CENTER ON BUDGET AND POLICY PRIORITIES

NEWS RELEASE

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May 17, 2005 202-408-1080

MANY STATES FACE STRUCTURAL BUDGET PROBLEMS, NEW REPORT FINDS
Policies Outlined to Prevent Chronic Budget Gaps

Many states risk chronic gaps between revenues and necessary expenditures in coming years because of structural weaknesses in their tax systems, a new Center report finds. These weaknesses are largely independent of the cyclical budget problems caused by economic downturns. Thus, even though states are now enjoying expanded revenues due to the economic recovery, they could face serious budget problems in coming years if their structural issues are not addressed.

"After we came out of the 1990s recession, states generally lost interest in fixing their structural problems because the bubble revenues of the late 1990s masked the problems — but the problems now have reemerged," said Liz McNichol, senior fellow at the Center and author of the report. "With the fiscal crisis easing in most states, states can take the initiative to modernize and strengthen their revenue systems."

The new report, *Faulty Foundations: State Structural Budget Problems and How to Fix Them,* is the first to provide state-by-state measures of the policies that put a state at risk of a structural deficit. It includes fact sheets with the findings for each state.

The report finds that the states most at risk of structural deficits are **Alaska, Arkansas, Colorado, Florida, Nevada, New Mexico, Pennsylvania, South Carolina, Tennessee, Texas and Wyoming.** These states scored nine or higher on the structural deficit risk scale developed in the report. More than half of the states scored seven or higher, and *no* state had fewer than three risk factors.

Obsolete Revenue Systems in Many States

A prime cause of structural deficits is that most states have failed to respond to the economy's shift from goods to services, which make up a growing share of all economic activity. That shift has cut into state sales tax revenues, since most states do not tax services. The rapid growth in Internet purchases is also hurting sales tax revenues, since states generally cannot collect taxes on these purchases.

State income taxes have weakened in recent decades as well. Corporate income tax revenues have shrunk by nearly half as a share of total state revenues over the past two decades, as a result of obsolete state corporate tax policies and corporations' increasingly aggressive tax-avoidance schemes.

Many states' personal income tax systems have become "flatter" as a growing share of taxpayers have moved into the top tax bracket (usually because the state failed to update its brackets to reflect rising incomes). In 18 states plus the District of Columbia, households with taxable income of $30,000 are in the same bracket as those with taxable income of $300,000. In addition, the extra tax breaks many states give to the elderly — regardless of income — are becoming increasingly costly as the population ages.

Other important causes of state structural deficits include federal restrictions on state taxing authority (such as the federal ban on state taxation of Internet access fees) and state budget requirements that limit revenues (such as tax and expenditure limits).

Comparing States' Risk
Of Structural Deficits

10 or 9	8	7	6	5	4 or 3
Alaska	Alabama	Arizona	Connecticut	Kansas	Minnesota
Arkansas	Georgia	California	Delaware	Louisiana	Nebraska
Colorado	Kentucky	Hawaii	Illinois	Maine	New Jersey
Florida	Missouri	Idaho	Iowa	Maryland	North Dakota
Nevada	Rhode Island	Indiana	Massachusetts	New York	Vermont
New Mexico	South Dakota	Michigan	Montana		Wisconsin
Pennsylvania	Washington	Mississippi	New Hampshire		
South Carolina		Oklahoma	North Carolina		
Tennessee		Virginia	Ohio		
Texas			Oregon		
Wyoming			Utah		
			West Virginia		

Most at Risk ◄────► **Least at Risk**

Inadequate Funds to Maintain Current Services

In states with structural deficits, revenues do not grow at the same rate as the cost of government. As a result, these states are unable to continue providing their current level of services, let alone respond to voters' demands for new investments in education and other areas.

Structural deficits have received little public attention to date, largely because states have adopted various ad-hoc measures to mask them. For example, many states raised sales taxes: the average sales tax rate rose by about 50 percent between 1970 and 2003. Sales tax *revenues*, on the other hand, rose by only 20 percent during this period because of the shrinkage of the sales tax base. Raising tax rates is not a permanent substitute for fixing underlying problems because it places unfair burdens on a narrow segment of the population and undermines public confidence in government.

Some States Strengthening Their Fiscal Foundation

The report evaluates each state's susceptibility to structural deficits by determining how many risk factors apply to the state. The report considers ten risk factors, including the extent to which the state taxes services, the strength of the corporate income tax, the progressivity of the personal income tax, and the presence of revenue barriers such as tax and spending limits.

The report also outlines policy responses to each of these risk factors, some of which have already been adopted by certain states:

- **Georgia, Maryland, New York, and Vermont** were the most recent of 23 states to strengthen their corporate income taxes by closing the "passive investment company" loophole, which allows corporations to avoid state taxes by shifting income into "tax haven" states.

- **Virginia,** which used to exempt all pension income from its income tax, recently phased out that exemption for higher-income people.

- Forty of the 45 states with a sales tax have embarked on a project to simplify their sales tax in order to encourage Congress to pass legislation allowing states to require mail-order and Internet vendors to collect sales taxes.

- **Nebraska** has expanded its sales tax base to include a number of services.

"States are playing a greater role than ever before in providing public safety, health care, and education." said Iris Lav, deputy director of the Center and co-author of the report. "Modernizing their fiscal systems by identifying and fixing structural problems will prepare them to shoulder these responsibilities."

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The Center on Budget and Policy Priorities is a nonprofit, nonpartisan research organization and policy institute that conducts research and analysis on a range of government policies and programs. It is supported primarily by foundation grants.