

# The State of State Tax Policy: Challenges Ahead

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## Future Growth in Spending Will Require State Funds, Focus

- Exploding entitlement costs
  - Little option for Federal help
- Property Tax Relief and Reform
- State Tax Options
  - Income Taxes
  - Sales Taxes
  - Alternative Funds



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## Introduction

- Most state/local governments have balanced budget rules
  - So if want to provide services, need funds
- Federal funds for local governments tightening as entitlements grow
  - Presidents budget limits growth in domestic programs
- Tax options often limited by rules and possible economic effects
- Goal – raise money need with minimal disruption to economy



## State Spending Has Been Growing Over Time

**Table 2: Total State Expenditures by Function**

(Billions of 2003 Dollars)

	1985	1990	1995	2000	2005
K-12 Education	114	161	182	225	254
Higher Education	57	86	90	115	124
Cash Assistance	31	35	35	26	23
Medicaid	57	88	172	197	267
Corrections	11	24	31	39	41
Transportation	55	70	79	92	100
All Other	188	241	279	321	359
Total	513	706	869	1,011	1,166



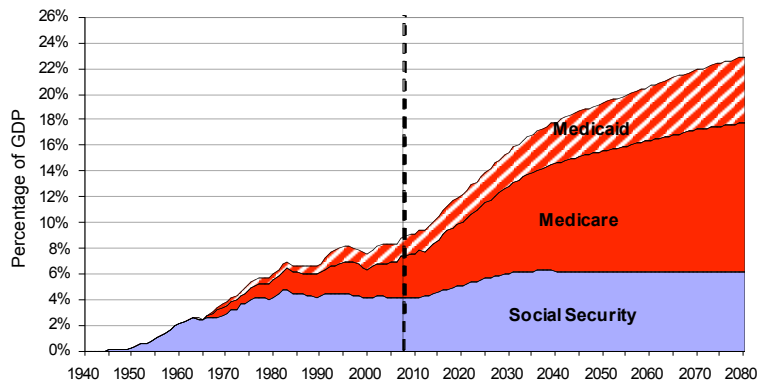
### Share of Total State Expenditures by Function

	1985	1990	1995	2000	2005
K-12 Education	22%	23%	21%	22%	22%
Higher Education	11%	12%	10%	11%	11%
Cash Assistance	6%	5%	4%	3%	2%
Medicaid	11%	13%	20%	20%	23%
Corrections	2%	3%	4%	4%	4%
Transportation	11%	10%	9%	9%	9%
All Other	37%	34%	32%	32%	31%

Source: NASBO "Fiscal Survey of the States"



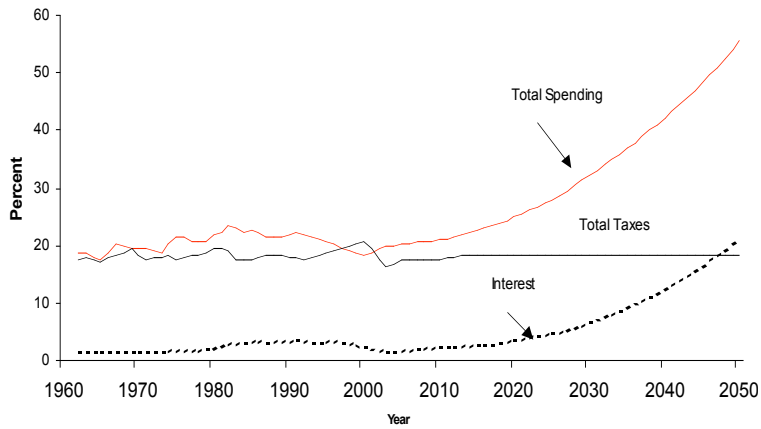
### Major Entitlements as a Percentage of GDP, Fiscal Years 1940 - 2080



Source: C. Eugene Steuerle, Adam Carasso, Elizabeth Bell, The Urban Institute, 2006.  
 Note: Authors used January 2006 CBO data for Social Security, Medicare, and Medicaid through 2016, and grew Social Security and Medicare levels with 2006 Trustees data and Medicaid with 2005 CBO data.



