

# The State of State and Local Government Finance

Ronald C. Fisher

This paper provides an overview of the state-local government sector, a review of the short-run impact of the 2007-09 recession on state and local governments, and a brief summary of key long-run challenges state and local governments will encounter in the next decade. State and local governments in aggregate represent about one-seventh of the U.S. economy, with education and welfare (mostly Medicaid) accounting for more than half. These governments currently face nearly unprecedented fiscal turmoil as a result of the recent recession. Even after the economy recovers, states and localities will face challenges both to improve effectiveness and efficiency in public service provision and to generate revenue sufficient to fund these crucial public services. (JEL E62, H1, H7)

Federal Reserve Bank of St. Louis *Regional Economic Development*, 2010, 6(1), pp. 4-22.

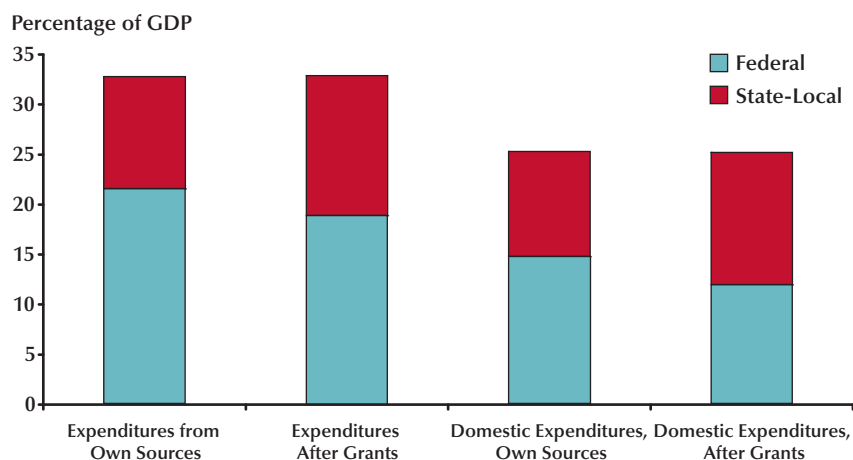
**T**he recession that began in late 2007 certainly is the most recent factor creating turbulent times for state and local governments. Some would say the current environment may be more reflective of a cyclone than mere turbulence, although the first decade of this century has been a continuing period of transition for these governments. After an era of remarkable growth from the end of World War II until the mid-1970s, these governments experienced remarkable stability from the mid-1970s to the end of the century. In the first decade of the twenty-first century, however, major structural changes in the economy, substantial demographic shifts, a blurring of the distinction between the private and public sectors, and now a long and deep recession have combined to alter the fiscal environment and behavior of these governments. The obvious issues are the nature of these factors influencing state and local governments to change, how these governments are responding, and what happens next.

Demographic changes—including aging of the population, changes in ethnic composition, and regional population shifts—have affected both service demand and productivity of the existing revenue structure. The decline of manufacturing and the corresponding growing importance of service, information, and financial industries also have had a dramatic effect. States have discovered that their tax structures may be poorly designed for the new economy and that reforms to the tax system are elusive. The increasing income inequality resulting in large part from the economic restructuring has increased the demand for a variety of state and local services, notably welfare and education. The rising relative cost of energy and increasing environmental concerns are additional factors pushing states and localities to develop or adopt new technologies for service provision. Certainly the recession has had a severe impact, but even after the economy recovers, state and local governments will continue to be affected by these long-term trends.

---

Ronald C. Fisher is a professor of economics at Michigan State University. The author thanks Amarpreet Jhita and Ravi Shah, undergraduate research assistants at Michigan State University, whose work was invaluable in tabulating and reporting data used in this paper. He also appreciates the assistance of the Governments Division of the U.S. Census Bureau, especially Christopher Pece and Stephen Owens, who arranged early access to Census of Governments data.

© 2010, The Federal Reserve Bank of St. Louis. The views expressed in this article are those of the author(s) and do not necessarily reflect the views of the Federal Reserve System, the Board of Governors, or the regional Federal Reserve Banks. Articles may be reprinted, reproduced, published, distributed, displayed, and transmitted in their entirety if copyright notice, author name(s), and full citation are included. Abstracts, synopses, and other derivative works may be made only with prior written permission of the Federal Reserve Bank of St. Louis.

**Figure 1****Government Expenditures as a Percentage of Personal Income**

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

These issues are reviewed in this paper, beginning with an overview of the state-local government sector. How large is it? Where does their money come from? How is the money spent? How do states differ from each other? Attention then turns to the key short-term policy issue: the aftermath of and response to the recession. To what degree have states responded with tax increases compared with expenditure reductions, and is there a preferred source for additional revenue? Finally, a number of fundamental long-term policy issues—key issues to resolve over the next 10 years—are noted, including the structural problems with the revenue system and challenges to service provision.

## AN OVERVIEW OF THE STATE-LOCAL SECTOR

### *The Magnitude of State and Local Governments*

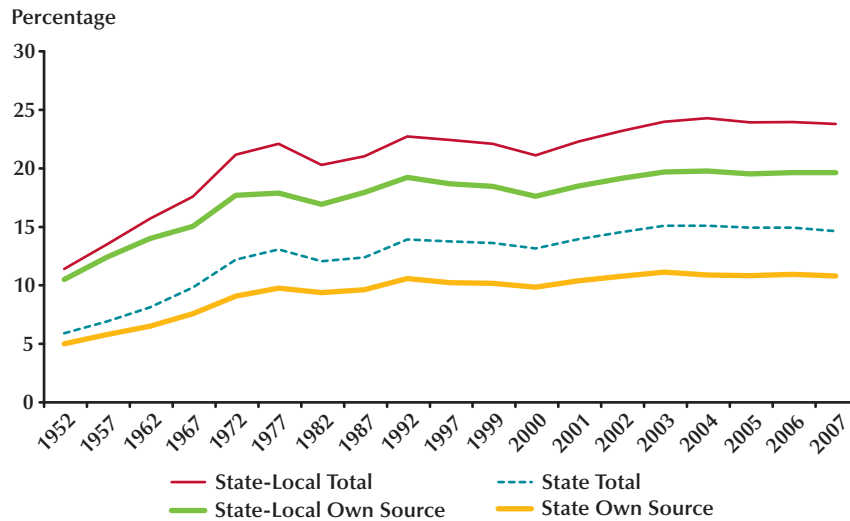
The state-local sector is an exceptionally important component of the U.S. economy, much more so than is often recognized. Individuals and federal officials may think only of their own state or city, which may indeed be small, but the aggregate impact of states and localities is substantial. In 2008,

state and local governments spent nearly \$9,000 per person. Spending by the sector accounted for about 14 percent of gross domestic product (GDP), double the share represented by consumer purchases of durable goods. State and local governments employ about 1 in 8 of all workers in the nation. When spending is measured by the levels of government that actually make the final expenditures (after accounting for grants received from higher-level governments), the state-local sector accounts for 43 percent of aggregate public spending and 52 percent of domestic public spending (excluding defense and international expenditures) (Figure 1). Perhaps most important, state and local governments are responsible for the public services most apparent to citizens, including education, health and welfare, transportation, public safety, and water and sanitation.

