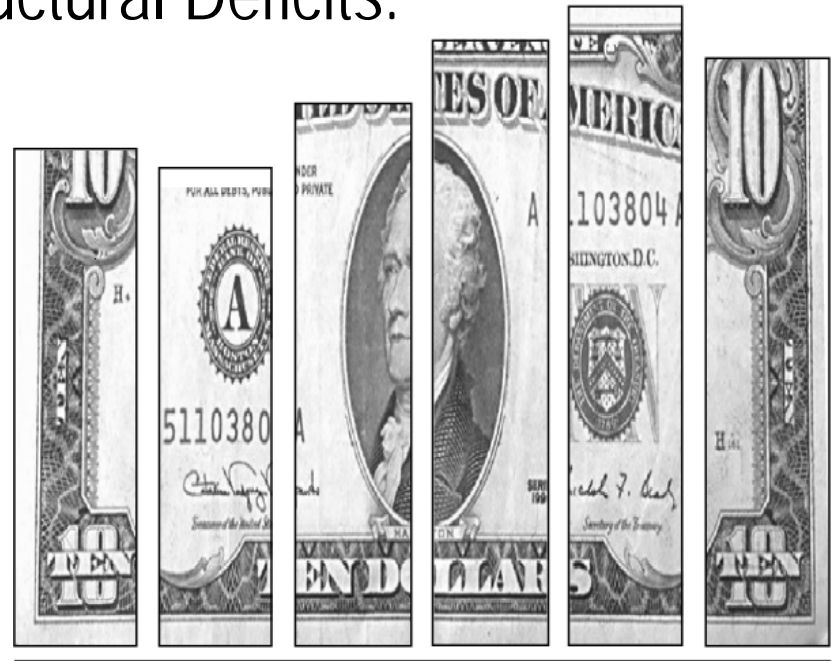


Comments on:  
"Revenue Bubbles and Structural Deficits:  
What's a state to do?"

Richard Mattoon and  
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Assessing the State and Local Sector:  
Where Will the Money Come From?  
Federal Reserve Bank of Chicago  
12 May 2009



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# Research Questions?

- Has state revenue volatility relative to the business cycle increased since the mid-1980s?
- Is revenue and expenditure composition more susceptible to economic downturns today?
- Do states have tools to address structural deficits?
- Do states have 'early warning' mechanisms?

- Reviewing earlier studies, find that
- state tax revenue correlated with the 1990 recession, lagging two quarters then rebounding.
- but lagged the 2000-01 recession, and didn't rebound due to
  - higher reliance on income tax (capital gains),
  - use of one-time revenues (not tax rate increases),
  - erosion of tax base (narrowing of tax sales tax base,
  - cross-border shopping, exemptions),
  - inelasticity of most tax sources,
  - revenue volatility

# Findings:

- Models established linkage between revenues and economic conditions
- Revenues more sensitive to economic conditions in latter period than earlier period
- Conclude: “state revenues became more sensitive to state economic conditions in 1998 and after ... explained by increased sensitivity of the income tax to capital gains realization.”

# Illinois v. Iowa

- Iowa has a more progressive tax structure
- Illinois more responsive to the business cycle (sensitivity to capital gains)

# What to do in response to business cycle downturn?

1. Reduce responsiveness of overall tax base by, e.g., raising sales tax rate, and reducing income tax reliance
2. Prepare for the downturn by creating a rainy day fund

