The State of State (and Local) Tax Policy

How does the deduction for state and local taxes work?

Q. How does the deduction for state and local taxes work?

A. Taxpayers who itemize deductions on their federal income tax returns can deduct state and local real estate and personal property taxes, as well as either income taxes or general sales taxes. The Tax Cuts and Jobs Act limits the total state and local tax deduction to $10,000.

The state and local tax (SALT) deduction previously was one of the largest federal tax expenditures, with an estimated revenue cost of $100.9 billion in fiscal year 2017. The estimated revenue cost for fiscal year 2019 dropped to $21.2 billion because the Tax Cuts and Jobs Act (TCJA) significantly increased standard deduction amounts (thereby reducing the number of taxpayers who will itemize deductions) and capped the total SALT deduction at $10,000.

State and local taxes have been deductible since the inception of the federal income tax in 1913. Initially, all state and local taxes not directly tied to a benefit were deductible against federal taxable income. In 1964, deductible taxes were limited to state and local property (real and personal property), income, general sales, and motor fuels taxes.

Congress eliminated the deduction for taxes on motor fuels in 1978, and eliminated the deduction for general sales tax in 1986. It temporarily reinstated the sales tax deduction in 2004, allowing taxpayers to deduct either income taxes or sales taxes but not both. Subsequent legislation made that provision permanent starting in 2015. Starting in tax year 2018, taxpayers cannot deduct more than $10,000 of total state and local taxes. That provision of the law is scheduled to expire after 2025.

WHO CLAIMS THE SALT DEDUCTION?

Before the TCJA, about 30 percent of tax filers opted to itemize deductions on their federal income tax returns. Virtually all who itemized claimed a deduction for state and local taxes paid. High-income households were more likely than low- or moderate-income households to benefit from the SALT deduction. The amount of state and local taxes paid, the probability that taxpayers itemize deductions, and the reduction in federal income taxes for each dollar of state and local taxes deducted all increase with income.

Sixteen percent of tax filers with income between $20,000 and $50,000 claimed the SALT deduction in 2017, compared to 76 percent for tax filers with income between $100,000 and $200,000 and over 90 percent of tax filers with income above $200,000 (figure 1). Tax filers with income above $100,000 were 18 percent of all tax filers, but accounted for about 78 percent of the total dollar amount of SALT deductions reported. The average claim in this group was of about $22,000.

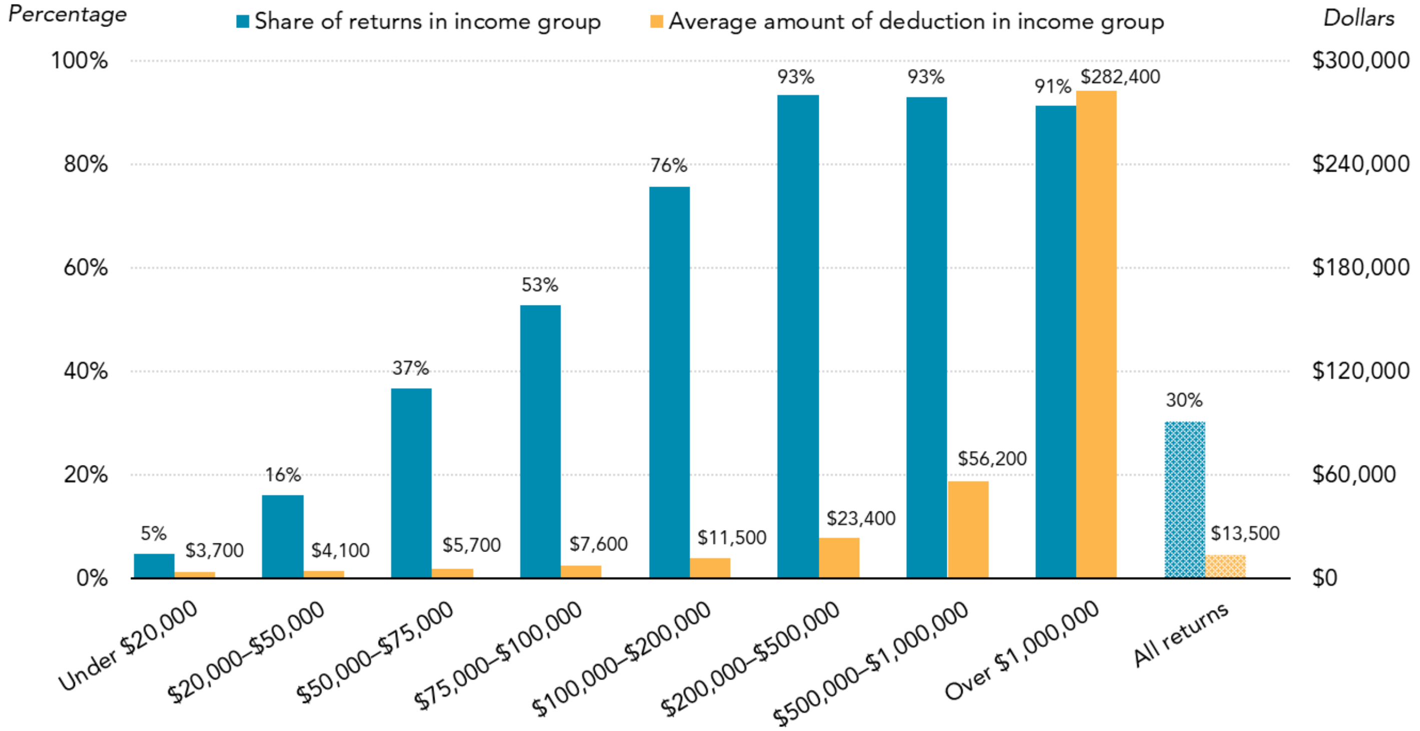
The State of State (and Local) Tax Policy

How does the deduction for state and local taxes work?

FIGURE 1

State and Local Tax Deduction

Share of returns claiming the deduction and average amount, tax year 2017



Source: Internal Revenue Service, Statistics of Income (SOI), Publication 1304, tax year 2017, tables 2.1 and 1.2, 2019; TPC calcuations.

Although most high-income taxpayers claimed a SALT deduction, the federal individual alternative minimum tax (AMT) limited or eliminated the benefit for many of them. The AMT is a parallel income tax system with fewer exemptions and deductions than the regular income tax as well as a narrower set of tax rates. Taxpayers potentially subject to the AMT must calculate their taxes under both the regular income tax and the AMT and pay the higher amount. Taxpayers cannot claim the SALT deduction when calculating their AMT liability, and under tax law prior to 2018, the disallowance of the deduction was the major reason why taxpayers were required to pay the AMT.

Although some taxpayers in every state and DC claim the deduction, taxpayers in states with a disproportionate share of high-income taxpayers and relatively high state and local taxes are more likely to claim the deduction (figure 2). The percentage claiming the deduction ranged from 17 percent in West Virginia to 47 percent in Maryland in 2017. In general, a higher share of taxpayers in Northeast and West states claimed the deduction than in other regions. The average deduction claimed was also higher in those regions.

