis based on data from the Center for the Study of Education Policy at Illinois State University and the State Higher Education Executive Officers Association.

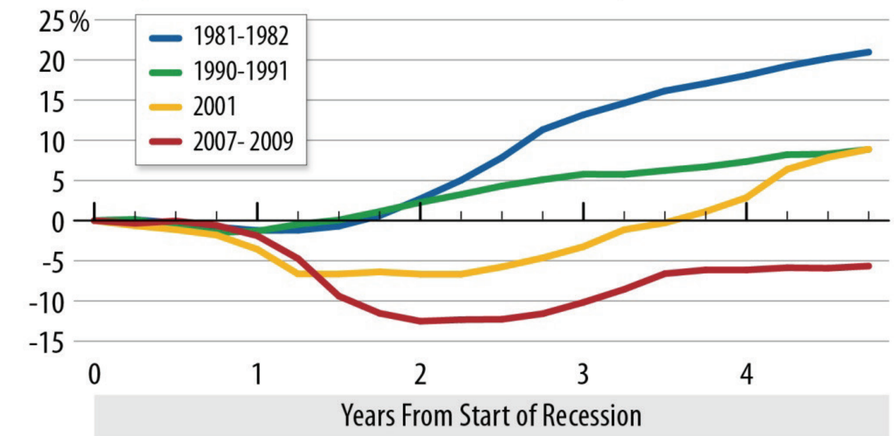
States and localities also have eliminated hundreds of thousands of jobs, resulting in layoffs for teachers, child abuse caseworkers, police officers, and many others. In recent months they have begun adding some of the jobs back, but there are still over 600,000 fewer state and local public workers to provide services than there were four years ago.

Reversing the damage from these cuts will take years. State revenues have improved lately but remain about 6 percent below where they were five years ago, partly because of the sluggish recovery and partly because the temporary tax increases enacted in some states have expired. Meanwhile, the number of people needing state services has grown due to normal population growth and the ongoing effects of the recession, further widening the gap between revenues and needs. This school year, for instance, there are some 535,000 more public school students and 2.5 million more public college and university students than when the recession began.

Figure 1

State Revenue Loss Far Exceeds Other Recent Recessions

Percent change in state tax revenue since start of recession, adjusted for inflation



Note: figures represent four-quarter rolling averages
Source: Census Bureau and Bureau of Labor Statistics

Any attempt to improve services above recession-depleted levels will conflict with another important priority: replenishing state funds that were diminished in the recession, such as "rainy day" budget reserves, pension funds for state workers, and unemployment trust funds. For example:

- States spent most of their rainy day funds after the recession hit and have not yet rebuilt them. When states entered the last two recessions, their rainy day funds averaged about 10 percent of their budgets. Now they are down to 4 percent — far too small to be of much help even in a mild recession.[6]

- States rapidly spent down their unemployment insurance trust funds to pay benefits after the recession hit and must start rebuilding them for the next recession. Only six states have the level of reserves that the U.S. Department of Labor recommends.[7] Some 20 state trust funds

[6] See Elizabeth McNichol, "2013 Is a Good Year to Repair (If Not Replenish) State Rainy Day Funds," Center on Budget and Policy Priorities, January 15, 2013, http://www.cbpp.org/cms/index.cfm?fa=view&id=3887.

[7] The U.S. Department of Labor recommends that states maintain a UI trust fund balance that will allow them to make one year of benefit payments at the level these payments reached in the average of the three worst years of the past 20 years. In technical terms, states meeting this recommended level have an Average High Cost Multiple of 1.0 or higher.

remain insolvent and are borrowing from the federal government to pay benefits; several others have issued bonds to pay off their federal loans, exchanging one form of debt for another.[8]

- The recession reduced the value of assets in pension trust funds, due largely to stock-market losses and (in some cases) insufficient deposits when state revenues were short. As a result, the average state pension fund is considered "underfunded," meaning that its assets are insufficient to pay 80 percent of the future retirement benefits that current state workers have earned, even taking into account those assets' future investment earnings and future contributions by employers and employees.