# Revenue Bubbles and Structural Deficits: What's a city to do?

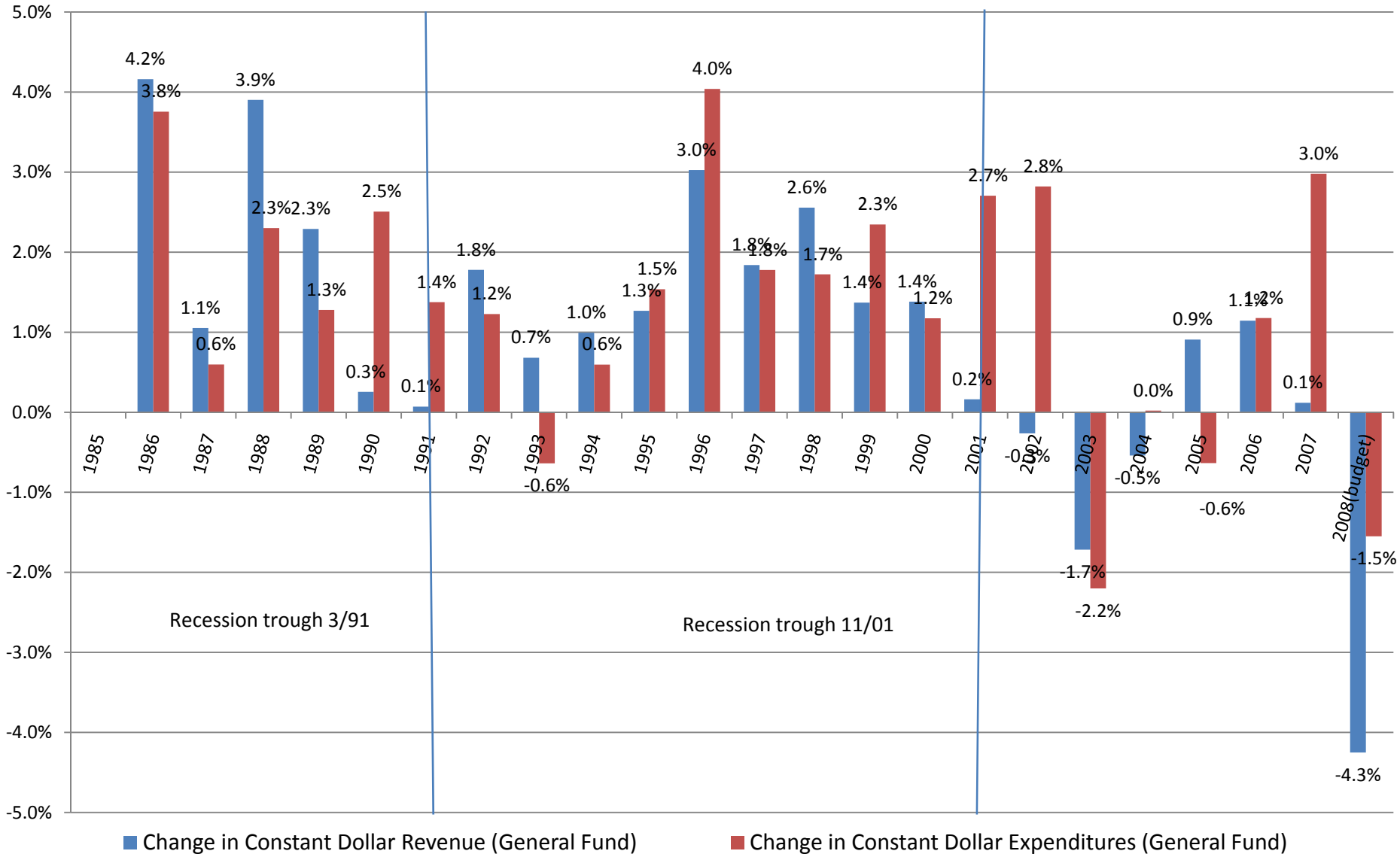
- Has city revenue volatility relative to the business cycle increased since the mid-1980s?
- Is revenue and expenditure composition more susceptible to economic downturns today?
- Do cities have tools to address structural deficits?
- Do cities have 'early warning' mechanisms?

# Municipal Revenue Structures?

- Features of municipal revenue systems vary considerably.
- Property tax receipts constitute less than 30% of own-source revenue, while user fees (including utilities) constitute nearly 40%
- More than half of US cities are granted access to the sales tax; about one in 10 to the income tax
- Average city? Myth.

