

How State Budget Woes Might Affect Your Business

Author: Daniel H. Levine

Principal, MetroCompare, LLC (a management consulting company advising corporations on relocation and incentive strategies)

Scotch Plains, New Jersey

This article appears in and is reproduced with the permission of the Journal of Multistate Taxation and Incentives, Vol. 20, No. 3, June 2010. Published by Warren, Gorham & Lamont, an imprint of Thomson Reuters. Copyright © 2010 Thomson Reuters/WG&L. All rights reserved.

From coast to coast, states continue to confront massive budget deficits caused by rising costs (e.g., Medicaid, pensions, and high unemployment), plunging tax revenues, and the end of federal fiscal stimulus money. According to the National Governors Association in its 2009 "Survey of the States," during the last fiscal year, 36 states cut fiscal expenditures by a total of over \$55 billion. Notwithstanding these cuts, the cumulative state budget deficits for the upcoming fiscal year still approach \$100 billion and many observers believe that, with the expiration of all federal stimulus dollars, the following fiscal year may be even worse. Given the depth of the recession, the structural nature of state budget deficits, and prevailing political climate, there will be profound changes in the size and scope of state governments over the next decade. How these changes might affect business climate in a particular state, is the subject of this article. The following table illustrates the extent of the current problem:

Largest Projected State Budget Deficits for FY 2011

	Deficit (\$ Billions)	% of Total Budget
Arizona	\$2.6	26.7%
California	\$12.3	12.5%
Connecticut	\$4.7	26.7%
Florida	\$4.7	18.1%
Georgia	\$4.0	23.2%
Illinois	\$12.8	34.3%
Maine	\$0.94	31.4%
Minnesota	\$4.0	26.4%
Nevada	\$1.8	59.8%
New Jersey	\$10.0	34.0%
New York	\$8.2	14.8%
North Carolina	\$4.4	21.0%
Pennsylvania	\$4.1	15.4%
Vermont	\$0.34	30.2%
Wisconsin	\$3.4	24.6%

Source: McNichol and Johnson, "Recession Continues to Batter State Budgets" (Center on Budget and Policy Priorities, 2/25/10).

Expanding economic development benefits ... and the tax

base. The good news for businesses (especially in the short term) is that given the combination of huge budget shortfalls and weak labor markets, there appears to be a near universal consensus that the bulk of the fiscal gap must be closed by spending cuts and not tax hikes. As tracked by the National Conference of State Legislators (NCSL), for example there is almost no proposed legislative activity that would increase corporate taxation in almost any state this upcoming fiscal year. Two relatively minor exceptions are in Colorado, where a measure recently passed that would cap loss carryforwards at \$250,000 per year, and New Mexico, where the legislature passed a measure that would increase the gross receipts and compensating tax rate by one-eighth of a percentage point. This low level of proposed activity follows a fiscal year in which the most common adjustment to corporate taxation was the introduction or expansion of job-creation or other economic-development-related tax credits. Clearly, there is no political appetite to go after corporations as a means to balance state budgets and, in fact, the longer-term trend appears to be toward continued base broadening and a lowering of general corporate tax rates.

Many states are seeking expansions in the sales tax base, and a few are considering increasing sales tax rates. Last year, several states (e.g., California, Nevada, North Carolina) enacted temporary sales tax rate hikes with specific sunset provisions, and this same general reluctance to increase sales tax rates seems to be the norm this year as well (per the NCSL tracking data). In the spring of 2010, Arizona voters will be asked to increase their state sales tax by one percentage point, but this referendum is clearly an exception to the rule. By and large, the most common approaches to boost sales tax revenue that are under consideration for this coming fiscal year are to increase "sin" taxes (tobacco and alcohol); to begin imposing sales taxes on candy, soda, and snack food (apparently, junk food is the new frontier in "sin" taxation); and, following a general trend that has been bubbling near the surface for some time, to attack the problem of Internet taxation (e.g., Colorado and Vermont).

What about the Internet? With respect to the Internet issue, eventually Congress might take action to restore sales tax equity and bring revenue to the states by closing the Internet "loophole" rather than continue to have the states keep trying to address the issue in piecemeal fashion. The Internet "loophole" costs states an estimated \$5 billion to \$10 billion annually and has a perverse economic development effect on "Main Street" brick-and-mortar businesses.

