



## Testimony of Mark Haggerty, Headwaters Economics, to the Washington State House Finance Committee

January 24, 2019

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Dear Chair and Members of the Committee,

Thank you for the invitation to present to this work session on state tax structures and the changing economy. I have been asked to share with this Committee a presentation I made at the 2018 National Conference of State Legislators (NCSL) Fiscal Leaders Western States Conference, “Is Tax Revenue Decoupling from the Underlying Economy?”

This document provides background on the genesis of the NCSL presentation and provides a narrative, explanation, and citations for the [slides I’ll present today](#).

The NCSL presentation is based primarily on research done in 2018 for Montana’s descriptively named “Joint subcommittee on the changing economy and impacts to the long-term viability of Montana’s tax structure.” The State of Montana has experienced revenue declines as a share of gross state product from 2000 and members of the subcommittee wanted to know whether the revenue erosion can be attributed to short-term volatility, or whether longer-term structural issues exist in Montana’s tax code.

To help answer this question, I was asked to provide an overview of how the state’s economy has changed over time and what implications that may have for state and local government revenue. Legislative fiscal staff was asked at the same meeting to provide an overview of the state’s tax structure and revenue trends. Based on these presentations and committee discussion, I worked during the next several months with staff to provide additional information to the committee.

The results of that work make up the bulk of this presentation, including a description of Montana’s and Washington’s growing and changing economies, lessons from economic transition at the local and state level as they related to fiscal policy, and initial answers about the source of Montana’s revenue erosion and questions going forward for Montana that also have relevance in Washington.

Please do not hesitate to contact me after this session with further questions, clarifications or concerns. Thank you again for the opportunity to present to this committee today, and I look forward to continuing conversations.

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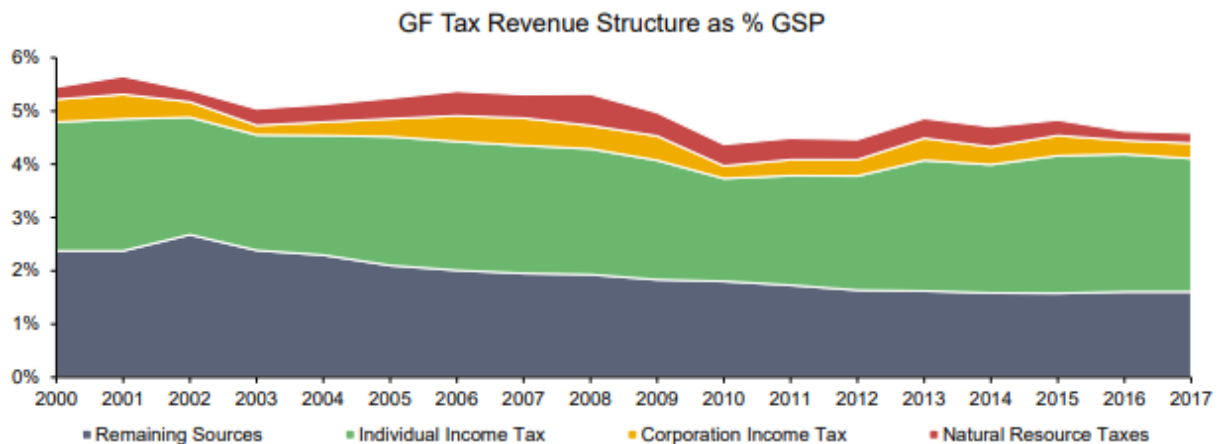
<https://headwaterseconomics.org/>

## Is Tax Revenue Decoupling from the Underlying Economy?

The Montana Legislature meets on a biennial basis. One of the most important tasks each session is to pass a budget. Estimating revenue and potential costs for a two-year budget is challenging. In 2017, Governor Bullock called a special legislative session to address a \$273 million budget gap that had opened after the end of the regular session. The gap opened partly due to unexpected costs, including a severe fire season that resulted in substantial spending over budget, and due to revenue coming in below projections.

The weak revenue performance in 2017 occurred despite economic growth. In fact, Montana's General Fund revenue had declined relative to Gross State Product (GSP) since 2000, suggesting that the poor revenue performance may be structural in nature rather than due to cyclical volatility.

Figure 1: Montana General Fund Revenue Has Declined Since 2000 as a Share of Gross State Product<sup>1</sup>



To explore these questions more fully, the state Legislature convened the “Joint subcommittee on the changing economy and impacts to the long-term viability of Montana’s tax structure.”

The subcommittee first reviewed how Montana’s economy has changed and with a review of current revenue sources and trends. With this information, the committee directed staff to explore potential causes of the long-term revenue erosion relative to GSP.

My testimony today is based on my participation in the work of the committee and is broken into three parts:

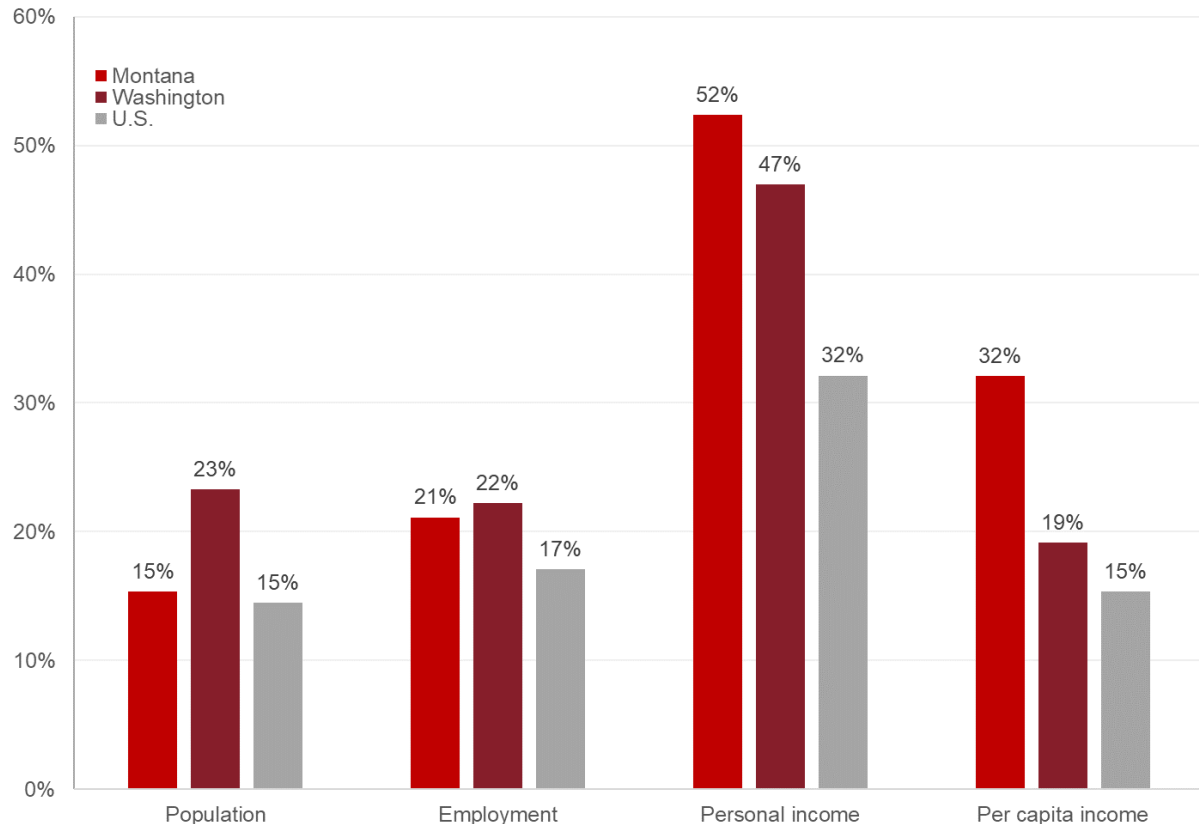
1. First, I describe Montana’s and Washington’s growing and changing economies.
2. Next, I review research and lessons from economic transition at the local and state level as they related to fiscal policy.
3. Finally, I’ll share initial answers about the source of Montana’s revenue erosion and questions going forward for Montana that also have relevance in Washington.

