Come the Devolution, Will States Be Able to Respond?

Robert Tannenwald

Assistant Vice President and Economist, Federal Reserve Bank of Boston. *The author thanks Dan Swaine for helpful technical advice and Yukiko Takada, Margaret Enis, and Patricia Bankowski for research assistance. Special thanks go to Jonathan Cowan, a graduate student at the Kennedy School of Government, Harvard University, who did all of the computations involved in updating estimates of fiscal capacity, fiscal need, and fiscal effort. Any errors in this article are the responsibility of the author. The views presented do not necessarily represent those of the Federal Reserve Bank of Boston or of the Board of Governors of the Federal Reserve System.*

Since the founding of the Republic, Americans have engaged in "endless debate" (Donahue 1997) about the division of fiscal and regulatory responsibilities among levels of government. The controversy has often involved the concomitant question of the optimal role of government as a whole. The issue has been not only which level of government should do what, but also what government at any level should do.

The most recent chapter of this long-standing dispute—the "devolution" debate—is no exception. The size of government is currently an issue largely because some analysts and policymakers doubt the ability and will of state and local governments to assume devolved responsibilities. These doubts are especially troublesome to those who believe that states and their municipalities should pick up where the federal government leaves off. They fear that many states will fail to take on devolved responsibilities because their residents are strongly opposed to higher taxes; because they suffer from chronic fiscal stress; or because interjurisdictional competition forces them to bid for workers, jobs, retirees, and tourists by depressing taxes and levels of public services. They argue further that states subject to the most fiscal stress will be forced to cut public services even more to compete in the short run, further eroding their long-run competitive position (Breton 1991; McGuire 1991). As a result, they may be drawn into a vicious cycle that can be mitigated only if the federal government provides intergovernmental fiscal assistance that narrows interstate fiscal disparities, thereby leveling the competitive playing field.

Proponents of devolution note that voters' opposition to higher taxes is precisely the reason why government should be smaller and more decentralized. In their view, federal spending has bloated government beyond what citizens in many areas of the country want. If states are given more fiscal independence and responsibility, they will be freer to respond to the preferences of their citizens (Gingrich 1995). As for the

problems raised by interstate fiscal disparities, many proponents of devolution believe that, even when the playing field is uneven, interjurisdictional competition induces efficient, responsive, innovative, and self-reliant government. Given political and administrative realities, any federal aid, no matter how well designed to narrow interstate differences in fiscal stress, weakens these desirable incentives.

If devolution were to proceed as extensively as the current congressional Republican leadership would like, how easily could state governments and their municipalities expand their fiscal domain, should they choose to do so? Which states would have the most difficulty? How disparate would be the capacity of states to respond? Would the states least able to respond tend to prefer relatively low levels of state and local public services anyway? This paper addresses these empirical issues, all central to the devolution debate. The first section analyzes recent trends in state and local revenue burden for clues concerning the fiscal constraints confronting the state and local government sector as a whole. The underlying premise is that a declining trend in revenue burden, if present, would suggest formidable political and economic impediments to future tax and spending increases. The second section examines the recent historical pattern of state and local surpluses and reserves to evaluate the extent to which subnational governments are "bulking up" in anticipation of losses in federal aid, whatever the long-term fiscal constraints they may face. The third section investigates interstate differences in fiscal stress to identify which states would have the most difficulty expanding their fiscal role in a devolutionary scenario. To this end, fiscal year 1994 (FY1994) estimates of fiscal capacity and fiscal need have been prepared, updated from fiscal year 1991 (FY1991) estimates using methodologies developed by the former U.S. Advisory Commission on Intergovernmental Relations.

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Has the State and Local Revenue Burden Been Falling?

Some policy analysts have argued that taxpayer resistance and interjurisdictional competitive pressures will deter state and local governments from enlarging their role in our federal system of government. If this prognosis were correct, one would expect to find a reduction in the state and local "revenue burden" over the past two decades, during which voter antipathy and interstate competitive pressures have intensified. Revenue burden is defined here as general "own-source" state and local revenues as a percentage of personal income. General revenues are those available for general purposes, as opposed to those earmarked for a particular function.[1] Own-source revenues consist of all revenues other than fiscal assistance from other levels of government.

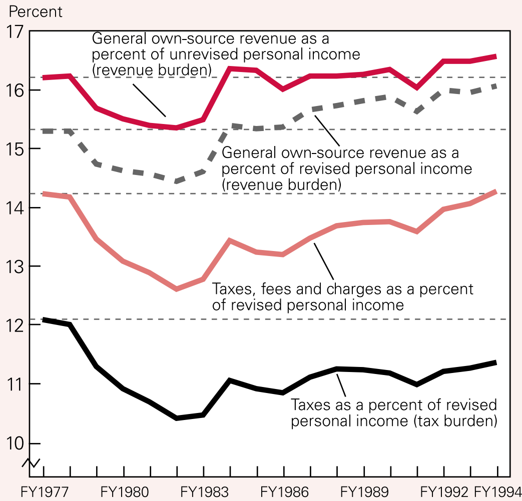
U.S. Census data indicate that the revenue burden has not fallen during the past 15 years. In fiscal year 1994 (the latest year for which both state and local Census revenue data are available), the revenue burden was 16.5 percent, an all-time high. The previous peak was 16.2 percent, reached in FY1978. According to these data, the state and local revenue burden has fluctuated between 16.2 and 16.5 percent since FY1984. Since FY1982, a period in which interjurisdictional competition has intensified dramatically, this burden has risen by 1.4 percentage points (Figure 1).

Not only has the state and local revenue burden increased during the past 15 years, but it increased most rapidly during the 1980s, when growth in federal aid slowed dramatically. From FY1980 until FY1990, federal aid as a percentage of personal income declined 1.2 percentage points, from 4.3 percent to 3.1 percent, while the state and local revenue burden rose 0.8 percentage point, from 15.5 percent to 16.3 percent. Thus, the state and local sector replenished two-thirds of its lost federal assistance with increases in own-source general revenues. The state and local revenue burden continued to rise between FY1990 and FY1994, even though federal aid as a percentage of income jumped by almost a full percentage point.

[1] An example of an earmarked revenue source would be unemployment insurance taxes. All collections from these taxes are placed in trust funds earmarked solely for unemployment compensation. Another example would be receipts from state liquor stores.

Figure 1

Selected Measures of the Burden of State and Local Revenues



Note: Horizontal lines are FY1977 values.
Source: U.S. Bureau of the Census, U.S. Bureau of Economic Analysis, and author's calculations.

These data underestimate the rise in the state and local revenue burden since FY1982 because they are based on unrevised personal income data reported by the Census Bureau. According to the most recent benchmark revisions undertaken by the U.S. Bureau of Economic Analysis, personal income was underestimated between the mid 1970s and the mid 1990s. The upward revisions range from 6 to 7 percent for 1976 through 1983, but have been only between 3 and 4 percent since 1984. As a result, estimates based on revised income data indicate a sharper rise in revenue burden since FY1982 (Figure 1, dashed line) than the unrevised data. As in the unrevised analysis, by FY1984 the revenue burden had rebounded sharply to surpass its previous peak (which revised data indicate was reached in FY1977). Unlike the pattern exhibited in the unrevised statistics, the revenue burden continued to rise steadily over the following 10 years, so that by FY1994 it was 0.8 percentage point above the FY1977 peak.[2]

However, one should not necessarily conclude from this history that state and local governments would be able to raise taxes with little difficulty in order to offset future reductions in federal aid. Much of the variation in state and local revenue burden over the past 15 years can be traced to interest earnings on holdings of cash and securities and user charges. With these revenue sources removed, the state and local revenue burden is still far below its FY1977 peak.

State and Local Revenue Burden from FY1977 to FY1982

The "property tax revolt" motivated the 0.9 percentage-point drop in revenue burden between FY1977 and FY1982, as indicated by the sharp reduction in property taxes as a percentage of personal income during this period (Table 1). A 0.4 percentage-point drop in the burden of selective sales taxes, attributable in part to oil shocks during this period, was also a contributing factor.[3] However, the drop in overall revenue burden would have been much steeper were it not for a 0.7 percentage-point rise in the ratio of miscellaneous revenues to personal income. The largest component of miscellaneous revenues is interest earnings.[4] Soaring interest rates caused interest earnings to grow much more rapidly than personal income between FY1977 and FY1982. The

[2] According to the revised personal income data, federal aid to state and local governments as a percentage of personal income peaked in FY1978 at 4.2 percent and bottomed out in FY1989 at 3.3 percent. During this 11-year period, the state and local own-source revenue burden rose from 15.2 percent to 15.8 percent. Thus, as according to the unrevised personal income data, state and local governments recovered two-thirds of the reduction in federal assistance.

[3] State and local motor fuel taxes are mostly *in rem* taxes, charged per unit of product sold (for example, a certain amount per gallon), rather than *ad valorem* taxes, charged as a percentage of price. The sharp rise in gasoline prices during the late 1970s and early 1980s depressed motor fuel tax revenues by drastically curtailing fuel consumption. Revenues from other excise taxes, such as those on alcohol and tobacco products, also grew sluggishly, reflecting a secular decline in the consumption of these products. The decline in selective sales tax revenues would have been steeper were it not for a spurt in growth in revenues from excise taxes on utilities (partially an indirect reflection of the jump in fuel prices) and miscellaneous excises.

[4] The category "miscellaneous revenue" comprises a variety of subcategories, including interest earnings, rents, net lottery receipts, special assessments, sales of property, and "other miscellaneous revenues not elsewhere classifiable." It is difficult to trace historical series for these subcategories because redefinitions by the Governments Division of the U.S. Census Bureau have put some components of one subcategory into another. For example, prior to FY1988, interest on mortgage revenue bonds was classified as part of "rents" and accounted for most of this category. In FY1988, the Census began classifying it as "interest earnings" (U.S. Bureau of the Census 1997).

State and local governments earn interest earnings on their holdings of cash and securities. A large part of the earnings accrues on the proceeds of bond offerings, which spend time in government coffers earning interest before they are spent on the investments the

Table 1
State and Local Own-Source Revenues and Components as a Percent of Personal Income, Selected Fiscal Years, 1977 to 1994

Percent	FY1977	FY1982	FY1984	FY1986	FY1988	FY1989	FY1990	FY1991	FY1992	FY1993	FY1994
General Own Source Revenue	15.3	14.4	15.4	15.3	15.7	15.8	15.8	15.6	15.9	15.9	16.1
Taxes, Fees, and Charges	14.2	12.5	13.4	13.1	13.6	13.7	13.7	13.5	13.9	14.0	14.3
Taxes	12.1	10.4	11.0	10.8	11.2	11.2	11.1	10.9	11.2	11.2	11.4
General Sales Taxes	2.5	2.4	2.6	2.6	2.7	2.9	2.7	2.6	2.6	2.6	2.7
Selective Sales Taxes	1.7	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.4
Property Taxes	**4.3**	**3.2**	**3.3**	**3.2**	**3.4**	**3.4**	**3.5**	**3.5**	**3.6**	**3.6**	**3.6**
Personal Income Taxes	2.0	2.0	2.2	2.2	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Corporate Income Taxes	.6	.6	.6	.6	.6	.6	.5	.5	.5	.5	.5
User Fees and Charges	**2.1**	**2.2**	**2.4**	**2.3**	**2.4**	**2.5**	**2.6**	**2.6**	**2.7**	**2.8**	**2.9**
Miscellaneous Revenues	**1.1**	**1.8**	**2.0**	**2.2**	**2.0**	**2.1**	**2.1**	**2.0**	**2.0**	**1.9**	**1.8**

Note: Estimates based on revised personal income data.
Sources: U.S. Bureau of the Census, U.S. Bureau of Economic Analysis, and author's calculations.

burden of taxes and the burden of the sum of taxes and current charges, neither of which includes miscellaneous revenues, both fell by 1.7 percentage points during the five-year period (Table 1 and Figure 1).

