White Paper on State Finance and Taxation

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Executive Summary

Louisiana state government requires a major overhaul of its functional responsibilities and the way in which they are financed.

The functional overhaul will require a major restructuring of the state's basic service delivery systems, eliminating unneeded programs, divesting local responsibilities and improving productivity. It is imperative that the next administration makes this a top priority and begins the redesign effort immediately.

The financial overhaul would include revising the state tax system, expanding local governments' fiscal capacity, improving the business tax environment and finding alternative funding mechanisms.

A number of recent studies and planning efforts have begun laying the ground work for redesigning various state services including: health and hospitals, public education finance, higher education, the court system, the juvenile justice system and highway construction. Proposals have included de-institutionalizing health care, localizing charity hospitals, providing alternatives to prison for non-violent offenders and expanding highway construction. Some efforts have produced recommendations, others have only raised options.

Building on these efforts, an overall, coordinated design for restructuring state services should be developed. The next step would be a constitutional convention to authorize the structural and financial changes needed to fully implement the plan.

Unfortunately, upgrading higher education, public education and highways–areas which could contribute the most to the state's economic development–cannot be achieved simply through improved efficiency. Each of these three areas alone will require roughly another $200 million in funding annually, in addition to savings that might accrue from improving their operations.

The additional funding could be provided through a combination of the following:

- Savings from economies and program reductions in other functional areas.
- Shifting of some fiscal responsibilities to local governments.
- Expanding the property tax base by improving assessment accuracy as a precursor to considering reductions in the homestead, industrial and other tax exemptions.
- Expanding local fiscal capacity and taxing authority.
- Capturing sales taxes on internet and catalogue purchases.
- Potential revenue growth generated by expanded economic activity.
- Additional user revenue, if needed (i.e., tuition, road tolls, motor vehicle license).

Increasing taxes should be the last option to consider after the other options for improv-

This is the second report in PAR's four-part white paper series to inform the issue debates of the 2003 gubernatorial and legislative campaigns. The white papers will address the topics of higher education, state finance, K-12 education, and governmental ethics/constitutional revisions.

ing efficiency, eliminating programs (i.e., urban and rural slush funds) and shifting responsibilities have been exhausted.

Tough decisions and political courage will be needed to restructure major state services, upgrade those functions key to economic development and reform the tax structure. This will be complicated by the need to balance state budgets over the next two years with a loss of nearly $700 million in temporary funding. Moving the state forward will not be simple, but living with the alternative will be far more difficult.

PAR Recommendations

No. 1 Streamline the sales tax law and prepare to tax internet and catalog sales.

No. 2 Exempt manufacturing machinery and equipment (MM&E) from the state sales tax.

No. 3 Keep the "Stelly Plan" changes intact and avoid dedicating the related revenue growth.

No. 4 Eliminate long-term debt from the franchise tax base.

No. 5 Periodically evaluate (sunset) existing tax credits and incentives to assure that they are effective.

No. 6 Give state agencies greater flexibility to levy true fees for services rendered.

No. 7 Assume state collection of local sales taxes, quit authorizing local taxes in excess of the 4% combined rate and provide the tax base uniformity required to tax internet and catalog sales.

No. 8 Allow parish governments, school boards and municipalities to piggyback the state income tax on individuals, with local voter approval.

No. 9 Require more frequent and accurate property reassessment and expand the property tax base.

No. 10 Evaluate all of the property tax exemptions and reconsider for reduction or elimination.

No. 11 Allow greater flexibility to make cuts in constitutionally protected spending.

No. 12 Allocate expenditures for education solely on the basis of funding formulas designed by the appropriate executive branch board to achieve equity and adequacy of funding.

No. 13 Develop meaningful performance indicators for all programs and agencies and use them in budget decision making.

No. 14 Use temporary taxes only to meet temporary exigencies.

No. 15 Overhaul the capital outlay budget process so that the budget includes only top priority state-level projects, which have had thorough feasibility studies and can reasonably be expected to be undertaken and funded during the fiscal year.

No. 16 Limit state aid to local capital outlay projects to serious emergencies and statewide programs and provide local governments with the mechanisms and capacity to fund their own projects.

No. 17 Devise a state-aid formula based on local need, revenue ability and tax effort to replace existing subsidy programs.

No. 18 Terminate the experience accounts in the state retirement systems, fund any future cost-of-living increases up front by appropriation, stop further benefit liberalization and avoid further backloading of payments on the unfunded accrued liability.

No. 19 Conduct a thorough, comprehensive review of the state's organizational structure and programs.

Introduction

This white paper provides a brief history and analysis of the growth in state spending over the last decade and discusses a number of revenue and budgeting process issues facing the state.

To place state spending into perspective, the paper draws on ten-year trend data using the *latest* available "actual" expenditure data–FY 1992 to FY 2002. These data and a reconstruction of the related program and funding changes were compiled through a cooperative effort of the state budget office, legislative fiscal office and house and senate fiscal staffs. (The detailed report may be accessed at www.legis.state.la.us/fiscal.)

The use of actual spending data is important because budgeted or appropriation data often change and can be quite misleading, particularly when compared to earlier actual data to determine growth.

PAR has prepared separate white papers dealing with spending issues related to two of the major areas of state spending–higher education and elementary/secondary education. (These papers may be obtained from PAR or accessed on PAR's web site www.la-par.org.)

This paper offers recommendations for improving the state's tax and revenue structure and its budgeting process.

Ten-Year Growth in Total State Spending

Over the ten-year period from FY 1992 to FY 2002, "actual" total state spending rose $6 billion reaching a total of $17.5 billion. However, this amount included interagency transfers, which are amounts that are counted twice in the budget–once for each agency they pass through.

With the double-counted spending removed, the ten-year increase was about $5.7 billion, rising from $9.8 billion to $15.6 billion. However, this apparent increase of 58.1% is also significantly overstated. (See Table 1.)

TABLE 1
Total State Spending, FY 1992 and FY 2002
Adjusted for Interagency Transfers and "Extra" Spending
(In Millions)

	FY 1992	FY 2002	Difference	Percent Change
Total Spending	$11,456	$17,479	$6,000	52.6%
Total Spending Without Double-count	9,839	15,557	5,007	58.1
Adjustment for Extraordinary Spending*	0	(935)		
Adjusted Total	$ 9,839	$14,622	$4,800	48.6%

* See explanation in text.

