NCSL TASK FORCE ON STATE AND LOCAL TAXATION VIRTUAL MEETING SERIES

The Pandemic and the Damage Done: Revitalizing State Revenue Streams

MAY 15, 2020

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AGENDA

- Welcome
- Tax Policy in a COVID-19 Era - William Fox, The University of Tennessee, Knoxville
- Revenues must be part of the solution to state budget shortfalls; states have many options - Michael Mazerov, Center on Budget and Policy Priorities
- The Pandemic and the Damage Done: Revitalizing State Revenue Streams - Jared Walczak, Tax Foundation
- Q&A

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PROTOCOL FOR TODAY'S VIRTUAL MEETING

- Mute your audio unless you are speaking
- Virtually "raise your hand" to be recognized by today's moderator
- Type your questions into the chat box on the right side of your screen

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TAX POLICY IN A COVID-19 ERA

William Fox
Director, Boyd Center for Business & Economic Research
The University of Tennessee, Knoxville
billfox@utk.edu

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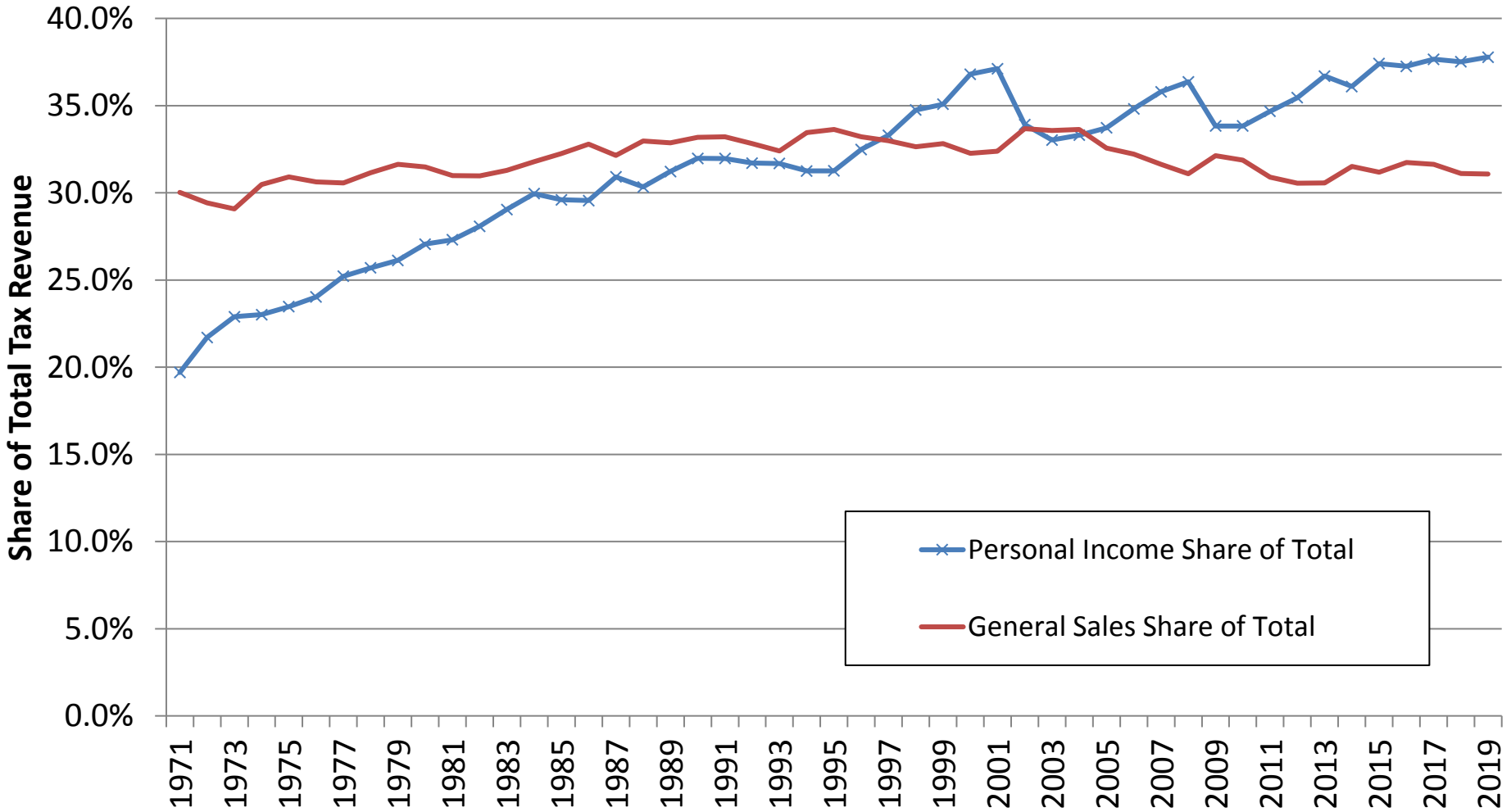
Introduction

- Good tax policy is good tax policy – Covid 19 has not changed this story
- My Fears
  - Use Covid 19 as an excuse to raise revenues any way possible
  - Use Covid 19 to cut tax rates/grant exemptions to stimulate the economy
    - state taxes are not the problem or the solution
    - the federal government can print money and stimulate the economy, all states can do is further erode their capacity to deliver key public services