## Economic Trends in Washington's and Montana's Economies

### Washington and Montana Are Growing Faster Than the U.S.

The first fact to recognize is that the economy is growing, adding jobs every month for more than 9 consecutive years. Unemployment remains low, people are reentering the workforce, and Gross Domestic Product growth is strong. The West, including Montana and Washington are growing even more rapidly than the U.S. From 2000-2016, Washington's and Montana's economies outperformed the United States with faster growth in population, employment, personal income, and per capita personal income.

Figure 2: Washington, Montana, and U.S., Percent Change, 2000-2016<sup>2</sup>



### Growth Is Concentrated in Metropolitan Areas

Despite strong growth, a defining feature of the economy particularly since 2010 has been increasing divergence between the nation's largest cities and rural counties. Between 2000 and 2015, Montana's population grew by 14 percent and jobs grew by 20 percent. But as the map below shows, three quarters of new jobs have located in just five counties while a larger number of counties lost population and employment opportunities. The same uneven economic geography is occurring in Washington.

Figure 3: 75 Percent of New Jobs in Montana Since 2000 Are Concentrated in Five Counties<sup>3</sup>

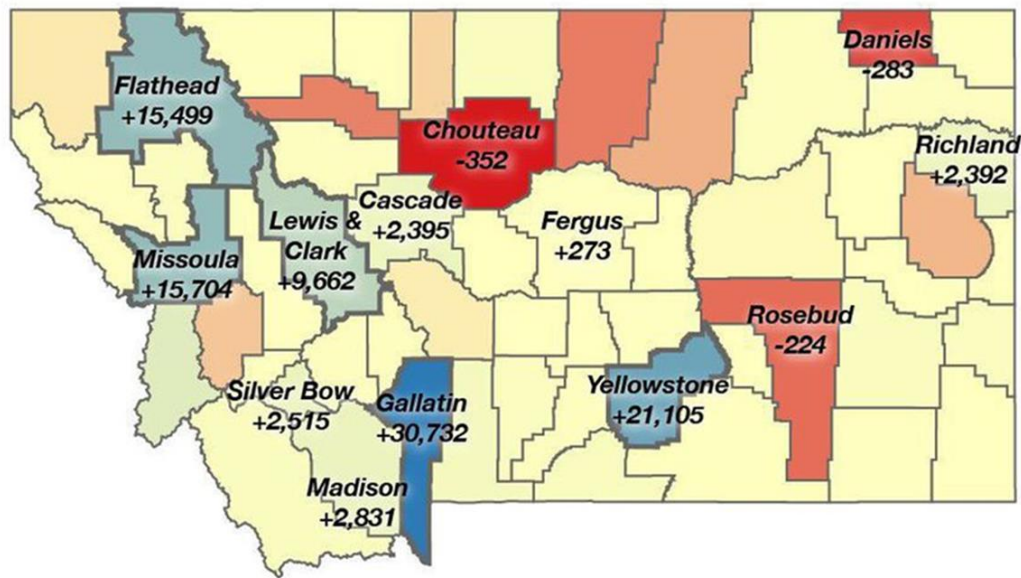
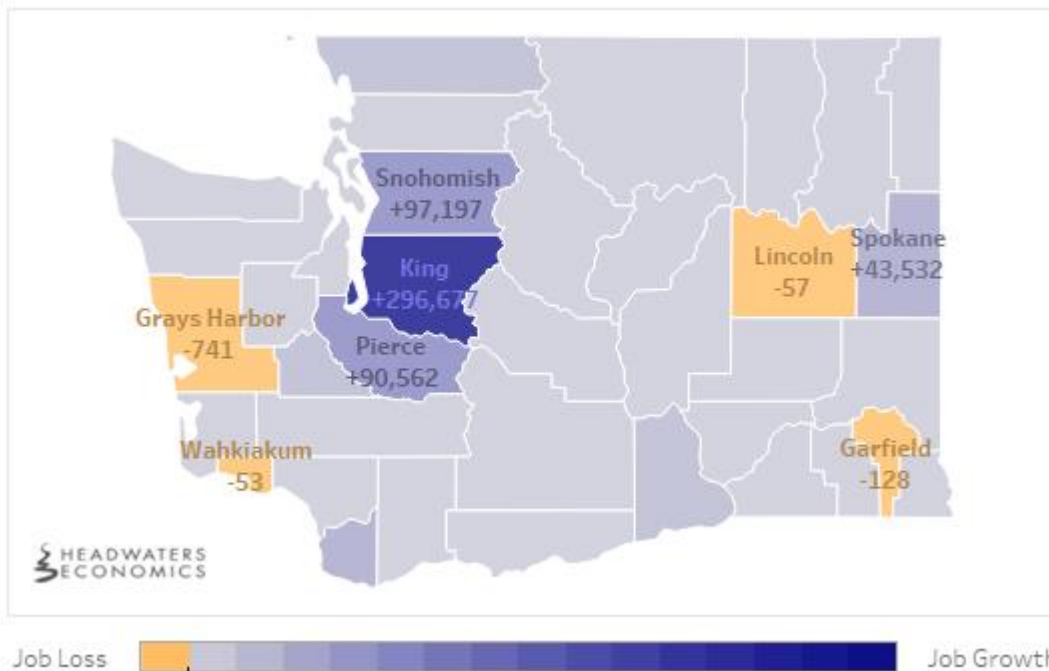


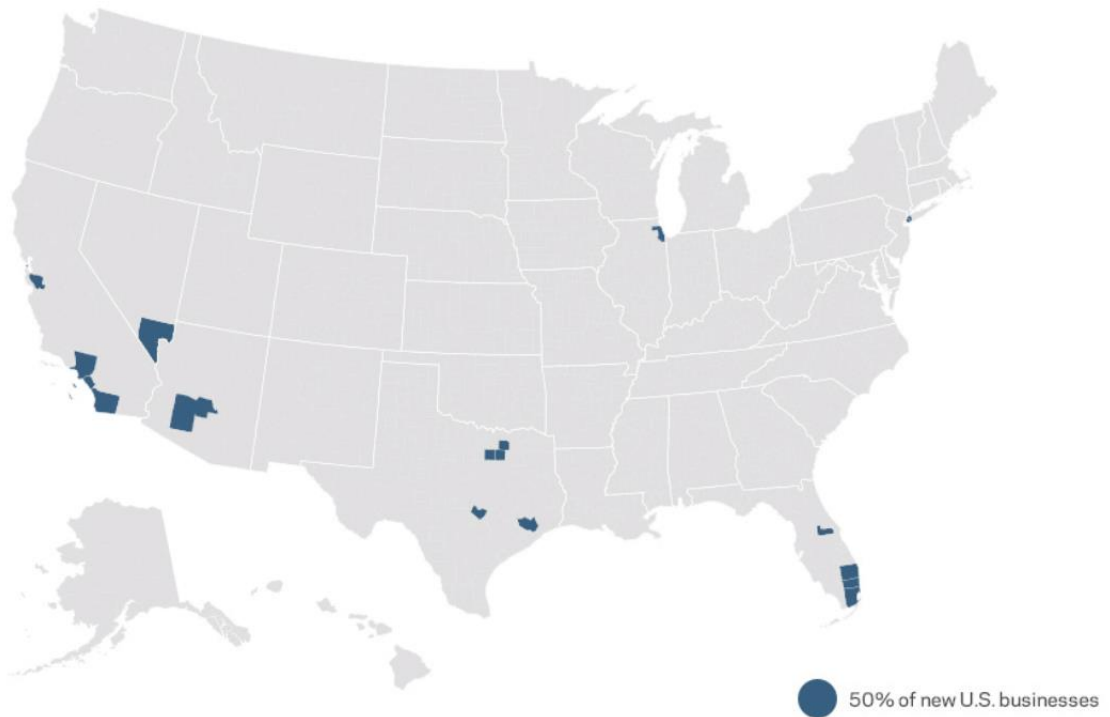
Figure 4: 67 Percent of New Jobs in Washington Since 2001 Are Concentrated in Four Counties<sup>4</sup>



### Montana's and Washington's Economic Geographies Are Consistent with U.S. Trends

The U.S. is experiencing an incredible concentration of wealth and opportunity in the nation's largest metropolitan areas. The Economic Innovation Group reports that most new jobs are concentrated in a handful of the nation's largest cities. In the four years coming out of the financial crisis (between 2010 and 2014), half of all new business startups were concentrated in only 20 major cities.