It will take years for states to restore these funds to levels sufficient to weather the next recession. That means states will have less money to address the existing backlog of state investments — including economically important investments in aging transportation networks, water systems, and levees[9] — and less money for innovative new investments in early education, job training, new business incubation, and other areas that promise substantial future economic returns. One estimate found that investing in high-quality early education targeted to low-income children would produce annual public benefits that exceed program costs by about 12 to 1; a number of other studies have found striking returns as well.[10]

Providing high-quality public services, replenishing drained reserves, and exploiting new opportunities for cost-effective public-sector investments should be top priorities for the revenues that result from the nation's economic recovery. States whose finances remain stuck in the depth of the recession because their policymakers enact unaffordable new tax cuts will fall behind.

State Revenue Systems Are Outdated

The challenge of restoring funding for schools, rebuilding reserves, and investing in the future would not be as great if states could expect strong revenue growth. Unfortunately, states' antiquated tax systems are ill-suited to raising adequate revenue in a 21st century economy.

- **Most states get most of their sales tax revenues from the purchase of goods, but the economy is increasingly service-driven.** Nearly half (45 percent) of total household purchases went for services in 2011, up from 30 percent in 1970.[11] Yet only a few states apply

[8] Based on U.S. Department of Labor, "Unemployment Insurance Data Summary," 3rd quarter 2012, table entitled Financial Information by State, http://ows.doleta.gov/unemploy/content/data_stats/datasum12/DataSum_2012_3.pdf. Twenty states still were insolvent and borrowing from the federal government as of January 10, 2013.

[9] The American Society of Civil Engineers gave a cumulative grade of D to the condition of the country's roads, bridges, drinking water systems and other public works in 2009, and found little improvement from 2005. See the "2009 Report Card for America's Infrastructure," http://www.asce.org/reportcard/.

[10] Robert G. Lynch, *Enriching Children, Enriching the Nation*, Economic Policy Institute, 2007, http://www.epi.org/publication/book_enriching/. See also Steffanie Clothier and Julia Poppe, "New Research: Early Education as Economic Investment," National Conference of State Legislatures, http://www.ncsl.org/issues-research/human-services/new-research-early-education-as-economic-investme.aspx.

[11] See Michael Mazerov, "Expanding Sales Taxation of Services: Options and Issues," Center on Budget and Policy Priorities, August 10, 2009, http://www.cbpp.org/cms/index.cfm?fa=view&id=2888.

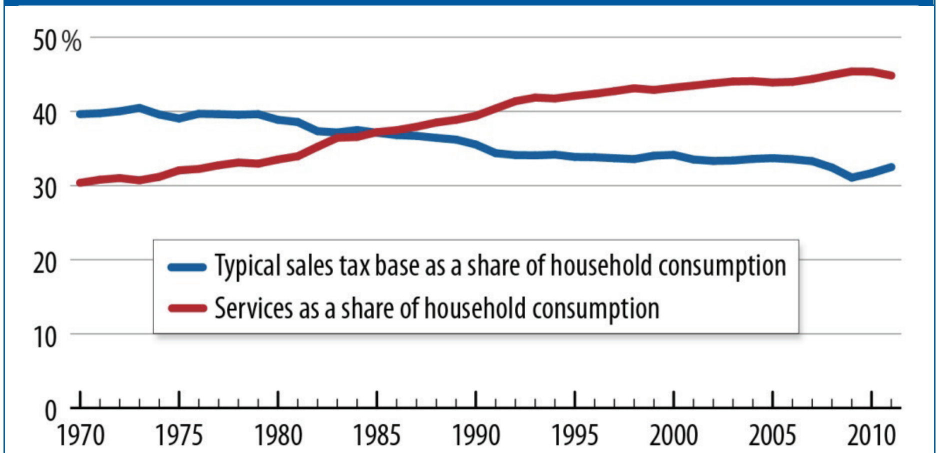
their sales taxes to a broad array of services; most states apply their sales tax to less than one-third of 168 potentially taxable services, according to the Federation of Tax Administrators.[12] As a result, states lose many billions of dollars in revenue each year, and the loss likely will grow as the trend toward services continues.