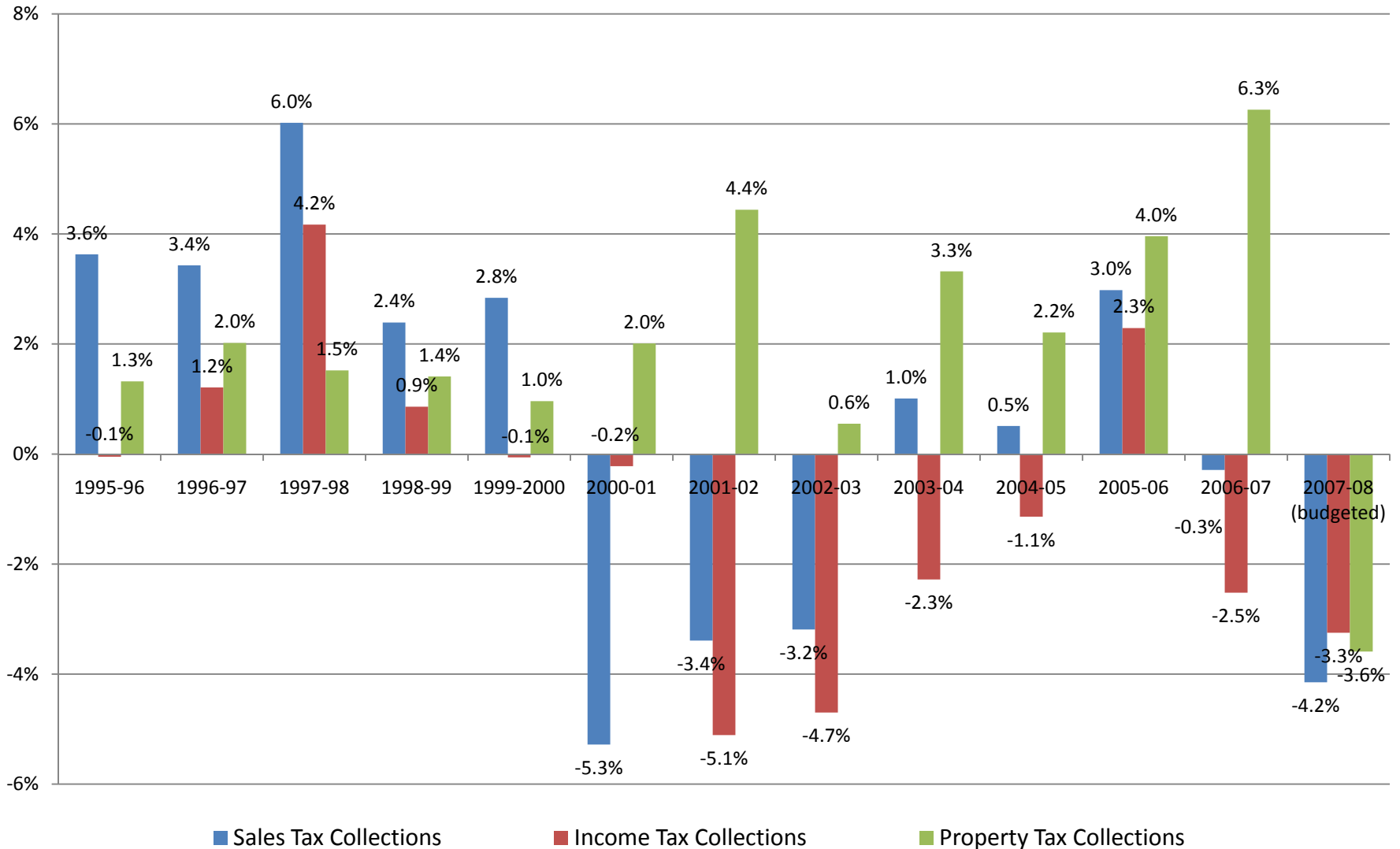


# Year-to-Year Change in General Fund Revenues and Expenditures (Constant Dollars)



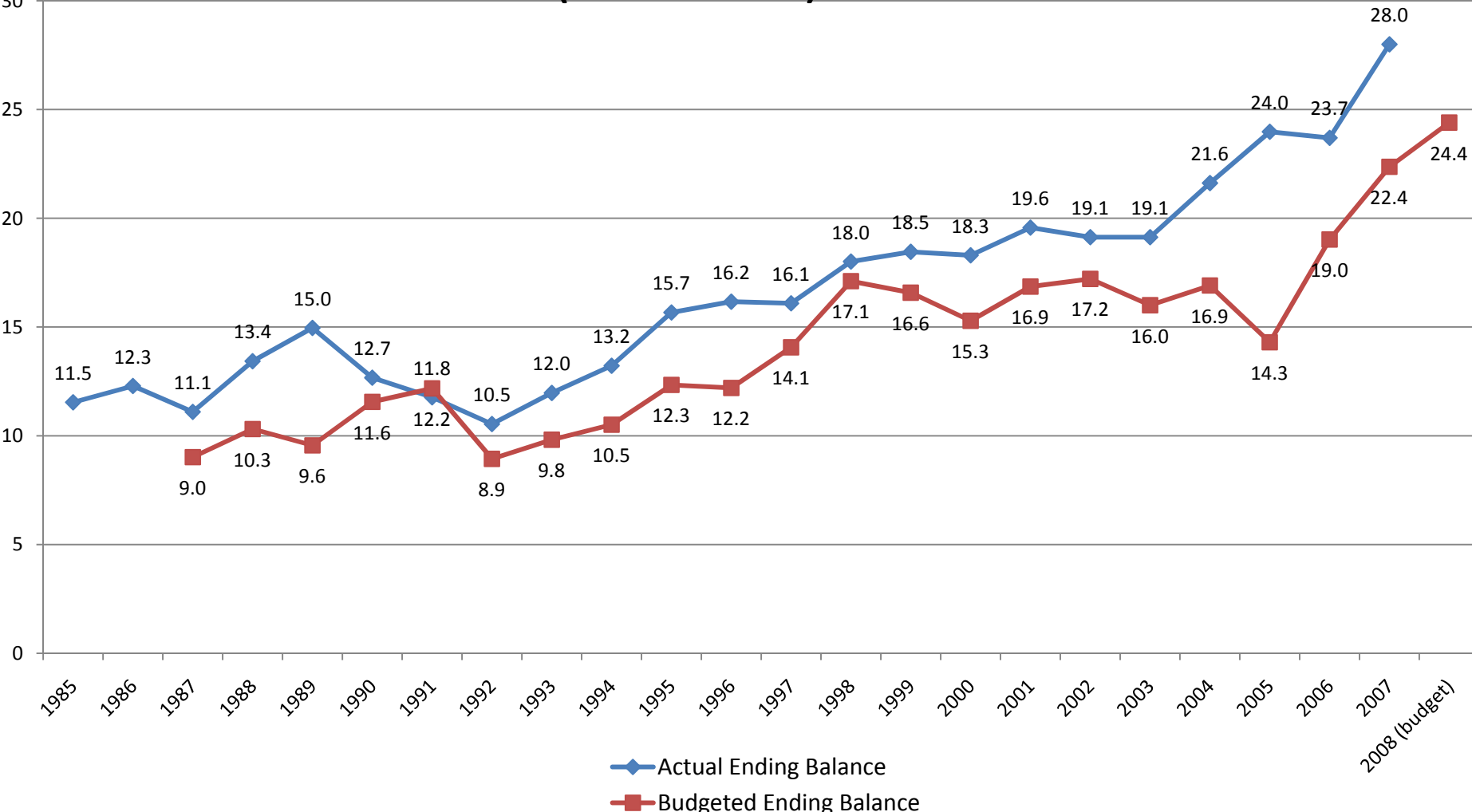
Source: Michael Pagano and Christopher Hoene, *City Fiscal Conditions in 2008* (Washington, DC: National League of Cities, 2008)