Goals for Good Tax Policy Remain

- Limit compliance and administration costs
- Limit tax created distortions
- Appropriate degree of fairness
- Appropriate revenues
  - Limit growing volatility of state taxes
  - Sales tax off food/ narrowing of base
  - Progressive and growing share of income taxes
  - Volatile corporate tax revenues

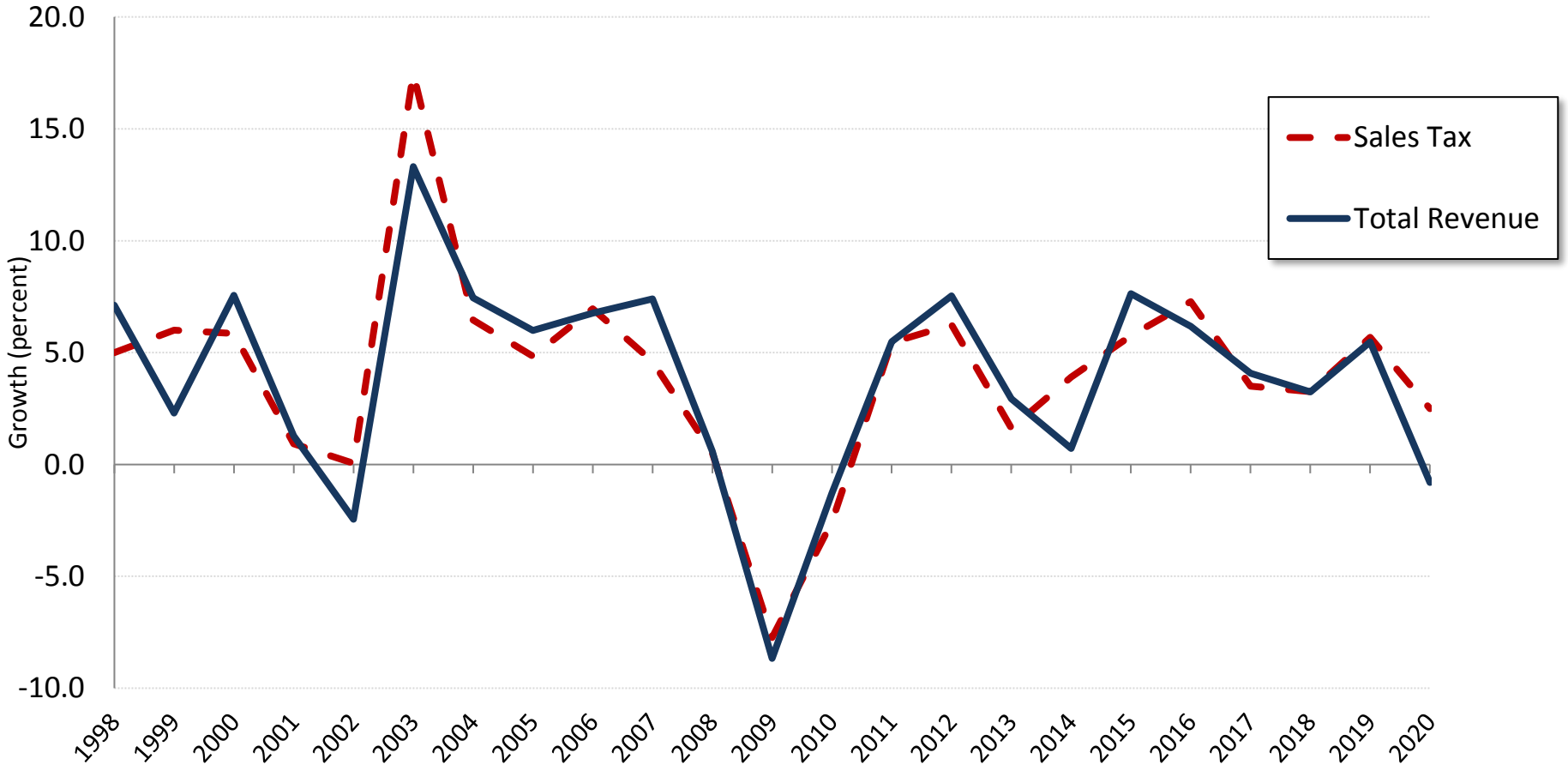
Personal Income Taxes have Risen Dramatically as a Share of Total Taxes



Budgeting in the Covid 19 Years

- Recessions affect state and local government revenues for several years, so be cautious about financing current shortfalls with rainy day funds
  - Corporate income taxes, for example, structurally impact revenues for three years plus effects of loss carryforwards
- Significant economic/fiscal risk on the downside
- Many states have delayed filing dates, which exacerbates the difficulty of understanding revenues as budgets are set for FY 21

