NTA Forum

Perspectives, Ideas and News from the National Tax Association

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State and Local Fiscal Health: The Effects of Economic and Demographic Changes

Sally Wallace, Georgia State University

Introduction

Recent economic and demographic changes have signaled potentially stressful times for state and local government finance.[1] Forecasted changes in the composition of income toward transfer payments and retirement income mean less taxable income; the movement toward heavier consumption of services and medical products means less taxable sales in many states; housing turnover due to demographic changes in some regions may mean smaller increases in property tax bases; and the changing composition of employment may lead to smaller increases in tax bases. All of this comes at a time when pressure from interstate and international competition forces state and local governments to remain competitive (which includes keeping taxes low), and when voters remain in a bad mood about taxes.

As state and local governments deal with tax bases that expand more slowly while trying to remain competitive, public expenditures will be scrutinized. Funding for programs that benefit children and the non-elderly poor are likely to fare the worst under this scrutiny, as these groups have little or no constituency. The aging of the population will mean more voting power for older citizens, and the competition "bogeyman" will protect infrastructure interests and keep taxes low.

Many of the trends are natural consequences of the development of our economy and the aging of our population, and policy can do little to reverse or even bend them. However, by understanding how these trends may reduce the rate of growth in revenue collections and change the composition of client populations, policymakers might be able to redesign expenditure programs and revenue instruments to the advantage of state and local finances.

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Economic and Demographic Trends

Income

Income is one of the main indicators of fiscal health. From a government finance perspective, growth in income is typically associated with growth in revenue bases as well as increased demand for public services. The Bureau of Economic Analysis (BEA) defines personal income as the sum of wages and salaries, dividends, rents, interest, transfer payments, other labor income, and income of proprietors.

The growth rate of real per capita personal income has declined somewhat over the last two decades. Average annual growth fell from 3.04 percent to 1.80 percent between 1970 and 1990. Real per capita personal income actually declined between 1990 and 1991 due to the recession. While the economic recovery pulled income growth up somewhat, the average rate from 1990 to 1993 (0.06 percent) is very low relative to the earlier years. BEA expects this positive real growth in personal

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Please send all correspondence to:
Robert D. Ebel
Executive Director
National Tax Association
282 North Washington Street
Falls Church, VA 22046
Phone (703) 237-7660
FAX (703) 237-7662

NTA Home Page:
http://www.cob.asu.edu/nta

income to continue at lower and lower rates throughout the next few decades, hovering at around 1.3 percent per year through 2000, then falling to 1.01 percent by 2010 and to 0.78 percent by 2025.

While New England and the Mideast showed relatively strong average annual growth in personal income from 1980 through 1990, they are not expected to fare as well in the coming years. The Far West is expected to see some increase, although growth is expected to remain low relative to other regions. Relatively strong income growth is expected for the Plains, Southeast, and Southwest regions.

The forecasted positive growth in personal income may be a sound indicator of future state and local fiscal health if it yields a similar growth in the tax base (income or consumption). However, declining growth and the changes in the underlying pattern of income suggest that the growth in tax bases may not be keeping up with the growth in personal income.

Between 1970 and 1993, wages and salaries–the largest share of personal income, which comprise over 70 percent of state and local income tax bases–declined in importance, while largely untaxed transfer payments grew substantially (see Duchi 1995, Snell 1993, and Mullins and Wallace 1992). Therefore, if wage and salary income grows more slowly, so do the income tax base and revenues.

The fastest growing transfer sector has been federal, state, and local payments for retirement and disability insurance, medical, income maintenance, unemployment insurance, veterans benefits, and others. The fastest growing individual payments have been for medical services (largely Medicaid and Medicare) and income maintenance (AFDC, food stamps, and others).

Retirement and disability payments (including Social Security) still remain the largest *share* of transfer payments, although their share fell from about 54 percent in 1970 to 50 percent in 1993. Over the same time, medical payments have risen from 17 percent of transfers to 31 percent (BEA 1994b). Although retirement income as a share of personal income has declined somewhat, government sponsored retirement income is still projected to grow faster than wages and salaries (Ratajczak 1995).

Employer contributions to private pension and welfare funds, and payments for workers' compensation and private health insurance are included in other labor income, which increased from about 4 percent of personal income in 1970 to about 6.2 percent in 1993. While still a relatively small share, this is another largely nontaxable income source, and as such it adds to a potentially slower growing tax base for state and local governments.