State-local spending grew much faster than income in the 1950s, 1960s, and most of the 1970s but has remained between 20 and 24 percent of personal income since the late 1970s (Figure 2). Compared with changes in population and inflation, real spending per person increased from 1950 to 2000, and especially fast from 1950 to 1990, but has remained essentially constant over this decade.

## Figure 2

### State and Local Expenditures as a Percentage of GDP: 2008



SOURCE: U.S. Census Bureau (State and Local Government Finance).

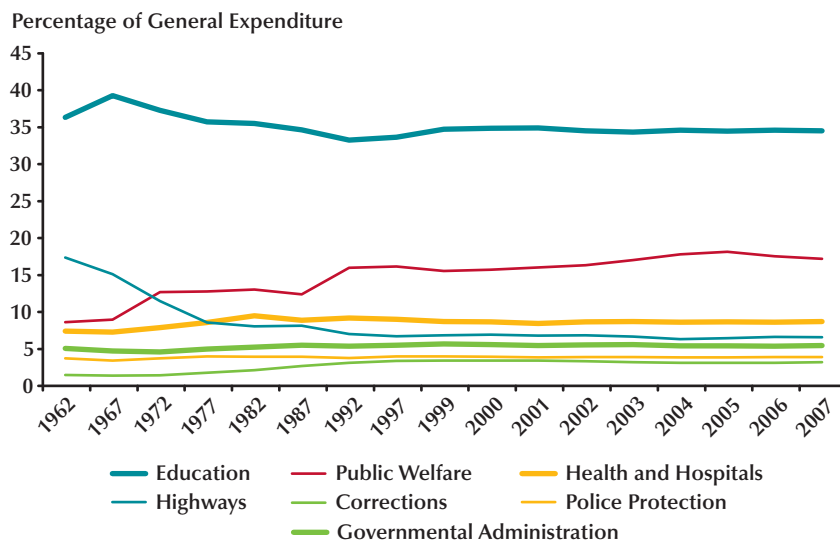
## Types of Services and Expenditures

Two categories—education (35 percent) and welfare (17 percent, which includes Medicaid)—account for more than half of state-local spending. No other single category accounts for more than 10 percent of aggregate spending, including highways (7 percent), government administration (5 percent), police protection (4 percent), and corrections (3 percent). Government administration may be particularly noteworthy, as critics sometimes argue that state-local fiscal problems could be eliminated simply by cutting government “overhead” and reducing the number of officials, a claim that seems dubious given its low, 5 percent share of the total budget. There are important differences between state and local government spending patterns. Welfare, including Medicaid expenditure, is the largest spending category for state governments (21 percent), whereas education (38 percent) is the largest spending category for local governments. Both categories are a bit deceptive, however, as a large portion of state spending for Medicaid is funded by grants from the federal government, and

state governments provide substantial grants to cities and school districts to fund education.

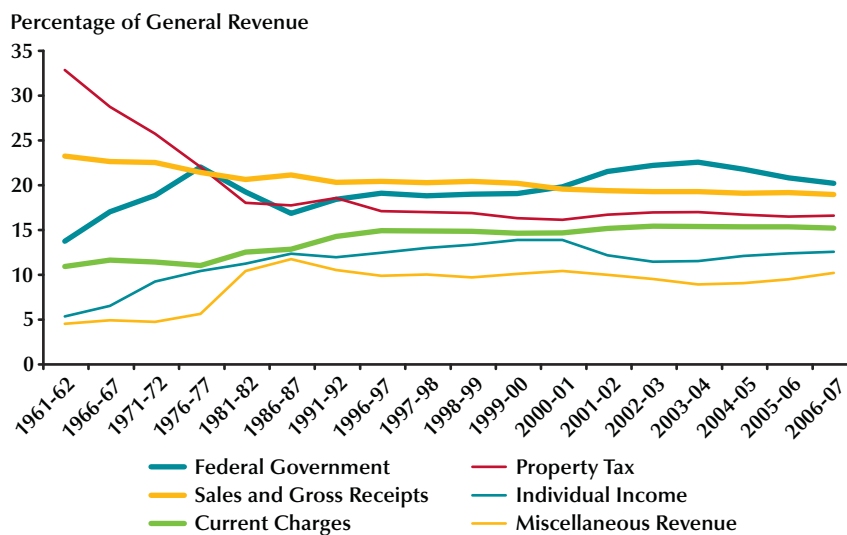
The composition of aggregate state-local budgets has been remarkably stable for 30 years, with education and public welfare accounting for about half of total spending (Figure 3). Taking a longer view, welfare spending increased as a share of the total budget, fueled initially by anti-poverty programs in the 1960s and then by Medicaid in recent decades. In contrast, expenditure for highways has not increased as fast as total spending, as construction of major roads and highways was completed and spending turned more to maintenance than expansion. Although the aggregate composition of state-local spending has not changed appreciably, there have been important changes within spending categories. For example, the share of education spending for K-12 schools increased, whereas the share for higher education institutions declined. Similarly, cash grants to low-income families have declined as a share of welfare spending, more than replaced by spending for health care.

**Figure 3**  
**Distribution of State-Local General Expenditure**



SOURCE: U.S. Census Bureau (State and Local Government Finance).

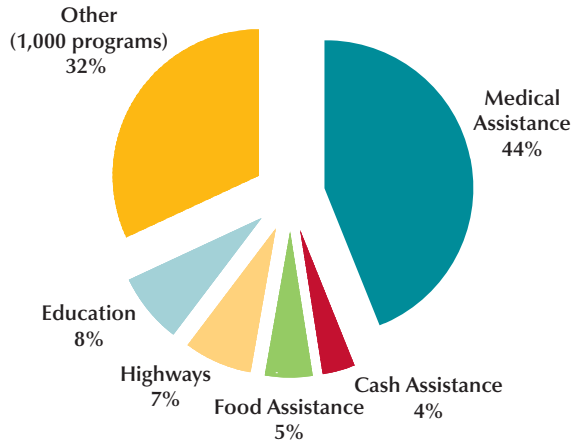
**Figure 4**  
**Distribution of State-Local General Revenue**



SOURCE: U.S. Census Bureau (State and Local Government Finance).

**Figure 5**

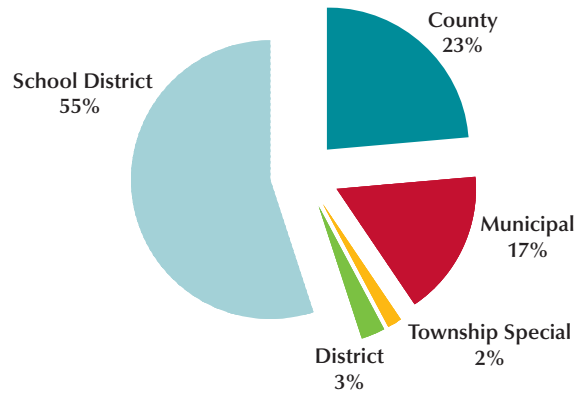
**Federal Aid to State and Local Governments: 2008 (Total \$469.8 billion)**



SOURCE: U.S. Census Bureau (State and Local Government Finance).

