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Executive Summary

State and local public finance has never been more important. Economic, political, and technological developments have dramatically changed how state and local governments raise revenue as well as on what they spend that revenue.

State and local public finance structures have not changed significantly over the past five decades. Indeed, the basic structure of the tax systems was designed for a different time and a much different economy. The world in which those systems operate has changed considerably.

The U.S. economy has moved from a manufacturing base to one dominated by the service sector and intellectual property. The challenge for state and local governments is that neither services nor intellectual property have been part of their tax base. Moreover, the economy in which people primarily bought locally manufactured tangible personal property no longer exists. Businesses no longer produce and sell products in one or a few states, but throughout the nation and the world.

Rapid technological advancements have also played a role in reshaping the fiscal landscape. The age of electronic commerce has revolutionized how people work, play, and communicate. Technology has affected all tax systems, but perhaps none greater than the traditional sales tax. Because state and local governments have been unable to impose sales taxes on most electronic commerce, they have lost billions in tax revenue. These loses have put enormous pressure on governments to find alternative sources of revenue or curtail public spending. In the end, the economy in which most of the state and local revenue systems were designed to operate has been replaced with a high technology, global economy where purchasing services or products from India and Italy is only a few keystrokes away.

The global economy has produced a new dimension into the use of fiscal policy to foster economic development. State and local governments have long engaged in a competition against each other for business investment and jobs. Over the past quarter century, political leaders have used their tax laws to encourage companies to relocate to (or to refrain from leaving) their state or locality. Such competition has put enormous pressure on state and local governments to keep tax burdens low, while providing the highest possible level and quality of public services. The globalization of the economy has magnified the scope of the competition. State and local governments are no longer competing with each other, but with nations around the world.

Another development with which states and local governments must contend is the changing scope of their duties. American subnational governments are providing more public services than ever before, and the need for revenue has never been greater. The states, for example, are not only providing the traditional services (state police, prisons, higher education, and highway maintenance.) They are also providing many services that were once almost exclusively provided and paid for by the federal and local governments.

Since the 1980s the federal government has been steadily shifting more and more responsibilities to the states. The states have been asked (or just as often have been forced) to administer and pay for many programs that traditionally have been the responsibility of the federal government. Welfare, Medicare, Medicaid, and highway maintenance are just some examples in which the states have replaced the federal government as the administrative body responsible for providing the services. While the costs of assuming many of these programs have been offset with increased federal funding and protections against unfunded mandates, this phenomenon, commonly called “devolution” in academic circles, has nonetheless contributed to the growth of state, and to a lesser extent, local government budgets.

This trend is likely to continue as the federal government, laboring under large deficits, devotes more resources to national defense and homeland security. State and local governments will be asked to do more.

At the same time, as the result of political pressure and a flood of legal challenges, state governments have taken on an increasingly greater share of the costs of public education. While elementary and secondary education was traditionally the financial responsibility of local governments, state governments have, over the past decade, paid a decidedly greater percentage of school finance costs.

In addition to the financial pressures from shifting responsibilities, state and local governments have experienced what could be called the “politics of anti-taxation.” Since the late 1970s there has been a concerted effort to politicize, even demonize, taxation. This often fervent anti-tax sentiment has festered at all levels of government during the past quarter century. Anti-tax politics fueled the passage of Proposition 13 in California and spurred property tax revolts around the country. Tax cutting became a regular theme for gubernatorial or legislative candidates seeking election in virtually every state. It has also helped spawn the initiative and referendum movement, a process that has traditionally been dominated by anti-tax crusaders. The politics of anti-taxation has limited state and local government ability to raise revenue precisely when the demand for services and education spending has increased.

This report provides a detailed description of state and local fiscal systems and how they operate given the developments discussed above. Some of the highlights of the report are set forth below.

1. Institutional Setting

State and local government finance in the United States is a complex and sophisticated system. The federal, state, and local governments each have their own sources of tax and non-tax revenue, their own budget processes, and to varying degrees political autonomy over their fiscal systems. Throughout the 20th and into the

21st Century, the federal government has relied predominantly on personal income taxes. State governments have relied on a combination of consumption and income taxes. And, local governments relied primarily on the property tax as their main source of tax revenue.

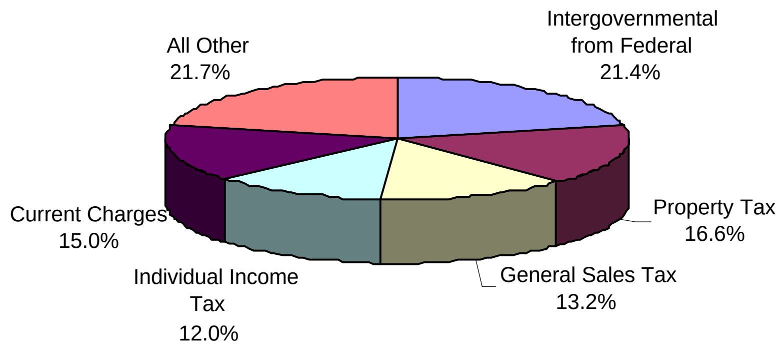
But the complexities extend beyond differences between levels of government. As discussed in detail in the report, there are wide variances in how governments at the same level collect revenue. For example, nine states do not tax personal income, five states do not tax sales, and ten states rely very heavily on severance taxes. Similarly, while the property tax is the dominant source of local government revenue, there are sectional differences in the reliance on this tax. Local governments in the Northeast, for example, rely far more heavily on property taxes than local governments in the Southwest. There are also significant differences in the number of local jurisdictions that impose sales and income taxes. These differences foster both intense interjurisdictional competition and heightened compliance and administrative costs for interstate commerce.

2. State and Local Revenue and Expenditures

The report details the amounts collected from all sources by state and local governments as of 2002. The report also explores the differences that exist across the 50 systems of state and local government in the U.S. Specifically, the report details the relative importance of state government in raising revenues as well as differences in the relative size of state and local governments across the 50 states. The report documents changes in these patterns over the decade of the 1990s. The research found clear differences between the fiscal structures of state and local governments as well as the relative size of state and local governments across different regions of the country.

In 2002, state and local governments collected a total of $1.7 trillion in general revenue, 78.6 percent of which came from their own sources including taxes, current charges and other non-tax revenue. Of the own-source general revenue, 68.3 percent represent tax revenues, while taxes amounted to 53.7 percent of the total general revenue. Taxation remains the most important source of government revenues, albeit the relative importance of tax revenues declined during the 1990s. See Figure I.

Figure I
Percentage Distribution of State and Local General Revenue, 2001-2002



State and local government general revenues increased in real terms by 33.6 percent between 1992-2002 and by 21.1 percent per capita. According to the data in Table A, on a per capita basis, state and local own source revenues increased by 16.5 percent, state and local taxes by 13.8 percent, and current charges by 28.8 percent. The largest increase in per capita tax revenues came from the individual income tax (23.5 percent), followed by the general sales tax (18.9 percent), the property tax (8.9 percent), and selective sales taxes (8.2 percent). Per capita receipts from the corporate income tax declined by 17.0 percent in real terms. Real per capita federal intergovernmental aid to state and local governments increased by 41.6 percent.

Table A
Real Per Capita State and Local General Revenue:
Percent Change, 1992-2002

Revenue Source	Year 1992 ($)	2002 ($)	Percent Change (%)
Intergovernmental Aid	702	995	41.6
Own-Source	3,136	3,653	16.5
Tax	2,195	2,497	13.8
Property Tax	707	770	8.9
General Sales Tax	517	615	18.9
Individual Income Tax	453	560	23.5
Other Taxes	517	552	6.7
Current Charges	542	699	28.8
All Other	399	458	14.8
Total	3,839	4,648	21.1

Note: 2002 data are converted into constant 1992 dollars using a deflator of 1.288, *Survey of Current Business*, August 2004 issue.

Data Source: State and Local Government Finances, 1992 and 2002 Census of Governments, and staff calculations.
URL: http://www.census.gov/govs/www/estimate.html

At the state level, individual income tax receipts rose after adjusting for inflation by 24.2 percent per capita and general sales tax receipts grew by 16.0 percent. See Table B. At the same time, corporate tax receipts, after adjusting for inflation, declined by 19.3 percent per capita and real per capita property tax receipts fell by 7.5 percent. Individual income taxes remain the most important source of state own-source revenue, accounting for 25.5 percent of all own-source revenue in 2002 compared to 23.9 percent in 1992. Intergovernmental aid is the most dominant source of *total* state general revenue, increasing in real per capita terms by 38.6 percent from 1992 to 2002. As a result, intergovernmental aid accounted for 31.6 percent of total state general revenues in 2002, up from 27.9 percent in 1992.

Table B
Real Per Capita State General Revenue:
Percent Change, 1992-2002

	Year		
Revenue Source	**1992 ($)**	**2002 ($)**	**Percent Change (%)**
Intergovernmental Aid	668	925	38.6
Own-Source	1,725	2,005	16.3
Tax	1,301	1,477	13.5
Property Tax	29	27	-7.5
General Sales Tax	427	496	16.0
Individual Income Tax	413	512	24.2
Other Taxes	433	442	2.1
Current Charges	208	275	32.4
All Other	215	253	17.8
Total	2,392	2,931	22.5

Note: 2002 data are converted into constant 1992 dollars using a deflator of 1.288, *Survey of Current Business*, August 2004 issue.

Data Source: State and Local Government Finances, 1992 and 2002 Census of Governments, and staff calculations. URL: http://www.census.gov/govs/www/estimate.html

At the local level, after adjusting for inflation, per capita revenues from the general sales tax increased by 31.0 percent, from selective sales taxes revenues increased by 25.1 percent, from the individual income tax 13.5 percent and from the property tax by only 9.6 percent. See Table C. Property taxes remain the most important source of local government own-source revenue, accounting for 45.1 percent of local own-source revenue in 2002, down from 47.9 percent in 1992. Local income taxes accounted for only 2.9 percent of local own-source revenues in 2002. Intergovernmental aid remained the primary source of *total* local government general revenue, growing by 28.6 percent from 1992 to 2002. As a result, intergovernmental aid accounted for 40.0 percent of total general revenues in 2002, compared to 37.6 percent in 1992. During the same period the share of total local general revenues borne by the local property tax fell from 30.0 percent to 27.1 percent.

Expenditures encompass all amounts of money paid out by a government during the fiscal year. In 2002, state and local governments spent approximately $2 trillion. Expenditures consist of intergovernmental expenditures and direct expenditures. Direct general expenditures, refers to all direct expenditures except that for liquor store, utility and insurance trust. While direct general expenditures can be further classified by function, direct expenditures can be classified by composition.

The report provides detailed information on expenditures for state and local governments in 2002 and notes expenditure trends for the ten previous years. The report also describes differences in expenditure patterns among the states and localities and between state and local fiscal systems.

Table C
Real Per Capita Local General Revenue:
Percent Change, 1992-2002

	Year		
Revenue Source	**1992 ($)**	**2002 ($)**	**Percent Change (%)**
Intergovernmental Aid	855	1,099	28.6
From Federal	79	119	50.3
From State	776	981	26.4
Own-Source	1,416	1,648	16.4
Tax	896	1,020	13.8
Property Tax	678	743	9.6
General Sales Tax	91	120	31.0
Individual Income Tax	42	47	13.5
Other Taxes	85	110	28.6
Current Charges	335	423	26.4
All Other	184	205	11.0
Total	2,270	2,747	21.0

Note: 2002 data are converted into constant 1992 dollars using a deflator of 1.288, *Survey of Current Business*, August 2004 issue.

Data Source: State and Local Government Finances, 1992 and 2002 Census of Governments, and staff calculations. URL: http://www.census.gov/govs/www/estimate.html

Total state and local expenditures increased in real terms by 38.2 percent from 1992-2002 and by 25.3 percent per capita. The greatest increases occurred in the area of public safety (31.6 percent per capita) and education (28.3 percent per capita). Real state expenditures per capita increased by 28.1 percent compared to 22.4 percent for local governments. The greatest per capita increases in state direct general expenditures were for public safety (38.0 percent) and education (31.6 percent). Similarly, the greatest increases at the local level were for public safety (28.3 percent) and education (26.9 percent).

At the state level, intergovernmental aid to local governments comprised the largest share of state spending in 2002 (28.5 percent), followed by income maintenance (24.4 percent). At the local level, education services accounted for 38.7 percent of local spending in 2002, an increase from 37.3 percent in 1992.

3. Ideals, Principles and Assessment of State and Local Tax Policy

The report describes the commonly accepted principles of sound tax policy. The principles include adequacy, equity, neutrality, efficiency, and accountability. The primary purpose of any tax system is to raise revenue in amounts adequate to cover the costs of public expenditures. In this regard, adequacy is often thought of in terms of sufficiency, stability, and certainty. Tax systems, like all aspects of government, should be fair. Fairness is usually thought of in terms of horizontal and vertical equity. Horizontal equity is the notion that similarly situated taxpayers are treated the same. Vertical equity requires that tax burdens be imposed with some relationship to the taxpayer's ability to pay.

Neutrality arises from the belief, held by most economists, that taxes should have as little effect on market decisions as possible. That is, neither business nor individuals should be forced (or encouraged) to take action solely because of the tax consequences whether they are burdens or benefits. Market conditions and economic efficiency -- and not the tax code -- should dictate business decisions.

Efficiency, in the context of tax policy, mandates that the public finance system minimize the costs of compliance for taxpayers and of collection for the government. Finally, public finance systems must be accountability. The government must insure that those charged with administration and enforcement of the tax laws are performing their duties efficiently and fairly. The government must also insure that the laws are enforced.

Public finance experts have long endorsed the principles discussed above. But, no tax system can be successful without political acceptance. The report discusses the requirement that all tax policies in democratic societies must have the support of the electorate.

Overall, state and local public finance systems get mixed reviews when measured by these ideals. Virtually every study indicates that state and local tax systems are decidedly regressive. This is particularly true with respect to state tax systems that rely heavily on the general sales tax and excise taxes. The imposition of personal income taxes lessens the regressivity, but only to a small extent. Those taxes are usually imposed on all income in the form of flat tax rates.

State and local tax systems also get low marks for neutrality. Most states offer a plethora of tax breaks specifically designed to influence economic and social behavior. Tax incentives granted through deductions, credits and exemptions are used to foster economic development. But such tax breaks also narrow the tax base and profoundly affect the overall fiscal system. In addition, all states impose excise taxes designed, not only to raise revenue, but also to deter specific behavior. Cigarette taxes are the most notable example of such tax policies.

With respect to efficiency, the state and local tax systems fair much better. For individuals, the property, sales, and income taxes are all very efficient methods of raising revenue. Each of these taxes is relatively inexpensive in terms of administration and compliance. There are more costs involved for business taxpayers, but overall the state and local tax system is much more efficient when compared to the federal income tax.

Politically, state and local tax systems also get mixed reviews. The property tax remains among the least popular means of raising revenue. The public's unhappiness has resulted in significant limitations on property taxation. Sales and income taxes have proven much more acceptable to the public. But political leaders have shown strong biases against taxing personal income in the belief that such taxes deter economic development.

4. Trends Affecting State and Local Public Finance

The report details numerous trends affecting state and local revenue and expenditures. A variety of external factors have influenced how state and local government raise revenue. Changing demographics, particularly an aging population, is one such external factor. Older people tend to spend less on taxable items and more on tax-exempt items like healthcare products, putting pressure on sales tax revenue. Similarly, 27 states out of the 41 states with an income tax exempt Social Security income from state income taxation, and 34 of those 41 states exempt at least some public pension income.

The continuing shift toward a service and high technological economy raises many issues for state and local governments. Services are not generally subject to sales taxes, but services now make up more than half of U.S. personal consumption. This has resulted in a substantial loss of sales tax revenue and greater reliance on other types of taxes. As the report shows, efforts to expand the sales tax base to include more services have largely been unsuccessful. Similarly, intangible assets have never been a major component of subnational tax bases, yet the growth of the technology sector has made intangibles and increasingly important part of the economy. The rapid spread of electronic commerce also has had a profound impact on state and local tax revenue, especially sales tax revenue. State and local governments have largely been unable to impose sales taxes on Internet transactions and stand to lose hundreds of millions of dollars in revenue.

Globalization has also had a major impact on state and local public finance. Traditionally, there has been intense competition between states and between localities for economic development and job creation. This competition takes several forms including low taxes and superior public services and infrastructure. In the global market states are no longer just competing with neighboring jurisdictions, but with countries around the world.

State and local governments have also had to contend with eroding trust in government and changing public preferences with respect to tax and spending policy. These changes in public opinion have created a decidedly anti-tax political atmosphere, and have given rise to the tax limitations movement

The increases in the number and costs of unfunded federal mandates have also had an affect on state and local public finance. Federal laws regarding public safety, education, welfare services, and health care have put pressure on the ability of state and local governments to meet their normal public service responsibilities.

As significant as federal mandates, has been the changes in federal tax policy. There is a profound relationship between federal tax policy and state and local public finance systems. The federal government and 41 state governments rely heavily on personal income taxes. The federal government and the states also levy estate taxes, corporate income taxes, and a variety of excise taxes on tobacco, alcohol, and fuel. Both the federal and state governments have traditionally designed their tax systems to interact in ways that minimize compliance and administrative costs. And most state governments have conformed their personal and corporate income tax regimes to federal law. In recent years, the federal government has made significant changes in tax policy that has caused state governments to either lose substantial amounts of revenue or end to some extent conformance with the federal tax laws.

Another trend that has affected state and local government finance has been the shift in governmental responsibilities. State and local governments are spending more on public safety and homeland security issues than ever before. State governments have also assumed a greater role in financing K-12 education, once the province of local governments, and a greater role in welfare, once the province of the federal government. These shifts in responsibilities have resulted in a corresponding shift in the level of state and local expenditures as well as revenue needs.

5. Recent Developments

Finally, the report describes several recent developments that have affected state and local public finances. The most significant development has been the proliferation of tax and expenditure limitations, mainly arising from the public's unhappiness with the property tax. Yet another development affecting the property tax has been the spread of property tax exemptions for non-profit organizations.

Still another development has been the issue of public education finance equalization. Courts in 18 states have ruled that using the property tax to finance public education violates the state constitution. Because local governments have traditionally relied on property taxes to fund K-12 education, the litigation has created significant problems as states struggle to find new ways of financing education.

What are the implications of these current and likely future fiscal trends on the real estate sector? The answer is complex because it involves the interaction between state and local taxes, and how the revenues from such taxes are spent.

A simplistic view would hold that higher taxes are not good for the economy and are likely to depress real estate values. There is however, a considerable body of economic theory, supported by empirical evidence that the reality is more complicated because one factor that clearly affects real estate values is the bundle of public services that "comes with" a piece of either residential or commercial property. There is, for example, considerable evidence that home values are positively affected by the quality of local schools, which depends in part on adequate financing of public schools (and also the efficiency with which tax revenues are transformed into educational services).

One important corollary of this general point is that the effect of taxes on real estate values depends on how the revenues are used. To a very rough first approximation, when revenues are used to maintain or to enhance public services that are valued by households and businesses, the "cost of paying higher taxes" can be offset, either partially or wholly by the "benefits of public services". An implication is that in some cases, raising taxes to finance needed public services can actually maintain or increase real estate values. This process is not likely to occur, however, when tax revenues are used to finance redistributive transfers, and in such cases, raising taxes to finance redistribution may have undesirable, though unintended, effects on local economic activity, and ultimately on real estate values.

I. Institutional and intergovernmental setting –The Fiscal Architecture of State and Local Fiscal Systems

A. Introduction

The various government revenue systems in the United States interact in a complex manner. The federal, state, and local governments each have their own sources of tax and non-tax revenue, their own budget processes, and to varying degrees political autonomy over their fiscal systems.

Throughout the second half of the 20th and into the 21st Century, the federal government has relied predominantly on personal income taxes. For example, while the federal government collects six different types of taxes, during the period 1952 to 2002 the personal income tax accounted for over 50 percent of total federal revenue[1]. During that same period, state governments relied on a combination of consumption and income taxes. For much of the last half century personal income taxes and the general sales tax have accounted for about two thirds of total state tax revenue. Traditionally, local governments relied primarily on the property tax as their source of revenue.

B. Variations between state and local fiscal systems

The states and localities maintain a delicate balance between their respective fiscal systems, taking care to avoid one another's fiscal turf. There is very little overlap between the tax systems of the states and those of local governments. Despite the distinctness of their two systems, what happens in one arena very much affects the workings of the other. This section examines the characteristics of the 50 different state and local fiscal systems in the U.S.

In 2002, state and local governments collected $1.7 trillion in total general revenue. State governments raised $726.9 billion of own source revenue in 2002. Local governments raised $597.3 billion. State governments accounted for 55 percent of own-source revenues in 2002, the same share as in 1992. There are great differences in how the state and local governments raise their revenue.

As noted above, the states have relied most heavily on a combination of income and consumption taxes, while local governments have counted on real property taxes to fund public services.

In 2002, state governments raised $185.7 billion or 25.5 percent of their own source revenue from personal income taxes. Local governments raised only $17 billion, less than three percent, of their own source revenue from taxing personal income.

[1] The Federal government collects personal income, corporate income, various excise, estate and gift and employment taxes.

In 2002, state governments raised $179.7 billion, or 24.7 percent, of their own source revenue from general sales taxes. But local governments raised $43 billion, or about seven percent, of their own source revenue from taxing general sales.

The variations in reliance between state and local governments with respect to property taxes are even greater. In 2002, state governments raised $9.7 billion or nearly two percent of their total tax revenue from property taxes. Local governments, however, raised $269 billion or nearly 73 percent of their total tax revenue from property taxes.

State and local governments also raise substantial amounts of revenue from non-tax sources. In 2002, state governments raised $191 billion or 26 percent of their own source revenue from various charges, licenses, and fees. In the same year, local governments raised $227 billion or over 38 percent of their own source revenue from charges and fees.

Overall, state and local reliance on taxes as a source of own revenues declined during the 1990s, continuing a longer-term decline. In 2002, states received 73.6 percent of their general own-source revenues from taxes, compared with 75.5 percent in 1992 and 83.4 percent in 1977. Similarly, local governments relied on taxes for 61.9 percent of their general own-source revenues in 2002, down from 63.3 percent in 1992 and 73.3 percent in 1977.

The variations between state and local fiscal systems increase the flexibility of each level of government to address their own unique situations. Because there is little overlap between the tax bases, state and local governments have greater authority and autonomy to design their systems to meet their particular spending and economic development needs.

C. Variations in the fiscal systems of the states

While the variations in state and local tax revenue systems are well known, there are also significant differences in how states raise revenue. For example, the single largest source of tax revenue for the states is the personal income tax. But not all states tax personal income. Forty-one states and the District of Columbia impose a broad-based personal income tax. Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming do not impose any levies on personal income. Tennessee and New Hampshire tax certain dividend, interest, and capital gain income, but do not tax wages and salaries.

There is much less variation with respect to consumption taxes, particularly the general sales tax. Sales and use taxes have long been among the most important sources of state revenue. Until the late 1990s, the sales tax raised more money than any other source of state tax revenues, consistently accounting for more than a third of state tax revenue.

Forty-five states and the District of Columbia currently impose sales and use taxes. In ten of those states, the sales tax accounts for more than forty percent of tax revenue, with Washington relying on the general and selective sales taxes for more than sixty-percent of its tax revenue. Alaska, Delaware, Montana, New Hampshire, and Oregon do not impose state sales taxes, although Alaska allows local option sales taxes. The states that do not impose a sales tax make up less than three percent of the United States population. Thus, the overwhelming majority of Americans are subject to the tax.

In 2002, state governments collected $25.1 billion of corporate income taxes or 4.7 percent of their own source tax revenue. Forty-six states and the District of Columbia tax corporate net income to some extent, including such traditionally anti-income tax jurisdictions as Tennessee, New Hampshire and Florida. Only Nevada, Texas, Washington, and Wyoming do not impose any taxes on corporate income.

There is also little variation with respect to excise taxes among the states. All states impose some form of excise taxes on alcohol, tobacco, and fuel products.

The largest variations among the states are with respect to severance taxes. Severance taxes are among the most important source of tax revenue. Alaska, Kentucky, Louisiana, Montana, New Mexico, Oklahoma, North Dakota, Texas, Washington, West Virginia and Wyoming all rely heavily on severance taxes to fund public services. Each of these natural resource rich states raise more than five percent of their total tax revenue from severance taxes. Alaska is the most dependent on severance tax revenue raising nearly 60 percent of its total state tax revenue. Severance taxes allow these states to reduce, or in many cases eliminate, other taxes. For example, Alaska, South Dakota, Texas, Washington, and Wyoming do not impose a personal income tax primarily because of their significant severance tax revenue.

D. Variations in the fiscal systems of local governments

Variations with respect to how revenue is raised exist among local governments. The main variation is the extent to which different types of local governments rely on the property tax. In 2002, local governments raised $269.4 billion in property tax revenue. This amount accounts for 16 percent of total general state and local revenue, 30 percent of total state and local tax revenue, and 45 percent of total local general own-source government revenue.

Property Tax

The property tax is the only tax levied in all 50 states and the District of Columbia. Traditionally, the tax has been the primary source of tax revenue for local governments. The property tax is imposed by counties in 45 states, municipalities in 49 states, townships in 24 states, school districts in 42 states, and special districts in 20 states. Not surprisingly, the reliance on the property tax varies by type of local government. Historically, of all types of local governments, large U.S. cities have relied on property taxes the least. This lesser reliance has become even more pronounced since the property tax revolts of the late 1970s. Large cities, because of their geographic size and intense commercial activity, have many more opportunities to raise revenue from other sources, such as levies on sales and income.

With respect to own-source revenues, independent school districts have relied most heavily on property taxes. In 2002, independent school districts raised more than $119 billion, or about 95 percent of their total tax revenue and about 78 percent of their total own-source revenue, from property taxes. Approximately 44 percent of all real property taxes in the United States are collected by independent school districts.

With respect to total revenue, townships actually rely most heavily on the property tax. In 2002, townships raised approximately $18 billion, or 72 percent of their total revenue, from property taxes. Unlike independent school districts, townships do not receive most of their income in the form of intergovernmental aid. The lack of support from state government, and the scarcity of viable alternative sources of revenue, has resulted in townships relying more heavily on the property tax than other general local governments.

Smaller cities and counties have relied more on the property tax than have large cities, but they depend on it less than independent school districts. Unfortunately, few data are available on the use of the property tax by smaller cities. But U.S. Census data show that in 2002, all municipalities in the United States raised $58 billion, or about 15 percent of their total revenue, from property taxes. Municipalities raised about 28 percent of their total tax revenue from property taxes in 2002. At the same time, American counties raised approximately $62 billion, or 39 percent of their total revenue, from property taxes. Although revenue from property taxes accounts for a relatively small percentage of total revenue,[2] about 69 percent of counties' total tax revenue comes from property taxes.

Special districts also raise the bulk of their tax revenue from property taxes. In 2002, special districts raised about $10 billion, or 71 percent of their tax revenue, from property taxes. Special districts, however, rely much more heavily on user fees and charges than other types of government do. Accordingly, property taxes accounted for only 16 percent of total special district revenue.

Property tax reliance also varies, often greatly, by region. U.S. local governments in the Northeast and Midwest have traditionally relied more heavily on property taxes than have local governments in the South or in the West (Minnesota Taxpayers Association 2001). In 2000, for example, Connecticut, Maine, New Hampshire, New Jersey, Rhode Island, Vermont, and Wyoming collected the most in property taxes as a percentage of personal income. Conversely, Alabama, Arkansas, Delaware, Hawaii, Kentucky, Louisiana, New Mexico, and Oklahoma collected the least. Not coincidentally,

[2] Total general revenue includes intergovernmental revenues, tax revenues, current charges and miscellaneous revenues.

regions in the nation that rely most heavily on property taxes have also had the strongest commitment to local autonomy.

Differences within regions are also evident. New Jersey, for example, is considered a high-property-tax state. In 2002, local governments in New Jersey raised $16 billion in property taxes, more than the revenue collected from the state's three largest taxes combined. The property tax accounted for 46 percent of all of New Jersey's state and local tax revenue in 2002. Moreover, New Jersey collected 98 percent of all its local own-source tax revenue from property taxes, compared with 73 percent nationwide. By contrast, in neighboring New York, the property tax accounted for 59 percent of all local own-source tax revenue, an amount well below the national average.

Similarly, in Alabama, traditionally a low-property-tax state, local governments raised a mere 39 percent of their total 2002 tax revenue from property taxes. But local governments in its border state, Mississippi, raised 92 percent of their total tax revenue from property taxes, more than most other states.

Local option sales tax

After the property tax, local-option sales taxes are the most important source of tax revenue for local governments. These taxes are widely used; 34 of the 45 states imposing a sales tax allow their local governments to impose similar taxes. Even Alaska, which levies no statewide sales tax, allows its local governments to collect local-option sales taxes. Of the 34 states that allow local-option sales taxes, 23 allow both cities and counties to impose the tax. Ten states are evenly split between allowing only cities or only counties to tax sales. Nine other states allow transit authorities or school districts to impose local-option sales taxes.

In 2002, 7,411 local governments, or about eight percent of all local governments in the United States, imposed local-option sales taxes. The tax is imposed in 4,696 municipalities, 1,602 counties, and 1,113 special districts. In 2002, local governments raised about $43 billion from local-option sales taxes, which accounted for 11.7 percent of total local government tax revenue.

Local option income tax

In the wake of the tax revolts and resulting property tax limitations, the local-option income tax was considered an alternative source of revenue for local governments. Indeed, after the 1986 Federal Tax Reform Act, many people thought that local-option income taxes would become an important source of local government revenue. These taxes, unlike sales taxes, remained deductible from federal taxable income.

The revenue-raising potential of taxing personal income never materialized. The percentage of total revenue collected from local-option income taxes barely changed over the past several decades. In 2002, local governments in the United States raised only $17 billion from taxing personal income or nearly two percent total local government revenue and 4.6 percent of total local government tax revenue.

The relatively small amount of revenue raised by local-option income taxes is in part attributable to the fact that few states authorize their use. Only 15 states allow local governments to tax some form of personal income. In two of the states (Arkansas and Georgia), despite having the authority, no local governments have opted to tax income. And only four states—Pennsylvania, Ohio, New York and Maryland—use local-option income taxes on a large scale. In 2002, Pennsylvania and Ohio collected $2.8 billion and $3.5 billion, respectively, in personal income taxes. Maryland and New York collected $2.9 billion and $4.6 billion, respectively, that same year. Together, those four states collected just over 80 percent of all local personal income taxes in the United States in 2002. In 2000, 543 municipalities in Ohio and 2,879 municipalities in Pennsylvania taxed income (Schmarr and Spretnak 2000).

The states vary in their authorization of local-option income taxes, with some granting authority to all local governments and some allowing only designated jurisdictions to impose the tax. In contrast to the broad local authority granted in Ohio and Pennsylvania, New York only authorizes two cities to tax income. Four states (Kentucky, Iowa, Pennsylvania, and Ohio) also allow school districts to tax income.

II. <u>Assessing State and Local Fiscal Systems</u>

A. Generally accepted criteria for assessing state and local tax systems

For purposes of state and local public finance, the principles of sound tax policy were perhaps best articulated in 1988 by the National Conference of State Legislators (NCSL) and the Lincoln Institute of Land Policy. Those organizations gathered a group of lawmakers and academics to discuss improving state tax systems. The outcome of that meeting was a seminal report, "Principles of a High-Quality State Revenue System." These principles restated what most tax theorists also believe constitutes a sound tax system. The report was widely circulated by the NCSL (1992) and appeared in a much-cited book, *The Unfinished Agenda for State Tax Reform* (Gold 1988). There is a remarkable amount of agreement on the part of public finance experts as to the general principles.

Although there has been much discussion about their relative importance, six broad concepts of sound tax policy have emerged with respect to state and local taxation.

Six Broad Principles

a. Adequacy

The primary purpose of any tax system is to raise revenue in amounts adequate to cover the costs of public expenditures. In this regard, the tax system is merely a means (collection) to an end (funding outlays determined through the political process) (Blough 1955). This principle of adequacy is particularly important with respect to state and local government taxation. These governments, unlike the federal government, must pay their expenses as they go from revenues in hand. All states, except Vermont, have balanced budget requirements that largely prevent governments from deficit spending. Most local governments also operate within systems that require balanced budgets. So the tax system must raise the requisite revenue to pay for services the public demands.

A tax system must not only provide for current spending, but also be capable of meeting the future revenue needs of the state. In its widely circulated and cited report, the NCSL asserted that to meet the revenue needs, a tax system must have sufficiency, stability, and certainty (1992, p. 7).

Sufficiency requires that revenue be adequate to balance the state and local budgets and adaptable to changes in state spending. The state and local tax systems must be designed to raise enough revenue to fund the programs and policies demanded by the citizens and enacted by their elected representatives. The hallmark of sufficiency is that state tax systems be flexible. Expenditures will vary over time in light of political and economic developments.

Stability requires a consistent amount of revenue to be collected over time, necessitating a mix of taxes, "with some responding less sharply to economic change" (NCSL 1992, p. 7). For example, personal income taxes are widely thought to produce more revenue than other types of levies when the economy is growing, but not in times of recession. By contrast, revenue raised through broad-based sales taxes tends to be more consistent during economic swings. Stability is important because most public services are designed to be provided over an indeterminate time. Much of what state and local governments spend money on (schools, roads, prisons) remains the same from year to year or changes only incrementally.

Certainty requires that the frequency and types of tax changes be kept to a minimum. Certainty is a requirement that benefits both individual and business taxpayers, both of whom ideally should not be subject to frequent changes in rates or bases. The NCSL recognized that frequent changes interfere with economic choices and with long-term financial planning for both business and individuals. Frequent changes in the law also lead to increased compliance and administrative costs.

b. Equity

Tax systems, like all aspects of government, should be fair. But equity, perhaps more than any other aspect of sound tax policy, is subject to substantial disagreement as to policy choices. After all, "equity" is a concept laced with normative value judgments. Fairness and justice are inherently difficult ideals upon which consensus can be attained. And charges of inequity can be politically powerful. Indeed, political leaders routinely assert the unfairness of the revenue code when advocating tax policy. Such cries of unfairness are as likely to be heard from "liberal" politicians crusading for the downtrodden as those representing the interests of wealthy corporations.

Despite the difficulties, two general equity concepts have emerged. For tax policy purposes, fairness traditionally has come to refer to horizontal and vertical equity (Reese 1980).

Horizontal Equity

The concept of a tax system that treats similarly situated taxpayers the same is known as horizontal equity. Simply put, persons and businesses with similar incomes and assets should be taxed alike. This concept is closely related to the issue of neutrality discussed below. But while neutrality is concerned primarily with economic efficiency, horizontal equity -- that people and firms should be treated equally -- is an imperative in democratic society.

Dissimilar treatment -- real or perceived differences in the taxation of equals -- undermines confidence in a tax system. Consider the homeowner who discovers that his neighbor, with essentially the same house, pays substantially less in property taxes, or the employee who sees his coworker earning the same salary but being taxed at a different rate. Such situations can only breed cynicism and distrust not only of the tax system, but also of government in general.

Moreover, the creation of horizontal inequities invariably leads to a smaller tax base. As individuals, groups, or particular transactions are exempted from tax, the base shrinks. And a shrinking tax base leads to higher tax rates for everyone not enjoying the exemption. If some purchases, such as food for home consumption, are exempt from sales tax, the state will have to increase rates on other purchases to raise the same amount of revenue. In effect, everyone not receiving the benefits subsidizes those who do receive the benefit.

There is of course widespread theoretical agreement that taxes should be horizontally equitable. In practice, however, horizontal equity is much more elusive at all levels of government. As noted above, there are literally thousands of examples of similarly situated individuals and businesses being treated differently by the tax laws of virtually every state. Despite equal income and economic assets, a citizen's status as a veteran, parent, senior citizen, or student will often result in more favorable tax treatment.

Businesses of course are rarely treated uniformly by the tax system. New investments in plant and equipment are often rewarded, while companies that have already made such investments are not. Companies are provided tax breaks for hiring specified numbers of employees; but existing companies that already have hired the requisite numbers of employees do not receive the benefit. Moreover, businesses, often with similar operations, revenue, and size are treated differently because of their choice of legal form – e.g., Limited Liability Corporation versus a C corporation.

The horizontal inequities presented by the tax system have not given rise to widespread public dissatisfaction. That particular groups of people, usually politically sympathetic groups of people, receive preferential tax treatment has not resulted in political upheaval or crisis. Part of the public's benign reaction is due to its general agreement that some of the groups (i.e., veterans) receiving preferential treatment deserve it.

Vertical Equity

It is also generally agreed that the tax system should be based, to some extent at least, on one's ability to pay. This much more politically problematic concept is known as vertical equity. One might argue that vertical equity requires a progressive form of taxation; that is, taxpayers bear a greater burden of paying for government services as their income grows. Progressive taxes, depending on their design, could include corporate and business taxes, inheritance, estate, and gift taxes, property taxes, and individual income taxes.

Alternatively, one might argue that equity requires a proportional form of taxation wherein all persons are taxed at the same rate. Most modern state taxes could be designed to impose a roughly proportional burden on all taxpayers.

However, it is virtually undisputed that a sound revenue system at the least minimizes regressivity (NCSL 1992). Regressivity is the concept that describes a tax system in which a person's relative tax burden increases as his or her income or wealth decreases. Scholars, policy makers, political leaders, and nearly everyone who has written on the subject of tax policy consider such a system unfair.

While this consensus exists in academia and among commentators, state tax systems historically have been decidedly regressive (Phares 1980, Pechman 1985, Citizens for Tax Justice 1996). In virtually every state, the poorer one is the greater percentage of one's income will be paid to support the government. And in recent years, state taxes have become more regressive (Johnson and Lav 1997).

The regressive nature of state revenue systems is largely the result of the heavy reliance on consumption taxes (both general sales and use and excises). Consumption taxes are regressive primarily because low-income individuals spend a larger percentage of their income on goods subject to tax than high-income individuals. For example, sales taxes are generally not imposed on services; and the wealthy spend a far greater percentage of their income on services than do the poor.

The effects of consumption taxes are somewhat blunted by the imposition of personal income taxes in 41 states and the District of Columbia. But this progressive form of state taxation is not enough to overcome the regressive effects of the significant reliance on consumption taxes. General sales taxes are imposed by 45 states and have long accounted for a third of state tax revenue. The various specialized excise taxes account for about 16 percent of total state tax revenue. The states, therefore, rely on regressive levies for about half of their tax revenue.

Moreover, most personal income tax systems are only mildly progressive. Most states have low rates and relatively few brackets. Of course, several of the largest states (Texas and Florida in particular) do not tax personal income. The other taxes that could be considered progressive, corporate income and inheritance taxes, make up a very small percentage of total state and local tax revenue.

Making state and local tax systems more progressive, or at least less regressive is a difficult, if not impossible, task. Consumption taxes are an important part of state public finance systems. They raise billions in revenue and cannot be easily replaced. Moreover, consumption taxes have positive attributes that many believe may in fact outweigh the problems of regressivity. Real and perceived problems associated with interstate competition prevent the states from significantly increasing their reliance on business and income taxes.

Thus, the states face a real dilemma. They rely for nearly half of their revenues on regressive taxes, which are unfair. At the same time, political and economic conditions are such that reducing that reliance is nearly impossible.

c. Neutrality

Most economists and political theorists agree that taxes should have as little unintended effect on market decisions as possible. That is, neither business nor individuals should be forced (or encouraged) to take action solely because of the tax consequences whether they be burdens or benefits. Market conditions and economic efficiency -- and not the tax code -- should dictate business decisions. Similarly, taxes should not be used to influence individual consumption choices. To be sure, all taxes currently in use affect decision making to some extent[3]. But optimally, the tax system should minimize unintended market distortions.

There is widespread agreement that tax neutrality is best attained by a system with a broad tax base (i.e., few exemptions, deductions, and credits) combined with low

[3] A land tax and a head tax would be examples of taxes that would not distort economic decision making.

rates (see NCSL 1992)[4]. Tax systems built on a foundation of low rates and broad bases will minimize the opportunity and incentive to make economic decisions based on tax savings. Moreover, if the state must differentiate tax burdens, those differentials should reflect the external costs created by the taxpayers or the transactions that bear the greater burdens (see Pogue 1998).

