State and Local Fiscal Reforms

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The Federal Reserve Bank of St. Louis held a conference on State and Local Government Finance and Economic Turbulence on April 9, 2010. The final conference panel looked at the themes of modernizing state tax systems, possible state budget reforms, and the proper role of state and local governments in the economy.

This paper discusses four reforms for state and local governments to consider: abolishing corporate income taxes, privatizing government activities, trimming public-sector compensation, and reforming public-sector labor laws. Those may seem like disparate policy ideas, but the common theme is that governments need to be smaller, more efficient, and more flexible if America is to prosper in an age of intense global competition.

With large budget deficits and huge pension funding gaps, many state and local governments face major financial challenges. But private businesses and individuals also face financial challenges, especially in a sluggish economy. As such, policymakers should try to reduce the burdens of taxes, spending, and regulations on the private sector. I have identified four areas for improvement, and these are discussed in the following sections.

Repealing State Corporate Income Taxes

Fiscal policy is not just concerned with governments raising enough revenue to match the spending desires of policymakers. That is the case because raising revenue creates distortions

that damage the private-sector economy. Governments should try to both minimize their funding needs and raise revenues with the least damaging tax structures. Corporate income taxes are probably the most economically damaging state taxes, at least relative to how much revenue is raised. Policymakers should consider repealing these taxes to improve the efficiency of state fiscal systems.

All the states except Nevada, South Dakota, and Wyoming impose corporate income taxes or similar levies such as gross receipts taxes.[1] State corporate income taxes raised just 2.6 percent of total state revenues and 4.0 percent of state tax revenues, on average, over the last decade.[2] Thus, states receive little revenue from the corporate income tax, but the tax substantially distorts business decision making and imposes large compliance costs on firms. One study found that business compliance costs for the state corporate tax were about twice as high as for the federal corporate tax relative to tax collected.[3] *Tax Notes* editor David Brunori notes that state corporate income taxes "consume an inordinate amount of intellectual firepower and economic resources in terms of planning, compliance, and administration."[4]

The problem is that many corporations carry out production, distribution, and other activities in numerous different states and all these states want to grab a share of corporate earnings. A three-factor formula of property, payroll, and sales is generally used to "apportion" a firm's profits between state governments, but varied and inconsistent formulas are used and the definitions of the factors are subject to disputes. The complexity of state corporate taxation is magnified because of uncertainty in the rules for "nexus," or the standards for how much presence a company must have in a state before it is required to pay taxes.

Businesses must keep track of different income tax rules for every state they operate in. They must also separate out "business income" from "nonbusiness income." Business income is apportioned between the states, while nonbusiness income (such as interest) is assigned to the state of commercial domicile. This distinction is complex and is subject to legal disputes. Some states allow separate reporting for each company in a corporate group, while other states require combined reporting for the whole corporate group. States also differ on how they tax firms' foreign affiliates.

To make it all worse, state policymakers carve out preferences and loopholes in the corporate tax base so it resembles Swiss cheese.[5] Incentive packages for favored companies and fancy credits for job training and other activities have proliferated. Such narrow breaks are unfair to businesses that pay the full tax load, and they open up government officials to corruption as firms lobby for special deals. Even if state corporate taxes were a good idea in theory—and they are not—state politicians have shown that they are incapable of enacting simple corporate taxes in practice.

The other factor to consider is that there has been a revolution in corporate taxation around the world during the last three decades.[6] Following Britain's lead in the mid-1980s, all major economies have cut their corporate tax rates. Just since the mid-1990s, the average top corporate tax rate in the 30-nation Organization for Economic Cooperation and Development has fallen from 38 percent to 26 percent.[7] During the same period, the average rate in the European Union plunged from 38 percent to 23 percent.[8] Those figures include both national and subnational taxes.

In the United States, the federal corporate tax rate of 35 percent hasn't been cut in more than two decades. At the state level, the average top rate in the 43 states that currently have corporate income taxes has actually increased slightly since 1980, from 7.0 percent to 7.5 percent today.[9] The result is that America is in a very uncompetitive position of having the second-highest corporate tax rate among industrial countries at 40 percent, including the federal rate and the average state rate. The U.S. rate is 17 percentage points higher than the average rate in the EU.

As we try to revive the national economy—and as states such as Michigan try to revive their state economies—repealing state corporate income taxes and related levies would be an excellent way to encourage long-term investment and job creation. As corporate profits become more mobile in the global economy, state corporate taxes will become even more difficult to enforce. As David Brunori notes: "The only people who really make money from the state corporate income tax system are the major law firms and big accounting firms."[10]

States should repeal corporate income taxes and make up any revenue losses by repealing business subsidies and other unwarranted giveaways on the spending side of their budgets. Actually, the corporate tax base has become so responsive in the global economy that

governments may not lose any revenue in the long run from corporate income tax repeal because repeal would cause an inflow of investment, which would generate higher state revenue from other types of taxes.[11] Either way, states should throw in the towel on the corporate income tax.

