

PERSPECTIVE

Developments and Practices in State and Local Finance

State and Local Tax Policy: Looking Ahead

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A Walk on the Expenditure Side: "Needs" and Fiscal Capacity

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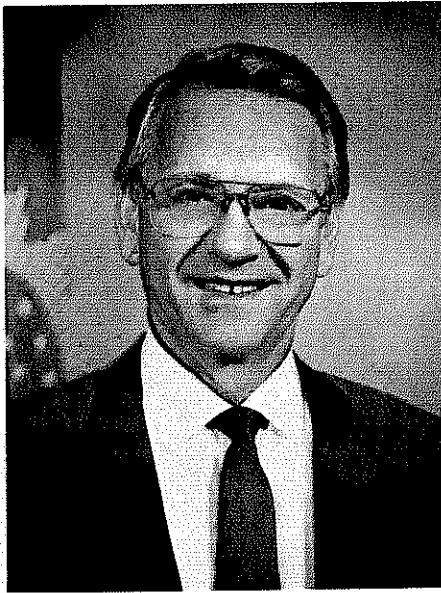
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A View from the Commission



When World War II ended, the world moved into a long period of uninterrupted shipping. We gradually moved toward a world economy that relied less and less on reserves. After all, if a nation needed wheat, it could simply snap the national finger and a boat load of wheat would be at the docks. Or if a nation was short of oil, the same exercise was all that was required to have a tanker of oil available. Steadily, reserves were lowered and pushed back into the hands of producers and first processors.

During the same period leading up and into the 1970s, the world also developed a very reliable futures market that helped exacerbate the tendency to push reserves, which were declining as a percentage of world utilization, back into the hands of producers and first processors. Producers of basic products became plagued by sluggish markets even as small inventories depressed markets.

In the 1970s, double digit interest rates added new difficulty to finding operating capital to carry inventories. Nations, as well as businesses, became less concerned about inventories. Even while some nations with a recent history of hunger continued to subsidize

food production to make certain they had a reliable supply, the world largely moved away from stockpiles because it just wasn't practical to hold them at any level.

By the time we hit the 1980s and the highest real interest rates, "just in time management" had become the watchword for business leaders the world over. It was the new magic formula for success, "just in time" raw products arrived, "just in time" delivery of processed products. Everything, even small inventories, became the stimulators of bear markets, even in products absolutely critical to human survival, like food and energy.

All of this seemed to be good private business theory. Tragically, it is now clear that it is unsound government policy in such vital, urgently needed products as energy and food. In a world that has a history of falling into war, a world with widely fluctuating currency values, a world with chronic trade imbalances, and a world almost universally affected by greed—human beings' basic needs are at risk and the peace of the world is at risk.

There seems to be a failure on the part of leaders to see the fragility of developed societies that fail to provide "safe, assured access" to food and energy. An almost blind allegiance to theories of supply and demand, profit and loss, and a free market has subjected domestic producers to cycles of boom and bust. Consumers become the ultimate victims, as does world peace, as we have so unfortunately learned today.

It is almost as if people have forgotten history and have forgotten that there are long periods of low production in food, and famines, that there are wars, and restrictions on shipping that can take away both energy and food. More than that, it is almost as if people have forgotten that the fragility of developed societies when energy and food supplies is threatened precipitates revolutions and wars.

We go on, year after year, without an energy policy, and we move toward non-policy in food, as well, without understanding that there is a clear, unequivocal obligation on the part of government to grant safe, assured access to not only clean air, water, and land, but food and energy as well.

What does all of this mean in terms of bottom line policy? First, it seems to me that there should be a requirement for floor prices for food and energy. Such floor prices must then be protected by tariffs or quotas or both. The suggestion that incentives can be used as we are now hearing for energy, may be a valid alternative. But incentives in the tax areas tend to produce all kinds of devious and diverse manipulations to take advantage of the incentives, often without achieving the required goal. Without these components, safe, assured access to these basics of human existence will be in great jeopardy. The nations of the world that have a sense of history have long since learned that a simplistic reliance on free trade is ruinous for producers and ultimately devastating for consumers.

I fear that the participants in the Uruguay Round of the General Agreement on Tariffs and Trade have not adequately understood this. Unless there is a clearer understanding of it, the world is headed for a disaster in food akin to the one it faces in energy.

When Jefferson composed the Declaration of Independence, he wrote, "We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable rights, that among these are life, liberty, and the pursuit of happiness." And then Jefferson added the most important line, "That to secure these rights, governments are instituted among men."

George A. Sinner
Governor of North Dakota

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ACIR Hosts Intergovernmental Roundtable

ACIR hosted a meeting of the Intergovernmental Roundtable on September 26. The topic was "Interjurisdictional Economic Competition," and the principal presentations were made by Parris Glendening, county executive of Prince George's County, Maryland; John Shannon, former executive director of ACIR; and Robert Schwab, professor of economics at the University of Maryland. The roundtable is sponsored by the National Capital Area Chapter of the American Society for Public Administration.

American Federalism Seminar in Spain

At the request of the government of Catalonia, ACIR organized a three-day seminar on American federalism for public officials and academics in Barcelona, Spain, October 8-10. Key U.S. participants were David E. Nething, ACIR commissioner and member of the North Dakota Senate; John Kincaid, executive director of ACIR; Robert D. Ebel, director of government finance research, ACIR; Robert F. Williams, professor of law at Rutgers University; and Joseph F. Zimmerman, professor of political science at the State University of New York-Albany. Since the end of the Franco regime, Spain has undergone a process of democratization and decentralization, which has sparked considerable interest in regional autonomy and federalism.

Conference on Federalism in Nigeria

ACIR Executive Director John Kincaid participated in a conference on federalism in Nigeria held at the Administrative Staff College of Nigeria, Lagos

State, October 18-19. The Federal Republic of Nigeria, which consists of 21 states and the federal capital territory, is scheduled to return to civilian government next year. The conference was attended by scholars, public officials, and journalists. The purpose of the conference was to examine key issues of federal democracy that need to be addressed if civilian governance is to succeed.

ACIR Contributes to Infrastructure Debate

In accordance with an interagency agreement, ACIR, has delivered drafts of two infrastructure issues papers to the U.S. Corps of Engineers. One is entitled "The Value of Infrastructure to America;" the other addresses "Alternative Federal Infrastructure Strategies and Implementation Techniques."

The Corps asked for these papers as aids in federal interagency discussions, which could lead to a coordinated national strategy for improving America's public works. Issues examined include: infrastructure's link to the economy; potential improvements to the productivity of American infrastructure; appropriate means of financing infrastructure; and potential roles for the federal, state, and local governments, as well as the private sector.

Research Director Honored

ACIR Director of Government Policy Bruce D. McDowell was honored October 11 with the Distinguished Achievement Award, bestowed by the National Capital Chapter of the American Planning Association. This award honored McDowell's many contributions to the planning profession over the past 31 years as a local planner, a top executive in the Metropolitan Washington Council of Governments, and a long-time careerist with ACIR. One of the achievements cited that "af-

December Meeting Agenda

The next meeting of the Commission will be held on Friday, December 14, 1990, from 8:30 a.m. to noon in Washington, DC. Items on the agenda include:

- Intergovernmental Management of Groundwater
- State ACIRs
- Federalism Resource Guide for Teachers
- Preemption Notes Process
- Estimating Mandate Costs
- Immigration
- Criminal Justice

fects every planner in America" was his pioneering work in establishing the federal-aid review and comment process, which grew out of a 1964 ACIR report, and his draft of legislation later enacted as Title IV of the *Intergovernmental Cooperation Act of 1968*.

Former Member Dies

Former Governor Scott M. Matheson of Utah, a member of ACIR from 1983 to 1985, died of cancer in Salt Lake City, October 7. Governor Matheson was active in the celebration of ACIR's 25th Anniversary. Following two terms as governor, Matheson was appointed chair of the Democratic National Policy Council in 1985.

State and Local Tax Policy: Looking Ahead

Hal Hovey

Are state and local tax hikes inevitable? What tax sources are likely to be tapped more, which ones less? Will interstate competition force states to reduce business taxes? Are some new approaches — say piggybacking on a national value added tax or more state sales taxes on services — the waves of the future?

No one really knows the answers to these questions. Nonetheless, thinking about them is worthwhile from several perspectives.

Why Worry about Future State and Local Tax Policy?

Predicting the future environment is an important element of effective policymaking for governments, business, and individuals. Tax policy changes, like demographic and economic changes, are an important part of that environment. For example, hopes of meshing local, state, and federal tax policies for ease of administration and compliance depend on each level making good guesses about future policies of the others. Taxpayer strategies depend on predicted answers. So do government policies that use the tax system as a means to achieve policy objectives like pushing economic competitiveness, alleviating poverty, and developing of distressed areas.

What Determines State and Local Tax Choices?

Looking ahead at taxes forces consideration of the factors affecting state and local decisions on tax policies.

- *The Economy*: Major fluctuations in the national economy have immense effects on state and local tax decisions. The Great Depression triggered widespread adoption of state sales taxes in the 1930s and general abandonment of the property tax base to local governments. Strong economic growth, like that experienced in the late 1980s, discourages any changes because growth makes it easy to cover costs without them. Conversely, periods of slow growth and recession, such as 1981-1982, lead state officials to consider increasing taxes and thus force decisions on what taxes should be raised.
- *Spending "Needs"*: How much government should spend cannot be mechanically assessed, nor how much government will spend be predicted, by demographic and economic factors. The outcome depends on hotly contested public policy questions, such as how much teachers and other public employees should be paid, the role of government in paying for health care, and balances struck through the political process between private and public spending. Looked at from the flip side—taxes rather than spending—the decision is what level of taxes the American public will tolerate. But state and local spending do respond to underlying demographic phenomena, such as the expansion of school spending in the 1950s and higher education spending in the 1960s in response to the baby boom at the end of World War II.
- *Federal Spending Policy*: Throughout the 1990s, the appropriate federal role in financing efforts to achieve such objectives as winning the war against drugs, providing universal access to health care, upgrading education, and providing adequate housing will continue to be debated. Expensive federal assaults on these domestic policy fronts could substantially relieve fiscal pressures on state and local governments. With no basis to assume anything else, state and local policymaking is likely to presume that federal officials will have their hands full without a major increase in the federal role in such fields.
- *Federal Tax Policy*: Any major revision in federal tax policy would likely have massive impacts on state and local tax choices. Wholesale revision in federal policy, such as adopting a value added tax

or other consumption-based levy as a major revenue source, could lead to a complete restructuring of state and local taxes. Despite occasional forays challenging this result, state and local decisions on income tax bases remain closely tied to federal decisions. So federal action expanding the tax base, such as to more employer-paid benefits, would broaden the state base. Federal base contraction, such as exempting a portion of capital gains, would likely contract the state base.

- *Federal Controls over State and Local Taxes:* The combination of decisions by federal courts and action, or inaction, by Congress will continue to impact state and local tax choices in many ways. Examples: (1) court decisions on jurisdiction to tax, such as mail order sales; (2) court decisions on discrimination against interstate commerce, such as cases on flat rate truck taxes and treatment of in-state and out-of-state insurance companies; and (3) congressional decisions, such as those protecting railroads and other carriers against certain state and local taxes.
- *Policy Preferences and Inertia:* Current thinking about tax policy, as discussed in this article, is also important—so is the tendency to avoid changes absent extreme pressure. For those who like the result, it's "stability," but critics call it "inertia" and "resistance to change." Economists have an old saw, "an old tax is a good tax," which is appealing politically because any tax reform involves raising some taxes and cutting others. Elected officials fear that voters will concentrate on the increases and not notice the cuts. The economic logic is that the economy will have adjusted to the old system, so losses in efficiency and windfall profits and losses will result from any major changes. For whatever reason, state and local tax policies in 2000 will tend to look about the same as those in 1990. Changes will be incremental, not wholesale. Decentralization alone means that the United States will not experience the quick and massive changes in tax policy that have recently taken place in Canada, Japan, and Great Britain.

Are State and Local Tax Increases Coming in the 1990s?

Prominent researchers have sought periodically to predict whether state and local governments will need tax increases. While not all these studies have produced identical conclusions, they all have produced roughly comparable findings by applying current policy choices to predictable future changes in population and the economy.¹

Overall, state and local tax revenues will tend to grow about as fast as personal income without any changes in tax law. With indexing for inflation rare, state personal income tax revenue tends to grow faster than personal income because of graduated rates and personal exemptions and deductions set at fixed dollar levels. This offsets the tendency of taxes, like excises on tobacco and gasoline, to grow more slowly than personal income. Without changes in policy, researchers have also suggested that spending won't grow faster than personal income, primarily because the number of public school students has been, and will be, dropping in relation to the population holding jobs.

In fact, state and local taxes have been increasing slightly as a percentage of personal income through the 1980s. The reasons: (1) state and local officials have chosen to expand their programs and improve their quality, (2) they have been forced by the federal government and the courts to assume new costs, and (3) federal sharing of state and local costs has been reduced.

The improvement of quality, or at least cost, is most obvious in public schools, where decisions in the 1980s have reduced the average class size from 17 to 16 and reduced the inflation-adjusted average teacher salary from \$26,000 to about \$31,000. The forced decisions appear in improved standards in correctional and other institutions, improved standards for water supply, sewage treatment, and other functions, and in some states in expanded school spending. The federal withdrawal is indicated by the decline in the federal contribution to state and local spending—24.4 percent in 1980, 16.8 percent in 1989.

A strong case can be made that these same factors will require an increase in the 1990s in the percentage of personal income taken by state and local taxes.² But a decision on overall state and local taxes remains to be made; there is not an inevitable result that can be reliably predicted.

The Implications of Fiscal Disparities among States

Fiscal differences among states are likely to continue to exert considerable influence on state and local tax policy and spending options. While intrastate fiscal disparities are in the news constantly through school finance litigation and proposals that states do more for hard-pressed intercity communities, the subject of interstate disparities receives little attention. This may lead to anomalous results. For policy and state constitutional reasons, many states will be rejecting as unfair and unconstitutional intrastate spending disparities as small as 10 percent per pupil. But federal policy and constitutional doctrines may continue to accept much larger interstate disparities.

No state or local decisions can cure these disparities, at least anytime soon. Some are getting worse. For example, the spread between Mississippi and Connecticut in the representative tax system grew from 70 index points in ACIR's 1986 calculation to 78 index points in the latest calculation. Some countries deal with this problem with equalization grants comparable to the way American states deal with disparities among their school districts. This policy isn't being seriously considered in the U.S., so state and local officials are likely to continue to press for indirect equalization by concentrating whatever federal spending flexibility is available on income-tested programs such as cash welfare assistance, the earned income credit, food stamps, and medicaid. The result, even if the federal government took 100 percent responsibility for these programs, wouldn't solve the disparities in ability to support government spending, such as that for education of the nonpoor and law enforcement, that isn't income tested.

The deductibility of state and local taxes from income subject to federal tax has muted the impact of these disparities, but the impact of deductibility has been reduced by: (1) increases in the standard deduction and reductions in other deductions and (2) elimination of deductibility of some state and local taxes, particularly sales taxes, with more eliminations or limitations under serious consideration.

Competition in State and Local Tax Policy

The situation of states like Mississippi adds ferocity to the already stiff competition among the states to enhance job opportunities and income for residents while minimizing their tax burdens. Much of this competition has taken the form of tax concessions that reduce state and local burdens on those viewed as capable of providing jobs and income are sufficiently footloose so that they can move in response to state and local incentives. The primary targets are corporations, particularly in manufacturing and nationwide services like credit card processing, the high income individuals who run them, and high income retirees.

While there is dispute about how effective these incentives are, the weight of the evidence suggests they have some impact. More to the point, state and local officials think they do. In response to the recession of the early 1980s, there was a new round of these concessions. With the economy humming in the late 1980s, interest waned but the old concessions remained and some new ones were added. The results can be seen in some major trends in tax policy that are likely to be as relevant in the 1990s as in the 1980s.

- **Holding Down Top Bracket Individual Income Rates:** The personal tax rate is now below 10 percent in every state except Hawaii, where the governor proposed a rate reduction this year but found legislators unwilling to increase sales taxes and lower top-bracket income tax rates simultaneously.
- **Holding Down Corporate Income Taxes:** When Pennsylvania started reducing its double-digit corporate income tax rates in the name of economic development, it helped encourage similar policies elsewhere. While there have been corporate income tax increases, such as New York's in 1990, they are typically rationalized as offsetting corporate tax declines for other reasons. The absence of a corporate rate rise in the tax packages of Massachusetts and New Jersey in 1990 was significant. States not reducing corporate rates have been making other changes that reduce effective corporate rates—R&D credits, investment credits, credits for increasing employment, enterprise zone concessions, and more.
- **Other Tax Concessions:** There is a long list of other changes in tax policy related to interstate competition, including: (1) enterprise zone exemptions; (2) eliminating or reducing sales taxes on purchases of business equipment and machinery and new plant construction; (3) attempts to hold down property taxes by use of taxes falling primarily on individuals and nonflexible businesses, such as the personal income and sales taxes; (4) changes in formulas for the apportionment of corporate income; and (5) selective relief for industries or for activities such as oil production from new and stripper wells.

Trends in the 1990s

There are some changes in state and local tax policy that seem predictable, reflecting: (1) "balance" in tax systems, (2) broadening the base of the sales tax, (3) more reliance on user charges, and (4) conformity to income definitions used in the federal tax system.

State and local tax systems will exhibit more "balance" as state and local officials abandon unusual patterns that persist in some states. From time to time, knowledgeable observers nationwide, as well as officials of individual states, have advocated "balance" in state and local tax systems.³ The notion is that state and local governments in each state should rely roughly equally on income, sales, and property taxes. The primary exceptions are: (1) states that receive a disproportionate amount of their income from taxes on resources, particularly severance taxes on oil and gas; (2) New Hampshire, with no statewide sales or income tax; (3) states without broad-based personal income taxes such as Florida, Tennessee, Texas, and Washington; (4) states without general sales taxes, such as Delaware and Oregon; and (5) states with extraordinarily low reliance on property taxes, particularly Southeastern states.