The principle of neutrality is more an exception in state and local public finance than the rule. State and local governments routinely implement policies that are intended to effect market decisions. For example, many excise taxes, particularly those on tobacco products, are imposed specifically to deter use of products. Conversely, various incentives (i.e., sales tax holidays) are granted to encourage the purchase of products. State and local governments also make widespread use of tax incentives to spur economic development. The political attractiveness of these and other popular policies lead state and local governments to neglect the principle of neutrality.

d. Efficiency

The administrative requirements of sound tax policy revolve around minimizing the costs of compliance for taxpayers and of collection for the government (Reese 1980; Shoup 1937). If a revenue system is efficient, it avoids complex provisions and regulations, multiple filing and reporting requirements, and numerous deductions, exclusions, and exemptions. In this sense the need for simplicity is related to the goal of neutrality since the factors that lead to complexity inevitable distort market decisions.

The more complicated the tax system, the greater the costs of taxpayer compliance. Both business and individuals will spend more time and money determining the requirements of the law and planning to minimize their tax burdens. Because a complicated tax system creates doubt as to the meaning of the law, both individuals and business will also spend more time and money defending against government audit activity as well as in litigation. Moreover, complexity often deters effective fiscal planning. On the other hand, a less-complicated system of taxation enables understanding of the law and enhances public confidence in the system.

e. Accountability

There are several aspects to the notion of accountability of tax systems. First, the government must insure that those charged with administration and enforcement of the tax laws are performing their duties efficiently and fairly. There is nothing more damaging to public morale than a corrupt, ineffective, or unresponsive tax collector.

At the same time, the government must insure that the laws are enforced. People and businesses must pay the taxes owed; and the government must have the means and political will to insure that taxes are collected. Each of the principles of

[4] Low rates and broad bases have long been recognized as a goal of sound tax policy at all levels of government. Indeed, they were the cornerstone of the last significant federal tax reform effort that culminated in the Tax Reform Act of 1986 (Steuerle 1992).

sound tax policy discussed herein requires the government to enforce the revenue laws. As many countries have discovered, lax tax enforcement leads to widespread tax evasion.

For the past quarter century, state revenue departments have largely been free of serious or widespread corruption. And by all accounts, the states have done an exemplary job of collecting revenue. Most revenue departments receive high marks for their professionalism and effectiveness.

But it is the third aspect of accountability at which states have been less successful. Tax policy in a democratic society should be arrived at openly. And the laws governing taxes should be explicit, not hidden. The costs and benefits of fiscal decisions, especially those that afford special treatment to particular taxpayers, should be understood by the electorate as well as tax administrators. In this regard, as much government information regarding the tax system should be open to the public. Certainly, all documents that promulgate tax policy should be widely available and easily accessible to the public and the press. Only through open government can the public insure that its elected officials are performing in a manner that serves their interests.

f. Political Viability

Public finance experts have long endorsed the principles discussed above. But, no tax system can be successful without political acceptance. In the United States, the tax system must be acceptable to the public in general and the electorate in particular. The most obvious examples of the intersection between tax policy and elections were the tax revolts of the late 1970s and 1980s. Many of the modern day tax limitations were enacted through the initiative and referendum processes and most reflected the electorate’s unhappiness with the property tax.

Tax policy has also influenced traditional elections. Whether they are incumbent or challenger, candidates for the state executive office have used tax policy as a means of furthering their campaigns. Incumbent governors often advocate tax cuts in the years preceding an election (see generally, Howard 1994). And there is ample evidence that voters judge incumbent governors on their tax policies, and in particular on whether or not their tax policies would increase tax burdens (Niemi, Stanley, and Vogel 1995; Kone and Winters 1993; Besley and Case 1995; Bowler and Donovan 1995). This fact is well known to both incumbents and challengers who are cognizant of the political risks to advocating or implementing tax increases (Berry and Berry 1992)[5].

In virtually every governor's race, taxes are an issue to some extent (see generally Brunori 2000). In some instances, taxes play only a peripheral part in the election with candidates generally promising to reduce tax burdens. This occurs when

[5] Of course, not all incumbents who support tax increases are defeated at reelection. Indeed, there are numerous examples of successful incumbents even though they supported significant tax increases (Winters 1999).

the incumbent administration has not significantly increased tax burdens or when the electorate is not concerned with issues of tax fairness. However, there are times when tax policy is the most important, indeed sometimes only, issue for the candidates. Examples of such elections are James Gilmore's 1997 victory in Virginia and James Florio's 1993 defeat in New Jersey. Both races were decided almost exclusively on tax policy issues.

Because tax policy matters to the electorate, it matters to political leaders and policy makers. Political leaders are motivated by economic development, job creation, minimizing tax burdens -- all factors influencing their chances of reelection. For example, state legislators have a decided political bias against personal income taxes. Numerous studies have found that when states run budget surpluses, the first tax to be cut is the personal income tax. When states run deficits, the last tax to be raised is that on personal income. The bias is motivated by the perception that income taxes deter economic growth and discourage investment. But whether real or perceived, it has had a significant effect on state and local public finance.[6]

This of course often leads state and local leaders to forego widely accepted principles. The proliferation of targeted tax incentives (i.e., the granting of tax relief to select companies) is and example of politics trumping sound economics.

B. How State and Local Taxes Measure Up

The purpose of this section is to review how well state and local revenue systems score according the principles of a good revenue system described in the previous section. The results are summarized in Table 1 and discussed in detail below.

Table 1
Score Card of State and Local Tax Systems

Tax	Adequacy/ Sufficiency	Adequacy/ Stability	Equity/ Horizontal	Equity/ Vertical	Neutrality	Efficiency	Accountability	Political Acceptance
Property	+	+	-	+	+ Land - Blding	+	+	-
Personal Income	+	-	-	+	-	+	+	-
General Sales	-	-	-	-	-	+	+	+

[6] Political perceptions have also led politicians to endorse gambling in lieu of taxes, support targeted tax incentives and other policies that run contrary to sound tax policy.

Adequacy

If a goal of a tax system is to raise adequate amounts of revenue to pay for existing and future public services, then state and local governments have generally been successful. State and local public finance systems have been remarkably adept at raising revenue through good and bad economic times.

Part of the states' success in raising sufficient revenue is attributable to balanced budget requirements that essentially preclude states from deficit spending. The constitutions of 24 states require that the final state budget be balanced. In eight additional states, a balanced budget is a statutory requirement. And all states, except Vermont, have some legal requirement that the budget be balanced at the time submitted by the governor or approved by the legislature. Thus political leaders are often forced to make hard choices between public services and the tax burdens that they produce.

Part of the state's success is attributable to the political will of the legislative leaders who seem to find a way to pay for public services despite continuing economic and political challenges to raising tax revenue. This aspect of state politics has not been studied and is little understood by academics or the public. Yet, legislatures have been remarkably resourceful in raising revenue through the most trying times. For the past quarter century, state lawmakers have been able to provide the services demanded by their constituents in an atmosphere plagued by balanced budget laws, a shrinking tax base, and decidedly anti-tax political sentiments.

But much of the success, in terms of funding government, is due to the structure of the state and local tax systems, which have proven to be quite capable at dealing with the public service demands through both prosperous and lean times. The state and local governments have relied on a mix of income, consumption, and property taxes for a majority of their revenue. The growth and stability of those respective types of levies had a profound impact on public finance. They attributed to the ability of the states and localities to weather economic cycles without significantly reducing public services.

Moreover, the reliance on various types of taxes and sources of revenue provided extraordinary flexibility and discretion to state and local legislators. State lawmakers have been able to target (or otherwise limit) revenue reductions or increases to a particular tax. Thus, revenue could be raised or tax cuts granted without significantly reforming the public finance system.

Equity

In the promotion of horizontal and vertical equity, the state and local government systems have generally not faired well. In terms of horizontal equity, all of the existing major taxes are designed in such a way that virtually insures uneven treatment of similar taxpayers, entities, and transactions.

The sales tax base does not reach most services, intangible property, real property, or items deemed to be necessities. The people who consume exempt services and property receive a tax break, while the people who spend the same amount on non-exempt services and property do not.

The property tax is riddled with similar inequities. Most real property owned by non-profit organizations is exempt from tax. State and local governments have granted exemptions worth billions of dollars to businesses to foster economic development. And even many individuals, particularly senior citizens and veterans, receive property tax breaks unavailable to owners of similar property.

The personal and corporate income taxes are also plagued by horizontal inequities. Income from certain sources (i.e., municipal bonds and retirement plans) is often exempt from personal income taxation. Corporations enjoy a plethora of exemptions and deductions provided to spur job creation and investment. These tax advantages are not available to all taxpayers, but only those who qualify under legislatively mandated requirements.

State and local public finance systems do not fair well with respect to vertical equity. The heavy reliance on consumption taxes (general sales and excise taxes) has rendered the state and many local government tax systems very regressive (Phares 1980, Pechman 1985, Citizens for Tax Justice 1996). In virtually every state, the poorer one is the greater percentage of one's income will be paid to support the government. In recent years, state taxes have become more regressive (Brunori 2001). The imposition the personal income taxes moderates the extent of the regressivity. But most states impose the tax on low-income wage earners and set relatively low rates on the wealthiest taxpayers.

Neutrality

With respect to neutrality, state and local tax systems have generally failed. There is a host of tax provisions designed specifically to influence both individual and business behavior. Indeed, there are literally thousands of such provisions. Businesses are provided deductions, credits, and exemptions as incentives to invest in plant and equipment, as well as to expand their workforce. These incentives are sometimes offered to all businesses in the state. And sometimes they are offered to particular industries or specific companies. The incentives usually involve reductions in corporate income, sales and use, and/or property taxes. These various tax incentives are offered specifically to induce businesses to take some action that government policy makers believe the businesses would not take without the incentives.

Individuals are granted tax breaks as well. Through the various state tax systems, people are encouraged to serve in the military, have children, own a home, attend college and numerous other activities in which they may or may not engage but for the tax rewards. Individuals are also influenced as to when and where they shop through sales tax holidays and exemptions for clothing and food for home consumption.

Most people would agree that activities encouraged by individual tax breaks are socially desirable, and should be encouraged by the government. Yet it is questionable whether the tax system is the most efficient way to accomplish these goals.

It should be noted that it is not only tax breaks that influence individual and business behavior, but tax burdens as well. Tobacco and alcohol excise taxes are designed in part to discourage their use. And, increasingly, taxes are aimed at encouraging businesses to adopt policies to prevent pollution or to clean up the environment.

Efficiency

State and local governments get high marks for the efficiency of their tax systems. The design of the major sources of tax revenue minimizes compliance burdens on taxpayers and administrative costs on government.

The property tax presents few compliance issues for property owners. Although not without problems, administration and compliance with the property tax is relatively easy and thus inexpensive (Sheffrin 1999). This is because the underlying tax base -- the land or improvements thereto -- is immobile. For government, the tax base is easily identifiable. And while values change, the number of acres, parcels, and buildings are easily ascertainable by most local government administrators.

Another virtue from the government's perspective is that taxpayers cannot easily hide or move property. Thus, unlike income and sales taxes the property tax is difficult, indeed virtually impossible, to evade. Moreover, the property provides collateral for the tax liability. If the property owner fails to pay the taxes a lien is placed on the property. That lien prevents the property from being sold or mortgaged until the tax liability is satisfied. If collection efforts are unsuccessful, the local government can seize and sell the property. The local government retains the taxes owed, penalties, interests, and administrative costs, and remits the remainder to the owner. While property tax sales are often the last resort for local governments, such sales provide powerful incentives to comply with the law.

The tax presents equally attractive compliance benefits for the taxpayer. Most residential property owners face minimal compliance costs. Unlike the much more onerous (from a compliance standpoint) federal and state income taxes, there are no forms to file when complying with property taxes. There are generally no calculations to be made. Indeed, the government calculates the property tax and the taxpayer's role begins and ends when the tax is paid. And it is rare for an individual property owner to incur fees for professional tax assistance (i.e., accountants, attorneys) when complying with the property tax. The property tax is rivaled only by the sales tax in terms of compliance burdens, or lack thereof, for individual taxpayers.

For the sales tax, the vendor collects the tax and remits payment to the state. In virtually all states consumers pay the tax at the time of purchase. At that juncture the taxpayer's responsibility with respect to the sales tax ends. For the individual taxpayer there are no forms to file, records to keep, accountants to pay, or other costs generally associated with tax compliance.

For businesses paying sales tax there are of course more costs of compliance. Business taxpayers must keep substantial records of their purchases and payments. But most businesses would retain such records for federal tax purposes, and in the case of publicly traded corporations, securities law purposes.

Compliance with the law is also obviously more costly for the vendor responsible for collecting the tax. The vendor must determine the amount of the tax owed, collect the tax, keep records of the transactions, file returns, and make payment to the state. This becomes even more expensive in states that offer many types of exemptions. In those cases, the vendor must identify what products and services are taxable and which are exempt from tax.

The costs of compliance, however, are somewhat offset in most states that allow the vendor to retain part of the tax to defray the administrative expenses of collecting and remitting the tax. As of January 1, 2005, 30 of the 45 states imposing the tax provided some compensation to the vendor.

For the state, too, the tax is relatively easy and efficient to administer. The vendor collects the tax and remits the payment to the state. If the vendor fails to collect the tax or make payment, the vendor becomes liable for the amount of the tax and could face civil and criminal penalties. Since any market advantage in evading or avoiding the tax is more than offset by the possible penalties, most vendors comply with the law. This is especially true for large and publicly traded companies.

There are more costs associated with sales tax collection and administration for small businesses. Smaller businesses as vendors generally have fewer accounting controls and records of sales. They are less likely to know the legal requirements of collecting tax from their customers. They are also more likely to have the ability and motivation to avoid collection and remittance of tax. For these reasons most of the state costs and efforts for administering the sales tax is concentrated on small business.

The ease of administration and compliance does not generally extend either to vendors with many multi-state transactions or to the use tax. With respect to the former, there are numerous problems identifying what is and is not subject to tax in the 45 states and more than six thousand localities that tax sales. Thus, businesses engaged in multi-state transactions incur the costs of complying with numerous jurisdictions. Still, modern technology designed to track tax compliance requirements around the country has minimized those costs to some extent.

Because a vendor that sells remotely into a taxing state does not generally collect the use tax, remittance to the state is the responsibility of the consumer. And use tax compliance for individual consumers is abysmally low.

While certainly more complicated for the individual than consumption and property taxes, state income taxes pose relatively modest burdens in terms of taxpayer compliance and government administration. This is especially true when compared to state corporate income and federal income taxes. Most Americans are subject to state income tax withholding. Thus, for most taxpayers the tax is collected and remitted to the state long before the return must be filed. Moreover, because of withholding the vast majority of taxpayers must file only one return per year. And with the exception of a handful of states and individuals with unduly complicated transactions, completing the state personal income tax return is neither complicated nor time consuming.

Moreover, since most taxpayers must use federal income as the starting point for determining their state income tax liability, they do not have as much flexibility to evade state taxes. Evading state taxes almost certainly requires evading federal taxes as well. Aiding the administration of the tax is the fact that virtually every state has entered into an agreement with the Internal Revenue Service to share information. If the Internal Revenue Service makes an adjustment to federal adjusted gross income, it promptly informs the state revenue department of the change. That is not to say the states engage in no audit activities in the personal income area. But most states can afford to limit their administration and enforcement activities to questions of domicile (was the taxpayer a resident for the requisite time), unreported income, and return errors.

Accountability

For the past quarter century, state revenue departments have largely been free of serious or widespread corruption. And by all accounts, the states have done an exemplary job of collecting revenue. Most revenue departments receive high marks for their professionalism and effectiveness (Brunori 2001).

Political Viability

As noted, no tax system can be successful without political acceptance. The various types of taxes imposed by state and local governments enjoy different levels of acceptance on the part of the political leaders and the electorate. The property tax, particularly the tax as applied to residential property, has been among the most unpopular levies in the United States. Indeed, it has now become part of public finance lore that the property tax is the "worst tax." During the latter half the 20th Century, the Advisory Commission on Intergovernmental Relations (ACIR) conducted an annual public opinion poll to gauge the people's views on the federal, state, and local tax systems. One of the most cited aspects of the poll was the request for people to identify the tax that they dislike the most. Over the course of the ACIR polling, the property tax was annually listed as the worst tax or the second worst tax following the federal income tax. The public’s unhappiness with the property tax led to the tax revolts of the late 1970s. The result has been limitations on property taxation in 40 states.

The other tax that engenders political opposition is the personal income tax. While the public has generally accepted the state income tax, legislators and other leaders have shown a strong bias against the tax. There is a widespread perception among legislators that the personal income tax deters economic development. That perception has led states to favor consumption taxes over broad base income taxes. When states need to raise additional revenue they are far more likely to increase sales and use taxes through either base broadening or rate hikes than to increase personal income taxes (National Conference of State Legislators (NCSL) 2000). Conversely, when states have the opportunity to reduce tax burdens, they are far more likely to cut personal income taxes through additional exemptions and deductions or rate decreases than they are to cut more regressive consumption taxes (NCSL 2000).

The other types of state and local revenue do not engender nearly as much political opposition as property and personal income taxes.

C. Criteria for Expenditure Assignment Across Tiers of Government

In the United States, most people subscribe to the view that the welfare of individuals is most likely to be maximized when individuals in the market place make decisions about the production and consumption of goods and services. Most would also agree that government has a critical role to play in setting and enforcing the "rules of the game" for the market. Beyond a consensus on these two points, however, there seems to be disagreement.

Some believe, for example, that government expenditures, with the possible exception of defense spending and protection of private property, are inherently wasteful. Supporters of this view, including organizations like Americans for Tax Reform and the 800 state and county organizations they work with, oppose all tax increases, at all levels of government, as a matter of principle and argue that the savings should be returned to individuals via tax reductions because they will know better how to spend those funds.

Those promoting this view overlook the fact that there are legitimate, and critical, roles for government to play in a market economy. A discussion of the assignment of expenditure responsibilities across tiers of government starts with acknowledgement of the three traditional functions of government – promoting equity in income distribution, stability in macroeconomic environment (promoting growth with high levels of employment and reasonable price stability) and efficiency in resource allocation.

In the first two cases, the general consensus is that those responsibilities should most properly lie with the central, or national, government. For example, if an individual local jurisdiction undertakes significant initiatives to improve the well being of its low-income citizens, such spending initiatives may attract low-income families from other jurisdictions, increasing the need for such programs. At the same time, local taxes will need to be raised to fund such programs and the resulting level of taxation might drive some higher income families from the jurisdiction to other jurisdictions not providing such income redistribution where taxes would be lower. To avoid such migration, local governments would tend ***not*** to provide an adequate level of income redistribution without the guarantee that all other jurisdictions would provide the same level of support. Since there is no way of compelling other jurisdictions to provide the same level of support, especially for jurisdictions across state boundaries, it is generally argued that the national government should be primarily responsible for promoting equity in income distribution. Similarly, promoting stability in the macroeconomic environment requires flexibility in expenditure and tax policies, which also must be coordinated with monetary and exchange rate policies. This can only be done at the national level.

In this view, local government has the most important role to play in promoting efficiency in resource allocation – a role shared between the national, state and local tiers of government. The need for government to act arises because of the failure of the private market to provide the right amount of some goods and services when individuals are left to act in their own self-interest. For example, there are some goods and services, referred to as public goods, which are not provided adequately by the private market because they have different characteristics than private goods. Let's say I consume a cheeseburger – I pay for the cheeseburger, I realize the benefits of eating the cheeseburger and the cheeseburger is not available to anyone else to eat. That is, the consumption of the cheeseburger is a rival relationship – if I eat it, others cannot – and I realize the benefits of its consumption, no one else does. Finally, if one is not willing to pay for the cheeseburger, he/she does not receive the benefits of consuming it. In other words, people can be excluded from enjoying the benefits of the cheeseburger if they are unwilling, or unable, to pay for it. These are the characteristics of a private good.

Alternatively, public goods are characterized by what is referred to as jointness of consumption, i.e., unlike private goods, my consumption of a public good or service does not prevent others from consuming the good or service. My enjoyment of the local park does not detract from others enjoying the park also. In addition, it may be difficult, or prohibitively costly, to exclude individuals that do not pay for such goods or services from consuming the public good. An example might be the road network of any community. In such circumstances, individuals will try to consume the good or service without paying for it. This is referred to in the public finance literature as the "free rider" problem. In such cases the market will not provide efficient amounts of such public goods and the government must step in to provide such public goods and services.[7]

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[7] To say that government has the responsibility for providing such public goods and services does not mean that the government must actually produce the good or service itself. For example, without government intervention, the network of streets and roads in a community may not get fully plowed after a snowstorm. While clearing the streets after a snowstorm may be the responsibility of the local government, the government can provide that service in a number of ways. For example, the local government could hire drivers and buy the trucks and salt needed to clear the streets itself, or it could contract with private firms to provide such services.

In the case of such public goods, a critical issue is determining which level of government should provide a specific good or service. A number of economic and political criteria have emerged as means for assigning specific spending responsibilities to individual tiers of government. These criteria for allocating expenditure responsibility among tiers of government are discussed below.

Benefit Areas

The first rule of thumb in assigning expenditure and service responsibilities to a specific tier of government is to consider the benefit area of the good or service being provided. In this case, services that do not extend beyond the boundaries of a neighborhood or local community should be provided by local governments – e.g., townships, municipalities, and counties. For example, fire protection services benefit primarily the residents of the immediate neighborhood or community. Alternatively, goods or services that provide benefits, or costs, that transcend the boundary of a particular jurisdiction (i.e., it generates either positive or negative externalities) should be provided by higher tiers of government, e.g., counties or state government. Examples of such goods and services might include intercity highways.

Economies of Scale

A second rule of thumb, or a qualification to the benefit area principle, is to assign the delivery of specific goods or services to that tier of government that can best realize economies of scale in the production of the good or service. Economies of scale refer to a situation where there is a general decline in the average cost of producing a good or service as the amount of the good or service produced increases. This criterion suggests that that level of government that produces a good or service in a quantity that allows it to be produced at the lowest possible cost should provide the good or service. Such economies of scale generally arise when there are significant capital costs associated with the delivery of a good or service. Such situations might include, for example, building a sewage treatment plant that services a number of smaller local jurisdictions, which could provide treatment services at a lower per unit cost than if each local jurisdiction built its own capital intensive treatment plant.

Adequate Capacity for Service Delivery

A third guiding principle for allocating expenditure responsibilities across tiers of government is to assign specific service delivery responsibilities to governments that have the capacity to effectively deliver the good or service in question. The capacity of a government to effectively deliver a specific good or services depends on a number of variables. First, the government must have the legal authority to deliver the good or service in question. Second, in addition to having adequate legal authority, the government in question must have the management capability to perform the function being assigned to it. Townships or small rural municipalities, for example, may not have the technical staff necessary to run a technologically complex wastewater treatment plant. Third, functions should be assigned to jurisdictions that have adequate fiscal capacity to finance the public service.

The Principle of Subsidiarity

Finally, functions should be assigned to governments that are accessible to and controllable by their residents in performing a specific function and which provide an opportunity to maximize citizen participation in the delivery of the service. This criterion ensures the legitimacy and accountability of government in performing a particular function. In this regard, it is generally agreed that the greatest benefit will come from assigning individual expenditures to the lowest level of government capable of delivering the service. This is referred to as the principle of subsidiarity. Exceptions to this rule exist when there are economies of scale or significant externalities (Center for Economic Policy Research, 1993)

III. Overview of State and Local Revenues

The following analysis of state and local finances is divided into two parts. This section provides an overview of state and local general revenues. The next section provides an overview of expenditures by state and local governments. Data used for these discussions come from the 2002 Census of Governments by the U.S. Census Bureau.

The Census Bureau defines general revenue to include all revenue collected by state and local governments except for revenues from liquor stores, utilities, or insurance trust funds. Total general revenues include intergovernmental revenue, taxes, current charges, and miscellaneous general revenue – with the last three categories comprising the components of state and local own-source revenues.

The purpose of this section is to explore the differences that exist across the 50 systems of state and local government in the U.S. Specifically, we explore the relative importance of state government in raising revenues and we explore differences in the relative size of state and local governments across the 50 states. We also look at changes in these patterns over the decade of the 1990s. These data clearly document differences between the fiscal structures of state and local governments as well as the relative size of state and local governments across different regions of the country.

A. Profile of Fifty State-Local Government Systems, 2002

In 2002, state and local governments raised a total of $1.7 trillion in general revenue, 78.6 percent of which came from their own sources including taxes, current charges and other non-tax revenue. Of the own-source general revenue, 68.3 percent represent tax revenues, while taxes amounted to 53.7 percent of the total general revenue. Taxation remains the most important source of government revenues, albeit the relative importance of taxes has been declining for the last 25 years.

The federal system allows for a considerable degree of variability in the organization of the 50 systems of state-local governments, both financially and politically. States differ not only in the distribution of power between state governments and their local subordinates, but also in the size and relative importance of the government.

First, states exhibit varying degrees of centralization. Known as the creatures of state governments, local governments are expected to enjoy less autonomy in their relationship with the states than states do in their relationship with the federal government. Judging from the share of state contribution to the total state and local revenues, however, some states apparently choose to delegate more responsibility to their local counterparts while other states retain a highly centralized form of governance.

In 2002, states raised $727 billion in own-source revenues, or 55 percent of total own-source revenues raised by state and local governments nationally. For individual states, state own-source revenues as a percentage of total state and local own-source revenues ranged between 46 percent in Colorado and 46.2 percent in New York to 80 percent in Delaware and 79.5 percent in Hawaii. See Table 2.

Table 2
Extent of Centralization in State/Local Own-Source General Revenues
State Share of Total State and Local Own-Source Revenues, 2001-2002
(Percent)

Top 10 States		Bottom 10 States	
Name	**State Share of Total State and Local Own Source Revenues**	**Name**	**State Share of Total State and Local Own Source Revenues**
Delaware	80.0	Colorado	46.0
Hawaii	79.5	New York	46.2
Vermont	77.3	Florida	47.2
Arkansas	73.9	Texas	47.3
New Mexico	72.6	Nevada	49.4
West Virginia	72.5	Georgia	50.0
Alaska	71.3	Illinois	51.3
Kentucky	67.6	Tennessee	51.8
Montana	65.0	Wyoming	52.4
Michigan	64.7	Nebraska	53.1

Source: Statistical Appendix Table 1 and Table 11 and staff calculations.

In 32 state/local systems the state government raised more than the aggregate average state share of 55 percent, suggesting an overall tendency toward centralization of revenue raising responsibilities. At one extreme of the spectrum, state governments in Colorado, Florida, New York, Nevada and Texas raised less than half of the total state and local own-source revenues, whereas at the other extreme, over 70 percent of the state and local own-source revenues came from the state governments in Alaska, Arkansas, Delaware, Hawaii, New Mexico, Vermont, and West Virginia.

There are no strong regional patterns in terms of the extent to which state governments are centralized. In the Northeast, [8] states tended to be more centralized than their counterparts in the rest of the country – for seven of the nine states in this Census region state governments accounted for more than 55 percent of total state and local own-source revenues. States in the Midwest region[9] tended to have relatively more decentralized state and local systems with state governments accounting for less than 55 percent of total state and local own-source revenues in six of the 12 states.

Second, the size of government varies from state to state. One can understand how the amount of own-source revenues state and local governments collect is highly correlated with population size and state wealth. Richer and more populous states are more likely to have more revenues at their disposal than their less fortunate counterparts. But even when such factors as population size and state personal income are controlled for, differences in the size of government remain, as illustrated by per capita own-source general revenue and own-source general revenue expressed as a percentage of state personal income.

In 2002, total state and local own-source revenues averaged $4,705 per person. Per capita state and local own-source revenues ranged from $3,494 in Tennessee to $8,644 in Alaska; per capita own-source revenues in Tennessee were just 40 percent of per capita own-source revenues in Alaska. Alaska not only boasted considerably larger state and local revenues per capita, but also a relatively highly centralized state government, with 71.3 percent of its total revenue from the state coffer. This reflects their heavy reliance on oil revenues. The District of Columbia raised $7,137 per capita in own-source general revenue, second in the nation. If Alaska and Washington DC are considered aberrations because of their special circumstances, the disparity in the size of government becomes less steep. See Table 3. Still per capita own-source state and local revenue in Tennessee is just 56 percent of the corresponding figure for New York ($6,290 per capita).

[8] Defined by the Census Bureau to include Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, and Vermont.
[9] Defined by the Census Bureau to include Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota, and Wisconsin.

Table 3
Top 10 and Bottom 10 States, Per Capita State and Local Own-Source General Revenues, 2001-2002

Top 10 States		Bottom 10 States	
Name	**Per Capita Own-Source ($)**	**Name**	**Per Capita Own-Source ($)**
New York	6,290	Tennessee	3,494
Wyoming	6,173	Arkansas	3,596
Delaware	5,920	South Dakota	3,645
Minnesota	5,510	Mississippi	3,750
Connecticut	5,510	Arizona	3,860
New Jersey	5,504	Missouri	3,884
California	5,266	Kentucky	3,913
Massachusetts	5,170	Montana	3,915
Colorado	5,062	Alabama	3,930
Maryland	4,983	West Virginia	3,934

Note: Alaska and the District of Columbia are excluded from this analysis.
Source: Statistical Appendix Table 3.

The majority of states, in terms of revenues raised per capita, fall on the lower end of the scale. Specifically, 17 states (including the District of Columbia) have per capita state and local own-source revenues greater than the aggregate average of $4,705, while 34 states have per capita state and local revenues less than the national average.

Another measure of the size of state and local government is to look at the claim they make on personal income in a state. Total state and local own-source revenues account for 14.9 percent of total personal income in the U.S. The range is from 11.8 percent of personal income in New Hampshire to 19.7 percent in Wyoming.[10] Using this measure of the size of state and local governments, New Hampshire accounts for just 60 percent of Wyoming's 19.7 percent. Unlike the per capita revenue measure of government size, differences in the percentage of personal income taken by state and local governments were fairly evenly distributed, with nine states in the 13 to 14 percent range, ten in the 14 to 15 percent range, 16 in the 15 to 16 percent range, and seven in the 16 to17 percent range. The state and local system in 28 states took more than 14.9 percent of total personal income in their state, while 21 states took less (excluding Alaska). See Table 4.

[10] Alaska is omitted from this comparison because of its heavy dependence on oil revenues.

Table 4
Top 10 and Bottom 10 States, State and Local Own-Source General Revenues as a Percentage of Personal Income, 2001-2002

Top 10 States		Bottom 10 States	
Name	**Own-Source (% of Personal Income)**	**Name**	**Own-Source (% of Personal Income)**
Wyoming	19.7	New Hampshire	11.8
Delaware	17.9	Tennessee	12.4
New York	17.4	Connecticut	12.8
Utah	17.3	Massachusetts	13.1
Louisiana	17.3	Maryland	13.3
Maine	17.0	South Dakota	13.4
New Mexico	16.8	Missouri	13.4
North Dakota	16.7	Illinois	13.6
West Virginia	16.6	Texas	13.7
Mississippi	16.5	New Jersey	13.7

Note: Alaska and the District of Columbia are excluded from this analysis.
Source: Statistical Appendix Table 4.

Overall, variation in own-source state and local revenues, expressed as a percentage of state personal income, show comparatively less variation across states than per capita revenue measures.

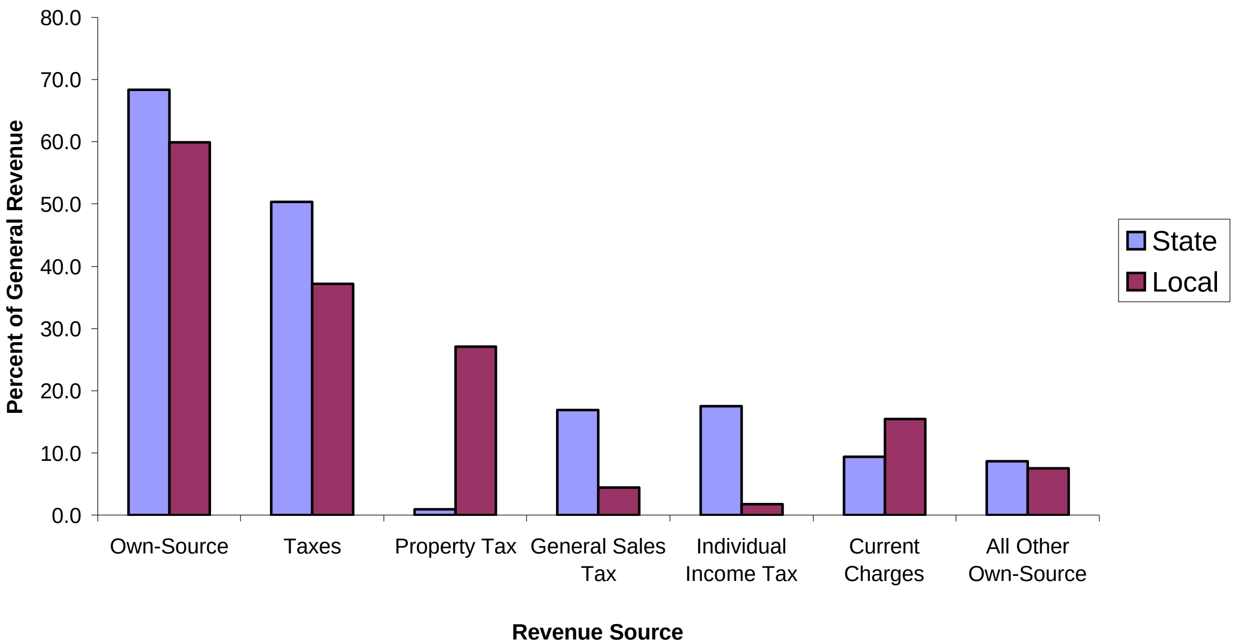
Judging by per capita revenues in 2002, the size of state and local governments followed some easily discernible regional patterns. Specifically, five of the nine states in the Northeast had above-average-sized governments and seven of the 13 states in the West also had relatively large state and local sectors. Only two of 13 states in the South and two of 12 states in the Midwest had above-averaged-sized governments.

Similar regional trends, however, did not emerge in the comparison of state and local revenues relative to state personal income. In six Northeastern states, state and local own-source revenues account for less than 15 percent of personal income, while in nine of 16 states in the South state and local governments claim more than 15 percent of personal income. Similarly, in the West nine of 13 states claim more than 15 percent of personal income, as do eight of 12 states in the Midwest. These data suggest that governments in South typically have relatively small state and local government systems as measured by per capita revenues, but many of those states exert an above average effort in terms of claims on the personal income of the state. Similarly, states like Arizona, Illinois, New Hampshire, and South Dakota have relatively small state and local governments when looking at revenues per capita, in part at least, because they take a below average share of personal income to finance state and local governments. Alternatively, states like Delaware, Hawaii, Maine, Minnesota and New York have relatively large state and local government systems, in part at least, because they choose to extract an above average share of personal income from their residents to fund government activities.

Differences between State and Local Fiscal Structures, 2002

When state data are disentangled from those for local governments, the data tell a more complex story. State and local governments differ significantly in their degree of reliance on various revenue sources. See Figure 1.

Figure 1
Percentage Distributions of State and Local General Revenues by Source, 2001-2002



First, state governments rely more heavily on own-source revenue than local governments. In 2002, own-source revenue constituted 68.4 percent of total general revenue at the state level while the equivalent figure for local governments is only 60 percent. In other words, local governments are more dependent upon intergovernmental funds than the states. In part, this reflects the increasing importance of state aid in financing education.

Second, state governments assign greater weight to taxation in revenue collection than their local counterparts. Tax revenues accounted for 50.4 percent of total general revenue and 73.6 percent of the own-source revenue for state governments while local governments had 37.1 percent of their total general revenue, or 61.9 percent of their own-source revenue coming from various taxes. Not surprisingly, current charges played a greater part in own-source revenue for local governments (25.7 percent) than for the states (13.7 percent).

Third, states rely more heavily on sales and personal income taxes than local governments, which, by contrast, rely primarily on the property tax. In 2002, general sales tax and personal income tax revenues respectively constituted 16.9 percent and 17.5 percent of state general revenue, either type of tax making up about one fourth of the own-source revenue and over one third of state tax revenue. For local governments however, general sales tax accounted for but 4.4 percent of the general revenue, 7.3 percent of the own-source revenue, and 11.7 percent of local tax revenue. The corresponding numbers for the local income tax are 1.7 percent, 2.9 percent, and 4.6 percent.

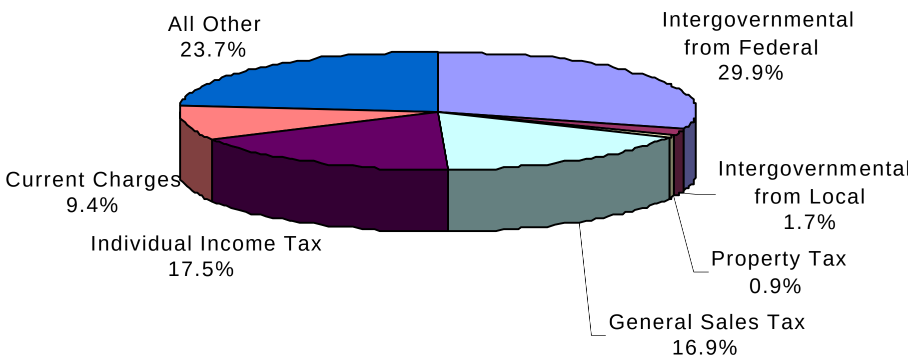
Property taxes constitute the dominant source of local own-source general revenue. Twenty-seven percent of total general revenue of local governments came from property taxes, which claimed 45.1 percent of the own-source revenue and 72.9 percent of taxes. In stark contrast, the property tax made up less than one percent of state general revenue and was only slightly over one percent of own-source revenue and less than 2 percent of tax revenue.

While the local property tax is levied in all 50 states and the District of Columbia, 37 state governments collect some revenue from the property tax. The pattern is somewhat different with regard to general sales taxes and personal income taxes. Local governments in 16 U.S states do not collect general sales taxes, while only 5 state governments do not collect any general sales taxes – Alaska, Delaware, Montana, New Hampshire, and Oregon. The gap is greater for the individual income tax: local governments in only 14 states collect some revenue from the local income tax, while only 7 states do not collect some revenues from personal income taxes –Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

Differences among States within and across U.S. Regions, 2002

As discussed earlier, state governments are relatively more fiscally independent, relying mainly on the sales tax and personal income tax for own-source revenue. In the aggregate, the combination of general sales and personal income taxes made up more than one-third o total state general revenues, but fully half of state own-source general revenue and two thirds of state tax revenue. See Figure 2. Taken individually however, state governments are quite different in terms of their fiscal structures. .

Figure 2
Percentage Distribution of State General Revenue, 2001-2002



First, states differ in their degree of fiscal autonomy, judging from the relative importance of own-source revenue as a share of their general revenue. In the aggregate, 68.4 percent of state general revenue in 2002 was composed of own-source revenues. The state of Delaware derived 80.1 percent of its general revenue from its own sources while Wyoming only managed to collect 57.8 percent of its general revenue from own sources, significantly below the national average. In 28 states, the share of own-source revenue was in the 60 to 70 percent range. Own-source revenue constituted 70 to 80 percent of the general revenue in 16 states.

Second, state governments vary in their reliance on tax revenue (as well as in their reliance on different types of taxes). In 2002, U.S. states collectively raised $535 billion in tax revenue, 73.6 percent of state own-source general revenue. Not surprisingly, with neither personal income tax nor general sales tax, Alaska generated only 28.2 percent of its own-source revenue from levying taxes. Alternatively, current charges and other non-tax revenue constituted the larger bulk of general revenue for that state. Aside from the aberration of Alaska, taxes as a share of own-source revenue ranged from 58.6 percent in Delaware to 81.7 percent in Nevada. On average (excluding Alaska), taxes accounted for 71.3 percent of state own-source general revenue. See Table 5.

Table 5
Top 10 and Bottom 10 States, Taxes as a Percentage of State Own-Source General Revenues,
2001-2002

Top 10 States		Bottom 10 States	
Name	**Taxes (% of Own-Source)**	**Name**	**Taxes (% of Own-Source)**
Nevada	81.7	Delaware	58.6
Minnesota	80.2	Oregon	60.1
Arizona	80.0	North Dakota	61.2
California	79.7	Utah	61.9
Georgia	78.7	Montana	62.9
North Carolina	78.6	New Hampshire	63.2
New York	78.4	Louisiana	63.4
Connecticut	77.8	South Dakota	63.4
Illinois	77.8	New Mexico	64.5
Kansas	77.7	Iowa	66.0

Note: Alaska is excluded from this analysis.
Source: Statistical Appendix Table 11 and staff calculations.

