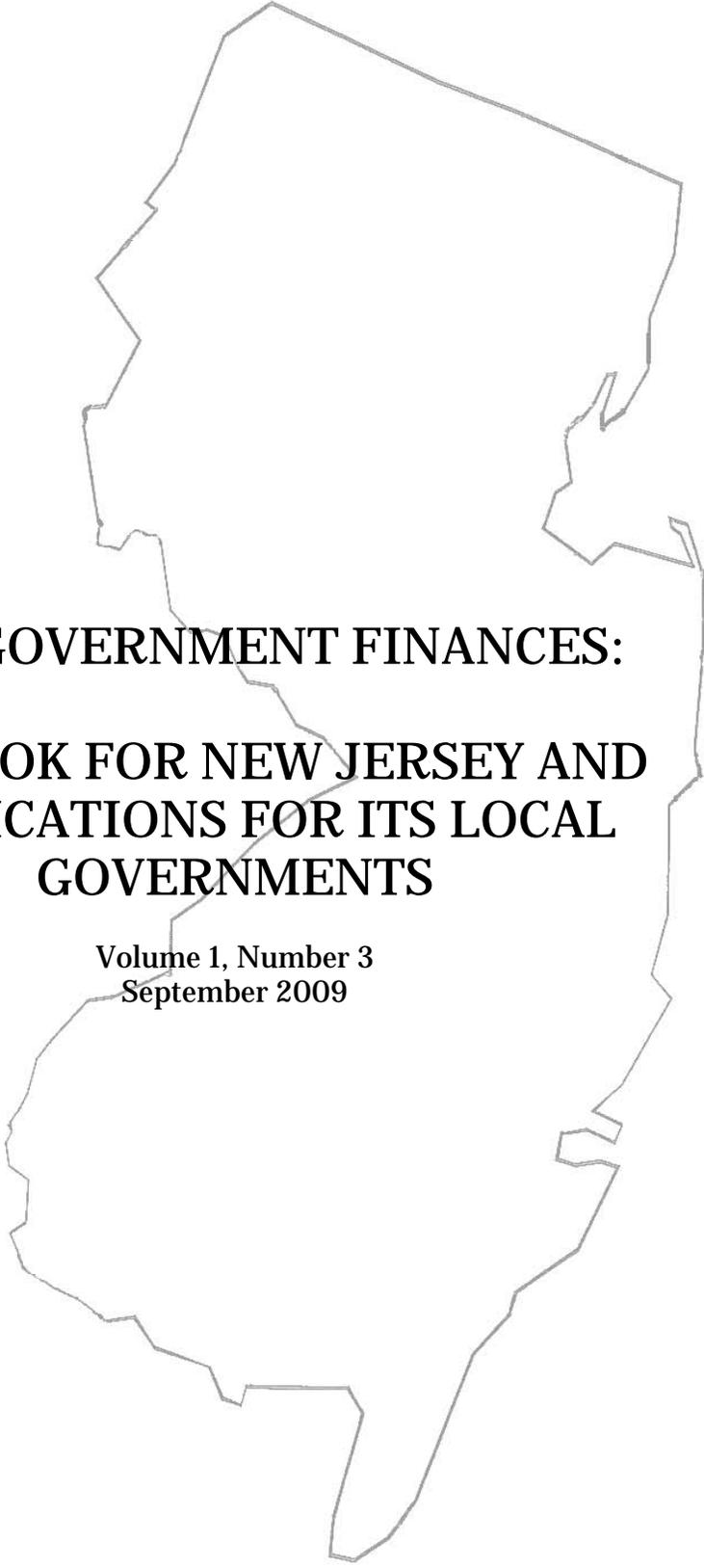


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**STATE GOVERNMENT FINANCES:
OUTLOOK FOR NEW JERSEY AND
IMPLICATIONS FOR ITS LOCAL
GOVERNMENTS**

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STATE GOVERNMENT FINANCES: OUTLOOK FOR NEW JERSEY AND IMPLICATIONS FOR ITS LOCAL GOVERNMENTS

Henry A. Coleman
Professor*
Public Policy Program
Edward J. Bloustein School of Planning and Public Policy
Rutgers-The State University of New Jersey

***Affiliation is for purpose of identification. The author bears sole responsibility for the views and interpretations contained in this paper.**

This is the third paper in NJLM Foundation's "Friends of Local Government" Policy Paper series. These papers will offer perspectives and analysis from organizations that are often heard on West State Street, but not necessarily on Main Street.

This paper offers a macro review of State government finances nationally, focusing on the implication on the Garden State's local governments. The Board of the NJLM Educational Foundation thanks the author, and believes you will find this paper informative.

We would also like to note the support of the Foundation's Board for this project, as well as staff from the New Jersey State League of Municipalities, including Bill Dressel, Michael Darcy and Taran Samhammer.

Michael F. Cerra, Policy Advisor
NJLM Educational Foundation
222 West State Street
Trenton, New Jersey 08608
www.njlmef.org

About the Author

Dr. Henry Coleman Coleman is currently a professor of public policy in the Bloustein School's Public Policy Program and the Interim Director of the New Jersey Public Policy Research Institute (NJPPRI). At the Bloustein School, Coleman teaches graduate-level courses on State and Local Public Finance, the Economics of Poverty, and Education Finance, along with an undergraduate course on Local Fiscal Policy.

Previously, Dr. Coleman was a full-time faculty member at Tufts University, and he held adjunct faculty positions at the American University, the University of Maryland, George Mason University, and Rutgers University. For almost 13 years, Coleman served as the director of the Center for Government Services, a component of the Edward J. Bloustein School of Planning and Public Policy at Rutgers, the State University of New Jersey.

Dr. Coleman is a graduate of Morehouse College, with a B.A. in Economics, and Princeton University, with a Ph.D. in Economics. He was a Brookings Economic Policy Fellow, which he spent in the Office of Policy Development and Research at the U.S. Department of Housing and Urban Development (HUD). He also served as a senior economist in the Office of the Chief Economist at the U.S. General Accounting Office (GAO) --- now the Government Accountability Office. His federal government service also includes having served as the director of Government Finance Research at the U.S. Advisory Commission on Intergovernmental Relations (ACIR).

Dr. Coleman also served as the executive director of the New Jersey State and Local Expenditure and Revenue Policy (SLERP) Commission. He also served state government as the assistant director of operations and research at the Office of State Planning and as a senior policy advisor in Governor Florio's Office of Management and Policy.

I. INTRODUCTION

Economists Therese McGuire and Gene Steuerle have observed that “at least once a decade over the past 30 years or so, the economy has taken a downturn, and state revenues have failed to keep pace with state expenditures (1).” The recession of 2007 seems to be no different. The headlines from around the country tell the story:

“Financial crisis torments states,”

(@ <http://cms.stateline.org/working/printable/story?contentId=410163>)

“The Credit Crisis and the States: Only Getting Worse,”

(@ http://taxvox.taxpolicycenter.org/blog/StateandLocalTaxes/_archives/2008/3/13/3578868)

“Shortfall Shock,”

(@<http://www.governing.com/node/2410>),

“N.J.’s credit outlook is ‘negative,’ a Wall Street agency says,”

(@ http://blog.nj.com/ledgerupdates_impact/2009/08/njs_credit_outlook_is_negative/print.html)

“N.J. state government in “worst” financial position ever.”