Recent signs of the times: (1) the declining rate of state and local revenue from severance and oil and gas-related taxes in Oklahoma and Texas resulting from economic diversification, lagging oil and gas prices and production, and increasing rates of other taxes; (2) the increasingly serious consideration being given to income taxes, particularly in New Hampshire, Tennessee, Texas, and Washington; (3) a quiet shift to greater reliance on property taxes for school finance in Georgia and Mississippi and reform movements affecting property taxes in Alabama and Louisiana.

The taxation of consumption will be broadened to go beyond the current emphasis on goods. In most states, the sales tax applies only to a relatively small percentage of total consumer spending. The major exclusions are: (1) food, (2) prescription medicines, and, above all, (3) consumer services. There are two primary problems with this emphasis. First, it has hitched the state and local fiscal wagon to a falling star, the percentage of consumer income spent on goods relative to services. Second, it has made sales tax revenues increasingly volatile because the tax places considerable reliance on consumer purchases of big ticket items like appliances, furniture, and vehicles, which tend to be the first category that customers cut back when they face adversity and the first to expand in prosperity.

The reliance on fees, rather than taxes, for government services that can be rationed will increase. This tendency can be seen in such policies as the increased popularity of impact fees by which developers pay for infrastructure, the starving of programs in state and local budgets where providing a rationable service to the public is the objective but fees don't cover costs, such as parks, and the continuing rise of higher education tuition. There also is an interest in using fees rather than taxes for municipal services, partly aided by institutional constraints on the use of taxes, including tax limits in California, homestead exemptions from taxes but not fees in Florida and Louisiana, and state and local doctrine that prohibits taxing nonprofit institutions like hospitals and trade associations but allows fees. An extra boost has come from recognition that fees may discourage excess use of scarce or expensive resources such as water supply and sewage treatment capacity.

State and local policy will likely continue to avoid adventuresome income tax policies affecting either individuals or corporations. Although there are many state and lo-

cal officials who don't agree with the policy preferences built into the federal income tax base, there are strong pressures for them to avoid straying too far from federal definitions of taxable income. Some notable forays into this minefield—unitary treatment of corporate income, treatment of corporate depreciation, attempts to adopt special state rules to discourage certain conduct (e.g., takeovers, expense account living)—have generally been rejected either when proposed or after experience is acquired. The exception is the continuing willingness of state officials to exclude some forms of income treated as taxable by the federal government, particularly social security payments.

The Battlegrounds of State and Local Tax Policy

In some areas of state and local policy, it is reasonable to predict that certain considerations affecting tax policy will become increasingly important, but predicting outcomes isn't easy. Examples: (1) tax treatment of low-income individuals, (2) emphasis on state versus local taxes, and (3) dealing with "generational equity."

Tax treatment of low-income individuals will likely continue to be a battleground. State and local tax policy affecting the progressivity-regressivity of state and local tax systems has been a mishmash and is likely to remain so. The increases in excise taxes on gasoline, tobacco, and alcohol, and higher reliance on fees hits lower income households disproportionately in relation to income. So does the tendency to lower top bracket rates. But there is little pattern. As New York legislators debated top bracket reductions in 1990 after implementing them in 1989, New Jersey legislators raised top bracket rates. As Georgia legislators partially exempted food from the sales tax and a substantial movement developed in Utah to do so, Louisiana and West Virginia turned to taxing food to deal with fiscal problems. Personal exemptions and deductions were increased in many states in the late 1980s, and some states adopted the provisions of federal law exempting low-income households from any income tax liability. But other states left their dollar exemptions and deductions alone, without inflation indexing, effectively increasing low-income tax burdens. Large states, like Illinois and Massachusetts, raised flat rate taxes.

Yet there also has been considerable state interest in increasing the incentive to work, part of which is reflected in the continuing popularity of the earned income tax credit. Federal expansions could easily be matched by expansions at the state level, perhaps including some of the family-size targeting recently adopted in Wisconsin.

Another battleground will involve relative reliance on state versus local taxes. There are many reasons to expect the trend for greater reliance on state resources in school finance to continue. Particularly important are the concerns, by legislators and educators as well as state courts and taxpayers, over equalization, which can only be bought with state dollars. Also relevant is that as state officials become more active in calling the tune they create an environment encouraging them to participate more in paying the piper. This tends to encourage additional state taxes to avoid higher local taxes—with policy decisions in Illinois, Nebraska, New Jersey, Oklahoma, and Texas being prime examples. Even within school finance, there are some contravening forces, with opposition to higher state taxes a big one. This has resulted in an emphasis on local tax increases in school finance in states like Florida and Mississippi and

voter rejection of proposed state tax increases to lower property tax reliance in Michigan.

For general government functions, however, there may be a somewhat different pattern. There is increasing resistance to state revenue raising for the sole purpose of sharing the costs of whatever county and city officials decide they want to do with money.⁴ In many states, the alternative being adopted is a systematic escalation of the level of government concerned with certain functions. Examples are movement of responsibility for cultural programs and transit to the region, as well as the state; levels and movement of responsibility for costs of courts, Medicaid other indigent health care, and cash welfare assistance from the county to the states. Local revenue diversification—such as recent authorization of county-option sales taxes in South Carolina and school district income taxes in Ohio—offers the option of shifting tax policy away from the property tax without shifting responsibility for raising money away from local officials.

Generational equity will become another battleground, affecting many aspects of state and local tax policy. Stimulated by concerns that the elderly were disproportionately poor, state and local policy has responded with many concessions for the elderly. These include special homestead exemptions in the property tax, exemption of income from social security, exemption of substantial other retirement income, and extra deductions and exemptions. Economic trends have made the presumption of poor older Americans increasingly untrue and the economic problems of the low-income family supported by earned income increasingly salient. But the concerns over the poor elderly remain significant in some instances and tend to persist even as reality changes and the political impact of the elderly—who are more likely to vote and participate in public policymaking—remains large and relevant. But the policies to respond to that concern have become expensive—encouraging a basis for continuing policy conflict.

There is excitement and policy ferment to come. While it is possible to suggest issues and trends in tax policy with some confidence, it is important to remember that most of state and local tax policy in 2000 will be set by inertia. That is, policies then will be dominated by policies in effect now. Also important is that state officials are continuing reflections of the 50 states as laboratories of democracy. No matter what anyone suggests as issues and trends, decisions in some states are likely to be outside of any predicted pattern.

Notes

¹ The U.S. Treasury Department study, *Federal-State-Local Fiscal Relations* (1985) is the most recent example.

² See Steven D. Gold, *The State Fiscal Agenda for the 1990s* (Denver: National Conference of State Legislatures, 1990).

³ See the discussions by Robert Kleine and John Shannon in *Reforming State Tax Systems* and by Helen Ladd in *The Unfinished Agenda for State Tax Reform* (Denver: National Conference of State Legislatures, 1986 and 1988, respectively).

⁴ See the extensive discussion of state-local relations in *State Policy Reports*, Vol. 7, Issue 19 (October 1989).

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Limiting the Deduction for State and Local Income Taxes*

Dennis Zimmerman

The Congressional Budget Office estimates that during the 1980s the effective federal tax rate decreased for higher income taxpayers and increased for lower income taxpayers.¹ Some policymakers, as a result, want to structure revenue-raising contributions to deficit reduction by limiting an individual's deduction for state and local income taxes to \$10,000, a proposal that is consistent with a desire to impose a tax increase on high-income individuals while leaving middle and low-income taxpayers unaffected.

The deduction for state and local taxes was discussed and analyzed in the years preceding the passage of the *Tax Reform Act of 1986*.² Those analyses evaluated deductibility's economic effects on the state and local sector, and assessed proposals to curtail deductibility within that framework. Eventually, the deduction for general sales taxes was eliminated by the 1986 act.

*This article is adapted from "Imposing a Ceiling on the Deduction for State Income Taxes: Horizontal Equity and Other Issues" (Washington, DC, Congressional Research Service, 1990).

The current proposal raises two problematic issues. The most important issue concerns horizontal equity, the degree to which all high-income taxpayers would be treated equally. A second issue concerns the economic effects on the state and local sector. Would this proposal cause some states to revamp their tax structures, to reduce taxes and spending, or to intensify interstate tax competition?

Horizontal Equity

As a general proposition, federal income tax policy is blind to geographical considerations. Federal distributional concerns are focused on vertical and horizontal equity among taxpayers, without regard to place of residence. If the object of this \$10,000 ceiling on deductibility is to raise revenues from higher income taxpayers, then horizontal equity implies that all such taxpayers should be treated equally.

When the vehicle for raising revenue is state and local tax deductions, geographical considerations are important to the pursuit of horizontal equity. Substantial interstate variations exist in both the level and composition of state and local tax deductions. These variations can cause itemizers with equal incomes in different states to experience very different changes in tax liability, depending on which limitation proposal is selected. The proposal to place a \$10,000 ceiling on an individual's state and local income tax deductions is fraught with horizontal inequity. A person in a high income tax state whose state and local income taxes exceed \$10,000 will contribute extra federal income tax of either \$0.28 or \$0.33 per dollar of state and local tax liability in excess of \$10,000. In a state with a low income tax, the person will pay considerably less additional federal income tax. A person in a state with no state and local income tax will pay no additional federal income tax. Equals are not treated equally.

Table 1 presents estimates of interstate differences in state income tax liability. These estimates are based on taxable income as defined in each state, with no allowance for interstate differences between federal taxable income and each state's definition of taxable income. Thus, taxpayers in different states with equal taxable incomes may not necessarily have identical federal adjusted gross incomes, and are not in that sense "equals." But the differences among state taxable incomes necessary to break through the ceiling identified in this table are far greater than can be explained by interstate differences in taxable income definition.

The second column estimates the state income tax liability for a single individual (or married taxpayer filing separately) with \$125,000 of taxable income as defined by each state.³ The third column asks "how much would the individual's state taxable income have to rise or fall to generate exactly \$10,000 income tax liability?" The states are ranked by the numbers in this column, from the biggest increase in taxable income to the biggest decrease in taxable income. The fourth column adds this income change to the \$125,000 of income on which tax liability in column 2 is calculated to provide an estimate of the taxable income required in each state for the \$10,000 ceiling to become effective for a single individual (or married taxpayer filing separately).

Table 1
**1989 State Income Tax Liability for Single Taxpayers and Married Filing Separately
 with \$125,000 of State Taxable Income**
Ranked by Income Change Necessary to Incur \$10,000 of Tax Liability

State ¹	Tax on \$125,000 State Taxable Income	Income Change to Incur \$10,000 of Tax Liability	Income Level for Ceiling to Apply	State ¹	Tax on \$125,000 State Taxable Income	Income Change to Incur \$10,000 of Tax Liability	Income Level for Ceiling to Apply
Illinois	\$3,750	\$208,333	\$333,333	South Carolina	8,470	21,857	146,857
New Jersey	3,775	177,857	302,857	North Carolina	8,623	19,679	144,679
Indiana	4,250	169,118	294,118	Vermont	8,890	15,859	140,859
North Dakota	4,978	128,103	253,103	Utah	8,895	15,342	140,342
Michigan	5,750	92,391	217,391	Delaware	8,931	13,883	138,883
Mississippi	6,100	78,000	203,000	New York	9,065	12,467	137,467
Alabama	6,210	75,800	200,800	Arizona	9,110	11,128	136,128
Colorado	6,250	75,000	200,000	Maryland ²	9,285	9,533	134,533
Louisiana	6,300	61,667	186,667	New Mexico	9,364	7,482	132,482
Nebraska	6,773	54,702	179,702	Minnesota	9,992	106	125,106
Virginia	6,938	53,261	178,261	Idaho	9,998	30	125,030
Ohio	6,331	53,171	178,171	Maine	10,085	(1,000)	124,000
Kansas	7,039	49,769	174,769	California	10,333	(3,580)	121,420
West Virginia	7,000	46,154	171,154	Oregon	11,110	(12,333)	112,667
Oklahoma	7,245	45,917	170,917	Iowa	11,385	(13,878)	111,122
Missouri	7,275	45,417	170,417	District of Columbia	11,375	(14,474)	110,526
Kentucky	7,300	45,000	170,000	Montana	12,210	(20,091)	104,909
Georgia	7,310	44,833	169,833	Hawaii	12,038	(20,375)	104,625
Rhode Island	8,164	28,551	153,551				
Arkansas	8,080	27,429	152,429	Mean	6,836	166,641	
Wisconsin	8,482	21,908	146,908	Range	12,210	228,708	

Numbers in parentheses represent negative amounts
 n.a. — not applicable.

¹ Connecticut, Massachusetts, New Hampshire, Pennsylvania, and Tennessee are not included because their systems either tax only a small portion of income (capital gains, interest, and dividends) or apply different rates to different types of income. Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming are not included because they do not have an income tax.

² Includes surcharge for local governments.

Source: CRS calculations based on Advisory Commission on Intergovernmental Relations. *Significant Features of Fiscal Federalism, Volume 1: Budget Processes and Tax Systems* (Washington, DC, January 1990), p. 51-56.

The average tax liability in the 46 states for which estimates are made (including the District of Columbia and the seven states with no income tax) is \$6,836, and the range is \$12,210. Among those states with an income tax, Illinois citizens reporting \$125,000 of taxable income had the lowest state income tax liability, \$3,750; Montana citizens had the highest tax liability, \$12,210. Only seven states have income tax systems that impose a tax liability of at least \$10,000 on citizens reporting \$125,000 of taxable income: California, District of Columbia, Hawaii, Iowa, Maine, Montana, and Oregon.

These figures are interesting, but the image of the proposal's horizontal inequity can be sharpened by calculating the state taxable income level at which the ceiling would become effective. Column 3 is an intermediate step in that it calculates and presents the amount of income in excess of \$125,000 that would be necessary to raise tax liability to exactly \$10,000 (or, in the case of seven states, how much less income would be necessary to lower tax liability to \$10,000). The largest required increase occurs in Illinois,

where an individual must earn \$208,333 of taxable income in excess of \$125,000 to have a tax liability of \$10,000. In contrast, a Hawaii citizen would pay \$10,000 of income tax with \$20,375 less than \$125,000 of taxable income.

The last column adds these required income changes to \$125,000 to identify the income level at which the ceiling becomes effective. The average income level that generates \$10,000 of tax is \$166,641; the range is \$228,708.⁴ An Illinois citizen must have \$333,333 of taxable income, a New Jersey citizen must have \$302,857. In contrast, a Hawaii citizen with only \$104,625 pays \$10,000 of state income tax; a Montana citizen reaches the threshold with \$104,909.⁵

In practical terms, these numbers mean that, for example, all single individuals in Hawaii with Hawaii taxable income in excess of \$104,625 would be paying higher federal income taxes. All single individuals in New Jersey with New Jersey taxable income less than \$302,857 would **not** be paying higher federal income taxes. Hence, for taxpayers with incomes between \$104,625 and \$302,857, those living in Hawaii would pay higher federal taxes under the propos-

al while those living in New Jersey would not. Of course, some of this differential is attributable to differences among states in taxable income definition, but differentials of the magnitude in column 4 of Table 1 are unlikely to be explained solely by taxable income differences. Imposing a ceiling on state income tax deductions appears very inequitable.

Effects on the State and Local Sector

Capping state and local income tax deductions at \$10,000 can affect three fiscal issues important to the state and local sector. First is the possibility that the increased price of a state income tax dollar in excess of the ceiling (rising, for example, from \$0.72 per dollar net of federal tax deduction for taxpayers in the 28 percent federal tax bracket to \$1.00 per dollar with no federal tax deduction) might cause a decreased willingness on the part of upper income taxpayers to pay state and local taxes. This effect depends on the influence those state and local taxpayers who lose tax deductions have on state and local tax and spending policy. Given the income levels identified in Table 1 that would be necessary to lose tax deductions, it is clear that the number of affected taxpayers would be very small relative to all state and local taxpayers. Of course, these taxpayers' influence in the political process may be disproportionately large.

Although it is difficult to say with any precision how great the effect might be, the state and local tax price change introduced by the *Tax Reform Act of 1986* did not seem to have a substantial effect on the level of state and local taxes and spending.⁶ This proposed change is also likely to have a relatively small effect.

A second possible effect is that imposition of the ceiling might cause state and local governments to alter their tax structures because the tax price of the income tax net of federal tax would rise relative to other state and local taxes, such as the property and sales taxes. Recent research suggests that substitutability between income and sales taxes is sensitive to deductibility-induced relative price differences.⁷ Again, possible changes would depend on the number of affected taxpayers and the degree of influence they exercise over the political process.

The third important issue is whether interstate tax competition would be intensified. Deductibility of state and local income taxes has the effect of reducing tax rate differences between states. For example, assuming a 25 percent federal marginal tax rate (for ease of calculation), the differential (ignoring the federal tax offset) between two states with top marginal tax rates of 12 and 8 percent is 4 percentage points. The tax rates net of the federal tax offset are 9 and 6 percent, reducing the differential from 4 to 3 percentage points. This ceiling proposal would move this differential back to 4 percentage points for high-income taxpayers, the very group that tends to be most mobile and from whom corporate decision-makers who make locational decisions are drawn.

Notes

¹ Congressional Budget Office, *The Changing Distribution of Federal Taxes: 1975-1990*; and *The Changing Distribution of Federal Taxes: A Closer Look at 1980* (Washington, DC, October 1987 and July 1988, respectively).

² For a discussion of the major issues and economic effects, see Nonna A. Noto and Dennis Zimmerman, "Limiting State-Local Tax Deductibility: Effects among the States," *National Tax Journal*, December 1984; and Daphne Kenyon, "Federal Income Tax Deductibility of State and Local Taxes: What Are Its Effects? Should It Be Modified or Eliminated?" in Advisory Commission on Intergovernmental Relations, *Strengthening the Federal Revenue System: Implications for State and Local Taxing and Borrowing* (Washington, DC, 1984).