Third, states vary widely in the composition of their revenue sources. Not all 50 states levy general sales taxes and neither do all of them collect tax on personal income. In 2002, state governments received a total of $186 billion in personal income tax revenue; albeit, 43 out of 50 states tax personal income; Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not tax personal income at all. Tennessee and New Hampshire do not tax wages and salaries, the major component of personal income. Among states with personal income tax, revenues, as a percentage of state own-source revenue, ranged from 10.9 percent in North Dakota to 46.4 percent in New York. On average, personal income taxes accounted for 26 percent of state own-source general revenue. For the same states, the per capita income tax revenue ranged from $311 in North Dakota to $1,348 in New York. When expressed as a percentage of state personal income, the personal income tax collections accounted for between 1.2 percent in North Dakota and 3.7 percent in New York.

In the same fiscal year, states collected a total of $180 billion in general sales taxes. While 45 of the 50 states levy a general sales; Alaska, Delaware, Montana, New Hampshire, and Oregon do not. Among states that impose a general sales tax, this type of tax constituted as high as 48.1 percent of state own-source revenue in Washington. By contrast, Vermont only had 10 percent of its own-source revenue from general sales taxes. In fact, the states that do not tax personal income, but tax general sales, all relied heavily on the latter tax. Florida, Nevada, South Dakota, Tennessee, Texas, and Washington are among the ten states with the highest proportion of their general revenue from the general sales tax. Meanwhile, general sales taxes per capita ranged from $353 in Vermont to $1,341 in Washington and ranged from 1.2 percent of personal income in Vermont and Virginia to 4.4 percent in Hawaii.

Although the property tax generally does not provide a major source of state revenue, some states are more inclined to collect property taxes than others. In 2002, states collected $9.7 billion in property tax revenue, only 1.3 percent of the total state and local own-source revenues and 1.8 percent of total state and local taxes. While 37 states tax property, the share of property tax in state own-source revenue ranged from 0.01 percent in New Jersey to 18.2 percent in Vermont, where the importance of property tax rivaled that of personal income tax. The share in New Hampshire was as high as 16.7 percent, far exceeding the share of any other tax levied in the state. By contrast, in almost half of the 37 states, the property tax failed to make up even one percent of their own-source general revenue.

It should be noted that variations in state fiscal systems also exhibit some regional patterns. Of the nine states that do not levy a personal income tax, seven are in the South and the West. States in the Northeast relied most heavily on personal income taxes as a source of general revenue, followed by states in the Midwest. The regional average share (excluding New Hampshire and South Dakota) of personal income tax in own-source revenue amounted to 30 percent in the Northeast and 26 percent in the Midwest. Within each region however, we also observe a wide range of variation in the relative importance of personal income taxes. In the Northeast, the range was from 19 percent in Vermont to 46.4 percent in New York; the range in the West spanned from 17.5 percent in New Mexico to 42.8 percent in Oregon, whose heavy reliance on personal income taxes is seen in relation to the absence of a general sales tax in Oregon. States in the Midwest and in the South saw a narrower gap in the importance attached to personal income tax. Still, the range was from the 10 percent to 30 percent.

With regard to general sales tax, three of the five states without that tax lie in the West. The Midwestern states consistently had general sales tax making up one quarter of their own-source revenue, whereas states in the South and West experienced greater variation in their reliance on general sales tax. In the South for instance, the share of general sales tax in own-source revenue ranged from 14.5 percent in Virginia to 45.4 percent in Tennessee. In the West, the range was between 19 percent in Colorado and 48.1 percent in Washington. None of the regional averages, however, was far off the national average, indicating less variance across states in the relative importance of general sales tax than that of personal income tax.

Despite the relative insignificance of property tax in state general revenue, two Northeastern states, Vermont and New Hampshire topped the list of property tax revenue when measured by its share in own-source general revenue, by per capita revenue, and by its ratio to personal income. A number of states in the West, such as Montana, Washington and Wyoming also have about eight to nine percent of their general own-source revenue coming from property taxes, above the national average of one percent.

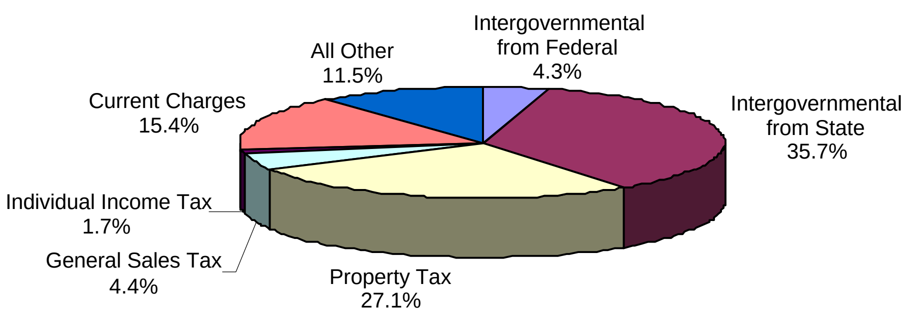
In terms of fiscal autonomy, states in the Northeast and in the Midwest on average were less dependent on intergovernmental funds than states in the South and in the West. Alabama, Mississippi, Montana, Oregon, South Carolina, Tennessee, and

Wyoming, for instance, are among the ten states that were least fiscally independent, with an average of approximately 60 percent of state general revenue from own sources. By contrast, Connecticut, Illinois, Massachusetts, Michigan, Minnesota, New Jersey, and Pennsylvania all boasted a share of their general revenue from own sources well above the national average.

Differences among Local Fiscal Systems across the U.S. States

In 2002, local governments collected $597 billion from their own sources, constituting 60 percent of their total general revenue. Of the own-source revenue, $269 billion were from local property taxes, 96.5 percent of total state and local property tax revenue, and 45.1 percent of local own-source general revenue. See Figure 3. In line with this general pattern, however, local fiscal systems are far from uniform.

Figure 3
Percentage Distribution of Local General Revenue, 2001-2002



First, local governments differ in their level of fiscal autonomy. Own-source revenue as a share of local general revenue ranged from 41.1 percent in New Mexico to 78.2 percent in Hawaii. While localities in five states failed to raise half of their general revenue from their own sources, local governments in 11 states collected more than two-thirds of their general revenue from own sources. Twenty-two states depend on own-source revenues for less than 60 percent of their total general revenues.

Second, local governments vary in their degree of reliance on tax revenue. In 2002, local governments in the aggregate collected $370 billion in taxes, accounting for only 40.9 percent of the state and local total tax revenue, and 61.9 percent of local own-source general revenue. The figures indicate that local governments are by and large less dependent on tax revenue than states. When we make comparisons across states, the range of variation is found to be large. Local governments in Connecticut raised

85.2 percent of their own-source revenue from taxes while their counterparts in Alabama raised only 41.3 percent of their own-source revenue from levying taxes. The discrepancy is much greater than at the state level. For localities with a lower reliance on tax revenues, current charges constitute a more important source of general revenue.

Third, local governments differ in their reliance on property taxes as the major component of own-source revenue. Property taxes as a share of local own-source revenue ranged from 16.5 percent in Alabama to 83.8 percent in Connecticut. See Table 6. Local governments in the state of Alabama are actually less dependent on property tax collections than state governments of Vermont and New Hampshire, which is quite contrary to the conventional perception. On the other hand, Alabama ranked highest on the share of current charges in local own-source revenue, i.e. 47.7 percent. In states where property tax revenue was less important for local governments, general sales taxes in most cases, or occasionally, personal income taxes, along with charges, made up the difference. In Louisiana, for instance, 31.6 percent of its local own-source general revenue came from the general sales tax, as compared to 24 percent from property taxes. In the District of Columbia, property taxes accounted for only 19.7 percent of its local own-source revenue while the share for personal income taxes was 23.3 percent.

Table 6
Top 10 and Bottom 10 States, Property Tax as a Percentage of Local Own-Source General Revenues, 2001-2002

Top 10 States		Bottom 10 States	
Name	**Property Tax (% of Own-Source)**	**Name**	**Property Tax (% of Own-Source)**
Connecticut	83.8	Alabama	16.5
Rhode Island	83.2	Arkansas	20.6
New Hampshire	79.1	Louisiana	24.0
Maine	77.5	Oklahoma	29.6
New Jersey	76.1	Kentucky	30.0
Massachusetts	74.0	Nevada	32.1
Vermont	68.9	New Mexico	33.2
Wisconsin	62.2	Washington	33.7
Illinois	57.6	California	35.0
South Dakota	55.2	Colorado	35.4

Note: Alaska and the District of Columbia are excluded from this analysis.
Source: Statistical Appendix Table 21 and staff calculations.

More distinct regional trends can be discerned from a comparison of the fiscal structures across U.S. localities, with regard to their fiscal independence, their reliance on tax revenue in general and on property taxes in particular.

First, local governments in the Northeast and in the Midwest are more likely than their equivalents in the South and in the West to have a higher share of their general revenue from their own sources. In over 80 percent of Northeastern states, local governments derived above 60 percent of their general revenue from own sources. The equivalent figures for the Midwest, the South, and the West, are 60 percent, 50 percent, and 40 percent, respectively.

Second, local governments in the Northeast and in the Midwest rely more heavily on tax revenue than localities in the Southern and Western states. Local tax revenue, on average, made up 77.1 percent of own-source revenue in Northeastern states, 61.6 percent in Midwestern states, 57.2 percent in the South, and 57 percent in the West. Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, Rhode Island, South Dakota, and Vermont were among the ten states with the highest share of tax revenue in local own-source revenue. By contrast, Alabama, Arkansas, California, Florida, Idaho, Mississippi, Nevada, North Carolina, and Wyoming were among the top ten states in which tax revenues are of least relative importance for local governments.

Third, local governments in the Northeast and in the Midwest are more heavily dependent on property tax revenue than their peers in the South and in the West. Local property tax collections, on average, constituted 70.2 percent of local own-source revenue in Northeastern states, 50 percent in the Midwest, 41.3 percent in the West, and 36 percent in the South. The ten states where the property tax accounted for the highest share of local own-source revenue are all situated in the Northeast and in the Midwest, while all ten states with the lowest reliance on property taxes are either in the South or in the West.

B. Profile of State-Local Government Systems, 1992

In 1992, states were as varied in their degree of centralization as they were in 2002. Specifically, in 1992, the national average state share of total state and local own-source revenues was 55 percent – virtually the same as it was in 2002. Similarly, in 1992, the state share of state and local own-source revenues ranged from 45.5 percent in New York to 79.2 percent in Delaware. Neither the spread of the range nor the average state share was significantly different from that in 2002.

In 1992, state governments in Colorado, Florida, Georgia, New Hampshire, New York and Texas contributed less than half of their state and local total own-source revenues, while the state governments in Alaska, Delaware, Hawaii and New Mexico raised over 70 percent of their state and local total own-source revenues. The list of states at either extreme did not change dramatically and only their order on the list shifted somewhat over time. The slight increase in the number of centralized state and local fiscal systems by 2002, however, indicates that the movement toward devolution was not uniform across the board. For example, the state and local fiscal systems in Michigan, New Hampshire and Vermont, in particular, became more centralized between 1992 and 2002 with the state share of state and local own-source revenue increasing by as much as 20 percent in just ten years.

The situation at the regional level remained fairly constant between 1992 and 2002. In 1992, six of the nine Northeastern states contributed a greater share than the national average to total state and local revenues, while in only half of the states in each of the other regions did states contribute more than the national average share of state and local general revenues. In 2002, the Northeast had a majority of its states that were relatively more centralized than the average state and local system nationally.

In 1992, per capita state and local own-source revenue averaged $3,136. The range in per capita spending across the 50 states and Washington D.C. went from a low of $2,181 in Arkansas to a high of $10,151 in Alaska. The District of Columbia had the second highest per capita own-source revenue in 1992, $4,984. If we exclude Alaska and Washington D.C. because of their unique circumstances, it is noteworthy still that the per capita revenue in New York ($4,640) is more than doubled that of Arkansas ($2,181). The low revenue raising state had per capita own-source revenues that were just 47 percent of the highest revenue raising state. In 1992, 34 states had per capita total own-source revenues that were less than the national average of $3,136.

A roughly similar pattern can be discerned from the 2002 data. Per capita own source revenues averaged $4,705 in 2002. If we exclude Alaska and Washington D.C. because of their unique circumstances, the range in per capita own-source revenues went from a high of $6,290 in New York to a low of $3,934 in Mississippi. The state with the lowest per capita own-source revenues, Mississippi, had per capita own-source revenues that were 62.5 percent of the state with the highest per capita own-source revenues, indicating a narrowing in the range between high and low revenue-raising states. In 2002, 34 states had per capita own-source revenues below the then national average of $4,705.

When we measure the size of government as a share of state personal income, there was a significant change in the size of government from 1992 to 2002. In 1992, on average, state and local own-source revenues accounted for 16.6 percent of personal income. This compares to just 14.9 percent by 2002. When Alaska and Washington D. C. are excluded because of their special circumstances, the percentage figure ranged from 13.4 percent in Missouri to 24.6 percent in Wyoming. In 1992, 24 states had own-source revenues that took less than 16.6 percent of state personal income; compared with 21 states in 2002 that had own-source revenues that took a smaller share of personal income than state and local governments nationally.

In 1992, six out of nine Northeastern states had per capita revenues well above the national average (Alaska excluded), whereas 14 out of 16 Southern states had per capita revenues lower than that average. Meanwhile, eight out of 12 Midwestern states had below-average per capita revenues, while nine out of 13 states in the West had above-average figures.

In 1992, state and local own-source revenues expressed as a percent of personal income exhibited quite different regional trends than those found in per capita figures. Notably, ten of the thirteen Western states had their own-source revenues claiming over 17 percent of their state personal income. By contrast, the majority of states in the other three regions had percentages below that national average (i.e. six out of nine Northeastern states, eight out of 12 Midwestern states, and 13 out of 16 Southern states). The regional discrepancy changed substantially in 2002. While own-source revenues relative to personal income remained below average for the majority of Northeastern states, the majority of Midwestern and Southern states made it into the above-average group (8 in the Midwest and nine in the South).

Differences between State and Local Fiscal Structures, 1992

In 1992, state governments received 72.1 percent of their general revenues from own sources while local governments received only 62.4 percent. Own source revenues accounted for just 68.4 percent of total general state revenues in 2002, and just 60 percent of total local general revenues. Both state and local governments became more dependent on intergovernmental aids over the 1992 to 2002 period.

In 1992, tax revenue constituted 54.4 percent of the general revenue and 75.5 percent of the own-source revenue at the state level while the equivalent percentages at the local level were 39.5 percent and 63.3 percent respectively. Again, a comparison with the statistics in 2002 revealed an overall decline in state and local reliance on tax revenue. On the other hand, however, the difference between states and localities remained roughly constant over the period. Taxes were still far more important as a major source of revenue for the states than for their local counterparts. Alternatively, local governments relied more on current charges than states. In the aggregate, current charges accounted for 23.6 percent of local own-source revenue and 12.1 percent of state own-source revenue in 1992.

In 1992, general sales tax revenues accounted for 17.9 percent of state general revenue, 24.8 percent of state own-source revenue and 32.8 percent of state tax revenue while the corresponding numbers for personal income tax were17.2 percent, 23.9 percent, and 31.7 percent. By contrast, general sales tax and personal income tax respectively made up four percent and 1.8 percent of local general revenue, 6.4 percent and 2.9 percent of local own-source revenue, and 10.2 percent and 4.7 percent of local tax revenue. Ten years later, the pattern of differences remained fairly consistent, albeit in 2002 personal income taxes accounted for 34.7 percent of state tax revenues while the general sales tax accounted for a somewhat smaller share of state tax revenues – 33.5 percent.

Property taxes amounted to 29.9 percent of total local general revenues in 1992; while the property tax accounted for 47.9 percent of local own-source revenue and 75.6 percent of local tax revenue. While the property tax remained the single most important source of local revenue, its relative importance declined from 1992 to 2002. For example, property taxes as a percentage of local general revenue dropped to 27.1 percent in 2002 – a decline in relative importance of nearly 10 percent between 1992 and 2002. Similarly, the property tax share of local taxes was 73 percent in 2002 – a decline of 3.4 percent between 1992 and 2002.

In 1992, only 1.2 percent of state general revenue came from the property tax, which constituted but 1.7 percent of own-source revenue and 2.2 percent of tax revenue for state governments. At the state level, the relative importance of the property tax was far below that of local governments in both 1992 and 2002, while the relative importance of the property tax as a revenue source slipped not only at the local level but also at the state level. The change, however, may be more consequential for local governments than for their state counterparts.

Differences among States within and across Regions, 1992

In 1992, U.S. states raised a total of $439 billion in own-source revenue, 72.1 percent of state general revenue. Omitting Alaska and Washington D.C. because of their special circumstances, the relative importance of own source revenues, as a share of total state general revenues, ranged from Mississippi, which derived 60.7 percent of its general revenue from own sources, to Delaware which collected 83.2 percent of its general revenue from own sources. Four states relied on own source revenues for less than 65 percent of their total general revenues – Louisiana (64.3 percent), Mississippi (60.7 percent) and New York (63.4 percent), and Wyoming (61.3 percent). By 2002, own source revenues accounted for just 68.4 percent of total state general revenues – a decline of 5 percent in the relative importance of own source revenues.

In 1992, state governments collected $331 billion in tax revenues, making up 75.5 percent of their own-source revenue. Excluding Alaska and Washington D.C. because of the unique circumstances, tax revenue as a share of own-source revenue ranged between 58.3 percent in South Dakota and 84.4 percent in Georgia. Compared with 2002, the degree of variation among states noticeably decreased while the overall level of state reliance on taxes declined.

While not all states levy personal income tax, there is considerable variation in the relative importance of that tax among states that do levy the tax. In 1992, personal income taxes, expressed as a percentage of state own-source revenue ranged from 10.2 percent in North Dakota to 42.4 percent in Oregon, with a national average of 25.8 percent, excluding states without a personal income tax.

In 2002, the range expanded by ten percent and shifted slightly to the higher end of the scale. This change suggests that the majority of the states increased their reliance on personal income taxes over the decade, while the distribution became more polarized. The states of Delaware, Iowa, and Vermont experienced the greatest declines in their reliance on the personal income tax, while Connecticut, Kansas and New Mexico witnessed the greatest increases in the relative importance of personal income taxes in their own-source revenues.

States that collect a general sales tax also differ in their reliance on it as a major revenue source. In 1992, general sales taxes accounted for as much as 48.2 percent of own-source revenue in Washington and as low as 13.2 percent in Vermont. Ten years later, the range extended a bit to the lower end while the national average remained fairly constant. In 2002, West Virginia and Vermont saw a considerable loss in the relative importance of general sales tax revenues as a share of their own-source revenue. By contrast, Wyoming experienced a 61 percent jump in the general sales tax share of state general revenues. Rhode Island and Massachusetts also had an upward change of over 20 percent.

Moreover, changes in state reliance on property tax occurred in complex ways between 1992 and 2002. In 1992, states levied a total of $7.4 billion property tax, constituting but 4.1 percent of state and local total property tax collections. The number of state governments that do not tax property changed only slightly from 1992 (14 states) to 2002 (13 states). In 1992, property taxes accounted for just 1.7 percent of state own-source revenue and ranged from 0.02 percent in Connecticut to 13.3 percent in Washington. By 2002, property taxes accounted for just 1.3 percent of state own source revenues. A number of states decreased their reliance on property taxes as a share of state own source revenues, while several states increased their reliance on property taxes – e.g., New Hampshire and Vermont.

Some regional differences can be discerned from the 1992 data. Judging from the proportion of general revenue from own sources, states in the Midwest and in the West enjoyed greater fiscal autonomy, on average, than their equivalents in the Northeast and in the South. The regional average for the West, followed by that for the Midwest was well above the national average. By contrast, both the Northeast and the South had a regional average below the national one. This regional pattern was considerably revised over the years between 1992 and 2002 – more Northeastern states were increasingly self-reliant, while more Western states joined their Southern brothers with greater dependence upon intergovernmental grants.

In 1992, states in the Northeast and the Midwest relied more heavily on the personal income tax as a major revenue source than states in the South and the West. The Northeast had the highest regional average even when New Hampshire, which has no personal income tax, was included. Two of states with the nation's largest shares of state own source revenues coming from the personal income tax, New York and Massachusetts, are located in the Northeast. The regional disparity was echoed by the 2002 data. On the other hand, however, the within-region variations were less prominent in 1992, especially for the Northeast.

In 1992, states in the Midwest and the South appeared more dependent on general sales taxes than their counterparts in the Northeast and the West. Northeastern states on average had a considerably smaller share of state revenue from sales tax than the rest of the country. Southern and Western states had greater within-region differences than states in the Midwest.

In 1992, among the ten states with the highest percentage of state revenue from property tax, six lie in the West and three lie in the South. By contrast, less than half of the Northeastern states saw the property tax make up as much as one percent of the state own-source revenue. The proportion was even lower in the Midwest. The situation changed fairly substantially in 2002. While several Northeastern states dramatically raised their property tax, their regional average surpassed that in the West by a large margin.

Differences among Local Fiscal Systems across States, 1992

In 1992, local governments raised $361 billion in own-source general revenue, 47.9 percent of which came from the property tax, which in turn accounted for 96 percent of state and local total property tax collections. Like states, localities also differ in their fiscal autonomy, their reliance on tax revenue and on the combination of different types of taxes.

Local governments in New Mexico received 44.5 percent of their general revenue from own sources in 1992 – the only state where local governments received less than half of their general revenues from own source revenues. Alternatively, local governments in New Hampshire depended on own source revenues for nearly 85 percent of total local general revenues. By 2002 the relative importance of own source revenues declined to just 60 percent of local general revenues. While shifting downward, the range of variation narrowed by eight percent ten years later. By 2002, an overwhelming majority of the states saw their localities more reliant on intergovernmental funds than they were just ten years earlier. Local governments in different states are trending toward convergence in the decline of their fiscal autonomy.

In 1992, tax revenue as a share of local own-source revenue ranged from 39.1 percent in Mississippi to 87 percent in Rhode Island. On average, local governments raised 63.3 percent of their own-source revenue from tax collections. In 2002, the difference between the two extremes became less dramatic while the average level of reliance on taxes remained stable. Local governments in Michigan, Oregon and Vermont experienced the greatest decline in their taxes as a percentage of local revenue, whereas, Alaska, New Mexico, and West Virginia underwent the largest increases in the importance of taxes relative to other local revenue sources.

In 1992, property taxes as a percentage of local own-source revenues varied between 16.2 percent in Alabama and 86.1 percent in New Hampshire. The degree of variation declined considerably in 2002, while local governments in 31 out of 50 states, in addition to the District of Columbia, saw a drop in their reliance on the property tax as the major source of revenue. Over the decade, Arkansas, District of Columbia, and Michigan had a drastically decreasing share of local revenue from property taxes. By contrast, local governments in New Mexico, West Virginia, and Alaska experienced increases in the relative importance of property tax in their own-source revenue. The magnitude of change, however, is greater for the declines. This may provide some evidence for the convergence of local governments in their reliance on property tax.

The 1992 data document several regional differences between local governments, which were largely retained throughout the decade. Local governments in Northeastern and Midwestern states were overwhelmingly more reliant on own sources for local revenue. On average, own-source revenue amounted to 67.2 percent of local general revenue in the Northeast states, while the comparable figure for the Midwest was 64.4 percent. In contrast, the regional averages for the South and the West were only 61.4 percent and 60.5 percent, neither able to match the national average of 63 percent.

In 1992, local tax revenue, on average, accounted for 79.2 percent of local own-source revenue in Northeastern states, 63.2 percent in Midwestern states, 56 percent in the South, and 55.4 percent in the West. The Northeast led the nation in its reliance on taxes, whereas the Southeastern and the Western states were left far behind in this regard.

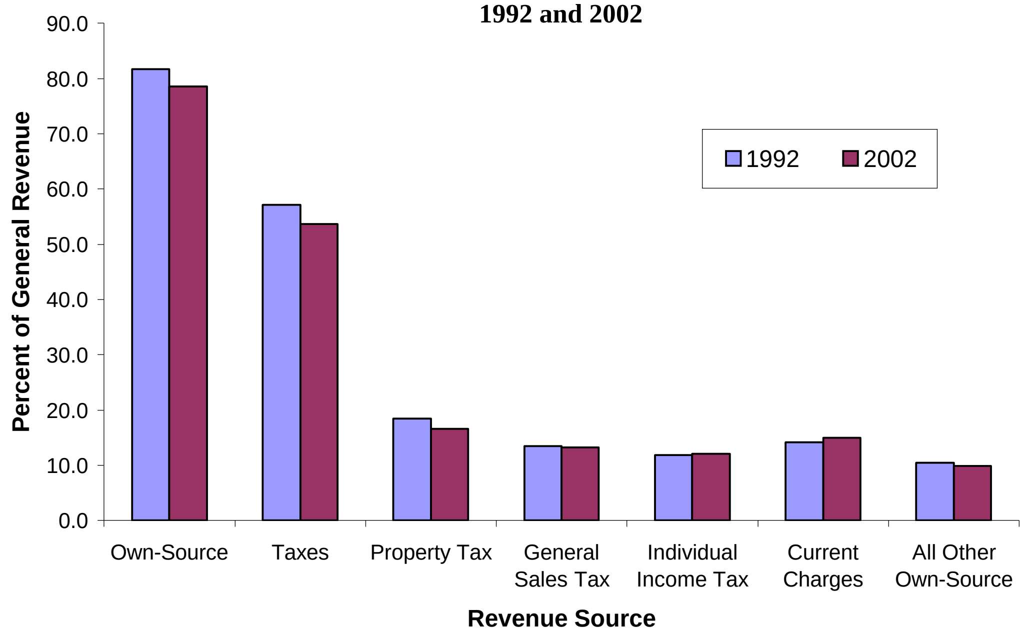
The Northeastern states again took the lead in reliance on property taxes as the dominant source of local revenue in 1992. The region boasted an average of 73 percent of local own-source revenue derived from property taxes. The Midwest followed with an average of 53 percent. The comparable numbers for the West and the South were 43 percent and 37 percent respectively.

The regional patterns remained by and large consistent over the years between 1992 and 2002. Yet the regional differences in local fiscal systems became less distinct in 2002 than a decade ago. It may suggest that a modest degree of convergence occurred at the regional level, along with convergences among localities across states.

C. Summary of Trends over the Decade, 1992-2002

The 1992 and 2002 data discussed above reveal noticeable differences between state and local fiscal systems, and between fiscal systems across localities, states, and regions. In 1992, state and local governments in the aggregate received $979 billion in general revenue, 81.7 percent of which fell in the category of general own-source revenue. Ten years later, general own-source revenues accounted for just 78.6 percent of total general revenues – a decline in relative importance of 4 percent. In 1992, taxes accounted for 57.2 percent of the general revenue, and 70 percent of general own-source revenue. Ten years later, taxes accounted for 53.7 percent of total general revenues and 68 percent of general own-source revenues. These changes document the declining relative importance of taxes over the decade; a continuation of a longer-term decline in the relative importance of taxes in state and local finances. For example, 25 years ago state and local tax revenues accounted for 58.4 percent of total general revenues, and 74.7 percent of general own-source revenues. See Figure 4.

Figure 4
Percentage Distribution of State and Local General Revenues by Source, 1992 and 2002



Revenues

In this section we look at changes in the real value of state and local revenues. To calculate changes in the real value of various revenue sources, we first adjust the 2002 figures to reflect the impact of inflation. Specifically, we express these 2002 data in terms of 1992 constant dollars.[11] We then calculate the percentage change over these two periods.

<u>State and Local Total General Revenue</u>: In the years between 1992 and 2002, state and local total general revenues increased 33.6 percent in real terms. When population size is taken into account, state and local governments experienced an increase of 21.1 percent in real total general revenues per capita over the same period. See Table 7.

[11] The conversion was based on state and local government current expenditure and investment price deflator from the *Survey of Current Business*, August 2004 issue.

Table 7
Real Per Capita State and Local General Revenue and Change, 1992-2002

Revenue Source	Year 1992 ($)	2002 ($)	Real Per Capita Change (%)
Intergovernmental Aid	702	995	41.6
Own-Source	3,136	3,653	16.5
Tax	2,195	2,497	13.8
Property Tax	707	770	8.9
General Sales Tax	517	615	18.9
Individual Income Tax	453	560	23.5
Other Taxes	517	552	6.7
Current Charges	542	699	28.8
All Other	399	458	14.8
Total	3,839	4,648	21.1

Note: 2002 data are converted into constant 1992 dollars using a deflator of 1.288, *Survey of Current Business*, August 2004 issue.

Data Source: State and Local Government Finances, 1992 and 2002 Census of Governments, and staff calculations. URL: http://www.census.gov/govs/www/estimate.html

Among the fifty states however, not only the magnitude of change, but also the direction of change, differed. Among states with a positive change in real total general revenue per capita, the magnitude of increase ranged from 6.8 percent in New Jersey to 37.5 percent in Mississippi. Seven states experienced an increase in real total general revenues per capita of less than 15 percent – Arizona, Connecticut, Massachusetts, Montana, New Hampshire, New Jersey, and New York. Alternatively, nine states experienced increases in real total general revenues per capita of over 30 percent – Alabama, Arkansas, Mississippi, Missouri, North Carolina, Ohio, Oklahoma, South Carolina and Utah. Only two states experienced an actual decline in real total general revenues per capita during this period – Alaska (-23.1 percent) and Hawaii (-2.6 percent).

The pattern of change also varied among different sources of state and local general revenue. For example, real intergovernmental aid per capita increased by 41.6 percent, current charges by 28.8 percent, income tax revenues by 23.5 percent, and general sales tax revenues by 18.9 percent. In contrast, real per capital corporate income tax collections dropped by 17 percent.

State General Revenue: A glance at trends over time in changes in real state and local total general revenues provides a general picture of trends over time, but it masks the different experiences of states and localities, which need to be examined separately. See Table 8.

Table 8
Real Per Capita State General Revenue and Change, 1992-2002

Revenue Source	Year 1992 ($)	Year 2002 ($)	Real Per Capita Change (%)
Intergovernmental Aid	668	925	38.6
Own-Source	1,725	2,005	16.3
Tax	1,301	1,477	13.5
Property Tax	29	27	-7.5
General Sales Tax	427	496	16.0
Individual Income Tax	413	512	24.2
Other Taxes	433	442	2.1
Current Charges	208	275	32.4
All Other	215	253	17.8
Total	2,392	2,931	22.5

Note: 2002 data are converted into constant 1992 dollars using a deflator of 1.288, *Survey of Current Business*, August 2004 issue.

Data Source: State and Local Government Finances, 1992 and 2002 Census of Governments, and staff calculations. URL: http://www.census.gov/govs/www/estimate.html

Compared with 1992, total state general revenue, after adjusting for the effects of inflation, increased by 35.5 percent by 2002 – a slightly stronger increase than state and local governments combined. The same can be said about real per capita state general revenue, which increased by 22.5 percent over the ten-year period.

The strength and direction of change in real per capita total general revenues varied widely from state to state. The range of positive changes rested between 4.1 percent in New Jersey and 48.9 percent in Mississippi, a greater degree of divergence than that found in the growth of real per capita state and local total general revenues. Between 1992 and 2002, seven states experienced an increase in real per capita total general revenues of less than 15 percent – Connecticut, Idaho, Indiana, Massachusetts, New Jersey, New York and Washington. In contrasted, 16 states experienced growth in real per capita total general revenues of more than 30 percent – Arkansas, Georgia, Kansas, Michigan, Mississippi, Missouri, North Carolina, Ohio, Oklahoma, Oregon, Texas, Utah, Vermont, Virginia, West Virginia and Wisconsin. Only two states experienced actual declines in real per capita total general revenues during this period – Alaska (-26.2 percent) and Hawaii (-1.7 percent).

Among the different sources of state revenue, real per capita federal aid saw the most dramatic change, rising by 40.2 percent from 1992 to 2002. For own-source state revenues, real per capita current charges increased by 32.4 percent over the same period. The two major sources of state tax revenue, income and general sales taxes, experienced increases in real per capita revenues of 24.2 and 16.0 percent, respectively. Against the general trend toward revenue growth, real per capita corporate income tax collections fell by 19.3 percent, while real per capita property tax collections declined by 7.5 percent.

Local General Revenue: In the aggregate, local governments experienced an increase in total general revenues, after adjusting for inflation, of 33.5 percent from 1992 to 2002. Over the same period, real per capita local general revenue increased by 21 percent. See Table 9.

Table 9
Real Per Capita Local General Revenue and Change, 1992-2002

	Year		
Revenue Source	**1992 ($)**	**2002 ($)**	**Real Per Capita Change (%)**
Intergovernmental Aid	855	1,099	28.6
From Federal	79	119	50.3
From State	776	981	26.4
Own-Source	1,416	1,648	16.4
Tax	896	1,020	13.8
Property Tax	678	743	9.6
General Sales Tax	91	120	31.0
Individual Income Tax	42	47	13.5
Other Taxes	85	110	28.6
Current Charges	335	423	26.4
All Other	184	205	11.0
Total	2,270	2,747	21.0

Note: 2002 data are converted into constant 1992 dollars using a deflator of 1.288, *Survey of Current Business*, August 2004 issue.

Data Source: State and Local Government Finances, 1992 and 2002 Census of Governments, and staff calculations. URL: http://www.census.gov/govs/www/estimate.html

The degree of interstate variation in the growth of real general revenues was no less dramatic for localities than states. For example, between 1992 and 2002, growth in real per capita local general revenue ranged from 6.8 percent in Connecticut to 43.9 percent in Alabama. Six states experienced increases in real per capita local general revenues of less than 15 percent – Connecticut, Florida, Minnesota, New Jersey, New York, and West Virginia. Alternatively, seven states experienced growth in real per capita local general revenues in excess of 30 percent between 1992 and 2002 – Alabama, Idaho, Indiana, Maryland, Massachusetts, Missouri and South Carolina.

Similar to the experience of state governments, real per capita federal aid experienced the greatest growth from 1992 to 2002 (50.3 percent). In terms of growth in real per capita terms from 1992 to 2002, local general sales taxes increased 31 percent, current charges increased by 26.4 percent, and selective sales taxes by 25.1 percent; while the category of other taxes experienced increases in real per capita terms of 37.5

percent in the aggregate. Alternatively, in spite of property taxes being the most important source of revenue for local governments, real per capita property tax collections increased by only 9.6 percent between 1992 and 2002.

IV. Overview of State and Local Expenditures

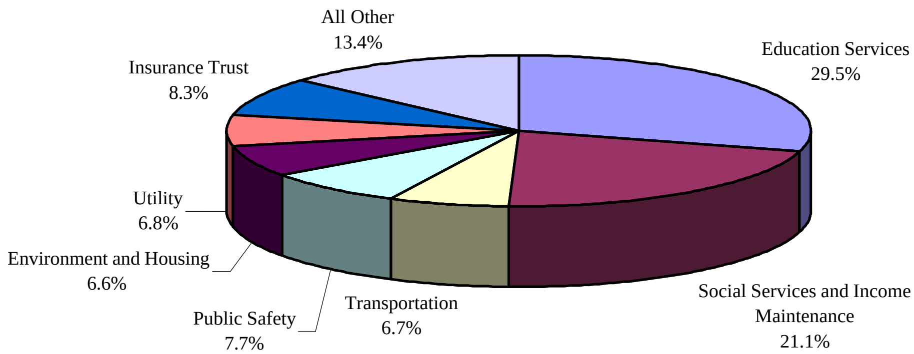
Expenditures encompass all amounts of money paid out by a government during the fiscal year. Expenditures consist of intergovernmental expenditures and direct expenditures. Direct general expenditures, refers to all direct expenditures except those for liquor stores, utilities and insurance trusts. While direct general expenditures can be further classified by function, direct expenditures can be classified by composition.

A. Expenditure by function, 2002

Distinguished by function, direct general expenditures cover education services, social service and income maintenance, transportation, public safety, environment and housing, governmental administration, interest on general debt, and miscellaneous general expenditure. Most of these categories also contain several sub-categories. Education services include education (ranging from elementary to higher education) and libraries. Social service and income maintenance include public welfare, hospitals, health, social insurance administration, and veterans' services. Transportation includes highways, airports, parking facilities, sea and inland port facilities, and transit subsidies. Public safety includes police protection, fire protection, correction, and protective inspection and regulation. Environment and housing natural resources, parks and recreation, housing and community development, sewage, and solid waste management. Finally, governmental administration includes financial, judicial and legal administration, general public buildings, and other governmental administration.

In 2002, the total expenditures of state and local governments surpassed $2 trillion, of which direct expenditures accounted for 99.8 percent and direct general expenditures accounted for 84.5 percent. Education services (29.4 percent) and social services and income maintenance services (21.1 percent) claimed the major bulk of state and local government spending, consuming fully half of total state and local spending and 60 percent of total state and local direct general expenditures. According to the data in Figure 5, contributions to insurance trusts was the next largest expenditure item accounting for 8.3 percent of the total expenditures, followed by public safety (7.7 percent), utilities (6.8 percent), transportation (6.5 percent), and environment and housing (6.4 percent). Providing a sketch of the distribution of expenditure by function, these aggregate figures tend to gloss over variations across localities, states, and regions, as well as differences between state and local fiscal structures, to be examined in greater detail in the following sections.

Figure 5
Percentage Distribution of State and Local Expenditure
by Function, 2001-2002



B. Differences in State-Local Government Systems, 2002

Just as states and localities differ in the way they raise revenues, they also vary in how those revenues are spent. A closer look at the 2002 expenditure data reveals considerable differences between states in terms of the state-local relationships as well as the size of government relative to population and personal income.

First, state and local governments contribute differently to the total expenditures in each state. In 2002, state direct expenditures as a share of total state and local direct expenditures ranged from 35.2 percent in Nevada to 77.9 percent in Hawaii. Spending responsibilities are more decentralized in some states than others. It can be taken as an indication that state governments vary in their degree of centralization and their willingness to shoulder the responsibility of providing public services. See Table 10.

Table 10
Top 10 and Bottom 10 States
Extent of Centralization of State and Local Spending
State Share of Total State and Local Direct Expenditures, 2001-2002
(Percent)

Top 10 States		Bottom 10 States	
Name	**State Share of Total State and Local Direct Expenditure (%)**	**Name**	**State Share of Total State and Local Direct Expenditure (%)**
Hawaii	79.1	Nevada	32.4
Alaska	66.9	California	35.5
Delaware	63.7	New York	35.7
Vermont	62.3	Arizona	36.7
West Virginia	62.0	Florida	38.2
Rhode Island	60.5	Colorado	38.3
Kentucky	59.4	Wisconsin	40.0
Maine	58.6	Illinois	40.1
Arkansas	57.9	Texas	40.4
North Dakota	57.3	Ohio	40.7

Source: Statistical Appendix Table 31 and Table 41, and staff calculations.

Direct expenditures, on average, were distributed fairly evenly between state governments and their local counterparts, with states responsible for 50.3 percent of the state and local totals. Over half of the states, however, titled toward decentralization, contributing less than 50 percent of the total direct expenditures. Arizona, California, Colorado, Florida, Nebraska, and Nevada were among the least centralized states, in which less than 40 percent of the total state and local direct expenditures were spent by the state governments. By contrast, state direct expenditures in Alaska, Delaware, Hawaii, Maine, Rhode Island, Vermont, and West Virginia accounted for over 60 percent of the total state and local direct expenditures.

When centralization of spending responsibilities is examined from a regional perspective, it can be observed that states in the Northeast tend to be more centralized than states in any other region of the country. In 2002, seven out of nine Northeastern states had a state share of total state and local direct expenditures greater than the national average and three of the seven most centralized states are situated in the Northeast. No match to their counterparts in the Northeast in terms of centralization, the Southern states had a bare majority (nine out of 16) that fell in the above-average category. States in the West seemed to be rather polarized in this regard. Both the top two most decentralized states and the top two most centralized states, in terms of allocation of spending responsibilities, are from the West. The Midwest appeared to be the least centralized region, as the state government in ten of its 12 states failed to contribute more than half of total state and local direct expenditures.

Second, state and local governments vary in their per capita expenditures. States differ widely in their population size. It follows that bigger states must have bigger budgets in order to provide sufficient public goods and services. Controlling for population, per capita state and local expenditures can be a general proxy for how well residents' needs have been addressed in each state. The higher the per capita expenditure, the greater the size of government is likely to be relative to its population.