(@ <http://www.newjerseynewsroom.com/state/new-jersey-state-government-in-worst-financial>)

These are among the headlines that have appeared in newspapers and magazines around the country in recent times signaling the depth, breath, and general severity of the fiscal problems currently confronting state governments, including New Jersey.

Few, if any, states seem to have been spared. Center on Budget and Policy Priorities analysts McNichol and Lav explain, “some states have not been affected by the economic downturn...Mineral-rich states---such as New Mexico, Alaska, and Montana---saw revenue growth as a result of high oil prices. However, the recent decline in oil prices has begun to affect revenues in some of these states. The economies of a handful of other states have so far been less affected by the national economic problems (2).”

Moreover, there appears to be no immediate end in sight for this “worst-ever” crisis. This paper reviews the current fiscal conditions for state governments, how they have responded to the crisis, and a few policy options that may prove useful. The underlying interest is on the fiscal outlook for New Jersey and the implications for local jurisdictions in the state.

Balanced-Budget Requirements

Most states operate on a fiscal year that runs from July 1st to June 30th. Twenty-nine states operate on an annual budget and 21 on a biennial budget. Within the prevailing budget cycle, 49 of the 50 states (all but Vermont) are required to balance spending and revenues, although the nature of the balanced-budget requirement varies significantly. As observed by Brian Knight, Andrea Kusko, and Laura Rubin,

... the manner in which state governments must correct shortfalls in operating budgets depends on the requirements’ details, which vary substantially across states. These rules are either stated explicitly in the state’s constitution or are part of the laws of the state, and some states have multiple provisions that require a balanced budget. Balanced budget requirements can be placed into the following five categories, according to the state’s most stringent provision:

- 1) governor must submit a balanced budget---that is, one that contains no projected shortfall (1 state);
- 2) legislature must pass a balanced budget (5 states);
- 3) state must correct any shortfall in the next fiscal year (7 states);
- 4) no carryover of shortfall into the next biennial budget cycle (7 states);
and
- 5) no carryover of shortfall into the next fiscal year (29 states). (3)

Where states encounter problems in generating revenues to match expected expenditures within their prevailing budget cycle, fiscal shortfalls (i.e., projected budget deficits) and a fiscal crisis result. These fiscal shortfalls generally reflect either a cyclical or a structural imbalance, or both.

Cyclical Versus Structural Imbalances (4)

The nature of the fiscal crisis facing states varies by causes, severity, and appropriate policy responses. For example, the deficit confronting a particular state may be caused by downturns in the overall economy, which is called a cyclical deficit, or by more chronic long-terms disparities between revenues and spending, which is referred to as a structural deficit. In other words, a cyclical budget shortfall occurs when, during an economic downturn, state revenues fall while spending pressures increase. Revenues decline because personal income decreases, consumption by individuals and businesses decreases, and business profits decline, which combine to reduce the revenue yield for the state's personal income, (general and selective) sales, and corporate income taxes, respectively. Spending increases because poverty and unemployment increase, which leads to increased demand for public assistance, housing assistance, healthcare assistance, etc. Cyclical imbalances are certainly a cause for concern, but they are generally felt to be temporary and will likely be reduced or eliminated as the economic recovery occurs. Budget reserves, including year-end balances and Rainy Day funds, coupled with special assistance from the federal government, can often cushion the impacts of cyclical downturns.

Structural deficits are said to exist when recurring revenues are not adequate to cover recurring spending needs. These deficits are considered chronic or long-term, and often reflect the fact that the state's revenue system is not responsive to the need for more revenues as the demand for and costs of providing needed public services increase. Perhaps more importantly, structural deficits are believed to result because the tax or revenue system for many states has not adapted to reflect evolving economic, demographic, or technological conditions.

Of course, a state may suffer from either one or a combination of these budget deficits. Because of their chronic nature, structural deficits are considered to represent the more serious long-run threat to the state government. In 2005, Iris Lav, Elizabeth McNichol, and Robert Zahradnik summarized several recent studies which suggest that between 27 and 44 states, including New Jersey, were experiencing significant structural gaps in their budgets (5).

Primer: How Do State Finances Affect Local Finances? (6)

As noted by economists Rueben, McGuire, and Kellam, “when tough economic times depress revenues at the top, jurisdictions at the bottom bear the burden (7).” This statement often seems to characterize the relationship between states and their local units.

There are several linkages between State finances and local finances, including State aid, State-mandated local spending, and fiscal controls on local revenue-raising efforts. The primary connection between State and local finances in New Jersey is through the property tax.

In New Jersey, there is not a single property tax, but rather a separate property tax for each jurisdiction that is authorized to impose the tax. The municipality is the property tax collection agent for all local government in the state, collecting from homeowners and businesses not only what is needed for municipal services, but also those imposed by school districts, counties, and other special-purpose local entities, such as library and fire districts.

In many other states, a property tax rate (often called a millage rate) is established and applied to the assessed value of property within the taxing jurisdiction. Things work a little differently in New Jersey where the amount (or property tax levy) that a jurisdiction needs to get from property taxes is the difference between how much the jurisdiction will spend and how much it can get from other, non-property tax sources---such as federal and state aid, fees and charges, interest earnings, the sale of assets, and so on. As such, property taxes in New Jersey are residual taxes. That is:

Property tax levy = (local spending minus revenues available from other sources)

Each jurisdiction, every year, comes up with a property tax rate, the percentage of a home or business' assessed property value that will go for taxes. The amount of money needed and the total property value in the local jurisdiction determine the tax rate in that jurisdiction, or:

Property tax rate = (Property tax levy ÷ Property value)

Any change that increases local spending and/or decreases non-property tax revenues will increase the property tax levy, all else being the same. If state aid or some other component of non-property tax revenues declines or simply fails to keep pace with the growth in local spending, upward pressures on local property taxes will result. Likewise, any decrease in property values, due (for example) to a reduction in the number of households and businesses or to an increase in the amount of property that is exempt from taxation, will reduce the size of the tax base and put upward pressure on local tax rates.

The State government in New Jersey influences the level and rate of property taxation in several ways. First, local spending is determined by the responsibilities that the state prescribes for local government. For example, to use a somewhat extreme example, if

primary and secondary education was provided directly by the State government, as is the case in Hawaii, more than half of local spending responsibility would be removed. In a less extreme sense, if the State of New Jersey assumed a level of responsibility for financing public education similar to the average for other states (i.e., just over 50 percent versus the current contribution of around 40-42 percent), approximately \$2 billion in local property taxes could be eliminated. More generally, where the State mandates that local units spend for specific services, it adds to the pressure for local property taxes and directly influences local finances.

In addition to local spending, the State also influences local revenue. This occurs primarily in three ways. First, State aid is the largest source of other (non-property tax) revenue available to local jurisdictions. Indeed, all of the proceeds of the State's gross income tax and a portion of the general sales and use tax are dedicated to property tax relief, including State aid. While school aid has grown significantly over the last 30 years, primarily reflecting court decisions on school-funding equity, much of that incremental aid has been targeted to a relatively small number of jurisdictions. Non-school State aid to counties and municipalities has failed to keep pace with local spending requirements over the years, although it should also be noted that the State also provides non-cash and other in-kind forms of assistance to local jurisdictions that also lessen the pressure to raise property taxes. Still, the level, rate of growth, and distribution of cash assistance from the State is a major factor affecting local jurisdictions.

