

FINANCING GOVERNMENTS IN THE 21ST CENTURY:

INTERGOVERNMENTAL COLLABORATION CAN PROMOTE FISCAL AND ECONOMIC GOALS

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A Summary Report from an Intergovernmental Forum of the
NATIONAL ACADEMY OF PUBLIC ADMINISTRATION

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INTERGOVERNMENTAL COLLABORATION CAN
PROMOTE FISCAL AND ECONOMIC GOALS

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The views in this report are based on the discussion at the Forum meeting and research by Academy staff. They do not necessarily represent the views of the Academy or the Forum Principals.

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THE INTERGOVERNMENTAL FORUM ON REVENUE SYSTEMS

Although governments at all levels have become increasingly interdependent, limited opportunities exist for officials to meet and discuss common problems and potential solutions across the boundaries of the intergovernmental system. The Intergovernmental Forums, convened by the National Academy of Public Administration in concert with a consortium of organizations representing state and local officials, seeks to fill that void.

Bringing together federal, state and local leaders to discuss shared challenges, the Forums are designed to reinstitute a neutral forum for informed dialogue in a manner that disappeared with the demise of the Advisory Commission on Intergovernmental Relations (ACIR) more than a decade ago. The Intergovernmental Forum on Revenue Systems was the first in the series of Intergovernmental Forums convened by the Academy.

This summary report captures the major themes, challenges and solutions shared among the forum participants over a ten-month span, from May 2005 to March 2006. The Academy will issue a more extensive final report in late summer 2006.¹

RECOGNIZING INTERGOVERNMENTAL REVENUE PRINCIPLES

How much revenue should be raised? *How* should revenue be raised? These questions are as old as government itself. Elected officials and administrators at all levels of government devote enormous amounts of time and energy figuring out how to pay for services and activities that the economy needs and the public values. The source is taxes, which nobody likes to pay and which themselves influence economic activity.

¹A list of individuals involved in this effort and the approach used is detailed in a section at the end of this Summary Report.

Looking forward, officials can expect to devote even more time to these questions. Revenue issues are an integral part of the mounting pressures for change that affect society and fiscal affairs at every level of government.

When deliberating about revenue systems, it is generally acknowledged that tax policy should be based on its conformance to principles of sound taxation.² Raising revenues sufficient to support the level of government desired by the public is fundamental. However, taxes do more than raise revenue. They affect economic decision making, change the distribution of income and impose compliance and administrative costs on tax filers. Tax policy also is expected to meet and attempt to balance other criteria or principles, including:

- economic efficiency
- equity
- transparency/simplicity
- administrability

These principles suggest that a sound tax system raises sufficient revenues; makes administrative sense in a way that taxpayers and administrators can understand; provides fairness in terms of how burdens are distributed; and does not inappropriately distort economic decision-making. All told, policymakers face a difficult task; compromises and accommodations are necessary to balance sometimes competing principles.

This summary report not only highlights these classic revenue system principles. It also encourages policymakers, administrators and the public to think about them from an intergovernmental perspective. Ultimately, it is the design of the entire tax system of all governments—not just the federal government—that determines whether the revenue system as a whole achieves the goals embodied in these principles. The magnitude of this challenge requires officials at all levels to become more thoughtful about revenue systems to ensure that they keep pace with the times and are not harmful to the economy and society or a barrier to change.

²An Issue Brief on Sound Principles of Taxation can be found in an Appendix to the forthcoming Forum report. The brief, prepared for the Principals of the Forum, includes a bibliography of resources that offer in-depth explanation of experts' views on these principles and ways to balance them.

USING FORESIGHT TO ANTICIPATE CHANGES

The Intergovernmental Forum on Revenue Systems identified major economic and social forces that are generating unprecedented pressure on revenue systems and public finances.³ They include:

- globalization
- advancing technologies
- shift to a knowledge-based economy
- aging of the population
- structural fiscal imbalances

These forces already have consequences for the tax bases and spending programs at all levels of government. Globalization makes most taxes more difficult to enforce. For instance, multinational corporations can exploit different tax rates and rules by allocating their income and assets across jurisdictions for tax planning reasons. Technologies, such as the Internet, have challenged tax officials to apply traditional sales taxes to transactions that easily cross geographic and jurisdictional boundaries. Further, a greater proportion of consumption occurs in services now than in the 1960s with much of it not reached by retail sales taxes.⁴ A greater share of business balance sheets is composed of intangible, knowledge-based assets that are more difficult to value for purposes of income and property taxes. The shifting base of the adapting economy should trigger governments to consider adapting their revenue systems, as well.