Figure 5: 20 Counties Generated Half of New Businesses After the Most Recent Recession, 2010-2014<sup>5</sup>

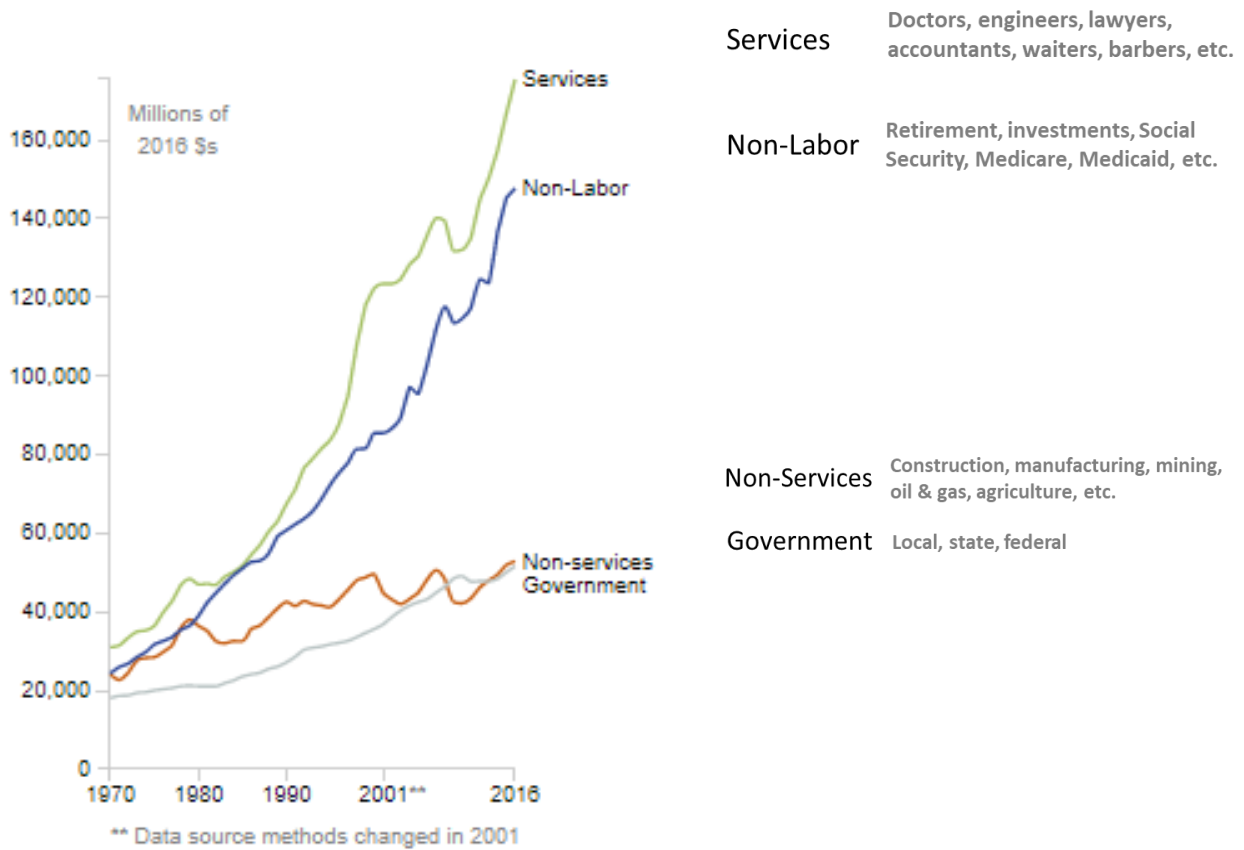


The trend toward employment and income concentration in cities is accelerating. Across the U.S. job growth and business formation has become more narrowly focused in major cities during each recent recovery following recessions. According to the Economic Innovation Group, the number of U.S. counties continuing to see net declines in business establishments following major recessions grew from only 17 percent of all counties during 1992 to 1996 to nearly 60 percent of all counties during 2010 to 2014.

### Structural Change in the U.S. Economy Is Driving New Economic Geography

Since 2010, 82 percent of all new job in Washington were added in services occupations. The exceptions include construction and manufacturing that together added about 14 percent of new jobs since 2010. This trend toward services in the same nationally and in Montana (85% of new jobs).

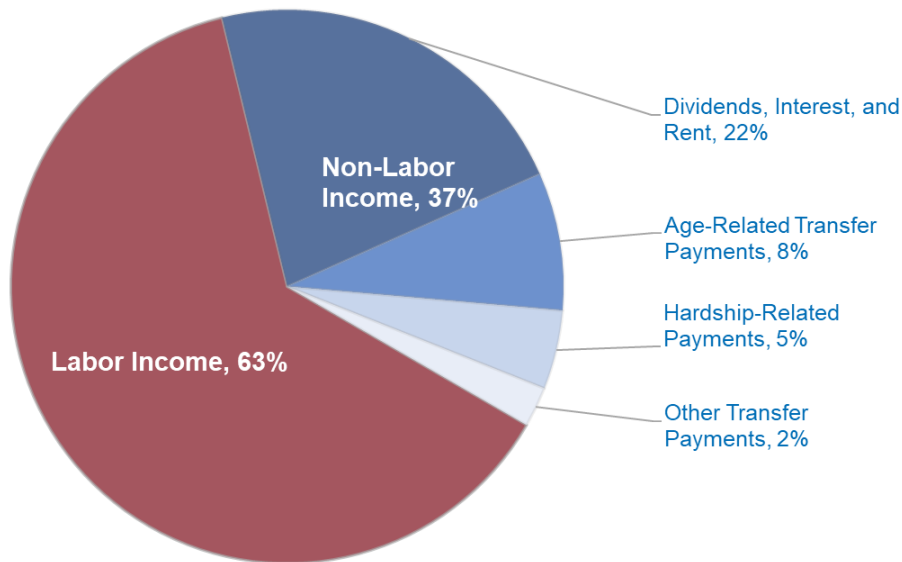
Figure 6: Most Income Growth Is in Services and Non-Labor: Change in Personal Income by Source, Washington, 1970-2016<sup>6</sup>



Non-labor income is one of the largest and fastest growing sources of income in Montana, Washington and the West. Comprised of three main types—investments, age-related payments, and hardship payments—non-labor income is affected by the stock market, retiring baby boomers, and changes to Medicare, Medicaid, and Social Security. Non-labor income is important because it stimulates growth in other sectors, such as construction, health care, and retail trade.<sup>7</sup>

In Washington, non-labor income accounted for 37 percent of total personal income in 2016, and nearly half of net new personal income growth during 2010-2016.

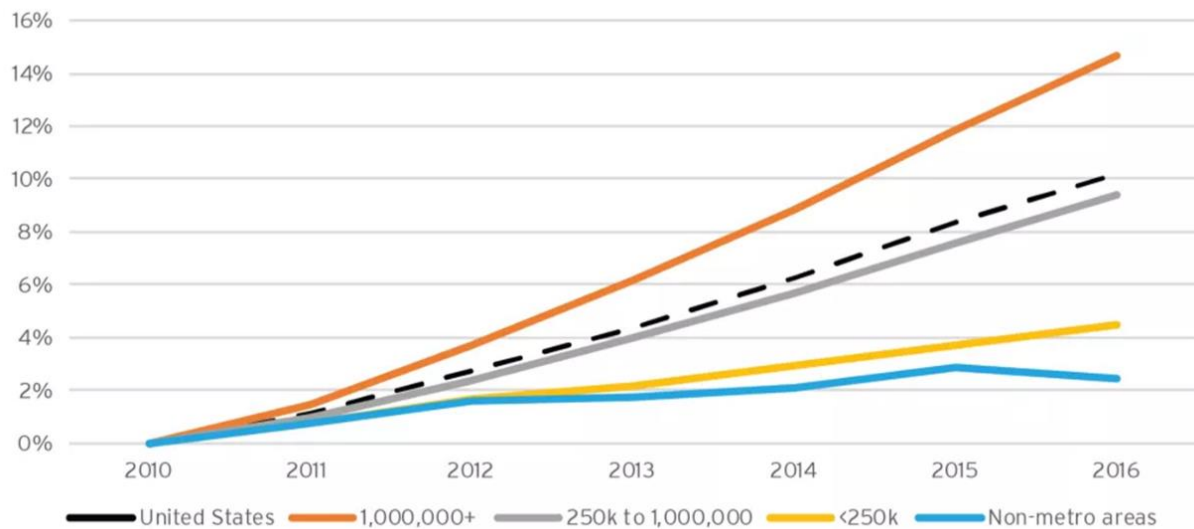
Figure 7: Non-Labor Income as Percent of Total, Washington, 2016



### High-Wage Jobs in Innovation Sectors Are Most Important Services

A significant implication of the shift to a services economy is that most new high-wage services jobs are locating in cities. For example, innovation jobs including software, research R&D, finance, and technology require access to finance, educated labor, and global markets—competitive advantages largely found in cities—and almost always require a college degree. Cities tend to have higher numbers and shares of workers who hold advanced degrees. Despite the promise that the internet and communications technology would destroy distance and allow workers to locate anywhere in the U.S., the new economy has placed a premium on being well connected to markets, capital, and other creative people and companies. As a result, much of the new economic growth in the U.S. has resulted in a concentration of wealth and opportunity in cities.