**Figure 6**

**Distribution of State Aid by Type of Local Government: 2007 (Total \$446.7 billion)**



SOURCE: U.S. Census Bureau (State and Local Government Finance).

**Sources of Revenue**

As shown in Figure 4, for the past 20 years state and local governments in aggregate have had a stable and balanced revenue structure based on five roughly equal major sources: federal aid (20 percent), sales and gross receipts taxes (18 percent), property taxes (17 percent), current charges and fees (15 percent), and individual income taxes (13 percent). Again, states differ a bit from local governments, with sales and excise taxes providing the largest source of own-source state revenues (24 percent) and property taxes the largest source of local revenues (28 percent). Since the early 1960s, the property tax and sales tax categories have declined in relative importance, whereas those for income tax and charges have increased.

As with spending, the apparent stability of this balanced revenue structure masks important changes within each tax category. For all three major state-local taxes, tax bases have been narrowed both by policy decisions and changes in the economy. Sales taxes apply to a smaller fraction of purchases largely because of the growth of spending on services and online purchases. Income taxes

now apply to a smaller fraction of income because exempt forms of income have grown in importance. And property tax exemptions for industrial and commercial properties intended to spur local economic development have reduced property tax bases.

**Intergovernmental Relationships**

Intergovernmental fiscal flows (resource transfers) between governments are an inherent characteristic of federal systems and particularly important fiscally in the United States. State governments receive 28 percent of their revenue from the federal government; local governments receive 4 percent from the federal government and 34 percent from state governments. The interdependence flows in both directions—federal and state governments provide substantial financial support to lower levels, and federal and state governments rely on states and localities, respectively, to provide services effectively with those funds.

Intergovernmental fiscal flows in the United States are especially important for the two largest subnational government service areas (Figures 5 and 6): school districts, which receive the largest

component of state aid, and medical assistance (mostly Medicaid), which receives the largest component of federal aid. As a result, local K-12 public education institutions receive 55 percent of their revenue from the state and federal governments, whereas state welfare expenditures receive 60 percent of their funding from the federal government.

### **Fiscal Diversity**

This aggregate perspective of the state-local sector can be deceiving, however, because individual states or localities *usually* differ from the mythical “average” state or locality. Indeed, fiscal diversity is the fundamental and essential characteristic of federal systems. Individual state and local governments have substantial autonomy to select fiscal structures that best reflect their citizens’ desires or are optimal for that jurisdiction’s economic and social circumstances. Without diversity, there is little reason for subnational governments. If all states had identical laws, taxes, and public services, there might as well be only one.

In fact, state and local governments in the United States differ substantially in structure, levels of spending and revenue, sources of revenue and categories of spending, and the institutional characteristics of taxes and expenditure programs. It is impossible in this brief overview to detail all of these differences, but a few examples can serve well to illustrate the nature and magnitude of the variation.

Spending differences among states remain large, influenced by variation in the desired quantity or quality of services demanded, differences in costs of providing public services, and even differences in which services are deemed to be public responsibility. In 2007, state-local spending per person varied from more than \$12,000 (in Wyoming) to about \$6,000 (in Tennessee).<sup>1</sup> The information in Table 1 reveals that state spending differences declined substantially during the past century; in 1982 the difference between the highest- and lowest-spending states was relatively greater than in 2002. But spending differences apparently have

widened again this decade, as the ratio of the highest to lowest is larger for 2007 than in 2002.

Diversity also exists among state revenue systems. Individual states often use less-balanced revenue structures than is true for the full sector. Nine states have no income taxes. Although 46 states have general sales taxes, only 14 tax food purchases. Often, state tax structures are designed for the economic conditions in that state. For instance, Florida and Hawaii rely on sales taxes to take advantage of their many visitors; states with substantial mineral deposits, such as Alaska, Louisiana, Montana, and Wyoming, rely disproportionately on severance taxes; and Oregon (income tax, no sales tax) and Washington (sales tax, no income tax) have selected tax structures essentially opposite despite their neighboring location partly because of the differences in the two states’ economies. Perhaps nothing better illustrates the variety among states as much as the differences in tobacco excise taxes, which vary from \$3.46 per pack of cigarettes (in Rhode Island) to \$0.07 per pack (in South Carolina, naturally).

### **SHORT-TERM POLICY ISSUE: THE EFFECT OF AND RESPONSE TO THE RECESSION**

The recession that began late in 2007 has imposed a nearly unprecedented fiscal decline on state and local governments. As shown in Figure 7, tax revenue for the overall sector declined for four consecutive quarters beginning in the third quarter of 2008. The changes by type of tax are shown in Figure 8; only the property tax maintained stability and continued to grow into 2009. As a consequence, *nominal* state-local tax revenue during calendar year 2009 was less than both 2007 and 2008 and about at the same level as 2006. The decrease in state-local tax revenue was led by dramatic declines in the individual income tax, which decreased more than 25 percent in the second quarter of 2009.

The effect on the revenue of state governments alone was substantially greater than for the sector as a whole because most state governments did not have the benefit of a stable property tax. State

<sup>1</sup> This excludes Alaska and Washington, D.C., jurisdictions with even higher per capita expenditure but special circumstances that make comparisons to other states deceptive.

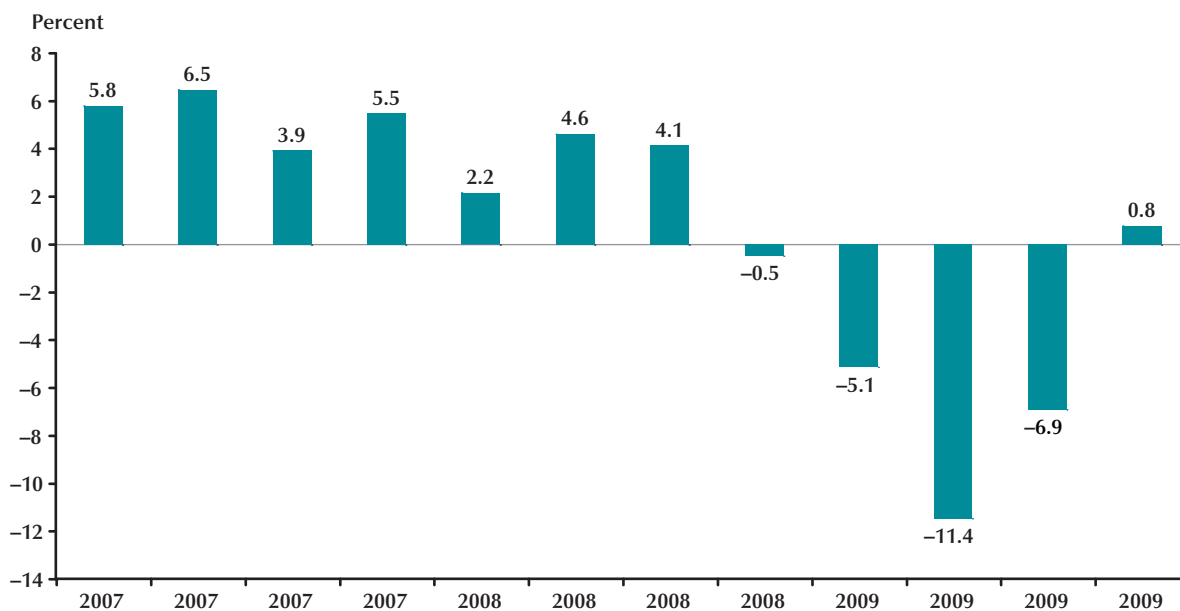
**Table 1**  
**Variation in Per Capita State-Local General Expenditure**

