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**State and Local Government Finances:
Today's Structure and Tomorrow's Challenges**

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Introduction

This report provides a comprehensive summary of the current condition of state and local government finances and a broad-based analysis of the key fiscal issues that state and local governments will confront during the next five to ten years. Although the report is long, we believe the combination of an executive summary and a detailed table of contents will allow members of the National Association of Realtors[®] to gain a quick overview of state and local fiscal issues, and to zoom in quickly on selected individual topics of interest.

State and local finances are closely intertwined and what happens at the state level can spillover into local finances and vice versa, for at least three reasons:

- Decisions that affect state revenue and spending often have implications for local revenue and spending decisions (and the other way around), either by design or necessity, as was the case in 1993 when Michigan repealed the local residential property tax for K-12 education without authorizing a replacement revenue source, leading voters to approved a large increase in the state sales tax to finance education;
- States vary widely in how they split state-local responsibilities. For example, Hawaii funds K-12 education, the largest area of state-local spending, almost entirely at the state level, while New Hampshire funds education mostly at the local level. Comparing Hawaii state taxes with New Hampshire state taxes without understanding the different ways they fund education will lead to a misunderstanding of differences between the two states; and
- Many fiscal issues affect both state and local governments. For example, the erosion of the sales tax base is probably the most important revenue issue that state governments face in the near future. But nearly 7,000 local governments in 22 states also impose the sales tax, and the sales tax issues they face are virtually identical to those that states face.

As a result, we have not organized the report into separate state government and local government sections, but instead have organized it around topic areas. However, in each topic area and in a wrap-up section, we make clear which issues are primarily state issues, which are primarily local, and which have important impacts on both state governments and local governments.

We begin with a background chapter on how state and local finances fit into the overall federal-state-local fiscal system. Next is a chapter on state and local revenue with subchapters on major revenue topics, followed by a chapter on expenditures with subchapters on major spending topics. We end by recapping major issues and conclusions.

Executive Summary

The Federal-State-Local Fiscal System

Public services in the United States are financed and delivered by a complex system including the federal government, the 50 states and the District of Columbia, and more than 85,000 local governments including counties, cities, towns, villages, school districts, and independent special districts. In fiscal year 2002, federal, state, and local governments raised nearly \$3.2 trillion in revenue and spent more than \$3.4 trillion, amounting to one-third of gross domestic product. The federal government raises nearly 60 percent of all government revenue in the US, but transfers more than 15 percent of its revenue to state and local governments, and states transfer about one-third of their budgets to local governments. As a result, state and local governments combined actually play a larger role in delivering domestic services than the federal government. The relative importance of state and local governments in delivering domestic services has risen considerably in the last two decades.

The conventional wisdom among economists is that the federal government rather than state and local governments should undertake any significant government efforts to redistribute resources (e.g., from rich to poor), largely because in an open economy taxpayers and firms can move easily from higher-tax states and localities to lower-tax areas, and because of the federal government's relatively greater tax capacity. In practice, though, state and local governments routinely redistribute resources—roughly one-quarter of state and local spending is on welfare, health insurance, services to the elderly, and other programs designed to redistribute resources by helping the needy, and about one-third is spent on education, which can redistribute resources but also provides benefits to society at large.

Traditionally, the federal government has been responsible for financing and delivering almost all services relating to national defense and most relating to economic security (particularly Social Security) and other programs that redistribute income, while state and local governments have played minor roles in these areas. State and local governments jointly finance most education spending, with local school districts delivering most of these services in the typical state. By contrast, the federal role in financing and delivering education services has been minor. In practice, local governments generally are primarily responsible for public order, delivering virtually all firefighting services and a considerable majority of police services—services generally consumed by local residents and that vary from place to place according to local needs and preferences. All three levels of government share responsibility for economic affairs.

State and local government accounted for nearly 15 percent of total nonfarm employment in 2003—larger than the entire manufacturing sector and several other major sectors of the economy. Local government dominates overall government employment, employing five times as many workers as the federal government and nearly three times as many as state governments.

State and Local Government Revenues

Nearly 70 percent of state and local government own source revenues come from taxes, another 20 percent from charges and over 10 percent from various other sources. Some variation

has occurred, but state and local taxes have represented approximately 11 percent of the nation's personal income for more than two decades. However, variation between states in both the level of taxes and the revenue sources relied upon is a very striking feature of the US system of federalism. In 2002, state and local tax revenues were 13.1 percent of personal income in New York and only 8.4 percent in Tennessee.

Tax Structure Choices

Five criteria are normally used to evaluate or design tax structures: tax neutrality; revenue elasticity, stability, and adequacy; taxpayer equity; administrative and compliance costs; and constitutional and political factors. Neutrality means minimizing the distortions created by the tax system. A tax system should also support revenue growth when the economy expands (elasticity), produce a stable flow of revenue over the ups and downs of the business cycle, and yield adequate revenues to fund government services. Taxes should be fair in the sense that those with similar circumstances, including income, should pay similar taxes. Finally, a tax system should minimize the costs of compliance and administration. These factors together with history have led state and local governments to rely on the property, sales, individual income, and selective sales taxes as the most important state and local tax sources. The variation in tax structures is very wide for states versus local governments and across states, as should be expected given that these criteria might often point in different directions and governments might apply different weights to the factors as policy decisions are made

The property tax dominates local tax revenues, though the share contributed by the property tax has fallen from 83.7 percent in 1972 to 72.9 percent in 2002. General sales taxes are the second largest local source, but they raise only about 12 percent of total local taxes. States generate about one-third of their revenues each from general sales taxes and from individual income taxes. Selective sales taxes on alcohol, gasoline, tobacco and other products raise one-sixth of state taxes. The remainder of state tax revenues comes from a variety of sources.

Property Taxes

The property tax accounts for over 30 percent of combined state and local tax revenues, a share that has fallen only slightly over the past 25 years. Local government reliance, however, has declined more markedly. Still, localities in 12 states raise more than 90 percent of their revenue from the property tax. Fifteen states have a statewide tax on real property, but only Vermont and New Hampshire raise a significant share of revenue with this source.

The property tax is a levy on the *stock* of property wealth, whereas most other taxes are levied on *flows*. The base in some jurisdictions may include real property, personal property and intangible property, though in practice most household personal property and intangible property is exempt. A classification system, wherein property in different classes is taxed at different tax rates, is used in less than one-half of the states. A number of special provisions, such as homestead exemptions and circuit breakers, are used to reduce residential tax burdens in some cases. Businesses may also benefit from exemptions such as those provided as economic development incentives. Tax exempt status is typically granted to a number of different organizations including religious, government, charitable, and health care related organizations.

It is very difficult to compare property tax burdens across jurisdictions because of all of the nuances in the tax, only a few of which were listed in the previous paragraph. One study of the largest city in each state illustrates that the median effective tax rate is 1.5 percent, with effective rates that range from 0.38 percent in Hawaii to 3.88 percent in Rhode Island.

Property tax revenues have traditionally been linked to education finance in the US, but this link has been broken over the past several decades as court cases seeking education finance equity and other factors have led states to play an increasingly large role in education finance. By 2002, states' contributions to primary and secondary education exceeded those of local governments by a good margin. Evidence suggests that the declining link between education finance and the property tax has been a factor in the property tax limitation movements that have occurred in many states.

Sales Taxes

General sales taxes are used by 45 states and the District of Columbia and by local governments in 34 states. Some states, such as Washington, Tennessee, and Florida raise over one-half of their state revenues with sales taxes, but New York gets only 20 percent from the sales tax and five do not impose the tax at all. The tax base and rates also differ widely. Hawaii's tax base is more than three times broader (relative to its economy) than that used by states such as Illinois and Rhode Island. States generally tax goods unless they are specifically exempt. Examples of exemptions that are often given are for products such as food and for sales by certain charitable or religious organizations. Hawaii and a few other states tax a broad set of services but the general pattern is to tax a relatively small share of the value of services. Every state gives exemptions for some intermediate transactions, but every state also taxes many business-to-business sales. The median state tax rate is five percent but the rates range from 7.0 percent in several states to 3.5 percent in Virginia. Sales tax rates reach 11 percent in a few places when local rates are included.

Erosion of the sales tax base because of rapid growth in consumption of services and expanding remote commerce (such as catalog sales and e-commerce) and other factors has been a major concern of states in recent years. Consideration of ways to stem the erosion has included efforts to tax more services and to find ways to increase collection of taxes on remote sales. The Streamlined Sales Tax Project is a major thrust by the states to come up with a mechanism to simplify the sales tax, but also to find a means of increasing collection of sales taxes on remote sales.

Individual Income Taxes

Forty-one states and the District of Columbia impose individual income taxes. As with the sales tax, states vary widely in their reliance on the tax. At one extreme, Oregon generates over 70 percent of its revenues from the income tax, and at the other extreme North Dakota raises less than 17 percent. Most states use a measure of income from the federal income tax as the starting point for determining the state tax base; 26 start with federal adjusted gross income and 10 with federal taxable income. Still, there are wide differences across the states in their definitions of the taxable base.

Most states have progressive tax rates, though in many cases the maximum rate is reached at a relatively low level of income. The median maximum tax rate is 6.8 percent, with Montana having the highest maximum rate at 11 percent. Seventeen states reduce taxes for the lowest-income filers with earned income credits.

Several policy issues are at the forefront of state thinking on income taxes today. States have evidenced considerable concern with the effects that income taxes have on such decisions as the number of hours to work, how much to save, housing demand, and migration of people. The conventional wisdom is that income taxes have little or no impact on these decisions. The effects of an aging population, and therefore one with less taxable income, are beginning to generate attention, though the effects of aging should be addressed in the context of the full budget effects across all types of taxes and expenditures. Finally, administrative and compliance concerns, such as the complexity and high degree of non-compliance, are getting attention by states as they seek to expand revenues and enhance fairness with the tax.

Business Taxes

Businesses pay some of nearly every tax imposed by state and local governments including the property, sales, gasoline, alcohol, gross receipts and transfer taxes in addition to taxes levied directly on business such as the corporate income tax. One estimate finds that payment of the property and sales taxes are responsible for about two-thirds of business tax payments and the corporate income tax accounts for less than 10 percent of the business tax burden. Nonetheless, the corporate income tax receives much of the attention when business taxation is discussed.

Corporate tax revenues have been falling as a share of state taxes, mostly because of erosion of the base. One cause of the erosion is state policy decisions that have granted tax exemptions and altered the formula used to distribute tax base across states. Narrowing of the federal tax base, which in most cases is the starting point for the state base calculation, and tax planning by businesses are other important reasons for the decline in state corporate tax bases.

Selective Sales Taxes and Other Revenues

States and some localities impose selective sales taxes on a variety of activities including tobacco products, motor fuels, pari-mutuels, and other products. These generate over one-tenth of state and local tax revenues, though the percentage is slowly declining. Many of these taxes are levied at unit rates, such as per pack of cigarettes or per gallon of liquor rather than on the price or value of the product. Unit taxes tend to grow slowly relative to the economy since taxes rise only with consumption of units and not with expenditures on the products. The taxes are often imposed at the wholesale rather than retail level to enhance compliance.

Increases in cigarette and alcohol tax rates were a very common means of increasing revenues during the state fiscal crises of 2001 to 2003. The median cigarette tax rate is now 60 cents per pack, with rates tending to be lowest in tobacco-producing regions. Eighteen states directly control liquor sales and generate revenue primarily from the profits. A variety of taxes are imposed on alcohol and wine in the other states. The infrequency with which the general

sales tax is imposed in addition to the excise taxes levied on fuel products is a key distinction from taxes on alcohol and cigarettes, where both taxes are normally imposed.

State and local governments also generate significant revenue from a number of other sources including intergovernmental aid from the federal government, inheritance and gift taxes, impact fees, realty transfer taxes charges, and gaming. Federal aid was 27.2 percent of state and local own-source revenue in 2002. As with other sources, the relative importance of intergovernmental aid varies widely by state. Most aid is tied to specific programmatic areas such as Medicaid, education, and transportation giving state and local governments little flexibility in the expenditure of these funds (though governments may use funds they otherwise would have spent on these services for other purposes).

State and Local Government Expenditures

State and local governments spent an average of \$6,086 per capita on goods and services in fiscal year 2002. About 80 percent (\$4,822) was financed by state and local governments' own revenue, with the remainder financed from federal grants. States vary enormously in how much they spend from their own funds, ranging from \$3,500 per capita in Arkansas to nearly twice as much (\$6,582) in New York (excluding Alaska's \$10,517 as an outlier).

Elementary and secondary education has long been the single-largest area of state and local government spending. About 10 years ago, the rapidly growing Medicaid program overtook higher education as the second-largest area. Other major areas of state and local spending, in descending order, include hospitals and health, highways, public welfare, police, and corrections.

For more than 100 years state and local government expenditures have been rising nearly continuously in real per-capita terms (a rough proxy for the "quantity" of services delivered) reflecting citizens' desire for additional government services as incomes rise, increasing reliance on state and local governments rather than the federal government to deliver domestic services (devolution of responsibilities to state and local governments), and different underlying pressures at different times. For example, the desire to educate baby boomers led to extraordinary growth in education expenditures in the 1960s, while more recently educating the children of baby boomers, financing health care for the poor and medically needy through Medicaid, and financing prison-building all contributed to rapid spending growth in the 1980s and 1990s.

Elementary and Secondary Education

Elementary and secondary education is the single-largest activity of state and local governments in the US. In 2001-02 it accounted for 24 percent of state and local government general expenditures and more than 40 percent of state and local government employment. In 2001-02, the nation's public elementary and secondary schools educated more than 50 million children at an expense of more than \$400 billion.

Elementary and secondary education is delivered primarily by local governments, but is financed by all three levels. For the nation as a whole, state governments finance approximately half of elementary and secondary education, followed by local governments, with the federal

government a distant third at a little less than eight percent of the total. States vary widely in how they split state and local responsibilities for financing education. The state government plays the largest role by far in Hawaii and New Mexico, supplying 89 percent and 72 percent of the funds respectively in 2001-02. States provide 60-70 percent of education funding in another eight states. At the other end, eight state governments provide less than 40 percent of funding, with Nevada providing the least, at 32 percent.

State government support for elementary and secondary education has risen considerably over time, particularly in the early part of the 20th century, in the 1970s, and in specific states in the 1990s. The increasing state role in the 1990s usually stemmed from one or more of three often-related motivations: (1) to reduce spending and revenue-raising disparities across school districts within the state, as was the case in Massachusetts, (2) to ease pressure on local property taxes, sometimes accompanied by explicit local tax and spending limits, as was the case with the Taxpayer Bill of Rights (TABOR) in Colorado and Measures 50 and 5 in Oregon, and (3) to respond to or pre-empt litigation over school financing systems.

Real per-pupil spending rose dramatically and nearly without interruption over the last century. Increases were large in each decade, but actually smaller in the 1990s than in earlier decades. Spending growth was widespread, with sizable increases in real per-pupil spending in every state or virtually every state in most decades.

Education spending varies widely across states—per pupil spending in 2000-01 ranged from \$11,248 in New Jersey to \$4,674 in Utah, barely more than 40 percent of the New Jersey amount. Southern and western states tend to spend the least per pupil, while northeastern and Great Lakes states spend the most.

Court decisions are playing an increasingly important role in school finance and can wreak havoc on state finances and politics. Since 1989, about two-thirds of court cases challenging education financing systems have been successful. In recent years, state financing systems in Arkansas, New Hampshire, New York, Ohio, Tennessee, Vermont, and Wyoming have been found wholly or partly unconstitutional, and litigation is pending in many other states.

Another important issue is the general movement toward higher standards in education at all three levels of government, culminating in 2002 in the federal No Child Left Behind Act (NCLB). While there is debate among researchers about the extent to which spending and other resources are related to student achievement, it is clear that the standards movement, with its emphasis on teacher qualifications and preparing students for standardized tests, is placing upward pressure on education expenditures.

Medicaid

Medicaid is a federal-state program that finances health care for low-income families, the elderly, and the disabled. Medicaid now exceeds \$300 billion annually and recently surpassed Medicare to become the nation's largest governmentally funded health care program. It accounts for about 21 percent of all state government spending, and 13 percent of spending from states' own funds.

Medicaid funded approximately one-sixth of the nation's health care spending in 2002. More than 50 million people benefit directly from Medicaid-financed health care: it insures about one in 11 Americans and about one-fifth of the nation's children, finances more than one-third of all births, and pays for one-half of all nursing home care.

Medicaid is not really one single program, but 50 different yet related programs. Federal rules allow states to make very different choices about who is eligible, the services covered, and the amounts they will pay for covered services. In addition, states often apply for and receive waivers from the federal government allowing major parts of their Medicaid programs—or even the entire program—to vary from the general federal rules. Medicaid spending per capita reflects this diversity, varying in 2002 from a high of \$1,928 per capita in New York to a low of \$372 per capita in Nevada (barely more than one-fifth of the New York amount).

Medicaid is often incorrectly thought of as primarily a welfare program for low-income adults and children. Although it does serve more than 32 million low-income individuals, accounting for roughly three-quarters of all enrollees, that is not where the bulk of the money is committed. Nearly three-quarters of Medicaid spending is for the disabled and elderly, despite the fact that they account for little more than one-quarter of Medicaid enrollment.

Medicaid is not technically a federal mandate imposed upon states. A state can choose not to participate at all if it wishes to forgo federal funds, but all states have chosen to participate. Once states choose to participate, they must provide certain services and cover certain populations.

The federal reimbursement rate varies from state to state and year to year under a formula that gives the greatest reimbursement to states with low per-capita incomes and the lowest reimbursement to high-income states. In fiscal year 2005, the federal share ranges from 77 percent in Mississippi to 50 percent in Connecticut and 11 other high-income states, and the overall federal share is about 57 percent on average. The relatively high federal share means that Medicaid reimbursement is a significant revenue source to states. In 2002, Federal reimbursement was nearly \$150 billion—only slightly less than the state sales tax and more than excise taxes and corporate income taxes taken together.

Medicaid is an uncapped federal entitlement to individuals and to state governments—in general, all individuals who are eligible in a state may receive services (there is no cap), and states may receive federal reimbursement for qualifying expenditures without limit. This is a constant source of tension between the federal government and the states, particularly given rapid growth in a program that tends to be difficult to control. Given the current pressure to rein in the federal budget deficit, and current fiscal pressures on states, there will be major political battles in coming years at the federal level and the state level over which services and populations to support under Medicaid, and which levels of government should pay for them.

State Welfare Programs

States have operated low-income cash-assistance programs with partial federal funding since the now-defunct Aid to Families with Dependent Children (AFDC) program was enacted in 1935. AFDC was an entitlement system funded by federal matching grants to the states. A

family's benefit duration was unlimited under AFDC rules as long as its income was sufficiently low, and benefits were larger for families with more children and less earned income. Under AFDC, there was no cap on matching funds states could receive from the federal government. AFDC involved tremendous incentives for recipients to remain out of work, stay on the program, remain unmarried, and produce many children.

The world of welfare changed dramatically with the passage of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (PRWORA), which replaced AFDC with a new welfare program known as Temporary Assistance for Needy Families (TANF). The most significant budgetary change from AFDC to TANF is that the new program is funded by federal block grants to the states. In order to receive the full amount of their block grants, states must maintain spending at 75 percent of their peak fiscal year 1994 levels.

Within these broad "maintenance of effort" restrictions, states are permitted to set their own program rules and develop unique low-income support programs. This freedom has resulted in a diverse array of state welfare programs in effect today. Average monthly family benefits ranged from \$154 in South Carolina to \$631 in Alaska in fiscal year 2002. Most state benefit amounts are now lower than they were in 1994. This diversity in program rules alongside existing variation in state populations has led to wide disparities in per capita state TANF spending, ranging from a low of \$8 in Alabama, Arkansas, Mississippi, and South Carolina to a high of \$102 in New York in fiscal year 2001.

Total federal and state spending on TANF and predecessor programs fell by about one-third from a peak of over \$30 billion in 1995 to a low of about \$21 billion in 1998, and has risen only slightly since then. Despite the fact that TANF represents less than one percent of total state spending (and TANF cash assistance less than one-half of one percent), welfare policies continue to receive a disproportionate share of attention in policy discussions.

TANF is different from the old AFDC program in many important ways. First, TANF is not an entitlement program. Federal funding cannot be used to provide benefits for any family beyond a total of 60 months during the caretaker's lifetime. A second major difference is that participants are expected to engage in some form of work-related activity in order to get benefits. Recognizing that many welfare recipients have severe barriers to employment, TANF provides for a system of support services. Many states have provided transportation and supplemental child care benefits. Indeed, more than half of all federal and state TANF spending is now on non-cash benefits and services.

The effects of these dramatically different policies have been varied and controversial. The most immediate indicator of potential policy impacts was a tremendous reduction in welfare caseloads across the US, and between 1994 and 2000, caseloads fell by nearly 57 percent. Debate continues over the extent to which this was driven by robust economic conditions or policy changes, but the most recent research finds that both played important roles. This large drop in caseloads, alongside required spending levels, resulted in the explosion of non-cash support services such as child care and transportation benefits. A second noticeable example of the possible impact of welfare reform has been a dramatic increase in work participation. While only about 8.8 percent of AFDC adults worked in 1995, 25.8 percent of TANF adults were working in 2000.

While welfare reform is widely considered to have been a successful policy change, a number of important revisions will be considered as the US Congress prepares to debate a more permanent reauthorization of PRWORA in the spring of 2005. Potential areas of debate include the size of the federal block grants as well as the time limit and work requirement provisions.

Higher Education

More than 12 million full and part-time students were enrolled in the nation's approximately 1,700 public degree-granting colleges and universities in fall 2001, accounting for 77 percent of all enrollment in public and private institutions. Public higher education institutions account for approximately 96 percent of all enrollment among 2-year institutions.

Higher education is the third-largest spending category for the state-local sector, after elementary and secondary education and Medicaid. State and local governments provided \$61.9 billion in direct appropriations to their higher education institutions in fiscal year 2001, plus \$8.1 billion in grants and contracts, and \$2.9 billion in scholarships and fellowships. State governments play a far larger role than local governments, and provided 90 percent of these sources of aid.

In 2002-03 state appropriations for public higher education institutions ranged from a high of \$396 per capita in Wyoming (80 percent above the US average) to a low of \$88 in New Hampshire (60 percent below the average). Several regional patterns are evident, including the fact that northeastern states tend to spend less than average per capita, even though they typically spend well above average on most other functions of government.

State government appropriations for public higher education institutions nearly tripled from 2.8 percent of gross domestic product in 1961 to a 1976 peak of 7.0 percent. State expenditures for higher education then began to decline relative to the economy and relative to other state spending, particularly in the 1990s. This reflected a decline in enrollment as a share of the population during the 1990s and also a more-general decline in higher education relative to other state government priorities.

During fiscal crises state governments have tended to cut funding for higher education more than other areas of the budget, and to increase funding substantially when the economy recovers. Although the 2001 recession was the mildest in recent history, spending cuts during the associated fiscal crisis in 2003 and 2004 were deeper than in the two prior fiscal crises. Real state appropriations for public higher education institutions fell by 7.8 percent between fiscal year 2002 and fiscal year 2004, and declined in 36 states.

State and local governments will face two important trends over the next five to ten years that will put upward pressure on higher education spending. First, during most of the 1990s spending on higher education was restrained by a long decline in the number of people of prime college-going age (18-24 years old). That trend reversed at the end of the 1990s, and now the children of baby boomers are entering college. Second, a longer-term trend toward greater participation in higher education by individuals of all ages will continue, driven in part by "pull" from the labor market as more and more jobs require at least some college.

Other Expenditure Areas

The spending activities described above account for approximately half of all state and local government spending in the US. The next-largest spending areas are public safety and judicial services, transportation, and health and hospitals. State and local governments face important policy issues in each of these areas, including pressures on prison-system spending, homeland security, and the upcoming federal reauthorization of the Transportation Equity Act for the 21st Century (TEA-21). State and local governments also will face important issues in areas of spending that cut across the budget, such as spending on pensions, employee and retiree health care.

How State and Local Finances Fit into the Federal-State-Local Fiscal System

Public services in the United States are financed and delivered by a complex system of federal, state, and local governments including counties, cities, towns, villages, school districts, and independent special districts. The general view among economists is that the central government should have responsibility for those public activities that have significant “spatial externalities”—where benefits and costs may spillover from one jurisdiction to another—and that other activities should be decentralized, so that local preferences can be taken into account through local political decision-making processes. National defense is a good example of an activity where benefits spillover, and garbage collection is an example of an activity with highly localized benefits.

In practice, the relative responsibilities of the federal, state, and local governments sometimes follow these principles and sometimes do not, and the distribution of responsibilities across levels of government changes over time and varies significantly across states.

The Relative Sizes of Federal, State, and Local Governments

In fiscal year 2002, federal, state, and local governments raised nearly \$3.2 trillion in revenue and spent more than \$3.4 trillion, amounting to one-third of gross domestic product (GDP).¹ (The gap between revenue and expenditures largely reflects the federal budget deficit.) The Organization for Economic Cooperation and Development (OECD) estimates that the United States’ total taxes as a percentage of GDP were fourth-lowest among the 30 OECD member countries in 2002—higher than Mexico, Korea, and Japan, but more than 25 percent below Germany and the United Kingdom (2004).

The federal government raises nearly 60 percent of all government revenue in the United States. Exhibit 1 shows the revenue each level of government raises from its own sources, such as taxes and fees, excluding revenue received from other levels of government. The majority of the federal government’s revenue comes from taxes, and it raises nearly twice as much tax revenue as state and local governments combined.²

¹ This includes money the governments spent directly and money they transferred to other sectors of the economy through programs such as Social Security, Medicare, and Medicaid. It is larger than the “Government” sector in gross domestic product, which only includes final purchases by government. These numbers are based on data on federal finances included in the Federal Budget for Fiscal Year 2005 and on state and local finances from the US Bureau of the Census. They are somewhat larger than measures of spending found in the National Income and Products Accounts, in large part because those accounts treat some revenue of government as “negative expenditures” whereas these numbers count gross expenditures.

² Based on calculations that treat payroll taxes for Social Security and Medicare as taxes. These levies are called “contributions” rather than “taxes” in both the federal budget and the National Income and Product Accounts but are generally considered by most analysts to be taxes.

Exhibit 1: Own-Source Revenue in Fiscal Year 2002

	Amount in \$ Billions	Percentage Share
Federal	1,853.2	58.3%
State	726.9	22.9%
Local	597.3	18.8%
State-local subtotal	1,324.2	41.7%
Total	3,177.4	100.0%

Sources: Federal Budget for Fiscal Year 2005 and US Census Bureau.

The federal government transfers more than 15 percent of its revenue to state and local governments (primarily to states), and states transfer about one-third of their budgets to local governments. As a result, state and local governments—especially local governments—play a far larger role in delivering and administering services than they do in financing those services. In fact, if we look at government direct purchases of goods and services and aid to individuals (excluding grants to other governments)—then state and local governments combined actually are slightly larger than the federal government (see Exhibit 2).³

Exhibit 2: Direct General Expenditures

	Amount in \$ Billions	Percentage Share
Federal	1,706.8	49.7%
State	744.4	21.7%
Local	986.2	28.7%
State-local subtotal	1,730.7	50.3%
Total	3,437.5	100.0%

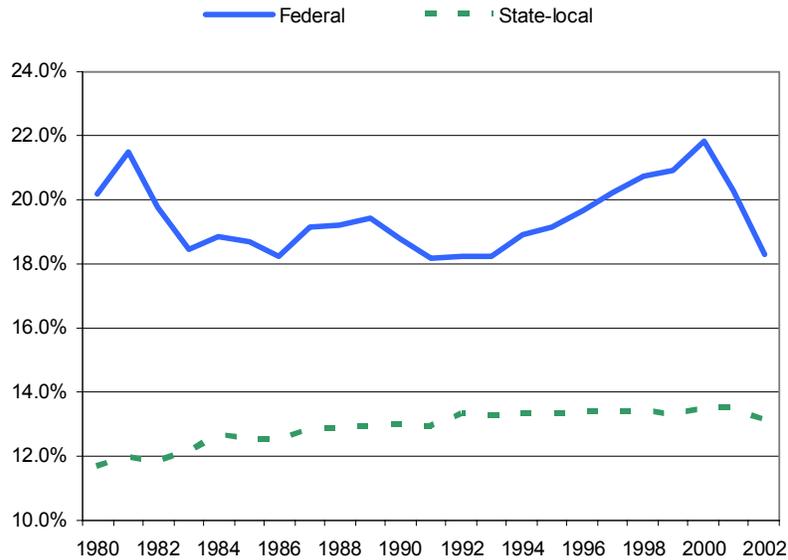
Sources: Federal Budget for Fiscal Year 2005 and US Census Bureau.

Trends in Financing Roles

The federal role in financing total government has fallen somewhat over the past two decades, from about 63 percent of revenue in 1980 to 58 percent in 2002, while the roles of both states and local governments have risen. Exhibit 3 shows federal and state-local own-source revenue as a percentage of gross domestic product since 1980. State and local revenue relative to the economy rose early in the period and then was relatively stable. Federal own-source revenue was far less stable, falling, rising and then falling again, reflecting legislated changes and a revenue structure that varies more over the business cycle than state-local revenue structures.

³ The exhibit shows “general” expenditures, as defined by the US Census Bureau. This excludes spending by pension funds and other trust funds (but does include payments by governments into those funds), and it excludes certain business-like activities of government such as utilities.

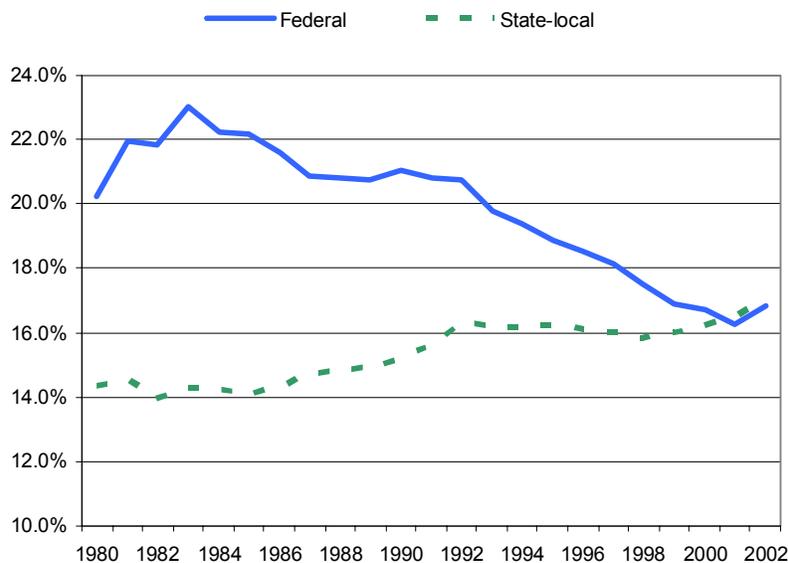
Exhibit 3: Government Own-Source Revenue as a Percentage of GDP



Sources: Federal Budget for Fiscal Year 2005 and US Census Bureau Government Finance data.

The role of state and local governments in delivering and administering services has risen far more over the last two decades than has their role in financing services. As Exhibit 4 shows, throughout most of this period direct federal expenditures on goods and services—not counting grants to other governments—have fallen relative to the economy, while state-local direct expenditures have risen and now exceed federal expenditures.

Exhibit 4: Government Direct General Expenditures as a Percentage of GDP (Grants counted in government that finally spends them)



Sources: Federal Budget for Fiscal Year 2005 and US Census Bureau Government Finance data.

Federal, State, and Local Service Responsibilities

The conventional wisdom among economists is that the federal government rather than state and local governments should undertake any significant government efforts to redistribute resources (e.g., from rich to poor), largely because in an open economy taxpayers and firms can move easily from higher-tax states and localities to lower-tax areas, and because of the federal government's relatively greater tax capacity. In practice, though, state and local governments routinely redistribute resources—roughly one-quarter of state and local spending is on welfare, health insurance, services to the elderly, and other programs designed to redistribute resources by helping the needy, and about one-third is spent on education, which can redistribute resources but also provides benefits to society at large.

The Bureau of Economic Analysis categorizes all government spending into several broad functional areas, the largest of which are income security (including Social Security and welfare programs); health; education; national defense; economic affairs (including transportation, agriculture, and natural resources); and public protection (including police, prisons, courts, and fire protection).

Traditionally, the federal government has been responsible for financing and delivering almost all services relating to national defense and most relating to economic security (particularly Social Security) and many other programs that redistribute income, while state and local governments have played minor roles in these areas. This is broadly consistent with the view that redistribution is more appropriate for the federal government than for state and local governments, although many state and local governments do redistribute income in other ways.

The federal government plays a major role in financing and administering health care for the elderly other than long-term care, through the Medicare program, and in financing (but not administering) health care for the poor and medically needy through Medicaid, with the states sharing major responsibilities for this program.

State and local governments jointly finance most education spending, with local school districts delivering most of these services in the typical state. By contrast, the federal role in financing and delivering education services has been minor. All three levels of government share responsibility for economic affairs.

In practice, local governments generally are primarily responsible for public order, delivering virtually all firefighting services and a considerable majority of police services—services generally consumed by local residents and that vary from place to place according to local needs and preferences. States play a major role in financing and running prisons, and both state and local governments are heavily involved in courts. The federal role in financing and delivering services related to public order is relatively small.

Exhibit 5 shows “direct” spending on goods and services (excluding grant payments to other governments) by level of government and functional area for 2001, the latest year for which detailed data are available, using BEA data and definitions of expenditures. The table

bears out the general patterns described above.⁴ As always, there is great variation across states, and the broad state-local patterns described above need not hold for individual states.

Exhibit 5: Federal, State and Local Government Direct Current Expenditures in 2001

	All Government			Share of all government			Share of own spending			
	(Billions of dollars)	Federal	State	Local	Federal	State	Local	Federal	State	Local
					Percentage	Percentage	Percentage	Percentage	Percentage	Percentage
Total current expenditures	\$2,951.6	\$1,659.0	\$585.1	\$707.5	56.2	19.8	24.0	100.0	100.0	100.0
National defense	344.1	344.1	--	--	100.0	--	--	20.7	--	--
Domestic spending	2607.5	1314.9	585.1	707.5	50.4	22.4	27.1	79.3	100.0	100.0
Income security	688.7	577.2	75.4	36.2	83.8	10.9	5.3	34.8	12.9	5.1
Health	561.9	293.9	248.2	19.8	52.3	44.2	3.5	17.7	42.4	2.8
Education	499.2	24.4	92.2	382.6	4.9	18.5	76.6	1.5	15.8	54.1
Net interest paid	235.6	238.1	-14.8	12.2	101.1	-6.3	5.2	14.4	-2.5	1.7
Economic affairs	206.4	98.6	63.4	44.4	47.8	30.7	21.5	5.9	10.8	6.3
Public order and safety	203.7	21.9	60.6	121.2	10.8	29.7	59.5	1.3	10.4	17.1
General public service (other than net interest)	165.7	38.9	53.7	73.2	23.5	32.4	44.2	2.3	9.2	10.3
Housing and community services	26.3	18.8	3.6	3.9	71.5	13.7	14.8	1.1	0.6	0.6
Recreation and culture	20.0	3.1	2.7	14.1	15.5	13.5	70.5	0.2	0.5	2.0

Note: Direct expenditures do not include grants by payor governments, but do include spending of grant funds by recipient governments.

Sources: Total government and federal government: Survey of Current Business, October 2002, NIPA Tables 3.16 and 3.17, US Bureau of Economic Analysis.

State and local government: Baker, Bruce, Receipts and Expenditures of State Governments and of Local Governments, 1959-2001, Survey of Current Business, June 2003, US Bureau of Economic Analysis.

State and Local Government Employment

State and local government accounted for nearly 15 percent of total nonfarm employment in 2003—larger than the entire manufacturing sector and several other major sectors of the economy. In keeping with the earlier observation that local governments have the largest role in delivering and administering services, local government dominates overall government employment, employing five times as many workers as the federal government and nearly three times as many as state governments (see Exhibit 6). More than one-half of all state and local government workers are employed in elementary and secondary education or higher education. Even though the federal role in financing services is large, its role as an employer is small because much federal spending involves direct payment to individuals (as with Social Security and Medicare) or delegation of service delivery to other governments and the private sector (as with Medicaid and other grant programs), rather than direct delivery of services by workers.

⁴ BEA definitions and measurement concepts differ from those used by the US Census Bureau, and so these numbers are not directly comparable to those presented elsewhere in this report based on Census data. Three of the biggest differences are: (1) These BEA numbers do not include actual capital expenditures of states, but rather estimates of the amount of capital consumed (used up), (2) BEA “current expenditures” do not include capital grants by the federal government to states, which are large in the case of transportation (in the “economic affairs” category), but unfortunately published data do not allow these to be taken into account, and (3) BEA data report certain expenditures on a “net” basis, subtracting revenue related to those activities from gross expenditures, whereas Census data generally report gross expenditures and record related revenue in government revenue accounts. As a result, it is possible for BEA to report negative expenditures as occurs in this table for net interest payments by states—reflecting the fact that state governments received more interest income than they paid. The differences between BEA data and Census data reflect the different purposes for which they gather and report data.