This shift in income toward transfer payments is especially significant for state and local governments that impose income taxes. Of the 43 states that impose some form of an income tax, virtually all have exemptions for general retirement and/or Social Security income. Most states have practically eliminated the tax on Social Security income, in contrast to recent federal actions to increase the Social Security income subject to taxation.[2] Many states allow retirees to exempt some part of private pension income as well. All state governments reduce their taxable income base by larger amounts each year as retirement income grows (see ACIR 1995).

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Forecasters in general expect that transfer payments will continue to grow faster than wages and salaries. The net effect is that a smaller share of personal income will be subject to tax. However, the *growth rate* of the taxable income base will ultimately have an impact on the growth rate in *tax revenue*. The important question is, while there is an unmistakable increase in the nontaxed share of personal income, is the taxable share growing any more slowly than it has in the past? In effect, it is the absolute level and growth of taxable income that is important.[3]

What about the growth in taxable versus nontaxable income beyond the next couple of years? Potential taxable income is defined as total earnings plus capital income, which comprise well over 90 percent of most state income tax bases and nearly 100 percent of most local income tax bases (see IRS and ACIR). The average annual growth rate for transfer payments (3.61 percent) was much higher than that for potential taxable income (0.93 percent) from 1979-1993, and will continue to increase.

Growth in potential taxable income is expected to be relatively strong for most regions through 2000. However, for New England and the Mideast states, even the short-term projections suggest that taxable income growth will decline. The longer term projections suggest that this growth may decline in all regions, thereby reducing the growth in tax revenue unless changes are made in tax rates or bases. BEA projects decline in the growth rate by 40 percent within approximately 10 years.

Age Distribution

One of the most widely acknowledged and discussed demographic trends is the aging of the population. As the "baby boom" period of the 1950s gave way to the "baby bust" starting in the late 1960s, population growth fell, and the average age increased from 28 years in 1970 to 32.8 years in 1990 (Census Bureau, 1994). By all accounts, this trend is expected to continue into the foreseeable future.

Population growth has remained relatively constant at a bit over one percent per year since 1973. Census projects a slight decline in overall growth through 2020, fastest growth in the South and West, and more limited growth in the Northeast and Midwest. As with income, however, it is change in the composition of the population that may create some fiscal stress. Census projects that between 1995-2005 those over age 75 will be the fastest increasing age group. Thereafter, the 65 and older category is expected to grow faster than the school-aged and working-aged population. In 1995, there were about 1.7 school-aged children for each elderly person (aged 65 or older). In 2010, there will be 1.57 school-aged children for each elderly person, and this falls to 1.2 in 2020. Also in 1995, there were approximately 3.4 working-aged adults for each elderly person; this falls to 3.1 in 2010 and to 2.43 in 2020.

These changes may have serious repercussions for state and local budgets. First is a potential change in demand for certain public services and financing mechanisms. The elderly will become increasingly influential at the voting booth, at the expense of working age and younger populations. This will likely call for increases in spending for health, hospital, and medical services; Social Security; transportation; and some types of recreation, with potential cuts in education, AFDC, and Medicaid.

Second, a growing elderly population is associated with changes in consumption patterns, which will in turn affect state and local revenues. As discussed below, consumption has moved increasingly toward services and health and medical goods, many of which are not included in state and local sales tax bases. Thus, the growth of the sales tax base is decreased. This impact is likely to be gradual, however.

Local property tax credits and exemptions to the elderly have grown, which reduces property tax revenue (see Mackey and Carter, 1995). ACIR reported that over half the states offer a circuit breaker to the elderly and that 60 percent of the states with homestead exemptions give preferential treatment to the elderly. As the population ages, these credits and exemptions will become increasingly expensive.

Finally, age has been found to be negatively related to housing demand, which may reduce property tax revenues (Mankiew and Weil 1989, and Goodman 1990). While there are other factors at work (e.g., general economic conditions, life span, adult children living with parents), age by itself may translate into a lower demand for housing due to changes in income and family structure, and movement from owner-occupied homes to other types of housing (see McFadden 1994). These changes mean that the elderly consume less housing, thereby reducing the amount subject to the property tax. The housing stock available to buyers increases without increases in the property tax base.[4] Absent property tax rate increases or repeal of exemptions, without additional building, the property tax base does not grow.