Revenue Burden from FY1982 to FY1988

According to conventional wisdom, state and local governments compensated for the loss in property tax revenues during the 1980s by relying more heavily on user charges. However, between FY1982 and FY1988, when the revenue burden rose by 1.3 percentage points, user charges as a percentage of personal income increased by only 0.2 percentage point (Table 1). Miscellaneous revenues continued to expand more rapidly than personal income, driven again by interest earnings and also by growth in lottery revenues. In FY1988, miscellaneous revenues were propped up by an expansion of the definition of interest earnings to include interest earned on all industrial revenue bonds.[5]

The two categories of revenues that grew most rapidly during this period were personal income taxes and general sales taxes. States relied heavily on legislated tax increases in both, and especially in personal income taxes, to deal with deficits resulting from the 1981–82 recession and the collapse of oil prices in 1983 and 1984. The relatively rapid growth in sales tax revenues also reflected an increasing ratio of consumption to personal income and, toward the latter part of the 1980s, a nationwide construction boom.[6]

Revenue Burden from FY1988 to FY1994

From FY1988 to FY1994, the revenue burden rose by 0.4 percentage point, despite a 0.2 percentage-point decline in miscellaneous revenues, primarily because of falling interest rates (Table 1). The revenue burden fell in FY1991 as a result of the recession and rose by 0.5 percentage point over the ensuing three years. Normally, one would suspect recession-induced increases in income taxes and sales taxes as the main factor driving the increase in the revenue burden during this period. In fact, the two sources of revenue expanding most rapidly between FY1988 and FY1994 were property taxes and current charges. The rise in the property tax burden primarily reflected local governments' response to the rising ratio of school-age children to the total population and slowing growth in state aid for education.

The 0.5 percentage-point rise in current user fees and charges came from increases in fees of all types.

bonds are intended to finance. In FY1994, the latest year for which data are available, state and local governments had $845 billion in cash and security holdings other than in trust funds.

[5] As noted in footnote 4, prior to that year, interest on mortgage revenue bonds had been included in rents, another category of miscellaneous revenues, but interest on other revenue bonds was not included in state and local revenues at all.

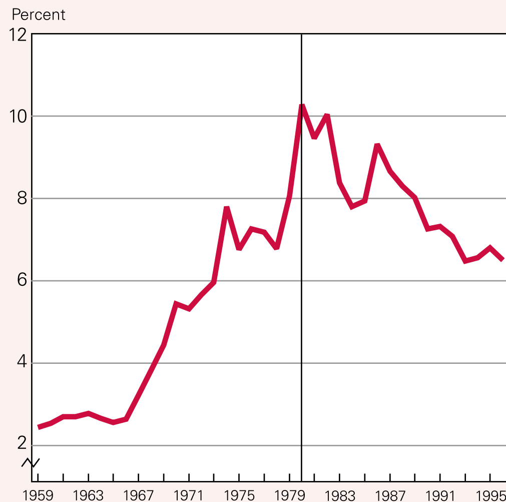
[6] Construction cycles tend to influence sales tax revenues heavily because, with so many exemptions for necessities and services, construction materials comprise a large share of sales tax bases.

While this growth in fee-based revenues may be encouraging to those searching for evidence of the ability of state and local governments to increase their revenue effort, two caveats should be kept in mind. First, one-half of all state and local current charges are hospital fees and tuition for higher education. The costs of providing both types of services skyrocketed during the late 1980s and early 1990s in both the public and private sectors. In raising hospital fees and tuition, state and local governments were passing on higher costs, not reducing their rate of subsidization. In fact, the ratio of user fee revenue to direct expenditure for both functions declined substantially over the six-year period.

Second, the rapid increase in user charge revenue between FY1988 and FY1994 coincided with serious fiscal difficulties, which began before the onset of the recession in many states and were severely exacerbated by it (Gold 1995). In the past, states had met such cyclical difficulties primarily with increases in broad-based taxes. During the most recent recession, state and local policymakers were reluctant to rely too heavily on tax increases to restore fiscal health because they feared their constituents would not tolerate it. They relied on increases in user fees in large part because traditional solutions would not have been sufficient. It remains to be seen whether voters will accept further increases in fees and charges.

Figure 2

State and Local Corporate Income Tax Burden[a] since Fiscal Year 1959



[a]State and local corporate profits tax accruals as a percentage of nationwide pre-tax corporate profits. Profits include IVA (inventory valuation adjustments) and CCA (capital consumption allowances); they exclude rest-of-the-world profits and profits of the Federal Reserve System.

Source: U.S. Bureau of the Census, U.S. Bureau of Economic Analysis, and author's calculations.

Conclusions from Trends in Revenue Burden

These trends do not offer much hope to those who would like state and local governments to expand their fiscal domain in a devolutionary scenario. The state and local *tax* burden fell by 0.7 percentage point between FY1977 and FY1994. The 0.8 percentage-point rise in the *revenue* burden during that period reflects primarily growth in receipts from fees and charges and miscellaneous revenues. The rise in the ratio of miscellaneous revenues to personal income reflects, depending on the years in question, increases in interest rates (temporary windfalls outside of state and local control), expansion of borrowing, changes in the definition of the category, and increases in net lottery revenues. Since increases in interest rates or borrowing create concomitant higher interest expenditures, they do not enhance the capacity of governments to finance services. Without the definitional changes, the increase in the revenue burden would have been smaller, although existing data do not reveal how much so. Lotteries have contributed significantly to the revenues of many states, but a number of researchers doubt that this source of revenue can continue to expand as rapidly as it did during the 1980s (for example, McGowan 1995).

An analysis of changes over time in the burden of specific taxes reveals further potential impediments to state and local governments seeking to expand their future fiscal scope. Corporate income tax receipts as a percentage of personal income has fallen gradually since FY1989 as states have stepped up efforts to lure employers with corporate tax breaks. The impact of this competition is more clearly revealed in the much steeper decline over the past decade in the ratio of corporate tax receipts to pre-tax corporate profits (Figure 2).

Receipts from selective sales taxes, especially those on motor fuel, alcohol, and tobacco, have been growing more slowly than personal income over the past 15 years because fewer people smoke and drink hard liquor (taxed more heavily than beer and wine), and because gas mileage has been improving (or at least had been improving until recreation vehicles became popular and the 55-mph speed limit was relaxed in some states). However, states have recently

begun to raise excise tax rates on tobacco and may continue to do so in the future. A settlement with tobacco companies concerning increased public health care costs resulting from smoking may also provide states with a significant source of revenue.[7]

While the burden of general sales taxes and the burden of property taxes have both increased slightly since the early 1980s, some obstacles lie in the way of future increases. It is not clear how much lower the nation's saving rate can get, although the performance of the stock market in recent years has created a "wealth effect" that will boost consumption in the near term. On the whole, states have not been especially successful at broadening their sales tax bases to include services, especially those provided to businesses. The mobility of service firms, coupled with the intensity of interjurisdictional competition, has thwarted such an expansion (Fox and Murray 1988; Francis 1988). Increasing usage of the Internet to consummate sales, and attendant enforcement difficulties, may further limit the returns from sales taxation. The property tax is not an especially promising future revenue source because of its continuing unpopularity among taxpayers and the increasingly successful attacks on the constitutionality of its use as the principal means of financing primary and secondary education (Evans, Murray, and Schwab 1997).

The mobility of service firms, coupled with the intensity of interjurisdictional competition, has thwarted expansion of state sales tax bases to include services, especially those provided to businesses.

Have State and Local Governments Been Building Reserves in Anticipation of Possible Future Cuts in Federal Aid?

Clues about the propensity of state and local governments to assume devolved fiscal responsibilities can also be gleaned from recent trends in their aggregate surplus or deficit and their efforts to build reserve balances. Anecdotal evidence suggests that state governments, at least, have been posting large surpluses and building reserves that could serve as a contingency against possible reductions in federal assistance. This section evaluates these purported trends by reviewing evidence from the National Income and Product Accounts (NIPA) and surveys conducted by the National Governors Association (NGA) and the National Association of State Budget Officers (NASBO).

Trends in the State and Local Surplus

According to NIPA's latest revised historical data, state and local governments as a whole have continuously operated in the black since 1929, the first year for which such data are available. This is true even when the net surplus in social insurance funds (primarily pension funds for public employees) is not included in receipts. Figure 3 displays the surplus of the state and local sector, social insurance funds excluded, in current dollars, as a percent of Gross Domestic Product (GDP) and as a percent of state and local government spending since 1967.

The surplus of the state and local sector has, in fact, been increasing since the last recession and has stayed between 4 and 5 percent of state and local spending since 1994. However, such percentages pale in comparison to those posted 30 years ago. While interstate tax competition has intensified in the past 30 years, and voters' tolerance for tax increases has diminished, voters' demand for state and local services, especially public safety, corrections, health care, and environmental protection, has increased. Federal aid, other than grants for human services (especially Medicaid), has shrunk. As a result, the state and local

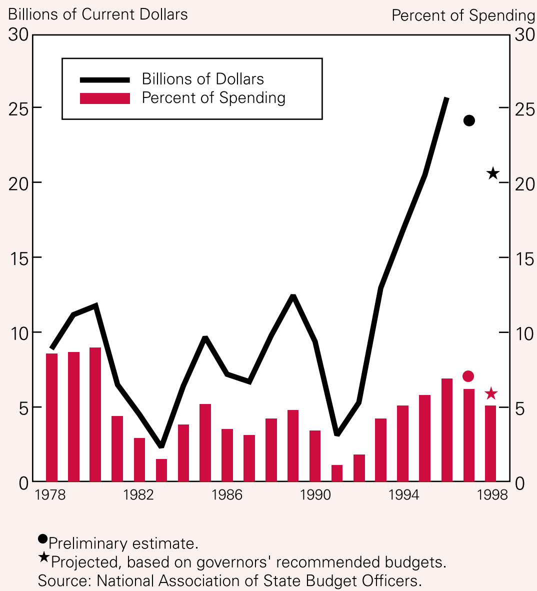
[7] The rise in the selective sales tax burden in FY1994 may not reflect tax increases at all but rather what have been euphemistically referred to as Medicaid "financial arrangements." During the early 1990s, state officials discovered a loophole in Medicaid regulations that permitted them in effect to channel federal Medicaid assistance into their general funds. In the most common arrangement, a state would impose a "health provider tax," usually a gross receipts tax on hospitals or nursing homes operating within their borders (which would be classified by the U.S. Census Bureau as a selective sales tax). The state would allocate part of the revenues from this tax into its general fund and part into its Medicaid program. The part dedicated to Medicaid would generate federal matching funds. The state would then use part of the dedicated revenues, supplemented by federal assistance, to pay health care providers an amount roughly equal to their provider tax liability, effectively wiping out the provider tax burden. Congress greatly narrowed this loophole in 1994, eliminating the incentive to create such arrangements and cutting them off as a significant future revenue source.

Figure 3

Note: Social insurance funds excluded. Shaded areas indicate recessions.
Source: U.S. Bureau of the Census, U.S. Bureau of Economic Analysis, and author's calculations.

Figure 4

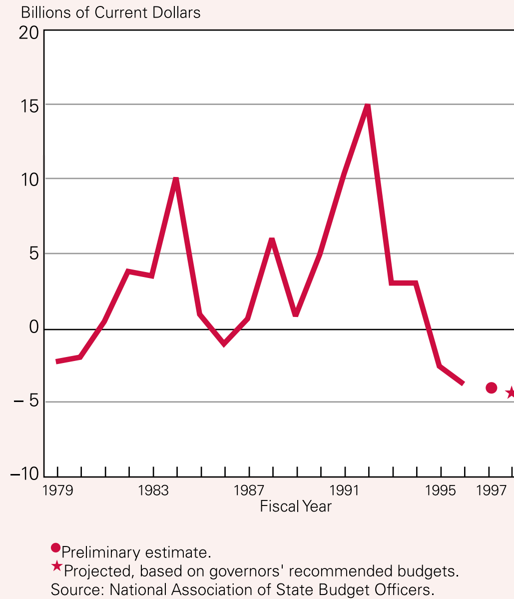
Total Year-End Balances in States' General Funds, Fiscal Years 1978 to 1998



●Preliminary estimate.
★Projected, based on governors' recommended budgets.
Source: National Association of State Budget Officers.

Figure 5

Change in State Revenues, Fiscal Years 1979 to 1998



●Preliminary estimate.
★Projected, based on governors' recommended budgets.
Source: National Association of State Budget Officers.

surplus as a percentage of spending has been in secular decline.