- **The rise of e-commerce also is weakening state sales taxes.** The Supreme Court has ruled that states cannot require businesses to collect the sales taxes consumers legally owe on purchases from out-of-state sellers. As a result, states and localities lose more than $20 billion a year in uncollected sales taxes, a figure likely to continue rising as e-commerce grows.[13] (Congress could establish fair rules that would resolve the problem but has not yet done so.) Meanwhile, many states have not updated their sales taxes to cover various goods sold on the Internet — downloaded computer software, music, and books, for example — even when these states tax the sale of identical items sold in physical stores. Since many online companies would collect the tax despite the Supreme Court's decision, states with outdated e-commerce tax laws lose significant revenue.

- **Many state income tax systems collect too little revenue because they were designed for past periods when income inequality was much less stark than today.** Over the last generation, the income gains stemming from economic growth have flowed disproportionately to those at the top of the income scale, raising income inequality to extreme levels. In times like these, states with robust income taxes and graduated rates are more able to produce sufficient revenue for public services than states with flat rates, since graduated rates require very wealthy households to pay a higher tax rate on much of their income. Many states, though, still maintain income tax systems with flat or nearly flat rates.

Figure 2

Service Sector Growth Erodes Sales Tax Base



Source: Bureau of Economic Analysis, with some CBPP calculations

- **States' widespread tax breaks for seniors will grow increasingly costly as the population ages.** States provide a wide variety of income tax and property tax breaks to all elderly residents — regardless of their income. The cost of these tax preferences will grow along with

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[12] Federation of Tax Administrators, Sales Taxation of Services: 2007 Update, October 2008, www.taxadmin.org/fta/pub/services/services.html. See report for extensive footnotes that affect classification as taxable or exempt.

[13] National Conference of State Legislators, "Collecting E-Commerce Taxes," http://www.ncsl.org/issues-research/budget/collecting-ecommerce-taxes-an-interactive-map.aspx.

the elderly population.

- **State tax laws do not reflect the reality of current corporate structures.** Corporations have grown over time and more conduct business in multiple states, very often through subsidiaries. Almost half of the states, though, still allow corporations to report the profits of the parent company separately from subsidiaries. This creates an enormous loophole that allows companies to avoid paying corporate income taxes on a large part of their profits by shifting those profits out of the states where they were earned and into states in which they will be taxed at lower rates — or not at all.

These structural problems aren't an immediate crisis requiring radical action, but they add pressure to state revenue systems that already are under extreme stress.

Some states have taken steps to develop revenue systems more appropriate to the 21st century. In recent years, for example, Connecticut and New Jersey have broadened their sales taxes to include many more services. Other states could raise significant revenue by modernizing their sales tax systems. States that tax few if any services — such as California, Illinois, Massachusetts, and Virginia — could likely boost their sales tax revenue by more than one-third if they taxed all services that households purchase.[14]

Similarly, while most states could do much more to modernize their taxation of digital goods and services, some states are leading the way. About half of states with a sales tax apply it to downloaded movies, music, and/or books, and a few states (including Idaho, Utah, and Washington) tax other digital goods as well.[15]

In addition, at least six states — California, Connecticut, Hawaii, Maryland, New York, and Oregon — have made their income taxes more progressive by setting new top brackets.

Many other states, however, have yet to begin modernizing their revenue systems. Such states risk a continuing erosion of their ability to finance public services essential to economic growth.

Federal Funding Cuts Will Worsen State Revenue Problems

In addition to recession-induced budget problems and outdated revenue systems, states must cope with cuts in federal funding. The 2011 Budget Control Act (BCA) will push federal funding for a wide range of state and local services — schools, water treatment, law enforcement, and other areas — to its lowest level in four decades as a share of the economy.[16]

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14 Michael Mazerov, "Using Economic Census Data to Estimate the Revenue Impact of Taxing Services," Center on Budget and Policy Priorities, February 15, 2012, http://www.cbpp.org/cms/index.cfm?fa=view&id=3683.