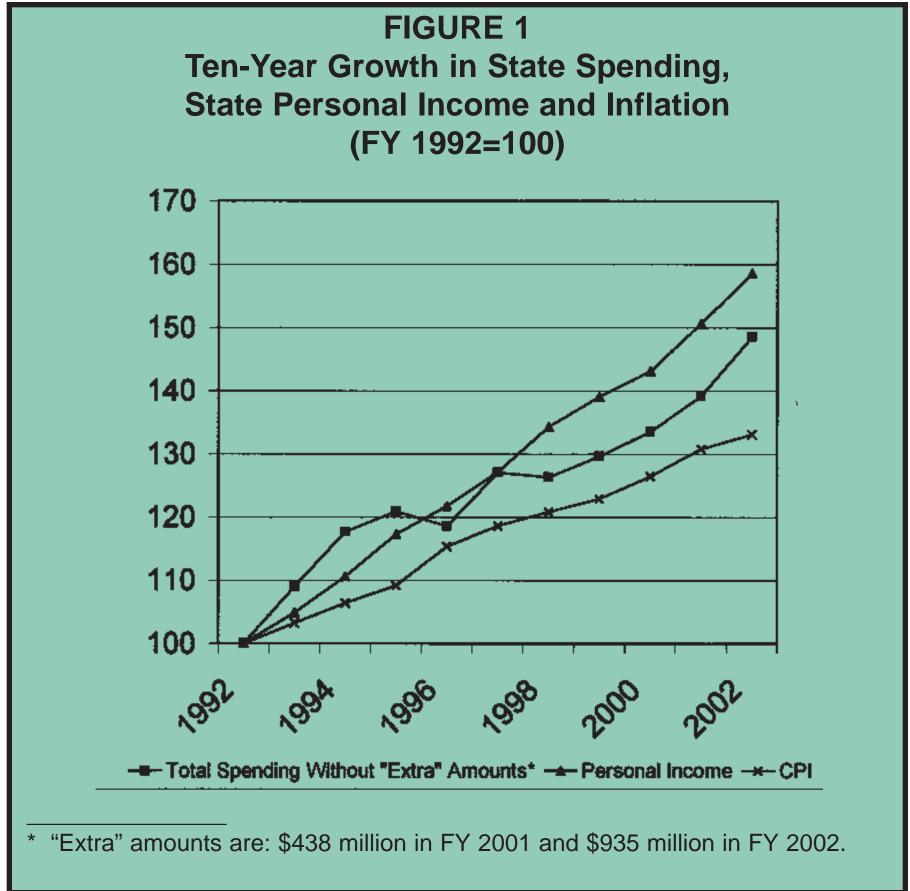
Fiscal year 2002 was the latest available actual audited data, but it was unusual in several respects. One-fourth of the total spending increase for the ten-year period (FY 1992 to FY 2002) was recorded in FY 2002 in spite of the fact that general fund revenues actually declined that year.

The apparent $1.4 billion increase in total spending for FY 2002 included significant amounts that were counted as state spending but were either not actually spent but placed in trust funds or were extraordinary non-recurring expenditures from one-time money:

- $721 million–$507 million in federal Medicaid money and $214 million in statutory dedications were paid to nursing homes and counted as being spent, but the money was returned to the state and placed in the Medicaid Trust Fund for the Elderly. This mechanism allowed the state to retain federal money it would have otherwise lost. (A $438 million deposit in the trust fund was similarly credited as spending in FY 2001.)
- $97 million–$192 million was collected in FY 2002 under the tax amnesty program ($40 million was spent on debt defeasance, the Saints and the Hornets; $57.2 million went to the Rainy Day Fund; and the remainder was carried over).
- $117 million–The $1 billion sale of 60% of the state's tobacco settlement proceeds resulted in additional pass-through payments to schools.

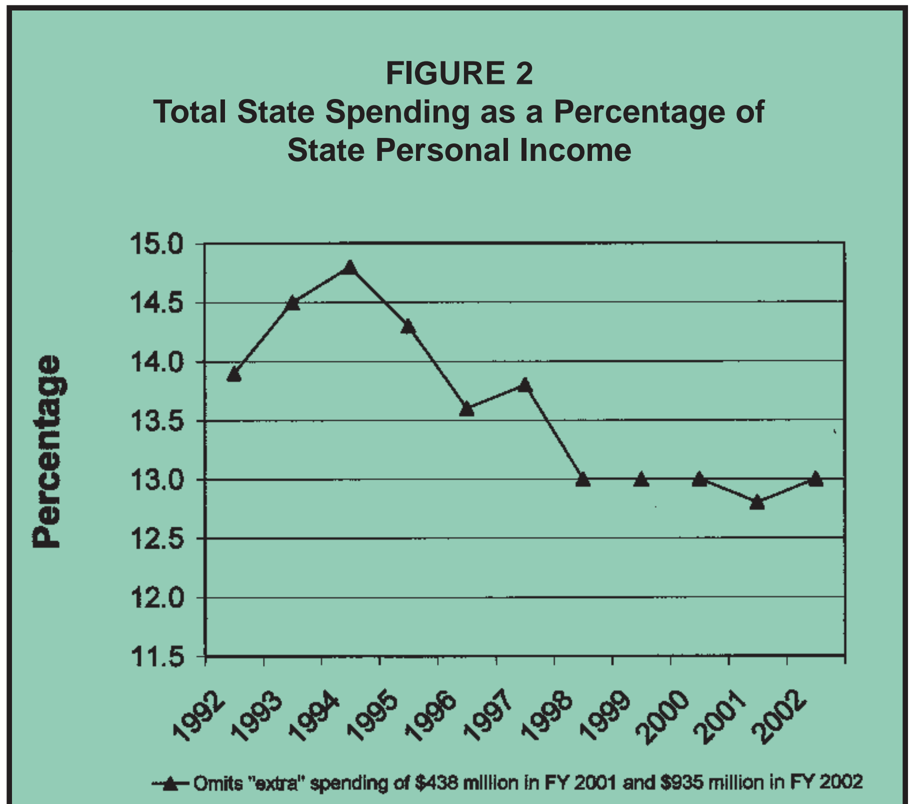
Together the three "extra" amounts total $935 million of the reported "actual" state expenditure growth, which was not an increase

FIGURE 1
Ten-Year Growth in State Spending, State Personal Income and Inflation (FY 1992=100)



* "Extra" amounts are: $438 million in FY 2001 and $935 million in FY 2002.

FIGURE 2
Total State Spending as a Percentage of State Personal Income



in recurring state spending in FY 2002. If these extraordinary amounts are deducted from the FY 2002 spending total, the ten-year increase is about $4.8 billion or 48.6%.

Figure 1 shows the ten-year cumulative growth in total state spending (minus the extraordinary non-recurring spending in FY 2001 and FY 2002) compared to the growth in state total personal income and the most common measure of inflation–the consumer price index (CPI).

A Context for Evaluating Spending Growth

Growth in state spending is often measured against some measure of inflation. Some analysts add the rates of inflation and population growth to provide a yardstick.