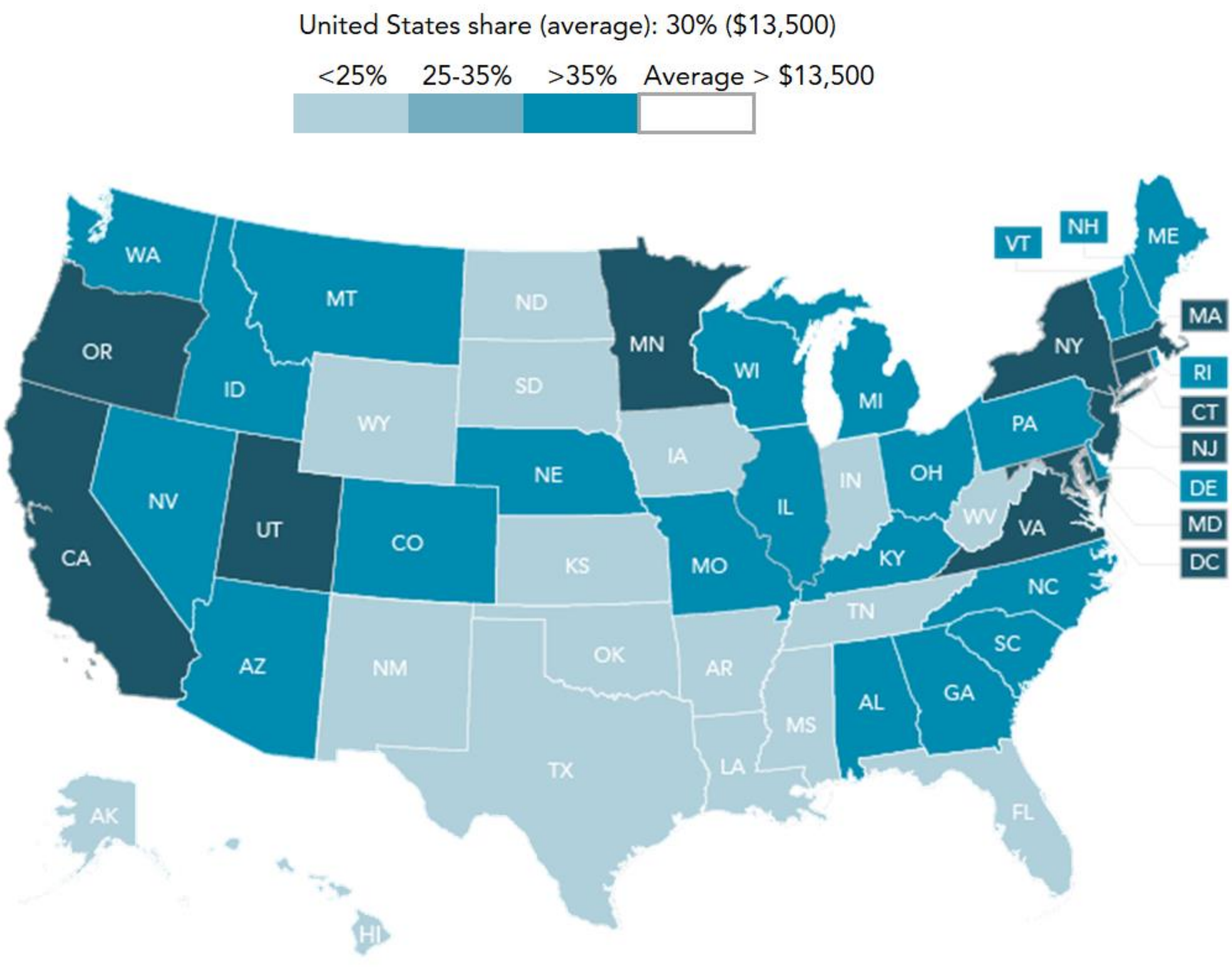
The State of State (and Local) Tax Policy

How does the deduction for state and local taxes work?

FIGURE 2

State and Local Tax (SALT) Deduction

Share of returns claiming the deduction and average amount, tax year 2017



Source: Internal Revenue Service, Statistics of Income (SOI), Historical table 2, tax year 2017; TPC calculations.

THE EFFECT OF TCJA ON THE SALT DEDUCTION

The TCJA has had a significant effect on the average tax saving from the SALT deduction. Both the percentage of taxpayers claiming the deduction and the average amount claimed fell dramatically in 2018 because of the changes enacted. Figure 3 compares the tax saving from claiming the deduction in 2017 and 2018, before and after the new tax law. The tax benefit is measured as the reduction in tax liability from the deduction, which considers the applicable tax rates in each year, the effects of the alternative minimum tax (which disallows the SALT deduction), and the limit on itemized deductions (the “Pease” limit) that was in place in 2017 but eliminated for 2018 by TCJA.

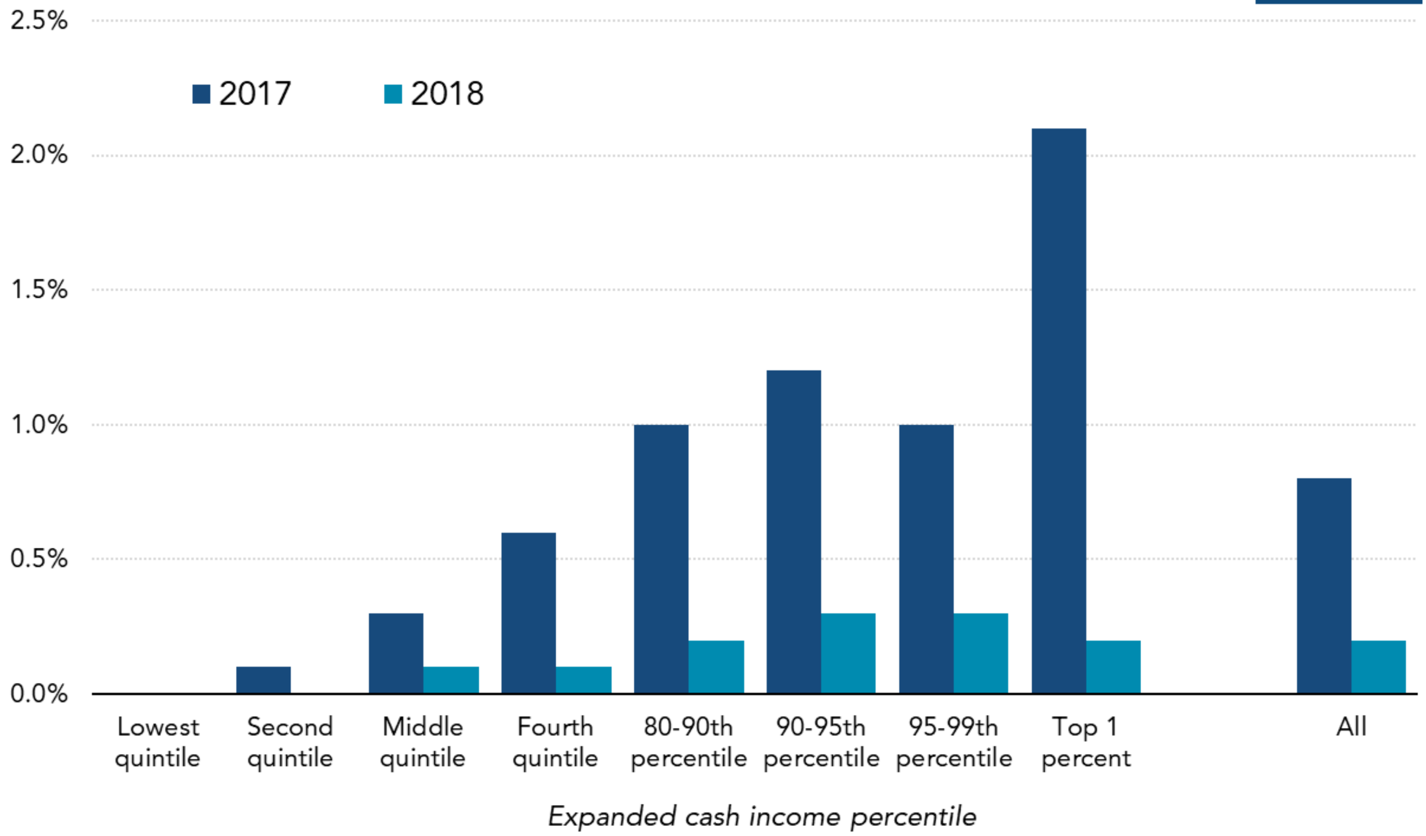
The State of State (and Local) Tax Policy

How does the deduction for state and local taxes work?

FIGURE 3

Itemized Deduction for State and Local Taxes

Benefit as a share of after-tax income, 2017 and 2018



Source: Urban-Brookings Tax Policy Center, "TPC Microsimulation Model, version 0718-1."

Measured as a percentage of after-tax income, the tax saving from the SALT deduction in 2018 was about one-quarter of what it was in 2017 overall. For taxpayers in the top 1 percent of the income distribution, the tax saving in 2018 was about one-tenth of the tax saving in 2017.

EFFECTS OF THE DEDUCTION

The SALT deduction provides state and local governments with an indirect federal subsidy by decreasing the net cost of nonfederal taxes for those who pay them. For example, if state income taxes increase by $100 for families in the 37 percent federal income tax bracket claiming the SALT deduction, the net cost to them is $63; that is, state taxes go up by $100, but federal taxes go down by $37. This federal tax expenditure encourages state and local governments to levy higher taxes (and, presumably, provide more services) than they otherwise would. It also encourages those entities to use deductible taxes in place of nondeductible taxes (such as selective sales taxes on alcohol, tobacco, and gasoline), fees, and other charges.

Critics of the deduction argue that state and local taxes simply reflect payments for the services those jurisdictions provide and, as such, should be treated no differently than other spending. They also point to the uneven distribution of benefits across income groups and states.

Proponents of the deduction counter that the portion of an individual's income claimed by state and local taxes is not disposable income, and that taxing it at the federal level is double taxation. Moreover, they argue that federal subsidies are warranted because a significant portion of state and local government spending is for education, health, public welfare, and transportation, all of which benefit the population in other jurisdictions as well. A counterargument, however, is that while federal support may be warranted, the substantial revenues gained by eliminating or limiting the deduction could be used to provide direct support through federal grants and loans.