Privatization

In recent decades, governments on every continent have sold major state-owned assets to private investors. Airports, railroads, energy utilities, highways, and other assets have been privatized. The privatization revolution has overthrown the belief widely held in the 20th century that governments should own the most important industries in the economy. Privatization can often reduce costs, improve service quality, and increase innovation in formerly moribund government industries.

Privatization of state government assets makes sense for many reasons. First, asset sales can help cut state debt levels. Second, privatization can reduce the responsibilities of governments so that policymakers can better focus on their core activities. Third, there is vast foreign privatization experience that can be drawn on in pursuing U.S. reforms. Fourth, privatization would spur economic growth by opening new markets to entrepreneurs and bringing new innovation to industries.

Transportation infrastructure is one of the most promising areas for privatization reforms. Before the 20th century, transportation infrastructure was usually financed and built by the private sector. There were more than 2,000 companies that built private toll roads in America in the 18th and early 19th centuries.[12] Most of those roads were put out of business by the spread of the railroads, which were also mainly privately financed. Then entrepreneurs financed and built networks of electric streetcars in America beginning in 1880s, with systems installed in more than 850 American cities.[13] Until the early 1960s, urban mass transit in United States was mainly provided by private bus companies.[14]

Just about any service that can be supported by customer fees and advertising can be privatized. A big advantage of privatized infrastructure is that private companies can freely tap debt and equity markets for capital expansion to meet rising demand. By contrast, government

infrastructure is subject to the politics and uncertainties of government budgeting processes. As a consequence, government infrastructure is often old, congested, and poorly maintained.

Today, a number of states are moving ahead with privately financed and operated highways. The Dulles Greenway in Northern Virginia is a 14-mile private toll highway opened in 1995, which was financed by private bond and equity issues. In the same region, Fluor-Transurban is building and mainly funding high-occupancy toll lanes on a 14-mile stretch of the Capital Beltway. Drivers will pay to use the lanes with electronic tolling, which will recoup the company's roughly $1 billion investment.

How about airports? Nearly all major U.S. airports are owned by state and local governments. By contrast, airports have been fully or partly privatized in many foreign cities, including Athens, Auckland, Brussels, Copenhagen, Frankfurt, London, Melbourne, Naples, Rome, Sydney, and Vienna. Britain led the way with the 1987 privatization of British Airports Authority, which owns Heathrow and other airports. A recent survey identified 100 different companies around the world that own and operate airports, finance airport privatization, or participate in projects to finance and operate new airport terminals.[15]

In the United States, there is some growing interest in airport privatization, or at least in leasing-out airport operations to private contractors. Chicago has been close to a deal on privatizing Midway airport, for example, but the financial crisis has put that plan on hold for now.[16] In 2009, a $140 million privately financed, built, and operated airport opened near Branson, Missouri for commercial flights by Airtran and other carriers.

Or consider seaports, which in the United States are virtually all owned by state and local governments. Many U.S. ports do not operate at top efficiency levels because of inflexible union work rules and other factors. A U.S. Maritime Administration report in 2005 found that "American ports lag well behind other international transportation gateways such as Singapore and Rotterdam in terms of productivity."[17] Numerous countries around the world have privatized their seaports. One Hong Kong company, Hutchinson Whampoa, owns 30 ports in 15 countries. In Britain, 19 ports were privatized in 1983 to form Associated British Ports, and today about two-thirds of British cargo goes through private ports.[18]

What is America waiting for? Privatization would allow state governments to raise funds from asset sales to reduce their debt loads. Private firms could better gather financing for new capital investments than governments, which are always complaining that they are cash-strapped. And because of the vital role played by highways, airports, and seaports in the economy and international trade, privatization should be a high priority reform area for states to foster greater economic growth.