Employment

In a now familiar tune, it is change in the composition of employment and not necessarily the forecasted level that may influence state and local budgets. BEA projects that total employment growth will remain positive through 2010, although it will diminish throughout the forecast period. Census data show that employment in the manufacturing sector declined from 21.6 percent of all employment in 1970 to 13.2 percent in 1993, while service employment grew substantially. Government employment remained relatively steady, declining a total of 2.6 percentage points over 13 years.[5]

How important are these changes in employment? Some may argue that it is the level of employment that is important in determining state and local revenue. While this is true in part for revenue generated from consumption (sales and excise taxes or user fees and charges) or personal income (individual income tax), there are reasons why the changing structure of employment may have a significant impact on property taxes and on the business portion of sales taxes.

First, the service sector is less heavily invested in tangible property and capital than the manufacturing sector (see Snell, and Fox 1995). Contracting services also reduces the real property involved in service production. Do these trends imply that

The changing structure of employment may have a significant impact on property taxes and on the business portion of sales taxes.

less equipment and real property is subject to the property tax? In fact, the real value of net capital stock (equipment and structures) per employee is almost five times larger in manufacturing than in the service sector (BEA 1994a). This ratio has been constant over time for the service sector, but, interestingly, it has grown in the manufacturing sector, especially over the last decade. In fact, this increase has more than offset the decline in the number of manufacturing employees. The net result is a *positive* growth in real net capital stock over the past two decades. This growth rate, however, has shown a general decline since the late 1970s. This may result in a slight reduction in the growth rate of property tax revenues from equipment and structures.

Additionally, revenues based on inventories will decline as an economy moves toward the service sector. Finally, because different forms of industry purchase different inputs, they likely pay different levels of sales taxes. One might expect that because service producers use fewer capital inputs, they pay less in sales tax. However, the value of inputs purchased by all sectors may be rising (e.g., technology). One rough approximation of this effect can be estimated using the BEA data on fixed reproducible tangible wealth (BEA 1994a). The average annual growth in the value of real net manufacturing capital equipment fell from approximately 2.7 percent per year over 1973-1983 to 1.6 percent per year over 1983-1993. The average annual increase in real net capital service-sector equipment fell from 6.6 percent to 6.4 percent per year. Combining these two sectors shows a reduction in the growth of the real net value of capital equipment from 3.6 percent to 2.8 percent per year.

Consumption

The National Income and Product Accounts reports that consumers spent approximately 29.5 percent of all expenditures on non-housing services in 1970. By 1994, this figure had risen to 41 percent. Within the category of services, medical expenditures increased from 8 percent of all expenditures in 1960 to 13.4 percent in 1994. These consumption pattern changes are a function of changing demographics, and it is probable that they will continue (see Hurd 1993, Fox 1992 and 1995, Mikesell 1992, and Snell).

The budget threat is that most state and local sales taxes do not tax goods for which consumption is growing, such as services and medical products. The Federation of Tax Administrators (1994) conducted a survey of the tax treatment of more than 164 services through July 1992.[6] FTA found that most states tax less than half of the services; Hawaii and New Mexico tax the largest portion. Delaware, South Dakota, Washington, West Virginia, and Iowa also tax a relatively large percentage of services. ACIR reports that virtually no state taxes medical services or prescription drugs.

Options for State and Local Governments

While state and local governments are not helpless against these trends, they face hard choices. It is difficult to undo special exemptions, tax credits, and the like, and the demands of many different constituencies must be weighed together. At the same time, state and local governments compete to attract new businesses, which dampens support for increasing taxes (see Kenyon and Kincaid 1991). However, from the viewpoint of long-term fiscal stability, it may be in the best interest of all to slow or stop the

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Fundamental Tax Reform — Possibilities and Problems

Monday, May 20, 1996

8:45 AM
Welcome and Introduction
Bruce F. Davie, Office of Tax Analysis, U.S. Department of the Treasury, *Symposium Chair*

9:00-10:30 AM
Responses to the Tax Reform Act of 1986—Harbingers for Future Reform?
Diane Lim Rogers, Congressional Budget Office, *Moderator*

Portfolio Shuffling and Tax Reform
Dean M. Maki, Board of Governors, Federal Reserve System

IRAs, 401(k)s, Debt, and the Tax Reform Act of 1986
Eric M. Engen, Board of Governors, Federal Reserve System
William Gale, The Brookings Institution

What Happened to Excess Foreign Tax Credits after the Tax Reform Act of 1986?
Harry Grubert, William Randolph, and *Donald Rousslang,* Office of Tax Analysis, U.S. Department of the Treasury

DISCUSSANTS
Jane Gravelle, Congressional Research Service
Richard Gordon, Arthur Andersen (invited)