Updated May 2020

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What are municipal bonds and how are they used?

Q. What are municipal bonds and how are they used?

A. Municipal bonds (a term that encompasses both state and local government debt) are obligations that entitle owners to periodic interest payments plus repayment of principal at a specified date. States and localities (cities, townships, counties, school districts, and special districts) issue bonds primarily to pay for large, expensive, and long-lived capital projects.

State and local governments issue bonds to pay for large, expensive, and long-lived capital projects, such as roads, bridges, airports, schools, hospitals, water treatment facilities, power plants, courthouses, and other public buildings. Although states and localities can and sometimes do pay for capital investments with current revenues, borrowing allows them to spread the costs across multiple generations. Future project users bear some of the cost through higher taxes or tolls, fares, and other charges that help service the debts.

States and localities issue short-term debt or notes to help smooth uneven cash flows (e.g., when tax revenues arrive in April but expenditures occur throughout the year). They also issue debt on behalf of private entities (e.g., to build projects with public benefit or for so-called public-private partnerships).

HOW LARGE IS THE MUNI BOND MARKET?

At the end of 2019, state and local governments had $3.85 trillion in debt outstanding (figure 1). About 98 percent of this debt was long term or with a maturity of 13 months or longer, while the remaining 2 percent was short term. As in most years, roughly 40 percent of municipal debt was issued by states and 60 percent by local governments.

The State of State (and Local) Tax Policy

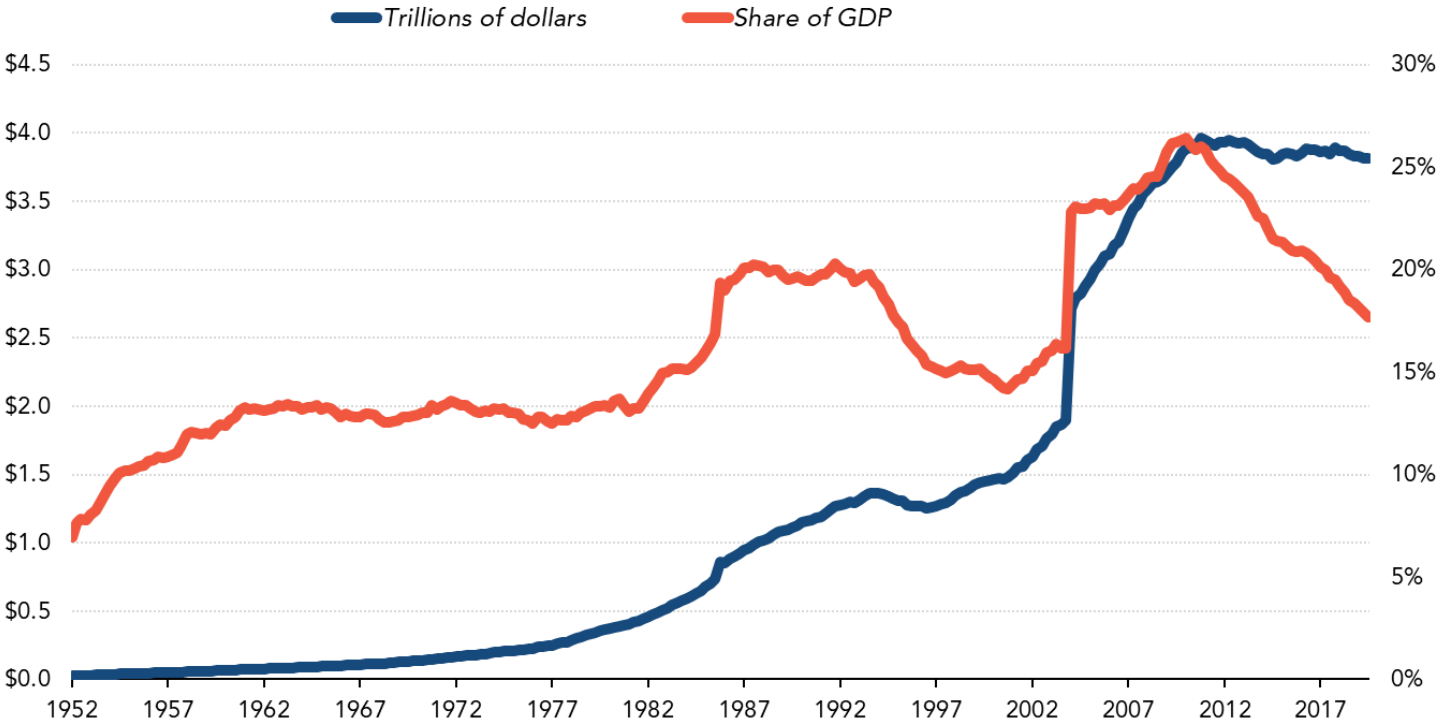
What are municipal bonds and how are they used?

FISCAL FEDERALISM AND FISCAL INSTITUTIONS

FIGURE 1

State and Local Government Debt Outstanding

1952–2019



Source: Board of Governors of the Federal Reserve System. Financial Accounts of the United States - Z.1. March 2020.
Note: Starting in the first quarter of 2004, the Federal Reseve made a one-time $800 billion adjustment to the stock of municipal debt outstanding.

Although municipal debt has more than tripled in nominal terms since the mid-1980s, the change is less dramatic as a percentage of gross domestic product.

States vary widely in their long-term municipal debt outstanding (figure 2).

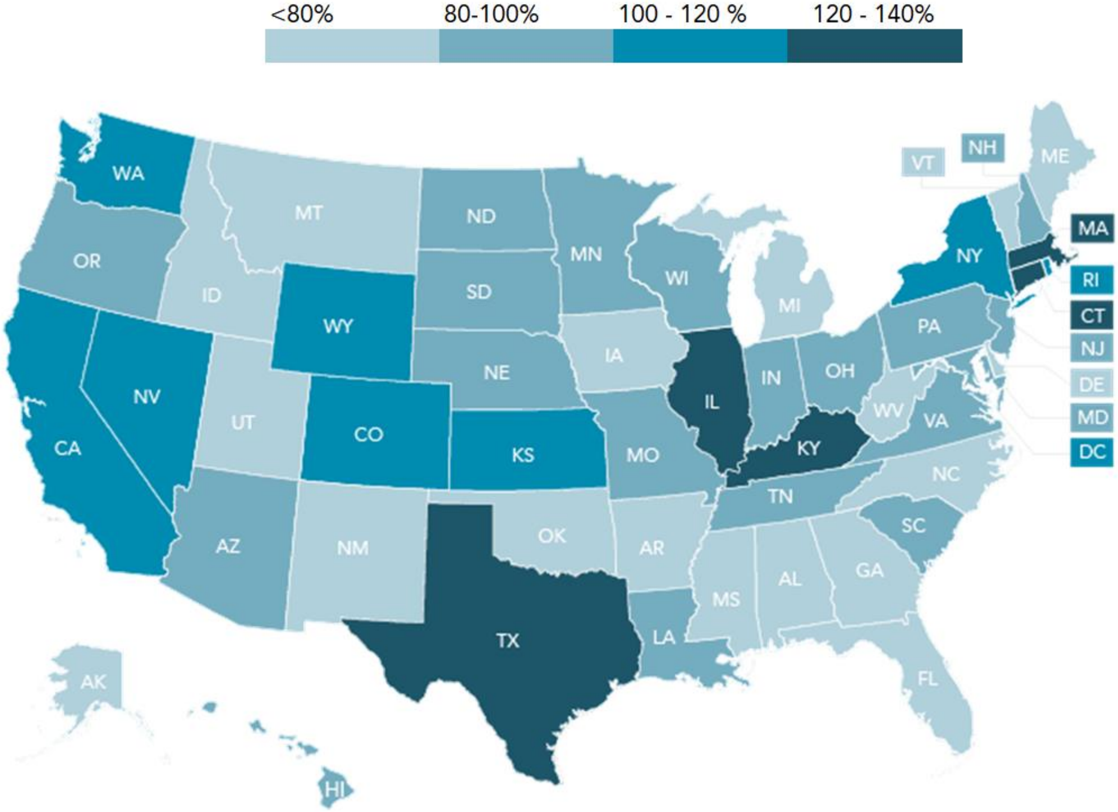
The State of State (and Local) Tax Policy

What are municipal bonds and how are they used?