³ The choice of \$125,000 is based solely on a desire to generate sufficient tax payments in some states to exceed the \$10,000 threshold. The calculations in the table are based on the description of 1989 state marginal tax rate structures in Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, 1990, Volume 1: Budget Processes and Tax Systems* (Washington, DC, January 1990), Table 19. Some states have since adjusted their rate structures, such as New York (reduction) and New Jersey (increase).

⁴ In one sense, these figures are underestimates. The seven states with no state income tax, if included in the calculation of average and standard deviation, would be represented by an infinitely large number. No level of income is sufficient to impose a \$10,000 tax liability on the citizens of these states.

⁵ These income levels are somewhat overstated for some citizens in the 11 states that allow local income taxes because these citizens would have a higher tax liability than is reported in column 2. In most of these local tax states, the local tax is neither uniform nor universal for all state residents.

⁶ For a discussion of the mechanics of how the *1986 Tax Reform Act* affected state and local tax prices, see Dennis Zimmerman, "Federal Tax Reform and State Use of the Sales Tax," Proceedings of the Seventy-Ninth Annual Conference, 1986 (Columbus, Ohio: National Tax Association Tax Institute of America, 1987). For a discussion of the effect of these changes on state and local spending, see Daphne Kenyon, "Implicit Aid to State and Local Governments through Federal Tax Deductibility," in Michael E. Bell (ed.), *State and Local Finance in an Era of New Federalism* (Greenwich, Connecticut: JAI Press, 1988).

⁷ See Mary N. Gade and Lee C. Adkins, "Tax Exporting and State Revenue Structures," *National Tax Journal*, March 1990.

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Earmarking State Tax Revenues

Ronald K. Snell

Voters' concern to limit legislators' discretionary control of state finances continues to be strong, to judge from the number of tax and expenditure limitations on the ballot in the 1990 state elections. Earmarking limits legislators' power through a constitutional or statutory requirement that revenues from a given tax be spent on a given purpose.¹

The Extent of State Tax Earmarking

Earmarking contrasts with combining revenues in a general fund and appropriating them for expenditure through a budgeting process. Statutory earmarking is more common and less restrictive than constitutional earmarking because a legislature can change a statutory provision more readily than a constitutional one.

As Table 1 shows, the national trend over the past 40 years has been a substantial decrease in earmarking. Earmarking fell from 51 percent of state tax collections in 1954 to 41 percent in 1963 to 23 percent in 1979 to 21 percent in 1984. (State data also appear in Table 1.) Why did earmarking decrease so dramatically? Although some states limited or removed earmarking provisions during this period, most of the decline resulted from two circumstances: First, from 1954 through 1988, 12 states adopted a general sales tax and 10 states adopted a broad-based personal income tax, taxes that are seldom earmarked.² Second, states' growing reliance on these highly productive taxes made excise taxes, which are more frequently earmarked, a smaller proportion of tax revenue. As a percentage of state tax collections, general sales taxes and personal income taxes grew from 32.0 percent in 1954 to 63.3 percent in 1988.

Table 1 also indicates that the decline in earmarking has stopped; the proportion of state earmarked taxes grew from 21 percent in 1984 to 23 percent in 1988. Is the state movement away from earmarking about to be reversed? There are two reasons for a cautious no in answer to that question.³

First, the growth in earmarking from 1984 to 1988 was entirely due to increases in the level of motor fuel taxes or increased earmarking of existing motor fuel taxes. Motor fuel taxes make up a large share of earmarked tax collections: almost 27 percent in 1984, and more than 31 percent in 1988. Thirty-eight states raised motor fuel taxes in the period 1985-1988, in some cases more than once.⁴ When earmarked motor fuel taxes are excluded from the calculation, 15.6 percent of total state tax collections was earmarked in FY1988, exactly the same percentage as in 1984. Earmarking motor fuel taxes is a special case; many people tend to think of motor fuel taxes as user fees. Thus, the increase in their use does not provide evidence that state governments are returning to earmarking as a tool of fiscal management.

Second, 1990 has produced the largest dollar amount of state tax increases ever, evidence of state fiscal stress. Of the \$8.6 billion in new revenue the increases will produce in FY1991, \$5.9 billion will come from sales and income taxes, with no changes in states' existing patterns of earmarking.⁵ Earmarking apparently continues to be regarded as a special-purpose tool, not one to be used in response to a general state fiscal crisis.

States' Use of Earmarking

The extent of earmarking varies considerably among states, as Table 1 indicates. Alabama is unique in earmarking 89 percent of tax collections, a figure unchanged from 1954. Only three other states—Montana, Tennessee, and Utah—earmark more than 50 percent of state tax collections. At the other end of the scale, six states earmark less than 10 percent of collections, with Rhode Island the lowest at 5 percent. Commonly, however, the state proportion of earmarked

Table 1
Proportion of Tax Revenue Earmarked by State, Selected Fiscal Years

State	1954	1963	1979	1984	1988	State	1954	1963	1979	1984	1988
New England						Plains					
Connecticut	26%	23%	0%	1%	12%	Iowa	51%	44%	19%	13%	21%
Maine	46	39	19	20	17	Kansas	77	66	29	25	21
Massachusetts	56	54	41	40	-	Minnesota	73	74	12	13	14
New Hampshire	53	54	31	24	24	Missouri	57	40	20	29	30
Rhode Island	6	4	0	1	5	Nebraska	55	53	41	29	22
Vermont	42	39	23	23	12	North Dakota	73	43	29	21	22
Mid-Atlantic						Southwest					
Delaware	0	3	0	5	7	Arizona	47	51	31	29	32
Maryland	47	40	34	24	20	New Mexico	80	31	36	44	47
New Jersey	7	2	25	39	36	Oklahoma	62	59	-	43	24
New York	13	10	0	6	-	Texas	81	66	54	20	24
Pennsylvania	41	63	15	15	14	Rocky Mountain					
Great Lakes						Colorado	75	51	17	25	18
Illinois	39	43	14	18	21	Idaho	51	44	38	32	25
Indiana	49	39	43	33	30	Montana	61	53	55	60	72
Michigan	67	57	38	39	35	Utah	74	62	52	48	-
Ohio	48	48	21	18	19	Wyoming	61	64	54	69	-
Wisconsin	63	61	n.a.	12	12	Far West					
Southeast						Alaska	-	6	1	2	9
Alabama	89	87	88	89	89	California	42	28	12	13	12
Arkansas	41	36	21	18	17	Hawaii	-	7	5	5	6
Florida	40	39	28	28	26	Nevada	55	35	34	52	49
Georgia	29	22	11	9	8	Oregon	47	36	23	19	23
Kentucky	46	29	-	16	-	Washington	35	30	29	26	29
Louisiana	85	87	5	4	9	Average	51	41	23	21	23
Mississippi	40	37	-	30	26						
North Carolina	38	30	20	8	14						
South Carolina	69	62	56	55	44						
Tennessee	72	77	60	61	66						
Virginia	39	32	27	24	25						
West Virginia	57	39	21	21	20						

- = not available

Source: 1954 and 1963, Tax Foundation, *Earmarked State Taxes*; 1979, Montana Office of the Legislative Fiscal Analyst, memo (March 19, 1980); 1984, NCSL surveys conducted in 1985, 1986; 1988, NCSL survey conducted in 1989.

taxes is close to the weighted state average of 23 percent: 19 states earmark from 20 to 30 percent of their tax collections.

Between 1984 and 1988, the proportion of earmarked tax collections shifted very little in most states. In four states (Alaska, Connecticut, Montana, and North Carolina), the reported amount of earmarking grew by more than 5 percentage points.⁶ In six states (Colorado, Idaho, Nebraska, Oklahoma, South Carolina, and Vermont), it diminished by more than 5 percentage points. The following report for these 10 states summarizes most of the history of state earmarking in the period.

Increases

Alaska (up 7 percent) earmarked, in 1988, one-third of its corporate income tax for municipal government, which it did not do in 1984.

Connecticut (up 11 percent) earmarked in 1988, all of its motor fuel tax for transportation, up from 7 percent in 1984.

Montana (up 12 percent) increased the earmarked proportion of the personal income tax; the tax also became a larger share of total state tax collections.

North Carolina (up 6 percent) increased its motor fuel tax rate and earmarked a utility tax for local government.

Decreases

Colorado (down 7 percent) reduced the share of its earmarked taxes as a result of the declining productivity of the earmarked insurance tax and the growing productivity of the non-earmarked personal income tax. Economic circumstances and not policy changes account for the reduction.

Idaho's reduction (down 7 percent) is due partly to reduced earmarking of the sales tax and partly to this report's exclusion of certain license fees from the definition of taxes.

Nebraska (down 7 percent) in 1984, used a temporary, earmarked sales tax enacted to provide a state cash reserve. It was no longer in effect in 1988.

Oklahoma (down 19 percent), in a significant policy change, ended the earmarking of its sales tax, which dated to the 1930s.

Table 2
Number of Major State Taxes Earmarked by Tax and by Purpose, Fiscal Year 1988

	States Levying Tax ²	States Ear- marking Tax ³	Purpose ¹								
			Local Govern- ment	Educa- tion	High- ways/ Mass Transit	Health/ Welfare/ Human Services	Pen- sions	Conser- vation	Debt Service/ Building Funds	Regu- lation	Other
General Sales	40	26	13	10	10	1	1	3	5	-	7
Tobacco	45	24	10	8	-	9	2	2	4	1	4
Alcoholic Beverage	45	29	22	6	2	15	2	-	2	3	8
Insurance	45	26	8	4	-	2	10	-	-	6	5
Public Utilities	39	12	4	4	-	1	-	-	-	3	1
Parimutuel	29	11	5	1	-	2	-	-	2	2	8
Personal Property	39	15	9	4	-	-	-	-	3	-	2
Income	42	13	8	3	1	-	-	-	2	1	3
Corporation Income	45	44	18	1	44	-	1	2	4	2	5
Motor Fuel	45	34	13	4	31	-	-	-	1	-	4
Motor Vehicle	45	18	5	1	16	1	1	-	-	-	2
Operator's Vehicle											
Registration	39	10	4	5	-	1	1	1	3	-	1
Severance	35	21	14	7	1	-	1	5	1	2	9

¹ Because a tax often is earmarked for several purposes, numbers under purposes may not add to the number of states earmarking the tax.

² This table is based on survey results from 45 states and on Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, 1990, Vol. 1* (Washington, DC, 1990).

³ Includes states earmarking only a portion of the tax.

South Carolina (down 11 percent) reduced the percentage of the alcoholic beverage tax dedicated to education, and changes in the relative productivity of state taxes reduced the earmarked percentage.

Vermont (down 11 percent) had no significant changes in the laws regarding earmarking; the proportion fell because of an increasing reliance on non-earmarked taxes.

What taxes are earmarked and how are they used? Table 2 summarizes the answer. The most common kind of earmarking is dedicating motor fuel taxes to highways and other transportation purposes. All 45 of the states that replied to the 1989 NCSL survey have a motor fuel tax (as do the other five), and 44 of the 45 earmark some or all of it for state and local highways (New Jersey does not earmark its motor fuel tax). As noted above, motor fuel tax collections made up nearly one-third of all earmarked tax collections in FY1988.

Other than funding highways, the most common purpose of earmarking is to benefit local governments for purposes other than education. States use a wide assortment of taxes to benefit local governments. The tax most frequently used for this purpose in FY1988 was the alcoholic beverage tax (22 states), with the general sales tax (13 states) second in frequency. Nevada is unique in earmarking a large percentage (almost 40 percent) of statewide sales taxes for local government. Mississippi follows at 16.9 percent. Tennessee earmarks 35 percent of its personal income tax for local government; otherwise, local government earmarking is drawn largely from excise taxes or small portions of sales and income taxes.⁷

Extensive earmarking of the three major state taxes—personal income, general sales, and corporation income—is rare. In FY1988, states earmarked a total of \$4 billion in personal income taxes (13.3 percent of collections), but

\$2.5 billion of that amount was due to New Jersey's earmarking for public education. About \$10 billion in sales taxes, 11.5 percent of collections, was earmarked.

Alabama, uniquely, earmarks almost all of its personal income, corporation income, and sales taxes for education. New Jersey earmarks 100 percent of personal income taxes for education and South Carolina does the same with sales taxes, but only a handful of other states (notably Indiana, Maryland, Montana, New Mexico, Nevada, Tennessee, and Virginia) earmark more than one-third of any of the major three state taxes.

The most rapidly growing earmarked state revenue is not a tax but income from state lotteries. Of the 32 states with lotteries, 21 earmark at least part of the proceeds. As of 1988, nine states had set aside some of their lottery proceeds for educational purposes. In 1989 and 1990, Indiana and West Virginia began earmarking a portion of their lottery revenue for education. Only New Jersey and California earmark lottery revenue for higher education.

Another form of dedicating revenue for a specific purpose is found in California and Michigan. Since 1978, the Michigan Constitution has dedicated 41 percent of the state general fund for aid to local government. In 1988, California voters approved a similar constitutional guarantee that public schools and community colleges must receive a minimum percentage of state general-fund collections.

Rationales for Earmarking

The major justification for earmarking is the "benefit principle"—those who benefit from a service ought to pay for it.⁸ This justification of earmarking has little practical value for state government because local governments are more likely than state governments to provide specific services to

recipients who can be identified and charged without excessive administrative expense. State examples can be found (e.g., tuition and other charges at a state university and toll roads), but these tend to involve fees, not taxes. Aside from motor fuel taxes, it is hard to find a state tax to illustrate the benefit principle. Even the use of motor fuel taxes for highway finance is not a perfect example. Motor fuel taxes are not paid in proportion to the costs that users impose on highways, and non-drivers, who receive indirect benefits from the existence of a highway network, do not have to pay.⁹ NCSL's state-by-state compilation of the purposes for which specific taxes are earmarked makes it clear that the benefit principle finds little expression in the earmarking of state taxes.

A second justification for earmarking is that it assures a minimum level of support and continuity of funding for specific projects or services. This point will be examined later, in the discussion of the fiscal implications of earmarking.

A further argument is that earmarking can induce the public to support new or increased taxes that voters might otherwise oppose (in a referendum or through their elected representatives) if the money were to go into the general fund to be allocated through the appropriations process. Recent practice does not indicate that legislators have found this argument persuasive in many states, perhaps in part because it can backfire. When new taxes are earmarked, what happens to the revenue from old taxes? Sometimes non-earmarked revenue can be moved away from a program at the same time the program gains new earmarked revenue. If that is done (and budgetary pressures may make the temptation very powerful), program proponents could be disillusioned.

Disadvantages of Earmarking

A disadvantage of earmarking state taxes, particularly if it is constitutionally required, is that it complicates comprehensive budgeting. In the 1980s, state control over state budgets tended to diminish as a consequence of federal mandates; consent decrees; judicial decisions, especially regarding education and corrections; and state entitlement programs. Earmarking further diminishes legislators' and governors' budgetary control, requiring them to budget around earmarked programs rather than across all state programs. Of course, statutory earmarking can be amended or repealed by the legislature, if the majority desires to do so. This is much more difficult in the case of a constitutional earmarking. Here, the voters who have tied the hands of legislators need to be called upon to untie their hands. In the case of statutory earmarking, however, the legislature chooses to tie its own hands.

Legislative budgeting focuses on the appropriations process, which in turn is governed by what is available in the general fund—the money subject to appropriation. One of the principles of good budgeting is to take all revenues and objects of expenditure into account. In no other way can elected officials carry out their responsibility to set priorities in response to current economic and social conditions. Weighing the relative merits of programs as diverse as road construction, education, corrections, and public health is both a question of effective financial management and a fundamental responsibility of elected officials.

Earmarked support for programs hampers this process because some revenues are removed from consideration.

Another problem with earmarking is that programs not dependent on appropriations may not receive evaluation in comparison with other programs and may outlive their usefulness. Earmarking can perpetuate past decisions possibly at the cost of present needs. The appropriation process implicitly, and often explicitly, serves as an evaluative process, but earmarking diminishes recipients' visibility.

Besides limiting policymakers' freedom of action, earmarking can produce a distortion of funding through the lack of relationship between a source of revenue and its use. State tax earmarking tends to create arbitrary relationships between sources of revenue and their uses. There is no reason to expect, for example, that a state sales tax earmarked for public schools will provide the amount required to operate the school system efficiently and fairly.

The principle of using an earmarked revenue source to support a public purpose can work well only if there is a direct relationship between revenues and program costs. The absence of such a relationship reduces the chances that revenue will match needs. If additional funding for a program has to be provided by appropriation, there is no rationale for earmarking revenue for the program because the question of the right amount of funding for the program remains in the public policy arena.

As one authority has commented, "earmarking inherently makes it impossible for elected officials to focus on the best mix of taxes, using criteria like impact on various income groups or convenience for taxpayers and administrators, or to concentrate on picking the best mix of spending. Earmarking often ties spending needs moving in one direction, such as indigent health care trending sharply upward, with a revenue source moving in another, such as taxes on tobacco products."¹⁰

This problem, however, can be addressed with tax increases, or additional appropriations, which would have to be done to fully fund the program even if it were not tied to an earmarked revenue source. The greater problem arises when earmarked revenues exceed the needs of the earmarked program but cannot be spent on other programs or easily cut back.

The Fiscal Impact of Earmarking

Earmarking can provide a specific level of funding for a program, but it cannot necessarily be relied on to increase total funding for the program by the amount of tax earmarked for the program. If, for example, a state spends \$1 billion a year from general funds on education and then earmarks \$500 million for education, program funding may not grow to \$1.5 billion. General funding could be reduced by the legislature. In a case like this, earmarking adds a complication to state budgeting but leaves the issue of appropriate program funding to be resolved politically. The amount of earmarked revenue in proportion to existing funding determines the impact of earmarking on a program, but earmarking itself cannot be counted on to provide a continuing level of adequate support, even if that existed initially. Thus, proponents of earmarking need to realize that a legislature may turn earmarking into a shell game and reassert its

prerogatives by reducing funding for an earmarked program simply by abandoning it to its earmarked revenue source.

