Losing Ground: Study Cites Eroding Revenues

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A recent national report on the stability of state revenues finds Alabama at high risk for developing a gap between revenues and necessary expenditures in the coming years. Economists call this chronic revenue shortfall a *structural deficit.* The report by the Washington, D.C.-based Center on Budget and Policy Priorities (CBPP), titled "Faulty Foundations: State Structural Budget Problems and How to Fix Them" *(www.cbpp.org),* raises many of the same concerns as Arise's 2004 fact sheet "Two Steps Back: Alabama's Structural Deficit" *(www.arisecitizens.org),* adding a national perspective on the problem and potential solutions.

Alabama earned a rating of high risk because it displayed eight out of the ten risk factors for structural budget problems identified in the CBPP study. As pointed out in Arise's 2004 fact sheet and again in this report, Alabama suffers from a structural deficit largely because the state has failed to modernize its revenue system to reflect far-reaching changes in the economy.

Ten risk factors for a structural deficit

According to the CBPP report, the main factors contributing to a state's structural deficit are:

- *The U.S. economy's shift from goods to services* – Alabama taxes fewer household services than the average state. Alabama's sales tax was last modernized in 1959, when the tax was extended to entertainments in addition to tangible personal property.

Keywords

structural deficit – the inability of a government's annual revenue to keep up with the normal increases in program costs caused by inflation and population growth.

earmarking – the practice of setting aside – through constitutional provision or statutory law – revenues from particular sources for particular budget items.

progressive tax (also called *graduated tax*) – a tax that requires people who make more money to pay a bigger share of their income than those who make less.

regressive tax – a tax that requires people who make less money to pay a bigger share of their income than people who make more money.

decouple (also called *de-link*) – break the connection between a state's tax code and certain provisions of the federal tax code.

transparent budget – a spending plan that lets taxpayers see how every tax dollar will be spent.

- *The growth of interstate sales* – The rapid growth of the Internet and on-line sales is beginning to erode sales tax revenues significantly. It is estimated that Alabama may lose in 2006 as much as $600 million in potential tax revenues to a combination of Internet sales and the failure to tax services. Internet commerce may also provide opportunities for avoiding state income taxes.
- *The aging of the population* – In 2011, the baby boom generation will begin turning 65. Alabama exempts those 65 and over from state property tax and exempts Social Security and many pension benefits without regard to need. The Legislative Fiscal Office estimated in 1999 that Alabama was losing $115 million per year in income tax from pension exemptions (the estimated loss was only $20 million in 1990). As seniors become a larger segment of Alabama's population, this tax break will likely become prohibitively expensive. In addition, consumer spending tends to decline with age, so sales tax revenue will erode as the population gets older.
- *The erosion of state income taxes* – State income tax structures are much flatter, thus less *progressive,* than the federal income tax. Alabama's tax has become flatter over time as the state has failed to change the income tax brackets to reflect salary growth and investment returns over the last 65 years.
- *The erosion of state corporate taxes* – Modern communications and transportation allow businesses to operate anywhere in the country or in the world. It is harder for states now to identify profits that should be taxable. Corporations have also exploited their increasing mobility by demanding special tax breaks from states as a condition of locating there.
- *States' failure to maintain a mix of taxes that can grow with the cost of government* – State spending pressures, such as from Corrections, Medicaid and state employees' and teachers' health care costs, continue to grow much faster than the rate of inflation. States jeopardize their ability to handle these costs by making themselves more dependent upon slow-growing revenue sources such as sales and excise tax receipts, while weakening the faster-growing taxes, such as the income tax, and failing to maintain the estate tax, a previously growing source of revenue for Alabama.

- *Federal policies that harm state revenues* – Federal law prohibits taxing Internet access and Internet sales. Alabama recently failed to *decouple* from a temporary business tax cut, known as "bonus depreciation" (since expired) that further eroded our tax base. Alabama also failed to decouple from the federal phase-out of the estate tax, which is costing us an estimated $56 million per year.
- *Other studies citing a structural gap* – Three recent independent reports found a structural deficit in Alabama.
- *Spending needs of state residents* – The CBPP study did not find greater-than-average growth in need for Alabama's state services such as health care, K-12 education and special education. However, we are at risk in two sub-factors: share of non-elderly population on Social Security Income (SSI) and growth in elderly as a share of the population. These Alabamians are dependent upon Medicaid for increasingly expensive health care needs.
- *Tax and expenditure limitations and super-majority requirements* – A number of states have laws designed to hinder tax increases, such as requiring a two-thirds or three-fifths legislative majority on such votes. The study didn't find this particular risk factor in Alabama, but we have similar problems. Our property and income taxes are bound by constitutional law rather than statute, making it difficult to modernize tax codes. Excessive *earmarking* also limits budget flexibility.

What can Alabama do?

The CBPP study offers steps to close the gap between dwindling revenues and increased costs of state government. Arise recommends the following:

- *Modernize the state sales tax* by taxing more of what people are consuming today – services, both personal and professional.
- *Ratify the streamlined sales tax agreement,* an interstate effort to simplify the design, administration and compliance requirements of state sales taxes. The agreement makes it easier for companies to collect sales taxes on online purchases by out-of-state residents. This should encourage Congress to pass legislation allowing states to require remote sellers to collect sales and use taxes. So far, 20 states have passed laws to implement the agreement.
- *Expand Alabama's definition of "business presence" in our state* and require that the state do business only with companies that collect sales tax on purchases from state residents.
- *Reduce or eliminate state property and income tax breaks based solely on age.* Adding an income limit for the existing exemptions would help.
- *Update the state income tax.* Alabama's income tax is generous to rich people and unfair to low-income taxpayers. A family with a taxable income of $6,000 pays at the same top rate (5 percent) as a family with a taxable income of $300,000. Brackets should be adjusted to make the income tax more progressive.
- *Revamp the state property tax* to capture fairer revenue, especially from under-taxed timberland and large farms.
- *Decouple from the federal law that phased out the estate tax.* This tax was a growing source of revenue for Alabama's General Fund at the time Congress passed a law to phase it out. It is estimated we are losing $54 million per year by not decoupling from the federal law.
- *Remove the corporate income tax deduction for federal income tax payments,* and lower the corporate income tax rate from 6.5 percent to 6 percent. The deduction reduces the effective rate of the current tax to only 4.2 percent. Alabama can also close loopholes that permit "profit-shifting."
- *Improve budget transparency.* Alabama needs longer-term projections of revenues and current services spending to help policymakers understand the lasting impact of their decisions on the state's financial structure. The Governor's SMART Budgeting plan, initiated in 2004, is a step in that direction. A more transparent budget would reduce opportunities for favoritism and focus attention on the greater public good.

If Alabama's tax system were a car, its license plate would read "Antique." Designed and built for the early 20th century, it can't meet our needs for the 21st. Will we continue to lurch along, struggling from year to year to write balanced budgets, or will Alabamians demand a new model? It's our choice.

This fact sheet was prepared by senior policy analyst Mary Weidler and publications director Jim Carnes. It may be reproduced with acknowledgment of Arise Citizens' Policy Project, P. O. Box 1188, Montgomery, AL 36101; (800) 832-9060; www.arisecitizens.org