Macroeconomic Impact Estimates of Governor Riley's 2003 Accountability and Tax Reform Package

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Summary

This report presents macroeconomic impact estimates of the tax portion of Governor Bob Riley's accountability and tax reform package. The tax package will be presented as a constitutional amendment at a statewide election on September 9, 2003. The accountability portion of the tax package proposes to make state government less cumbersome and less wasteful, and therefore more efficient. The tax reform portion addresses revenue adequacy, tax fairness, and efficiency of the Alabama tax structure.[1] However, this study focuses solely on the macroeconomic impact of the tax portion of the package.

Revenues of about $1.2 billion are expected to be raised with the package at full phase-in by fiscal year 2007. More than $1.0 billion will go into the new Alabama Excellence Initiative Fund (AEIF) and the remainder mainly to local government. Income and property taxes, which are allowable federal deductions, generate $912 million and make up the bulk of the package. New taxes must be funded by a reduction in personal consumption expenditures (PCE). A little more than $1.0 billion reduction in Alabama PCE is required to generate $1.2 billion in new taxes because of the aforementioned federal deductions. The analysis therefore estimates the combined macroeconomic impact of a decrease in PCE and an increase in government expenditure with $120 million set aside for scholarships. AEIF funds are not earmarked for any specific purpose and thus provide some flexibility. A sensitivity analysis on use of new revenues that shifts funds between the construction sector and government and miscellaneous services is used to incorporate this flexibility. The study also considers worst-case scenarios of no federal deduction and no scholarships.

The tax package will raise employment, earnings, and gross state product (GSP) if the new tax revenues are spent in the same way as current revenues while allowing for maximum scholarship amounts. GSP is the value of goods and services produced in the state. Employment rises by 0.53 percent (10,544 jobs), earnings by $216 million, and GSP by 0.38 percent or $533 million. Shifting $100 million of new revenues from government and miscellaneous services to construction results in slightly higher gains in GSP (0.40 percent or $557 million) and earnings ($221 million) but a lower gain in employment (0.50 percent or 10,055 jobs). A reverse $100 million shift from construction to government and miscellaneous services produces lower gains in GSP (0.37 percent or $510 million) and earnings ($210 million) but a higher 0.55 percent

[1] Efficiency deals with balance among revenue sources, flexibility of revenue distribution and use (the earmarking issue), and general management of tax revenues to avoid waste and promote best use.

increase in employment, 11,033 jobs. The worst-case scenarios of no federal deduction and no scholarships are extreme and very unlikely but help to define the domain of possible impacts. Together, they yield net increases of 0.35 percent (6,939 jobs) in employment, $125 million in earnings, and 0.16 percent or about $219 million GSP.

The tax package is good for Alabama.

Introduction

On September 9, 2003 the people of Alabama will vote on Governor Riley's accountability and tax reform plan. The governor has indicated that passing the package will move Alabama forward by protecting our seniors, creating higher paying jobs, and making the state a leader in education.[2] The accountability portion of the tax package is aimed at making state government less cumbersome and less wasteful, and therefore more efficient. The tax portion addresses revenue adequacy, tax fairness, and efficiency of the Alabama tax structure. Efficiency deals with balance among revenue sources, flexibility of revenue distribution and use (the earmarking issue), and general management of tax revenues to avoid waste and promote best use. The governor has also noted that rejecting the package will cost Alabama dearly because the state is facing a $675 million shortfall that will result in devastating cuts in essential services if nothing is done. Specific effects of doing nothing include

- Closure of 60 Senior Service Centers, eliminating 800,000 meals for the elderly
- Laying off thousands of teachers
- Adverse impact on 50,000 child support cases, causing a loss of $50 million in annual child support payments
- Reduction by one-third of State Trooper routine patrol and response manpower
- Loss of almost all drug coverage for 11,000 mentally ill Alabama citizens
- Bankruptcy of as many as 25 of the poorest school systems, affecting 100,000 students
- Slashing of Medicaid budget in 2005, jeopardizing 450,000 Alabamians or 10 percent of the state's population
- Layoff of hundreds of corrections department employees and release of thousands of prisoners.