A program that is entirely or largely dependent on earmarking is at the mercy of the growth (e.g., elasticity) characteristics of its source of revenue. Making a state transportation department largely dependent on motor fuel excise taxes is an example. As fuel consumption per mile has fallen in recent years, earmarking has not provided funding to keep up with demand and cost increases; additional tax increases have been needed, although again, such increases would have been needed in any event. A guaranteed level of revenue is not always an adequate level of revenue.

Since the key issue is the amount of money earmarked in comparison with what was already being spent on the designated program, it follows that earmarking will tend to have more significance the larger the earmarked revenue source is in proportion to the budget of the designated program. Even a large revenue source earmarked for a major function may have no fiscal significance, while a relatively small revenue source devoted to a minor function may increase its budget.

A classic instance of the failure of an earmarked revenue to increase spending as it was expected to do occurred in Illinois, where a state lottery was created to increase funding for education: all net state lottery revenue is earmarked for the Common School Fund. It amounted to \$524 million in fiscal year 1988. But according to a recent analysis of the role of the lottery in Illinois state finance: "While lottery revenues to education have skyrocketed, state budgetary allocations (which include the lottery revenues) are increasing at a decidedly reduced pace relative to the pre-lottery years. . . . Funding from sources other than the lottery immediately began to decline after the lottery's inception. . . . [T]he only conclusion that can be drawn is that lotteries which are designated to support education, in all likelihood, do not."¹¹ Although the example involves earmarking lottery proceeds and not a tax, the point is that because money is transferable, earmarking cannot guarantee funding growth for a program.

It is important, therefore, to distinguish between earmarking a revenue source and setting the tax rate desired to produce that revenue. Earmarking per se merely dedicates particular revenues to a particular purpose or set of purposes. It does not guarantee a particular level of revenue. The next step is to establish an appropriate tax rate and to make provisions for altering that rate as circumstances dictate, or adding funds from other sources as necessary.

Earmarking actually can decrease funding for a particular area. An analysis by the Children's Defense Fund noted that "some advocates . . . feel that Children's Trust Funds provide a way to let many state legislators 'off the hook.' Many legislators may feel they have already 'done their bit' for children and will be likely to leave other pressing budget needs for children such as AFDC and medical assistance without adequate support."¹² Such a perverse result is especially likely if the earmarked tax source grows at a relatively slow rate.

Conclusion

The use of earmarked taxes in state government appears to have stabilized, with its major role being in high-

way finance. Even that use, which is reasonably consistent with the benefit principle, illustrates one of the problems of earmarking: single revenue sources will not automatically provide funding equal to demand for services. Thus, policy decisions remain even when programs are financed by earmarked revenue: Is the level of service to be governed by the source of taxes or by level of need, which might require additional funding? From the perspective of program finance, earmarking alone may not live up to expectations.

At the same time, if legislatures fail to meet citizen expectations, the appeal of earmarking will continue. The key to legislative flexibility is earning public confidence in legislative decision-making on tax and spending policies.

Notes

¹ This article is based on a forthcoming National Conference of State Legislatures' (NCSL) report: Martha Fabricius and Ronald K. Snell, *Earmarking State Taxes* (Denver: National Conference of State Legislatures). The report is based on data for FY 1988 as reported by legislative fiscal officers in 45 states.

² Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism 1990 Edition, Vol. 1* (Washington, DC, 1990), p. 26.

³ A review of the 1984 figures revealed that there was some underreporting for 1984, and that consequently the actual growth in earmarking may be even less than 2 percentage points.

⁴ The Road Information Program (Washington, DC) prepares annual studies of motor fuel taxes and their use for transportation. See also Victor J. Perini, Jr., "Protecting State Highway Funds," *The Fiscal Letter*, January/February 1988.

⁵ Corina L. Ecklet et al., *State Budget and Tax Actions 1990* (Denver: National Conference of State Legislatures, 1990), pp. 67-81.

⁶ Table 1 shows growth of 7 percentage points in Iowa's earmarking between 1984 and 1988. The apparent growth results from an error in the 1984 figure.

⁷ Fabricius and Snell, *Earmarking State Taxes*, provides full data on each state's earmarking practices and detail on what taxes are earmarked for major purposes nationally.

⁸ The following discussion draws on Steven D. Gold et al., *Earmarking State Taxes* (Denver: National Conference of State Legislatures, 1987); and Tax Foundation, *Earmarked State Taxes* (New York, 1965).

⁹ U.S. Department of Transportation, Federal Highway Administration, *Road User and Property Taxes on Selected Motor Vehicles: 1987* (Washington, DC, 1988), p. 14, and *Alternatives to Tax on Use of Heavy Trucks: Surface Transportation Assistance Act of 1982* (Washington, DC, 1984), Table III-5; Robert D. Ebel, editor, *A Fiscal Agenda for Nevada: Revenue Options for State and Local Governments in the 1990s* (Reno and Las Vegas: University of Nevada Press, 1990), p. 161.

¹⁰ Hal Hovey, "Earmarking Tax Revenues," *State Policy Reports*, May 1990, Vol. 8, Issue 9, p. 6.

¹¹ One should note that, in the case of statutory earmarking, this could be the very outcome that is intended by the legislature. Mary O. Borg and Paul M. Mason, "The Budgetary Incidence of a Lottery to Support Education," *National Tax Journal*, March 1988, 81-82.

¹² Children's Defense Fund, "Questions Frequently Asked Concerning Children's Trust Fund" (Washington, DC, n.d.).

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State Fiscal Capacity and Effort: The 1988 Representative Tax System Estimates

Carol E. Cohen

Fiscal disparities—differences among states and localities in their fiscal capacities, or abilities to raise revenues relative to their service responsibilities—are an integral feature of our federal system. The unique economy and population of each jurisdiction give rise to differing tax bases, service needs, and political preferences for each jurisdiction's fiscal system. Regardless of one's view of these differences—as the healthy result of a diversity of private and public choices or as the cause of unacceptable inequities in tax burdens and services—the first task is to understand the magnitude of these disparities.

Almost from its beginning, ACIR has sought to find better ways to measure the variation in *revenue-raising ability* among state and local governments. The Representative Tax System (RTS), developed in 1962 as an alternative measure to personal income, continues to be an important tool for analyzing the relative tax capacity and effort of states and their local governments. In 1986, a measure similar to the RTS, but capturing the ability of state and local governments to raise some non-tax revenues as well, was introduced as the Representative Revenue System (RRS). Those measures and their results for 1988 are the focus of this article.¹

ACIR also is sponsoring research measuring the relative *expenditure needs* of state and local jurisdictions. This research, which builds on RTS and RRS concepts, is discussed in the following article. ACIR also has begun to experiment with applying fiscal capacity (revenue-raising ability and expenditure need) measures to local government. Such analyses have been performed under contract for Hawaii and Maryland, and work is now under way on a study of a sample of municipalities in the Chicago metropolitan area.

Measuring fiscal capacity is an evolving exercise. Not only is ACIR developing new or extended measures, but the existing measures also must be updated periodically to adapt to the changing world of state and local finance. Accordingly, the RTS and RRS methods used to prepare the 1988 estimates reflect a number of changes from those used to prepare previous years' estimates (see box on page 20). The general methodology is explained briefly below.

The RTS and RRS Methodologies

The RTS approach to measuring revenue-raising ability is based on defining a standard tax system of rates and bases that is "representative" of actual state-local tax systems. This representative tax system includes all the taxes of state and local governments (broken down into 27 separate categories), defines the tax bases to be typical of those actually in use, and employs nationwide average tax rates. By applying this standard tax system to estimates of the tax bases in each state—whether actually used by jurisdictions in that state or not—a measure is obtained of the hypothetical tax yield, or *tax capacity*, of each state. The state-by-state capacity estimates reflect the varying types and levels of taxable resources in each jurisdiction, and provide the basis for comparing revenue-raising ability among states. The RRS methodology is similar, but defines a revenue system that includes such major non-tax own-source revenues as user charges and mineral rents and royalties, as well as all of the taxes included in the RTS.

Capacity is calculated separately for the 27 different taxes (30 revenue sources for the RRS), and then aggregated to produce overall estimates of tax capacity. The estimates of capacity for each state are divided by population and then indexed to the national average to provide a standardized basis for comparison. (An alternative to using population in estimating fiscal capacity taking service needs into account is discussed in the next article.) Once a state's capacity is estimated, its *tax effort* can be calculated by dividing a state's actual revenues (for a particular tax or all taxes) by its calculated capacity. Tax effort is thus a measure of the extent to which a state and its local governments are utilizing the tax bases available to them.

Uses of the RTS/RRS Capacity and Effort Measures

The revenue-raising capacity and effort measures produced using the RTS and RRS provide valuable information about states' relative fiscal potentials and policies. The aggregate measures of capacity can be used to compare the overall taxable resources, and therefore, revenue-raising ability, of the states relative to each other. The aggregate capacity measures are also useful for monitoring and comparing trends in states' economic health and revenue-raising ability. Because the indexes for states in a region tend to move together, they provide perspective on regional fiscal and economic trends.

The aggregate effort measures can be used to compare states' relative positions in their overall taxing policies. The RTS and RRS measures of effort, however, should not be confused with tax burdens. "Effort" refers to the extent to which governments are utilizing the tax bases available to them, while "burden" refers to the extent to which residents of a taxing jurisdiction actually shoulder the expense of government. In many cases, taxes imposed by a state or local government may be paid by residents of other jurisdictions.

The aggregate capacity and/or effort indexes could also be used in grant formulas to target aid to states with lesser abilities to raise revenues from their own sources and/or with prescribed tax effort levels. Although the RTS and RRS are not currently used in U.S. aid formulas, their potential for this use has been reflected in legislative proposals and in Canada's use of an RTS in its program of federal-provincial equalization assistance.²

The disaggregated capacity and effort data are used extensively in analyzing states' tax and revenue systems. The capacity measures are used to determine a state's relative strength or weakness in specific economic and tax bases, and the effort measures are used to compare a state's level and mix of taxes and revenues with other states and with the national average. In an environment of economic change and interstate competitiveness, the tax effort indexes are helpful to policymakers and analysts evaluating a particular state's tax policies and opportunities.

Results of the 1988 Estimates

Table 1 shows the overall 1988 RTS and RRS capacity and effort indexes for each state. The indexes are based on per capita capacity and effort calculations, compared to a national average of 100. For example, California's RTS index of 116 means that, in 1988, the state's capacity to generate tax revenues was 16 percent above the per capita national average. Similarly, Wisconsin's RTS capacity index of 90 means that it would have collected 10 percent less per capita than the average state in 1988 had it used an average tax system.

The RTS indexes of capacity range from 159 in Alaska to 65 in Mississippi. Under the RRS, Alaska's index increases to 255, enlarging the range even further. Despite this wide difference in 1988 capacity, overall disparities among the states have been decreasing. In 1986, Alaska's RTS capacity index was 177 and its RRS index 287, while Mississippi's capacity under both measures remained at 65.³

The range in effort indexes is only slightly smaller, from 66 in New Hampshire to 154 in the District of Columbia under the RTS measure (and to 141 for New York under the RRS). There is no close relationship between the capacity and effort levels for a particular state. For example, some of the states with the highest capacity, namely Alaska

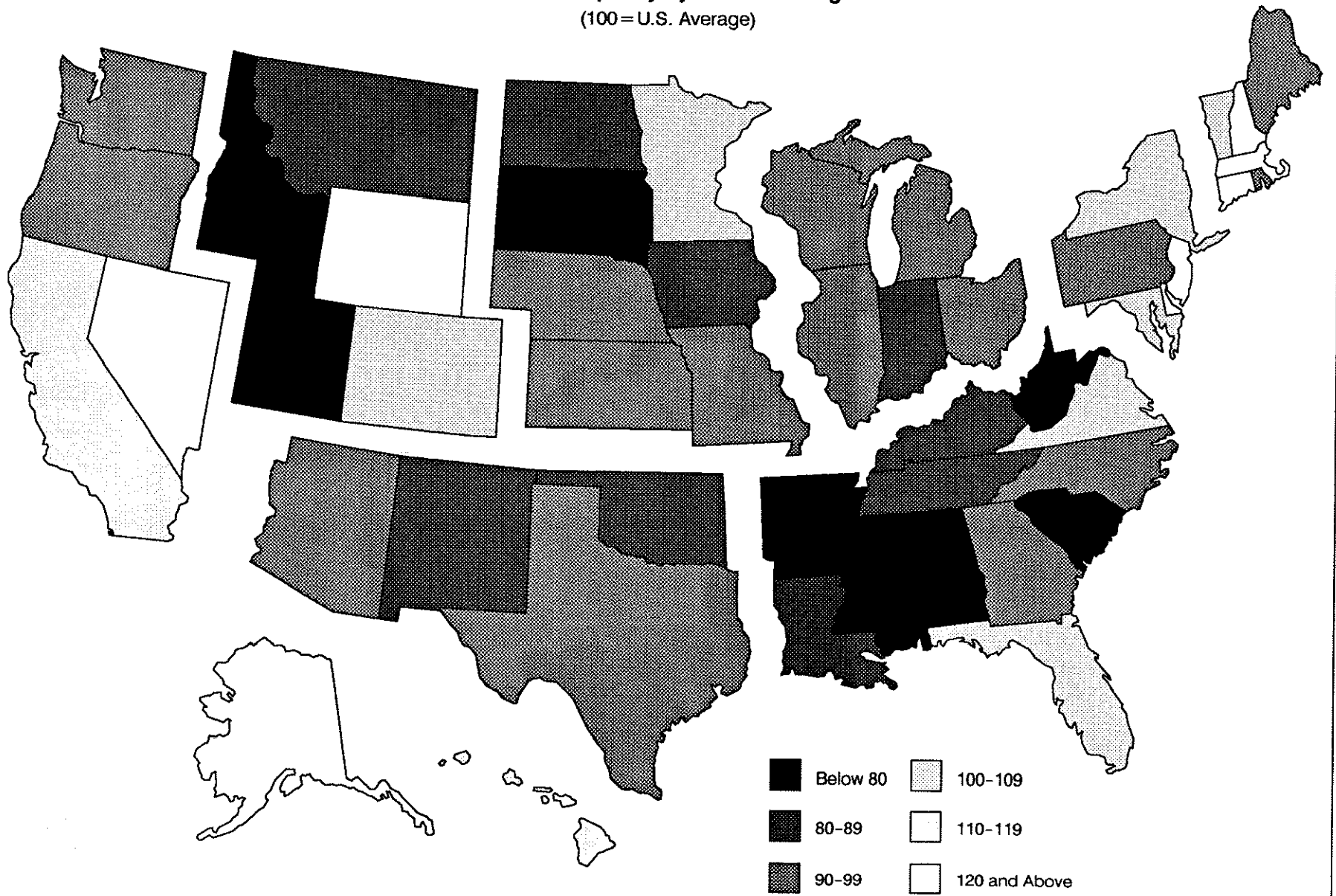
Table 1
Total 1988 RTS and RRS Capacity
and Effort Indexes by State

	Representative Tax System		Representative Revenue System		Exhibit: Per Capita Personal Income
	Capacity	Effort	Capacity	Effort	
Alabama	76	84	77	95	78
Alaska	159	127	255	122	116
Arizona	99	96	97	97	91
Arkansas	74	84	74	86	74
California	116	94	115	98	114
Colorado	107	89	106	94	100
Connecticut	143	90	142	83	140
Delaware	124	84	120	94	107
District of Columbia	123	154	126	137	130
Florida	104	82	103	87	101
Georgia	94	89	93	98	93
Hawaii	114	112	111	111	102
Idaho	76	93	76	98	77
Illinois	99	102	100	95	107
Indiana	87	93	88	96	91
Iowa	83	113	84	118	89
Kansas	91	104	91	104	96
Kentucky	81	88	80	89	78
Louisiana	83	90	84	97	75
Maine	98	105	97	99	92
Maryland	109	108	111	102	118
Massachusetts	129	94	131	89	126
Michigan	95	112	96	112	100
Minnesota	104	112	103	117	101
Mississippi	65	94	65	108	67
Missouri	90	86	89	86	94
Montana	85	102	84	102	78
Nebraska	90	98	89	106	90
Nevada	135	69	129	75	106
New Hampshire	126	66	123	66	118
New Jersey	124	101	126	95	133
New Mexico	83	99	88	103	76
New York	109	152	110	141	117
North Carolina	91	93	89	91	87
North Dakota	86	91	85	107	78
Ohio	91	97	92	98	94
Oklahoma	89	89	87	95	81
Oregon	91	99	91	104	90
Pennsylvania	94	97	95	93	98
Rhode Island	99	104	100	99	102
South Carolina	79	96	78	102	78
South Dakota	78	95	78	95	77
Tennessee	84	83	84	89	84
Texas	96	88	95	89	88
Utah	78	106	76	109	74
Vermont	105	100	102	100	93
Virginia	104	91	104	90	107
Washington	98	102	98	105	100
West Virginia	78	88	76	90	71
Wisconsin	90	119	90	117	94
Wyoming	123	94	118	105	83
U.S. Total	100	100	100	100	100

and the District of Columbia, are also some of the ones with the highest effort, while other states with high capacity, including Nevada and New Hampshire, have some of the lowest effort indexes among the states.

The exhibit in Table 1 allows comparison of the 1988 indexes of state per capita personal income with the RTS

Map
1988 RTS Capacity by State and Region
 (100 = U.S. Average)



Source: ACIR.

and RRS indexes. Personal income is a widely used measure of fiscal capacity. In contrast to the RTS and RRS, however, it fails to reflect the diversity of tax and revenue sources actually used by state and local governments, as well as their ability to "export" taxes to nonresidents.⁴ Per capita income thus understates the fiscal capacities of states with significant tax exportation opportunities, such as tourist-rich Hawaii and Nevada and energy-rich Alaska and Wyoming. For example, the 1988 per capita income of Nevada's residents is 106, or 6 percent higher than the national average. The RTS measure, however, shows Nevada's taxing capacity to be 135, or 35 percent above the national average. The additional tax capacity accounted for

by the RTS is largely due to the special economic bases in the state (e.g., gambling and other tourist-related activity) which enable Nevada to collect large amounts of taxes from nonresidents through amusement and sales taxes.