Reforming Government Worker Compensation

With large budget gaps in many states, substantial savings could be gained by cutting the generous compensation packages of the nation's 20 million state and local workers. In 2009, wages and benefits of government workers totaled $1.1 trillion, which accounted for half of total state and local government spending.[19]

Are state and local workers overpaid? Let's compare average compensation per hour worked in state and local governments with the U.S. private sector. According to the Bureau of Labor Statistics, public sector compensation averaged $39.66 per hour in 2009, which was 45 percent higher than the private sector average.[20] Just looking at wages, the public sector advantage was 34 percent. However, a recent job-for-job comparison of private sector and state and local workers by *USA Today* showed that wages were similar, on average.[21]

It is on the benefit side that state and local government compensation is out-of-line. Health and pension benefits are excessive. The BLS data shows that public-sector benefits per hour are 70 percent higher than in the private sector. In addition, public-sector workers receive one high-value non-monetary benefit: very high job security. "Layoffs and discharges" in the public sector occur at just one-third the rate of the private sector in good times and bad.[22]

Public sector pension benefits are recently receiving a great deal of media scrutiny, and for good reasons. As baby boomers in public-sector workforces retire, the large and underfunded (or overpromised) benefits in government pensions are starting to have a big impact on state and local budgets. Also, media articles have revealed a great number of pension abuses in states across the nation.[23]

In 2009, defined benefit pension plans were available to 84 percent of state and local workers but just 21 percent of private workers.[24] And public sector DB plans are generally much more generous than the remaining private plans. One study found that the median public sector DB plan paid benefits more than twice as high as the median private plan.[25]

State and local pension plans have a funding gap of about $1 trillion, according to official estimates.[26] But those estimates understate the poor shape of pension plans because they rely on optimistic assumptions to value future liabilities. A recent study by Robert Novy-Marx and Joshua Rauh found that governments are "severely underestimating" their pension liabilities by the use of high discount rates.[27] Using more realistic assumptions, the authors found that state and local pensions were underfunded by $3.2 trillion. At more than $27,000 for every U.S. household, that indicates a huge exposure for state and local taxpayers.

Some of the factors driving up costs in public-sector DB plans include:

- *Early Retirement*. Public sector workers generally retire earlier than private sector workers and enjoy generous pension benefits for life indexed for inflation. They can typically retire at age 55 after 30 years of work, as in California's CalPERS system.[28] In CalPERS, workers receive an annual pension equal to 60 percent of final salary after 30 years. Public safety workers in CalPERS can retire at age 50 after 30 years of work with benefits equal to 90 percent of their final salary. These lucrative benefits have put CalPERS in deep financial trouble.

- *Pension Formulas*. Virtually all public sector plans calculate benefits based on pay in the last one to three years of work. Private plans are more likely to use a lower-cost approach such as the last five years of pay or career-average pay.[29] Also, public plans typically have a more generous factor to adjust pension benefits for number of years worked. In the public sector, benefits equal to about 60 percent of pay after 30 years of work is typical. In some jurisdictions, government workers inflate or "spike" their pension earnings by getting themselves big raises or working overtime in their final year or two on the job.[30]

- *Double Dipping*. In California, New Jersey, Utah, and other states, public workers can "retire" early and then either resume their existing job or take a new job, thus receiving a salary and pension at the same time.[31]

- *Disability Claims*. Excessive and fraudulent disability claims are a growing problem. In Nevada, "firemen hobbled by heart disease can collect an inflation-protected $40,000 a year for life on top of their pension. That applies even if they're healthy enough to work in another occupation."[32] *Governing* notes that "hundreds of local governments and several states are wrestling with what some view as out-of-control disability pension and health insurance systems hard-wired to allow police and fire personnel to retire early and with very generous benefits. At the same time, they may pursue other full-time careers."[33]

- *Excessive Benefits*. News articles have revealed eye-popping annual pension amounts received by civil servants in run-of-the-mill positions in cities across the nation. In California, there are 6,144 retired public employees in the CalPERS plan and 3,090 retired teachers in the state teacher's plan receiving annual pension benefits of more than $100,000.[34]

Excessive pension benefits are creating a looming crisis for government budgets and state taxpayers. To make matters worse, governments have also built up large unfunded costs in their retiree health care plans, a type of benefit that is rare in the private sector. With a colleague, I estimated that state and local health obligations are underfunded (or overpromised) by at least $1.4 trillion, or about $12,000 per household in the United States.[35]

A final looming threat to taxpayers is the large amount of bond debt that governments are building up. Total state and local bond debt jumped 92 percent between 2000 and 2009—from $1.2 trillion to $2.3 trillion.[36] Governments are using debt to fund investments that used to be funded on a pay-as-you-go basis, and some governments are using debt to paper over routine budget shortfalls, which is the height of fiscal irresponsibility.

Policymakers should stop piling costs onto the next generation of young taxpayers. Government spending should be cut and bond debt reduced. New state and local employees should be offered

defined-contribution plans, not defined-benefit plans. Pension and health care premiums for state and local workers should be increased. Retirement ages and years-of-service requirements for pensions should be raised. Pension and health care benefits should be cut. Government staffing levels should be reduced. This may all sound quite drastic to some folks, but the huge structural gaps in government finances won't go away without dramatic action on the spending side of budgets.