## Year-to-Year Change in General Fund Tax Receipts (Constant Dollars)



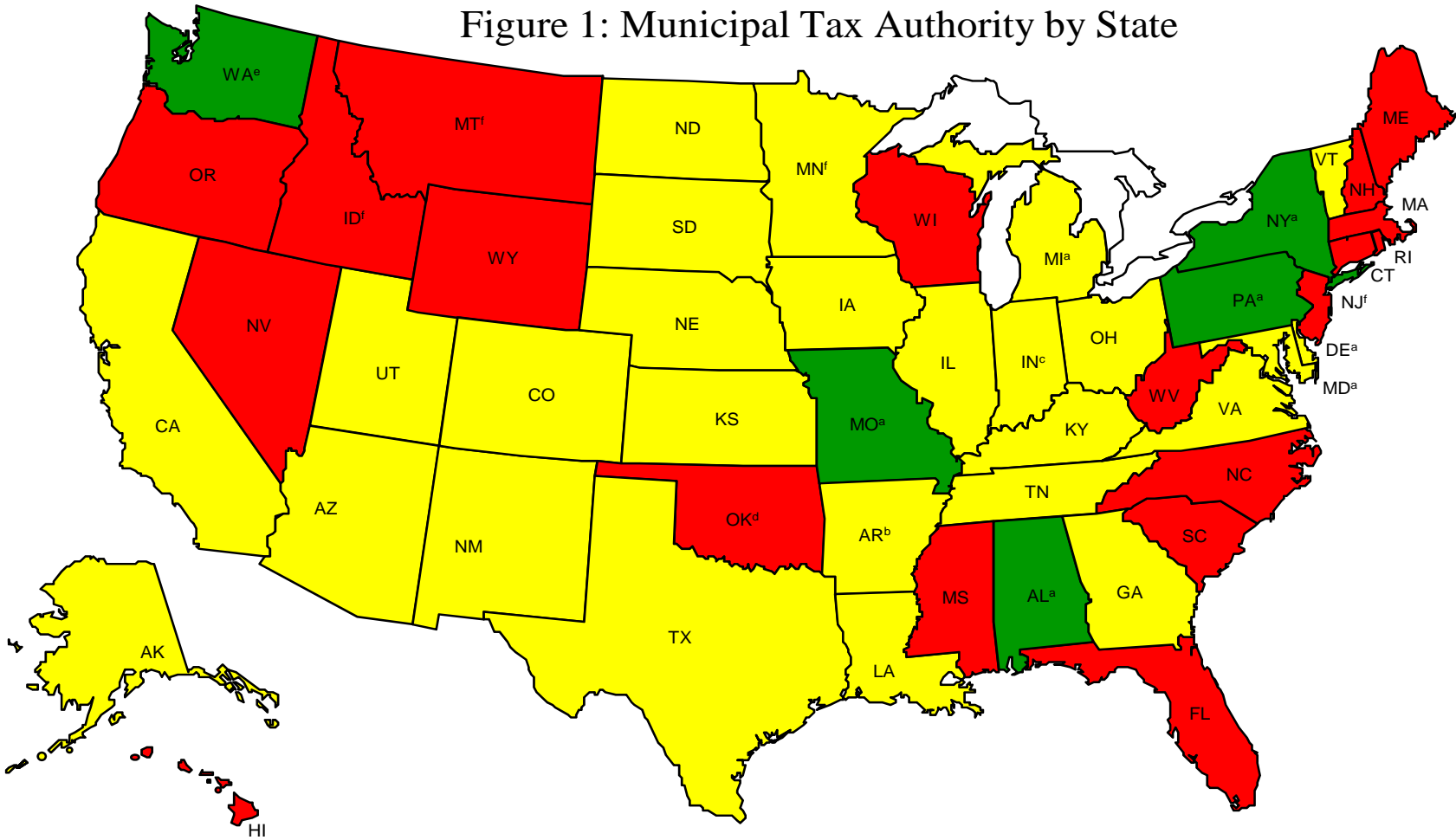
Source: Michael Pagano and Christopher Hoene, *City Fiscal Conditions in 2008* (Washington, DC: National League of Cities, 2008)

# Ending Balances as a Percentage of Expenditures (General Fund)



Source: Michael Pagano and Christopher Hoene, *City Fiscal Conditions in 2008* (Washington, DC: National League of Cities, 2008)

Figure 1: Municipal Tax Authority by State



**a** Income or sales tax for selected cities. **b** Cities can levy a local income tax, but no locality currently does so. **c** A local income tax under certain circumstances. **d** Sales tax only; cities can levy a property tax for debt-retirement purposes only. **e** Cities can impose the equivalent of a business income tax. **f** Sales taxes for selected cities and/or restricted use only.

