

FISCAL FEDERALISM: CAN WASHINGTON HELP?

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“I’m from Washington ...”

- Dare one ask for help from Washington?
- My thesis adviser, Thomas Pogue, always reminded me that practitioners know their territory. What works in practice, and what works in theory?
- “I’m from academia ...”
- Asking an academic whether Washington can help puts us on treacherous ground!

Plan of Talk

- I. The Fiscal Architecture of State/Local Governments.
- II. The Big Picture: Structural Instability of Federal Finances.
- III. Rethinking (Some Aspects of) Fiscal Federalism.
- IV. State Government Finances and Washington: Policy Issues:
Bailouts, Risk Management, Revenue Autonomy.
- V. Conclusion

I. The Fiscal Architecture of State/Local Governments: A Quick Overview

- To establish perspective, let's review the main sources of state/local revenues.
- Why state *and* local?
 - ▣ Because states divide fiscal responsibilities with localities.
 - ▣ Because states regulate localities.
 - ▣ Because states provide much local financing.
- BTW, we might ask: can the states help the localities, or vice versa?

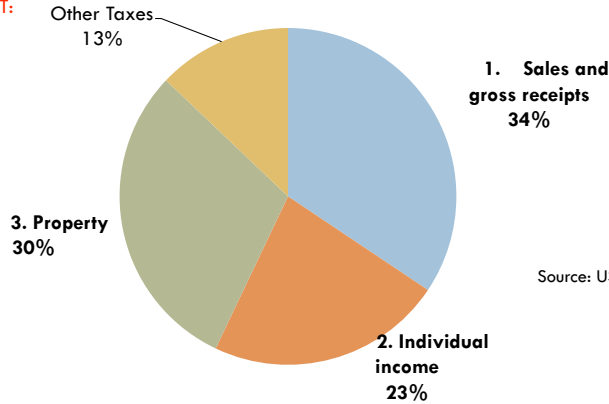
For whom the fiscal bell tolls:

“No government is an island..”

Taxes First

**State and Local Tax Revenues
2006-2007: The "Big Three"**

COMMENT:
"Other":
Relatively
Minor.
CIT < 5%.



