Editor's Introduction

Thomas A. Garrett

The Federal Reserve Bank of St. Louis co-hosted a one-day conference on state and local public finance on April 9, 2010. Our co-host was the Weidenbaum Center on the Economy, Government, and Public Policy at Washington University in St. Louis. The purpose of the conference, titled "State and Local Public Finance Amid Economic Turbulence," was to provide attendees with a nontechnical description of the major issues surrounding state and local public finance during the recent economic crisis and ongoing recovery.[1]

To provide diverse views and experiences, the conference brought together state and local government officials, economic development professionals, academics, and local government policymakers. The conference format consisted of presentations of papers by academic scholars and a panel session involving recognized experts on state and local public finance. This issue of *Regional Economic Development* contains the proceedings from the conference.

THE CURRENT STATE OF STATE AND LOCAL PUBLIC FINANCE

Ronald Fisher, professor of economics at Michigan State University, provided the keynote address. Fisher provides an overview of the state and local government sector and a review of the short-run impacts of the recent recession on state and local governments. He notes that governments currently face nearly unprecedented fiscal turmoil as a result of the 2007-09 recession. Fisher argues that despite an economic recovery, state and local governments will continue to face challenges both to improve effectiveness and efficiency in the provision of public services and to generate revenue sufficient to fund crucial public services.

AN ECONOMIC EVALUATION OF STATE AND LOCAL TAXES

Ray Nelson explores the relationship between the growth and volatility of state tax revenue. He argues that policymakers should carefully anticipate and consider the potential effects of proposed tax reforms and revenue enhancements on the long-term growth and volatility of state government revenue portfolios, especially during economic downturns. Nelson notes that although states cannot alter the volatility and growth rates of their economies, they can change the composition of their tax portfolios to minimize the effects of the business cycle on states' fiscal health. For this reason, state officials need to consider the natural tendencies of their economies when formulating tax policy.

In her discussion, Elizabeth McNichol argues that state revenue will not recover from its current depressed level until employment returns to normal levels, which is expected to take several more years. She estimates that states are facing budget shortfalls

[1] More information on the conference can be found at http://research.stlouisfed.org/conferences/turbulence/.

Thomas A. Garrett is an assistant vice president and economist at the Federal Reserve Bank of St. Louis.

Federal Reserve Bank of St. Louis *Regional Economic Development*, 2010, *6*(1), pp. 1-3.

in fiscal year 2011 that are just as large as those they closed in fiscal year 2010 and that these problems will continue into 2012 and beyond. McNichol also presents several reasons that complicate measuring the growth and variability of state revenue—namely, changes in state tax rates and tax bases that occur over time.

FISCAL FEDERALISM IN THE UNITED STATES

Robert Inman discusses the fiscal relationship among various levels of government, known as fiscal federalism. Specifically, he evaluates the recent American Relief and Recovery Act (ARRA) as relief for states in fiscal distress. Inman finds that while the Act did provide significant aggregate fiscal relief to all state governments, the allocation of the program's funds provided at best weak relief for the states in greatest fiscal distress. The majority of each ARRA dollar went toward increased funding of state services generally or to new programs favored by Congress and the Obama administration. In place of federal assistance, Inman argues that each state should maintain a budget stabilization fund, or "rainy day" fund, equal to at least 10 percent of state expenditures to weather downturns in revenue. The best way to encourage such behavior, according to Inman, is for Congress to commit to no future federal bailouts of states in fiscal distress.

In his discussion, Paul Rothstein focuses on the efficiency of federal fund transfers to state governments and outlines several reasons why federal-to-state transfers may increase or decrease economic efficiency. Rothstein questions the existence of "moral hazard" in federal-to-state bailouts such as the ARRA; that is, state governments take excessive risk because they presume federal bailouts will supplant any losses, since political leaders are often punished for bad outcomes regardless of federal support to the states. He argues that an effective and efficient policy can be developed that delivers federal support during crises for qualifying states, encourages transparent budgeting and larger stabilization funds, and need not present moral hazard problems.

ALTERNATIVE REVENUE SOURCES AND IMPLICATIONS FOR GROWTH

William Fox evaluates selective sales taxes (taxes on alcohol, tobacco, and gambling) and business gross receipts taxes in terms of the characteristics of a good tax system: economic efficiency, adequacy, and equity. Rather than increasing tax rates on existing traditional taxes (corporate income, personal income, taxable retail sales) or expanding tax bases, in recent years state governments have been considering nontraditional forms of taxation as alternative revenue sources. Fox argues that (i) competition between states for gambling and sales of alcohol and tobacco will likely make it increasingly difficult for tax rates on nontraditional sources to rise dramatically higher and (ii) cross-border shopping and bootlegging will limit states' ability to push tax rates dramatically higher. The result will be that revenues from these sources will fall relative to total state tax revenues over the longer term. He also discusses many of the advantages and disadvantages of the gross receipts tax versus the corporate income tax and concludes that much more study on the economic effects of each tax is needed before enacting good public tax policy.

In his discussion, Gary Wagner notes that states' increasing reliance on nontraditional sources of revenue, such as selective sales taxes and gross receipts taxes, is in part due to the growth and variability problems facing traditional sources of tax revenue. Specifically, he notes that the U.S. economy has experienced a well-documented shift away from goods toward services in both production and consumption and that, combined with the increasing importance of "knowledge-based" production, sales tax bases are shrinking relative to the value of economic activity. In addition, since World War II state governments have become increasingly reliant on individual income tax revenue and less reliant on alcohol, tobacco, and motor fuel tax bases that are significantly less volatile over the business cycle. Wagner concludes by expanding on the advantages and disadvantages of the gross receipts tax and notes concern that the political appeal associated with a low gross receipts tax rate and its broad base tax will lead policymakers to rapidly move toward some form of a gross receipts tax without a solid understanding of the consequences.

PANEL DISCUSSION: THE FUTURE OF STATE AND LOCAL PUBLIC FINANCE

The final session of the conference, a panel discussion, focuses on the future of state and local public finance. The panelists are Robert Tannenwald from the Center for Budget and Policy Priorities, Chris Edwards from the Cato Institute, and Karl Kurtz from the National Council of State Legislatures.[2] They discuss several issues, including the proper size of state governments in terms of expenditures and taxation, whether a more dynamic economy is making the current tax systems of state and local governments obsolete, and innovative revenue-generating strategies for state governments.

ACKNOWLEDGMENTS

I thank the authors, discussants, and panelists for their participation. I also thank the Weidenbaum Center at Washington University in St. Louis for their professional partnership in organizing this event. Finally, I thank the managing editor of *Regional Economic Development*, George Fortier, and his staff, Judy Ahlers, Lydia Johnson, and Donna Stiller, for their fine work in putting the conference proceedings together.

---

[2] Karl Kurtz's comments were not available for publication.