Designing Revenue Policy for Wisconsin's Future

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The recent recession has left in its wake high unemployment rates and tax revenues that are slow to rebound. The biggest challenge facing state policymakers is designing revenue systems that will work beyond the current budget cycle. Revenues should match the spending that is required to maintain the level of services that a state chooses to deliver without frequent rate adjustments. States have four basic strategies for balancing state budgets: expenditure cuts, federal stimulus money, reliance on reserves, and policy-based revenue enhancements. This chapter outlines which policy options states are implementing to develop more sustainable revenue streams and what economists say about their effectiveness. The chapter concludes with specific budget lessons of this recession.

Economists often evaluate tax systems according to their fairness, economic effects, revenues, administrative costs, and political and legal constraints. Each characteristic is important. However, the biggest challenge facing state policymakers is designing revenue systems that will work beyond the current budget cycle. States may differ in their decision on the appropriate size of government. Tax policy should be designed to generate sufficient revenue to finance the preferred size of government without the need for frequent rate adjustments.

This chapter begins by describing the unique situation of state governments, including what constitutes sufficient revenue and appropriate spending growth. I then describe the effect of the recent recession on states and the strategies states are currently using to address budget shortfalls. I conclude with budget lessons that state policymakers have learned through our recent recession experience.

Sufficient Revenue and Government Spending

One goal of state tax policy should be generating *sufficient revenue*—revenue that is sufficient in the current year and also in the years to come. The services that government funds typically do not begin and end with a state's fiscal calendar. So, fiscal crises are typically not the outcome of a single year of difficulties; they are more often the result of an accumulation of problems over a number of years. Thus, sufficient revenue exists when revenue growth matches the growth in spending that is required to maintain the level of services a state chooses to deliver.

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No simple answer exists as to the question of how fast government spending should be expected to rise. An easy answer is that revenues should rise at approximately the same rate as the economy. This means that state government would stay a constant share of the economy unless an explicit decision is made to decrease or increase the size of government. One state, Colorado, through the Taxpayer Bill of Rights (TABOR), has chosen to limit spending from revenue growth to no faster than the combination of inflation plus population change. Choosing an appropriate inflation rate for state government is problematic; for example, state budgets are disproportionately affected by rising health care costs given their expenditures for Medicaid, employee fringe benefits, and so forth.

In the long run, a simple formula like that of TABOR will result in a decrease in a state's ability to deliver services. Consider the case in which K-12 education rises as the sum of these two factors (inflation plus population change). Teachers would be able to receive a raise equal to the rate of inflation, and schools would be able to continue buying the same items each year. However, teachers would receive raises that are lower than the average in the private sector, because private sector raises are approximately equal to inflation plus productivity gains. Over time, as relative wages fall, the quality of people who choose careers in education and who stay in education will decline; ultimately, the quality of education will drop. Thus, to keep the quality of education constant, education expenditures must rise faster than inflation plus population change.

Similar arguments can be made for many other public services. Government spending should rise at a rate that is unique from the private sector, taking into account the specific services that states fund.

The Recession's Effect on State Revenue

In the search for good tax policy, every state must begin with the realities of the recent recession. State economies were not impacted evenly by the recession, but every state felt its effects. The private sector in every state experienced employment losses, and the overall economy has fallen in nearly every state during the past year. Overall, the U.S. economy lost 8.4 million jobs during the recession, including declines in nearly every industry except health care. The private sector experienced almost all of the job losses. Job losses have stopped, but it will take several years to replace all of the lost jobs; moreover, some industries, such as housing construction, will not return to their former peaks. The economy has added back about 0.9 million jobs during the past 10 months.

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Experience of the past two recessions suggests that state tax revenue is becoming increasingly variable. Tax revenue in the states fell by 8.2% on average during the 2009 fiscal year; personal income taxes declined by 13.6%, the greatest loss among the major taxes. Corporate income declined by 10.9%, and sales tax revenue declined by 4.8%.

Tax revenues will likely bounce back more slowly than the economy; in fact, tax revenues in many states will have started growing again by the 2011 fiscal year, but revenues will not reach the peaks attained in the 2008 fiscal year until 2012 or 2013. It will be even longer before tax revenues return to their earlier share of the economy.

Strategies for Financing Revenue Shortfalls

In the midst of these shortfalls, states are using some combination of four strategies for balancing their budgets: expenditure cuts, federal stimulus money, reserves, and policy-based revenue enhancements.