One idea, for example, is for Congress to impose a 10% excise charge on all Internet transactions not already subject to state sales tax reporting and collection requirements. A business then could avoid paying this federal "Internet" tax by registering as a sales tax agent in any state in which it makes Internet sales (even those in which the business has no established nexus). At a 10% federal rate, it generally will be cheaper for a company to "voluntarily" register as a sales tax agent and collect state sales tax rather than subject its transactions to the higher federal tax rate.

Without some level of federal support, however, it is difficult to see how the states will get much traction in addressing this issue, despite their individual efforts at reform. (For background the states' efforts, see, e.g., Friedman, Kearns, and Houghton, "Streamlined Sales Tax Update: The Long Journey Towards a Simplified Sales Tax System," 16 JMT 6 (March/April 2006), and Edwards, "Streamlined Sales Tax Project Seeks to Expand Collection of Tax by Remote Vendors," 11 JMT 6 (August 2001).) Over the longer term, many businesses might prefer that states be allowed to tax all retail sales (including Internet) rather than limiting new ideas for raising sales tax revenue to the taxation of

more and more business service transactions (a trend likely to resurface once the economy improves but before the state budgets recover).

Taxing high earners while cutting services: will it affect economic development?

So, given that for this fiscal year at least, the states are not generally relying on an expansion of sales tax or corporate tax to balance these massive budgetary shortfalls, where is the money coming from? One place is from the increased taxation of high earners, and the other key area is in unprecedented proposed spending cuts. The state budgetary crisis might be sparing your business from taking a direct hit, but chances are that your employees will not be so lucky.

Last fiscal year, a whole host of states (including Connecticut, Delaware, Hawaii, Oregon, and Wisconsin) raised personal income taxes on high-wage earners. Although many of these increases are "surcharges" with specific sunset provisions, time will tell whether legislatures actually let them expire. This fiscal year, the same trend appears in place with new high-wage surcharges currently proposed in Illinois, North Carolina, Virginia, and several other states. Taken in isolation, increases in personal income tax rates might be annoying to those required to pay but, in and of themselves, are rarely so onerous as to fundamentally change a state's business climate. Very high-tax-rate states like California, Oregon, New Jersey, or New York (each with a top personal income tax rate in excess of 10%) are, of course, the exception. This time around, however, dramatic cuts in overall state spending, in combination with increasing personal income tax rates, has the potential to begin fundamentally altering the economic development climate more quickly than might be imagined.

Spending cuts at the state level inevitably mean that local spending will be commensurately reduced or property taxes will rise. For example, according to the National Governors Association, the states spend 35% of general fund revenue on K-12 education and an additional 11% on higher education. Thus, with nearly half (46%) of state expenditures going to support education, it becomes inevitable that K-12 and post-secondary public institutions will bear the brunt of spending cuts implemented by states with severe fiscal imbalances. Last fiscal year, 66% of school districts experienced teachers layoffs and there is every indication that this percentage will rise next fiscal year. For example, Kansas City has already announced that it is closing 50% of its public schools. Rising property taxes, perceived deterioration in the public schools, and potentially higher personal income tax rates may prove to be a lethal combination in communities already confronting a disgruntled population. If your company happens to be situated in such a locale, pay close attention to adverse trends that emerge in employee recruitment or retention.

While all states have been adversely affected by the recession, the most severe problems show regional variation. The biggest state budget deficits tend to be concentrated in those regions that were already showing signs of fiscal and economic development stress going into the recession; for example, the Northeast, Great Lakes, and West Coast regions. In contrast, regions that had relatively healthy business climates going into the recession have been much less severely inflicted with budgetary woes as a result of the recession; for example, the Gulf Coast, Central Plains, and Rocky Mountain regions. Arizona, Florida, and Nevada, however, are important exceptions to this overall trend. Stated differently, in the interstate competition for jobs, those regions that were already winning going into the recession appear poised to strengthen their relative position coming out of the recession.

Conclusion. What does all this mean for your business? Traditionally, one of the great constraints preventing businesses from moving operations to a lower-cost location is fear of employee turnover. Now, employee dissatisfaction with the home community, recruitment difficulty, and increasing employee turnover may accelerate a company's need to move to a lower-cost location. When it comes to reducing cost and improving business climate, this time around your company and your employees might literally want to move in the same direction. □

© 2010 Thomson Reuters/RIA. All rights reserved.