The combination of capacity and effort shown in Table 1 gives some indication of the governmental service expenditures in each state. In general, those states with the lowest capacity and effort have the lowest levels of governmental expenditures, while those with high capacity and high effort have the highest level of expenditures. The measures, however, abstract from the issue of efficiency in taxation and service provision, and carry no judgment as to what is the "right" level of taxation or services.

Changes in the RTS/RRS Methodology for the 1988 Estimates

The RTS and RRS are rooted in the actual tax policy of state and local governments. To continue to be representative, therefore, these systems must adapt to the changing policies, data, and research on state-local finance. The revisions outlined below do not reflect fundamental alterations of the concepts underlying the RTS or RRS, but small changes designed to rationalize and strengthen the measures. Thus, the 1988 estimates are generally consistent with previous years' estimates.

- **A category of "Other Taxes" is included in the RTS rather than the RRS.** Because this category is a residual consisting of small taxes previously not included in the RTS, it had been part of the RRS. However, to ensure consistency and comprehensiveness in taxes, it is appropriately included in the RTS.
- **Food and drugs are no longer excluded from the RTS base for General Sales and Gross Receipts taxes.** These items had been excluded from the base because most states exempt these items from taxation. But because food and drugs represent a large part of the potential sales tax base in every state, and one whose importance varies from state to state, excluding these items ignores a significant determinant of tax capacity. Eliminating this exclusion removes the special treatment given to food and drugs in the RTS and makes the results easier to interpret.
- **Certain adjustments to General Sales and Gross Receipts Tax revenues reported by the Bureau of the Census are made** to obtain better consistency across states. Revenues from sales taxes on specific industries normally imposed as a separate tax, such as severance taxes collected under the sales tax in Arizona, were deleted from sales tax revenues and added to the revenues of the other tax. Also, revenue from selective excise taxes on items commonly included in a general sales tax base—most importantly, motor vehicle titling, room occupancy, and soft drink taxes—are included in General Sales Tax revenues. These changes principally affect tax effort for those states with adjustments.
- **Corporate license revenues based on economic activity or net worth are included with corporate income tax revenues.** This adjustment reflects the judgment that such revenues are more like taxes on corporate net income than license taxes levied at a flat or nominal rate. This change affects the distribution of tax effort for some states between the Corporation Licenses and Corporate Net Income (now Corporate Net Income and Net Worth) categories.
- **A new revenue source of "Lottery Net Income" has been added to the RRS,** reflecting the increasing prevalence of state lotteries and their significance as a source of state revenue. Using regression analysis, a potential revenue base of gross lottery sales is estimated for every state, whether or not that state actually had a lottery in 1988.
- **A tax base for Selective Sales Taxes on Parimutuels is attributed to all states,** regardless of whether they authorize parimutuel gambling. Previously, the 19 states and the District of Columbia with no parimutuel events or revenues had been assigned a tax base of zero. The tax base is estimated for all states using regression analysis.
- **Special assessment revenues have been added to the category of User Charges** to make the RRS more comprehensive. Special assessments are included in the user charges category because of their similarity in being paid by an identifiable subset of taxpayers based on the benefits received from a specific service.
- **The category of Mineral Leasing Act Payments has been eliminated from the RRS.** Previously included on the rationale that such payments were public equivalents to the mineral rents and royalties earned by states and included in another category of the RRS, they have now been excluded on the ground that they are intergovernmental revenues, and thus not relevant to a measure of own-source revenue-raising ability.

Regional Patterns in Tax Capacity

The RTS/RRS indexes show patterns in revenue-raising ability that reflect similarities in economic bases among states in a region. The map (see page 19) illustrates the level of RTS capacity of each state, which can then be compared with that of other states in the region. In general, the 1988 indexes continue the regional patterns begun in the early 1980s and observed throughout the intervening years.

The strong economies of many **New England** and **Midwest** states in 1988 are reflected in the capacity indexes of the states in these regions. Six of the 12 jurisdictions (Connecticut, Massachusetts, New Hampshire, Delaware, the District of Columbia, and New Jersey) have capacity over 20 percent above the national average. The capacities of the three lowest states (Maine, Rhode Island, and Pennsylvania) are within 10 percent below the national average. Also, nearly all the states in these regions experienced strong growth in their relative revenue capacities from the early 1980s through 1988. The recent downturns in the economies of some states in these regions, however, would be expected to be reflected in the next set of estimates, those for 1990.⁵

Most of the **Far West** states (including Alaska and Hawaii) continue to show above-average capacities in 1988, with Nevada and Alaska having capacity indexes well above 120, and California and Hawaii having indexes between 110 and 120. Only Oregon and Washington do not show above-average capacities, though both are between 90 and 100 percent of average.

The capacity indexes of the **Great Lakes** states fall between 80 and 100. All five of the states in this region experienced a decline in capacity during the recession of the early 1980s, and their capacities have either stayed relatively constant or recovered slightly since then. In particular, Illinois and Wisconsin showed small increases in capacity between 1986 and 1988.

The **Plains** states show more diversity in their revenue capacities, with indexes ranging from above 100 for Minnesota to below 80 for South Dakota. This region suffered from the national recession of the early 1980s as well as the farm recession of the mid-1980s. In addition, North Dakota felt the slump affecting energy states. As a result, the states in this region—with the exception of Minnesota—experienced nearly continuous declines in their capacity through the 1980s.

The four states in the **Southwest** share in having capacity between 80 and 100 percent of average. While Arizona's capacity has increased slightly from the early 1980s, New Mexico, Oklahoma, and Texas have seen their capacities fall from their well above average peaks in the early 1980s to their current below average levels. This pattern demonstrates the sensitivity of the estimates to factors such as energy prices, which can have volatile effects on the fiscal fortunes of states.

The **Rocky Mountain** states exhibit the widest range of capacity of any region, from Wyoming's index of more than 120 to Idaho's and Utah's of less than 80. This wide variation reflects the disparities between those states with significant energy resources, such as Wyoming, and those which are more agriculturally based, such as Idaho. All of the states in this region, however, experienced varying degrees of declining capacity in the 1980s.

While the **Southeast** contains the largest number of states with the lowest capacities, the capacities of some states in this region are above average. The five states in

this region with capacities below 80 (Alabama, Arkansas, Mississippi, South Carolina, and West Virginia) have historically had some of the lowest capacities in the nation. Three states (Kentucky, Louisiana, and Tennessee) have capacities between 80 and 90 percent of average, and another two (North Carolina and Georgia) are within 10 percent below. Only Florida and Virginia have capacities above the national average. Despite their overall low capacities, half the states in the Southeast (Florida, Georgia, North Carolina, South Carolina, Tennessee, and Virginia) increased their capacities in the 1980s.

States with the Largest Changes in Capacity and Effort

Table 2, which shows the states with the largest changes in RTS capacity and effort between 1986 and 1988, also illustrates the regional nature of economic and fiscal trends.⁶ Of the eight states with the largest gains in capacity, five are in the New England region (all the New England states except Maine). Such increases in capacity can be largely attributed to economic growth; the RTS results do not appear to have been affected significantly by the methodology revisions for 1988.

All of the states showing the largest decreases in capacity between 1986 and 1988 are in the central or western parts of the country, and nearly all are states with major energy and/or agricultural sectors. Because state-local severance tax revenues from oil and gas, coal, and non-fuel minerals—and, therefore, aggregate capacity for states with these resources—dropped by almost 30 percent between 1986 and 1988, the states and regions with large energy sectors show some of the largest declines in capacity. Of the ten states with the largest decreases in capacity, for example, four (Louisiana, Texas, New Mexico, and Oklahoma) are in the Southeast-Southwest "oil patch." Nevada's decrease in capacity, however, is largely explained by the effect of the change in sales tax methodology on that state's relative capacity (see box on page 20).

The RTS tax effort indexes for 1988 reflect a number of developments since 1986. First, they reflect tax policy changes made between 1986 and 1988, including, importantly, state actions either to keep or to avoid realizing part or all of the income tax "windfall" created by the *Tax Reform Act of 1986*.⁷ Second, tax effort is affected by changes in economic bases or capacity, as effort is calculated relative to capacity. Finally, the tax effort figures reflect a slightly revised set of revenue figures as a result of changes to the methodology noted earlier.

Even with these effects, the states with the largest changes in tax effort between 1986 and 1988 also show some regional patterns. Four of the ten jurisdictions with the largest increases in tax effort (Maine, Vermont, Maryland, and the District of Columbia) are in the New England and Midwest regions. The tax effort for all of these four except Maine was affected by the inclusion of titling taxes in the RTS for the first time. Four states (New Mexico, Texas, Kansas, and Colorado) are also on the list of states with the largest decreases in capacity. This inverse relationship between changes in capacity and effort indicates that revenues have not fallen as fast as capacity in these states. In Vermont, however, revenues increased faster than capacity.

Of the states with the largest decreases in tax effort, three (Ohio, Michigan, and Wisconsin) are in the Great Lakes region. The two New England states (Rhode Island

Table 2
States with Largest Changes in RTS Capacity and Effort Indexes between 1986 and 1988

	Largest Changes in Capacity		Largest Changes in Effort		
	Region*	Change	Region*	Change	
Connecticut	NE	8	New Mexico	SW	11
Rhode Island	NE	7	District of Columbia	ME	11
New Hampshire	NE	7	Vermont	NE	9
Vermont	NE	6	Maryland	ME	9
Kentucky	SE	5	Texas	SW	9
Massachusetts	NE	5	Kansas	PL	8
Wisconsin	GL	4	Hawaii	FW	7
Pennsylvania	ME	4	Virginia	SE	6
			Maine	NE	6
			Colorado	RM	6
Kansas	PL	-5	Ohio	GL	-6
Louisiana	SE	-7	Michigan	GL	-6
Texas	SW	-8	Rhode Island	NE	-7
New Mexico	SW	-8	Arkansas	SE	-7
North Dakota	PL	-8	Massachusetts	NE	-9
Oklahoma	SW	-9	West Virginia	SE	-10
Colorado	RM	-10	Wisconsin	GL	-15
Nevada	FW	-12	Wyoming	RM	-23
Alaska	FW	-18	Alaska	FW	-41
Wyoming	RM	-28			
*Regions:					
NE—New England	GL—Great Lakes		SE—Southeast	RM—Rocky Mountains	
ME—Midwest	PL—Plains		SW—Southwest	FW—Far West	

and Massachusetts) that experienced decreases in tax effort also exhibited significant increases in tax capacity during the period. The large decreases in tax effort for Alaska and Wyoming accompany the large decreases in tax capacity for those states.

The RTS and RRS as Measures of Fiscal Capacity

The RTS and RRS capacity estimates measure the relative ability of states and their local governments to raise taxes and other revenues. They do not directly address the cost of providing services. However, population, which is used primarily as a scaling factor in computing capacity per capita and the capacity indexes, can also be regarded as a rough indicator of public service needs. Thus, the RTS/RRS measures of tax and revenue capacity also have been referred to as measures of fiscal capacity.

Since the mid-1980s, however, there has been research on improving on population as a measure of service needs. This effort, which uses a representative expenditure approach to measuring relative service needs and costs, parallels the concepts embodied in the RTS and RRS. Readers interested in learning about this development in measuring fiscal capacity should turn to page 25.

Notes

¹ The full report is *1988 State Fiscal Capacity and Effort*, August 1990. In addition to the 1988 estimates, it contains detailed discussions of the RTS methodology and changes for 1988, an analysis of the 1988 estimates, state-by-state graphs summarizing the RTS data, and appendices containing the definitions, methods, and sources for the 1988 estimates, and historical fiscal capacity and effort data.

² *1988 State Fiscal Capacity and Effort* contains a chapter written by Douglas Clark, administrator of the Canadian fiscal equalization program, which describes the program and compares the Canadian RTS with the U.S. RTS.

³ The population-weighted standard deviation of the estimates, a measure of the dispersion of the state estimates around the national average, also shows a lessening of disparities. This indicator decreased from 14.7 in 1986 to 14.5 in 1988, down from a high of 18.5 in 1981.

⁴ Exporting refers to the ability of states to levy taxes that are ultimately paid by nonresidents, thereby reducing the fiscal burden on residents for any given level of revenues raised. A state's revenue-raising ability is increased to the extent its economy is made up of activities that permit it to pass on taxes to nonresidents in their roles as consumers (e.g., through hotel room taxes) or factor suppliers (e.g., via corporate taxes ultimately borne by out-of-state shareholders).

⁵ One indicator of this downturn, the leveling off of employment after a long period of vigorous growth, is discussed by Edward Moscovitch in "The Downturn in the New England Economy: What Lies Behind It?" *New England Economic Review*, July/August 1990. He reports that New England lost 94,000 jobs between 1984 and 1988.

⁶ 1986 is the year for which the last set of RTS/RRS estimates was produced. Previously, the estimates had been generated annually. Beginning with the 1988 estimates, they will be updated biennially.

⁷ The *Tax Reform Act of 1986* broadened the base of the federal income tax at the same time it reduced federal statutory tax rates. For states that conformed their individual and corporate income tax bases to the federal tax base definitions, the broadening of the federal tax base automatically resulted in a broadening of the state tax base. Without taking any action to reduce statutory tax rates accordingly, those states would have received a 1987-88 revenue "windfall" as a result of the higher income tax base. Estimates of the changes in state tax liabilities resulting from provisions of the *Tax Reform Act of 1986* are presented in ACIR, *Tax Reform Act of 1986—Its Effect on Both Federal and State Personal Income Tax Liabilities*, January 1988.

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Intergovernmental Digest

Furor Over 4-R Tax Proposal

State and local governments have expressed concern about proposed legislation in the U.S. House of Representatives that would permit U.S. district courts to enjoin, suspend, or restrain state property-tax levies on interstate natural gas pipelines. The provision, known as a 4-R preference, derives from the *Railroad Revitalization and Regulatory Reform Act of 1976*. This statute gives railroads federal court jurisdiction over their property tax disputes and allows them to obtain federal injunctive relief on disputed taxes while their cases are pending in court. In *Burlington Northern Railroad v. Oklahoma Tax Commission* (1987), the U.S. Supreme Court also permitted federal courts to review property tax valuation methods in addition to rates and assessments. Similar 4-R provisions have been extended to airlines and motor carriers, and are being sought by natural gas, telecommunications, and trucking companies.

NCSL Finds Federal Policies Shifting Costs of Immigrants and Refugees to the States

In a new State-Federal Issue Brief entitled "United States Immigration and Refugee Policy: The Federal Policy and Its Impact on the States," the National Conference of State Legislatures reviews the implementation of the 1980 Refugee Act and the 1986 Immigration Reform and Control Act. In both cases, these laws were passed in recognition of a federal responsibility to assist state and local governments to help persons of foreign origin become self-supporting and contributing members of their adopted communities. Substantial federal funding was authorized in both acts. However, NCSL found that as the number of refugees and immigrants increased in recent years, federal funding decreased. The shift of responsibility to the state and local governments, for a function of government over which they have no control, has been substantial enough to cause NCSL to issue a call for adequate federal financial assistance to aid in implementing national policies of legalization and resettlement.

Georgia Becomes Seventh State to Legislate Development Impact Fees

According to the Summer 1990 issue of *The Public's Capital* newsletter, Georgia is the latest state to legislatively authorize local governments to levy impact fees on developers in proportion to the need for new public works generated by their developments. Other states include Texas, Nevada, Tennessee, Illinois, Maine, and Oregon. Impact fees are used in several other states without explicit legislative authorization. Many developers and local government officials supported this legislation in order to create a level on which all developers would be treated the same, and to avoid the uncertainties that come with letting the courts gradually define the rules in a series of cases developed over a number of years, as has happened in some other states. The legislative approach was recommended in 1988 by the Governor's Growth Policy Commission, but it took two years to work out the details with all of the concerned parties.

Community Reinvestment Gets Attention

One of the few "silver linings" in the savings and loan bailout is a new emphasis on reinvesting in local housing and community development projects by federally insured banking institutions. These provisions, strongly supported by the U.S. Conference of Mayors and the National League of Cities, went into effect July 1, 1990. NLC is preparing a special series of articles and a guidebook to help local officials take advantage of this new law.