Table 11
Top 10 and Bottom 10 States, Per Capita Direct Expenditures, 2001-2002

Top 10 States		Bottom 10 States	
Name	**Per Capita Direct Expenditure ($)**	**Name**	**Per Capita Direct Expenditure ($)**
New York	10,430	Arkansas	5,451
Wyoming	8,780	South Dakota	5,663
Washington	8,554	New Hampshire	5,717
California	8,548	Idaho	5,846
Minnesota	8,237	Missouri	5,904
Oregon	8,106	Indiana	5,971
Connecticut	8,101	Oklahoma	6,008
Massachusetts	8,027	Mississippi	6,076
Hawaii	7,746	Arizona	6,102
New Jersey	7,631	Kentucky	6,145

Note: Alaska and the District of Columbia are excluded from this analysis.
Source: Statistical Appendix Table 33

In 2002, per capita state and local direct expenditures ranged between $5,451 in Arkansas and $14,988 in Alaska. The expenditure gap is quite phenomenal, approaching $10,000. Alaska is quite noteworthy in that besides its large government size, the state government is the second most centralized in the nation, responsible for 67.5 percent of its state and local total expenditures in 2002. The District of Columbia and the state of New York followed Alaska on the list of state and local systems with high spending per capita, with per capita direct expenditures of $13,693 and $10,430 respectively. The disparity in government size is substantially reduced when Alaska and Washington DC are omitted. Yet, New York had per capita direct spending nearly twice that of the lowest spending state – Arkansas. Half of the states had a per capita direct expenditure within the range of $6,000-$7,000, leaning more toward the lower end of the scale. See Table 11.

From a regional perspective, the Northeast and the West stand out with considerably higher per capita state and local direct expenditures. Of the nine Northeastern states, seven had per capita expenditures greater than the national average of $6,922 (excluding Alaska and the District of Columbia). Ten of the thirteen Western states also boasted above-average per capita direct expenditures. In stark contrast, state and local per capita spending in 14 out of 16 Southern states was below the national average, while only half of the states in the Midwestern region of the U.S. had per capita direct expenditures greater than the national average.

Third, state and local direct expenditures, when expressed as a percentage of personal income, differ from state to state. The size of the public section in a state may be influenced, in part, by the wealth of the state. One might expect that states with greater amounts of resources at their disposal might tend to spend more on delivering public goods and services. Total state and local direct expenditure as a percentage of personal income offers a way of gauging government size, controlling for the effects of state wealth on expenditures. See Table 12.

Table 12
Top 10 and Bottom 10 States, Direct Expenditures as a Percentage of Personal Income, 2001-2002

Top 10 States		Bottom 10 States	
Name	**Direct Expenditure (% of Personal Income)**	**Name**	**Direct Expenditure (% of Personal Income)**
New York	28.9	New Hampshire	16.3
Wyoming	28.0	Maryland	18.0
West Virginia	27.8	Virginia	18.3
New Mexico	27.6	Connecticut	18.8
Oregon	27.4	New Jersey	19.0
Utah	27.2	Florida	20.0
South Carolina	26.9	Massachusetts	20.3
Mississippi	26.7	Missouri	20.4
Washington	25.5	Texas	20.6
Hawaii	25.3	South Dakota	13.7

Note: Alaska and the District of Columbia are excluded from this analysis.
Source: Statistical Appendix Table 34

In 2002, state and local direct expenditures as a percentage of personal income ranged from 16.3 percent in New Hampshire to 44.7 percent in Alaska. Immediately following Alaska, the District of Columbia had direct expenditures taking 29.4 percent of the personal income, nearly doubling the figure for New Hampshire. The percentage disparity is significantly reduced when Alaska and Washington D.C. are omitted, but remained quite impressive. The share of personal income going to total state and local direct expenditures was between 21 percent and 25 percent in a small majority (28) of the states. Generally speaking, total state and local direct expenditures, as a percentage of personal income, revealed less variation in the size of government across states than per capita expenditure did.

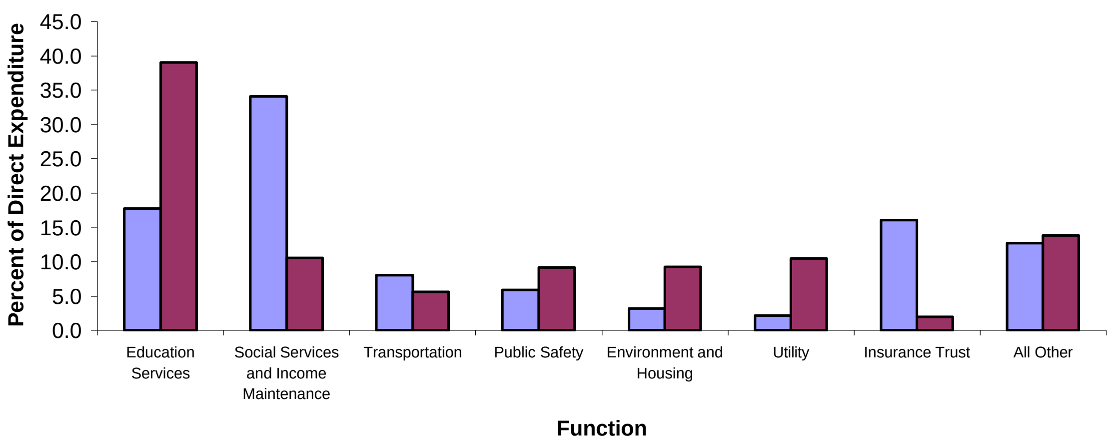
Judging by the size of direct expenditures relative to personal income, states in the West tend to have larger public sectors than their counterparts in other regions, consistent to the findings by per capita expenditure. Nine of the thirteen Western states had public sectors claiming a higher share of personal income than the national average of 23.2 percent (excluding Alaska), while only a bit over half of the states in the Midwest went beyond the average. In six of the nine Northeastern states, however, state and local direct expenditures amounted to less than 23.2 percent of state personal income. Ten of the sixteen Southern states also failed to beat the national average.

C. Differences between State and Local Fiscal Systems, 2002

Not only do the state-local systems differ by state, the relative roles of state governments and their local counterparts are quite distinct from each other in how they spend money. With different budgetary priorities on their agenda, states and localities diverge systematically in their allocation of funds. See Figure 6.

First, state governments devoted substantially more financial resources to intergovernmental expenditures than local governments. In 2002, intergovernmental expenditures constituted 28.5 percent of state expenditures while the equivalent number for local governments is only one percent. In large part, this reflects state aid to education.

Figure 6
Percentage Distribution of State and Local Direct General Expenditures by Function, 2001-2002



Source: Statistical Appendix Table 42 and Table 52

Second, state governments spend more on insurance trusts, but less on utilities than local governments.[12] In 2002, state spending on insurance trusts accounted for 11.5 percent of total expenditures, and 16.1 percent of direct expenditure, while the comparable figures for local governments are both 2 percent. For the same year, states allocated 1.6 percent of their expenditures, which was 2.2 percent of their direct

[12] The utility category includes publicly provided water systems and mass transit services, both of which are typically provided by local governments.

expenditures, for utilities. By contrast, 10.4 percent of local expenditures went for utilities. In fact, over half of the states did not spend on utilities at all.

Third, state governments contribute more to expenditures on social services and income maintenance, and transportation, while local governments contribute more to spending on education services, public safety, and environment and housing. These differences in expenditure patterns can be attributed to the conventional division of responsibilities between state and local governments. As states take more responsibilities for redistributing income and building infrastructure, local governments take care of education (especially elementary and secondary), police and fire protection, and housing development.

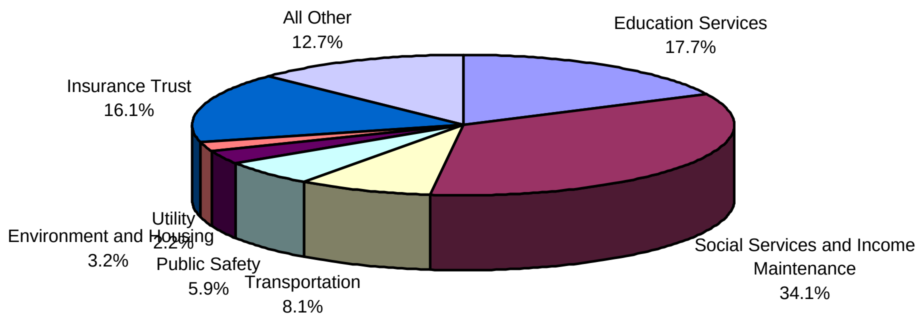
In 2002, social services and income maintenance claimed 41.9 percent of state direct general expenditure while spending on similar programs took up only 12.1 percent of local direct general expenditure. For the same year, local governments devoted 44.7 percent of their direct general expenditures to education services while states allocated 21.8 percent of their direct general expenditures to education. It can be concluded that social services and income maintenance are the major programs that state governments sponsor while local governments act as the chief sponsor of education.

Environment and housing programs are another spending category that distinguishes local governments from their state governments. In 2002, local governments allocated 10.6 percent of their direct general expenditures to environment and housing while the percentage of state expenditures allocated to this spending category was only 3.9 percent. The differences in spending on other programs are less striking, but equally worth mentioning. In 2002, state governments spent 9.9 percent of their direct general expenditures on transportation, and 7.2 percent on public safety. The equivalent figures at the local level are 6.4 percent and 10.4 percent.

D. Differences among States across Regions, 2002

Compared with local governments, states dedicate a considerable share of their total expenditures for intergovernmental transfers – principally state aid to education. States allocate the largest share of their direct expenditures for social services and income maintenance programs (34.1 percent). The second largest spending category for states is spending on education services, which accounts for 17.7 percent of total state direct expenditures. In addition, a significant share of state direct expenditures are contributes to insurance trust funds (16.1 percent), followed by spending for transportation services (8.1 percent). See Figure 7. Examined individually, however, states are far from uniform in the above aspects.

Figure 7
Percentage Distribution of State Direct Expenditure by Function, 2001-2002



First, states vary widely in their contribution to intergovernmental aids. In 2002, Hawaii had the smallest share of total state expenditures allocated for state aid to local governments – only 1.8 percent of its total expenditures. In part, this reflects the fact that Hawaii is by far the most centralized state and local system in the U.S. In contrast, California allocated 40.4 percent of its total expenditures to aid for local governments. Because of the high degree of centralization characterizing the state/local system of government, Hawaii is sort of an aberration. Rhode Island, the next in line in terms of state aid to local governments, allocated 13 percent of its total state expenditures for intergovernmental transfers. The discrepancy remained substantial, though. It should be noted that the least generous states are also those previously found to be highly centralized, whereas the most generous ones also correspond to those previously found to be most decentralized. For instance, Alaska, Delaware, Hawaii, Maine, Rhode Island, and West Virginia contributed least to intergovernmental expenditures, but had the largest state share in state and local total expenditures. Arizona, California, and Nevada are at the other extreme of both spectrums.

Fairly distinctive regional patterns emerge from a comparison of the relative importance of intergovernmental expenditures. States in the Northeast are least likely to provide large amounts of financial aid to their local counterparts. On average, Northeastern states allocated 21.7 percent of their expenditures for intergovernmental transfers, below the national average of 28.5 percent. In fact, in the Northeast, only New York (32.7 percent) allocated a larger share of total state expenditures to intergovernmental grants than the national average. By contrast, the regional average for the Midwest was 27.8 percent, followed by the West and the South, whose regional averages were also less than the national one.

Second, states differ in the emphasis they give to contributing to their employees' retirement systems through contributions to insurance trusts. In 2002, state contributions to insurance trusts, as a share of state direct expenditures, ranged between 6.7 percent in Nebraska and 26.4 percent in Ohio. Insurance trusts, on average, accounted for 14.2 percent of state direct expenditures, albeit a majority of states fall on the lower end of the scale. States with a smaller share of direct expenditures allocated for contributions to insurance trusts tended to put more emphasis on direct general expenditures. Liquor store expenditures picked up the difference in a small number of states. New Hampshire, for instance, had 10.1 percent of its direct expenditures allocated for contributions to insurance trusts and 7.6 percent for expenditures on state run liquor stores, while 33 states had no liquor store expenditures. New York was quite unique in that it had an exceptionally high share of state direct expenditures on utilities (11.8 percent) as well as a fairly high share of direct expenditures allocated for contributions to insurance trusts (16.5 percent).

There seemed to be no compelling regional differences in the share of state direct expenditures contributed to insurance trusts, except that states in the West boasted a higher average share for insurance trusts than states elsewhere. Southern states shared the lowest regional average while the Midwest and the Northeast had an average equivalent to the national average.

Third, the distribution of direct general expenditures by function varies from state to state. Although the general pattern for state expenditures is that social services and income maintenance constitute the largest share, followed by education, transportation, public safety, governmental administration, interest on general debt, environment and housing, etc., states have considerable discretion in deciding which type of programs should take budgetary priority.

In 2002, social services and income maintenance, as a share of state direct general expenditures, ranged from 21.8 percent in Alaska to 54.5 percent in Tennessee, with an average of 40.4 percent. Alaska, Delaware, and Hawaii had a share less than 30 percent, while Alabama, Mississippi, and Tennessee had a share greater than 50 percent. For the same year, education services consumed as high as 34.9 percent of state direct general expenditures in Hawaii (the only state where primary and secondary education is a state function), contrasted with 13.3 percent in New York. On average, 22.6 percent of states direct general expenditures went for education. The share of state direct general expenditures allocated for transportation services ranged between 5.1 percent in Michigan and 21.7 percent in Wyoming, with an average of 11.2 percent.

States also vary in their share of their direct general expenditures allocated for other functions besides the three analyzed above, but the degree of variation is relatively small. Note that although interest on general debt in most states did not take up much of direct general expenditures, New Hampshire and Massachusetts paid an unusually high share of their state direct general expenditures on interest payments – 10.7 percent and 12.1 percent, respectively. California, Delaware, and Nevada devoted more than ten percent of state direct general expenditures budgets to public safety, matching the magnitude of local expenditures in many states.

In terms of expenditures on social services and income maintenance, states in the Midwest and the South were more likely to spend greater shares of their direct general expenditures on these functions than their counterparts in the Northeast and the West. In 2002, eight out of 12 states in the Midwest and 11 out of 16 states in the South devoted a greater share of their direct general expenditures to these activities than the national average, while the relevant numbers for the Northeast and the West are four out of nine and three out of 13 states, respectively.

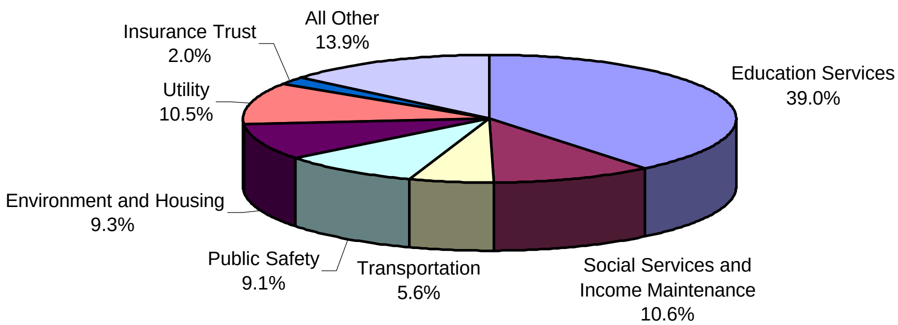
When it comes to expenditures on education services, there was a significant regional disparity between the Northeast and the rest of the country. In 2002, none of the Northeastern states contributed a share of state direct general expenditures that went beyond the national average. In part, this reflects the generally decentralized manner in which education services are provided in most of these states. By contrast, nine of the 12 Midwestern states put more than 22.6 percent of their direct general expenditures toward education. The corresponding ratios for the South and the West are ten out of 16 and six out of 13 states, respectively.

With respect to transportation spending, the Northeastern states typically allocated a smaller share of their state direct general expenditures to transportation than states in other regions. Six of the nine Northeastern states assigned less than 11.2 percent of their direct general expenditures to transportation while none of the regional averages in the Midwest, the South and the West, was far off from the national average.

E. Differences among Local Fiscal Systems across States, 2002

In contrast to states, local governments focus almost exclusively on direct expenditures. Specifically, local governments spend nearly 40 percent of their direct expenditures on education services, followed, in relative importance, by social services and income maintenance (10.6 percent) utilities (10.5 percent), environment and housing (9.3 percent) and public safety (9.1 percent). See Figure 8. Just as state governments differ from one another, local governments in different states also vary in their expenditure pattern.

Figure 8
Percentage Distribution of Local Direct Expenditure by Function, 2001-2002



First, local governments vary in the share of direct expenditures allocated for expenditures on education services. In 2002, education services accounted or as much as 66.1 percent of local direct general expenditure in Vermont. In Hawaii, on the other hand, local governments spend virtually nothing on education services because that is a state responsibility, not a local function. The more reasonable lower bound was 35.8 percent of local direct expenditures going to education in Nevada. Except for Hawaii and DC, the national average for local expenditure share on education was 48.4 percent. While localities in California, Colorado, Florida, Nevada, and New York devoted less than 40 percent of their direct expenditures to education services, local governments in Delaware, Vermont, and West Virginia committed more than 60 percent.

Almost reversing the regional patterns for state expenditures, the Northeast contributed most generously to local education expenditures compared to states in the rest of the country. Local governments in seven out of nine Northeastern states committed over half of their direct expenditures to education, localities in only three Western states, three Midwestern states, and seven Southern states, were able to do the same.

Second, although social services and income maintenance is more of a major function for states than for localities, some local governments invest more in this field than others. So is the case with transportation. In 2002, social services and income maintenance, as a share of local direct general expenditure, ranged from 0.4 percent in Rhode Island and Vermont to 21.7 percent in North Carolina (excluding the District of Columbia, which had an exceptionally high share of 32.8 percent), with an average of nine percent. For the same year, the share for transportation expenditures ranged between 1.2 percent in the District of Columbia and 12.3 percent in North Dakota. On average, seven percent of local direct general expenditure were allocated for transportation services.

Third, local governments differ in the share of direct expenditures allocated to utility expenditures. In 2002, utility spending, as a share of local direct expenditures, ranged from 2.2 percent in New Hampshire to 29.2 percent in Nebraska. On average, utilities accounted for ten percent of local direct expenditures. Yet local governments in 33 states had a share below the national average. For local governments with less of their budgets spent on utilities, direct expenditures went almost exclusively to direct general expenditures. Liquor stores seemed to be the least popular spending category with local governments, as local governments in 43 states did not spend a penny on liquor stores. Insurance trust expenditures were far less important than utilities at the local level. Six states did not have this type of spending.

Compared by region, utilities claimed far more local resources in the West than in the Northeast while the South and the Midwest lay in between. The West boasted a regional average of 12.3 percent of local direct expenditures on utilities, whereas the comparable figure for the Northeast is 6.1 percent, significantly below the national average.

Fourth, localities assign widely different weights to various types of public services other than education. In 2002, public safety as a percentage of local direct general expenditure ranged from 5.6 percent in Vermont to 20.5 percent in Hawaii. The budget share for environment and housing spanned a range between 7.6 percent in Mississippi and 14.1 percent in North Dakota (excluding Hawaii which had an exceptionally high percentage of 33.6 percent) On average, environment and housing, like public safety, accounted for about ten percent of local direct general expenditure.

Not surprisingly, local governments that did not commit the major share of their direct general expenditures to education attached greater importance to public safety, environment and housing, or social services and income maintenance. Hawaii and the District Columbia are good examples. A side note is that Kentucky spent 11.9 percent of its direct general local expenditures on interest on general debt, a percentage substantially higher than any other state.

Some regional variations may be discerned from local expenditures on public safety and on social services and income maintenance. In 2002, localities in the West and the Northeast were more likely to commit more resources to public safety than their counterparts in the South and the Midwest. While nine out of 13 Western states and five out of nine Northeastern states had a share on public safety greater than ten percent, only seven out of 16 Southern states and three out of 12 Midwestern states were able to reach beyond the national average. For the same year, local governments in seven of the nine Northeastern states spent less than nine percent on social services and income maintenance. By contrast, 11 of the 16 Southern states used over nine percent of their local direct general expenditures to sponsor similar programs.

F. Trends over the Decade

Given the variation in state and local expenditures in 2002, examining comparable data from a decade earlier highlights changes in state and local finances over time.

Percentage changes in real state and local direct general expenditures between 1992 and 2002 depict how the expenditure side of the budget evolved over time. The findings are consistent with those in the revenue trend section in that states with smaller increases (or even losses) in general revenue tend to see smaller increases in expenditures as well.

State and Local Total Expenditure: In comparison to 1992, total state and local direct expenditures in 2002 increased, after adjusting for inflation, by 38.3 percent. When population size is controlled for per capita; total state and local direct expenditures increased by 25.4 percent over this period.

The magnitude of increase, however, was not uniform across the fifty states during the same time span. Real per capita total state and local direct expenditures in New Hampshire, for instance, went up 7.9 percent, in contrast to Mississippi where real per capita total state and local direct expenditures increased by 46.3 percent. Four states experienced growth in real per capita total state and local direct expenditures of less than 10 percent from 1992 to 2002 –Alaska (3.7 percent), Hawaii (4.5 percent), New Hampshire (7.9 percent), and New Jersey (9.0 percent). Alternatively, in addition to Mississippi, only seven other states experienced increases in real per capita total state and local direct expenditures of more than 35 percent during this period – Alabama (36.5 percent) Arkansas (38.6 percent), Illinois (35.9 percent) Missouri (40.1 percent), Oregon (36.5 percent), South Carolina (37.7 percent) and West Virginia (36.1 percent).

As state and local government expenditures are distributed among different types of policy programs, the magnitude of change in spending by function, after adjusting for inflation, also varied over this period. For example, according to the data in Table 13, real per capita expenditures on public safety experienced growth of 31.6 percent over this period. The equivalent changes for education services and transportation were respectively 28.3 percent and 23.7 percent, followed by social services and income maintenance (23.1 percent) and environment and housing (20.4 percent).

Table 13
Real Per Capita State and Local Direct Expenditure and Change, 1992-2002

Expenditure Function	Year 1992 ($)	Year 2002 ($)	Real Per Capita Change (%)
Education Services	1,297	1,663	28.3
Social Services & Income Maintenance	967	1,190	23.1
Transportation	306	378	23.7
Public Safety	329	433	31.6
Environment and Housing	307	369	20.4
Governmental Administration	197	256	29.7
Interest on General Debt	217	208	-4.1
All Other	877	1,140	30.0
Total	4,496	5,637	25.4

Note: 2002 data are converted into constant 1992 dollars using a deflator of 1.288, *Survey of Current Business*, August 2004.

Data Source: State and Local Government Finances, 1992 and 2002 Census of Governments, and staff calculations.
URL: http://www.census.gov/govs/www/estimate.html

State Expenditure: Similar to the revenue side of the budget, separate analyses of state expenditures and local expenditures are necessary to bring to light more nuanced patterns of change that may not emerge from the aggregate data.

In the years between 1992 and 2002, state governments increased their real direct expenditures by 42.4 percent, a more rapid increase than experienced by state and local spending in the aggregate. Similarly, adjusting for population real state per capita, direct expenditures increased by 28.8 percent.

After adjusting for inflation, per capita state direct expenditures differed in their rate of growth across states; while two states actually experienced declines in real per capita direct expenditures – Nevada (-6.8 percent) and New Hampshire (-1.3 percent). Five states experienced growth of less than 10 percent in real per capita state direct expenditures – Alaska (9.7 percent), Arizona (6.0 percent), Hawaii (5.1 percent), New Jersey (9.4 percent) and Rhode Island (7.7 percent). A dozen states experienced growth in real state per capita direct expenditures of more than 40 percent from 1992 to 2002 – Arkansas (46.7 percent), Colorado (42.1 percent), Minnesota (48.2 percent), Mississippi (65.7 percent), Missouri (48.1 percent), North Carolina (48.5 percent), Oregon (46.7 percent), South Carolina (43.1 percent), Texas (41.0 percent), Utah (49.8 percent), and West Virginia (50.5 percent).

The pattern of variation by function for state and local total spending does not seem to hold exactly for state expenditures. Real per capita state direct expenditures on public safety and education services grew by 38 percent and by 31.6 percent, immediately followed by social services and income maintenance, with an increase of

27.8 percent. The equivalent real change for environment and housing was 24.3 percent, slightly higher than that for transportation (22.9 percent). See Table 14.

Table 14
Real Per Capita State Direct Expenditure and Change, 1992-2002

Expenditure Function	Year 1992 ($)	Year 2002 ($)	Real Per Capita Change (%)
Education Services	341	448	31.6
Social Services & Income Maintenance	674	861	27.8
Transportation	166	203	22.9
Public Safety	107	148	38.0
Environment and Housing	65	80	24.3
Governmental Administration	78	110	41.0
Interest on General Debt	97	87	-10.4
All Other	435	587	35.2
Total	1,962	2,525	28.8

Note: 2002 data are converted into constant 1992 dollars using a deflator of 1.288, *Survey of Current Business*, August 2004.

Data Source: State and Local Government Finances, 1992 and 2002 Census of Governments, and staff calculations.
URL: http://www.census.gov/govs/www/estimate.html

Local Expenditure: Over the decade between 1992 and 2002, local governments in the aggregate witnessed an increase in real direct expenditures of 35.2 percent and, adjusting for population, local governments experienced an increase of 22.5 percent in real per capita direct expenditures. Both numbers reflect a magnitude of change that was moderately smaller than that for state and local total expenditure, and significantly lower than that for state expenditures.

Like the case of state expenditures, changes in real per capita local direct expenditures varied substantially across states. Local governments in four states plus the District of Columbia (7.5 percent) experienced growth in real per capita local direct expenditures of less than 10 percent – Connecticut (8.9 percent), Hawaii (2.7 percent), Montana (8.6 percent) and New Jersey (8.6 percent). Real per capita local direct expenditures rose by over 30 percent in seven states – Alabama (39.3 percent), Idaho (31.6 percent), Illinois (40.1 percent), Indiana (33.2 percent), Missouri (33.5 percent), Ohio (39.2 percent), and South Carolina (31.4 percent).

The pattern of spending by local governments differed from spending by state governments. Specifically, between 1992 and 2002, real local per capita spending on public safety claimed a gain in real change of 28.3 percent, while the change for education services reached 26.9 percent. Both transportation and environment and housing saw a greater increase than social services and income maintenance. Expenditure in the former two categories rose by 24.3 percent and 19.3 percent respectively, while the change in the latter category was only 11.6 percent. See Table 15.

Table 15
Real Per Capita Local Direct Expenditure and Change, 1992-2002

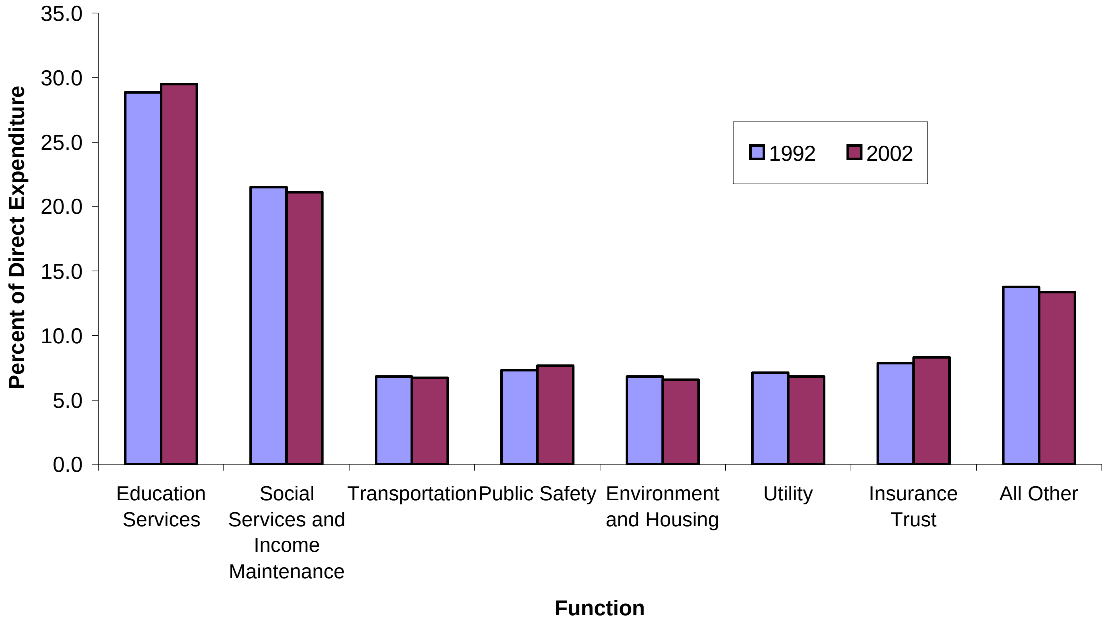
Expenditure Function	Year 1992 ($)	Year 2002 ($)	Real Per Capita Change (%)
Education Services	957	1,215	26.9
Social Services & Income Maintenance	295	329	11.6
Transportation	140	175	24.3
Public Safety	222	284	28.3
Environment and Housing	242	289	19.3
Governmental Administration	119	146	22.2
Interest on General Debt	120	121	0.8
All Other	444	553	24.6
Total	2,539	3,112	22.5

Note: 2002 data are converted into constant 1992 dollars using a deflator of 1.288, *Survey of Current Business*, August 2004.

Data Source: State and Local Government Finances, 1992 and 2002 Census of Governments, and staff calculations.
URL: http://www.census.gov/govs/www/estimate.html

In 1992, state and local government expenditures totaled $1.1 trillion, of which 99.7 percent fell into the category of direct expenditures and 84.5 percent were classified as direct general expenditures. Although total expenditures in 2002 almost doubled those in 1992, the percentage distribution for direct and direct general expenditures stayed largely unchanged over the ten years. In 1992, education services constituted 28.8 percent of the total expenditures while social services and income maintenance accounted for 21.4 percent. In addition, 7.8 percent of the state and local expenditures was allocated for insurance trusts, 7.3 percent for public safety, 7.1 percent for utility services, 6.8 percent for transportation, and 6.8 percent for environment and housing. Ten years later, the relative importance of expenditures on insurance trusts, public safety and education were marginally higher, while the relative importance of other functions declined marginally. See Figure 9.

Figure 9
Percentage Distribution of State and Local Direct Expenditures
by Function, 1992 and 2002



Differences in State-Local Government Systems

In 1992, state direct expenditures as a share of total state and local direct expenditures ranged from 34.7 percent in Florida to 77.5 percent in Hawaii. On average, states contributed 49 percent of the state and local total expenditures. While state expenditures accounted for less than 40 percent of the state and local total in 11 states including Arizona, California, Colorado, Florida, and Nebraska more than 60 percent was spent by the state governments in Alaska, Delaware, Hawaii, Rhode Island, and West Virginia. In 2002, the range of difference narrowed a bit and the national average shifted upward slightly. The number of the most decentralized states decreased while the number of the most centralized states went up.

The Northeast stood out as the region with the most centralized state and local systems of government, with eight of the nine state governments accounting for more than 49 percent of state and local total expenditures in 1992. In contrast, nine of the 12 Midwestern states had a state share of state and local expenditures below the national average. This regional disparity was found in 2002 also. The number of states with the state share of total state and local expenditures above the national average remained the same while the West became more polarized than ten years before.

In 1992, per capita state and local direct expenditures ranged from $3,053 in Arkansas to $11,226 in Alaska. The District of Columbia and New York ranked immediately after Alaska, boasting per capita direct expenditures of $9,886 and $6,841. When Alaska and the District of Columbia are omitted because of their unique circumstances, the national average is driven down to $4,294 and the upper bound of the range is New York and Wyoming ($5,862). The per capita expenditure in 30 states fall below this national average, indicating a distribution skewed to the lower end of the scale. The situation remained roughly the same in 2002, except that the number of states in the below-average category was reduced to 26.

Compared on a regional basis, the Northeast boasted the highest per capita state and local direct expenditures in 1992, seven of its nine states where characterized has having above-average per capita expenditures. In sharp contrast, 14 of the 16 Southern states had a figure smaller than the national average. The regional differences remained relatively stable between 1992 and 2002, while more states in the West and the Midwest ascended to the above-average group over the ten years.

In 1992, state and local direct expenditures as a percentage of personal income ranged between 18.4 percent in Missouri and 54.8 percent in Alaska. When Alaska, and the District of Columbia, is omitted because of their unique circumstances, New York and Wyoming had the highest per capita direct expenditures relative to state personal income – 30.5 percent and 35.1 percent, respectively. The national average share of personal income going for state and local expenditures declined from 24.4 percent in 1992 to 23.0 percent in 2002. The range was from 16.3 percent in New Hampshire to 28.9 percent in New York. While the variation between high and low spending states increased somewhat from 1992 (54.2 percent) to 2002 (56.4 percent), the overall level of state and local spending, relative to personal income, declined over the decade.

Quite contrary to the patterns found for per capita expenditures, Northeastern states seemed the least prone to big government as measured by direct expenditures relative to state personal income. In six of the nine states, state and local expenditures were less than the national average of 23.0 percent of personal income. By contrast, 11 of the thirteen states in the West had a percentage well above the national average. The situation was not significantly changed in 2002, although several Midwestern states joined their Western counterparts in the above-average camp.

Differences between State and Local Fiscal Systems

In 1992, intergovernmental expenditures accounted for 28.9 percent of state total expenditures. By contrast, only 1.1 percent of local expenditures can be attributed to intergovernmental transfer. The disparity between state and local intergovernmental expenditures were the same in 2002 as they were in 1992, suggesting little change in states' role in providing fiscal assistance to local governments.

In 1992, contributions to insurance trusts made up 11.4 percent of total state expenditures, and 16 percent of state direct expenditures. At the local level, however, contributions to insurance trusts only amounted to approximately 2 percent of total local expenditures and of total local direct expenditures. Ten years later, contributions to insurance trusts by state governments remained stable share of total state expenditures, while the share in local expenditures rose by a small margin.

In 1992, states allocated one percent of their total expenditures, or 1.4 percent of their direct expenditures to the provision of utility services. In contrast, 11.3 percent of local expenditures went for utility service provision. The utility share of local expenditures decreased from 1992 to 2002, while the share of state expenditures allocated to provision of utility services went up slightly. The increase may be explained by the fact that five states with no utility expenditures in 1992 had actual expenditures in this category in 2002.

In 1992, states used 41.9 percent of their direct general expenditures to provide social services and income maintenance, while only 13.4 percent of local direct general expenditures went for the same purpose. For the same year, education services claimed 43.4 percent of local direct general expenditures while the equivalent figure for states was 21.2 percent. Compared with data from 2002, local spending on education increased as a share of local direct general expenditure while expenditures on social services and income maintenance dropped. Meanwhile, state commitments to these programs remained largely unaffected by the passage of time.

In 1992, local governments allocated 11 percent of their direct general expenditures for environment and housing, contrasted to four percent of state expenditures on similar programs. Besides, state governments spent 10.3 percent of their direct general expenditures on transportation, and 6.7 percent on public safety. The corresponding numbers for localities are 6.4 percent and 10.4 percent. In aggregate, there was considerable stability in the distribution of expenditures by function in state and local governments.

Differences among States across Regions

In 1992, intergovernmental aid as a share of state expenditures ranged from 2.4 percent in Hawaii to 42.1 percent in California. If Hawaii were to be excluded as an outlier, the alternative lower bound of the range became 10.2 percent in New Hampshire. States, on average, devoted 25.5 percent of their total expenditures to assisting local governments. The range shrank noticeably in 2002.

States in the Northeast contributed less to local governments than their counterparts in the Midwest in terms of intergovernmental expenditure in 1992. Northeastern states allocated an average of 20.2 percent of their expenditures on intergovernmental aids, well below the national average. The Midwest, however, boasted a regional average of 27.4 percent, followed by 26.5 percent in the West and 24.8 percent in the South. The regional patterns remained intact over the decade between 1992 and 2002.

In 1992, allocations to insurance trusts, as a share of state direct expenditure, ranged between 3.8 percent in Nebraska and 29.6 percent in Nevada with an average of 13.6 percent. A decade later, the percentage disparity was considerably reduced while the entire scale shifted upward; an indication that states became less varied in their expenditure shares allocated for insurance trusts.

In 1992, while Western states had the highest average share of expenditures allocated to insurance trust expenditures, the Northeast also had a regional average well above the national average. By contrast, states in both the South and the Midwest, on average, allocated less than 13.6 percent of their state direct expenditures to insurance trusts. Over the ten-year period, some Northeastern states fell below the new national average while their Western counterparts maintained their position.

In 1992, social services and income maintenance as a percentage of state direct general expenditures ranged from 15.2 percent in Alaska to 49.4 percent in New York, with an average of 39 percent. For the same year, the state of Utah allocated 33.2 percent of its direct general expenditures for education. By contrast, education services constituted only 11.2 percent of the state budget in Massachusetts. An average state devoted 22.4 percent of its state direct general expenditures to financing education. Transportation as a share of direct general expenditures ranged between 5.4 percent in Michigan and 26.7 percent in Wyoming.

The overall trend suggests that the range across states and local governments for each category of spending became narrower between 1992 and 2002. In other words, whether it was an increase in the relative importance of social services expenditures or reduction in the relative importance of transportation spending; state variations trended toward convergence over the decade.

The 1992 expenditure data suggests that states in the West tended to invest far less on social services and income maintenance than their counterparts in any other region. Twelve of the 13 Western states had an expenditure share below the national average. By contrast, 13 out of 16 Southern states had an above-average budget share for social services and income maintenance. The relevant ratios for the Midwest and the Northeast were nine out of 12 and six out of nine respectively. In 2002, the regional differences were somewhat reformulated. The gap between the West and the rest of the country narrowed while the proportion of above-average states in any region other than the West decreased.

A fairly clear regional pattern emerged from the 1992 data. The Northeast distinguished itself from other regions by its exceptionally low state expenditure shares on education. Only one of the nine Northeastern states had a share greater than the national average, while the seven states with the lowest share of expenditures allocated to education spending are all located in the Northeast. By contrast, nine out of 12 Midwestern states spent over 22.4 percent of their direct general expenditures on education services. This regional disparity continued its course in the year 2002.

In 1992, the Northeast stood alone as the region within which none of the states had an expenditure share on transportation greater than 11.9 percent, i.e. the national average. By contrast, each other region saw a majority of its states with an above-average share.

Differences among Local Fiscal Systems across States

In 1992, local expenditures on utility services, as a percentage of local direct expenditures, ranged from 2.7 percent in New Jersey to 36 percent in Nebraska, with an average of 10.8 percent. Local governments in 33 states allocated less than 10.8 percent of their direct expenditures to providing utility services, implying that the distribution was skewed to the lower end. Compared with figures in 2002, the percentage gap shrank significantly while the whole scale moved slightly downward. Local governments in most states tended to spend less on utility services. At the same time, differences across states became less distinct than they were ten years ago.

Judging by average local expenditure share on utility in 1992, there was considerable regional disparity between the Northeast and the South and the West. The Northeastern states, on average, contributed 7.1 percent of local direct expenditures to the provision of utility services, a share far below the national average. States in the South and the West, by contrast, had regional averages well above 10.8 percent. The Midwestern states, on the other hand, shared a regional average about the same as the national one. In 2002, the regional average for local governments in Northeastern states sank ever lower, increasing the regional gap in percentage distribution.

In1992, education services as a share of local direct general expenditures ranged between 0.1 percent in Hawaii and 68.7 percent in Vermont. The District of Columbia ranked next to Hawaii, with 17.3 percent of its local expenditures going for education. If Hawaii and the District of Columbia are not counted because of their unique circumstances, the minimum value of the range becomes 35.1 percent in California. On average, education services consumed 48.5 percent of local direct general expenditures. In 2002, the range of variation became smaller, while the average level of education expenditures remained quite stable.

In 1992, local governments in the Northeast and the Midwest allocated a greater share of their direct general expenditures for education services than their counterparts in the West and the South. While six out of nine Northeastern states and eight out of 12 Midwestern states committed nearly 50 percent of their local direct expenditures to education, only half of the Southern states and less than half of the Western states were able to go beyond the national average. The regional average for the Northeast grew even higher in 2002, while the reverse happened to all the other regions.

In 1992, public safety as a share of local direct general expenditures ranged from 4.9 percent in West Virginia to 19 percent in Hawaii. The local expenditure share for environment and housing ranged between 6.8 percent in Mississippi and 15.1 percent in Delaware (excluding the extreme value of 41.4 percent for Hawaii). On average, environment and housing consumed 10.3 percent of the local direct general expenditure while the average share for public safety was 9.3 percent. In comparison to 2002, the variation for environment and housing expenditures noticeably narrowed. The range for public safety, however, did not change significantly, although moving slightly to the upper end of the scale.

Social services and income maintenance as a percentage of local direct general expenditures ranged between 0.4 percent in Vermont to 21.8 percent in Georgia (excluding the extreme value of 32.1 percent for District of Columbia which provides both state and local level services). Local governments in an average state used 9.6 percent of local expenditures to support redistributive programs. For the same year, the local expenditure share for transportation ranged between 2.1 percent in West Virginia and 13.1 percent in Colorado, with an average of 6.9 percent. In 2002, the range of variation for social services remained roughly the same while that for transportation shifted slightly upward.