Year	States	Mean (\$)	Coefficient of variation	Maximum (\$)	Minimum (\$)	Maximum-to-minimum ratio
1982	All	1,992	0.47	7,958	1,345	5.9
1992	All	3,900	0.30	9,893	2,751	3.6
1998	All	5,224	0.23	11,502	4,037	2.9
2002	All	6,217	0.23	13,466	4,889	2.8
2007	All	7,832	0.24	15,595	6,025	2.6
1982	All, excluding Alaska and Washington, D.C.	1,841	0.19	3,157	1,345	2.3
1992	All, excluding Alaska and Washington, D.C.	3,708	0.17	7,788	2,751	2.1
1998	All, excluding Alaska and Washington, D.C.	5,025	0.12	7,351	4,037	1.8
2002	All, excluding Alaska and Washington, D.C.	5,856	0.13	8,523	4,889	1.7
2007	All, excluding Alaska and Washington, D.C.	7,383	0.16	12,024	6,025	2.0

SOURCE: U.S. Census Bureau (State and Local Government Finance).

**Figure 7**

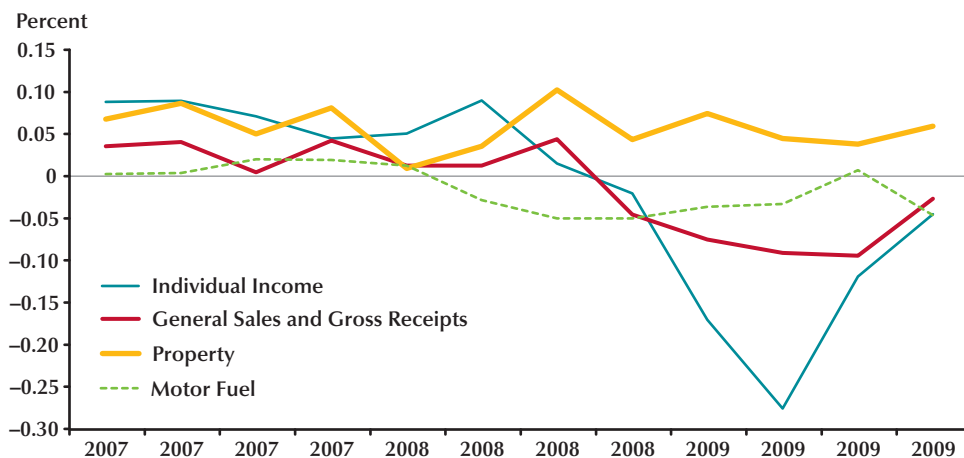
**Percentage Change in State-Local Tax Revenue (quarter over quarter)**



SOURCE: U.S. Census Bureau (Quarterly Summary of State & Local Tax Revenue).

**Figure 8**

**Percentage Change in State-Local Tax Revenue by Tax Category (quarter over quarter)**



SOURCE: U.S. Census Bureau (Quarterly Summary of State & Local Tax Revenue).



government tax revenue has declined for five consecutive quarters, through the fourth quarter of 2009 (and preliminary estimates at the time of this writing suggest a further decrease for most states in the first quarter of 2010). The decreases were so large that state government *nominal* tax revenue in calendar year 2009 was at about the same level as 2005; essentially, state governments lost three years of revenue growth.

State and local governments responded in a number of ways to the recession, as one might expect. Declining revenue coupled with increased demand for services caused states to face potential deficits, or “budget gaps,” of more than \$60 billion for fiscal year (FY) 2009 and more than \$120 billion for FY 2010, according to the National Governors Association and the National Association of State Budget Officers (NGA and NASBO) estimates. About 30 states raised taxes or fees for FY 2010, including 12 that increased the income tax, mostly for higher-income taxpayers. But the number of states increasing various excise taxes or various charges and fees was much greater (NGA and NASBO). States and localities also benefited from federal stimulus support provided by the American Recovery and Reinvestment Act of 2009 (ARRA)—about \$140 billion for the period July 2008 to December 2010, intended to increase federal government financing of Medicaid and support state financing of public education. By all accounts, ARRA funding had its largest effect in FY 2010. Even with tax increases and more federal support, states still enacted cost-saving measures and reduced spending by about 4 percent in 2009 and an additional 5 percent in 2010.

The conventional wisdom since World War II had been that state and local governments in aggregate have been a countercyclical force during recessions, using reserves and tax increases to maintain, or even increase, spending. As noted by Robert Rafuse (1965) in a classic article, “abstracting from trend, state and local expenditures have been a stabilizing factor in the economy during every post-war expansion and contraction.” Such a policy was supported by the development of “rainy day,” or budget stabilization, funds in many states and the automatic (unemployment compensation, federal matching funds for Medicaid, food stamps,

and so on) and discretionary federal support that flows to states during recessions.

The current response by state and local governments to the recent recession seems to be different from that to previous recessions, however, as shown by the analysis in Table 2. Comparing the 2010 response to the 2007-09 recession with the 1984 response to the 1981-82 recession, which was the last economic decline of a similar magnitude, reveals the following. In the current cycle, state and local governments have had smaller relative revenue increases and larger relative spending decreases, with relatively less reliance on broad-based taxes (income and sales) and relatively more reliance on narrow excise taxes (tobacco, alcohol, gambling). In 1984, spending decreases totaled less than 1 percent because 29 states increased taxes by a total of more than 3.1 percent of aggregate revenue. In 2010, spending decreases totaled more than 5 percent, whereas 30 states increased taxes by a total of only about 1.75 percent of aggregate revenue.

A number of factors may account for the difference, but one is clear. States acted in the 1990s and earlier in this decade to reduce taxes substantially—relatively more than in the past. From 1994 through 2001, when the economy was growing rapidly, states acted explicitly to reduce taxes substantially. Then for FYs 2005-06 through 2008-09, about half the states acted in each prior year to reduce taxes or tax rates. Indeed, states acted 62 times in this later period to reduce income taxes, with a net reduction of about \$4.4 billion. So, state and local governments took advantage of periods of economic growth to reduce tax rates, which both limited the buildup of reserves and made these governments vulnerable to subsequent economic declines.