Special Districts Buck Trend of Declining Federal Aid

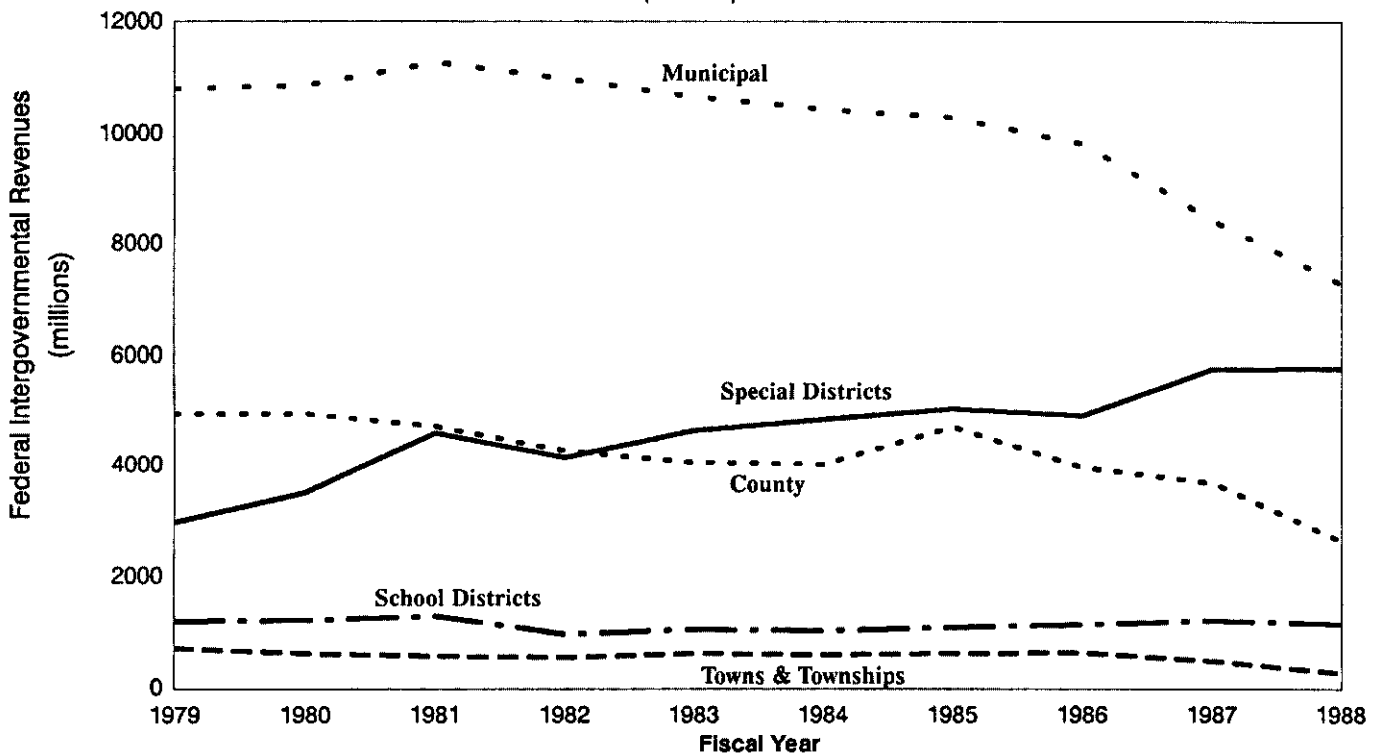
Total federal aid to all local governments has decreased by 23.6 percent in actual dollars between 1981 and 1988, but the amount of federal aid to special districts increased by 94.7 percent from 1979 through 1988. After reaching a peak of \$22.4 billion in 1981, federal revenues received by all local governments, as a group, fell to \$17.1 billion in 1988. The decline has been particularly severe since 1985 when these revenues fell from \$21.7 billion to \$17.1 billion, or 21.2 percent. General govern-

ments (municipalities, counties, and townships) bore the brunt of the decline in federal intergovernmental revenues from 1985 to 1988: counties from \$4.7 billion to \$2.6 billion (43.8 percent); municipalities from \$10.3 billion to \$7.3 billion (29.2 percent); and townships fell from \$617 million to \$272 million (56.0 percent). To some extent, the most recent decline in federal aid to local governments is due to the elimination of the general revenue sharing in 1986.

In contrast, special districts, excluding school districts, have been growing in number, and have been receiving increasing amounts of federal intergovernmental revenues during the entire period. These districts perform limited functions, often involving capital construction (in 1987, 93 percent of the special districts performed only a single function), and have a high degree of administrative and fiscal autonomy from general governments. Between 1979 and 1988, federal aid received by special districts increased from \$3.0 billion to \$5.8 billion (94.7 percent). Since 1986, federal intergovernmental revenues to special districts have climbed from \$4.9 billion to \$5.8 billion (17.6 percent). Revenues for housing and community development increased the most, from \$2.6 billion in 1986 to \$3.1 billion in 1987 to \$3.4 billion in 1988. The number of housing and community development districts also increased the most, by 1,052 between 1977 and 1987 (43.7 percent).

At least one caution should be mentioned in using these aggregate data. A greater proportion of federal aid to state and local governments now goes to the states than in the 1970s, and some of that state aid is passed through to local governments. This pass-through figure is not available. It may be that pass-through funds would somewhat alter the relationships described above.

Federal Intergovernmental Revenues, by Type of Local Government Fiscal Years 1979-1988
(millions)



A Walk on the Expenditure Side: “Needs” and Fiscal Capacity

Robert W. Rafuse, Jr.

Measurement of the fiscal capacities of state and local governments has been a matter of some controversy for more than half a century.¹ With one recent exception, per capita personal income (PCI) has been the only measure of fiscal capacity incorporated in federal programs, and it has been the object of increasing criticism since it was first adopted during the Great Depression.

One of the most influential critiques of personal income as a measure of the relative abilities of the states to raise revenues from their own sources appeared in an ACIR report by Selma J. Mushkin and Alice M. Rivlin nearly three decades ago.² The report introduced the representative tax system (RTS) as a measure designed to remedy the most important defects of personal income.

This article addresses a shortcoming of all current measures of fiscal capacity—the RTS as well as PCI. The difficulty is that the measures rely (for the most part implicitly) on resident population as a proxy for the relative costs of the service responsibilities (commonly referred to as “needs”) of state and local governments. The discussion begins with the reasons why this is a problem. A “representative” approach to assessing relative public service needs is outlined, and two sets of estimated representative expenditures for the 50 states and the District of Columbia are presented. The article concludes with a brief analysis of the consequences of substituting the estimates of representative expenditures for resident population in the RTS estimates of fiscal capacity.

Fiscal Capacity and Resident Population: The Problem

Fiscal capacity is, in essence, an indicator of the relative fiscal well-being of the governments in a state, as a group.³ More specifically, the fiscal capacity of a state is the potential ability of its governments to raise revenue from their own sources relative to the cost of their service responsibilities, allowing for revenues received from the federal government and other states.

For decades, the controversy surrounding per capita personal income as a measure of fiscal capacity centered on the validity of the personal income of a state’s residents as the indicator of revenue-raising ability. It was this debate that prompted the introduction of the RTS, which was designed to (1) take into account differences in relative reliance on the specific bases actually taxed by state and local governments and (2) include bases that either are not part of personal income (the major exclusion is corporate retained earnings) or are not highly correlated with the distribution of personal income among the states (oil and gas production being the most important of these).

The RTS is, in essence, the average (or representative) tax system actually in use by the nation’s state and local governments. The estimated yield of that system in a state is its “tax capacity.” That amount, divided by the state’s resident population, is referred to as fiscal capacity, following the established practice for personal income.

Few questions were raised about the expression of these measures on a per capita basis until the past few years, when analysts began to challenge the implicit assumption of the convention. That assumption is that the costs of the service responsibilities of a state’s governments depend only on the state’s total population. The next part of this article summarizes the representative expenditure approach, which was developed in response to these challenges to the use of resident population as the measure of relative needs.⁴

Fiscal capacity relates to a state’s potential, not to the actual policies of its governments. Those policies determine the extent to which a state’s fiscal potential is exploited, but not the potential itself. (Over time, the policies of a state’s governments may promote or depress its potential, but these interactions are complex and too little un-

derstood to be taken into account empirically.) For this reason, the fundamental prerequisite for a measure of service costs—as of a measure of revenue-raising ability—is that it abstract as completely as possible from the actual tax and expenditure policies of any individual state.

Sources of Variation in the Costs of Public Services

Given that the actual policies of any one state are to be disregarded, variations in the costs of public services among the states depend on three general classes of factors:

- The range and types of services that must, by law, be provided;
- The prices of the inputs used to produce the services, such as wages and salaries, gasoline prices, and the cost of asphalt; and
- Factors that determine the scope of the services provided, such as traffic and miles of highways maintained.

Legal Requirements: The services for which a jurisdiction is responsible are a key consideration in the cost of local government, where obligations prescribed by state law vary among the states and among different types of entities. At the state level, however, requirements imposed by the federal government apply uniformly throughout the nation. States are essentially free to offer, in conjunction with their localities, whatever services they choose. State and local choices are, of course, embodied in policies, from which the analysis must abstract. Hence, the first of the three types of factors is not germane in considering differences in the costs of public services that are not the result of the policies of the governments in a state.

Prices: The prices of the goods and services purchased by state and local governments vary with climate, with distance from the point of production, between rural and urban areas, and as a consequence of state-local policy. For example, state laws relating to the compensation of public employees vary widely, with major consequences for the costs of public services. Cost differences traceable to the policies of state and local governments must be abstracted from, however.

Too little information is available on the prices paid and the mix of goods and services purchased by the states and localities to permit estimation of a comprehensive index of the relative input costs of governments in all of the states. It is possible, however, to estimate the differences among the states in the cost of employee compensation. This cannot be accomplished by looking at the wages and salaries (and fringe benefits) actually paid to state and local employees because those expenditures reflect policy as well as underlying economic realities. Rather, the reference must be to the compensation state and local governments have to pay to compete effectively in the market.

The best possible indicator of the relative magnitude of this compensation is the statewide average earnings of full-time employees of a given age, sex, and educational attainment. Estimates of differences among the states in employee earnings can, in turn, be used to compute an overall index of relative input costs for each major service function, or category of expenditure, on the assumption that unit costs other than employee compensation are uniform

around the nation.⁵ The estimates of representative expenditures presented in this article are shown unadjusted and adjusted for differences among the states in unit input costs.

Scope of Services: This leaves the factors that influence the amount or scope of public services that must be provided. Accounting for the variability of these factors is the primary objective of the representative expenditure approach.

Estimating Representative Expenditures

The RTS achieves policy neutrality by estimating the yield in each state of a standard revenue system. Given the taxes included in the representative system, the key issue is

Exhibit 1

Workload Measures for Representative Expenditures

1. Elementary and Secondary Education

The workload measure is the weighted sum of three population groups: (1) children of elementary school age (5-13) net of enrollment in private elementary schools, (2) youth of secondary school age (14-17) net of private secondary enrollment, and (3) the population under 18 living in households with incomes below the poverty line. The weights are, respectively, 0.6, 1.0, and 0.25.

2. Higher Education

The measure is the weighted sum of the population in the age groups 14-17, 18-24, 25-34, and 35 and older. Each weight (1.32%, 22.44%, 4.16%, and 0.83%, respectively) is the full-time-equivalent number of students in the age group enrolled in institutions of higher education nationwide as a proportion of the total population in the age group.

3. Public Welfare

The workload measure is the population living in households with incomes below the poverty line.

4. Health and Hospitals

The measure is the sum of the equally weighted percentage distributions of (1) persons age 16-64 with work disabilities, (2) the population living in households with incomes below 150 percent of the poverty line, and (3) the total population.

5. Highways

The workload measure is the weighted sum of the percentage distributions of two variables: (1) vehicle miles traveled, and (2) lane-miles of streets and roads other than those on federally controlled land. The first is weighted 0.825, the second 0.175.

6. Police and Corrections

The measure is the sum of the equally weighted percentage distributions of: (1) the population age 18-24, (2) the number of murders committed, and (3) the total population.

7. All Other Direct General Expenditures

The workload measure is total population.

Table 1
Indexes of Actual Direct General Expenditures of State and Local Governments, Estimated Relative Input Costs, and Estimated Representative Expenditures; and Ratio of Actual to Representative Expenditures, 1986-87

State	Actual Direct General Expenditures (1)	Implicit Overall Index of Unit Input Costs (2)	Representative Expenditures		Actual as Percentage of Representative Expenditures (5)
			Not Adjusted (3)	Adjusted (4)	
United States	100	100	100	100	100%
Alabama	77	96	113	109	71
Alaska	371	117	103	121	306
Arizona	104	99	104	103	102
Arkansas	71	94	113	106	67
California	114	103	98	101	112
Colorado	106	100	98	98	108
Connecticut	109	104	88	92	119
Delaware	111	100	96	96	116
District of Columbia	192	98	105	103	187
Florida	88	96	96	93	95
Georgia	89	97	112	109	82
Hawaii	105	98	91	90	118
Idaho	78	93	107	100	78
Illinois	94	105	98	102	92
Indiana	81	100	99	99	81
Iowa	94	98	98	96	98
Kansas	93	98	101	98	94
Kentucky	78	99	109	108	72
Louisiana	92	101	109	110	83
Maine	92	90	99	89	104
Maryland	103	103	94	97	106
Massachusetts	111	98	89	87	128
Michigan	108	106	102	108	100
Minnesota	122	101	97	98	125
Mississippi	75	93	122	113	67
Missouri	77	98	102	100	77
Montana	107	93	109	102	105
Nebraska	92	95	101	96	96
Nevada	105	99	97	96	109
New Hampshire	83	94	91	85	98
New Jersey	113	104	89	93	121
New Mexico	100	95	117	111	91
New York	145	101	95	95	152
North Carolina	77	94	105	99	79
North Dakota	108	94	112	105	103
Ohio	91	102	98	100	91
Oklahoma	83	97	106	104	80
Oregon	105	99	99	98	107
Pennsylvania	88	100	90	90	97
Rhode Island	104	97	89	86	121
South Carolina	79	94	110	103	76
South Dakota	95	90	116	105	91
Tennessee	77	96	107	104	75
Texas	87	101	108	110	79
Utah	95	98	107	105	90
Vermont	102	90	99	89	115
Virginia	89	99	99	99	91
Washington	103	102	97	99	105
West Virginia	85	97	106	103	82
Wisconsin	106	100	95	94	112
Wyoming	165	98	104	102	161

Note: Relationships among columns may not calculate precisely because of rounding. Column 2 = [(column 4)/(column 3)]•100. Column 5 is column 1 as percentage of column 4.

Sources: U.S. Bureau of the Census, *Government Finances in 1986-87*, GF-87-5 (November 1988), Table 29; Robert W. Rafuse, Jr., *Representative Expenditures: Addressing the Neglected Dimension of Fiscal Capacity* (ACIR, forthcoming in 1990).

the definition of a base for each and estimation of its value in every state.

The representative expenditure approach parallels that of the RTS. The crucial step is the identification of the best possible measure of the workload for each of the major categories of state-local expenditures.⁶ A state's workload for a service indicates its need for outlays on that function relative to that of the other states. To ensure that the measures are independent of the actual policies of the governments in a state, such program-client variables as enrollment in public schools and the number of people receiving welfare benefits are not used.

The workload measures for the categories of expenditures analyzed in the report are identified in Exhibit 1. The measures are derived from a review of the literature and consultation with authorities in each functional area.

Given the workload measure for a function, the representative expenditure per unit of workload (the equivalent of the representative tax rate in the RTS) is calculated by dividing total actual state-local outlays for the service by the U.S. total for the workload measure. A state's representative expenditure for the function is then arrived at by multiplying the representative outlay per unit by the state's workload. The result is an estimate of how much it would cost the governments in the state to provide the national-average (representative) level of the service.

Results of the Analysis

Table 1 shows, in column 1, relative actual spending of state and local governments in the 50 states and the District of Columbia.⁷ The data are direct general expenditures per capita indexed to the U.S. average. Actual outlays range from 71 percent of the per capita national average in Arkansas to 371 percent in Alaska.

Indices of the estimates of representative expenditures, unadjusted and adjusted for differences in input costs, are shown in columns 3 and 4 of Table 1. (The index of input costs implicit in the adjustment appears in column 2.) The range in the cost-adjusted estimates of representative expenditures is much smaller than that in actual outlays: from a low of 85 in New Hampshire to a high of 121 in Alaska.

New Hampshire's unadjusted index is 91 (column 3). Unit labor costs in that state are only 86 percent of average, however, so the cost of producing national-average public services is the lowest in the country.

Alaska's position at the high end is largely attributable to its extremely high unit labor costs, which are 134 percent of the U.S. average. Adjustment of the estimate of Alaska's representative expenditures (103) in column 3 by its overall index of unit input costs (117), raises the state's index of representative expenditures to 121. If the adjustment for input costs were not made, the national-average level of public services would cost the most to produce per capita in Mississippi, whose unadjusted index of representative expenditures is 122. It would be least costly in Connecticut, whose unadjusted index is 88. Allowing for labor costs that are only 84 percent of the national average in Mississippi, but that are 109 percent in Connecticut, moderates their respective indexes of representative expenditures to 113 and 92.

Column 5 of Table 1 displays the ratios of actual expenditures to the representative estimates for each state. Missis-

issippi's below-average actual spending and above-average needs yield a ratio of only 67 percent, the lowest of all the states. Alaska's extremely high actual expenditures (371 percent of the national average per capita) keeps it at the top of the list, although—when its above-average needs are considered—its ratio in column 5 is only 306 percent.

Representative Expenditures in a Measure of Fiscal Capacity

Table 2 presents a comparison of the RTS index of fiscal capacity calculated in two different ways.⁸ The first uses resident population as a proxy for needs; the second uses the estimates of representative expenditures.

Column 1 reproduces the unit-cost-adjusted index of representative expenditures from Table 1. Column 2 shows ACIR's recently published estimates of fiscal capacity, calculated by indexing per capita RTS tax capacity. The third column shows the index of RTS fiscal capacity that results when estimates of representative expenditures are used as the measure of service need.⁹ Column 4 displays the change in a state's index of fiscal capacity when representative expenditures are substituted for population in the calculation. A positive change indicates that the estimate is increased by the substitution; a negative change denotes a decrease.

A general pattern is apparent in column 4. Positive changes dominate among states with high fiscal capacities (Alaska is a notable exception—it drops from first to sixth in the ranking). Negative changes dominate among states with low fiscal capacities. This says, in essence, that the use of resident population in the calculation of a measure of fiscal capacity tends quite systematically to understate the estimates for high-capacity states and to overstate the estimates for low-capacity states.

Summary of Results

A variety of general findings can be drawn from the estimates in tables 1 and 2. The most important is that population is an inferior measure of the relative cost to governments of providing a standard level of public services. The use of population in a measure of fiscal capacity overstates the capacities of most states below the national average and understates those of most states above the average. As a consequence, fiscal disparities among the states are significantly larger than suggested by most measures available until now.

The differences among the states in the cost of providing a given level of public services are substantial. They are smaller, however, than the differences in own revenue-raising ability identified by per capita estimates of RTS tax capacity.

The actual outlays of 22 out of the 30 states with fiscal capacities below the national average are lower than their representative expenditures. In other words, the 22 states are not spending enough by this measure, to provide a national-average level of public services.