Louisiana state spending (48.6%) clearly ran well ahead of inflation, as measured by the CPI (28.9%), over the last decade. Adding the state's 4.6% population growth would do little to close the gap. However, a comparison to inflation alone (or even with population growth included) ignores much of the growth in demand for services, the impact of federal mandates, the growth in specific service costs and the comparative deficit in service levels from which the state began. Tracking a state's spending as a share of its economy provides a more meaningful comparison than inflation. As shown in Figure 2, the growth in state spending has generally mirrored personal income growth since 1999.

Nationwide, the state and local government sector has remained a fairly constant share of the economy as a whole. State and local spending has remained about 11-12% of the gross domestic product (GDP) for three decades. While there are obvious variations among the states, it appears that society has generally accepted a certain level of state and local government.

As in other states, Louisiana's governmental sector has generally maintained its share of the economy and hence has grown with it. Louisiana state government spending as a percent of state personal income (another measure of the economy) was 13.9% in 1992, reached nearly 15% in 1995 when federal aid was at its peak, and then fell to 13% where it has remained for five years. (See Figure 2.)

Where the Increased Spending Went

Most of the growth in state spending over the last decade can be accounted for in relatively few general areas. Table 2 lists ten of the more significant functional-area spending increases from FY 1992 to FY 2002. Some agency or program increases were excluded, because they were clearly one-time spending; or, as in the case of social services, the increases in some programs were largely offset by decreases in others.

The list total of $4.956 billion in increases is shown for illustrative purposes only. The program spending amounts in the list include some double-counting and one-time spending. The list omits numerous smaller program increases and some significant spending decreases (i.e., $100 million decline in debt service).

Source of Financing for the Ten-Year Growth

As shown in Table 3, the state general fund and fees and self-generated funds grew at nearly the same rates–about 46% over the ten years. Adjusting for the "extra" spending amounts greatly reduces the apparent growth in federal revenue to a modest 35% and the growth in statutory dedications from 152% to a still very significant 110%. Statutory dedications include a variety of taxes, licenses and fees that are constitutionally or statutorily dedicated for specific spending purposes.

The only difference between most statutory dedications and general fund revenues is the flexibility the governor and Legislature have in selecting the purposes for which they may be used. Since 1992, numerous new or existing taxes, licenses, fees and windfall revenues have been dedicated to

TABLE 2
Significant Program Spending Increases (FY 1992 - 2002)
(In Billions)

$1.900	Medicaid (Includes $1.35 billion in provider payments for hospitals, nursing homes, drugs, etc.)
1.100	Pre K-12 Education (Includes $665 million MFP and $58 million for the accountability program)
0.728	Higher Education (Includes $188 million in tuition and fees)
0.362	Group Benefits (Employee health insurance)
0.341	Corrections (79% increase in number of inmates)
0.163	Transportation Trust Fund
0.110	State Police (Homeland security and gaming regulation)
0.101	TOPS
0.089	Risk Management
0.062	Higher Education Capital Outlay (Self-funded)
$4.956 Billion	

TABLE 3
Ten-Year Increase in Funding Sources (FY 1992 - FY 2002)
(Amounts in Billions, Excludes Interagency Transfers)

Funding Source	FY 1992	FY 2002	Increase (Adjusted)		Increase (Unadjusted)*	
			Amount	Percent	Amount	Percent
State General Fund	$4.445	$6.484	$2.039	45.9%	$2.039	45.9%
Statutory Dedications	0.726	1.064	1.559	152.3	1.131	110.5
Fees and Self-generated	1.024	2.582	0.338	46.6	0.338	46.6
Interim Emergency Board	0.001	0.005	0.004	23.3	0.004	23.3
Total State Funds	$6.195	$10.135	$3.939	63.6%	$3.512	56.7%
Federal Funds	3.644	5.422	1.778	48.8	1.271	34.9
Total All Sources	**$9.839**	**$15.557**	**$5.718**	**58.1%**	**$4.783**	**48.6%**

*Adjusted by removing "extra" spending in FY 2002.

specific purposes instead of being placed in the state general fund. Statutory dedications were 16.5% of all state funds for FY 1992 but rose to 25.5% in FY 2002. For the most part, statutory dedications and self-generated revenues simply replace spending that would otherwise have to come from the general fund. Thus, it is important to look at the growth in total state funds as opposed to just the general fund.

Factors Affecting the Growth in State Spending

A number of factors create a continual pressure for spending growth. Some of the more important are mandates (self-imposed and external), growing clientele, general inflation and specific cost increases.

Mandates and Other Nondiscretionary Spending

Roughly two-thirds of the state's general fund spending is nondiscretionary. Of the nondiscretionary spending, about two-thirds is mandated by the state constitution, with the Minimum Foundation Program (MFP) for education taking the largest share.

Federal mandates and court orders or consent decrees make up most of the remaining nondiscretionary spending. These mandates have fueled spending growth in higher education (for desegregation), corrections (to upgrade prisons), juvenile justice, education accountability, elderly care, special education and, particularly, health and hospitals.

Federal Funding

More than one-third of total state spending has been from federal money. While federal policy has encouraged growth it has also led to cutbacks. It has helped fund program start-ups and then left the state to fund the continuation. The Medicaid program, with its $7 for $3 state match, is difficult to resist and difficult to cut.

Demographics

Louisiana's demographic makeup obviously impacts government spending. The state's slow growth in total and school-age population tends to dampen spending growth somewhat. However, the rapid growth in the 65+ age group has important implications for health and nursing home costs. The state's high poverty level, lack of health insurance, low educational attainment and large number of disabled assures continued pressure on health and human services. The state's extremely high crime rate continues to feed the highest incarceration rate in the nation.

Cost Increases

The Consumer Price Index (CPI) rose a modest 2.6% a year from FY 1992 to FY 2002. However, from 1996 to 2002, while the CPI grew 11.5%, the implicit price deflator (IPD) for state and local government consumption rose 16.3%. At the same time, the IPD for the compensation of state and local government employees rose 18.8%. By comparison, during those six years, Louisiana state spending rose 8.6% (adjusted for "extra" spending). Prescription drug costs rose 19% a year for three years and recent highway construction cost increases have doubled the CPI.

Employee Costs

Employee compensation is a major cost with built-in increases. During the last decade, the average salary for classified employees rose 3.4% a year, the cost of group benefits rose 7.4% a year and payments on the unfunded debt of the retirement systems rose an automatic 4.5% a year.

Major Unfunded Proposals and Potential Obligations

Demands for major new or expanded programs continue to put pressure on the state to increase spending. Referred to by some as "unmet needs," these include some very large and costly projects, programs and potential obligations such as coastal restoration ($14 billion), highway construction backlog ($8.6 billion), state retirement systems' unfunded liability ($8 billion) and potential liability for damages ($1.1 billion).