FIGURE 2

Long-Term Oustanding Debt

As a share of general own-source revenues, 2017



Source: Source: State & Local Government Finance Data Query System. http://slfdqs.taxpolicycenter.org/pages.cfm. The Urban Institute-Brookings Institution Tax Policy Center. Data from U.S. Census Bureau, Annual Survey of State and Local Government Finances, Government Finances, Volume 4, and Census of Governments (2017). Date of Access: (09-Mar-2020).

WHAT ARE THE MAIN TYPES OF STATE AND LOCAL GOVERNMENT DEBT?

General obligation bonds are backed by an issuer's "full faith and credit," including its power to tax. Bonds may also be secured by future revenue streams, such as dedicated sales taxes or tolls and other user charges generated by the project being financed.

General obligation bonds typically require voter approval and are subject to limits on total debt outstanding. Revenue bonds and bonds secured by anticipated legislative appropriations are not subject to these requirements or limits. In 2018, roughly 58 percent of state and local issuances were revenue bonds, 36 percent were general obligation bonds, and 6 percent were private placements. (Private placements are direct purchases by commercial banks and other large investors.)

The State of State (and Local) Tax Policy

What are municipal bonds and how are they used?

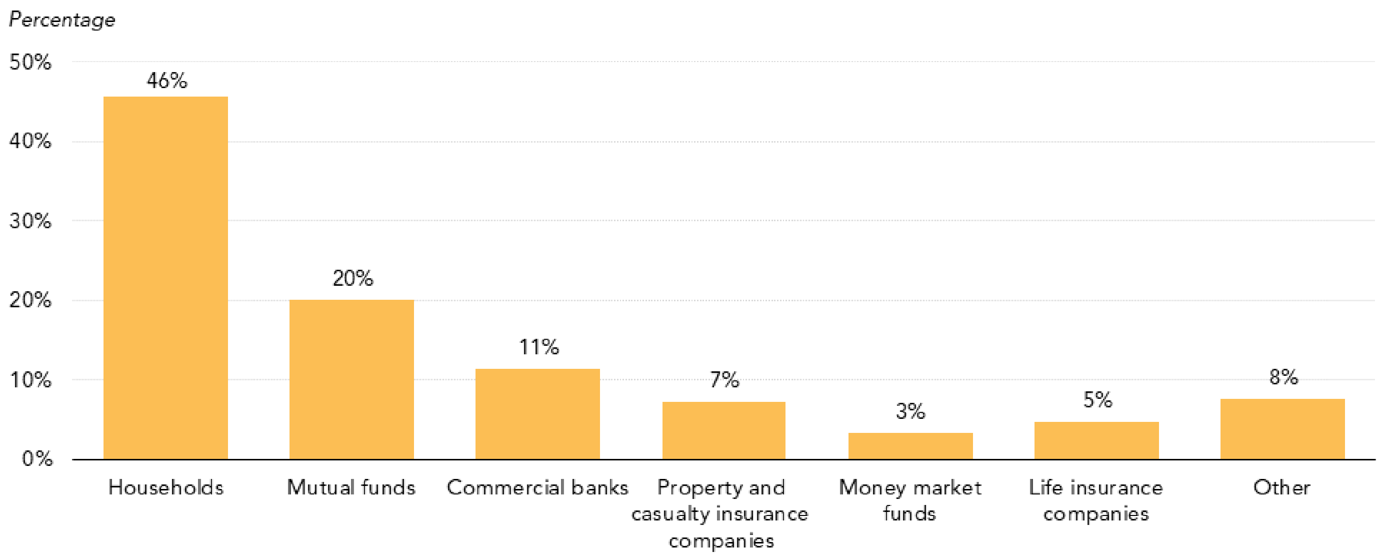
WHO HOLDS STATE AND LOCAL GOVERNMENT DEBT?

Most state and local bonds are held by households, followed by mutual funds (which also represent household investors) (figure 3). Banks and life insurance companies used to be more prominent municipal bond holders until the Tax Reform Act of 1986 and subsequent litigation limited the advantages of doing so.

FIGURE 3

Holders of State and Local Debt

Share of total by type, fourth quarter 2019



Source: Board of Governors of the Federal Reserve System. Financial Accounts of the United States - Z.1. March 2020.
Note: "Other" category includes closed-end funds, foreign investors, brokers and dealers, nonfinancial corporate businesses, government-sponsored enterprises, savings institutions, exchange-traded funds, state and local government general funds, and state and local government retirement funds.

HOW DOES THE FEDERAL TAX EXEMPTION WORK AND WHAT ARE PROPOSALS FOR REFORM?

Since its inception in 1913, the federal income tax has exempted interest payments received from municipal bonds from taxable income. State and local governments also typically exempt interest on bonds issued by taxpayers' state of residence. However, the US Supreme Court in *Department of Revenue of Ky. v. Davis* upheld states' ability to tax interest on bonds issued by other jurisdictions.

Because of the federal tax exemption, state and local governments can borrow more cheaply than other debt issuers, such as corporations, for a given level of risk and length of maturity. The federal tax exemption therefore functions as a federal subsidy to state and local public infrastructure investment. This subsidy comes at a cost in foregone tax revenues, estimated at $28 billion in fiscal year 2020.

The federal tax exemption has been criticized as inefficient because high-bracket taxpayers receive more than the inducement needed to purchase municipal bonds. In 2018, for example, a high-grade tax-exempt municipal bond yielded 3.53 percent. The yield for a comparable taxable corporate bond was 3.93 percent. Thus, taxpayers whose federal tax rate is about 10 percent should be just indifferent between the two types of bonds (the gap in yields—0.4 percentage points—is about 10 percent of 3.93 percentage points). Anyone in a higher tax bracket receives a windfall that generates no additional benefit for the borrower.

In light of this inefficiency, proposals have long circulated to cap the federal tax exemption, most recently by former Vice President Joe Biden among his 2020 campaign tax proposals. However, the revenue gain from eliminating or capping the deduction would depend on whether states and localities responded by issuing as many or fewer bonds and whether bondholders responded by shifting their portfolios toward taxable bonds or other investments (Poterba and Verdugo 2011). It is also difficult to hold constant all relevant bond features, including risk, time to maturity, fixed versus variable interest payments, and liquidity (Congressional Budget Office and Joint Committee on Taxation 2009).

Notably, President Donald Trump's most recent budget proposals have not suggested a cap on the bond interest exemption.

Updated May 2020

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What are municipal bonds and how are they used?

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The State of State (and Local) Tax Policy

What types of federal grants are made to state and local governments, and how do they work?

Q. What types of federal grants are made to state and local governments and how do they work?

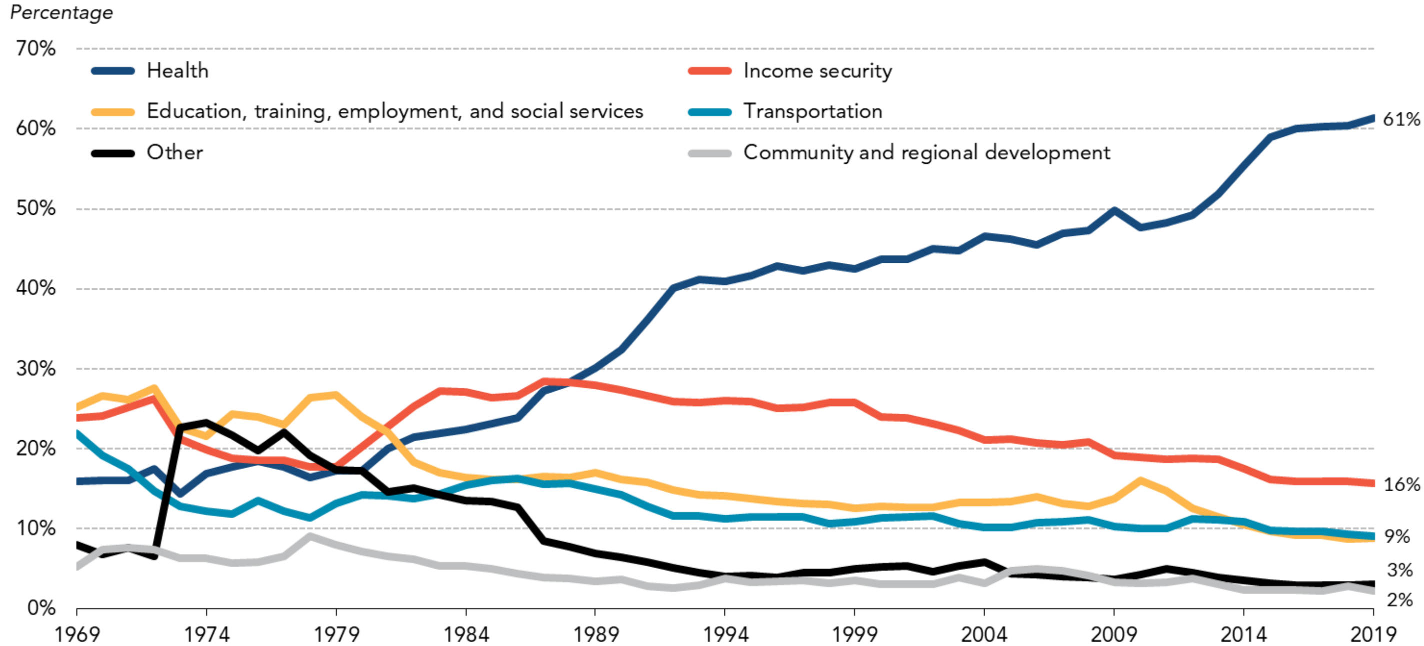
A. The federal government distributes grants to states and localities for many purposes, but the bulk are dedicated to health care. Some grants are restricted to a narrow purpose but block grants give recipients more latitude in meeting program objectives.

