The State Budget Crisis Task Force

FINDINGS FROM SIX STATES
IMPLICATIONS FOR THE DISTRICT OF COLUMBIA

Presentation to the DC Tax Revision Commission, January 7, 2013

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Overview

I. The Task Force

II. Major Threats to Fiscal Sustainability

III. DC: Good News and Challenges
The Task Force

Co-chairs Richard Ravitch & Paul Volcker

Focus on State & Local governments: $2.5 trillion; >19 million workers

- They provide the basic services citizens expect:
  - finance & build public infrastructure
  - educate children
  - maintain public safety
  - implement social safety net

- They face large problems which, with uncertain and constrained resources, are not going away as the economy improves.

Three goals:

- Analyze fiscal condition & structural budget gaps in six states (CA, IL, NJ, NY, TX, VA)
- Analyze fiscal decision-making environment
- Engage state and federal policymakers

- Initial report in July (www.statebudgetcrisis.org)
- Individual state reports rolled out through December
States Limping Up from the Bottom of the Cliff

Notes: Data have been seasonally adjusted by the Task Force and converted to annual rates.
Sources: U. S. Bureau of the Census and Bureau of Economic Analysis.
Tax Revenues Recovering More Slowly Than Economy

Economic drivers and state tax revenue since the start of recession, adjusted for inflation

Sources: Bureau of Economic Analysis (economy) and Census Bureau (tax revenue), Taxable components estimated by Task Force

www.statebudgetcrisis.org
Income & Sales Tax Recovery Extremely Slow
Property Tax – Some Weakening

Tax revenue since the start of the recession; four-quarter moving average, adjusted for inflation

Source: U.S. Bureau of the Census (tax revenue) and Bureau of Economic Analysis (GDP price Index)
Different Timing: Public & Private Jobs

Employment in selected industries in the current recession

2007 Recession: Substantial Loss of State & Local Government Jobs Compared to Prior Recessions

State and Local Government Employment in Selected Recessions

II. Task Force Findings

Major Threats to Fiscal Sustainability

1. Rapid Medicaid growth
2. Underfunded retirement promises
3. Volatile revenues, narrowing tax bases
4. Local government fiscal stress
5. Federal deficit reduction
6. Inadequate state budget laws & practices
The Threats to Fiscal Sustainability Create Risks to Essential State Functions:

- **Education:** crowding out by Medicaid & pensions
  - Since 2008, state funding for K-12 has declined as share of spending
  - Significant cuts to public higher education, partially replaced by tuition
  - Access, quality & student performance at risk

- **Infrastructure:** capital needs (repair/replace aging pipes, roads, structures) postponed due to immediate spending pressures.

- **Ability to borrow** for long-term capital needs & short-term cash flow threatened by improper borrowing for current operations.

In sum, building for the future is sacrificed for today.
Decade After Decade, Medicaid Grows Faster Than States’ Capacity to Pay for It
Total State Spending* on Medicaid Now Surpasses K-12 Education

Source: National Association of State Budget Officers (NASBO), State Expenditure Report

*Note: Figures are for total state expenditures, including both general fund spending and federal funds

www.statebudgetcrisis.org
Pensions & Retiree Health Benefits (OPEB) Are Large Unfunded State & Local Promises

- Pensions = $1-3 trillion underfunded
- Retiree health benefits >$1 trillion underfunded
- Opaque reporting
- Contributions underpaid by governors & legislatures
States’ Reliance on Income Tax is Growing

PIT revenue as a share of total state revenue in past 30 years

Capital Gains Are a Major Cause of Increased State Tax Volatility

Capital gains as percent of GDP

Sources: U.S. Department of the Treasury, Bureau of Economic Analysis
## Boyd’s Index of State Dependence on Capital Gains

<table>
<thead>
<tr>
<th>State</th>
<th>Capital gains as share of AGI, 2007</th>
<th>PIT as share of taxes, 2009</th>
<th>Rank, capital gains share &amp; top rate together</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>10.7%</td>
<td>44%</td>
<td>1</td>
</tr>
<tr>
<td>New York</td>
<td>13.5%</td>
<td>57%</td>
<td>2</td>
</tr>
<tr>
<td>Idaho</td>
<td>10.3%</td>
<td>37%</td>
<td>3</td>
</tr>
<tr>
<td>Oregon</td>
<td>8.9%</td>
<td>73%</td>
<td>4</td>
</tr>
<tr>
<td>New Jersey</td>
<td>7.9%</td>
<td>39%</td>
<td>5</td>
</tr>
<tr>
<td>Remainder of top 10: Maine, Connecticut, Massachusetts, Vermont, Nebraska</td>
<td></td>
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</tbody>
</table>

*Rhode Island had the lowest capital gains dependency among PIT states. Others in bottom 10: RI, WI, IN, NM, PA, ND, MI, MS, IL, WV*

State Sales Tax Bases Have Shrunk By More Than a Quarter (26.2%) Since 1970

- Services growing faster than goods.
- Few services are taxed.