Federal funding would be expected to cover much of the coastal and highway proposals. However meeting the state's portion of these and other "needs" would have substantial ongoing annual funding costs, which would continue to grow over time. For example, the estimated annual additional cost to the state for some of these programs would include:

$200 Million	Coastal Restoration
$250 Million	Highway Construction
$200 Million	Higher Education Upgrade
$200 Million	Teacher Salaries to Southern Average
$210 Million	Pre-K Program for All At-risk 4-Year-Olds
$160 Million	Restore Risk Management Reserves
$100 Million	Assume the Cost of the Court System

If everyone's idea of unmet needs were considered, the list could be expanded to include community college facilities, community medical services, health insurance subsidies, park developments, mass transit and retiree cost-of-living adjustments (COLAs) among others.

Revenues

National experts suggest that a changing economy has rendered most state tax structures obsolete, particularly those heavily dependent upon sales taxes. The shift from manufacturing to services has removed much of the economic activity from the sales tax base. Tax-free internet and catalogue sales have further eroded collections. Business redesign, aggressive tax planning and incentives have cut sharply into corporation taxes nationwide. Various excise taxes suffer from changes in use (i.e., fewer smokers, fuel efficiency and a shift from hard liquor).

At the same time, the tremendous deficits currently facing many states are attributed in large part to a heavy reliance on elastic personal income taxes. During the 1990s, incomes rose rapidly and income taxes even more rapidly as taxpayers ascended to higher brackets. The stock market collapse and resulting recession slowed or reversed the growth in many states' income tax collections.

No tax structure can insulate a state against economic downturns, particularly if it is designed to grow with the economy. Louisiana's recent fiscal hardships were likely lessened by the relatively low elasticity of its overall tax structure.

In 1981, mineral revenues were 38% of Louisiana's general revenues, sales taxes were 25% and individual income taxes a little over 5%. Through the 1980s, mineral revenues declined and the gap between sales and income tax collections began closing. Today, the state government's sales and individual income tax collections are nearly equal. (See Figure 3.) Passage of the "Stelly Plan" in 2002, further helped to close the gap.

One goal of the fiscal reform movement over the last decade was to shift some of the burden from the sales tax to the income tax. While this has largely been accomplished at the state level, fiscal reformers would have preferred doing so while broadening tax bases and lowering rates. The state also has overcome its earlier over-reliance on mineral revenues and has added a whole new component–gaming revenues.

Over the past two decades, a more diversified and balanced tax structure has evolved at the state level. However, the overall state/local tax structure continues to exhibit an imbalance.

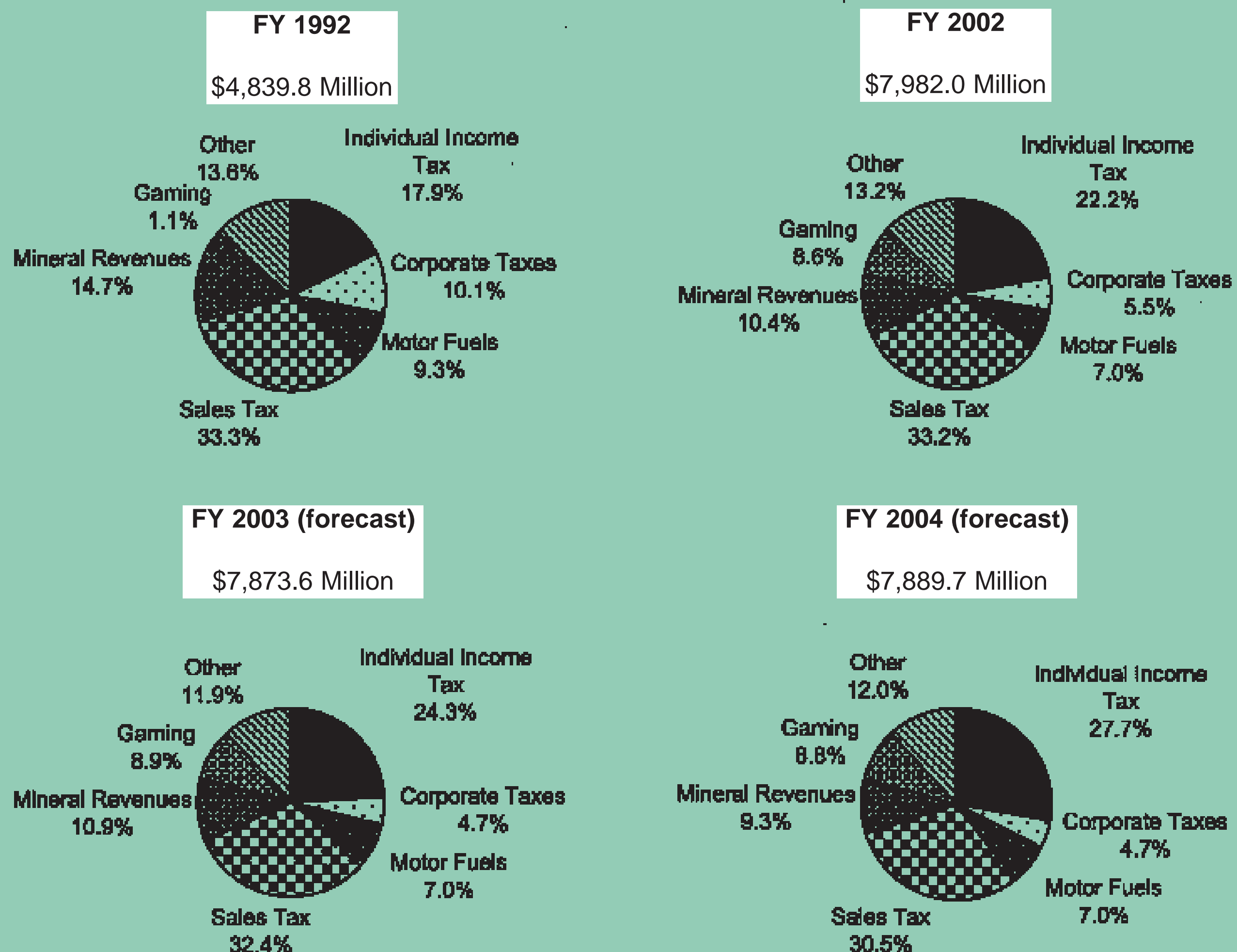
Of the major taxes comprising the "three-legged stool" of state and local finance, the sales tax remains the longer leg due to its heavy local use. By comparison to other states, Louisiana's property tax remains a very short leg. The census data for FY 2000 ranks Louisiana's per capita collections from property tax 46th among the states, from individual income tax 39th and from sales tax eighth from the highest.