Exhibit 6: Nonfarm Employment in Selected Major Industry Groups, Calendar Year 2003

	Number of Jobs (Thousands)	Percent of Nonfarm Total
State government	5,016	3.9%
Local government	13,801	10.6%
State and local government subtotal	18,816	14.5%
Federal government	2,758	2.1%
Wholesale and retail trade	20,525	15.8%
Education and health services	16,580	12.8%
Professional and business services	15,992	12.3%
Manufacturing	14,524	11.2%
Leisure and hospitality	12,128	9.3%
Financial activities	7,974	6.1%
All other	20,641	15.9%
Nonfarm total	129,937	100.0%

Note: Federal government includes Postal Service.

Source: Bureau of Labor Statistics. Current Employment Statistics (National), CY 2003.

<<http://www.bls.gov/ces/home.htm>>

Over the last two decades, state and local government employment has risen nearly 10 percent relative to the population, from 59.0 workers per 1,000 population in 1980 to 64.7 workers in 2003, reflecting similar increases in both state and local governments. Over the same period, federal employment fell by 28 percent per 1,000 population, from 13.2 workers per 1,000 in 1980 to 9.5 workers in 2003. Combined federal, state, and local government employment per 1,000 population increased a slight 2.6 percent over the period.

The Role of Intergovernmental Transfers

Intergovernmental grants play a major role in our federal fiscal system. They flow almost exclusively from higher levels of government to lower levels. (A rare and notable exception is a recently enacted provision that requires states to reimburse the federal government for estimated state government savings from the Medicare prescription drug bill, described later in this report.) In fiscal year 2002, the federal government transferred approximately \$352 billion to state and local governments (predominantly to states), accounting for about 17 percent of federal outlays and 21 percent of all state-local general revenue. State grants to local government were \$360 billion, accounting for one-third of state general expenditures and about 36 percent of local government general revenue.

Three broad reasons usually are given for intergovernmental grants:

- Benefits and costs of government services sometimes spillover from the government providing the service to other jurisdictions, and without grants voters might choose “too little” or “too much” of a service. For example, a stretch of highway running through a small town may benefit citizens in several counties or even throughout the nation. Costs of a service could spillover to other jurisdictions if, for example, much of the tax burden is borne

by nonresidents. Grants can help offset these externalities, leading to more efficient use of resources.

- Grants sometimes are used explicitly to redistribute resources, particularly in programs to help the poor. For example, federal Medicaid grants reimburse low-income states for a higher share of expenditures than high-income states.
- Occasionally, grants are considered on the argument that they can help stabilize the economy, offsetting the reactions of lower governments to an economic downturn. This was one of the main reasons given for temporary federal aid to states after the 2001 recession.

Grant programs have several important dimensions:

- *Categorical versus general*: Categorical grants are given for a specific purpose, such as health care or housing, while general grants are unrestricted. Almost all federal grants are categorical grants.
- *Formula grant versus block grant*: Formula grants base the amount of aid on a specific formula that often can be influenced by actions of the recipient government, particularly in the case of matching grants such as Medicaid, where the federal government matches a percentage of the recipient's expenditures. In this kind of grant the more a state spends the more it receives. Block grants, by contrast, are fixed. Block grants tend to provide more flexibility to recipient governments than do formula grants. Formula grants can create very different incentives for recipients than do block grants.
- *Open-ended versus closed-ended*: Some grants are open-ended or uncapped, while others are closed-ended with the total amount of the grant capped at a maximum. Medicaid currently is an open-ended grant.

Grants can influence spending of recipient governments by changing the price of a service, and by changing income available to finance services. Pure block grants that provide a lump sum of money, with little or no restriction, can be thought of as raising overall income in the receiving jurisdiction thus providing opportunity to spend more on anything voters want—the grant-related service or other services. It is even conceivable that a state could receive a block grant, spend no more money and simply lower taxes. Pure matching grants, by contrast, change the price to state and local taxpayers of funding public services. For example, the federal government reimburses about 57 percent of state health spending under the Medicaid program, allowing the average state to buy \$1 of health services for a price of 43 cents. (By reducing the price of services, matching grants also effectively increase the income of recipient governments.)

Because of their price effects, matching grants stimulate more spending by recipient governments than do block grants. Still, even matching grants provide opportunities for recipients to shift grant funds to other purposes. As a result, many grants have maintenance-of-effort requirements and other rules intended to prevent siphoning off of grant funds for unintended uses. Rules and restrictions governing grants are a constant source of tension among federal, state, and local governments. In practice, governments receiving grants appear to divert less grant money to other uses than might be expected if grant funds were no different than extra income to the jurisdiction—some grant money tends to stick where it hits, a phenomenon known to economists as the flypaper effect.

Grants rarely have “pure” characteristics described above—for example, a matching grant could be open-ended over a range of spending, increasing as state spending increases, after which it hits a cap. In addition, the characteristics of grant programs can change over time.

Federal policy changes in recent years have tended to favor closed-ended block grants—reducing the fiscal risk to the federal government by capping grants (making them closed ended), but giving states greater flexibility in return by using block grants. In 1996 the federal government converted the nation’s primary cash assistance welfare program, Aid to Families with Dependent Children (AFDC), from an open-ended formula grant to a fixed block grant known as Temporary Assistance to Needy Families (TANF).⁵ President Bush has suggested on several occasions that Medicaid, the largest federal grant, also should be converted to a closed-ended block grant.

Federal Grants to State and Local Governments

Exhibit 7 shows federal grants to state and local governments in fiscal year 2003 by major category, with selected individual grants that often receive significant public attention lined out. Grants for health care and financing programs are the largest category by far, with Medicaid dwarfing all other federal grants.

Exhibit 7: Federal Grants to State and Local Governments, Federal Fiscal Year 2003

	Amount in \$	
	Billions Share of Total	
Medicaid	160.8	41.5%
State Children's Health Program (SCHIP)	4.4	1.1%
Other health programs	8.7	2.2%
Health total	173.8	44.9%
Temporary Assistance to Needy Families (TANF)	19.4	5.0%
Housing and urban development	26.0	6.7%
Other income security	41.1	10.6%
Income security total	86.5	22.3%
Education, training, employment, and social services	51.5	13.3%
Highway aid from the Highway Trust Fund	30.0	7.7%
Other transportation aid	11.1	2.9%
Transportation total	41.0	10.6%
Community and regional development	15.1	3.9%
Other federal grants	19.3	5.0%
Total federal grant outlays	387.3	100.0%

Source: Federal Budget for Fiscal Year 2005, Historical Table 12.3.

Nearly 90 percent of federal grants go directly to state governments rather than local governments, although states often redistribute these funds to local governments. The two

⁵ TANF also includes certain other programs that were closely related to AFDC.

largest categories of federal grants that go primarily to local governments are grants for housing and community development and grants for mass transit purposes.⁶

Are Federal Grants to States and Localities Likely to Increase or Decrease?

The Congressional Budget Office has projected that the cumulative federal budget deficit from 2005-2014 will total \$2.3 trillion, under assumptions it is required by law to make (2004). Under the law, CBO must assume that (1) tax cuts will expire as scheduled after 2010, implicitly assuming elected officials will allow taxes to increase in 2010, (2) discretionary spending will grow at the rate of inflation rather than increasing along with the economy or according to historical trends, implicitly assuming that politicians will cut spending in real per-capita terms, and (3) expenditures on operations in Iraq and Afghanistan will continue at their current levels rather than decline gradually over time. Many analysts consider all three of these assumptions unrealistic. (The first two are likely to keep the projected budget deficit artificially low, while the third is likely to make it artificially high.) CBO provided alternative projections for these items showing that, in combination, arguably more realistic assumptions would lead to projections of a cumulative deficit of more than \$4 trillion and perhaps as much as \$5.5 trillion over 2005-2014.

While policy and economic changes could alter the federal budget outlook for better or worse, current projections clearly suggest fiscal strain for the federal government over the next decade. This, in turn, suggests that state and local governments should not expect increased aid from the federal government, and that cuts in federal aid could be part of the solution to the federal budget outlook.

State Grants to Localities

Grants by state governments to local governments are nearly as large as federal grants to state and local governments. In fiscal year 2002 (the latest year for which state-local data are available), state governments paid \$365 billion in aid, representing approximately one-third of state spending as shown in Exhibit 8.⁷

⁶ The federal budget does not break out grants by level of government, so this is based on analysis of Census of Government Finances data on intergovernmental revenue by level of government for fiscal year 2002.

⁷ A very small percentage of this amount would have been payments by state governments to the federal government.

Exhibit 8: State Intergovernmental Aid Payments in 2002

	Amount in \$ Billions	Percentage Share
K-12 education	217.5	60.6%
Public welfare	47.1	12.8%
Health and hospitals	20.9	4.5%
Highways	12.9	4.0%
Other	66.3	18.2%
Total intergovernmental aid	364.8	100.0%
Total general expenditures	1,109.2	
Intergovernmental as % of total	32.9%	

Source: US Census Bureau.

More than 60 percent of state aid was for education, and another 13 percent was for public welfare. As the largest single item in the typical state budget, aid for education plays a huge role in annual state budget debates. It also plays a huge role in school district finances, amounting to roughly half of school district revenue.

The Institutional Structure of State and Local Governments

In our nation's federal system, the 50 states sort out state and local government responsibilities in different ways. Functions that local governments perform in one state may be performed by the state government in others. We think of elementary and secondary education as a local function, and usually it is. In every state but Hawaii, which has a single statewide school district, education is delivered almost exclusively by local school districts, albeit funded by all levels of government. But in states where local governments deliver 100 percent of education services, the share financed by local government varies because state aid varies widely—from 32 percent of school budgets in Nevada to 72 percent in New Mexico (NCES 2001-02).

It is not just in education that states and localities have sorted out responsibilities in diverse and complicated ways, but in fact in every area of local activity. Most states require local governments to pay little or none of the cost of Medicaid, but in New York, county governments and New York City pay nearly 25 percent of the cost. Even policing, a traditionally local function, varies considerably. In 33 states, local government budgets pay for 80 percent or more of policing costs (supported in part by state aid), but in Vermont local budgets support only 52 percent of these costs, reflecting policies Vermont adopted beginning in 1947 to strengthen the state role in policing. The story is similar for highways, another traditionally local function—local budgets in Minnesota pay 60 percent of total highway costs, but in West Virginia, they pay less than six percent. And whether we look at Medicaid, policing, highways, community development, or other activities, even if local governments in two different states deliver similar services, they may receive vastly different state aid to support those services.

In addition, states have sorted out responsibilities among different kinds of local governments in very different ways. Connecticut and Rhode Island have no county governments, but the other 48 states do. Most cities are wholly or partly contained within county

governments, but Baltimore and St. Louis are completely outside their adjacent counties. Among the largest cities, the District of Columbia is the most comprehensive, performing the functions of a state, county, city, and school district, all rolled into a single government and a single budget. New York is next—it is a city, five counties, and a school district. By contrast, in Los Angeles the city, county and school district are three separate governments, with separate budgets, and they do not have the same boundaries—Los Angeles County has more than twice as many residents as Los Angeles the city. The same is true in many other large cities—Phoenix has at least 17 independent school districts partially within its borders with more than 10,000 pupils each, and San Antonio has six school districts overlapping its borders.

Even when governments fall into the same classification, they can have different responsibilities. New England towns provide urban services offered by cities and other types of urban governments in other states. In most counties of New York, cities and villages provide most police services, but in Nassau County the county government plays a major role. In sum, local governments vary widely in how they are organized and how they overlap.

Finally, the sheer number of local governments is daunting and varies significantly across states. In 2002, there were 87,525 general and special purpose local governments, as shown in Exhibit 9. Many local government functions are performed not by general purpose local governments, but by special districts and other such entities. Over the last two decades, the number of special districts increased by nearly 7,000, while the number of general purpose local governments was virtually unchanged. In addition, many important functions of local government are financed or delivered by quasi-independent agencies such as water and transit authorities and hospital corporations that in some respects are part of a city government and in other respects are independent.

Exhibit 9: Number of Governments in the US

	Number in FY 2002	Percent Distribution
Total	87,576	
Federal government	1	
State governments	50	
Local governments	87,525	
Breakdown of Local Governments	87,525	100%
<i>General purpose local governments</i>	<i>38,967</i>	<i>45%</i>
County	3,034	3%
Municipal	19,429	22%
Township	16,504	19%
<i>Special purpose governments</i>	<i>48,558</i>	<i>55%</i>
School district	13,506	15%
Special district	35,052	40%

Source: US Census Bureau, Preliminary Report on the 2002 Census of Governments, GC02-1(P), July 2002.
<http://www.census.gov/prod/2003pubs/gc021x1.pdf>.

State and Local Government Revenues: History, Structure and Policy Options

Requirements of a Good Tax System

A number of well-established criteria are used to design and evaluate tax systems. These criteria offer a systematic basis for analysis of tax policy and have been used extensively at the federal, state and local levels.

Tax Neutrality

A good tax system should not distort the decisions made by people and businesses, i.e., the tax system should be neutral. For example, a good tax system should not influence where people live or how much a firm invests. Tax rate and base differentials within and across jurisdictions are generally distortionary, creating costs for taxpayers and society. Rate and base differentials also can lead to revenue losses for state and local governments as individuals and firms seek to evade or avoid taxation. Thus an important policy goal is to minimize the extent to which taxes distort behavior.⁸

Revenue Elasticity, Stability and Adequacy

Elasticity is the responsiveness of revenues (net of policy changes) to growth in the economy, commonly measured as the percentage change in revenue divided by the percentage change in personal income.⁹ A tax is elastic if it is responsive to growth (i.e. elasticity exceeds 1.0) and inelastic if it is unresponsive to growth (or elasticity is less than 1.0). Over time an elastic tax produces revenue growth that exceeds changes in economic activity.

Stability reflects the short-run performance of revenues over the ups and downs of the business cycle. In practice it is simply a short-run measure of elasticity that may vary significantly for different points in the business cycle. Generally a tax with an elasticity less than 1.0 is viewed as stable as revenue changes will be more modest than changes in economic activity. A stable tax system reduces the need to cut services or raise tax rates during periods of economic contraction. A balanced tax system relies on a portfolio of taxes that perform differently over the business cycle so as to minimize instability given other tax policy objectives.

The public sector must have adequate revenue to fund its service obligations, including intergovernmental transfers. Adequacy is closely tied to the expenditure side of the budget and the desired size of government. Once the scope of service responsibilities is determined, the tax system should produce adequate revenues to finance these services without creating planning difficulties for government and causing service interruptions for taxpayers. An elasticity of 1.0 will maintain government spending as a constant share of the economy.

⁸ Tax neutrality may be in conflict with a separate policy goal, economic development. In practice tax policy often deviates from pure neutrality by intentionally creating distortions to *encourage* economic development and promote competitiveness, as with the use of tax incentives.

⁹ An alternative concept, *buoyancy*, is used to reflect revenue responsiveness inclusive of tax rate and tax bases changes.

Taxpayer Equity

Fairness in taxation is an essential element of a fiscal system. There are two well-accepted measures of tax fairness based on the notion of ability to pay. The first is horizontal equity or the way in which similar individuals and households are treated by the tax system. Horizontal equity calls for equal treatment of equals, something most people would find to be an acceptable measure of fairness. Horizontal equity is violated when two individuals or two households that are otherwise similar confront different tax burdens. In practice, similar is often taken to mean the same income, although adjustments for other factors like family size may be taken into account as well.

The second notion of fairness is vertical equity or the way in which taxpayers with differential ability to pay are treated by the tax system. A tax is progressive if taxes as a share of income rise as income grows, regressive if taxes as a share of income fall when income grows, and proportional if taxes remain a constant share of income. Unfortunately, it is impossible to make an objective statement on whether a tax should be proportional, progressive or regressive. Highly progressive taxes were popular decades ago as governments sought to redistribute income. But there has been significant movement away from progressive taxation due to the adverse incentive effects they engender, including disincentives to work and save, and distortions in residential and business location. Regressive taxes (including sales and excise taxes) are viewed by many as unfair since the poor pay a higher share of income in tax than higher income taxpayers, even though higher income taxpayers may pay more in total taxes.

Another concept of fairness is based on the benefit principle: taxes should be commensurate with the benefits one receives from government services. The benefits-received concept is the foundation for user charges like gasoline taxes and park fees. User fees are a particularly good means to finance government services that are directly and uniquely received by individual taxpayers. They are less appropriate when government services jointly benefit a large number of citizens and the benefits for any one taxpayer are obscured. Examples include public safety, public health and policies to protect the environment. User fees and benefit charges are often criticized as ignoring an individual's ability to pay.

Administration and Compliance Costs

All taxes entail costs of administration and compliance. Compliance costs arise through the tax reporting and remittance process for individuals and firms while administrative costs arise through the tax collection and enforcement process. Tax complexity—often associated with special provisions in the tax system—is a primary source of high administration and compliance costs. Simplicity, uniformity and transparency lead to low costs of administration and compliance and can promote government accountability.

Constitutional and Political Considerations

Other considerations can influence the structure of a tax system. While these factors are not tax policy criteria per se, they nonetheless help shape the structure of the state and local tax system. Federal and state constitutions, court rulings, legislative actions, voting and citizen initiatives all help shape the tax environment and the policy options facing state and local

governments. For example, states are limited in their ability to tax interstate corporate income and interstate sales by the Commerce Clause of the US Constitution. Legal rulings have subsequently determined the basis for assigning tax nexus to firms under both the corporate and sales taxes. States may confront their own constitutional constraints as with a balanced-budget requirement. Similarly, legislation and ballot initiatives may create constraints as with the Taxpayers Bill of Rights (TABOR) in Colorado which limits state government spending growth and Proposition 13 in California which limits growth in property taxes.

Political factors are also important. For example, Congress could act in the interest of the fiscal health of the states by broadening the basis upon which nexus could be assigned to firms for collection of the sales tax. The absence of Congressional action likely reflects the perceived negative consequences of expanding the power of the states' right to tax.

State and Local Government Revenues

This section provides an overview of state and local government revenue. Detailed discussions of individual revenue sources are in subsequent sections. Both total statistics for all state and local governments and averages across governments are presented here, but these should not be expected to represent the conditions of individual state or local governments. Nonetheless, one point that should become readily apparent is that state and local governments differ widely across the US, both in the amount of revenues collected and the ways in which they are collected. The diversity across states will also be highlighted to allow a perspective on how disparate actual practice is across the states. Of course, it is not possible to discuss the individual details of every state.

Total state and local government general revenues include tax revenues, fees and charges, and miscellaneous revenues,¹⁰ which together provided \$1.32 trillion in 2002.¹¹ Tax revenues represented 68.3 percent of total general revenues, charges were 19.1 percent, and miscellaneous general revenues were 12.5 percent. Charges have risen in importance over time as other sources have fallen. For example, charges were 15.3 percent of general revenue in 1987 and taxes were 70.8 percent. Local governments generate 25.7 percent of their revenues from charges as state governments raise only 13.7 percent, a difference that is not surprising since, as a general rule, local governments deliver more services and state governments finance more services (as in the case of K-12 education, for example). Governments collect charges for many services including health care, water, education, transportation, and parks and recreation.

State and Local Government Tax Revenue

Tax revenue, composed of personal income, sales, corporate income, selective sales, property and other taxes, is the main focus of the revenue side of this report, though fees and charges are also considered to some extent. Together state and local governments raised \$905.0

¹⁰ This report focuses on what the US Census Bureau defines as general revenues, which excludes utility revenues, trust fund revenues, and miscellaneous revenues. Trust fund revenues include those for unemployment and employee retirement systems. Utility revenues include those for water, electric, gas, and transport utilities. Miscellaneous revenues include liquor store revenues.

¹¹ The data provided in this report are generally for fiscal years. The fiscal year in forty-six states runs from July 1 through June 30 and the other four states use varying fiscal years.

billion in tax revenues in 2002, a 5.5 percent annual increase from the \$404.8 billion generated in 1987.¹² In 2002, these tax collections represented \$3,143 for every man, woman and child in the US, varying from \$4,373 per person in Connecticut to \$2,170 in Alabama. California, with the nation's largest state economy, also collected the most tax revenue in 2002. California's \$120.4 billion in tax revenue was more than 13 percent of the national total. North Dakota raised the least, at \$1.7 billion.

Revenues as a Percent of Personal Income

State and local revenues rise nearly every year¹³ from a combination of inflation and real economic growth. This pattern of rising revenues is not in itself a very meaningful way to evaluate the demand that governments make on the nation's resources since the national and state economies are also growing. A comparison over time of the resources committed to state and local governments is best made relative to the size of the economy. Personal income, a broad measure of state and national economies that includes wages, non-wage income (such as fringe benefits), proprietor income, dividends, rents, interest and transfer payments, is a convenient base to allow comparison of tax burdens over time. Personal income is also a convenient means of measuring ability to pay taxes.

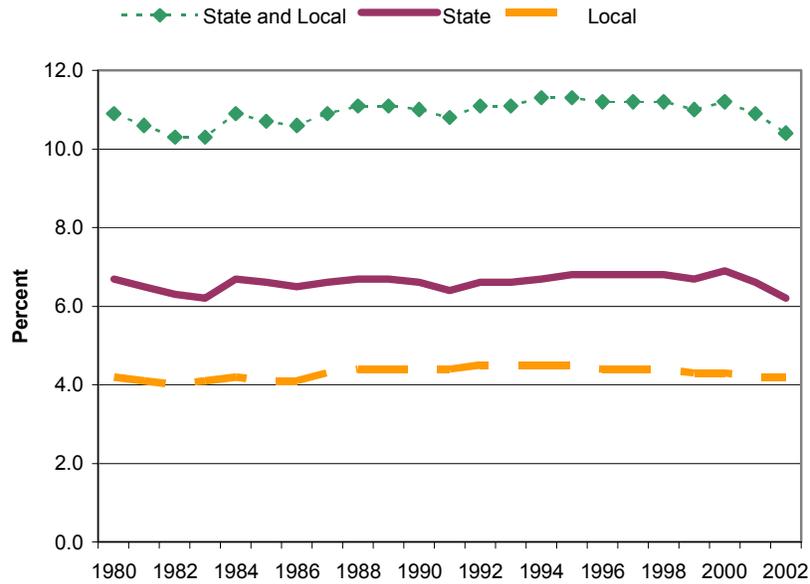
State and local tax revenues as a percent of personal income have stayed in a relatively small range during the past several decades (see Exhibit 10). Tax revenues were 11.2 percent of personal income in 1979, 11.0 percent of personal income in 1990 and 11.2 percent of personal income in 2000. Revenues are the lowest share of personal income around economic recessions and slowdowns. For example, revenues were 10.3 percent of personal income in 1983 and 10.4 percent in 2002. A question that cannot be answered yet is whether revenues will rise back above 11.0 percent again with the stronger economy of the next several years or whether the size of government has fallen. The answer to the question is part economic and part political, since tax rate increases are probably necessary to maintain revenue.

The *combined* state and local tax burden is the best way to compare tax burdens across states because of the widely different service delivery role played by state versus local governments in different places (see expenditure discussion below). For example, the state of Hawaii provides primary and secondary education without local school districts while other states use local school districts. But, other states vary significantly in the share of education financed at the state versus local level. In 2002, New York was the highest, raising 13.1 percent of personal income in taxes, followed by 13.0 percent in Maine (see Exhibit 11). At the lower end, Tennessee generated only 8.4 percent of personal income in tax revenues. California collected the most tax dollars, but this only represented a slightly above average share of personal income, at 10.6 percent.

¹² The growth rate was 6.0 percent through 2001 but was lowered by the fall in revenues from 2001 to 2002.

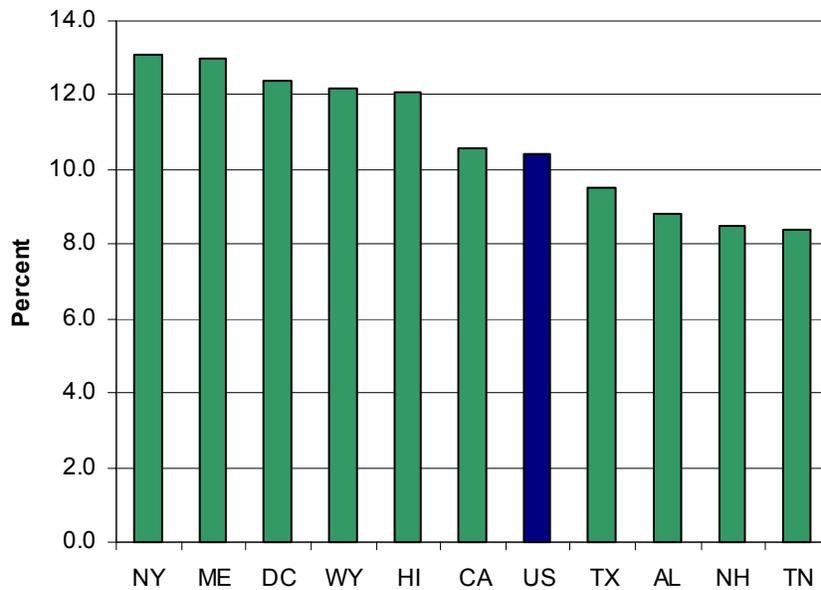
¹³ The only state tax revenue decline during modern times (post-1970) was between 2001 and 2002.

Exhibit 10: US Total Tax Collections as a Percentage of Personal Income, 1980 to 2002



Source: Authors' calculations

Exhibit 11: State and Local Tax Collections as a Percentage of Personal Income, Selected States, 2002



Source: Authors' calculations

State governments collected just under 60 percent of combined state and local tax revenue in 2002 and on average 6.1 percent of personal income (in 2003).¹⁴ Alaska and Hawaii *state* governments raise the largest percentage of personal income (9.9 percent), and New Hampshire

¹⁴ The most recent data on state tax revenues is for 2003 and for local governments is for 2002. For both, the most recent data for charges and fees is for 2002.

generates the smallest percentage (3.3 percent). Various explanations can be given for these wide differences. For example, in the case of these three states, Alaska receives significant amounts of oil-related revenues at the state level, Hawaii is the only place where K-12 education is a state function, and New Hampshire is the only state with neither a general income nor a general sales tax. New Hampshire relies relatively heavily on property taxes and is a very low tax state.

Local governments raised just over 40 percent of the combined total state and local tax revenue in 2002, or \$370.0 billion. On average, local governments collected 4.2 percent of personal income in 2002. New York was the highest, at 6.7 percent, and Maine was a distant second at 5.5 percent. Delaware and Arkansas were the lowest at 2.0 percent.

Individual states can also be compared in terms of the relative amount of taxes collected at the state versus the local government level. On average, states raise 59.2 percent of tax revenues, but the relative responsibilities for tax collection differ widely. State governments in Arkansas and Delaware raise 80.9 percent of tax collections, and in Hawaii 80.7 percent. State governments are responsible for less than one-half of tax collections in Colorado, New York and Texas.

Choice of Specific Tax Instruments

A number of criteria should be used when determining which tax instruments are best levied at the federal, state and local levels of government. The criteria suggest that higher levels of government are better able to collect those taxes that benefit from large economies of scale in collection and are subject to easy movement of the tax base to avoid (or evade) the tax. The tax base moves as businesses relocate to avoid paying high corporate or other business taxes, workers relocate their residence across state lines to avoid an income tax, or consumers make purchases online to avoid the sales tax. Thus, higher levels of government are better able to collect corporate income taxes and broad based income taxes. Of course, some of these same benefits can be obtained through cooperation between the national and state or local governments, or cooperation between a set of state governments. The individual income tax may also be preferred when governments want to redistribute income. The national government is more likely than state or local governments to try to redistribute income. Local governments are relatively better able to collect property taxes based on the presumption that it is more difficult to move property and to collect fees and charges because local governments are more likely to provide services that can be moved. Sales taxes have often been considered good sources for states and perhaps for local governments. However, rapid growth in remote sales (such as via catalogs, television and the Internet) is causing reconsideration of the ways in which the traditional sales tax is collected and administered because movement of the tax base has become easier.

The ability to diversify tax sources is particularly important to state and local governments. They must act much like individuals who often seek to diversify their retirement savings because tax sources grow at diverse rates and respond differently to economic slowdowns. Further, state

and local governments have limited capacity to run deficits in difficult economic environments.¹⁵ Thus, the desire to diversify can also lead governments to employ multiple tax instruments. On the other hand, some have argued that state and local governments diversify their tax instruments to make it difficult for taxpayers to realize the total amount of their tax burden.

Constitutional and statutory provisions also limit state and local government tax choices. The US Constitution places very few limits on state tax choices, the most important of which is that states cannot place undue burdens on interstate commerce. Of course, this limitation can have very large implications. State constitutions may place other constraints on what taxes can be levied or the ways in which they can be levied, and these can differ significantly by state. The creation of local governments is generally done by constitution and statute in each state, and local government's ability to impose certain taxes and the rate at which they can be imposed can be severely curtailed.

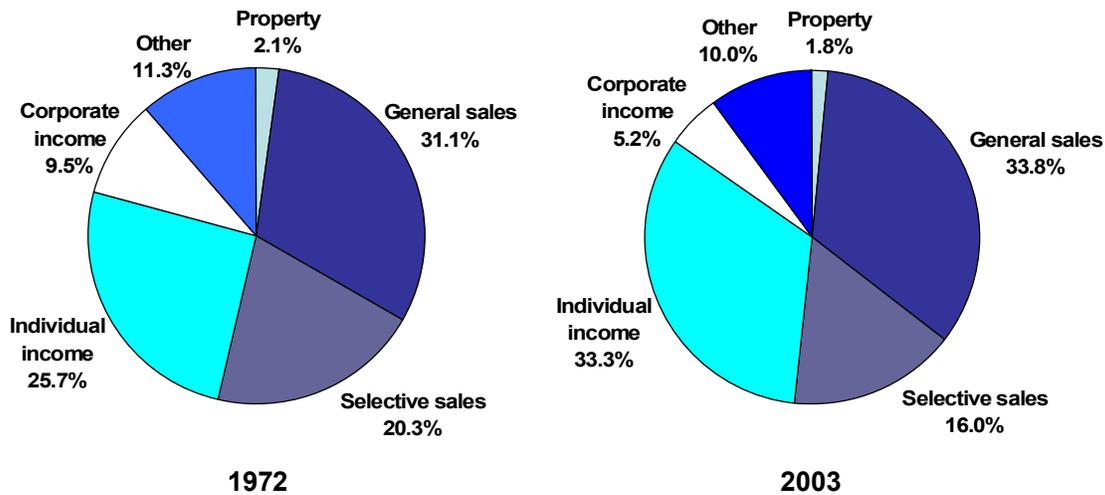
US governments have shown some propensity to specialize in collection of taxes that is consistent with these principles. The federal government generally relies upon the broad-based personal income tax and the corporate income tax. Non-wage income and corporate income are good bases for the national government to tax because these bases can often move easily to avoid taxes and because specialized tax administrators can be important to effective administration. Local governments tend to use taxes on real and tangible personal property and user fees, though there has been some tendency for local governments to move to the sales tax.

State Tax Sources

The general sales and personal income taxes each provide about one-third of state tax revenues (see Exhibit 12). Selective sales taxes generate about one-sixth of tax revenues. Selective sales taxes are the set of levies on specific commodities, including those on fuel products, tobacco products and alcoholic beverages. The corporate income tax generates only about five percent of tax revenues, though this does not represent all taxes paid by business. These averages mask wide differences across states in the relative importance of the revenue sources. Oregon, for example, receives over 70 percent of tax revenue from the personal income tax as Washington and Tennessee raise over 60 percent from the sales tax. Thirty-four states report some property tax revenue, but the tax only accounted for 1.8 percent of total tax revenues. The tax is particularly important in Vermont (26.7 percent) and New Hampshire (25.8 percent), both of which instituted significant state property taxes in the second half of the 1990s.

¹⁵ During the recent economic slowdown, state governments evidenced considerable capacity to work around constitutional and statutory limitations on their ability to incur deficits. States reduced payments to retirement accounts, sold assets, changed the timing of receipts, used other one-time revenue sources to finance ongoing activities, and employed many other maneuvers to finance what otherwise would have been deficit conditions.

Exhibit 12: State Tax Collections by Source, US Total, 1972 and 2003



Source: US Census Bureau.

The relative role that various tax sources play in state tax revenues has been shifting over time (see Exhibit 12). Personal income and sales taxes have been rising rapidly in importance while the role of selective sales and corporate income taxes has been falling. In 1970, the general sales tax replaced the selective sales taxes as the largest source of state tax revenues. The sales tax maintained the position as largest revenue source until 1998, when the personal income tax became the largest source. However, the personal income tax experienced much of the revenue decline between 2001 and 2003, and the sales tax has again become the largest tax. The sales tax rose modestly from 31.1 percent of revenue in 1972 to 33.8 percent in 2003. The individual income tax, on the other hand, rose from 25.7 percent of tax revenues in 1972 to 33.3 percent in 2003 (revenues peaked at 36.1 percent in 2000). Personal income tax revenues fell between 2000 and 2003 mostly because of lower income from capital gains, interest and dividends, and stock options. The income tax will almost surely retake the position as the largest tax source within the next several years. Selective sales taxes have fallen from 20.3 percent to 16.0 percent of revenues, though more than 40 cigarette tax rate increases have caused a slight rebound in the tax share over the past several years.

A combination of legislated actions and underlying revenue growth has explained the changing importance of various taxes. Legislated actions were responsible for much of the growth in personal income and sales taxes from the 1930s until around 1990. First, many states added the income and sales tax during the 1930s through 1960s.¹⁶ Second, legislated rate increases, and most notably for the sales tax, have been an important source of the growth, particularly through the early 1990s. Sales and personal income taxes also have a higher elasticity, meaning they grow faster from natural growth in response to economic expansion, than the corporate income and selective sales tax.

Tax elasticities measured over a number of years are often thought of as a good way to assess whether states are confronted with structural deficits. Simply, the revenue elasticity must

¹⁶ Connecticut was the most recent, adding the personal income tax in 1991.

be approximately the same as the expenditure elasticity¹⁷ or states will be forced to either raise tax rates or lower expenditure growth rates. That is, states are confronted with a structural deficit if the response of revenues to economic growth is less than the response of expenditures to economic growth. Exhibit 13 shows the tax elasticity for the average state from 1992 to 2003. This time period includes a long economic expansion, a short recession, and a modest recovery. The average state had an overall tax elasticity of 0.91 meaning that tax revenues grew only about nine-tenths as fast as the economy. Only the individual income tax has risen as fast as the economy, and the sales tax grew slightly slower. Corporate taxes have shown very modest response to economic growth. These calculations include any effects of rate changes, which tended to increase revenues (and therefore the elasticity) for the sales and selective sales taxes, decrease personal income tax revenues, and leave corporate tax revenues unchanged.

Exhibit 13: Selected US Tax Elasticities, 1992 to 2003

<u>Tax</u>	<u>US Average</u>
Total	0.91
General Sales	0.96
Selective Sales	0.83
Individual Income	1.00
Corporate	0.48

Source: US Census Bureau and authors' calculations.

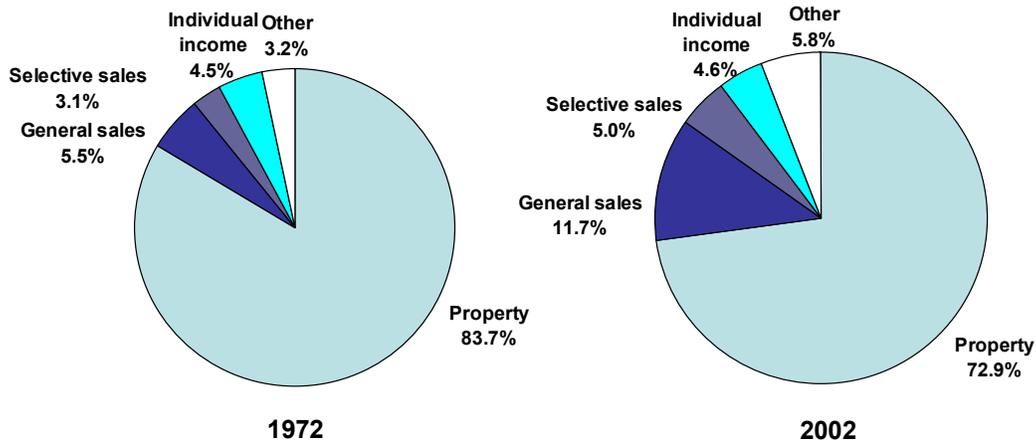
Local Tax Sources

The property tax, providing nearly three-fourths of revenue, easily dominates local government tax sources (see Exhibit 14). Indeed, combined the local and state property taxes are the largest of any state and local government tax sources. Still, having some other tax sources allows local governments a degree of diversification. The general sales tax, used in 34 states, provides just over one-tenth of local tax revenues. Local income taxes, used in 13 states, generate just under five percent of local revenues. Selective sales taxes are also used to a limited extent and provide slightly more revenue than local income taxes.