A second manner in which the state influences local revenue raising is through fiscal controls over the types of revenue instruments available to local units. In New Jersey, 98 percent of local tax revenue comes from property taxation. In other states around the country, local jurisdictions have access to local-option taxes, especially on personal income and sales. While arguments could certainly be made that the property tax is much better suited for local revenue raising because of its stability and predictability as a revenue source, it remains a fact that local units in many other states have far more diversified revenue bases than is the case in New Jersey.

Third, so-called "caps," or limitations on the use of the property tax, also constrain local revenue raising. Similar limitations are also imposed on the types of investments local jurisdictions can pursue with surplus revenues and on the fees and charges imposed by local governments.

Finally, growth management controls, affordable housing requirements, and property tax exemptions granted under the state constitution or statutes may limit the growth of the property tax base in some jurisdictions, thereby (*ceteris paribus*) imposing upward pressures on property tax rates.

In sum, the property tax burden in a given place relates directly to:

- The level and rate of growth of local spending
- The amount and distribution of state aid and other alternative revenue sources
- Property values, which reflect both real and inflation-induced growth

Of course, State policies and actions may affect local finances in other ways, such as through requirements for binding arbitration, pension financing, and so on. Still, the property tax mechanism is the most direct and significant in New Jersey.

II. MEASURING STATE FISCAL CONDITION

A measure of a government's ability to pay for services demanded by its residents is called "fiscal capacity," which refers to the relationship between a jurisdiction's spending needs and the resources available to finance those services. Where those resources are inadequate to meet the spending needs of the jurisdiction, fiscal stress is said to exist. Moreover, fiscal stress may be chronic and self-perpetuating if it goes unaddressed, or if the actions taken by policymakers to raise revenues and/or reduce spending turn out to exacerbate the situation. For example, there is still a good deal of debate about whether tax increases, especially if targeted on upper income households, will cause these individuals to exodus the state, thereby reducing the overall size of the tax base and making it more difficult to raise tax revenue. Therefore, changes in fiscal capacity are an important indicator of changes in fiscal stress.

There may be other important indicators of state fiscal stress. For example, the inability of a state to meet its financial obligations in a timely manner may provide a signal. The recent experience of the state of California presents a good example whereby the state was forced to issue IOUs to its workers and creditors because it was unable to raise or even borrow cash. As observed by Economics Professor Jeff Chapman, "...fiscal sustainability is the long-run capability of a government to consistently meet its financial responsibilities (8)." Also, the inability to arrive at a budget agreement in a timely manner may signal a cause for concern. For example, as of June 30, 2009, 10 states had failed to reach a budget agreement for their fiscal year that was to start on time July 1st (9). This was an unusually large number of states and their situation seems indicative of the current general status of finances for many states.

Resort to Gimmicks

Similarly, New Jersey and other states have been placed on "negative credit watch," as bond rating agencies became concerned about their use of fiscal "gimmicks"--- such as deferring expenditures to the next fiscal year, tax amnesties, inter-fund shifts within the budget, accelerating tax payments, selling assets, passing down the problem to their local units, or temporary and other one-shot revenues--- and respond to such actions by downgrading the state's bond rating (10).

Heavy Tax Burdens

Finally, heavy and/or rapidly increasing tax burdens are also considered a sign of fiscal duress among states, although there may be little agreement about what constitutes heavy or excessive tax levels. The Tax Foundation, a policy think tank that monitors government finances, notes that state and local tax burdens are at or near record levels. According to the Tax Foundation, relative tax burdens among states should be determined by examining both the state and its local governments, counting every tax that they impose, and comparing those totals to a proper measure of income.

Using their methodology, the Tax Foundation found that state and local taxes reached a record-setting 11 percent of the nation’s income in 2007. New Jersey’s state and local tax burden as a percentage of income increased from 10.5 percent in 1990 to 11.8 percent in 2008. With these increases, the New Jersey’s rank among all states rose from 33rd in 1970 to 14th in 1990 to 10th in 2007. Indeed, according to their methodology, the Tax Foundation ranked New Jersey number one among states with the highest (11.8 percent) state and local tax burden in 2008 (11).

Table 1: State and Local Tax Burdens by State for Selected Years

Jurisdiction	1977	1990	2005	2008
U.S. average	10.3%	9.9%	9.8%	9.7%
CT	10.2	9.9	11.5	11.1
NY	12.8	12.2	11.9	11.7
PA	10.2	9.8	10.3	10.2
DE	9.7	8.6	9.5	9.5
NEW JERSEY	11.1	10.5	11.4	11.8

Source: Tax Foundation (2008), “State-Local Tax Burdens Dip As income Growth Outpaces Tax Growth,” Special Report No. 163 (August).

Unmet Spending Needs

The budget numbers presented later in this report do not reflect the fact that there may be legitimate spending needs that the state will have to forego because of the fiscal difficulties that it is experiencing. “Unmet” spending needs (especially as they related to social services, education, or infrastructure maintenance or improvements) often signal fiscal difficulty for a state. For example, according to a recent news report, “New Jersey has the worst roads in the country (12).” This is a cause of concern for several reasons. First, as witnessed by the recent tragedy of a collapsing Interstate highway and bridge in Minnesota, poor roads represent a significant threat to the health and safety of residents and visitors to the state. In addition, the availability of a sound infrastructure system in a state is very important to that state’s economic development. Moreover, the budget stress experienced by the state of New Jersey may limit its ability (and willingness) to provide services needed to meet basic human needs of many of its most vulnerable citizens (13). As noted by State Treasurer David Rousseau, “to put things in perspective, we will be spending about \$9 billion less than we otherwise would spend to more fully meet New Jersey priorities and fully fund programmatic formulas (14).” Certainly, infrastructure and human service needs are likely among the casualties noted by Rousseau.

Still, budget shortfalls are probably the most common and readily available measure of the extent of fiscal difficulty being experienced by a state. Budget shortfalls are examined in the following section.

III. SCOPE AND SCALE OF THE CURRENT CRISIS

The current fiscal crisis among states is of unprecedented scope, scale, and duration. All regions of the country and all major taxes have been affected. Relative to the previous recession, the current downturn is already deeper. For example, the national unemployment rate peaked at 6.3 percent in the previous recession, but was reported at 9.7 percent for August 2009. Fears are that the unemployment rate will surpass 10.0

percent. How a particular state is affected is a function of several factors, including the differences in the national and state economies, how these differences have shaped and affect each state's revenue system, and legislated policy changes in response to these circumstances (15).

In terms of scope and scale, all but two states (Montana and North Dakota) still face or recently dealt with shortfalls in their fiscal year 2010 budget. Moreover, the pressures of the fiscal crisis were felt as far back as fiscal 2007, as three states enacted cuts to their approved budget for that year. Thirteen states made downward adjustments to their approved fiscal year 2008, and 42 states had to make reductions in their fiscal year 2009 budget after it had been adopted. In addition, about half of all states experienced negative budget growth in FY 2009, and nearly three-quarters recommended FY 2010 budgets with negative growth (16).

According to the most recent report on state revenue issued by the Rockefeller Institute of Government at SUNY-Albany, state tax collections declined for each region of the country and for each of the three major state tax revenue instruments. As seen by Boyd "...declines in state tax revenue now are worse than those of other recent recessions (17)."