In terms of local expenditures on public safety in 1992, Northeastern states devoted a much higher share of their local direct general expenditures than their counterparts in the Midwest, while states in the West and the South lay between the two extremes. Six out of nine Northeastern states had an above-average profile, contrasted by four out of 12 Midwestern states. Ten years later, the regional disparity between the Northeast and the Midwest turned into a gap between the West and the Midwest.

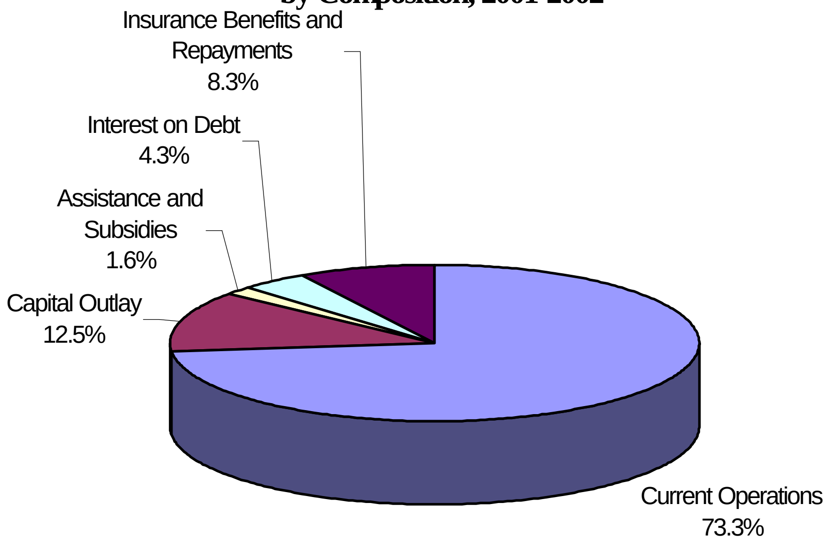
In 1992, all but one Northeastern state allocated less than the average share of local expenditures for social services and income maintenance. Yet, nine out of 16 Southern states spent more than 9.6 percent of the local expenditures on similar programs. The regional disparity remained apparent in 2002, while the regional averages for both the Northeast and the South improved.

G. Expenditure by composition

Classified by composition, rather than functions, direct expenditures consist of current operations, capital outlay, assistance and subsidies, interest on debt, and insurance benefits and repayments.

In 2002, state and local governments spent a total of $2 trillion on direct expenditures. Expenditures on current operations reached $1.5 trillion, accounting for 73.3 percent of the total direct expenditures. See Figure 10. While current operations accounted for the lion's share of direct expenditures, expenditures on capital outlays was the second most important component of direct expenditures, accounting for 12.5 percent of total state and local direct expenditures. In addition, allocations to insurance benefits and repayments constituted 8.3 percent of state and local direct expenditures. The shares for interest on debt and assistance and subsidies were 4.3 percent and 1.6 percent respectively.

Figure 10
Percentage Distribution of State and Local Direct Expenditure by Composition, 2001-2002

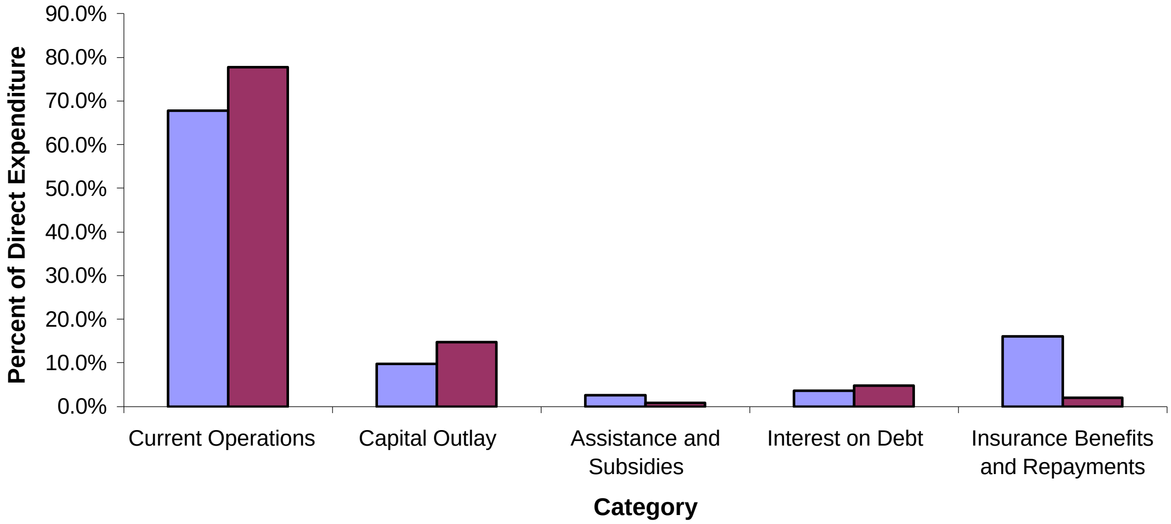


Differences between State and Local Fiscal Structures, 2002

While total state and local direct expenditures and the percentage contribution to each component provide a good overall picture, such an aggregate view glosses over differences between state and local governments in the composition of their direct expenditures. A comparison of state expenditures by composition with expenditures by local governments by composition reveals that states and localities differ in important ways in the relative weight they assign to different types of expenditure. See Figure 11.

First, insurance benefits and repayments claim a much greater share of direct expenditures in states than in localities. In 2002, for instance, 16.1 percent of state direct expenditures went for insurance benefits and repayments while its share in local expenditures was only two percent. Local governments in six states had no expenditures on insurance benefits and repayments. For the same year, state and local governments spent a total of $169.7 billion on insurance benefits, 86.8 percent of those payments occurred at the state level.

Figure 11
Percentage Distribution of State and Local Direct Expenditures by Composition, 2001-2002



Second, state governments spend a much greater share of direct expenditures on assistance and subsidies than their local counterparts. In 2002, states in the aggregate devoted 2.7 percent of direct expenditures to assistance and subsidies while the comparable figure for local governments was 0.8 percent. In fact, most local governments did not spend on assistance and subsidies at all. Not surprisingly, 73.1 percent of the state and local total expenditures in this category came from state governments.

Third, current operations account for a greater share of direct expenditures at the local level than at the state level, although being the most important component of expenditures for both state and local governments. In 2002, local governments allocated 77.7 percent of their direct expenditures for current operations while the equivalent figure for states was 67.8 percent. For the same year, local governments were responsible for 58.5 percent of state and local total expenditures on current operations.

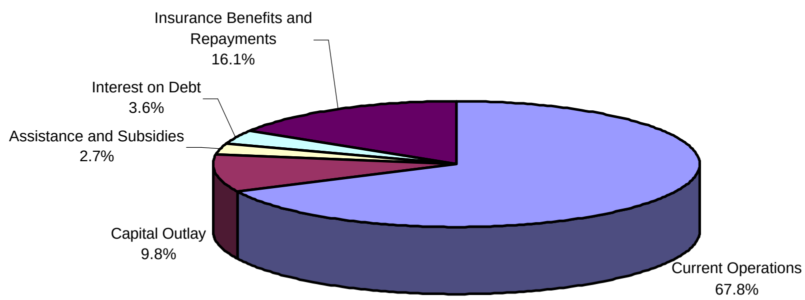
Fourth, local governments contributed a greater share of direct expenditures to capital outlays than their state counterparts. In 2002, 14.7 percent of local direct expenditures went for capital outlays while expenditures in the same category accounted for 9.8 percent of state direct expenditures. Of the state and local total expenditures on capital outlays, 64.9 percent came from local governments.

In sum, the relative importance of different types of expenditures in state expenditures is quite different from that in local expenditures. In 2002, the second most important component of state expenditures was insurance benefits and payments, while capital outlays was the second most important for local governments. In states, capital outlay was the third major component, followed by interest on debt and assistance and subsidies. In localities, by contrast, interest on debt, insurance benefits and payments, and assistance and subsidies came in a descending order of importance.

Differences among States across Regions, 2002

In the aggregate, states and localities exhibit compelling differences in their fiscal structures. When taken individually however, states also differ from one another in the composition of direct expenditure.

Figure 12
Percentage Distribution of State Direct Expenditure by Composition, 2001-2002



In the aggregate, states allocated two-thirds of their direct expenditures to current operations. The other third of their direct expenditures are allocated to insurance benefits and repayments (16.1 percent), capital outlays (9.8 percent), interest on debt (3.6 percent), and assistance and subsidies (2.7 percent). See Figure 12. The composition of spending, however, varies across individual states.

First, states differ noticeably in their contribution to insurance benefits and payments. While insurance benefits and payments constituted the second largest share of total state direct expenditures, it was not the case in some states. In 2002, insurance benefits and payments as a share of state expenditures ranged from 6.7 percent in Nebraska to 26.4 percent in Ohio. Besides New Jersey, Ohio, Oregon, Washington, West Virginia, and Wisconsin contributed over 20 percent of their state direct expenditures to insurance benefits and payments. By contrast, Delaware, Nebraska, North Dakota, South Dakota, Tennessee, and Vermont committed less than ten percent to expenditures in the same category. In fact, in all these six states, except Tennessee, capital outlays surpassed insurance as the second most important component of direct expenditure.

Judging from the average share insurance took up in direct expenditures; states in the West contributed the most to insurance benefits and payments while states in the South contributed the least. On average, insurance constituted 15.4 percent of state expenditures in the West. The average share in Southern states, however, was only 13.1 percent. Both the Midwest and the Northeast had a regional average not far off the national average of 14.2 percent.

Second, states vary in their commitment to expenditures on assistance and subsidies. In 2002, assistance and subsidies as a percentage of direct expenditures ranged between 1.2 percent in New Jersey and 4.5 percent in Arizona (excluding the exceptionally high value of 6.7 percent in Alabama). While in ten states, assistance and subsidies claimed less than two percent of state expenditures, in 19 states, the expenditure share for assistance and subsidies surpassed that for interest on debt.

Compared by region, states in the South and the Midwest tended to spend a greater share on assistance and subsidies than their counterparts in the Northeast and the West. On average, Southern states contributed three percent of direct expenditures to assistance and subsidies, while the regional average for the West was 2.6 percent.

Third, capital outlays as a share of direct expenditures varied from state to state. In 2002, capital outlays consumed 17.9 percent of state direct expenditures in South Dakota. By contrast, the expenditure share for capital outlays was as low as five percent in California. Twenty states devoted less than ten percent of direct expenditures to spending in this category. While Southern and Midwestern states were slightly more likely to spend a greater share on capital outlays than states in the Northeast and in the West, there was more variation within a region than across regions.

Fourth, states also vary widely in their expenditure share for interest on debt. In 2002, the spending share for interest on debt ranged between 1.3 percent in Tennessee and 10.3 percent in Massachusetts. In nine states, interest on debt accounted for less than two percent of direct expenditures, whereas the share was greater than five percent in ten states.

The regional disparity between the Northeast and the rest of the country loomed large in expenditures on interest on debt. In 2002, Northeastern states, on average, allocated 5.9 percent of their direct expenditures for interest on debt, well above the national average of 3.7 percent.

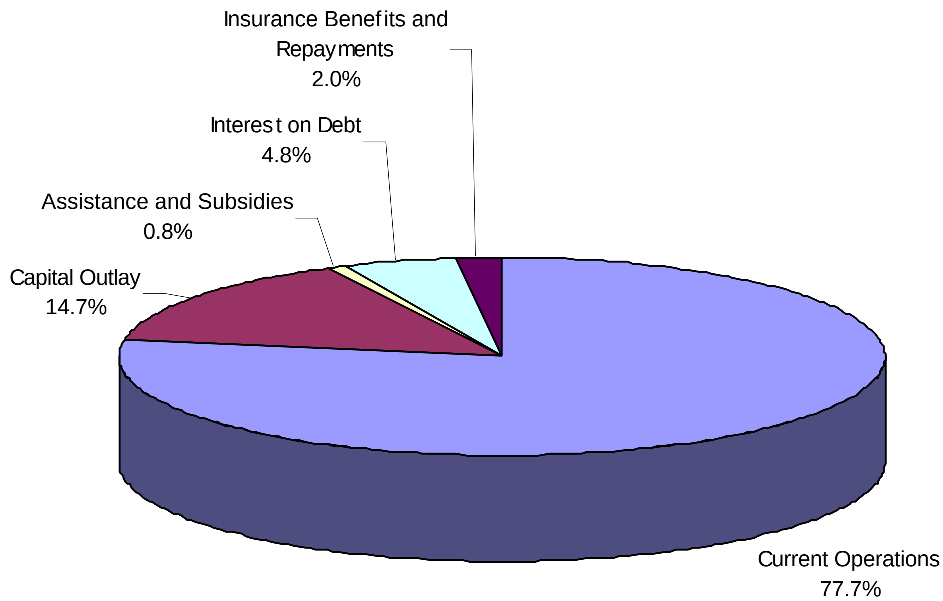
Finally, although current operations consistently consume the largest share of expenditures in all states, some states spend a lot less in this category than others. In 2002, current operations as a percentage of state direct expenditures ranged from 58.2 percent in Ohio to 76.8 percent in Nebraska, with an average of 69 percent.

While the South distinguished itself from the other regions with the largest expenditure share on current operations. In 2002, on average, states in the South contributed 70.1 percent of direct expenditures to current operations, while the regional average for the Northeast was 67.4 percent.

Differences among Local Fiscal Systems across States, 2002

Just as states vary considerably in their expenditure patterns, local governments are far from uniform in terms of the composition of their direct expenditures. Localities in different states tend to focus on different types of expenditures. There are considerable variations in local expenditure on current operations, capital outlay, and interest on debt, but less variation in the other types of local expenditure.

Figure 13
Percentage Distribution of Local Direct Expenditure by Composition, 2001-2002



In the aggregate, current operations accounted for 77.7 percent of local direct expenditures. That was followed by capital outlays (14.7 percent), interest on debt (4.8 percent), insurance payments (2 percent) and assistance and subsidies (0.8 percent). See Figure 13. The experience of local governments in individual states, however, varies in important ways.

First, local governments differ in their commitment to current operations. In 2002, current operations as a share of local direct expenditures ranged from 69.2 percent in

Hawaii to 89.4 percent in Rhode Island. Local governments with a smaller share on current operations tended to place more weight on capital outlays.

The regional patterns for state expenditures on current operations were somewhat reversed at the local level. In 2002, local governments in the Northeast boasted the highest expenditure share for current operations. On average, Northeastern states committed 83.3 percent of local direct expenditures to current operations. In stark contrast, states in the West on average contributed only 76.8 percent. The regional averages for the Midwest and the South were about the same as the national average.

Second, local governments vary in their contribution to capital outlays. In 2002, capital outlays claimed as much as 25.2 percent of local direct expenditures in Hawaii, but as little as 4.3 percent in Rhode Island. While in Maine, Mississippi, Montana, New Jersey, Rhode Island, Vermont, and West Virginia local governments devoted less than ten percent of local direct expenditures to capital outlays, the share was greater than 20 percent in Alaska, Arizona, the District of Columbia, Hawaii, and Nevada.

With regard to expenditures on capital outlays, an apparent regional gap existed between the Northeast and the West. In 2002, local governments in Northeastern states, on average, contributed 10.6 percent of their expenditures to capital outlays, while the regional average for the West was as high as 17.7 percent.

Third, local governments spend differently on interest on debt. In 2002, interest on debt as a percentage of local direct expenditures ranged between two percent in Idaho and 11.2 percent in Kentucky. On average, interest on debt accounted for 4.8 percent of local direct expenditures.

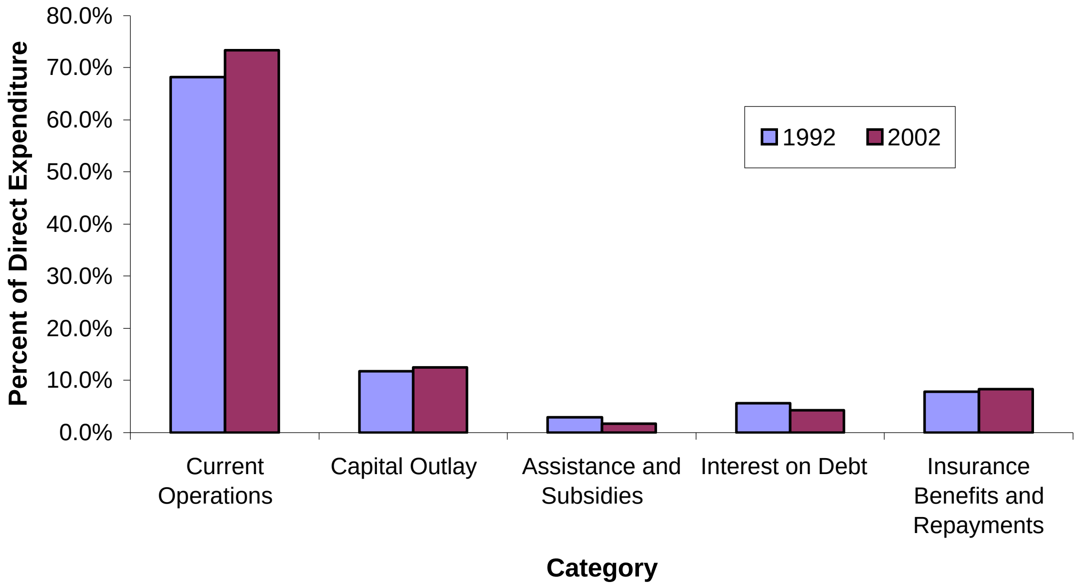
From a regional perspective, local governments in the South and the West were more likely to contribute a greater expenditure share to interest on debt than those in the Northeast and the Midwest. The regional average for the Northeast was 3.7 percent while those for the South, the West, and the Midwest, were five percent, 4.8 percent, and four percent respectively.

Trends over the Decade: Changes in Expenditure Composition

A comparative analysis between 1992 and 2002 may help us examine whether the composition of government expenditure changed in any significant way at both the state and local levels.

In 1992, state and local government direct expenditures totaled $1,146,853 million, of which 68.1 percent was spent on current operations, 11.7 percent on capital outlay, 7.9 percent on insurance benefits and payments, 5.7 percent on interest on debt, and 2.9 percent on assistance and subsidies. Compared with 2002, the relative importance of different components of expenditure remained stable. The shares for current operations, capital outlays and insurance increased over the decade, while the shares for the other categories went down. See Figure 14.

Figure 14
Percentage Distribution of State and Local Direct Expenditures by Composition, 1992 and 2002



Changes in State and Local Fiscal Structures, 1992-2002

The 1992 expenditure data suggested relative stability in the differences between state and local fiscal structures over time. State and local disparities found in 1992 were largely sustained in 2002.

In 1992, insurance benefits and payments accounted for 16 percent of state expenditures while only 1.6 percent of local expenditures went for spending in this category. For the same year, local governments in nine states did not spend on insurance at all. Ten years later, local governments in more states had expenditures on insurance benefits and repayments, and the gap between state and local expenditure narrowed slightly. In 1992, states were responsible for 88.5 percent of the state and local total expenditures on insurance benefits. The state share dropped in 2002 as the disparity between state and local governments became less steep.

In 1992, assistance and subsidies amounted to 4.1 percent of state direct expenditures while its share in local expenditures was 1.9 percent. For the same year, 62.2 percent of state and local total expenditures in this category came from states. In 2002, the share for assistance and subsidies dropped at both the state and local levels, while the magnitude of change was greater at the local level. As a result, states shouldered a significantly larger share of the state and local total expenditures on assistance and subsidies than ten years before.

In 1992, current-operating expenses accounted for 70.7 percent of total local government direct expenditures, while the comparable figure for states was 64.7 percent. In other words, local governments accounted for 58.7 percent of total state and local expenditures for current operations. By 2002, both state governments and local governments were spending a larger share of their direct expenditures on current operations and the state share increased somewhat faster. However, in 2002 local governments accounted for 58.5 percent of total state and local current operating expenditures.

In 1992, capital outlays accounted for 13.1 percent of local direct expenditures, while 10 percent of state expenditures went for the same category. Local expenditures on capital outlays contributed to 62.8 percent of total state and local expenditures on capital outlays. In 2002, as the share for capital outlays decreased in both state and local expenditures, the gap between states and localities apparently widened. Local governments turned out to shoulder a greater share of the state and local total expenditures in this category.

Changes in State Spending Patterns across Regions, 1992-2002

In 1992, insurance benefits and payments as a share of state direct expenditures ranged from 3.8 percent in Nebraska to 29.6 percent in Nevada. While California, Nevada, Ohio, and West Virginia contributed over 20 percent of state expenditures to insurance, nine states committed less than ten percent. In 2002, the range of variation among states shrank, suggesting that states are becoming less divergent in their expenditure shares on insurance benefits and payments.

Compared by region, states in the West and the Northeast committed a larger share of expenditures to insurance benefits than their counterparts in the Midwest and the South in 1992. The West boasted a regional average of 15.7 percent, followed by the Northeast with an average of 14.7 percent. By contrast, the comparable numbers for the Midwest and the South were 12.4 percent and 12.3 percent respectively. The regional pattern was revised in 2002. As the gap between the West and the South widened, the difference between the Midwest and the Northeast disappeared.

In 1992, the share of state expenditures for assistance and subsidies had a range between one percent in New Jersey and 7.7 percent in Illinois. While California, Colorado, Indiana, New Jersey, New York, and Nevada contributed less than two percent of state expenditures to assistance and subsidies, the percentage was greater than seven percent in Illinois, Michigan, and Minnesota. In 2002, state variation in assistance and subsidies spending had a much narrower range. State governments became closer in deciding their share of expenditures in this category.

An apparent regional gap emerged between the Midwest and the West in 1992. Midwestern states, on average, allocated five percent of their expenditures for assistance and subsidies. By contrast, the regional average for the West was only 3.2 percent. In 2002, the regional disparity between the Midwest and the West was significantly reduced. While more Southern states moved to the upper end, the average share in the Northeast slipped down.

In 1992, capital outlays as a percentage of state expenditures ranged from 3.2 percent in New Hampshire to 23.7 percent in Hawaii. Eighteen states had a share smaller than ten percent. Compared with 2002, states became less varied in their spending share for capital outlays ten years later.

There was considerable regional variation in expenditures on capital outlays in 1992. While states in the West allocated an average share of direct expenditures of 12.7 percent for capital outlays, the comparable figure for Northeastern states was only 8.8 percent. The regional averages for the South and the Midwest rest around the national average of 11 percent. A decade later, however, the regional disparities disappeared, as the Western states joined the Northeastern states in lower shares for capital outlays.

In 1992, the state expenditure share for interest on debt ranged from one percent in Kansas to 12.6 percent in Oregon. In 17 states, interest on debt constituted a smaller share of direct expenditures than assistance and subsidies. In 2002, the range of variation among states apparently shrank, another sign of state convergence in expenditure composition.

In 1992, the Northeast had an average share for interest on debt far greater than other regions. While Northeastern states boasted an average contribution of 7.6 percent, the regional average was 5.7 percent in the West, 4.7 percent in the Midwest and 4.5 percent in the South. In 2002, the regional disparity maintained its magnitude, while the differences between the other regions became less apparent.

In 1992, current operations consumed 51.6 percent of state expenditures in Nevada, whereas its share was 75.3 percent in Indiana. Again, the degree of state variation declined in 2002, providing further evidence for state convergence.

From a regional perspective, the South and the Midwest experienced a greater state expenditure share for current operations than the Northeast and the West in 1992. The regional average in the South was as high as 68 percent. In contrast, the West only had an average of 62.7 percent. In 2002, the regional gap shifted to the South and the Northeast, as the magnitude of difference declined.

Changes in Local Fiscal Systems across States, 1992-2002

In 1992, current operations as a share of local direct expenditures ranged from 56.1 percent in Washington to 87.1 percent in Vermont. The spread of this range was significantly reduced in 2002. Local governments became less varied in their expenditure in this category.

Local governments in the Northeast, in 1992, committed to current operations a share much greater than their counterparts from the rest of the nation, especially those in the West. On average, local governments in Northeastern states contributed 78.5 percent of their direct expenditure to current operations, while the regional share in the West was 68.4 percent. This regional pattern remained fairly stable in the next ten years.

In 1992, the share of local direct expenditures allocated for capital outlays ranged between 5.8 percent in Rhode Island and 25.7 percent in Hawaii. Compare with 1992 the range of difference in 2002 expanded slightly over the decade. Local governments appeared less alike in this regard than ten years before.

In 1992, local governments in the Northeast were much less likely than those in the West to contribute a significant share of their direct expenditures to capital outlays. Local governments in the Northeastern states, on average, had 9.8 percent of their direct expenditures going for capital outlays. In sharp contrast, localities in the West had an average share of 16.2 percent. The regional disparity was carried over from 1992 to 2002, with its magnitude increasing slightly.

In 1992, interest on debt claimed as much as 15.1 percent of local direct expenditures in Utah and as little as 2.4 percent in Idaho. Local governments in Idaho, Rhode Island, Vermont, and South Dakota committed less than three percent of their expenditures to interest on debt. In contrast, interest on debt accounted for over ten percent of local direct expenditures in Utah, Texas, Kentucky, Arizona, and Alaska. The range of variation was narrowed in 2002, implying a trend toward convergence among local governments in their expenditure patterns.

With respect to expenditures for interest on debt, a considerable disparity lay between localities in the South and West and localities in the Northeast and the Midwest. On average, local governments in the Western states contributed 7.7 percent of their expenditures to interest on debt while their counterparts in the South contributed seven percent. By contrast, the regional averages for the Northeast and the Midwest were 4.4 percent and 4.9 percent respectively. In 2002, the regional pattern remained roughly the same. The magnitude of the difference, however, became less impressive.

V. <u>Significant Trends Affecting States and Local Fiscal Systems</u>

According to Ronald K. Snell, Director of Economic, Fiscal and Human Resources for the National Conference of State Legislatures, an aging population and a global economy are not going to mix well with state tax bases that were created some 40 years ago. For example, sales and income taxes now make up approximately 70 percent of state tax revenues. As people spend more on services and less on tangible goods a larger share of economic activity falls outside the base of the sales tax. An aging population, where older people tend to spend less on taxable items and more on tax-exempt items like healthcare products, exacerbates this situation.

Similarly, 27 states out of the 41 states with an income tax exempt Social Security income from state income taxation, and 34 of those 41 states exempt at least some public pension income.[13] This becomes a concern as the population ages and an increasing share of income comes from such transfer payments.[14]

These concerns are not limited to state governments. The same trends are having a profound impact on the fiscal health of cities as well. For example, a 2004 report by the National League of Cities, *Cities and the Future of Public Finance: A Framework for Public Discussion*, concludes, "A new system of public finance is needed to address the governance, economic, and intergovernmental challenges facing municipal governments." The report discusses the impacts of the changing economy, demographic trends and changes in the intergovernmental system on state revenue raising capacity and spending needs.

Concern about the future of state and local fiscal affairs is not just the concern of membership organizations like the National Conference of State Legislatures or the National League of Cities. For example, Robert Tannenwald of the Federal Reserve Bank of Boston is one of many researchers who have also expressed concern about the future of state and local fiscal systems. Tannenwald considers the impact on state and local taxes of four factors:

1. the shift in the nation's mix of production and consumption from goods to services;
2. the growing importance of intangible assets in generating output;
3. the proliferation of electronic commerce; and
4. the intensification of interjurisdictional competition.

He concludes "While I provide evidence that all four factors threaten the revenue productivity of state and local taxes, I have no good solutions to offer. . . . No solution presents state and local policymakers with a clear win-win situation, in which they could halt or reverse the decline in the revenue productivity of their taxes without sacrificing autonomy, competitiveness, neutrality, or administrative simplicity" (Tannenwald, 2002, p. 467).

The critical point all these examples are making is that the demand for state and local services and the ability of state and local governments to raise revenues depends, to a large extent, on the context or environment in which state and local governments operate. This is often referred to as the *fiscal architecture* of a state/local system of government where demographic, institutional and technical factors influence the spending requirements and revenue raising potential of that state/local system (Wallace, Forthcoming).

[13] ***State Tax Notes***, Volume 34, Number 12, December 20, 2004, p. 797.
[14] In 1960 transfer payments accounted for about 6 percent of national personal income, but increased to nearly 13 percent by 2000. At the same time, wages and salaries fell from nearly 79 percent of personal income in 1960 to just 66 percent in 2000. See National Conference of State Legislatures, ***New Realities in State Finance***, 2004, Table 3, p. 28.

Many such factors, generally beyond the control of state and local officials (at least in the short run), have profound impacts on the ability of state and local governments to perform adequately their responsibilities. Such factors include, but are not limited to,

- The erosion in trust in state and local governments and the rise of organizations like Americans for Tax Reform and their 800 local affiliates which agitate against tax increases of any kind;
- The changing relationship between the federal government and the states which often result in unfunded mandates being imposed on state and local governments;
- Changing federal tax policy and its impact on state and local government revenues;
- Changes in the level and composition of federal intergovernmental grants;
- An aging population and other demographic trends that impact the need for certain state and local services (e.g., Medicaid) as well as undermining the ability of state and local governments to raise revenues as discussed above;
- Technological changes and the changing nature of the economy which is shifting more and more toward the production of services that are typically exempt from sales taxes;
- The rapid growth of electronic commerce,
- Interjurisdictional competition and the pressure that puts on both state and local spending and revenue raising;
- The boom and bust cycles of state and local revenues;
- Increasing globalization of the economy; and
- Pressures for school finance reform coming from the courts.

All of these, and other, factors contribute to the concerns expressed by Robert Snell and the National League of Cities about the ability of state and local governments to provide the goods and services needed by their citizens. These factors and how they impact state and local fiscal situation are discussed further below. State and local fiscal systems must have the flexibility to adapt to changing circumstances. The viability of these systems is ultimately at stake.

A. Citizen Trust in Government

Trust in Government

It is widely recognized that trust is a critical component of our democracy. As Hubert H. Humphrey once observed, "Surely anyone who has ever been elected to public office understands that one commodity above all others, namely the trust and confidence of the people, is fundamental in maintaining a free and open political system."

The opening plenary session at the National Tax Association's annual meeting in 1998 was entitled ***Trust in Government***. The panelists included Peggy Musgrave, Richard Musgrave and Eugene Steuerle from the Urban Institute. In her opening paper, Peggy Musgrave argued "It is clear that trust in government is a bedrock requirement for the efficient and equitable conduct of the public sector." She paraphrases Abraham Lincoln – "if I have the trust of the people I can do anything, but if there is no trust, I can do nothing." She continues by arguing that

- Distrust of government and the cynicism that usually accompanies it undermines willingness to abide by the rules (such as tax compliance);

- Distrust can undermine other aspects of civic morality, such as participation in the political process, leaving the field open to extremist groups to determine the course of government;

- Distrust of the government's resolve to stabilize the economy results in spending behavior that adds to the government's difficulties; and

- Distrust of the motivation and conduct of public employees will have a corrosive effect on the relationships between the public and those who serve them in the public sector, with inadequate compensation for services rendered and declining quality of those services.

Finally, she argues that "trust in government is reduced by implanting in the public's mind that government expenditures . . . are inherently wasteful and should be cut back, with savings transferred to individuals via tax reduction where they can be better spent" (Peggy Musgrave, 1998, p. 3).

In the next paper, Richard Musgrave quotes Oliver Wendell Holmes in saying that "Taxes are the price we pay for civilization." Musgrave argues that we ought to do so willingly, as we pay our other bills. But in order to do so, citizens need to trust that the distribution of tax burden is fair – that is each person must trust that they are paying their fair share – based on some notion of ability-to-pay according to Musgrave. But he is clear that "Fair taxation, like all good things in life, is not simple and has its cost, but one that must be paid if the system is to be trusted" (Richard Musgrave, 1998, p. 8). Thus, he concludes that "…trust in government is a social capital without which a democratic society cannot function" (Richard Musgrave, 1998, p. 9).

Finally, in his presentation on that panel, Eugene Steuerle from the Urban Institute acknowledged, "From the very beginning of American politics, democracy and distrust have gone hand in hand." But his concern was that such historical skepticism toward governmental authority has evolved to a much more negative cynicism toward anything that happens in politics thereby undermining citizen trust in politicians and political institutions. He presents evidence that "From the late 1950s onward, Americans have expressed a mammoth loss of faith in politics and government" (Steuerle, 1998, p. 10).

The decline in trust in government has been widely commented upon in the media and is, at least in part, supported by polling data over a relatively long period of time. The polling data that is usually cited comes from a question that is asked in the American National Election Survey biennially on whether the respondent trusts the government in Washington just about always, most of the time, only sometimes, or never. The percentage of the population that responds just about always or most of the time has declined from 73 percent in 1958 to 36 percent in 2003, although there was an upward blip in the late 1990s (from 27 percent in 1996 to 40 percent in 1998 and 44 percent in 2000) and a pronounced upward swing in the immediate post 9/11 era to 56 percent in 2002. (See Table 1B: Council for Excellence in Government, p. 3).

However, it is important to note that the question asks specifically about government in Washington, i.e., the federal government. The Gallup organization has periodically asked respondents how much trust and confidence they have in various levels of government: a great deal, a fair amount, not very much or none at all. At the federal government level the percentage who responded a great deal or a fair amount has declined from 70 percent in 1972 to 61 in 2003. Trust and confidence have not shown the same precipitous decline at the state and local level, however. At the state level trust and confidence rose from 63 percent in 1972 and remained at or above that level through just prior to 9/11. However, by September 2003 it had fallen to 53 percent, the lowest level Gallup had ever recorded on that question (although Gallup attributes the low figure partly to the "political storm" occurring in California at that time, i.e., the recall of Gov. Grey Davis). Trust and confidence in local government has remained very steady across time, moving from 63 percent in 1972 to 68 percent in 2003. It appears that support for state and (especially) local government far exceeds that for the federal government and *has not* significantly eroded over the past several decades.

The National Conference of State Legislatures, through their Trust for Representative Democracy program, in conjunction with the Center for Civic Education at Indiana University, conducted a survey in August 2003 divided into DotNets (the 40 million young Americans between 15 and 26 years of age – born after 1976) and their older cohorts – the over 26 age group. The survey found that 35 percent of the respondents agreed with the statement that elected officials work to serve the public interest while 41 percent agreed with the statement that elected officials work to serve their personal interests. Only 27 percent of the respondents agreed with the statement that government is run for the benefit of all, while 54 percent agreed with the statement that government is run by a few big interests. The NCSL report, *Citizenship: A Challenge for All Generations*, concludes that the public is cynical about the people and processes of government.

To some extent, then, citizens are distrustful of governmental institutions and the people that run them. This is consistent with the thesis put forward by Uslaner that "People either like government – both in Washington and their states – or they don't." Uslaner uses data from the *Washington Post*/Kaiser Family Foundation/Harvard

University survey in 1995 of people's attitudes toward government. When asked to choose whether they prefer Washington to their own state government, most people preferred their own state government (71 percent to 29 percent). However, going beyond this false choice to ask people how they feel about their state government specifically, most expressed the same distrust – 58 percent of respondents distrusted both tiers of government and only 35 percent indicated they trusted their state governments. Uslaner finds that neither ideology nor partisanship is responsible to the observed levels of distrust in state government. He concludes

> "If you do not like Washington, you are not likely to be convinced that your state is more trustworthy. People dislike their states for mostly the same reasons they do not like Washington. . . . Shifting the locus of power will not solve the problem of trust in government" (Uslaner, p. 133)

These conclusions are re-enforced by a series of polls done by the U.S. Advisory Commission on Intergovernmental Relations annually from 1972 until its demise in the early 1990s and then repeated once by Cole and Kincaid for 1999 (Cole and Kincaid, 2000). These polls asked respondents "from which level of government do you feel you get the most for your money. In 1972, 39 percent said they received the most for their money from the federal government, 18 percent from their state government, and 26 percent from their local government. By 1999, these figures had undergone a dramatic change: only 23 percent thought they received the most for their money from the federal government compared to 29 percent from their state government (a gain of 11 percentage points from 1972) and 31 percent from their local government (a gain of five percentage points).

It is possible, of course, that these results could be consistent with a sense of getting less or even much less from all levels of government in 1999 than in 1972. This question was explored by Jennings (Jennings, pp. 218-44). Using data from the Opinion Research Center and the Gallup Organization Jennings shows a significant decline in trust in the federal government from 1972 to 1992 – a drop of more than 30 percentage points. Over the same period, trust and confidence in state government dropped by about half that much, while trust and confidence in local government declined, but only barely. These data, read in conjunction with the relatively stable data on trust and confidence in state and local governments described above, suggest that trust in local government has been fairly stable, while trust in state government has declined somewhat.

Public Preferences on Spending and Taxes

The National Election Survey has asked respondents the following question every two years since 1982: "Some people think the government should provide fewer services, even in areas such as health and education, in order to reduce spending. Other people feel that it is important to provide many more services even if it means an increase in spending." It then asks people to place themselves on a seven-point scale with one being cut services/spending and seven being more services/spending. Adding up the percentages who rank themselves one - three (cut services/spending) and comparing the results to those who rank themselves five - seven (increase services/spending) it appears that support for government ***spending*** actually increased from the early 1980s to 2000. In 1982 42 percent of the respondents fell into the cut-spending category compared to 24 percent for increased spending. In 2000 the results were nearly reversed; 18 percent favored cutting spending, while 39 percent favored increasing it. However, there is a substantial amount of volatility in the responses. In 1994, for example, 36 percent favored cutting spending, while 27 percent favored increasing it.

On the tax side, not surprisingly, people consistently think that their taxes are too high. Gallup and NORC have a long time series of questions asking people whether their federal income tax is too high, about right, or too low. From 1967 to 2002, the percentage responding that their income tax was too high never fell below 55 percent and bounced back and forth between 55 percent-70 percent, with no obvious trend. However, in 2003, the too high response fell to 50 percent (AEI, 2004)

The data discussed above on both spending and taxing do not seem to show any major change in public preferences for spending or taxing. However, they are generic and the tax question relates specifically to federal rather than state or local taxes. Data on attitudes toward state and local taxing and spending are more difficult to come by, but there have been a substantial number of studies on public opinion related to state and local tax and expenditure limitations and on voting behavior on initiatives and referenda on these limitations that provide useful information. Mullins (2003, pp. 108-110) reviews these studies and concludes:

> "Assessments of general voter support for these limitations suggest a desire for lower taxes and more efficiency in government, rather than any desire for reduced public services. Voters were, in essence, attempting to lower the price of the existing service package…Based on the result of public opinion polls, dissatisfaction with the "size and scope" of the state and local public sector has not been a primary motivation for the adoption of limitations."

Alm and Skidmore (1999) estimate the probability of the passage of tax and expenditure limitations in state elections as a function of various economic, fiscal, demographic, and political factors of the state as well as specific features of the limitation proposal. They find that (p. 506)

> "Growth in property taxes and in the share of local revenues in total state taxes both increase the probability of TEL passage, but growth in overall taxes is associated with a lower probability. These results suggest that voters do not necessarily desire a reduction in overall taxes and spending; rather, they are interested in reducing certain types of taxes."

Indeed, Mullins also notes that dissatisfaction with the property tax has been a motivating factor in a number of states. A Gallup/CNN/USA Today poll in April, 2003 found that 38 percent of Americans thought the local property tax was the worst tax compared to 21 percent who chose the federal income tax. This was a near turnaround from earlier Gallup polls; in 1988 only 24 percent identified the local property tax as the worst (least fair) tax compared to 26 percent who designated the federal income tax.

The U.S. Advisory Commission on Intergovernmental Relations conducted an annual survey from 1972 to 1993 of changing public attitudes about government and taxes.[15] One question asked "Which do you think is the worst tax – that is the least fair tax?" In the early years of the survey, from 1972 through 1978 (with the sole exception of 1974) the local property tax was viewed as the least fair tax followed by the federal personal income tax, the state sales tax and the state income tax. The explosion of property tax limits after Proposition 13 in California in 1978 had the effect of changing public attitudes by making the federal personal income tax seem to be the least fair tax from 1979 through 1988, followed by the local property tax, the state sales tax and the state income tax. In 1989, 1990 and 1991 the federal personal income tax and local property tax again traded positions. They were essentially tied for least fair tax in 1992, before the federal income tax once again became perceived as the least fair tax in 1993.

The set of polls discussed above would seem to leave state and local governments (and particularly the latter) in a dilemma. Despite widespread media coverage to the contrary, the public continues to trust state and local governments and maintains a taste for state and local services. However, the public wishes to reduce the taxes it pays for them and seems to either 1) believe that service levels can be maintained, or even increased, even with tax reductions through exercise of greater efficiency or 2) ignore the connection between spending and taxes.