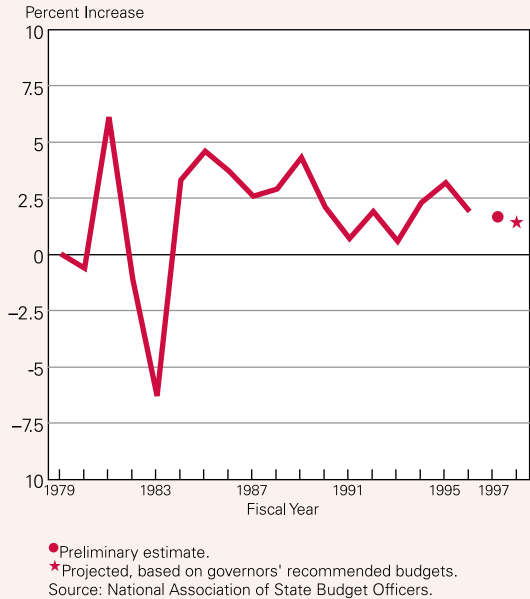
Periodic cyclical jumps have interrupted this long-term downward trend. After the recessions of 1969–70, 1974–75, and 1981–82, the state and local surplus increased sharply for one to three years. In the late stages of a recession and early stages of a recovery, state and local governments tend to impose tax increases and hold down spending in order to restore their fiscal health. Proceeding further into the recovery, as the economy accelerates, these legislated tax increases help to produce a sharp increase in revenues which, combined with continued restraint in spending, boosts the surplus. As the recovery matures and reserves swell, spending discipline loosens and some of the tax increases (many of which were intended to be temporary) are rescinded. Consequently, surpluses shrink into the next recession, when the cycle renews.

Thus, the increase in the surplus-to-spending ratio since 1991 has been a standard cyclical phenomenon. As Figure 3 shows, by historical standards its amplitude is small and, since peaking in 1993, it has more or less plateaued. This leveling off contrasts with previous cycles during the past 30 years, when the ratio fell sharply one to three years past peak. That this ratio has not declined much during the past three years is consistent with the belief that state and local governments are "bulking up," partially to offset federal aid cuts.

Evidence from the *Fiscal Survey of the States*, first taken in FY1978 and now conducted every six months by the National Governors Association and the National Association of State Budget Officers, suggests that *state* governments have been exercising considerable fiscal restraint since the trough of the last recession. According to the latest *Survey*, state general fund year-end balances as a percentage of expenditures rose from a record low of 1.1 percent in FY1991 to 6.9 percent in FY1996, a level not seen since 1980 (Figure 4). Moreover, the surpluses are widespread, not confined to a few large states that exert a big influence on the aggregate state totals (for example, California, Texas, New York, and Florida). More recently, the buildup may be moderating. Preliminary estimates for FY1997 and projections based on governors' budget recommendations for FY1998 indicate a decline in this percentage to 5.1 percent by the end of the current

Figure 6

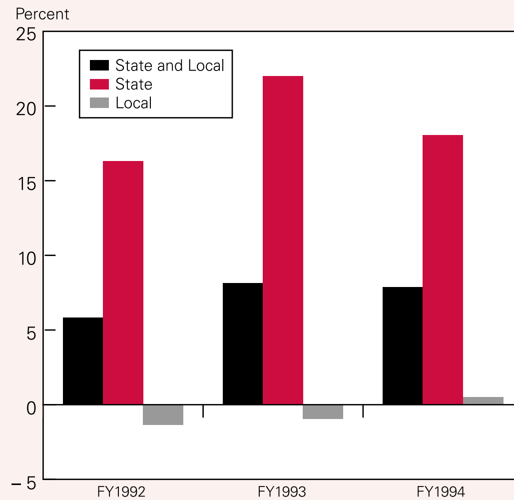
Annual Inflation-Adjusted Increases in State Budgets, Fiscal Years 1979 to 1998



●Preliminary estimate.
★Projected, based on governors' recommended budgets.
Source: National Association of State Budget Officers.

Figure 7

State and Local Sector Surpluses (Deficits), NIPA Basis, as a Percent of Government Expenditures, Fiscal Years 1992 to 1994



Note: See footnote 7 and U.S. Bureau of Economic Analysis (1988) for methodological details.
Source: Prepared by Daniel G. Swaine, using data from U.S. Bureau of Economic Analysis, National Income and Product Accounts, and U.S. Bureau of the Census.

fiscal year. The estimated declines are based on enacted and proposed tax reductions rather than an acceleration in spending (Figures 5 and 6). In fact, since FY1995, growth in constant-dollar state general fund spending has slowed to its slowest rate since FY1983.

The contrast between the states' budgetary strength demonstrated in the *Survey* evidence and the weaker condition of states and municipalities as a whole evident in the NIPA data, suggests that, as a whole, local governments are in poorer fiscal shape than state governments. Disaggregating the NIPA surplus into its state and local components bears this out (Figure 7). In FY1992 and FY1993, the local sector ran a small deficit, while in FY1994 it barely broke even. By contrast, at the state level, the surplus exceeded 16 percent of spending in all three years.

This asymmetry presents a problem for devolution advocates. Local governments are at the bottom of the fiscal food chain. If federal aid is cut and restructured so as to be less responsive to economic cycles, state governments are going to be hard-pressed to maintain levels of local aid, especially during recessions. As John Shannon has noted, we live in a time of "fend for yourself" federalism. With the property tax under judicial attack and both businesses and households increasingly mobile, local governments are going to have an increasingly hard time fending for themselves. The NIPA data suggest that, in addition to their chronic fiscal problems, local governments as a whole lack reserves, a cushion that would help them cope in the short run with aggravated fiscal stress.[8]

Devolution and Fiscal Disparity among the States

The core issues in the devolution debate concern differences among the states at least as much as fiscal

[8] The weak local fiscal picture painted in Figure 7 contradicts the results of the latest study of city fiscal conditions published periodically by the National League of Cities (*City Fiscal Conditions in 1997*). According to the report, U.S. cities as a whole (excluding New York City and Washington, DC) enjoyed an aggregate balance at the end of FY1994 equal to 10.5 percent of spending. This percentage has climbed steadily since FY1992; the National League of Cities estimates that it was between 17 and 20 percent at the end of FY1977. These results are puzzling in light of the results displayed in Figure 7.

trends in the aggregate state and local public sector. Many who question the wisdom of devolution are concerned that some states will lack the ability to assume abandoned federal fiscal responsibilities, even if they wanted to. They also worry that those states least able to respond would be at a disadvantage in interstate competition, forcing them into a vicious circle of reduced public services, loss of labor and capital, intensification of their fiscal problems, and further spending cuts or tax increases. By contrast, devolution's proponents see diversity among states as its raison d'être. Because states differ so much in their preferences concerning the size and composition of the public sector, proponents say, let each decide what level and mix of services is most suitable. This section examines these differences among the states. How widely do states differ in terms of their fiscal strength? To what extent do the weakest states tend to prefer "small" government anyway?

The Problem of Fiscal Disparity in More Detail

Every state, along with its municipal governments, must provide vital public services to those who reside, work, travel, and vacation within its borders. Many states, through no fault of their own, must work relatively hard to meet their fiscal responsibilities, compelled to cope with difficult problems that require costly solutions. For example, some have a high proportion of low-income residents, who need cash assistance, special education, and extensive health care. Others may have a large percentage of their population in the school-age bracket of 6 to 18 years, requiring them to spend relatively large per capita amounts on primary and secondary education. Still others, with a large geographic area and widely dispersed population, must spend high per capita amounts on road construction and maintenance. Such states are said to have high *fiscal need.* By contrast, some states have low fiscal need, that is, they are free of conditions that increase the cost of delivering services or augment the scope of programs they must deliver.

On the revenue side, some states are endowed with rich potential tax bases. They may have large income and property tax bases attributable to residents' high average income and wealth, a large potential sales tax base due to physical beauty and natural resources that attract tourists, or a rich severance tax base because of high concentrations of extractable minerals or lumber. These states have a high *fiscal capacity.* By contrast, states suffering from meager potential tax bases have low fiscal capacity.

Fiscal capacity and fiscal need are both dimensions of *fiscal comfort*. States with high fiscal capacity and low fiscal need enjoy the most fiscal comfort, while those with low capacity and high need suffer the least comfort or the most stress. States with high capacity and high need or low capacity and low need fall between the two extremes.

Many who question the wisdom of devolution are concerned that some states will lack the ability to assume abandoned federal fiscal responsibilities, even if they wanted to. They also worry that those states would be at a disadvantage in interstate competition.

Measuring States' Fiscal Capacity

The most sophisticated analysis of interstate differences in fiscal capacity was performed in the past by the U.S. Advisory Commission on Intergovernmental Relations (ACIR), an organization that no longer exists. Between 1962 and 1991, ACIR periodically published an index that gauges each state's *relative* fiscal capacity.[9] The methodology used to construct this index, known as the representative tax system (RTS) approach, was pioneered by Alice Rivlin and Selma Mushkin in the early 1960s (ACIR 1962; Clark 1990). The approach evaluates states' tax capacity by estimating the per capita tax yield that a uniform, hypothetical, representative tax system would produce in each state. Such a tax system consists of the principal taxes levied by state and local governments for which data comparable across states are available. There are 26 taxes in all in ACIR's 1991 RTS estimates. Table 2 presents ACIR's index values for all 50 states and the District of Columbia for 1987

[9] Another indicator occasionally used is "total taxable resources" (see Sawicky 1986).

Table 2
Tax Capacity as Measured by Representative Tax System Approach, by State, Fiscal Years 1994, 1991, and 1987
Index: National Average = 100

	1994	Rank	1991	Rank	1987	Rank		1994	Rank	1991	Rank	1987	Rank
Nevada	141	1	128	5	110	12	Ohio	97	22	93	28	91	31
Connecticut	136	2	130	4	139	2	Montana	96	27	91	32	87	37
Alaska	131	3	178	1	169	1	Vermont	95	28	105	15	103	17
Wyoming	128	4	134	3	137	3	Georgia	95	28	91	32	94	26
New Jersey	128	4	119	8	122	7	Texas	95	28	97	22	99	20
Hawaii	125	6	146	2	113	10	Nebraska	95	28	95	24	91	31
District of Columbia	124	7	123	7	122	7	Rhode Island	94	32	89	38	96	24
Delaware	116	8	125	6	124	5	Missouri	94	32	91	32	91	31
New Hampshire	113	9	110	11	123	6	North Dakota	93	34	91	32	90	34
Massachusetts	112	10	117	9	127	4	Iowa	93	34	93	28	84	41
Colorado	110	11	109	12	111	11	Arizona	93	34	94	26	100	19
Maryland	107	12	106	14	109	13	Louisiana	92	37	89	38	86	40
Illinois	107	12	102	19	97	22	North Carolina	91	38	93	28	90	34
California	105	14	115	10	117	9	South Dakota	91	38	86	42	78	46
Minnesota	104	15	101	20	104	16	Tennessee	90	40	82	45	84	41
Virginia	104	15	103	16	102	18	Idaho	90	40	82	45	77	47
Washington	103	17	108	13	99	20	New Mexico	90	40	87	40	87	37
Michigan	101	18	94	26	95	25	Maine	89	43	95	24	97	22
New York	101	18	103	16	108	14	Oklahoma	87	44	87	40	93	27
Florida	100	20	103	16	105	15	South Carolina	86	45	83	43	80	43
Oregon	98	21	100	21	92	29	Utah	85	46	82	45	79	44
Indiana	97	22	90	36	87	37	Kentucky	85	46	83	43	79	44
Pennsylvania	97	22	96	23	92	29	Alabama	83	48	81	48	75	49
Kansas	97	22	93	28	93	27	Arkansas	81	49	78	49	75	49
Wisconsin	97	22	90	36	88	36	West Virginia	81	49	77	50	77	47
							Mississippi	71	51	68	51	65	51

Note: Sources, methodology, and detailed statistics are presented in a Statistical Appendix available from the author upon request.

and 1991, along with this study's estimates for 1994 using the ACIR approach.

In the application of each tax, a uniform rate is levied on a base whose definition represents "standard practice," a concept whose measurement is necessarily somewhat subjective. In order to determine it, ACIR first identified what the base would look like if it were devoid of all "tax incentives" or "tax breaks," that is, exclusions and deductions intended to encourage certain forms of behavior or to relieve groups of taxpayers in particular circumstances.[10] Put another way, this base would be that which state and local governments would use if they were constructing it solely on the basis of fairness and neutrality. For example, the general sales tax is intended to be a tax on all retail sales of all goods and services (other than a few subject to specific selective excises, such as motor fuels), including such frequently excluded items as food and clothing. ACIR subtracted from this normative ideal items that are generally not taxed, such as business services. The underlying rationale for these exclusions is that, given administrative and political constraints, states are not capable of obtaining revenue from the taxation of these components of retail sales.