The federal government distributed about $721 billion (about 16 percent of its budget) to states and localities in fiscal year 2019, providing about one-quarter of these governments' total revenues. About 61 percent of those funds were dedicated to health care, 16 percent to income security programs, and 9 percent each to transportation and education, training, employment, and social services (figure 1).

FIGURE 1

Federal Grants to State and Local Governments

Share of total by category, fiscal years 1969–2019



Source: Office of Management and Budget. 2020. Historical Tables. Table 12.2. Total Outlays for Grants to State and Local Governments by Function and Fund Group: 1940 - 2025.

What types of federal grants are made to state and local governments, and how do they work?

The federal government distributes grants to state and local governments for several reasons. In some cases, the federal government may devolve or share responsibility for a given service or function because state and local governments have better information about local preferences and costs. In others, the federal government may offer states and localities incentives to undertake additional spending benefiting neighboring jurisdictions or the country as a whole.

Over the past 50 years, the composition of federal grants has shifted dramatically. For example, federal grants for health care programs were less than 20 percent of the total until the 1980s.

There are two main types of federal grants. Categorical grants are restricted to a narrow purpose, such as providing nutrition under the Special Supplemental Nutrition Program for Women, Infants, and Children, also known as WIC. Even more restricted are grants limited to specific projects, such as building a highway. Block grants give recipients more latitude in meeting program objectives, such as assisting needy families and promoting work under the Temporary Assistance for Needy Families (TANF) program. States also set TANF eligibility requirements within federal parameters. Less common are grants targeted to redistributing resources across jurisdictions, such as the General Revenue Sharing program that ended in 1986.

Federal grants may also be classified according to how funds are awarded. Formula grants allocate federal dollars to states based on formulas set in law and linked to factors such as the number of highway lane miles, school-aged children, or low-income families. A prime example is the federal-state Medicaid program, which provides subsidized health insurance to low-income households.

Grants may also be awarded competitively according to specified criteria, as in the Race to the Top or Transportation Investment Generating Economic Recovery awards. In addition, grants may require states and localities to contribute their own funds (matching requirements) or maintain previous spending despite the infusion of federal cash (maintenance-of-effort requirements).

A recurring question with federal grants is how they influence state and local behavior. Research finds that states and localities substitute federal dollars for some of their own spending. However, magnitudes vary and in some cases federal grants may “crowd in” rather than crowd out state and local dollars. (See, for example, Gramlich and Galper (1973), who found that $1.00 of unrestricted federal aid stimulated $0.36 in state and local spending, $0.28 in lower state and local taxes, and $0.36 in higher fund balances or saving. However, other research has found evidence that federal dollars stimulate more than the expected state and local spending response. Some early “flypaper effect” research may have mistaken matching as lump-sum grants or overlooked maintenance-of-effort requirements. Other explanations include tacit understandings between federal appropriators and grant recipients about how recipients will respond to federal money (Chernick 1979; Knight 2002). See also Leduc and Wilson (2017).)

Beyond grants, the federal government also subsidizes state and local governments by allowing federal income taxpayers to deduct state and local taxes already paid (up to a $10,000 cap in 2018 through 2025 under current law) and by excluding bond interest from taxable income. The value of these subsidies was about $44 billion in forgone dollars to the US Treasury in FY 2019 (JCT 2019).

The State of State (and Local) Tax Policy

What types of federal grants are made to state and local governments, and how do they work?

FISCAL FEDERALISM AND FISCAL INSTITUTIONS

Updated May 2020

Data Sources

Joint Committee on Taxation (JCT). "Estimates Of Federal Tax Expenditures For Fiscal Years 2019-2023." Publication JCX-55-19. Washington, DC: JCT.

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What are state rainy day funds, and how do they work?

Q. What are state rainy day funds, and how do they work?

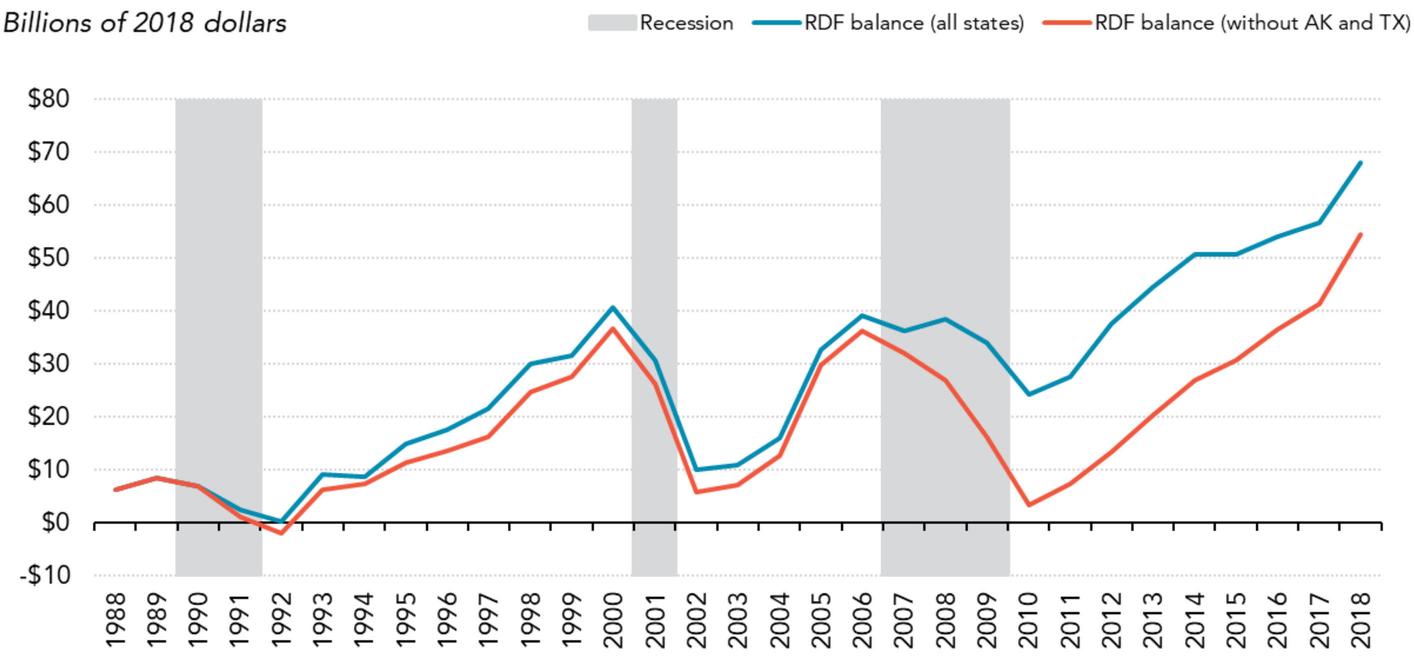
A. Rainy day funds, also known as budget stabilization funds, allow states to set aside surplus revenue for use during unexpected deficits. Every state has some type of rainy day fund, though deposit and withdrawal rules vary considerably.

FIGURE 1

Total Rainy Day Fund Balance

All states, 1988–2018

Billions of 2018 dollars



Source: National Association of State Budget Officers, Fiscal Survey of the States.

What are state rainy day funds, and how do they work?

SOURCES OF FUNDING

States finance their reserve funds differently (table 1). Most allow some or all their year-end surplus to flow to the rainy day fund (RDF). Other states require a flat contribution out of total or special revenue sources. California, for example, dedicates a portion of its capital gains tax revenue to its budget stabilization account. Similarly, natural resource–rich states like Texas and Louisiana dedicate a portion of oil extraction revenues to various reserve funds, in combination with other deposit mechanisms.