The relative role of local taxes has shifted significantly over the years, in particular between the early 1970s and the late 1980s. The property tax provided 83.7 percent of total local taxes in 1972, and the percentage had fallen to 73.6 percent by 1987. Change has been modest in subsequent years, with the property tax only falling to 72.9 percent by 2002. Local governments have doubled their relative reliance on sales taxes and increased the importance of selective sales taxes by more than 50 percent since 1972. The percentage of revenues from local individual income taxes has changed very little.

¹⁷ The expenditure elasticity is defined as the percent change in expenditures divided by the percent change in personal income.

Exhibit 14: Local Tax Collections by Source, US Total, 1972 and 2002



Source: US Census Bureau.

Equity in Taxation

Horizontal equity is usually lessened when exemptions are built into the tax system because people's tax burdens are affected by the degree to which they can benefit from the exemptions. For example, horizontal equity of the individual income tax can be lessened if capital income (such as from capital gains, interest and dividends) is taxed at lower rates than labor income because a person earning capital income will pay less tax than a person earning wage income even when their incomes are the same. Similarly, horizontal equity for the sales tax is lessened by exemption of services because the person who buys relatively more services bears a smaller tax burden.

The District of Columbia Department of Revenue does a study each year of the relative tax burden across state and local governments. The study examines the state and local property, individual income, sales and automobile taxes that individuals of various income levels would pay in the largest city of each state. Studies of equity are very difficult to do because the results are heavily influenced by many technical questions about the specific characteristics of the households and the incidence of the individual taxes. Still, the District of Columbia (DC) study provides an overall perspective on the equity implications of state and local taxes. The 2003 study generally concludes that state and local government tax systems are regressive, in the sense that households earning \$25,000 pay a higher percentage of their income in taxes than households earning \$150,000. Low-income residents in only 11 cities were found to have lower tax burdens than the higher income individuals. The most regressive tax structures were found in New Orleans, Louisiana; Boise, Idaho; and New York City. The most progressive tax structures were in Las Vegas, Nevada; Sioux Falls, South Dakota; and Seattle, Washington.

Sales Taxes

The general sales tax is the second largest source of combined state and local revenues. It is the largest source used by state governments and the second largest used by local governments. It should be remembered that state and local governments impose both general

sales taxes and selective sales taxes. These differ in two ways. First, the general sales tax base is broader, though not as broad as is often thought, while selective sales taxes are imposed on narrow categories of goods, such as alcohol, tobacco products or motor fuels. Second, general sales taxes are imposed at *ad valorem*, or percentage-based, rates while selective sales taxes are frequently, though not always, imposed at specific rates on the quantity purchased (e.g., cents per gallon). This section only addresses the general sales tax. Some discussion on selective sales taxes is provided below.

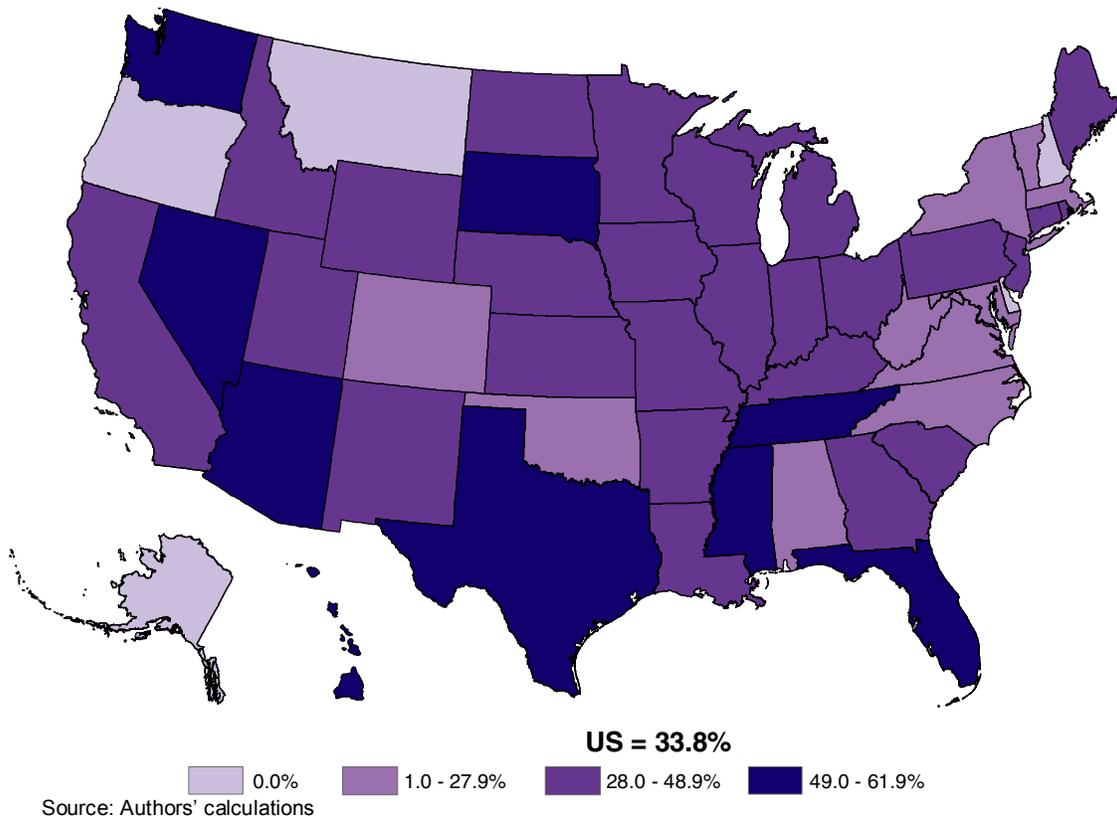
In 1930, Mississippi and Kentucky were the first states to impose sales taxes. Today, they are levied by 45 states and the District of Columbia.¹⁸ Twenty-four of the states first legislated the tax during the 1930s, six in the 1940s, five in the 1950s, and eleven in the 1960s. In 1969, Vermont was the last state to impose a sales tax. Alaska, Delaware, New Hampshire, Montana and Oregon do not levy general state sales taxes. Thirty-four states have local sales taxes, including Alaska, which has no state sales tax.

State sales taxes raised \$179.7 billion in 2002 and local sales taxes generated an additional \$43.3 billion, for combined collections of \$223.0 billion. Total sales tax collections represented 2.51 percent of personal income, about the same percentage that was raised through most of the past decade. A longer term look shows state sales taxes rising as a share of personal income during the 1960s through 1980s, but stabilizing during the 1990s.

Reliance on the sales tax varies widely by state. Sales taxes are much more important in the South and West than in New England and the industrial Midwest (see Exhibit 15). Florida, Washington, Tennessee and Texas all generate more than 50 percent of their tax revenue from the sales tax, and several of these states raise 60 percent from the sales tax. New York, on the other hand, only collects about one-fifth of its revenues from the sales tax. Local government use of the sales tax varies from Louisiana at 52.0 percent of tax revenues to Idaho at 0.1 percent.

¹⁸ The legal construct of what is termed a sales tax differs across states. In about one-third of the states, such as Hawaii or New Mexico, the tax is a levy on business gross receipts. The tax is imposed on consumers in about one-third of the states. The tax is a mixture of these two approaches in the other one-third of the states.

Exhibit 15: State General Sales Taxes as a Percentage of Total Taxes, 2002



Sales Tax Base Structure

Most states impose sales taxes on all sales of tangible personal property, unless specifically *exempted*, and all sales of services that are specifically *enumerated*. In practice this general approach results in very different tax bases across states. Hawaii imposes the broadest sales tax, levying it on a base that exceeds the state economy.¹⁹ New Mexico, Arkansas and South Dakota are among other states with broad tax bases. At the other extreme, the tax base in states such as Illinois and Rhode Island is less than one-third of the state economy. As described below, all states tax a number of intermediate transactions by business, even if their tax base appears relatively narrow.

Cross-state differences in bases are mostly attributable to the extent to which business-to-business transactions (B2B), basic consumer goods such as clothing and food, and services are taxed. The sales tax is often viewed as a tax on consumers, but much of the tax is levied on purchases by businesses rather than individuals. Data are not collected in a way that allows direct measures of the extent to which the sales tax is collected on business purchases, but there are indications that as much as 40 percent of sales tax revenue comes from business-to-business transactions.²⁰

¹⁹ Much of the Hawaii base is taxed at a lower 0.5 percent rate rather than the general four percent rate.

²⁰ Ray Ring (1999) estimated that 41 percent of the tax is paid by purchasers other than local consumers, which would include both businesses and tourists.

States have two general sets of exemptions for B2B purchases: component parts and sales for resale. Manufacturing firms are exempt on purchases of materials that actually become a component part of the final product. A related exemption in many states is for the equipment used to produce manufactured goods. However, these exemptions can be construed narrowly. For example, conveyor belts used to move materials through the production process are often taxable because they are not actually used for manufacturing. Firms are also normally exempt on goods purchased for resale.²¹ Thus, a retailer does not pay tax on its purchases of products for resale.²² The specific application of these exemptions combined with a series of narrowly construed exemptions given by each state lead to widely different taxation across states. Despite the exemptions, many transactions remain taxable, including such common examples as packaging, office equipment, computers and cash registers.

States offer an array of exemptions for consumer goods. One set of exemptions is by type of vendor. For example, sales by some not-for-profit firms are exempt in many states. Also, exemptions can be granted for specific products. Food and prescription drugs are common examples. Currently, 28 states and the District of Columbia exempt food for consumption at home (in some cases the local rate is applied), and four states tax food at a lower rate. There are differences across states in how food is defined. Almost every state exempts prescription drugs. Clothing is exempt in several states. The granting of sales tax holidays is a relatively new phenomenon that began in New York in 1997. Twelve states plus the District of Columbia offer sales tax holidays for varying periods of time (usually just a few days right before school begins) and for various types of commodities (often for computers and some clothing).

Taxation of services, like the rest of the sales tax, varies widely by state. The Federation of Tax Administrators (FTA) surveyed the states in 1996 to determine the extent of sales taxation of services. FTA identified 174 services that were potentially taxable and found Hawaii to tax the most services (157). Washington, New Mexico and South Dakota also tax more than 140 services. Nevada, Connecticut, Colorado and Massachusetts taxed 20 or fewer of the services. Taxation of services often depends on whether the purchaser is a business or an individual consumer.

The sales tax base varies not only across states but also over time. The sales tax base in the average state has fallen from 52.8 percent of the economy (personal income) in 1979 to 40.6 percent in 2002. Legislated exemptions, remote transactions, shifts in consumption patterns and technological change have been key causes of the relative base decline. The base shrinks every time that states exempt additional transactions, regardless of whether the exemptions are good tax policy. Adding to the list of exemptions seems to be a nearly continuous process by many states, with food for consumption at home, manufacturing equipment and non-prescription drugs being recent additions to the list in many states.

In most cases, local tax bases are set by the state government and are very similar to the state's. In Tennessee, for example, the state base also applies to the local governments with only minimal differences such as the maximum local sales tax that could be paid on any single item,

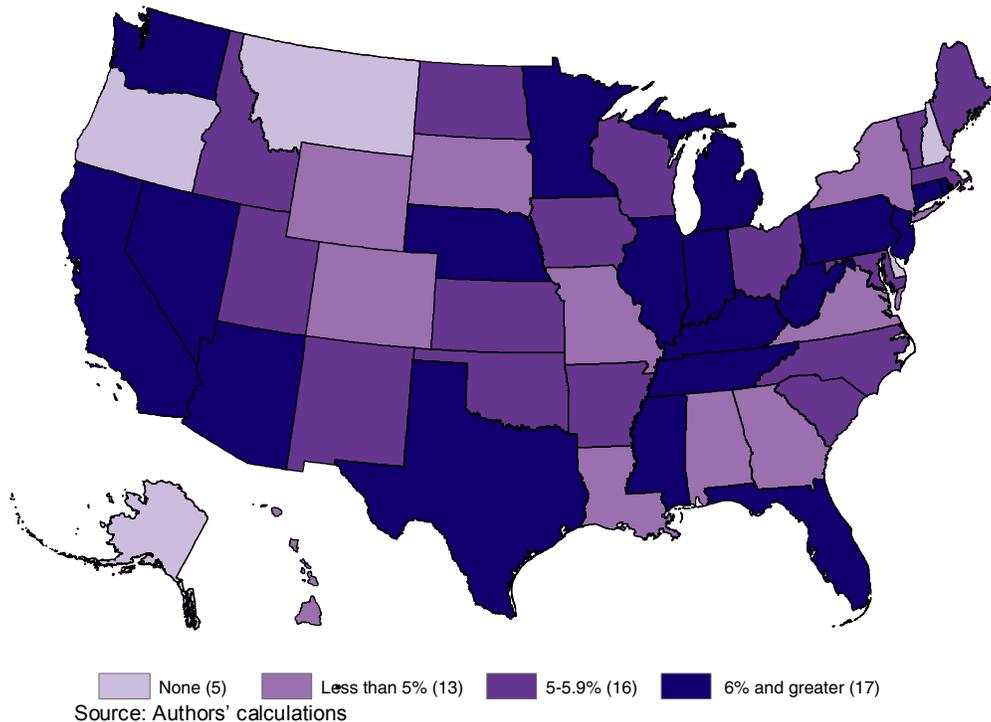
²¹ Several states, such as Hawaii and Washington, impose low-rate taxes on these transactions.

²² Sale for resale exemptions are much less common for the sale of services, which can lead to significant cascading of the tax. Cascading occurs when the sales tax is levied on the same underlying value at different levels in the production process, resulting in tax being imposed on tax.

but the divergences are minimal.²³ However, several states including Colorado allow local control over the base.

There has been a tendency for sales tax rates to rise, at least in part because of the narrowing base. The median state sales tax rate was 3.25 percent in 1970, 4.0 percent in 1980 and 5.0 percent in 1990, where it remains today (see Exhibits 16 and 17). The number of sales tax rate increases has slowed, but there are now 20 states (out of 45 sales taxing states) with at least a 6.0 percent state sales tax rate. Rate increases have historically been most prevalent in the years around recessions, because this is when the base shrinkage relative to the economy is greatest. However, rates have been increased much less frequently since the 1990 recession, allowing the share of personal income paid in sales taxes to fall slightly.²⁴ Sales tax rate increases caused the sales tax to maintain or increase its share of the economy until the mid-1990s. The Sales Tax Clearinghouse reports that combined state/local rates vary from 1.05 percent in Alaska (which only has a local sales tax) to 9.4 percent in Tennessee. The local rate ranges from as low as 0.1 percent in Idaho to as high as 4.15 percent in New York.

Exhibit 16: States Sales Tax Rates, 2003



²³ Tennessee recently enacted legislation based on the Streamlined Sales Tax Project (SSTP), so the differences between the state and local bases have been entirely eliminated.

²⁴ Revenues will fall relative to the economy if the elasticity is less than 1.0 and if tax rates increases are not legislated.

Exhibit 17: State and Local Sales Tax Rates, January 2004

	Food Items (1) Taxable (T) Exempt (E)	State Rate	Maximum Local Rate (2)	Maximum State/Local Rate (2)
Alabama	T	4	7	11
Alaska	T	---	7.00 (3)	7
Arizona	E	5.6	4.5	10.1
Arkansas	T	5.125	5.5	10.625
California	E	6	2.75	8.75
Colorado	E	2.9	7	9.9
Connecticut	E	6	---	6
District of Columbia	E	5.75	---	5.75
Florida	E	6	1.5	7.5
Georgia	E (4)	4	3	7
Hawaii	T*	4	---	4
Idaho	T*	6	3	9
Illinois	T**	6.25	3	9.25
Indiana	E	6	---	6
Iowa	E	5	2	7
Kansas	T*	5.3	3	8.3
Kentucky	E	6	---	6
Louisiana	E (4)	4	6.25	10.25
Maine	E	5	---	5
Maryland	E	5	---	5
Massachusetts	E	5	---	5
Michigan	E	6	---	6
Minnesota	E	6.5	1	7.5
Mississippi	T	7	0.25	7.25
Missouri	T**	4.225	4.5	8.725
Nebraska	E	5.5	1.5	7
Nevada	E	6.5	1	7.5
New Jersey	E	6	---	6
New Mexico	T	5	2.25	7.25
New York	E	4.25	4.5	8.75
North Carolina	E (4)	4.5	3	7.5
North Dakota	E	5	2.5	7.5
Ohio	E	6	2	8
Oklahoma	T	4.5	6	10.5
Pennsylvania	E	6	1	7
Rhode Island	E	7	---	7
South Carolina	T**	5	2	7
South Dakota	T*	4	2	6
Tennessee	T	7	2.75	9.75
Texas	E	6.25	2	8.25
Utah	T	4.75	2.25	7
Vermont	E	6	1	7
Virginia	T**	3.5	1	4.5
Washington	E	6.5	2.4	8.9
West Virginia	T	6	---	6
Wisconsin	E	5	0.6	5.6
Wyoming	T*	4	2	6

Notes:

(1) Food purchased for consumption off-premises.

(2) Highest local rate known to be actually levied by at least one jurisdiction.

Includes local taxes for general purposes and those earmarked for specific purposes (e.g. transit).

Taxes applying only to specified sales (e.g. lodging or meals) are excluded.

(3) Alaskan cities and boroughs may levy local sales taxes from 1 percent to 6 percent.

(4) Food exempt from state tax, but subject to local taxes.

* Income tax credit allowed to offset sales tax on food.

** Food taxed at lower rate.

Source: Compiled by the Federation of Tax Administrators from various sources.

Sales Tax Vertical Equity

The sales tax has often been perceived as regressive based on the expectation that lower-income people spend a higher percentage of their income on sales-taxable purchases than higher income people. As a result, reductions in regressiveness have been one of the justifications for exempting items such as food, drugs, and clothing. Fox (2002) investigated the vertical equity of the very broad-based sales tax in Hawaii (and earlier in Ohio) and reached several conclusions. First, the sales tax is regressive relative to people's current income. The regressiveness arises primarily because the lowest-income people spend much more than their annual income and higher-income people spend less than their income. Second, the consumption of almost all items is regressive (low-income people spend a higher percentage of their income) so granting specific exemptions will do little to make the tax less regressive. Third, higher-income people pay more in sales tax revenue than lower-income people, even though it is a smaller percentage of their income. Fourth, the sales tax is approximately proportional against lifetime income in contrast with the perception of the tax. The notion is that people's income in the current year may not be a good proxy for their ability to earn income and pay taxes over their lifetime. A key reason is that low-income groups in a particular year include many individuals, such as students or retirees, who frequently have much higher income over other portions of their life and are able to consume much more than their current income. On the other hand, many high-income people earn high incomes for only short time periods and spend less than would be anticipated based on their current year's income. The tax is approximately proportional when these factors are taken into account.

The Use Tax to Create a Destination Tax

Every state with a sales tax has a corresponding use tax. The use tax is imposed on items that are consumed or used in a state but on which the sales tax has not already been paid. The intent is to make the overall sales and use tax structure "destination-based"—that is, the tax is paid where the goods are consumed or used. As a general rule, the sales tax is collected in the state of purchase on items where possession is taken in the state. The use tax becomes applicable when items are purchased out of state but where possession is taken inside the state, such as when goods are shipped to the buyer.²⁵ The use tax is imposed at the same rate, and generally with the same base, as the sales tax. The effect of the combined sales and use taxes is to impose a tax on consumption or use within a state not on sales or production (assuming that consumption occurs where possession is taken). One feature that results from the ability to impose a destination-based tax is that the tax liability is the same regardless of where items are purchased, so that firms and people do not have a tax incentive to purchase out of state.²⁶

The use tax is necessary because firms can only be required to collect the sales tax in states where they have nexus. Nexus is the minimum presence necessary to have taxable contact under

²⁵ The use tax is also collected when businesses purchase items for a tax-exempt use but ultimately employ the items for a taxable purpose. For example, if a home improvement store purchases lumber for resale, but it uses it to build a room for employees to take a break.

²⁶ Most economists prefer destination-based taxes because they are believed to have smaller influences on behavior than "origin-based" tax structures, where the tax is levied at the point of production or sale rather than the point of consumption or use.

the Constitution. The Supreme Court ruled in 1992 in the *Quill* case²⁷ that firms must have physical presence in a state before it has sales tax nexus. The *Quill* case was decided on commerce clause grounds that the compliance costs for multi-state vendors exceed those for single state vendors, which therefore caused the tax to become a burden on interstate commerce. The Court did not rule what level of presence reached the physical presence that established nexus and suggested that Congress do so. Congress has failed to act thus far.

A *local* use tax is only imposed in about one-half of the sales-taxing states, and even in these cases the destination-based structure may be used only on cross-state transactions and not on in-state transactions. The Streamlined Sales Tax Project (SSTP) (discussed below) requires that the use tax be imposed on goods that are purchased in one local government and delivered to people or businesses in another, even if the delivery is within the state. This provision has been controversial in a number of states, including Kansas, Texas and to a lesser extent Tennessee because of the redistribution of revenue across jurisdictions and because of additional compliance costs of tracking the destination of deliveries.

Use tax compliance is very poor, particularly for individuals. States find it very difficult to collect the use tax from individuals because their compliance is essentially voluntary. Few people understand the details of the tax, or even know that a use tax exists, making reliance on voluntary compliance very risky. Further, states seldom have any information that allows them to audit compliance by individuals. Nineteen states now use the individual income tax structure in an effort to enhance use tax compliance. These states either include a line on the individual income tax return or provide information with income tax returns on how to comply with the use tax.

Though use tax compliance is better for businesses, it appears to be the lowest of any tax. The state of Washington undertook detailed audits of a random sample of registered taxpayers and concluded that there was 27.3 percent non-compliance with the use tax, versus 1.5 percent for the sales tax. Firms with over \$50 million in receipts had the greatest extent of non-compliance. States are better able to audit businesses but still only audit about two percent of firms each year. The result is significant non-compliance.

Sales Tax Policy Issues

This section addresses several key policy issues including the appropriate design of the tax base, remote transactions and the SSTP, and taxation of services.

Appropriate Design of the Sales Tax Base

Economists normally evaluate the sales tax as if it were a tax on consumption. Key characteristics of a broad consumption tax are that it would tax all household consumption within a state or local government,²⁸ regardless of what items are purchased, how the items are obtained, where the items are obtained, what type of vendor is used or what source of income is used to purchase the items. Further, no tax would be levied on business-to-business transactions.

²⁷ *Quill Corp. v. North Dakota*, 504 U.S. 298, 318 (1992).

²⁸ It is preferable to tax durable goods purchases when the items are consumed rather than purchased but no state seeks to do this.

The sales tax violates all of these criteria. As already noted, many B2B transactions are taxable. Consumer purchases are treated differently for all of the reasons listed here. Many items are exempt. Taxability, or at least the ability to collect the tax, is influenced by whether transactions occur out of state (via mail order, Internet, television or physically traveling out of state to make purchases). In some cases the tax is imposed on sales by for-profit firms but not sales by not-for-profit or government organizations. Of course, states are constitutionally prohibited from imposing the sales tax on the federal government. Sales tax is not imposed on food purchased with food stamps, even in those states that otherwise impose the sales tax on food.

These deviations from the standard for a consumption tax have several implications. First, the tax is horizontally inequitable because the consumer's liability depends on what they buy, their ability to buy online and so forth. Second, the structure influences the location and success of businesses within the US. For example, Merriman and Skidmore (2000) found that nearly one-fifth of the growth in the service sector during the past several decades could be attributed to the failure to impose the sales tax on most services.²⁹ Taxation of B2B purchases gives firms incentives to locate in low sales tax states (to avoid the tax on their purchases) and produce things inside the firms (vertically integrate) rather than purchase from other firms. Also, taxation of B2B purchases means that the effective sales tax paid on the final consumption of various goods varies depending on how much tax on intermediate transactions is included. Finally, the exemptions raise the compliance cost for businesses, which must determine whether their sales are taxable or not.

Remote Commerce and the Streamlined Sales Tax Project

Most states have been very concerned about the revenue loss associated with the growing extent of remote sales. As noted above, the use tax is due on these transactions but compliance is poor relative to the standards of other taxes. Bruce and Fox (2004) estimate that states lost \$15.5 billion in 2003 from inability to collect tax on Internet sales, and the losses are growing rapidly. Revenue is also being lost through mail order, television sales and other remote sales.

Over the past several years, the states have undertaken the SSTP in cooperation with the business community in an effort to find a mechanism through which vendors can be required to collect the use tax on remote transactions. The SSTP's intent is to simplify sales and use tax compliance to the point that compliance burdens for multi-state and single state firms are similar. The hope is that Congress would pass legislation allowing states to require remote vendors to collect the sales tax on their behalf, the Supreme Court would rule that the sales tax did not impede interstate commerce, or that firms would voluntarily comply. Simplifications arising from the SSTP include developing common definitions of taxable and exempt transactions, limiting each state to a single tax base (not permitting deviations for local governments), limiting the number of tax rates that a state can levy and many others.

Legislative action by the states is necessary as the next step in the process. A Streamlined Sales Tax Agreement was developed out of the SSTP and the Agreement indicates that it will be implemented when it is passed by at least 10 states with at least 20 percent of the population.

²⁹ Economists are generally concerned when tax policy, as opposed to the underlying demand for goods and services, has a significant effect on the economy.

The National Governors Association reports that 20 states representing more than 20 percent of the population have passed the legislation, though not all of these states may have fully complied with the Agreement.

The Agreement's full benefits await legislation by Congress that would allow states to require firms to collect the sales tax on behalf of those states that are in compliance. Legislation has been introduced in Congress, but it has made little progress thus far. Congress is also considering an extension of the Internet Tax Freedom Act (ITFA). The ITFA prevents states from imposing a tax on access to the Internet unless the state was grandfathered in during the initial legislation (passed in 1998). The legislation also prohibits states from imposing differential taxes on sales over the Internet but *does not* prohibit the imposition of sales and use taxes on transactions over the Internet. Both the Senate and the House have passed a version of the legislation, but the new Congress will need to reconsider the issue. The differences between the Senate and the House have focused primarily on whether the new ITFA would be permanent and on the definition of Internet access. Many have interpreted the House version so broadly that it would define Internet access to include Voice Over the Internet Protocol (VOIP). The states fear that extension of the ITFA to VOIP would significantly lower sales tax collections.

Taxation of Services

States differ widely in their taxation of services and the potential for broadening the base consistently gets attention when states believe that they need additional revenues. Potential benefits perceived from broadening the base to services include: (1) a lower tax rate for any given amount of revenue, (2) greater horizontal equity, (3) faster revenue growth and (4) a less regressive tax structure.

Few states have been successful in undertaking significant broadening of the base to services. States have generally been effective in legislating only minor changes in taxation of services. In 1987, Florida enacted legislation that taxed many services, but it was repealed six months later. Massachusetts passed base broadening legislation but never enacted it. Texas was able to do a relatively large expansion. Other states have tended to legislate very small expansions of the base and have been unsuccessful in taxing the broader services that include health care, professional services and construction services.

Individual Income Taxes

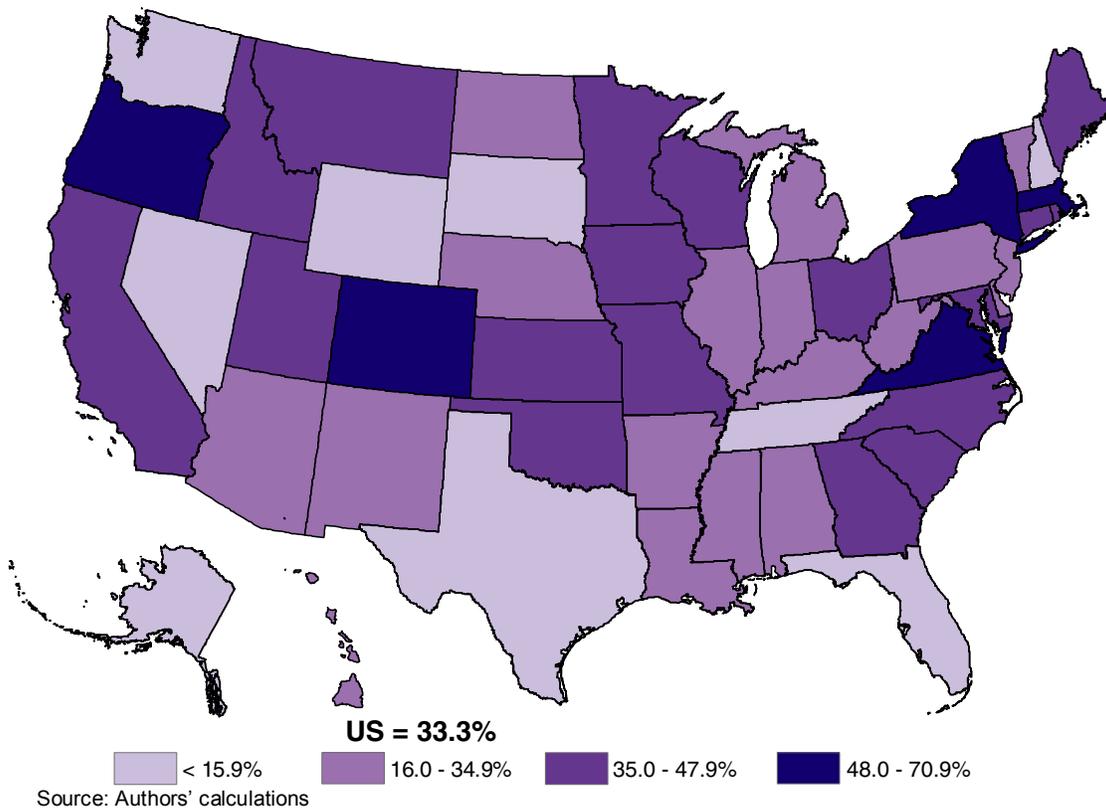
Individual income taxes, henceforth referred to as income taxes in this section, comprise the third largest source of state and local tax revenues, behind property and general sales taxes. They are much more important for state governments, representing one-third of total state taxes in 2003 and the second largest source just behind general sales taxes. As noted above, income taxes will likely become the largest source of state taxes as the economy continues to improve.

Income taxes are popular for a number of reasons. First, they involve a tax base—personal income or some variant of it—that grows with the economy. Income taxes are highly elastic taxes as described earlier. Second, they are often built upon the principle of ability-to-pay, where individuals with more income pay more income taxes. Third, income taxes play an important role as an automatic stabilizer in the economy. As the economy grows, so do income

and tax collections. Excess collections during good times can be saved for future downturns, when income tax collection growth naturally slows. Fourth, income taxes are highly visible and reinforce the taxpayer's attachment to his or her government. Finally, like the federal income tax, state and local income taxes have become important mechanisms for enacting social policy. It has become much easier to pass a tax credit that favors a certain type of activity rather than a separate spending program that would accomplish largely the same goal.

Wisconsin enacted the first state income tax in 1911, and Philadelphia introduced the first local income tax in 1939. Today, income taxes are used by 41 states and the District of Columbia. Connecticut was the most recent to enact an income tax, having passed legislation in 1991. Two other states, New Hampshire and Tennessee, have limited income taxes that apply only to interest and dividend income. In the 41 states with broad-based income taxes, their importance ranges from a low of 16.9 percent of total state taxes in North Dakota to a high of 70.6 percent of total state taxes in Oregon, a state without a general sales tax. There does not appear to be a significant geographic pattern in the emphasis on individual income taxes (see Exhibit 18).

Exhibit 18: State Individual Income Taxes as a Percentage of Total Taxes, 2003



Local governments in 13 states report significant revenue from income taxes, ranging from a low of 0.2 percent of total local taxes in Arkansas and New Jersey up to a high of 32.5 percent in Maryland.³⁰ Local income taxes were responsible for less than five percent of total local taxes

³⁰ Additionally, four other states (Louisiana, Maine, Texas and Virginia) report very small amounts of individual income tax revenues at the local level.

in 2002. State income taxes raised \$185.7 billion in 2002, and local income taxes generated an additional \$17.2 billion, for combined collections of \$202.9 billion.

State income taxes have increased as a share of personal income over the past few decades but have fallen slightly in recent years as a result of the recent overall economic slowdown. Total state and local individual income tax collections represented 2.33 percent of personal income in 2002, down slightly from a high of 2.71 percent in 2000. State income taxes were 2.04 percent of personal income in 2003, down from 2.50 percent in 2000. Local income taxes have historically represented about 0.20 to 0.25 percent of total personal income over time.

Income Tax Structure

Exhibit 19 presents key features of state income taxes. Most states begin with some measure of income from the US federal individual income tax. Twenty-six states plus the District of Columbia start with federal adjusted gross income (AGI) and an additional 10 states begin with federal taxable income. Rhode Island's income tax is specified as a flat rate—25 percent—of federal income tax liability. The remaining five states with broad-based income taxes do not employ a federal starting point. Linkages to the federal income tax are designed to increase simplicity and reduce compliance costs.

Despite the prevalence of formal linkages to the federal income tax base, state income tax bases vary widely. For example, 26 of the 41 states with income taxes did not tax Social Security benefits in 2000.³¹ The 15 states that did tax Social Security benefits often had rules to reduce the effective tax rate on them relative to other forms of income. Also, most states exempt one type or another of non-Social-Security pension benefits. These provisions are designed in part to attract elderly individuals to a state or enhance equity. States also differ in the extent to which they tax capital gains, unemployment compensation, state and municipal bond interest, and active duty military pay among other income sources.³²

Most states follow the federal structure in specifying a standard deduction or a set of allowable itemizable deductions. The primary departure from federal rules concerns the deductibility of state taxes, which is permitted on the federal income tax but not allowed on some state income taxes. In addition to standard or itemized deductions, all but three states (Colorado, Pennsylvania and Rhode Island) generally allow certain personal exemption amounts to be subtracted from their chosen measure of income. The exemption for married filers is often but not always twice that for single filers. Additional exemptions are specified for dependents such that tax liabilities can be adjusted for household size in the pursuit of greater horizontal and vertical equity.

Most states apply a series of graduated or increasing tax rates to their chosen measure of income (minus deductions and exemptions). As with the federal income tax, different rate schedules typically apply to different filing statuses (e.g., single, married or head of household). A total of six states have essentially flat-rate income taxes, while Rhode Island applies a flat rate

³¹ For more details on state taxation of social security and pension benefits, see Baer (2001).

³² For a detailed assessment of the differences in state income tax bases focusing on the 1999 tax year, see Russell (2001).

to federal income tax liability, as noted above. The highest marginal income tax rate is observed in Montana at 11 percent. Missouri and Montana have the most (10) tax brackets.

Tax structures in 14 states are at least partially indexed for inflation. Indexing permits tax brackets, exemptions or deduction amounts to rise as the general price level in the economy rises. Without such indexing, an individual's tax liability could increase over time in dollar terms as his or her income rises, given statutory tax brackets that remain unchanged. The problem with this is that if prices also rise, the purchasing power (or real value) of income is not necessarily increasing over time. Rising tax liabilities over time alongside constant real incomes are perceived to be unfair. One important reason for states' failure to index their tax codes is that the resulting "bracket creep" creates welcome growth in income tax collections over time.

Income taxes are favored by some for their progressivity. As described in the introductory section of this document, progressive taxes place a larger burden on higher-income households (as a share of their income) than lower-income households. States enhance the progressivity of their overall tax systems by applying more sharply increasing income tax rates as household income rises. It should be noted, however, that the bulk of the progressivity inherent in state income taxes appears at low to middle income levels. The top tax rate applies at a moderate income level in most states. States with the most progressive income tax systems include New York, North Dakota, North Carolina and Wisconsin.

States can also enhance the overall progressivity of their income tax systems by reducing tax burdens on low-income families. As of March 2004, 17 states had what are called earned income tax credits (EITCs) that resemble the federal EITC.³³ These provisions allow tax filers in the very lowest income brackets to reduce their income tax payments if they meet certain restrictions regarding income and household composition (e.g., the presence of a qualifying child). In 12 states, these credits are refundable; if the EITC amount exceeds tax liability, the tax filer can actually receive a check for the difference.

Income tax rates increased gradually during the 1970s and early 1980s, fell from 1986 through 1999, and have recently increased slightly. The median top marginal income tax rate across the states with income taxes was 6.5 percent in 1970. It increased to eight percent in 1985 and then fell to about 6.8 percent in 1999. State income tax rate cuts enacted during the revenue surpluses of the 1990s have since been scaled back alongside flagging revenues. The median top marginal income tax rate increased slightly from 6.785 percent to 6.81 percent between 1999 and 2000.

³³ Additionally, Colorado has an EITC on the books but it has been suspended due to budget pressures for two years in a row. For more information on state EITCs, see Llobrera and Zahradnik (2004).