More specifically, "total state tax revenue in the first quarter of 2009 declined by 11.7 percent relative to a year ago, before adjustments. The income tax was down by 17.5 percent, the sales tax was down by 8.3 percent, and the corporate income tax was down by 18.8 percent (18)." Moreover, the Rockefeller researchers report that preliminary figures for the second quarter of 2009 show that declines in personal income tax revenues will exceed the 22.3 percent recorded during the second quarter of 2002, the largest drop ever reported.

Total adjustments for fiscal year 2009, including those made at the start of the year to address shortfalls in enacting the state budget as well as any subsequent adjustments that were made once the budget was adopted, were estimated at \$110 billion. In the brief period since most fiscal year 2010 state budgets were approved, new shortfalls have appeared in 15 states, and this number is expected to increase. Moreover, more than two-thirds of the states are already anticipating deficits for their fiscal year 2011 budgets. Cumulative shortfalls covering fiscal years 2010 and those projected for 2011 are estimated at around \$350 billion, and may get even larger as states update their projections (19). Finally, as noted earlier, as late as mid-August 2009, several states have still not been able to approve a budget for their fiscal year starting July 1st, indicating on-going uncertainty and the enormity of the scale of their overall fiscal problems.

In terms of duration, recent recessions have lasted on average 8-16 months. The current recession, which began in December 2007, is already 20 months in duration and, in the eyes of several observers, there's no end in sight. The current situation has already been dubbed as the "worse situation in the last 50 years," if not the worse ever! Moreover, as discussed later, the end of the economic downturn does not necessarily signal the end to the fiscal crisis facing the states.

Many analysts agree that the current fiscal crisis is more difficult to address because many states never fully recovered from the fiscal crisis of the early part of the decade. “State spending fell sharply relative to the economy during the 2001 recession, and for all states combined it still remains below the fiscal year 2001 level (20).” Rueben, McGuire and Kellam also note the importance of the previous downturn in that “the recession of 2001 was further exacerbated by tax reductions enacted by state governments in the boom period of the late 1990s... (21)”

The size of the fiscal crisis in New Jersey has been without parallel. The state grappled with an overall deficit of \$4.4 billion in the fiscal year budget and a deficit of \$8.8 billion for the fiscal 2010 budget (see Table 2), with revenue shortfalls accounting for over 90 percent of the shortfall in FY 2009. The state’s base revenues are estimated to be down by 12% since fiscal 2008. In fiscal year 2009, revised revenues show declines for all three major categories of taxes, including the corporate business tax (down by 12 percent), the sales tax (down by almost 8 percent), and the personal income tax (down by 11.4%) (22). Problems are already evident for fiscal year 2011.

Table 2: State Budget Gaps for FY2010 and (Projected for) FY 2011 (in billions)

Jurisdiction	FY2010-\$	FY2010-% of G.F. Budget	FY2011-\$	FY2011-% of G.F. Budget
U.S. Total	\$167.6	24.3%	73.9	15.0%
CT	4.2	23.9	5.0	19.3
NY	20.0	36.1	4.6	8.4
PA	4.8	18.0	4.1	15.4
DE	0.557	17.6	N/A	N/A
NEW JERSEY	8.8	29.9	6.0	20.4

Source: Center on Budget and Policy Priorities (2009), “New Jersey Brings No Relief from Unprecedented State Budget Problems,” (September 3)

IV. WARNING: THE CRISIS MAY BE LARGER THAN IT APPEARS IN THE REAR-VIEW MIRROR

For a number of reasons, the current budget for a state may not provide an accurate or complete picture of the fiscal stress facing the state. For one thing, the budget reflects anticipated spending and revenue for the current fiscal year (or biennium). However, not all obligations confronting a state are captured by the state budget, especially in any single budget year. Moreover, there may be constraints on state fiscal actions that will limit their ability to confront future fiscal problems. Finally, the overall role of the state in the U.S. federal system appears to be expanding, albeit involuntarily in some instances.

Tax Expenditures (23)

The overall level of spending and/or the potential for revenue loss may even be greater than suggested by the budget trends noted above. This is because of tax expenditures, which are essentially spending through the tax code as states provide preferential treatment to certain taxpayers or activities that result in foregone tax revenue. Tax expenditures are often referred to as “spending masquerading as tax cuts.” They include preferential tax treatment in the form of favored tax rates, credits, exemptions, exclusions, deductions, and abatements. Many tax expenditures are provided as an inducement to economic development as policymakers attempt to influence business

decisions about where they will locate or expand their facilities, make other investments, and create jobs. Tax expenditures in the form of economic development subsidies generally differ from overall reductions in business taxes in that they are often made available to a single or limited number of taxpayers.

Tax expenditures have grown significantly over recent decades, as states have become more engaged in interstate competition for economic development. Estimates of the total amount of revenue foregone by all states are difficult to produce because not all states provide some type of tax expenditure reporting, and the reporting that is done varies widely with respect to the taxes covered, the frequency of reporting, and the methodology used to estimate revenue losses. However, McIntyre and Nguyen, researchers at Citizens for Tax Justice, a liberal policy research and advocacy organization, examined over 250 Fortune 500 companies over the 2001-2003 period. They calculated an average statutory state corporate income tax rate of 6.8 percent, which should have produced about \$67 billion in state corporate tax revenue when applied to the \$981 billion in pre-tax corporate profits realized by these firms. However, the actual amount of state corporate tax revenue paid by these 252 firms was \$25 billion, which suggests that states lost \$42 billion in corporate tax revenues over the three-year period (24).

New Jersey is one of only nine states not currently producing a tax expenditure report of any kind, even though there is a state statute that requires such a report to be prepared. As such, it is difficult to gauge just how much the state engages in this back-door spending practice, but recent actions suggest that the amount could be substantial (25).

Pensions and OPEB

The U.S. Government Accountability Office (GAO) states that there are nearly 20 million employees and 7 million retirees (and their dependents) of state and local governments who are promised pensions, and that many of these past and present workers are also promised health benefits. GAO also notes that in fiscal year 2006, state and local government pension systems paid out almost \$152 billion in benefits, while in 2004 they paid almost \$21 billion for retiree health benefits (26).

A recent report from the PEW Center on the States estimated states' retiree pensions and other post-employment benefits bill coming due over the next few decades at \$2.73 trillion, including \$2.35 trillion for employee pensions and an additional \$381 billion for retiree health care and other non-pension benefits (often referred to as other post-employment benefits or OPEB) for state (and local) employees. Estimates are that states have reserves adequate to cover about 85 percent of the pension bill, but most states have few if any reserves to cover non-pension benefits. States face about \$731 billion in unfunded retirement obligations coming due and, while the pension bill is much larger than the unfunded OPEB liabilities, it is 85 percent funded (27). Reserves for OPEB total only about three percent of outstanding obligations. The PEW study notes that in 2006, the annual cost to state and local governments for retiree health plans averaged about 2 percent of employee salaries. The cost of retiree health plans is projected to rise to 5 percent of payroll in 2050. The annual spending on these plans has been increasing

rapidly due to the general rise in medical costs and the increase in the number of retired public employees (28).