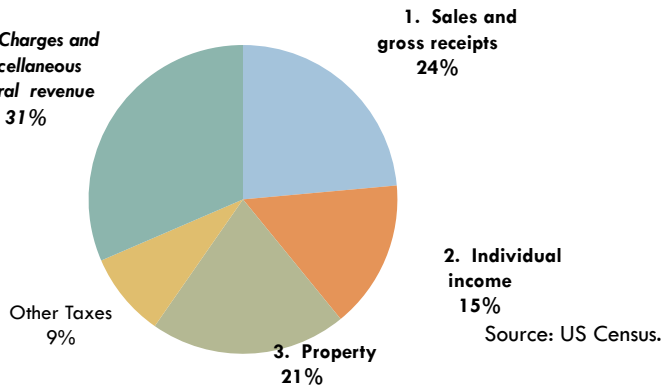
Source: US Census

Next: "Own Source" (Tax Plus Nontax) Revenues

**State/Local Own-Source Revenues, 2006-2007:
The "Big Four"**

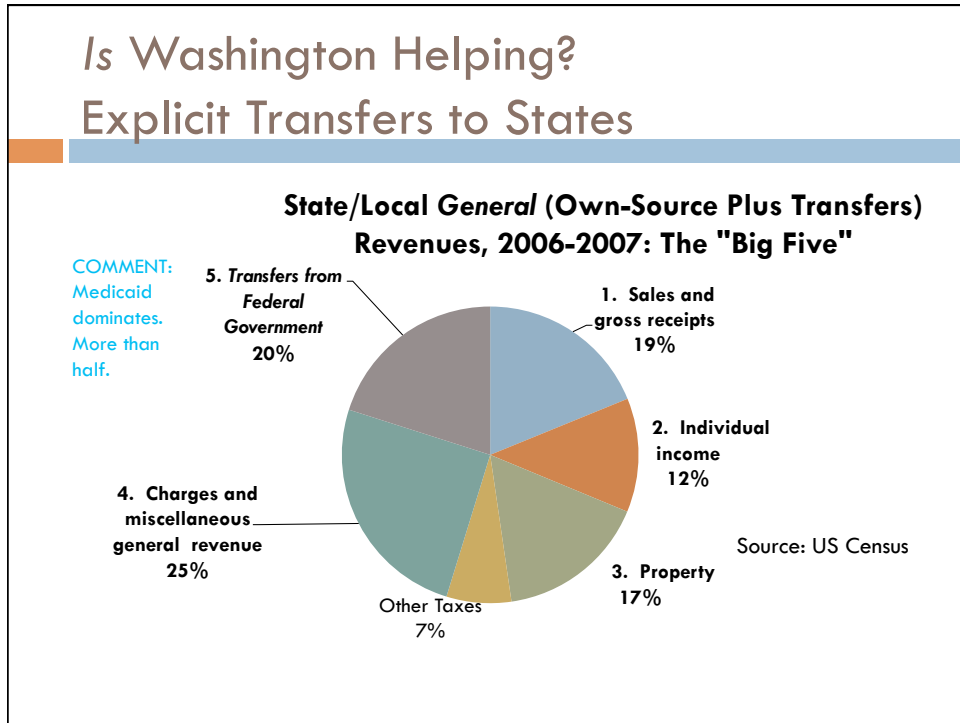
COMMENT:
Bigger than
Any of the
"Big Three".
Price-like
Revenue
Instruments:
Efficiency
Properties.

**4. Charges and
miscellaneous
general revenue**
31%

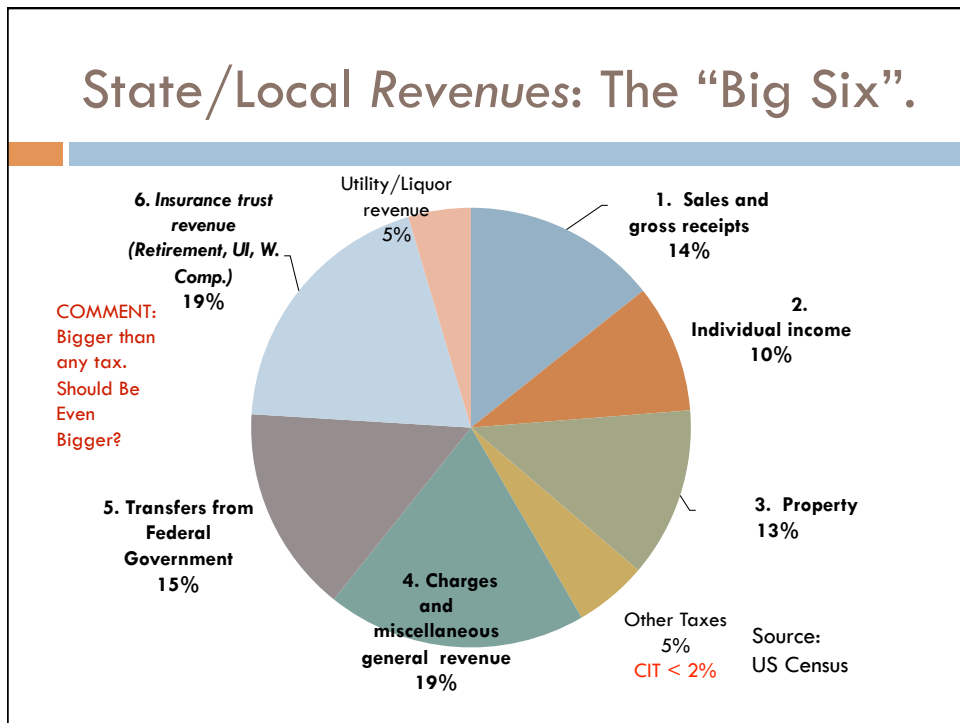


Source: US Census.

Is Washington Helping? Explicit Transfers to States



State/Local Revenues: The "Big Six".