Exhibit 19: State Individual Income Tax Structures

	Tax Rate Range (%)		Number of Brackets	Income Brackets		Personal Exemptions			Federal Starting Point
	Low	High		Lowest	Highest	Single	Married	Dependents	
Alabama	2	5	3	500	3,000 (b)	1,500	3,000	300	
Arizona	2.87	5.04	5	10,000	150,000 (b)	2,100	4,200	2,300	AGI
Arkansas (a)	1	7.0 (e)	6	3,999	27,500	20 (c)	40 (c)	20 (c)	
California (a)	1	9.3	6	5,962	39,133 (b)	80 (c)	160 (c)	251 (c)	AGI
Colorado	4.63		1	Flat rate			None		Taxable Income
Connecticut	3	5	2	10,000	10,000 (b)	12,500 (f)	24,000 (f)	0	AGI
Delaware	2.2	5.95	6	5,000	60,000	110 (c)	220 (c)	110 (c)	AGI
District of Columbia	5	9.5 (x)	3	10,000	30,000	1,370	2,740	1,370	AGI
Georgia	1	6	6	750	7,000 (g)	2,700	5,400	2,700	AGI
Hawaii	1.4	8.25	9	2,000	40,000 (b)	1,040	2,080	1,040	Taxable Income
Idaho (a)	1.6	7.8	8	1,104	22,074 (h)	3,100 (d)	6,200 (d)	3,100 (d)	Taxable Income
Illinois (a)	3		1	Flat rate		2,000	4,000	2,000	AGI
Indiana	3.4		1	Flat rate		1,000	2,000	1,000	AGI
Iowa (a)	0.36	8.98	9	1,211	54,495	40 (c)	80 (c)	40 (c)	AGI
Kansas	3.5	6.45	3	15,000	30,000 (b)	2,250	4,500	2,250	AGI
Kentucky	2	6	5	3,000	8,000	20 (c)	40 (c)	20 (c)	AGI
Louisiana	2	6	3	12,500	25,000 (b)	4,500 (i)	9,000 (i)	1,000 (i)	AGI
Maine (a)	2	8.5	4	4,250	16,950 (b)	4,700	7,850	1,000	AGI
Maryland	2	4.75	4	1,000	3,000	2,400	4,800	2,400	AGI
Massachusetts	5.3		1	Flat rate		3,300	6,600	1,000	AGI
Michigan (a)	4 (y)		1	Flat rate		3,100	6,200	3,100	AGI
Minnesota (a)	5.35	7.85	3	19,440	63,860 (j)	3,100 (d)	6,200 (d)	3,100 (d)	Taxable Income
Mississippi	3	5	3	5,000	10,000	6,000	12,000	1,500	
Missouri	1.5	6	10	1,000	9,000	2,100	4,200	2,100	AGI
Montana (a)	2	11	10	2,199	76,199	1,740	3,480	1,740	AGI
Nebraska (a)	2.56	6.84	4	2,400	26,500 (k)	94 (c)	188 (c)	94 (c)	AGI
New Jersey	1.4	6.37	6	20,000	75,000 (l)	1,000	2,000	1,500	
New Mexico	1.7	6.8	5	5,500	26,000 (m)	3,100 (d)	6,200 (d)	3,100 (d)	AGI
New York	4	7.7	7	8,000	500,000 (n)	0	0	1,000	AGI
North Carolina (o)	6	8.25	4	12,750	120,000 (o)	3,100 (d)	6,200 (d)	3,100 (d)	Taxable Income
North Dakota (a)	2.1	5.54 (p)	5	28,400	311,950 (p)	3,100 (d)	6,200 (d)	3,100 (d)	Taxable Income
Ohio (a)	0.743	7.5	9	5,000	200,000	1,200 (q)	2,400 (q)	1,200 (q)	AGI
Oklahoma	0.5	6.75 (r)	8	1,000	10,000 (b)	1,000	2,000	1,000	AGI
Oregon (a)	5	9	3	2,600	6,500 (b)	151 (c)	302 (c)	151 (c)	Taxable Income
Pennsylvania	3.07		1	Flat rate			None		
Rhode Island	25% of Federal tax liability (t).								
South Carolina (a)	2.5	7	6	2,400	12,300	3,100 (d)	6,200 (d)	3,100 (d)	Taxable Income
Utah	2.3	7	6	863	4,313 (b)	2,325 (d)	4,650 (d)	2,325 (d)	Taxable Income
Vermont (a)	3.6	9.5	5	27,950	307,050 (v)	3,100 (d)	6,200 (d)	3,100 (d)	Taxable Income
Virginia	2	5.75	4	3,000	17,000	800	1,600	800	AGI
West Virginia	3	6.5	5	10,000	60,000	2,000	4,000	2,000	AGI
Wisconsin (a)	4.6	6.75	4	8,610	129,150 (w)	700	1,400	400	AGI

- (a) 14 states have statutory provision for automatic adjustment of tax brackets, personal exemption or standard deductions to the rate of inflation. Michigan, Nebraska and Ohio indexes the personal exemption amounts only.
- (b) For joint returns, the taxes are twice the tax imposed on half the income.
- (c) tax credits.
- (d) These states allow personal exemption or standard deductions as provided in the IRC. Utah allows a personal exemption equal to three-fourths the federal exemptions.
- (e) plus a 3% surtax. A special tax table is available for low income taxpayers reducing their tax payments.
- (f) Combined personal exemptions and standard deduction. An additional tax credit is allowed ranging from 75% to 0% based on state adjusted gross income. Exemption amounts are phased out for higher income taxpayers until they are eliminated for households earning over \$54,500.
- (g) The tax brackets reported are for single individuals. For married households filing separately, the same rates apply to income brackets ranging from \$500 to \$5,000; and the income brackets range from \$1,000 to \$10,000 for joint filers.
- (h) For joint returns, the tax is twice the tax imposed on half the income. A \$10 filing tax is charged for each return and a \$15 credit is allowed for each exemption.
- (i) Combined personal exemption and standard deduction.
- (j) The tax brackets reported are for single individual. For married couples filing jointly, the same rates apply to income brackets ranging from \$28,420 to \$112,910.
- (k) The tax brackets reported are for single individual. For married couples filing jointly, the same rates apply to income brackets ranging from \$4,000 to \$46,750.
- (l) The tax brackets reported are for single individuals. For married couples filing jointly, the same rates apply to income brackets ranging from \$20,000 to \$150,000.
- (m) The tax brackets reported are for single individuals. For married couples filing jointly, the same rates apply to income brackets ranging from \$8,000 to \$40,000. Married households filing separately pay the tax imposed on half the income. Tax rate is scheduled to decrease in tax year 2005.
- (n) The tax brackets reported are for single individuals. For married taxpayers, the same rates apply to income brackets ranging from \$16,000 to \$500,000.
- (o) The tax brackets reported are for single individuals. For married taxpayers, the same rates apply to income brackets ranging from \$21,250 to \$200,000. Lower exemption amounts allowed for high income taxpayers. Tax rate scheduled to decrease after tax year 2005.
- (p) The tax brackets reported are for single individuals. For married taxpayers, the same rates apply to income brackets ranging from \$47,450 to \$311,950. An additional \$300 personal exemption is allowed for joint returns or unmarried head of households.
- (q) Plus an additional \$20 per exemption tax credit.
- (r) The rate range reported is for single persons not deducting federal income tax. For married persons filing jointly, the same rates apply to income brackets ranging from \$2,000 to \$21,000. Separate schedules, with rates ranging from 0.5% to 10%, apply to taxpayers deducting federal income taxes.
- (s) Deduction is limited to \$10,000 for joint returns and \$5,000 for individuals in Missouri and to \$5,000 in Oregon.
- (t) Federal Tax Liability prior to the enactment of Economic Growth and Tax Relief Act of 2001.
- (u) One half of the federal income taxes are deductible.
- (v) The tax brackets reported are for single individuals. For married couples filing jointly, the same rates apply to income brackets ranging from \$48,500 to \$319,100.
- (w) The tax brackets reported are for single individuals. For married taxpayers, the same rates apply to income brackets ranging from \$11,480 to \$172,200. An additional \$250 exemption is provided for each taxpayer or spouse age 65 or over.
- (x) Tax rate decreases are scheduled for tax years 2005.
- (y) Tax rate is schedule to decrease to 3.9% after June, 2004.
- Source: The Federation of Tax Administrators from various sources.

Income Tax Policy Issues

This section addresses several key policy issues including the effects of income taxes on taxpayer behavior, the effects of an aging population, the issues arising from administration and compliance, and the impact of federal policy changes.

Income Taxes and Taxpayer Behavior

Taxes that cause individuals to change their work effort, savings, consumption or state of residence (among other decisions) are said to be *distortionary* taxes. Such taxes cause a loss in economic efficiency if individuals deviate from their preferred choices in response to tax policies. Income taxes (mainly the federal income tax) have received the bulk of the attention in the economic literature on behavioral responses to taxation.

Perhaps the most common area of research along these lines has been examination of the effects of income taxes on individual work hours. Income taxes essentially represent a reduction in the wage that is earned per hour of work. Some workers will respond to this by working more hours if possible, such that their after-tax income is the same as it would have been in the absence of the tax. Other workers will respond by working fewer hours, given that the reward for working has been reduced by the presence of the income tax. The conventional wisdom is that the net effect of an income tax rate increase on labor hours across all of society is very small, especially among men in their prime working years. Research has shown, however, that married women are somewhat more responsive to changes in income tax rates.

This line of research, which focuses on work hours, has been criticized in recent years for its failure to capture the true economic distortion of income taxes. The main feature of this criticism is that many aspects of a worker's daily life can change in response to changes in tax rates even though observed hours of work might not change at all. Specifically, a worker can change the type or location of her job and other job conditions either by moving or bargaining with her employer, without actually changing her work hours. More recent research has addressed this criticism by focusing on the responsiveness of *taxable income* to changes in tax rates. This literature is very new and thus far inconclusive, but results generally indicate that the elasticity of taxable income with respect to marginal income tax rates is also very small but highly variable over time.

Other research has focused on the effects of tax rates on individual savings, housing demand, the decision to engage in some form of entrepreneurial activity, and just about any other economic decision that could possibly be affected by tax rates. For two main reasons, state income taxes are likely to have little if any effect on these decisions. First, this research generally finds small behavioral response elasticities to income taxes in general.³⁴ Second, state income tax rates are much lower than federal tax rates, which have been the focus in virtually all of this research.

One behavioral response that has received a great deal of attention and is likely to be more important than those discussed above involves interstate migration in response to tax policies.

³⁴ In this context, elasticity refers to the response of behavior (such as work or savings) to price (or tax rate) changes.

Given the wide variety of tax rates across the states, as well as the fact that seven states do not have income taxes and two others have only limited taxes, it is not surprising that certain individuals—especially high-income taxpayers—might decide to relocate to a state with a lower (or no) income tax. While the conventional wisdom has long been that taxes affect location decisions, recent research by Sally Wallace (2002) casts doubt on this by showing that state income taxes are not a driving force in interstate migration decisions.

Effects of an Aging Population

It is well-known that the US population is gradually increasing in age as the baby-boom generation enters retirement. This trend has important implications for state income taxes, as retirees typically have less taxable income to report. This is especially true in states that either exempt or only partially tax Social Security and pension benefits. States that rely more heavily on income taxes might feel more of a pinch from the graying of America than states that rely more heavily on sales taxes, as retirees will continue to make purchases of sales-taxable items throughout their lives, even as their taxable incomes fall over time.

On the other hand, retirees and older taxpayers tend to have more income from non-labor sources such as capital gains, interest and dividends. States with income taxes that treat these income sources equally with wages will not be as strongly impacted by the aging of the population. States that tax only (or primarily) wages will obviously be more heavily impacted by this trend.

The overall impact of the aging population on state and local government finances must be examined in a full-budget framework, however. Potential impacts on tax and other revenues must be studied alongside the potential effects on expenditures. For example, the finding that a state's expected tax collections might fall in response to the aging population might not be as bad if older residents of that state require less government spending. This will be explored in more detail in later sections of this report.

Administration and Compliance Issues

Perhaps as a result of their many ties to the federal income tax system, state income taxes are notoriously among the most complex taxes faced by taxpayers at the state and local levels. This complexity, together with ignorance of the tax rules, outright cheating and financially strapped enforcement agencies, results in a high degree of noncompliance relative to other taxes.

States have taken various actions to counter income tax noncompliance. First, states have adopted the federal practice of income tax withholding by employers. Increased compliance is also a strong argument in favor of formal linkages to the federal tax code. With fewer state-specific tax rules, compliance is expected to be greater. Also, state revenue agencies engage in joint audit programs with the federal Internal Revenue Service. This involves sharing tax records and other data in the pursuit of tax evaders.

States have offered seemingly attractive amnesty programs, where individuals can remit back taxes due without fear of penalties or interest payments. While these programs give tax evaders peace of mind as they come clean on past tax obligations, they are also valuable sources

of data for state and federal tax authorities. Participants in tax amnesty programs essentially identify themselves as tax evaders. This information alone can help tax officials track future evasion efforts while also presumably increasing future compliance among amnesty participants. States also favor amnesty programs because they generate tax revenues.

On the other hand, amnesty programs have been criticized for a number of reasons. First, they offer somewhat lenient treatment of tax evaders. Many states have offered such tax amnesty on multiple occasions, so tax evaders might come to expect them. Consequently, amnesty programs might simply accelerate or decelerate tax evasion into the amnesty period and therefore might not raise much new revenue from individuals who did not already have some contact with tax authorities. Finally, tax amnesties can also erode confidence in the tax system if they reveal the extent of existing tax evasion.

The Corporate Tax and Business Taxes

This section examines the state corporate income tax, which is only one of many taxes that are collected from businesses. Corporate income taxes are imposed in 44 states and the District of Columbia. Other forms of general business taxes are used in several other states including Michigan, which levies a single business tax, and Texas, which uses a franchise tax. Corporate income tax rates vary across states from 4.0 percent in Kansas to 12.0 percent in Iowa.³⁵

Many economists would argue that corporate income taxes are poor revenue instruments for states because of the ease with which many firms can use accounting maneuvers to shift the tax base from one state to another and because of the potential for firms to move production to avoid the tax. Further, many states are unable to develop or maintain the technical expertise necessary to audit and enforce a tax on sophisticated, large corporations.

Businesses pay some of almost every general state and local tax, including the sales, property, gasoline, alcohol, gross receipts and transfer taxes, so care must be taken in using the corporate income tax to evaluate tax payments by business. Even the individual income tax is paid on entrepreneurial income. Other taxes are imposed only on businesses, including corporate franchise taxes and gross receipts taxes. State franchise taxes (using a variety of different names) are usually levied on the net worth or property of corporations. Cline, et al. (2004) estimated that the corporate income tax was responsible for only about nine percent of the total state and local taxes that were paid by businesses in 2003. The property (39 percent) and sales (25 percent) taxes are much larger shares of business tax burdens. In addition, businesses are often the collection point for taxes that are intended as levies on people, such as the individual income tax and much of sales and selective sales taxes.

Corporate income taxes have been a falling share of total state revenues. The corporate income tax provided 9.7 percent of total tax revenues in 1980 but had declined to 5.2 percent by 2003. The revenues are very volatile. For example, corporate taxes provided 6.6 percent of state tax revenues in 1998, down as low as 4.7 percent in 2002, and back to 5.2 percent in 2003. The corporate income tax has been a lightning rod in many states, despite the small share of total and business taxes that it represents. This is probably driven by perceptions that have arisen

³⁵ Many states impose progressive rates on corporate income, but the highest rate is reached at relatively low levels of corporate income.

from the corporate scandals involving firms such as Enron, that have used extreme forms of tax planning and other accounting maneuvers to reduce taxes and manipulate income.

The Corporate Income Tax Base

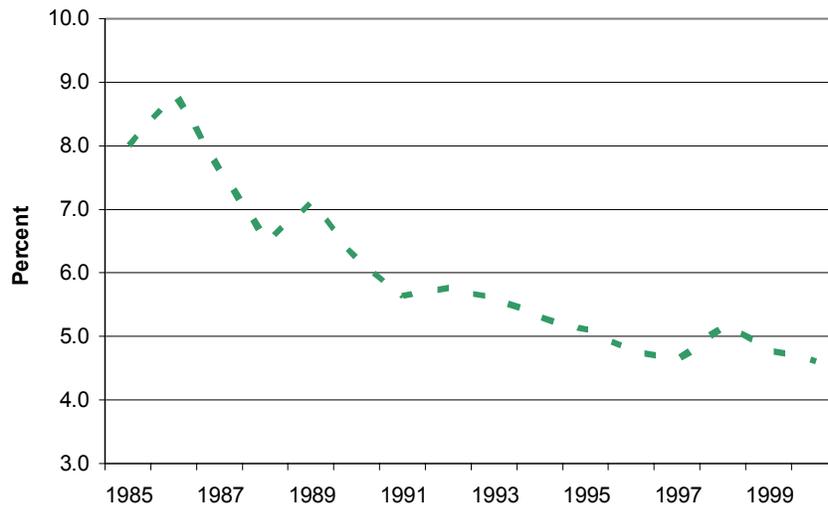
The Current Tax Structure

The corporate tax base in almost every state begins with the definition of income for federal corporate income tax purposes. States then make a series of adjustments based on various policy decisions and some constitutional restrictions. The taxable income for multi-state firms is apportioned across states using formulas that vary by state. The formula seeks to estimate the percentage of a multi-state corporation's income earned in a state based on the percent of activity that is in that state. The traditional three-factor formula, which placed equal weight in the apportionment formula on the percent of a firm's property, payroll and sales that is in the state, is now the exception rather than the rule. Over two-thirds of the states at least double-weight the sales factor. Thirteen states have sales factors that exceed 50 percent, and nine states have a single sales factor apportionment formula for at least some taxpayers (Fox et al. 2005). The intent is to lower the relative taxation of firms that produce heavily in a state and to increase the relative taxation of firms that sell heavily in states.

Corporate Tax Base Erosion

As with the sales tax, the corporate income tax base has been eroding relative to the economy and corporate profits for many years (see Exhibit 20). The effective corporate income tax rate has fallen by about one-third since the late 1980s, even as the simple average nominal tax rate rose about 0.1 percent. Thus, the effective tax rate decline must be substantially the result of an eroding taxable base relative to actual corporate profits. Three primary factors have contributed to this decline: legislated base changes, federal tax base shrinkage and tax planning.

Exhibit 20: State Corporate Tax Base Erosion: Corporate Profits Taxes as a Percentage of Corporate Profits



Source: U.S. Census Bureau

The federal tax base decline accounts for as much as 30 percent of corporate tax erosion, much of it because federal policies that narrow the federal base also reduce state bases. For example the bonus depreciation provisions enacted in 2002 and 2003 have had a dramatic impact on taxable income in those states that did not decouple from federal depreciation rules.³⁶ Similarly, the Job Creation Act of 2004 granted manufacturing deductions that will reduce the state tax bases unless states choose to decouple from these federal provisions. The deductibility of stock options for tax purposes has also reduced the corporate income tax base relative to book income, although those deductions should generally be offset by an increase in the personal income tax base.

Several types of legislated exemptions have narrowed the base, and they have often arisen from tax competition among states for increasingly mobile businesses. Tax breaks targeted at selected firms and concessions built into the tax code that are intended for all firms are granted in essentially every state.³⁷ Restructuring of the apportionment formula is another example of potential base narrowing, though in principle new apportionment could shift the tax burden between firms without actually decreasing it.

Most forms of tax planning take advantage of differences across state (or national) tax structures by shifting income from high to low tax states. For example, many businesses exploit the passive investment company (PIC) loophole by forming a PIC in states, such as Delaware, that either exclude intangible income from taxation or levy low rates. The PIC imposes a fee on related operating entities that is allowable as a deduction in many states. For example, Toys-R-Us has a PIC in Delaware that charges the operating stores a fee to use the company trademark,

³⁶ Approximately 34 states no longer conform to federal depreciation rules.

³⁷ Some overlap exists between these two groups. In some cases, states build a discretionary concession into the code but describe the characteristics of qualifying firms so narrowly that only one or a very small number of firms could possibly obtain the concession.

Geoffrey the Giraffe. The intent is to create corporate income in Delaware, a state that chooses not to tax income earned from such intangibles, and to lower corporate income in other states. The overall company corporate taxes are reduced through this strategy. Companies can also manipulate transfer prices between related firms, or charge inter-company management fees and interest expense to move profits from one state to another.

Firms create “nowhere income” by exploiting the protections provided by P.L. 86-272, which says that a state cannot assert nexus (taxable presence) over a firm whose only contact with a state is to solicit for the sale of tangible personal property.³⁸ The emergence of limited liability companies (LLCs) as a viable entity for large businesses also provides tax avoidance opportunities.

State Efforts to Lessen Tax Planning

Many states have been investigating means to lessen the effects of tax planning. Combined reporting for related entities involved in a unitary business is perhaps the best available solution for combating corporate income tax erosion. Just over 15 states use combined reporting (almost all are in the western US). Connecticut was the most recent state to add combined reporting but the legislation was quickly rescinded. In general, combined reporting ignores the existence of separate entities and taxes the business on its combined income, regardless of corporate form. The advantage of combined reporting is that transfer prices and inter-company charges (e.g., management fees, royalties and interest) are irrelevant in the tax calculation because the expenses are effectively eliminated in combination. The expectation is that combined reporting will increase overall state corporate income tax revenues, although a particular business could owe more or less, depending on the income and losses of the members of the unitary group.

Combined reporting is not a perfect solution because only worldwide combined reporting will prevent the use of non-US PICs for tax planning. Further, the Supreme Court has ruled that only companies with a unitary relationship can be combined, but there are uncertainties about what entities constitute a unitary operation. The uncertainty has led to considerable litigation.

Some states have enacted anti-PIC legislation to prevent the shifting of income. For example, 12 states deny deductions for royalties and interest paid by the “related” operating company to the holding company. However, the laws are written in different ways and are often very narrow, meaning the impacts of these provisions on tax planning will differ across states and in some cases may achieve relatively little.

The Property Tax

Economists often look favorably at the property tax, viewing it as the price residents pay to consume public services. The property tax is thus perceived as a benefit tax that promotes efficiency by aligning public services with tax payments. The public, on the other hand, has never been enamored with the property tax. Indeed, surveys often show it to be the most disliked of all major taxes. The property tax receives poor marks from taxpayers because of its

³⁸ For example, a firm headquartered in New York that only solicits sales in Massachusetts can not be taxed under the Massachusetts corporate income tax.

complexity, perceptions of unfairness (particularly with respect to farmers and the elderly), concern over the adequacy of assessment practices, and relatively large one-time annual tax payments. Despite public attitudes, the property tax remains the mainstay of local government finance in the US.

Contribution of the Property Tax to Government Finance

In the early twentieth century the property tax was the dominant revenue source for both states and localities. With the advent of state personal and corporate income taxation and with the introduction of the sales tax, relative reliance on the property tax has fallen significantly especially for state governments. In more recent times, from the late 1970s to the present, shifts in revenue reliance have been far more modest. In 1979, state and local property taxes accounted for 31.6 percent of state and local tax revenue falling slightly to 30.8 percent in 2002, as shown in Exhibit 21.

The property tax remains a critical revenue source for local governments although dependency has fallen slightly from 77.5 percent of tax revenue in 1979 to 72.9 percent in 2002. For most states the change in local revenue reliance has been modest, although there are exceptions. Arkansas cut its reliance by more than half while New Mexico reduced its reliance from 77.1 to 56.3 percent. Most localities that increased reliance did so by a small margin, although again there are exceptions, including New Jersey (from 88.5 to 98.4 percent) and Pennsylvania (from 65.8 percent to 70.1 percent). Localities in 12 states depended on the property tax for at least 90 percent of own-source tax revenue in 2002. Local governments in only three states (Alabama, Arkansas and Louisiana) and the District of Columbia relied on the property tax for less than half of tax collections in the same year.

Only 15 states make use of a statewide property tax on real property, with most choosing to tax only narrow categories of property (e.g., certain public utilities or railroads). State-level reliance on the property tax has fallen slightly from 2.0 percent in 1979 to 1.8 percent in 2002 (see Exhibit 21). Only two states (Alaska and Washington) relied on the property tax for more than 10 percent of tax collections in 1979, but by 2002 the number of states had grown to five. New Hampshire and Vermont are notable for their adoption of significant statewide property taxes in the late 1990s. In 2003 the statewide property tax accounted for 25.8 percent of taxes in New Hampshire and 26.7 percent of revenue in Vermont. For 31 states the state property tax generates less than one percent of total state tax revenue. These figures do not account for the state's role in the local property tax. For example, many states mandate local effort in support of education finance, thereby reducing local budgetary flexibility.

Exhibit 21: Property Tax Collections as a Percentage of Total Tax Collections

	1979			2002		
	State	Local	State and Local	State	Local	State and Local
US Total	2.0	77.5	31.6	1.8	72.9	30.8
Alabama	2.5	38.2	11.6	3.0	39.8	15.2
Alaska	19.9 *	79.8	32.4	4.6	79.6	40.1
Arizona	7.6	79.5	35.2	3.9	66.0	29.5
Arkansas	0.2	89.9	21.1	9.3	41.8	15.5
California	3.8	70.9	25.2	2.5	66.3	25.1
Colorado	0.3	71.8	33.6	0.0	59.7	29.9
Connecticut	0.0	98.9	45.1	0.0	98.4	39.6
Delaware	0.0	86.7	16.0	0.0	77.9	14.9
District of Columbia	-	24.2	24.2	-	24.9	24.9
Florida	1.8	83.0	32.0	1.7	78.6	35.1
Georgia	0.3	76.2	27.9	0.4	64.0	27.6
Hawaii	0.0	80.3	16.0	0.0	75.1	14.5
Idaho	0.0	97.1	31.9	0.0	94.0	29.1
Illinois	0.1	80.2	35.0	0.3	82.8	38.2
Indiana	0.8	95.3	33.0	0.1	88.0	35.2
Iowa	0.0	96.0	37.9	0.0	86.6	34.5
Kansas	1.5	92.9	40.7	1.1	78.0	31.7
Kentucky	7.8	56.9	17.7	5.5	54.9	18.3
Louisiana	0.0	40.8	12.8	0.5	39.5	15.9
Maine	2.3	99.3	37.9	1.8	97.4	42.1
Maryland	2.8	62.2	26.2	2.5	56.8	27.2
Massachusetts	0.0	99.3	46.4	0.0	96.1	36.5
Michigan	2.1	91.5	35.8	8.6	90.0	32.0
Minnesota	0.1	95.6	28.4	2.3	93.8	28.3
Mississippi	0.4	94.4	21.6	0.0	91.7	25.2
Missouri	0.2	65.4	28.3	0.2	60.4	25.7
Montana	6.2	96.4	45.3	12.6	96.9	39.9
Nebraska	0.5	91.2	43.4	0.2	75.0	32.9
Nevada	6.8	66.4	31.5	2.9	63.9	26.5
New Hampshire	2.8	98.3	59.0 *	26.4	98.0	60.3 *
New Jersey	2.2	88.5	47.4	0.0	98.4 *	46.3
New Mexico	2.4	77.1	15.8	1.5	56.3	15.5
New York	0.1	67.7	35.2	0.0	58.8	30.2
North Carolina	1.5	81.1	22.9	0.0	77.0	24.0
North Dakota	0.8	96.4	34.0	0.1	86.8	30.8
Ohio	2.9	73.4	33.9	0.1	66.3	29.4
Oklahoma	0.0	65.3	19.8	0.0	54.3	16.9
Oregon	0.0	89.6	38.2	0.5	81.1	34.9
Pennsylvania	0.7	65.8	24.9	0.2	70.1	29.0
Rhode Island	1.1	99.0	40.9	0.1	97.7	40.4
South Carolina	0.3	93.1	22.2	0.2	84.2	31.8
South Dakota	0.0	89.3	46.3	0.0	77.2	36.3
Tennessee	0.0	64.2	23.4	0.0	66.7	26.6
Texas	0.9	84.3	36.5	0.0	80.9	41.6
Utah	0.0	77.7	28.6	0.0	67.6	23.6
Vermont	0.1	99.4 *	39.8	25.7 *	96.9	41.9
Virginia	0.9	67.9	27.4	0.2	71.6	30.3
Washington	15.6	66.9	31.1	11.5	62.9	29.7
West Virginia	0.1	80.7	16.9	0.1	82.3	19.4
Wisconsin	3.0	98.5	33.9	0.8	93.8	34.7
Wyoming	5.9	88.4	39.7	13.2	75.7	38.1
Mean	2.2	80.6	31.2	2.9	74.9	30.3
Median	0.8	81.1	31.9	0.2	77.0	30.2

Note: * denotes the high in each column.

Source: US Census Bureau.

*The Structure of the Property Tax*³⁹

The property tax is a levy on the *stock* of property wealth, whereas most other taxes are levied on *flows*, including transactions (e.g., sales) and corporate and personal income. Depending on the taxing jurisdiction, the base of the property tax may include some combination of real property (land and structural improvements), personal property (all tangible property that is not real property, including equipment) and intangible property (e.g., financial assets). In practice most personal property held by households and most intangible property is excluded from the base. Assessment of most property is made by local assessors under some form of state oversight to ensure uniformity within and across substate taxing jurisdictions.

Centrally-assessed property, i.e., certain public utility property, is often assessed at the state level in part because of the unique expertise required to conduct such assessments. This includes natural gas, electric utility, telecommunications and railroad property. These sectors were traditionally viewed as natural monopolies⁴⁰ and were subject to heavy property tax burdens that were not transparent to consumers, even though consumers are believed to bear the burden of such taxes. Changes in technology, successful legal challenges regarding uneven classification systems, deregulation, and increased competition have put downward pressure on property values and the ability to extract high property tax payments. These trends will continue, as with the emerging VOIP telephone service available on the Internet that gives rise to an elusive property tax base and puts additional pressure on traditional telecommunications firms. The policy response varies by jurisdiction, but there has been some tendency to shift revenue reliance towards taxes on transactions.⁴¹

Intangible property like stocks and bonds are often afforded exempt status. The reasons vary but include concerns over tax compliance, costs of administration and enforcement, litigation associated with separating intangible assets from tangible property, and the ability to tax income flows from intangibles through the income tax.

Fewer than half the states use a classification system wherein different classes of property—residential, commercial and industrial, utility, agricultural and personal—may be assessed at different rates. Classification systems reduce the base below market value and treat different types of property differently for tax purposes. For example, an assessment ratio of 50 percent means only one-half of the property value is actually subject to tax. Residential and agricultural property is typically assigned low assessment rates relative to other classes of property. In some instances there is no state classification system but localities may differentiate assessments across certain classes of property. The presence or absence of a classification system is generally a reflection of a state's constitution.

Tax rates ultimately are applied to the property tax base to yield tax liability. In some local jurisdictions there may be a single property tax rate whereas in other jurisdictions there

³⁹ This section draws extensively on NCSL (2002a), NCSL (2002b) and NCSL (2004). Also see Fisher (1996).

⁴⁰ A natural monopoly means that the average cost of production falls as more output is produced. This enables a single firm to produce the same output at lower cost than having several firms produce the same level of total output.

⁴¹ For example, in 2000 Montana reduced its assessment on electric generation facilities and implemented a tax on wholesale energy transactions. To help level the playing field, Illinois has chosen to change the basis for electric utility taxation from cost minus depreciation to fair market value (Seaman and Hildreth 2003).

may be numerous rates reflecting school districts, general government (e.g., counties and cities), and any special taxing authorities (like utility districts). The tax rate is often stated in terms of *millage* where one mill is equivalent to \$1 dollar of tax per \$1,000 of property. For example, a millage of 2.0 translates into a \$200 tax liability for a property with assessed value of \$100,000.

There are provisions that may yield property tax reduction for certain residential taxpayers. These provisions arise because of concerns regarding equity and the ability to pay taxes from current-year income. Common are homestead exemptions (an exempt amount of property for residential property owners) and circuit breakers (where the maximum tax liability is inversely linked to household income). Virtually all states offer some variant of a homestead exemption while 34 states provided a circuit breaker program in 2002. Homestead exemptions benefit all households while circuit breakers target relief (and thus foregone revenue) to lower-income households. There are programs in some states that are confined to particular groups like the elderly, the disabled and renters. The states commonly hold local governments harmless for losses in revenue, using the state's relatively broader tax capacity to fund property tax equity provisions.

Business property also may benefit from special provisions in the property tax system with the intent of improving competitiveness and promoting development. Some of these mechanisms are available to broad classes of business, like the inventory exemption available in most states. Others are more focused as with the exemption of manufacturing equipment (a form of personal property). The general trend has been towards broader exclusion of tangible business property to promote economic development. More focused still are many incentive programs, including abatements (which tax property at lower rates) and exemptions (that provide tax free status to property). An Enterprise Zone is another development tool, one that offers tax breaks to qualified investments. But they are focused on distressed regions rather than specific taxpayers or types of business.

Property held to promote the public interest—including that held by government, health care providers, religious organizations, charities and educational institutions—typically benefits from exempt status.⁴² There are concerns regarding the scope of these exemptions as they effectively reduce tax capacity and may create fiscal stress for local governments (Mullen 1990). The amount of exempt property varies substantially across jurisdictions, although precise data are not available for all states. For example, exempt property in Wisconsin in 1998 was 5.9 percent of total taxable property, while in New York City exemptions were nearly 45 percent of assessed value in 1999. While the evidence is limited, Netzer (2003) argues there has not been significant growth in exempt property in recent years.

Effective Tax Rates

All of the nuances associated with the local property tax make it exceedingly difficult to compare tax burdens across jurisdictions. But burden differentials are potentially important as they may influence residential and business location choices, as well as the magnitude of

⁴² The federal government generally makes payments in lieu of taxes, or PILOTs, for its property holdings.

investments in property.⁴³ Simple comparisons of *nominal* tax rates are largely meaningless. Alternatively *effective* tax rates account for key facets of the property tax that vary across jurisdictions, like classification systems, and enable comparison of actual tax burdens confronted by taxpayers. Estimates of effective property tax rates are ideally expressed in terms of taxes as a percent of market value. There are very few estimates of effective property tax rates across local taxing jurisdictions.

Exhibit 22 provides an illustration for five different types of property using two different data sources. The study undertaken by the District of Columbia (DC) estimates the effective tax rate for a hypothetical family of four in the largest city of each state. Since the focus of the DC study is taxpayer equity, housing values across states are estimated based on a common assumed level of household income, producing variation in housing values from \$120,000 in Kansas to \$515,000 in Hawaii. The estimated variation in rates is rather dramatic, ranging from a low of 0.38 in Hawaii to a high of 3.88 in Rhode Island. The mean and median rates across all states and the District of Columbia are 1.65 and 1.50.

Selected results from the latest study by the Minnesota Center for Public Finance Research (MN) are shown in the remainder of the exhibit. This study differs in intent from the DC study by focusing on how variations in property tax *systems* (rather than household income) affect property tax liabilities. Hypothetical properties and the actual characteristics of state and local property tax systems are used to isolate property tax burdens. For “lower-valued residential property,” which assumes \$70,000 of real property and \$10,000 of personal property, the average effective rate is 1.23. Connecticut has the highest rate (3.00) while Massachusetts enjoys the lowest rate (0.09). The remaining columns reflect taxes on businesses and apartments, exclusive of any tax incentives. There is some propensity for effective rates to be high (or low) across property types but there certainly are exceptions. The estimates generally show higher effective tax rates on business property versus residential property.

⁴³ Households and businesses presumably consider property tax burdens as well as public service benefits like school quality when making location and investment decisions.