This concern for state finances here reflects two developments. First, states across the country reduced their public pension funding levels in the early part of this decade. Second, the Government Accounting Standards Board (GASB) promulgated new accounting rules requiring for the first time that the large obligations that many governments have incurred for retiree health care and other non-pension benefits be made more transparent. In June 2004, GASB approved Statement 45, which requires public employers to produce an actuarial statement for retiree health benefit plans using generally accepted accounting standards. GASB 45 requires state and local governments to report the present discounted value for the future liability of health care promises to current retirees. The actuarial report must indicate the annual required contribution that is needed to pay current health care costs and to amortize current unfunded liabilities. (Note that GASB 45 does not require public sector employers to establish trust funds for their retiree health plans or move toward full funding.) Further evidence from the Center for State and Local Government Excellence suggests that, among individual states, there is a substantial variation in unfunded liabilities depending on factors such as the size of the workforce, the generosity of the retiree health plan, the portion of the plan paid for by the state, and the type of employees in the plan. Their study finds that the problems may not be widespread or pervasive among states---some states in trouble, while others are not.

GAO describes “three key measures help to understand different aspects of the funded status of state and local government pension and other retiree benefits. First, government’s annual contributions (ARC) indicate the extent to which governments are keeping up with the benefits as they are accumulating. Second, the funded ratio indicates the percentage of the actuarially accrued benefit liabilities covered by the actuarial value of assets. Third, unfunded actuarial accrued liabilities (UAAL) indicate the excess, if any, of liabilities over assets in dollars (29). Again, states have been reporting these measures for pensions for years, but GASB 45 now requires them to report the same figures for retiree health benefits.

GAO notes that it is difficult to compare pension and OPEB funding status among states because of the many and sometimes significant differences in actuarial assumptions and methodologies used. Still, estimates provide by PEW show New Jersey as leading the laggards in that it provides only 27 percent of its annual pension bill. As a result, the percentage of total pension liability funded in the state has fallen from 102 percent in 1997 down to only 79 percent in 2006 (30).

Regarding OPEB, according to data compiled by CSLGE, New Jersey (at \$68.8 billion) has the highest UAAL among all states. New Jersey also has the highest per capita debt with a value of \$7947, which reflects a UAAL of 139.66 as a percent of the state budget and an ARC of 11.85 percent (31). Table 3 shows the unfunded liability, annual required contribution, and actual payments for both pensions and OPEB for New Jersey and selected other states in 2006.

Table 3: Pensions and OPEB Funding Levels in 2006 (in billions)

Jurisdiction	Pension			OPEB		
	Unfunded Liability	ARC	Actual Payments	Unfunded Liability	ARC	Actual Payments
CT	\$14.9	\$1.03	\$1.03	\$21.7	\$1.60	\$0.39
NY	0	2.78	2.78	49.7	3.81	0.93
PA	12.2	1.88	0.65	13.5	1.13	0.512
DE	0.21	0.12	0.12	4.4	0.48	0.14
NJ	23.1	2.18	0.59	21.6	1.88	0.31

Source: The PEW Center on the States (2008), Promises with a Price

Tax and Expenditure Limitations (TEs)

Thirty-one states have some type of tax and expenditure limitation (TEs), usually enacted via voter initiative or referendum or through actions by a state legislature. TEs may be constitutional (in 17 states) or statutory (in 14 states), and are defined to include super-majority requirements to raise state taxes. Twenty-four states have spending limits, four states have revenue limits, and 3 states have limits on both spending and revenues (32). Many of these limits tie future spending increases to changes in personal income and population.

Recent research shows that TEs have impacted state finances in several ways. First, spending has been held down. Research shows that state-level TEs serve to reduce the median state’s per capita spending from \$5867 down to \$5762, or by 1.8 percent. In addition, TEs may have different impacts on different areas of spending, with public safety being negatively affected and transportation being positively affected. TEs were not shown to affect spending levels for education, health and hospitals, public welfare, and several other areas. Moreover, state-level TEs were found to affect various revenues differently, with the share of revenues from individual and corporate income taxes (along with federal transfers) declining, and they increase the relative reliance on fees and charges. State sales taxes do not appear to be affected by the presence of TEs (33). Perhaps of greatest concern is the limitation imposed by TEs (or the fear that such a measure will be introduced) on a state’s flexibility to raise taxes in its efforts to address a future fiscal crisis. Currently, twelve states require approval by a supermajority (such as two-thirds majority vote margin) in the state legislature for an increase in taxes or fees, and another three states require voter approval.

In 1976, New Jersey was the first state to enact a state-level TE. The original TE expired in 1983. The current TE was enacted in 1990 as a statutory provision that limits the growth in the appropriation for direct state services to no more than the growth in personal income for the state.

V. HOW HAVE STATES RESPONDED---THE PERVERSITY HYPOTHESIS

The “perversity hypothesis” holds that, largely because of their balanced-budget requirements, states will be inclined to cut spending and raise taxes during economic downturns---actions that potentially add to the depth and duration of the downturn. Both

tax increases and spending reductions have been evident among state responses to the current crisis, although these actions would certainly have been much more severe in the absence of significant budget reserves and federal assistance. In addressing its fiscal year 2010 budget shortfall of \$8.8 billion, New Jersey also relied on a combination of these four strategies.

Draw Down Reserves

Total balances include budget year-end reserves and rainy day funds. These balances represent the first line of defense for states as fiscal difficulties appear. As reported in the June 2009 Fiscal Survey of the States, “after reaching a peak in fiscal 2006 at \$69 billion or 11.5% of expenditures, balances declined in fiscal 2008 to 9.1% of expenditures. However, balance levels have fallen during fiscal 2009, as balance level estimates now represent 5.5% of expenditures. Balance levels are projected to decrease to 5.3% of expenditures based on governors’ recommended fiscal 2010 budgets (34).” As such, states held the largest level of reserves ever accumulated at the start of the current fiscal crisis.

However, the existence of total reserves, especially a rainy day fund, is no guarantee that a state will not have to make difficult decisions about spending cuts and tax increases during a crisis, in part because such reserves are seldom adequate in the face of a significant and sustained economic downturn. While these reserves surely helped states to avoid more drastic actions in terms of spending cuts and tax increases to date, looking ahead, states have already used up a significant portion of their reserves and the remaining balances may not be enough to contribute very much to resolving the fiscal problems that lie ahead for states.

In New Jersey, while fiscal year 2009 budget reserves were used as a part of the governor’s strategy to close the fiscal year 2010 budget gap, a last-minute infusion of revenue from the state’s tax amnesty program provided much-needed resources to achieve the state’s balanced-budget objectives.

Spending Cuts (35)

A number of budget-cutting strategies have been employed by various states, ranging from across-the-board reductions to more targeted cuts aimed at areas generally protected against reductions during fiscal crises. While cuts are occurring in all major areas of state spending, some have argued that services directed at more vulnerable low-income residents have been more heavily targeted for reduction.

Budget cuts have been enacted in almost 80 percent of the states, with about 20 percent of all states imposing or currently considering across-the-board reductions. Even where cuts are not occurring across the board, they are affecting all major areas of state services (see Table 4), including healthcare (21 states have cut), services to the elderly and disabled (22 states), K-12 education (24 states), higher education (32 states), among other areas.

States are also passing down their fiscal problems to their localities, which in turn may result in further reductions in services such as meals for seniors and the disabled, hospital care, services for veterans, and so on.

Finally, more than 40 states have reduced the size, number of workdays or hours, or compensation for their workforce. That is, more than 26 states have instituted hiring freezes, 11 have announced layoffs, 17 have reduced state worker wages, and several have delayed costs-of-living and other scheduled pay increases. Researchers from the Center on Budget and Policy Priorities note that these budget scale backs reduce the flow of income to households and businesses, which may have adverse implications for state and local economies. New Jersey, for example, is said to have eliminated an estimated 2000 state jobs through layoffs, early retirements, and leaving vacancies unfilled.