10:45 AM-12:15 PM
New Techniques for Evaluating Tax Reform Proposals
Diana Furchtgott-Roth, American Enterprise Institute, *Moderator*

The Monetary Response to Tax Reforms
Lawrence Lindsey, Board of Governors, Federal Reserve System

New Modes of Distributional Analysis
R. Glenn Hubbard, Columbia University

The Role of the Joint Committee on Taxation in Analyzing Tax Restructuring Proposals
Kenneth Kies, Chief of Staff, Joint Committee on Taxation

12:30-2:00 PM Luncheon
Presiding: **Emil M. Sunley,** International Monetary Fund and President, National Tax Association
Presentation: **The Evolving Budget Process—Implications for Fundamental Tax Reform**
June E. O'Neill, Director, Congressional Budget Office

2:00-3:30 PM
State and Local Responses to Changed Fiscal Environments
Dennis Zimmerman, Congressional Research Service, *Moderator*

A New State VAT: Lessons from New Hampshire
Daphne A. Kenyon, Simmons College

Betting on Casino Revenues: Lessons from State Experiences
Ranjana Madhusudhan, Taxation Division, New Jersey Treasury

A General Equilibrium Analysis of Flat Tax Proposals on State and Local Government Revenues
Jorge Martinez-Vasquez and Richard McHugh, Georgia State University
Mark Rider, Office of Tax Analysis, U.S. Department of the Treasury

DISCUSSANT
Robert Tannenwald, Federal Reserve Bank of Boston

3:45-5:15 PM
Compliance Aspects of Tax Reform
Andrew Lyon, University of Maryland, *Moderator*

Compliance: A 21st Century Approach?
Phil Brand, KPMG Peat Marwick

Compliance and Tax Reform
Jonathan Feinstein, Yale University

Corporate Tax Compliance and Financial Reporting
Lillian F. Mills, University of Michigan

DISCUSSANT
C. Eugene Steuerle, The Urban Institute (invited)

Tuesday, May 21

8:15-9:30 AM
The Tax Reform Act of 1986: Lessons for Future Reform
Thomas A. Barthold, Joint Committee on Taxation, *Moderator*

Lessons from 1986: Hot Buttons and Third Rails
Robert J. Leonard, Washington Counsel, PC

The Tax Reform Act of 1986: Did Congress Love It or Leave It?
Randall D. Weiss, Deloitte & Touche

9:45-11:15 AM
Consumption-Based Taxation—The Devil is in the Details
Harry Grubert, Office of Tax Analysis, U.S. Department of the Treasury, *Moderator*

Consumption Taxes and State and Local Governments
Douglas Holtz-Eakin, Syracuse University

Consumption Tax Treatment of Financial Products and Institutions
Peter Merrill, Price Waterhouse

Problems in the Implementation of Consumption-Based Taxes
Jack Mintz, University of Toronto

NTA 1996 Spring Symposium Speakers

Phil Brand is Director, IRS Policies and Dispute Resolution, KPMG Peat Marwick (Washington National Tax Practice). He formerly was Chief Compliance Officer for the Internal Revenue Service, where he was responsible for the general oversight, planning, management, and coordination of all administrative and criminal enforcement programs. He also served on the IRS Executive Committee.

Jonathan S. Feinstein is Professor of Economics, Yale School of Management. He is the author and co-author of numerous studies of tax compliance and enforcement, including "An Econometric Analysis of Income Tax Evasion and Its Detection," "The Relationship between Federal and State Tax Audits" (with Jim Alm and Brian Erard) and "Econometric Models of Compliance and Enforcement: Reporting Behavior and Audit Selection Decisions" (with Brian Erard).

William Gale is a Senior Fellow and the Joseph A. Pechman Fellow, Economic Studies Program, The Brookings Institution. He formerly was Assistant Professor of Economics at UCLA, a senior staff economist for the Council of Economic Advisers, and a consultant for the General Accounting Office and The World Bank. His areas of expertise include the budget, fiscal and tax policy, capital formation, federal credit programs, intergenerational transfers, and Social Security. He is working (with Henry Aaron) on *A Citizen's Guide to Fundamental Tax Reform.*

Harry Grubert is an economist in the Office of Tax Analysis, U.S. Treasury. He received a Ph.D. from the Massachusetts Institute of Technology.