Caveats and Advice on Interpreting the Results

Three points deserve emphasis in interpreting these findings. First, no implication should be drawn that the representative outlays are objectively correct or "needed" in any absolute sense. The estimates merely show how much it would cost each state to provide the national-average level of each service.

Table 2
**Index of the Estimates of Representative Expenditures
 and RTS Measures of the Fiscal Capacities
 of the States, with Public Service Costs Accounted for
 by Resident Population and the Estimates
 of Representative Expenditures, 1987-88**

State Rank	Representative Expenditures (1)	Popu- lation (2)	RTS Fiscal Capacity	
			Representative Expenditures (2/1) (3)	Change (3 - 2) (4)
United States	100	100	100	0
1. Connecticut	92	143	156	13
2. Massachusetts	87	129	148	19
3. New Hampshire	85	126	148	22
4. Nevada	96	135	141	6
5. New Jersey	93	124	133	9
6. Alaska	121	159	131	(28)
7. Delaware	96	124	129	5
8. Hawaii	90	114	127	13
9. Wyoming	102	123	120	(3)
10. District of Columbia	103	123	120	(3)
11. Vermont	89	105	118	13
12. Rhode Island	86	99	115	16
13. California	101	116	115	(1)
14. New York	95	109	114	5
15. Florida	93	104	112	8
16. Maryland	97	109	112	3
17. Maine	89	98	110	12
18. Colorado	98	107	109	2
19. Minnesota	98	104	106	2
20. Virginia	99	104	106	2
21. Pennsylvania	90	94	104	10
22. Washington	99	98	99	1
23. Illinois	102	99	97	(2)
24. Arizona	103	99	97	(2)
25. Wisconsin	94	90	96	6
26. Nebraska	96	90	94	4
27. Oregon	98	91	93	2
28. Kansas	98	91	93	2
29. North Carolina	99	91	92	1
30. Ohio	100	91	91	0
31. Missouri	100	90	90	(0)
32. Michigan	108	95	88	(7)
33. Indiana	99	87	88	1
34. Texas	110	96	88	(8)
35. Iowa	96	83	87	4
36. Georgia	109	94	87	(7)
37. Oklahoma	104	89	86	(3)
38. Montana	102	85	83	(2)
39. North Dakota	105	86	82	(4)
40. Tennessee	104	84	81	(3)
41. South Carolina	103	79	76	(3)
42. Idaho	100	76	76	(0)
43. West Virginia	103	78	76	(2)
44. Louisiana	110	83	75	(8)
45. New Mexico	111	83	75	(8)
46. Kentucky	108	81	75	(6)
47. South Dakota	105	78	75	(3)
48. Utah	105	78	74	(4)
49. Alabama	109	76	70	(6)
50. Arkansas	106	74	70	(4)
51. Mississippi	113	65	57	(8)

Note: The states are sorted by the RTS index calculated using representative expenditures as the measure of public service costs (column 3).

Sources: Table 1 and ACIR, *1988 State Fiscal Capacity and Effort*, Report No. M-170 (September 1990), Table 5.

Second, the estimates assume that every government could produce the representative level of each service with the same efficiency. In other words, a given level of spending per capita (adjusted for differences in input costs) buys the same level of service in every state. Hence, no inferences about operating efficiency can be drawn from the relationship between actual spending for a function and the representative expenditures.

Third, and a closely related point, the estimates are silent on the issue of performance. A dollar of spending (adjusted for differences in unit costs) in one state is assumed to yield the same quantity and quality of a service as it does in every other state. Although we know that public services are not of equal quality per dollar spent everywhere in the nation, it is, regrettably, impossible to take this into account because credible measures of performance are not available.

Representative Expenditures and the Fiscal Capacities of Local Governments

The representative expenditure approach used to prepare the estimates reported in this article is equally applicable, with considerable adaptation, to analysis of the fiscal capacities of local governments within a state. In fact, the approach, in combination with representative revenue methods, has been applied in a recently completed ACIR analysis of Hawaii's state-local fiscal system and in a study of the fiscal capacities of the 23 counties (and the City of Baltimore) in Maryland.¹⁰ The approach is currently being used in a study of the fiscal capacities of a sample of 40 municipalities in the Chicago metropolitan area.

Notes

¹ The assessment of local fiscal capacity has been an important issue since the first "foundation" programs of equalizing state aid to local governments for elementary and secondary education were enacted in the 1920s.

² *Measures of State and Local Fiscal Capacity and Tax Effort*, M-16 (1962). Since this pioneering analysis was completed, the RTS has been refined and periodically reestimated by ACIR staff. See the article by Carol E. Cohen in this issue.

³ Fiscal capacity is also an attribute of the fiscal circumstances of a state or local government. To simplify the discussion, this article refers only to all governments in a state.

⁴ Initial work on this approach is reported in "A Representative Expenditure Approach to the Measurement of the Cost of the Service Responsibilities of the States," Robert W. Rafuse, Jr. (ed.), *Federal-State-Local Fiscal Relations: Technical Papers*, Vol. I (Office of State and Local Finance, Department of the Treasury, 1986), pp. 133-86. The past two years as Visiting Senior Fellow at ACIR, on detail from Treasury, have given me the opportunity to refine and extend this work. The result, from which this article is drawn, will be published this fall by the Commission—*Representative Expenditures: Addressing the Neglected Dimension of Fiscal Capacity*.

⁵ In *Representative Expenditures*, an index of differences in employee compensation is calculated from 1980 census data on average earnings in each state in 1979. A separate index of input costs is then derived for each major function because the share of outlays accounted for by employee compensation, which in the aggregate amounts to roughly half of all state-local spending, varies dramatically among functions. For example, employee compensation accounts for 81 percent of expenditures for police and corrections but only 13 percent of outlays for public welfare. The index for each function appears in *Representative Expenditures*. The overall, implicit index for total expenditures is shown in Table 1.

⁶The availability of reliable data of reasonable currency is an important constraint on the selection process.

⁷Actual expenditures and all estimates are presented separately for 10 functions in *Representative Expenditures*. All other expenditures, for which total resident population is the workload measure, are broken into four categories: environment and housing, interest on general debt, governmental administration, and all other.

⁸The indexes in Table 2 are not really measures of fiscal capacity, as that concept is defined earlier in this article, because revenues received from the federal government (and other states) are not taken into consideration. The RTS indexes in Table 2 are more properly referred to as measures of own-revenue-raising ability relative to expenditure needs. An analysis of the fiscal capacities of the states using the RTS and three other measures of own-revenue-raising ability, taking actual amounts of federal grants into account, appears in *Representative Expenditures*.

⁹As shown in the table, column 3 is calculated by dividing column 2 by column 1. Because columns 1 and 2 both display indices of per capita amounts, population is in the numerator and the denominator of the ratios in column 3. Therefore, population cancels, and column 3 is identical to an index of the dollar amount of each state's RTS tax capacity divided by the dollar amount of the estimate of adjusted representative expenditures.

¹⁰Copies of the reports are available from ACIR at cost.

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(see page 38 for order form)

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- View the tax base and revenue data underlying the 1988 RTS and RRS.
- Recreate one table from the 1988 RTS or RRS.
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- Recreate the entire set of 27 tables for the 1988 RTS or 30 tables for the 1988 RRS.

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- Hard drive required for saving largest spreadsheet.

Price: \$20—Single diskette

(see page 38 for order form)

The State and Local Bond Rating Process

Cathy L. Daicoff

Observers of public finance are fond of pointing to two elements that, unlike the federal government, force the fiscal discipline of balanced budgets on state and local jurisdictions. First, most states and localities face constitutional and/or statutory balanced-budget requirements. Second, because state and local governments cannot “print” money, it must either pay for its expenditures and bonded indebtedness in a timely manner or face limited and expensive terms in the credit markets.

The legal requirements are the lesser of the two factors. Indeed, 18 states have no provision that the governor must sign a balanced budget, and there is legal silence in 27 states as to whether the government may carry over a deficit from one fiscal year to the next.¹

The bottom line in fiscal discipline is the credit market. And, as in any market, however, the players must have access to information if the system is to operate efficiently. It is here—systematically sorting out the information—that the bond rating agencies play a crucial role.

Crucial though it may be, the process whereby state and local bonds or “municipals” are rated is a pretty murky topic for most people. As New York Governor Mario M. Cuomo recently said, he does not understand what the rating agencies are all about: “I don’t understand your ultimate objective. What is it that you are telling people with your rating? What is it that you are saying? It seems to be that, as an investor, what I want to hear [from the issuer of the bonds], is will they pay the debt or won’t they.”²

Fair enough—rating is a complex and subjective business. The purpose of this article is clear up some of the mystery. Specifically, this article discusses the rating process, trends in ratings, the agencies’ view of recent problems in some states, and the important issues that lie ahead in the municipal credit market.³

The Rating System

There are two major bond rating agencies, Moody’s Investor Service and Standard and Poor’s Corporation (S&P). A third agency, Fitch Investors Service, has recently become more active in the municipal market. All of the agencies are located in New York City, and Moody’s and S&P provide ratings for at least 8,000 local, state, and federal entities.

A rating is an opinion that is designed to serve as a guide to investors regarding the credit risk associated with a security. When an agency is asked to evaluate a government’s credit rating, it answers the question: “What is the likelihood of a timely repayment of principal and interest?” To put it in the negative, a rating is not a recommendation of “attractiveness” with respect to a decision to buy or sell, nor is it a comment on the market price or forecast of the market price of a security.

Agency opinions are classified by using a variety of symbols. At Standard and Poor’s, for example, the symbols used for long-term ratings range from “AAA,” the highest rating, to “D,” which is an instrument in default. Ratings of “BBB-” or above are considered as an investment-grade category. Ratings of “BB+” through C are “speculative”; that is, the bonds are exposed to major uncertainties.

Table 1 summarizes the long-term municipal bond rating symbols. Each agency also uses other symbols to evaluate private issues and public and private short-term credit instruments.

When evaluating information for a debt rating, all credit analysts review basically the same information. The different opinions these analysts arrive at are the result of how that information is weighted. Thus, at S&P, for example,

Table 1
Rating Symbols for Long-Term Bonds¹

	Highest Grade	Other Investment Grade ²	Other ³	Default
Fitch Investors Service	AAA	AA,A,BBB	BB,B,CCC,CC,C	DDD,DD,D
Moody's Investors Service	Aaa	Aa,A,Baa	Ba,B,Caa,Ca,C	
Standard and Poor's, Inc.	AAA	AA,A,BBB	BB,B,CCC,CC	D

¹ Not all governments are assigned one of these ratings. Other categories include "conditional" on successful completion of a project or event (Fitch and Moody's), and suspended for inadequate information (Fitch, Moody's, and Standard and Poor's).

² Ratings may be accompanied by a plus or minus sign (Fitch, Standard and Poor's) or other symbol (Moody's, which uses a "1" to denote a +, e.g., A1) to show relative standing within categories.

³ Categories may be "speculative" to the degree that bonds have elements of large uncertainty or major exposure to adverse conditions (Standard and Poor's), or when the analysts judge that whole future payment is not well assured. Bonds on the low end of this category may reflect bonds in a bankruptcy petition or imminent default (Fitch).

Source: Compiled from primary sources by ACIR staff.

analysts begin their evaluation by reviewing four key areas: the structure of the issuer's economy, debt factors, administrative considerations, and financial condition.

The Economy. Clearly, it is a plus if the issuing entity has an economically diverse tax and service base that is reflected in its *employment, income, and financial profile*. The creation of jobs and income ultimately generates the vital ingredient, the ability to repay debt.

However, a sound economy is not a sufficient condition. To be fully reflected in a debt rating, economic base strengths need to be captured through an adequate revenue structure, namely, a structure that is designed to generate new revenue automatically as the economy grows, thereby minimizing the need for making frequent ad hoc legislative changes.

Debt. Factors relating to the debt structure play an obviously important role. These factors include the type of security being pledged to debt repayment and the jurisdiction's overall debt burden and history. The debt burden is measured against certain aspects of the ability to repay, including income and the government's total budget resources. Debt history as well as projected debt needs are considered too. A community desiring an optimum debt rating should demonstrate an effective planning program for capital improvements.

Administrative. The form of government and its ability to implement plans and fulfill legal requirements is the third key factor. Important considerations here are tax rate and levy limitations, debt limitations, and current unused margin in each of these categories. Focus on management capabilities includes personnel turnover ratios, the history of labor-management relations, and legal and political restraints evident in the issuing entity's structure and environment. Assessment procedures and property valuation are also important credit ingredients.

Financial. Current account analysis will include an examination of fiscal performance versus the budget. The balance sheet for the main operating account is examined, with emphasis on current financial position and fund balances. Trends in these factors are important. If, for example, a current deficit is scheduled for elimination within a year, it will not be viewed too negatively. An accumulated

deficit for three successive years, however, would be a definite negative. Pension liabilities are critical: their funding should be adequate and on schedule. It is important that pensions be funded on an actuarial basis.⁴

For project financing, particularly in the revenue bond area, it is important to look at issues such as legal protections⁵ and industry-specific trends. For example, in health care, the quality of staff and the demand for the facility are important. In airport ratings, the demand for the facility is evaluated along with the financial condition of the airlines serving the facility. For water and sewer utilities, compliance with the *Clean Water Act* as well as the financial status of leading ratepayers are considered.

The Process

To establish a rating, an issuer first requests a rating.⁶ A list of the informational requirements is then provided. This includes standard financial information, such as three years of audited financial statements and the current operating budget. Other documents include an official statement and a variety of other financial/economic statistics. Examples of these would be a feasibility study, a capital improvement plan, and a long-term financial plan. Rating agency analysts also use data available through internal data bases, such as economic information and industry trends.

The information is then presented in a verbal and written presentation to a rating committee. The committee process is the filter to ensure that all ratings are consistent and not influenced by any individual's opinion. In S&P, only officers of the company are allowed to vote on these deliberations. Once the committee issues an opinion, the issuer receives the rating. At S&P, issuers can appeal the rating if they think the information was misinterpreted or an important piece of information was lacking. Moody's and Fitch also have appeal processes. After review and a final rating determination, the rating is released and then reviewed on a regular cycle.

CreditWatch

Because of the sharp change in economic conditions and the reduced financial stability of many issuers, the agencies maintain on-going reviews in order to alert users

of a potential ratings change due to an unresolved event. Fitch's system is called FitchAlert. S&P employs the term CreditWatch. CreditWatch and FitchAlert focus on events that may result in a rating change. At S&P, for example, these events include recapitalization, voter referendums, regulatory actions, or unanticipated operating developments. CreditWatch listing, however, does not mean a rating change is inevitable, and, where possible, alternative ratings are provided. For example, S&P could place an issuer on CreditWatch if there is a voter referendum that could have severe financial effects on an issuer. In this situation, the issuer is placed on CreditWatch with "negative implications." If the initiative is approved by voters, the next step would be to evaluate the issuer's reaction. Then, an issuer's rating would either be removed from CreditWatch with no change or removed with a rating adjustment downward.

In recent months, S&P has used CreditWatch for some very visible ratings. For example, S&P placed New York State on CreditWatch in February 1990. The listing stated: "Ratings of New York State and its agencies are placed on CreditWatch with negative implications as the state's fiscal condition continues to erode. As a result, the budget, submitted January 16, does not provide the basis for solid fiscal balance." After several months of budget deliberations, the rating was reviewed, removed from CreditWatch, and adjusted downward. The uncertainty, in this situation, was how the state was going to resolve its budget deliberations.

Not all CreditWatch listings result in a downgrade. New Jersey is an example of an issuer that was placed on CreditWatch on April 12, 1990, with negative implications and removed without a rating change. This "AAA" state faced a major budget gap, which was ultimately closed through a three-year plan for annual balanced budgets that included a combination of spending cuts, sales tax base broadening, and a sharp increase in the personal income tax. As a result of the achieved fiscal balance, the "AAA" rating was affirmed.⁷

The "AAA" rating notwithstanding, New Jersey's fiscal plan has generated a great deal of negative citizen reaction. The apparent paradox between a positive credit-market rating and a negative taxpayer response points out that what is imperative with respect to credit ratings is not politics, but whether a government produces a fiscal package that will satisfy the credit market requirements for timely repayment of debt principal and interest. The rating agencies do not advocate a specific tax and spending adjustments. What does matter, for example, is whether fiscal changes either limit economic growth or are subsequently and significantly weakened.⁸ After all, these are long-term bonds.

Importance of Budget Reserves

In examining a state's credit rating, most credit analysts consider the presence of a budget reserve (e.g., stabilization or "rainy day" fund) as an important and positive contingency factor for helping states minimize ad hoc budget adjustments resulting from revenue shortfalls and/or the inevitable errors in general fund budget projections. Although the number of states creating budget reserve funds has increased significantly in the past decade, the

commitment to their use varies considerably. Of the 35 states that have budget stabilization funds, 15 limit their size, and some (eight of the 35 in 1989) may even go unfunded. However, for those states that make appropriations to the fund and then limit its "withdrawals" for cushioning general fund budget problems, the fund will be counted as a positive in the credit rating determination.

Recent Trends and Outlook

Rating trends over the last several years reveal some interesting developments.⁹ During 1988, of the state and local ratings that changed, 30 percent were increased. By 1989, 55 percent of the changed ratings were upgraded. The trends for rating changes in 1989 at 55 percent adjusted upward did show some interesting examples of general obligation issuers that experienced relatively weak economies in the mid-1980s, but managed to work toward fiscal soundness. Issuers included Oregon; Cleveland, Ohio; Wayne County, Michigan; and Newark, New Jersey.

Overall, however, recent rating trends across the country are not as encouraging as they were a couple years ago. During the first quarter of 1990, only 23 percent of the changed ratings were adjusted upward and, as noted, several state ratings were downgraded. In the hospital area, there were more downgrades than upgrades in the first quarter of 1990. Certain large visible revenue bonds have, however, showed rating increases. These include the Chicago O'Hare Airport and the New Hampshire Turnpike.

