By E. Matthew Quigley

issues in economics

"STATES ARE FACING THEIR WORST FISCAL CRISIS SINCE WORLD WAR II."
"GOVERNOR TO ANNOUNCE $300 MILLION IN CUTS."
"STATE RESERVES DEPLETED."
"CORE STATE SERVICES THREATENED BY RECESSION."

Over the past several months, newspaper headlines such as these have appeared almost daily, as state governments across the nation confront record deficits. These shortfalls threaten to force large cuts in the services state governments provide. But does this matter?

Most people know that the federal government pays for the Army, Navy, and Air Force that defend us; regulates the planes and automobiles in which we travel; insures our bank deposits; and protects the safety of our food. Local governments protect our homes from robbery and fire, educate our children, and pick up the trash. But, aside from collecting taxes, maintaining highways, and licensing cars, most people know relatively little about what state governments do and whether it makes a real difference. Should we be concerned about spending cuts?

The short answer is "yes," for two reasons. First, states are major economic players, spending a combined total of $1.1 trillion in 2000. Their spending—which includes funds spent directly by states, transfer payments to individuals, and aid to local governments—represents 11 percent of GDP. Second, state governments provide an array of important services that are not covered by federal or local governments.

HOW DOES THE STATE SPEND MY MONEY?

Education is the largest area of state spending, accounting for 32 percent of spending nationwide and 27 percent in New England. Programs ranging from kindergarten to graduate school all fall within this category. At public elementary schools and public universities, this money buys books, Bunsen burners, and basketballs; it pays teachers and librarians, coaches and security guards; it provides reeds for clarinets and seeds for playing fields.

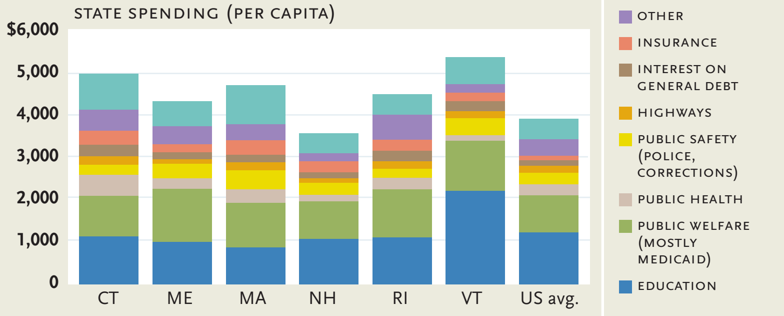
But comparing states within this category is tricky, since schools are funded jointly by state and local government, with the share assumed by each varying from state to state and town to town. New Hamp-

With states facing record budget deficits, it's worth asking what state governments do

ILLUSTRATION BY TAVIS COBURN

Where the money goes

Education and public welfare comprise half of spending.



SOURCE: U.S. Census Bureau

shire and Vermont, for example, impose statewide property taxes and redistribute revenues to municipalities based on need. Thus, most education spending is attributed to the state. The remaining New England states fund education primarily through local property taxes, supplemented by state funds. In these cases, most education spending appears on local government books. As a result, state support for education appears higher in Vermont both as a percent of overall expenditures (44 percent) and per person ($2,190). State spending appears lower in Massachusetts, where education accounted for 19 percent of overall state spending, or $889 per person—but where more of the money flows through the cities and towns.

The second-largest category of state spending is public welfare. Assisted by matching funds from the federal government, expenditures in this category mainly support Medicaid, which provides basic healthcare to millions of uninsured and low-income people. Like education, these services vary by state. Some states cover prescription drugs, others may not. Some cover visits to the optometrist, others visits to the dentist. Beyond Medicaid, public welfare spending also underwrites programs for the mentally ill, the elderly, abused children, and other human services. In New England, public welfare expenditures ranged from a high of 29 percent of expenditures in Maine to a low of 19 percent in Connecticut. Per capita, Maine spends the most, at $1,228 per person, while New Hampshire spends the least, at $868 per person.

The other half of state spending is divided among seven categories. They are public health, public safety, highways, interest on general debt, insurance trust expenditures, government administration, and a remaining category called "other and unallocable."

Spending on public health, including outlays on public hospitals as well as programs such as those aimed at preventing the spread of infectious diseases and discouraging smoking, comprised roughly 7 percent of the typical state budget. Within New England, public health spending varied significantly, from 10 percent of expenditures in Connecticut to 2 percent in Vermont, with per capita spending slightly less than the national average.

Public safety—keeping prisoners housed, providing police protection, and other programs—costs states about 4 percent of their budgets nationwide and 3 percent in New England.

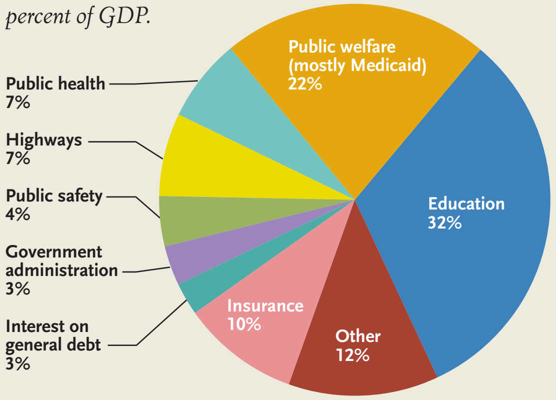
Another 7 percent of spending pays for highway, bridge, and tunnel operation and maintenance. Massachusetts, saddled with the costs of the Big Dig and other large transportation projects, led the pack in New England, spending $439 per person on highways, roughly $174 more than the national average. Interest payments on bonds issued to finance construction or fund special projects such as a convention center ranged from a high of just over 7 percent of expenditures in Massachusetts to a low of roughly 4 percent in Vermont. New England's older infrastructure was one reason why these costs, at $259 per person, were more than double the national average.

