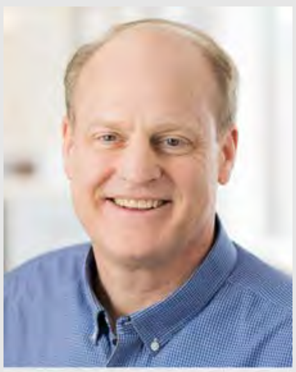
The Shape of the Recession Will Reshape State And Local Tax Policies

by Michael J. Bernard and George L. Salis



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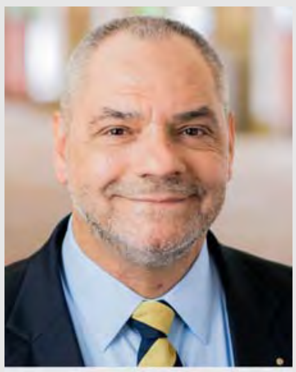

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In this article, the authors discuss how economic stabilization measures enacted in response to the COVID-19 pandemic could affect state and local tax policies and how businesses can influence these outcomes.

Economic rescue efforts in response to COVID-19 have proven necessary and indispensable. However, the repercussions of the unprecedented economic stabilization and stimulus measures will linger far into the future. Once stabilization takes hold and growth resumes, many state and local governments will make major fiscal policy adjustments to cover the extraordinary costs inflicted by the pandemic. These initiatives occupy three categories: tapping rainy day or revenue stabilization funds, reducing spending, and making tax policy changes. These typically include tax rate increases, the introduction of new tax types, aggressive tax auditing approaches, and other ways to expand the jurisdiction's tax base, specifically the sales tax base. Over the past few years, states have been able to fill revenue shortfalls in large part thanks to the 2018 *Wayfair* decision that allowed states to collect taxes from remote e-commerce sellers.[1] Although e-commerce sales continue to flourish in this social distancing economy, many states, like New York, are operating under budget deficits and revenue constraints.

Some state and local sales tax increases will be passed on to consumers while use taxes must be absorbed by businesses. Other taxes, including gross receipts tax and payroll head taxes, also directly affect companies and cannot be passed on. The expansion of sales taxes to services can pose risks to revenue. If a state extends sales tax to legal or consulting services, for example, client companies that traditionally outsourced those services to external providers will be paying sales tax on top of professional fees. Client companies could elect to bring those services in-house, but often that expertise may be difficult to procure. Also, companies subjected to collecting new tax types may not have the tax technology systems in place to manage additional compliance requirements.

Although it is too early to accurately forecast precisely how tax policies will be adjusted to refinance future debts, tax executives can take several actions today that will help their organizations respond with greater agility once tax policy overhauls commence. These steps include:

- recognizing how the depth and duration of the recession will affect the timing of future fiscal and tax policy adjustments;

[1] *South Dakota v. Wayfair Inc.*, 585 U.S.___(2018).

- assessing the range of fiscal and tax policy levers government leaders are most likely to reach for; and
- considering how they can influence state and local tax policy decision-making.

A W-Shaped Recovery Model May Delay Tax Policy Changes

The shape of the recession and the recovery that follows it largely determine when state and local governments can shift their attention from stabilization and stimulus activities to the fiscal adjustments needed to cover those rescue costs.

Despite widespread hope for a V-shaped recovery (a swifter, more dramatic resumption of economic growth), we expect that a W-shaped shaped recovery (a more prolonged adjustment period with two low points) is more likely.

To be sure, the intensity and duration of the recession will be determined by a range of factors. Some of these influences are known while others may unexpectedly materialize in the months ahead. The corporate debt bubble could pop, for example, or the paused trade war between the United States and China could suddenly rekindle. A massive hurricane could inflict billions of dollars in damages throughout the southeastern United States. A second wave of COVID-19 infections in the fall or winter also could hinder recently resumed business activity.

Given these wild cards, the W-shaped model appears more realistic. The question, a big one, is how low will the depths of the recession reach and how long will those periods endure before the economy's upward trajectory resumes?

5 Fiscal Retrenchment Factors

The length and depth of the recession will influence the timing and magnitude of the fiscal adjustments that state and local governments implement in response to COVID-related costs and revenue losses.

The timing of those actions is critical. Pivoting from economic stimulus actions to fiscal retrenchment efforts too soon can prolong a recession. For example, federal grants that financed state and local government spending increased in the immediate wake of the 2007-2009 recession. However, most of those grants were discontinued by 2011, "and overall spending by the sector dragged on growth for several years," according to Brookings Institution research. "This turn to fiscal austerity undoubtedly impeded the economic recovery. Hopefully, policymakers learned that lesson and will ensure that fiscal support is provided quickly and is not withdrawn prematurely."[2]

As tax executives watch what occurs when state legislatures begin to reconvene (46 states begin their fiscal years in July, although local pandemic guidelines could cause delays), they should keep the following considerations in mind.