With expectations that employment and income will grow slowly and that federal stimulus support will end in 2010, it is projected that states will face potential deficits for FY 2011 and FY 2012 in the magnitude of \$55 to \$70 billion annually (NGA and NASBO). What should states do? Many options have been used already. As noted, expenditure reductions were greater than revenue increases for 2010, even though more than half of the states increased taxes. State-local employment was reduced, wages were cut, state grants to local gov-

**Table 2**  
**State Fiscal Actions in Recession Periods**

Fiscal year	States increasing revenue*	Amount of revenue increase* (\$ billion)	Percentage of state general revenue*	Income tax and sales tax increases*	Percentage of state budget change*	Peak unemployment rate (%)
1984	29	10	3.10		-0.7	10.8
1992	31	15	2.50	20; 18	5.1	7.8
2003	23	8	0.65	5; 11	1.5	6.3
2010	29	24	1.75 (estimate)	10; 8	-5.4	10.1

NOTE: \*At the time budgets were enacted.

SOURCE: NGA and NASBO (*The Fiscal Survey of the States*).

## Fisher

ernments were reduced, and funds from available balances and reserves were shifted to cover budget gaps. My expectation is that tax increases will be necessary. Indeed, I believe they are desirable. And if tax increases are warranted, I suggest that state income taxes seem the best revenue option.

Maintaining state services and spending, even with tax increases, will have a positive effect on the recovery. Spending by state and local governments can provide important stimulus to both local and national economic recovery, especially when spending by consumers is weak. Some may be concerned about increasing taxes during the downturn, but it is difficult to understand how laying off teachers and police officers, wage reductions, lowering reimbursement to health care providers, or reducing maintenance or construction of public facilities will help the economy grow.

Income taxes are the fairest source of additional revenue, especially given the differential effects of the recession. Unemployment remains high, and workers in some industries who are still employed have made wage concessions. Workers in strong or growing businesses have, in contrast, enjoyed wage increases. Income tax increases are collected from those still working in proportion to earnings. Individuals faring the best during the recession and recovery pay the most, and tax increases may even be targeted to higher-income taxpayers through the use of graduated rates. By contrast, even people who are out of work may pay sales taxes or excise taxes on such things as gasoline, cigarettes, or alcohol.

Income tax rate increases, even if temporary, provide the best prospect for future revenue growth as economic conditions and employment improve. Research shows clearly that income taxes have the largest long-run revenue elasticity and thus respond much more in the long run to economic growth than either excise taxes or general sales taxes. Indeed, that is precisely why income tax revenues declined so drastically during the recession. As employment and income grow, states will want to generate revenue to replace the lost federal stimulus funds, reinstate service reductions required by the recession, and rebuild balances and state rainy day funds in preparation for the future. Income taxes provide states and localities

the best opportunity to accomplish these goals quickly.

Income tax increases, especially if targeted to higher-income taxpayers, are effectively a way for states to leverage additional stimulus support from the federal government. Because state-local income taxes are deductible in calculating federal income tax for individuals who itemize deductions, a \$100 increase in state taxes costs a taxpayer in the 35 percent tax bracket as little as \$65. The difference is reduced federal tax. Thus, for every \$100 of additional income tax revenue received by states and localities, residents pay substantially less; the remainder is effectively additional federal stimulus.

Finally, as shown in Figure 8, income taxes declined more than any other state-local revenue source since 2005 because of direct state decisions and the recession. When the economy was growing, states acted to reduce income taxes or income tax rates. When the recession hit, income taxes were affected more than any other source of funding for states and localities. Temporary income tax increases as the recovery begins and accelerates would simply replace that lost revenue. If states are going to reduce tax rates during periods of economic growth, rather than using the growth to establish substantial reserves, then it seems reasonable for them to increase tax rates when the economy (and revenue) is not growing.

## LONG-TERM POLICY ISSUES

### *Revenue Structure*

Substantial economic, demographic, and technological changes have already affected state and local government revenues greatly. With the prospect of these changes continuing, or even intensifying, state and local governments are expected to continue to consider a number of substantial reforms to their revenue structure. Five of these crucial challenges are noted briefly below:

- (i) State and local income taxes often provide preferential treatment for retired individuals by taxing the types of income earned by retired individuals at lower rates than other forms of income and by providing additional exemptions or credits. With the population

aging and relatively more retired individuals, the cost of such preferential treatment is expected to increase greatly. This issue is considered in greater detail below.

- (ii) Most state and local retail sales taxes were designed initially to apply to sales of tangible property and thus, even today, often do not apply to sales (or consumer purchases) of most services. As the consumption of services continues to represent a rising share of consumer spending, the exemption of services means that sales taxes apply to a declining share of spending. Over time, therefore, sales tax revenue will not increase as fast as consumer spending and higher tax rates may be necessary. There also may be important distributional effects because those taxpayers who buy relatively more services pay less tax.

The Federation of Tax Administrators (2008) reports that of 168 specific services identified, only 8 states tax the sale of at least half of those services and only 23 tax more than one-third. Only about half of the states tax ticket sales for entertainment and sporting events, and professional services by doctors, lawyers, and so on are taxed in only seven states. In contrast, Hawaii and New Mexico are known for having broad-based sales taxes that include most of these services.

- (iii) State and local sales taxes were designed as “destination-based” taxes, with liability determined by the location of the buyer rather than the location of the sale. Under current federal law, states and localities cannot require out-of-state sellers to collect a sales tax unless the seller has a physical presence (“nexus”) in that jurisdiction, such as a retail branch. In addition, it is often difficult for states to collect sales and use taxes from buyers if the sale transaction occurred in another location. The increasing prevalence of cross-jurisdiction sales as a result of Internet transactions is another reason state and local sales taxes may apply to fewer purchases and become less productive.

In essence, both the issue of taxation of service purchases and the difficulty of taxing

cross-border purchases illustrate how the typical state sales tax structure is outmoded, having been designed for a different time and economy. So, the challenge to states is either to redesign the sales tax or scrap it entirely for a different consumption tax.

- (iv) The dislike of property taxes, even compared with other state-local taxes, has been a recurring theme in state-local finance for a number of years. But recent challenges to the property tax seem to be motivated by different factors rather than traditional concerns and may imply a renewed wave of proposals for reducing or constraining this tax, which has continued to provide nearly 30 percent of local government revenue and 75 percent of local tax revenue. Three factors seem to have been important in driving recent concerns about property taxes and proposals for reductions: (i) uneasiness and uncertainty created by the growth of property taxes, especially related to growth in housing values for homeowners, (ii) concern about the value of fiscally independent local governments as opposed to tax revenue collection or direct provision of services by state governments, and (iii) concern about the distributional impact of property taxes compared with alternative state-local taxes. This seems quite different from the 1980s and 1990s when disparities in property tax wealth and the resulting implications for financing schools were the prime motivators of “reform” efforts.