Effects of passing the tax package, while implied, have not been specified as clearly. It is true that tax revenues are used to provide public infrastructure and services. Taxpayers do get something in return. The real question is whether it is worthwhile to pay more taxes: do consumers get enough back to justify the extra tax? Of course, the

[2] *Laying the foundation for Greatness*: Governor Bob Riley's Plan to Invest in Alabama's Future. June 2003. http://www.governorpress.state.al.us/downloads/03-06-12-Tax-Reform-Presentation.ppt

return may be both quantitative and qualitative and it is up to taxpayers to value it all. The Public Affairs Research Council of Alabama (PARCA) and the Governor's office have analyzed and made available the effects on income and property taxes for taxpayers at various income levels. Tax calculators are available on their websites. The Alabama Policy Institute (API) commissioned a macroeconomic impact study with the Beacon Hill Institute (BHI) at Suffolk University but their findings have been questioned and their study is under revision.[3] Proponents and opponents of the tax package are working feverishly, airing TV ads on their respective positions. What is clearly lacking in the debate is a reliable, objective, and neutral macroeconomic impact analysis of the package. This study attempts to fill the gap.

Analysis and Results

At the macroeconomic level personal consumption should be reduced to increase tax revenues, a transfer of sorts. Therefore any analysis of the impact of the tax package must consider the decrease in personal consumption together with the increase in tax revenues and associated government expenditure. Governments and consumers have different spending patterns and this must also be taken into consideration. All these factors are considered in estimating the impact of the tax package in the analysis that follows. Input-output (IO) multipliers obtained from the Regional Input-Output Modeling System (RIMS II), an IO model developed and maintained by the U.S. Department of Commerce's Bureau of Economic Analysis are used to estimate the impacts. RIMS II is available for the nation, states, metro areas and many counties.

New tax revenues of about $1.2 billion are expected to be raised with a little over $1.0 billion going into the new Alabama Excellence Initiative Fund (AEIF) and most of the remainder to local government at full phase-in of the tax package (Table 1).[4] Fiscal

[3] Visit http://parca.samford.edu for PARCA, http://www.governor.state.al.us for the Governor's office, and http://www.alabamapolicy.org for API.
[4] The Governor's office and the Legislative Fiscal Office (http://www.lfo.state.al.us) have estimated somewhat similar potential revenues to be raised with the tax package. We use the Governor's office estimate of $1,195 million and a federal deduction of $855 million for new property and personal income taxes.

year 2007 is assumed for full phase-in of the package. Raising taxes requires a reduction in personal consumption. Allowable federal deductions for state and local income and property taxes enable raising $1.2 billion with a little more than $1.0 billion reduction in personal consumption expenditure. This is because new income and property taxes that together raise $912 million make up the bulk of the package. The analysis, therefore, estimates the combined macroeconomic impacts of a $1,036 million decrease in personal consumption and a $1,195 million increase in state and local government expenditure. Amounts in the AEIF are not earmarked for any purpose and thus provide some flexibility of use of new revenues. This flexibility is incorporated with a sensitivity analysis on the use of new tax revenues by shifting some new revenue between the construction sector and government and miscellaneous services. Also considered are worst-case scenarios of no spending on scholarships and no federal deductions.

Table 1. Potential Revenues of Tax Package

$ Millions

Tax component	State	Local	Total
Personal income tax	$375		$375
Property tax	410	70	480
Corporate income tax	45		45
Banks excise tax	12		12
Sales tax	118	65	183
Cigarette tax	50		50
Insurance premium tax	5		5
Mortgage and deed recording fees	45		45
TOTAL	$1,060	$135	$1,195

Source: *Laying the foundation for Greatness*: Governor Bob Riley's Plan to Invest in Alabama's Future. June 2003. http://www.governorpress.state.al.us/downloads/03-06-12-Tax-Reform-Presentation.ppt.

Expenditure distribution patterns and the associated changes in expenditure for Alabama personal consumption and state and local government are shown in Tables A1, A2, and A3 in the Appendix. Table A2 first puts $120 million of new tax revenue into government and miscellaneous services for scholarships and then distributes the remainder. Table A3 assumes zero federal deduction for income and property taxes in determining personal consumption expenditure and zero set-aside for scholarships on state and local government expenditure.

