PAR Commentary
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# New Taxes, New Troubles

## The three legislative sessions brought more revenue, transparency and uncertainty

The first six months of 2016 at the state Capitol brought major tax increases, modest budget cuts and further uncertainty about Louisiana's financial future and business climate. Although the new governor did not achieve all his goals, he took significant steps in the direction of his preferred policies by raising state revenue and expanding Medicaid. The state budget placed less emphasis on one-time resources than in recent years and both the operational and construction budgets were built with a more transparent process.

This commentary highlights several changes and trends occurring over the three recent legislative sessions, provides budget comparisons and offers perspective on the challenges ahead. In the near future, Louisiana still faces a daunting gap between revenue and spending and a serious potential cash flow problem. For the longer term, the state faces a fiscal cliff when the temporary revenue enhancements fade out two years from now, a situation that could encourage fiscal reform.

## The ups and downs

The state's overall level of budgeted spending for the new fiscal year that began July 1, based on all state and federal money, is $31.2 billion, an increase of $2.1 billion, due largely to additional funds made available to cover the Medicaid expansion. Spending of all forms of only state revenue – counting taxes, fees, licenses, infusions of one-time money and any other kind of non-federal resource – is budgeted to increase almost 1% to $17.5 billion this year compared to fiscal 2016, a year in which one-time money was used extensively to balance the budget. Those infusions for 2016 included money from the rainy day fund, a tax amnesty program, raids on various state dedicated funds and a windfall of cash from one of the BP oil spill settlements.

So, even though the Legislature has raised about $1.5 billion in new annual tax revenue, state spending has remained about the same. That comparison is an indication of how unbalanced the state budget had become.

These budget comparisons are based on the House Fiscal Division estimates for spending in fiscal 2016. Because the budget for fiscal 2016 had so many drastic changes during the year, the net spending after cuts and additions can be difficult to determine. An updated calculation will be made by the Legislative Fiscal Office this year and the final accounting will come in January. Although some officials describe the budget in terms of the governor's spending targets or according to the differences in the House and Senate proposals for appropriations, the public's best and most understandable comparisons ultimately will be the actual spending figures.

## Impact on programs

Some agencies have fared better than others. Here is a concise look at some key changes:

● The Department of Health will see a nearly 8% rise in state-based support to $3.8 billion this year, banking partly on new assessments for hospitals and insurers to leverage federal Medicaid dollars. The agency's budget was warped in fiscal 2016. As a solution to a mid-year budget shortfall, the Jindal administration, with the consent of the Legislature, delayed until fiscal 2017 the payment of $126 million owed to medical vendors. This move did not relieve the state from the obligation of making those payments, but it allowed the health department's 2016 budget to be balanced on paper.

● The Department of Children and Family Services's state funding will increase 3%. Cut back in recent years, that social services department will see a 20% increase compared to 2015.

● Some construction projects were put on hold, including proposed facilities for the community and technical college system that were being financed outside of the usual capital outlay process and beyond the state's means.

● Breaking from past practice, no money was stripped from the state's transportation trust fund to pay for State Police or other costs unrelated to transportation.

● Higher education's level of state-based funding -- including direct state support, tuition and fees – will increase 2%.

● The Taylor Opportunity Program for Students, or TOPS, was cut by 29%, or $85.3 million less than last year. Students will get nearly their full amounts for the fall semester but will be cut short in the spring unless, as some legislators hope, a new appropriation can be made before then.

● After years of being protected from the budget ax, the judiciary branch will be cut 5% and the Legislature will be cut 9%.

● The state's funding of local school districts will decline slightly. Although the Minimum Foundation Program will not be cut, the amount of supplemental appropriations for local school districts will decline this year, leading to an overall state decrease of 0.4% for schools. That cut is $16.4 million out of an overall allocation of $3.67 billion.

Early this year, PAR recommended that the budget imbalance be addressed with a combination of revenue increases and specific state spending decreases. A number of those spending recommendations were implemented at least partially. Although budget cuts can lead to strains and fewer public services, the circumstances were appropriate for the state to dial back spending in some areas to reset the state budget at a less inflationary level.

## A new cash crisis

Over time, the revenue estimates and the budget for the current year could be revised based on state economic growth, oil price changes and a better understanding of the impact of new taxes and the suspension of some tax exemptions. But indicators for the near-term outlook are a serious concern. Revenue expectations for fiscal 2016 will be well above actual collections, based on the latest calculations. The state is likely in a deficit mode. State reserves of cash, which normally might be called upon to cover the bills during months when revenue is slack, are extraordinarily low. The downturn in the oil sector has dampened job numbers, consumer spending and corporate profits. In sum, the next state financial predicament could be imminent.