Having defined and measured the standard base of each tax, ACIR then determined the standard *rate* to be applied to each base. The standard tax rate was set equal to the actual nationwide collections from the tax divided by the value of the nationwide standard base. For example, for FY1991, ACIR determined that

[10] These features are often referred to as "tax expenditures," a term coined by Stanley Surrey (1973).

nationwide the standard base for the general retail sales tax was $1,983 billion. In that year, receipts from state and local general sales taxes totaled $128.5 billion. The standard general sales tax rate was then assumed to be $128.5 billion/$1,983 billion, or 6.48 percent.

After the characteristics of each tax in the standard system were determined, ACIR divided each base among the states and applied the standard rate to each state's base to estimate the state's capacity to raise revenues from that tax. To give a FY1994 example, California's standardized general sales tax base was estimated to be $278.1 billion, or about 11.3 percent of the nationwide total. The standard general sales tax rate for 1994 was estimated to be 6.04 percent. California's general sales tax capacity was estimated to be 0.0604 × $278.1 billion or about $16.8 billion, $536 in per capita terms. The comparable estimate for the nation as a whole is $572 per capita. Thus, California's general sales tax capacity in FY1994 was $536/$572, or about 94 percent of the nationwide average.

This exercise was repeated for every tax for each state. For certain taxes, such as that on corporate profits and net worth, apportionment of the nationwide base was complicated by a lack of state-specific data. As a result, apportionment formulas had to be developed and implemented to estimate each state's standard base. For each state, per capita capacity estimates for all taxes were totaled to arrive at a total tax capacity figure. Total tax capacity estimates were indexed to the national average (set equal to 100). The results, along with those for selected previous years estimated by the ACIR, are presented in Table 2. They are supplemented by state-by-state estimates of FY1994 capacity indices for each tax, in a Statistical Appendix available from the author upon request.

Tax Capacity: Results

Tax capacity has varied widely among the states, exhibiting a degree of dispersion that supports the anti-devolutionary concerns discussed above. In FY1994, the values of the RTS tax capacity index ranged from a high of 141 in Nevada to a low of 71 in Mississippi. States with extraordinarily high tax capacity include those with large potential income or property tax bases (such as Connecticut, Delaware, the District of Columbia, Hawaii, and New Jersey), those blessed with an abundance of extractable minerals (such as Alaska and Wyoming), and those with an unusually high sales tax capacity by virtue of their large tourist industry (such as Hawaii and Nevada).

Tax capacity has varied widely among the states, exhibiting a degree of dispersion that supports anti-devolutionary concerns. States with the lowest tax capacity tend to be concentrated in the South.

States with the lowest tax capacity tend to be concentrated in the South and have low capacity indices for all three major state and local broad-based taxes: property, personal income, and general sales. In addition to Mississippi, examples include Arkansas, West Virginia, Alabama, Kentucky, and South Carolina.

A concept related to tax capacity is "revenue capacity," measured with the representative revenue system (RRS) approach. This approach is the same as RTS except that it also takes into account a state's relative capacity to raise revenues from user charges, rents and royalties, and lotteries. Table 3 compares states' indices of revenue capacity for 1994 and 1991. A state's relative revenue capacity is generally similar to its relative tax capacity.

Has Dispersion in Tax Capacity Increased or Decreased over Time?

A narrowing of interstate differences in fiscal disparity over time would dispel some of the concerns of devolution's opponents about the undesirable consequences of interstate competition pursued on a slanted playing field. Figure 8 shows mean absolute deviations from 100 (the value for the nation as a whole) in tax capacity (as measured by the RTS approach) for selected years between FY1975 and FY1994. By this measure, dispersion in tax capacity increased slightly between FY1975 and FY1977 and then grew sharply from FY1977 to FY1981. Between FY1981 and FY1987 about half of the earlier increase was erased. After an uptick in FY1988, dispersion again declined, returning in FY1994 almost to its FY1975 level.

Fluctuations in dispersion between FY1977 and FY1988 were heavily influenced by movements in energy prices. The pronounced widening of dispersion between FY1977 and FY1981 is attributable in

Table 3
Revenue Capacity as Measured by Representative Revenue System Approach, by State, Fiscal Years 1994 and 1991
Index: National Average = 100

	1994	Rank	1991	Rank		1994	Rank	1991	Rank
Alaska	157	1	240	1	Rhode Island	95	26	91	32
Connecticut	136	2	130	3	Indiana	95	26	89	38
Nevada	133	3	123	6	Nebraska	94	28	94	25
District of Columbia	129	4	124	5	Texas	94	28	96	23
New Jersey	128	5	122	7	Georgia	94	28	91	32
Wyoming	122	6	128	4	Vermont	94	28	102	19
Hawaii	122	6	137	2	Montana	93	32	89	38
Delaware	115	8	120	8	Missouri	93	32	90	34
Massachusetts	114	9	119	9	Louisiana	93	32	89	38
New Hampshire	112	10	111	11	Iowa	92	35	92	28
Maryland	109	11	108	12	Arizona	92	35	92	28
Illinois	108	12	103	16	New Mexico	92	35	90	34
Colorado	108	12	107	13	North Dakota	91	38	90	34
California	105	14	113	10	North Carolina	91	38	92	28
New York	105	14	105	15	Tennessee	90	40	84	43
Virginia	104	16	103	16	South Dakota	89	41	85	41
Minnesota	103	17	99	20	Idaho	88	42	82	45
Washington	103	17	106	14	Maine	88	42	94	25
Michigan	101	19	95	24	South Carolina	85	44	83	44
Florida	100	20	103	16	Oklahoma	85	44	85	41
Pennsylvania	97	21	97	21	Kentucky	84	46	82	45
Wisconsin	96	22	90	34	Alabama	84	46	82	45
Kansas	96	22	92	28	Utah	84	46	80	48
Ohio	96	22	93	27	Arkansas	80	49	78	49
Oregon	96	22	97	21	West Virginia	80	49	76	50
					Mississippi	71	51	69	51

Note: See Table 2.

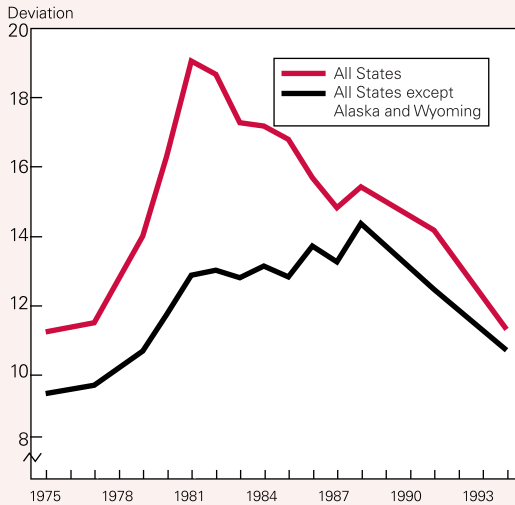
large part to oil-shock-induced spikes in energy prices, which in turn dramatically raised the fiscal capacities of states whose economies depended heavily on fossil fuel extraction. During the four-year period, Alaska's tax capacity index, already high, increased from 158 to 324 and Wyoming's, from 154 to 216. The swings in these two states' fiscal capacities were so large that they exerted a significant effect on the numbers. From FY1981 to FY1987, dispersion in tax capacity declined even though many states in the Northeast, generally enjoying perennially high tax capacities, prospered economically and widened their advantage. This expansion in tax capacity in the Northeast was overpowered by the effects of the "bust" in energy prices during the mid-1980s. The bust caused a precipitous decline in the tax capacities of the energy-producing states, pulling down the overall dispersion measure.

From FY1988 to FY1991, the relative fortunes of the nation's various regions reversed. The states in the Northeast, which had enjoyed high fiscal capacity during much of the 1980s, saw their RTS index values drop substantially, while a mild rebound in oil prices boosted the tax capacities of the energy-producing states. As a result dispersion narrowed further. Between FY1991 and FY1994, a 10-point decline in California's tax capacity index, along with smaller declines in other traditionally high-capacity states like New York, Texas, Florida, Ohio, and Washington, produced a sharp narrowing in dispersion. Declining oil prices were a contributing factor—Alaska's index declined 44 points.

The large effect of swings in oil prices on dispersion in tax capacity is evident when one removes Alaska and Wyoming from the computations (black

Figure 8

Mean Absolute Deviation from National Average (100) in States' Tax Capacity, as Measured Using the Representative Tax System (RTS) Approach



Source: U.S. Advisory Commission on Intergovernmental Relations (1993) and author's calculations.

line in Figure 8). In every year, dispersion is less without Alaska and Wyoming, especially between FY1979 and FY1985, when fluctuations in oil prices were especially pronounced. Year-to-year variations in dispersion are also much smaller. Finally, dispersion in the 49-state sample exhibited a generally upward trend through FY1988, a reflection of the relatively robust growth of California and states in the Northeast with traditionally high fiscal capacity. Without Alaska and Wyoming, the narrowing in dispersion since FY1988 is a reversal in trend, not the continuation of a narrowing that began earlier.

Measuring Fiscal Need

A state with a high fiscal capacity will not necessarily enjoy a relatively comfortable fiscal position if it faces a high fiscal need. Until about 25 years ago, it was assumed that fiscal need was proportional to population. Consequently, the index of fiscal capacity described above, which is defined in per capita terms, was thought to be an adequate measure of fiscal comfort as well. Beginning with the work of Musgrave and Polinsky (1970) and Reischauer (1974), economists have rejected this simplistic assumption and have attempted to evaluate interstate differences in fiscal need by taking into account factors affecting the cost of providing a given level of public service and the scope of services that a state and its municipalities must provide.

In 1986, Robert Rafuse, then Deputy Assistant Secretary of the Treasury for Intergovernmental Fiscal Relations, published such an evaluation based on the representative expenditures system (RES) approach. In 1990, he prepared an update for ACIR, based on 1987 data (Rafuse 1990a, 1990b). Analogous to the representative tax system methodology, the RES approach attempts to answer the following questions: (1) What are the characteristics of a representative bundle of state and local spending functions? (2) What constitutes a standard level of services for each function? and (3) What would each state and its municipalities have to spend, in per capita terms, to provide this standard bundle and level of services? If a state has to pay a relatively large per capita amount, its fiscal need is high.

The first step in the RES methodology is to identify and define those state and local governmental spending categories whose level of spending within a state is significantly influenced by factors other than population. Rafuse's report identifies six such functions: elementary and secondary education, higher education, public welfare, health and hospitals, highways, and police and corrections. In FY1987, these six functions accounted for about 70 percent of all state and local governmental expenditures. The need for other spending functions, such as general administration, environmental protection, and housing, is assumed to be proportional to population.

The second step is to identify, for each of the six functions, measurable "workload" factors—determinants of the cost providing a given level of service *other than the price of inputs used by governments.* For example, Rafuse identifies two measurable workload factors for highway expenditures in a given state: (1) the number of vehicle-miles traveled, and (2) lane miles of streets and roads other than those on federally controlled land. The first factor is a determinant of maintenance costs attributable to traffic, while the second, a measure of the stock of roadway, is a determinant of maintenance costs attributable to time and exposure to the elements.[11] The percentage of the

[11] A more accurate measure would also include more specific indicators of rainfall, snowfall, temperature, and the incidence of heavy truck traffic. Unfortunately, reliable state-specific indicators

nationwide work factor accounted for by each state is computed. For example, California accounted for 4.2 percent of the nation's lane miles of roadway and 11.8 percent of vehicle miles traveled.

Where more than one workload factor is used for a particular function, a weighted average of each factor is computed to derive a workload "measure" for the spending function. For example, the number of vehicle miles traveled is weighted seven times more heavily than the total number of lane miles in the construction of the highway workload measure in order to reflect the consensus of experts that highway use is the more important determinant of the need for maintenance and repairs. As a result, California's workload measure for highways was $0.125 \times 4.2 + 0.875 \times 11.7$, or about 10.5 percent.

The nationwide spending on each function by state and local governments is then multiplied by the state's workload measure for that function to determine how much the state would have spent if it had had a standard or representative set of programs, that is, if it had spent an average amount per "work measure unit." For example, in FY1987, the nation's state and local governments spent \$52.2 billion on highways. With a workload measure of 10.5 percent, California's outlays for highways would have been approximately \$5.5 billion ($0.105 \times$ \$52.2 billion) or about \$198 per resident, if it had provided a standard level of highway maintenance services. Nationwide, per capita state and local spending on highways was higher, about \$214, because California's workload measure was lower than its share of the nation's population. In other words, partly because of its large areas of mountains and desert, where road usage is light, the state's per capita fiscal need for highway services was about 92 percent of the national average.