A handful of states tie their reserve accounts to either revenue or economic growth. Indiana, for example, ties its deposits to personal income. Arizona also ties its deposits to a personal income growth formula, but the legislature must authorize the transfer and in practice rarely adheres to the recommended formula. Other states require specified set-asides until the fund reaches its minimum required balance. A few states replenish their funds with discretionary appropriations as part of the budget process, but regular contributions are not automatic or required in these states. Except for the few states (such as Colorado) required to remit surplus revenues to voters, most states can also carry additional general fund surpluses into the following fiscal year once any RDF funding requirements are met.

TABLE 1

Rainy Day Fund Deposit Mechanisms

March 2020

Deposit mechanism	States
All or portion of year-end surplus	Georgia, Kentucky, Minnesota[d], Mississippi, Montana, New Jersey, New Mexico, New York, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Dakota, Utah, Vermont, West Virginia, Wisconsin
Portion of total or special revenues	Alaska, California, Rhode Island, Wyoming
Tied to revenue or economic growth	Arizona[a], Idaho, Illinois[b], Indiana, Michigan, North Carolina, Tennessee, Virginia
Required minimum balance	Colorado, Florida, Iowa, Missouri, South Carolina
Combination	Connecticut, Delaware, District of Columbia, Hawaii, Louisiana, Maine, Maryland, Massachusetts, Nebraska, Nevada, New Hampshire, Texas, Washington
No required payments	Alabama, Arkansas, Kansas[c]

Sources: National Association of State Budget Officers, *Budget Processes in the States*, 2015, https://www.nasbo.org/reports-data/budget-processes-in-the-states; the Pew Charitable Trusts, "Building State Rainy Day Funds," July 15, 2014, http://www.pewtrusts.org/en/research-and-analysis/reports/2014/07/15/building-state-rainy-day-funds-policies-to-harness-revenue; the Pew Charitable Trusts, "State Rainy Day Funds in 2017, July 18, 2017, http://www.pewtrusts.org/en/research-and-analysis/fact-sheets/2017/07/state-rainy-day-funds-in-2017; and Tax Policy Center staff review of state constitutions and statutes.

Notes:

(a) In practice, Arizona rarely adheres to the recommended formula when determining RDF deposits, and the legislature routinely suspends required transfers.

(b) According to NASBO (2015), Illinois has not contributed to its fund since the deposit rules were established in 2004.

(c) Kansas established an RDF in 2016 and enacted a funding mechanism that will go into effect in 2021, dedicating 10 percent of unappropriated general fund surplus to its RDF. Currently, it is funded via discretionary legislative appropriation.

(d) Minnesota creates savings targets based on a rigorous analysis of state revenue volatility, but these targets are recommendations rather than requirements.

The State of State (and Local) Tax Policy

What are state rainy day funds, and how do they work?

USE OF FUNDS

In most states, the RDF is dedicated to closing deficit gaps in the current year or maintaining government spending when revenues are projected to decline. However, withdrawal rules vary. Some states include transfers from the rainy day fund to the general fund in normal appropriations bills, while others require an emergency declaration or a supermajority (e.g., three-fifths or two-thirds) of the legislature to make a transfer. Several states can use the RDF to cover short-term cash flow gaps. Money is transferred to the general fund and must be paid back by the end of the fiscal year.

In addition to an RDF that can be used for general purposes during a fiscal crisis, some states have reserve funds available only for specific uses. For example, 37 states and the District of Columbia (DC) have a reserve account dedicated to disaster recovery. Other states have separate reserve funds for education or Medicaid spending, designed to cover shortfalls in these vital programs. Deposit and withdrawal rules for these supplemental reserve accounts may vary considerably from the rules governing the state's primary RDF.

CAPS ON FUND BALANCES

Forty-one states and DC cap the balances of their funds. The cap is typically a percentage of either revenues or expenditures, although some states have more complex formulas for determining maximum fund size. Most states that finance their RDF with operating surpluses stop transfers once the cap has been reached, allowing the surplus to remain in the general fund. A few redirect those operating surpluses to other funds for special projects or taxpayer relief. Maine, for example, after transferring the required fixed amounts to several other reserve funds, directs 80 percent of the remaining surplus to its budget stabilization fund and the remaining 20 percent to its tax relief fund for residents. If the RDF is at its cap, excess surplus flows to the tax relief fund.

MITIGATING FISCAL CRISIS

An economic downturn can cause significant fiscal stress for states because, without changes in policy, revenues decline even as demands on programs such as unemployment insurance and Medicaid increase. Savings in rainy day funds help states weather a fiscal downturn with fewer expenditure cuts. The median balance of state RDFs declined significantly after each of the last three recessions, but states have gradually built them back up each time (figures 1 and 2).

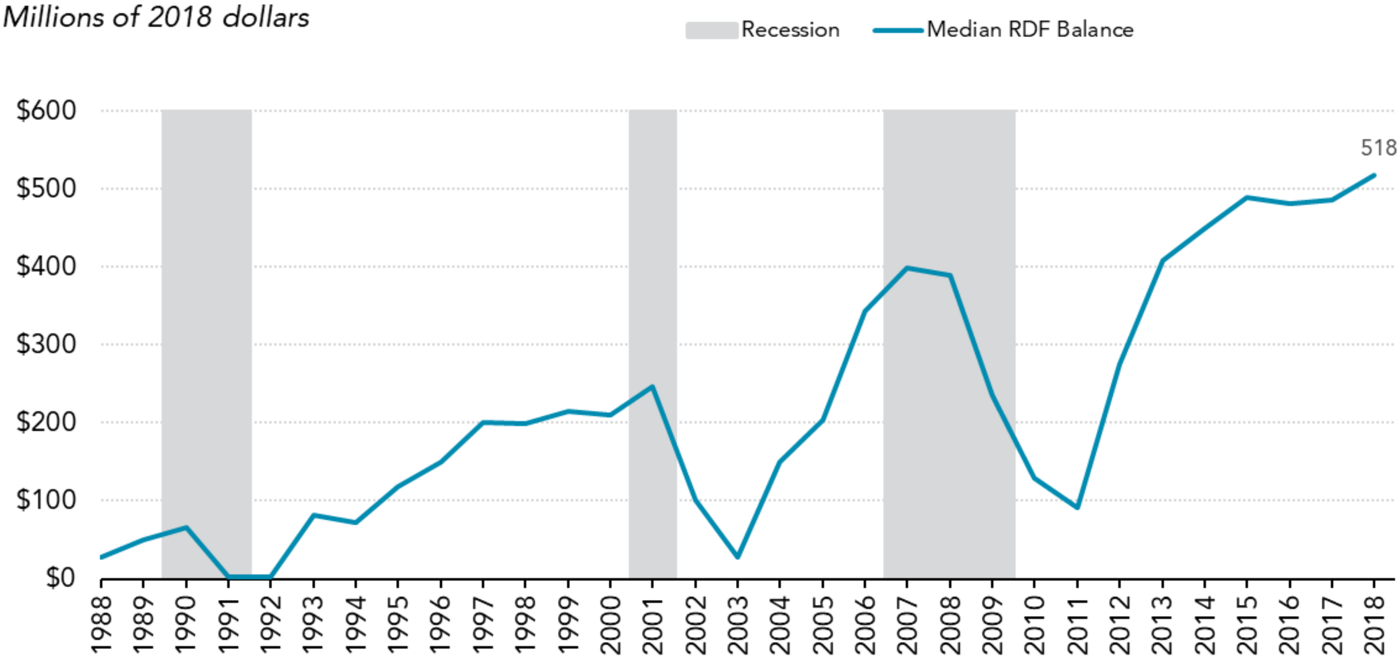
What are state rainy day funds, and how do they work?

FIGURE 2

Median Rainy Day Fund Balance

All states, 1988–2018

Millions of 2018 dollars



Source: National Association of State Budget Officers, Fiscal Survey of the States.

Capping the amount in the RDF is a sensible approach to preventing the unnecessary build-up of restricted funds, but the cap must be set appropriately. Before the Great Recession, a typical rule of thumb was to maintain at least 5 percent of total expenditures or revenues in reserves. States that cap out at 5 percent or less, therefore, may find reserves inadequate to close fiscal gaps. Currently, 9 of the 41 states with caps, as well as DC, specify caps of 5 percent or less.

Many states have reconsidered the 5 percent rule since the Great Recession, as even states with robust prerecession RDFs exhausted much of their reserves. The Government Finance Officers Association now recommends states set aside at minimum two months of operating expenditures (i.e., roughly 16 percent of total general fund spending). Only five states had RDF balances at or above 16 percent at the end of 2018, all of which except California were natural resource–rich states (i.e., Alaska, Texas, West Virginia, and Wyoming). In another approach, also recommended by the Government Finance Officers Association and others, some states have begun to tie and tailor their caps and deposit mechanisms to their own revenue volatility.