Douglas Holtz-Eakin is Professor of Economics and Senior Research Associate, Center for Policy Research, Syracuse University. He also is a Faulty Research Fellow for the National Bureau of Economic Research, and a member of the Board of Economic Advisers, New York State Assembly Committee on Ways and Means. He has taught at Columbia and Princeton, and has been a Senior Staff Economist for the Council of Economic Advisers, and a consultant to several state revenue and policy groups. His research has included the economics of public policy, federal taxes, and state and local government finance.

R. Glenn Hubbard is Russell L. Carson Professor of Economics and Finance, Graduate School of Business, Columbia University. He has been a visiting professor at Harvard and the University of Chicago, Deputy Assistant Secretary (Tax Analysis) in the U.S. Treasury Department, and John M. Olin Fellow at the National Bureau of Economic Research. He also has been a research consultant for several federal departments and international groups. He has published numerous articles on public finance, financial economics, and public policy.

Daphne A. Kenyon is Associate Professor of Economics, Simmons College. She also has served as a senior economist with the Office of Fiscal Analysis in the U.S. Treasury Department, the Urban Institute and the U.S. Advisory Commission on Intergovernmental Relations, and as an Assistant Professor at Dartmouth College. She has contributed to several state tax studies and is currently studying New Hampshire's business enterprise tax. She has published articles in a variety of journals and co-edited *Competition among State and Local Governments* (with John Kincaid) and *Coping with Mandates* (with Michael Fix).

Kenneth J. Kies is Chief of Staff, Joint Committee on Taxation. He was a partner, Baker & Hoestler (Washington DC office). He was Tax Counsel for the American Resort Development Association, Section 457 Tax Force, Amortization of Intangibles Task Force, the Insurance Accounting Group, and Coalition of Independent Casualty Companies of America. He served previously as Chief Minority Tax Counsel on the U.S. House Committee on Ways and Means. He has been a member of numerous public and private sector advisory councils and tax committees. He has published many articles on federal tax and budget policy and legislation, and taxation of employee benefits and insurance.

Robert J. Leonard served as Chief Counsel and Staff Director of the U.S. House Committee on Ways and Means. Previously, he served the Committee as Chief Tax Counsel, Staff Director of the Subcommittee on Select Revenue Measures, and budget specialist. He was involved in major legislation covering all aspects of the Committee's jurisdiction, including the *Tax Reform Act of 1986,* deficit reduction acts, and trade measures; and also played a key role in health, social security, unemployment, and welfare reform initiatives.

Lawrence B. Lindsey is a Governor of the Federal Reserve Board. He was a Special Assistant to the President for Policy Development during the Bush Administration. He is a former Professor of Economics at Harvard University. He also served as a Senior Staff Economist for Tax Policy for the Council of Economic Advisers. He was a Citicorp/Wriston Fellow of the Manhattan Institute, and received NTA's Outstanding Doctoral Dissertation Award.

Ranjana G. Madhusudhan is a Research Economist, New Jersey Department of Treasury. She has been an analyst for the New Jersey State and Local Expenditure and Revenue Policy Committee and The World Bank, and also was an economist at the National Institute of Public Finance and Policy in New Delhi. She specializes in tax policy and admininstaration, and revenue analysis. She currently is studying the tax policy implications in New Jersey of interstate banking and branching. She is Chair of NTA's Standing Committee on Taxation of Financial Institutions, Products, and Services.

Dean M. Maki is an economist at the Board of Governors of the Federal Reserve System. He is author of "Household Debt and the *Tax Reform Act of 1986*" (Center for Economic Policy Research Publication #346). His research focuses on tax policy and household financial decisions, the effect of education and financial sophistication on saving and borrowing choices, and the relationship between household debt burdens and consumption.

Jorge Martinez-Vasquez is Associate Director of the Policy Research Center and Professor of Economics, Georgia State University. He has served as a consultant on public finance to several state governments, The World Bank, IMF, and the Agency for International Development. He is a widely published authority on taxation, intergovernmental relations and public expenditures.

Richard McHugh is Associate Professor of Economics, Georgia State University. Previously, he was Director of the Center for Economic and Management Research at the University of South Florida in Tampa and the Rural Economic Development Program at Iowa State University. His other experience includes the Federal Reserve Bank of Philadelphia and the faculty ot the University of Missouri. He has served as a consultant to many state and local governments on issues of taxation and regional economic development. His current research includes telecommunications taxation, economic development policies and transportation.

Lillian F. Mills is a doctoral candidate at the University of Michigan. She is conducting research in corporate tax compliance and financial reporting. She formerly was a practicing CPA with Deloitte Haskins and Sells, and Price Waterhouse, where she was senior tax manager. She also has taught accounting and taxation at the University of Detroit.