Figure 8: Percent Employment Growth from 2010 by Metropolitan Size Tier<sup>9</sup>

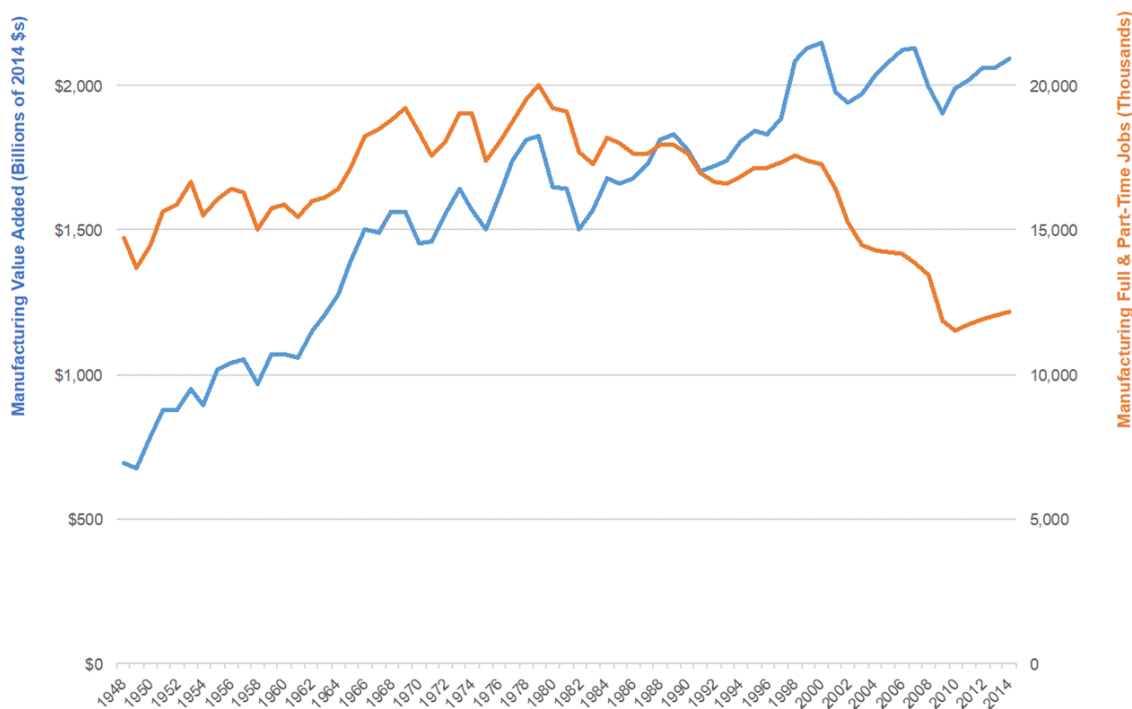


## Manufacturing and Traditional Sectors Are Losing Jobs

By comparison, non-metro areas grew the slowest and had more volatility largely associated with uncertain commodity prices. Not only are non-metro, and more importantly rural areas, not capturing the innovation jobs locating in cities, they are struggling with the incredible productivity gains in the economy that have shed jobs in traditional non-services sectors. Manufacturing employment in the U.S. has declined sharply beginning in about 1980, falling from 20 million jobs to about 13 million jobs in 2015.<sup>10</sup> At the same time, manufacturing’s contribution to Gross Domestic Product (GDP)—the total value of manufactured products—has grown from \$1.66 trillion in 1980 to \$2.14 trillion in 2000 and \$2.17 trillion in 2015 (in constant \$2014 dollars).<sup>11</sup>

The decline in manufacturing jobs can be attributed to trade and “offshoring” of jobs in low-value manufacturing sectors, and to increasing productivity and automation in high-value manufacturing sectors that remained in the U.S. In total, between 12 percent<sup>12</sup> and 25 percent<sup>13</sup> of manufacturing job losses can be attributed to increasing trade. Most manufacturing job losses can be attributed to labor-saving technologies and the shift to high-tech manufacturing.<sup>14</sup>

Figure 9: Manufacturing Employment and GDP, U.S., 1948-2015



In Washington, manufacturing employment has declined by nearly half, falling from 13.6 percent of employment in 1990 to 7.2 percent of employment in 2016.<sup>15</sup> Manufacturing has added jobs since 2010, but continues to decline as a share of total employment. In terms of GDP, manufacturing has also fallen, but by a smaller margin, making up 15.7 percent in 1997 and 12.6 percent in 2016 (a 20 percent decline).<sup>16</sup> These trends again show the relative resilience of manufacturing in terms of the value of manufactured goods, and the labor-saving effects of automation.

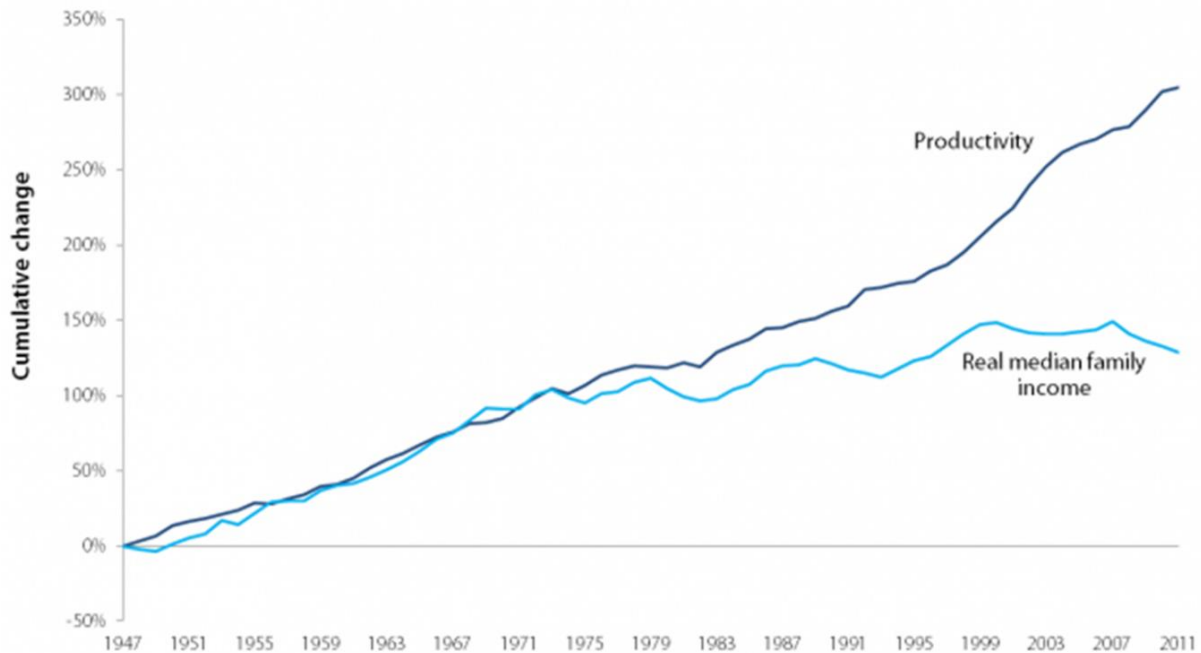
This dichotomy can be seen across a variety of traditional sectors. The coal industry, for example, lost 180,000 mining jobs even as coal production nearly doubled from 1985 to 2011. A shift from inefficient underground mines in Appalachia to the hugely productive surface mines in Wyoming made the



employment efficiencies possible. It happened in agriculture much earlier. In 1900, three in five Americans worked on farms while today less than two percent of Americans work on farms. Consolidation and automation in timber mills and mechanization in timber harvesting technology destroyed two thirds of timber jobs in the Pacific Northwest between 1990 and 2000,<sup>17</sup> although this trend was overshadowed by highly politicized changes federal land management during the same period and is not as well understood.