## Spending and Revenue as Percentage of GDP, 1962-2050



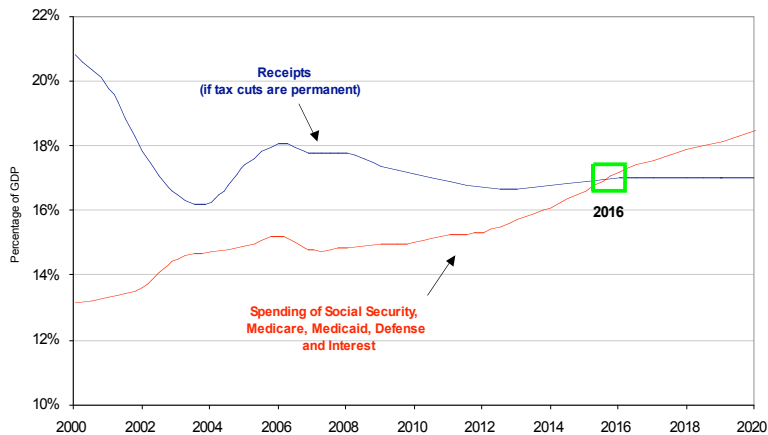
Source: CBO, Long-Term Budgetary Trends (2005). Chart assumes entitlement spending growth follow its recent trend, revenues equal to historical norms, and other spending growth at rate of GDP or less.



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## The Big Squeeze on Spending



Source: C. Eugene Steuerle, Adam Carasso, and Gillian Reynolds, The Urban Institute, 2006. Authors' calculations based on data from CBO Budget Outlook (August 2006) and OASDI and HI-SM Trustees Reports (2006).



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## Property Taxes

- Many calls for property tax relief
- Proposals to Eliminate (GA, IN, FL)
- Property Tax Caps
- Increased Homestead Exemptions
- Smart alternatives
  - Circuit breakers
  - Tax Deferments



## WHY THE PROPERTY TAX IS UNPOPULAR WITH VOTERS

- Judgmental Assessment
- Unrealized Gains
- Visibility
- Increasing Burden



**Table 1. Selected Indicators of Property Tax Revenue Performance**

Decade Averages	Real Per Capita Dollars		Percent of GDP	
	Property Tax	SLG Taxes	Property Tax	SLG Taxes
1930-39	341.40	539.69	5.61	8.79
1940-49	275.33	567.20	2.59	5.31
1950-59	334.34	772.09	2.57	5.94
1960-69	520.12	1,222.69	3.23	7.56
1970-79	654.03	1,832.12	3.21	8.94
1980-89	647.89	2,148.94	2.59	8.59
1990-99	837.63	2,751.34	2.77	9.07
2000s	983.71	3,260.46	2.74	9.10

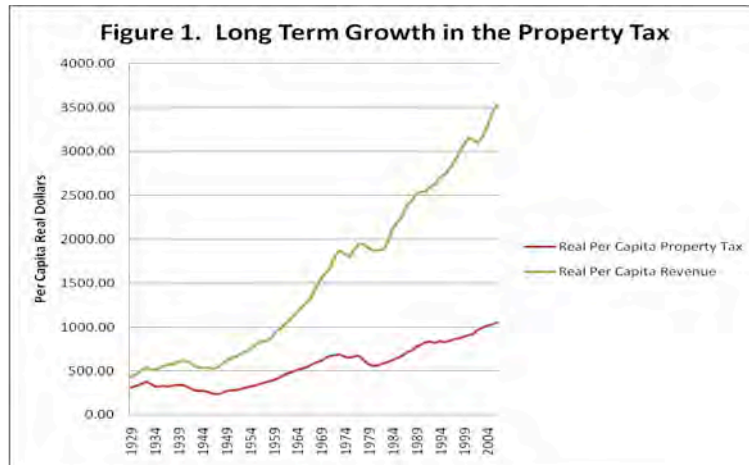
Source: *Survey of Current Business*



## WHY THE PROPERTY TAX IS A POLITICAL TARGET

- Unpopular with Voters
- Somebody Else's Tax
- Delinked from Services?
- Hidden Consequences
- Immediate Tax Relief
- The Accountability Puzzle