Some argue that these views are reinforced by the changing relationship between government and the citizen, which has come to be known as "The New Public Management." After Proposition 13 passed in California, local officials were concerned about how to reconnect with citizens/taxpayers. Elected officials started thinking of citizens as customers for government services and there was increased emphasis on improving customer satisfaction. Crenson and Ginsberg, however, argue that there are crucial differences between citizens and customers that have tended to undermine trust in government. Specifically, they argue

> "…citizens were thought to own the government, while customers merely receive services from it. Citizens belong to a political community with a collective existence and public purposes. Customers, however, are individual purchasers seeking to meet their private needs in a market. Customers are not involved in collective mobilization to achieve collective interests." (Crenson and Ginsberg, 2002, p. 8)

The reinvention of American government that emerged after Proposition 13 recast citizens as customers. As Crenson and Ginsberg argue, "It emphasizes private

[15] No survey was done in 1976.

rights at the expense of collective action." It is important to recognize that, at least in part, the emphasis on individual rights is a result of concerted efforts by some organizations dedicated to undermining support for all taxes. Such organizations are often ideologically driven and oppose all tax increases as a matter of principle. There are some 800 state and local groups pursuing this objective; often through efforts to get politicians to sign pledges that they will not, under any circumstances, increase state or local taxes.

The dilemma facing state and local government is obvious. With constant or rising expectations for services, but opposition to tax increases, and particular opposition to the local property tax, how will state and local governments meet public expectations? Or more fundamentally, how do state and local governments strengthen citizen trust in government institutions, elected officials and fiscal policies?

B. Federal and state mandates and their impact on state and local finances

The New Deal era witnessed the beginning of the nationalization of public policy and the expansion of federal intervention in state and local affairs. For decades thereafter the federal government relied extensively on the strings it attached to grants-in-aid to exert its influence (Nivola 2002). The 1960s ushered in a period when the federal government enacted a multitude of mandates that reoriented state and local programs with rising fiscal assistance. The growth of an aggressive federal government slowed in the late 1970s. Yet the Reagan administration's emphasis on devolution failed to curb the proliferation of federal mandates.

For a number of reasons, mandates, especially unfunded ones, have become an accepted congressional tool for national policy making. In part, such initiatives have become acceptable because, as a result of political and institutional changes, Congress has become detached from state and local concerns and indifferent to the institutional interests of state and local governments (Elazar 1990) In addition, congressional entrepreneurs and interest groups have become more skilled in defining mandate goals in terms where only the benefits of the mandate are perceived as being legitimate. For example, Megan's Law was passed after the slaying of Megan Kanka by a released sex offender living near her home. After extensive national media coverage, Congress passed a bill mandating state and local law-enforcement notification to communities of released sexual offenders. Defined in such symbolic terms, objections to the bill by civil libertarians or members philosophically opposed to unfunded mandates were not politically possible (Posner 1997, p. 64)

Such unfunded mandates allowed federal elected officials to claim credit for programs urged by lobbyist groups without paying for the costs of implementation and enforcement (Nivola 2002; Posner 1998). With seemingly well-justified purposes, many mandates nonetheless render state and local governments vulnerable to financial crisis and threaten to undermine their capacity to address the unique needs of their constituencies (Posner 1998). Using case studies, Nivola demonstrates that cities, such as New York, Chicago, Philadelphia, and Los Angeles, bear substantial mandate compliance costs. The financial burden tends to compound the already severe problems of central cities.

Lav identifies four major areas in which states are burdened with unfunded or under-funded mandates: Individuals with Disabilities Education Act (IDEA), No Child Left Behind (NCLB), Help America Vote Act, and homeland security. The National Conference of State Legislatures (NCSL) estimates that these mandates impose an annual cost between $23.5 billion and $82.5 billion to state and local governments.

IDEA, initially passed in 1975 and amended most recently in 1997, guarantees each disabled child an assessment and an individualized education plan, including being brought into the mainstream of the educational system when appropriate. When initially enacted, the federal government promised to fund 40 percent of the additional costs states were mandated to incur under the law. Yet the federal government has never fulfilled its promise. According to the National Conference of State Legislatures, it would currently require $11 billion in additional annual funding for the federal government to reach its 40 percent share of the "Part B" average per pupil expenditures currently provided by the states.[16] The Center for Special Education Finance, which is financed by the U.S. Department of Education, estimates it would take more than $25 billion in immediate additional federal funding to meet all the excess costs of educating children with special needs.[17]

The No Child Left Behind Act also imposes mandates on state and local governments. The Act includes a variety of steps that schools must undertake regarding the testing of elementary school students in grades three through eight (likely to be extended to all high school students as well according to legislation being proposed by the Bush administration). If a school fails to meet specific performance standards, the Act prescribes various remedies that a school must pursue, including ultimately giving children the right to transfer to other schools. While it is unclear exactly how much it will cost state and local governments to comply with these mandates, the NCSL estimates the annual costs to be in the range of $5 billion to $35 billion a year.[18]

Using evidence from Texas, where the implementation costs are expected to be lower than most other states because Texas has been a leader in providing measures of student performance and holding schools accountable for their performance, Imazeki and Reschovsky (2004) argue that NCLB results in states undertaking initiatives they would not otherwise undertake if left to their own. As a result, they conclude NCLB imposes federal mandates on state and local education. They estimate the additional annual costs to Texas of complying with the requirements of NCLB are in the order of $1.7 to $5.5 billion. Since the state received only $329 million in additional funding for

[16] National Conference of State Legislatures, "Current Levels of Selected Unfunded Mandates and Underfunded National Expectations Imposed on State and Local Governments" April 16, 2003, http://www.ncsl.org/standcomm/scbudg/budgmandates03.htm.
[17] Ibid.
[18] Ibid.

these purposes, they conclude that the additional costs imposed by NCLB far exceed the increased federal education funding. In their view, it is not unreasonable to expect that the foreseeable fiscal burden that results from this underfunded federal mandate may force several states to consider foregoing federal funding and opting out of the provisions of NCLB (Imazeki and Reschovsky 2004).

In the aftermath of the 2000 presidential election, Congress passed the Help America Vote Act that mandated states upgrade voting equipment and electoral procedures. While the Act authorized funding for these purposes of $3.2 billion for FY 2003 and FY 2004, only $1.5 billion was actually appropriated in FY 2003 and the Bush administration requested only $490 million for FY 2004. As a result of these funding shortfalls, states were left at least $1 billion short of the funds needed to implement the Help America Vote Act. (Lav 2003)

The greatest concerns with unfunded federal mandates may be in the health care area with the rapid growth in Medicaid. Posner notes a comment of Joseph Zimmerman that many federal grants take on the characteristics of mandates when they are so large that state and local governments cannot safely turn them down or when amendments to establish grants are imposed that carry more onerous restrictions. He notes the $3 billion state price tag that came with extending Medicaid to newly eligible groups (Posner 1998, pp. 12-3)

The passage of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996, and the creation of the Temporary Assistance to Needy Families (TANF) fundamentally changed the way assistance was provided to the most vulnerable in our population. This federal policy change means that states will carry a larger share of the welfare spending in the next recession than they have in previous ones, and that states with revenue systems least affected by economic swings will be able to weather this heavier burden somewhat better than states with revenue systems more vulnerable to economic cycles (Dye and McGuire 1997)

Finally, homeland security constitutes another big challenge to state and local budgets, with federal funding falling short by tens of billions (Lav 2003). Costs being borne by state and local governments under the rubric of homeland security include, but are not limited to, emergency management and assistance, disaster relief, counter terrorism, public safety and first responder training, smallpox inoculations, public health, purchasing equipment, improving the safety of the water supply, strengthening food and agricultural security, and upgrading communications. While there has been some additional federal funding in these areas, the NCSL estimates that the annual shortfall in funding for mandated homeland security initiatives by state and local governments is in the range of $6.5 billion to $17.5 billion annually. A January 2002 survey conducted by the U.S. Conference of Mayors found that city officials, alone, expected to spend an additional $2.6 billion on security between September 11, 2001 and the end of 2002.

According to New Orleans Mayor Marc Morial, “Tightening security in the aftermath of September 11 threatens to break the bank for many city budgets.”[19]

In addition to federal mandates, cities and towns are also faced with pressures from unfunded state mandates, which seek to impose state objectives on local agendas (NLC 2003a). While state infringement on local fiscal autonomy threatens curbs on local political control (Brunori 2003), state mandates might have coerced local governments to divert resources from providing goods and services that are most needed by local residents.

The Unfunded Mandates Reform Act of 1995 came about to stem the tide of federal mandates. State and local groups were able to achieve some success in blunting some new mandates and in reducing some existing ones in the wake of this reform legislation (Posner 1998, p. 202) Posner concluded that state and local governments’ “effectiveness in forestalling new mandates continued to be compromised by internal conflicts and crosspressures” (Posner 1998, p. 207) Further “the broad public appeal” of many of the mandates made state and local elected official opposition difficult to rally (Posner 1998, p. 217) State and local government interests were occasionally able to shift the focus of debate to the cost terms of mandates and away from the benefit terms of mandates, notably with safe drinking water and highway mandates. The success of state and local opposition to unfunded mandates, he suggests, has rested on their effective ability to make visible these costs relative to benefits of the mandates in question (Posner 1998, p. 225) Through examination of the resurgence of mandates in the 1980s and the 1995 mandate reform, Posner identifies a cyclical pattern of mandate popularity, in tune with the cyclical pattern of the nationalization of public policy.

A number of studies attempt to assess the effectiveness of the Unfunded Mandates Reform Act of 1995 (UMRA) for alleviating fiscal pressures on state and local governments. Their findings, however, are mostly discouraging. The disclosure and other procedural requirements have effectively increased the supply of information about the costs of mandates and Congressional demand for such information before enactment (Gullo, 2004). Gullo finds that most of the intergovernmental mandates since 1996 would not have imposed costs greater than the thresholds set by UMRA ($50 million). The threshold does prompt Congress to lower the costs. On the other hand, however, few of the bills with mandates below the threshold contained federal funding to offset the costs. In other words, UMRA has not effectively blocked unfunded mandates, which continue to restrict state and local authority and push the limits of state and local finances (Gullo 2004; Lav 2003; NLC 2003a; NLC 2003b).

Although the number of new mandates declines in response to the reform, local governments cannot avoid suffering from the negative impact of unfunded mandates passed prior to 1995 (NLC 2003b). Lav and St. George (1995) claim that even if curbs on unfunded mandates materialized, states and localities would still be confronted with

[19] Cited in Dale A. Krane, “The State of American Federalism, 2001-2001: Resilience in Response to Crisis,” ***Publius***, Volume 32, Number 4, Fall 2002, p. 21.

the difficult choices of “eliminating needed benefits and services or raising their own funds to pay for them.” The reduction of federal grants-in-aid, the transformation of existing federal programs into block grants, and the persistence of unfunded mandates and preemptions manifest a trend to shift the costs and responsibilities for carrying out government functions to states and localities (Lav and St. George 1995). Given their heavy reliance on intergovernmental aid as a major source of revenue, state and local governments have to struggle with the downturn in net federal assistance.

Posner’s conclusions suggest, though not emphatically, that “new waves of national policy impulses may very well continue to sweep over Washington in the form of mandates or other national policy tools.” Their continued usage will feed the “cumulative impact” that mandates have had “on state and local governments, progressively eroding their discretionary resources to respond to unique state or local needs. However compelling each individual mandate and preemption is to the national community, their continued expansion at some point becomes incompatible with a healthy federal system.”[20]

C. Federal government tax policy

There is a profound relationship between federal tax policy and state and local public finance systems. That relationship is important in two critical respects. First there is considerable overlap in the types of taxes imposed by the federal and state, and to a lesser extent, local governments. The federal government and 41 state governments rely heavily on personal income taxes. The federal government and the states also levy estate taxes, corporate income taxes, and a variety of excise taxes on tobacco, alcohol, and fuel.

Both the federal and state governments have traditionally designed their tax systems to interact in ways that minimize compliance and administrative costs. The federal government constructed the estate tax in such a manner. And most state governments have conformed their personal and corporate income tax regimes to federal law.[21]

The second critical aspect of the federal/state relationship is where there is no overlap of taxes. The federal government does not impose general sales or property taxes. This restraint has given state and local governments, significant flexibility with respect to tax policy. State and local governments have been able to set sales and property tax rates and establish bases without interference from the federal government. This has granted the states autonomy over their fiscal systems that allows for responsiveness to citizen demands.

[20] Posner, p. 223.
[21] For example, Federal law changes in 1995 made electing LLC and LLP entity status much easier for purposes of federal taxation. All states have conformed their laws so that LLCs and LLPs that are treated as partnerships for federal tax purposes will be treated same for state tax purposes (see Ely and Grissom 2000).

Because of the various relationships within the current fiscal system, changes in federal tax policy potentially have a significant effect on state and local government budgets. The rest of this section discusses federal tax policy changes and their consequences for the states.

Personal and Corporate Income Taxes

The federal government, 41 states and the District of Columbia impose taxes on personal income. To minimize compliance and administrative costs, 27 states start with federal adjusted gross income to determine state taxable income for individuals. The taxpayer prepares his or her federal return and simply transfers the adjusted gross income amount to the state return. While some adjustments are made at this point, the difficult part of return preparation (determining what taxable income is) is only performed once.

Ten other states use federal taxable income (as opposed to adjusted gross income) as the starting point for calculating state income tax liability. Only four states (Alabama, Arkansas, Pennsylvania, and Mississippi) do not use any part of the federal tax scheme for determining their taxes. But even in those states, while there are often additions and subtractions to the federal income amount, these changes are usually inconsequential for most taxpayers.

Similarly, the federal government and 45 states tax corporate income. All states imposing a corporate income tax start with federal adjusted gross income. Once again, as the federal government grants deductions or exemptions to corporations, there are corresponding reductions in state corporate income tax revenue. Such reductions are automatic unless individual states actively de-couple from the particular federal provision.

The challenge to the states has been when the federal government makes a significant change to personal income tax base. If the federal government grants additional deductions or exempts certain types of income from tax, the states automatically receive less income tax revenue[22]. The trend on the part of the federal government has been to increase deductions and exemptions as a means of reducing taxes.

In recent years, the federal government has made significant changes to the personal and corporate tax systems, all of which have affected state taxation. Here are three recent examples.

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[22] Interestingly, nine states actually gain some revenue when the federal government reduces taxes. Alabama, Iowa, Louisiana, Missouri, Montana, North Dakota, Oklahoma, Oregon, and Utah allow taxpayers to deduct federal taxes on their state return.

Economic Growth and Tax Relief Reconciliation Act

The Economic Growth and Tax Relief Reconciliation Act of 2001 was the federal government's attempt to bolster the economy after the September 11 terrorist attacks in New York City and Washington D.C. In addition to the repeal of the federal estate tax (discussed below), the law provided additional exemptions for retirement savings as well as expanded deferred compensation. The law also reduced federal income and corporate tax rates. In the wake of the economic recession, all states conformed to the new federal tax laws. The lost state personal and corporate income tax revenue was estimated to be $4 billion annually (Duncan 2002).

Interestingly, while no states de-coupled from the federal laws, EGTRRA had another impact on state taxation. Before 2001, three states (Rhode Island, Vermont, North Dakota) used federal tax liability as the starting point for calculating personal income tax liability. Taxpayers of those states would calculate their federal tax liability and pay the state a percentage. Because of the size of the federal income tax reductions, each of these states changed their laws.

Bonus Depreciation

As part of its economic stimulus package, Congress enacted the "Job Creation and Worker Assistance Act of 2002". A cornerstone of this legislation is a special, first year 30 percent bonus depreciation for certain investments made over the next three years. State depreciation rules generally conform to federal tax law depreciation schedules, meaning that the new provision would potentially have a significant impact on state revenues. The Center on Budget and Policy Properties estimated that state revenues would be reduced approximately $4.8 billion a year if all states were to maintain their conformity to the federal law (Catts 2003).

That left the states with a difficult choice. They could do nothing and provide the same tax relief as the federal government. Or they could "de-couple" from the federal depreciation rules. As of the end of 2004, twenty-eight states have opted to follow the federal government and continue to conform to the national depreciation rules. At the same time, eighteen states have chosen to de-couple from the federal system with respect to how they treat depreciation[23].

Section 179 Expenses

In 2002, Congress enacted a tax relief measure under Section 179 of the Internal Revenue Code that allows an immediate deduction for small and mid sized companies that make equipment purchases. Traditionally, taxpayers had to depreciate those assets over time. Because every state except California follows the federal rules regarding expensing of business purchases, the states lost approximately $1.1 billion in 2003

[23] Four states (Nevada, Washington, South Dakota and Wyoming) were not affected by the federal depreciation changes.

income tax revenue as a result. And the expected loss in state income tax revenue through 2013 was estimated by the Joint Committee on Taxation to be $5.2 billion.

Estate and Gift Taxation

Among the most controversial federal policy decisions affecting state public finance has been the repeal of the federal estate and gift tax. In June 2001, federal law changed and the estate tax is being phased out, scheduled for complete repeal in 2011. It may be phased out even earlier (Sullivan 2004).

Unlike the federal government, states impose two types of taxes at the time of death. First, all states impose an estate tax. An estate tax is a levy on the privilege of transferring property at death, measured by the value of the estate. In every state, the estate tax is designed to be absorbed by the credit allowed under the federal estate tax for state death taxes. A person subject to federal estate tax receives a credit for state estate taxes up to certain amount. Most states impose their estate taxes at rates that ensure that the entire amount will be credited against the federal tax bill. Indeed, the majority of states provide that their estate taxes equal the federal estate tax credit. The estate tax credit system is in reality nothing more than an intergovernmental transfer of funds. It is not surprising that states take advantage of this system, as there is no downside economically or politically.

With the pending repeal of the federal estate tax, states are faced with a serious dilemma. If they do nothing, most state estate taxes will expire with the federal provision. This course of action will cost states millions in lost revenue as the credit is phased out. Alternatively, states could decouple from the federal law and impose their own independent estate taxes.

To date, seventeen states and the District of Columbia have decoupled from the federal changes. These states are Kansas, Illinois, Maine, Maryland, Massachusetts, Minnesota, Nebraska, New Jersey, New York, North Carolina, Ohio, Oregon, Rhode Island, Vermont, Virginia, Washington, and Wisconsin.

In most of the remaining states, the legislature is empowered to decouple from the federal estate tax system. The only exceptions are California, which requires a popular vote, and Alabama, Florida, and Nevada, which require changes to the state constitution. The states that have not decoupled from the federal law will lose approximately $15 billion between 2003 and 2007.

Congress Returns State Sales Tax Deductibility Option For Two Years

Before 1986, the federal government allowed a deduction from federal taxable income for all state and local property, income, and sales taxes. The deduction served as a form of intergovernmental aid in the sense that the federal government was defraying some of the costs of state and local public services. In the 1986 Tax Reform Act, Congress repealed the deduction for sales taxes. The repeal was prompted by the desire to broaden the federal income tax base and lower rates. Congress retained the federal deductions for income and property taxes.

In October 2004, the United States Congress enacted a corporate tax bill allowing taxpayers to deduct either their state and local income taxes or their state and local general sales taxes from their federal income tax returns. Nine states--Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming--have no broad-based income tax; and because Alaska has no statewide sales tax (but provides local option authority) and New Hampshire has no income tax on wages or salaries and no statewide sales tax, the new provision is more appealing to taxpayers in the remaining seven states.

To calculate the deduction for sales taxes paid, taxpayers are not required to save all their receipts for purchases made throughout the year. Rather, they can use tables to be provided by the Internal Revenue Service, which will estimate the amount of their deduction based on tax rates, income and family size. The provision is effective for the 2004 and 2005 tax years and is available to those taxpayers who itemize deductions on their federal tax returns, rather than taking the standard deduction.

Federal Tax Policy in the Future

In recent years there has been renewed discussion and debate on the possibility of replacing the federal income tax with some type of consumption tax. Policy makers in Washington have discussed various national sales tax proposals.[24] In 2004, Rep. John Linder's, R-Ga., H.R. 25 and a companion S. 1493 introduced by Sen. Saxby Chambliss, R-Ga., endorsed a national sales tax. Former Rep., and now Senator, Jim DeMint from South Carolina campaigned on a platform of adopting a national sales tax and eliminating the federal income tax.

The wisdom, or folly, of adopting a national sales tax is outside the scope of this work. But it is important to note that a national sales tax would present serious issues for the states. One problem with adopting a federal sales tax is that it would seriously curtail the states' ability to collect their own tax. The states have considerable autonomy within the limitations of the Commerce Clause to impose the sales tax. That the federal government has traditionally refrained from taxing consumption (except for various excises) added to that autonomy. Should the federal government adopt a national sales tax, the national rate is expected to be so high that ability of the states to raise revenue under their separate tax would be severely hampered. Indeed, Gale (1998) estimated that a revenue neutral federal sales tax rate could be as high as 60 percent.

Moreover, a federal consumption tax would likely result in national rules governing state tax bases and rates. The states' ability to design their tax systems to meet the needs of the citizens and business community would be constrained.

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[24] Other federal tax reform proposals calling for levies on consumption include the so-called U.S.A. Tax, proposed by former Sen. Sam Nunn, D-Ga., and Sen. Pete Dominici, R- N.M. and a national retail sales tax proposed by Sen. Richard G. Lugar, R-Ind.

Moreover, the state personal income tax burden is partially offset by the fact the tax is deductible for federal income tax purposes for those taxpayers who itemize their federal return. Of course, only 26 percent of Americans itemize their federal returns. Yet that small percentage is among the most politically active segments of society. The benefit of the federal tax deduction inures to the people who are most likely to show their appreciation at the voting booth. There is no doubt that the availability of federal deductibility has contributed to the success of the tax.

Elimination of or serious alterations to the federal income tax presents serious problems for the states. As noted above, most states conform their tax systems to the federal income tax at least to some extent. Without federal conformity, much of the ease of compliance and administration that have led to the success of state income taxes would be eliminated (Sheffrin 1996). Moreover, much of the political acceptance of the tax would evaporate once the state income tax became the only levy withheld from pay.

In some sense the states would enjoy more autonomy and discretion if the federal government did not tax personal income. At the same time, however, the increased administrative and compliance costs have led most observers to conclude that the state income tax could not survive an end of the federal income tax (see e.g., Bucks 1995).

Moreover, a national sales tax raises the possibility of significant changes to the distribution of tax burdens. Because of the increase in overall tax rates on consumption, a revenue neutral national sales tax would shift the burden toward lower income taxpayers. One recent study found that the bottom 80 percent of taxpayers would face much higher taxes under a national sales tax (Gale 2004).

D. Federal intergovernmental grants

Another way that the federal government impacts state and local finances is through intergovernmental grants. In 2002, state governments received $317.6 billion in federal intergovernmental grants – 29.9 percent of total state general revenues, up slightly from 26.1 percent of total state general revenues in 1992. Local governments received just $43.0 billion in federal grants in 2002 – 4.3 percent of total local general revenues, up slightly from 3.5 percent in 1992. In the aggregate, state and local governments received $360 billion in federal intergovernmental grants – or 21.4 percent of total state and local general revenues, up slightly from 18.3 percent a decade earlier.

Federal intergovernmental grants reached a peak in relative importance in 1977 when they accounted for 21.9 percent of total state and local general revenues. The relative importance of federal grants declined for the next decade bottoming out at just 16.8 percent of total state and local general revenues in 1987. The relative importance of federal grants has been increasing slowly since 1987, nearly matching their 1977 peak by 2002.

More important than the relative importance of federal grants has been the dramatic shift in the composition of federal grants over the years. For example, as indicated in Table 16, 27.6 percent of federal grants to state and local governments in 1972 were for education programs, followed by income support programs which accounted for 26.3 percent of federal grants to state and local governments. Federal grants for health programs accounted for 17.5 percent of total grants to state and local governments; while federal grants for Medicaid accounted for 13.4 percent of total grants to state and local governments.

Table 16
Percent of Federal Grants in Aid to State and Local Governments by Function,
Selected Years

	1972	1982	1992	2002	2006 est.
Nat. Res. And Environment	2.2	5.5	2.2	1.4	1.4
Transportation	14.7	13.7	11.5	11.7	10.7
Education	27.6	18.4	14.8	12.8	13.2
Health	17.5	21.4	40.1	45.1	48.0
Medicaid	13.4	19.7	38.1	42.0	44.2
Income Support	26.3	25.3	25.8	23.2	21.0
All Other	11.7	15.7	5.6	5.8	5.8

Source: Compilations based on 2006 Federal Budget, Historical Tables, Table 12.3.

Over the intervening 30 years there has been a steady decline in the relative importance of education programs as their share of federal grants to state and local governments declined steadily to 12.8 percent in 2002. Similarly, there has been a steady decline in the relative share of federal grants for transportation purposes and a dramatic drop in all other grant programs after 1982. At the same time, there has an explosive growth in the relative importance of health grants, increasing from 17.5 percent of federal grants to state and local governments in 1972 to 45.1 percent in 2002 and a projected share of 48.0 percent by 2006. Increases in federal grants to states for Medicaid has driven the growth in the relative importance of health as a share of federal grants to state and local governments. Medicaid grants increased from 13.4 percent of total federal grants to state and local governments in 1972 to 42.0 percent in 2002 and are projected to increase to 44.2 percent in 2006. Grants for Medicaid have become much more important in the health area increasing from 77 percent of health related grants in 1972 to 93 percent of health related grants in 2002. Medicaid grants are the only category of federal aid projected to increase in inflation adjusted terms from FY 2000 to FY 2006 (Tannenwald 2002, p. 468)

State and local officials might be concerned about the extent to which Medicaid grants will continue to crowd out other program areas – increasing to a projected 44.2 percent of total federal grants to state and local governments by 2006. This concern is probably exacerbated by the increasing focus on homeland security and the record budget deficits of the federal government which raise questions about possible cuts in future federal grants.

E. Demographic changes and their impact on state and local finances

Like other advanced economies of the world, the United States is undergoing a shift toward an older society. Increased longevity and declining fertility, along with the post-war baby boom have contributed to the aging of the population (Auerbach and Lee 2001; Frey 1999). In 2000, only one state (Florida) had a 17.5 percent of its residents aged 65 or older; by 2030 44 states and the District of Columbia will be in this situation. (Lav, McNichol and Zahradnik, 2005, p. 60) As individual or household circumstances change because of aging, their needs and economic behavior also change. These changes have important implications for state and local fiscal behavior.

On the expenditure side of state and local budgets, for example, the positive association between health care costs and aging suggests that the demographic shift toward an older society is likely to create a rapid increase in both acute-care medical spending (Medicare) and nursing-home expenditures (Medicaid) (Cutler and Sheiner 2001). While the Medicare program is fully financed by the federal government, the states and the federal government, which matches state expenditures, jointly fund Medicaid. Currently, Medicaid covers services that Medicare does not, such as prescription drugs and long-term care. As a result, Medicaid pays for a growing share of health costs for the aged and disabled (Lav 2003). Taking together the aging of the population and the shift of costs from Medicare to Medicaid, without any changes in the Medicaid program, one can expect a growing fiscal burden on the shoulder of state governments in the decades to come.

In addition to health care costs, an aging population will have far reaching impacts on other state and local services. For example, older drivers account for a disproportionate share of accidents and motor vehicle deaths. In New Jersey, the elderly make up 13.7 percent of the population, but 25 percent of traffic fatalities. This adds to traffic congestion and delays. As a result, states will have to invest more in traffic safety including, among other things, enhances signage, longer highway on-ramps, improved sidewalk and crosswalk configurations, and longer signal timing. Similarly, local governments will need to consider mobility needs of older citizens and local transportation resources when considering site plans for new retirement and assisted living facilities (Connery and Bell, 2001, p. 9)

Since demographic characteristics determine the type of public services to be provided in a community, the national trend of an aging society would also impact the fiscal capacity of local governments (Frey 1999; MaCurdy and Nechyba 2001). MaCurdy and Nechyba (2001) suggest that the age makeup of a county's residents has a strong influence on its allocation of government spending on education, health, welfare, police and fire protection, and infrastructure. Identifying interjurisdictional spillovers[25] as the major "culprit" of local fiscal burdens, the authors argue that demographic changes at the local level may alter the types and sizes of spillovers encountered, which call for adjustments in intergovernmental transfers.

Frey (1999) highlights another impact of an aging population, which he refers to as the "demographic divisions" within today's elderly population and their implications for central cities and suburban communities. Despite the fact that today's older Americans constitute "the most highly educated elderly cohort in history", there are social and racial cleavages among the elderly population. For instance, female-headed households in poverty are more prevalent among seniors in their late 70s and 80s. Blacks and Hispanics fare less well than whites, judging by income, wealth and home ownership.

Frey (1999) also points out the spatial divisions within today's elderly population. Whereas the retirement haven areas, the sunbelt region, and suburban communities are able to attract or retain the "demographically advantaged" segments of the senior population (e.g. well-educated "young elderly, married couples in good health, with high disposable incomes and low demands on public services), central cities, inner suburbs and specific metropolitan areas will be populated by disproportionate numbers of the "demographically disadvantaged" elderly (e.g. oldest old, female-headed households, those with low-income and high levels of disability, and low-income minorities). The spatial distribution of elderly population, which Frey argues perpetuates the trend for the entire population as a result of "aging in place", indicates the potential for growing fiscal disparities between regions and between inner cities and suburbs. The wealthier and healthier elderly may contribute more to a locality's tax base than they take away. By contrast, the "older, economically vulnerable, and disability-prone populations" may exacerbate the situation of local governments that are already financially strapped. Frey further projects that as baby boomers age into elderhood, many of the suburban communities, with growing numbers of "demographically disadvantaged" boomers "aging in place", will be ill-prepared to deal with the social services, health care, and transportation needs of the less well-off seniors.

Apart from its impact on local public expenditures, population aging will also affect the revenue side of state and local budgets in a variety of ways. As discussed above, an aging population, which becomes more reliant on retirement income, will undercut the base of the income tax. In addition, Lav (2003) argues that states to which retired people move may suffer substantial revenue losses due to federal preemption of state authority to tax the pension income of non-residents, including deferred income earned when the individual became a resident. In fact, much of the deferred income is never taxed because the three major retirement destinations—Nevada, Florida, and Texas—do not collect personal income tax. In addition, income declines as people age – according to the U.S. Treasury Department, in 2000 the average income for people

[25] Goods and services provided by one jurisdiction that bestow benefits on residents of another jurisdiction result in spillovers. That is, the benefits of these locally provided goods and services "spill over" the boundaries of the jurisdiction providing such services and impact residents of neighboring jurisdictions.

over 65 and over was $25,200, about half of the average income of the 55-64 age group. (Lav, McNichol and Zahradnik, 2005, p. 64)

Similarly, as discussed above, the level and composition of spending by the elderly varies substantially from the non-elderly. Older households average annual consumption spending that is about one-third less than spending of households aged 55 to 64. (Lav, McNichol and Zahradnik, 2005, p. 64) In addition, it is important to note the increasing share of spending on health care products and medications of older households, which are typically not included in state and local sales tax bases. An aging population will tend to undermine the base of the sales tax as consumption shifts from taxed, to non-taxed items.

Finally, an aging population may tend to undercut the ability of local governments to mobilize revenues from the local property tax (Brunori 2003). With fixed income, senior citizens tend to oppose taxes in general and property taxes in particular because property taxes are based on the value of an asset, real estate, which tends to rise over time due to appreciation of property values, but the taxes have to be paid out of current income. Because of the perceived disconnect between tax paid and services received, the elderly may be increasingly unwilling to support elementary and secondary public education and are more likely to vote unfavorably on school tax issues.

In addition, many states provide varies types of property tax relief to the elderly. For example, the elderly, regardless of income level or ability to pay taxes, may receive some form of property tax exemption. Such exemptions erode the base of the local property tax. However, such exemptions may make it easier for seniors to vote for increases in local property taxes since they will not have to bear the full burden of any increases in local property taxes. Eleven states provide property tax exemptions or credits for the elderly without any means testing. (Lav, McNichol and Zahradnik, 2005, p. 64)

On the revenue side, the net result is that an aging population will tend to undermine the base of the income tax, the sales tax and the property tax. State and local governments need to re-evaluate some of the tax preferences given to the elderly with awareness that age alone is not a good proxy for ability to pay taxes.

In addition to an aging population, there are also spatial changes taking place in the distribution and composition of the population. Geographic quadrants of America grew at different rates over the past decade, the West and the South at 20 and 17 percent, and the Midwest and Northeast at eight and six percent (Perry and Mackun, 2001, p. 3). Normal population births, plus domestic and international migration into and between regions, fuel these growth rates.

As the population grows, it is also distributed across the landscape in changing ways. For example, contrary to the conventional view that suburbs are predominantly white, the decade between 1990 and 2000 witnessed the trend toward minority suburbanization (Fasenfest, Booza, and Metzger 2004; Frey 2001). As minorities make up about 27 percent of suburban populations, a mixed white and Hispanic/Asian population has replaced predominantly white communities as the most common neighborhood type (Fasenfest, Booza, and Metzger 2004). Frey (2001) labels the 35 metropolitan areas, whose suburbs had disproportionate gains of minority population, "melting pot metros."

In addition, the racial and ethnic composition of metropolitan areas began to change as more affluent blacks left the central city for suburban communities. Rapid economic growth and the availability of amenities have turned the South into a new magnet for blacks and the migration of young, college-educated blacks to the South also contributed to the region's surge in black suburban populations (Frey 2001; Frey 2004).

Immigrant-driven Hispanic and Asian population growth, helps account for the increased prominence of non-black minority populations (Fasenfest, Booza, and Metzger 2004; Frey 2001). Singer (2004) identifies six types of immigrant "gateways", among which "emerging gateways" (such as Atlanta, Dallas, and Washington D.C.) saw the fastest immigrant growth in the past two decades. Immigrants in emerging gateways are found to be more likely to live in the suburbs than in central cities, contributing to the diversification of suburban communities. Frey focuses on another type of immigrant gateway- states that are magnets for domestic migrant populations and for foreign-born migrants (Frey 2002, p. 2)

Intraregional mobility in the form of sprawl also influences state and local finances. Services provision costs increase as density falls, governments may pay a premium to expedite services provision, the distribution of the property tax base may be affected by sprawl, and fiscal costs may be associated with balancing social versus private costs (McGuire and Sjoquist, 2003, p. 322). This population mobility redistributes human capital and wealth, and shifts services needs.

As a result of the suburbanization of Hispanic and Asian populations, state and local governments will have to provide a different set of support services, including such things as translation and school expansion. In addition, the consumption patterns of different ethnic groups may be different which has implications for sales tax revenues for state and local governments. In the final analysis, the new pattern of migration and immigration will challenge the fiscal capacity of local governments by raising new demands for public services and by altering the tax base.

A baby boomlet driven by baby boomer parents has increased school-age populations with consequent impacts on school expenditures.[26] The baby boom generation – dwarfing in numbers their parents' and children's generations alike – comprises 28 percent of the population, pushing the 50-54-year age group to a 55 percent increase in the last decade (Meyer, p. 2) They spend differently, the wealthier ones seeking high-ticket items, but they may become an economic drain as they age

[26] Between 1990-2000, the 5-9 year olds age group and the 15-19 age group grew almost 14 percent, while the 10-14 age group increased almost 20 percent (Meyer 2001, p. 2).

and need social services into retirement (Frey, Abresch and Yeasting, p.9). The next largest cohort jump was a 45-percent bump in the 45-49-age group and the 90-94 age group.

About one-fifth of those 65 and over moved to a new residence during this five year period. By contrast, nearly half of those under 65 had moved during this same five-year time period. This made them more than twice as likely to have moved as their elders (Ile and Schachter, 2003, p. 2). Of those 65 and over, the oldest old [85 and over] moved the most, with one-third of the moving between 1995-2000, suggesting that failing health prompts moves to be near family or specialized health care. Most of those 65 and over will remain within their current state. Because the elderly who move do so to only a few states, Arizona, Nevada and Florida, the impacts of their moves are magnified.

In summary, as demographic changes in the nation's population emerge over time; they have strong implications for patterns of public expenditures and sources of revenues. Population aging creates fiscal pressures on all levels of government by undermining the base of state and local taxes while increasing pressure on state and local spending needs (Auerbach and Lee 2001).

F. Technological changes

The single greatest challenge to state and local public finance systems over the past two decades has been the rapid and profound changes in technology. The advent of the age of electronic commerce and the revolution in communications technology has affected virtually every aspect of state and local public finance.

The high-technology economy has changed the way state and local governments raise revenue. Technology is creating new business structures, new services, and more "remote" activities (Neubig and Poddar 2000). For example, the Internet makes it possible for relatively small businesses to expand their base and to sell goods and services throughout the world. These businesses are highly mobile and have few geographic constraints. Small and medium-sized businesses are no longer limited to local markets.

State and Local Sales Taxation

Nowhere has technology had a greater impact than in the area of state sales and use taxation. The sales tax has consistently accounted for about one third of state tax revenue. And it is the sales tax that is most affected by changing technology. Perhaps the most daunting issue facing state fiscal systems as we enter the new millennium is the treatment of remote sales. Remote sales (the sale of goods and services through the mail, over the telephone, and increasingly on the Internet) have troubled policy makers for decades. But with the advent of the age of electronic commerce the issue of remote sales has taken on a new significance.

In the now well known Quill decision[27], the United States Supreme Court concluded that a state cannot compel a vendor to collect sales and use tax unless that vendor has a "physical presence" in the state. Businesses that sell through mail order catalogs, via telemarketing, or through Web sites often do not have a physical presence in the state. Thus, they are not obligated to collect sales or use tax on the transaction and remit the proceeds to the state. The problem is that the success of the sales tax has been attributable in part to the requirement that the vendor has the responsibility for collection of the tax. Since the vendor is liable for uncollected or unremmitted tax, and since the state defrays some of the vendor's costs, compliance with the tax has traditionally been very high. Without vendor responsibility for collection, the sales tax could likely not survive.

Internet vendors without a physical presence in the state are not required to collect sales tax. As more consumers purchase goods and services online, the states will continue to lose tax revenue. In all states taxing sales, the consumer is legally obligated to pay use tax on all goods that were purchased without sales tax. But use tax compliance in the United States is very low. By some estimates only four percent of consumers who owe use tax actually pay the tax (Brunori 2001, and sources cited therein). Some states, however, are stepping up use tax collections efforts, for example, through inclusion of use tax lines on income tax returns. In 2000, North Carolina and Michigan improved collection efforts; the former saw collections rise to $4.9 million from $125,000 the prior year, while the latter increase payees by nearly 25 times from 2500 to 62,000 to net an extra $2 million.[28]

The primary concern for the states is that uncollected taxes from remote sales will cost billions of dollars and require dramatic reforms, significant service reductions, or steep rate increases for other taxes. Online sales reached $104 billion in 2003 (Bruce and Fox 2004). And analysts believe e-commerce will continue to grow. Indeed, some studies conclude that Internet retail sales alone will reach $230 billion by 2008 (Forrester 2004). That compares to just $9.8 billion in 1998 (Duncan 1999).

The states fear that remote sales will add to an already eroding tax base problem.[29] And those concerns are justified. Conservative estimates show that the states lost about $170 million in sales tax revenue in 1998 (Cline and Neubig 1999). That number grew to an astounding $15.5 billion in 2003 (Bruce and Fox 2004). More significantly, projections for lost sales tax revenue are as high as $33.7 billion in 2008 (Bruce and Fox 2004).

In addition to the potential revenue loss, remote sales pose other political and policy problems for the states. By failing to tax remote sales, the states create horizontal inequities between traditional in store purchases and transactions conducted via mail

[27] Quill v. North Dakota, 504 U.S. 298 (1992).
[28] Bell and Kay, "Use Tax Scofflaws Abound," Bankrate.com.
[29] Bruce and Fox found that the sales tax base as a percentage of personal income has fallen from 51.4 percent in 1979 to 42.8 percent in 1998 (2000).

order or the Internet. The perpetuation of this horizontal inequity goes against the principles of sound tax policy. In essence, the states have created an economic incentive to sell and purchase remotely -- i.e., at the expense of traditional retailers. This of course creates significant political issues for state policy makers. Traditional retailers have protested the fact that the state tax system places them at a competitive disadvantage in the market place (Brunori 2000).

Technological advances will continue to have profound effects on local government finance as well. The ability to purchase goods and services through the Internet has sharply reduced reliance on sales taxes. Although this problem is much more serious for state than for local governments, it calls into question whether local governments can view sales taxes as an adequate source of revenue. Local governments are expected to lose tens of billions of dollars a year in sales tax revenue (Bruce and Fox 2000).