Table 4: States Service Cuts

Jurisdiction	Public Health	Elderly/ Disabled	K-12 Education	Higher Education	State Workforce
US Total	27	24	25	34	42
CT			X	X	X
NY	X			X	X
PA		X		X	X
DE			X		X
NJ	X			X	X

Source: Center on Budget and Policy Priorities (2009), "An Update on State Budget Cuts," (September 3).

Revenue Increases (36)

Given the severity of the current crisis, every state has proposed or enacted some kind of tax or fee increase. Tax increases have been a significant part of the response by states to the current fiscal crisis, although fewer states have resorted to tax increases relative to the previous recession. Thirty states have raised taxes and another seven states are considering doing so just since the start of this calendar. These steps are in addition to the revenue actions taken by 10 states in late 2007 and 2008 as the nation entered the economic downturn. Finally, this response by state policymakers is similar to their behavior in past recessions. That is, in the recession of the early 1990s, some 44 states raised taxes, and some 30 states raised taxes in the early 2000 recession.

Based on data from more than two-thirds of the states reporting, the National Conference of State Legislatures (NCSL) reports that net tax increases to date have totaled more than \$24 billion (3% of total state tax collections) that will help reduce fiscal year 2010 budget gaps. Sixteen states have increased taxes by more than one percent.

Two somewhat new and related trends developed in terms of state tax increases. First, states relied heavily on increases in personal income taxes to raise new revenue, which had not been the pattern in recent years. Second, states specifically targeted higher income residents to assume more of the burden, although in several cases (such as in New Jersey) the increases on upper income residents are designed to be temporary. Top rates were increased and/or capital gains breaks were scaled back by several states. Many

analysts contend that raising taxes on the wealthy weakens the perversity hypothesis in that such increases are less damaging to the economy. It should be noted that several states also looked to higher fees in their efforts to address budget gaps. On balance, the net effect of tax increases and fee increases during prior state fiscal crises and the more progressive actions that characterize the current crisis seems to be that state tax systems are still becoming more regressive (37).

Federal Assistance (ARRA)

A recent article appearing in USA Today proclaimed, "...Uncle Sam has supplanted sales, property and income taxes as the biggest source of revenue for state and local government (38)." This no doubt reflects in part the impact of the \$787 billion American Recovery and Reinvestment Act (ARRA) of 2009. ARRA included approximately \$140 billion for states, or just over 35 percent of the estimated \$350 billion in state budget shortfalls. Donald Boyd of the Rockefeller Institute notes that the federal stimulus package contains about \$87 billion for a temporary increase in the federal share of Medicaid costs, about \$54 billion for a State Fiscal Stabilization Fund to help stave off cuts states might otherwise make to public education and other programs; a number of smaller funding streams that will benefit state needy populations and/or state finances; plus grants for transportation, clean water, and other construction projects. He further notes that although the federal stimulus package is very important to the finances of state governments, it is unlikely to prove large enough or sustained enough to eliminate the need for significant spending cuts or tax increases (39).

Perhaps more significant, many feel that "the low-hanging fruit has already been picked" in that state budget reserves have already been reduced, obvious budget cuts have been made, major taxes have already been increased, and the prospects of further federal assistance are dim due to growing concerns about the size of the federal budget deficit. Options for closing future budget gaps get even more difficult from here.

To close an estimated \$8.8 billion FY 2010 budget gap, Governor Corzine proposed revenue solutions of \$1.480 billion, reductions to the base budget of \$3.602 billion, elimination of reduction of projected growth of \$1.180, use of federal fiscal stimulus of \$2.263 billion, use of a portion of the FY2009 excess surplus of \$0.199 billion, and growth offset by other sources totaling \$0.035 billion.

VI. IS THIS A PROBLEM OF TOO-LITTLE REVENUE OR A TOO-MUCH SPENDING?

Economists Therese McGuire and Eugene Steuerle have concluded that "...the primary contributor to the large deficit of the early part of the present decade appears to be policy choices---the reductions in taxes and increase in expenditures made by state policymakers in the years leading up to the current fiscal crisis (40)."

Regarding state spending during the 1990s, there appears to be some disagreement as to the role that it potentially played in contributing to the current fiscal mess. Economist David Merriman argues that state spending grew significantly, albeit unevenly, during this period, from about \$2000 per capita to \$2600 per capita. He notes,

...almost half of the increase in state spending was due to increased spending for public welfare. There was also significant growth in spending for education at the elementary, secondary, and college levels, accounting for about one-quarter of the total increase in state spending. Corrections spending grew rapidly (54 percent), but accounted for only a small share of the total. Health and hospitals expenditures also grew substantially, by \$46 per capita. ...other categories of expenditure (highways, interest, and other general expenditures) grew more slowly than the economy (41).

Center on Budget and Policy Priorities analysts Elizabeth McNichol and Kevin Carey, on the other hand, show that the growth in state spending during the 1990s was slightly below the average of 2.9 percent that characterized the decades from 1949-1989, and that most of the growth in state spending that occurred during the 1990s was growth in response to population increases, inflation-induced increases in costs, and spending necessary to accommodate a growing economy (42).

Archaic Revenue System (43)

Several researchers have argued that the tax system currently in place in most states is not adequate to address the revenue needs of those states, either in the current period of the foreseeable future. The tax systems were established when the economy, technology, and demographics were very different than today. These tax systems have not been modernized to reflect current circumstances.

For example, the general sales and use tax is a major source of revenue for state government, representing slightly more than a third of general fund revenues in 2003. The state sales tax, which was first introduced back in the 1930s, was established when the U.S. economy (and that of most states) was a goods-based economy, and face-to-face contact characterized most sales transactions. However, today's economy is a services-based economy, with more and more transactions taking place through remote means, such as over the Internet or through mail-order catalogs. State sales and use taxes have not been revised to reflect this new economic reality.

As noted by the Institute on Taxation and Economic Policy, "...in 2003, services represented almost 60 percent of personal consumption nationally. Few states have successfully adapted to this change in consumption: only Hawaii, New Mexico, and South Dakota taxing services comprehensively...(44)" Similarly, Michael Mazerov of the Center on Budget and Policy Priorities notes that "... a majority of the states apply their sales tax to less than one-third of 164 potentially taxable services. Eight of the 45 states with sales taxes impose them on fewer than 20 service categories (45)."

Similarly, remote sales---including sales through the Internet, mail-order catalogs, and direct marketing--- have cost states significant amounts of foregone sales tax revenues. Whenever the resident of a state makes a purchase from an out-of-state vendor but the good in question is to be primarily consumed within the state of residence, a "use" tax obligation is incurred. Because of the U.S. Supreme Court decisions in *National Bellas*

Hess vs. Illinois Department of Revenue [386 U.S. 753 (1967)] and *Quill Corporation vs. North Dakota* [112 S Ct 1904 (1992)], the state of residence cannot force the out-of-state vendor to collect and remit the taxes generated by the transaction. The so-called Streamlining Project was initiated by several organizations---including the Multi-State Tax Commission, the Federation of Tax Administrators, and the National Conference of State Legislatures--- to address the concerns raised by the Supreme Court so that states may be able to compel out-of-state vendors to collect sales and use taxes, but the Congress has shown little interest or inclination to enact legislation that embodies the work of the Streamlining Project.