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1) **Expenditure cuts.** In general, expenditure cuts are being used by states at levels not seen in recent history. Actual cuts occurred in 2009 and are expected again in 2010 for the first time since 1983, when very small cuts were enacted. For example, in 2009, 30 states reported making targeted expenditure cuts, 20 reduced aid to local governments, 17 laid off employees, and 15 instituted furloughs.[1] Many states will need to make additional cuts in the 2011 fiscal year.

2) **Federal stimulus money.** During 2009 and 2010, an estimated $560 billion will be spent (including tax cuts) as part of the federal American Recovery and Reinvestment Act. More than one-fourth of the funds are transfers to states; moreover, an additional one-seventh is infrastructure spending, some of which will also go to states. States have varying degrees of flexibility in spending the money, but it has clearly lessened the effects of declining revenues on state budgets. Still, the stimulus money was not sufficient to prevent the need for spending cuts. Most of the transfers to states will be spent by the end of the 2011 fiscal year. As a result, most states will have fewer resources in the 2012 fiscal year, forcing additional spending reductions.

3) **Reserves.** Most states had rainy day funds and other reserves as the recession began. Use of reserves to lessen the impact of falling revenues can be good policy if implemented appropriately. However, reserves should be thought of as one-time funds, whereas the fiscal problems associated with the recession will last at least five years. States would have needed reserves of more than 30% of their revenues to maintain expenditure patterns in the face of such significant revenue losses. So reserves cannot be seen as the only solution; they can only be used to prevent the most extreme cuts or to allow the state's books to be balanced.

4) **Policy-based revenue enhancements.** In 2010, tax rate hikes and other policy-related revenue enhancements are expected to cause the largest policy increase in revenues in recent history.[2] For example, at least 10 states raised their sales tax rates and 10 states boosted their income tax rates in 2009 and 2010. In fact, until these recent rate increases, there had been a strong decreasing trend in income tax rates since the mid-1980s (and 5 still cut their income tax rates in 2009 and 2010). In contrast, sales tax rates have been rising continuously for decades, to offset the effects of a shrinking tax base. The median state rate was 3.25% in 1970 and has now reached 6%. The tax that grows faster relative to the economy is the individual income tax, which can offset slower growth of other revenue sources.[3] Income tax grows along with the economy in the long term, although it has been more variable in the short term. Few additional rate increases can be expected during the next year given the current political environment, which will place more pressure on expenditure cuts.

Policy Options to Build More Sustainable Revenue Systems

If you ask economists for advice on good revenue policy, here is the consensus: Select the appropriate revenue sources, structure them correctly, and put the necessary weight on each source. Below we consider which steps states have taken to develop more sustainable revenue streams and what economists say about their effectiveness.

Economists believe that sales by nonprofits should generally be taxable.

Arizona, Arkansas, Iowa, Missouri, Nevada, New Mexico, New York, North Dakota, South Carolina, and Vermont allow relatively broad tax exemptions for sales by not-for-profit entities, and many more allow exemptions for purchases by not-for-profit entities. Economists believe that sales by nonprofits should generally be taxable. Most states do not explicitly require that nonprofits be in the public interest, yet they still permit the exemption. The exemption is sometimes seen as a subsidy to the nonprofit but, if so, the subsidy is poorly targeted and likely more expensive than a direct subsidy. If nonprofits are treated like businesses, their purchases often should be exempt since they represent inputs for production.

Washington, Florida, and Tennessee raise over 60% of revenues from the sales tax. **South Dakota, Texas, and Arizona** raise over 50% of their revenues from the sales tax. Since 2009, at least 10 states have increased sales tax rates.[4] Overall, 45 states levy a general sales tax with the average state raising 31.9% of its tax revenue in this way. In Wisconsin, 28.2% of revenues derive from the sales tax.[5]

Economists offer two pieces of policy advice if sales tax is to be good for economic growth and economic efficiency. First, sales taxes should be levied at low, flat rates on the broadest possible base of consumption. That is, instead of increasing tax rates, it is better to expand the base. In studies, a broad base did not reduce the size of the state's economy. Also, a broad base does not steer consumer behavior because it provides a small set of choices between exempt and taxable items.[6] Taxing all consumption goods generally eases compliance and administrative burdens. However, in most states, the base is too narrow. Exemptions exist for many services and an increasing number of consumer goods (e.g., food for consumption at home, some clothing, etc.).