Exhibit 22: Effective Property Tax Rates, Residential and Business Property

	Residential Property (largest city)				Urban Property (largest city)					
	\$80,000 Market Value				Commercial \$1 Million		Industrial \$1 Million		Apt. - \$600k Land & Bldg / \$30k Fixtures	
	2003 ¹		2002 ²		2002 ²		2002 ²		2002 ²	
	Eff. rate	Rank	Eff. rate	Rank	Eff. rate	Rank	Eff. rate	Rank	Eff. rate	Rank
Alabama	0.7	48	0.5	46	1.39	41	1.15	39	1.36	33
Alaska	1.62	25	1.43	21	1.65	33	1.67	25	1.64	25
Arizona	1.17	37	1.02	27	3.41	5	2.87	6	1.4	31
Arkansas	1.38	30	0.71	40	1.27	42	1.31	33	1.25	36
California	1.08	44	0.98	30	1.25	43	1	43	1.25	37
Colorado	0.53	50	0.47	47	1.7	31	1.36	32	0.59	50
Connecticut	3.86	2	3	1	4.11	2	3.34	1	4.07	2
Dist. of Columbia	0.96	46	0.44	48	1.97	27	1.86	20	0.91	48
Delaware	1.45	27	1	29	0.97	48	0.58	50	1.11	43
Florida	1.94	13	1.45	20	2.58	16	2.06	13	2.58	11
Georgia	1.79	17	0.6	45	1.65	32	1.72	21	1.63	26
Hawaii	0.38	51	0.14	49	0.77	50	0.47	51	0.4	51
Idaho	1.75	18	0.72	39	1.56	35	1.28	35	1.53	28
Illinois	1.69	23	2.06	6	5.63	1	3.2	2	5.58	1
Indiana	2.17	10	1	28	1.94	29	2.36	8	1.76	24
Iowa	2.17	9	1.64	16	3.19	7	2.02	16	3.64	4
Kansas	1.31	34	1.03	25	2.65	15	2.84	7	1.34	35
Kentucky	1.21	36	0.77	38	0.94	49	0.68	49	0.92	47
Louisiana	1.75	19	0.09	50	2.28	21	2.33	9	1.6	27
Maine	1.75	20	1.78	12	2.34	20	1.92	19	2.3	15
Maryland	2.46	8	1.92	8	2.81	10	1.4	30	2.38	14
Massachusetts	1.33	32	0.09	51	2.86	8	2.17	11	0.93	46
Michigan	1.82	15	2.36	2	3.93	3	3.18	3	3.91	3
Minnesota	1.32	33	0.68	42	2.82	9	1.69	24	1.78	23
Mississippi	1.69	22	1.02	26	2.54	17	2.03	15	2.54	12
Missouri	1.16	39	1.18	23	2.77	12	2.18	10	1.4	30
Montana	1.62	24	0.96	32	1.42	38	1.19	37	1.11	42
Nebraska	2.03	12	1.7	15	1.98	26	1.62	26	1.99	22
Nevada	1.09	43	0.96	33	1.11	46	0.9	46	1.09	44
New Hampshire	2.57	6	2.05	7	1.95	28	1.17	38	2.23	17
New Jersey	2.96	3	1.81	11	2.46	18	1.48	29	2.81	8
New Mexico	1.27	35	0.92	34	1.39	40	1.14	40	1.18	41
New York	1.12	41	1.47	19	3.5	4	2.1	12	3.59	5
North Carolina	1.13	40	1.04	24	1.21	45	0.99	44	1.2	39
North Dakota	2.12	11	1.74	13	1.77	30	1.06	42	2.03	20
Ohio	1.45	28	1.2	22	1.58	34	1.72	22	1.49	29
Oklahoma	1.16	38	0.91	35	1.24	44	1.38	31	1.19	40
Oregon	1.79	16	1.86	10	2.12	24	1.7	23	2.12	18
Pennsylvania	2.64	4	2.25	4	2.14	23	1.28	34	2.45	13
Rhode Island	3.88	1	1.73	14	3.4	6	2.01	17	3.45	6
South Carolina	1.4	29	0.8	37	2.2	22	2.97	4	2.07	19
South Dakota	1.5	26	1.49	18	1.99	25	1.2	36	2.28	16
Tennessee	1.73	21	1.54	17	2.69	13	2.04	14	2.78	9
Texas	2.62	5	2.2	5	2.81	11	2.94	5	2.87	7
Utah	1.36	31	0.69	41	1.4	39	1.13	41	1.4	32
Vermont	1.86	14	1.86	9	2.35	19	1.96	18	2.02	21
Virginia	1.11	42	0.97	31	1.54	36	0.99	45	1.23	38
Washington	0.99	45	0.85	36	0.98	47	0.8	47	0.97	45
West Virginia	0.88	47	0.61	44	1.52	37	1.61	27	1.35	34
Wisconsin	2.53	7	2.26	3	2.69	14	1.56	28	2.69	10
Wyoming	0.67	49	0.63	43	0.72	51	0.7	48	0.72	49
Mean	1.65	-	1.23	-	2.14	-	1.69	-	1.92	-
Median	1.5	-	1.02	-	1.98	-	1.62	-	1.63	-

1. Source: Tax Rates and Tax Burdens in the District of Columbia - A Nationwide Comparison, 2003. Government of the District of Columbia, 2004.

2. Source: 50 State Property Tax Comparison, Payable Year 2002. Minnesota Center for Public Finance Research, 2003.

Property Tax Elasticity, Stability and Buoyancy

There is strikingly little evidence on the way in which the underlying property tax base responds to growth in personal income and the economy. One reason is the relatively weak linkage between property values (a stock) and personal income (a flow) as compared to other taxes like the sales tax and income tax. There is also the practical difficulty of controlling for variations in tax rates, assessments, tax limitations and so on across time and place, all of which can influence the base and collections. The consensus that emerged in the 1960s has not been seriously challenged: the long-run elasticity of the base with respect to income is roughly 1.0 while the short-run elasticity is less than 1.0. This conclusion is supported by a recent study in Washington that estimated the long-run elasticity to be between 1.0 and 1.2 and short run elasticity to be 0.2 (State of Washington, 2002). Thus, on average the property tax base appears to grow at the about the same rate as state economies.

There are important caveats to this conclusion. First, substantial differences in elasticity and stability across classes of property are likely, even though empirical evidence to support this conclusion is scant. Second, there may be significant differences in elasticity across jurisdictions, including jurisdictions in a single state, due to structural differences in the property tax and the economy. Finally, estimates of the response to economic growth can be expected to vary depending on whether revenue, assessed value or market value elasticities are estimated.

Buoyancy is an alternative means of measuring the responsiveness of the property tax. Buoyancy estimates encompass the influence of the economy, behavioral responses to policy, and importantly the structure of policy itself, like changes in tax rates or the introduction of a tax limitation. (Recall that elasticity is measured in such a way as to be independent of policy changes.) In practice buoyancy is calculated by dividing the change in property tax revenue by the change in personal income. Measures of property tax buoyancy show dramatic variation across states and time, as one would expect. Over the long-run period from 1983 to 2002 the buoyancy of the state and local property tax averaged 0.99, reflecting a buoyancy of 1.0 for the local property tax and 0.91 for the state property tax. Some states restructured their state property taxes yielding particularly large measures of buoyancy, including Arkansas, Minnesota, New Hampshire, Oregon and Vermont. The highest buoyancy at the local level for this time period was in Kentucky (1.58). The short-run buoyancy (calculated for individual years) for the local property tax in 1990-91 was 1.26 versus 1.13 in the slow-growth period from 2000 to 2002.

Financing Education

Prior to the 1970s, local governments contributed more than the states to the financing of elementary and secondary education. By 2002, local governments contributed 42.8 percent, state governments contributed 49.4 percent, and the federal government accounted for the remaining 7.8 percent of total funding. At the local level, the property tax is by far the dominant source of education funding in most states. Hawaii is unique as the state has assumed responsibility for funding education yielding a negligible contribution from local government.

The local government contribution to education funding is typically an important determinant of the property tax rate. Educational expenditure needs are evaluated, various external funding sources (e.g., state aid) are considered, and the local property tax rate is then set

to fund service delivery. State funding usually flows through a formula-based system like a foundation grant program. The term foundation is intended to reflect a funding base upon which local contributions can build. Funding from the federal government is generally targeted to needy students, for example, the disabled and those with nutritional needs. States have increasingly mandated local contributions for education finance.

Most states have seen some form of legal challenge to their funding mechanism for elementary and secondary education in the past 30 years. The process began with the now-famous *Serrano v. Priest* case in California in 1971. At the core of these challenges has been a fundamental concern over property wealth (i.e., tax *capacity*) disparities at the local level and the resulting inequities in funding across local school districts. Many state constitutions have equal protection clauses that have been interpreted as requiring some degree of funding equity at the local level. The courts have responded to the challenges by deeming numerous state education funding mechanisms to be unconstitutional. The fiscal consequence has been a rise in state funding and greater attention to formula-based schemes that reduce or neutralize the effects of wealth disparities at the local level. Jurisdictions with greater capacity thus receive relatively less state aid while jurisdictions with lower capacity receive relatively more aid. Under some programs, wealthier jurisdictions may lose some share of incremental own-source revenue derived from increasing local property tax effort. This is intended to stave off further inequities in funding. More recent court challenges have turned to the issue of funding adequacy rather than funding equity.

Michigan and New Hampshire are examples of states that have struggled with education finance reform in recent years. Michigan voters passed a resolution in 1995 that reduced local reliance on the property tax and raised the state sales tax rate from four to six percent. One result is that the property tax contribution to education finance in Michigan was halved. New Hampshire, on the other hand, ultimately adopted a statewide property tax to help fund schools following a 1997 state supreme court decision. In 1999, New Hampshire's state property tax accounted for only 0.1 percent of state and local tax revenue but jumped to 27.9 percent of total tax revenue in 2000.

The Property Tax Limitation Movement

The increased state role in financing education has proven to be unpopular in some places because it generally entails some form of redistribution from richer to poorer school districts. A more subtle consequence is that the traditional benefit tax linkage between the local property tax and local service delivery has been frayed if not severed. This more tenuous linkage has been argued to be an important cause of the property tax limitation movement (Fischel 1996). But there are certainly other causes for imposition of the constraints, including general concerns over rising tax burdens and more specific concerns over rising property tax burdens, especially in rapidly growing communities where existing residents have confronted sharp increases in property tax liabilities.

The property tax limitation movement had its modern genesis in Proposition 13, passed in California in 1979. The assessed value of property in California cannot increase more than two percent per year until it is sold, whereupon assessed value reverts to market value. Most states have some limit on property taxes or on local government spending; only Hawaii, Maine, New

Hampshire and Vermont have no limits (NCSL 2002). All of the eight states that impose expenditure limits also have some form of constraint on the property tax as well. In some instances the expenditure limit is linked to inflation plus population growth as in Colorado. A criticism of such constraints is that they preclude growth in real spending and thus limit the quality of service delivery. Of course the intent of the limitations is to rein in spending growth. Mechanisms for overriding constraints through referenda and other means are common.

Limits on the property tax may apply to tax rates or growth in assessments and may entail assessment rollbacks or tax freezes. A limit on the tax rate alone may have little effect on tax burdens absent a limit on assessments. While 38 states have rate limits and 19 have assessment limits, only 13 states make use both of rate and assessment constraints. Tax rate limits include freezes on the rates themselves and constraints on growth in the rates, as well as constraints on taxes as a percent of market value. Limits on assessment growth (such as Proposition 13) generally apply until a parcel is sold, protecting existing property owners, but creating a lock-in effect that discourages sales and produces tax burden inequities with respect to market value.

Rollback provisions are present in 15 states and generally apply when property is re-assessed and assessments grow substantially. In such cases millages are reduced to avoid an increase in tax liability. Property tax freezes are targeted property tax relief schemes. Twelve states have such programs, linked to household income or to elderly status.

Selective Sales Taxes

States and some localities impose selective excise taxes on a variety of economic activities, such as tobacco products and motor fuel. Selective sales taxes, as defined by the US Census Bureau, fall on alcoholic beverages, motor fuels, pari-mutuels, tobacco products and “other” products. Individually these taxes may produce little revenue, as with taxes on cigars or chewing tobacco. In other instances, including taxes on gasoline and diesel fuel, the revenues are substantial and represent an essential source of state revenue. Collectively, selective sales taxes accounted for 12.4 percent of state and local tax revenue in 1982, slipping to 11.2 percent in 2002. The taxes generally represent a larger share of state tax revenue than local tax revenue.

All states impose sumptuary or sin taxes on cigarettes, alcohol, beer and wine either directly, or in the case of alcohol and wine, potentially indirectly through state-operated monopolies and the profits they generate. (Most states apply sales tax to the excise-tax inclusive price of these goods.) The levies are generally unit-based taxes on quantity rather than ad valorem taxes. For example, spirits are taxed on a per gallon basis rather than on the wholesale or retail price of a gallon of liquor. A consequence is that rising prices do not expand the base of these taxes. Price increases will tend to slow or potentially erode the tax base over time depending on how responsive consumers are to price changes. Indeed, demand has grown slowly with the passage of time as consumers have become increasingly health conscious. The combination of quantity-based taxes and slow demand growth has yielded an inelastic (slow growing) set of taxes.

Excise taxes are typically imposed at the wholesale level at least in part because this is believed to promote tax compliance. Wholesale levies also entail lower costs of compliance and administration than retail levies that encompass a much larger number of firms. Enforcement is

facilitated by the use of stamps for tobacco products, liquor and wine and red dye to identify tax exempt diesel fuel.

Since demand for these products often responds relatively little to price increases, taxes do little to curtail consumption, contrary to common claims. While revenue growth over time may be modest, tax increases can at any point in time yield a predictable amount of revenue. State legislatures across the country took advantage of this fact and sharply increased their sin taxes to help plug budget shortfalls brought about by the recession of 2001.

High tax rates have several other effects. For example, the high prevailing tax rates yield a regressive tax burden for consumers. High tax rates also encourage border shopping and promote tax evasion activities. This has proven to be the case with cigarettes. Enforcement problems have arisen from smuggling and tax exempt sales, including the importation of cigarettes from Canada and sales of cigarettes on Indian reservations—aggravating a longstanding problem.

The median excise tax rate on cigarettes was 60 cents per pack in 2004.⁴⁴ Rates tend to be lower in tobacco producing regions and much higher in the northeastern states. For example, the rates in Virginia, North Carolina and Kentucky were only 2.5 cents, 5.0 cents and 3.0 cents per pack in 2004, while New Jersey and Rhode Island imposed tax rates of \$2.05 and \$1.71 per pack. Local option taxes are enabled in Alabama, Illinois, Missouri, New York, Tennessee and Virginia. Other tobacco products, including cigars, snuff and chewing tobacco, are commonly subject to special levies.

Eighteen states directly control liquor sales and generate revenue primarily from profits. A variety of taxes may fall on alcohol and wine in those states that allow sales by independent vendors, although the excise tax is typically most important. For these states the median excise tax rate on distilled spirits was \$3.75 per gallon in 2004, ranging from a low of \$1.50 in Maryland to \$6.50 in Florida. Special on-premises excise taxes and differential taxes based on alcohol content apply in some states. The median levy on wine was 64 cents per gallon in 2004. Florida had the highest rate (\$2.25 per gallon) while the lowest rate was in Louisiana (11 cents per gallon). Like spirits, other special levies may apply, including much higher tax rates on fortified wine products. Excise taxes on beer vary from only two cents per gallon in Wyoming to a high of 92 cents per gallon in Hawaii. Additional wholesale and on-premises retail taxes apply in a number of states.

Excise taxes on gasoline and diesel fuel share many of the characteristics of sin taxes. They are unit levies applied at the wholesale level, tax base growth is inelastic (in large part because of improved vehicle fuel economy), tax burdens are generally regressive, a small number of states enable local option add-on taxes, and exempt sales of gasoline on Indian reservations has proven to be a compliance problem. But there are significant differences as well. Most importantly, it is less common for the general sales tax to apply to the sale of petroleum products, and excise tax revenues are usually earmarked for support of transportation infrastructure. Earmarking reflects the perspective that petroleum levies are a form of benefit taxation. (Earmarking also creates budgetary inflexibility, limiting the ability to move funds

⁴⁴ The tax rate data in this section are drawn from the Federation of Tax Administrators (www.taxadmin.org).

across programs and expenditure areas.) Motor fuel taxes were 6.0 percent of state tax revenue in 2002 and represented only 0.3 percent of local tax revenue in the same year. Excise taxes on diesel fuel used by interstate carriers are apportioned across states based on mileage.

Excise taxes on petroleum products show wide variation across the states. For gasoline, Rhode Island and Wisconsin had the highest taxes in 2004 (30 cents and 28.5 cents per gallon), while the lowest rates prevailed in Florida (4 cents per gallon) and Alabama (8 cents per gallon). Diesel fuel excise tax rates vary from 7.5 cents per gallon in Georgia to 28 cents in Wisconsin. Nineteen states impose an additional tax on gasoline and diesel fuel, varying from 0.03 cents in Missouri to 14.6 cents in New York (for diesel fuel). These additional taxes may serve several different purposes including inspection fees and environmental remediation. Only nine states apply sales tax to petroleum product sales.

Other Revenue

States and localities derive revenue from a number of other tax and nontax sources, including intergovernmental aid, inheritance/estate/gift taxes, impact taxes and fees, realty transfer taxes, charges, gaming revenue, public service enterprises like liquor stores, and insurance trust funds.

Intergovernmental Aid

By far the most important source of nontax revenue to states and localities is intergovernmental aid. Federal aid to state and local governments was 19.9 percent of total revenue, 21.4 percent of general revenue and 27.2 percent of general own-source revenue in 2002. There is considerable variation in the relative contribution of federal aid to state and local finance across individual states, with poorer jurisdictions typically in receipt of greater assistance. Federal aid is generally tied to specific programmatic areas like transportation and education leaving little room for direct substitution to other spending areas. For localities, aid from higher levels of government was 36.8 percent of total revenue and exceeded collections from the property tax by a wide margin in 2002.

Inheritance/Estate/Gift Taxes

In addition to the property tax, states have long used three other methods of taxing wealth accumulation: inheritance taxes, estate taxes and gift taxes. Inheritance taxes—the oldest of the three—are levied on recipients of bequests at graduated rates. Inheritance tax rates are typically set such that taxes are lower (or zero) for closer relatives such as spouses and children and higher for more distant relatives. Estate taxes are also levied at graduated rates but on the estates of deceased individuals. Gift taxes are levied on transfers of wealth between two living parties and are intended to stave off efforts to avoid estate and inheritance taxes. Gift taxes are similar to inheritance taxes but are paid by donors rather than recipients. These taxes are intended to break up large holdings of wealth and reduce inequality but can also promote charitable contributions and increase work effort among heirs.⁴⁵

⁴⁵ For an exhaustive review of these and other issues, see US Congress Joint Economic Committee (2003).

These so-called “death taxes” typically contribute less than one percent of all state taxes, but they receive a significant amount of attention due to extensive efforts to avoid them through aggressive tax planning activities. Given significant cross-state differences, death taxes have potentially significant effects on interstate migration of retired people. It is also hypothesized that death taxes have negative effects on small businesses and family farms, although evidence has been mixed on this issue. All of these concerns, alongside robust state tax revenue growth in the 1990s, likely have played a significant role in the overall deterioration of estate, inheritance and gift taxes as a state revenue source.

So-called “death taxes” were used primarily by state governments during the 1800s and have remained in effect in many states since those early days.⁴⁶ The federal estate tax was not instituted until 1916, although earlier death taxes were instituted to provide short-term funds for war efforts. Legislation passed in 2001 started the process of gradual repeal of the federal estate tax that will become final in 2010. However, unless Congress acts to make this repeal permanent, the federal estate tax will resume its 2002 form in 2011. This uncertainty has affected policy planning among state governments.

At the heart of this uncertainty is the fact that the federal estate tax allows an exemption for a certain amount of estate taxes paid to state governments. Seeing this as essentially free money, all states instituted what are called “pick-up” taxes in order to capture a large part of the federal estate taxes that would have been paid anyway. Unfortunately for state revenues, the federal credit for state estate taxes paid is set to be eliminated completely by 2005. Only 12 states had an inheritance, estate or gift tax beyond the pick-up tax as of the passage of the federal repeal, and two of those states have since acted to repeal them. However, given the impending loss of pick-up tax revenues if the federal repeal becomes permanent, 17 states had formally decoupled from the federal estate tax as of January 2004 in order to preserve this revenue source (McNichol 2004). Most of these de-coupling efforts were undertaken during lean state revenue years, so it remains to be seen whether state death taxes will survive as revenues rebound.

Impact Taxes and Impact Fees

Impact taxes and impact fees are similar in that they are one-time levies paid by developers to local governments. Their use has accelerated in the last 20 years due to population growth, pressures on public infrastructure and insufficient local own-source general tax revenue. (Insufficiency is more related to political opposition to property tax rate increases than to tax capacity.) Impact taxes and fees differ in important ways, including the legal authority for granting their use, the nature of the tax versus fee schedule and the uses to which revenues are put (NCSL 1999). Generally the authority to enable *taxation* is granted by legislative act or through a state constitution. *Impact fees*, on the other hand, are enabled through the regulatory power of subnational governments. Impact taxes need not be linked in any direct way to the costs associated with new development, and revenues may be used to fund general government activity. Impact fees are a form of *exaction* and as such must be carefully set so as to be roughly proportional to new development costs; impact fee revenue must be earmarked to fund such costs. These costs are generally related to off-site infrastructure development impacts, including

⁴⁶ See Conway and Rork (2004) for an excellent history of state death taxes and a review of the associated literature.

water, sewer, school and public safety facilities. There has been considerable litigation over the authority to implement impact fees and the way in which impact fees themselves are structured.

Impact fees in particular are intended to generate revenue to help fund public sector infrastructure costs associated with development and potentially slow the speed of development itself. Advocates argue that fees offer a means of pay-as-you go infrastructure finance and can help control where development takes place. Critics contend that the levy increases housing costs, contributes to sprawl and effectively subsidizes existing residents who also benefit from infrastructure expansion. There is merit to both sides of this debate. Since existing residents dominate the local political process, the use of impact fees will likely continue to grow. A recent National Association of Realtors[®] report indicates that impact fees are in place in 25 states.⁴⁷

Realty Transfer Taxes

Many states, counties and cities levy special taxes on realty transfers and the issuance of mortgages. These levies fall under a variety of headings, including realty transfer taxes, documentary stamp taxes, deed transfer taxes and mortgage taxes. The legal incidence of the tax may fall on buyer or seller depending on the jurisdiction. The taxes were originally nominal charges for the recording of property transactions, as suggested by the name “stamp tax.” But policy intent in many jurisdictions has broadened with the passage of time to include revenue generation.

Thirty-seven states and the District of Columbia enable realty transfer taxes (NAR 2003). The tax is usually a small percentage of property value, although the rate exceeds one percent in the District of Columbia and in six states. Proceeds may be deposited into a general fund, although they are often earmarked for specific purposes such as parks and open spaces. Revenue performance is closely linked to the vitality of the real estate market. The taxes may raise property costs and may slow development as well. Like impact fees, they treat existing (unsold) property differently than newly sold property, so they often have appeal to existing residents and voters.

Charges

Charges are user fees for the delivery of specific services. They apply to a wide range of activities, including education (tuition), roads, airports, parks, solid waste management and sewer. The services are often directly provided by government entities or through private parties with government oversight.

User fees are most appropriate for services wherein the benefits accrue directly and specifically to the consumer, as with fees for road usage and sewer services. In such cases they work like the price system to ensure that people confront the full costs of the services and benefits they receive, thereby ensuring that consumption is aligned with the cost of the service. User fees and charges have proven to be an increasingly attractive revenue source in the face of resistance to broad-based taxation. A criticism of user fees is that they disregard ability to pay and may yield a regressive tax burden.

⁴⁷ See <[www.realtor.org/SG3.nsf/files/ImpactFeeRates2002.pdf/\\$FILE/ImpactFeeRates2002.pdf](http://www.realtor.org/SG3.nsf/files/ImpactFeeRates2002.pdf/$FILE/ImpactFeeRates2002.pdf)>.

Gaming Revenue

Gaming revenue can come from several sources. First are taxes and fees on parimutuel betting which are categorized by the US Census Bureau as selective sales taxes. These levies represent an inconsequential source of funds for both states and localities. Second are taxes on casinos, which are classified as amusement taxes. Thirteen states derived revenue from taxes on casinos in 2004.⁴⁸ The casino taxes are typically based on a measure of gross receipts; progressive rate structures are applied in six states. Revenues are commonly earmarked for specific uses. Because of the unique status of Indian casinos, they cannot be subjected to state taxation. Indian casinos are sanctioned in 27 states, and seven of these states have established revenue sharing arrangements with Indian nations.

A third source of gaming revenue is the lottery. Net lottery proceeds—receipts minus administrative expenses and prize payouts—are classified as miscellaneous general revenue. These proceeds are a much more substantial source of revenue and are typically earmarked for specific purposes, notably education, although some states deposit receipts into a general fund or earmark for welfare and public projects. Lotteries have become increasingly attractive and most states now have one in place. Profit-to-sales ratios can be substantial and generally hover around 30 percent (Murray et al. 2003). Lottery revenues are generally inelastic. Aggressive marketing campaigns and the creation of new games are used to maintain interest and sustain receipts. The embedded lottery tax (i.e., the amount of lottery receipts retained to fund government services) is regressive and the uses to which lottery proceeds may be put can favor middle and higher income households (e.g., merit-based scholarships). Lottery sales may drain taxes away from other transactions, including the general sales tax and selective sales taxes on tobacco and alcoholic beverages, to the extent consumption expenditures shift toward the lottery.

Public Service Enterprises

Many states and localities operate public service monopolies, including liquor stores and utilities. Aside from liquor stores, most of these operations are owned and controlled by local governments. Unlike specific user fees and charges, the service monopolies may allow the public sector to earn profits that are then diverted to other uses. By the same token, deficits may accrue that require financial support from other revenue sources. Absent market competition and full financial accountability, the public service monopolies can be inefficient.

Government's role has been justified by the public interest (e.g. ensuring public health or universal access to a service) and by economic considerations, particularly economies of scale. Economies of scale arise when it is more efficient for a single firm rather than several firms to provide a service. For example, natural gas and electricity distribution systems are subject to economies of scale. In these cases, the per-unit costs associated with utility distribution are lower when there is only one distribution network rather than several overlapping networks. The presence of economies of scale does not require government ownership of the service-delivery infrastructure. But it may require the granting of a monopoly franchise to a private sector entity, accompanied by public sector oversight of the same firm.

⁴⁸ <<http://www.ncsl.org/programs/econ/casinotaxes.htm>>.

Insurance Trust Funds

Insurance trust funds may be operated by any level of government, but aside from the federally-administered Social Security system, they are dominated by the states. The most important programs are workers' compensation, unemployment insurance compensation and employee retirement systems. Contributions are generally dedicated and cannot be diverted for use in other programs.

Retirement systems reflect a jurisdiction's long-term commitment to employees. Many public and private retirement systems have been under pressure due to recent weak performance of the stock market, management problems and large commitments to the baby-boom generation. Unemployment insurance compensation and workers' compensation are funded by premiums paid by firms. These are typically *experience-based* systems wherein contributions are based on past usage of the system. Thus, firms in industries with higher layoff propensities and injury rates will face higher premiums. Business views unemployment insurance and workers' compensation as another tax that distorts location, investment and hiring decisions.

Consequences of Federal Tax Reform

Discussions of large-scale changes to the federal tax system have resurfaced in recent years, with some analysts going as far as to say that recent income tax cuts and other changes have been precursors to more fundamental federal tax reform. Given that most state income tax systems are very heavily linked to the federal income tax, any federal tax changes are inherently state tax changes as well.⁴⁹ Changes in federal income tax rates will have little effect on most state income taxes with the notable exception of Rhode Island, where state income tax liability is calculated as a fixed percentage of federal income tax liability.

Federal income tax changes will have the largest impact on state income taxes if they involve changes in the federal income tax base. This is a direct consequence of the fact that all but five state income taxes begin either with federal AGI or taxable income. Many of the reform proposals that are likely to be seen in coming months involve a gradual transition from income taxation to potentially narrower-based consumption taxation. The new tax system could be as radical as a national retail sales tax or Value-Added Tax (VAT) or as straightforward as an exemption for all types of savings within the structure of the existing federal income tax. In either case, the federal tax base—as well as state bases that are tied to the federal system—could be significantly smaller.

A number of common features of most consumption tax proposals have important implications for state and local governments. For example, municipal bond interest, which is currently tax-exempt under the income tax, would likely be taxable in a pure consumption tax system. Consumption taxes would also do away with the federal deductibility of state and local taxes if they replace the federal income tax. Both of these changes would essentially increase the price of state and local public services.

⁴⁹ For an interesting discussion, see Holtz-Eakin (1996).

In the case of a national retail sales tax, a key concern for state and local governments is whether it would replace or supplement the existing federal income tax. In the former case, states would be forced to either change their income taxes such that they stand independently of federal rules or replace them with more reliance on other revenue sources such as sales and property taxes. Also, if the intent is to replace the federal income tax, a national retail sales tax would likely involve a very high tax rate—26 percent according to William Gale (2004). State and local governments that rely more heavily on sales taxes would thus need to be concerned about the effects of such a high national retail sales tax rate on overall retail sales levels, especially when the high federal sales tax rate is combined with existing state sales tax rates.

Barring any “fundamental” federal tax reform, the current federal tax system has one very important problem with potentially significant ramifications for state and local governments. More and more taxpayers face the federal Alternative Minimum Tax (AMT). This tax, which is layered on top of the regular federal income tax, was originally intended to increase tax liabilities for high-income taxpayers who are able to reduce their regular income tax liabilities through the use of exemptions and deductions. The AMT essentially adds back in some excluded income types and reduces the value of exemptions and deductions for affected taxpayers.

Unfortunately for many middle-income taxpayers, the AMT income threshold is not indexed for inflation. Over time, as nominal incomes rise, more and more taxpayers will “creep” into AMT liability. While only about three million taxpayers faced AMT liability in 2003, a recent estimate from the Tax Policy Center suggests that this number could jump to 30 million by 2010. This has the same effect on state and local governments as removing the deductibility of state and local taxes as discussed above. The AMT is essentially a reduction in the value of itemized deductions for higher-income taxpayers, which consequently increases the effective price of state and local public services. The current policy environment is unclear as to the timing and extent of AMT reform, but the issue is being widely debated among policy makers.

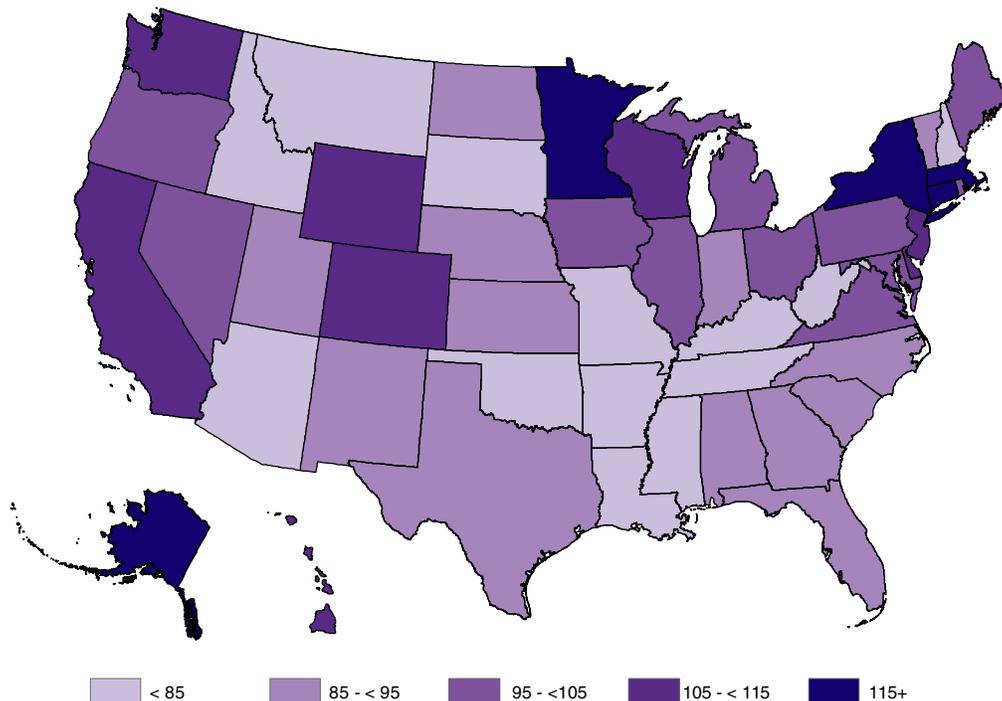
State and Local Government Expenditures: History, Structure and Policy Options

Overview of State and Local Government Expenditure Structures

In fiscal year 2002 state and local governments spent an average of \$6,086 per capita on goods and services.⁵⁰ About 80 percent (\$4,822) was financed by state and local governments' own revenue, and the remainder was financed from federal grants.⁵¹

States vary enormously in how much they spend from their own funds, ranging from \$3,500 per capita in Arkansas to nearly twice as much (\$6,582) in New York (excluding Alaska's \$10,517 as an outlier). Exhibit 23 shows the regional patterns in spending, with mid-Atlantic and New England states generally spending above the national average and southern states generally spending below average.

Exhibit 23: Per-Capita State and Local General Expenditures Financed from Own Revenue Indexed to US Average



Source: US Census Bureau.

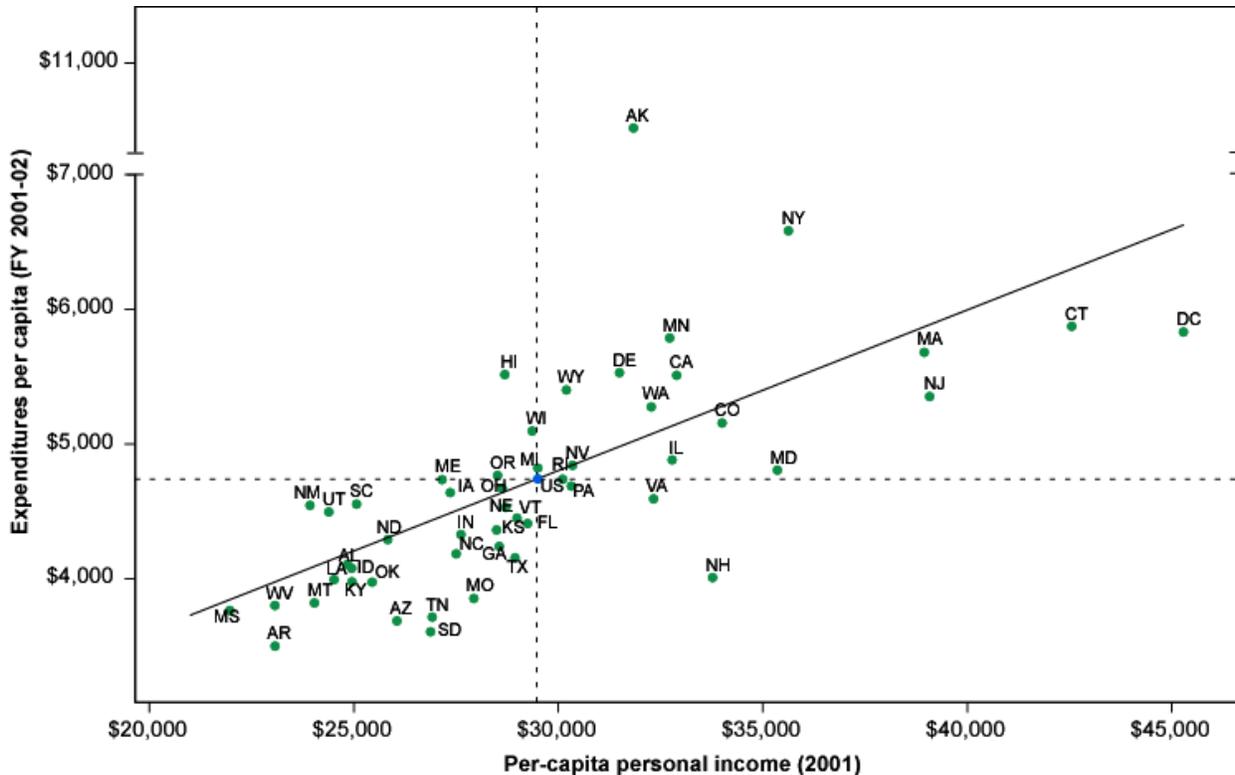
Government spending is influenced by many factors that vary greatly across states and often are difficult to measure, including voter attitudes toward government, ability to pay, need

⁵⁰ This is based on the US Census Bureau's "general expenditures" concept which includes all activities of government other than the operations of trust funds and business-like activities financed from charges, such as water and electric utility systems.

⁵¹ Expenditures from own revenue were calculated by subtracting revenue from federal grants from total general expenditures. Due to timing differences between revenue and expenditures this is likely to be an imperfect—but very good—measure of actual expenditures from own funds.

for services, the prices of “inputs” that government purchases (e.g., labor, land and materials), and the efficiency with which services are delivered. In general, states whose residents have higher incomes tend to spend more per capita than do lower-income states, as Exhibit 24 shows, although it is clear that many states deviate significantly from this general pattern.⁵² Per-capita income is associated not just with ability to pay, but also differences in prices and differences in attitudes toward government, so readers should be cautious in interpreting the exhibit.

Exhibit 24: State and Local Expenditures Financed from Own Revenue versus Personal Income



Notes: Dashed lines show average values. Diagonal shows average relationship between expenditures and income. Source: U.S. Census Bureau, Bureau of Economic Analysis

State and Local Expenditures by Function

Elementary and secondary education has long been the single-largest area of state and local government spending. About 10 years ago, the rapidly growing Medicaid program overtook higher education as the second-largest area. Exhibit 25 shows state and local spending in selected large US Census Bureau categories (“medical vendor payments” correspond fairly closely with Medicaid).

⁵² The diagonal line represents the average relationship between expenditures and income, computed from an ordinary least squares regression.

**Exhibit 25: State and Local Government General Expenditures by Function,
Fiscal Year 2002**

	Percent of total by level of government		
	State-local	State	Local
Total general expenditures	100.0%	100.0%	100.0%
Elementary and secondary education	23.7%	20.0%	40.9%
Medical vendor payments	11.1%	17.1%	0.2%
Higher education	9.0%	12.6%	2.6%
Hospitals and health	8.4%	7.9%	8.0%
Highways	6.7%	7.6%	4.4%
Public welfare, other than medical payments	5.3%	8.8%	4.5%
Police	3.7%	1.0%	5.5%
Corrections	3.2%	3.5%	1.8%
All other	29.0%	21.6%	32.0%

Note: "General" expenditures include direct payments plus intergovernmental payments to other governments.

Source: US Census Bureau.