Applying RIMS II multipliers to the vectors of final demand expenditure changes in Tables A2 and A3 yields the macroeconomic impacts shown in Table 2. Reducing personal consumption spending by the estimated $1,036 million produces a $2,051 million contraction in Alabama gross state product (GSP), the value of goods and services produced in the state. Earnings drop by $576 million and 20,808 jobs are lost. However, the impact of $1,195 million in new tax revenue and state and local government expenditure more than make up for the negative effects of lower personal consumption expenditure. If new tax revenues are spent as usual (i.e., with the same distribution as old revenues) while making the scholarship consideration, the tax package will add 31,352 jobs, increase earnings by $792 million, and raise GSP by $2,584 million. The net macroeconomic impact is that employment increases by 0.53 percent (10,544 jobs), earnings rise by $216 million, and GSP grows 0.38 percent or about $533 million. Net macroeconomic impact shows the effect of the tax package relative to the status quo.

The flexibility that the AEIF provides will enable spending to address pertinent needs. For example, $100 million of new revenues can be shifted from government and miscellaneous services to construction. The net impacts of doing this are slightly higher gains in GSP (0.40 percent or $557 million) and earnings ($221 million) but a lower gain in employment (0.50 percent or 10,055 jobs) than in the previous case. These results are due to differences in the nature of the sectors. For example, construction jobs earn higher wages and the sector is less labor intensive than government and miscellaneous services. A reverse shift of $100 million from construction to government and

miscellaneous services yields lower GSP (0.37 percent or $510 million) and earnings ($210 million) gains but a higher increase in employment (0.55 percent or 11,033 jobs).

Table 2. Macroeconomic Impacts of Tax Package

	Output	Earnings	Employment
Federal Deduction and Scholarship	$ Millions	$ Millions	Jobs
Personal Consumption Expenditure Reduction	($2,051)	($576)	(20,808)
State and Local Expenditure - Business as usual	$2,584	$792	31,352
Net impact	$533	$216	10,544
Percent Change	0.38%		0.53%
State and Local Expenditure - More construction	$2,608	$798	30,863
Net impact	$557	$221	10,055
Percent Change	0.40%		0.50%
State and Local Expenditure - More services	$2,561	$786	31,840
Net impact	$510	$210	11,033
Percent Change	0.37%		0.55%
No Federal Deduction and No Scholarship			
Personal Consumption Expenditure Reduction	($2,366)	($665)	(24,001)
State and Local Expenditure - Business as usual	$2,585	$790	30,940
Net impact	$219	$125	6,939
Percent Change	0.16%		0.35%

Note: Numbers in parentheses are negative. Net macroeconomic impact shows what the effect of the tax package is relative to the status quo.

Source: Center for Business and Economic Research, The University of Alabama

The worst-case scenarios of no federal deduction and no scholarships are extreme and very unlikely but help to define the domain of possible impacts. Reducing personal consumption by $1,195 million results in a loss of 24,001 jobs and decreases of $2,366 million in GSP and $665 million in earnings. Not having a scholarship set-aside in new state and local government expenditure more than makes up for the negative effects of the larger decline in personal consumption expenditure. Spending new tax revenues

with the same distribution as old revenues adds 30,940 jobs and increases GSP and earnings by $2,585 million and $790 million, respectively. The net macroeconomic impact is that employment increases by 0.35 percent (6,939 jobs), earnings by $125 million, and GSP by 0.16 percent or $219 million.

Discussions and Conclusions

Clearly, from a macroeconomic perspective, Governor Bob Riley's accountability and tax package is beneficial to the state. Although we have not fully investigated the flexibility in spending to be provided by the AEIF, it does seem that shifting funds to address targeted investment, development, education, or other needs does not significantly affect the net positive impact of the tax package. While some may question the positive impacts of increasing taxes, it must be noted that the existence of the aforementioned $675 million shortfall indicates that Alabama taxes are not adequate. Taken together, the fact that our taxes are the lowest and the $675 million shortfall show that Alabama taxes are not optimal.

A recent Institute on Taxation and Economy Policy (ITEP) report titled "Who Pays: A Distributional Analysis of the Tax Systems in All 50 States" is just one in a long line of reports and news about the regressive nature of Alabama's tax structure. The state tax structure has even been labeled immoral. Alabama taxes are regressive because of the low income tax threshold and high dependence on sales and excise taxes, especially when applied to food items and medicines. To make our tax system fairer a progressive income tax rate structure would be needed to counter sales and excise taxes, which are based on price or unit of goods purchased. The tax package proposes a more progressive income and property tax rate structure. In addition to problems with fairness, PARCA has documented that Alabama taxes are neither adequate nor efficient. It is important to rid government of waste but resources are needed for that effort. This point combined with the inadequacy of state taxes makes raising revenues the best way to address both adequacy and efficiency issues.