An aging population includes both a higher number of retirees and a lower number of workers available to finance the social insurance costs of retirees. This population will slow the growth of specific revenue sources as the elderly have lower income (affecting the revenue productivity of income taxes); consume less goods and services (affecting sales tax productivity); and

³Numerous reports and papers have commented on forces at work in the United States and their implications for public finance, including *Governance in the New Economy*, Raymond C. Scheppach and Frank Shaffroth, National Governors Association, Washington, DC, 2000. Also *Toward a System of Public Finance for the 21st Century*, National League of Cities, 2000.

⁴According to the Bureau of Economic Analysis (BEA) National Income and Product Accounts, the percentage of personal consumption spent on services grew rapidly from January 1959 to January 2003 (from 39.7 percent to 59.3 percent). See Table 2.8.5, Personal Consumption Expenditures by Major Type of Product, last revised June 30, 2006.

often are exempted from portions of the property tax through local “circuit breakers” (affecting property and wealth taxation). Most important, a slower growing workforce is expected to inhibit economic growth and tax revenues at the very time when government spending is projected to explode due to these same demographic changes.⁵ Aging populations and rising health care costs are the single largest drivers of longer-term spending pressures on federal and state governments. These shifting economic, demographic, technological and political forces have rendered fiscal affairs increasingly unsustainable. Simply put, current revenue systems are unable to generate sufficient revenues to meet spending needs.

U.S. Government Accountability Office (GAO) models show that, absent policy changes on the tax and spending sides of the federal budget, federal deficits could balloon over the next three decades to levels exceeding 20 percent of Gross Domestic Product (GDP). At current levels of taxation, the federal government would be able to finance little more than payments to the elderly and their doctors. An Academy committee recently concluded that fundamental changes are necessary on both sides of the budget; revenue and spending policies must be reexamined to restore the federal government’s finances to a sustainable footing.⁶

These fiscal trends are not confined to the federal level. They affect society and the entire economy and leave a lasting imprint on every level of government. For example, aging populations will exact a fiscal cost for state and local governments, through both the accrued pension and health care obligations owed to their employees and retirees and the growing share of state budgets devoted to health and long-term care. Reflecting increasing interdependence among levels of government, states’ matching share for the Medicaid program has become the largest single spending item in their budgets. Given such intergovernmental linkages, state and local governments’ fiscal affairs are more vulnerable to actions taken by the federal government to right its own fiscal imbalance.

⁵The Congressional Budget Office (CBO) projects that the workforce already is growing slower, with a decline from an average growth rate of 1.6 percent in the preceding 50 years to a level of 0.6 percent during the next decade. The Budget and Economic Outlook, Fiscal Years 2007 to 2016, January 2006.

⁶*Ensuring the Future Prosperity of America: Addressing the Fiscal Future*, National Academy of Public Administration, Washington, DC, 2005.

INSTILLING INTERGOVERNMENTAL COOPERATION

Public service delivery has become increasingly intertwined over the past several decades. State and local governments now implement a growing array of programmatic efforts that are nationwide in character. Employing nine times as many employees as the federal government, they have become the real workhorses of public governance, vital partners in implementing most major federal programs, including welfare support, health care and environmental protection. Federal reliance on state and local capacity has accelerated in the past five years as former bastions of state and local autonomy—election administration, fire departments, education quality and motor vehicle licensing, among others—have been integrated in new, federally-devised efforts.

Yet this level of intergovernmental interdependence has not extended to revenue systems. To the contrary, intergovernmental conflict and tension threaten to undermine state and local revenue bases that are the underpinning for their roles in the system. Intergovernmental competition over tax and fiscal policy will intensify in the coming years. Federal and state governments share a common income tax base while federal policymakers eye the states' command of consumption. Meanwhile, local governments increasingly seek sources of revenue beyond the property tax to finance growing responsibilities.