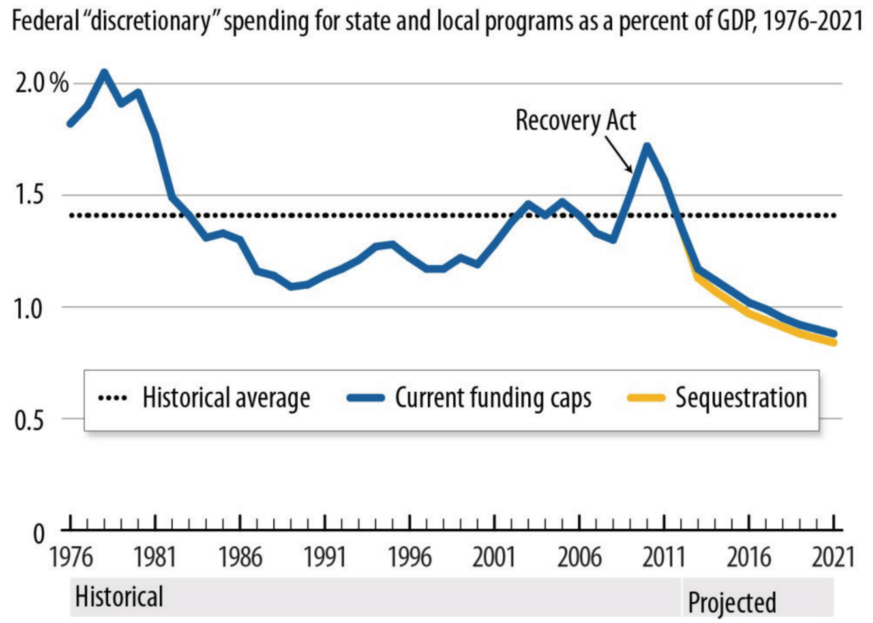
15 Michael Mazerov, "States Should Embrace 21st Century Economy by Extending Sales Taxes to Digital Goods and Services," Center on Budget and Policy Priorities, December 13, 2012, http://www.cbpp.org/cms/index.cfm?fa=view&id=3874.

16 The Budget Control Act caps apply to all non-defense discretionary state aid programs, except for federal funding for transportation projects.

The BCA imposes funding caps, which grow more restrictive over time, in the part of the federal budget known as "discretionary" funding (because it is subject to annual appropriation, as opposed to so-called "mandatory funding," most of which is tightly tied to specific benefits and services for individuals). Discretionary funding represents a quarter of all federal grants to states and localities.

Figure 3

State and Local Aid Already Scheduled to Fall Far Below Historical Levels



Source: Center on Budget and Policy Priorities based on Office of Management and Budget and Congressional Budget Office data. All data represent outlays.

Medicaid is a "mandatory" program and thus not subject to the BCA caps, and Medicaid grants to states likely will grow due to rising health care costs and projected increases in the number of people eligible for the program. (States will also receive additional Medicaid funding to help implement health reform beginning in 2014.) But Medicaid funds will only help states cover Medicaid-related expenditures. They cannot compensate for cuts in federal funds for schools, law enforcement, and other state services.

In addition, automatic, across-the-board cuts known as sequestration, now scheduled to start March 1, 2013, would impose steep additional cuts in funding for schools and other discretionary state and local aid programs (a major exception is transportation programs). In 2013, under sequestration, federal funding for education and most other state and local aid outside of Medicaid would fall by over $6 billion, or 5.2 percent, *on top* of the cuts already imposed by the BCA.

Even worse, states face a significant risk that policymakers could impose *additional* cuts to discretionary funding, on top of the cuts imposed last year and the further cuts pending under sequestration, most likely through a further reduction in the BCA caps.

Additional reductions in funding for schools and other discretionary programs are particularly likely if the next round of deficit reduction achieves savings solely through spending cuts, rather than balancing cuts with significant new revenue. As an illustration, the budget that the House passed in the spring of 2012, which sought to reduce the deficit without raising any revenue, cut non-defense discretionary funding by *three times* as much in 2014 as the cuts scheduled under sequestration.