Second, intermediate transactions, or business input purchases for the purpose of creating "product," should be exempt from sales taxation. The first piece of policy advice, that taxes apply broadly to sales, does not apply to business-to-business transactions. This is the case because businesses produce; they do not consume. Essentially all states already exempt goods that become component parts of manufactured goods, and exempt goods purchased for resale, along with a number of other specified purchases. Extending exemptions to all business purchases, however, would likely lead to widespread evasion.

Additionally, policymakers must be aware of how hard it is to comply with a piecemeal approach to sales taxation. When there are multiple exemptions, bases, and tax rates, it is difficult for businesses to comply and also for government to administer.

Unfortunately, economists are hard pressed to find states that follow these combined rules. A few states, such as Hawaii and New Mexico, tax consumer purchases broadly, but those states continue to tax many business-to-business transactions.

Texas expanded its taxation of services in the 1990s. **Hawaii and New Mexico** tax medical services. The economy is rapidly shifting from a goods to a service society. However, services are much less likely to be taxed than goods. Health care, construction services, and some other professional services offer the greatest potential for additional revenue. Services that most economists think should not be taxed include intermediate inputs (e.g., legal and accounting services) that are largely purchased by businesses. The number of services that each state taxes can be found at http://www.taxadmin.org/fta/pub/services/btn/0708.html#table.[7] Administrative and compliance costs will likely rise as more services are taxed.

Hawaii taxes service on a destination basis. Research on cross border shopping indicates that states can expect some buyers to take advantage of state tax differences, at least along the border; however, these effects are likely to be small. Administering sales taxes on a destination basis is a better solution. Destination taxation, or collection of sales tax at the "destination" of the sale rather than the "origin," eliminates the potential for revenue competition between governments.[8] Consumers can only avoid tax by not purchasing taxable items, not by purchasing out-of-state. However, destination taxation can increase compliance and administrative costs.

Most states have taken some action to broaden, rather than narrow, the sales tax base. **Nebraska**, for example, added 27 services in 2002. Still, the tax base of all states has narrowed over the past decade.

Essentially every state except Hawaii started with narrow sales tax bases and have further disregarded good tax advice—they have narrowed the tax base even more. For example, all states with a sales tax (except Illinois) have exempted prescription drugs. Moreover, there are now 12 states that exempt at least some nonprescription drugs and one imposes a lower rate on nonprescription drugs.[9] Several states have enacted tax holidays on such items as clothing, computers, and school supplies.

Most states have disregarded good tax advice by starting with a narrow tax base and narrowing it even further.

Wisconsin provides another example of narrowing the tax base. Prior to 2008, Wisconsin limited the amount of Social Security benefits that were taxable to 50%; after 2008, a new law stipulated that 85% of Social Security benefits are exempt. The financial impact of this decision was an estimated $148 million decrease in state revenue.[10]

Where feasible, states could broaden their sales tax base by including some previously exempt items. Food, clothing, and motor fuels are obvious examples. Food is usually exempted from sales tax because it is considered to be regressive, that is, harmful to those with fewer resources. Many states have countered regressivity through policy levers such as providing tax relief to low-income

States can counter regressive taxes by providing tax relief to low-income families (e.g., Earned Income Tax Credits; raising of the minimum tax threshold; and child care, energy, and homestead tax credits).

families. For example, a number of states across the country have enacted policies to increase the Earned Income Tax Credit, raise the minimum tax threshold, and enact or enhance child care, homestead, and energy tax credits. According to economists, policies such as these to protect vulnerable families would be more efficient than broad exemptions that are poorly targeted.[11]

Table 1 lists the current sales and use tax exemptions in Wisconsin that have fiscal effects of $90 million or greater:

Table 1. Sales and Use Tax Exemptions in Wisconsin Greater than $90 Million

Sales and Use Tax Exemptions	Amount
Fuel and Electricity Used in Manufacturing	$90,500,000
Trade-Ins and Lemon Law Refunds	$113,000,000
Fuel and Electricity for Residential Use	$154,500,000
Religious, Charitable, Scientific, and Educational Organizations	$156,000,000
Prescription Drugs and Medicines (Excluding Insulin)	$157,200,000
Personal Property and Supplies Used in Farming	$158,000,000
Machinery and Equipment Used in Manufacturing	$173,000,000
Sales to State and Local Governments and Schools	$340,000,000
Motor Fuels	$577,000,000
Food, Food Products, and Beverages (sold primarily to households)	$598,000,000
Labor Input into Construction	$695,000,000