Jack Mintz is Arthur Andersen Professor of Taxation and Associate Dean, Faculty of Management, and co-director of the International Centre for Tax Studies, University of Toronto. He is Clifford Clark Visiting Economist and Special Adviser to the Minister of Finance. He has served as a Special Adviser to the Assistant Deputy Minister, Tax Policy Branch, and as director of the John Deutsch Institute, Queen's University. He also has been a consultant with The World Bank, IMF, OECD, and national and provincial government agencies in Canada. He has published more than 100 books and articles on public finance and fiscal federalism. He is editor-in-chief of *International Tax and Public Finance*, and an associate editor of *Contemporary Accounting Research*.

June E. O'Neill is Director of the Congressional Budget Office. She previously was Director of the Center for the Study of Business and Government, and Professor of Economics and Finance at Baruch College and the Graduate Center, City University of New York. She has been an economist and researcher at the Brookings Institution, the President's Council of Economic Advisers, and the Urban Institute; Chief of CBO's Human Resources Cost Estimates Unit; and Director of the Office of Policy and Research of the U.S. Commission on Civil Rights. She has authored publications on income distribution, health insurance, labor supply and earnings, social security, welfare, and tax issues.

Mark Rider is a member of the staff of the Office of Tax Analysis, U.S. Department of the Treasury. He develops receipts forecasts for federal excise taxes and customs duties. He also provided revenue estimates for proposed legislation affecting excise tax receipts. His areas of research include tax compliance and policy.

Donald J. Rousslang is an economist in the Office of Tax Analysis, U.S. Department of the Treasury. He formerly was Chief of Economic Research at the U.S. International Trade Commission and an Adjunct Professor of Economics at George Washington University.

Randall D. Weiss is Director of Tax Economics and a Principal in the Washington National Tax Group, Deloitte & Touche. His practice consists of analysis of client-related tax policy and transfer pricing issues. He previously was Deputy Chief of Staff of the Joint Committee on Taxation, U.S. Congress, where he also served as Chief Economist. Formerly, he was an Assistant Professor of Economics at the University of Maryland. He also serves as a member of the Joint Committee on Taxation's Advisory Board on Revenue Estimation.

HOTEL INFORMATION

The Crystal City Marriott Hotel has blocked a limited number of rooms at reduced rates for those attending the NTA Symposium. Please register as soon as possible to be assured of these rates. Some rooms will be available at the prevailing government rate. **The cutoff date is May 6, 1996.** To reserve a room, call the Marriott at **(703) 413-5500 or 1-800-228-9290**, or write the Crystal City Marriott, 1999 Jefferson Davis Highway, Arlington, VA 22202-3564. **Be sure to mention that you are attending the National Tax Association Symposium.**

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trend of tax base erosion through "give-aways," not for the purpose of increasing taxes but simply to put revenue growth on a higher growth path. If such changes are not made, the growth of real revenue will decline unless adjustments are made in the rates. Again, this is due to the structural changes in the economy that cause a reduction in the elasticity of major revenue producers.

State and local governments may be tempted to make "quick fixes" to make up for revenues lost due to base erosion, instead of investing in revenue restructuring. Often, these fixes are adjustments in tax rates, and they are made with little regard to the overall tax structure and the changes in economic base that caused a problem in the first place (see Bahl 1994 and 1995, and Snell). Making these types of changes may compromise long-term usefulness of the revenue structure, reduce economic efficiency, alter equity goals, and encourage tax evasion. Increased rates also do not guarantee that the growth in revenue will keep up with the growth in income for more than a few years because the structural mismatch may continue to exist.

Following is a basic, comprehensive menu of options for discussion of ways state and local governments can adjust their revenue structures to prevent against further revenue base erosion.

- Reduce, or stop the growth of expansion of, retirement income exclusions.
- Eliminate or reduce property tax exemptions and credits, or redesign them to consider equity.
- Eliminate preferential property tax treatment for manufacturing inventories and equipment.
- Expand state and local sales tax bases to include more services and, possibly, food if it is not taxed.
- Expand user fees and charges to capitalize on personal income growth.
- Investigate the feasibility of privatizing services to reduce potential expenditure-side stress.