Tennessee Tax Revenues Fall in Recessions, but This One is Different



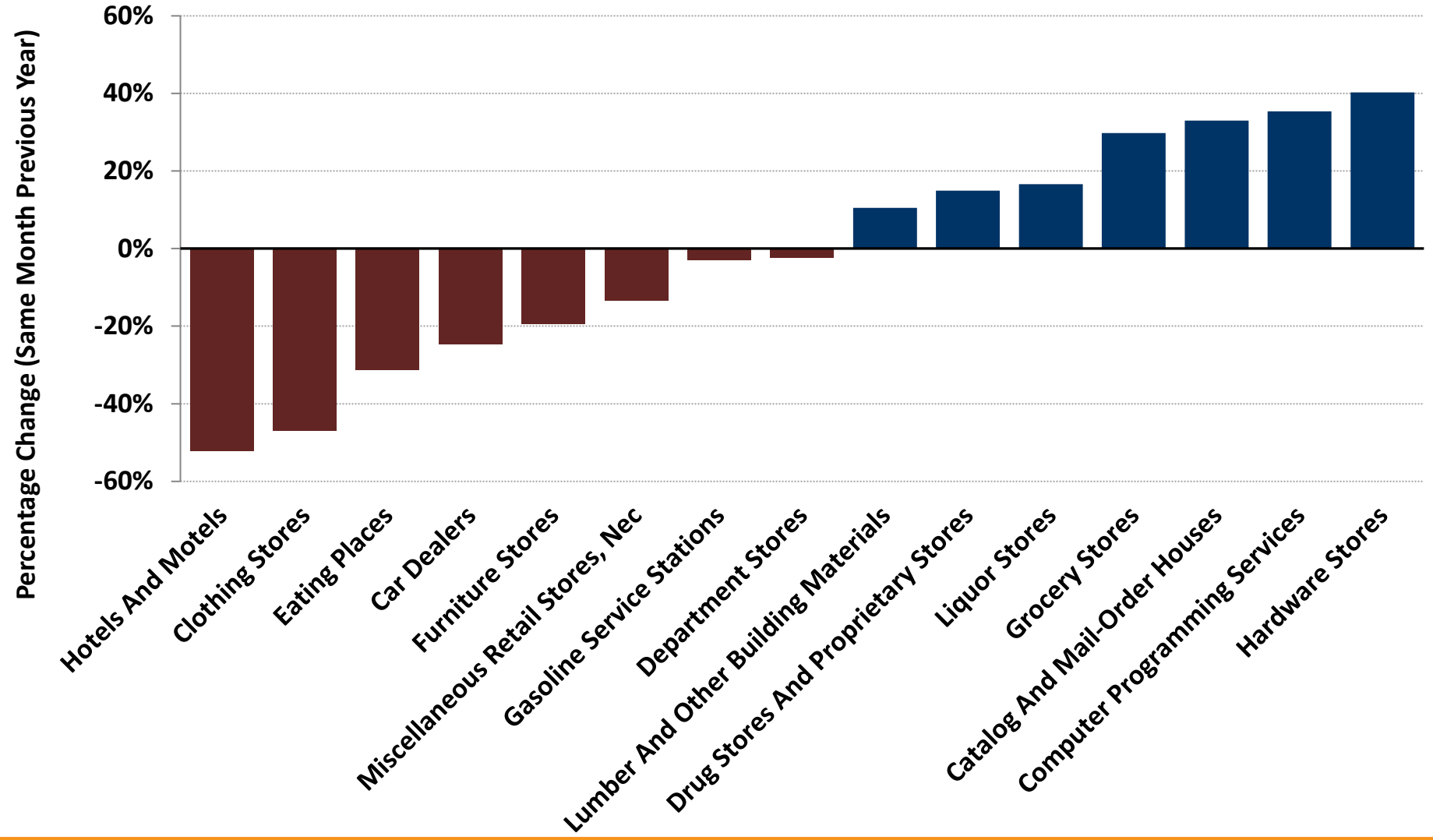
** 2020 growth rate is year to date through April*

Budgeting in the Covid 19 Years

- Effects of this recession on revenues differs from previous recessions because of the immediate decline in economic activity
- The degree of decline and rate of recovery are extremely hard to estimate, so issue is how much risk to accept as budgets are set – very unlikely to be a V-recovery
- Is initially more substitution across activities than might have been expected

Big Losses in Expected Areas, but Big Gains in Others

Tennessee sales tax revenue growth, April 2019-20



Remote purchasing skyrocketed in importance

- Importance of collecting neutral tax on remote and local sales never more clearly evidenced than during the past two months – Wayfair matters
- Much more than buying from another state, is a dramatic change in how consumers get goods and services
  - Retail space/employment will decline dramatically
  - Taxing delivery charges?
- Destination sourcing
- Local tax administration – Colorado and Louisiana

Sales (and all) Taxes Long Term Goal

- Ultimate goal is to have one tax system - not a different one for large and small business
  - Thresholds and notches create problems
  - Why should a local firm selling $200,000 annually collect the tax while a firm selling $200,000 from outside the state does not?
  - May need some allowances for compliance, but ultimately smaller firms operating in multiple states should strongly consider purchasing sales tax compliance from vendors
  - Will take time to achieve this goal, but it should be the target

Federal Legislation on State Tax Policy is a Bad Idea

- Easy to give away another level's revenue sources, often resulting in poor tax structures and excessive exemptions
- Products and behaviors are changing too fast and Feds will not stay current with the best ways to tax
- Reasonable coordination between states on policy and administration is still important and best for all of us