For more than 100 years state and local government expenditures have been rising nearly continuously in real per-capita terms (a rough proxy for the “quantity” of services delivered) reflecting citizens’ desire for additional government services as incomes rise, increasing reliance on state and local governments rather than the federal government to deliver domestic services (devolution of responsibilities to state and local governments), and different underlying pressures at different times. For example, the desire to educate baby boomers led to extraordinary growth in education expenditures in the 1960s, while more recently educating the children of baby boomers, financing health care for their parents through Medicaid, and financing prison-building all contributed to rapid spending growth in the 1980s and 1990s.⁵³

Some important activities of state and local government cut across functions, especially capital expenditures and pension contributions. In 2002, capital expenditures were 7.6 percent of state general expenditures and 14.2 percent of local expenditures. Highways accounted for 58 percent of state capital spending and higher education accounted for another 19 percent. Elementary and secondary education accounted for 37 percent of local spending, and highways accounted for another 12 percent.

State contributions to pension funds and payments for health insurance plans of workers and retirees generally are included in the data on spending by function, but data to disaggregate them are hard to come by. In aggregate, state pension contributions amounted to about 1.5 percent of general expenditures in 2002, and local contributions were 2.2 percent of local expenditures. As will be discussed below, although this percentage was relatively small in 2002, it can change significantly and rapidly in times when investment returns change rapidly.

Changes in Spending Over Time

Exhibit 26 shows growth in real per-capita spending by major functional area over the two most-recent decades, a period that continued the longer-term trend of quite rapid increases in

⁵³ For a primer on the history of state and local government finances, see Penner (1998).

state and local government expenditures.⁵⁴ The only major category that did not experience growth in this period was non-medical public welfare spending (including cash assistance, foster care, housing assistance).

Exhibit 26: State and Local Government Real Per-Capita Expenditures, Percentage Change by Decade

	1982 to 1992	1992 to 2002
Total general expenditures	43.2%	21.1%
Elementary and secondary education	37.0%	23.9%
Medical vendor payments	130.0%	39.6%
Higher education	29.0%	27.7%
Hospitals and health	38.7%	13.2%
Highways	24.4%	17.4%
Public welfare, other than medical payments	29.1%	-2.4%
Police	36.8%	24.7%
Corrections	116.9%	30.0%
All other	41.4%	18.3%

Sources: US Census Bureau, Bureau of Economic Analysis,
Inflation adjustment based on state-local chain-weighted price index.

The growth in spending was surprisingly widespread—every state but Alaska increased real per-capita state-local spending substantially over the two decades, with Wyoming having the lowest two-decade growth (28 percent) and South Carolina having the highest (116 percent). Even states with stringent tax and expenditure limits had substantial increases in real per-capita expenditures.⁵⁵

Although growth in the level of services was substantial as measured by real per-capita spending, much of this was financed by growth in the economy. Spending as a share of personal income grew far more modestly, rising by 15.2 percent between 1982 and 1992 and by 2.3 percent between 1992 and 2002.⁵⁶

Most state and local government spending is far less sensitive to short-term cyclical swings in the economy than is tax revenue—recessions tend to drive tax revenue down sharply and to place modest upward pressure on state and local government spending. Recessions and recoveries do not lead to major changes in the numbers of students in schools or the salaries paid to their teachers, so there is little direct effect on elementary and secondary education expenditures, although states may cut aid to local governments in response to their own tax revenue shortfalls. Medicaid costs are driven upward somewhat by recessions—as unemployment rises, more people tend to become eligible for cash assistance and other forms of

⁵⁴ It often is preferable to measure fiscal or economic changes from peak to peak of the business cycle rather than over fixed periods. However, in this case the business cycle peaks are quite near the years we have chosen, and the differences in numbers using that approach are generally minor and not related to the economy itself, so we use the simpler approach of examining 10-year periods.

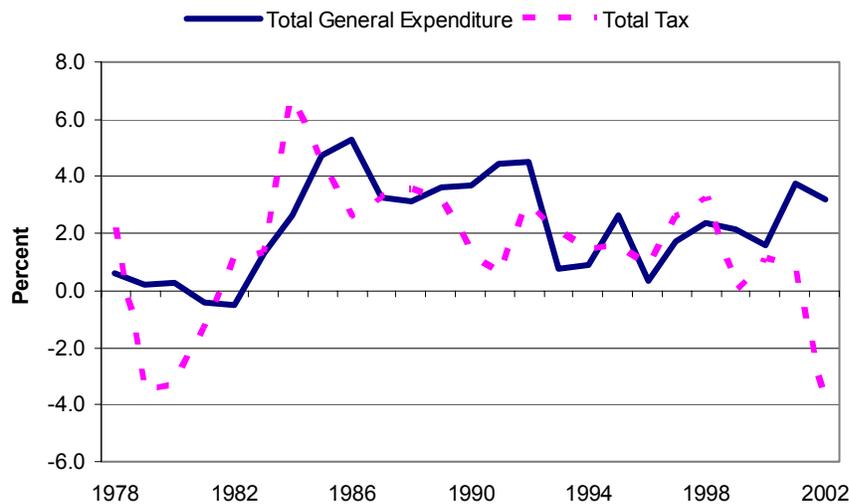
⁵⁵ This remains true even if we look only at spending financed from own funds, rather than total spending, which includes state-local spending financed by federal grants.

⁵⁶ State and local spending as a percentage of personal income rose from 16.9 percent in 1982 to 19.5 percent in 1992 to 19.9 percent in 2002.

public welfare (increasing costs of these programs), and these individuals also generally are categorically eligible for Medicaid benefits. One estimate suggests that a one percentage point increase in the unemployment rate could cause the number of Medicaid beneficiaries to increase by almost four percent and Medicaid expenditures to rise by slightly over one percent (Holahan and Garrett 2001).⁵⁷ However, the vast bulk of Medicaid expenditures are for the elderly and disabled, and neither the number of beneficiaries nor the costs of their care is likely to change much due to the business cycle. Higher education, the third-largest category of state-local spending, tends to experience modest upward pressure during recessions—when jobs are scarce, many people stay in school longer and others return to school to sharpen job skills. These effects are most-pronounced in two-year colleges.

Exhibit 27 shows that in periods surrounding each of the last three recessions (1980-82, 1990-91, and 2001-02), state-local tax revenue growth fell sharply while expenditures generally were more stable. These numbers are not adjusted to remove the impact of policy changes (that is very hard to do). If adjustments for policy changes were available, they would show adjusted spending—before fiscal-crisis-induced budget cuts—growing somewhat faster during recessions than actual spending.

Exhibit 27: Percentage Change in State and Local Real Per-Capita Taxes and General Expenditures



Sources: US Census Bureau, Bureau of Economic Analysis.

Elementary and Secondary Education

Elementary and secondary education is the single-largest activity of state and local governments in the US. In 2001-02 it accounted for 24 percent of state and local government general expenditures and more than 40 percent of state and local government employment. Spending on elementary and secondary education even exceeds federal spending on national

⁵⁷ Expenditures would not increase as rapidly as enrollment because a disproportionate share of the new enrollees would be children, who are relatively inexpensive to care for, and because the average new enrollee is expected to be healthier than otherwise similar existing enrollees.

defense. All states have compulsory education laws, and nearly 90 percent of all children aged five to 17 are enrolled in public elementary and secondary schools (NCES 2003). In 2001-02, the nation's public elementary and secondary schools educated more than 50 million children at an expense of more than \$400 billion.

The largest education finance issues state and local governments face are educating students in an environment of increased public and state legislative demands for higher education standards and accountability, increased federal oversight and requirements under the No Child Left Behind Act (NCLB), increased labor-market demands for an educated workforce, and ongoing widespread litigation over how education is financed.

How State, Federal and Local Governments Finance Education

An important argument for public funding of education is that the benefits generally are thought to extend far beyond children and their families to society at large—benefits such as a more productive workforce, better health status, educated juries and voters, and perhaps smaller prison populations and lower welfare caseloads. Parents, property owners, and other citizens in local school districts benefit from strong schools not just because of their children's education, but also through the opportunities for civic interaction that schools provide and other benefits, all of which may be reflected in higher property values, and as a result they have incentives to hold schools accountable for the quality and cost of education. This is one of the arguments for local funding of schools. But the benefits of education also spillover well beyond individual school districts, affecting entire states and crossing state lines—education has “positive externalities” in the parlance of economists—which is an argument for state and federal funding of education. Furthermore, the capacity of local school districts to finance education varies enormously from district to district, and absent financial assistance low-tax-capacity districts will not provide as much education as society more generally might want.⁵⁸

Elementary and secondary education is delivered primarily by local governments, but it is financed by all three levels. For the nation as a whole, state governments finance approximately half of elementary and secondary education, followed by local governments, with the federal government a distant third at a little less than eight percent of the total. Exhibit 28 shows the relative roles in 2001-02.

⁵⁸ For an overview of these and related issues, see Taylor (1999).

**Exhibit 28: Revenue Sources for Elementary and Secondary Education,
Fiscal Year 2001 to 2002**

	\$ billions	Share of total
State governments	206.8	49.3%
Local governments	179.8	42.8%
Federal government	33.2	7.9%
Total	419.8	100.0%

Source: National Center for Education Statistics, Common Core of Data (CCD), "National Public Education Financial Survey," 2001-02, as reported at <http://nces.ed.gov/programs/digest/d03/list_tables2.asp#c2_1>.

States vary widely in how they split state and local responsibilities for financing education. The state government plays the largest role by far in Hawaii and New Mexico, supplying 89 percent and 72 percent of the funds respectively in 2001-02. States provide 60-70 percent of education funding in another eight states. At the other end, eight state governments provide less than 40 percent of funding, with Nevada providing the least at 32 percent.

The State Government Role

The vast majority of state government spending for elementary and secondary education is in the form of aid to local school districts rather than direct spending on education. This aid typically falls into two broad categories: basic state aid that may be used for almost any purpose, generally computed under a formula that takes school district needs and wealth into account, and categorical aid that is intended for specific purposes such as transportation, special education, or bilingual education. In practice the distinction can be blurry, as basic aid formulas often take into account transportation needs, special education needs, and other factors that may also be taken into account in categorical aid formulas. In any event, basic aid is much larger than categorical aid. One of the most important objectives of state aid is to reduce disparities across districts in spending and capacity to raise revenue. As a result, basic aid formulas usually generate more aid per pupil for low-wealth school districts than they do for higher-wealth districts.

The most common kind of aid formula is known as a foundation program. Under this approach, a state sets a "foundation" per-pupil spending level assumed to be necessary to provide an adequate education, and provides aid to cover the difference between foundation spending and desired local contribution. For example, a state might decide that \$8,000 in per-pupil spending is needed to provide an adequate education, and that each district should kick in the amount of revenue it can raise at a one percent property tax rate. If a poor district has \$100,000 of wealth per pupil, it will receive aid of \$7,000 per pupil (\$8,000 minus one percent of \$100,000), while a rich district with \$600,000 of wealth per pupil would receive aid of \$2,000 per pupil. States use many variants of this approach, and some include bells and whistles such as adjustments for price differences in different parts of the state, adjustments for cost differences for pupils with disabilities and other kinds of special needs, requirements that local school districts actually

make the desired contribution implicit in the formula, limits on annual increases and decreases, and so on.⁵⁹

Aid formulas are political compromises and they rarely are pure. Often they include special features designed to target aid to specific districts, and sometimes legislatures might even “run the formula backward,” deciding where they want money to go and then designing a formula to accomplish it. Still, they can reduce disparities in spending and revenue-raising capacity across districts within a state, and often but by no means always do. As will be covered in a later section, many state financing approaches have been challenged in court on the ground that they do not provide sufficient funding for an adequate education, or that the resulting funding is too unequal to be acceptable.

State support for elementary and secondary education has risen considerably over time, particularly in the early part of the 20th century, in the 1970s, and in specific states in the 1990s. The increasing state government role in the 1990s usually stemmed from one or more of three often-related motivations: (1) to reduce spending and revenue-raising disparities across school districts within the state, as was the case in Massachusetts, (2) to ease pressure on local property taxes, sometimes accompanied by explicit local tax and spending limits, as was the case with the Taxpayer Bill of Rights (TABOR) in Colorado and Measures 50 and 5 in Oregon, and (3) to respond to or pre-empt litigation over school financing systems, an issue that will be discussed later.

The Federal Role

The federal fiscal role in financing education historically has been small, although it has been growing consistently for more than four decades. The early reasons for the small federal role included concern by Southern lawmakers that it would force them to end segregation, opposition by Roman Catholics to aid that excluded private schools, concern by teachers’ unions that it might lead to aid to private schools, fears that it would lead to federal intervention in what had been primarily a state and local policy arena, and concern that it would lead to growth in the federal budget (Robelen 1999; Kaestle 2001).

The beginning of the modern federal role in education was enactment of the Elementary and Secondary Education Act of 1965, which provided \$2 billion in aid to improve educational opportunities for disadvantaged students and increased dramatically in size over the ensuing decade. Another important element of ESEA, which actually predated the 1965 enactment, was “Impact Aid,” which supports local school districts with concentrations of children who reside on Indian lands, military bases, low-rent housing properties, and other Federal properties, or who have parents in the uniformed services or employed on eligible Federal properties.

As a result of the 1965 expansion, federal aid for elementary and secondary education rose from 4.4 percent of education revenue in 1963-64 to 7.9 percent in 1965-66, and to 9.8 percent in 1979-80 (NCES 2003). In 1980 under President Carter the federal government established the

⁵⁹ State aid formulas for individual states are described in brief at the National Conference of State Legislatures’ website <www.ncsl.org/programs/educ/ed_finance/index.cfm> and in more detail but with older information at the National Center for Education Statistics’ website <nces.ed.gov/edfin/state_finance/StateFinancing.asp> and also at <www.ed.sc.edu/aefa/reports/nces_rpt.html>.

US Department of Education. Candidate Ronald Reagan campaigned in favor of abolishing the Department of Education, and while he was president federal funding for education declined 21 percent. However, he influenced education in other ways: under President Reagan the National Commission on Excellence in Education issued the landmark report, *A Nation at Risk*, which documented the mediocre results of elementary and secondary education and called for a common core curriculum and higher academic standards. *A Nation at Risk* helped kick off the modern movement toward higher standards, and President Reagan left it to the states to develop these standards (NCSL 2004).

The federal government continued to push for higher standards and accountability under President George H.W. Bush (the National Education Goals Panel) and President Clinton (Goals 2000: Educate America Act). The largest change in this direction was the 2001 reauthorization of ESEA, which was proposed by President George W. Bush and renamed the No Child Left Behind Act of 2001. NCLB, which dramatically increased requirements for higher standards and accountability, is addressed in a separate section below.

Because much of the federal aid for education is related to disadvantaged children and to Indian lands, it varies significantly, from 15.8 percent of total revenue in Alaska and 13.9 percent in New Mexico, to 3.9 percent in New Jersey (NCES 2003, Table 157).

The Local Role

Local school districts generally decide independently how much to spend on elementary and secondary education, taking into account expected aid from state and federal governments. Most of the nation's nearly 14,000 school districts are independent governments with the power to levy taxes, but approximately 1,500 are dependent on an overlying level of government, such as a city. For example, the New York City and Philadelphia school districts are part of their respective city governments, and their budgets are determined as part of the overall city budget process rather than by a separate vote by the school board or district voters. According to the Education Commission of the States, 16 states have no fiscally dependent school districts, and nine only have fiscally dependent districts, with the other states having a mix of both types (Education Commission 2004).⁶⁰ Advocates for education in fiscally dependent school districts often are concerned when state or federal aid increases that the overlying city government will reduce its contribution to district finances, diverting locally raised funds to other city priorities or to local tax reduction. This sometimes leads to "maintenance of effort" requirements for the city government contribution in an attempt to prevent this.

The vast majority of locally raised revenue for education is from the property tax. In 2000-01, 63 percent of local school district revenue was from direct levy of the property tax and 17 percent was considered a "parent government contribution" (revenue from an overlying government in the case of fiscally dependent school districts), most of which also would be from the property tax although it is not possible to allocate this precisely.

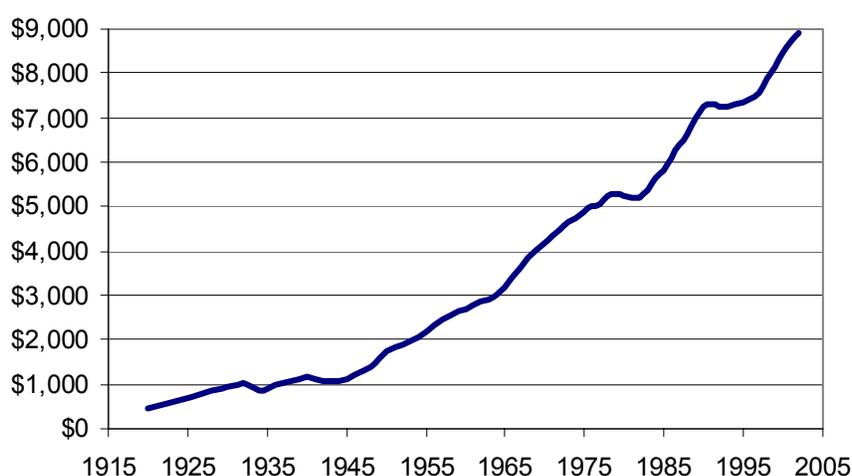
⁶⁰ Also see US Census Bureau, Government Finance data.

Most state governments impose tax or spending limits of some sort on local school districts. According to the Education Commission of the States, 40 states had one or the other, with 34 states having tax caps and 12 having spending caps (Education Commission 2004).

History and Pattern of Spending Changes

Real per-pupil spending rose dramatically and nearly without interruption over the last century, as Exhibit 29 shows.⁶¹ Increases were large in each decade, but actually smaller in the 1990s than in earlier decades. Spending growth was widespread, with sizable increases in real per-pupil spending in every state or virtually every state in most decades.

Exhibit 29: K-12 Education Expenditures per Pupil, in Constant 2001-2002 Dollars



Source: National Center for Education Statistics, Digest of Education Statistics 2003, Table 166, <http://nces.ed.gov/programs/digest/d03/list_tables2.asp#c2_9>.

During the 1950s and 1960s, per-pupil spending increases were coupled with large increases in enrollment as a share of the population as the nation educated the baby-boomer cohorts, and the combination led to large increases in education spending as a share of the economy (measured relative to gross domestic product). In most other recent decades, enrollment actually declined or was relatively flat so that large real per-pupil spending increases resulted in far more modest changes in spending relative to the economy, in some cases increasing and in others decreasing. Exhibit 30 illustrates this for recent decades, as well as the general trend toward greater state government financing of elementary and secondary education particularly in the 1970s.⁶²

⁶¹ For a good discussion of the historical development of elementary and secondary education, see Goldin (1999).

⁶² There are some differences in the real per-pupil spending measure used in Exhibit 29, which is based on inflation adjustments calculated by the National Center for Education Statistics using the Consumer Price Index, and real per-pupil spending used in Exhibit 30, which is based on inflation adjustments calculated by the authors using the Bureau of Economic Analysis' gross domestic product price index. In general, the GDP index shows less inflation and therefore more real growth than the CPI.

Exhibit 30: Elementary and Secondary Education Spending through the Decades

	Real spending per pupil, percent change	Enrollment as share of population, percent change	Spending as share of GDP			State gov't financing as share of total, end of decade
			Share of GDP, end of decade	Change from prior decade-end	Percent change	
1940s	49.4%	-13.3%	2.0%	-0.3%	-14.0%	39.8%
1950s	45.9%	20.6%	3.0%	1.0%	49.3%	39.1%
1960s	57.8%	11.5%	3.9%	1.0%	32.1%	39.9%
1970s	31.4%	-18.0%	3.4%	-0.5%	-12.2%	46.8%
1980s	50.9%	-11.4%	3.7%	0.2%	6.6%	47.1%
1990s	26.7%	4.6%	3.9%	0.2%	6.1%	49.5%

Note: 1940s defined as school year 1939-40 to 1949-50 and so on.

Sources: NCES Digest of Education Statistics 2003, various tables; and Bureau of Economic Analysis.

Education historically has been a very labor-intensive enterprise, and staff compensation accounts for approximately 85 percent of all education expenditures (NCES 2003, Table 160). One major reason for the increase in real per-pupil spending is a dramatic increase in education staff relative to the number of students in an effort to improve educational outcomes. Exhibit 31 shows changes in staff by major category over four decades. Teachers are the largest labor “input,” and the ratio of teachers to pupils increased more than 60 percent over four decades, in part reflecting widespread efforts to reduce class sizes. But the increases in other instructional staff such as teachers’ aides, principals, and guidance counselors, have been even more remarkable, increasing more than 600 percent per thousand pupils over the last four decades.

Exhibit 31: Education Staff per 1,000 Pupils

	Instructional staff			
	Total	Teachers	Other instructional staff	Support & administrative staff
1960	59.4	38.5	2.7	18.2
1970	73.8	44.3	5.3	24.3
1980	102.0	53.4	13.3	35.2
1990	109.0	58.2	15.8	35.0
2000	121.0	62.3	19.8	38.8
	From 1960 to 2000			
Change in number of staff per 1,000 pupils	61.6	23.8	17.1	20.6
Percent change	103.7%	62.0%	629.4%	113.4%

Source: Authors' calculations based on Digest of Education Statistics 2003, National Center for Education Statistics, Table 79, 2004.

Not only did the number of teachers increase, but so did the qualifications by which they are compensated, in another effort to improve education quality. Teacher salary contracts generally provide for increased pay for graduate degrees and credits, and for additional experience.⁶³ In 1960, only 23.5 percent of teachers had a master’s degree or higher, but by

⁶³ Although these are important elements of teacher salary contracts, they do not necessarily reflect teacher quality. Many economists have concluded that additional graduate degrees for teachers do not generally lead to improved

2000 fully 56.8 percent of teachers had at least a master's degree. Over the same period, median years of teacher experience increased from 11 to 14. These and other factors contributed to an increase in the average real teacher salary of 44 percent, which was fairly consistent with increases in other sectors of the economy on average.⁶⁴

Other factors also have contributed to increased education spending, including increases in the numbers of children receiving special education services and increases in the intensity of those services, and expanded provision of kindergarten and pre-kindergarten education in the public schools.

Stanford University economist Eric Hanushek has labeled the dramatic increase in resources for public education coupled with a trend of flat or declining student performance the “productivity collapse in education.” Based on reviews of statistical studies relating resources to student achievement, he argues that there is no evidence that additional money for education is *systematically* related to improved student learning, although additional money well applied certainly may lead to higher achievement.⁶⁵ He and several other economists argue that public education lacks the kinds of incentives that make other markets function reasonably efficiently.⁶⁶ Education researchers Larry Hedges and Rob Greenwald argue that Hanushek misinterprets the available evidence and that there is some evidence that resources put into education are systematically related to improved student learning (Hedges and Greenwald 1996).

Variation in Spending across States and within States

Education spending varies widely across states—per pupil spending in 2000-01 ranged from \$11,248 in New Jersey to \$4,674 in Utah, barely more than 40 percent of the New Jersey amount. Southern and western states tend to spend the least per pupil, while northeastern and Great Lakes states spend the most, as Exhibit 32 shows. Spending varies for many reasons, including differences in the cost of living, differences in the number of staff per pupil, differences in qualifications and pay for teachers, and differences in the characteristics of students.

student academic achievement, and that additional experience in the early years of a teaching career can lead to improved student achievement but that longer-term experience yields little additional improvement.

⁶⁴ Data in this paragraph based on National Center for Education Statistics 2003, Table 69.

⁶⁵ See, for example, Hanushek (1997) and Hanushek (1996).

⁶⁶ For example, public education typically has (a) relatively few choices for parents or students in school selection aside from moving to other districts or paying tuition in another district in addition to taxes in the home district (although charter schools and other forms of choice have been growing in recent years), (b) highly regulated teacher training that limits entry into the occupation, uniform salary structures that do not reward teacher performance and usually do not reflect the fact that some teachers may have higher alternative earning potential than others (e.g., math and chemistry teachers might be able to earn more in private-sector occupations than elementary school and social studies teachers) or that some schools in a district may be less attractive to work in than others, and (c) salary contracts that require lengthy procedures for removing poorly performing teachers.

The large differences in spending within states often have been the subject of litigation.

Recent Policy Trends

The Important Role of Court Decisions in Education Finance

Court decisions are playing an increasingly important role in school finance, and can wreak havoc on state finances and politics. A wave of litigation began in 1971 with *Serrano v. Priest*, in which the California Supreme Court found the state school finance system unconstitutional because of substantial disparities in per pupil revenue across districts, due to heavy reliance on local property tax. In 1973, the US Supreme Court ruled in *San Antonio Independent School District v. Rodriguez* that education is not a fundamental right under the United States constitution, effectively foreclosing this avenue of litigation. The Supreme Court also noted that a state's financing system could be challenged in state court, and that a state might justify unequal funding in order to advance local control. The plaintiffs in *Rodriguez* then challenged the Texas system in state courts and won, paving the way for further litigation under state constitutions across the nation (Dayton 1997-98).

All state constitutions require the state to provide a free and public education, with many also requiring a "thorough and efficient" education or some variant. In the last 30 years, state education financing systems in 45 states have been challenged in court.

Many of the early challenges in the 1970s and 1980s on the basis of equal protection have come to be known as "equity" lawsuits. These challenges argued that the financing system in a given state was impermissible because the system resulted in substantial differences across districts or schools such as unequal expenditures, revenue, capacity to raise revenue, or opportunity to learn. State financing systems survived about two-thirds of these challenges, but were overturned in a few significant cases including Connecticut, Washington, and West Virginia.⁶⁸

Since 1989, about two-thirds of court cases challenging education financing systems have been successful. Many of these lawsuits have been brought on "adequacy" grounds, arguing that a financing system was unconstitutional not because it resulted in unequal resources or opportunity, but rather because in some schools or districts it resulted in resources or opportunity that were simply inadequate to meet the requirements for a free public education under the state constitution's education clause.

Many states have made significant changes in their financing systems in the wake of lawsuits, either in response to court orders or to pre-empt them. The remedies in equity and adequacy lawsuits can be very different but in all cases can disrupt state and local finances. Meeting an equity standard can require equalizing spending across districts, possibly using "Robin Hood" techniques, and can require the politically difficult step of capping expenditures in rich districts. Meeting an adequacy standard can require bringing resources and educational

⁶⁸ Based on the Access website <www.schoolfunding.info/litigation/litigation.php3>, which is an initiative of the Campaign for Fiscal Equity, a plaintiff in New York state's school finance litigation.

opportunity in poorer school districts up to some minimum standard, but does not necessarily require limiting resources in wealthier districts.

In recent years, state financing systems in Arkansas, New Hampshire, New York, Ohio, Tennessee, Vermont, and Wyoming have been found wholly or partly unconstitutional, and litigation is pending in many other states. In many cases states are still adjusting their financing systems in response to litigation.

It may seem surprising that litigation seeking additional education funding is so prevalent and successful in light of conclusions by Hanushek and others, discussed earlier, that there is no systematic relationship between education spending and student academic achievement and that changes in incentives are needed to spur improvement. However, Hanushek and several colleagues have testified in some of these lawsuits and many judges have heard and largely rejected their arguments, and have heard and largely accepted arguments of those who disagree. The explanation for this may stem from the incredibly poor learning environments in the school districts bringing adequacy lawsuits—overcrowded and dilapidated buildings, underqualified teachers, inadequate and missing textbooks, and so on—conditions that probably cannot be remedied without additional money.

Charter Schools

Traditionally, the primary way parents and guardians can choose public schools is by choosing where to live, or by choosing to pay public school tuition in a nearby district while still paying taxes to the district of residence. Both can be expensive options.

More recently, other less-expensive forms of choice have become more accessible. One increasingly popular form is “charter schools”—public schools that are granted a charter to operate within a public school district, typically for a three to five year period. The "charter" describes the school's mission, program, goals, students served, methods of assessment, and ways to measure success. Charter schools typically operate with freedom from many of the regulations that apply to traditional public schools, in exchange for which they may have greater accountability—if a school is not satisfying parents and other stakeholders, its charter may not be renewed.

Minnesota passed the first charter school law in 1991, followed by California in 1992. By 2004 42 states had authorized charter schools and they were operating in 37 states. The states with the greatest number of charter schools are Arizona (464), California (428), Florida (227), Texas (221), Michigan (196). Despite their growing popularity, charter schools still serve a relatively small proportion of students—approximately 685,000 students, or less than two percent of public school students. The vast majority of students are unlikely to be served by charter schools.

The State Standards Movement and No Child Left Behind

In January 2002, President George W. Bush signed the No Child Left Behind Act (NCLB) into law. NCLB is both a significant incursion by the federal government into the traditionally state and local policy domain of elementary and secondary education, and an extension of earlier

federal efforts to encourage and require accountability in education.⁶⁹ Many states had already begun raising education standards and imposing accountability requirements before NCLB was enacted, and now have NCLB rules layered on top of existing rules. Many school district officials appear to resent the federal government's involvement in education policymaking in light of the small role the federal government plays in financing education.

While NCLB is often viewed as a mandate, it does not technically require anything of state and local governments. But to receive funding for education under Title I of the Act, states and school districts must comply with its provisions, which include:⁷⁰

- **Annual testing:** By 2005-06 states must begin testing students in grades 3-8 annually in reading and math. By 2007-08, they must test students in science at least once in elementary, middle, and high school. The tests must be aligned with state academic standards.
- **Academic progress:** States must bring all students up to the "proficient" level on state tests by 2013-14, and individual schools must meet state "adequate yearly progress" targets for the entire student population as a whole and for certain demographic subgroups. If a school receiving federal Title I funds fails to meet the target two years in a row, the local education agency must provide technical assistance and the school's students must be offered a choice of public schools. Schools failing three years in a row must offer supplemental educational services, including private tutoring. Continued failures could lead to governance changes possibly including state takeover of a failing school.
- **Teacher qualifications:** By the end of 2005-06 every public school teacher in core content areas must be "highly qualified" in each subject he or she teaches, meaning certified and demonstrably proficient in his or her subject matter.
- **Report cards:** States must provide annual report cards showing student-achievement data broken down by subgroup and information on the performance of school districts, and districts must provide similar report cards with school-by-school data.

In addition to creating important education policy issues for states, the standards movement and NCLB requirements will create pressures to increase education spending substantially, as discussed in the next section.

Looking Forward

The good fiscal news for states and school districts is that the mini-enrollment boom of the 1990s, when the "baby boom echo" (children of baby boomers) was being educated has subsided, and fiscal pressure from rising enrollments has begun to ease. Enrollment grew by 6.2 percent between 1995 and 2000, and is estimated by the National Center for Education Statistics to have slowed to 2.8 percent between 2000 and 2005. Enrollment growth is projected to slow further, to 1.2 percent, between 2005 and 2010. There will be pockets of rapid growth, however,

⁶⁹ For a political history of NCLB, see Rudalevige (2003).

⁷⁰ Much of the following is based closely on Edweek.org, <www.edweek.org/rc/issues/no-child-left-behind/index.html?querystring=history%20federal%20role>.

particularly in western states and some mountain states, and enrollment actually will decline in many northeastern states and selected other states.⁷¹

However, states and school districts will face substantial pressure to increase per-pupil spending, largely as a result of the standards movement, No Child Left Behind, and litigation. There are costs related to the testing and report card requirements of NCLB, and other administrative implementation costs, but these are likely to be only a small fraction of the total costs of higher standards. The larger costs are likely to be related to actions states and school districts may take in an effort to help children learn more, such as smaller class sizes, pre-kindergarten education, more extensive tutoring and mentoring, additional summer school opportunities, new textbooks, longer school days, more extensive and intensive training for teachers, and so on.

Although Hanushek and some other economists argue that schools, districts, and states could become more productive and lower education expenses by deregulating teacher labor markets, adding incentives to teacher labor contracts, giving school managers more flexibility, and making other changes to incentives and the management environment, there appears to be little broader support for these kinds of changes.

No one can estimate with any confidence the cost of state and school actions to improve learning, but the demands for additional spending related to the standards movement, litigation, and NCLB could be large. Several analyses provide insights into just how large the spending demands could be:

- A consultant report commissioned by the Ohio Department of Education assumed that additional educational programs would be required to bring the kindergarten through 3rd grade students performing below proficiency up to NCLB standards for the remainder of their education careers. The additional programs – which were illustrative rather than policy proposals – included summer school, a longer school day, and lower student-teacher ratios. The projected annual cost of these programs was \$1.4 billion, or 11 percent of total elementary and secondary education spending (Driscoll and Fleeter 2003).
- Economists Andrew Reschovsky and Jennifer Imazeki (2004) estimated statistically the costs of bringing low-performing school districts in Texas up to the statewide average on certain exams, and concluded that it would take a doubling of state aid to school districts in Texas to accomplish this.
- The court-appointed special masters in the adequacy lawsuit in New York issued a report in November 2004 with their estimates of what it would cost to provide all students in New York City the opportunity for a sound basic education. The referees concluded that it would cost \$5.6 billion annually, or a more-than-40 percent increase in total elementary and secondary education spending in New York City (Feerick, Milonas and Thompson 2004). Cost studies associated with litigation in other states also have concluded that spending increases would need to be very large to provide all students with an adequate opportunity to learn.

⁷¹ Growth rates calculated from Table B5 of US Department of Education (2003); regional differences based on Tables A and B.

These studies suggest that although the true costs of meeting higher standards may not be knowable, they will be large. Whether these costs could be lowered substantially through improvements in incentives and management remains to be seen. Whether incentive and management reforms are achievable politically also remains to be seen—at present there appears to be little public demand for major change.

Medicaid

Medicaid is a federal-state program that finances health care for low-income families, the elderly, and the disabled.⁷² Medicaid now exceeds \$300 billion annually and recently surpassed Medicare to become the nation’s largest governmentally funded health care program.⁷³ Exhibit 33 shows that Medicaid funded approximately one-sixth of all health care spending in 2002, and that public health care programs in aggregate accounted for 44 percent of health care spending (based on data from before Medicaid passed Medicare in size).

Exhibit 33: Personal Health Care Expenditures in the US, by Source of Payment, 2002

	Expenditures (\$ billions)	Share of Total
Medicaid	232.4	17.3%
Medicare	259.1	19.3%
Other public payments	100.7	7.5%
Public subtotal	592.2	44.2%
Insurance and related payments	535.5	40.0%
Out-of-pocket payments	212.5	15.9%
Private subtotal	748.0	55.8%
Total	1,340.2	100.0%

Sources: Centers for Medicare & Medicaid Services, Office of the Actuary, National Health Statistics Group; US Census Bureau, as reported in Table 4 of National Health Expenditures Accounts, <<http://www.cms.hhs.gov/statistics/nhe/historical/t4.asp>>.

Medicaid has a huge impact on people, state governments, the health care industry, and state economies:⁷⁴

- More than 50 million people benefit directly from Medicaid-financed health care;
- Medicaid insures about one in 11 Americans and about one-fifth of the nation’s children;
- Medicaid finances more than one-third of all births;
- It fills gaps in Medicare by providing outpatient prescription drugs (which until recently were not covered under Medicare) and long-term care coverage, and by paying Medicare

⁷² In addition, a handful of states require some local government contribution. New York, where the local share is 25 percent for some services, is the only state in which the local contribution is significant.

⁷³ Medicare also provides health care for the elderly, but it covers different services and populations than Medicaid, with some overlap, and it is funded solely by the federal government.

⁷⁴ The information in the bullets was drawn from Wachino, Schneider and Rousseau (2004), except for the information on state budget percentages, which were calculated from National Association of State Budget Officers, (2004).

premiums for many of the seven million people who are dually eligible for Medicaid and Medicare;

- Medicaid pays for one-half of all nursing home care;
- It accounts for about 21 percent of all state government spending, and 13 percent of spending from states' own funds; and
- It is an important source of revenue to literally thousands of health care providers in urban and rural communities—in 2002, more than 5,000 community hospitals, 17,000 nursing homes, 7,000 group homes for the mentally retarded, and hundreds of community health centers and managed care plans participated in Medicaid.

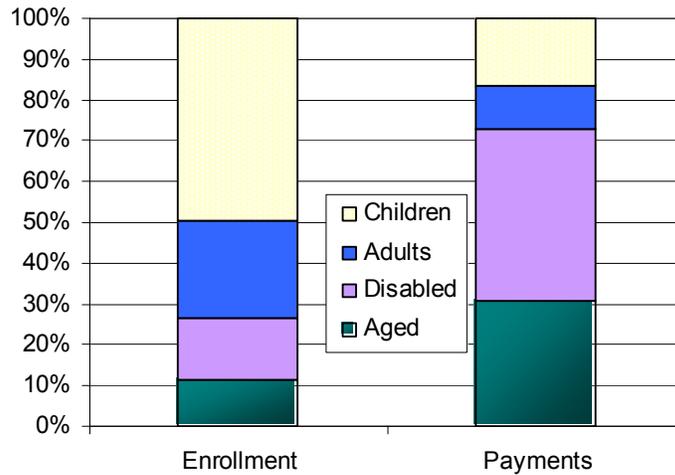
An important adjunct to Medicaid is the State Children's Health Insurance Program (SCHIP), created in 1995. SCHIP offers federal funding to states to provide health insurance to low-income children who cannot afford private insurance but are not eligible for Medicaid. SCHIP is tiny in comparison but has been growing very rapidly. It has been very popular with state governments in part because it has a higher federal reimbursement rate than Medicaid and enrollees are not subject to the same stigma that Medicaid recipients sometimes experience.