Age-related income and property tax exemptions and credits are especially costly, and their growth is difficult to stop as states appear to use them to compete for the support of the elderly population (Edwards and Wallace 1995). However, they will only become more expensive. In particular, state and local governments should consider the size of the retirement income/Social Security exemptions they allow. From the property tax side, retiree exclusions and exemptions are often made for equity purposes. Governments may want to do more means testing to uphold equity while preserving some of the growth in the tax base.

State and local governments are in a perfect position to take advantage of the consumption trend. The time is right to examine the taxation of services of all types. Taxation of most services is justified on equity as much as on revenue grounds. Some argue that the taxation of large service expenditures, such as those for accountants, lawyers and doctors, would be too difficult and may be inequitable. This argument has not been made in a compelling way (see Fox 1995).

Expansion of the sales tax base to food has been a controversial issue in most states (see Fox 1992), with opponents arguing that such a tax would be regressive. However, taxation of staples such as food and clothing add stability to tax bases and as such may be desirable from the standpoint of long-term growth and stability of state and local budgets. Also, exempting food from the sales tax base gives a tax benefit to high-income individuals as well as low-income individuals. The potentially regressive nature of a sales tax on food can be virtually eliminated through an income tax credit (see Fox 1992, 1995). Currently, 20 states tax food at least partially (ACIR).

As noted by Sjoquist (1995), there is an increasing trend to exempt manufacturing inventories and equipment from the property tax in an attempt to prevent further decline in the sector. Wasylenko (1995) finds that these types of tax incentives have little impact on reversing the trend of decline. In the short term, such exclusions help to erode property tax bases even further. By eliminating such tax preferences, governments may be able to stabilize some of the growth in their property tax bases. Such a measure would probably be more helpful for revenue in the short run because the decline of the manufacturing sector is likely to continue. However, equal treatment of industries is generally viewed as a basic tenet of tax policy (Musgrave and Musgrave 1984), and, as such, the elimination of such preferences may be viewed as a movement toward a more efficient system of taxes in general.

State and local governments are also in a position to look closely at user fees and charges. Fees for roads, airports, public education, and other public services may provide a steady revenue source for state and local governments. While each should be examined with respect to a community's views on the equity of such fees, there is significant room for expanding the use of such revenue instruments.

Summary

To summarize, the current economic and demographic trends and forecasts suggest that state and local governments will be faced with slower growing revenue sources while public service demands shift toward the elderly. Without some fundamental changes to income, sales, and property taxes, these trends will cause trouble for governments in the near future. However, preventing further erosion and supporting expansion of these revenue bases will put state and local governments in a higher revenue growth path without raising tax rates. Additionally, state and local governments should be encouraged to investigate expanding user fees and charges.

Notes

1. This article is based on Sally Wallace, "The Effects of Economic and Demographic Changes on State and Local Budgets," prepared for The Finance Project, Washington, DC, December 1995.

2. The federal government subjects up to 85 percent of Social Security income to taxation; prior to 1994 it was 50 percent. ACIR (1995) reports that eight states follow the federal Social Security exemption rules, 26 states fully exempt Social Security income, and the remainder use some alternative form of exemption.

3. IRS estimates that $25 billion of Social Security income was included in federal adjusted gross income in 1993. If all states imposed an average tax rate of 4 percent on this income, revenues could be increased by as much as $1 billion, or about one percent of all state income tax revenue in 1993. While this example is very rough, it helps show the magnitude of the issue of taxation of retirement income. The cost to state and local governments becomes more pronounced when other pension income also is excluded from taxation, as it is in many states.

4. Increases in the property tax base may occur due to required reappraisals at the time of sale. However, this type of housing *turnover* does not add to the property tax base as quickly as new housing *construction*.

5. Other measures of economic activity show

Fiscal Health *(continued from page 9)*

an increase in service sector output and a decline in manufacturing output. For example, in 1980, the manufacturing sector represented 19.6 percent of total gross state product; in 1990, it was 18.9 percent. The service sector represented 16.4 percent of total gross state product in 1980, increasing to 17.8 percent in 1990 (BEA 1995).

6. The broad categories of services include: utilities (16), personal services (20), business services (34), computer services (6), administrative/amusement services (14), professional services (8), fabrication, repair, and installation services (19), and other services (47).