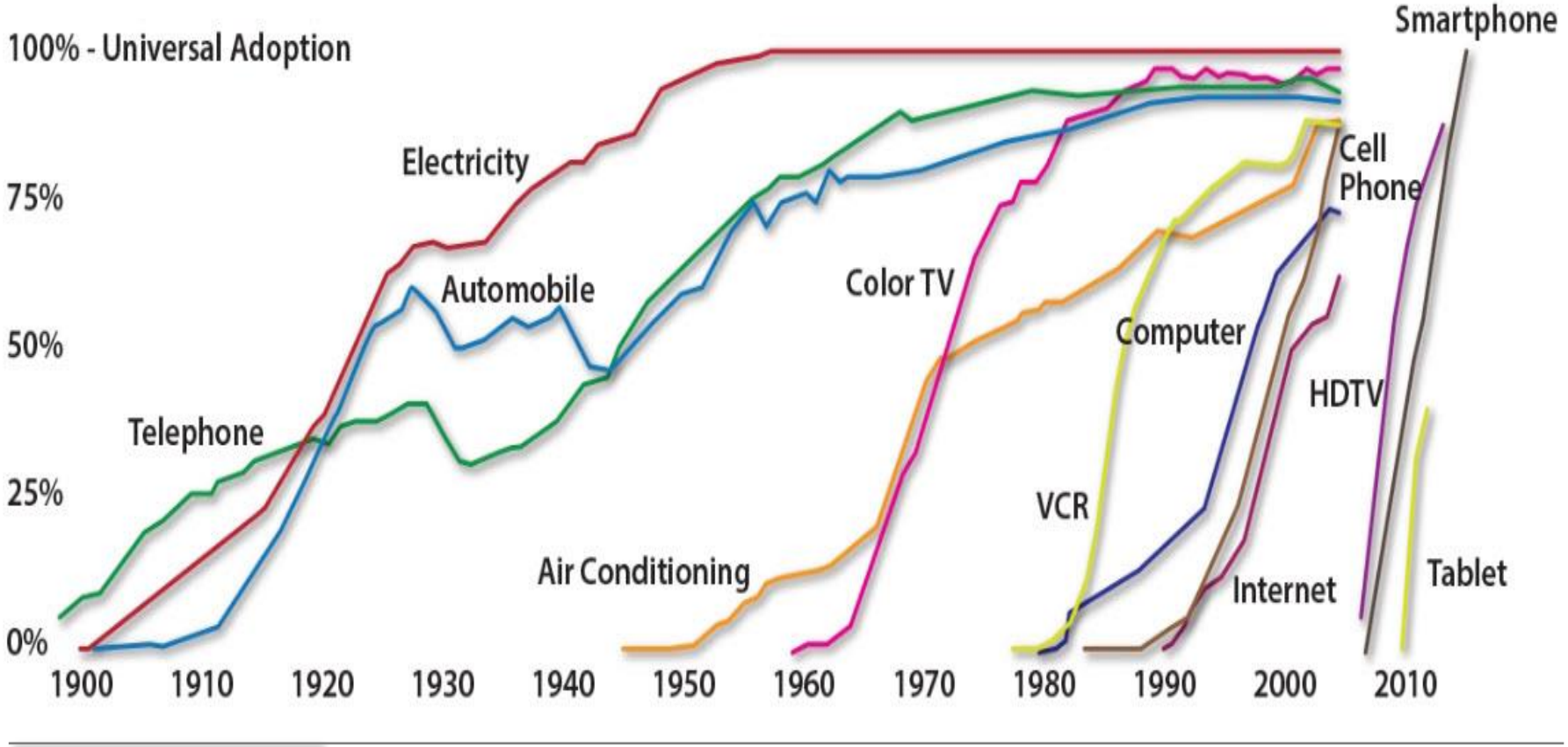
Gross Receipts Tax

- Not arguing for large business tax increase, but is a good time to stabilize business tax liabilities/reduce tax volatility
- Ohio style CAT is the model – no deductions, low rate, on all forms of business
- Advantages:
  - Simple – numerator of the sales factor
  - Combined reporting less of an issue
  - More stable revenue structure
  - Does not distort business structure choice
- Disadvantage:
  - Pyramiding – keep the rate low

Keep the Tax Bases Broad

- Expand the sales tax base to appropriate services
  - Much more discussion than policy changes – KY added a list
  - Collect on a destination basis
  - Collect on shared services
- Avoid age based exemptions from the income tax

Speed of Adoption for Major Technology Innovations



Source: HDR CAV Services

Kentucky sales tax base expansion

- Landscaping services (including snow plowing or removal services)
- Janitorial services (including commercial cleaning services)
- Small animal veterinary services (excluding certain animals that are commonly considered livestock) • Pet care services
- Industrial laundry services (including industrial uniform supply services and industrial mat and rug supply services)
- Non-coin operated laundry and dry cleaning services • Linen supply services (including table and bed linen supply services)
- Indoor skin tanning services
- Non-medical diet and weight reducing services
- Limousine services if a driver is provided
- Extended warranty services