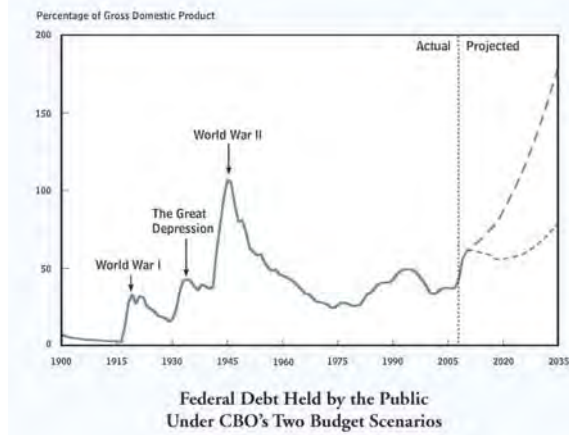
Conclusion: Washington Is Important ...

- But state/local governments have considerable revenue autonomy ...
 - subject to constitutional constraints;
 - subject to statutory constraints;
 - subject to administrative constraints;
 - and, of course, subject to accounting, market, and political constraints.

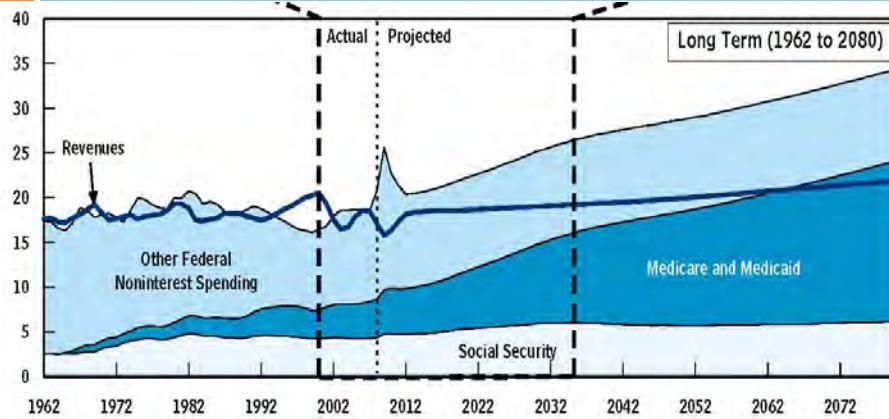
II. Structural Instability of Federal Finances

- The story is well-known: “Short-run” and “long-run” problems.
- Explicitly or implicitly treated in recent FTA presentations by L. Burman (2007), S. Pattison (2008), H. Duncan (2009), E. Steurle (2009).
- Where are we going, and what are all these handbaskets? One or two pictures tell the tale:

CBO Long Term Outlook: “Baseline” and “Alternative”



“The Culprits”: “Mandatory” Expenditure Growth without Higher Taxes



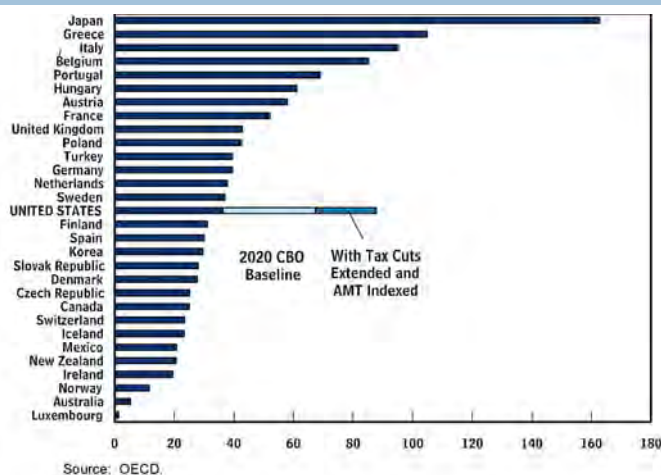
Source: Congressional Budget Office.

The US Is Not Alone

- Debt-GDP ratios generally have been rising.
- Aging populations throughout OECD. (History's long demographic shadows.)
- Strikingly low fertility rates, esp. Europe, E. Asia.
- Immigration: An important related issue (omitted here).
 - See D. Wildasin, "Public Finance in an Era of Global Demographic Change: Fertility Busts, Migration Booms, and Public Policy", 2008.

Debt/GDP ratio, OECD Countries

(My source: D. Elmendorf, CBO, May 2010 AAAS presentation slides.)