The “Great Decoupling” describes the fact that mechanization and productivity gains in the U.S. economy have not resulted in more middle-income jobs or higher family incomes.<sup>18</sup> In manufacturing, increases in productivity led to fewer, not more jobs. And in other sectors of the U.S. economy including agriculture, timber, mining, and retail trade where jobs are more easily automated, productivity increases also led to fewer jobs and failed to raise family incomes.

Figure 10: The Great Decoupling<sup>19</sup>



Many people worry that we are not “making things” anymore in the U.S. because of the decline in manufacturing, agriculture, timber, and mining. However, innovation jobs replacing these blue-collar jobs perform the same role in the new economy: innovation services create wealth in the economy and support other sectors (e.g., they have multipliers that create additional jobs in related sectors).<sup>20</sup> The value of an iPhone, for example, is primarily in the innovation related to the software, industrial design, marketing, and distribution. Workers engaged in these activities earn higher wages and there are many more of them compared to the wages and jobs required to produce the raw materials and assemble the iPhone. The same is true of agricultural products whose value today is generated by high-tech software and machinery that has replaced labor on the farm and created innovation jobs in remote sensing, software development, and high-tech manufacturing.

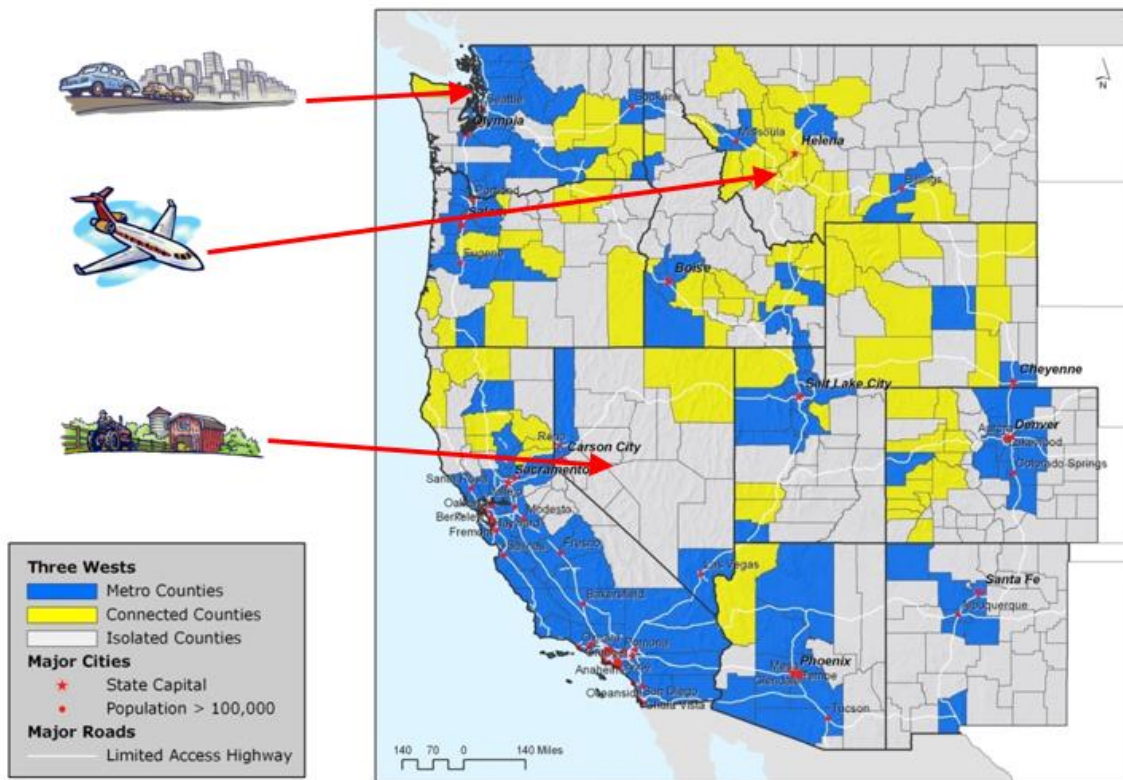
### The “Three Wests” Helps Explain Diverging Opportunities

In the West, the economic shift is creating winners and losers among regions based on their access to metropolitan areas via road or air travel.<sup>21</sup> Access to cities is critical for economic development, and

ideally access means the ability to meet clients, suppliers, and customers in person and learn from other creative individuals and companies.

Washington’s metropolitan counties and non-metropolitan counties that are “connected” to cities via air travel are characterized by higher average earnings per job, lower income volatility, and offer more high-wage service sector jobs. They are growing more rapidly. The workforce is younger and more highly educated. By comparison “isolated” counties that lack access to cities are growing more slowly, are older and less well-educated on average, and have fewer high-wage services jobs and lower average earnings. Rural broadband is necessary, but not always sufficient to connect rural communities to larger markets and opportunities.

Figure 11: The Three Wests



The growing urban-rural divide reveals underlying structural challenges for states that if resolved, would help both cities and small towns. Cities are struggling to finance needed services and infrastructure to facilitate rapid growth and face a housing affordability crises and workforce challenges. Rural areas are trapped by fiscal dependence on declining sectors and are seeing outmigration of the most talented workers. This divergence of economic performance is driving political divides and may ultimately slow growth.

## Fiscal Policy Lessons from Economic Transition

To better understand how states and local governments can better address geographic inequality, Headwaters Economics recently looked at the current economic performance of counties in the Pacific Northwest historically reliant on timber (defined as counties where 20 percent or more of workers’

earnings came from timber-related jobs in the 1980s). Seven counties met this threshold in Washington. We wanted to know, how are they doing today? Are there examples of successful economic transitions that we can learn from and apply those lessons to communities facing similar challenges today?

Each dot in the figure below represents a county. The position of each county on the vertical axis shows its current relative performance across several measures of economic and demographic indicators. We found that there is very little, if any relationship between historic commodity dependence and current economic performance. In other words, there is no evidence that several decades of substantial wealth generated from timber harvest and processing led to lasting prosperity in these counties.

Figure 12: County Performance on Various Measures of Growth and Prosperity Predicted by Trajectory in 1990<sup>22</sup>



But the performance of these counties today is entirely predictable based on trends in the new economy detailed in the previous section. Counties that are adjacent to or connected to cities by commercial airports are growing. They perform more like the cities they are connected to than their rural and isolated peers. Rural counties that have natural amenities including national parks also are growing. These “amenity counties” are trading on recreation and tourism assets and are attracting visitors and amenity migrants as people choose to live in these areas because of the access to outdoor amenities. By comparison, counties that are relatively isolated from cities and that lack premier natural amenities are stagnant or even losing jobs and population.

Our findings are consistent with socioeconomic monitoring conducted by the Forest Service of the counties affected by the Northwest Forest Plan adopted in 1993. Current economic performance of historically timber-dependent communities reflects the diversity and growth trajectory of these counties in the late 1980s. In other words, counties that were already growing and diversifying their economies

beyond timber before the loss of a timber mill or timber harvesting jobs continued to grow despite the loss of a major employment sector. Those counties already growing in the late 1980s were those connected to metropolitan markets that could more easily participate in growing economic sectors, or those that developed a tourism, recreation, or retirement economy based on local natural amenities.

A more surprising finding is that even among the isolated rural communities we do see differences in their resilience and performance, including some success stories. Communities that have a shared vision, that know where they want to go, and that have strong bonds both locally among business, non-profit, and government sectors and strong linkages out to regional and state institutions, tend to do better. These findings are consistent with a growing body of literature that shows communities can outperform their basic economic geography by establishing and nurturing strong local partnerships and institutions that can share information, convene local planning processes, network with regional and national governments and participate in economic development activities.