State and Local Income Taxes

Technology will affect personal income and wage taxes as well. The age of electronic commerce has resulted in more people working from remote locations. The Internet, personal digital assistants, cell phones, and laptop computers allow employees in many industries to perform their responsibilities away from the employer’s main office. Remote workers may pose challenges to local governments relying heavily on wage taxes. Employees and employers may have opportunities to avoid wage and payroll taxes. If the local government imposes taxes according to the location where the employee performs work, such opportunities will certainly exist.

State and Local Business Taxes

Electronic commerce will also make it much more difficult to impose state and local business taxes. Technological developments have made businesses increasingly mobile. Businesses today are no longer as dependent on plants and equipment. Thus, relocating to another jurisdiction, while still a significant undertaking, is much easier today than it was a decade ago. This mobility will prevent expanded reliance on business taxes and will likely result in a continuing reduction of all local business taxes, as governments realize that such taxes are perceived to hurt their competitiveness. Local governments will not be able to rely on business property tax revenue to the extent they once did.

Property Taxes

To the surprise of many, the high-technology economy is also affecting local property taxes. When heavy manufacturing dominated the American economy, a large portion of the property tax base consisted of business land, plants, and equipment. Factories and heavy equipment, as well as extensive business ownership of land, have filled the coffers of local government for much of the 20th century.

Modern businesses, which tend to rely on computers and technology, have fewer plants and less equipment relative to large manufacturing firms (Bonnet 1998). These businesses do not own significant amounts of real property; this lack of ownership leads to a decrease in business property tax revenue (Strauss 2001). It also leads to a shift in property tax burdens from business to residential property (Strauss 2001).

The new economy creates another problem for the property tax. Capital-intensive firms (that is, those with relatively large amounts of plants and equipment) now incur a larger burden of the property tax than high technology or service-centered businesses (Green, Chevrin, and Lippard 2002). That inequity ultimately undermines support for the tax, particularly within the business community. Such inequities lead to calls for lower tax burdens on capital-intensive firms.

Most commentators agree that changing technology will increase the limitations on local taxing authority (Break 2000). For this reason, researchers have cited growth in technology as one of the major factors affecting American local governments in general, and cities in particular (National League of Cities 1997).

G. Multistate and Federal Efforts Addressing Electronic Commerce Taxation

Streamlining Sales Tax Project

In an effort to stem sales tax losses from remote transactions, state governments have participated in the Streamlined Sales Tax Project since its inception in 1999[30]. The Streamlined Project is a multistate project controlled by its participating states. Its purpose and objective are to design and establish, through state legislation, a voluntary, streamlined multistate system for the administration and collection of state and local government sales and use taxes. The project's primary design objective is to reduce the complexity and administrative burden currently borne by businesses in collecting use taxes in interstate transactions. After normalizing that burden on interstate businesses, the project's secondary objective is to secure the passage of federal legislation whereby Congress, acting under its Commerce Clause powers, would authorize the states participating in that streamlined tax system to require remote vendors to collect and remit use taxes imposed by those states and their constituent local governments. By authorizing such state laws, the federal law would override the rule sustained by the U.S. Supreme Court in Quill Corp. v. North Dakota.

The "Streamlined Sales and Use Tax Act" (SSUTA) (H.R. 3184 and S. 1736) was introduced in 2003 in the U.S. Senate and House of Representatives. The bills' primary sponsors are U.S. Sen. Mike Enzi, R-Wyo., and Rep. Ernest J. Istook Jr., R-Okla. The federal legislation would allow states already in compliance with the Streamlined Sales and Use Tax Agreement to require out-of-state vendors to collect state sales and use

[30] The Streamlined Sales Tax Project was not the first multistate effort to address the problem. The National Tax Association sponsored the Communications and Electronic Commerce Tax Project in 1997. And the federally chartered Advisory Commission on Electronic Commerce met in early 1999.

taxes. Currently, collection by remote sellers is only voluntary according to the model legislation enacted by 21 states to implement the simplification criteria necessary to earn membership in a multistate sales tax collection compact. The target date for getting the compact's governing board up and running is October 1, 2005.

Currently, 42 states are involved in the SSTP, and as of July 1, 2004, 21 states have passed legislation to bring state sales tax laws into compliance, or at least partial compliance, with the Streamlined Sales and Use Tax Agreement. States cannot become members of the SSUTA until they amend their tax laws to comply with the SSUTA. None of these states have yet been certified as being in compliance. Following is a list of these states, taken from the SSTP's Web site. For most of these states the SSTP has published an effective date for the amendments to the tax law. If there is no effective date indicated, the SSTP did not publish one.

Arkansas, effective when SSUTA becomes effective
Indiana, effective January 1, 2004
Iowa, effective July 1, 2004
Kansas, effective July 1, 2003
Kentucky, effective July 1, 2004
Michigan, effective September 1, 2004
Minnesota, effective January 1, 2004
Nebraska, effective January 1, 2004
Nevada, effective July 1, 2003
North Carolina
North Dakota, effective December 31, 2005
Ohio, effective January 1, 2005
Oklahoma, effective November 1, 2003
South Dakota, effective January 1, 2004
Tennessee
Texas, effective October 1, 2003/July 1, 2004
Utah, effective January 1, 2004
Vermont
Washington
West Virginia, effective January 1, 2004
Wyoming

Internet Tax Freedom Act

In 1998, the U.S. Congress passed the Internet Tax Freedom Act that provided a three-year moratorium on all “new” and “discriminatory” taxes on the Internet. The primary effect of the legislation was to prohibit states and local governments from imposing taxes on Internet access. In 2001, Congress voted to extend the moratorium for two years. The moratorium expired in October 2003. In December 2004, President Bush signed legislation extending the moratorium until November 2007.

The latest legislation was held up because of problems with defining Internet access. Many members of Congress feared that voice over Internet protocal (VOIP) would be bundled with Internet access services, allowing charges for long-distance telecommunications to fall into the tax-free zone. The controversy over VOIP was avoided when Congress agreed to exclude VOIP from the definition of Internet access.

H. Interjurisdictional competition and the proliferation of tax incentives

One of the most significant influences on state and local tax policy is the interstate and intrastate tax competition for economic development. Since the beginning of the Republic, state and local governments have competed for economic development in the form of investment and job creation. Tax policy has played a large role in that competition. Indeed, political leaders have viewed tax policy for much of the last quarter century as the key to encouraging economic development. Tax laws, or more accurately tax benefits, are used to lure corporations into a jurisdiction or convince corporations to stay. Taxes are also used to encourage in-state companies to expand through investment in plant and equipment, as well as to encourage business to expand their workforce through additional hiring.

The role of taxation in interstate and intrastate competition for economic development has been studied and debated for years. Indeed, there are volumes written on virtually all aspects of competition among state and local governments (see generally, Schweke, et. al., 1994, Kenyon and Kincaid 1991, Lynch 1996). Most of the literature has a decidedly negative tone with respect to interstate tax competition. The policy choices that result from interstate tax competition are thought to violate one or more of the principles of sound tax policy (see generally Brunori 1997).

There are three concepts important to understanding interstate tax competition for economic development. First, interstate competition in general, and tax competition in particular, is a fact of life in the United States. It has continued unabated for hundreds of years. Political leaders implement policies that they perceive will benefit their citizens and businesses. The more attractive those policies, the more likely citizens and business will remain in or locate to the state. And as long as the states enjoy even a small amount of sovereignty over their public affairs they will set policies that inevitably retain or attract people and business.

Second, not all forms of interstate competition are equal. Some types of competition are desirable since they promote innovation, productivity, efficiency, and/or responsiveness. Such desirable competition includes providing an attractive package of public services (presumably better than those offered in neighboring states) while imposing an overall tax burden in line with those imposed by other states. If competition is inevitable, as history suggests, it is up to state lawmakers to decide which form that competition should take.

Third, there is a political bias in favor of the most pernicious type of competition: the use of targeted tax incentives. This form of competition involves granting tax breaks to individual companies to move to or remain in a state. Such tax incentives are inequitable, inefficient, and largely unnecessary. They violate virtually every principle of sound tax policy and good government. (Brunori, 1997) Public officials and academics alike routinely criticize targeted tax incentives. Yet they have proliferated in the past quarter century, and are offered in what could be called epidemic proportions.

Why State and Local Governments Compete

As noted above, interstate and intrastate competition in general and tax competition in particular is almost inevitable. The competition is premised on the belief that government policy influences, at least to some degree, where people live and work. It is also based on the premise that individuals and business are cognizant of the tax burdens imposed and public services provided by other states. In this atmosphere, competition is driven by state sovereignty, a changing economy, and the political pressure to create jobs. Each of these causes is discussed below.

States as Sovereigns

The principal cause of the never-ending battle between the states for economic development is the structure of the federal system of government. In essence, the states have autonomy to govern as they wish within the limits imposed by the federal and state constitutions. Their significant sovereignty provides to states the ability to set policies that will make them more attractive to business and industry than the policies offered by other states. In this atmosphere, the system is ripe for competition. There are few outside limits on the ability of a state government to tax and spend. While the Commerce Clause prevents states from being overly aggressive in their efforts to compete, its prohibitions are generally limited to insuring that states do not impose tax burdens on out of state companies and transactions that are greater than the burdens placed on in state companies and transactions.

The Changing Economy

The federal system itself provides the forum for state tax competition for economic development. There are other factors, however, that contribute to an atmosphere that virtually insures such competition. After all, the federal system has been in existence for more than 225 years, but the use of tax incentives has increased dramatically only in the past quarter century.

One factor in the increasing prevalence of interstate competition is the changing world economy. In the not too distant past, most American business was centered on the manufacture of tangible personal property and the production of agricultural products. Transactions were generally conducted within a radius of one or a few states. Most importantly, capital was largely immobile. The means of production (factories and farms) could not be moved easily from one state to another. Thus, while there is evidence of competition dating back to the beginning of the nation, the likelihood of attracting significant capital and investment did not materialize until well into the 20th Century.

The changes in the world economy are obvious. The service industry has replaced manufacturing as the dominant part of the American economy. One of the hallmarks of the service industry is that it relies far more on human capital and intangible property (copyrights, patents, trademarks) than traditional manufacturing industries. The age of electronic commerce has further changed the business landscape as companies increasingly create, market, and sell goods and services through the Internet. Plant, equipment, and land, the inputs most difficult to move, are insignificant components of the electronic economy.

An economy built on mobile capital and intangible property is far more likely to be the subject of interstate competition. High technology and service companies can relocate to other states at much less cost than traditional manufacturing companies.

The Quest for Jobs

In the federal system and new economic order described above, states will inevitably compete -- if the object of the competition is worthwhile. The object of interstate competition for economic development is jobs.

Politicians have always looked at job creation as one of their primary responsibilities. Today, civil service and government contract reforms have significantly curtailed the use of patronage in American public life. But the lure of creating jobs still remains. One relatively efficient and effective means of creating jobs is to provide incentives for established companies to move into the state. Indeed, commentators have long noted the relationship between the political pressure to create jobs and interstate tax competition (Wolman 1988; Walker 1989).

A political leader's ability to create jobs through economic development incentives is far greater than under the old patronage system. In the traditional system there were inherent limits to the number of jobs that could be created. But political leaders can provide, or at least give the impression of providing, thousands of jobs through a single incentive agreement.

Not all Tax Competition Is Equal

Contrary to some of the negative literature on interstate tax competition, there are some positive aspects to such competition. Indeed, most commentators and scholars generally view competition with respect to overall state tax levels positively. In this form of competition, states measure the attractiveness of their business climate by comparison to the overall tax burden to those in surrounding states or those with which they feel in "competition" for business development.

As Duncan (1992) has noted, insuring that one's state does not "stand out" from other states in terms of rates, burdens, or compliance costs promotes many aspects of sound tax policy. Such evaluation often leads to a balanced tax system or at least protects against serious imbalances. It promotes stability in the tax system. It can also promote broad-based, low-rate tax systems, which is thought necessary to sound tax policy.

In its most broadly accepted form, interstate competition involves the use of a variety of means, including tax policy, to develop an attractive mix of public services at a reasonable cost to taxpayers. As such, states attract people and business by providing quality transportation, public safety, and education systems while still keeping their tax burdens in line with other states. Fearing migration, states cannot increase tax burdens substantially beyond those imposed by their neighbors (Musgrave 1959, Oates 1972).

John Shannon (1991), one of the leading thinkers on federalism and interstate competition, has noted that in this type of competition states act like ships in a wartime convoy. The states cannot risk getting too far out in front of their comrades by raising tax burdens, nor can they afford to fall too far behind in providing public services. Individuals and firms evaluate the costs (taxes) and benefits (services) of living or doing business in a jurisdiction. If costs outweigh benefits, then the individual or firm will opt to live or conduct business in a more favorable environment.

Most importantly, this form of interstate competition is generally accepted, even endorsed, by many public finance experts (Duncan 1992) and political theorists (Kincaid 1991) as promoting innovation, responsiveness, and efficiency.

That is not to say that there are no negative connotations to this type competition. While seemingly benign, this type of interstate competition likely reduces the progressivity of state tax systems. If the premise upon which tax competition is based is true, firms and households will locate in states in which public benefits outweigh tax costs. But in general only wealthy individuals and firms have the means to relocate -- a fact well known to most policy makers. To attract (or retain) wealthy firms and households, states adjust their taxes and services accordingly (Reschovsky 1998). Tax liabilities for those on the top of the economic spectrum are thus held in check. But at the same time demand for quality public services must be met. Thus, such competition forces the tax burden downward toward those firms and households perceived to be less likely to leave the jurisdiction.

Nonetheless, this general type of interstate tax competition despite its subversive effects on tax equity is far more attractive from a policy perspective than the alternative discussed below.

Targeted Tax Incentives

The most criticized, and pervasive, form of competition involves granting "targeted tax incentives" to specific companies. Targeted tax incentives are those laws that provide preferential tax treatment to a limited number of taxpayers and are not readily available to taxpayers in general. Such incentives offer special tax treatment to specific companies in return for some specified business activity in the state. These incentives often include property tax abatements, sales and use tax exemptions, job and investment credits, and accelerated depreciation deductions.

Targeted tax incentives should not be confused with general tax policies applicable to broad segments of the business community. Rather, the incentives are aimed at one or several corporations. The states providing the incentives want the recipient company to locate, expand, or remain in the state.

Targeted tax incentives are often offered as part of a general revenue law that allows any business meeting certain requirements to qualify for the special tax status. Actually, however, these "general" statutes benefit only a few companies. For example, the Virginia major facility job tax credit enables individuals, estates, trusts, and corporations that engage in "qualifying industry" to receive an income tax credit of $1,000 for each job created in excess of 100 (Va. Code section 58.1-439).

Targeted tax incentives have proliferated over the last quarter century as states have stepped up efforts to spur economic development and create jobs. There are literally hundreds of such incentives granted each year, costing hundreds of millions of dollars. Despite a legion of scholarly articles and reports criticizing their use, targeted tax incentives remain a favorite weapon in the battle for economic development. Companies need only hint at the possibility of relocation or expansion, and state governments quickly descend with offers to pay for infrastructure improvements, help with job training, and provide numerous tax breaks.

In the past 25 years, states have increasingly used targeted tax incentives to persuade companies to relocate to or remain in the state. Such incentives have entailed billions of dollars and have usually been offered to the largest multinational corporations. Table 17 lists the largest tax incentive packages from 1980 to 2004, illustrating the kinds of companies that receive incentives and the general magnitude of the programs.

Table 17
The Largest Tax Incentive Packages
1986-1996

Company	State	Dollars (in millions)	Jobs Created	Year
Sears	Illinois	240	5,500	1986
Toyota	Kentucky	150	3,000	1988
Diamond Star	Illinois	118	2,900	1988
Saturn (GM)	Tennessee	70	3,000	1990
United Airlines	Indiana	300	6,000	1992
BMW	South Carolina	170	1,900	1992
Mercedes	Alabama	253	1,500	1993
Dofasco	Kentucky	140	400	1994

Every year, states offer incentive programs to specific companies in the hope of creating jobs and are willing to spend an increasingly greater amount on a per-job basis. In 1980, Tennessee offered Nissan $33 million in incentives to create 3,000 jobs, or $11,000 per job (Milward and Newman 1989). The cost per job rose to about $26,000 in 1984 when Tennessee offered General Motors $80 million to build a Saturn plant employing 3,000 (Milward and Newman 1989). By 1992, South Carolina offered BMW $170 million to create 1,900 jobs, or about $89,000 per job (LeRoy 1994). In 1993, Alabama offered Mercedes-Benz over $250 million to create 1,500 jobs -- well over $150,000 per job (Schweke, Rist, and Dabson 1994). In 1994, Dofasco Inc. received nearly $140 million from Kentucky to create 400 new jobs, nearly $350,000 per job (LeRoy 1994).

According to one recent study, state and local targeted tax incentives totaled $48.8 billion in 1996, with half of that amount attributable to property tax incentives (Thomas 2000). Other more targeted studies show similar results. In 1996 alone, two Ohio cities combined—Cincinnati and Columbus—offered more than $600 million in property tax abatements to specific businesses (Thomas 2000).

Why State and local governments Use Targeted Tax Incentives

States utilize targeted tax incentives in part because the more benign types of competition (low tax rates and good services) are not perceived to work, as quickly as political leaders would like. Targeted tax incentives have provided a relatively new and expedient method of creating jobs. Many types of public services (transportation and education systems in particular) often require years to develop or improve. States, or more appropriately state political leaders, often do not want to wait for those public sector improvements that might entice a corporation to locate to or expand in the state. As history illustrates negotiations for and approval of tax incentives can be accomplished in a matter of months. Targeted tax incentives are linked inextricably to the desire of state political leaders to move quickly in matters of economic development.

Moreover, once states begin bidding for companies, there is much pressure to "strike first," to make the offer of an incentive package before competing states have the chance (Noto 1991). There often develops an "arms race" mentality in which governments feel the need to develop incentive strategies because other states are doing so (Grady 1987). Finally, where companies are being lured away, states feel they must act defensively to ward off the challenge and retain their industry (Grady 1987). Many states have developed policies, usually implicit, whereby they automatically match or exceed offers of tax incentives made to corporations by other states.

Notably, when state legislatures adopt property tax exemptions state political leaders often promise to reimburse lost revenue to the local government. But rarely do the state governments follow through with enough funds to cover the losses attributable to property tax incentives (Brunori 2001b).

Public finance experts have long noted that the proliferation of tax exemptions in the name of economic development has proved a major challenge to the property tax, significantly reducing reliance on the tax. As one noted commentator has observed, the need to create jobs and the negative appearance of "doing nothing" are simply too great to cause states to quit joining such bidding wars (Duncan 1992, 269). Because of this fear of "doing nothing," political leaders have essentially ignored the criticism. Tax policy, at least as far as targeted tax incentives are concerned, is a matter of political expediency.

I. Affect of Boom and Bust Cycles on State and Local Revenues

State and local governments experienced significant budgetary pressures as a result of the recession in 2001. According to Dye, real per capita state tax revenues saw zero growth in FY 2001 overall and a majority of states experienced a decline in revenues. The problem became much worse in FY 2002 when there was a 7.3 percent decline in overall real per capita revenues and 46 states experienced actual declines. The problem for state governments persisted in FY 2003 with a 2.6 percent overall decline and 39 states experienced falling real per capita revenues (Dye 2004, p. 133). In fact, the decline in state revenues after the 2001 recession was unmatched in the last 50 years and the decline was not a result of an anomalous pre-recession growth in revenues (Giertz and Giertz, 2004).

Not all states, however, were impacted the same way during this period. For some states, the dual recessions of the early 1980’s were associated with larger revenue declines (Giertz and Giertz, 2004, p. 112). This is not surprising given the variation in the impact of a recession across states depending on their economic structure, the differing revenue mixes across states, and the differential impact changing economic circumstances have on the tax collections of specific taxes across states. As a result, there are too many things that can happen in a given state in a given year to change the structure of the relationship between economic activity in the state and actual tax revenues collected. Added to this is the general lack of political will to engage in major tax-mix changes, rainy-day funding or the fiscal discipline that would significantly smooth revenues over the business cycle (Dye 2003, p. 143).

In this context, there are those who argue for a variety of automatic or semi-automatic strategies to force policy makers to prepare for and deal with the impact of business cycles on state and local revenues. Such strategies include, but are not limited to, expenditure growth limits, rainy-day funds, budget rules limiting discretionary tax and spending changes, and the like. Giertz and Giertz conclude that such measures would not have mitigated the impact of the 2001 recession on state revenues. They argue that while such proposals are put forward in the name of promoting fiscal stability over the business cycle, they often have other intended purposes. For example, conservatives argue for expenditure growth limits as a means to reduce the relative size of government. Similarly, liberals may promote the idea of stabilization funds as a means of protecting the tax base against permanent tax cuts during expansions (Giertz and Giertz, pp. 130-31). One possible response to stabilize revenues during periods of economic downturn would be to reassess the role of local property taxes in the state/local revenue system since property taxes weathered the 2001 recession much better than the income or sales taxes (Giertz and Giertz, p. 131).

J. International effects

In the high tides of globalization, state and localities have to cope with competition from both within and outside the country. Declining governmental trade barriers, lowered communications and transportation costs, and increased individual and capital mobility have fostered the rapid growth of international trade. To compete for foreign investment, states and localities may choose to stimulate economic development at the expense of tax revenue. Aside from tax incentives offered by state and local governments, tax exemptions are often available to foreign companies through international trade agreements and treaties.

Tax incentives by foreign governments and lower production costs in developing countries also attract businesses to branch out overseas, making interstate or inter-city competitions more strenuous (Cohen 2000; Hira 2004). As state and local taxes depend heavily on location, businesses may strategically choose their location or relocation to avoid taxes (Fox and Luna 2002). Offshore outsourcing provides an alternative to moving within the states. Hira (2004) reports that the number of companies announcing expansion of overseas operations is accelerating and so is the number of white-collar jobs moving offshore. Attracted by lower wage rates for highly educated workers many high-technology businesses are downsizing their domestic workforce and moving research and development as well as production overseas. As a consequence, states with relatively high concentrations of technology workers have been disproportionately affected by persistent unemployment. The unemployment of large numbers of high-wage workers implies an extended drop in tax revenues (Hira 2004). The tax base may be adversely affected even when these workers are re-employed in lower wage professions and when off shoring creates a downward pressure on wages for technology occupations as a whole.

Faced with such international competition, state and local governments will have to compete more aggressively for businesses and jobs. As a result, they will face limited autonomy in fiscal decisions as it becomes more difficult to tax mobile factors of production. In fact, there is some preliminary evidence that firms do respond to such differential tax treatment of mobile factors of production (Grubert 1997; Hines 1999). In addition, the ability of companies to move capital easily and to sell products and services around the world will make compliance and administration of state and local taxes more expensive and difficult, especially on mobile bases (Brunori 2001; Brunori 2003). As a result of such competition, there may be downward pressure on tax rates as well as a shift from taxes on mobile factors of production to immobile factors – e.g., the local property tax.

Finally, globalization may provide opportunities for some state and local governments as well. Since factors of production are more mobile, states that provide a high quality package of public services at a reasonable tax price may successfully compete for economic activity.

K. School Finance Equalization and the Property Tax

Traditionally, paying for elementary and secondary school education was primarily the responsibility of local governments. In meeting this obligation, local governments relied almost exclusively on the property tax. Throughout the 20th and into the 21st Century, the property tax has accounted for 80 and 97 percent of own source revenue for independent school districts (U.S. Census).

Over time, there increasingly arose concerns with equity issues of relying so heavily on property taxes to fund K-12 education. The specific concern centered on the fact that wealthier jurisdictions had a much larger property tax base, allowing them to pay more for teachers, buildings, computers, and other resources than poorer communities. Consequently, wealthier communities could spend more money per capita on their children's education than could poorer cities and counties. That greater spending often translated into better schools.

Forty-nine states have education provisions in their Constitutions.[31] In the past three decades, advocates for poor school districts have used these state constitutional provisions to challenge the inequality of public education finance. In a 1971 landmark ruling, Serrano v. Priest, the California Supreme Court declared the state's public school finance system illegal under the state constitution.[32] That court decision triggered a nationwide debate on education finance and numerous efforts to equalize school finance. By 2004, citizens had challenged the constitutionality of using property taxes to

[31] The only state without a constitutional guarantee of education is South Carolina, which repealed its provision in the wake of Brown v. Board of Education.
[32] Challenges to school financing in federal court have largely been unsuccessful since the Supreme Court's 1973 decision in *San Antonio v. Rodriquez* that education was not a fundamental right under the Constitution.

finance education in 40 states. In 18 states, plaintiffs seeking to change the way schools are financed were successful.

It should be noted that the nature of the state challenges have changed over time. The first court cases dealt primarily with equity issues, i.e., the disparities in funding between rich and poor jurisdictions. The premise of those lawsuits has been that relying on property taxation to finance education unfairly disadvantages students who live in districts in which there are relatively low levels of property tax wealth. Because voters in districts with relatively low property tax wealth must levy a higher rate to raise the same revenue as compared with voters in districts with relatively high property tax wealth, there is a natural tendency toward inequality in educational expenditure across districts. While all states provide some funding to equalize spending, the lawsuits contend that state funding does not provide sufficient equalization.

Since 1989, the court cases have dealt mainly with adequacy issues, i.e., whether the state is providing a basic level of funding to insure a proper level of education. The premise of those lawsuits has been that the state is not providing adequate levels of funding to satisfy the constitutional requirements of an adequate education.

These lawsuits, both successful and unsuccessful, have prompted state legislatures to reform their educational financing systems. The result of these reforms has been that a higher percentage of funding for education has been undertaken at the state level. Econometric studies show that, while general school finance reforms do not necessarily reduce total educational spending, reforms that rely on increasing the state share of school spending do tend to depress spending. Moreover, the states that tried to equalize spending by providing incentives for poor districts to spend more were generally less successful in reducing inequalities.

William Fischel (1989) first drew attention to the link between school finance reform and property tax revolts with his provocative thesis that Proposition 13 in California was "caused" by Serrano v. Priest, a successful equalization lawsuit in California. As a result of this ongoing litigation, the California Supreme Court in 1976 mandated that the legislature reduce inequalities in per-student spending across districts to within $100 of the state mean. Fischel argued that this ruling destroyed the previous political and economic equilibrium in the state. Prior to this ruling, citizens would choose to locate in the jurisdiction that offered the combination of taxes and public goods (especially education) that they desired and that they could afford. High-income residents of the state who desired high- quality public services would locate in communities that would vote for high property taxes and high spending. After Serrano, taxpayers could no longer raise property taxes to increase spending on their own school but would have to increase funding for all school districts within the state to increase their own local spending. As a result, the marginal benefit of paying property taxes was significantly reduced, and the rationale for local property taxation was undercut. High-income communities (which were paying substantial property taxes) no longer had an interest in supporting a decentralized property tax system. The result, according to

Fischel, was Proposition 13, the landmark tax limitation measure. Fischel's theory is consistent with the notion that education finance reform efforts draw much support from antitax activists who see the movement to centralize education finance as a means of lowering overall tax burdens (see generally Youngman 1997).

The political support for the local property tax system is severely undercut if the local property tax cannot be used to finance additional education spending within a community.

The Results of School Finance Litigation

Courts have ordered states to "equalize" funding of schools between rich and poor communities. The states have usually reacted by earmarking certain statewide taxes to pay for public schools. For example, Michigan imposed an additional one percent statewide sales tax to pay for virtually all public school expenses (and tied that tax increase to a dramatic cut in the property tax). In 1999, New Hampshire adopted a statewide property tax. The tax was collected locally, remitted to the state, and then redistributed to poorer communities. In 1997, Vermont, through Act 60, imposed a similar statewide property tax, which required localities to remit a portion of property tax revenue to the state for redistribution. In 1993, Texas enacted the so-called Robin Hood law, which required wealthier school districts to remit a portion of their revenue to the state for redistribution to the poor. The shift to statewide property taxes has proved to be politically divisive (Brunori 2001). The controversies stem from the fact that the property tax can fund local governments, but it generally fails politically as a means of redistributing wealth.

Conclusion

State centralization of school finance has reduced reliance on the property tax. State funding of schools has also made it more difficult for local governments to raise taxes in general, and property taxes in particular (Bowman, MacManus, and Mikesell 1992). Research by Bahl, Sjoquist, and Williams (1990) shows that school finance litigation has led directly to decreased reliance on the property tax. Less reliance on the tax means policymakers have less rationale for supporting the property tax (see Break 1995, 2000; Sexton and Sheffrin 1995; Sokolow 1998).

As Sheffrin (1999) notes, "School finance litigation is the single most important factor affecting property tax today. It ultimately undercuts the rationale for the property tax as a truly local tax. In my view, homeowners were willing to pay higher property taxes if they were convinced that this would lead to quality schools. The school finance litigation movement essentially breaks this tie."

L. Summary

A number of trends, generally beyond the control of state and local policy makers impact revenue raising needs and spending requirements. Based on the discussion in this section, a number of major trends and their likely impact on state and local fiscal policies is summarized in Table 18.

Table 18
Summary of Trends Impacting State and Local Fiscal Policies

Trend	State/Local Revenues	State/Local Expenditures
Erosion of trust in government	Undermines ability of government to raise funds through general taxes	
Federal Mandates		Unfunded mandates put pressure on state and local spending, especially in the area of health care and homeland security
Federal Tax Policies	Undermines state (and to lesser extent local) efforts to raise taxes, especially income and sales taxes, and is forcing states to decouple from federal government	
Federal Intergovernmental Grants		Shifting emphasis toward Medicaid while all other aid categories decline in relative importance
Demographic Changes	Undermines ability of state and local governments to raise tax revenues – especially income, sales and property taxes	Puts added pressure on state and local spending – particularly health related categories, but other categories as well
Technological Change	Undermines state and local efforts to raise revenue from sales and income taxes, as well as the local property tax	
E-commerce	Undermines state and local governments ability to raise revenues from sales taxes	
Interjurisdictional Competition	Puts pressure on state and local governments to keep taxes low	Puts pressure on state and local governments to keep spending low, except maybe for infrastructure services vital to economic growth like education and transporation
Targeted Tax Incentives	Undermines ability to raise local taxes, especially the property tax	
Globalization	Undermines ability of state and local governments to raise taxes	Puts pressure on expenditures, especially in infrastructure services needed to compete with other jurisdictions
School Finance Reform	Undermines legitimacy and acceptance of local property taxes	Can lead to declining quality of education services

The cumulative impact of these trends can be devastating for state and local governments as they come under increasing pressure for spending and face increasing resistance to raising general taxes. Specifically, the more of these trends a state confronts, the more likely it is the state will face serious structural gaps in its budget. Lav, McNichol and Zahradnik have rated states on the likely severity of their structural budget problems based on how many of ten specific trends a state faces. For example, they argue that Alabama is one state facing a high risk of structural deficits in its budget because

- it has experienced a larger-than-average decline in the breadth of its sales tax base;
- it has a greater-than-average loss resulting from e-commerce;
- its income tax has low progressivity;
- it provides preferences to seniors in its income tax;
- it has a greater-than-average share of residents on SSI and students with special needs;
- it has limitations on property taxes;
- it remains linked to the federal phase-out of the estate tax; and
- it requires a supermajority in the legislature for raising many of its taxes.

Overall, they find that 27 states face 7 or more of the ten trends they identify. They identify 11 states that face nine or 10 of the trends they discuss giving them the highest risk of facing structural deficits in their budgets – Alaska, Arkansas, Colorado, Florida, Nevada, New Mexico, Pennsylvania, South Carolina, Tennessee, Texas and Wyoming. (Lav, McNichol and Zahradnik, 2005, Figure 5, p. 84)

VI. Recent State and Local Policy Changes Affecting State and Local Fiscal Structure

A. Tax and expenditure limitations

In the past quarter century, there has been the myriad of constitutional and statutory limitations placed on the state and local tax systems, particularly pertaining to the property tax. As of 2002, 44 states had some restrictions on the ability of state and local governments to impose taxes. The initiative process, which arose in part out of citizens' unhappiness with the tax, spawned many of the limitations; 58 different ballot initiatives aimed at reducing property taxes were put before voters between 1979 and 1984 (Sexton and Sheffrin 1995).

Tax and expenditure limits take several forms. The most common forms of limitation are rate limitations. For example, as of 2002, 33 states have imposed property tax rate limitations (for a list of states with property tax rate limitations, see Appendix A). These laws prohibit the imposition of rates over a predetermined level. The most notable rate limitation was established in California by Proposition 13 in 1978, which set the maximum property tax rate at one percent. Rate limitations are thought to reduce local government reliance on the property tax (see Brunori 2003 and sources cited therein).

States also impose property tax revenue limits. As of 2002, 32 states had (or have had) such limits as part of their statutory or constitutional law. (For a list of states with property tax revenue limits see Appendix B). These laws prohibit property tax revenue increases from exceeding certain levels. Property tax revenue limitations take two forms. Some states require a reduction in property tax rates if property tax revenues exceed a certain amount. Other states require reductions in property tax assessments when property tax revenues exceed a certain amount. The property tax revenue increase limits vary from two percent in Arizona to 15 percent in Delaware (Brunori 2003).

Another form of tax and expenditure control are property tax assessment limitations. Property tax revenue is a function of assessed property values. During times of high real estate inflation, property values and hence property tax burdens have the potential for dramatic increase. This contributes to the public's unhappiness with the property tax, particularly among low and fixed income homeowners. Assessment limitations are a means of controlling assessments. As of 2002, eight states have enacted assessment limitations. These states are listed in Appendix C. The most noted property tax assessment limitation was imposed by California's Proposition 13 which limited increases in assessed value to two percent a year.

Expenditure limits have been enacted by eight states (listed in Appendix D). These limits, all constitutionally mandated, place caps on the amount local governments can spend during a fiscal year. The caps limit growth in spending to a certain percentage over the previous year. The percentages are often indexed to inflation or population growth.

There are two other indirect methods for controlling tax and expenditure growth. In twenty-two states there are disclosure laws governing the enactment of tax increases of any kind. These states are listed in Appendix E. These laws require some level of public notice and public hearings before a legislative vote takes place on a tax or levy increase.

A more significant limitation on taxation is the enactment in sixteen states of legislative supermajority requirements. Supermajority requirements are constitutional mandates that require more than 50 percent majority of the legislature to approve a tax increase or adopt a new type of tax. Proponents of supermajorities believe that requiring a greater than majority vote will make it harder for state legislators to raise taxes (See Appendix F).

The Modern Tax Revolts

The public's dislike of the property tax is well known (Brunori 2003 and sources cited therein). That dislike combined with a growing cynicism and distrust of government lead to one of the most significant public finance developments in American history -- the tax revolts of the late 1970s and early 1980s.

Proposition 13 and its progeny not only dramatically changed property taxation but also were a defining moment in the public's attitudes toward taxation in general in the United States. The tax revolts changed the way many local governments raised revenue. But they also signaled the beginning of a new and decidedly anti-tax political philosophy that continues to this day.

Proposition 13

The causes of Proposition 13 were varied. The public was frustrated by continuously rising property tax burdens. California real estate values were increasing 25 percent a year in the decade before passage of Proposition 13. The public was equally frustrated with local government leaders that refused to lower tax rates and state government leaders who refused to offer relief. In the years leading up to Proposition 13, the state of California enjoyed multibillion budget surpluses. Political leaders around the state were aware of the property tax problem for at least a decade before 1978.

Another cause for Proposition 13, and indeed other property tax protests, was school finance litigation. In 1972, the California Supreme Court held (in Serrano) that the system of financing education through local property taxes was unconstitutional. The court ordered that the state assume the primary role in financing the schools. That decision had the effect of diminishing public support for property taxes and is arguably one of the reasons for the public's willingness to approve Proposition 13 (Fischel 1989).

On June 2, 1978, two thirds of California voters chose to radically reduce and limit property taxes in the state. Proposition 13 rolled back assessment values to 1976 levels. It limited increases in assessed value to two percent a year as long as the property was not sold. It imposed a one percent limit on the property tax rate. The measure also required that all state tax increases must be approved by a two-thirds vote of the legislature and that all local tax increases be approved by a vote of the electorate.

The effect was dramatic. Property tax revenue immediately fell by 57 percent across the state. Local governments in California collected over $6.6 billion less in property tax revenue in 1979 than they did in 1978. California property taxes went from being 51 percent above the national average in 1978 to being 22 percent below the average in 1981.

Idaho

Less than six months after the passage of Proposition 13, Idaho voters had the opportunity to decide the fate of their property tax system. Idaho was not a likely candidate for a tax revolt. The state enjoyed a relatively low property tax burden. But in the preceding decade, property tax liabilities rose sharply particularly for residential owners. The Idaho Supreme Court had forbidden the use of separate assessment ratios for residential property and the homeowners' share of the property tax burden had rise from 24.5 percent in 1969 to 44.5 percent in 1978. In November 1978, Idaho voters overwhelmingly approved a one percent property tax rate limit, as well as a limit on assessment increases of two percent a year.

Massachusetts Proposition 2 1/2

That Massachusetts would follow California in the property tax revolt is not surprising. In 1980, Massachusetts had the highest effective property tax rates on single family homes and the highest property tax rates as a percentage of state personal income. Efforts during the 1970s to provide property tax relief repeatedly failed.

Proposition 2 1/2 passed in 1980 with 59 percent of the vote. The measure limited the property tax levy for each city and town to 2.5 percent of the assessed value. It also limited the growth of property tax revenue to no more than 2.5 percent a year. Within a year, property tax revenue fell 9.5 percent or $311 million (O'Sullivan 2000). Property tax revenue in Boston alone fell by 75 percent during that time.

The Legacy of Proposition 13

The immediate impact of Proposition 13 was significant. Within six months after passage of Proposition 13, tax limitation measures were on the ballots in 17 states and all but five were approved. There were 58 ballot measures during the 1979-84 period concerning property tax classification, exemptions, assessment reform, and rollbacks. Among the most successful were tax and expenditure control measures. Forty-three states adopted new property tax limitations or relief plans between 1978 and 1980. Idaho and Massachusetts followed California's lead and adopted measures that both cut and limited property taxes. New state spending limits were set in New Jersey and Colorado. Several states (Arizona, Michigan, Louisiana, Oregon, Utah, and Washington) tied growth in local government spending or revenue to growth in personal income or population. Michigan restricted growth in local property tax revenues to the rate of inflation, and state revenues were limited to the share of personal income they represented in 1978-79.

Although the tax revolt movement lost momentum in the latter half of the 1980s, continued dislike of the property tax together with the fiscal pressures resulting from the recent recession have served to maintain interest in changing the tax and spending activities of state and local governments. In 1992, voters in Florida approved a three percent limit on assessed value increases until sale for homeowner property.

A Final Note

The most dramatic property tax limitation since Proposition 13 was defeated in Maine in November 2004. Question 1 would have limited property tax rates to one percent and limited assessment increases to two percent a year. The ballot initiative was defeated by a 63 to 37 percent margin. The initiative was spawned by rapidly increasing property tax burdens, which left Maine among the states with the highest per capita property taxes in the nation. But the measure was defeated as voters heeded municipal officials' warnings about likely cuts in education, police, and fire services.

B. Attempts to expand the sales tax base to include services

Sales and use taxes have long been among the most important sources of state revenue. Indeed, for most of the last half century, the sales tax raised more money than any other source, consistently accounting for more than a third of state tax revenue. In 2002, states raised over $179 billion from the sales tax (U.S Bureau of the Census).

As a tax on consumption, the sales tax should be applied to consumer services (Fox 1998, Mikesell 1998, Zodrow and Hendrix 2004). Yet, for historical reasons, most services are exempt from tax in most states imposing the sales tax. In 2002, only three states, New Mexico, South Dakota, and Hawaii subjected most services to sales tax. The Federation of Tax Administrators found that most states apply their sales tax to less than one third of the 164 potentially taxable service categories. And eight states taxed virtually no services.

When sales and use taxes were first implemented during the Great Depression the exemption for services was not a significant issue. Services were a small segment of the national economy. Professional services at the time (e.g., legal, medical, accounting) were thought to be impossible to tax for political reasons; while many non-professional services were thought to be impossible to tax for administrative reasons (Brunori 2001).

The exclusion of services in today's economy, however, results in considerable loss of revenue for the states. Between 1979 and 1996, services rose from 47.4 to 57.5 percent of personal consumption. During that period, tangible goods as a percent of personal consumption fell by the same percentage (Fox 1997). While states have broadened the tax base to include more services in the past decade, many of the services that would yield the most revenue (health care, construction, legal and accounting) go untaxed (Fox 1998).