Predicting Population Aging: Not Rocket Science. (UN, 1999 report)

TABLE 10. MEDIAN AGE AND PERCENT AGED 60 OR OLDER
BY MAJOR AREA, 1950, 1999 AND 2050

Major area	Median age (years)			Per cent aged 60 or older		
	1950	1999	2050	1950	1999	2050
World total	23.5	26.4	37.8	8.1	9.9	22.1
More developed regions	28.6	37.2	45.6	11.7	19.3	32.5
Less developed regions	21.3	24.2	36.7	6.4	7.6	20.6
Africa	18.7	18.3	30.7	5.1	5.0	12.0
Asia	21.9	26.0	39.3	6.7	8.7	23.5
Europe	29.2	37.4	47.4	12.1	20.1	34.7
Latin America and the Caribbean	20.1	24.2	37.8	5.9	7.8	22.3
Northern America	29.8	35.6	42.1	12.4	16.4	28.0
Oceania	27.9	30.9	39.3	11.2	13.4	24.2

Source: United Nations Population Division.

Change Is Coming

No legislature can overpower the laws of arithmetic!

Spending will fall, taxes will rise, debt will rise, or (likely) some combination of these.

Plausible candidates (among many):

Introduce a VAT (C. McLure, FTA 2009).

Raise retirement ages.

Cut social security, health expenditures.

Increase borrowing, perhaps monetize the debt (until markets react).

Ways Washington Can Help

- Structural reforms at *Federal* level can:
 - help to avoid financial crises;
 - ease pressure to monetize debt, avoid currency crises;
 - reduce overall uncertainty, facilitate rational private-sector savings and investment decisions;
 - promote economic growth (invest rather than consume, less transfers to old, preserve savings/investment incentives, ...)

Will Washington Help?

- Don't expect miracles.
 - Structural reform will be the work of many years.
- Reform: The sooner the better...
 - ... but don't hold your breath: the fundamental problems have been well recognized for many, many years; we keep digging a bigger hole.
- Regulation from Washington: Help or Hindrance?

III. Elements of Fiscal Federalism

- Funding:
 - “Tax assignment” problem.
- Spending:
 - “Expenditure” (functional) assignment problem.
- Intergovernmental transfers.
 - Why, how, how much should upper-level governments contribute to lower-level governments?
- Intergovernmental regulation.
 - Why, how, how much should upper-level governments control lower-level governments?

Mandates and Transfers: Harmful or Helpful?

- Lower-level governments seem to desire transfers. (S/F, L/S)
- Higher-level governments invariably impose regulations. (F/S, S/L)
- Is the only good regulation no regulation?
- Are the only good transfers no transfers?

An Illustration: Kentucky

- State supports localities with transfers.
- State statute limits local property taxes (HB44).
- Constitution/statutes allow a range of other taxes:
 - local payroll taxes;
 - local business net profits taxes;
 - local insurance premium taxes;
 - but no local sales taxes. (Formerly had a local utilities GRT; all localities choose 3% rate [a cap]; now state collects it.)
 - The Bluegrass and the Golden state: Kentucky and California both very dependent on income taxes (19-21%), less so on property (18% of local revenues vs. 32% all-US).

D. Wildasin, "Intergovernmental Transfers to Local Governments", forthcoming.

Local Insurance Premium Taxes

- Local IPTs are a significant (5-10%) local revenue source.
 - Administratively complex: 400 local governments impose much, some, little, or no tax on all, some, few, or no types of insurance at rates that may be substantial, modest, or zero.
- **Policy issues:** Should local IPTs be prohibited? Levied statewide at uniform rate? Transfer revenues to localities?
- **Policy evaluation:** Efficient or distortionary? Equitable or inequitable?

D. Wildasin, "Kentucky Local Government Insurance Premium Taxation: Opportunities for Reform", 2008.

Nexus and Apportionment: Kentucky's Local Profits Taxes

- Local governments can tax wage income and/or business net profits.
 - Many (but not all) do.
 - Rates vary, within statutory limits.
 - Administrative issues include apportionment (sales/payroll), nexus.
- **Policy issues:** Should local profits taxes be prohibited? Folded into state CIT? Transfer revenues to localities?
- **Policy evaluation:** Efficient or distortionary? Equitable or inequitable?