How Are States Reacting to Disappearing Tax Base?

1. **Raise tax rates:** 1970-2000 average sales tax rate up from 3.5% to 5.5%

2. **Tackle internet purchases**
   - Congress restricts state tax reach to sellers with physical presence in the state.
   - Amazon Law: physical presence includes use of third parties to ‘establish and maintain a market’ in the state.

3. **Traditional base broadening**
   - Food & clothing
     - Prepared food to consume at home
     - Limited prices or children’s clothes/shoes only
   - Motor fuel
   - Selected services, but only marginally to professional services
Transportation Infrastructure Funding Emergency: Gas Taxes Don’t Do it Anymore

1960-2010: S+L gas tax share of GDP fell by 60%
- Most levied as $/gallon & rarely increased
- Gas mileage has improved

So, dedicated revenues for new transportation & repairs are disappearing.

Responses?
- Some states levy tax as percentage.
- Increased dependence on auto-related fees, but they are neither large nor buoyant revenues.
- States fill funding gap with general revenue.
- Could index to inflation...
Federal Deficit Reduction Threatens State Finances

- Federal grants >$600 billion = 32% state revenue
- Other federal spending affects state economies
- Loss of federal tax deductions for S&L taxes & municipal bond interest can reduce state revenues
- Impact on states should be major concern in federal decision-making: **But, will it be considered?**
How Did States Get Through the Great Recession?

- All states benefited from the federal stimulus
- Those that had adequate rainy day funds used them
- States relied on “dependable” one-shots (some worse than others) to get them over the budget finish line.
  - they did not pay their bills;
  - transferred money from dedicated uses;
  - cut & delayed payments to local governments & schools;
  - sped up tax receipts, delayed refunds & issued amnesties;
  - some reneged on funding pensions; some borrowed

Rank Order/Relative Magnitude of Nonrecurring Actions in SFY 2002-2012
(Lower number indicates higher use ($); x=none/negligible)

<table>
<thead>
<tr>
<th>Category</th>
<th>CA</th>
<th>IL</th>
<th>NJ</th>
<th>NY</th>
<th>TX</th>
<th>VA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Stimulus</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Rainy Day Funds</td>
<td>x</td>
<td>x</td>
<td>4</td>
<td>x</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Temporary taxes</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>1</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Bond Borrowing/Securitization/Refinancing</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>3</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Disguised Borrowing*</td>
<td>4</td>
<td>2</td>
<td>3</td>
<td>2</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Asset Sales</td>
<td>x</td>
<td>4</td>
<td>x</td>
<td>4</td>
<td>x</td>
<td>4</td>
</tr>
</tbody>
</table>

*Fund Raids, Sweeps, Delays and Deferrals of Payments and/or Benefits, Furloughs, etc.)
As a Result, an Illusion of Balance via Cash-Based Budgets & Gimmicks

<table>
<thead>
<tr>
<th>State</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>Years of borrowing for operations created $28B “wall of debt”</td>
</tr>
<tr>
<td>Illinois</td>
<td>$10B pension obligation bonds in 2003; Unpaid bills about $8B.</td>
</tr>
<tr>
<td>New Jersey</td>
<td>Securitized tobacco settlement revenue in 2003 and 2004</td>
</tr>
<tr>
<td>New York</td>
<td>Multiple temporary tax increases &gt; $2 billion</td>
</tr>
<tr>
<td>Texas</td>
<td>Moved $2 billion from one budget year to the next through delayed school aid</td>
</tr>
<tr>
<td>Virginia</td>
<td>Underpaid pension contributions; accelerated sales tax payments from one budget year to the next</td>
</tr>
</tbody>
</table>
TF Concluded: States Need Better Ways to Manage Fiscal Threats

- Better fiscal tools:
  - multi-year planning
  - disclose full costs of services delivered
  - more transparency

- Stronger rainy day funds

- Broad-based, stable, productive tax bases

- Federal entity to analyze impact of federal deficit reduction on states
III. The District— with State and Local Functions— Faces Same Threats to Fiscal Sustainability

- Spending pressures: Medicaid, health care costs (OPEB)
- Revenue volatility, tax base erosion
- Slow growth, structural unemployment, poverty
- Federal budget spending & tax reform
Uncertainty from Federal Actions

Federal Spending Matters to States:
- Procurement >$850 billion
- States have counted on its growth: >$120 billion in past 30 years.

