(C) Tax Analysts 2010. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

The Real Problem in State Finance

by David Brunori

The states continue to face large deficits. Many experts blame either the Great Recession or structural deficiencies in our tax system for the bleak fiscal picture. High unemployment, a crashing real estate market, and the inane way we tax have certainly contributed to the crisis. But we have seen recessions before, and our tax system has been dysfunctional for decades.

The problem now is that we want more public services — at all levels of government — than we are willing to pay for. In a just, rational, reasonable world, the public would determine the type and level of services it wanted and pay for them with broad-based taxes. By broad-based taxes I mean real taxes on property, income, and sales. During times of deficits, the elected officials would either raise broad-based taxes or cut spending, or devise some combination thereof.

Instead we are 1) using accounting gimmicks to move money around; 2) trying to expand gambling; 3) looking for more cigarette taxes; 4) trying to impose taxes on the really wealthy; and 5) seeking quick, temporary fixes. Look at what we're doing. Virginia Gov. Bob McDonnell (R) has pledged not to raise taxes but needs money and is willing to privatize the liquor stores to get it. Wyoming Gov. Dave Freudenthal (D) last month called for the federal government to give the state part of Grand Teton National Park so it could sell it to developers for $125 million to keep the schools running. Some policymakers in California are pinning the state's fiscal future on the legalization of marijuana. Are they high?

In the past couple of weeks, people from state legislatures have asked me about raising money by selling naming rights to public colleges, leasing lottery operations, selling off toll roads, and taxing escort services and massage parlors. Yes, there are people who think hookers will actually collect tax like Sears or the Gap. This is tax policy in 2010.

What gives rise to this insanity is the disconnect between government services and taxes. I blame the disconnect largely on conservatives, who have made taxes — but not necessarily spending — the enemy. One need only look at the ridiculous proliferation of politicians who promise that they will never raise taxes for any reason. Most of them never promise not to spend money; they just won't raise taxes to pay for the spending. The pledge results in paying for government with gambling, excise taxes, borrowing, and intergovernmental aid. It also makes tax reform impossible. One of the bedrock principles in our business is that a good tax system is based on a broad base and low rates. Almost every public finance expert in the world believes that. But those thousands of politicians who take the pledge are unwilling to broaden the base on sales or income taxes because that would break their promise.

The problem now is that we want more public services — at all levels of government — than we are willing to pay for.

What also gives rise to this insanity is the delusion that you can starve the beast. The pledge takers and conservatives in general have argued for many years that if we prevent the government from raising taxes, it will have to cut spending. We saw how well that has worked for the federal government. At the state level, it is fueled by the great myth of the balanced-budget requirement. I have heard for years that the virtuous state governments, unlike the spendthrift central government, must balance their budgets. That is nonsense. State balanced-budget requirements deal with annual operating budgets. Every state has a loophole for capital spending and pension obligations. The Pew Center on the States estimates that the states are over $1 trillion in the red. But that's a conservative estimate. Some folks believe that the debt is closer to $5 trillion. Balanced budgets indeed.

The pledge is a carnival gimmick that has done nothing to help bring fiscal discipline to government. We should have a debate over the appropriate levels

of government. But whatever level of government we choose must be paid for with real taxes. Anything short of that is dishonest.

Ayn Rand Would Be an A Student; Che Would Get an F

When I was younger, I used to poke fun at the Cato Institute's fiscal report card for governors. I have changed my thinking. Cato doesn't like excessive government spending or taxation. It is honest about that and grades the governors accordingly. If you like big government and are willing to raise taxes to pay for it, you won't do well at Cato University. But if you like minimal state government and smallish tax burdens, you'll move to the top of the class. There are sincere people who would reverse the grading scheme used by Cato. That is, the governors who want a larger public role, and hence greater tax burdens, would get better grades. But neither Cato nor folks who are more pro-government should tolerate politicians who are willing to spend without accepting the discipline to pay the bills.

Incentives Run Amok

The Ohio Department of Development has been handing out tax incentives like crazy. In the last week, it granted state tax credits to an auto parts maker that promised to add 300 jobs in Toledo, a steel processor that said it would add 80 jobs, and an alternative fuel company looking to add 22 jobs. If I were a tax adviser in Ohio, I would counsel my clients never to add a job before first asking the state for a tax incentive.

Campaign Stuff

In Nevada, Republican Brian Sandoval and Democrat Rory Reid are running for governor. The state faces a big deficit — maybe close to $3 billion. Sandoval says he can save $500 million by eliminating waste, fraud, and abuse. He says he won't raise taxes. Reid says he wants to spend more on education and green energy but won't say how he'll pay for anything. In the meantime, there is a growing belief among Nevadans, including many conservatives, that a tax increase is necessary. GOP pollsters have found that fewer than a quarter of state citizens think their taxes are too high. More business leaders are getting behind the idea of a tax increase. Nevada has seen tremendous population growth. It doesn't have a lot of frivolity in government. Sure, costs can be cut. But there aren't $3 billion worth of things to be cut.

California Doesn't Collect Sales Tax Very Well

The sales tax should be easy to administer. The vendor collects it from the consumer and remits it to the state. If the vendor fails to collect it, the vendor is liable for the tax. If the vendor collects it and does not remit, the vendor can go to jail. That system seems to work well everywhere except in California. Apparently, vendors there have collected but neglected to remit $1.4 billion. When a state has a $20 billion budget deficit, you'd think it would do a better job of collecting what's owed. What's worse, it appears that the State Board of Equalization actually knows the identities of many vendors that owe the money. I think that before anyone mentions service cuts or tax increases, the state should get this problem under control.

Los Angeles Times: Vote No on Proposition 24

I like it when the civilian world weighs in on tax policy. The *Los Angeles Times* editorial board is urging readers to vote no on Proposition 24. The initiative would repeal three corporate tax breaks that were part of budget deals struck in 2008 and 2009. The breaks allow corporations to 1) carry back losses, 2) share tax credits with affiliated corporations, and 3) elect single-sales-factor apportionment. If all those breaks were repealed, the state would collect nearly $1.3 billion. The *Times* says that the tax breaks are not bad tax policy. Really? Giving corporations a choice to elect a single-sales-factor formula isn't bad tax policy? Actually, it's the epitome of bad tax policy. It gives corporations the option of choosing a formula that minimizes their tax burden. Those with property and wages in the state will opt for single-sales-factor. Those corporations that only sell into the state will opt for the modified three-factor formula. What's good about that policy?

Worth Reading

With the recession lingering and poverty on the rise, the Institute on Taxation and Economic Policy (ITEP) released a study this week explaining how states can help out their poorest citizens. The report says that states should offer refundable earned income tax credits (only 24 states now have them). ITEP calls for property tax circuit-breakers for low-income homeowners and renters (many states have those programs but limit them to the elderly). ITEP calls for low-income tax credits to ensure that the poorest citizens are not subject to tax (only nine states offer those programs). Finally, it recommends more child-related tax relief for low-income taxpayers.

States are facing big deficits. But a society as rich as ours should not put the burden of paying for government on the backs of our poorest citizens. Citizens and policymakers should heed ITEP's advice. ✰

The Politics of State Taxation is by State Tax Notes *contributing editor David Brunori, who welcomes comments at dbrunori@tax.org.*

(C) Tax Analysts 2010. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.