In six state and local spending categories, the level of spending is significantly influenced by factors other than population: elementary and secondary education, higher education, public welfare, health and hospitals, highways, and police and corrections.

The next step in computing a state's fiscal need index is to adjust its estimated per capita "standard" spending on each function for its relative costs of inputs for that function. The methodology for constructing an index measuring a state's relative cost of inputs for state and local services is rather complicated. It is explained in Rafuse (1990) and in this study's Statistical Appendix. In 1987, California's input costs for highway maintenance were 1.6 percent higher than the national average. Thus, its unadjusted per capita standard spending on highways was raised to $1.016 \times$ \$198, or about \$201, roughly 94 percent of the nationwide average.

For each state, the per capita standard spending levels on each function are totaled to obtain the state's spending on a standard expenditure package. These totals are indexed to actual national per capita spending to arrive at an index of fiscal need for each state. Table 4 presents values for the index for FY1987 (as computed by Rafuse) and for FY1994, as estimated in this study. (Subindexes for selected individual functions can be found in this study's Statistical Appendix.)

Fiscal Need in FY1987 and FY1984: Results

In both FY1987 and FY1994, states with high fiscal need tended to be those with a high incidence of poverty or a large proportion of their population of school age (5 to 17 years). These factors are the primary determinants of need for primary and secondary education and public welfare, the two largest functions of state and local governments, and an important determinant of the need for the health and hospitals function. Together these three functions accounted for 49 percent of all state and local direct spending in FY1994. Certain states, such as California, the District of Columbia, Louisiana, and New York, also ranked high in terms of fiscal need in part because of unusually high crime rates, an important determinant of the need for police and corrections. States exhibiting low fiscal need tended to have small populations, such as Maine, Vermont, Nebraska, New Hampshire, Hawaii, Delaware, and Rhode Island.

In both years, dispersion in fiscal need is narrower than is dispersion in fiscal capacity. In addition, there have been dramatic changes in the fiscal needs of many states. Over the seven-year period, indexes of fiscal need rose in California and the Northeast states,

of climate and truck traffic capturing all relevant factors affecting road maintenance were not available to Rafuse.

Table 4
Fiscal Need as Measured by Representative Expenditure Approach, by State, Fiscal Years 1994 and 1987
Index: National Average = 100

	1994	Rank	1987	Rank		1994	Rank	1987	Rank
District of Columbia	116	1	103	16	South Dakota	97	23	105	11
Louisiana	115	2	110	4	Wyoming	96	27	102	20
California	110	3	101	23	Minnesota	96	27	98	31
Texas	110	3	110	4	South Carolina	96	27	103	16
New York	107	5	95	40	New Jersey	95	30	93	42
New Mexico	107	5	111	3	Utah	95	30	105	11
Mississippi	105	7	113	2	Florida	94	32	93	42
Alaska	104	8	121	1	Maryland	94	32	97	35
Kentucky	104	8	108	8	Virginia	94	32	99	27
Michigan	104	8	108	8	North Dakota	93	35	105	11
Georgia	104	8	109	6	Nevada	93	35	96	36
Alabama	102	12	109	6	Washington	93	35	99	27
Oklahoma	102	12	104	14	Pennsylvania	93	35	90	45
Connecticut	101	14	92	44	Montana	91	39	102	20
West Virginia	101	14	103	16	Oregon	91	39	98	31
Arizona	100	16	103	16	Massachusetts	90	41	87	49
Missouri	100	16	100	24	Wisconsin	89	42	94	41
Illinois	100	16	102	20	Delaware	88	43	96	36
Tennessee	99	19	104	14	Iowa	88	43	96	36
Indiana	99	19	99	27	Rhode Island	88	43	86	50
Ohio	99	19	100	24	Colorado	88	43	98	31
Kansas	99	19	98	31	Nebraska	86	47	96	36
North Carolina	97	23	99	27	New Hampshire	86	47	85	51
Idaho	97	23	100	24	Maine	85	49	89	47
Arkansas	97	23	106	10	Hawaii	85	49	90	45
					Vermont	83	51	89	47

Note: See Table 2.

whose rates of economic growth lagged that of the nation as a whole. At the same time, indexes fell in many states located in the South, Rocky Mountain, and Great Plains regions, where economic growth was relatively rapid.

The Correlation between Fiscal Capacity and Need

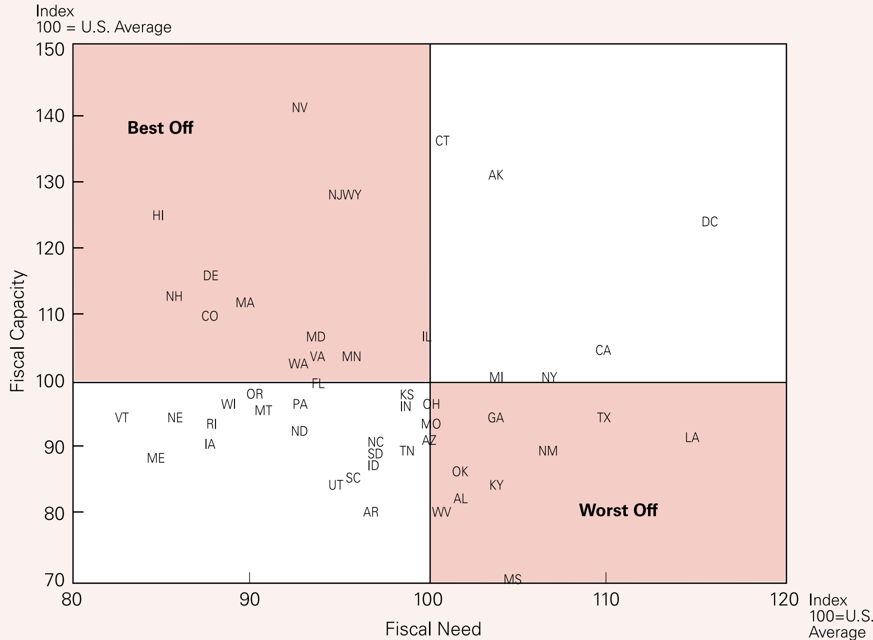
Devolution's opponents would be less concerned if states facing the most severe fiscal need enjoyed the most fiscal capacity. As the scatter plot in Figure 9 shows, the opposite was true in FY1994. Only Alaska, California, and the District of Columbia ranked high on both measures (upper right quadrant). Several Southern states, as well as New Mexico, Oklahoma, and Texas, suffered from both low capacity and high need (lower right quadrant). However, several states with weak fiscal capacities faced relatively mild need, including Maine, Nebraska, North Dakota, South Carolina, and Vermont (lower left quadrant). The most fortunate states, enjoying both ample capacity and little need, included Colorado, Delaware, Hawaii, Maryland, Massachusetts, New Hampshire, New Jersey, Nevada, and Wyoming (upper left quadrant). Overall, the correlation between capacity and need was slightly negative (−0.11), and not statistically different from zero. The negative correlation between the two was stronger in FY1987 (−0.21), although still statistically insignificant.

Fiscal Comfort

An index of fiscal comfort for FY1994 was created for each state by dividing its index of fiscal

Figure 9

Correlation between RTS Fiscal Capacity and RES Fiscal Need, Fiscal Year 1994



Source: Author's calculations.

Fiscal Comfort, Tax Effort, and Interstate Differences in Preferences for Levels of Public Services

As noted in the introduction, diversity across states in preferences for the size of state and local government is a key issue in the debate over devolution. Both supporters and detractors worry that such diversity is substantial but disagree over what to do about it. Proponents of decentralization contend that the nation would be better off giving citizens an opportunity to realize their diverse preferences rather than have the central government suppress differences. Opponents fear that states with preferences for limited government would fail to provide levels of service consistent with the national interest. To both sides, the degree of diversity in preferences is a highly relevant issue.

capacity by its index of fiscal need. The only other year for which estimates of fiscal comfort are available is FY1987 (the year for which Rafuse estimated fiscal need). State-by-state values of this fiscal comfort index for both years are presented in Table 5. The least fiscally comfortable (most fiscally stressed) states are concentrated in the South. The most fiscally comfortable states tend to be those with the highest fiscal capacity, although Maine, Montana, Rhode Island, Vermont, and Wisconsin are exceptions. Given the slightly negative correlation between fiscal capacity and fiscal need, the dispersion in fiscal comfort exceeds the dispersion in fiscal capacity, a fact that reinforces the concerns of devolution's detractors. However, variation in fiscal comfort was less in FY1994 than in FY1987.[12]

The extent of this diversity can be estimated roughly from the measures of fiscal capacity and fiscal comfort presented in this section. Other things equal, states with low capacity relative to need (low comfort) are compelled to spend a high fraction of their tax bases to provide a given level of public services. Consequently, if preferences for levels of state and local public services were similar across states, one would expect states with low levels of fiscal comfort to tax their revenue bases relatively intensively, that is, to exert a relatively high *tax effort*. A lack of correlation, or a negative one, between fiscal comfort and tax effort would imply that fiscally *un*comfortable states prefer lower levels of government than their fiscally comfortable partners.

How should one measure a state's "tax effort?" In the first section, the ratio of taxes (or some broader revenue measure) was used to estimate the "tax effort" of the state and local sector as a whole. This indicator is less useful for individual states because it fails to take into account the degree to which a state can

[12] In FY1994, the mean absolute deviation from 100 (the national average) was 14.4, while in FY1987, it was 18.7.

Table 5

Indexes of Fiscal Comfort, Fiscal Years 1994 and 1987

Using RTS Measure of Fiscal Capacity and RES Measure of Fiscal Need

Index: National Average = 100

	1994	Rank	1987	Rank		1994	Rank	1987	Rank
Nevada	152	1	147	2	Pennsylvania	104	26	102	21
Hawaii	147	2	126	9	North Dakota	100	27	86	38
New Jersey	135	3	131	7	Indiana	98	28	88	34
Connecticut	135	3	152	1	Ohio	98	28	91	29
Wyoming	133	5	134	6	Kansas	98	28	95	24
Delaware	132	6	128	8	Michigan	97	31	88	34
New Hampshire	131	7	144	4	California	95	32	116	11
Alaska	126	8	139	5	New York	94	33	113	13
Colorado	125	9	113	13	Missouri	94	33	91	29
Massachusetts	124	10	145	3	South Dakota	94	33	75	45
Vermont	114	11	115	12	North Carolina	94	33	91	29
Maryland	114	11	112	16	Arizona	93	37	97	23
Washington	111	13	100	22	Idaho	93	37	77	43
Virginia	111	13	104	20	Georgia	91	39	87	36
Nebraska	110	15	94	26	Tennessee	91	39	81	40
Wisconsin	109	16	93	28	South Carolina	90	41	76	44
Minnesota	108	17	106	19	Utah	89	42	75	45
Oregon	108	17	94	26	Texas	86	43	90	32
Illinois	107	19	95	24	Oklahoma	85	44	90	32
District of Columbia	107	19	119	10	New Mexico	84	45	78	41
Rhode Island	107	19	112	16	Arkansas	84	45	70	49
Florida	106	22	113	13	Kentucky	82	47	73	48
Iowa	106	22	87	36	Alabama	81	48	69	50
Montana	105	24	85	39	West Virginia	80	49	75	45
Maine	105	24	109	18	Louisiana	80	49	78	41
					Mississippi	68	51	57	51

Note: See Table 2.

"export" its tax burden to nonresidents. For example, states endowed with large deposits of extractable fossil fuels have a greater revenue-raising capacity than their per capita personal incomes would suggest because they can impose severance and property taxes on oil, gas, and coal companies. These companies can usually shift much of the burden of these taxes onto their customers, located throughout the world. Similarly, Nevada's revenue-raising ability is augmented by its large tourist and gambling industries, which attract visitors from many different regions and foreign countries.

An alternative measure of a state's tax effort, used by the ACIR, divides a state's total tax (or own-source revenue) collections by the amount that it would raise under the Representative Tax System (RTS) or under the Representative Revenue System (RRS). These ratios are then multiplied by 100 to create indexes of tax effort for which the value of the nationwide average is set equal to 100. Table 6 ranks the states by tax effort (using RTS and RRS measures of fiscal capacity) for FY1994. New York and the District of Columbia exert the most tax effort, by far.

