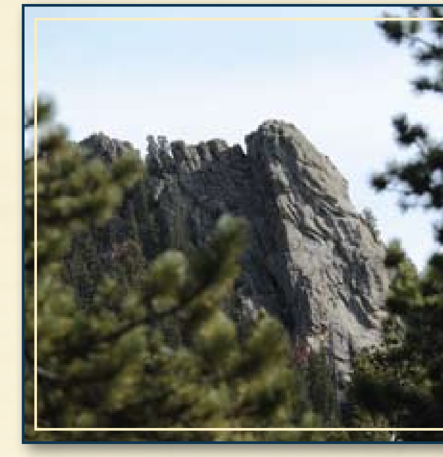
KIMBERLY BLOOMER visits Eldorado Canyon and other Colorado state parks weekly. Their upkeep is funded in part by state tax revenues, which are affected by economic conditions.

PHOTO BY JOSHUA LAWTON

REVENUE STREAM

How state taxes fund public services, amenities



Kimberly Bloomer is a home health aide who spends hardly any free time in her own home.

"I'm constantly outdoors," she says, listing off her favorite state parks in Colorado that she visits to rock climb, mountain bike and hike year-round.

Bloomer, 38, realizes some of the state taxes she pays in part fund the parks' upkeep, but says she wouldn't be willing to pay higher taxes in order to avoid cuts, such as reduced hours or maintenance, although she would want any cutbacks to be minimal.

"I love state parks," Bloomer says. "It's pretty much why I live in Colorado."

While Colorado's state parks haven't experienced a reduction in hours or services since 2004 (which caused a loud public outcry), the state's government and others are challenged to maintain state-funded services without raising taxes, especially during tough economic times like these.

Many factors influence state tax revenues, but a major component is the makeup of its tax portfolio. Just like individual investors, each state has a tax portfolio with a varying assortment of revenue sources, such as income tax and sales tax. This pays for state services, whether it's parks, schools, state troopers or correctional facilities.

"A state's tax portfolio plays a critical role in determining the growth and stability of tax revenues," says Alison Felix, an economist with the Federal Reserve Bank of Kansas City. Felix recently researched tax revenue sources in the Tenth Federal Reserve District, measuring growth and stability during the past 40 years. The District's states are Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and New Mexico.

"This is important for understanding the overall performance of state tax revenues," Felix says. "Taking a look at the growth and stability of each tax instrument makes it possible to assess potential risks and rewards of a state's overall tax portfolio."

Unlike the federal government, states must have a balanced budget. State tax collections are closely related to the economic health of a state as well as the nation. For example, volatile corporate tax revenues and reduced personal income tax revenues (as capital gains slow from a sagging stock market) have negative effects on state tax revenues.

"When times boom, revenues abound," Felix says. "When the economy takes a downturn, revenues tend to follow."

During this nationwide economic downturn, more than half of all state governments are projecting budget shortfalls in 2009 totaling billions. Although Felix says tax revenues for District states likely will fare better in the near term than revenues for the nation as a whole, the tough times are evident. For example, Colorado recently announced a hiring freeze on new state employees and a halt on new construction, including a full-day kindergarten project. Although Wyoming has a surplus, the state tapped its rainy day fund to balance the '09 budget, and Nebraska predicts future reductions to its K-12th grade education, according to the National Conference of State Legislatures.

"Residents don't like either option," Felix says, "but less money coming in means state services are going to get cut or taxes will be raised. Therein lies the challenge for state governments."

> **"Growth and stability are important characteristics of tax instruments."**

What's in states' portfolios?

To make up their portfolio, states choose from a variety of tax sources, each of which responds to varying degrees to changes in the overall health of the economy. Sales tax on food, for example, is stable because people buy food regardless.

"Growth and stability are important characteristics of tax instruments," Felix says. "Because these vary for each tax source, the right balance can be a challenge."

During the past 40 years, District states have become more reliant on personal income taxes and less so on selective sales taxes, but there haven't been many major changes to states' tax structures. Felix's research shows state tax revenues have grown faster than personal incomes during the past 40 years. In the District, most states' tax revenues are more volatile than personal income. As the economy fluctuates, the volatility of tax revenues means how much revenues respond to these changes.

Felix examined the growth and volatility in the past 40 years of the five most important tax sources in states' portfolios in the District:

General sales taxes: Revenues grew at a similar pace as personal income. These revenues were generally less volatile than others, but a drop in consumer spending leads to a drop in sales tax revenues. The structure of general sales taxes varies widely. Many states exempt food (including Nebraska, Wyoming, Colorado and New Mexico) and prescription drugs (including all District states) from sales taxes. Another difference is the number of services (utilities, professional services and others) taxed. For example, in 2007, Colorado taxed 14 services and New Mexico taxed 158. Taxing a large number of services boosts revenue growth and can reduce volatility through diversification, Felix says.