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New Members

The Association is pleased to welcome the following new members:

NAME	STATE OR COUNTRY
David Colker	San Francisco, CA
E. William Dinkelacker	Silver Spring, MD
Douglas B. Elliott	Richland, VA
Robert F. Faisant	Orlando, FL
Janice H. Faulkner	Raleigh, NC
A. Fossati	Genoa, Italy
Michael Hannah	Raleigh, NC
Paul Hargrove	Monroe, LA
Jack L. Harper	Raleigh, NC
Michael S. Hodges	Raleigh, NC
Kenneth Hubbell	Kansas City, MO
Edward Hurley	Washington, DC
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Ednaldo Silva	Washington, DC
Niki Underwood	Raleigh, NC
Nestor S. Valeroso	Manila, Philippines
David Wentworth	Washington, DC
Hiroshi Yoshida	Tokyo, Japan
Arthur Earle Young	Lubbock, TX

Nomination Suggestions Sought

NTA Nominating Committee Chair Gerald D. Bair is requesting suggestions for nominations for five members of the Board, who will be elected to three-year terms to begin at the conclusion of the Annual Conference in November 1996.

Please send your suggestions by May 15th to:

Gerald Bair
Nominating Committee
National Tax Association
282 North Washington Street
Falls Church, VA 22046

Sales Tax Seminar A Great Success

Nearly 150 tax professionals met in Clearwater, Florida, in February, for the Sales Tax Seminar co-sponsored by the Institute of Property Taxation and the National Tax Association. The program—"The Sales Tax in the Twenty-First Century"—featured sessions on

The interstate dimensions of the sales tax (Jefferson Lines, drop shipments, compliance complexity)

Sales taxation and federal policy (consumption tax, GATT and NAFTA, the VAT)

New auditing administrative techniques (managed audits, contract auditing, how business would like states to audit)

Emerging technologies and auditing practices (taxpayer technologies, tax collector technology, taxpayer information systems, statistical sampling)

Changing who pays the sales tax (politics of sales tax exemptions, moving retail sales tax to a retail tax, intermediate transactions and supply elasticities)

Information technology and the sales tax (emerging technologies and implications for taxation, who gets to tax the services, separating intangibles from goods, the states' view)

We invite you to join us in our work

APPLICATION FOR MEMBERSHIP

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I wish to become a member of the National Tax Association.

My check for $__________ is enclosed for the payment of annual dues. I understand that $50.00 of my dues ($55.00 for foreign members) covers the subscription cost of *The National Tax Journal*, and that I will receive the *Proceedings of the Annual Conference,* the *NTA Forum,* and all other publications of the Association at no additional cost.

Sustaining Member	$ 500.00 or more
Corporation or Government Agency	$ 300.00*
Professional, corporate employee, others	$ 120.00
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* Allows up to three individuals in case of corporations, up to five in case of government agencies.

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PROGRAM AT A GLANCE – NTA 26th SPRING SYMPOSIUM

Monday May 20, 1996

RESPONSES TO THE TAX REFORM ACT OF 1986 - HARBINGERS FOR FUTURE REFORM?

- ❑ Portfolio Shuffling and Tax Reform
- ❑ IRAs, 401(k)s, Debt, and the Tax Reform Act of 1986
- ❑ What Happened to Excess Foreign Tax Credits after the Tax Reform Act of 1986?

NEW TECHNIQUES FOR EVALUATING TAX REFORM PROPOSALS

- ❑ The Monetary Implications of Tax Reforms
- ❑ New Modes of Distributional Analysis
- ❑ The Role of the Joint Committee on Taxation in Analyzing Tax Restructuring Proposals

LUNCHEON PRESENTATION – *June E. O'Neill, Director, CBO*

The Evolving Budget Process - Implications for Fundamental Tax Reform

STATE AND LOCAL RESPONSES TO CHANGED FISCAL ENVIRONMENTS

- ❑ A New State VAT: Lessons from New Hampshire
- ❑ Betting on Casino Revenues: Lessons from State Experiences
- ❑ A General Equilibrium Analysis of Flat Tax Proposals on State and Local Government Revenues

COMPLIANCE ASPECTS OF TAX REFORM

- ❑ Compliance: A 21st Century Approach?
- ❑ Compliance and Tax Reform
- ❑ Corporate Tax Compliance and Financial Reporting

Tuesday May 21, 1996

THE TAX REFORM ACT OF 1986

- ❑ Lessons from 1986: Hot Buttons and Third Rails
- ❑ The Tax Reform Act of 1986: Did Congress Love It or Leave It?

CONSUMPTION-BASED TAXATION: THE DEVIL IS IN THE DETAILS

- ❑ Problems in the Implementation of Consumption-Based Taxes
- ❑ Consumption Taxes and State and Local Governments
- ❑ Consumption Tax Treatment of Financial Products and Institutions

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