Recent research reported in Fisher, Bristle, and Prasad (2010) suggests that the rapid growth in property taxes and resulting taxpayer uncertainty, especially for homeowners, has been the major impetus for the most recent wave of proposals to reduce property taxes. It is not clear whether this focus on rising property taxes reflects concern about the uncertainty of property tax bills when taxes change often and substantially, an illusion that homeowners are not wealthier despite large capital gains, uncertainty about the permanence of capital gains, or a perception that homeowners are now bear-

**Table 3****Sources of Personal Income (percentage distribution)\***

Income source	1960	1980	2000	2009
Wage and salary disbursements	66.3	59.7	57.3	52.3
Employer contributions for employee pension and insurance funds	3.5	8.0	7.2	8.7
Employer contributions for government social insurance	2.3	3.9	4.1	3.8
Personal interest income	6.0	11.9	12.0	10.3
Personal dividend income	3.3	2.8	4.5	4.6
Old-age, survivors, disability, and health insurance benefits	2.7	6.7	7.4	9.6
Family assistance	0.2	0.5	0.2	0.2
Other personal transfer receipts	1.1	3.2	4.2	7.7

NOTE: \*Columns do not total 100% due to unreported categories.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

ing an “unfair” share of public service costs due to the relative growth of residential property taxes.

- (v) Public finance economists have long noted that pricing of state-local services (that is, financing either construction or use of facilities and services with fees as opposed to taxes) has potential advantages for some services often provided through state and local governments. Prices (fees) can target direct users in proportion to the benefit, assist in measuring the demand for public services, and be used to allocate use during periods of congestion. Such pricing is most common for services that have largely private benefits, such as water, electricity, health care at public hospitals, higher education, recreational facilities, and transportation. Indeed, fees collected for health care and higher education accounted for more than half of state-local charges and fees in 2007.

Two recent trends suggest that the use of pricing (fees) may become more attractive in the future. First, state governments across the nation have decided that public higher education students should pay a larger fraction of the cost of education. For all public institutions, tuition has increased from 23 percent of revenue to 37 percent in the past 13 years. Even with the large increases in

prices, enrollment in public higher education continues to grow. It seems unlikely that this trend will be reversed, and in fact the concept may be applied to other government-provided services. Second, changes in technology have made it easier, less costly, and more efficient to collect fees and tolls for roads, public transit, and other public utilities (think electronic monitoring and meters). I imagine that some of that technology might eventually be applied to other public services as well.

### ***Income Taxation and Senior Citizens***

Although many of these issues have been widely discussed and dissected in detail, here I review one—senior citizen taxation—that has not had the same attention but illustrates the combined economic and political aspects of the issues discussed here.

In 1960, wages and salaries of workers accounted for two-thirds of total personal income, whereas Social Security (Old-Age, Survivors, and Disability Insurance [OASDI]) provided less than 3 percent (Table 3). By 2009, wages and salaries had fallen to only 52 percent of personal income and Social Security (OASDI) benefits had risen to nearly 10 percent. Income from interest, dividends, and employee pension and insurance funds also

had grown in relative importance. This changing relative importance of income sources reflects the aging of the U.S. population and the growth of both public and private retirement benefits—facts relevant to states, which historically have provided favorable tax treatment for senior citizens. According to a report by Davis Baer (2007), 26 states and Washington, D.C., exempt Social Security benefits from state income taxation, 23 states exempt private pension benefits (at least partially), and 28 states plus Washington, D.C., provide additional personal tax exemptions for seniors.

Michigan is an extreme example. Menchik (2003) reports that the effective state income tax rate for senior citizens in that state is *negative*—seniors as a group pay no state income tax but receive refunds or credits. Specifically, in Michigan Social Security and public pension benefits are tax exempt, there is a large exemption for private pension benefits, and seniors receive an additional personal exemption, a partial capital income exemption, and a generous and refundable property tax credit administered by the state income tax.

As the demographic trend continues in the next decades and retired individuals comprise a growing fraction of the population, income taxes in states with such tax benefits will be applied to a declining share of income and thus become less productive. So, an obvious philosophical and policy question arises: Should senior citizens pay toward state services? Certainly they continue to benefit directly and indirectly from state services after retirement. Many of the state income tax provisions noted were enacted when a substantial proportion of senior citizens lived near or below the poverty level. But the growth of Social Security, pensions, and other benefits has changed the environment. Today, fewer than 10 percent of senior households live below the poverty line, which is less than any other major population segment. Yet, any official in state government will tell you that senior citizens are also a powerful political force.

### **Service Provision**

For state and local governments, if the main long-term revenue challenge is designing a revenue system for the modern economy, the main long-

term expenditure challenge is improving the “effectiveness” of service provision—that is, finding ways to get the greatest result for the money expended. Four services that top this “bang for the buck” list of issues are reviewed (including the criminal justice system, which is discussed in further detail below). In addition, the structure of state-local government, which is itself becoming a major issue, is also discussed.

- (i) State education policy has shifted from the focus in the 1980s and early 1990s on reducing disparities in school resources to a focus in this decade on considering methods of evaluating and improving educational results. The story is now quite well known. Increased state government financing of K-12 education reduced spending differences among schools and increased real per student spending substantially, which resulted in specialized attention and dramatically smaller class sizes. Yet, educational outcomes measured by a variety of standardized tests or school completion rates have not improved substantially.

Not surprisingly, the state and federal governments reacted. States adopted enhanced graduation requirements (47 states), graduation tests (23 states), school “report cards,” and opportunities for nontraditional teachers and schools (“charter schools”). The federal government’s “No Child Left Behind” law mandates annual evaluation and improvement, with a set of prescribed remedies for schools that are not improving. This has been a dramatic change, with centralized governments assuming increased responsibility for traditionally local issues. With the growing importance of education in the international job market, one expects this push for “improvement” in educational outcomes to continue.

- (ii) Improving the effectiveness of criminal justice systems has become a focus of state governments across the nation. Especially during the 1990s and earlier in this decade, state-local spending on public safety and corrections increased rapidly, in large part

because the number of people in state prisons increased substantially. As incarcerations grew, corrections and public safety occupied an increasingly larger fraction of state budgets amid concern that public safety outcomes have not improved proportionately. As a result, states are now reconsidering criminal justice policy. This issue is considered in greater detail below.

- (iii) Although not exclusively a state-local issue, expanding access to and controlling the costs of health care are exceedingly important for state and local governments. Health care costs affect states both in their role as the primary financial supporter of health care for low-income families (principally through Medicaid) and in their role as a major employer. Medicaid expenditures are approaching 15 percent of total state-local spending, and various estimates of aggregate health-related spending by state and local governments (including Medicaid, public health programs, health care benefits for employees, and the cost of health care for prisoners) suggest a range between 25 and 30 percent of total state-local expenditures. If health care costs continue to increase at relatively fast rates nationally, then these expenditures could easily take an even larger share of state-local budgets.