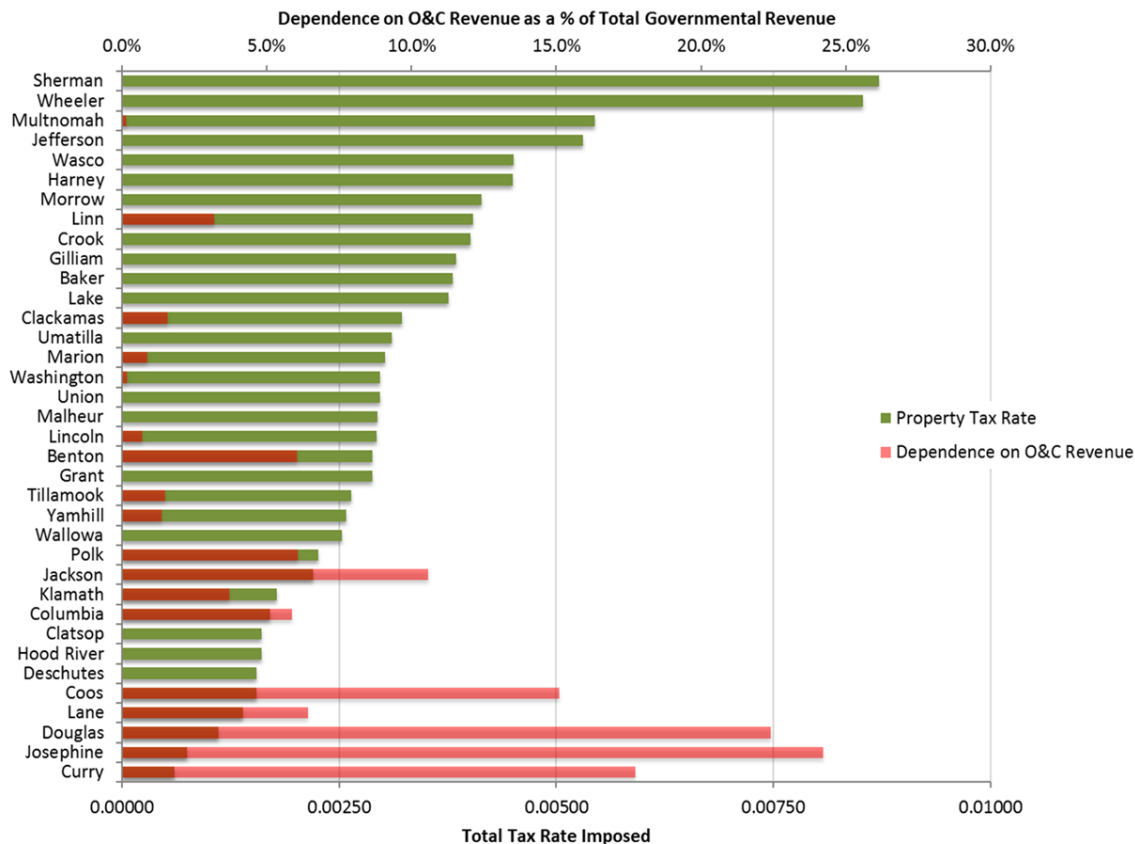
These findings support a theory of rural economic development that focuses on fiscal policy. It says that the local comparative advantage associated with a resource endowment—including timber, range, oil and gas, or a national park—can lead to a virtuous cycle of growth only if the wealth generated by exploiting the endowment is invested into new assets that will continue to generate wealth over time. For example, investing in local institutions and workforce (human and social capital), infrastructure (physical capital), restoration and recreation amenities (natural capital).

The example of the formerly timber-dependent counties bears this out, but in the negative. Poor fiscal policy related to timber revenue is one reason why many of these counties have failed to overcome their economic geography. Revenue generated from timber management was largely used to drive down local property taxes. It wasn't invested into new assets but was used instead to offset other less popular sources of revenue, including property taxes on individuals and local businesses.

Figure 13 shows that Oregon counties that historically received the largest revenue sharing payments maintained among the lowest property tax rates of all counties in the state.

These local choices are understandable within local electoral politics. It would be exceedingly difficult for local leaders to maintain high or even average tax rates on local residents while windfall revenue is saved or used to increase spending on infrastructure, economic development and education.

Figure 13: Dependence on Timber Revenue vs. Local Property Tax Rates<sup>23</sup>



Oregon’s local governments also faced substantial barriers from the state when two constitutional amendments passed in the 1990s and froze property tax rates and property assessments. Oregon’s Measure 5 limited local property tax rates without a popular vote, while Measure 50 lowered and limited growth in property assessed values. These measures in Oregon and state taxation and expenditure limitations (TEs) in other states, including Washington, ossified local dependence on volatile sources of revenue by making it more difficult to raise local tax revenue to replace declining timber payments.<sup>24</sup> When timber revenue ultimately declined due to changing markets and federal policy, several of these counties couldn’t afford to maintain basic government services and found themselves in a situation where they could not grow themselves out of fiscal crisis because of their own tax structure and property tax limitations.

For example, according to an Oregon Governor’s Task Force convened in 2007:

“In 1995, Alcan Cable, an industrial manufacturer located in Douglas County. By 2008, the value of Alcan Cable’s plant and 200 new homes to house employees resulted in only \$63,000 of county taxes for public services. A typical Deputy Sheriff now costs Douglas County \$75,320 per year, or 20 percent more than public revenues generated from this extensive development. Contrast that with a medium-sized saw mill cutting 60 million board feet of timber per year purchased from federal O&C forests. At about \$300 per thousand board feet, the cost to the mill of that timber was \$18 million. One-half of those revenues, or \$9 million, was shared with O&C counties as discretionary revenues. Of that \$9 million,

Douglas County received \$2,254,500, over 35 times the property taxes generated by the Alcan plus-homes development.”<sup>25</sup>

In Oregon and other rural Pacific Northwest counties, dependence on uncertain external revenue and weak authority to manage local revenue resulted in counties cutting services and staff and forgoing investments in infrastructure and community capacity.<sup>26</sup> Over time, these decisions weaken community resilience and lead to slower long-term growth. Counties are not able to support local institutional capacity or form partnerships that can help them overcome their basic economic geography.

These lessons have implications for states and counties experiencing current transitions in energy, manufacturing, and services. For example, counties that host coal mines and coal-fired power plants have little if any revenue set aside to fund economic transition activities and will face significant revenue declines at the precise moment they will need to invest in their workforce and local government capacity.<sup>27</sup>

For example, Wyoming is overly reliant on revenue from fossil fuels extracted largely from public lands. Because Wyoming has no income tax and maintains relatively low taxes on individuals and other sectors, it finds itself in a situation similar to Oregon’s rural counties in that economic development in any sector other than energy results in less revenue than the cost of services. According to a recent report to the Wyoming Legislature from the Regional Economic Modeling Inc. (REMI), 100 new jobs in health care, technology or other services sectors would result in a budget gap.

The outcome of structural fiscal policy choices is hard not only on rural areas. Cities that are growing rapidly and confronting challenges associated with housing affordability, transportation infrastructure, and education are also affected by state limitations on local government fiscal autonomy and a structural mismatch between economic growth and tax revenue. Fiscal policies that fail to capture wealth from growing services activities can have the same effect on revenue erosion and an inability to invest in urban infrastructure and institutions. Tax incentives for business location, lower tax rates on investment capital and income, and exemption of services from taxation may all lead to declining revenue over time.