Local Autonomy: When, How Much?

- These local taxes raise substantial administrative challenges:
 - for local revenue authorities;
 - for taxpayers.
- Policy benefits, policy drawbacks:
 - Policies can adapt to local needs: +.
 - Revenue diversification, flexibility: +.
 - Administrative/compliance costs: -.
 - Lack of transparency for taxpayers *and* for voters: -.

Possible State “Help” for Kentucky Localities

- Should the state
 - ▣ (a) impose uniformity requirements;
 - ▣ (b) prohibit these taxes altogether, and increase transfers; or
 - ▣ (c) does Kentucky have it about right?
- What about property tax deregulation?

IV. State Government Finances and Washington: Policy Issues

- A. Bailouts: The Wave of the Future?
- B. Risk Management: Funding mandates?
RDFs, Pensions, MDRs.
- C. Revenue autonomy: A Federal Role in State
Tax Coordination?
Sales, CIT, PIT.

D. Wildasin, “Pre-Emption: Federal Statutory Intervention in State Taxation”, 2007.

A. Bailouts: Hard and Soft Budget Constraints

- How can the Federal government *not* help in times of crisis?
- How can states not come to depend on this help? (Bailouts? SBCs?)
- SBCs may produce poor policies:
 - ▣ inviting regulation, or
 - ▣ upward reassignment of government functions.
- In either case, state/local autonomy is sacrificed and federalism may be undermined.

D. Wildasin, "The Institutions of Federalism: Toward an Analytical Framework", 2004.

To be clear ...

- Not all intergovernmental transfers, explicit or implicit, should be viewed as "bailouts".
 - ▣ Medicaid? (No.)
 - ▣ State/local tax deductibility? (No.)
 - ▣ Interest exemption for munis? (No.)
 - ▣ Disaster assistance? (Yes/no.)
 - ▣ ARRA? (Yes/no.)

B. Prudent Risk Management for States/Localities

- Revenue diversification: Mandatory?
 - Get rid of CIT? More property/sales taxation? Less reliance on non-wage income?
- Retirement funding: Mandatory?
 - Move to DB systems?
- Rainy Day funds: Mandatory?
 - When to rebuild? When to draw down?
- Disaster reserves: Mandatory?
 - Do states prepare adequately for hurricanes, earthquakes, droughts, ...?

D. Wildasin, "State and Local Government Finance in the Current Crisis: Time for Emergency Federal Relief?", 2009.
D. Wildasin, "Disaster Policy in the US Federation: Intergovernmental Incentives and Institutional Reform.", 2007.

C.1. Revenue Autonomy: Sales Taxes

- Possible Federal Roles:

States might welcome some statutory oversight, but perhaps not all:

 - Override *Quill*, facilitate taxation of remote sales.
 - Streamlined sales/use tax project will have been a potentially valuable investment in base definition;
 - might consider extension of taxing powers for compliant states.
 - Mandate taxation of services?
 - Broader, more efficient, more equitable (?) base.
 - Prohibit taxation of business (GRT)?
 - Narrower, more efficient, more equitable (?) base.

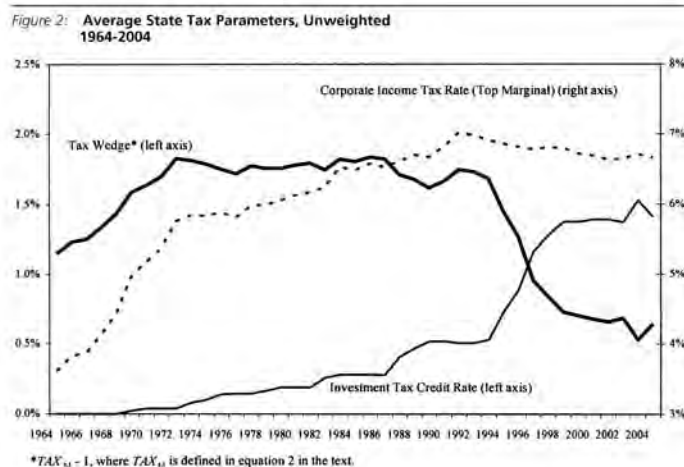
C.2. Revenue Autonomy: Corporation Income Tax