Competition and tension need not be destructive. In fact, they often have resulted in important innovations and efficiencies. Each government uses such tools as better services, improved efficiencies and lower tax burdens to gain advantages in vying for stronger economies and taxpayers.⁷

Nonetheless, intergovernmental cooperation is more vital than ever to enable governments at all levels to effectively cope with changing economic and demographic forces. As economic transactions flow more easily across boundaries, fragmented and inconsistent tax systems increasingly will undermine economic

⁷"A pure theory of local expenditures," Tiebout, C.M., in *Journal of Political Economy*, vol. 64, no. 5, 416-424.

productivity and growth. Intergovernmental cooperation is critical if governments are to effectively employ revenue measures intended to reach increasingly mobile economic activities. This is especially true of the sales tax, but it also applies to the taxation of capital which can easily be moved by taxpayers seeking lower tax rates, often using technological means. Globalization makes corporate taxation more complex as multi-national firms can succeed in eluding revenue authorities through complex transfer pricing schemes. In short, the open nature of the U.S. economy and globalization means that there is greater economic interdependence. This should elevate the importance of intergovernmental cooperation in the design and administration of the revenue system of the United States.

EXACERBATING INTERGOVERNMENTAL CONFLICT THROUGH POLICY ACTIONS

Intergovernmental cooperation is extraordinarily critical when deciding tax and spending policies. The partnerships that are so necessary to implement most domestic policies on the spending side can be undermined when unilateral policy actions constrain the fiscal flexibility and capacity of governmental partners. Spending programs and mandates and revenue policies typically are decided in separate committees and venues.

Recent tax legislation has resulted in unilateral federal changes to tax bases shared by the states. These changes, whether pertaining to depreciation schedules or the estate tax, have caused many states to decouple from federal tax bases. Decoupling has been considered necessary to maintain state revenues, yet the unraveling of shared tax bases complicates the tax system, increases burdens facing taxpayers and unwinds a tax administration and enforcement partnership that took years to develop.

The pace of federal preemptions of state and local taxation has accelerated in recent years. For instance, as corporate income has become more global in nature, the federal government has acted to prohibit states from imposing business taxes on out-of-state companies with limited nexus. Federal courts have

constrained the scope of state sales taxes by excluding collection of taxes on goods produced by remote sellers not located within the state. And, Congress has banned states from taxing access to the Internet.

States' competition for economic development has undermined intergovernmental cooperation among state and local governments, as well. Many states have chosen not to extend their sales taxes to services and very few have taxed intangible assets in their property tax systems.⁹ In an effort to gain an economic advantage, some states have effectively become tax havens for multi-state enterprises by taxing each unit of these firms independently rather than on a combined basis, thus enabling the firms to shift income to states with little or no taxation of particular units or lines of business.

Tax systems have become less integrated across governments, but there are several examples that illustrate well-conceived initiatives to forge tax policy changes in a collaborative manner across governments and economic sectors. State and local governments have made efforts to recast tax policy applying to remote sales and taxation of mobile telephones. The collaboration among states has brought progress in recasting tax policy in these two volatile areas, but the results are a work in progress subject to continuing challenges by various factors and economic interests.

UNDERSTANDING THE IMPLICATIONS OF FEDERAL TAX REFORM INITIATIVES

Given the current and longer-term structural imbalances facing the federal budget, it is likely that fundamental changes in tax policies will become a regular feature of federal policy debates. Tax reform proposals will, in all likelihood, have significant consequences for state and local governments, becoming a perennial source of volatility for state and local revenue systems. Ideally, such initiatives represent windows of opportunity to reform tax systems from a "whole-of-government" perspective that could strengthen revenues and the economy alike for the entire system.

⁹*Federalism at Risk*, Multistate Tax Commission, Washington, DC, 2003, p. 44.

Changes in federal tax policy can affect state and local governments in various ways:

- changes to **federal tax subsidies** intended to support state and local fiscal affairs. Examples include the deductibility of state and local taxes and exemption for interest on state and local bonds.
- changes in shared **tax bases**. The broadening or narrowing of the federal income tax base for individuals and corporations will affect the tax bases of states that couple to the federal definitions.
- changes in **federal tax rates** for shared taxes. Tax rate changes at the federal level may indirectly affect state or local taxes by affecting the available “tax room” for those shared areas.
- shifts to a **new base**. Shifts can crowd out the flexibility currently enjoyed by other governments occupying this base.
- **federal regulation of state or local tax policies**. Federal preemptions have increasingly influenced the applicability of state and local taxation.
- **indirect influences**. Several proposed provisions have interactive effects with state and local revenue systems. For instance, a proposal to cap the mortgage interest deduction may reduce property tax revenues if it succeeds in curbing housing sales and price escalations.