Delaware, Michigan, Ohio, Texas, and Washington use various types of gross receipts taxes. States have implemented gross receipts taxes for several reasons. For example, the rates are very low compared with those levied on corporate profits. Texas levied a .5% rate and Ohio imposed a .26% rate. They are also more difficult to avoid. Firms are unlikely to choose not to sell in a state merely to avoid a tax rate this low. To the contrary, however, firms do alter their measured profits by changing their corporate structure, moving production to low-tax states, and so forth.[12]

Kentucky, Pennsylvania, and other states are looking for ways to expand gambling. Gambling has remained a near constant source of total state tax revenues for some years—between 2.1% and 2.5%. Evidence suggests that lotteries result in higher levels of public expenditures than other voluntary revenue mechanisms.[13]

Several states and the District of Columbia have significantly increased alcohol and cigarette tax rates since 2000. Cigarette tax rates have increased at least 100 times since 2000. Alcohol tax rates have also risen, but to a much lesser extent than tobacco products; alcohol taxes raise only 26% of the combined revenues of alcohol and tobacco. Cigarette tax rates vary considerably across state lines. As a result, between 13% and 25% of consumers purchase cigarettes in lower-tax states or Native American reservations.[14] So higher-tax rates in a home state may not decrease consumption and may have little effect on tax revenue. The growth of these taxes is expected to be slow because each depends on the quantity consumed.

States could tax remote transactions. Expanded taxation of remote transactions is a key to enhanced sales tax efficiency. The shrinking tax base and incentives to buy out-of-state cannot be eliminated until the tax is enforced on a destination basis; this can only happen with vendor collection of the tax. Creating a collection responsibility for all vendors will rely on federal congressional or judicial action as well as interstate and likely international cooperation.

Budget Lessons Learned

As state policymakers design revenue policies and create effective fiscal strategies for the future, they will be served well to remember the specific budget lessons of this recession:

Policymakers should design tax structures to provide sufficient revenue beyond the current budget.

- Much larger revenue declines are possible than previously expected. Fiscal policy can be designed to lessen, but not eliminate, this possibility.
- Tax structures should be designed to provide sufficient revenue across the business cycle, not just on a biennium-to-biennium basis. This requires states to build reserves during the expansion years, not just reduce tax rates and narrow tax bases.
- States can avoid building new programs and growing expenditures rapidly during expansion years. Instead, they could design a size of government that is consistent with the demands for public services and the revenues that will be available over the long term.
- It is particularly important to ensure that all costs—including pension funds, debt service, and others—are properly funded during expansion years.
- Despite the political difficulty, states should build reserves that are much greater than 10% of revenue. Plans can be made in advance to ensure efficient and appropriate expenditures from the reserves.

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Endnotes

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Glossary

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Destination Tax (or Destination-Based Sales Tax)

Retailers collect sales tax based on the destination of a shipment or delivery, rather than its origin.[1] Consumers can only avoid the tax by not purchasing taxable items, not by purchasing out-of-state.

Gross Receipts Taxation
Taxing of businesses based on the total amount of money or other benefit received from all sales activities.[2]

Intermediate Goods/Inputs/Transactions
These terms all refer to transactions in which businesses purchase goods or services for use in production. Because businesses primarily produce, rather than consume, most economists believe these purchases should not be taxed.[3]

Regressive Tax or Regressivity
"A tax that takes a larger percentage of income from low-income groups than from high-income groups."[4] The opposite of a regressive tax is a progressive tax where the effective tax rate increases as income increases. A proportional tax has an effective tax rate that is fixed so that it takes the same percentage of income from everyone regardless of how much they earn.

Sufficient Revenue
Revenue that is sufficient in the current year and also in the years to come.

Use Tax
An excise tax that may be levied on purchases made from out-of-state or Internet sellers. Use tax is similar to the sales tax paid on purchases made within a state.[5] Goods may be subject to sales or use tax, but not both. "Thus, use tax compensates when sales tax has not been paid."[6]

Glossary Endnotes

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