Selective sales taxes: These include taxes on tobacco, alcohol and gasoline; their revenues have grown slower than personal income. These taxes were the slowest growing and least volatile in the District—as their incomes grow, people don't greatly change their tobacco use, for example. Consumption of these goods doesn't decrease much during economic slowdowns either.

Personal income taxes: These were the fastest growing revenue sources nationwide and in the District. Although they grow faster than personal income (more than double in the last 40 years), Felix says they were more volatile because, in most states, capital gains are taxed as ordinary income—stock market returns are more volatile than personal income.

Corporate income taxes: Revenues grew slower than personal income and were the most volatile in both the nation and the District.

Where does state tax revenue come from?
Composition of state tax portfolios in 2007

How are state services like roads, correctional facilities and public education funded? Your taxes.

In most states, general sales taxes and personal income taxes make up the largest share of total tax revenues. Selective sales taxes include motor fuel, alcohol, tobacco and others, and represent 15 percent of the average general fund. Corporate tax revenues make up 7 percent, and severance taxes (imposed on the extraction of a state's natural resources that will be used in other states) and other taxes (such as property taxes) make up about 11 percent.

Overall, the Tenth District states rely more on personal income and severance taxes, and less on sales and corporate taxes. State tax portfolios in the District are somewhat unique to the national average.

Some noteworthy components of portfolios in the District from the past 40 years include:

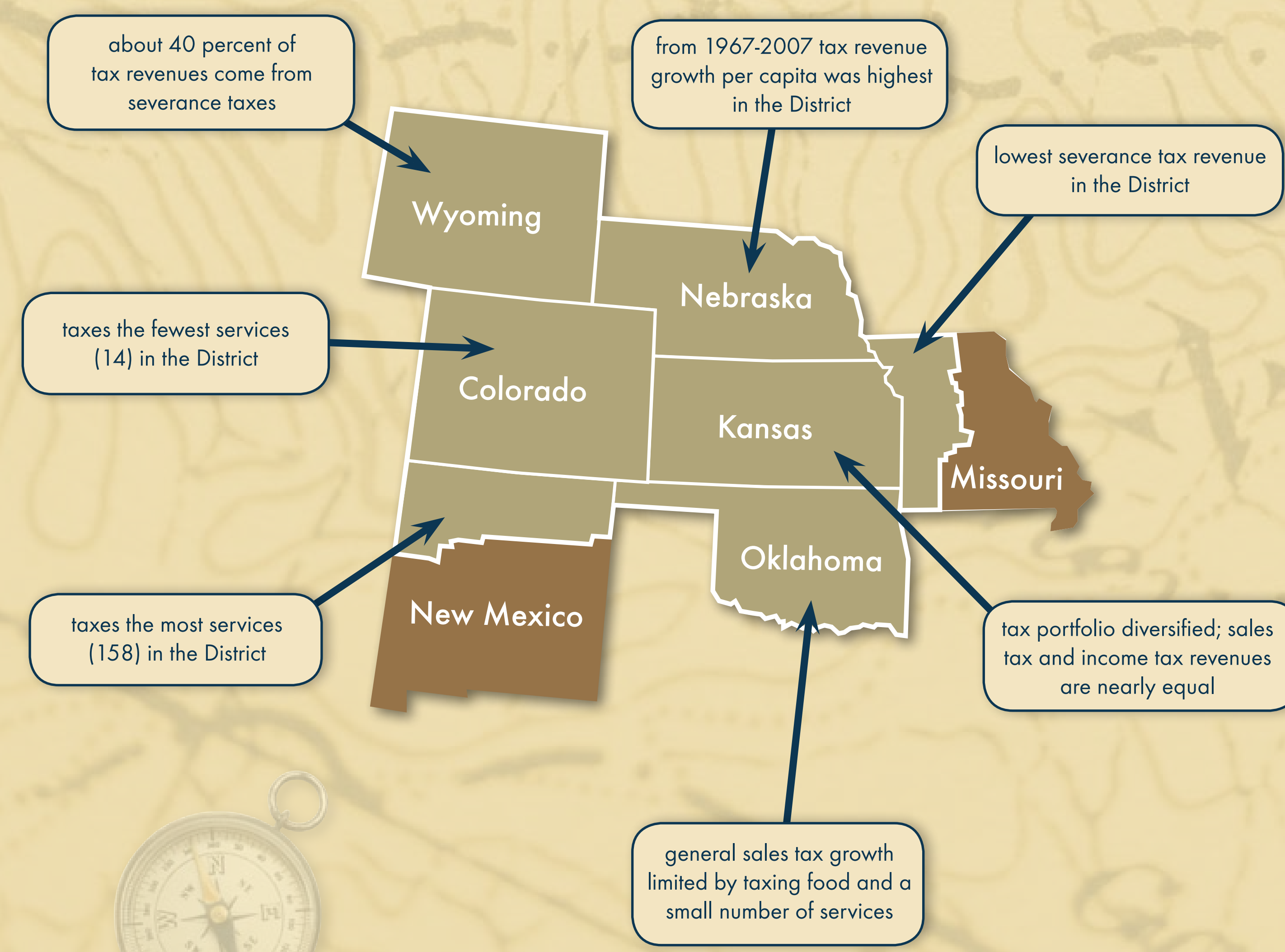


PHOTO BY GETTY IMAGES

The slow growth can be attributed to state governments' increased use of business tax incentives through the years. In the late '90s, only Nebraska and New Mexico in the District didn't offer corporate tax exemptions, and had the fastest growth of corporate revenues of District states.