The tax package is a good start to addressing problems with the current state tax structure. The tax portion addresses revenue adequacy, tax fairness, and efficiency. The accountability portion is aimed at making state government less cumbersome and less wasteful, and therefore more efficient. The package has dynamic features built in to prevent a regression over time. There are several other benefits that can be realized if the tax package helps to raise the level and quality of education. For example, a higher skilled labor force is more attractive to higher wage and high tech industries. Also, less crime is associated with better education. The state must not stop improving the tax structure and making government more accountable whether the package is passed or not. Perhaps, sales taxes on food items and medicines could be eliminated in a revenue-neutral but more progressive manner in the future.

APPENDIX

Table A1. Expenditure Distribution: Personal Consumption and State and Local Government

Percent

Industry	Personal Consumption	State & Local Government
Farm products & agricultural, forestry, & fishing services	0.6	0.4
Forestry & fishing products	0.1	0.0
Coal mining	0.0	0.0
Oil & gas extraction	0.0	0.0
Metal mining & nonmetallic minerals, except fuels	0.0	0.0
Construction	0.0	17.5
Food & kindred products & tobacco products	6.2	1.0
Textile mill products	0.2	0.0
Apparel & other textile products	1.9	0.2
Paper & allied products	0.3	0.4
Printing & publishing	0.7	0.7
Chemicals & allied products & petroleum & coal products	3.1	2.4
Rubber & miscellaneous plastics products & leather & leather products	0.7	0.6
Lumber & wood products & furniture & fixtures	0.5	0.1
Stone, clay, & glass products	0.1	0.1
Primary metal industries	0.0	0.0
Fabricated metal products	0.2	0.2
Industrial machinery & equipment	0.2	0.3
Electronic & other electric equipment	1.0	0.2
Motor vehicles & equipment	2.4	0.3
Other transportation equipment	0.3	0.0
Instruments & related products	0.3	0.6
Miscellaneous manufacturing industries	1.1	0.3
Transportation	2.1	1.1
Communications	2.3	1.0
Electric, gas, & sanitary services	3.2	2.5
Wholesale trade	3.7	1.0
Retail trade	12.8	0.1
Depository & nondepository institutions & security & commodity brokers	5.0	1.5
Insurance	3.3	0.1
Real estate	14.7	1.3
Motels & other lodging places, amusement & recreation services, &	2.6	0.5
Personal services	1.5	0.3
Business services	2.0	4.1
Eating & drinking places	4.3	0.4
Health services	15.2	0.1
Government and miscellaneous services	7.4	60.8
Private households	0.2	0.0
TOTAL	**100.0**	**100.0**

Source: *IMPLAN 1998*, Minnesota Implan Group, and Center for Business and Economic Research, The University of Alabama.

Table A2. Changes in Personal Consumption and State and Local Government Expenditures