Massive costs will need to be covered. The $2 trillion economic stabilization package the federal government approved this spring includes $150 billion to cover state and local COVID-related expenses. States remain hungry for additional aid to cover healthcare, unemployment, and other costs. In a letter to Congress quoted in *The Wall Street Journal*, the president of the National Association of State Budget Officers (NASBO) asserts that "states are currently facing revenue impacts that could dwarf what was observed in the last recession." The NASBO report indicates that states' revenue, which declined a total of 11.6 percent during the 2007-2009 recession, is now forecast to decrease up to 20 percent, primarily because of massive drops in sales and income taxes as a result of the crisis.[3]

State finances were not as rosy as they seemed before the pandemic. First, the good news: States' rainy day funds had reached all-time highs just before the onset of the pandemic. Late 2019 research from the NASBO indicates that rainy day fund balances reached a median of 7.6 percent as a share of general fund spending in fiscal 2019. That marks a record and a major improvement compared with 1.6 percent in fiscal 2010 (after the global financial crisis).[4] Yet, closer scrutiny of states' financial health before the pandemic reveals some troubling news. Despite those robust rainy day funds, "states may not be as

[2] Sage Belz and Louise Sheiner, "How Will the Coronavirus Affect State and Local Government Budgets?" Brookings Institution (Mar. 23, 2020).

[3] Scott Calvert and David Harrison, "States See No Immediate Sign of Financial Help," *The Wall Street Journal*, Apr. 23, 2020.

[4] National Association of State Budget Officers, "The Fiscal Survey of States" (Fall 2019).

prepared for the next recession as they think," an October 2019 Pew Charitable Trusts research report concludes. The research points to states' high fixed costs (e.g., Medicaid spending, which tends to increase in economic downturns), lower spending levels due to cuts made in response to the 2008 financial crisis, and recent revenue volatility.[5]

States will make tax policy changes according to their unique economies and interests. As state legislators and departments of revenue consider how to increase revenue, they will target tax types and categories that provide the greatest economic returns at the lowest political cost. States will try to revitalize the industries that are important to their economies and have been disproportionally affected. Preserving the competitive economic base in each state will be as vital as sustaining and increasing the tax base, because one is dependent upon the other.

New types of taxes may be considered. State legislatures may consider expanding sales taxes to traditional personal and professional services. These efforts have cropped up in several states over the years as services industries have driven more and more of U.S. gross domestic product. However, most of these efforts have failed because of a range of factors that include strong opposition, the possibility that these taxes would have a discriminatory impact on smaller companies, and the complexity of administering sales taxes on services across state lines. Roxanne Bland, *Tax Notes State* contributing editor, recently reported on these efforts to tax services and concluded: "It seems, however, that something will eventually have to be done with respect to taxing services. What that will be remains to be seen."[6]

Cities and counties are also hurting. According to the National Association of Counties, the pandemic has the potential to collectively affect county budgets by more than $144 billion through fiscal year 2021 ($114 billion in lost revenue and $30 billion in additional expenditures). That estimate does not account for funding and revenue share cuts from state sources, like state-collected sales, income, or gasoline taxes.[7] At last count, at least 2,100 cities were projecting budget shortfalls, according to research from the National League of Cities and U.S. Conference of Mayors. Los Angeles forecasts a $231 million revenue decline this year along with a $600 million drop in in 2021 revenue.[8] These budget shortfalls will spur county and city governments to consider the fiscal adjustments at their disposal.

When legislators and rulemakers come to terms with the economic damage that the pandemic has inflicted, a range of policy decisions will be made, not just the imposition of taxes. Governments need to think more broadly about working with the business community when addressing alternatives.

A Call to Influence

Potentially widespread changes to indirect tax legislation will increase pressure on tax executives to strengthen their advocacy for thoughtful and balanced tax policies.

This will come as no surprise to tax executives in the largest global companies — businesses that have long operated sophisticated government relations functions that exert influence on a range of company-relevant issues, including tax policy. Other tax and finance executives, especially those who wear many tax management hats in small and mid-sized companies, have traditionally been less focused on fiscal and tax policy analysis and the shaping of those policies.

However, those responsible for the tax function in companies large and small should be aware that they can and should monitor tax-related policy changes at the state and local levels — and that there are ways to shape and influence policymaking that do not require large amounts of time or resources.

State lawmakers frequently consult with their DORs when drafting tax-related laws and responding to citizen-initiated ballot initiatives

[5] Mary Murphy, Steve Bailey, and Airlie Loiaconi, "Rainy Day Funds in 2019: Are States Ready for the Next Recession?" Pew Charitable Trusts (Oct. 1, 2019).

[6] Roxanne Bland, "Sales Taxes on Services: An Uphill Battle," *Tax Notes State*, Nov. 18, 2019, p. 567.

[7] National Association of Counties, "Analysis of the Fiscal Impact of COVID-19 on Counties: Executive Summary" (May 2020).

[8] Scott Calvert, "Farewell — For Now — To Planned Teacher Raises and Property Tax Rebates," *The Wall Street Journal*, Apr. 17, 2020.

concerning tax matters. When new tax legislation emerges, legislators want to know if the DORs can enforce the requirements.

While a small group of tax leaders have forged direct and ongoing relationships with state DORs, there are several ways to exert influence indirectly. Chambers of commerce often take positions on tax matters, and tax executives can get involved with these efforts. Nonprofit research-based organizations in many states represent corporate taxpayer interests while sharing insights on tax policy with state and local rulemakers. In addition to working with groups like these, tax professionals can join relationship-building efforts spearheaded by tax functions in larger companies with more advanced government relations capabilities.

Influencing tax policy, directly or indirectly, will intensify as more state and local governments take an "everything's on the table" approach to alleviating pandemic-driven fiscal pain. ■