Severance taxes: Extracted natural resources like oil, natural gas and coal bring in almost a billion dollars a year each to New Mexico, Oklahoma and Wyoming. Severance tax revenue in the District has grown faster than personal income, due to price increases and increasing tax rates. These revenues are highly volatile, primarily because prices of natural resources are often unstable. The District's overall strong reliance on severance taxes provided a revenue boost while the price of natural resources was at an all-time high last summer, Felix says.

HAVING A BALANCED TAX REVENUE PORTFOLIO that maintains services without much change in taxes is a challenge for states. Residents don't want services, like education or highways, cut.

Where does the money go?

Whether visitors want to go ice fishing and snow shoeing at Steamboat Lake, or rock climbing and horseback riding at Eldorado Canyon, $7 per vehicle gets them a day pass (or $60 per year) at any of Colorado's 40-some state parks.

And although the parks see about 11 million visitors a year, entrance fees only cover about a third of the expenses, which includes upkeep, staffing and visitors' services, says Deb Frazier, Colorado State Parks communications manager. The parks rely primarily on a combination of state sources to fund its $62 million annual budget.

"If there's a slowdown in the economy, especially if gas prices are high, it cuts both ways," Frazier says, explaining less tax revenue comes in and fewer out-of-town visitors go to the parks, though there still seems to be a high number of local visitors opting for a "staycation."

Frazier doesn't anticipate budget-related cuts in the near future, thanks in large part to the nearly 7,000 volunteers—like Kimberly Bloomer, the home health aide, who volunteers as a trail builder.

"These are very special places to people," Frazier says. "The loss of that is something that cuts deeply."

Since moving to Westminster, Colo., from Pittsburgh, Penn., about nine years ago, Ed Twele discovered his new "passion." Twele, 50, frequents the state parks weekly to fly-fish. He and his wife, Cathy, also go hiking and cross-country skiing, and enjoy taking their out-of-town visitors to the parks as well.

"I want to be able to go there whenever my schedule permits," says Twele, who is a partner in a financial advising firm. "I would rather pay higher taxes than have reduced services or hours."

For many states, unpopular budget cuts are certain. There is an "incredible amount of linkage" between a state's economic health and its revenues generated from personal income tax and general sales tax, says Arturo Perez, a fiscal analyst with the National Conference of State Legislatures, a bipartisan organization that provides research and other assistance on state issues to legislators. For example, a slow economy spikes unemployment and reduces personal income tax revenues, or affects spending and reduces general sales tax revenues.

PHOTO BY GETTY IMAGES

In response to reduced revenues, states typically cut spending first to balance their budgets, followed by, if necessary, tapping reserves, and finally raising taxes. Sometimes federal fiscal relief can be an option.

"Each state has its own priorities," when it comes to balancing the budget, Perez says, but when it's time to cut, "higher education is a favorite. It's the largest discretionary area of state spending."

States' current budget shortfalls somewhat mirror those seen after the dot-com bust and post-9/11, Perez says. These downturns were short and revenue performance was back up until 2007. As for how states will fare this time, he says it all depends on the severity of the nationwide downturn.

Importance of portfolios

A national slowdown affects each state differently because of the makeup and performance of its tax portfolios.

"There are states which are in a huge heap of trouble," says David Blatt, director of policy at the Oklahoma Policy Institute.

Oklahoma, and other states in the District, is not as severely affected because severance taxes helped spare the state. While Oklahoma is not in a budget crisis, there are some strains, namely in the health-care and education sectors, Blatt says.

Roy Bishop, a former teacher of 15 years and now the president of the Oklahoma Education Association, a 40,000-member advocacy organization, says, "We have to get past the mantra that taxes are the worst thing ever … . This is what pays for your services. Tax dollars are an investment in our society."

Economic fluctuations can reinforce the importance of states' portfolios, Felix says. While she is not suggesting one type of tax or portfolio is better than another, Felix says portfolios should be developed to fit a state's economic makeup because each potentially affects the state's economic growth, and in turn residents' services.

"To maintain revenues that can keep pace with increasing constituents' demands and survive economic downturns," Felix says, "policymakers should be aware of the growth and volatility of each tax source."

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BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

"THE GROWTH AND VOLATILITY OF STATE TAX REVENUE SOURCES IN THE TENTH DISTRICT"
By R. Alison Felix
KansasCityFed.org/TEN

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.