Some policymakers seeking additional deficit reduction — especially those intent on reducing the deficit without new revenue — may also pursue deep cuts in federal Medicaid funding, such as by imposing a cap on how much federal funding per beneficiary states may receive and setting that cap below the level of costs that states are actually expected to incur. The Obama Administration, which previously proposed tens of billions of dollars in Medicaid cuts, no longer supports cuts of such magnitude, but some members of Congress continue to press for large Medicaid reductions. Significant cuts in federal Medicaid funding would force states to make up for the lost federal funds with higher state taxes, cuts in medical services for low-income people, cuts in other state services and programs, or a combination of such actions. Because Medicaid is already lean — it costs much less per beneficiary than private insurance does — and states already exercise considerable flexibility, they could not absorb large federal funding cuts simply by providing Medicaid coverage more efficiently. (It is the case that the federal Affordable Care Act will provide large amounts of additional funding to states to expand their Medicaid programs to cover more people who cannot afford private insurance, and some of this funding may make state budgets stronger by paying for services that states were already funding. But such savings would likely be overshadowed by large federal Medicaid cuts. In particular, states that fail to adopt the Medicaid expansion option offered through the Affordable Care Act would be hurt, because they would not realize the savings in their own budgets resulting from the expansion of health insurance but would still be hit hard by federal cuts.)

Other potential federal actions could harm states also. As part of tax reform, the federal government may consider repealing the tax exemption for municipal bond interest, which would raise borrowing costs, or the tax deduction for state and local taxes, which would make it harder for states and localities to sustain revenue streams. (More modest reforms to those provisions would have smaller effects.) The federal government also perennially considers measures to preempt certain state and local taxes, such as last year's proposal to bar some taxes on digital goods and services.[17]

Many States Considering Extreme, Damaging Fiscal Policies

Adding to states' budget problems, a significant number of governors and legislative leaders are pushing irresponsibly large tax cuts and other misguided fiscal policies that would further curtail states' ability to invest in education, health care, and other services.

- **At least five states are considering *eliminating* income taxes.** Governors or legislative leaders in Kansas, Louisiana, Nebraska, and both North and South Carolina are proposing to eliminate all state personal and corporate income taxes. This is highly unusual. No state with an income tax has ever eliminated it, except for oil-rich Alaska, which only eliminated it after the completion of the Trans-Alaska Pipeline in the late 1970s assured the state a huge new, long-term revenue source.

- **At least eleven other states are considering deep tax cuts.** Nine states — Indiana, Missouri, Montana, New Mexico, North Dakota, Ohio, Oklahoma, Pennsylvania, and

[17] Michael Mazerov, "'Digital Goods and Services Tax Fairness Act' Would Impair Funding for Education, Health Care and Other State and Local Services," May 2012, http://www.cbpp.org/cms/index.cfm?fa=view&id=3783.

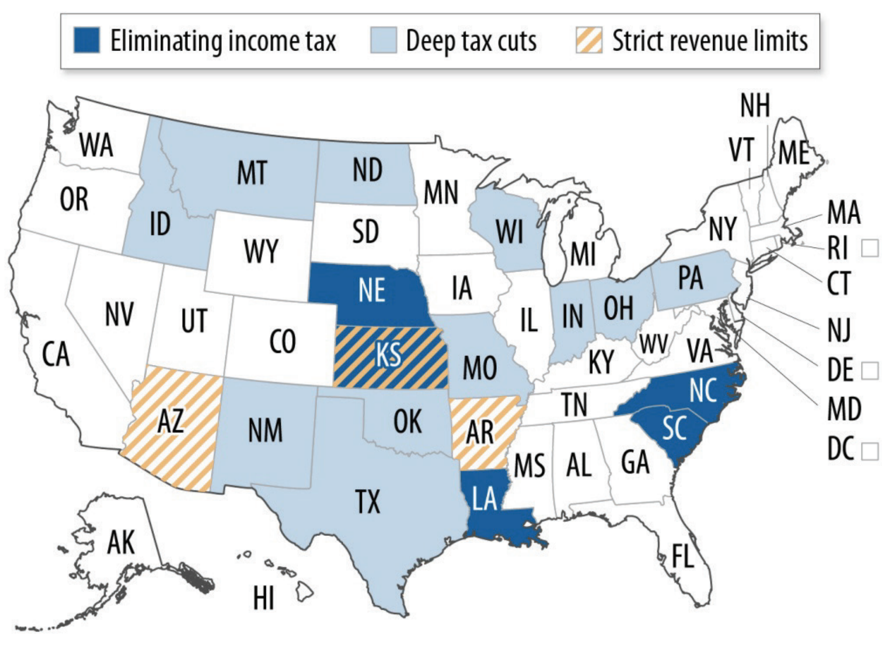
Wisconsin — are considering personal or corporate income tax cuts projected to cost in the hundreds of millions of dollars when fully implemented. These states are considering major tax cuts even though two-thirds of them (all except Indiana, Montana, and North Dakota) reduced funding for K-12 schools after the recession hit and have yet to restore this funding.[18] In addition, Texas' governor has called for $1.8 billion in unspecified tax cuts, and Idaho is considering a business property tax cut that would cost more than $140 million.