As will be discussed in the section on state variation, Medicaid is not really one single program, but 50 different yet related programs. Federal rules allow states to make very different choices about who is eligible, the services covered, and the amounts they will pay for covered services. In addition, states often apply for and receive waivers from the federal government allowing major parts of their Medicaid programs—or even the entire program—to vary from the general federal rules.

Medicaid Beneficiaries and Services They Receive

Medicaid is often incorrectly thought of as primarily a welfare program for low-income adults and children. Although it does serve more than 32 million low-income individuals, accounting for roughly three-quarters of all enrollees, that is not where the bulk of the money is committed. Nearly three-quarters of Medicaid spending is for the disabled and elderly, despite the fact that they account for little more than one-quarter of Medicaid enrollment, as Exhibit 34 shows. Elderly and disabled beneficiaries include not just the poor, but also beneficiaries who come from families who either are in the middle class or would be but for their high health-care expenditures.

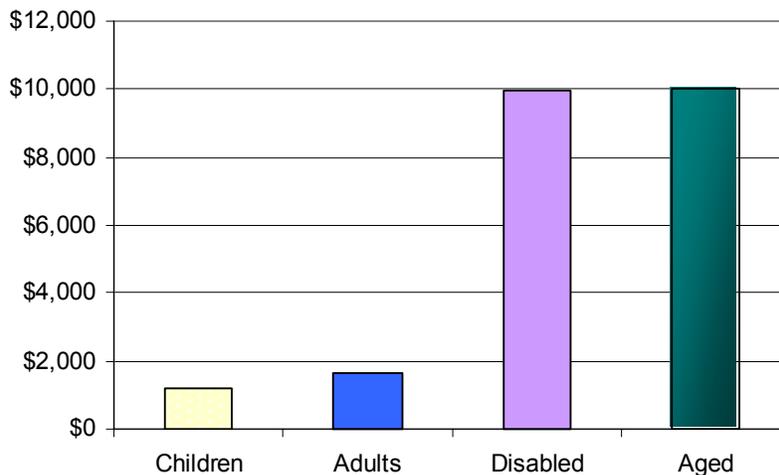
Exhibit 34: Medicaid Enrollment and Payment by Enrollment Group, Fiscal Year 2000



Source: Kaiser Commission on Medicaid and the Uninsured, 2000 State and National Medicaid Enrollment and Spending Data (MSIS), <www.kff.org/medicaid/kcmu031104bpkg.cfm>.

Medical care for adults and children tends to be less intensive and expensive than care for the disabled and elderly, in large part because much care for the elderly and disabled is in nursing homes and other expensive institutional long-term care settings, and because their care often requires use of expensive prescription drugs.⁷⁵ As a result, annual Medicaid spending per disabled and elderly enrollee tends to be six to eight times higher than expenditures for low-income adults and children, as Exhibit 35 shows.

Exhibit 35: Medicaid Payments per Enrollee, Fiscal Year 2000



Source: Kaiser Commission on Medicaid and the Uninsured, 2000 State and National Medicaid Enrollment and Spending Data (MSIS), <www.kff.org/medicaid/kcmu031104bpkg.cfm>.

⁷⁵ There are two important exceptions to this general statement: health care for newborns and for pregnant young women tends to be far more expensive than care for children and adults in general.

Approximately 56 percent of Medicaid spending is for acute care services such as inpatient hospital care, outpatient care, prescription drugs, and physician services, whether provided directly or through managed care organizations. Another 38 percent of Medicaid spending is on long-term care services such as nursing home facilities, home health and personal care, and mental health and retardation facilities. (Assisted living facilities are not generally covered under Medicaid.) The remaining six percent is for payments to hospitals that serve a disproportionate share of low-income individuals, known as DSH payments (pronounced “dish”). (See Exhibit 36 for a more-detailed breakdown of Medicaid spending by service category.)

Exhibit 36: Medicaid Spending by Service Category, Fiscal Year 2002

	Expenditures (\$ billions)	Share of Total
Managed care & health plans	34.8	14.0%
Inpatient hospital	32.7	13.2%
Prescribed drugs	23.4	9.4%
Outpatient services	17.2	6.9%
Physician, lab, & x-ray	9.2	3.7%
Other acute care services	22.2	8.9%
Acute care total	139.6	56.1%
Nursing facilities	48.0	19.3%
Home health & personal care	29.9	12.0%
Mental health and retardation facilities	15.4	6.2%
Long-term care total	93.2	37.5%
Disproportionate share hospital (DSH) payments	15.9	6.4%
Total	248.7	100.0%

Sources: Kaiser Commission on Medicaid and the Uninsured, 2002 State and National Medicaid Spending Data (CMS-64), Tables 1, 2, and 3 <www.kff.org/medicaid/kcmu031104apkg.cfm>.

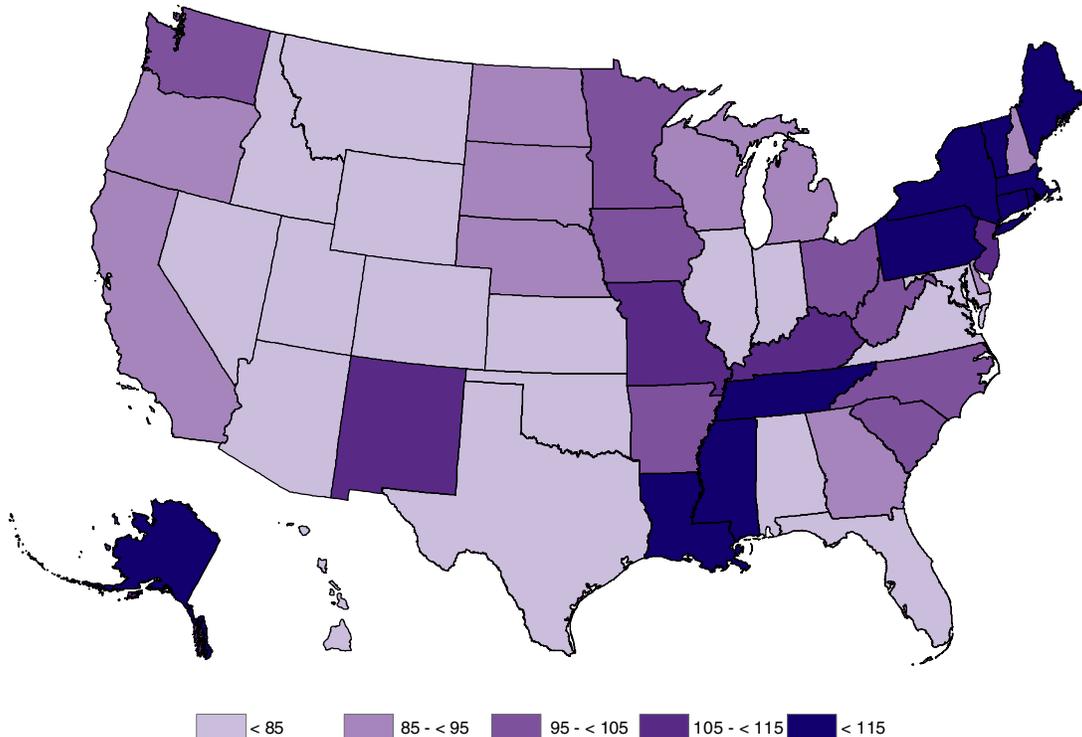
As noted in Exhibit 36, approximately 14 percent of Medicaid was made through managed care and health plans. While many of these payments would have been for physician services, outpatient services, and other categories shown elsewhere in the table, it generally is not possible to identify the services paid for by managed care plans. Between 1991 and 2000, the number of beneficiaries served through managed care plans increased nearly seven-fold. Growth in managed care has since slowed; many Medicaid beneficiaries not in managed care are in institutional settings or have very severe chronic health problems, and may not be well-suited for managed care (Kaiser Commission December 2001). Many analysts believe that states have already reaped much of the fiscal benefit from shifting to managed care and that further savings are likely to be limited.

Enormous State Variation in Medicaid

Within federal guidelines each state can adopt its own policies regarding Medicaid eligibility, services, and payments to health care providers, and in addition many states receive waivers from the federal government allowing them to alter their Medicaid programs in more significant ways. As a result, states cover vastly different proportions of their low-income

populations, they pay for different services, and they pay different amounts to providers. In addition, they have different poverty rates and at-risk populations and health care needs, different capacities to tax themselves to pay for health care, and different price structures. Medicaid spending per capita reflects this diversity, varying in 2002 from a high of \$1,928 per capita in New York to a low of \$372 per capita in Nevada (barely more than one-fifth of the New York amount). Exhibit 37 shows Medicaid spending per capita in 2002 indexed to the United States average.

Exhibit 37: Medicaid Expenditures Per Capita Indexed to US Average, Federal Fiscal Year 2002



Source: Kaiser Commission on Medicaid and the Uninsured.

Medicaid Financing

Medicaid is not technically a federal mandate imposed upon states. A state can choose not to participate at all if it wishes to forgo federal funds, but all states have chosen to participate. Once states choose to participate, they must provide certain services and cover certain populations. For example, physician and hospital services are mandatory, while prescription drugs and physical therapy are optional; states must cover children under age six in families with income under 133 percent of the poverty level, but they have the option of covering children under six up to somewhat higher income levels. Most states go well beyond the federally required minimums, and according to the Kaiser Commission on Medicaid and the Uninsured (July 2001), approximately two-thirds of Medicaid spending is for optional services or populations.

Under the joint federal-state financing arrangements, states pay doctors, hospitals, nursing homes, and other health care providers for services they provide, and draw partial reimbursement for these payments from the federal government. The federal reimbursement rate, known as the Federal Medical Assistance Percentage (FMAP, pronounced “F map”), varies from state to state and year to year under a formula that gives the greatest reimbursement to states with low per-capita incomes and the lowest reimbursement to high-income states, with a cap of 80 percent and a floor of 50 percent. In fiscal year 2005, the federal share ranges from 77 percent in Mississippi to 50 percent in Connecticut and 11 other high-income states, and the overall federal share is about 57 percent on average.

The relatively high federal share means that Medicaid reimbursement is a significant revenue source to states. In 2002, Federal reimbursement was nearly \$150 billion—only slightly less than the state sales tax and more than excise taxes and corporate income taxes taken together.

Medicaid is an uncapped federal entitlement to individuals and to state governments—in general, all individuals who are eligible in a state may receive services (there is no cap), and states may receive federal reimbursement for qualifying expenditures without limit.⁷⁶ This encourages states to provide broad support to low-income individuals and others who need assistance with health care, a primary goal of the program. It also gives states great incentive to game the system, finding ways to include individuals under Medicaid who might otherwise qualify for health care under other state programs, and finding ways to characterize state activities as part of Medicaid. It also creates incentives for states to maximize federal reimbursement using forms of “financial engineering” that will be discussed below.

The result is a cycle of fiscal tension layered on top of federal and state efforts to meet Medicaid’s objectives of providing health care to the poor and medically needy: states devise ways to maximize federal revenue; the federal government attempts to clamp down on these devices; states innovate and develop new devices; the federal government clamps down again, and so on.

Three of the most important techniques states have used to maximize federal reimbursement include disproportionate-share hospital payments (DSH), Upper Payment Limits (UPLs), and intergovernmental transfers (IGTs). All three devices involve the state making special payments to a medical provider it has some control or influence over, such as a private hospital, a private nursing home, or a county hospital. These payments are not directly tied to the cost of specific medical services, but rather support health care expenditures by that provider more generally, or exceed the actual cost of services. The payment by the state is treated as a Medicaid expenditure, and the state draws federal reimbursement at its matching rate. The state then encourages or requires the health care provider to return most or all of the payment to the state, in the form of a tax (e.g., a tax on nursing home revenue) or an outright transfer, thus effectively recouping the state share of the spending. All three kinds of payments are expressly authorized under federal law and can have legitimate objectives, but in some guises the net effect

⁷⁶ Some elements of federal reimbursement can be capped under waivers (agreements between specific states and the federal government) and under rules governing disproportionate hospital payments and certain other arcane aspects of Medicaid.

is that the state obtains federal reimbursement with no net expenditure of state funds. The federal government has imposed a variety of caps on DSH payments, and has imposed regulatory constraints on IGTs and UPLs.⁷⁷

There is considerable flexibility in the federal-state relationship. In many areas of Medicaid, individual states and the federal government have opportunity to strike state-specific agreements about what kinds of services the state may provide, how these services may be arranged, who may be covered, and the extent to which the federal government will reimburse the state. These “waiver” agreements often begin in relation to a demonstration program, but then can be extended on a broader basis within a state. The overriding fiscal principle that governs waiver agreements is that they are supposed to be fiscally neutral—they should not cost the federal government more than Medicaid would cost if the federal government did not waive its rules. Waiver agreements contribute to substantial variation in Medicaid across states.

Recent Growth and Outlook

Medicaid has grown extremely rapidly and almost continuously since its inception in 1965, punctuated by occasional brief lulls. Between 1982 and 1992, real per-capita state government spending on “medical vendor payments,” a US Census Bureau concept that is a fairly good proxy for Medicaid, grew by 143 percent, *after* adjusting for inflation and population growth—far faster than the 45 percent growth in overall state real per-capita spending. Between 1992 and 2002, real per-capita medical vendor payments grew by 40 percent, outpacing the 24 percent growth in overall spending albeit by less than in the preceding 10 years. The growth in medical vendor payments between 1982 and 2002 accounted for 27 percent of overall state spending growth, even though these payments accounted for only nine percent of state spending at the start of the period.^{78,79} After a brief slowdown in the late 1990s, Medicaid has returned to annual double-digit growth rates in the past several years.

Medicaid expenditures have been growing rapidly for many reasons, including:

- Forces that drive health care expenditures up in the private sector as well as the public sector, such as:
 - Rapidly evolving and expensive technologies that improve the quality of health care
 - Development of new and expensive prescription drugs—in recent years, Medicaid spending on prescription drugs has been increasing about 20 percent annually; and
 - Even if consumers paid full price for health care, their demand likely would be relatively inelastic, and the amount of health care they seek would not decline substantially if prices rise;
 - Unlike most private goods, health care price increases do not quickly and directly lead consumers to scale back their purchases, because consumers are relatively insulated from price increases—as noted in Exhibit 33—consumers pay only about one-sixth of the cost of health care directly out of their pockets;

⁷⁷ For more on DSH, IGTs, UPLs, and other state efforts to maximize federal reimbursement, see Rousseau and Schneider (2004) and Coughlin and Zuckerman (2003).

⁷⁸ Growth in medical vendor payments based on author’s analysis of US Census Bureau data.

⁷⁹ For detailed analysis of Medicaid spending trends, see Boyd (2003), Bruen and Holahan (2002), and various other papers and reports prepared by the Urban Institute and by the Kaiser Commission on Medicaid and the Uninsured.

- Rapid growth in Medicaid enrollment of the expensive-to-care for disabled population;
- Rapid growth in the “dual eligible” population – elderly and disabled individuals who are eligible both for Medicare and for Medicaid. Dual-eligible individuals tend to have very expensive health care needs;
- State and federal policy choices to expand Medicaid to cover more low-income children and pregnant women; and
- Expanded state efforts to reach out to potentially eligible populations and enroll them in Medicaid.

Looking forward, Medicaid forecasters at the Center for Medicare and Medicaid Services in the US Department of Health and Human Services and at the Congressional Budget Office expect Medicaid spending to grow at about 8-9 percent a year in a period when the economy is expected to grow about 5-6 percent (Heffler et al. 2004). CBO forecasters also expect Medicaid to grow considerably faster than federal tax revenue.

These forecasts reflect a continuation of trends described above that caused Medicaid to grow rapidly in recent years. In addition, the aging of the population will finally begin to have a significant impact on Medicaid: between 2005 and 2015, the US Census Bureau expects the population aged 65 and over to grow by 26 percent, while the under-65 population will grow by only six percent.⁸⁰ As the population ages states may find it difficult to finance rapidly increasing demand for Medicaid-financed prescription drugs and expensive long-term care services.

Medicaid Cuts, Resistance to Cuts, and Broader Medicaid Reforms

Continuing rapid growth in Medicaid under current policies will place strain on the federal government and on the states, and will lead to increased pressure to cut or control Medicaid spending growth. States often find it difficult to cut Medicaid or curtail its growth in ways that achieve substantial budget savings. In the recent fiscal crisis it was common for states to claim that they were achieving budget savings by cutting Medicaid. Many states scaled back planned expansions and some actually cut enrollment, but while these actions may have had significant impacts on many people, they often did not achieve significant budget savings. One recent analysis of 10 states’ actions in the recent state fiscal crisis found that Medicaid cuts were common but usually not large—they often did not reduce Medicaid enrollment, and where they did the enrollment cuts were focused on relatively inexpensive-to-care-for low-income children and adults rather than the disabled and the elderly (Fossett and Burke 2004).

In addition to political support Medicaid may have as a health care program for the needy, Medicaid is difficult to cut for other reasons, as the 10-state study noted:

- States share budget savings with the federal government and so must cut more than a dollar of services to obtain a dollar of state budget savings. For example, since Mississippi’s reimbursement rate is 77 percent, it would have to cut more than \$4 of services to save \$1 in its budget; a state with a 50 percent reimbursement rate would have to cut services by \$2 to

⁸⁰ Based on the middle projections from the US Census Bureau, data files NP-T3-A through NP-T3-E, (2000).

achieve a dollar of budget savings. State elected officials bear all the political pain for Medicaid cuts but get only some of the fiscal gain.

- Medicaid funds more than 17 percent of the nation's health care and about half of all nursing home care, and is a major source of revenue to the health care industry. As a result it has powerful constituencies in this industry that lobby heavily and effectively against cuts. Medicaid is often viewed partly as an economic development program, and the health care industry often is able to warn state legislators of how Medicaid cuts might affect specific health care providers in specific state legislative districts, especially in rural areas.
- The elderly and disabled and some other beneficiaries of Medicaid-financed care also have advocacy organizations lobbying effectively against Medicaid cuts.

The federal government has faced and will face pressure to cut Medicaid or at least to curtail its growth. However, the two most recent large federal changes actually moved in the opposite direction. In 2003, in response to the state fiscal crisis Congress enacted temporary fiscal relief for states that increased the federal reimbursement rate by 2.95 percentage points in each state for six quarters, providing a temporary boost of \$10 billion to states intended to stave off Medicaid cuts. This relief expired at the end of June 2004.

The other major recent federal change in Medicaid was part of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003—the legislation that added a prescription drug benefit to Medicare. Because states have long shared with the federal government the cost of providing prescription drugs to the subset of elderly citizens who are on Medicaid, and because virtually all of these individuals also are dually eligible for Medicare, a Medicare drug benefit would shift the cost of drugs for dually eligible individuals from the federal-state Medicaid program to the federal Medicare program. To help limit the cost of the Medicare prescription drug program, Congress enacted a “clawback” provision that requires states to pay the federal government partial reimbursement for their Medicaid savings. These payments are expected to be about \$6 billion in 2006, rising to \$15 billion in 2013.⁸¹

States will still save money as a result of the prescription drug bill, but far less than they would have in the absence of the clawback provision. Some observers have expressed concern about the “reverse grant” nature of these payments and the risk that states could have to make greater payments in the future if the federal government changes the law.

Over the longer term significant federal cuts seem likely given the pressure that rapidly growing Medicaid spending places on the large and growing federal budget deficit. The battle between the federal government and the states over state efforts to game the Medicaid reimbursement system will continue: it has capped and regulated the DSH, UPL, and IGT techniques discussed above, but as states discover new ways to draw reimbursement from the federal government it will find new ways to respond, possibly not just capping a technique but cutting it back substantially, to the fiscal detriment of state governments.

The biggest Medicaid issue states could face in the near term is a federal effort to overhaul the way Medicaid is financed. In 1995, Congress passed legislation, vetoed by President Clinton, that would have converted Medicaid into a block grant known as Medigrant. The

⁸¹ See, for example, Schneider (2004).

program no longer would have been an open-ended entitlement to individuals and states; instead, federal participation would be capped at the grant amount, much as welfare reform capped payments to states in exchange for giving them far greater flexibility in how to design and implement welfare programs. Medicaid grants are more than eight times as large as Temporary Assistance to Needy Families (TANF) grants under welfare reforms, and the consequences of such a shift would be huge, creating large winners and losers among the states, and important short-run and long-run issues for states to examine.

President Bush's FY 2004 budget proposed allowing states to accept a cap on Medicaid in exchange for restructuring of eligibility and services covered. His FY 2005 budget expressed continued support for this proposal but said the Administration would pursue it on a state-by-state basis through waivers (Kaiser Commission June 2004).

Less-sweeping changes also are possible. The National Governors Association has proposed a swap under which the federal government would take full responsibility for long-term care and states would take full responsibility for health care for the poor. Given the rapid growth expected in long-term care, if this began as an even swap, over the longer-term it probably would provide fiscal relief to states and would increase the federal deficit. Others have proposed that the federal government pay fully for elderly and disabled individuals who are dually eligible for Medicaid and Medicare, while states take full responsibility for low-income citizens not on Medicare.⁸²

Given Medicaid's huge size, its rapid growth, and the federal budget deficit, it is sure to be a target of federal and state budget cutters and health care reformers in years ahead. Given the importance Medicaid plays in the nation's health care system, the persistent rates of uninsured individuals in the United States, the nation's aging population, and the large constituencies for Medicaid among beneficiaries and health care providers, there is sure to be major opposition to most proposals for significant change. A collision of these forces is likely, but it is not possible to predict the outcome.

State Welfare Programs

States have operated low-income cash assistance programs with partial federal funding since the enactment of the now-defunct Aid to Families with Dependent Children (AFDC) program as part of the Social Security Act of 1935. AFDC was an entitlement system funded by federal matching grants to the states. A family's benefit duration was unlimited under AFDC rules as long as its income was sufficiently low, and benefits were larger for families with more children and less earned income. Further, benefits were generally only available for families that had been deprived of at least one parent. The matching-grant nature of AFDC did not place caps on state spending; states could receive matching federal funds no matter how much they spent from state funds.

AFDC involved tremendous incentives for recipients to remain out of work, stay on the program, remain unmarried, and produce many children. Perhaps at least partially in response to this policy environment, welfare caseloads and expenditures rose dramatically until they peaked

⁸² For summaries of these and other options, see Schactman and Doonan (2002).

in 1994 with over five million families on AFDC representing about one in every eight American children. Approximately \$23 billion was spent on AFDC in that year, consisting of \$13 billion in federal funds and \$10 billion in state funds.

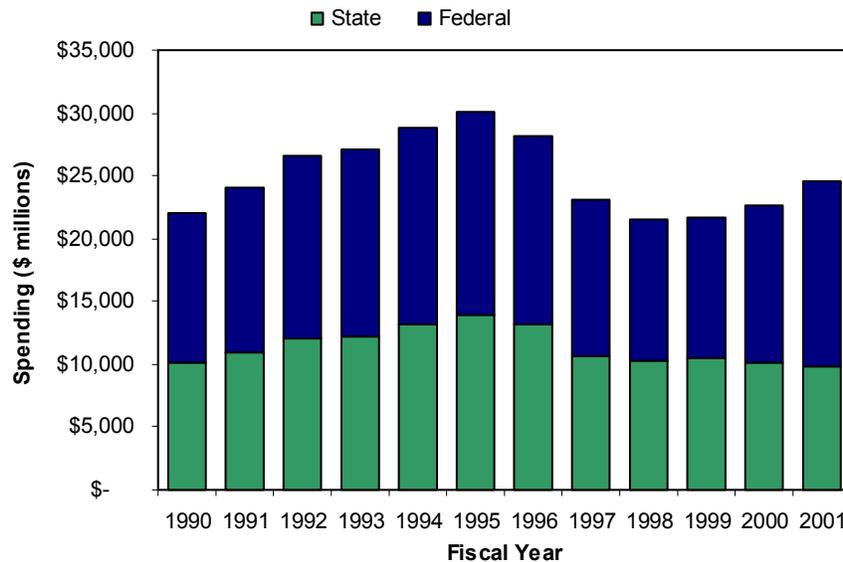
The world of welfare changed dramatically with the passage of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (PRWORA), which replaced AFDC with a new welfare program known as Temporary Assistance for Needy Families (TANF). PRWORA actually expired in 2002 but has been extended eight times. The most recent extension, passed in September 2004, provides for a continuation of federal funding for the program at fiscal year 2002 levels through March 2005. The most significant budgetary change from AFDC to TANF is that the new program is funded by federal block grants to the states. In order to receive the full amount of their block grants, states must maintain spending at 75 percent of their peak fiscal year 1994 levels. This arrangement has been criticized on equity grounds, as richer states that could afford to spend more on AFDC in the mid-1990s were rewarded with larger TANF block grants.

Within these broad “maintenance of effort” restrictions, states are permitted to set their own program rules and develop unique low-income support programs. This freedom has resulted in a diverse array of state welfare programs in effect today.⁸³ Average monthly family benefits ranged from \$154 in South Carolina to \$631 in Alaska in fiscal year 2002. Most state benefit amounts are now lower than they were in 1994. This diversity in program rules alongside existing variation in state populations has led to wide disparities in per capita state TANF spending, ranging from a low of \$8 in Alabama, Arkansas, Mississippi, and South Carolina to a high of \$102 in New York in fiscal year 2001 (Wilkins and Glaspey 2002).

Total federal and state spending on TANF and predecessor programs (AFDC, Emergency Assistance to Needy Families, and the Job Opportunities and Basic Skills Training program) fell dramatically since the mid-1990s as shown in Exhibit 38. Indeed, total spending fell by about one-third from a peak of over \$30 billion in 1995 to a low of about \$21 billion in 1998. The state share also fell during this time period, from a peak of 46.6 percent in 1996 to a low of 39.8 percent in 2001 (US House 2004). Interestingly, the federal government has borne a disproportionate share of the spending increases in the latter years of Exhibit 38. It should be noted that the non-federal share of AFDC/TANF funding has come almost entirely from state and not local funding sources. Also, despite the fact that TANF represents less than one percent of total state spending (and TANF cash assistance less than one-half of one percent), welfare policies continue to receive a disproportionate share of attention in policy discussions. We highlight some of the more common themes after summarizing the key differences between AFDC and TANF below.

⁸³ In fact, six states (Hawaii, Nebraska, Oregon, South Carolina, Tennessee, and Virginia) operate their TANF-like programs under waivers from federal restrictions. These waivers, which were more commonly used before the passage of PRWORA, are intended to provide even more flexibility to the states in setting welfare policies.

Exhibit 38: Federal and State Spending on TANF and Predecessor Programs, 1990 to 2001



Sources: Congressional Research Service and US Department of Health and Human Services, as reported in Table 7-18 of the *2004 Green Book*, US House Committee on Ways and Means.

TANF is different from the old AFDC program in many important ways. First, TANF is not an entitlement program. Federal funding cannot be used to provide benefits for any family beyond a total of 60 months during the caretaker’s lifetime. About half of the states use the federal 60-month lifetime limit, while most of the others have adopted shorter lifetime limits. Some states have what are called interim (or single-spell) time limits. The purpose of the time limit policies is to end the culture of welfare dependency by providing strong incentives for self-sufficiency. Up to 20 percent of a state’s caseload can be exempted from time limits for various reasons, and state funds may be used to provide benefits beyond the federal time limit of 60 months.

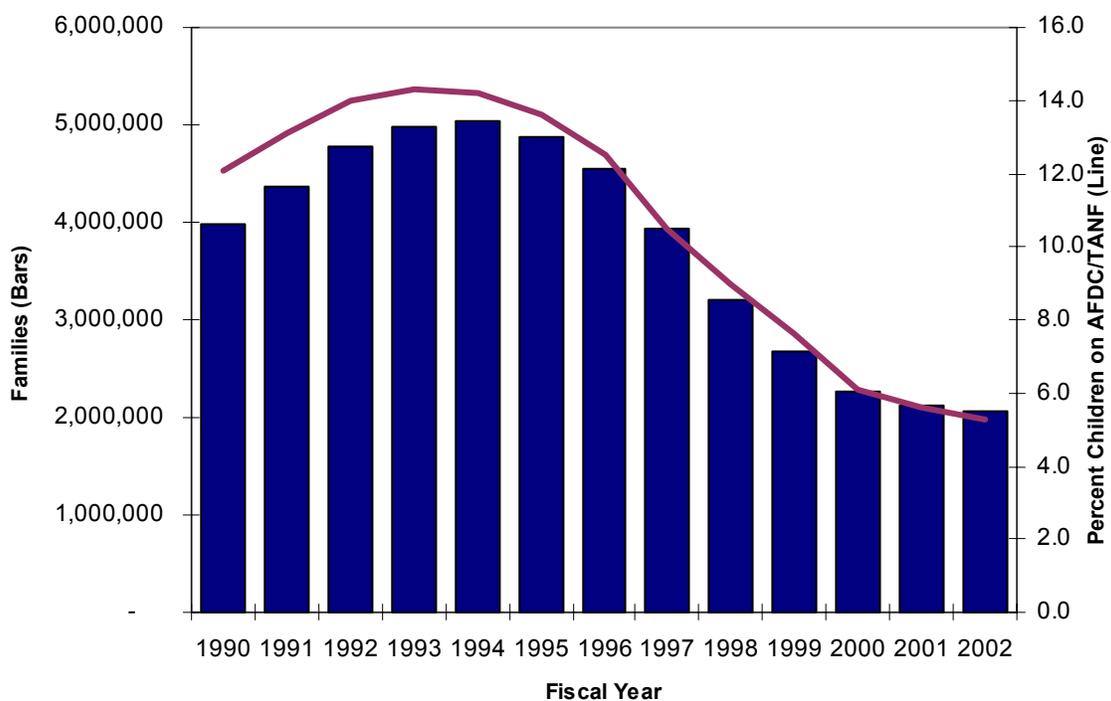
A second major difference is that participants are expected to engage in some form of work-related activity in order to get benefits. Under federal guidelines, participants must find a suitable activity for at least 30 hours per week within 24 months of receiving benefits. At least 20 of those weekly hours must be spent in work or work-like activities, while up to 10 hours can be used for work-related education or training. The timing and severity of the work requirement, as well as the list of acceptable activities, vary widely across family types and across the states. TANF provides for a system of exemptions and sanctions (partial or complete benefit reductions) which apply in the event that a recipient is unable or unwilling, respectively, to comply with their work requirement. Half of a state’s caseload must be working in order for the state to receive full federal funding for their TANF program. A state’s required work participation rate is reduced one-for-one for each percentage point reduction in its caseload relative to 1995.

Recognizing that many welfare recipients have severe barriers to employment, TANF provides for a system of support services. In addition to the non-TANF network of services such as Medicaid, Food Stamps, and federally-supported child care assistance, TANF funds may be used by the states to provide important work supports. Many states have provided transportation

and supplemental child care benefits. Indeed, more than half of all federal and state TANF spending is now on non-cash benefits and services. While 43.6 percent of all spending in fiscal year 2001 was on cash assistance, 26.3 percent was on transportation, child care, and other work supports. The remaining 30.1 percent was spent on other unspecified benefits and on administration.

The effects of these dramatically different policies have been varied and controversial. The most immediate indicator of potential policy impacts was a tremendous reduction in welfare caseloads across the US as shown in Exhibit 39. Between 1994 and 2000, caseloads fell by nearly 57 percent. Only about two million families were on TANF in 2002. Debate continues over the extent to which this was driven by robust economic conditions or policy changes, but the most recent research finds that both played important roles.⁸⁴ A contributing factor is the array of diversion programs in some 30 states, which generally provide one-time grants or services in times of short-term emergency to give families an alternative to actually joining the welfare rolls.

Exhibit 39: Average Monthly AFDC/TANF Caseload and the Percentage of All Children under 18 on AFDC/TANF



Sources: Congressional Research Service and US Department of Health and Human Services, as reported in Table 7-6 of the 2004 *Green Book*, US House Committee on Ways and Means.

This large drop in caseloads, alongside required spending levels, resulted in the explosion of non-cash support services such as child care and transportation benefits. Also, many states simply did not spend their entire block grant allotment, electing to roll the funds over for future

⁸⁴ See Blank (2002) and the references therein for more information on this and all other program impacts noted in this section.

use. As caseloads have crept upward in the aftermath of the most recent recession, however, a number of support service programs have been reduced or cut entirely and unspent balances have been gradually depleted.

A second noticeable example of the possible impact of welfare reform has been a dramatic increase in work participation. While only about 8.8 percent of AFDC adults worked in 1995, 25.8 percent of TANF adults were working in 2000. Recent studies of welfare leavers have found that post-program employment levels are also quite high, reaching 50-65 percent in some states. Other programs such as the Earned Income Tax Credit and the minimum wage might have assisted in these outcomes, however.

TANF regulations are also designed to reduce the disincentives for marriage that were inherent in AFDC. One of the more high-profile welfare policy debates in recent years has been whether and how policy might be further augmented to promote healthy marriages or at least become more marriage-neutral. Similarly, TANF was designed to reduce the incentives for child-bearing that were so common under AFDC. In twenty states, family cap policies stipulate that benefits do not increase if a recipient conceives a child while on TANF. Also, the original welfare reform law set up a system of bonus payments to the states that reduce rates of non-marital childbirth by the largest amounts. There is suggestive evidence that these provisions have been successful, as out-of-wedlock birth rates have fallen in recent years despite continued declines in marriage rates.

One fear expressed during the welfare reform debate of the mid-1990s was that local labor markets would be unable to absorb the sudden inflow of welfare recipients. If jobs were not available, it was thought that the work requirements would increase unemployment and drive down market wages. Post-reform studies have found, however, that the increased labor demand during the economic boom of the late 1990s was more than enough to offset the new increase in labor supply. Another fear was that states would enter a “race to the bottom” if they cut funding for welfare programs in the absence of a federal matching grant. This also does not appear to have come to fruition despite continued variation in the generosity of state welfare programs.

While welfare reform is widely considered to have been a successful policy change, a number of important revisions will be considered as the US Congress prepares to debate a more permanent reauthorization of PRWORA in the spring of 2005. When welfare reform first expired in 2002, there was some concern that the federal block grants—which were based on peak-caseload years in the mid-1990s—were too high. The recent economic downturn has muted this concern, however, as states have spent down accumulated balances and in some cases have even experienced shortfalls.

More likely areas for policy change include time limit and work requirement provisions. With so few families meeting time limits and those who meet them being supported by state funds, there is some speculation that time limit policies will be made less stringent. Also, with the relative success in getting welfare adults into paying jobs, a number of proposals include increases in work requirement hours and immediacy.

Higher Education

Public higher education institutions play the predominant role in higher education, especially at the undergraduate level, and among 2-year institutions in particular. More than 12 million full and part-time students were enrolled in the nation's approximately 1,700 public degree-granting colleges and universities in fall 2001, accounting for 77 percent of all enrollment in public and private institutions. Public higher education institutions account for approximately 96 percent of all enrollment among 2-year institutions (NCES 2003, Table B).⁸⁵

Higher education is the third-largest spending category for the state-local sector, after elementary and secondary education and Medicaid. State and local governments provided \$61.9 billion in direct appropriations to their higher education institutions in fiscal year 2001, plus \$8.1 billion in grants and contracts, and \$2.9 billion in scholarships and fellowships. State governments play a far larger role than local governments, and provided 90 percent of these sources of aid. State and local governments also provide approximately \$2.5 billion in aid at private institutions consisting primarily of scholarships and fellowships, and also provide low-interest loans for students attending both public and private institutions (NCES 2003, Tables 28 and 30).

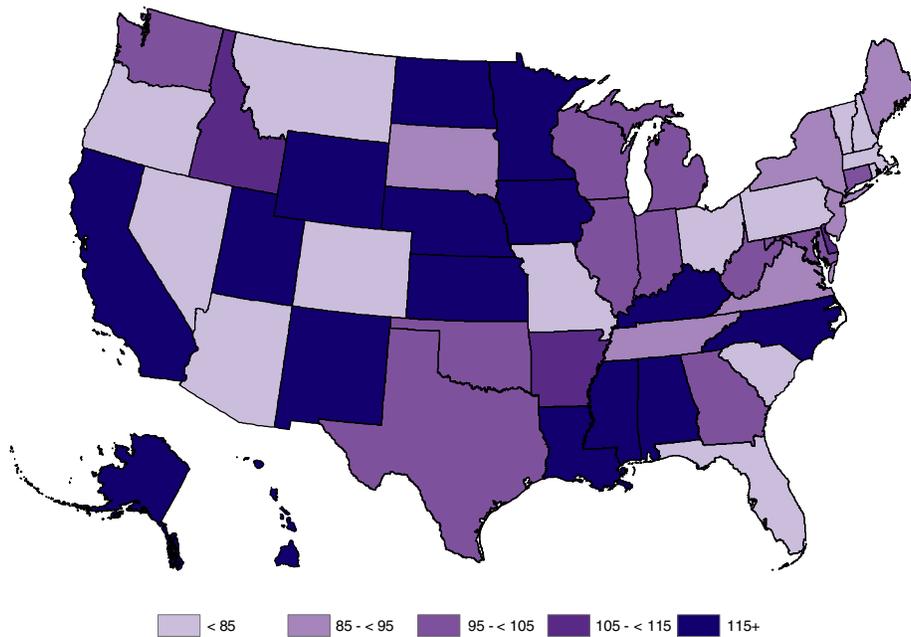
State and local governments are the largest source of revenue for public colleges and universities: in 2001 direct appropriations constituted 35 percent of revenue for all public colleges and universities and 55 percent for 2-year institutions. Tuition and fees amounted to 18 percent of revenue, in contrast with 41 percent at private institutions. Another 15 percent of public institutions' revenue was from the federal government—10 percentage points of this was from grants and contracts and four percentage points from Pell grants and other scholarships (NCES 2003, Tables 28 and 30).