Other policies in the state tax system are similarly in need of updating. For example, many states with a personal income tax provide for special treatment of retirement income, without applying any type of means test to the taxpayer. At the time that these preferences were introduced, retirement income was a relatively small component of personal income. As the population ages and more individuals reach retirement age, income from pensions and other retirement accounts has become a more significant portion of total personal income. It now represents a significant personal income tax loss to the states (46).

The corporate income tax has also declined considerably as a source of revenue for state governments. This has occurred in part because states are attempting to reduce business taxes in order to encourage economic development.

Unfortunately, many of these concerns apply directly to New Jersey, especially those related to the treatment of retirement income on the state's gross income tax, the limited extent to which services are included under the state's sales tax base, and the tendency to engage in costly (and perhaps unnecessary and ineffective) tax competition for businesses through recent changes in its corporate business tax.

Spending Cuts Versus Tax Increases

As discussed earlier, the so-called perversity hypothesis holds that both state tax increases and spending cuts are potentially harmful during times of recession. The question is, if states have to do one or the other, which is less harmful? On the one hand, it is argued that tax increases are less harmful, especially if targeted to upper income individuals. This is because at least a portion of the higher taxes will be paid for through reduced savings. This removes fewer dollars from the income flow, and therefore has less of a dampening effect on demand and on local economies. However, opponents of this approach contend that higher taxes on upper income individual will induce flight from the state, which ultimately serves to contract the size of the personal income and sales tax base. Counterarguments are that other factors are much more important than taxes in location decisions made by households and firms. Indeed, research finding indicate that public services are more important to location decisions than tax cuts, especially if those tax cuts are financed by reductions in services valued by households and firms, such as public safety, education, and infrastructure investment.

In aggregate, evidence does not seem to support the notion that states have been profligate in their approach to spending in recent times. The increased state spending that has occurred seems consistent with the growth necessary to accommodate inflation, population growth, a growing economy, and resident demand for selected services. Moreover, the devolution of federal responsibilities to states, coupled with the growing concentration of sub-national public spending at the state level to accommodate court-ordered school funding changes, further suggests that state spending has not (in aggregate) been out of control.

However, the support in favor of the need for more revenue seems a bit more compelling in that state tax systems still reflect an economy and technology that existed 30-40 years ago. Moreover, states have engaged in (costly and destructive) tax competition through economic development incentives and other tax cuts targeted on revenue instruments that have the greatest ability to respond to economic growth and/or help states to weather the ill effects of an economic downturn. As such, these tax policy decisions have contributed to both short-run cyclical deficits and long-term structural imbalances. Both budget process reforms (especially in terms of greater transparency and discipline regarding state spending and revenue raising) and specific fiscal reforms to improve the efficiency, effectiveness, and productivity of state revenue systems would seem to be in order.

VII. WILL THE RECOVERY SOLVE STATE FISCAL PROBLEMS?

Many analysts believe that a significant and sustained economic recovery offers the best hope for states to regain their fiscal footing. Indeed, to the extent that the current crisis reflects a cyclical downturn, an economic expansion could help to alleviate much of the spending and revenue pressures being felt by state governments.

However, a return to economic prosperity is no guarantee of a return to good fortune for states. Indeed, McGuire and Steuerle emphatically state, "...an upswing in the economy will not be sufficient to solve the current fiscal crisis (47)." As McNichol and Lav further contend, "several factors could make it difficult for states to recover from the current fiscal situation. Housing markets might be slow to fully recover; their decline already has depressed consumption and sales tax revenue as people refrain from buying furniture, appliances, construction materials, and the like ...as the employment situation continues to deteriorate, income tax revenues will weaken further and there will be further downward pressure on sales tax revenues as consumers are reluctant or unable to spend (48)."

As Boyd explains, "tax revenue generally follows a U-shaped pattern after a recession, falling sharply for two or more years before beginning to recover (49)." He further notes that for the 1990 and 2001 recessions, state tax revenues have taken at least five years to return to pre-recession peaks. Moreover, the recovery for state revenues from the current recession may take even longer because of its greater depth and duration. As a major own-source state revenue, general sales taxes are especially sluggish as consumers attempt to rebuild savings and other assets after losses in their financial holdings and home values (50). As stated in the Fiscal Survey of the States, "State fiscal conditions historically lag behind any national economic recovery, which indicates that state fiscal

conditions will remain weak in fiscal 2010 and likely into fiscal years 2011 and 2012 (51).” The National Conference of State Legislatures explains that “ many states are looking at a minimum of four to five consecutive years of deep fiscal problems, and maybe more (52).”

Unfortunately, the outlook for New Jersey’s fiscal situation is not any brighter than that of the rest of the country. Several observations from David Rosen, the fiscal director of New Jersey’s Office of Legislative Services are illustrative. Rosen states that

...he expects the national economy to strike bottom in the next two to six months and then begin a slow climb upward, he foresees the state needing at least six years to dig out of the multi-billion hole in which it is presently stuck.” Moreover, he notes, “it will take to 2014 to get back to the (tax) revenue the state had in 2008.” Finally, Rosen told state legislators that “...fiscal problems can be expected to get worse as the 2010-11 budget takes shape next spring. ...the state will lose \$1.6 billion in federal aid while facing pension obligations of \$3 billion and the expiration of one-year taxes that presently bring in \$780 million. At the same time,..., there will be a need for an additional \$600 million in school aid.” “We are looking at a series of deficits in the \$6 billion range (53).

VIII. A FEW OPTIONS FOR REFORM IN NEW JERSEY

It is difficult to conceive of very much good coming from the current fiscal difficulties facing states. Perhaps looking for a silver lining, John Shannon, former executive director of the U.S. Advisory Commission on Intergovernmental Relations, has argued that

...states and localities need budget crises to squeeze painful but strengthening tax and budget decisions out of risk-averse politicians.... The adoption of most modern forms of income and sales taxes in the states occurred during bad economic times; at the same time, they achieved ‘trimmer expenditure waistlines’ (54).

There are several reforms that could prove useful in helping states to better prepare to withstand the ravages of a fiscal crisis. Some of these suggestions would improve the budget process itself, to make it more transparent and disciplined. Other reforms would improve state finances more directly.

Budget Process Reforms

First, there should be greater transparency and discipline in state budgeting. Actions here would include fulfilling the requirements of the current statute that calls for the regular reporting of tax expenditures, especially those that are aimed at providing incentives for economic development. It is impossible to determine the efficacy of such incentives in the absence of regular and accurate reporting. Information included in a comprehensive tax expenditure report would enable policymakers to determine if their goals are being met, and at what costs. Excessively costly or unsuccessful programs could be revamped or terminated. Moreover, a tax expenditure report would give policymakers a better sense of the total amount of resources being spent through tax preferences, which should

presumably facilitate their overall allocation of limited state resources in pursuit of the many objectives contained in the state budget. Again, New Jersey is currently one of only nine states that does not prepare a tax expenditure report (55).

Current Services Reporting

New Jersey should also consider producing a current services budget on a regular basis. A current services budget is an estimate of the spending requirements necessary to maintain the current level of state services, programs, and activities for future years (i.e., 5-10 years out), taking into account factors that influence future spending, such as increases in prices, overall population, and the caseloads for specific programs. A current services budget is important for several reasons. First, it allows policymakers and analysts to distinguish growth in spending from discretionary policy changes from that resulting from factors largely beyond their control. Second, it forces policymakers to be more aware of back loading, where the bulk of the costs of a new, modified, or expanded program occur in out years. Based on a report by McNichol and Okwuje, only 13 states currently prepare a current services budget (56). New Jersey would be well advised to join this list.