- **At least three states are considering harsh revenue limits.** Arizona, Arkansas and Kansas are considering limiting future revenue growth to very low levels, which would make it impossible for these states to raise the revenue needed to support their schools and other fundamental public services in the future.

Deep tax cuts at a time when state revenues already are severely diminished would lock in the recession's damage to funding for schools and other public services, and over time would further erode states' ability to perform basic functions essential to the country's future. To compete in the 21st century, the nation will need quality schools, modern transportation networks, healthy people, and efficient court systems. States that undermine their ability to pay for these and other fundamental public services are crippling their own futures and limiting the nation's progress.

Figure 4

Many States Are Proposing Deep Tax Cuts



Source: CBPP Survey

Most of the proposed tax cuts would reduce or eliminate income taxes. Some of these proposals would replace a portion or all of the revenue lost to income tax cuts by raising other taxes, primarily by expanding the base of the sales tax, increasing the sales tax rate, or both.

Cutting income taxes and raising sales taxes generally results in an overall tax *increase* for middle-class and low-income people, and a tax cut for the wealthy and corporations. That's largely because income taxes typically require people with higher incomes to pay higher rates while sales taxes do not. Moreover,

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18 Phil Oliff, Chris Mai, and Michael Leachman, "New School Year Brings More Cuts in State Funding for Schools," Center on Budget and Policy Priorities, updated September 4, 2012, http://www.cbpp.org/cms/index.cfm?fa=view&id=3825.

middle-class and low-income people must spend a larger share of their income to meet basic needs than the wealthy, so it's hard for them to avoid paying more of their income in sales taxes than the wealthy pay.

These tax shift plans also would make it even harder for states to raise the revenue they will need to invest in the future. Since income taxes account for 40 percent of state tax revenue on average, fully replacing the lost revenue would require a much higher sales tax rate — often higher than proponents claim — and extending the tax to many more goods and services by including for example food, prescription drugs, home sales, and more business-to-business transactions. Such a large expansion of the sales tax would spark furious efforts to exempt many purchases from the tax. But if a state granted such exemptions, it would have to compensate by raising the sales tax rate even higher. The ultimate result, most likely, is that the new tax would fail to offset fully the lost income tax revenue — forcing cuts to education, transportation, and other essential services to meet state balanced-budget requirements.

Conclusion

Four years after the recession of 2007-09, state revenue systems have not yet recovered. They remain under pressure from a sluggish economic recovery, and from the demands of reserve funds and trust funds that need to be replenished. Their antiquated tax structures make them ill-suited to collect revenue adequately and fairly in a 21st century economy. Federal actions, both those already enacted and those that may come in the future, will further reduce revenues. On top of all these challenges, some governors and legislative leaders are proposing tax cuts with little regard for their fiscal consequences.

Without attention by policymakers to these problems, it will be difficult for the nation to find the necessary revenue to make needed new investments in education, health and human services, infrastructure, or other areas important to the economic prospects of individuals, families, communities, states, and the nation.