RDFs are an important tool for states to avoid sharp cuts in spending or tax increases when they are hurting economically. It is generally recommended that states mitigate fiscal and economic volatility by pairing strong balanced budget requirements with robust RDFs. Moreover, states should design their RDF deposit mechanisms and caps with an understanding of their revenue volatility.

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What are state rainy day funds, and how do they work?

Updated May 2020

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The State of State (and Local) Tax Policy

What are state rainy day funds, and how do they work?

FISCAL FEDERALISM AND FISCAL INSTITUTIONS

What are tax and expenditure limits?

Q. What are tax and expenditure limits?

A. Tax and expenditure limits (TELs) restrict the growth of government revenues or spending by either capping them at fixed-dollar amounts or limiting their growth rate to match increases in population, inflation, personal income, or some combination of those factors. As of 2020, 33 states had at least one kind of TEL, including those states requiring a supermajority vote of the legislature to raise new taxes or revenues.

DESIGNING TAX AND EXPENDITURE LIMITS

Spending versus revenue limits. States can limit their own revenues, appropriations, or both. Some states also limit the growth of local revenues, for example, restricting the growth of local property taxes. Appropriations and spending limits are more common than revenue limits. In 2020, 25 states imposed limits on their own government spending (figure 1). By contrast, 21 limited state revenue; 13 of these states capped both. Among states with revenue limits, 19 required a legislative supermajority (usually three-fifths or two-thirds of the legislature) to raise taxes or revenue, six limited revenue via other mechanisms, and four did both.

Mechanism. The means states use to limit spending and revenue vary considerably. The limit can be either a cap on growth or a restriction on the level, for example. The most common formula restricts expenditure *growth* to the pace of personal income, but some states include population and inflation growth in the formula. Other states restrict expenditures to a specific *level*, also often determined by a formula, such as a set percentage of personal income. Idaho, for example, limits expenditures to 5.33 percent of state personal income, thereby allowing expenditures to grow at the same rate as the economy. Another method is to restrict expenditures to a percentage of *projected* revenue, maintaining a cushion in case revenues fall short of projections.

Stringency. In general, constitutional provisions are more difficult to change or override than statutory TELs. By the same token, TELs imposed directly by voters rather than by legislators are more restrictive (New 2010). The most stringent revenue limits require that surplus revenue go back to taxpayers as rebates or be sequestered in rainy day funds. Oregon's "Kicker" rebate and Colorado's Taxpayer Bill of Rights are examples.

In some states, lawmakers can evade their TELs by imposing unfunded mandates upon, or transferring program responsibility to, local governments. Several states prohibit such actions, however and, more often, the measure of a TEL's stringency is whether the governor or legislature can override the cap with a simple

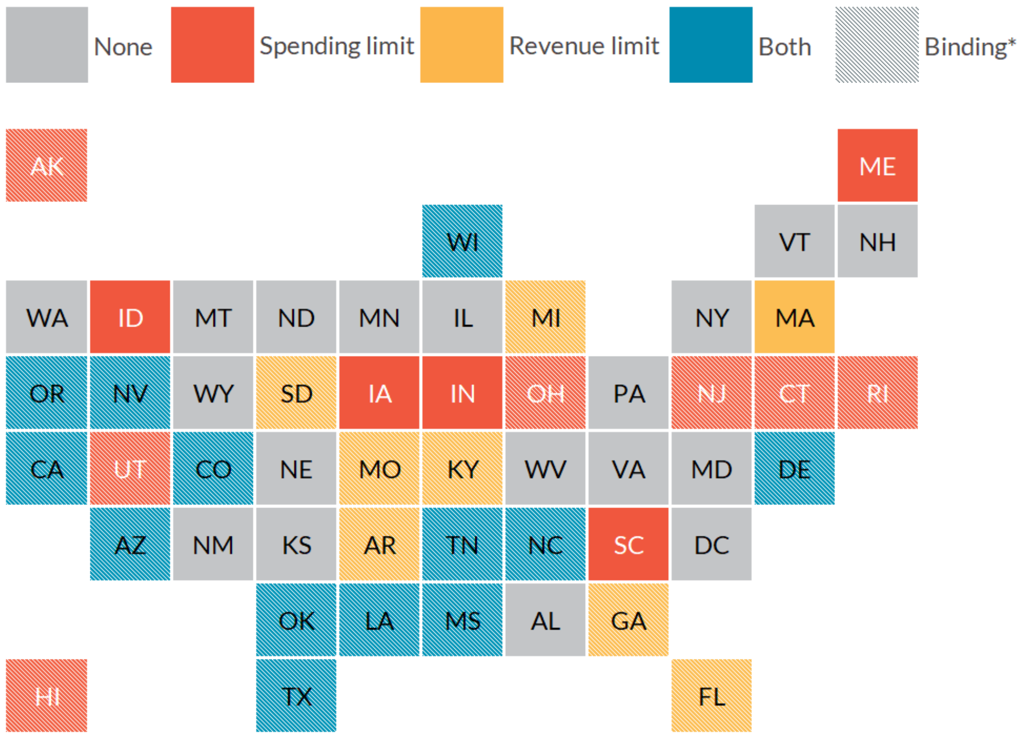
What are tax and expenditure limits?

majority. Several states have what, at first glance, appear to be restrictive TELs, but require only simple legislative majorities to override (i.e., the same threshold for approving a standard budget). Fifteen states require either a legislative supermajority or a popular vote to override their spending limits, and five impose this requirement on their revenue limits. Additionally, as mentioned, 19 states stringently bind revenues by requiring a legislative supermajority to raise new taxes or revenues.

FIGURE 1

Tax and Expenditure Limits by State

2020



Source: Urban-Brookings Tax Policy Center analysis of literature, including Kallen (2017), Lee (2018), NASBO (2015), and Waisanen (2010); as well as independent review of state statutes, constitutional provisions, and state sources.
Notes: Binding limits requireme either a vote of the people or legislative supermajority vote to ovverride. Legislative supermajority requirements to raise new taxes or revenues are counted among binding expenditure limits. Four states (Georgia, North Carolina, Texas, and Nevada) constitutionally cap or ban state income taxes. These are classified above as binding revenue limits, since they require a supermajority vote of the legislature to amend. Nebraska constitutional prohibits a state property tax, but we do not count this as a revenue limit, since property taxes do not generally constitution a large share of state revenue. States with both a spending and revenue limit are classified as binding if either of their limits meets the above criteria.

The State of State (and Local) Tax Policy

What are tax and expenditure limits?

FISCAL FEDERALISM AND FISCAL INSTITUTIONS

BACKGROUND

Most TELs emerged during the "tax revolt" of the late 1970s or the economic recession of the early 1990s. Although many of the best-known local property tax limits, such as California's Proposition 13 and Massachusetts's Proposition 2½, were adopted through citizen initiatives, most state TELs originated in their legislatures and limited expenditures, not revenue. As of 2015, only nine states had enacted TELs through voter initiative. New (2010) found that TELs adopted through citizen referendum were more effective than those adopted by legislatures.

Evidence on whether TELs limit state and local spending is mixed (Gordon 2008). Rueben (1996) found that laws' details matter and that TELs requiring a legislative supermajority or popular vote to modify spending reduced state general fund expenditures by 2 percent. However, those savings were partly offset by higher local spending.

Knight (2000) found that states with both a supermajority requirement to raise taxes (a kind of revenue limit) and an additional tax or expenditure limit had lower expenditures than states with just one constraint. Poterba and Rueben (1999) found that TELs affect the costs of state borrowing in two ways: not surprisingly, spending limits lower the costs and revenue limits increase them.

The strictest tax limitations, like the original implementation of the TABOR rule in Colorado, can prevent states from saving revenues in rainy day funds to cushion against downturns. Randall and Rueben (2017) synthesized decades of research on TELs and other budgetary institutions, concluding that states should reform TELs that prevent them from saving during good times. Rueben, Randall and Boddupalli (2018) found that, during the Great Recession, states with binding revenue limits or a combination of binding revenue and expenditure limits were more responsive to deficit shocks than states with weaker rules.

PROPERTY TAX LIMITS

Property tax limits constitute a special category of revenue limit because, in most cases, they are set by state governments but apply to local governments. Only two states—New Hampshire and Vermont—do not limit property taxes. State restrictions can apply to the property, to the jurisdiction, or both. Rate limits impose maximum rates on jurisdictions (e.g., counties, municipalities, and school districts). Limits on the growth of property tax assessments are typically applied to properties.