Another goal of fiscal reform was to make the property tax a more productive revenue for local governments with the hope that state aid could be reduced and local jurisdictions could fund their own services.

Louisiana's Revenue Problem

A good tax structure should provide equity among taxpayers; stable, reliable and sufficient revenues; balanced revenue sources; a competitive business tax environment; and, balance between state and local revenues. Individual taxes should have a broad base and low rates; be easy to administer; require minimal compliance costs; not unreasonably distort economic decisions; and, not be hidden from the taxpayer. Louisiana's state and local tax structure does not fully meet all of these criteria.

FIGURE 3
Total Taxes, Licenses and Fees



Over the ten-year period (FY 1992 to FY 2002), revenues from state sources as a whole outgrew the economy slightly rising from 8.8% of personal income to 9.0%. However, if the new revenues added during the period (gaming revenues, provider fees and tobacco settlement funds) were removed, the revenues in place in FY 1992 actually declined as a percent of personal income to 8.2% by FY 2002.

Sales and individual income taxes grew at double-digit rates during much of the ten-year period but slowed significantly in the last four years. There was at least a temporary resurgence in oil and gas revenues; however, a number of other traditional tax sources (i.e., corporate taxes) grew little or even declined.

The problems with the tax structure have been identified and discussed endlessly by numerous study groups. Their recommendations have had little political success. The "Stelly Plan," adopted by voters in 2002, was successful possibly because it was a limited reform. The plan lowered the state sales tax slightly by permanently exempting residential utilities and food used at home and raised income taxes on higher incomes. The changes were initially revenue neutral, made the tax structure less regressive, eliminated some of the temporary taxes and provided for slightly more revenue growth in the future.

The following are some of the more obvious steps that, at a minimum, should be taken to modernize and improve the state's tax structure and bring it more into line with the criteria discussed above.

It is essential that all taxes levied be collected efficiently and effectively. The results of the recent tax amnesty program suggests that more could be done to ensure timely payment. This requires revenue collection agencies be given adequate staffing and appropriate, up-to-date technology.

State Revenues

Sales Tax

Louisiana's general sales tax continues to be the state's primary revenue source, yet the combined state/local rates in many jurisdictions have reached or even exceeded the maximum practical level. Making the sales tax more responsive to economic growth will require changes in the base.

One option is to add various untaxed services to the base. However, this could threaten the state's competitiveness as long as the surrounding states continue to exempt these services. A more promising approach is to expand the tax to capture internet and catalog sales.

The state's sales tax on the purchase of manufacturing machinery and equipment (MM&E) currently places Louisiana at a competitive disadvantage for industrial location and expansion.

Recommendation No. 1: Streamline the sales tax law and prepare to tax internet and catalog sales.

Louisiana should begin bringing its laws into line with the national plan to simplify each state's sales tax structure, whereby sales taxes could be collected on internet and catalog sales. Louisiana is among 34 states and Washington, D.C. that passed legislation to develop a streamlined sales tax plan. It is a voluntary agreement that the states hope will sway Congress to act nationally.

The state will have to meet some thirty standards set in the agreement. The major problem will likely be the central collection of all state and local taxes–locals are afraid of delayed funds. Aligning state and local tax bases present problems; however, the agreement would allow locals to tax food while the state does not. The exemptions and definitions would likely have to be adjusted somewhat.

Recommendation No. 2: Exempt manufacturing machinery and equipment (MM&E) from the state sales tax.

While it runs counter to the ideal of a broad tax base, a sales tax exemption for MM&E can be justified on the basis of competitiveness and equity. Eight southern states exempt MM&E entirely, while the other six have very low special rates or lower normal rates than Louisiana. Louisiana's high combined state/local rates make a firm's investment in plant and equipment much more expensive in Louisiana than in competing states if they are not eligible for one of the state's existing exemption programs–enterprise zone or quality jobs.

An MM&E exemption would remove the inequities within the state as well as with other states. It would significantly reduce the cost of start-ups and expansion or modernization, particularly for capital-intensive firms. The exemption, which would cost the state roughly $80 million this year, could be phased in over time.

Income Tax

The personal income tax has become the state's second largest revenue producer and has experienced an average growth rate in advance of inflation in recent years. The tax is generally progressive, although not enough to fully offset the regressiveness of the sales tax. Still, it has relatively low, effective rates, taking 1.4% of a family income of $26,200 and 3.4% of $528,000, according to a recent study by the Institute on Taxation and Economic Policy.

Recommendation No. 3: Keep the "Stelly Plan" changes intact and avoid dedicating the related revenue growth.

Comprehensive tax reform will not likely be achieved outside of a constitutional convention. In the meantime, the "Stelly Plan" is an important step in the right direction and should not be undermined. Dedicating the small amount of revenue growth it will generate would defeat a major purpose of the plan.

Corporation Tax

Revenues from corporation income and franchise taxes have been in actual decline over the past decade, in Louisiana and the nation. Combined, they currently produce about $370 million compared to $500 million ten years ago. The rush to form or convert to limited liability corporations (LLCs) that pay no franchise or income tax directly, the phase-in of the inventory tax credit, effective corporate tax avoidance planning, the use of 15-year net operating loss (NOL) writeoffs, a variety of other incentives and the recent weak economy have all contributed to this decline. In addition, the corporate income tax is quite volatile.

Louisiana's corporate income tax collections per capita are the lowest in the South except for Texas, which does not levy the tax. (Louisiana ranks 43rd among 44 states that levy the tax.) However, Louisiana collects as much franchise tax as it does income tax and most other states emphasize one or the other. While census data does not permit a direct comparison, Louisiana would likely rank in the top half of the southern states in per capita collections of income and franchise taxes combined.

Recently, the Tax Foundation ranked Louisiana 41st among the states using its own state business tax climate index for 2002. The foundation's primary problem was with the structure and characteristics of the state's corporate income tax. This is strange considering Louisiana's low ranking on income tax collections. Also, the ranking does not square with PAR's corporate tax burden study, which found Louisiana's taxes slightly higher than the southern average for manufacturing corporations but about average for most other types of corporations. However, the ranking does indicate how quirks in a tax structure can affect national perceptions.

Industrial development professionals continually argue for more incentives of all types to add to the existing arsenal. The difficulty is in measuring to what extent such incentives actually affect location decisions. Businesses that pay franchise taxes

have long sought removal of long-term debt from the tax base, arguing that taxing debt is unfair and that only one other southern state, Oklahoma, does so.