Public-Sector Unions

Spending reforms, such as privatization and cuts to employee compensation, often face substantial political opposition. Reforms are more difficult to achieve particularly in those states with high levels of unionization in their public sector workforces. Public-sector unions have a substantial effect on state fiscal policies through aggressive lobbying, particularly in those states that allow public-sector collective bargaining and forced union dues.

In 2009, 39 percent of state and local workers were members of unions, or more than five times the share in the private sector of 7 percent.[37] Prior to the 1960s, unions represented less than 15 percent of the state and local workforce.[38] At the time, courts generally held that public-sector workers did not have the same union privileges that private workers had under the 1935 Wagner Act, such as collective bargaining.

That changed during the 1960s and 1970s, as a flood of pro-union laws in dozens of states triggered a dramatic rise in public-sector unionism.[39] Many states passed laws that encouraged collective bargaining in the public sector and laws imposing compulsory union dues and fees.

Today, about 26 states have collective bargaining for essentially all state and local workers. A further 12 states have collective bargaining for a portion of their state and local workers. The remaining 12 or so states do not have collective bargaining in the public sector.[40]

The union shares of state and local workforces vary widely, and they are strongly correlated with state rules regarding collective bargaining.[41] The rules range from states that actively require it, to states that allow it, to states that ban it, such as Virginia and North Carolina. In states that

require collective bargaining, half or more of public workers are unionized. In states with no collective bargaining, public-sector union membership averages just 17 percent.[42]

State union shares are also correlated with “agency shop” rules. Agency shop rules require workers to either join the union or pay a fee to the union. Today, 28 states have agency shop rules, while 22 are “right-to-work” states where workers cannot be forced to join a union or pay union fees.[43] Right-to-work states generally have much lower union shares in their workforces.[44]

Unionized public sector workers have much higher average wages and benefits than nonunionized public sector workers. Bureau of Labor Statistics data show that union members have a 31-percent advantage in wages and a 68-percent advantage in benefits over nonunion members of the public workforce.[45] However, part of this union-nonunion pay difference stems from general labor market variations across states. States with generally higher wages tend to be more unionized. Analyses that hold constant such cross-state differences find that public-sector unions increase average pay levels by roughly 10 percent.[46]

Besides raising compensation costs, unions reduce government efficiency in other ways. Unions tend to protect poorly performing workers, they often push for larger staffing levels than required, and they discourage the use of volunteers in government activities. Unions also tend to resist the introduction of new technologies and they create a more rule-laden workplace. Simple regression analyses show that states with higher union shares in the government workforce have higher levels of government debt and they receive poorer grades on public management based on Pew Center research.[47]

A final type of inefficiency created by public-sector unions is the cost of strikes in those states that allow it. In November, for example, transit workers in Philadelphia went on a six-day strike over disagreements regarding pay, which created chaos for 800,000 residents of the city who rely on government rail and bus services.[48]

In the private sector, businesses can mitigate such union-caused inefficiencies. In response to union demands for higher pay, for example, businesses can substitute capital for labor. Unfortunately, public-sector managers have little incentive or flexibility to make such changes.

Public sector unions have a broad effect on fiscal policy, as they are some of the nation's most powerful special interest groups. The National Education Association, the American Federation of Teachers, the American Federation of State, County, and Municipal Employees, and the Service Employees International Union have more than 7 million members combined, and they are very well financed. The NEA and AFT, for example, collect about $2 billion a year in member dues and fees, most of which is from jurisdictions with agency shop rules.[49]

With their large war chests, public-sector unions are active in political campaigns. Over the last two decades, AFSCME was the second-largest contributor to campaigns in the United States. The NEA was the seventh largest, the SEIU tenth largest, and the AFT fifteenth largest.[50] During 2007 and 2008, public-sector unions spent $165 million on campaigns and ballot measures.[51]

These groups generally favor increases in government spending partly because they personally benefit from expanded programs. In states such as California and Oregon, they have spent millions of dollars on various ballot measures, nearly always favoring the side of higher taxes and spending. Public-sector unions fight against school choice, privatization, and many other policies that can improve government efficiency.

To conclude, collective bargaining gives a privileged position in our democracy to government insiders who focus on expanding the public sector to their personal benefit. Monopolies in the business world usually create higher cost and lower quality services. Monopoly unions create similar problems in labor markets. With the many large fiscal challenges facing governments—such as huge pension funding gaps—policymakers need flexibility to make tough budget decisions. But powerful unions make budget reforms more difficult.

To put citizens and taxpayers back in control of their governments, collective bargaining and forced union dues should be outlawed in the public sector, following the successful policies of Virginia and North Carolina. Public employees should be free to join worker associations, but they should not be given a special legal status and handed extra power to block needed fiscal reforms.

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