The President established an Advisory Panel on Federal Tax Reform which issued a report in late 2005. The panel was tasked with considering revenue neutral approaches to abolish the Alternate Minimum Tax, yet the report addressed a wide range of reform proposals. Although the Forum did not take a position on these reforms, it did acknowledge that they do have substantial impact on intergovernmental revenue systems. The impact on national savings, business, real estate and health care

industries has been extensively analyzed, yet the Forum remains concerned that the intergovernmental effects have not received sufficient visibility or attention, either in the Advisory Panel report or in subsequent debate.

The Intergovernmental Forum considered several federal tax changes highlighted by the Advisory Panel, including:

- the proposed elimination of the federal income tax deductibility of certain state and local taxes which could indirectly increase the “price” that affected state and local taxpayers would face
- the proposed exclusions of significant portions of savings and investments which would narrow the tax base and affect the state and local bond marketplace, as well as proposals to broaden the base through limitations on deductions and exclusions for mortgages and health care
- shifts to consumption taxation which would have significant consequences for tax regimes, depending on the design and implementation of federal proposals

Further consideration of the Advisory Panel’s proposals is not likely to happen in the short term, but they are reflective of the kinds of tax reform initiatives that will continue to surface in future debates. Many of these proposals may have salutary effects on the federal budget and economy; these deserve serious consideration. But, such review and deliberation should be done from a whole-of-government perspective, taking into account how the changes would affect revenue systems across all levels of government. This is particularly important because tax subsidies are the primary vehicle used by the federal government to deliver general fiscal assistance to state and local governments—not spending, where funds are targeted to specific federally-proscribed purposes. These subsidies include the income tax deductibility of state and local taxes and the federal income tax exemption for state and local bond issues.



CONCLUDING OBSERVATIONS

The Intergovernmental Forum on Revenue Systems concludes that all levels of government will face a continuing need to revise their revenue systems to respond to the fast-paced changes of the 21st Century. They must recast and update tax systems to be better aligned with trends in a rapidly globalizing and changing economy and to better meet expanding spending pressures stemming from an aging society.

A process of reform and renewal should be done on the whole-of-government basis. Decisions on broad tax policy should be based on a truly collaborative process with all governments having a seat at the table. State and local governments must be viewed as more than “just another interest group;” indeed, they must be recognized as vital partners with primary roles for addressing public needs and implementing national programs with intergovernmental dimensions. To be sure, the federal government must be a key player in bringing about tax collaboration, yet state and local governments also must substitute cooperation for competition in the interests of pursuing greater harmonization of their own tax systems, be it sales taxation of remote sellers or business taxes on multi-state enterprises.

A certain level of intergovernmental conflict is expected in any federal system; interests and values held by each level of government often differ as they reflect varied political constituencies and responsibilities. However, the overarching interests of every actor in our system can be more effectively advanced through active collaboration on fiscal policy.

The stakes of this process are high. Informed tax policy can better ensure that revenues are appropriately matched with expenditure responsibilities. A more coordinated and cooperative tax system also could generate dividends for economic efficiency and productivity. The federal tax system is the primary vehicle for the federal government to provide fiscal assistance to the state and local levels. Because of this, it is important to consider the intergovernmental fiscal consequences of changes in the federal system.

Notwithstanding the need for intergovernmental collaboration, an institutional framework does not currently exist to promote effective dialogue and partnerships. The dialogue begun by this Forum must become institutionalized through the establishment of a neutral focal point to convene all levels of government periodically to engage in dialogue, deliberation and consensus building. Such a process should have a research and information collection function to ensure that the dialogue is robust and well informed.

Improved research and information will help, but it is critical that the information be more readily available for decision makers and the public at key points in the process. The President's budget does not include significant discussion of key intergovernmental fiscal issues nor does it highlight the intergovernmental implications of budgetary proposals beyond a chapter on intergovernmental grants. In addition, Congress needs more transparent information highlighting the whole-of-government consequences of proposed legislation. The Unfunded Mandates Reform Act has established a useful process, anchored in the Congressional Budget Office, for estimating the costs of mandates on the state and local sector. However, the statutes do not include many federal tax policy changes or grant conditions in its purview.