Discontinuing the corporation taxes altogether might be the simplest way to deal with the confusing array of old, new and proposed tax credits, deductions and other incentives. It would be an interesting and perhaps effective promotional tool and would certainly be fairer to those taxpayers who have not obtained concessions or taken steps to avoid the taxes. Yet, while they are currently less than 5% of general fund receipts, replacing the resulting $370 million loss to the budget would be difficult.

Another approach would be to rework the corporate taxes to better meet the criteria of a broad base and low rate. This, however, would best be undertaken as a comprehensive effort involving various other business taxes in a constitutional convention. A complex balancing of revenue effects would be required. Until then, several actions should be taken.

Recommendation No. 4: Eliminate long-term debt from the franchise tax base.

The loss of revenue from removing debt, roughly $100 million to $120 million, could be eased by phasing it out.

Recommendation No. 5: Periodically evaluate (sunset) existing tax credits and incentives to assure that they are effective.

Numerous tax breaks have been put on the books and remain there regardless of their usefulness or effectiveness.

Fees

Fees and other self-generated revenues have become a very important source of funding, almost the sole source for some state functions or services. Fees grew rapidly to compensate for slower growing tax sources and the response was a constitutional amendment requiring a super-majority legislative vote to increase a fee. In some cases this requirement has severely limited agencies (particularly higher education institutions) from securing legitimate payment for the cost of services rendered.

Recommendation No. 6: Give state agencies greater flexibility to levy true fees for services rendered.

The constitutional requirement for a two-thirds vote of the Legislature to increase a fee or civil fine needs to be repealed. The Legislature should then authorize agencies to set fees within limits to meet actual costs of providing services, schedule periodic reviews and strictly enforce the restrictions placed on agency fee authority. For example, higher education boards should be allowed to increase tuition up to the average of their southern peers without further legislative approval. Proposed fees that would significantly exceed the related cost of service or are clearly intended to fund something other than a related service, should be treated as a tax, which would require a two-thirds vote of the Legislature in a fiscal session.

Local Revenues

The capacity and willingness of local governments to adequately fund local services from local sources has a significant impact on the fiscal health of the state government. To fill gaps in local funding, the state is called upon to share its own revenue sources or to directly supplement local spending. Louisiana's constitution severely restricts local taxing and revenue authority resulting in added pressure on the state.

Local Sales Tax

Local governments have been given unusually broad authority to levy sales taxes. However, combined with the 4% state sales tax, rates in many urban jurisdictions have reached 9% or higher. With no reasonable alternatives, local entities continue to ask and receive special legislative authority to exceed the 4% limit on the combined local sales taxes rate in a given jurisdiction. Local governments are experiencing the same problems as the state with slow growth in sales tax receipts, but they have fewer other options to draw upon.

Recommendation No. 7: Assume state collection of local sales taxes, quit authorizing local taxes in excess of the 4% combined rate and provide the tax base uniformity required to tax internet and catalog sales.

In adopting the Uniform Local Sales Tax Code this year, the state took a few critical steps toward reforming the local tax system. The code combines local sales tax laws, provides for a uniform electronic return and remittance system and requires uniform policies (without altering existing tax bases). However, the code leaves Louisiana far from being in conformity with the multi-state streamlined sales tax agreement.

Local Income Tax

Local governments and school boards are constitutionally prohibited from levying an income tax. Many jurisdictions in the state are at a disadvantage in raising revenue through sales and property taxes. Bedroom communities may have residents with relatively high incomes but no major shopping centers to generate sales taxes and no major industry to contribute property taxes.

Recommendation No. 8: Allow parish governments, school boards and municipalities to piggyback the state income tax on individuals, with local voter approval.

A number of states allow local governments to levy income taxes. Allowing Louisiana local governments to levy up to a maximum rate of 1% or 2% would provide an option voters could use or not. Piggybacking on the state tax would make administration fairly easy. The potential of payroll or earnings taxes should be given consideration but these are not recommended at this time.

Property Tax

The property tax is a stable revenue source that provides about $2 billion in local revenues. However, current limitations on the property tax greatly reduce the fiscal capacity of local governments and school districts. Local taxpayers have not been able to use this revenue source effectively to fund local services they desire.

While there have been no major changes in the property tax recently, it has been a growing revenue source over the past decade. Total property tax levies rose at an annual average growth rate of 5.9% between 1991 and 2001 for a 77% overall increase. Millage increases added about 10% of this growth, while taxable assessed values grew 62% or 4.9% a year on average. By comparison, the state's personal income grew 69% during the same ten years.

Louisiana has the most liberal homestead exemption in the nation. For three decades, repeated calls for the elimination or reduction of the exemption have been generally ignored by policy makers. However, efforts to further increase this exemption have failed. Politically, preventing increases may be the only realistic option. By simply holding the homestead exemption constant, home values have continued to climb above the $75,000 market value mark and homeowners have begun to gradually pay a little more tax–at least when their property was being properly assessed. Whereas 83% of all homes were 100% exempt in 1991, by 2001 the percentage had fallen to 67%.

Recommendation No. 9: Require more frequent and accurate property reassessment and expand the property tax base.

The property tax must be made a more effective revenue source for funding local services. This requires better and more frequent assessment. Updating old assessments and keeping them up to date would likely expand the statewide tax base.

Improved assessment will require greater professionalism in assessors' offices, modern technology and better state supervision. The state could levy a one or two mill property tax and use the revenue to strengthen the Louisiana Tax Commission's oversight role and to provide technology and training for local assessors. The small state tax would also give the state standing in court when property tax matters are considered.

Using available technology, all taxable property (both real and personal) could be reassessed annually based on current fair market value.

Recommendation No. 10: Evaluate all of the property tax exemptions and reconsider for reduction or elimination.

The homestead exemption, at the very least, should not be increased. This will permit some growth in the tax base. Other options should also be considered. These include: removing the exemption from new and renewal millages, removing the exemption for school millages only, or eliminating the exemption altogether and implementing a circuit-breaker to protect low-income homeowners and renters.

The industrial tax exemption should be considered for phasing out over a period of time. This could accompany the phasing in of the proposed sales tax exemption for MM&E and removal of debt from the franchise tax.

Budgeting

A review of recent budget reform efforts in other states indicates that Louisiana already has in place nearly all of the progressive budgeting procedures and fiscal controls being discussed nationally. Louisiana's balanced budget requirement, procedure for officially adopting revenue estimates, prohibition on using non-recurring funds for recurring expenditures, "Rainy Day" Fund, feasibility study requirement for capital outlay projects and debt limit are among the significant reforms adopted in the 1990s.

While Louisiana has adopted many fiscal reforms, not all have been perfected in practice. For example, actual feasibility studies have not been required for local projects in the capital outlay budget. Also, performance budgeting is still in its infancy and has thus far had little impact on funding decisions.