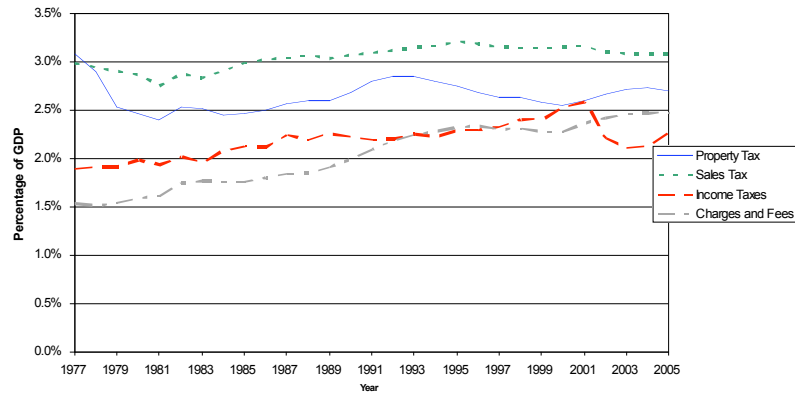
## The “Invisible” Consequences

- Home Rule
- Regressive
- Hard to take it back
- Financing Local Services



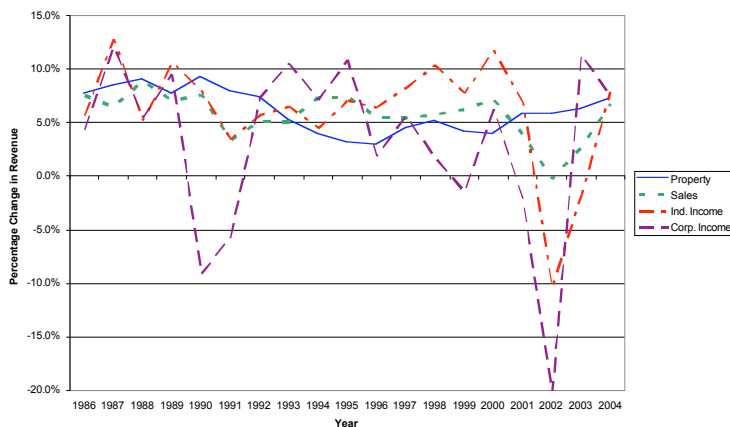
## State and Local Tax Sources

State and Local Tax Revenue as a Percentage of GDP



## Income Tax Shows Most Volatility

Figure 3  
Annual Percentage Change in Revenue from Major State and Local Taxes



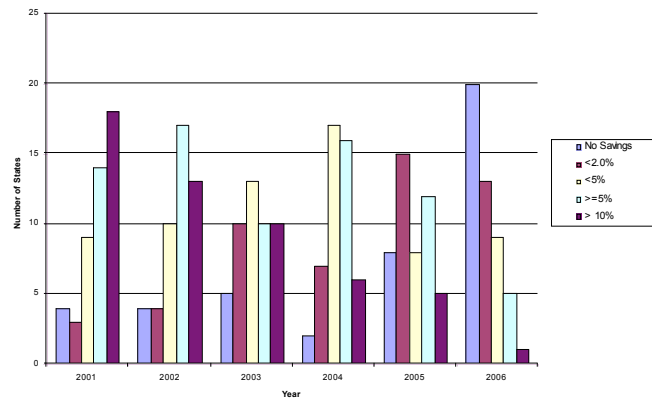
Source: Dye and Reschovsky, 2007





## Last Recession Moderated Due to Rainy Day Funds, Shift in Local Aid

Figure 4. General Fund and Rainy Day Fund Savings as a Percent of Expenditures



Source: Maag and Merriman (2007)



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## Sales Taxes

- Erosion in revenues
  - Shift from goods to services
  - Shift to on-line sales
- Expansion of taxes to services
- Coordinated Programs
  - Streamline Sales Tax Consortium
    - Consistent definitions potential removal of nexus requirement
  - Federal add-on VAT



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## Solutions Going Forward

- Important to budget for downturns
- Long-term need for additional state revenues high
- Protect revenue sources
  - Resist cuts to property taxes
- Potential Role for Energy Taxes
  - Add-on to Federal Policy
- Federal VAT – Could help sales tax erosion