REVENUES MUST BE PART OF THE SOLUTION TO STATE BUDGET SHORTFALLS; STATES HAVE MANY OPTIONS

Michael Mazerov
Senior Fellow
Center on Budget and Policy Priorities
mazerov@cbpp.org

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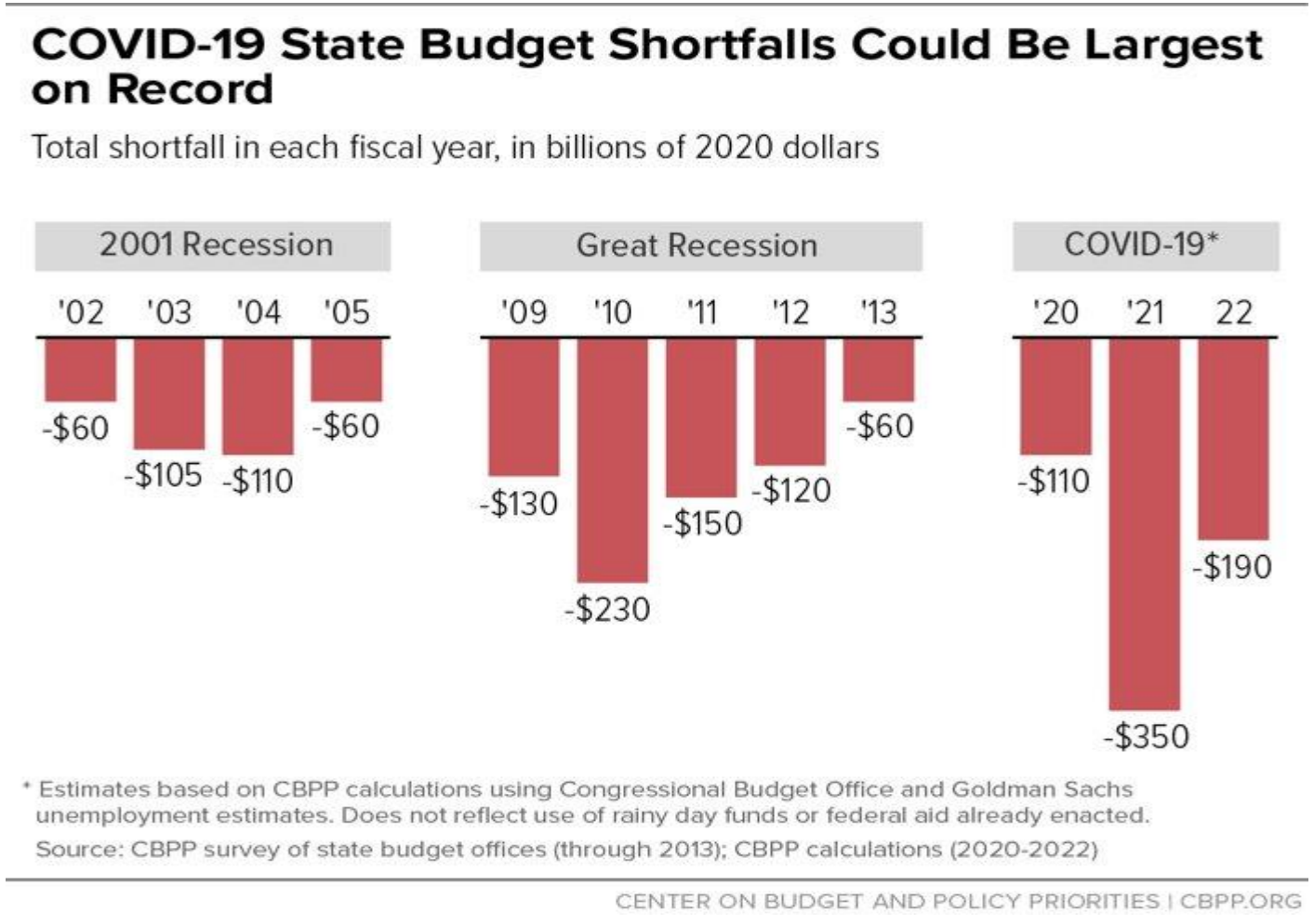
STATES ARE CONFRONTING BUDGET SHORTFALLS THAT ARE UNPRECEDENTED IN THEIR LIKELY SEVERITY



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STATES ARE CONFRONTING BUDGET SHORTFALLS THAT ARE UNPRECEDENTED IN THEIR LIKELY SEVERITY

- CBPP predicting aggregate state budget gaps of $650 billion for FY20, FY21, and FY22 combined
- Based on CBO and Goldman Sachs forecasts of unemployment and Brookings historical analysis projecting that each 1%-point increase in unemployment rate will result in budget gap (from revenue shortfalls and increased Medicaid expenses alone) of about $45 billion
- Calculation doesn't include increased medical care and public health costs from pandemic (although significant share of those likely covered by CARES Act funds)
- Use of flexible CARES Act $65 billion and $75 billion in rainy-day funds still leaves budget gaps of $510 billion.