Property + sales + income

Property + sales OR ncome

Property or sales only

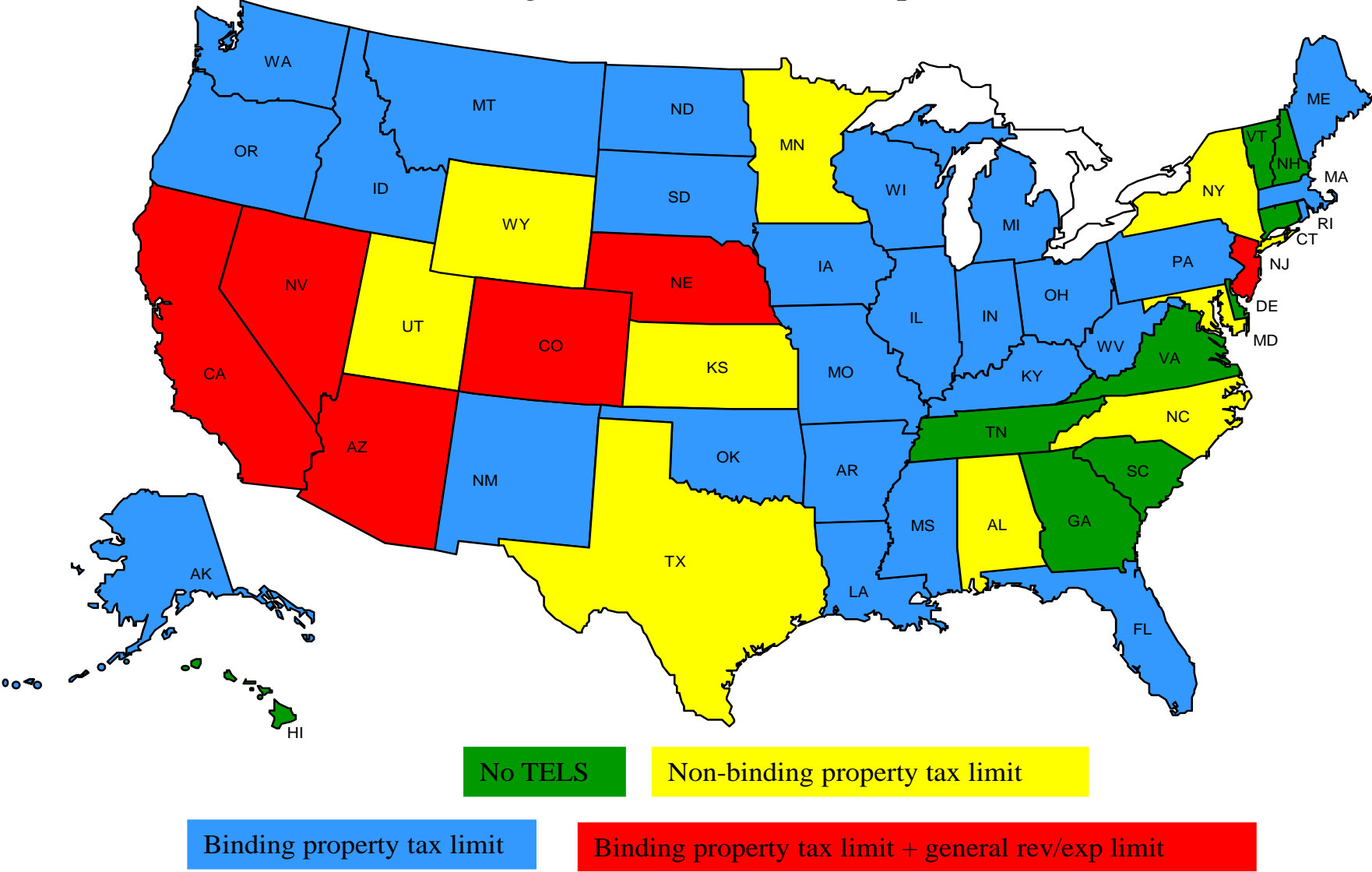
Source: Michael A. Pagano and Christopher Hoene, "States and the Fiscal Policy Space of Cities," Paper prepared for Property Tax Roundtable sponsored by the George Washington Institute of Public Policy and the Lincoln Institute of Land Policy, 14 February 2009.