Analysts are taking a close look at several states experiencing budget problems. The current ratings of these states range from "BBB" or "A" to the highest category, "AAA." The reason for this stems from the fact that the recent economic downturns, first evidenced in the Northeast, are spreading throughout the country. About half the states are reporting unexpectedly weak tax collections. The corporate income tax is the primary source of the weak tax collection, although several states also report low sales tax activity.

Moreover, after several years of strong expenditure growth during the economic expansion of the 1980s, the budget outlook is deteriorating in many areas. This decline is also due to increasing mandates for spending on prisons and on health and welfare (including Medicaid). Total state year-end balances, which registered a record high of \$12.6 billion at the end of FY 1989, are forecast to drop to \$8.3 billion in 1990, a dramatic decline of more than a third in just one year. Indeed, for FY 1990, ending balances as a percentage of spending are estimated to be at their lowest level since the recession year of 1983 and are forecast to drop even more in FY 1991.¹⁰

What lies ahead? Recognizing that what ultimately matters in the credit market are the fundamentals of economic and budget stability, the credit agencies will be monitoring the following developments.

The Coming(?) Tax Revolt. Statewide anti-tax ballot initiatives and referendums will reach a ten-year peak on November 6. These range from a repeal of enacted legislative packages to constitutional limits on certain taxes and to a supermajority voting requirement for approval of new

taxes. What is important about tax revolts is their impact on economic growth and the ability of state and local governments to balance their budgets in a time of economic uncertainty.

Court Intervention. State and federal courts are intervening increasingly in the legislative fiscal process. At least a dozen states face, or soon will face, challenges to their system of education funding. In some cases, decisions could call for major spending and tax adjustments. In addition, as suggested by *Missouri v. Jenkins* (1990), even if acting through direct citizen action, state and local governments may not have their tax operations totally within their control.

Federal Tax Reform. Tax reform continues to influence the ability of state and local governments to raise bond proceeds in the capital markets, and the alternative minimum tax, volume caps,¹¹ and arbitrage restrictions have diminished state and local government's borrowing capacity.

Tax Structure. Finding the right mix of taxes to fund state and local government, without negatively influencing economic trends, continues to be a key challenge for policymakers and credit analysts alike. Key issues range from broadening the sales tax base to include personal and business services, to the debate in some states to adopt a broad-based personal income or sales tax, and to a complete restructuring of the state-local fiscal relationship.

Taxable Debt. In the mid-1980s, taxable debt was heralded as a potentially important tool for generating public capital. However, the evidence indicates that very few issuers will take advantage of this instrument. Because of the nature of the taxable market, most issuers would have to issue a very large amount of debt compared to the average size of municipal debt issues. For example, Los Angeles issued \$1 billion of taxable notes over the last several years and invested these funds in high-yielding instruments to make money on legal arbitrage. Because the yield curve is now unfavorable and the risks have risen relative to the yield potential, the county is no longer issuing taxable notes.

Short-Term Failures/Long-Term Problems. The response to a short-run fiscal crisis can be translated into long-term credit problems. For example, Massachusetts issued \$415 million of 18-month debt to pay for its FY 1989 deficit. The FY 1990 deficit will probably be financed with seven-year debt of \$1.3 billion. Thus, financial pressures will be evident for some time to come. This state is just beginning to grapple with its structural budget deficit.

Expenditure Policy. State and local governments have moved to the front lines in terms of nearly every domestic spending issue. The ability of these governments—and the intergovernmental system in general—to carve out the appropriate public role with respect to a host of economic and social concerns, such as rising health and welfare costs, infrastructure maintenance and construction, illegal drugs, solid waste disposal, and urban decline. In addition, federal-state and state-local program mandates potentially reduce portions of the public budget that will be discretionary.

Comment

The message from the credit rating process is that fundamentals are paramount. Budgets can be balanced with one-time revenue devices and deferrals of necessary expenditures, but eventually, the real trends become evident. As the financial flexibility of state and local governments has been diminished over the last several years, it is important not to look for the quick fix to balance the budget. This is particularly true as the nation enters a time of economic uncertainty. Prudence, thoughtful study, planning for uncertainty, and back-to-basics financing provide the template for maintaining credit quality into the 1990s.

Notes

¹ Moreover, 13 states have no constitutional provision to limit general obligation debt. See also, U.S. Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism: Budget Processes and Tax Systems*. January 1990, Table 3.

² Quoted by Joe Mysak in *Muni Week*, July 2, 1990, p. 3.

³ This discussion is limited to the rating process as it applies to "municipals"—that is, state and local bonds. The Wall Street rating agencies also rate bonds and preferred stock issues of federal entities and private domestic and foreign corporations. The "municipals" market refers to debt issued by state and local governments and their instrumentalities as general obligation bonds, revenue bonds (e.g., for hospitals, transportation authorities, housing agencies) and industrial revenue bonds.

⁴ This requires that pensions be funded according to the money that will be needed in the future, not just what is needed to meet a given year's cash flow. Failure to be actuarially sound will cause an unfunded liability to rise faster than assets. This may "work" in the short term; eventually, the contributions must be made up, or it will be necessary to dip into assets.

⁵ These include rate covenants, additional bond tests, and remedies available for violation of bond covenants.

⁶ To some extent this is a formality. De facto, for most governments, investors' concerns and interests dictate such a request.

⁷ A rating can be adjusted downward or upward without being placed on CreditWatch.

⁸ At present, S&P has placed Massachusetts on CreditWatch due to uncertainty regarding the ongoing budget debate, liquidity after September 30, and the Citizens for Limited Taxation petition, which could negatively affect the state's revenue-raising abilities if the petition is adopted and upheld by the courts.

⁹ The following trends refer to S&P ratings.

¹⁰ Marcia A. Howard, *Fiscal Survey of the States* (Washington, DC: National Governors' Association and National Association of State Budget Officers, March 1990).

¹¹ See U.S. Advisory Commission on Intergovernmental Relations, *The Volume Cap for Tax Exempt Private Activity Bonds: State and Local Experience in 1989*, by Dennis Zimmerman (Washington, DC: U.S. Advisory Commission on Intergovernmental Relations, M-171, July 1990).

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Future Changes in Financial Reporting: A Primer on GASB

James R. Fountain, Jr.

A process of dramatic change has begun in our government financial reporting system that will alter how citizens think about their state and local government financial reports and budgets. Earlier this summer, members of the Governmental Accounting Standards Board (GASB) began deliberations to develop new governmental accounting and financial reporting standards. Although GASB is a private group, independent of any governmental body, the recommendations it makes over the next several years will carry a lot of clout. GASB was organized in 1984 by the Financial Accounting Foundation, with participation from the Council of State Governments, Government Finance Officers' Association, International City Management Association, National Association of Counties, National Association of State Auditors, Controllers and Treasurers, National Conference of State Legislatures, National Governors' Association, National League of Cities, and the U.S. Conference of Mayors.

GASB started out with the accounting and financial reporting standards established by its predecessor, the National Council on Governmental Accounting (NCGA). Those standards, provided a basis for governmental financial reporting for more than five decades, were generally accepted by state and local governments. Unfortunately, the standards did not keep pace with changes in government, primarily because NCGA consisted of volunteers who met four times a year for two or three days and did not have funds for staff research. The financial crises of the late 1970s and early 1980s brought increased attention to governmental financial reporting. With New York City and Cleveland teetering on the brink of financial collapse, bond holders, bond rating agencies, and taxpayers all recognized the need for better financial reporting by state and local governments.

GASB provided an independent mechanism for setting governmental accounting and financial reporting standards. The standards must be followed by state and local governments, however, if there is to be improvement. Several factors have been set in place to give clout to GASB's standards. First, several states have passed legislation requiring local governmental entities to follow GASB standards for their annual financial reports. Second, the American Institute of Certified Public Accountants (AICPA) changed its guidance to auditors, recognizing GASB as the primary standard-setting body for state and local governments. Third, the bond rating agencies have indicated that they expect annual financial reports to comply with GASB standards. Finally, the federal government required all governmental entities receiving federal funds to be audited in accordance with the *Single Audit Act*, which requires a statement as to whether the financial report complies with GASB standards.

Objectives of Financial Reporting

GASB seeks to establish and improve standards of state and local governmental accounting and financial reporting that will result in useful information to guide and educate the public, including issuers, auditors, and users.

Early in its deliberations, the board identified accountability as the cornerstone of its objectives. Accounting and financial reporting standards are essential to the efficient and effective functioning of our government. Financial reporting plays a major role in fulfilling government's duty to be publicly accountable, with those reports providing the basis on which to assess accountability and to make economic, social, and political decisions.

The concept of interperiod equity also was identified as a significant part of accountability. Interperiod equity reports whether current-year revenues are sufficient to pay for the services provided that year, or whether future taxpayers will be required to assume burdens for those services.

Based on these concepts, GASB set the following three objectives for financial reporting:

- Financial reports should assist government efforts to be accountable, provide information to determine whether current-year revenues were sufficient to pay for current-year services, demonstrate whether resources were obtained and used in accordance with the budget and with other finance-related legal or contractual requirements, it also should provide information to assist users in

assessing the service efforts, costs, and accomplishments of the government.

- Financial reports should help users and managers evaluate the operating results for the year by identifying the financial sources and uses and how the government financed its activities and met its cash requirements. They should also contain the information necessary to determine whether the financial position improved or deteriorated.
- Financial reports should assist users in assessing the level of services that can be supplied and in estimating the government's ability to meet its obligations as they become due. In addition to financial information, the report should detail physical and other nonfinancial resources having useful lives that extend beyond the current year, including information that can be used to assess the service potential of those resources. It should also disclose legal or contractual restrictions and risks of potential loss of resources.

Future Governmental Financial Reporting

Based on the concept of accountability and the GASB objectives, the board has begun reviewing and modifying state and local accounting and financial reporting standards. This is a major task that requires reconsideration of the reporting model and the measurement focus and basis of accounting, as well as how to measure and report on the use of capital assets and the "results of operations."¹

Present standards require general purpose financial statements (GPFS) with combining statements for various types of funds. The funds include: general, special revenue, fiduciary, and debt and capital projects. These statements are often supplemented by the more detailed comprehensive annual financial report (CAFR) with statements for each fund and statistics showing revenue and expenditure trends. The present CAFR often contains more than 120 pages and may include more than 30 pages of notes to the financial statements alone. Despite this abundance of information, financial reports often do not permit users to judge the results of operations or accountability for the management of taxpayer and other resources.

GASB is considering a multiple-statement format, possibly with three levels of reporting:

Potential Government Operating Statement	Purpose	Basis of Accounting
Budget to Actual Comparison (by fund)	Budget Compliance Measurement	Budgetary
Fund Statements	Financial Resource Flow	Accrual of Financial Resources Measurement
Some Form of Aggregate Statements	Interperiod Equity Measurement	Accrual Basis with Some Measure of Capital Consumption (flow of economic resources)

Budgetary Compliance. Reporting whether revenues were received and expenditures were made in accordance

with a legally adopted budget requires accounting information that is reported on the same basis as the budget. Because the budget is the financing plan of the government, it is usually prepared on a flow of current financial resources basis,² although a cash basis is used by many entities. Based on GASB's Concept Statement 1, it is likely that a statement comparing actual revenues and expenditures to budget, prepared on a budgetary basis of accounting, will continue to be required.

The Acquisition and Use of Financial Resources. Although necessary for showing compliance with the budget, neither the flow of current financial resources nor the cash basis provides an adequate measure of acquisition and use of financial resources. They both leave out or ignore certain revenues and expenditures that are incurred in the period³ but may not be received or paid for months or even years. Examples of expenditures of this type are actuarially required pension contributions that may not be paid to a pension plan, or claims and judgments that have been incurred during the period but not paid in cash. In addition, the budgetary basis often reports encumbrances (purchase commitments) as expenditures, whereas they are excluded for the flow of current financial resources basis because no goods or services have been received and no claim against financial resources has been incurred.

Measurement of financial resource flows, therefore, often will require the recognition of revenues and expenditures on a different basis than that used for budgetary accounting. It is important to measure financial resource flows within the funds. GASB Statement No. 11, *Measurement Focus and Basis of Accounting—Governmental Fund Operating Statements* (effective for periods beginning after June 15, 1994), requires the flow of financial resources basis of accounting for operating statement reporting for governmental funds. This moves the accounting away from the budgetary basis toward an accrual basis by recognizing claims against and for financial resources when they are incurred, regardless of when cash will be paid. It does so without modifying the traditional treatment of capital assets and related debt.⁴

This will result in a number of changes in the reporting of revenues and expenditures for operations of governmental funds. For example, at present, pension expenditures are reported as the amount paid to the pension plan, regardless of the amount identified as being required to fund the plan on an actuarially sound basis. The new measurement focus and basis of accounting will require recognition of pension expenditures in fund operating statements that are calculated in accordance with an accepted actuarial method, regardless of the amount actually paid to the plan. Other changes include the recognition of compensated absences as they are earned, not as paid, and recognition of prepaid expenses in the period that receives the service, not when the payment was made.

Service Costs and Interperiod Equity. The flow of financial resources basis, while moving reporting toward an accrual basis, does not provide a complete measure of interperiod equity (IPE). Recognizing that the individual governmental funds do not provide an adequate base for reporting a measure of IPE, GASB is considering the use of aggregate state-

ments that may include all governmental funds and account groups on one operating statement and one balance sheet.

The measurement basis for this "top of the pyramid" report is still in the very early stages of development, and it is impossible to be precise about the nature and content of this report. However, it seems probable that it might include treatment of capital assets as resources of the governmental entity, which could mean that the acquisition of capital assets would be reported not as an expenditure but as the conversion of financial resources into capital resources with no operating statement effect. Some measure of the use or consumption of capital assets would be reported as an operating cost.⁵

The resulting operating statement might provide information about the cost of governmental services and might recognize, to the extent practical, economic events that have occurred during the period. This cost provides a basis for consistent comparisons between periods and governmental entities for developing information on the efficiency (cost per unit of output or service) and cost effectiveness (cost per unit of outcome or result) of governmental services.

It is quite possible that any requirement to report financial information on the accrual basis, including a measure of the use of capital assets, may raise questions from the public and their representatives about why it is possible to have a balanced budget and yet have a decrease in the equity position of the government. Does a balanced budget really mean that the cost of current-year services is being paid for by revenues from that period, and does it mean that the assets brought forward from prior periods have been maintained? Difficult questions may be raised about the differences between budgetary accounting, flow of financial resources, and accrual accounting with a measure of capital asset use, why they occur and what they mean.

Service Efforts and Accomplishments. The final piece of the foundation of the financial report as an accountability document is the most difficult and, some would say, the most important. To satisfy the accountability objectives of financial reporting, it is necessary to provide information that will assist users in assessing the efficiency and effectiveness of the use of governmental resources—information with which the users can begin to assess the "results of operations" of the government.

The measurement and reporting of service efforts and accomplishments (SEA) is still in its formative stages. Extensive experimentation with and analysis of SEA indicators are needed before they are ready to be considered for inclusion as part of the information required for financial reporting. To assist in this process, GASB commissioned research on SEA measurement and reporting. Two reports have been issued and there may be reports on 11 more governmental services. The overview report released in September 1990 includes an analysis of the research project, with findings on the state of the art of SEA reporting and recommendations for proceeding with further experimentation.⁶ The recommendations include a set of indicators for each of 12 services researched, with input, output, outcome, and efficiency indicators, as well as explanatory information. The indicators are meant to be used as a starting point in developing a comprehensive set of SEA indicators tailored specifically to match the goals and objectives of the government.

Conclusions

Governmental accounting and financial reporting is in the process of slow but dramatic change. Financial reports as presently seen are likely to be modified over the next 10 years to improve their usefulness to citizens and their representatives. This focus is likely to result in an expanded requirement for multiple financial statements, presenting information on additional bases of accounting to address the need for different types of financial information.

The changes in financial reporting will likely create new questions from citizens and their representatives, and it is extremely important that communication between the preparers, auditors, and users of financial reports and GASB be increased and made clearer. This increase in communication will help assure meeting GASB's objectives of financial reporting to "assist in fulfilling government's duty to be publicly accountable and . . . enable users to assess that accountability" and to "provide information to help users in assessing the service efforts, costs, and accomplishments of the governmental entity."⁷

Notes

¹The "results of operations" would include measures of how economically, efficiently, and effectively a government has met its goals. Present financial reports do not provide accountability information about the economical, efficient, and effective use of resources.

²The flow of current financial resources basis includes as current-year revenue items that are received as cash within the current fiscal period or soon enough after the end of the period to be used to pay current liabilities incurred during the period. It includes as current-year expenditures claims incurred during the period that are due to be paid within a short time after the end of the period. Therefore, the flow of current financial resources basis of accounting removes some of the ability to manipulate the level of revenue or expenditures credited to a period that would be possible using the cash basis of accounting. With cash basis accounting it is relatively easy to delay deposits or payments of bills until after the official end of the period and by doing so increase or decrease the revenue or expenditures recognized.

³This would result in a claim against financial resources that may not be due for several periods but still is part of the cost of a good or service that was provided in the current period.

⁴In the present governmental fund financial reporting model, the acquisition of capital assets is reported as an expenditure (use of financial resources), and no depreciation or other measure of their use is reported in the operating funds.

⁵Although the need for a measure of the use, consumption, or perhaps reduction in economic or service value of capital assets may be necessary, the traditional method—depreciation based on historic cost—is not currently considered by GASB to be an accurate measure of capital asset use, especially for long-lived capital assets such as roads and other infrastructure systems.

⁶GASB, *Service Efforts and Accomplishments Reporting: Its Time Has Come*, Research Report (SEA Series), edited by Harry P. Hatry, James R. Fountain, Jr., Jonathan M. Sullivan, and Lorraine Kramer (Norwalk, Connecticut: GASB, September 1990).

⁷GASB, *Concepts Statement 1, Objectives of Financial Reporting* (Stamford, Connecticut: GASB, 1987), para. 77.

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