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ADDITIONAL DIRECT FEDERAL AID TO STATES TO BACKFILL REVENUE LOSSES IS VITAL

- Closing budget gaps of that that magnitude with state budget cuts alone would
  - Devastate state aid to K-12 (26% of state spending) and higher education (15%)
  - Devastate health care (17% of state spending)
  - Lead to major withdrawal of purchasing power from state economies and deepen and prolong recession
- Just last month, states and localities furloughed or laid off nearly 1 million workers
- Takeaway #1: Every Task Force member should be an advocate for more direct, flexible aid to state and local governments to help them backfill revenue losses not of their own making

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BALANCED APPROACH TO CLOSING BUDGET GAPS ESSENTIAL

- Amount of federal aid likely forthcoming will be insufficient to eliminate shortfalls in most states
- Takeaway #2: States will have to take a balanced approach to closing budget gaps, *including revenue increases* as well as tapping reserves and cutting spending
- All cuts approach inevitably will harm health care, higher ed, and aid to local schools, since corrections, basic state operations, state highway snow removal, child protective services, etc. so difficult to cut and/or small share of state spending

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TAX INCREASES SLOW ECONOMY LESS THAN SPENDING CUTS

- Economists Joseph Stiglitz and Peter Orszag:

"[E]conomic analysis suggests that tax increases would not in general be more harmful to the economy than spending reductions. Indeed, in the short run (which is the period of concern during a downturn), the adverse impact of a tax increase on the economy may, if anything, be smaller than the adverse impact of a spending reduction, because some of the tax increase would result in reduced saving rather than reduced consumption. For example, if taxes increase by $1, consumption may fall by 90 cents and saving may fall by 10 cents. Since a tax increase does not reduce consumption on a dollar-for-dollar basis, its negative impact on the economy is attenuated in the short run."

TAX INCREASES CONCENTRATED ON HIGH-INCOME FAMILIES SLOW ECONOMY LESS THAN SPENDING CUTS

- Economists Joseph Stiglitz and Peter Orszag:

"The more that the tax increases or transfer reductions are focused on those with lower propensities to consume (that is, on those who spend less and save more of each additional dollar of income), the less damage is done to the weakened economy. Since higher-income families tend to have lower propensities to consume than lower-income families, the least damaging approach in the short run involves tax increases concentrated on higher-income families. . . [Takeaway #3:] The conclusion is that, if anything, tax increases on higher-income families are the least damaging mechanism for closing state fiscal deficits in the short run."

TAX INCREASES CONCENTRATED ON HIGH-INCOME FAMILIES ESPECIALLY SLOW ECONOMY LESS THAN SPENDING CUTS

- Economists Joseph Stiglitz and Peter Orszag:

"For states interested in the impact only on their own economy rather than the national economy, the arguments made above are even stronger. In particular, the government spending that would be reduced if direct spending programs are cut is often concentrated among local businesses…. By contrast, the spending by individuals and businesses that would be affected by tax increases often is less concentrated among local producers — since part of the decline in purchases that would occur if taxes were raised would be a decline in the purchase of goods produced out of state. Thus, more of the reduction in purchases that results from tax increases than from government budget cuts falls on out-of-state goods (relative to in-state goods), lessening the adverse impact of a tax increase on the state economy."

CORPORATE TAX INCREASES ALSO LESS LIKELY TO HARM STATE ECONOMIES THAN EQUAL STATE SPENDING CUT

- Stiglitz/Orszag analysis also applies to state corporate income tax increases
- Increases in corporate income taxes don't affect corporations that are truly unprofitable because of economic downturn
- Because corporate investments in new plant and equipment will be very limited due to uncertainty about severity/longevity of recession and demand for output, state corporate tax increases on profitable corporations likely to come out of otherwise retained earnings rather than adversely affect in-state investment
- Moreover, due to widespread shift by states to sales-only apportionment of corporate taxes, corporate investment location decisions largely divorced from state corporate tax liabilities in any case

SOME STATE TAX POLICY OPTIONS CONSISTENT WITH STIGLITZ/ORSZAG ANALYSIS

- Increasing personal income tax rates on existing high-income brackets
- Shifting from flat tax to graduated structure (where state constitution allows)
- Phasing out itemized deductions and personal exemptions at high income levels
- Corporate income tax rate increases
- Corporate tax surcharges on windfall profits (e.g., profit rates in excess of average pre-recession levels)

TAKEAWAY #4: FOR THE FORESEEABLE FUTURE, EVERY DOLLAR OF STATE REVENUE IS A PRECIOUS RESOURCE

States cannot afford to:

- Cut existing taxes
- Stay coupled to ineffective or unfair federal income tax provisions

States need to:

- Eliminate their own existing ineffective or unfair tax breaks
- Close loopholes, fix structural flaws, and broaden the bases of their existing taxes
- Lobby Congress to enhance state revenue-raising ability

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FIRST, DO NO HARM: STATES CANNOT AFFORD TO CUT TAXES NOW

- A number of states are in the process of phasing in multi-year tax cuts. Those should be suspended immediately.
- Nor can states afford to cut taxes to help businesses or try to stimulate their economies. (There is a bill in Louisiana that would cut severance tax rates to stimulate oil production when there already is no place for the oil to go!)
- Businesses are in trouble because of plunging demand; trying to encourage them to expand by cutting their taxes is like pushing on a string.
- Small businesses need aid, but the federal government needs to be the one providing it and is providing it. States must balance their budgets.