Figure 5: TELs and Municipalities



Source: Michael A. Pagano and Christopher Hoene, "States and the Fiscal Policy Space of Cities," Paper prepared for Property Tax Roundtable sponsored by the George Washington Institute of Public Policy and the Lincoln Institute of Land Policy, 14 February 2009.



# Five Clusters of Cities by State

	Cluster				
	“Relatively autonomous, but TELs”	“No TEL, two revenue sources”	“Property Tax Cities, No TELS”	“One Revenue, but TEL constrained”	“Straightjacket”
Authority to Levy General Taxes (3 point scale; 1 is most authority)	1.45	2.00	3.00	2.72	2.44
Reliance on one general tax source (4 point scale, 1 is most diversified)	1.91	2.14	3.80	3.50	2.56
Proportion of total revenues derived from own-source authority	0.71	0.75	0.56	0.68	0.61
Proportion of city revenue derived from state	0.17	0.11	0.27	0.20	0.18
Four point scale of restrictiveness (1 is least restrictive)	2.91	1.71	1.40	3.11	3.89



“Maybe a new normal will take another generation to set in.”

# What to do?

- The New Normal:
  - Real estate market will be slow to recover: 2011-12?
  - Consumer spending and wages also down
  - Cities will tap into ending balances/reserves
  - Public concern/ will limit options
- Don't Waste a Crisis:
  - Renegotiate Tax Authority with the State
  - Match “engines of growth” with fiscal authority
  - Create reserve funds
  - Improve Pricing System for city services. Who Pays?

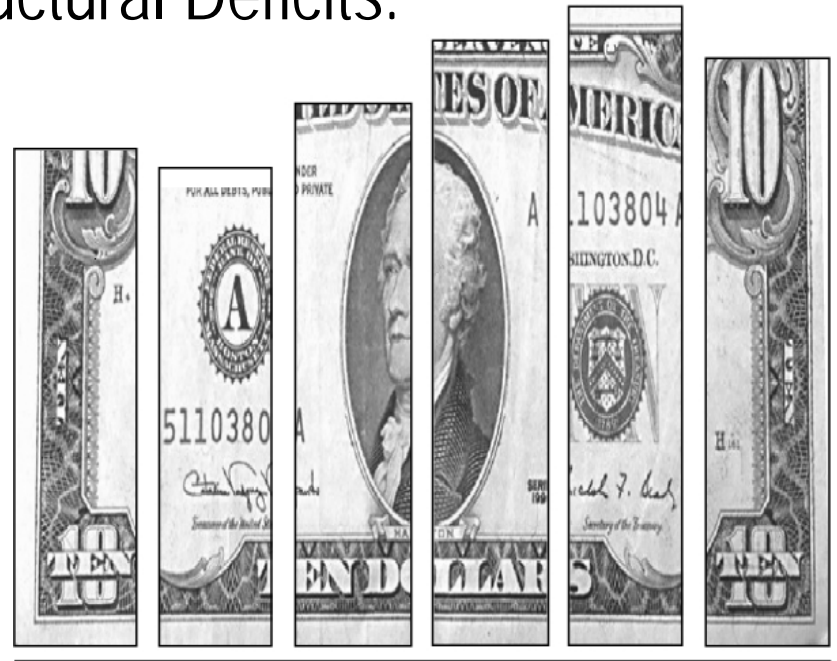
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DNK
- Is revenue and expenditure composition more susceptible to economic downturns today?  
Yes, but
- Do cities have tools to address structural deficits? N, but
- Do cities have 'early warning' mechanisms? N

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