Uncertainty has become the key word. Credit rating agencies already have taken a diminished view of Louisiana's financial stability. Businesses are adjusting to tax increases from several different directions. State revenue forecasts are shaky. Much of the newly increased tax base is only temporary through mid-2018. The temporary removal of a variety of sales tax exemptions was legislated in a manner that has created unnecessary confusion and compliance difficulties. The state's business incentives and special tax breaks are being re-examined, which is appropriate but nevertheless creates uncertainty. Major tax reforms will be contemplated in the next year, also an appropriate and worthwhile endeavor that creates uncertainty about the future.

The past six months have established a higher level of recurring revenue that has contributed to a more honest operating budget. The goal for the next 12 months should be to contain expenditures and to seek a fiscal reform that will give Louisiana a more stable long-term outlook. Also, during this time, the state should clarify its programs and practices on business taxes and incentives so that private sector decision-makers can make plans and investments based on more reliable government policies.

## Peering over the cliff

The Legislature has increased the state sales tax from 4% to 5% and has temporarily removed or reduced credits, rebates and exemptions. But the Legislature was hesitant to approve permanent tax increases. So the sales tax increase and several other bills have sunset dates, creating a revenue cliff two years from now, when fiscal 2019 begins.

Table 1 shows the state's revenue year to year from taxes, licenses and fees. It does not include most sources of one-time money, such as taps on the rainy day fund. Tax increases helped boost revenue in fiscal 2016 by $220 million and by an additional $1.3 billion for the current year. State revenues are expected to grow further in fiscal 2018 through a combination of growth and additional taxes kicking in. When the tax increases end in July 2018, the estimated cliff would be about a $1.1 billion drop in state revenue.

*Table 1*

**Future Revenue Cliff**

| Fiscal Year | Total Tax, Licenses and Fees* (Millions) | Change from Previous Year (Millions) |
|---|---|---|
| **FY13-14 Actual** | $10,300 | $67 |
| **FY14-15 Actual** | $10,468 | $168 |
| **FY15-16 Projection** | $10,688 | $220 |
| **FY16-17 Projection** | $12,032 | $1,344 |
| **FY17-18 Projection** | $12,318 | $286 |
| **FY18-19 Projection** | $11,209 | -$1,109 |
| **FY19-20 Projection** | $11,398 | $189 |

**Due to dedications the entire amount listed is not available for appropriation as state general fund.*
*Source: Legislative Fiscal Office.*

These figures are just the revenue side of the budget. Expenses will continue to go up from mandated costs such as Medicaid utilization, state retirement obligations, pay increases, the K-12 school funding formula and state employee healthcare premiums.

How will the governor and the Legislature handle this situation? They could wait for the cliff and make drastic cuts in state services, but this outcome is unlikely. They could extend or remove the sunset provisions, keeping the same tax system in place. As a third option, the governor and the Legislature could work together to reform the tax code, and that is what leaders are saying they will try to do.

To develop a plan for comprehensive reform, the Legislature created the Task Force on Structural Changes in Budget and Tax Policy. The governor has embraced the initiative. This task force, of which PAR is a member, is charged with reviewing the current structure and design of the state budget together with state tax policies. They are to prepare a report with recommendations by Sept. 1. Tax reform will be difficult but necessary. Action is expected to be taken in the legislative period beginning in April 2017, a so-called fiscal session that can deal with taxes. Special sessions are a possibility also.

## Looking ahead

As the state assesses the impacts of the three fiscal sessions and considers the next steps, several key problems areas should be highlighted:

● ***Near term shortfall***. Attention must be paid to potential cash flow problems and deficit spending to keep state finances steady and to anticipate budget adjustments early.

● ***Business outlook***. Government policies should be clarified to provide a more stable outlook for businesses and economic development. Louisiana is a big question mark for business at this time. The state's economy, tax structure, tax rates and rules for exemptions and credits are all in flux. Although the governor and lawmakers are expected to focus on the state government's financial health as it considers fiscal reform over the next year, they should place a high priority on establishing a healthy business environment as well. That means first and foremost a clearer and more predictable regulatory and tax regime.