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STATES CANNOT AFFORD TO REMAIN COUPLED TO INEFFECTIVE OR UNFAIR FEDERAL INCOME TAX PROVISIONS

- The handful of states still allowing NOL carrybacks (especially as dramatically expanded by the CARES Act) should decouple immediately retroactively to the beginning of the year.
- States allowing full expensing of equipment should decouple. (Why lose revenue to subsidize investment occurring in other states?)
- Decouple from Opportunity Zone tax breaks (see my Task Force presentation from last summer)
- 20% passthrough deduction from TCJA that some states are still coupled to
- Doubling of the amount of passthrough "losses" that can be used to offset non-business income (costly break snuck into CARES Act)

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STATES NEED TO ELIMINATE THEIR OWN INEFFECTIVE OR UNFAIR TAX BREAKS

- State capital gains breaks (Why allow a resident to pay lower tax on the profit from sale of a share of stock issued 50 years ago by a company that's never created a job in your state?)
- Non means-tested pension income exclusions and other senior tax breaks
- 8 states don't tax the unemployment benefits received by someone with an employed, high-earning spouse
- If ever there was a time for states to intensely scrutinize and limit ineffective economic development incentives, this is it.
- Sales tax holidays

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STATES NEED TO CLOSE LOOPHOLES, FIX STRUCTURAL FLAWS, AND BROADEN THE BASES OF THEIR EXISTING TAXES

- Most states are still not imposing sales tax on online streaming service, a loss of easily obtained and fair revenue at a time when so many people are watching.
- Many states don't tax shipping and handling charges connected to online sales and local deliveries or Amazon Prime membership charges.
- Less than a dozen states have closed the Online Travel Company loophole that this Task Force appropriately addressed several years ago.
- One third of states have still not acted to prevent interstate corporate profit shifting by adopting water's edge combined reporting; even fewer have done anything to mitigate international profit shifting, which remains a serious problem. (Watch Tax Policy Ctr 5/21 webinar!)

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STATE POLICYMAKERS SHOULD PUSH CONGRESS TO TAKE ACTION TO ENHANCE STATE REVENUE-RAISING CAPACITY

Options:

- Reinstate the federal credit for state estate taxes
- Repeal the prohibition on non-discriminatory sales taxation of Internet access services (CBPP and Tax Foundation agree!)
- Repeal Public Law 86-272 and substitute reasonable property/payroll/sales thresholds for state corporate income tax nexus
- Approve an interstate compact setting ground rules for state economic development incentives

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SUMMARY

- Closing budget shortfalls of the size states are facing by cutting employees and services alone would be very harmful to public school students, young adults trying to get a college education, people losing employer-provided health care in the middle of a pandemic, and many others who depend on state and local services.
- Revenue increases must be part of the solution, and if they're targeted at people at the top of the income and wealth distribution and still-profitable businesses they'll be less of a drag on the economy than if they take the form of increased consumption taxes on people at the bottom.
- Current crisis should also spur states to fix long-standing flaws in their tax structures
- Thank you! Questions? Comments?

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THE PANDEMIC AND THE DAMAGE DONE: REVITALIZING STATE REVENUE STREAMS

Jared Walczak
Director, State Tax Policy
Tax Foundation
jmw@taxfoundation.org

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REVENUE OPTIONS

- Clear out targeted incentives in CIT and PIT
- Modernize the sales tax
  - Consumer services, digital goods, and better targeting of progressive provisions to shield low-income consumers while still taxing everyone else
- Consider new sources of revenue
  - Gaming, marijuana, etc.
- Inflation-adjust eroding taxes like the gas tax
- Make higher rates on general taxes a last resort

THINGS TO AVOID

- Policies that discourage employment or reinvestment
  - Avoid restricting NOLs, limiting the interest deduction, curtailing expensing provisions, taxing international income
  - UI tax increases may be necessary, but timing matters, as does how the pandemic effects the "experience rating"
- Taxes that are indifferent to ability to pay
  - Don't look to gross receipts taxes, capital stock taxes, tangible personal property taxes, etc.

