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Executive Summary

Recent State and Local Fiscal Trends

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The Federal-State-Local Fiscal System

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

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

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

services generally consumed by local residents and that vary from place to place according to local needs and preferences. All three levels of government share responsibility for economic affairs.

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

State and Local Government Revenues

Nearly 70 percent of state and local government own source revenues come from taxes, another 20 percent from charges and over 10 percent from various other sources. Some variation has occurred, but state and local taxes have represented approximately 11 percent of the nation's personal income for more than two decades. However, variation between states in both the level of taxes and the revenue sources relied upon is a very striking feature of the US system of federalism. In 2002, state and local tax revenues were 13.1 percent of personal income in New York and only 8.4 percent in Tennessee.

Tax Structure Choices

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

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

Property Taxes

The property tax accounts for over 30 percent of combined state and local tax revenues, a share that has fallen only slightly over the past 25 years. Local government reliance, however,

has declined more markedly. Still, localities in 12 states raise more than 90 percent of their revenue from the property tax. Fifteen states have a statewide tax on real property, but only Vermont and New Hampshire raise a significant share of revenue with this source.

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

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

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

Sales Taxes

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

Erosion of the sales tax base because of rapid growth in consumption of services and expanding remote commerce (such as catalog sales and e-commerce) and other factors has been a major concern of states in recent years. Consideration of ways to stem the erosion has included efforts to tax more services and to find ways to increase collection of taxes on remote sales. The

Streamlined Sales Tax Project is a major thrust by the states to come up with a mechanism to simplify the sales tax, but also to find a means of increasing collection of sales taxes on remote sales.

Individual Income Taxes

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

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

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

Business Taxes

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

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

Selective Sales Taxes and Other Revenues

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

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

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

State and Local Government Expenditures

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

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

For more than 100 years state and local government expenditures have been rising nearly continuously in real per-capita terms (a rough proxy for the "quantity" of services delivered) reflecting citizens' desire for additional government services as incomes rise, increasing reliance on state and local governments rather than the federal government to deliver domestic services (devolution of responsibilities to state and local governments), and different underlying pressures at different times. For example, the desire to educate baby boomers led to extraordinary growth

in education expenditures in the 1960s, while more recently educating the children of baby boomers, financing health care for the poor and medically needy through Medicaid, and financing prison-building all contributed to rapid spending growth in the 1980s and 1990s.

Elementary and Secondary Education

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

Elementary and secondary education is delivered primarily by local governments, but is financed by all three levels. For the nation as a whole, state governments finance approximately half of elementary and secondary education, followed by local governments, with the federal government a distant third at a little less than eight percent of the total. States vary widely in how they split state and local responsibilities for financing education. The state government plays the largest role by far in Hawaii and New Mexico, supplying 89 percent and 72 percent of the funds respectively in 2001-02. States provide 60-70 percent of education funding in another eight states. At the other end, eight state governments provide less than 40 percent of funding, with Nevada providing the least, at 32 percent.

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

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

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

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

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

Medicaid

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

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

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

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

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

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

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

State Welfare Programs

States have operated low-income cash-assistance programs with partial federal funding since the now-defunct Aid to Families with Dependent Children (AFDC) program was enacted in 1935. AFDC was an entitlement system funded by federal matching grants to the states. A family's benefit duration was unlimited under AFDC rules as long as its income was sufficiently low, and benefits were larger for families with more children and less earned income. Under AFDC, there was no cap on matching funds states could receive from the federal government. AFDC involved tremendous incentives for recipients to remain out of work, stay on the program, remain unmarried, and produce many children.

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

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

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

TANF is different from the old AFDC program in many important ways. First, TANF is not an entitlement program. Federal funding cannot be used to provide benefits for any family beyond a total of 60 months during the caretaker's lifetime. A second major difference is that participants are expected to engage in some form of work-related activity in order to get benefits. Recognizing that many welfare recipients have severe barriers to employment, TANF provides

for a system of support services. Many states have provided transportation and supplemental child care benefits. Indeed, more than half of all federal and state TANF spending is now on non-cash benefits and services.

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

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

Higher Education

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

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

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

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

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

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

Other Expenditure Areas

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

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