The Forum concludes that states must work more collaboratively with their local governments to achieve the goals of intergovernmental tax policy reform. As legal creatures of the state, local governments often face the brunt of state mandates on a wide range of issues. Indeed, states have more control over of sub-state governments' tax and budget policies than the federal government does over the states'. The states' partnership in tax administration extends to collecting taxes on behalf of local governments and returning them to the source. Accordingly, states should become better informed about unfunded mandates created by statute and policy, including restrictions on local government revenue systems, and conduct studies that consider the impact of these mandates on local governments.

RECOMMENDATIONS

The Intergovernmental Forum on Revenue Systems recommends the following broad principles to guide the tax policy actions at all levels of government:

- **Policymakers should adopt a whole-of-government perspective when developing and considering tax reform proposals.**
- **Policymaking partnerships are particularly critical for changes to shared tax bases. One strategy that should be considered to promote federal policy objectives with shared tax bases would be to adopt tax credits rather than deductions or exclusions since credits would not shrink state tax bases.**
- **State and local governments should work more cooperatively to harmonize and modernize tax bases, including collective arrangements to reach mobile tax sources and extend sales taxes to a greater portion of the service economy. Where possible, Congress should facilitate and support interstate compact initiatives by the states.**
- **Federal and state governments should observe forbearance when considering preemption proposals affecting revenues and taxes. In general, there should be a presumption against preemption by national and state policymakers, but rather support for more cooperative and collaborative tools of governance.**
- **When considering new tax sources, such as consumption taxes, federal policymakers should carefully consider the implications for state and local tax systems. Should a national consumption tax be considered, ample consideration should be given to ways to mitigate the impact on state and local sales tax regimes. Opportunities for**

conformity and shared administration with states should be encouraged.

The Forum also makes the following recommendations to policymakers at all levels of government.

- **Congress and the President should establish a permanent, independent organization to serve as a neutral convener to bring together officials from all levels of government to discuss common issues on tax and other intergovernmental fiscal issues. Financial support should be provided to support research on intergovernmental tax and fiscal issues.**
- **The President's budget should include a report on the status of the intergovernmental fiscal system. The report should have discussion of the prospective consequences of new revenue and spending proposals as well as recently enacted changes affecting all levels of government, including accounting for preemptions and unfunded mandates.**
- **Congress should amend the Unfunded Mandates Reform Act to include the intergovernmental fiscal effects of federal tax law changes as mandates. This would permit members of Congress to raise a point of order if such covered mandates exceed certain cost thresholds.**
- **All levels of government should provide support for collaborative tax policy initiatives. Specifically:**
 - ♦ **States and Congress should support completion of the Streamlined Sales Tax Project.**
 - ♦ **The federal government should enact legislation to support the taxation of mobile sources by states.**
 - ♦ **State and local governments should expand their participation in the Sales Tax initiative.**

The Academy intends to monitor the whole-of-government approach as it unfolds across the United States. Working in conjunction with the Forum Principals and other leaders, the Academy will:

- **Convene periodic meetings to discuss these issues and follow up on this report.**
- **Promote a research agenda that can be recommended to federal and state agencies, universities and public policy organizations.**
- **Continue to work with federal, state and local officials and others to improve public understanding and discourse on intergovernmental revenue issues.**

BACKGROUND ON THE INTERGOVERNMENTAL FORUMS

ESTABLISHING AN INFORMED DIALOGUE

In February 1962, President John F. Kennedy wrote in support of the new federal Advisory Commission on Intergovernmental Relations (ACIR). He and others noted the “growing interdependence of national life” and the “strains placed on traditional governmental” policies.⁹ This generation of national leaders identified the need to bring representatives together to consider common problems and “to encourage discussion and study at an early stage of emerging public problems that are likely to require intergovernmental cooperation” (Public Law 86-380).¹⁰

A new generation of leadership has come together to re-focus attention on the strains placed on government policies and the growing interdependence influenced not only by national life, but global forces and other powerful trends, as well.

With the sponsorship of the National Academy of Public Administration,¹¹ a demonstration Council on Intergovernmental Cooperation was established in late 2004 to help guide the Forum process. The Council had a formative role in choosing the topic and determining the rules governing selection of Forum participants and the conduct of meetings. The Council was composed of membership from the Academy and organizations representing state and local governments. The organizations were the Council of State Governments, International City/County Management Association, National Association of Counties, National Conference of State Legislatures, National Governors Association, National League of Cities and U.S. Conference of Mayors. The federal Administration, representatives of the Congress and others also have participated in this effort.

⁹John F. Kennedy, letter to Frank Bane, Chairman, Advisory Commission on Intergovernmental Relations, February 26, 1962.