Some of the budgeting procedures have been negatively affected by political considerations. Examples include horse-trading in the capital budget process and legislative efforts to micro-manage the education funding formula.

Current Budget Process

The preparation of this paper focused on the most recent ten years of "actual" spending (FY 1992 to FY 2002). Comparing that data to the estimates for FY 2003 or the appropriations for FY 2004 can be misleading. However, compared to the FY 2003 estimated budget of $16.5 billion, the FY 2004 budget of $16.8 represents a 1.48% increase. Without a $316 million increase in federal funds, the budget would have decreased.

The process of forging the FY 2004 budget was difficult and it will have continuing consequences. The budget process was severely tested in the 2003 legislative session. Legislation was even proposed to shift budget-making responsibility to the Legislature. The executive budget as submitted attempted to maintain the administration's education priorities and avoid cuts to the extent possible. However, the initial submission included massive cuts in the health area including closing institutions for the disabled and mentally ill. A hastily assem-

bled health and hospital spending plan to move away from an emphasis on institutional care toward more community- and insurance-based programs was unrealistic in that it could not be implemented in one year. The proposed budget also included some $274 million in spending from revenues that were highly uncertain.

A new spending plan for health was devised and the Legislature got involved in redesigning and paring down the budget to fit the available revenues (general fund revenue was forecast to grow less than 1%). At mid-session, when Federal Fiscal Relief provided a $254 million bailout, most of the health cuts were avoided and the Legislature even restored some of its own pet spending projects beyond the urban and rural slush funds, which had previously been halved.

As adopted, the FY 2004 budget included $680 million in one-time and temporary money from federal and state sources. As shown in Table 4, several of these sources run out the following year.

Without additional federal aid, about $432 million in the current budget will not be available for the FY 2005 budget. Another $227 million will not be available in FY 2006. These revenue losses will present significant budgeting challenges.

The FY 2004 budget takes advantage of one-time money, debt defeasance (using nonrecurring revenue to pay debt early to free general fund money the next year), using federal money as the state match for more federal funding and asking agencies to once again eat their merit pay raises and inflation. Appropriately, the debt defeasance was spread over three years and the resulting funds used primarily for one-time expenditures.

Budget Cutting Discretion

Recommendation No. 11: Allow greater flexibility to make cuts in constitutionally protected spending.

A 2002 constitutional amendment allowed cuts in certain constitutionally protected funds to prevent a deficit during the year after a 0.7% cut in general fund expenditures has been made. In preparing a budget for the next year, up to 5% cuts may be made in protected spending (1% of the non-instructional portion of the MFP) if recurring revenues are forecast to fall 1% below the current forecast. However, the present thresholds and limits are proving too stringent to make this authority very useful.

TABLE 4
One-time and Temporary Funding in FY 2004 and FY 2005
(In Millions)

FY 2004	FY 2005	Funding
$143	$ 0	Federal, flexible grants
111	0	Federal, reduction in state Medicaid match
29	0	Premium on 2003 bond sale
196	196	Federal, 175% disproportionate share reimbursement, public and non-public hospitals
117	22	Federal, nonrecurring TANF funding
46	30	Debt defeasance (21 in FY 2006)
38	0	Fund surpluses and miscellaneous sources
$680	**$248**	**Total One-time or Temporary Funding**
$432		**Available in FY 2004 but not in FY 2005**
	$227	**Available in FY 2005 but not in FY 2006**

Proponents of the amendment were unhappy that the provision could not be applied in FY 2003 or in preparing the FY 2004 budget. In preparing the FY 2005 budget, the provision will likely not come into play either, because revenues are expected to rise by $272 million. However, if the $639 million in one-time money is gone, the state would be down a net of $367 million from the current budget. The cuts would have to come from the discretionary portion of the budget–primarily health and higher education.

Formula Funding

Recommendation No. 12: Allocate expenditures for education solely on the basis of funding formulas designed by the appropriate executive branch board to achieve equity and adequacy of funding.

The Minimum Foundation Program for Pre-K through 12 education should be redesigned by BESE for better adequacy and equity among school districts, taking into account local financial ability and effort. BESE should seek input from the Legislature and other resources, but should make the final decision itself.

The postsecondary funding formula, developed by the Board of Regents, should provide equity among institutions in meeting well-designed funding targets for each type of institution and reflect the level of student and cost of programs offered.

The role of the Legislature should be to approve the funding formulas or return them, with suggestions, to the appropriate board for reconsideration and to appropriate the funding called for by the formula or a lesser total amount if revenues are deemed insufficient. The Legislature should not be involved in funding decisions concerning individual institutions or salaries.

Performance-Based Budgeting

Recommendation No. 13: Develop meaningful performance indicators for all programs and agencies and use them in budget decision making.

Many agencies and programs still lack the meaningful performance indicators needed to make performance-based budgeting credible and useful. Indicators are being submitted with the executive budget without any narrative to explain what they mean. In addition, the appropriations bill has become cluttered with mission statements, general information, data for prior years, extraneous data and insignificant indicators. Only "performance standards" for major agency or program objectives should be included in the appropriations bill.

Performance budgeting has not yet begun to fill a very important role in funding decisions. However, the state has put a great deal of effort into its development, and it should not be allowed to go the way of the earlier efforts to apply rationality to budgeting (i.e., zero-based budgeting, program budgeting, etc.).

The consensus estimating conferences created to provide official estimates of economic, demographic, education, criminal justice, health and social services and transportation data for budgeting purposes should be fully developed and utilized.

Supplemental Budgets and Temporary Taxes

Temporary taxes can be useful to deal with temporary problems, but they should not be allowed to run for more than two years without being made permanent. Temporary taxes and supplemental budgets based on their renewal result in confusing and

Recommendation No. 14: Use temporary taxes only to meet temporary exigencies.

misleading executive budgets. Eliminating temporary taxes would remove some of the confusion and perhaps the need for some special legislative sessions. The "Stelly Plan" eliminated $397 million in temporary taxes that would have come due in 2004 but left another $157 million on the books.

Capital Outlay Budget

Recommendation No. 15: Overhaul the capital outlay budget process so that the budget includes only top priority state-level projects, which have had thorough feasibility studies and can reasonably be expected to be undertaken and funded during the fiscal year.

The capital outlay budget has become a "wish list" loaded with projects, many of a purely local nature, with little chance of being funded unless the administration takes a special interest in moving one up the list. The capital outlay budget should include only the highest priority state projects from the first year of the state's five-year capital improvements plan. Those included should be projects that can reasonably be expected to be undertaken during the fiscal year with the expected cash and bond revenues available.