The recent adoption of new health insurance legislation by the federal government certainly is expected to affect state-local government expenditures, although the nature and magnitude of those effects are not yet clear. Changes in Medicaid rules are expected to increase eligibility in some states, adding to the number of people covered; but on the other hand, requirements for businesses and individuals to purchase health insurance may reduce the number of persons requiring Medicaid assistance. To the extent that provisions in the law intended to reduce the growth rate of health care costs are successful, those reductions will reduce budget pressure for state and local governments. Thus, individual states and localities are in much the same position as private businesses, having

to respond to rising health care costs but not being in a position to alter those national trends independently.

- (iv) Public employees have been a target in the state-local government response to the recession, with widespread reductions in employment and salaries, but concern about public employee pension and benefit plans had arisen even before the recession. Three issues are often discussed. First, most state-local employees continue to be covered by defined-benefit pension programs, even as many private employers have shifted to defined-contribution or 401(k) plans. Second, often public employees are eligible for retirement and receipt of pension benefits at relatively young ages, sometimes after working 25 or so years, even when retirement ages for Social Security and some private pensions are rising. Third, in many cases, state-local employee contracts have required that these workers pay a smaller fraction of health insurance costs than many employees in the private sector.

These differences resulted from a number of factors. Sometimes public employees were paid lower salaries than comparable private sector workers, with the difference offset by more-generous benefits. Sometimes, as also happened in the private sector, employers agreed to generous retirement benefits because those costs were deferred into the future. And in some cases, retirement at relatively young ages was in recognition of the strenuous nature of some jobs, as often cited in the case of public safety workers, for instance. Changing circumstances have called all of these into question. Life expectancy and quality of health have improved substantially, with people now commonly working well into their 60s. Individual retirement savings plans are now the norm. With many past state-local employees now retired, state and localities are bearing the retirement costs that were once considered “deferred.” And states are worried about the implicit debt that the future retirement costs of current employees represents. Thus,

it seems almost certain that all of these aspects of state-local employee contracts will be reexamined in the future.

- (v) Finally, even the basic structure of local government is being reexamined, with two aspects often mentioned. First, with about 89,500 local governments—including counties, municipalities, townships, school districts, and other special districts, some with overlapping responsibilities and boundaries—questions are being raised as to whether some consolidation in this structure would reduce costs or improve accountability to citizens. The more than 14,500 school districts are a second concern. Many school district boundaries were set many years ago and often do not correspond to boundaries of other local governments. And the boundaries established in the past coupled with population change and migration means that school districts vary greatly in both area and number of students. So, it seems likely, especially in some states, that the structure of these local governments may be reconsidered as the pressure for more effective and lower-cost service provision continues.

### **Criminal Justice Policy**

Criminal justice expenditures and policy, especially for corrections, deserves further discussion, partly because this has been an especially fast-growing component of state-local budgets and partly because it raises important issues of social policy as well as fiscal policy. As with taxation of senior citizens, criminal justice policy also illustrates the interaction between economic and political forces.

In 2007, state and local governments spent about \$68 billion on corrections and about \$191 billion on criminal justice services in aggregate. Although spending in this category grew exceptionally fast in the 1980s and 1990s, with average annual growth of about 10 percent, spending is still a relatively low fraction of state and local budgets. Criminal justice expenditures in aggregate (including police, courts, and prisons) are about 7 percent of state-local expenditures, and corrections spend-

ing alone is less than 3 percent. However, because of this category's rapid spending growth, its share of state-local budgets has doubled since the early 1980s.

Despite the increased spending and the implications for states' fiscal conditions, it seems to me that the key issues here are ones of efficiency and social policy. The United States has the highest incarceration rate in the world, with 1.6 million persons incarcerated in federal and state prisons in 2008, or 504 per 100,000 people. Incarceration rates doubled in the 1980s, increased by 60 percent in the 1990s, but have increased only 5 percent since 2000. And the incarceration rate actually *decreased* in 2008 for the first time in many years, suggesting that states have begun to make policy adjustments. The efficiency of criminal justice policy based on jail time can be questioned partly because recidivism remains high. After release, many former prisoners violate release conditions or commit other crimes and return to prison. And crime rates had declined nationally even while incarceration rates continued to increase substantially.

The criminal justice policy followed by the state and local governments in the 1980s and 1990s not only led to a high rate of incarceration but also had disproportionate effects among the population. In 2008, 58 percent of federal and state prisoners were black or Hispanic, with 35 percent being black males; both rates far exceed the ratio of those minority groups in the population. Indeed, the incarceration rate for black males (3,161 per 100,000) is six times greater than that for the total population.

A general equilibrium perspective is helpful, I believe, in interpreting these disproportionate effects of criminal justice policy. Policy decisions concerning illegal drugs substantially contributed to increased incarceration rates. Indeed, 53 percent of prisoners in federal prisons and 20 percent of state prisoners were sentenced for drug-related offenses, some involving supply and some use. Involvement with illegal drugs may be related to the success or failure of our public education system, also a service provided through state and local government. High school completion rates in many large urban school districts remain low, possibly contributing to the drug business and subsequently



to prison populations. Finally, a disturbing statistic is that about half of the prisoners in state and federal prisons are parents of minor children (Loury, 2007). So, high incarceration rates contribute to the number of single-parent households, which is the group with the greatest concentration of poverty in the United States today and a substantial component of those whose health care is financed through Medicaid. Therefore, one important aspect of state-local budgets—corrections costs—is influenced by another important state-local service (education) and influences the fastest-growing component of state spending (Medicaid).

## **SUMMARY OF THE STATE-LOCAL “STATE”**

State and local governments in aggregate represent about one-seventh of the U.S. economy, with education and welfare (mostly Medicaid) accounting for more than half. For the past 20 years, the state-local sector has been stable in relative size, with spending varying only between 21 and 24 percent of personal income. These governments rely on five roughly balanced revenue sources— income, property, and sales taxes and federal grants, with a growing role for pricing of services through fees and charges. State and local governments currently find themselves under stress from both the recession and long-term economic and demographic changes. So, they are faced with a set of challenging questions. Where will future revenue come from? How can they provide services more effectively? What structural changes are warranted?

Given the magnitude of the challenges, it seems likely that this transition decade will lead to a period of major change. In the short run, taxes may be increased to restore fiscal stability as the economy recovers. Of course, tax increases alone will not be enough. Several options have been widely discussed, including redesigning corrections systems, reconsidering public employee pension and benefit plans, broadening tax bases, building more substantial fiscal reserves (often called rainy day funds), and even reorganizing local government structure.

To minimize fiscal problems in the future, state and local governments seem likely to be forced to consider a number of long-term structural changes. Most important, it seems there is little support for relative growth of spending (that is, spending that rises faster than income or population), but changing demands and costs likely will result in a different mix of services produced differently than currently. It is not difficult to forecast a continued focus on improving K-12 outcomes and access to health care while simultaneously controlling health care costs. These two large programmatic areas dominate state-local budgets, so fiscal stability and service efficiency seem impossible without addressing these concerns.