● ***Existence taxes***. Louisiana is increasingly focused on government collection of taxes from companies that do not make a profit or on factors other than net income. This trend can be seen through the expansion of the franchise tax and changes in inventory tax credits and the rules governing net operating losses, among other developments. This trend might escalate in future tax sessions and could contribute to further evidence of a dysfunctional tax system, particularly if pursued mainly as a means to raise revenue rather than as an intended improvement in tax policy.

● ***Pension burden***. The state's annual obligations to pay for the unfunded accrued liabilities of the retirement systems is a major burden on the state operating budget. Some relief might be achieved approximately in 2028 as a portion of the liabilities are scheduled to be paid off, which will result in more state money available to address other priorities. However, the retirement systems' expected actuarial rate of return is too high. The rate should be adjusted, which unfortunately will cost more money to maintain in the short term but will pay dividends to the state in the long term. The state's fiscal reform initiatives should consider means of financing that rate change as well as ways to accelerate the pay off of the initial UAL. Cost of living adjustments should be restrained according to state law and policy, which the Legislature failed to do in the regular session.

● ***State health care***. The Charity hospital privatizations are undergoing a revamp as the Medicaid expansion takes hold and provides coverage for more low-income people. This renegotiation is appropriate under the circumstances. However, many people remain uninsured as the Medicaid expansion continues and questions remain whether adequate access to care will be available from enough providers accepting Medicaid patients. In most markets, the privatizations have improved health care outcomes and provided better access and proactive measures through clinics and other programs. Those gains should not be lost as the state renegotiates its private partner deals with hospital operators. Over time, state control and support of designated institutions to serve the poor and uninsured is likely to be shifted more to a shared community responsibility in some areas.

● ***Medical education***. The state's policy and sense of value toward medical education needs a reality check. Budget considerations are driving the decisions, which seem increasingly uninformed by the health care goals and workplace needs of a medical education infrastructure in Louisiana. Pension and risk management costs for this sector of the state's health care program are severe and must be taken into account in finding solutions. State leaders and legislators should agree on long-term plans and goals for medical education and labor requirements across the communities of Louisiana. They should focus their budget discussions along those lines. While no spending program should escape scrutiny or the need for greater efficiencies, a failure to adequately understand and support medical education would cause long-term and perhaps irreparable damage to the state and economic development.

● ***TOPS baseline***. A law passed in the regular session would establish a level for TOPS funding based on actions in fiscal 2017. The question has arisen as to whether the law's new baseline applies to the Legislature's TOPS appropriation or to the amount of tuition charged this year. Under the concept of the law, as tuition rose in the future, the level of TOPS appropriations would not be expected to rise with it. The idea was to decouple TOPS funding from the escalating cost of tuition. However, the law may have presumed that TOPS would be fully funded for this year, but in fact the program was appropriated at only 70%. The Legislature might have to revisit this issue to clarify its intent.

● ***Sales tax instability.*** Local governments may be overly dependent on sales taxes as a source of revenue. Compared to other states, local government finances in Louisiana are more strongly tied to our relatively high sales tax rates and revenues. Changing times and conditions should be causing a serious re-evaluation of this approach. Purchasing trends and fluctuations in the Louisiana economy are causing cutbacks in many parishes affected by lower sales tax revenue. Local government spending tends to boom and bust with the sales tax cycles. Property taxes are a more stable form of revenue. It is time to reconsider whether Louisiana's model for local government funding is appropriate for the 21st century.

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## Constitutional Amendment Proposals on the November 8 Ballot

1. **Act 677** (HB459 2016 Regular Session) - Establishes requirements for the qualifications needed for local registrars of voters.

2. **Act 680** (SB80 2016 Regular Session) - Moves tuition-setting authority from the Legislature to the higher education boards.

3. **Act 31** (HB31 2016 First Extraordinary Session) - Eliminates the federal income tax deduction for corporate income tax filers. If passed, separate legislation would trigger a corporate flat tax of 6.5%. The top corporate rate currently is 8%.

4. **Act 678** (HB505 2016 Regular Session) - Provides a property tax exemption for certain surviving spouses of persons killed in the line of duty, such as for armed forces, police or fire protection.

5. **Act 679** (HB603 2016 Regular Session) - Creates a new Revenue Stabilization Trust Fund into which a portion of mineral and corporate tax revenue would annually flow if those revenue sources are unusually high. The fund is intended to smooth out the volatility of corporate and mineral tax receipts over time and prevent government expansion in flush times.

6. **Act 681** (SB201 2016 Regular Session) - Adds an additional trigger that allows legislators to tap into constitutionally protected funds to balance budget deficits.