## Is Revenue Erosion a Thing?

Moody’s Analytics reports that nationally the underlying relationship between state tax revenues and the economy has changed considerably over time.<sup>28</sup> Moody’s attributes the change to two primary factors:

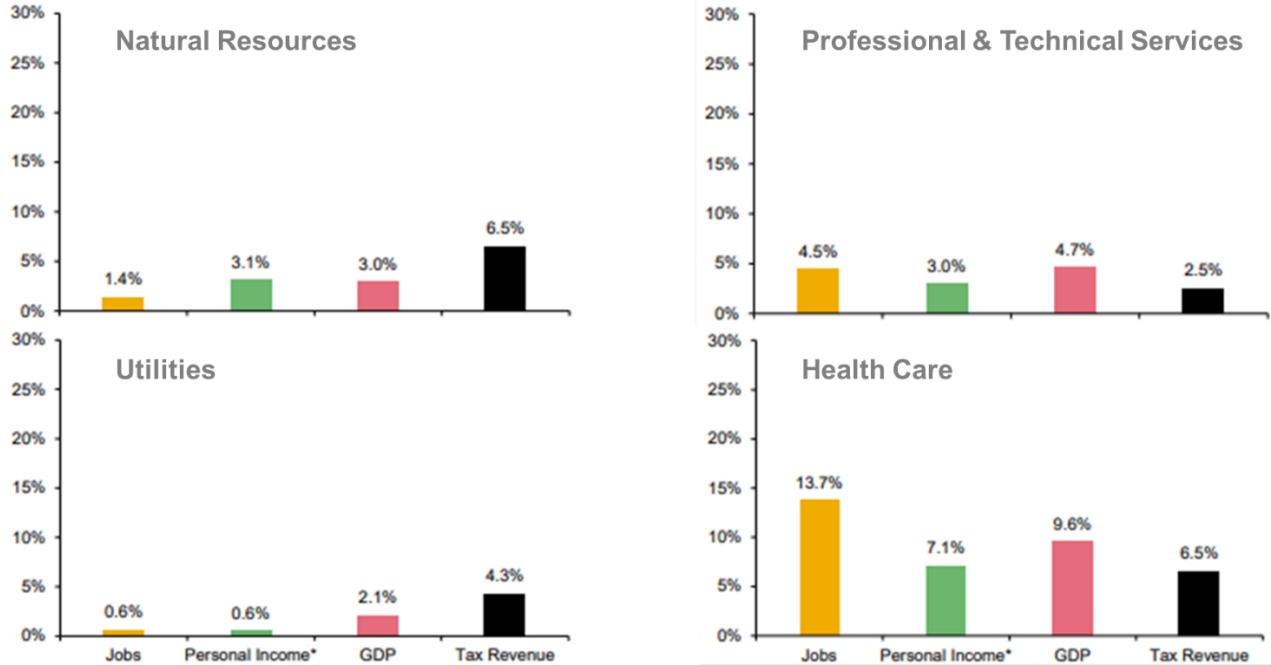
1. “Long-term changes in the U.S. economy, particularly its transition from a reliance on goods producers to an orientation around services”; and
2. “The growing use of economically targeted tax incentives” that have the “unintended consequence of distorting the relationship between tax revenues and the underlying economy.”

Montana’s investigation of its tax structure has relevance for Washington. Montana’s long-term revenue erosion as a share of gross state product, made acute by the budget gap that opened in 2017, raised questions whether Moody’s attributes were at play. At least some would say yes: the director of the Montana Taxpayers Association has quipped, “Montana has a 20th century tax code in a 21st century economy.”

One of the first things Montana’s “Joint subcommittee on the changing economy and impacts to the long-term viability of Montana’s tax structure” explored is the relative contributions of different economic sectors to the state’s economy (in terms of jobs, income, and gross state product) and to governmental

revenue. Figure 14 shows that capital-intensive goods-producing sectors, including natural resources and utilities, pay a larger proportion of state revenue compared to their contributions to total state jobs, personal income, or gross state product.

Figure 14: Industry Sectors Contribute Different Shares of Revenue to the State General Fund<sup>29</sup>



### Montana's Tax Structure Levies Different Taxes on Different Sectors

Service sectors pay less in taxes relative to their contribution to employment, personal income, and gross state product because fewer revenue sources are associated with services compared to taxes on traditional sectors, including timber, coal, oil and gas. For example, as shown in Table 1 all industry sectors pay corporate income taxes and workers across all industries pay personal income taxes. Similarly, property taxes apply to all business sectors, although natural resource sectors tend to be more capital-intensive and some services, such as health care, may receive exemptions from certain levies. Most importantly, natural resource extraction and utilities also pay production taxes—effectively a sales tax—on the value of resources extracted and pay royalties to state and federal landowners when resources are extracted from government lands. Similarly, electricity-generating utilities pay generation taxes on energy production.<sup>30</sup>

Table 1: Tax Levies and Tax Intensity on Selected Montana Industry Sectors YEAR?

	Natural Resources	Utilities	Professional and Technical Services	Health Care
Income Tax	Yes	Yes	Yes	Yes
Corporate Income Tax	Yes	Yes	Yes	With Exemptions
Property Tax	Capital Intensive	Capital Intensive	Labor Intensive	Labor Intensive With Exemptions
Sales Tax	Severance/Royalties	Electricity Generation Tax	No	No

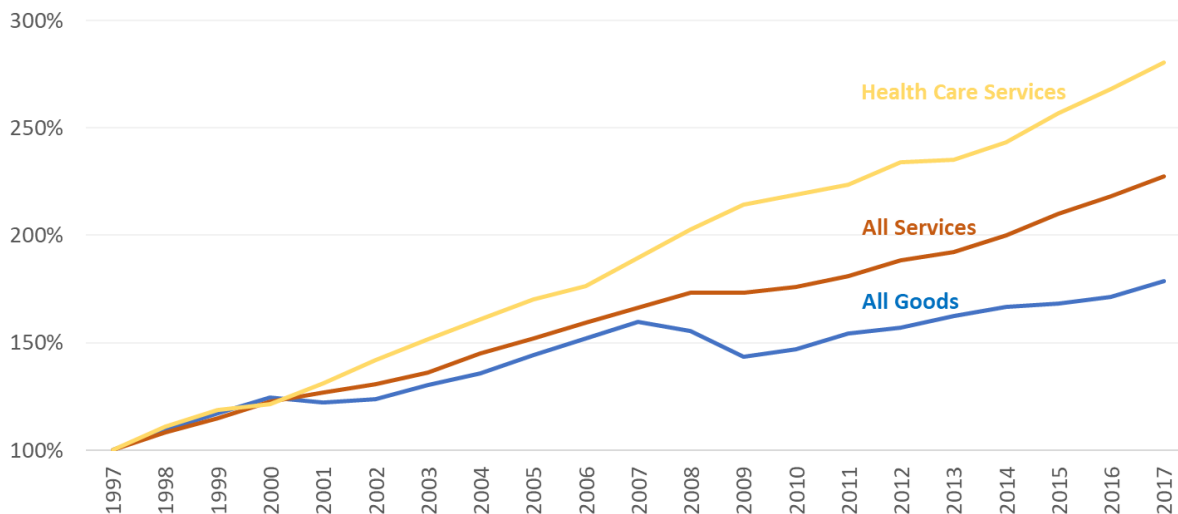
### Current Taxes Generate Different Levels of Revenue from Different Sectors

Another driver of different effective tax rates on industry sectors is that individual components of Montana’s tax structure are applied differently. For example, capital-intensive activities, including manufacturing, utilities, and mining, pay relatively high property taxes as a share of their total product compared to labor-intensive activities. As capital-intensive activities decline, lost revenue is difficult to replace with new economic development, particularly at the local level where dependence on property taxes is greatest.

Another concern with changing industry structure is the shift in consumption from goods to services and the impact on the sales tax base. Montana does not levy a general sales tax but does levy a variety of consumer taxes (e.g., alcohol, lodging, gaming taxes, and other fees) that have declined based on changing consumer behavior. Legislative staff identified changing consumer behavior as one of three primary causes of General Fund revenue erosion to date (along with flat fee structures and tax expenditures/legislative appropriations).