$ Millions		State & Local Government		
Industry	Personal Consumption	Business as usual	More construction less govt services	More govt services less construction
Farm products & agricultural, forestry, & fishing	(6.0)	4.4	4.4	4.4
Forestry & fishing products	(0.7)	0.0	0.0	0.0
Coal mining	(0.0)	0.1	0.1	0.1
Oil & gas extraction	0.0	0.0	0.0	0.0
Metal mining & nonmetallic minerals, except fuels	(0.0)	0.3	0.3	0.3
Construction	0.0	187.7	287.7	87.7
Food & kindred products & tobacco products	(63.9)	10.8	10.8	10.8
Textile mill products	(1.6)	0.4	0.4	0.4
Apparel & other textile products	(20.0)	2.2	2.2	2.2
Paper & allied products	(3.1)	4.2	4.2	4.2
Printing & publishing	(7.4)	8.0	8.0	8.0
Chemicals & allied products & petroleum & coal products	(32.3)	25.5	25.5	25.5
Rubber & miscellaneous plastics products & leather & leather products	(7.7)	6.1	6.1	6.1
Lumber & wood products & furniture & fixtures	(5.2)	0.6	0.6	0.6
Stone, clay, & glass products	(0.8)	0.7	0.7	0.7
Primary metal industries	(0.0)	0.2	0.2	0.2
Fabricated metal products	(1.7)	1.7	1.7	1.7
Industrial machinery & equipment	(1.9)	3.6	3.6	3.6
Electronic & other electric equipment	(10.6)	2.0	2.0	2.0
Motor vehicles & equipment	(24.9)	2.9	2.9	2.9
Other transportation equipment	(2.7)	0.2	0.2	0.2
Instruments & related products	(2.7)	6.4	6.4	6.4
Miscellaneous manufacturing industries	(11.0)	3.2	3.2	3.2
Transportation	(21.5)	11.6	11.6	11.6
Communications	(23.3)	10.5	10.5	10.5
Electric, gas, & sanitary services	(32.8)	27.3	27.3	27.3
Wholesale trade	(38.5)	11.1	11.1	11.1
Retail trade	(132.3)	0.7	0.7	0.7
Depository & nondepository institutions & security & commodity brokers	(51.5)	16.1	16.1	16.1
Insurance	(34.3)	0.6	0.6	0.6
Real estate	(152.8)	14.2	14.2	14.2
Motels & other lodging places, amusement & recreation services, & motion pictures	(27.1)	5.1	5.1	5.1
Personal services	(15.6)	3.4	3.4	3.4
Business services	(20.4)	44.4	44.4	44.4
Eating & drinking places	(45.1)	4.7	4.7	4.7
Health services	(157.2)	0.7	0.7	0.7
Government and miscellaneous services	(76.9)	773.6	673.6	873.6
Private households	(2.4)	0.0	0.0	0.0
TOTAL	**(1036.0)**	**1195.0**	**1195.0**	**1195.0**

Note: Numbers in parentheses are negative.

Source: Center for Business and Economic Research, The University of Alabama.

Table A3. Worst-Case Changes in Personal Consumption and State and Local Government Expenditures

$ Millions

Industry	Personal Consumption	State & Local Government
Farm products & agricultural, forestry, & fishing services	(6.9)	4.9
Forestry & fishing products	(0.9)	0.1
Coal mining	(0.0)	0.1
Oil & gas extraction	0.0	0.0
Metal mining & nonmetallic minerals, except fuels	(0.0)	0.3
Construction	0.0	208.6
Food & kindred products & tobacco products	(73.6)	12.0
Textile mill products	(1.9)	0.4
Apparel & other textile products	(23.0)	2.4
Paper & allied products	(3.6)	4.6
Printing & publishing	(8.6)	8.9
Chemicals & allied products & petroleum & coal products	(37.3)	28.4
Rubber & miscellaneous plastics products & leather & leather products	(8.9)	6.8
Lumber & wood products & furniture & fixtures	(6.0)	0.7
Stone, clay, & glass products	(1.0)	0.8
Primary metal industries	(0.0)	0.3
Fabricated metal products	(2.0)	1.9
Industrial machinery & equipment	(2.2)	4.0
Electronic & other electric equipment	(12.2)	2.2
Motor vehicles & equipment	(28.8)	3.2
Other transportation equipment	(3.1)	0.2
Instruments & related products	(3.1)	7.1
Miscellaneous manufacturing industries	(12.6)	3.5
Transportation	(24.8)	12.9
Communications	(26.9)	11.7
Electric, gas, & sanitary services	(37.8)	30.4
Wholesale trade	(44.4)	12.3
Retail trade	(152.6)	0.8
Depository & nondepository institutions & security & commodity brokers	(59.4)	17.9
Insurance	(39.5)	0.7
Real estate	(176.2)	15.7
Motels & other lodging places, amusement & recreation services, &	(31.2)	5.7
Personal services	(18.0)	3.8
Business services	(23.5)	49.4
Eating & drinking places	(52.0)	5.2
Health services	(181.3)	0.8
Government and miscellaneous services	(88.7)	726.5
Private households	(2.7)	0.0
TOTAL	**(1195.0)**	**1195.0**

Note: Numbers in parentheses are negative.

Source: Center for Business and Economic Research, The University of Alabama.