In terms of revenue, discussion certainly will continue about broadening tax bases to make the main state government taxes (income and sales) more relevant to the modern economy. Whether the appropriate policy changes will be implemented seems more problematical, as those changes face substantial political challenges. There are interesting parallels between reforming and modernizing income and sales taxes at the state government level and reforming and modernizing Social Security at the federal government level. Everyone seems to think it is necessary, but implementation is another matter. And if these difficult political decisions are not made, then the fiscal problems of the relevant governments certainly seem likely to worsen. Finally, given the continuing aversion to taxes and the growing use of digital technology, increased interest in charging for services provided through state and local governments seems likely.

Although many fiscal changes seem probable for the state-local government sector of our economy, one fundamental fact seems unlikely to change: State and local governments will continue to be central in the lives of most citizens through the public services they provide—schools and universities; roads, parking, public transit, and airports; health care and public hospitals; police and fire protection; courts and state prisons; water and sanitation; waste collection and disposal; parks and recreation opportunities; income support for low-income families; and environmental protection—essential services for everyday living.

## REFERENCES AND OTHER READINGS

- Baer, David. "State Taxation of Social Security and Pensions in 2006." AARP Public Policy Institute *Issue Brief*, No. 84, November 2007.
- Boyd, Donald J. and Dadayan, Lucy. "State Tax Decline in Early 2009 Was the Sharpest on Record." Nelson A. Rockefeller Institute of Government *State Revenue Report*, No. 76, July 2009.
- Dadayan, Lucy. "Overall State Tax Revenue Is Up, But Losers Still Outnumber Gainers." Nelson A. Rockefeller Institute of Government *State Revenue Flash Report*, June 3, 2010.
- Federation of Tax Administrators. "FTA Survey of Services Taxation—Update." *By the Numbers*, July 2008; [www.taxadmin.org/fta/pub/services/btn/0708.html](http://www.taxadmin.org/fta/pub/services/btn/0708.html).
- Federation of Tax Administrators. "State Excise Tax Rates on Cigarettes." March 2010; [www.taxadmin.org/fta/rate/tax\\_stru.html](http://www.taxadmin.org/fta/rate/tax_stru.html).
- Fisher, Ronald C. *State and Local Public Finance*. Third Edition. Mason, OH: Thomson South-Western, 2007.
- Fisher, Ronald C. "What Policy Makers Should Know About Property Taxes." Lincoln Institute of Land Policy *Land Lines*, January 2009, pp. 8-14. Reprinted in *State Tax Notes*, February 23, 2009, 51(8), pp. 591-97.
- Fisher, Ronald C. "Major State-Local Policy Challenges: Outside-the-Box Solutions Needed," in Sally Wallace, ed., *State and Local Fiscal Policy: Thinking Outside the Box*. Northampton, MA: Edward Elgar Publishing, 2010, pp. 9-27.
- Fisher, Ronald C.; Bristle, Andrew and Prasad, Anupama. "An Overview of the Implications of Eliminating the Property Tax: What Do Recent State Debates and Prior State Experience Tell Us?" in M. Bell, D. Brunori, and J. Youngman, eds., *The Property Tax and Local Autonomy*. Cambridge, MA: Lincoln Institute of Land Policy, 2010, pp. 165-202.
- Fisher, Ronald C. and Prasad, Anupama. "An Overview and Analysis of State Intergovernmental Aid Programs." Presented at the National Tax Association Annual Conference on Taxation, Denver, CO, November 12-14, 2009.
- Glaze, Lauren E. and Bonczar, Thomas P. "Probation and Parole in the United States, 2008." U.S. Department of Justice, Office of Justice Programs, Bureau of Justice Statistics, December 2009; <http://bjs.ojp.usdoj.gov/index.cfm?ty=pbdetail&iid=1764>.
- Johnson, Nicholas. "Budget Cuts or Tax Increases at the State Level: Which Is Preferable When the Economy Is Weak?" Center on Budget and Policy Priorities, updated April 28, 2010; [www.cbpp.org/files/1-8-08sfp.pdf](http://www.cbpp.org/files/1-8-08sfp.pdf).
- Johnson, Nicholas; Collins, Catherine and Singham, Ashali. "State Tax Changes in Response to the Recession." Center on Budget and Policy Priorities, March 8, 2010; [www.cbpp.org/files/3-8-10sfp.pdf](http://www.cbpp.org/files/3-8-10sfp.pdf).
- Loury, Glenn C. "Racial Stigma, Mass Incarceration and American Values." Tanner Lectures in Human Values, Stanford University, April 2007.
- Menchik, Paul L. "Michigan's Personal Income Tax," in C. Ballard et al., eds., *Michigan at the Millennium: A Benchmark and Analysis of Its Fiscal and Economic Structure*. East Lansing, MI: Michigan State University Press, 2003, pp. 535-57.

## Fisher

Milken Memorial Fund, the National Association of State Budget Officers, and the Reforming States Group. *2002-2003 State Health Care Expenditure Report*. Washington, DC: 2005; [www.milbank.org/reports/05NASBO/index.html](http://www.milbank.org/reports/05NASBO/index.html).

National Governors Association and the National Association of State Budget Officers. *The Fiscal Survey of States*. Washington, DC: various years; [www.nasbo.org/](http://www.nasbo.org/).

Papke, Leslie E. "Public Pensions and Pension Policy in Michigan," in C. Ballard et al., eds., *Michigan at the Millennium: A Benchmark and Analysis of Its Fiscal and Economic Structure*. East Lansing, MI: Michigan State University Press, 2003, pp. 413-34.

Rafuse, Robert W. Jr. "Cyclical Behavior of State-Local Finances," in Richard A. Musgrave, ed., *Essays in Fiscal Federalism*. Washington, DC: The Brookings Institution, 1965, pp. 63-121.

Sabol, William J.; West, Heather C. and Cooper, Matthew. "Prisoners in 2008." U.S. Department of Justice, Office of Justice Programs, Bureau of Statistics *Bulletin*, December 2009.

State Higher Education Executive Officers. *State Higher Education Finance, FY 2009*. Boulder, CO: 2010.

U.S. Census Bureau. State and Local Government Finance (various years); [www.census.gov/govs/estimate/](http://www.census.gov/govs/estimate/).

U.S. Census Bureau. Quarterly Summary of State & Local Tax Revenue (various years); [www.census.gov/govs/ntax/](http://www.census.gov/govs/ntax/).

U.S. Department of Commerce, Bureau of Economic Analysis. National Economic Accounts Data (various years); [www.bea.gov/](http://www.bea.gov/).

U.S. Department of Education, National Center for Education Statistics, Institute of Education Services. *Digest of Education Statistics: 2007*. Washington, DC: 2008.

U.S. Department of Justice, Office of Justice Programs, Bureau of Justice Statistics, Washington, DC; [www.ojp.usdoj.gov/bjs/](http://www.ojp.usdoj.gov/bjs/).