As shown in Figure 10, there is no correlation between fiscal comfort and tax effort. Only a handful of states, including Michigan, Mississippi, New York, and South Carolina, have low fiscal comfort and medium-to-high tax effort (upper left quadrant). Several states have either low fiscal comfort and low tax effort (lower left quadrant) or high comfort and high effort (upper right quadrant)—just the opposite of what one would expect if preferences were similar. However, a number of states—most notably Nevada and New Hampshire—show high comfort and low

Table 6
Indexes of Tax Effort by State, Fiscal Year 1994
Ratio of Taxes Collected to RTS Tax Capacity and RRS Tax Capacity, Indexed
Index: National Average = 100

	RTS	Rank	RRS	Rank		RTS	Rank	RRS	Rank
New York	159	1	144	1	Oregon	96	22	103	12
District of Columbia	149	2	127	2	Kentucky	95	27	95	33
Wisconsin	116	3	113	3	Ohio	95	27	95	33
Rhode Island	111	4	100	18	West Virginia	95	27	99	21
Maine	110	5	104	11	Georgia	93	30	99	21
Minnesota	109	6	112	4	Utah	93	30	101	16
Vermont	109	6	102	15	Florida	91	32	96	31
Hawaii	107	8	107	7	Indiana	91	32	97	26
Connecticut	106	9	94	36	Idaho	90	34	96	31
Michigan	105	10	105	10	North Dakota	90	34	99	21
Washington	105	10	107	7	Texas	89	36	90	41
Massachusetts	105	10	100	18	Delaware	89	36	97	26
New Jersey	104	13	98	24	Oklahoma	89	36	95	33
Maryland	103	14	97	26	South Carolina	88	39	103	12
Iowa	103	14	108	6	Arkansas	86	40	88	45
Alaska	103	14	110	5	Virginia	86	40	89	43
Pennsylvania	101	17	97	26	Montana	85	42	87	46
Nebraska	100	18	103	12	Colorado	85	42	89	43
Kansas	99	19	100	18	South Dakota	83	44	86	48
Mississippi	97	20	106	9	Missouri	83	44	82	49
Arizona	97	20	94	36	Wyoming	82	46	93	39
North Carolina	96	22	97	26	Tennessee	81	47	87	46
Illinois	96	22	90	41	New Hampshire	81	47	78	50
California	96	22	98	24	Alabama	80	49	94	36
New Mexico	96	22	101	16	Louisiana	78	50	91	40
					Nevada	69	51	75	51

Note: See Table 2.

effort (lower right quadrant). The correlation coefficient between effort and comfort was −0.01 in FY1994, suggesting negative correlation between comfort and the level of public services preferred.

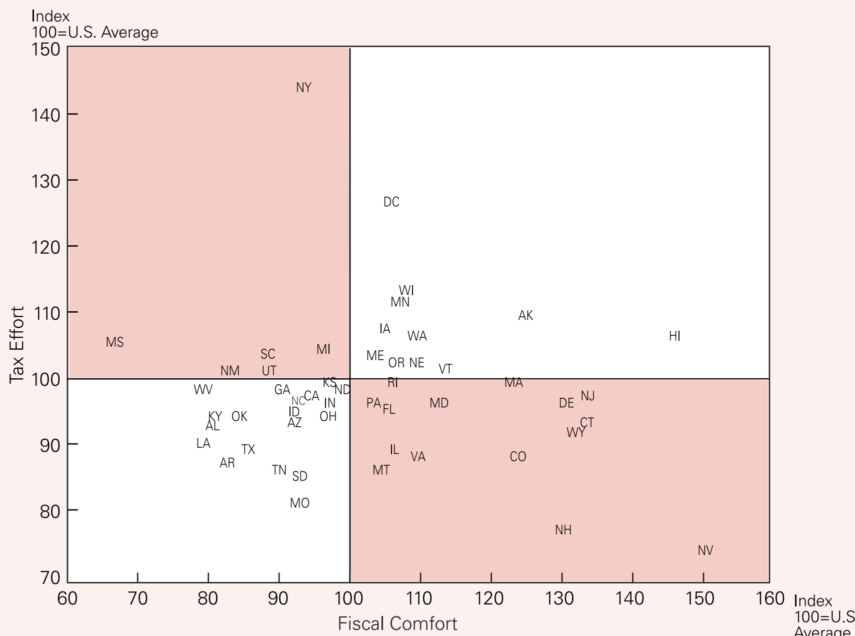
Two other plausible explanations for this negative correlation come to mind. One is that the federal government distributes aid according to a fiscally equalizing pattern (it provides disproportionately generous assistance to fiscally uncomfortable states), and fiscally uncomfortable states substitute federal dollars for their own. In fact, the evidence indicates that federal aid is not equalizing across states, especially if one takes into account the geographic distribution of tax breaks benefiting state and local governments (Kenyon 1995; Tannenwald 1989).[13]

Another possible explanation for the weak negative correlation between effort and comfort is the fiscal restraint engendered by interstate economic competition. According to this view, fiscally stressed states are at a competitive disadvantage, pressuring them into providing a lower level of public services than they would otherwise choose. Other states, including fiscally comfortable ones, feel compelled to respond. States are caught in a "negative sum game" in which

[13] The two so-called major "tax expenditures" benefiting states and municipalities are the deductibility of state and local personal income taxes and residential property taxes and the excludability of interest on state and local debt. Kenyon (1995) and Tannenwald (1989) found a strong positive correlation between the value of these tax breaks to a state and the state's fiscal capacity measured by the RTS method. Tannenwald (1989) found a positive correlation between the value of these benefits and fiscal comfort.

Figure 10

Correlation between RTS Fiscal Comfort and Tax Effort, Fiscal Year 1994



Source: Author's calculations.

tax effort and the level of public services would be higher if states could agree collectively to moderate the intensity of their tax competition. Some analysts who embrace this view (for example, Burstein and Rolnick 1995; Enrich 1996) recommend federally imposed restraints to curb interstate tax rivalries. Short of such measures, the antithesis of devolution, equalizing federal aid would mitigate the inefficiencies attributed to interjurisdictional competition.

Summary and Conclusions

The analysis presented in this paper suggests that devolution would bring about a shrinkage in government, not merely a realignment of fiscal responsibilities among levels of government. While state governments have recently built up considerable reserves, they have been constrained over the past 20 years by public resistance to tax increases and will probably continue to be so constrained in the foreseeable future. Should the federal government cut its level of state aid sharply, states generally will have neither the capacity nor the will to replace forgone federal dollars with additional tax revenues of their own. It would be especially difficult for states that suffer from chronic fiscal stress—low fiscal capacity combined with high need—to assume devolved functions. By contrast, states enjoying ample fiscal comfort would have much less difficulty taking on new responsibilities.

If states and municipalities are to have the capacity to play a more prominent role in the nation's federal system, they probably will need new sources of revenue. As suggested by Rivlin (1992), the federal government might consider dedicating to the states some portion of a nationally administered tax on value added, sales, or corporate profits. Federal administration of the taxes would relieve states of enforcement and compliance costs and competitive pressures to pare the taxes back. However, obtaining agreement on how revenues from such taxes should be allocated among the states would be a daunting political task.

Whatever level of intergovernmental assistance the nation considers optimal, it might consider it in a more fiscally equalizing manner. Such a redistributional shift would mitigate the inefficiencies and inequities created by interstate economic competition and increase the chances chronically stressed states could render assistance to their most severely disadvantaged citizens. Many Canadian aid programs for the provinces, like the U.S. revenue-sharing program of the 1970s, are explicitly designed to reduce interjurisdictional fiscal disparities.

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Discussion

John D. Donahue, Associate Professor of Public Policy, John F. Kennedy School of Government, Harvard University

I would like to add my voice to the praise of Robert Tannenwald's effort on this paper. In a topic that is so often swamped in ideology and generalizations, it is extraordinarily useful to have someone make so much effort to keep us grounded in the facts and informed by the details. This paper is an important contribution, and my other comments should be taken against that backdrop.

Two largely distinct traditions of thinking about the federal-state balance characterize the debate in general, and we see both represented here today. One tradition, to which Tannenwald belongs and where I put myself as well, is the policy-analytic tradition. Here, people talk about economies and diseconomies of scale and scope and how they might factor in the federal-state balance; about the relative capacity of the state and national governments to innovate and experiment and the importance of that relative capacity across policy areas; about whether citizen priorities and preferences tend to differ across states as well as cluster within states, and the implications for the match between citizen priorities and what the government actually does; about whether a policy's costs and benefits are contained within state borders or flow across them; about the advantages and disadvantages of competition, and so on. We discussed many of these issues this morning.

The other tradition, which was represented most clearly by John Kincaid this morning, is the Constitutionalist tradition. At its most extreme, this tradition responds to policy analysts by saying, "You guys are out of your league. We had this debate, and did this policy analysis, back in the 1780s, and we settled it then." At the Constitutional Convention, James Madison and Alexander Hamilton, in particular, might have argued for elastic boundaries around the federal and state governments—that is, an elastic definition of federal responsibilities. But they lost.

If you read the text of the Constitution, this tradition says, you do not find the wide range of options for the federal government that Cathy Minehan referred to today. In fact, the scope of federal action is quite tightly bounded, and so analyzing the issues we are considering today is not a job for the policy analysts and the economists, but rather for the historians and the legal scholars. And when they do that job, what they tell us is that we have lost our way. We went astray at some point—pick one: the Great Society, the New Deal, the post-Civil War Reconstruction. Now the name of the game is getting back to the correct balance, with only a limited legitimate domain for contemporary analysis about what would make for better government.

> *Two largely distinct traditions of thinking about the federal-state balance characterize the debate in general: the policy-analytic tradition and the Constitutionalist tradition.*

Although the two traditions overlap in quite a few areas, one important difference between them is that the policy-analytic tradition tends to look more or less equally at state, local, and even other hybrid forms of government as candidates for taking on formerly federal functions, while the Constitutionalist tradition focuses heavily on the states as the legitimate locus of sovereignty. We could talk for hours about the similarities and differences between the two perspectives and the prescriptions each gives. But in fact, as has been hinted at in many comments here today, neither tradition really is driving the practical policy debate at present. I am reminded of a metaphor we used to use about the policy debate in Washington. The image was of a fallen tree rushing down a stream, drawing close to some rapids. On that tree were several thousand ants crawling around, bumping into one another, crawling over one another—and each individual ant convinced that he or she was what made that tree move.

Similarly, the rising relative importance of the states that we see now is not driven primarily by either of these intellectual traditions. It is less a matter of the states taking a step forward than of Washington taking two steps back. We have talked about the declining public confidence in government and the way it has been concentrated on the failures of Washington. Opinion poll data in fact show that the big picture is not rising confidence in the states but rather

falling confidence in government in general, just falling faster for the central government than for the states.

Aside from this declining legitimacy in the view of the public, the budget constraints on the federal government have by default increased the importance of the states. This has occurred both because of the indirect budget constraints resulting from rising entitlement spending and interest on the debt, and because of the more direct constraints resulting from a series of spending limitation bills passed over the past few years, limiting Washington's ambition. More broadly, the climate of frustration in Washington has caused many people, particularly those with experience in government there, to have a sense that because we have wrecked one level of government, it is fortunate that the framers provided a spare! I call this the "spare government" phenomenon.

I agree with John Kincaid that devolution is an inaccurate label for recent developments, but the shift toward the states is real. It is more than just welfare reform, even though it is not an unalloyed trend. There is a lot of movement in the other direction, but we are seeing a rebalancing that is worth noticing. If you look at public spending over the period from 1980 to 1996, state and local spending funded by state and local resources gained about 2 percentage points of gross domestic product, rising from about 8.5 percent to about 10.5 percent. Over the same period, federal domestic spending (other than transfers and interest, which mask this trend), fell from roughly 4.5 percent of GDP to under 2 percent. It was only 1.7 percent in 1996.

The latter trend, falling federal domestic spending other than for entitlements and interest, will likely continue. It may exhibit a brief hiccup in the near future, based on the terms of the budget deal. But after that, the downward pressure on federal domestic activity is likely to continue. This brings us to Tannenwald's question: Will the first trend, that of rising state and local taxation and spending, also continue? Will the states occupy the terrain or something similar to the terrain from which Washington now retreats? Or will government as a whole shrink as Washington fades? Tannenwald claims the states will not, by and large, take up the slack, and I tend to agree with him, particularly if we take into account the deeply entrenched anti-tax politics that are common at the state and local level, and the mobility of those we look to for payment of the taxes the states would raise.