Patterns Across States

States spend widely varying amounts on higher education. In 2002-03 state appropriations for public higher education institutions ranged from a high of \$396 per capita in Wyoming (80 percent above the United States average) to a low of \$88 in New Hampshire (60 percent below the average) (Grapevine). Exhibit 40 shows these appropriations for all states, indexed to the US average. Several regional patterns are evident, including the fact that northeastern states tend to spend less than average per capita, even though they typically spend well above average on most other functions of government.

⁸⁵ The discussion here and in subsequent paragraphs is limited to degree-granting institutions receiving federal Title IV funds, which includes nearly all institutions receiving public funds.

Exhibit 40: State Higher Education Tax Appropriations Per Capita, Indexed to US Average, Fiscal Year 2003



Source: Center for the Study of Education Policy at Illinois State University (Grapevine).

One reason state support per-capita varies so much is because states have very different proportions of students enrolled in public higher education, reflecting both the location of private institutions and the propensity to attend private as opposed to public institutions. For example, only seven percent of Wyoming’s full-time enrollment is in private higher education, while 46 percent of New Hampshire’s is in private institutions (NCES 2003, Table 205). Many of the states with low per-capita spending on public higher education have well developed private higher education systems, relatively few students in public higher education, and relatively high spending per public student despite low per-capita spending.

States with high per-capita spending do not necessarily have high spending per-student. Even though Wyoming spends more per capita than any other state, its spending per full-time-equivalent in public institutions is at the national average, in part reflecting the relatively small role of private sector higher education in the state. By contrast, many of the northeastern states with low per-capita spending have above-average spending per student—in particular, Connecticut, Massachusetts, and New Jersey—all spend well above the national average per FTE student.

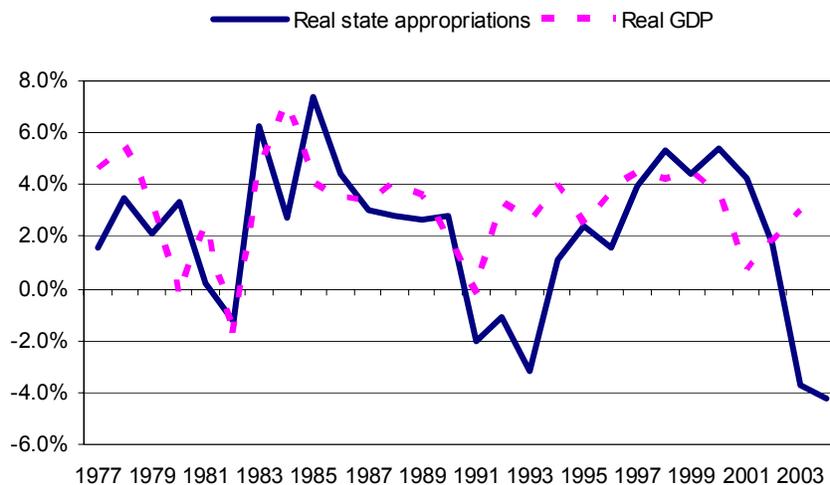
Changes Over Time

Higher education enrollments increased rapidly during much of the 20th century as did expenditures per student, resulting in large increases in state government expenditures on public higher education, particularly after the baby boomers entered their college years. State government appropriations for public higher education institutions nearly tripled from 2.8 percent of gross domestic product in 1961 to a 1976 peak of 7.0 percent. State expenditures for higher education then began to decline relative to the economy and relative to other state

spending, particularly in the 1990s. This reflected a decline in enrollment as a share of the population during the 1990s and also a more-general decline in higher education relative to other state government priorities. Between 1977 and 2002, state appropriations for higher education fell almost continuously, from 12 percent of state-financed expenditures to 8.1 percent, and to about six percent of gross domestic product. Although state government spending on public higher education has declined relative to other priorities, real state spending *per student* has risen for most of the last two decades, albeit with some very significant ups and downs, including a decline of 10 percent between 2001 and 2003.⁸⁶

During fiscal crises state governments have tended to cut funding for higher education more than other areas of the budget, and to increase funding substantially when the economy recovers. Exhibit 41 shows that state appropriations for higher education generally move with changes in real gross domestic product (a broad measure of the economy). Appropriations fell sharply during the crises associated with the 1980-82, 1990-91, and 2001 recessions. Although the 2001 recession was the mildest in recent history (real GDP did not even decline for the year as a whole), spending cuts during the associated fiscal crisis in 2003 and 2004 were deeper than in the two prior fiscal crises. Real state appropriations for public higher education institutions fell by 7.8 percent between fiscal year 2002 and fiscal year 2004, and declined in 36 states, as shown in Exhibit 42. Nevada and Wyoming were the most significant exceptions to this pattern, where appropriation increases reflected better fiscal conditions than in other states and rapid growth in enrollment.

Exhibit 41: Percentage Change in Real State Appropriations for Public Higher Education and Real Gross Domestic Product



Sources: Grapevine and US Bureau of Economic Analysis.

⁸⁶ The decline continued in 2004, but enrollment data are not yet available for that period.

**Exhibit 42: Percentage Change in Real State Appropriations for Higher Education,
Fiscal Year 2002 to Fiscal Year 2004**

	<u>Two-year percent change</u>
Nevada	33.7%
Wyoming	16.9%
Hawaii	9.7%
Louisiana	5.8%
Vermont	3.5%
Kentucky	3.1%
New Mexico	2.3%
South Dakota	2.2%
Alaska	2.0%
Arkansas	1.5%
Florida	1.3%
New Hampshire	0.5%
Alabama	0.2%
Mississippi	0.1%
New York	-0.9%
Indiana	-1.1%
Delaware	-1.4%
Montana	-3.4%
North Carolina	-3.8%
Maine	-3.9%
North Dakota	-3.9%
Ohio	-4.1%
Connecticut	-4.3%
Rhode Island	-4.8%
New Jersey	-5.1%
Georgia	-5.9%
Tennessee	-6.2%
Idaho	-6.3%
Arizona	-6.6%
Nebraska	-7.2%
Washington	-7.3%
Kansas	-7.6%
Pennsylvania	-7.6%
Utah	-7.7%
United States total	-7.8%
Iowa	-7.9%
Texas	-9.3%
Wisconsin	-10.1%
Minnesota	-10.4%
Illinois	-10.6%
Michigan	-11.5%
Oklahoma	-11.7%
West Virginia	-12.3%
California	-13.2%
Maryland	-14.6%
Oregon	-14.9%
Missouri	-17.3%
Virginia	-21.0%
South Carolina	-23.5%
Colorado	-24.9%
Massachusetts	-26.0%

Source: Center for the Study of Education Policy, Illinois State University
<www.coe.ilstu.edu/grapevine>.

Economists Thomas Kane, Peter Orszag, and David Gunter (2003) recently conducted a statistical analysis of state spending on higher education, Medicaid, corrections, and other spending categories. They concluded that higher education is one of the most cyclical state government budget categories, and that Medicaid has tended to crowd out higher education spending, especially in periods of economic weakness and during the 1990s as a whole.

State Appropriations, Tuition, and Institution Spending

At the same time that state governments are cutting appropriations to colleges and universities during a fiscal crisis, enrollment tends to rise because more students enter college and stay longer when the job market is weak. The net result during and shortly after recessions often is a sharp decline in state funds per enrolled student, which can lead to a financial squeeze on public higher education institutions and strong pressure to raise tuition. For example, in the three years most closely associated with the 1980-82 recession, public four-year institutions raised average published tuition by about 4.5 percentage points more per year than in the three prior years; in the three years closely associated with the 1991 recession, they raised tuition by about five percentage points more per year than in the three preceding years, and in the most recent crisis they raised published tuition rates by about five percentage points more per year than in the three preceding years (College Board 2004).

Although public higher education institutions have increased tuition significantly, particularly during periods of fiscal crisis, these increases often are not as large as they appear, and have not kept pace with overall institutional spending or with tuition at private institutions. Actual tuition increases to students have been mitigated by large increases in state government tuition assistance and in tuition discounts offered by institutions. For example, an analysis of federal data by the National Education Association (2003) concluded that although reported tuition and fee charges at public 4-year colleges increased by 22 percent in constant dollars between 1993 and 2001, net real costs to students increased by 16 percent after reflecting institutional and other aid.

Kane and Orszag (2003) argue that it is more difficult for public institutions than private institutions to raise tuition, and that this has contributed to relatively lower spending per student at public institutions. Between fiscal years 1970 and 1996 (the latest year for which per-student expenditure data by sector are available from NCES, Table 345), real expenditures per student at public institutions increased by 31 percent, while increasing 50 percent at private institutions. Based on a statistical analysis of data on expenditures and institution quality, Kane and Orszag argue that the relative decline in public institution spending appears to be exerting an adverse effect on the relative quality of public higher education, as measured by trends in student-faculty ratios, faculty workload, faculty salaries, and faculty assessment of institution quality.

Looking Forward

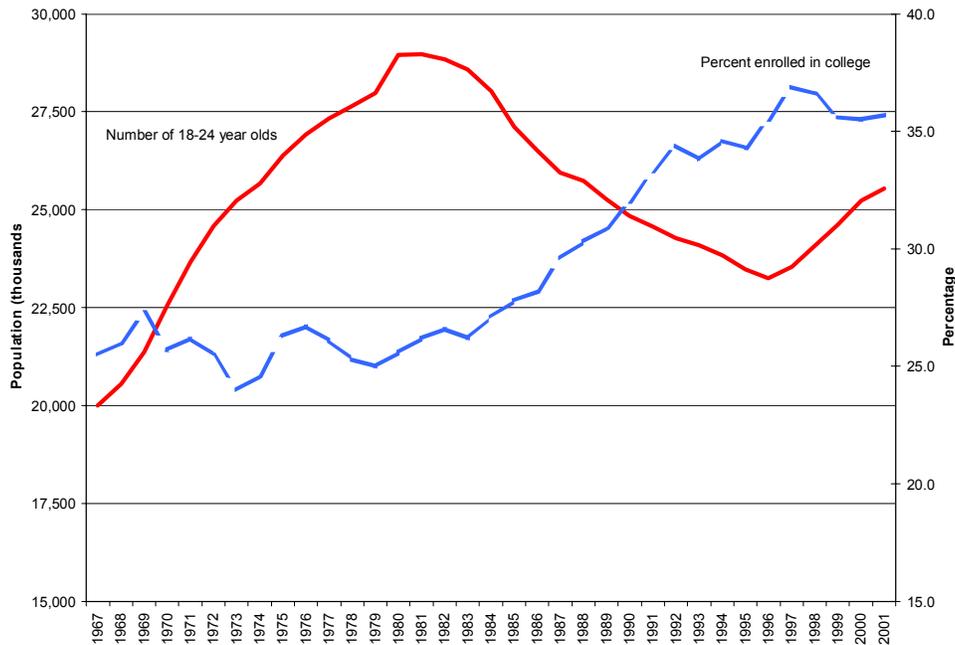
State and local governments will face two important trends over the next five to ten years that will put upward pressure on higher education spending. First, during most of the 1990s spending on higher education was restrained by a long decline in the number of people of prime college-going age (18-24 years old) due to the exit of baby boomers from the higher education system. That trend reversed at the end of the 1990s, and now the children of baby boomers—a

mini-baby-boom echo—are entering college. As a result, growth in this prime group will continue for the next five to ten years.

Second, a longer-term trend toward greater participation in higher education by individuals of all ages will continue, driven in part by “pull” from the labor market as more and more jobs require at least some college. According to projections by the US Department of Labor, occupations in which three-quarters or more of workers have at least some college education currently constitute only 29 percent of the market, but will constitute 43 percent of the new jobs over the decade from 2002 to 2012. To meet these labor market demands, the share of high school completers entering and completing college will need to continue to rise.

Exhibit 43 shows the recent reversal and increase in the number of 18-24 year olds, and the long-term increase in college enrollment rates, both of which will likely continue over the next five to ten years.

Exhibit 43: Enrollment Rate Increases No Longer Being Offset by Population Declines



Source: Reproduced from Kane, Thomas J., and Peter R. Orszag, Challenges Facing Public Higher Education, PowerPoint presentation, March 2004.

Other Expenditure Areas

The spending activities described above account for approximately half of all state and local government spending in the US. The next-largest spending areas are public safety and judicial services, transportation, and health and hospitals, which in aggregate account for another quarter of state and local spending.

Public Safety and Judicial Services

Overview

State and local governments spent \$188 billion on public safety and judicial services in 2002, accounting for 11 percent of total state and local spending.⁸⁷

About one-third of this spending was for police protection, which accounted for 3.7 percent of total state-local spending. Policing is primarily a local government function in most states, and local governments financed nearly 85 percent of all police spending on average. Per-capita police spending in 2002 ranged from \$418 in Alaska to \$104 in West Virginia. Between 1982 and 2002, real per-capita spending on police increased by 71 percent, slightly slower than the 74 percent growth in overall state-local expenditures.

Corrections is the next-largest public safety activity, accounting for 29 percent of the category and 3.2 percent of total state-local spending. Corrections is largely a state function, with state governments financing more than 70 percent of spending. The federal penitentiary system plays a relatively small role, accounting for eight percent of prisoners under state or federal jurisdiction. Per-capita state and local corrections spending in 2002 ranged from \$308 in Delaware to \$91 in New Hampshire. Much of the variation in spending across states is driven by big differences in the fraction of each state's population in prison—ranging from 801 prisoners per 100,000 population in Louisiana to 149 in Maine, compared with a national average of 430 prisoners per 100,000 population. Incarceration rates tend to be considerably higher in southern states than in the rest of the country. (In addition, there are large differences in expenditures per inmate, driven in part by big differences in the number of inmates per staff—northeastern states, for example, tend to have fewer inmates per employee than do southern states, making northeastern prisons more expensive.) Between 1982 and 2002, real per-capita spending on corrections increased by 182 percent (a near-tripling).

Judicial and legal activities (including civil courts as well as criminal courts) are also an important element of this category but are relatively small in the scheme of the typical state or local government budget, accounting for 1.8 percent of total state-local spending in 2002. Per capita judicial expenditures in 2002 ranged from \$207 in Alaska to \$52 in South Carolina. Nationally, real per-capita judicial and legal expenditures increased by 187 percent between 1982 and 2002.

Fire protection was 14 percent of public safety and judicial expenditures in 2002, and 1.5 percent of overall state-local spending. Fire protection as tracked by the US Census Bureau is exclusively a local area of activity, with no reported expenditures by state governments. Per capita fire protection expenditures in 2002 ranged from \$179 in Rhode Island to \$30 in Delaware. In many rural and suburban areas of the country, a large part of fire protection services are provided by volunteer fire companies. Nationally, real per-capita fire protection expenditures increased by 63 percent between 1982 and 2002.

⁸⁷ The statistics in this section are drawn from US Census Bureau data on government finances.

Rapid Growth in Corrections Spending

Corrections has been the most variable component of public safety spending, reflecting changes in crime rates and changes in attitudes and policies toward sentencing. The reported rate of violent crime nearly quintupled between 1960 and 1991, and then declined by about 35 percent between 1991 and 2002 and appears to have continued to decline. (Property crime rates peaked in 1980, after which they declined in fits and starts.)

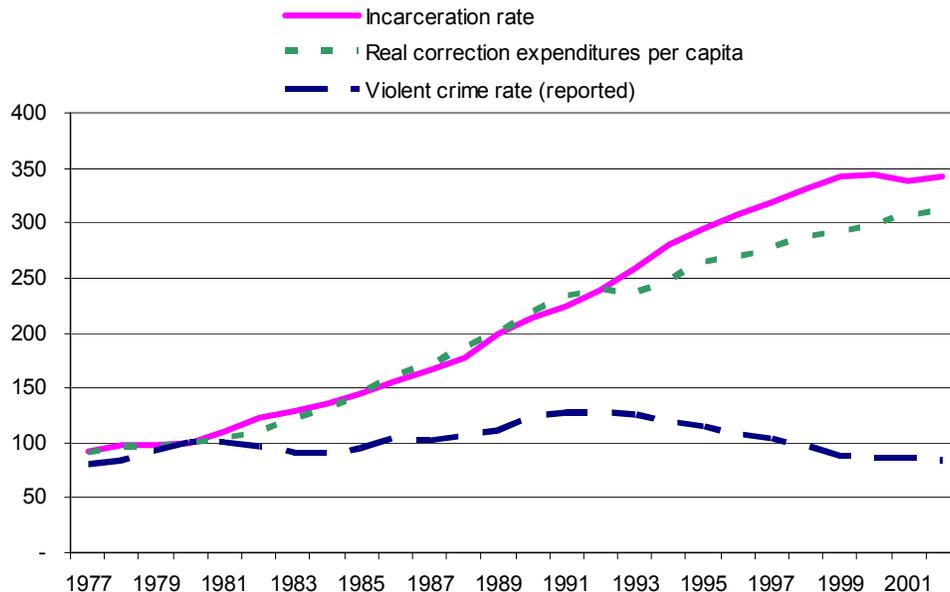
Despite the drop in crime, the prison population continued a dramatic rise that began around 1975. Between 1925 and 1975 the incarceration rate remained quite close to 100 prisoners per 100,000 population, but then nearly quintupled by 2002 (Chaiken 2000; Harrison and Beck 2004). The increase in incarceration reflected many factors, including sentencing policies such as “three strikes and you’re out” and policies to reduce judges’ sentencing flexibility; more stringent parole policies leading to longer stays in prison; and a large increase in the number of nonviolent drug offenders in prisons.⁸⁸ Whether and how much of the drop in crime rates was caused by the increase in incarceration rates (by reducing convicted criminals’ opportunity for crime and raising the perceived cost of committing crimes) is a matter of debate among criminologists.

Traditional incarceration is extremely expensive, costing more than \$22,000 in operating expenses per inmate in 2001. The increase in incarceration rates corresponded with a rapid rise in state and local government spending on corrections, as shown in Exhibit 44. States embarked on a prison-building boom that caused real per-capita capital spending on correctional facilities to more than triple between 1977 and 1991. The prison-building boom has since subsided, and real per-capita capital expenditures have fallen nearly in half since 1991, but operating expenditures continue to grow.⁸⁹

⁸⁸ See, for example, US General Accounting Office (1996).

⁸⁹ Authors’ analysis of finance data from the US Census Bureau. Also, see Dadayan (2004).

Exhibit 44: Violent Crime, Incarceration Rate, and State-Local Corrections Expenditures, Indexed to 1980



Sources: US Bureau of Justice Statistics; US Census Bureau.

In recent years incarceration rates have flattened out for the nation as a whole and corrections-related budget pressures on state and local governments have eased in some states. However, growth in the number of prisoners did accelerate in 2003 and in any event, many states will run counter to the national trend and continue to face pressure from growing prison populations and related expenses. In addition, the prison population is aging and the related health problems and expenses of prisoners is causing per-prisoner expenses to increase.

Recent actions by state governments suggest that states are trying to avoid building new prisons and are looking for alternatives. According to the Vera Institute of Justice more than half of the states have loosened sentencing rules in recent years and other states are considering the same (Scolforo 2004). For example:

- In 2003 Missouri enacted an early-release law for certain first-time nonviolent offenders (Lieb 2004);
- Michigan, New York, and Pennsylvania have enacted changes to their drug laws to give more emphasis to treatment and less to incarceration (Cooper 2004);
- Vermont is considering additional work camps, expanded use of global positioning satellite-linked ankle bracelets for nonviolent offenders, greater use of a community-based approaches such as furloughs and probation, and sentencing-guideline changes to give judges greater discretion, all of which can reduce the number of offenders in prison and the associated costs (Associated Press 2004).
- Other states have announced that they face increasing pressure from growing prison populations, or are considering policy changes to reduce prison populations, or both, including Alabama, Arkansas, Hawaii, Indiana, Kentucky, New Hampshire, Oklahoma, Oregon, Tennessee, and Wisconsin.

Additional loosening of sentencing laws and various alternatives to incarceration seem likely to be increasingly popular in the years ahead.

Transportation

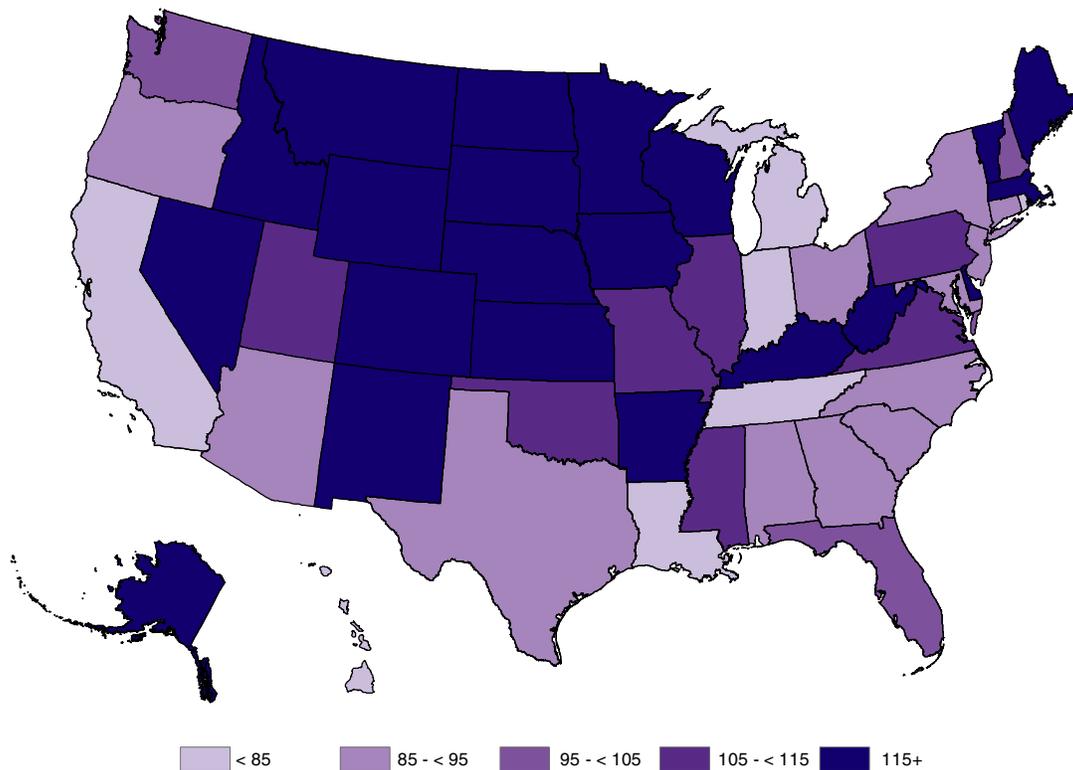
The nation's transportation system includes 3.9 million miles of roads and highways, 5,400 public airports, 200,000 miles of freight and passenger railroad track, 5,800 miles of urban mass transit track with more than 2,300 stations, and 3,600 waterport terminals (American Road). Total federal, state, and local government expenditures to build, maintain, operate, and administer this system were \$168 billion in 2000 (the latest year for which spending for all three levels of government is available).

Transportation financing differs in important respects from other areas of state and local finance. First, the federal government plays a larger role in financing transportation than it does in most other areas: including grants it makes to state and local governments, the federal government financed 30 percent of transportation spending in 2000 (US Department of Transportation 2004). Another important difference is that transportation is extremely capital intensive—fully 57 percent of highway expenditures are for capital purposes, compared with 10 percent for the rest of state and local government spending. Finally, unlike other areas of government activity, most of the revenue raised to finance transportation spending is dedicated by law for this purpose and comes in large part from federal and state gasoline and motor fuel taxes.

State and local governments spent \$137 billion on transportation in 2002 (including spending of grants received from the federal government), accounting for eight percent of total state and local spending.⁹⁰ Nearly 85 percent of this was for highways. Per-capita highway spending in 2002 ranged from \$1,447 in Alaska and to \$309 in Tennessee. Many of the states that spend the most on highways tend to have populations spread out over large sparsely populated areas, often located in the Rocky Mountain and Plains regions, while lower-spending states tend to be in the northeast and other densely populated regions, as Exhibit 45 shows. Nationally, state and local real per-capita transportation expenditures increased by 52 percent between 1982 and 2002, less than the 74 percent increase in overall state-local spending.

⁹⁰ The \$137 billion cited here is based on data from the US Census Bureau, whereas data in the preceding paragraph were from the US Bureau of Transportation Statistics. The two concepts are not directly comparable.

Exhibit 45: Per-Capita State and Local Highway Expenditures Indexed to the US Average



Source: US Census Bureau.

The federal government's primary transportation program is the Transportation Equity Act for the 21st Century (TEA-21), which authorized more than \$200 billion of federal funding (financed by the federal gas tax and other dedicated revenue sources) over the six federal fiscal years from 1998 through 2003 for highway, highway safety, transit and other surface transportation programs. TEA-21 is a major source of transportation financing to state and local governments, and it was supposed to have been reauthorized by its September 30, 2003 expiration but instead has been extended for several months at a time. It currently expires on May 31, 2005.

TEA-21's eventual reauthorization will raise major issues for state and local governments, including questions about the overall level of federal funding, the way it is allocated across states and associated issues relating to "donor" and "donee" states, and the degree of flexibility states will have to transfer funds among different transportation modes and purposes.

Health and Hospitals Spending

Health and hospitals spending was \$146 billion in 2002, accounting for 8.4 percent of state and local government general expenditures. Hospital spending is approximately 50 percent larger than health spending, but health spending has been growing faster—147 percent in real per-capita terms from 1982 to 2002, compared with only 26 percent for hospitals. Hospital expenditures vary more across states than do health expenditures: hospital spending ranged from

\$817 per capita in Wyoming to \$15 in Vermont, while health expenditures varied from \$381 in Hawaii to \$81 in Nebraska.

Cross-Cutting State and Local Government Expenditure Issues

Perhaps the most important trend that will cut across state and local government budgets is the aging of the American population:

- As discussed earlier, Medicaid costs will grow rapidly when the leading edge of the baby boomer generation ages and begins to require more health care and long-term care.
- As mentioned previously, the prison population is becoming much older: in 1995 13 percent of the nation's prisoners were age 45 or older, but this group accounted for 34 percent of the growth in the number of prisoners between 1995 and 2003, reflecting older ages at the time of entrance into prison and sharply longer time served (Harrison and Beck 2004). The aging of the prison population is expected to continue. Older prisoners will require more expensive health care, and many states are beginning to notice this new and growing expense in their corrections budgets.
- A related issue is that older workers account for a large and growing proportion of government employment. About 46 percent of the 20.6 million government workers in 2001 were 45 years of age or older, compared with only 31.2 percent of the private sector workforce. In 1994, only 39.0 percent of government workers were 45 or older. Local governments, particularly in the New England and the Mid-Atlantic states, will face a retirement bubble in the next decade. Nationally, 50 percent of government jobs are in occupations requiring specialized training, education or job skills compared to just 29 percent in the private sector, and this may present hiring and retention challenges for government managers (Abbey and Boyd 2002).

A related issue is that health care costs in both private and public sectors have been rising rapidly—faster than the overall rate of inflation—regardless of the age of the person cared for. The largest impact of this is reflected in state Medicaid budgets, but it will appear in other places as well: in prisoner health care costs as noted above, in state-only health care programs, in employee health insurance expenditures, and in expenditures state and local governments make for retiree health care. For state governments these expenditure categories are far smaller than Medicaid—for example, the National Association of State Budget Officers and collaborators estimate that state Medicaid expenditures are more than eight times as large as state expenditures on employee health care (2003). No reliable estimates are available for local governments but they employ more than twice as many workers as state governments and employee and retiree health care can be significant budget items in individual jurisdictions.

State and particularly local governments are on the frontlines of homeland security, and the costs of this is spread throughout budgets—in police and fire protection, emergency medical response, hazardous waste response, public health, transportation systems, water and power utilities, and in other areas. An independent task force sponsored by the Council on Foreign Relations estimated in 2003 that “America will fall approximately \$98.4 billion short of meeting critical emergency responder needs over the next five years if current funding levels are maintained,” above and beyond the \$53-103 billion the task force expects federal, state, and local governments to spend on emergency response in the five years beginning in 2004. (The CFR

shortfall of \$98.4 billion over five years, if funded by state and local governments, would amount to about one percentage point of state-local spending.) Meanwhile, the American Enterprise Institute argues that state and local government spending of federal grants for first responders frequently has been wasteful, and is inefficient in the sense that federal grants for emergency response will necessarily be allocated politically rather than based on risk assessment, and that the federal role should be focused on investigation, interdiction, and elimination of terrorist threats, and on national-level response (de Rugy 2004).

Another issue that cuts across expenditure categories is the cost of employee pensions. Some governments embed these costs in the compensation costs of individual agency budgets while others consolidate them in a single pension contribution line, but in any event they are affected by similar forces. The vast majority of state and local government employee retirement plans are defined benefit plans, where the government pension fund generally guarantees a steady stream of income to retirees. The trend toward defined contribution plans, where an individual's future income depends on his or her investment returns, has been far less pronounced in the public sector than in the private sector (Mason 2003).

In the short run, state and local government budgets are affected not by the size of pension benefits or pension fund investment returns, but through contributions the government is required to make to a pension plan that in any single year may be only loosely connected to benefits and returns. Over the longer run, these contributions will change in lagged and usually smoothed manner in relation to changes in benefits, investment returns, and workforce demographics.

Although local governments have far more workers than state governments, states actually account for about 55 percent of all state-local pension contributions (including state contributions for local workers). However, the impact of contributions relative to budget size is larger for local government than state government because state budgets are larger. In 2002, pension contributions paid by local governments were 3.6 percent of own-source revenue while contributions paid by states were 2.4 percent of own-source revenue.

While pension contributions may seem small relative to overall budgets, they can be quite variable as they respond to pension fund earnings. In 1993 pension fund earnings were 8.9 percent of state-local own-source revenue but as the stock market rose in the mid- and late 1990s earnings rose to a peak of 18.6 percent of own-source revenue in 2000, and they actually exceeded total state-local income tax collections in every year from 1997 to 2000 (earnings are not included in state or local budgets; however, they remain within the pension fund). This rapid increase in pension fund earnings allowed state and local governments to reduce pension fund contributions by approximately 30 percent, with a slight lag.

With the subsequent fall in stock markets, pension fund earnings have fallen as well—in fact earnings were negative in 2002—and pension contributions in the typical government will have to rise. For example, Rhode Island's contribution increase could amount to four percent or more of the state budget, and many other state and local governments face similar pressure (Tavares 2004).

Federal Mandates

Many state and local government officials are concerned about the impact of federal mandates upon their finances and policy choices, particularly when those mandates come without federal funding. Unfunded mandates can be particularly attractive to the federal government because they allow it to pursue policy goals with no direct impact on the federal budget.

In response to concerns from state and local governments that Congress was increasingly turning to unfunded mandates, Congress enacted the Unfunded Mandates Reform Act of 1995 (UMRA). UMRA does not prohibit new unfunded mandates, but is intended to encourage greater Congressional debate by requiring “mandate statements” from the Congressional Budget Office on specific legislation and by prohibiting or limiting consideration by Congress of bills that exceed certain fiscal-impact thresholds if they do not have mandate statements.

The scope of UMRA is much narrower than state and local governments would like it to be. UMRA generally defines a mandate as any provision in legislation, statute, or regulation that would impose an enforceable duty on state, local, or tribal governments or the private sector, or that would reduce or eliminate the amount of funding authorized to cover the costs of existing mandates. This does not cover many actions that state and local governments consider mandates. For example, it does not cover federal laws or rules that make grant aid contingent on state action, reduce funding but do not reduce state requirements, extend or expand existing mandates, or create national expectations that state and local governments will spend money (as in the case of homeland security).

As a result, UMRA did not cover the No Child Left Behind Act because it is voluntary (the NCLB requirements must be met if states wish to receive NCLB funds, but not otherwise), and it did not cover the provisions of the 2001 tax act phasing out the federal estate tax thereby making state estate taxes impractical and creating a revenue loss to states, because it creates no enforceable duty on state and local governments. It also does not cover most federal Medicaid rules because they are generally voluntary in the same way that NCLB is voluntary. Only three laws since 1995 meet UMRA mandate definitions and have exceeded its thresholds, and they have had relatively little fiscal impact (US Congressional Budget Office 2004).

The National Conference of State Legislatures remains concerned about unfunded federal mandates and tracks its own concept of federal mandates, which it calls “cost shifts,” shown in Exhibit 46. As defined by NCSL these are actions by the federal government that shift costs to the states or local governments, even if not qualifying as mandates under UMRA. The NCSL estimates generally are based on the gap between the amount the federal government authorized for a specific purpose and the amount of funding the federal government actually provided.

Even the NCSL cost-shift concept is narrow from some perspectives. For example, the estimates for No Child Left Behind reflect costs of implementing the act, but not the potentially larger costs of actions state and local governments may take to meet higher standards.

Exhibit 46: NCSL Estimates of “Cost Shifts,” Federal Fiscal Year 2005

	Amount in \$ Billions
No Child Left Behind	10.0
Individuals with Disabilities Education Act (IDEA)	9.0
State Drug Costs for Dually-Eligible Individuals (Medicare and Medicaid)	6.6
Medicaid limits on Intergovernmental Transfers (IGTs) and related activities	1.9
Environmental cost shifts	1.5
Homeland security spending	1.3
State Criminal Alien Assistance Program (SCAAP)	0.3
Food Stamps administration	0.2
Other	1.2
Total	30.7

Source: National Conference of State Legislatures, *Mandate Monitor*, July 2004.

Conclusions

State and local government direct expenditures as a share of GDP have risen steadily over the past two decades and now exceed federal direct expenditures. Despite pressures for expenditures to continue rising, fiscal constraints will ultimately prevent expenditures from growing at the same pace relative to GDP. Slower growing revenues than during the past two decades will be the primary constraint on state and local government spending. To be sure, reductions in expenditure pressures will take place in some areas, such as slowing enrollment in primary and secondary education, and this could lower growth rates. Pressures for higher expenditures in some sectors such as health care will remain, however, and it seems that some other new demand for public expenditures is always on the horizon. Given the limitations imposed by revenues the battle on the spending side will be over the allocation of available spending rather than over how to spend more dollars.

Growing state and local government expenditures have been financed heavily by rising non-tax revenues, such as charges and fees, and federal aid (particularly for Medicaid). Taxes as a share of GDP, on the other hand, have stayed approximately constant. Political and economic pressures will keep each of these revenue sources more subdued over the next decade. First, state and local governments are likely to look to Washington for increasing financial assistance, but estimated budget deficits suggest that the federal government will not be receptive to calls for more intergovernmental transfers. If anything, the winds in Washington will call for less rather than more intergovernmental assistance.

Second, political pressure and globalization will make it difficult for most states to increase the role of taxes, and if anything taxes will decline relative to GDP. The sales and corporate income tax bases can be expected to continue shrinking relative to the economy and selective sales tax revenue will grow very slowly. States may be able to slow the base shrinkage, but probably will be unable to halt it. Experience of the last decade or so suggests that states will find it more difficult than had been true in the 1970s and 1980s to replace narrowing bases with higher tax rates, particularly for sources other than excise taxes on cigarettes, alcohol and gasoline. But excise tax rate increases will not even be enough to keep selective sales tax revenues from falling as a share of the economy. This is not to say that all tax revenues will be slow-growing relative to the economy. The individual income tax will expand faster than the economy because of the strong underlying elasticity of the tax, even though states have been slowly pushing income tax rates downward. The tax sources together will at best maintain their share of the economy and more likely will fall.

Third, state and local governments will continue looking to charges and fees for an increasing share of their financing. Higher education tuition and greater fees for services will be increasingly important. Of course, fees have generally been a bigger component of local government than state government finance, with the exception of tuition.

In sum, slow to moderate revenue growth combined with more rapid expenditure growth will necessitate some difficult but important policy changes in the coming years. State and local governments will have to choose between enhancing revenue streams (by increasing tax rates or broadening tax bases), cutting expenditures, or some combination of the two. These decisions could be either more or less difficult depending on federal policy actions on such things as interstate sales taxation, Medicaid financing, and general federal tax reform among many others.

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