Tax Incidence Reporting

As noted earlier, up until the current crisis, New Jersey was similar to many other states with respect to its pattern of changing taxes. That is, the state cut progressive taxes during prosperous times, and raised more regressive taxes during periods of fiscal difficulty. While many factors may have contributed to this pattern, it also seems plausible that the absence of current and accurate information about the distribution of the state's tax burden may have played a role. As such, the state would be better prepared to make future decisions about which taxes to raise (and by how much) during a time of fiscal stress if armed with a comprehensive tax incidence report that showed how state (and local) tax burdens were distributed among households by income levels.

Fiscal Reforms

As indicated earlier, several analysts contend that, even though economic downturns occur every decade or so, policymakers are never quite prepared to respond to the ensuing fiscal crisis. McGuire and Steuerle suggest a multi-prong approach whereby, "rainy day funds can be built to higher levels, and revenue systems can be strengthened and made less volatile. Expenditures should not be set during boom times on unsustainable paths. Pension plans should adopt more conservative assumption (57)."

The following reforms have been proposed by various public finance experts to improve states ability to deal with both cyclical and structural deficits.

Rebuild Reserves

In the current and 2001 state fiscal crises, total balances played an important role in limiting the size of the responses state had to make in terms of reducing spending or raising taxes. As indicated earlier, total balances have declined from record levels of \$69 billion (11.5 percent of expenditures) down to an estimated 5.3 percent of expenditures projected for fiscal year 2010. While the suggestion is to increase both year-end balances

and rainy day funds, public finance economists Cornia and Nelson suggest that rainy day funds in particular can be improved in their design if states rely less on arbitrary rules to capitalize the funds and instead use a value-at-risk procedure to "...calculate the historic variability of state revenue sources and ...determine the amount to put in rainy day funds by how much is required to protect the state under most probable circumstances (58)." New Jersey currently follows a somewhat arbitrary rule by depositing a percentage of the revenues received in excess of anticipated levels into its rainy day fund.

Reform Tax System

Rueben, McGuire, and Kellam correctly observed that "ensuring sufficient revenues going forward, as well as having the flexibility to revamp fiscal structures, will be important for state and local governments, especially due to the growing future spending needs (59)." Over the last several decades, states have increased their reliance on non-tax revenues, including fees and charges and gambling revenues. This is largely in response to tax revolts around the country, and the resulting reluctance on the part of state policymakers to raise taxes. Although states continue to find ever more innovative ways to impose new fees or raise existing ones, the future potential of this revenue source may be limited. As such, states may have to increase their efforts to improve the efficiency and productivity of their major taxes, including revising TELs that make it more complicated to raise tax revenues when the need arise.

As previously discussed, personal income, general sales and use, and corporate income are the big three own-source tax instruments employed by state governments in the U.S. Economist David Merriman accurately predicted that, because of the pattern established by states of cutting personal income taxes when times were good and raising sales and other regressive taxes when revenues were needed during a fiscal crisis, states would have to look more to their personal income tax during future fiscal crises (60). As noted earlier, states have looked to their personal income tax (and particularly increases on their wealthiest residents) in dealing with the current crisis. The question now becomes, what do they do the next time around?

George Break laments the fact that states continue to try to deal with the "new economy" by using an old tax system (61). That is, states need to modernize their tax systems, and in so doing, they will be better prepared to deal with any future fiscal exigencies. As a general rule, economists favor taxes with broad bases and narrow or modest rates. In this regard, revising the sales tax may prove appropriate and productive. For example, Mazerov estimates that the revenue yield to states from extending the sales tax to cover "feasibly taxable services" (which consist of services consumed by households, excluding housing healthcare, education, transit, legal, funeral, and certain banking and insurance services) would total around \$87.4 billion---New Jersey's share would be just under \$4.2 billion (62).

In a separate study, Mazerov also analyzed New York State's attempt to limit revenue losses due to Internet sales when he observes that "the inability to collect all sales taxes that are legally due on purchases made over the Internet costs states billions of dollars a year in lost revenue (63)." That state enacted a new law to help address this situation in

2008, dubbed New York’s “Amazon Law.” Heretofore, states have been restricted in their ability to force out-of-state retailers to comply with their sales tax collection requirements because of two U.S. Supreme Court decisions that limited such requirements to only retailers with an in-state (bricks and mortar) presence (see above discussion). Mazerov holds that “because most of the largest Internet retailers operate affiliate programs, a significant portion of the revenue loss arising from untaxed Internet sales could be avoided if numerous states enacted and enforced similar [to New York’s Amazon Law] laws (64).” While there are no national estimates of the potential revenue yield to states if all states followed Mazerov’s prescription, he reports that New York state officials expect \$25 million in new state sales tax collections in fiscal year 2009, and they expect to generate \$33 million more in fiscal year 2010. New Jersey’s totals would probably not equal those in New York, but such a law could be helpful even if only half as productive. Similarly, University of Tennessee researchers Donald Bruce, William Fox and LeAnn Luna estimate the revenue losses to states resulting from uncollected state sales tax on e-commerce would be \$7.2 billion in 2007, with the total increasing to \$11.4 billion by 2012. New Jersey’s revenue loss in 2007 is estimated at \$128.8 million, and increasing to \$202.5 million by 2012 (see Table 5).

Table 5: State and Local Revenue Losses from E-Commerce Sales (in Millions)

Jurisdiction	2007	2009	2010	2011	2012
US total	\$7,245.6	\$6,951.4	\$8,620.4	\$10,135.8	\$11,392.7
CT	40.6	38.9	48.3	56.7	63.8
NY	550.4	528.1	654.9	770.0	865.5
PA	220.0	211.0	261.7	307.7	345.9
DE	N/A	N/A	N/A	N/A	N/A
NJ	128.8	123.5	153.2	180.1	202.5

Source: Donald Bruce, William Fox, and LeAnn Luna (2009), “State and Local Sales Tax Revenue Losses from E-Commerce,” State Tax Notes (May 18), pp. 537-557.

IX. SUMMARY AND CONCLUSIONS

A compelling case can be made that the future outlook for state finances does not bode well for local jurisdictions. This conclusion reflects the fact that the economic recovery may still be a ways off, and that state finances will not likely rebound for quite some time even after the recovery commences. Moreover, unless state revenue systems are modernized, they will continue to poorly serve state budgets. As seen by Adrienne Berman, “until the tax systems of local and state governments are fundamentally restructured, localities will be funded at the whim of the state legislatures and will be at their mercy during times of recession (65).”

Moreover, when these archaic revenue systems are combined with spending pressures that states will face during and after the fiscal crisis, budget shortfalls are likely to persist. This pattern seems to be emerging for New Jersey and other states around the country.

Indeed, in New Jersey (in the absence of court-ordered school funding assistance from the state), one can question how much of a state funding priority local jurisdictions have been over recent decades. New Jersey localities may well be firmly entrenched in what John Shannon has called the era of fend-for-yourself federalism.

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48. McNichol and Lav, "New Fiscal Year ...," p.3.
49. See Boyd, "What Will Happen..." p. 2.
50. Ibid, p. 3.
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