DC Region at Center of Risk:
- VA, MD, & DC are 1st, 4th, and 5th ranked states to receive federal procurements in 2010
  - Metropolitan Washington’s share of total federal spending: 9%
  - Regional share of national population: 1.7%
- Slowing federal spending, $1.2 trillion sequestration, ongoing budget uncertainty may be DC’s Fiscal Cliff
The Good News: DC’s Fiscal Crisis Left a Positive Legacy

- Medicaid: Higher federal share.
- Prior long-term pension liabilities back in hands of the Feds. Ongoing pension liabilities funded.
- OPEB liabilities partially reserved, transparently displayed.
- The Control Act brought multi-year planning, accrual accounting for budgeting, full costs disclosed, greater transparency & stronger rainy day funds.
- Feds bearing some of the “state-type” cost of higher ed. for DC residents, who receive in-state tuition at public institutions around the country.

**But:**
- Economic Development aid fell short.
- Infrastructure Bank & needed funding never materialized.
Threats to Sustainability Challenge DC’s Ability to Meet Essential Functions:

- Half budget concentrated in:
  - K-12 (> 20%)
  - Police & Fire, where future contracts will increase costs
  - Medicaid
  - Debt service

- Pressure on borrowing: competition for revenues from debt service vs. operations

- Infrastructure needs
  - DC Water: rates growing at double digit rates to fund $2.6B mandate to eliminate sewer overflow through 2026
  - DC gov’t: debt service limit operates to restrict ability to borrow
  - Transportation: DC one of the most congested regions in U.S. – roads & rails
Challenges: Starved Transportation Infrastructure

Congestion:

- **Traffic:**
  - 38% increase in rush hour congestion by 2040
  - 96% of District roads in poor condition (US. Dept. Transportation, 2009)
  - Each year, costs average driver $1,495 in extra fuel and lost wages (per Washington Post)

- **Metro:**
  - By 2020, Red, Blue and Yellow lines will be "highly congested,": 100 -120 people per car;
  - Orange Line will be "unmanageable," with >120 riders per car (per Washington Post)

Underfunding:

- Revenue streams have not kept pace with the region’s needs
- Gas tax increasingly insufficient
- Federal capital contribution ($3B) to DC budget expires 2020, no legislation to extend & no commitment by states to match
- DC govt. contribution to WMATA = 4% DC operating budget
Challenges: Federal Tax Reform?

DC Treasury has both State-type & Local-type taxes

- Elimination of deductions nationally
  - Property taxes = $27 billion
  - Other state & local taxes = $54 billion
  - Interest on tax exempt debt = $43 billion

- Impact of losing Federal S & L tax deduction depends:
  - How extensively does DC rely on these taxes?
  - To what extent do DC taxpayers claim the deduction on federal taxes? [Note: this is complicated by AMT.]

- CBO indicates NY, NJ & California are most at risk.

- Whither DC?
  - Raises “tax cost” of services, putting pressure on spending & increasing incentives to relocate to lower taxed areas.
  - Feeds back in form of increased taxable income (and revenue) unless rates are adjusted.
  - Without a different form of federal subsidy for S&L debt, borrowing costs for capital projects will rise.
Conclusion: Where We Are

- The Task Force found major threats to fiscal sustainability, leading to risks to essential state functions.

- DC, thanks to the 1990’s fiscal crisis, avoids some:
  - Feds (Revitalization Act) picking up costs of some “state-type” functions
  - Federally mandated multi-year financial planning, multiple reserves, accrual budgeting, and high transparency

- DC faces similar major threats -- cost drivers & revenue challenges.

- DC also has unique issues -- revenue limitations, no sovereignty in facing MD & VA, inadequate representation in Congress (its constitutional parent) – to be acknowledged & addressed.

DC must seriously consider these fiscal challenges when planning for its future. Find solutions that will work both today and tomorrow.
Conclusion:

**Base Erosion: How important is this for DC?**
- How to pay for infrastructure with eroding motor fuel taxes?
- Is breadth of DC sales tax base (vs. personal income) worse or better than nationwide experience?
- Can a small center city tax high-value services & still compete for location?
- Does the Amazon Tax offer some hope on internet purchases?

**Volatility: Does DC have enough protection for its budget needs?**
- It has a real property tax, which is less volatile, if vulnerable to the perception of unfair assessments, which can limit revenues.
- It has a mandated system of reserves, with limited flexibility.
- There are limited user fees & charges.
Together, these need to counter-act the volatility & budget instability from:
- PIT/Capital gains
- Property transfer taxes

**Tax Revision Should Not Ignore the Need for Fiscal Stability**
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