I am fascinated with the differential mobility across categories of individuals and institutions, in particular the decline in personal mobility across state lines and the general rise in business mobility. These trends cast some serious doubt, not so much on the economic ability but rather on the political will of states to expand or even sustain their current levels of spending. The mobility, by the way, feeds back into the politics. If you look at the rhetoric in state political races in recent years, the question of business mobility enters more and more. A candidate will say, "We would like to spend more on education, highways, and the like, but we cannot raise taxes because we are in competition with the states next door." State-level activism simply becomes less plausible even in states that, given their prior political history, might have invited such activism.

The decline in personal mobility across state lines and the general rise in business mobility cast some serious doubt on the political will of states to expand or even sustain their current levels of spending.

You would also expect to see state tax codes evolve in response to increased business mobility, and I think we are seeing such a trend. The years 1995 and 1996 were the first back-to-back years of net state tax cuts since the early 1980s, I believe. There was a wave of tax-cutting legislation, most of it concentrated on business taxes and personal income taxes. Meanwhile sales taxes actually rose, amid this wave of tax cuts, to hit a record in 1996 of over 5 percent, the highest they have ever been on average. This shift in the burden of state taxation is likely to continue, and it has important implications for the capacity of government to operate as well as for citizens' attitudes toward government.

My prediction, consistent with Tannenwald's, is that the shift toward the states will have weak, ambiguous, and sometimes negative effects on the quality of government, despite the fact that the arguments about states as laboratories of innovation and experimentation are quite sound. So if you think that government is too big and has grown past the proper bounds that citizens want, if you want to shrink it and

make sure it stays shrunk (at least for a while), devolution is a terrific horse to ride and you should ride it hard.

If you are worried about *better* government, not necessarily smaller government, devolution may turn out to be a distraction and perhaps even a setback. The public, by the way, is maddeningly ambivalent on this point. You can make an excellent case that the public wants lower taxes. You can also make an excellent case that the public wants government that is closer to the people and more accountable. It is very difficult to make a case that people want government to do less.

I agree with Tannenwald that ultimately a big part of the solution will be to follow the motto, "Fund nationally, act locally." I agree with William Fox that a number of entities other than the states—cities, regions, individuals—could be the implementers of activities that are funded centrally. And David Ellwood's earlier point, that it is tricky to figure out how to structure these kinds of relationships to get the incentives right for both accountability and efficiency, may be good news, in one sense. We are going to have plenty of time to figure these things out, because it will be quite a while before the politics and the fiscal environment at the central level permit much of an expansion of governmental functions.

Discussion

Patricia McGovern, Esq., Partner, Goulston & Storrs, PC

I have been sitting here thinking about how long all this takes. The Massachusetts state budget of 1987, or perhaps 1988, had an entire section devoted to devolution, because it was going to happen, and happen quickly, and boy, we were going to be ready! So we were ready about ten years ago, in terms of policy analysis and thinking about devolution, but very little has in fact happened since then.

I would like to build on John Donahue's comments about the two relevant policy traditions, the Constitutionalist tradition and the policy-analyst tradition, and the fact that they are not driving the current debate so much as politics is. I too believe that most politicians, at all levels of government, are driven by considerations other than those prominent in the analytical discussion we have had here today. The whole question of devolution, and what we do in a state like Massachusetts versus what the federal government does, is entirely politically driven.

Politicians do not ask the kinds of questions that have been asked here today, and they do not try to answer them. The process of policy formulation is much more visceral, more intuitive. It is focused on the public when it says, through an elected representative, "We feel a disconnect at the federal level. We want things done closer to home." This sentiment is very real and, like John, I think devolution is real. Its pace is extremely slow, but more and more we will see certain aspects of this so-called devolution process happening. People at all levels feel disconnected from their government; the further away the level of government, the more disconnected they feel. Issues of accountability and responsibility are key, as people ask, "What is the government doing for me?" in a rational way.

The whole question of devolution, and what we do in a state like Massachusetts versus what the federal government does, is entirely politically driven.

Sometimes it is hard to answer these questions. Recently I was speaking with a friend at the regional office of the Department of Health and Human Services. She noted that the federal government oversees roughly 84 programs for children. Some of these have been centralized a bit through block grants in the past few years, but until quite recently there were 84 separate programs. Each program had separate requirements, mandates, application forms, and grant processes—which makes no sense. These public funds could easily have been disbursed through five programs rolled into one, each labeled Health, Child Safety, Education, and so on. To have over 80 different programs betrays the amount of waste and foolishness in their organization. The public is ahead of policymakers and politicians in wanting these programs both simplified and brought closer to home. That trend is happening all over America.

One of the questions asked today was, "What

programs will the states take up?" I believe a threshold question should be asked first, "What programs *should* states take up?" even if states have the fiscal capacity. It is widely assumed that if the states have adequate fiscal capacity, we will want them to pick up all these wonderful federal programs.

In general, I am perceived as a progressive and pro-government person. Certainly I am not antigovernment, but we are at the point where many federal and some state programs are so fundamentally foolish and out of control that they make no sense and do not respond to people's needs. The threshold question we should ask, then, is as follows: "If the state has the fiscal capacity, should it pick up a federal program?" That is an important question, and I do not hear it being asked. The question one hears more frequently is, "Does the state have the fiscal capacity to pick up a particular federal program?" We should ask first whether it is a program we want.

I would also make two points about interesting political experiences in my past. First, I lived through the Proposition 2½ revolution in Massachusetts, when "the sky was falling." The public in Massachusetts followed the trend in California and other states and rose up to say, "We have had enough of this property tax nonsense and we are going to stop it." One of the reasons this legislation passed in Massachusetts, and the public responded as it did, was that originally the legislature would not listen. The public informed the legislature that the property tax burden in Massachusetts was completely skewed, and that it ought to be fixed. The legislature did nothing: It was paralyzed. So the public used the wonderful initiative process that exists in this state and fixed the problem itself. Then every one said, "Well, we cannot survive here in Massachusetts with this Proposition 2½ in place." It has been a number of years now, and some problems did surface, but the state stepped in and provided tremendous amounts of new local aid to the cities and towns to help them cope with the burdens of Proposition 2½.

I also lived through the end of general revenue-sharing, when everyone said, "The states cannot cope and it will not work." In fact, there was nary a ripple in Massachusetts or in most other states. People often get excited about what might happen and exaggerate the consequences, instead of thinking through the issues and making reasoned judgments about which programs should be kept, which should not be kept, and the political implications of those choices.

Finally, if you evaluate many states' fiscal capacity, it becomes clear that a number of states will find it extremely difficult to pick up programs if we have true devolution. If the federal government gives the states the programs but not the funding, many states will clearly have problems. If, on the other hand, the federal government transfers both the programs and the funding to the states, I think the states can do a meaningful job of coping with such responsibilities.

The states are more independent and more thoughtful than they are given credit for. I have always seen myself as quite supportive of the federal government, but it amazes me how far I have moved to support devolution in recent years. I see the states as more in touch with the people and more willing to experiment than the federal government.

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The variety around this country also fuels the discussion of the federal government versus state governments. I have just returned from the Southwest, and now realize how different their way of looking at their history with the federal government is, in say Nevada or Arizona, from the way we think about it in the Northeast. You begin to understand the richness of the discussion on the national level.

In general, the states do have good understanding of how to put new programs into place. They will continue to experiment and to try programs that are a bit different from those of the past. They will succeed in some instances and fail in others. But as the process unfolds in a very slow manner, the states will have time to figure much of this out.

Discussion about devolution is interesting, and it has gone on for a very long time. I enjoyed reading both papers presented today, and I only wish more politicians were involved in these sorts of discussions, so they could understand more of the policy implications of an issue such as devolution. In conclusion, I think we can do some exciting things, because devolution is definitely here, even though it is moving at an extremely slow pace.

Discussion

Isabel V. Sawhill, Senior Fellow, Adeline M. and Alfred I. Johnson Chair, The Urban Institute

Last night, as I was thinking about what my comments today would be, I concluded that I would say that devolution is all candy and no castor oil so far, at least from a state fiscal perspective. That is, the good economy is sugarcoating the pill that states will eventually have to swallow.

We are all indebted to Bob Tannenwald for having gone through a statistical tour de force. The main lesson I take away from his paper is that there is enormously wide diversity in both state fiscal capacities and state needs, and the two do not match up very well.

The questions that seem most relevant today are, first, "What has really changed at the federal level that will affect federal-state fiscal relations?"; second, "How are states likely to respond?"; and finally, "What are the broader social and political implications?"

Let me start with a couple of caveats. Obviously no one knows the answers to these questions. Any answer is an informed speculation, but that seems to be what this day is largely about. Devolution may not be the most important variable driving state policymaking, and many other factors that may be more important have been mentioned over the course of the day.

Consider health care cost inflation and what it is doing to the cost of Medicaid. Consider the competitive economic environment that states are in nowadays, brought about by advances in international competition, advances in transportation and communication, and increased mobility of capital and labor. These factors require states to worry more about economic development, about attracting new businesses and staying competitive. Or at least, it is perceived that they need to worry more about such issues.

The tobacco settlement is now looming, and no one knows exactly what impact it will have on the states. The enactment of tax credits for higher education will provide tremendous incentives to states to raise tuition and to save public funds on higher education. This could have important ripple effects that might even dominate the issues we have focused on in the welfare arena. Who knows how states will use the proceeds if they raise tuitions? They could conceivably use the funds for everything from cutting taxes to funding work programs for welfare recipients. I do not see the latter as very likely, but who can say? The federal government intended to encourage more enrollment in higher education by enacting a sizable tax credit program. But because money is fungible and states are quite clever in the way they handle it, by the time this program gets down to the state level, who knows what the ultimate impact will be? I do not mean to imply that all of these funds will go into tuition increases and, thus, the saving of state funds, but certainly a big part could. The more general lesson I want to emphasize is that you have to trace these money flows to their final resting place—it is not enough to analyze only their first-order impact.

To return to my three big questions, what has really changed that will alter federal-state fiscal relations? From a fiscal perspective, two things have changed: first, the amount of money available, and second, the terms upon which it is available. On the amount, less money will probably flow from the federal government to states and localities, if we project out the next five years or so. The Congress has put tight caps on discretionary spending in the annually appropriated items, which is where large parts of state and local programs got their funding. In addition, funding for welfare programs has been reduced relative to what states would have received under prior law, under most projections (which, thanks to a strong economy, now seem too pessimistic). Also, the recent budget deal scaled back some of the big savings associated with cutbacks in programs for immigrants.

The new welfare law has produced a big windfall for the states because caseloads have fallen by over 20 percent. The big question is, "Where will this money go?"

For now, however, none of this is having much impact. The discretionary spending cuts are very much backloaded. The new welfare law has produced a big windfall for the states because caseloads have fallen by over 20 percent. States get the same number of dollars as they did before to spend on a smaller

number of people. Some of them, like Wisconsin, are spending a lot more per person for such programs as child care, work programs, earnings subsidies, and the like. The big question is, "Where will this money go? Will it go to increase spending per welfare recipient and help to make welfare work, or will it be used for other purposes including, possibly, tax cuts?" The answers drive what you think about whether or not devolution will be a force for smaller government, as well as how it will affect the narrower question of whether or not welfare reform works.

The drop in the caseload also has made it easier for states to achieve the work participation goals in the new legislation, which for single-parent families require that states have 25 percent of their caseload in work activities in fiscal year 1997. As Ellwood explained this morning, they get credit for all of the reduction in the caseload that already has occurred, in calculating whether they have achieved that goal. Thus, the economy has done their job for them. It really was not very difficult.

The debate is ongoing about how much of the drop in caseloads has been due to the economy and how much to the fact that we are in a new policy environment. (Recall that waivers were introduced prior to 1996 and had produced a lot of innovation.) People are leaving the welfare rolls faster or are coming on more slowly, for both policy-related and economic reasons. The studies that have tried to sort this out come to somewhat different conclusions, but most think that the economy is by far the more important of the two explanations. This is why I say that because of the good economy, devolution so far is all candy and no castor oil. The states have gotten greater flexibility but did not have to trade money to get it, at least not in the short run. In fact, the states have greater flexibility and more money with which to exercise it. For them, right now, it is a win-win situation.

Over the long term, things could become much less rosy. Federal aid is likely to shrink as these discretionary caps tighten up in future years. A recession obviously could drive up welfare caseloads again and lead to other expenses. Long-term demographic and economic trends, such as the continuing growth of single-parent families and increasing poverty among children, could add to the problem and leave states stuck with much higher costs for welfare as well as for social services generally. Of course it is possible, as many of the proponents of devolution like to argue, that welfare reform itself will affect these economic and demographic trends. That remains one of the big unknowns.