Funding Local Construction Projects

Recommendation No. 16: Limit state aid to local capital outlay projects to serious emergencies and statewide programs and provide local governments with the mechanisms and capacity to fund their own projects.

The political distribution of state aid for local capital projects to individual legislators should be permanently discontinued (i.e., the governor's urban and rural slush-funds). The practice of placing local projects in the state capital outlay budget should be sharply curtailed. Instead, a procedure for evaluating emergencies should be developed and aid should otherwise be limited to statewide programs with uniform requirements governing project characteristics and the expected local funding match.

Local governments' capacity to fund their own projects should be strengthened through tax reform and by expanding the use of state-seeded revolving loan funds for local capital outlay projects.

State Aid to Local Governments

Recommendation No. 17: Devise a state-aid formula based on local need, revenue ability and tax effort to replace existing subsidy programs.

Various elements of state aid to local governments, such as revenue sharing and salary supplements, are so bound up in constitutional mandates that a rational solution could only be achieved in a constitutional convention that deals with all of the elements at one time.

Public Employee Retirement

Recommendation No. 18: Terminate the experience accounts in the state retirement systems, fund any future cost-of-living increases up front by appropriation, stop further benefit liberalization and avoid further backloading of payments on the unfunded accrued liability.

The annual report of the Legislative Actuary has for years highlighted the actuarial damage being done to the retirement systems for state employees and teachers by the legislated benefit enhancements. The experience accounts, which have been used to justify granting COLAs suppos-

edly paid from excess investment earnings, have in fact been increasing the unfunded liability (UAL) of the systems.

Benefit liberalization continues apace often with little appreciation or concern for the costs. One example was the recent proposal to guarantee DROP program participants a better interest rate than that actually earned on retirement system investments.

The use of experience accounts and the DROP programs have increased the UAL of the retirement systems for state employees and teachers and contributed to increased employer costs. In FY 2002, the UAL for the teacher and state employee systems was at $7.3 billion, the employer cost for normal retirement was $624 million and employer payments on the UAL were $327 million.

State Organization and Program Review

Recommendation No. 19: Conduct a thorough, comprehensive review of the state's organizational structure and programs.

Several new administrations have undertaken comprehensive organization and program reviews. These combined the efforts of public and private experts in various functional areas, either in transition teams or in more extended formal studies. A great deal of work has been done recently or is under way by special commissions or task forces dealing with a variety of subjects including school finance, school accountability, teacher quality, indigent health care and medical education, juvenile justice, environmental quality, revenue and taxation and state civil service, among others. Department level efforts have developed plans and options in various functional areas.

A comprehensive review could incorporate these recent and ongoing efforts, help bring some of the deliberations to a conclusion and, in some cases, improve or expand on the solutions. Such a review would allow the findings and conclusions of these functional studies to be considered in a broader context.

Conclusion

A review of the past ten-year growth in actual state spending shows that it has exceeded inflation and the growth in population. However, state government's share of the state's economy actually declined during the 1990s and then remained stable for the last five years. Nationally, state and local government spending has maintained the same share of the economy (GDP) for three decades.

The cost factors related to health services, corrections and highway construction have recently far outpaced the rate of inflation. So has the cost of personnel benefits, which affect all functions. Federal mandates, growing incarceration rates, expanded health programs for children, and efforts to increase teacher and faculty salaries are also among the factors contributing to the growth in state spending.

Maintaining the existing level of state services is currently made possibly only by a federal bailout. The next administration's first two budgets will have to cope with the loss of nearly $700 million in one-time and temporary funding. Compounding this challenge will be the continuing pressure of cost increases and a long list of "unmet needs."

State sales and individual income taxes have achieved a better balance, but the state/local mix remains overly dependent on sales taxes and underdependent on the property tax. The goal of broad tax bases and low rates has not been achieved. Neither has the goal of increasing local fiscal capacity.

Improved property tax assessment is the key to local fiscal capacity. Once all property assessments are based and maintained on true market value, consideration can be given to reducing or phasing out various exemptions including the homestead and industrial exemptions.

Exemptions continue to narrow tax bases, particularly for the property tax. Yet, the need to meet the competition of other states, provides a justification for phasing in two additional business tax

breaks. These would remove capital debt from the franchise tax base and exempt manufacturing machinery and equipment from the state sales tax.

Over the last ten years, state-source funds as a percentage of personal income increased slightly, but would have declined if new revenues had not been added (gaming, provider fees and tobacco settlement).

A comprehensive restructuring of the state's revenue system is needed, but it will not provide an immediate solution. The changes recommended in this report, however, will spur future economic growth and improve the fiscal stability of the state in the long-term. Making optimum use of existing planning and budgeting procedures would help maximize the use of existing resources and help set priorities. But this alone will not ensure the continuation of the existing level of services with existing revenues.

A more dramatic effort will be required to "reinvent" state government combining the best of the many plans, special commission recommendations and options currently under consideration. It is imperative that the next administration makes it an immediate and top priority to undertake this redesign effort.

There is a potential for savings in reordering the way health, hospital, higher education, corrections and other services are provided. In some cases, however, this could simply lead to improved and expanded service at the same cost.

The unfortunate dilemma is that adequate funding for those functions that most directly contribute to economic development–higher education, public education and transportation infrastructure–cannot be achieved solely through improving the efficiency of those functions. The state must decide whether it wants to make slight improvements in these functions or make them truly competitive.

Shifting students to two-year colleges, increasing K-12 class size and down-sizing DOTD might free up some funding. But, it would not ensure full funding for colleges and a nationally ranked research university; the ability of all school systems to compete for qualified teachers; or a highway program that can begin reducing the backlog in construction needs.

The additional funding required to bring these functions to a truly competitive level could be provided through a combination of the following:

- Savings from economies and program reductions in other functional areas.
- Shifting of some fiscal responsibilities to local governments.
- Expanding the property tax base by improving assessment accuracy as a precursor to considering reductions in the homestead, industrial and other tax exemptions.
- Expanding local fiscal capacity and taxing authority.
- Capturing sales taxes on internet and catalogue purchases.
- Potential revenue growth generated by expanded economic activity.
- Additional user revenue, if needed (i.e., tuition, road tolls, motor vehicle license).

The importance of colleges, schools and highways to the state's economy and society, warrants the consideration of all options for providing adequate funding. However, increasing taxes should be the last option to consider after the other alternatives for improving efficiency, eliminating programs (i.e., urban and rural slush funds) and shifting responsibilities have been exhausted.

Tough decisions and political courage will be needed to restructure major state services, upgrade those functions key to economic development and reform the tax structure. This will be complicated by the prospect of very tight budgets over the next two years. Moving the state forward will not be simple, but living with the alternative will be far more difficult.

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