MODERNIZING THE TAX CODE

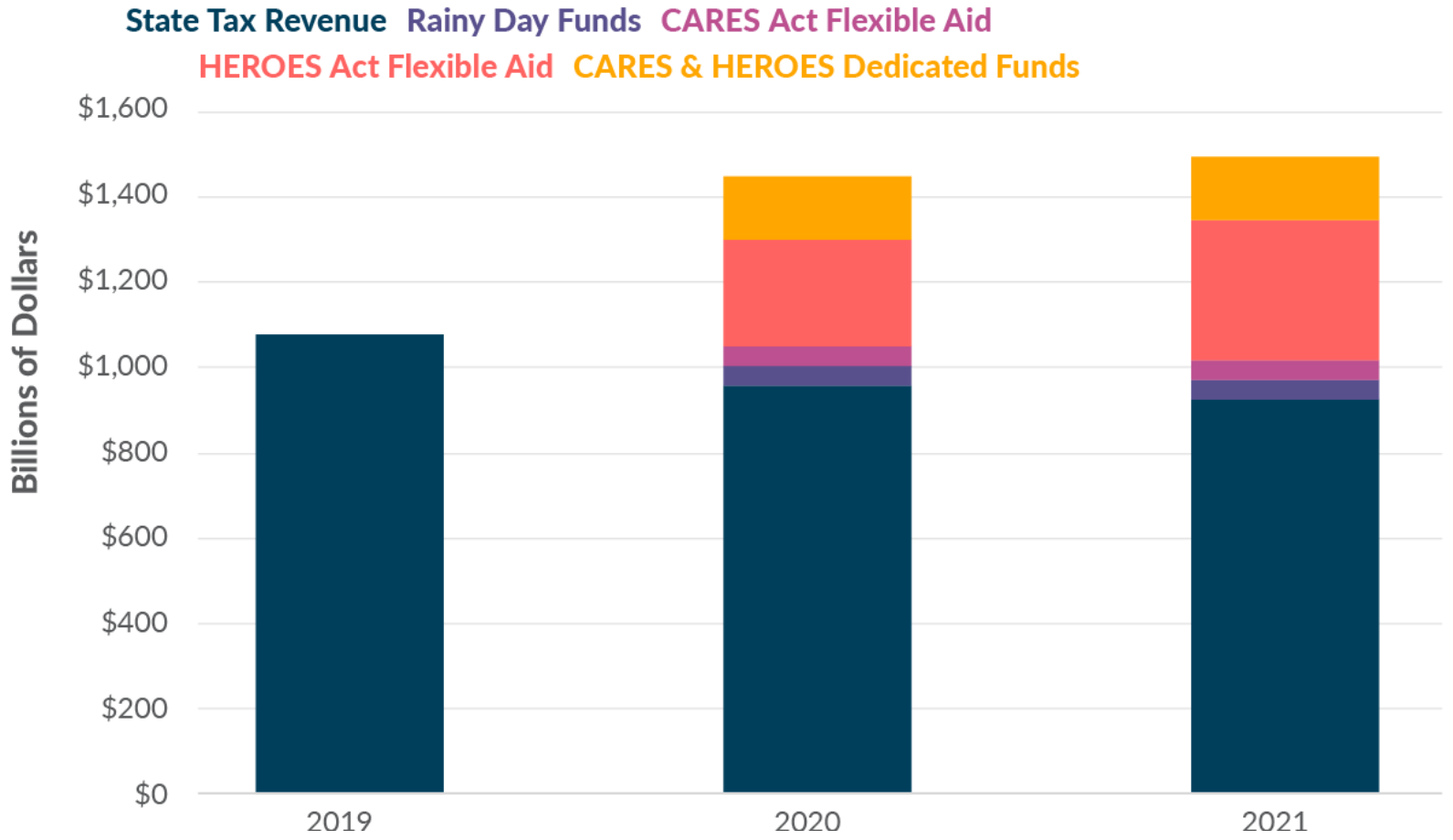
- The COVID-19 crisis will bring about permanent changes, particularly regarding employer and employee mobility
- Modernize tax rules to be friendlier to new trend toward remote work and teleworking arrangements
- Modify nexus and enhance conformity to prevent needless double taxation impacting new economy business models

THE ELEPHANT IN THE ROOM

- **Will there be a new federal relief package for state and local governments, and if so, what will it look like?**
  - How large will it be?
  - How many years will it cover, implicitly or explicitly?
  - How will it be allocated?
  - How will its use be restricted?
- Both tax and spending questions will be affected by this

State Revenues if States Can Spend Their Full HEROES Act Allocations

Actual and Projected State Tax Collections Plus Estimated State Fiscal Relief Allocations by Fiscal Year



Key Considerations in Designing a State Relief Package

Design Choice	Considerations
Allocation Method	Choice of allocation method interacts with every other choice federal lawmakers face on the size, timing, and flexibility of a relief package
Population-Based	Favors timely administration, does not skew state incentives or reward fiscal imprudence, fails to capture disparities in the virus's impact
Economic or Fiscal	Tied more directly to specific needs, but long lag in relevant economic data, consistency issues, discriminates based on size of government, can reward poor planning, and dissuades states from necessary reforms
Coronavirus Cases	Proxy for need independent of state's budgetary choices, but has snapshot date issues, neglects costs in states that have kept case counts low at significant economic cost
Amount of Relief	Inadequate levels could force states to make economically harmful tax and budgetary decisions that slow the recovery, but excessively generous provision staves off necessary reform and introduces moral hazard
Timing of Aid	Multiple years of funding in a single installment could delay difficult decisions, leading to a sharper contraction in the end
Flexibility	Greater flexibility will allow federal funding to flow to states' most urgent needs and is less likely to create long-term dependency

Questions and Answers

Please type your questions into the chat box on the right side of your screen or unmute yourself to ask your questions.

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PREVIOUS SALT TASK FORCE MEETINGS

- **All recordings and slides from the previous SALT Task Force virtual meeting series have been posted on the NCSL SALT Task Force website:** https://www.ncsl.org/ncsl-in-dc/task-forces/task-force-on-state-and-local-taxation.aspx

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