One obvious reason for taxing more services is to raise additional revenue. Michigan estimated that it would raise an additional $4.8 billion a year if it expanded its sales tax to all services. Other studies have shown that most states would raise 25 to 30 percent more sales tax if the base were expanded to services. A Texas study found that broadening the sales tax base to include five additional services would raise an additional $600 million a year.

Public finance experts have identified several other reasons for taxing services. First, there is no theoretical or economic reason for excluding services from the tax base. Services, after all, are consumed like tangible personal property. By exempting services, the tax system discriminates against taxable goods. Thus, persons who consume goods bear a greater tax burden than similarly situated persons who consume services.

Taxing services will likely make the sales tax less regressive. Wealthier people have and will continue to spend a greater percentage of their income on services. Therefore, taxing services would likely improve vertical equity.

Taxing services would also broaden the tax base and provide some opportunity to raise more revenue or reduce rates. With a great percentage of consumption sales now escaping taxation, broadening the base would result in significant additional revenue for the states. Indeed, aggregate sales tax revenue would more than double if all services consumed by individuals were subject to tax.

Taxing services would also lead to a more elastic tax base. One of the virtues of the sales tax is that it is a stable source of revenue. It neither rises nor falls as quickly as personal income. But that stability is dependent on a broad base and it is challenged when large segments of the potentially taxable consumables are removed from the tax base. The sales tax base is not nearly as stable as it was designed to be, or could be if the base were broader. And the most viable policy for broadening the base is to tax services.

Public finance experts have also identified several disadvantages to taxing services. First, taxing services would inevitably lead to greater sales tax burdens on business, since business purchases account for a significant majority of services. As discussed below, business inputs should not be taxed in a pure consumption tax. And since services represent business inputs, the sales tax would be imbedded in the ultimate costs to consumers.

Taxation of services would also increase the administrative and compliance costs for both the government and taxpayers. Unlike products, many services do not leave a record of production and inventory. Tracking the quantity and value of services rendered is a daunting task. The administrative and enforcement costs are magnified when the sales tax is applied to cash transactions. Many personal services, i.e., haircuts, are provided in a cash economy. It is virtually impossible to enforce the sales tax laws with respect to these types of transactions.

As services increasingly dominate the United States economy, the sales tax has shrunk as a percentage of total state tax revenue. Indeed, in 1998 for the first time the personal income tax became the largest single source of revenue for the states, surpassing the sales tax. The relative decline of the sales tax is attributable to a number of factors including the advent of electronic commerce. But most public finance experts have concluded that main cause of the decline has been the growth of the service sector (Fox 1998, Mikesell 1998).[33]

This in turn has led many states to consider expanding their sales tax bases to include more services. This is particularly true in states that do not impose personal income taxes and rely heavily on the sales tax. Between 1989 and 2004, there have been over 800 proposals before state legislators to expand the sales tax base to include services.[34] The vast majority of these proposals were unsuccessful, but the sheer number illustrates the concern legislators have shown for this issue.

For political reasons efforts to expand the sales tax base have centered on non-professional services. That is, legislators have tried to extend the sales tax to haircuts, dog grooming, landscaping, and other similar services. With a small number of exceptions, states never attempt to impose the sales tax on professional services. As the state of Florida discovered in 1987 and 2002 when it tried to broaden its tax base to include many services, the political opposition is virtually impossible to overcome.

The problem with continuing to exempt professional services is that subjecting such services to tax would generate substantial revenue. Imposing the sales tax on car washes will not raise nearly the money as taxing advertising. Furthermore, professional and high-end services are administratively easier to tax. Bankers, lawyers, doctors, etc. usually keep meticulous records and there are few, if any, cash transactions.

But calls for taxation of professional services have gone unheeded. Iowa has a long history of taxing many non-professional services.[35] Iowa Governor Tom Vilsack (D) called for expansion of the sales tax to include just two professional services engineering and accounting services in his 2004 state of the state message. But the governor could not get his Democratically controlled legislature to propose legislation to that effect.

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[33] A review of numerous studies, conferences, and tax reform commission reports show a remarkable consensus in the belief that the sales tax base should be expanded to include more services. See for example the Arizona Citizens Finance review Commission (2004) report "A Fiscal Tool Box: Tool for a More Fair and Effective Revenue Policy for Arizona."

[34] Source: State Tax Today.

[35] Iowa subjects the following services to tax: alteration and garment repair; armored car; vehicle repair; battery, tire, and allied services; investment counseling; service charges of all financial institutions; barber and beauty; carpentry; roof, shingle, and glass repair; dance schools and dance studios; dating services; dry cleaning, pressing, dyeing, and laundering; golf and country clubs and all commercial recreation; house and building moving; household appliance, television, and radio repair; executive search agencies; private employment agencies, excluding services for placing a person in employment when the principal place of employment of that person is to be located outside of the state; swimming pool cleaning and maintenance; telephone answering service; test laboratories, including mobile testing laboratories and field testing by testing laboratories, and excluding tests on humans or animals; termite, bug, roach, and pest eradicators; and lawn care, landscaping, and tree trimming and removal (Iowa code section 433.43).

The few instances, in which professional services were subjected to sales tax, resulted in relatively quick repeal. In 2002, as a revenue raising measure, Kansas expanded its sales tax base to include professional services used in developing custom computer programs. But that law was repealed in 2004.

All successful base broadening has occurred with respect to non professional services. For example, in 1999, Maine expanded its sales tax base to include furniture rentals and prepaid calling cards (Sec. 1. 36 MRSA section 1752 (furniture rental) and Sec. 1. 36 MRSA section 112, sub-section 9-A (prepaid calling cards)).

In 2001, the North Dakota legislature rejected several proposals to tax professional services and instead enacted a law expanding the tax to auto rentals.

In 2002, Minnesota began taxing pet grooming, waste disposal, health club membership, fire alarm services, and installation services (HF3).

In 2002, Nebraska expanded the sales tax to include: building cleaning and maintenance, security, and pest control; automobile washing, waxing, and painting; computer software training; and labor in installing or applying tangible personal property if sale of the property is taxable (HB1085).

In 2004 Arkansas expanded the sales tax base to include services but limited that expansion to wrecker and towing services, parking, gutter cleaning, dry cleaning, self storage, pest control, alarm monitoring, boat storage, pet grooming, body piercing, tattooing, and locksmith services (Arkansas HB1030).

C. Proliferation of property tax exemptions for non-profits

Property owned by charities and nonprofit organizations has long been a challenge to local governments. In all states, such property is generally exempt from property taxation. The increased use of charitable exemptions has left a whole class of property exempt from taxation; property held by churches, synagogues, schools, charities, universities, and other nonprofits. The total value of charitable property exempt from tax exceeded $990 billion, or about seven percent of the total real estate values in the United States in 2000 (Netzer 2002). According to one estimate, the lost property tax revenue owing to charitable exemptions is as high as $13 billion (Cordes, Gantz, and Pollack 2002).

The significant amount of property tax exemptions for non-profits raises a number of property tax policy issues.[36] First, the very idea of exemptions violates the notion of horizontal equity. Identical properties, enjoying identical public services, are treated differently by virtue of ownership. Non-profit organizations receive public

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[36] The problem of charitable exemptions has become so acute that the Urban Institute and the Lincoln Institute of Land Policy held a major national conference to address the issue, which culminated in a widely regarded book on the subject (Brody 2002).

services, which generally must be paid by nonexempt taxpayers. This results in higher tax burdens on nonexempt property owners, which in turn heightens public unhappiness with the property tax.

The widespread use of exemptions further shrinks the property tax base for local governments. The property tax is under severe pressure from rate and assessment limitations, economic development incentives, and general political antipathy.

To alleviate the impact of lost revenue, most states allow the use of payments in lieu of taxes (PILOTs). PILOTs are voluntary payments made to local governments to defray the costs of public services.[37] But payments in lieu of taxes (PILOTs) are not universally used. Indeed, in 1998 only seven of the 51 largest cities in the United States actively solicited PILOTs from non-profits (Leland 2002). There is no evidence that PILOTs come remotely close to covering the revenue that would be raised if the charitable property were not exempt.[38]

The Proliferation

Exemptions from taxation for nonprofit organizations, particularly religious organizations, have existed since the beginning of the nation. There is widespread popular support for such exemptions and virtually no support for their repeal (Brunori 2003).[39] As a result both the number and the value of exempt properties have grown significantly over time.

Netzer (2002) compiled the values of property owned by non-profits over a 35-year period (1963-1998). He found that the value of real estate owned by nonprofits grew from $76 billion in 1963 to $995.6 billion in 1998. Netzer (2002) also investigated the value of buildings owned by tax-exempt religious, education, and health care organizations. He found that the values of such property increased from $191 billion to $658 billion -- an increase of 245 percent -- between 1977 and 1997.

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[37] While PILOTs are voluntary, they often are made as a result of threats by local governments. Some governments will threaten to withhold building permits or to formally challenge and organization's exempt status (Steinberg and Bilodeau 1999).

[38] Another problem with exemptions for charitable organizations is that they insert a higher level of complexity into the local tax system. Determining which organizations are entitled to exemptions is a difficult task under many states' tax laws (Brunori 2001, Youngman 2000). For example, in 2002 the Texas legislature expanded the breadth of charitable exemption to property owned by organizations "primarily" engaged in charitable work. The earlier law provided exemptions only to property owned by organizations engaged "exclusively" in charitable work. This broadening of the scope of eligibility created much uncertainty amongst local governments and charitable organizations. It also opened up the possible that many more organizations would apply for exemptions. The potential property tax revenue loss troubled local governments (Croteau 2002).

[39] The last serious effort to repeal property tax exemptions for nonprofits occurred in Colorado in 1996. An initiative that would have completely repealed the exemption for all nonprofits was defeated by a 4 to 1 margin.

Conclusion

Property tax exemptions for charitable organizations have proliferated over the past 30 years. This proliferation has placed considerable strain on the property tax system and undermines the equity of the tax. The strain is magnified when the proliferation of exemptions is considered along with the property limitations and the increased use of property tax incentives to spur economic development.

E. Recent attempts to strengthen the state corporate income tax by closing loopholes

Forty-seven states and the District of Columbia tax corporate net income to some extent, including such traditionally anti-income tax jurisdictions as Tennessee, New Hampshire and Florida. In 2002, the tax accounted for about $25.1 billion in tax revenue for the states (U.S. Census Bureau). Only Nevada, Washington, and Wyoming do not impose any taxes on corporate income.[40]

The corporate income tax has steadily declined as a percentage of total state revenue. From a high of 9.5 percent of total state tax revenue in 1977, corporate income and franchise taxes account for only 4.5 percent of state tax revenue, and only three percent of state own source revenue in 2002 (U.S. Census). And many commentators expect that decline to continue (McLure interview in Brunori 1999C; Duncan interview in Brunori 1999D).

The decline of corporate income tax revenue, relative to other taxes, is attributable to a number of factors. The proliferation of tax related economic development incentives has substantially narrowed the base. There are literally hundreds of tax breaks given out to corporations to encourage economic development. States provide significant corporate income tax incentives as part of their effort to retain or attract corporate investment. Corporate income tax incentives generally include tax credits for "investment," job creation and worker training, as well as expanded deductions for accelerated depreciation. They are offered every year by virtually every state taxing corporate income (see e.g., Brunori 1997; Pomp 1998).

Another reason for the decline of corporate tax revenue is the increased use of limited liability companies and other pass through entities. LLCs and similar entities are not traditionally subject to state corporate income taxes. Today, LLCs are the most prevalent form of new business organization. And businesses are taking advantage of the tax savings by converting traditional C corporations into LLCs. For example, since 1998, over 4,000 corporations changed their status in Texas alone (Kidd 2003).

Yet, another reason for the decline in the corporate income tax is that many states have essentially abandoned the notion that an effective corporate income tax system requires uniformity across state lines. For the state corporate income tax to work

[40] Washington's Business and Occupation Tax is viewed as a business activity tax on gross income.

effectively for interstate business, uniformity is essential (Bucks interview in Brunori 2000A; Pomp 1998). Uniformity for purposes of this discussion means that all states imposing corporate income taxes should use the same (or very similar) rules for determining how corporations are taxed and which states have authority to tax corporate income.

Uniform laws facilitate determination of tax liability by multistate taxpayers, including the equitable apportionment of tax bases. Uniformity reduces the compliance costs (return preparation and filing) for taxpayers. Uniformity also avoids the possibility of double taxation of income. That is, if state corporate income tax laws were uniform, no two states could tax the same income.

Today, the state corporate tax system is anything but uniform. To provide tax relief to manufacturers, many states have abandoned the three-factor apportionment formula. The traditional three-factor formula calculates tax liability based on the amount of sales, wages, and property in the state. Twenty-eight states at least double-weight their sales factors, and four states have adopted single sales factor formulas.

More importantly, 33 states use what is known as separate accounting systems for determining corporate tax liability.[41] Under separate accounting, incorporated related parties are treated as independent taxpayers. This gives rise to tax minimization techniques in which related party transactions are used to shift taxable income from high to low or no tax states.

The lack of uniformity and the use of separate accounting have led to very aggressive corporate tax planning, particularly with the use of passive investment or holding companies. Typically, a corporation will establish a holding company subsidiary in Delaware (which does not tax holding companies) or Nevada, which has no corporate income tax. The corporation will transfer all of its intangible assets, such as trademarks, to the holding company. The corporation will then lease the trademarks back from holding company in return for a large payment. The corporation deducts the payments to the holding company from its state taxable income (often reducing it to zero). And because holding companies are exempt from tax in Delaware, the subsidiary does not incur any tax liability on the lease payments.

Passive investment company tax planning cost the states billions of dollars a year. The Multistate Tax Commission found that sheltering activity resulted in at least $8.32 billion in lost corporate tax revenue (Multistate Tax Commission 2003). Other studies have come to the same conclusion. For example, a 2003 Florida senate study found that creating subsidiaries in no tax states enable Florida companies to shift earnings and costs the state $500 million a year (Wasson 2003). Similarly, a study by the Pennsylvania Public Interest Research Group in 2003 found that the use of the Delaware holding companies cost the Commonwealth of Pennsylvania $296 million a year (Fitzgerald 2003).

[41] Seventeen states use what is known as combined reporting to calculate tax liability. This method requires profits for all related parties to be combined and subjected to an apportionment formula

Recent Efforts to Strengthen the State Corporate Income Tax

The debate over the appropriate level of corporate income taxation has intensified in recent years. The economic slow down beginning in 2001 produced severe state budget deficits. Political reluctance to raise direct taxes on individuals led governors and legislators to consider strengthening their corporate tax systems. These considerations were fueled by the corporate governance scandals of the early 2000s. These considerations were also fueled by heightened media coverage of how little many Fortune 500 corporations paid in state taxes. For example, the fact that 30 of the 50 largest corporations in New Jersey paid only the minimum tax of $200 -- despite earning billions of profits attributable to the state -- was widely reported in the media.

The corporate crisis and budget problems have led a number of states to take steps to increase corporate tax revenue. Many of the policies enacted by the states had the duel purpose of raising immediate additional revenue, as well as strengthening the corporate tax systems for the future. Most of the efforts have focused on closing the Delaware holding company loophole discussed above. These efforts are described in Appendix G.

A Final Note

Over the years, 12 states have adopted policies to combat tax sheltering through Delaware holding companies. In November 2004, Delaware passed a law that allows corporations to create headquarters management corporations (HMCs). Unlike a holding company, an HMC owns property and has employees in Delaware. It thus provides the same tax advantages to out of state corporations. Delaware has provided generous tax breaks to HMCs. The new law allows businesses to shield themselves from taxes in the same manner as using holding companies (the HMC will own the intangibles).

VII. <u>Impact of Trends on Real Estate Sector</u>

So far, this report has examined trends in state and local spending from 1992 to 2002, highlighted changes that took place in state and local finances during that period, and discussed a number of trends, generally beyond the control of state and local policy makers, that are having, and will continue to have, profound impacts on state and local finances well into the 21st century. It is important, also, to understand how those trends impact real estate markets.

The demographic and economic trends discussed above will certainly impact directly real estate markets across the country, often in different ways and to different degrees. For example, the shift from a manufacturing economy to an economy that is based on services, intangible property, and electronic commerce will likely decrease the demand for, and thus the value of, commercial property. Businesses no longer need large tracts of land and big plants. Our focus here, however, is on how changing state and local fiscal systems will impact real estate markets.

There is a literature in economics that tries to determine the impact of state and local taxes and spending on housing values. It is referred to as a capitalization literature because it explores how state and local taxes (mostly local) and state and local spending (mostly local) are capitalized into the sales prices of individual residential properties. In this context, state and local fiscal policies are a two-edged sword when it comes to their impact on real estate markets. For example, increasing taxes, if everything else is held constant, will have a somewhat negative impact on the sales prices of residential properties. Alternatively, if the level and quality of public goods provided is improved, holding everything else constant, the sales prices of residential properties can be expected to increase.

It must also be recognized that state and local fiscal policies are never the major, or primary, factor driving real estate prices. More important are the characteristics of the land and buildings of individual parcels and the supply and demand conditions existing within individual real estate markets. We are also learning that the cost of capital and new creative financing mechanisms, like interest only loans, can have a significant impact on real estate markets.

But we do know that, at the margin, the level and quality of public goods provided by a local government and the means used to finance those goods and services can influence real estate prices. Therefore, as state and local governments face an increasingly difficult fiscal environment, it is likely that the impact on real estate values will be negative, over the long term.

Specifically, many of the trends noted above are likely to place greater demands on state and local governments. Such increasing demands include the imposition of (largely) unfunded mandates on lower levels of government, as well as the planned devolution of services from federal to state and local governments. Since the 1980s the federal government has been steadily shifting more and more responsibilities to the states. The states have been asked (or just as often have been mandated) to administer and pay for many programs that traditionally have been the responsibility of the federal government. Welfare, Medicare, Medicaid, and highway maintenance are just some examples in which the states have replaced the federal government as the administrative body responsible for providing the services. While the costs of assuming many of these programs have been offset with increased federal funding and protections against unfunded mandates, this phenomenon, commonly called "devolution" in academic circles, has nonetheless contributed to the growth of state, and to a lesser extent, local government budgets.

At the same time, other trends are making it harder for state and local governments to raise the revenue needed to meet these demands. The continuing shift toward a service and high technological economy raises many issues for state and local governments. Services are not generally subject to sales taxes, but services now make up more than half of U.S. personal consumption. This has resulted in a substantial loss of sales tax revenue and greater reliance on other types of taxes, as efforts to expand the sales tax base to include more services have largely been unsuccessful. Similarly, intangible assets have never been a major component of subnational tax bases, yet the growth of the technology sector has made intangibles and increasingly important part of the economy. The rapid spread of electronic commerce also has had a profound impact on state and local tax revenue, especially sales tax revenue. State and local governments have largely been unable to impose sales taxes on Internet transactions and stand to lose hundreds of millions of dollars in revenue.

Globalization has also had a major impact on state and local public finance. Traditionally, there has been intense competition between states and between localities for economic development and job creation. This competition takes several forms including low taxes and superior public services and infrastructure. In the global market, states are no longer just competing with neighboring jurisdictions, but with countries around the world.

State and local governments have also had to contend with eroding trust in government and changing public preferences with respect to tax and spending policy. These changes in public opinion have created a decidedly anti-tax political atmosphere, and have given rise to the tax limitations movement, mainly arising from the public's unhappiness with the property tax.

Changes in federal tax policy have also had the effect of eroding state and local revenue raising abilities. Most state governments have conformed their personal and corporate income tax regimes to federal law in an effort to ease compliance burdens on business and individual taxpayers, but an unintended effect has been that changes in federal tax policy that shrink the federal tax base have been transmitted to state tax bases.

What are the implications of these current and likely future fiscal trends on the real estate sector? The answer is complex because it involves the interaction between state and local taxes, and how the revenues from such taxes are spent. For example, a deteriorating quality of state and local goods and services would create downward pressure on real estate prices. Alternatively, however, is that despite periodic attempts to abolish or reduce reliance on the local property tax, this revenue source is likely to remain, and perhaps become even more important as a mainstay of local revenue. Increasing interjurisdictional competition will make it difficult for state and local governments to raise needed revenues through income and sales taxes because of their generally mobile tax bases, thereby putting more pressure on the local property tax as a source of revenue. Similarly, federal efforts to prevent state and local governments from taxing e-commerce will narrow the sales tax base and ultimately put more pressure on the local property tax.

To the extent that increased demands on state and local governments puts upward pressure on taxes, a simplistic view would hold that higher taxes are not good for the economy and are likely to depress real estate values. There is however, a considerable body of economic theory, supported by empirical evidence that the reality is more complicated because one factor that clearly affects real estate values is the bundle of public services that “comes with” a piece of either residential or commercial property. There is, for example, considerable evidence that home values are positively affected by the quality of local schools, which depends in part on adequate financing of public schools (and also the efficiency with which tax revenues are transformed into educational services).

One important corollary of this general point is that the effect of taxes on real estate values depends on how the revenues are used. To a very rough first approximation, when revenues are used to maintain or to enhance public services that are valued by households and businesses, the “cost of paying higher taxes” can be offset, either partially or wholly by the “benefits of public services”. An implication is that in some cases, raising taxes to finance needed public services can actually maintain or increase real estate values. This process may not occur, however, when tax revenues are used to finance redistributive transfers, and in such cases, raising taxes to finance redistribution may have undesirable, though unintended, effects on local economic activity, and ultimately on real estate values. This latter observation, however, suggests that many local governments facing a daunting challenge as what was once seen as a federal responsibility for income maintenance is increasingly devolved on state and local governments.

In the final analysis, state and local fiscal policies and their impact on real estate markets are certainly about taxes, especially property taxes; but it is also about the level and quality of services being provided. State and local governments will compete for families and businesses by providing the level and quality of services demanded by families and firms. These will have to be paid for somehow. This may require a reversal in the trend of reducing reliance on taxes as a source of funding state and local activities.

VIII. Summary and Conclusion

What can we learn from the research set forth in this paper? State and local public finance has never been more important -- or more complicated. State and local governments are being asked, and often forced, to do more than in any time in American history. Over the past quarter century, their responsibilities with respect to education, transportation, welfare, and public safety have grown. These responsibilities have increased state and local government need for revenue. The expectations that Americans place on their sub-national governments have significantly increased public budgets and correspondingly the need for money.

But at the dawn of the 21st Century, raising additional revenue is a difficult task. Structural, political, economic, and intergovernmental factors have made revenue raising by state and local governments more difficult than ever before.

State and local tax systems were developed in a different time and for a much different economy. State sales taxes were instituted during the Great Depression, state income taxes nearly a generation before. The property tax has been in place, in one form or another, since the beginning of the Republic. The manner in which these taxes are imposed has not changed significantly since their inception. But the world in which they operate has.

State and local governments have labored under a decidedly anti-tax political atmosphere for much of the past 30 thirty years. The anti-tax sentiments have been fueled by an eroding trust in government. Raising taxes in general has been more difficult as politicians, particularly during election campaigns, have taken a strong stance against tax increases. The anti-tax climate has manifested itself in the form of a plethora of constitutional and statutory limitations on tax increases, particularly with respect to property taxes. Beginning with Proposition 13 in 1978 a vast majority of states have placed limits on the ability of local governments to rely on property taxes. State and local reliance on taxes as a source of revenue has been in decline for more than a quarter of a century.

The United States no longer has an economy centered on the manufacture of tangible personal property. The continuing shift toward a service and high technological economy raises many issues for state and local governments. Services are not generally subject to sales taxes, but services now make up more than half of U.S. personal consumption. This has resulted in a substantial loss of sales tax revenue and greater reliance on other types of taxes. Efforts to expand the sales tax base to include more services have largely been unsuccessful. Similarly, intangible assets have never been a major component of subnational tax bases, yet the growth of the technology sector has made intangibles and increasingly important part of the economy. The rapid spread of electronic commerce also has had a profound impact on state and local tax revenue, especially sales tax revenue. State and local governments have largely been unable to impose sales taxes on Internet transactions and stand to lose hundreds of millions of dollars in revenue.

Globalization has also had a major impact on state and local public finance. Traditionally, there has been intense competition between states and between localities for economic development and job creation. This competition takes several forms including low taxes and superior public services and infrastructure. In the global market, states are no longer just competing with neighboring jurisdictions, but with countries around the world.

The mobility of capital and increasing globalization have dramatically increased the level of interjurisdictional competition. Local governments are not only competing for firms in their regions, but across state lines and in other countries. State governments are now offering a large array of tax incentives in the hope of convincing companies to relocate to or remain in their jurisdiction. These incentives have taken the form of job creation tax credits, accelerated depreciation, and sales tax exemptions. In an attempt to spur investment, most states have greatly reduced corporate tax burdens by creating a wide range of incentives. Local governments now routinely offer property tax incentives as a means of fostering economic development. Interjurisdictional competition has narrowed the tax base in many states and their localities.

The changing economy and adverse political climate are not the only factors putting pressure on state and local public finance. Local governments in particular have been challenged by the proliferation of property tax exemptions for non-profit organizations. Exemptions have dramatically narrowed the property tax base, causing burdens to rise for non-exempt property owners.

The ongoing issue of public education finance equalization has also affected state and local governments. Courts in 18 states have ruled that using the property tax to finance public education violates the state constitution. Because local governments have traditionally relied on property taxes to fund K-12 education, the litigation has created significant problems as states struggle to find new ways of financing education.

Similarly, there are increasing pressures for spending on medical care, particularly for the poor and disenfranchised. Medicaid caseloads have grown by 40 percent over the last five years. Medicaid now accounts for 22 percent of state budgets. The situation will only get worse, in large part, because the U.S. does not have a long-term care program. Medicaid accounts for 46 percent of all nursing home revenue nationally and is the primary payer of long-term care services in home and community based settings. States are being forced to cut funding for higher education to fund Medicaid. The dilemma facing state policy makers is deciding whether to take care of your grandfather in the nursing home or your grandson in kindergarten.[42]

In the end, as a result of these pressures, the revenue needs of state and local governments have never been greater. But meeting those needs has never been more difficult. Some believe that state tax systems are becoming an impediment to growth since they are evolving into systems with high rates of taxation applied to very narrowly defined bases. Raymond Scheppach, the Executive Director of the National Governor's Association, concludes that state tax systems are out of sync with the U.S. economy in the 21st century. He goes further to argue that our entire federal system is out of sync with the economy in the U.S. at the beginning of the 21st century; and the situation is being made worse by increasing federal preemption of state responsibilities and changes in the federal tax code that impact directly state and local efforts to raise revenues. He concludes that representatives from the federal, state and local governments must come together to develop new approaches to meeting intergovernmental responsibilities that provide more national uniformity where necessary, yet promotes innovation and experimentation across our 50 systems of state and local government.[43]

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[42] These are the views of Raymond Scheppach, Executive Director of the National Governors Association, as reported in Shafroth [2005]
[43] On this point also see Pagano [2005].

These pressures have a direct impact on state and local fiscal policies during the decade of the 1990s. For example, the data in the report document the declining importance of taxes as a source of state and local general own-source revenues – falling from 70 percent of state and local own-source revenues in 1992 to 68 percent in 2002. The data also show that state and local governments are less reliant on own-source revenues in 2002 than they were in 1992. Reliance on current charges increased during this period as real per capita state and local current charges increased 28.8 percent – faster than any other source of state and local own-source revenues.

In addition, the trends discussed above suggest that despite periodic attempts to abolish or reduce reliance on the local property tax, this revenue source is likely to remain, and perhaps become even more important as a mainstay of local revenue. Increasing interjurisdictional competition will make it difficult for state and local governments to raise needed revenues through income and sales taxes because of their generally mobile tax bases, thereby putting more pressure on the local property tax as a source of revenue. Similarly, federal efforts to prevent state and local governments from taxing e-commerce will narrow the sales tax base and ultimately put more pressure on the local property tax.

Between 1992 and 2002, state and local revenues increased by 33.6 percent, after adjusting for inflation, while state and local expenditures increased by 38.2 percent, after adjusting for inflation. The increasing cost of health care, especially Medicaid, has contributed to the rapid rise in state and local spending, has as the cumulative impact of unfunded mandates from the federal government.

The trends identified and discussed in this paper raise a number of important issues relevant to the development and pursuit of future state and local fiscal policies. For example, the data reported in this report focuses on aggregate measures of state and local general revenues. We need more disaggregate data to understand more fully how state and local governments have been responding to the challenges they face in raising revenue as outlined in this paper. For example, as discussed in this paper, state and local reliance on taxes as a source of own revenues declined throughout the 1990s. State and local governments are depending more heavily on current charges and other sources of revenue like lotteries and gambling for a larger share of their own-source general revenues. What are the implications of shifting away from general tax revenue sources for the provision of goods and services that benefit the broader community, like roads, schools, etc.? What other mechanisms have state and local governments used to raise revenues to meet increasing expenditure demands from citizens and the federal government? Such an investigation would explore changes in the local option sales and income taxes, as well as the increasing reliance on selective, rather than general, sales taxes. What are the implications of the increasing reliance on gambling revenues?

Related to efforts to raise more revenues to meet increasing demand for locally provided goods and services, what have state and local governments been doing to build trust with voters and strengthen the legitimacy of the role of state and local governments in a market economy? Have state and local governments moved beyond the view that their constituents are customers who purchase services from government, to promote the view that individuals are citizens who are members of a political community pursuing collective interests and who should own their government? What have state and local governments done to respond to increasing public participation in decision making through the use of initiatives to impose strict limitations on their ability to raise revenues, limitations that are often the result of initiatives by the voters intended to bypass elected representatives? Specifically, we need to understand better the long-term effects and consequences of tax limitations on state and local finances and the extent to which and under what circumstances the public supports overrides of these limitations. Also, we need to understand whether elected officials in city councils or state legislatures are more or less likely to override limitations than through public referendum and how have requirements for super majorities to increase taxes impacted state and local governments.

Finally, we know that the trends we have discussed will impact the real estate sector. The capitalization literature has generally documented the impact of property taxes and general measures of local spending on real estate values. The literature convincingly shows that increased taxes, without equivalent increases in value to residents, reduces value, but also that taxes that increase valued services can increase real estate value. As we have noted in our discussion, this suggests that policies that redistribute tax revenues from property owners in the area to others are not likely to increase property values and higher levels of government should pursue such redistributive policies. However, more needs to be known about how other specific taxes (specifically local taxes) and specific expenditures (particularly local expenditures) impact real estate markets. What is the impact of local taxes other than the property tax and of local spending on specific activities on real estate values - including, for example, measures of education, public safety, infrastructure services, and other services relevant to local property owners?

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Appendix A- Tax Rate Limits

State	Overall Property Tax Rate Limit	Specific Property Tax Rate Limit
Alabama	1972/78 CMS	1875 CM 1916 S
Alaska		1972 M
Arizona	1980 CMS	
Arkansas		1883 CM
California	1978/86 CMS	1997 CMS
Colorado		1992 CMS
Florida		1968 CM 1855/68/73 S
Georgia		c. 1890/81(r) C 1945 S
Idaho	1978 CMS	1913 C 1967 M 1963 S
Illinois		1939 C 1961 MS
Iowa		n.a./83 C 1972/92 M 1989 S
Kansas		1933/89(s) CMS
Kentucky		1908 C 1908/85 M 1946 S
Louisiana		1974 CMS
Massachusetts		1980/91 M
Michigan	1933 CS	1949 M 1994 S
Minnesota		1993(r) M
Missouri		1875 CMS
Montana		1931/87 C n.a./65 M 1971 S
Nebraska		1903 C 1957 M 1921/99 S
Nevada	1936 CMS	1929 MS
New Mexico	1914 CMS	1973/87 CMS
New York		1894 CMS
North Carolina		1973 CM
North Dakota		1929 CMS
Ohio	1929/34/53 CMS	
Oklahoma	1933 CMA	
Oregon	1991 CMS	1997 CM 1991/97 S
Pennsylvania		1959 CMS
South Dakota		1915 CMS
Texas		1876 CM 1883 S
Utah		1898/61 C 1929 M 1929/88 S
Washington	1944/73 CMS	1973 CM
West Virginia	1939 CMS	1939 CMS
Wisconsin		1944 C
Wyoming		1890 CM 1911 S

C= county; M= municipal; S= school district.
(r)= Repealed effective year specified.
(s) Suspended effective year specified.

Sources: State Tax Today, State Tax Notes, and National Conference of State Legislatures.

Appendix B- Revenue Limits

State	Property Tax Revenue Limit	General Revenue Limit
Alaska	1972 M	
Arizona	1913/80 CM	
Arkansas	1981 CMS	
California		1972 S
Colorado	1913 CM 1992 S	1992 CMS
Delaware	1972 C	
Idaho	1979/92(r) CMS	
Illinois	1991[44] CMS	
Indiana	1973/77/80 CMS	
Kansas	1970/89(s) CM	
Kentucky	1979 CMS	
Louisiana	1978 CMS	
Massachusetts	1980/83 M	
Michigan	1978 CMS	
Minnesota		1971/93(r) CM
Mississippi	1980 CM 1983/09 S	
Missouri	1980 CMS	
Montana	1987 CM	
Nebraska	1990 CM	
Nevada	1983 C 1983/87 M	1984/89(r) CM
New Jersey	1980 C	
New Mexico	1979 CMS	
North Dakota	1981 CM	
Ohio	1976 CMS	
Oregon	1916/97 CMS	
Pennsylvania	c.1940 C	
Rhode Island	1985 M	
Texas	1982 CMS	
Utah	1969/86(r) CMS	
Washington	1971/79/01 CM 1979/01 S	
West Virginia	1990 CMS	
Wisconsin		1994 S

C= county; M= municipal; S= school district.
(r)= Repealed effective year specified.
(s) Suspended effective year specified.
Sources: State Tax Today, State Tax Notes, and National Conference of State Legislatures.

[44] Applies to non-home rule taxing units located in counties contiguous to Cook County.

Appendix C- Assessment Limit

State	Assessment Limit
Arizona	1980 CMS
Arkansas	2000 CMS
California	1978 CMS
Florida	1995 CMS
Iowa	1978/80 CMS
Maryland	1957/91 CMS
Michigan	1994 CMS
New Mexico	1979/00 CMS
New York	1981[45] C 1986[46] M
Oklahoma	1996 CMS
Oregon	1997 CMS
Washington	2000[47] CMS

C= county; M= municipal; S= school district.

Sources: State Tax Today, State Tax Notes, and National Conference of State Legislatures.

[45] Nassau County only.
[46] New York City only.
[47] Ruled unconstitutional by Washington State Supreme Court, 2001.

Appendix D- General Expenditure Limit

State	General Expenditure Limit
Arizona	1921/80 CM 1974/81 S
California	1979/90 CMS
Colorado	1992 CMS
Iowa	1971 S
Kansas	1973 S
Minnesota	1971S
Nebraska	1996 CM 1991/96 S
New Jersey	1976/91 M 1976/90 S

C= county; M= municipal; S= school district.

Sources: State Tax Today, State Tax Notes and National Conference of State Legislatures.

Appendix E- Disclosure

State	Disclosure
Colorado	1983 CM 1992 S
Delaware	1976 C
Florida	1974/80 CMS
Georgia	1991 CMS
Hawaii	1977 C
Idaho	1991 CMS
Illinois	1981 CMS
Iowa	1983 C
Kentucky	1979 CMS
Maryland	1977 CM
Michigan	1982 CMS
Minnesota	1988 CMS
Montana	1974 CMS
Nebraska	1990 CM
Nevada	1985 CMS
Rhode Island	1979 M
South Carolina	1975 CMS
Tennessee	1979 CM
Texas	1982 CMS
Utah	1986 CMS
Virginia	1976 CM
Washington	1990 CMS

C= county; M= municipal; S= school district.
Sources: State Tax Today, State Tax Notes and National Conference of State Legislatures.

Appendix F- Legislative Supermajority to Raise Taxes- 2004

State	Year Adopted	Legislative Supermajority Vote Required	Applies To…
Arizona	1992	2/3	All taxes
Arkansas	1934	3 /4	All taxes except sales and alcohol
California	1979	2/3	All taxes
Colorado	1992	2/3	All taxes (1)
Delaware	1980	3/5	All taxes
Florida	1971	3/5	Corporate income tax (2)
Kentucky	2000	3/5	All taxes (3)
Louisiana	1966	2/3	All taxes
Michigan	1994	3 /4	State property tax
Mississippi	1970	3/5	All taxes
Missouri	1996	2/3	All taxes (4)
Nevada	1996	2/3	All taxes
Oklahoma	1992	3 /4	All taxes
Oregon	1996	3/5	All taxes
South Dakota	1996	2/3	All taxes
Washington	1993	2/3	All taxes (5)

Source: National Conference of State Legislators.

Appendix G - School Litigation

States in which courts have ordered school finance reforms

Alaska. Kasayulie v. State (1997); court ordered equalization holding funding system unconstitutional.

Arizona. Roosevelt v. Bishop (1994), Crane v. State (2001); court ordered equalization holding funding system unconstitutional.

Arkansas. Lake View v. Huckabee (2002); court ordered equalization holding funding system unconstitutional.

California. Serrano v. Priest (1971, 1976); court ordered equalization holding funding system unconstitutional, Williams v. State (1999); unsuccessful adequacy challenge.

Connecticut. Horton v. Meskill (1977), court ordered equalization holding funding system unconstitutional.Sheff v. O'Neill (1996); successful adequacy challenge to Hartford's school system.

Kansas. Montoy v. State (2003); court found education funding system unconstitutional.

Kentucky. Rose v. Council for Better Education (1989); court ordered equalization holding funding system unconstitutional.

Massachusetts. McDuffy v. Secretary (1993); successful adequacy litigation.

Montana. Helena Elementary v. State (1989); court ordered equalization holding funding system unconstitutional.

New Hampshire. Claremont v. Governor (1993, 2001). Court found that state system inadequately funded public education.

New Jersey. Robinson v. Cahill (1973); court ordered equalization holding funding system unconstitutional.

Ohio. DeRolph v. State (2002); court ordered equalization holding funding system unconstitutional.

Tennessee. Tennessee Small School Systems v. McWherter (1995); court ordered equalization holding funding system unconstitutional.

Texas. Edgewood v. Kirby (1995); court ordered equalization holding funding system unconstitutional.

Vermont. Brigham v. State (1997); court ordered equalization holding funding system unconstitutional.

Washington. Northshore v. Kinnear (1974); court ordered equalization holding funding system unconstitutional. Seattle School District v. State (1989) court found that school inadequately funded education.

West Virginia. Pauley v. Kelly (1979), Tomblin v. Gainer (1997); court ordered equalization holding funding system unconstitutional.

Wyoming. Washakie County v. Herschler (1980); court ordered equalization holding funding system unconstitutional.

States in which school finance litigation has thus far been unsuccessful.

Alabama. ACE v. Hunt (1993), ACE v. Siegelman (2002); district court ordered equalization later rejected by state supreme court.

Colorado. Lujan v. Board of Education (1982); court held that state education clause did not require equality of funding.

Florida. Coalition for Adequacy and Fairness v. Chiles (1996); Court found no unconstitutional adequacy of funding.

Georgia. Mcdaniel v. Thomas (1981); court found education funding system constitutional.

Idaho. Thompson v. Engelking (1975); Court upheld school financing system.

Illinois. Committee for Education Rights v. Edgar (1996); Court rejected equity and adequacy claims.

Louisiana. Charlet v. State (1998); court upheld education finance system.

Maine. School Administrative District v. Commissioner (1994); court found no inequities or inadequacies in school funding system.

Maryland. Honrbeck v. Somerset (1983); court rejected equity challenge to state education system.

Michigan. Governor v. State Treasurer (1972); Miliken v. Green (1973); court ultimately rejected equity challenge to education finance system.

Minnesota. Skeen v. State (1993); court upheld adequacy of education finance system.

Nebraska. Gould v. Orr (1990); Court held that equal funding was not guaranteed by state constitution.

New York. Levittown v. Nyquist (1982); court held that state constitution does not require equal funding. But court in Campaign for Fiscal Equity (1995) held that taxpayers can bring suit on adequacy grounds.

North Carolina. Leandro v. State (1997), court held that taxpayers can challenge education finance on adequacy grounds.

North Dakota. Bismarck Public Schools v. State (1994); court upheld school financing system.

Oklahoma. Fair Finance Council v. State (1987); court upheld school finance system.

Oregon. Olsen v. State (1976); court ruled school finance system constitutional.

Pennsylvania. Danson v. Casey (1979); court upheld school finance system.

Rhode Island. City of Pawtucket v. Sundlum (1995); court held education finance system constitutional.

South Carolina. Richland v. Campbell (1988); court dismissed equity suit.

Virginia. Scott v. Commonwealth (1991); Supreme Court held state system constitutional.

Wisconsin. Kukor v. Grover (1989); supreme court upheld school finance system.