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5 Hot Topics Hitting Public Finance in 2017.

In what could be a tumultuous year for state and local finances, these five issues are likely to take center stage.

Tax Reform

Many Capitol Hill watchers expect federal tax reform to roll forward in some fashion in 2017 now that a Republican will be in the White House. There are two major proposals on the table that could directly result in higher costs for states.

For starters, many in Congress have been supportive of limiting the tax-exempt status of municipal bonds. Removing this tax perk for bond investors would force governments to offer higher interest rates on the debt, thus increasing their cost of paying off that debt.

It's hard to overstate the potential impact of such a move. One estimate pegged the current tax perk savings for state and local governments at about $714 billion from 2000 to 2014. For its part, the federal government estimates it loses as much as $30 billion in potential income tax revenue each year as a result of the perk.

President-elect Donald Trump recently told a group of mayors he would protect the tax exemption. The comment was the first time he'd specifically mentioned the issue and it was immediately met with hopeful praise from industry groups like the National Association of State Treasurers and the Council of Development Finance Agencies.

But how far that pledge will go remains to be seen.

Second, the tax reform discussion may also include eliminating the ability for tax filers to deduct their state and local taxes from their taxable income at the federal level.

Naysayers of the deduction argue it subsidizes high-tax states. While eliminating this perk wouldn't have an immediate impact, said Michael Mazerov, senior fellow at the Center on Budget and Policy Priorities (CBPP), it would have a long-term impact on states' ability to raise additional revenues through tax hikes. This is particularly true for higher-tax states where citizens would no longer get a substantial tax break at the federal level.

"Certainly," he said, "the elimination could have one of biggest impacts on state and local finances."

Budget Shortfalls

Weak revenues are causing the highest number of state budget shortfalls since the Great Recession, and that trend is expected to weigh on lawmakers as they draw up their fiscal 2018 budgets in the coming months.

According to the National Association of State Budget Officers' annual state spending survey, half of all states saw revenues come in lower than projected for fiscal 2016. And nearly as many states (24) are seeing those weak revenue conditions carry into fiscal 2017. It marks the highest number of states falling short since 36 budgets missed their mark in 2010.

Unless lawmakers make significant corrections, some believe the picture could look bleaker as 2017 wears on.

“I tend to think it’s going to skew toward worse nationally,” said Matt Fabian, a partner at Municipal Market Analytics. “That means more budget gaps and reduced aid to local governments.” Any changes at the federal level, Fabian added, “are probably going to make it worse.”

Medicaid funding could also cut into state finances. Trump and other Republicans have proposed converting the program into a block grant. A Congressional Budget Office (CBO) assessment of earlier Medicaid block grant proposals projected declines of between 4 and 23 percent in federal funding over 10 years. Aid from the feds makes up approximately 15 percent of total state expenditures.

If the CBO’s estimates are accurate, Fitch Ratings said, “reductions of this magnitude would have a significant effect on states’ budgets.”

Tax Break Transparency

A new accounting rule, called GASB 77, will result in more hard data than ever on what was a previously murky part of state and local finances.

The rule requires governments to report the tax breaks they give to businesses as forgone tax revenue on their balance sheets.

While some wish the rule included more specific requirements — such as naming the companies receiving the breaks — most believe the new disclosures will be a watershed moment for transparency. The new data will likely inform policy discussions for years to come.

New York City has already reported its foregone revenue, disclosing that it waived more than $3 billion in potential tax revenue in 2016 alone, mostly in uncollected property taxes.

Noting that many states already produce tax expenditure reports, the CBPP’s Mazerov predicts that the new reporting requirements will be particularly revealing at the city and county level, as “there’s so little information locally about economic development giveaways.”

Increasing Pension Contributions

State and local retirement benefit expenditures have grown roughly twice as fast as revenues and most other spending areas in recent years, according to a new analysis by Fitch Ratings. While much of this growth has been driven by pensions, a rise in health-care and Medicaid costs have also played a part.

Meanwhile, the last two years have seen pension plans significantly miss their target rate of return (7.5 percent), which will trigger higher pension bills in the coming years. Governments with well-funded plans are much better positioned to absorb any increases. But many plans have less than three-quarters of the assets they need to fully meet their liabilities. The lower-funded the plan, the more extreme the impact of low-investment returns will be on a government’s pension bill.

The last 10 years have seen retirement benefit expenditures growth exceed or crowd out growth rates for all other major spending categories.

“With tax rate increases remaining politically challenging and due to the historically slow economic and revenue recovery after the financial crisis, state and local governments have been forced to hold the line on spending for other services,” Fitch said. “This trend is likely to continue over the near term.”

Online Sales Tax Battles

After more than a decade of badgering Congress to solve the issue nationally, states have taken it upon themselves to win the right to tax online purchases made by their residents.

Generally, consumers are only taxed on purchases from retailers with a physical presence in their state. But legal challenges by states are moving forward on several fronts.

First, Colorado recently scored a win when the U.S. Supreme Court effectively upheld a 2010 law by refusing to hear the case and letting the lower court ruling stand. The law makes collecting an online sales tax from Colorado consumers more palatable than going through the reporting requirements for companies that don’t do so.

Other states have already begun to follow suit, and both Louisiana and Vermont have enacted similar laws that take effect in 2017.

“At this point,” said Matt Walsh, Sovos Compliance’s vice president of tax, “we would also expect to see many states move to enact similar legislation early in 2017.”

Meanwhile two other states have cases moving forward that also challenge the status quo.

One company is challenging Alabama’s new sales tax rule that bases the tax on revenue, not location. In South Dakota, several companies are challenging the state’s 2016 law that outright permits it to collect a sales tax on Internet purchases from remote retailers who have a so-called “economic presence” in the state.

Many believe the South Dakota case could be fast-tracked to the Supreme Court as early as 2017.

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