□ Policy Perspective

- Few economists can find a policy (efficiency, equity) justification for a *state* CIT (Pogue, McLure, Fox *et al.*, others), even if administered effortlessly at zero compliance cost.
 - Incidence: Unknown mix of owners, consumers, workers.
 - Allocative: Highly indirect tax, at uneven rates, on investment, consumption, employment.
- Economic impact of tax has evolved over time due to changing apportionment formulae, erosion of base through credits, expanding nexus criteria.

CIT: Effective vs. Statutory

(Source: Chirinko-Wilson, NTA Proceedings, 2007)



Apportionment Rules in Flux

- “Classic” 3-factor formula seems to be going the way of classics ...
- 1979: Sales factor overweighted in only 5 states.
- 1995: 20+ states
- Present: 9 states use 1/3 weight, 22 50% weight, 5 100% and more coming.
- Sales factor is especially relevant for out-of-state firms (especially because of PL86-272).

Why?

- Why do states choose to give tax credits (*a la* Cuno/DaimlerChrysler) for in-state investments while maintaining statutory rates ...
... while extending reach of CIT to out-of-state firms with no tangible in-state presence?
- Perhaps to capture rents accruing to nonresident owners of firms (“tax exporting”)
... while avoiding adverse effects on in-state employment and investment?

D. Wildasin, “State Corporation Income Taxation: An Economic Perspective on Nexus”.

C. Wrap-up: Sales Tax vs. CIT Nexus

- Should Federal government regulate state taxes? (recall Kentucky examples).
- To the extent that sales tax approximates a consumption tax, desirable to broaden base to reach both out-of-state and in-state vendors.
- Sales-factor-based CIT, combined with broad nexus standard, provides opportunity for tax exporting, while distorting trade.

On Policy Grounds ...

- We might have very different answers for these two very different state taxes. Policy considerations may favor broader or narrower nexus standards.
 - Sales tax is and has been a mainstay of state government fiscal systems for decades.
 - It lies within striking distance of a consumption tax, which has reasonable efficiency and equity impacts;
 - it is (in its consumption aspects) fairly visible to citizens;
 - and is reasonable from administrative/compliance perspective (modulo out-of-state and gross receipts vs. consumption considerations).
 - It is hard to say the same of state CITs.

V. Conclusion: Can (and Will) Washington Help?

- Structural reforms of Federal fiscal system (tax, spending, debt policies) should be anticipated.
- US federation has been resilient, with important roles for all levels of government.
- Washington can be part of the “solution”
 - (a) by not being part of the “problem”;
 - (b) by encouraging and facilitating sound state/local policies:
 - (i) maybe some unfunded mandates (or “funding mandates”);
 - (ii) maybe some limits on state tax policies;
 - (iii) but always preserving and enhancing substantial state revenue (and expenditure, and regulatory) autonomy.

Thank You!

Some References: Recent Writings on Related Topics

- “The Institutions of Federalism: Toward an Analytical Framework,” *National Tax Journal* 62 (2), Part 1, June 2004, 247–272.
- “Pre-Emption: Federal Statutory Intervention in State Taxation,” *National Tax Journal* 60 (September, 2007), 649-662.
- “Disaster Policy in the US Federation: Intergovernmental Incentives and Institutional Reform,” National Tax Association, *Proceedings of the 99th Annual Conference* (2007), 171–178.
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- “Public Pensions and Demographic Change in Developed Countries: Fertility Bust and Migration Boom?”, in J. Bhagwati and G. Hanson (eds.), *Skilled Immigration Today: Problems, Prospects, Policies* (Oxford: Oxford University Press, 2009), 81-129.
- “State and Local Government Finance in the Current Crisis: Time for Emergency Federal Relief?”, *Municipal Finance Journal* 29 (4), Winter, 2009, 49-64.
- “State Corporation Income Taxation: An Economic Perspective on Nexus”, unpublished.