¹⁰ACIR closed its offices when Congress did not appropriate funds for it in 1996.

¹¹The Academy is a non-partisan, non-profit organization chartered by Congress to improve public governance and the performance of public institutions at every level. It is led by a Fellowship of more than 600 distinguished leaders in public administration. They include current and former Members of Congress, Cabinet secretaries, governors, legislators, city and county executives and others known for their contributions to improving public administration.

FIRST INTERGOVERNMENTAL FORUM

More than one dozen topics were reviewed as potential choices for the first Intergovernmental Forum. The council of organizations chose something that President Kennedy requested as an agenda item for the ACIR's second term: the Revenue Systems of the United States.

“The rising costs of Government at all levels, coupled with the growing interdependence of national life, has called new attention to the strains placed on traditional governmental taxing practices. We must improve Federal, State, and local coordination of tax and fiscal practices and policies to achieve equitable taxation, increase administrative efficiency, and make it possible for our taxpayers to pay their taxes with a minimum of confusion and administrative burden. Equitable and reasonable intergovernmental tax policies will facilitate the free flow of trade among our States and will contribute to our economic growth.”

John F. Kennedy, February 26, 1962

The Intergovernmental Forum on Revenue Systems has allowed leaders from all levels of government to bring an intergovernmental perspective to this critical topic. Its findings and statements will offer guiding principles and an opportunity to better prepare the nation's governments to meet the trends and powerful forces at work on society.

FORUM LED BY PRINCIPALS SELECTED BY THE COUNCIL

The Council members designate public administration leaders as Principals for the Forum. They also designate other experts with deep knowledge of the forum's topic. A representative from the federal Administration and congressional staff are involved as principals of the Forum.

The Council asked Academy Fellow Paul Posner to chair this first Intergovernmental Forum because of his deep expertise in intergovernmental relations and his understanding of fiscal and budget issues. Professor Posner is a member of the faculty of George Mason University.

The Intergovernmental Forum on Revenue Systems was launched in May 2005. The Forum held its public meeting on January 11, 2006 where the Principals discussed the key issues from their differing perspectives. Staff performed a literature review, conducted interviews, authored issue briefs and worked with an Experts Group formed to provide advice to the Forum. This report is based on the Forum meeting, as well as the considerable research conducted by staff and deliberations of the Expert Group convened earlier to discuss the issues. The views in this report are based on the discussion at the Forum meeting and research by Academy staff. **They do not necessarily represent the views of the Academy or the Forum Principals.**

The report was provided in draft in late May to all of the Principals, experts, selected Academy Fellows and other interested parties. The draft was revised considering these comments.

RULES ADOPTED FOR THE FORUMS

Several basic yet critical agreements have governed the Intergovernmental Forums:

- Principals selected for any Forum come to it as individuals, though they may represent organizational views when they want or are asked to do so.
- A Forum can address statements to all levels of government, and to other stakeholders.
- A Forum will be stakeholder and research informed as much as practicable. Also, it will bring an intergovernmental perspective to the chosen topic.
- A Forum is intended to be “solution-oriented” with consideration of alternatives.

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EXPERTS GROUP

An Experts Group was formed to provide advice to the Forum. It met three times, twice in person and once via teleconference. E-mail was exchanged among the members of the group and with Forum staff. The commentary offered within this report should not be attributed to any individual member of the group or to the group as a whole.

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The Intergovernmental Forum was established through a consortium of organizations with the participation of the Administration and senior congressional aides. The individuals listed below had key roles in providing leadership and staff support to the consortium and Forum process.

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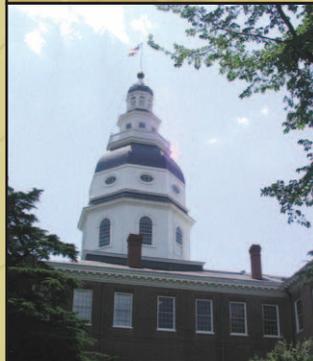
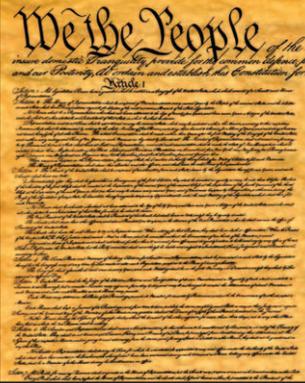
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