The impact of changing consumption patterns is more acute in states (including Washington) that have a general sales tax. The figure below shows the indexed change in consumption for all goods, all services, and health care services, which is one of the fastest growing sectors in the U.S. and in Washington and is typically exempt from taxation. The change in consumer behavior is important because services are generally excluded from the sales tax base.<sup>31</sup>

Figure 15: Changing Consumer Spending is Eroding the Tax Base, 1997-2017<sup>32</sup>



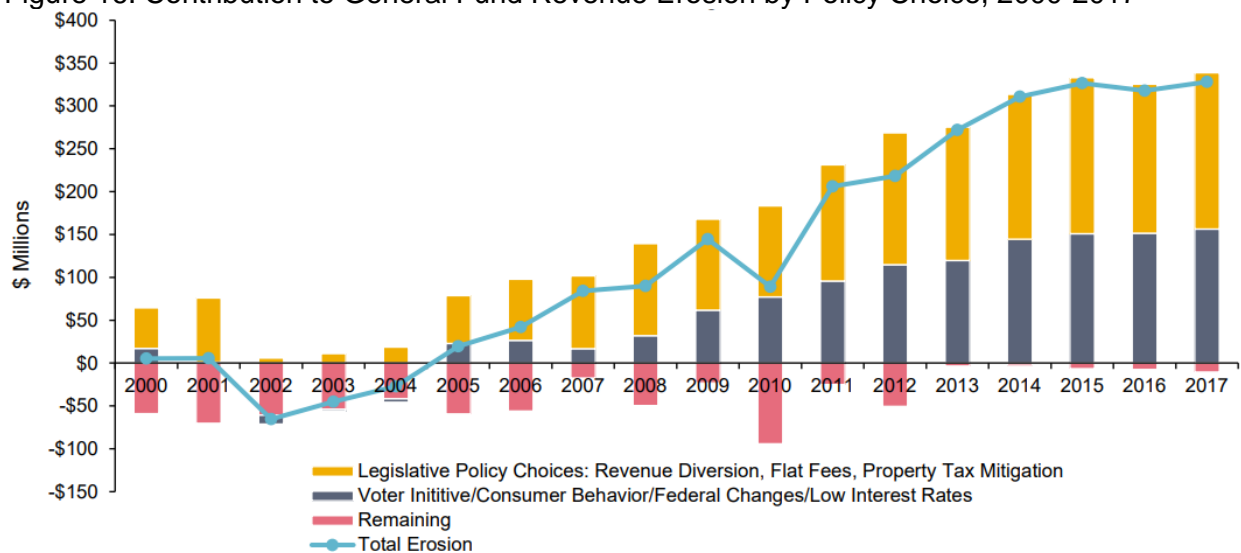


## Flat Fees and Tax Expenditures Erode Revenue Over Time

Montana also has structural challenges built into its tax structure, primarily from a variety of taxes and fees that are not adjusted for inflation. This amounts to built-in tax expenditures that are not reviewed or paid for during the budget cycle. Montana's tax code also includes mandatory tax switching in the form of property tax mitigation and other tax expenditures that reduce revenue from certain activities. These sources are responsible for more than half of revenue erosion in Montana.

Tax expenditures for business location are not as important in Montana as in other states, but the state does have some permanent tax incentives (e.g., an oil and natural gas drilling incentive to draw activity from other oil- and gas-producing regions to Montana) and Montana offers a variety of tax abatements, credits, special zoning designations, and grants for business recruitment.<sup>33</sup> There is little evidence that these incentives work and they are expensive to offer.<sup>34</sup> As noted by Moody's, tax competition among states can become so expensive that the long-term loss of revenue directly associated with new and expanding sectors can be another factor driving the mismatch between revenue collections and economic growth.

Figure 16: Contribution to General Fund Revenue Erosion by Policy Choice, 2000-2017



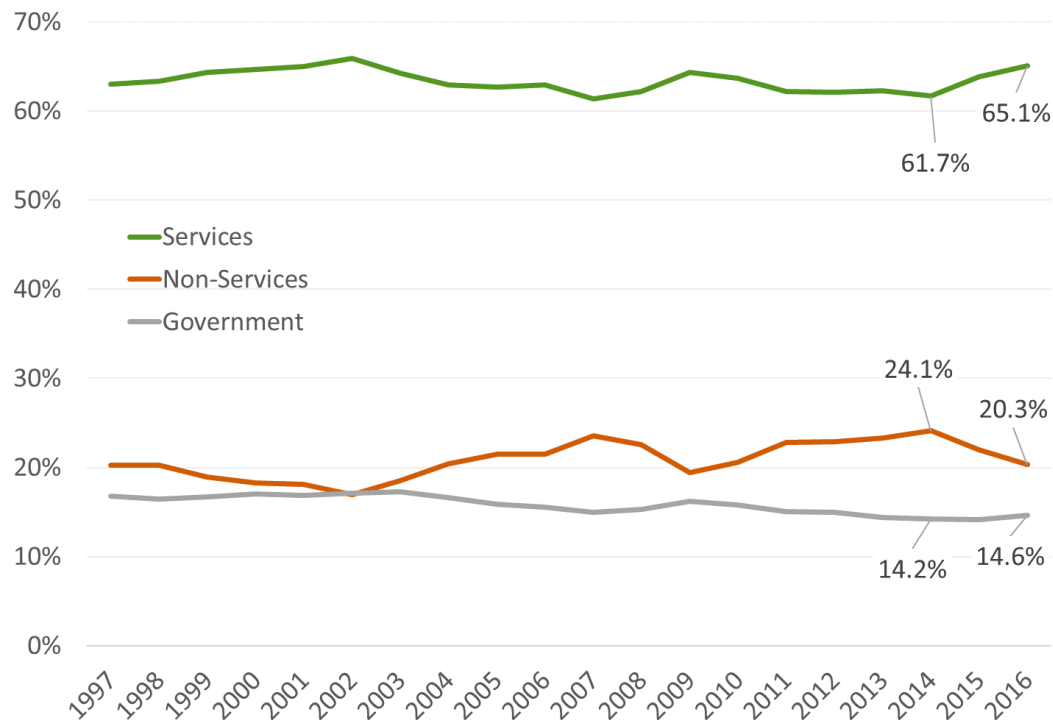
## Increase in Non-Labor Sources of Personal Income

Another potential driver of structural imbalance between state tax structures and the underlying economy is the increase in non-labor sources of income, particularly investment-related income from dividends, interest, and rent. Income inequality means that a larger share of total personal income is earned by a smaller percentage of income tax filers. In addition, the way that income is earned by these highest income earners also is changing. Rather than earning income through a traditional wage and salary, the most highly compensated individuals now may earn income via bonuses, stock options, and other financial instruments and employer-provided benefits. These changes may lead to revenue erosion because Montana's income tax levies different rates on capital gains and investment income compared to wage and salary income.<sup>35</sup> High-income earners may also be able to time when they take income to maximize potential tax incentives and write-offs. Montana and other states are also seeing an increase in the use of pass-through businesses to report income for tax purposes.<sup>36</sup>

## What's the Impact of Services on State Tax Revenue?

Montana has experience revenue erosion over time, to date driven largely by changing consumer behavior, flat fee structures, and tax expenditures. Broader concerns about the transition to services related sectors have already been acute in some resource-dependent communities, but the impact on state revenue is not clear yet. The contribution to state GSP from non-services related industries remained relatively high until 2014, potentially masking the revenue impact of a transition in employment and personal income from non-services to services until recently. For example, the recent downturn is led by a sharp decline in mining which may be the start of a long-term downward trend (coal production and generation is expected to experience permanent declines). If this is the case, recent budget gaps may be the first indications of structural problems.

Figure 17: Change in Gross Domestic Product by Source, Montana, 1997-2016<sup>37</sup>



Other factors may lessen or eliminate the revenue impact of changing industrial structure. For example, the relative contribution to GSP from goods-producing sectors remains more important relative to their declining employment and personal income contributions, moderating some of the revenue losses. The switch to labor-intensive sectors may also generate additional income tax sufficient to offset much or all of the decline in property tax and production tax revenue.

## Conclusion and Discussion

The U.S. economy, including Montana and Washington, is experiencing rapid growth, but this growth is concentrated in the larger cities creating a new, uneven economic geography. Geographic inequality is driven by two factors: the new economy places a premium on proximity to ideas, capital, and markets in “innovation” services that are agglomerating jobs, businesses, and capital in cities; and employment opportunities in rural areas are lessened by automation and trade.

The ways that states experience economic transition are not inherent features of industrial change but are the result, at least partially, of decisions made about fiscal policy. Fiscal policies that encourage over-reliance on volatile or declining industries, fiscal policies that exclude services from taxation, and tax incentives that decouple revenue from economic growth are leading to long-term revenue erosion. These policies affect cities struggling with too few revenues to facilitate rapid growth and address rising inequality. These policies also affect rural areas facing economic transition without resources or autonomy to invest in capacity and institutions that contribute to resilience. Neither geography has the fiscal tools or resources required to solve problems or affect significant change without partnering with state policy.

Reforms might include:

- Broad-based sales/gross receipts tax that includes services;
- Income tax applied evenly to income earned through wage and salary and non-labor (investment-related) sources;
- Fees and levies adjusted for inflation;
- Avoidance of tax competition among states;
- Greater autonomy for local governments to better manage volatile sources of revenue (e.g., new savings and long-term budgeting authority); and
- Spending strategies that recognize the importance of building capacity in local institutions that facilitate information sharing, planning, and economic development.

## Endnotes

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