Insurance trust expenditures cover the costs of insurance for the state, its employees, and those covered under state programs. Nationally, these fixed expenditures cost states nearly 10 percent of their budgets. In New England, the bill ranged from 13 percent of expenditures in Rhode Island to 4 percent in Vermont.

State and federal functions

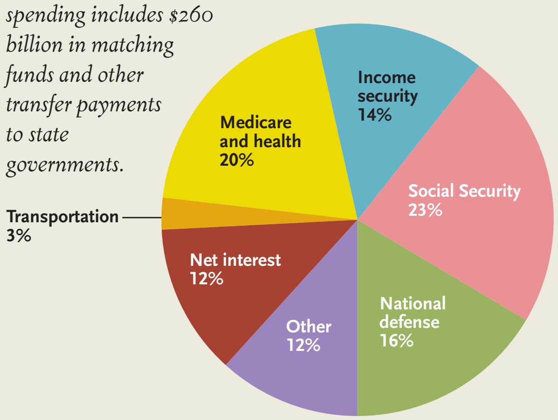
State spending in 2000

At $1.1 trillion, state spending accounts for about 11 percent of GDP.



Federal spending in 2000

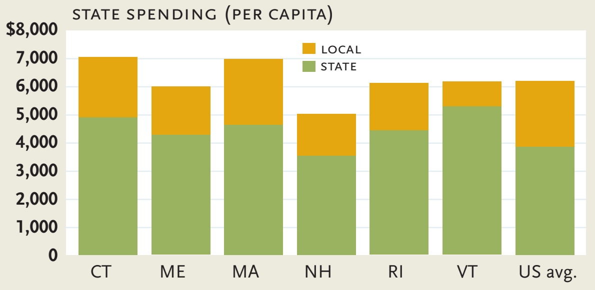
The $1.8 trillion of federal spending includes $260 billion in matching funds and other transfer payments to state governments.



SOURCES: U.S. Census Bureau and *Economic Report of the President*, 2003

Sharing the burden

Each New England state divides spending responsibilities between its state and local governments differently.



SOURCE: U.S. Census Bureau

Beyond these large and clearly delineated functions, states provide a number of other services that do not fall into any other category and are thus classified as "other and unallocable." Depending on how states classify various services, these can range from economic development programs to environmental protection and conservation programs to housing subsidies and childcare. The wide spread of programs that can fall into this category and the differences among states in how they categorize certain programs make comparisons across the states difficult.

Finally, administering all these programs, like running a business or household, costs money. Compliance with federal laws and regulations needs to be monitored, salaries need to be paid, inventories tracked, pension funds administered, and floors swept. New England's state governments cost about $200 per resident, slightly over 4 percent of overall expenditures.

WHY DOES SPENDING ALWAYS RISE OVER TIME?

Even when not embarking on major new initiatives, state spending tends to increase at roughly the same rate as economic growth for two reasons: inflation and population growth.

Inflation affects state governments, just as it affects businesses and consumers. Police cars and chalkboards cost more in 2003 than they did in 1993. Employees expect higher wages and vendors charge higher prices. Overall, services that cost New England state governments $1,000 to provide 10 years ago cost nearly $1,400 today.

Population growth also places cost pressures on government. More residents mean more children in the schools, more drivers on the roads, more readers in the libraries, and higher caseloads for social service agencies. In order to provide the same level of service to citizens over time, government spending must increase.

Beyond these two factors, the devolution of many government programs from Washington to the states, coupled with the rising costs of healthcare and prescription drugs, exerted spending pressure on New England states in the 1990s. Likewise, the court-ordered changes in how the public schools are funded in New Hampshire and Vermont have forced these two states to significantly realign state spending, while cost overruns from the Big Dig are taking a toll in Massachusetts.

FACING DIFFICULT CHOICES

Unlike the federal government, most states—including all six in New England—are not legally allowed to carry deficits from one budget period to the next. Budgets must be balanced. Therefore, when revenues collapsed in 2001, New England states had only two options: cut spending or raise taxes. Most states chose both. As the fiscal crisis continued into 2002 and 2003, cuts became deeper and tax increases more widely discussed. Barring a dramatic turnaround in tax revenues, further cuts are likely.

Determining the appropriate distribution of cuts is a difficult task involving a series of tradeoffs. As many commentators have noted over the years, there is no line item for fat or waste. Programs that some consider frivolous or wasteful are cherished by others. Even within a particular line item or program, separating needless from necessary spending is a difficult task. In addition, significant portions of state spending, such as pension-fund obligations and debt service, are largely fixed, leaving spending cuts to fall disproportionately on those programs where there is flexibility—typically in social services and public health.

Complicating matters, state revenue growth has historically lagged overall economic recovery, and state revenue forecasters are widely predicting another tough year in fiscal year 2004, which begins July 1, 2003. As a result, lawmakers will face another round of difficult choices as they sit down to consider their budgets this spring. ❋

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Spending measures

State budgets are confusing enough. But comparing spending across states can be even more confusing because different measures highlight varying aspects of the differences among states.

Spending per capita shows the average dollar amount spent per person. By controlling for population, this measure makes it easier to compare spending in large and small states. However, it doesn't take into account differences in demographic characteristics across states. For example, some states have higher shares of elderly people, while others have higher shares of children. Thus, it might be useful to compare how much different states spent on programs for the elderly per elderly person or on programs for children per child.

Share of state expenditures describes how spending in a particular category—public welfare or transportation, for example—compares to spending in other categories for that state. This measure shows how states prioritize functions relative to one another within the overall spending mix. Note that in a poor state, the spending share in a particular category can be high even though the amount spent per person is lower than in a rich state.