Not only has the availability of federal aid changed, but also the terms on which it is available. When the Congress shifted from an open-ended matching grant process for welfare to a block grant process, it radically changed the incentives for states to spend their own dollars. It used to be that if the state of Mississippi spent a dollar less on welfare, it would lose about four dollars of federal aid. Now, if it spends a dollar less, not only does it not lose anything, but it may actually gain a bit because there is some food stamp funding offset to a loss in welfare funding. Thus, the recent welfare reform has brought about a profound shift in fiscal incentives at the state level. Forget about the amount of money, it is a shift in the terms under which that money can be used.

When the Congress shifted from an open-ended matching grant process for welfare to a block grant process, it radically changed the incentives for states to spend their own dollars.

So how do we think the states are going to respond? I think that their response will be quite predictable: Other things being equal, they will spend less. Some believe that the states in fact will engage in a so-called "race to the bottom." And as Howard Chernick noted earlier today, the econometrics literature contains a wide array of estimates on this question. A maintenance-of-effort provision in the law will, to some extent, limit the states' response, but Chernick's guesstimate, based on the literature, is that average welfare benefits will likely drop by roughly 20 percent and total welfare spending by roughly 30 percent.

Another important point: Not only are benefits likely to be lower in response to these incentives, but also the disparities in benefits across states are likely to be greater. Mississippi now has much more of an incentive, given the way matching worked in the past, to cut its benefits than, say, Connecticut. That change will further widen the existing disparities in benefit levels.

So far, I have focused on some standard fiscal issues. Clearly, this story involves more than just fiscal

issues. Political ideology and preferences may also influence the process of devolution. States have a tendency to follow the leader. Certainly that is the lesson we learned from the waiver process; many of the waivers that states requested were in such areas as time limits, following a major national debate about whether we should have time limits, started by the President of the United States. There was a message effect there.

I would characterize the new mood in the country as having three dimensions: first, a feeling that the era of big government is over; second, a feeling that decentralization is a good thing; and third, the feeling that it is acceptable to embed moral principles in legislation. By this I mean that more emphasis is being placed on trying to line up government policy with what is perceived to be public concern about a breakdown in the willingness to work and to take responsibility for children, as shown by the increase in out-of-wedlock childbearing and other trends many people find disturbing.

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Ellwood's description this morning of the Blair House meeting with the President interested me. My own recollection of one of the more amusing moments in that meeting is when Senator Moynihan got up to give his typical lecture on the growth in out-of-wedlock childbearing and how difficult it is to do anything about that, because, after all, everybody does it. As he said, very pointedly, "Bees do it, birds do it, even newts do it." More seriously, I do not think there is a human resource secretary in the country who does not now believe that the primary objective of the welfare system is not to provide an adequate income, but rather to encourage work and responsible family behavior.

My final point is that the fiscal situation of the states may have some political ramifications. Again, we need to continue following the story. A plausible scenario might be that states do what they have always done, which is to try to raise spending and cut taxes in ways that are not sustainable, while times are good. If I understand the literature correctly, states are constantly in the process of doing things that do not keep their budgets in structural balance. This means that when bad times come, they are forced either to reduce spending or to raise taxes. Who will have to do that this time around? Primarily those 33 Republican governors who are now in office. They may, as a result, get their comeuppance at the polls, because although the public likes the rhetoric about smaller, leaner government, they do not like specific taxes being increased, or specific programs being reduced. There is some castor oil in their futures.

Overall, I tend to agree with both Bob Tannenwald and Jack Kincaid that devolution will be a force for smaller government. It may be a leaner and more effective government, and certainly it has its positive aspects. But I would add that it is also quite likely to be a government which, in fiscal terms anyway, will treat citizens more unequally than is now the case.

Discussion

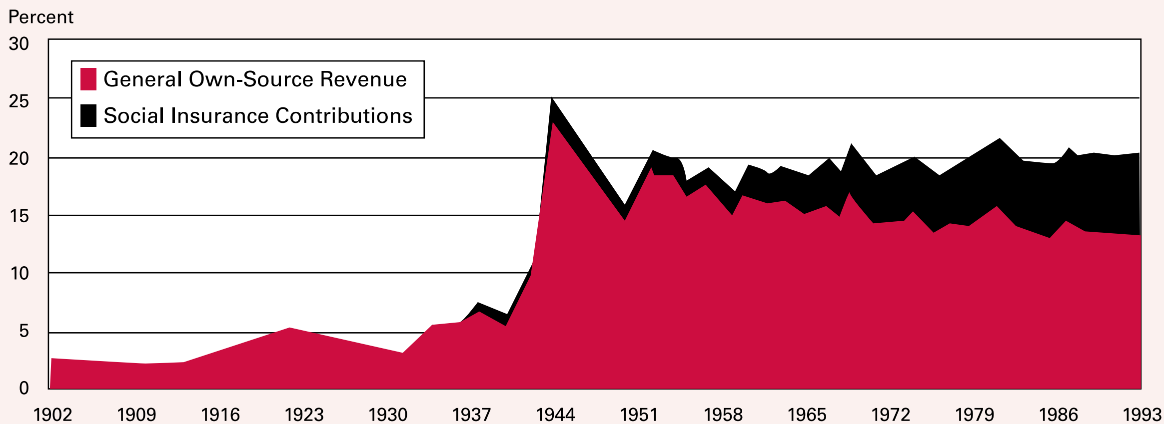
John Shannon, Senior Fellow, The Urban Institute

I am not as pessimistic as Bob Tannenwald over the future revenue prospects of state and local governments. One reason is the disastrous prediction I made many years ago. When we were drafting the general revenue-sharing legislation back in the 1960s, I cited Walter Heller's claim that the Congress had to pass general revenue-sharing because the states were hobbled, paralyzed by the fear of interstate tax competition. So unless the affluent national government turned over large sums of revenue on an unconditional basis, the state and local governments would wither on the vine.

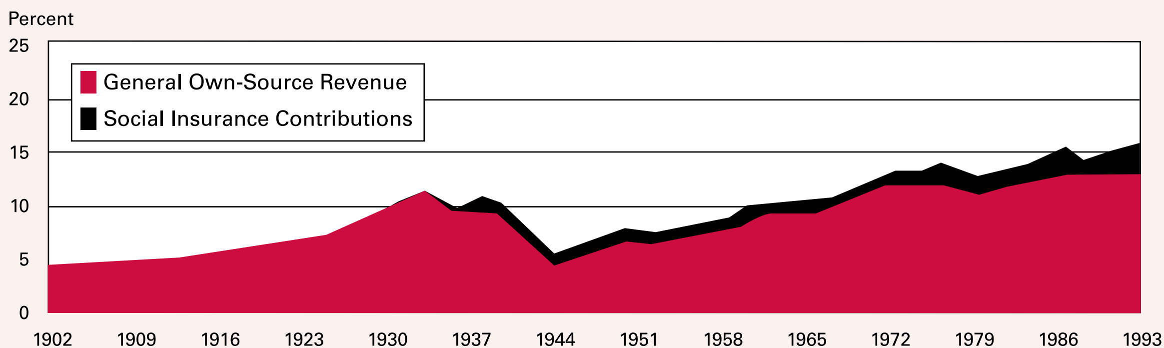
Figure 1 traces the growth in state and local own-source, general revenue since the end of the Korean War, and it illustrates how history has knocked that concept into a cocked hat. In fact, on the own-source, general revenue front, state and local governments have consistently outperformed the national government. While federal own-source general revenue has declined somewhat, the state and local

Figure 1

Federal Government Revenue as a Percentage of GDP, 1902-1993 [a]



State and Local Government Revenue as a Percentage of GDP, 1902-1993 [b]



Source: C. Eugene Steuerle and Gordon Mermin, The Urban Institute.
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a Excluding postal revenue.
b Excluding federal grants to state and local governments and utility and liquor store revenue.

What is really new about the "new federalism" is this: We are now moving toward a much more balanced division of power between the national government and the state and local system.

level has experienced an upward trend. There was a bit of a catch in the late 1970s and early 1980s when the tax revolt movements were felt most strongly. More recently a cover of *Governing* magazine depicted a state capitol deluged with red ink, painting a horrible picture of what might be the scenario for the states in the 1990s.

So, the state and local sector has consistently outperformed the expectations of the experts. At some point, the experts have got to be right about this, but so far, without question our 50 states and 85,000 local governments are more adept at reaching further into the pockets of the general taxpayers, in particular the middle-class taxpayers, than is the federal government. President Bush did increase the income tax on the wealthy in 1990 and President Clinton increased it again in 1993. But the federal government is scared stiff of the middle class, so the only time it raises their taxes is during a war. We have seen this happen three times in the past 50 years: during World War II, during the Korean War, and during the Vietnam War. In contrast, state and local governments dare not hit the upper-income taxpayers too hard for revenue, because they are the most footloose. So state and local taxes tend to be much less progressive, and they must get the bulk of their revenue from the middle class.

Another reason why I am somewhat optimistic about the state and local fiscal system is the growing economic convergence among the 50 states. The process started right after World War II. The message from this convergence is that the Southern and Rocky Mountain states, which were the poorest, are becoming less poor relative to the nation. And the rich states in the Northeast and the Midwest are becoming less rich relative to the nation. During the 1980s, the process of convergence broke down somewhat, but it still appears to be moving forward, primarily because mobile capital and mobile labor continue to move to the areas of lower cost. So the South and the Rocky Mountain states no longer are the poor cousins in the federal system that they were right after World War II. The South can thank the air conditioner as much as any federal policy, I believe, for its advance.

Several questions have come up today that I would like to address. First, why is it so difficult to develop a satisfying rationale for federalism? For two reasons, in my view. At its core, federalism represents an uneasy compromise between the values of national unity and those of regional diversity, that is, between national sovereignty and regional autonomy. It is difficult, particularly in times of great change, to continue to strike the right balance between these conflicting value systems. The constitutional fathers did not take any chances: They designed a constitutional system that tipped the domestic power scales in favor of state and local governments in general, and in favor of the private sector, in particular.

Figure 1 shows that at the turn of the twentieth century, the federal government was still a small player: Americans had retained a state-dominated federal system, characterized by a minimalist federal presence, a very modest state and local sector, and a virtually unfettered private sector. From the time that George Washington took office in 1789 until the time that Franklin Roosevelt took office in 1933, our system was a state-dominated federal system. Then, those two back-to-back super-crises, the Great Depression and World War II and its evolution into the Cold War,

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completely pushed the system to the opposite end of the spectrum. The state and local governments lost their preferred constitutional and political status, and Washington, DC, dominated federalism for the next 40 years, picking up two tremendous advantages in the process, great public confidence and a robust revenue system.

What is really new about the "new federalism" is this: *We are now moving toward a much more balanced division of power between the national government on the one hand and the state and local system on the other.* Lopsided federalism, initially in favor of the states, and later in favor of Washington, DC, is on the wane.

I call this movement middle-of-the-road federalism, as it is neither state-dominated nor Washington-dominated. Each side has lost its advantages, that is, the advantages the federal government picked up through the crisis years and the advantages that the state and local governments were granted by the Constitution.

Where does this leave us? It leaves us with a system that is slowly struggling toward the use of comparative advantage. Only the federal government, with its continent-wide jurisdictional reach, can create a national safety net for the poor. Only the federal government can really underwrite social insurance for the middle class. And only the federal government can set the general rules for such critical areas of national concern as interstate commerce, civil rights, environmental protection, telecommunications, and health care financing. On the other hand, because of their closeness to the people, the 50 states and their 85,000 local governments are in a far better position than Washington to calibrate the pain of taxation to fit local preferences for domestic governmental benefits. Why? Because state and local jurisdictions are marked by widely varying tastes for public goods and services.

Also, because of their limited jurisdictional reach, state and local governments are forced to operate under much more fiscal discipline and have to react to competitive pressures as well. To paraphrase the father of the Constitution, James Madison, "If the 50 states and 85,000 local governments did not exist, we would have to create them." But middle-of-the-road federalism will constantly require trade-offs, which may be difficult to sort out. For example, the Secretary of Education, Richard Riley, mentioned not long ago that elementary and secondary education was now a federal priority, a state responsibility, and a local function.

The way this system merges will result in mixed strategies, hybrid arrangements, much negotiation between the governors and the Congress, and, I must say, much controversy. When you think about middle-of-the-road federalism, it is good to remember that most accidents and sideswipes occur in the middle of the road. So fasten your seat belts. It will be an exhilarating experience having balanced federalism for the first time in American history. And it will stay balanced until the next great galvanizing, centralizing crisis tips the scales back toward Washington.