For example, Arizona limits residential property assessment to 10 percent of a home's value, growth in its property tax base to 5 percent annually, combined state and local tax rates for owner-occupied residences to a maximum of 1 percent of the state's limited property value, and growth in local property tax levies to 2 percent annually plus new construction. The state also caps expenditures for most local governments.

Updated May 2020

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The State of State (and Local) Tax Policy

What are state balanced budget requirements and how do they work?

Q. What are state balanced budget requirements and how do they work?

A. Balanced Budget Requirements (BBRs) are constitutional or statutory rules that prohibit states from spending more than they collect in revenue. They vary in stringency and design, and some research finds that stricter BBRs can produce "tighter" state fiscal outcomes, such as reduced spending and smaller deficits. However, they can also contribute to volatility and force states to cut services or raise taxes when their economies are already hurting. The effects of BBRs also depend critically on the details of the laws and implementation.

BACKGROUND

Balanced Budget Requirements (BBRs) have become a pillar of state budgeting practice over the last thirty years, requiring states to balance projected revenue with expenditures. In general, stricter BBRs, which prohibit states from carrying deficits into the following fiscal year, are associated with tighter fiscal outcomes, such as smaller deficits and more rapid spending adjustments during recessions.

Although all states except North Dakota and Wyoming have some restrictions, the design and stringency of requirements varies across states. For example, although Minnesota and New Mexico require the governor to propose a balanced budget, they do not require the legislature to pass one. Texas and West Virginia, by comparison, require the legislature to pass a balanced budget, but they do not require the governor's initial proposal to be balanced. In California, the governor must propose, the legislature must pass, and the governor must ultimately sign a balanced budget. In 2015, 38 states required the governor to submit a balanced budget to the legislature; 38 (though not necessarily the same 38) required the legislature to pass a balanced budget; and only one, California, required the governor to ultimately sign a balanced budget. BBRs typically only apply to states' operating budgets, while capital and pension funds are usually exempt from these limitations.

While researchers have debated how to best classify the relative strength of a state's BBR, recent research suggests a BBR is more binding if it meets at least one of the following requirements:

- the governor must sign a balanced budget;
- the state is prohibited from carrying over a deficit into the following fiscal year or biennium; or
- the legislature must pass a balanced budget accompanied by either limits on supplementary appropriations or within fiscal-year controls to avoid a deficit.

The State of State (and Local) Tax Policy

What are state balanced budget requirements and how do they work?

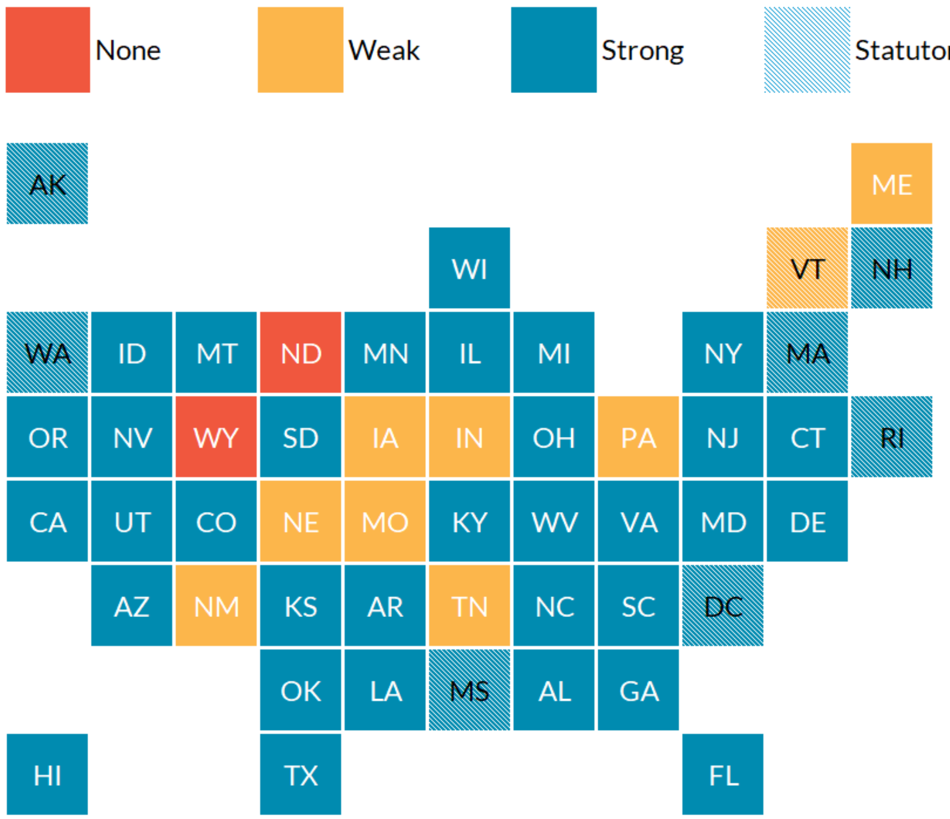
Most states have a strong BBR per this classification system (figure 1), and in general states have tended to strengthen their BBRs over time.

BBRs can be either constitutional or statutory. While constitutional or statutory designations do not necessarily determine whether a rule is strong or weak, constitutional requirements can be more difficult to override, and may require a legislative supermajority or vote of the people to amend.

FIGURE 1

State Balanced Budget Requirements

2015



Source: Urban-Brookings Tax Policy Center review of literature, including Hou and Smith (2006), Smith and Hou (2013), and NCSL (2010), as well as independent review of state statutes, constitutional provisions, and state sources.

Notes: A strong balanced budget requirement meets one or more of the following criteria: 1) requires the governor to sign a balanced budget; 2) prohibits the state from carrying over a deficit into the following year or biennium; or 3) requires the legislature to pass a balanced budget, accompanied by within-year fiscal controls or limits on supplemental appropriations. A "statutory" designation indicates that all balanced budget rules in that state are statutory. A non-statutory designation indicates that one or more of that state's rules is constitutional. In the District of Columbia, the mayor must propose, council must pass, and mayor then present a balanced budget to the president for submission to the US Congress. We classify this as a strong requirement.

The State of State (and Local) Tax Policy

What are state balanced budget requirements and how do they work?

CIRCUMVENTING BALANCED BUDGET REQUIREMENTS

Under some circumstances, state policymakers can circumvent their BBRs. These rules typically apply to a narrowly defined share of total state spending, and government fund accounting practices can provide opportunities to shift obligations between funds or years.

For example, because BBRs are applied on a cash rather than accrual basis, states can push a payroll or state aid payment from the last month of the current fiscal year into the first month of the next. This allows states to meet the legal requirement to balance their budgets while leaving actual resources and obligations out of balance. During the 2009–10 budget cycle, for example, California moved its payroll obligation by one day to balance its budget.

These actions only produce one-time savings, however, as the state simply transfers its obligation to the following fiscal year. If a shortfall results from sudden changes in economic conditions, this flexibility can allow a state time to recover economically and meet its fiscal obligations. However, it can also lead to ongoing reallocation of expenses to the next budget year.

IMPACT

Strong antideficit provisions, such as those in BBRs, are associated with:

- reduced spending;
- smaller deficits;
- more rapid spending adjustments during recessions;
- less debt;
- lower borrowing costs; and
- higher surpluses, which states can then deposit into a budget stabilization fund to smooth over gaps in spending at later dates.

Fiscal and budgetary institutions like BBRs, particularly when enforced strongly, influence both the size and composition of states' responses to fiscal deficits.

Poterba (1994), for example, found that states with strict BBRs, which prohibited them from running deficits into the following year, were better able to adjust to deficit shocks, especially if one political party controlled both the governorship and the state house of representatives. States with weak antideficit provisions reduced spending by $17 for every $100 deficit overrun, compared with $44 in strong antideficit states (Poterba 1994).

More recent research continues to show that states with relatively strong BBRs cut their budgets more in response to deficits than states with weaker rules. This was true for the two decades preceding the 2008 recession, with even more pronounced effects between 2008 and 2015 (Rueben, Randall, and Boddupalli 2018) Additionally, in more recent years, states with strong balanced budget rules bridged less of their gap with revenue increases than in years prior, leaning more on spending cuts or possibly reserve funds to bridge gaps.

However, strict BBRs can also increase states’ fiscal and economic volatility, since they force a state to enact spending cuts or revenue increases when a state’s economy is already contracting (Bayoumi and Eichengreen

1995; Levinson 1998, 2007). These actions exacerbate, rather than counter, the effects of an economic contraction. During and following the Great Recession, for example, states with strong BBRs cut their budgets and raised revenues precisely when the economy and residents would benefit from states spending more and easing taxes.

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