Trends in State Government Finances

By Henry S. Wulf

This essay describes some recent patterns of state financial activity – how the state governments obtain their revenues, the types of activities on which they expend their resources, their reliance on economic resources such as borrowing and the state of their financial assets. The analysis relies primarily on data from U.S. Census Bureau surveys of state and local government finances, the most complete set of comparative information available. It is primarily a retrospective look, using the information for fiscal year 2000 and comparing that with trends from prior years. The final section looks at a few present-day issues and prospects for state finances.

The state governments are highly significant players in the economic activity of the United States, whether viewed together or as individual economic entities. If lumped together, the state governments would be nearly a $1.3 trillion industry. They comprise about 4 percent of the gross domestic product – financially equivalent to the economic contribution of all transportation plus all communications industry activity.[1] When looked at individually and in relation to the economies of their local areas, the state governments are almost always among the most financially important businesses. If we measure them against a scale often used for private industries, the Fortune 500, two state governments would be in the top 10 (California third and New York seventh), 15 would be in the top 100 and South Dakota, the state government with the least amount of economic activity, would fall about 350th on the list.[2]

With state governments playing such a major economic role, their financial choices and conditions assume great economic importance, whether one considers states as providers of services or consumers of goods.

Summary of State Finances

Total state-government revenue amounted to $1.26 trillion in 2000, an increase of 9.3 percent over 1999.[3] This year-to-year percent change was the highest since 1992, and it was somewhat above the average annual change for the decade of 7.2 percent. Two major components comprise these state revenues: general revenues, monies that usually have some flexibility or fungibility and are therefore largely available for the activities of government; and special revenues, funds that are usually restricted in some way for proprietary government activities and insurance or pension needs. In 2000, general revenues were the predominant category (78 percent), and special revenues provided the balance (22 percent). The largest revenue contributors by type were: taxes (43 percent), intergovernmental revenue from the federal government (21 percent), insurance-trust revenue[4] (21 percent) and general and special charges (7 percent).

Looking back a decade, we see a small but significant relative change in magnitudes among these major pieces of state revenues. In 1990, taxes were 48 percent of total state revenue, federal intergovernmental revenues were 19 percent and insurance-trust revenues were 16 percent. Though it is not clear precisely why these proportions changed in these directions, we can see that while taxes increased at an average annual rate of 6 percent over that period, insurance-trust revenues rose at an unusually high average annual rate of 10.1 percent. Since the predominant revenue for state insurance-trust systems is earnings on public-employee retirement-system investments, the general economic boom that occurred during the decade was in good part responsible for the change in these proportions.

Expenditures in 2000 totaled $1.084 trillion.[5] This was an increase of 8.5 percent over the previous year, well above the average annual rise for states over the past decade of 6.6 percent. Fully three out of every 10 state dollars went to support subordinate local governments, emphasizing a key function that states serve in the intergovernmental finance system: using the efficiency of the larger state government to collect revenues and redistributing and equalizing those funds for services provided by local governments. There are two principal services that state-government funds support: education (both elementary and secondary) and public welfare, respectively 32.1 and 22 percent of all state expenditures. Compared with 1990, education expenditures were almost exactly the same proportion, but public welfare's portion of state expenditures climbed 3.6 percent from the 1990 figure of 18.4 percent. The two next most important financial activities for states were payment of insurance-trust benefits (9.7 percent) and highways (6.8 percent).

State-government indebtedness amounted to $548 billion in 2000, but it was not nearly as financially significant as the amounts of debt issued by other levels of government. It was only about 60 percent of the level of local-government debt. However, federal-govern-

ment debt far outstripped both at $5.6 trillion. The comparison with local-government debt might be somewhat misleading, because state governments are undoubtedly supporting a fair amount of local-government debt indirectly through intergovernmental funding of local-government programs, especially in education.

Cash and investment holdings of state governments totaled $2.5 trillion in 2000. For the most part, this figure represents holdings that the states have set aside for future liabilities. These encumbered funds will be used for activities such as redemption of long-term debt and retirement payments for state and local-government employees. In fact, only a fairly small portion of these funds – about one of every seven dollars – could be considered uncommitted for future obligations. And even those uncommitted funds often have some self-imposed limits that restrict their use. Trust funds for education or highways or rainy-day funds are examples of self-imposed limitations on state cash and investment holdings. The single largest portion of the state funds is held by public-employee retirement systems, making these monies a very important source of investment capital.

State Government Revenue

Of the three major revenue sources for state governments – taxes, intergovernmental revenue from the federal government and insurance-trust revenue – only taxes are mostly under the control of the state government. Since tax revenues for the most part reflect underlying economic conditions, it is only by changing the status quo – by increasing or decreasing rates or narrowing or broadening scope – that the governments can effectively control how much money they receive in taxes. And changing the status quo on taxes, especially to increase rates or broaden the scope, might be one of the most politically difficult tasks with which any government struggles.[6]

Each state's tax system reflects a singular mixture of current politics, history, geography and economics. Most states rely on a mixture of income taxes and sales taxes as the primary underpinnings for their tax systems. The U.S. average is 32.4 percent of state taxes deriving from general sales taxes and 36 percent from individual-income taxes. Thirty-eight states have a strong mix of these two taxes.[7] However, these averages belie the wide variety that exists even among the states that rely fairly heavily on both these tax staples. Seven of these states fall outside a parameter of plus or minus 10 percent around the U.S. average for sales taxes – four below, with Vermont the lowest at 14.8 percent, and three above, with Mississippi the highest at 48.8 percent. Similarly, for personal-income taxes, six states fall 10 percent above the U.S. average, with Massachusetts the highest at 54.6 percent, and four below, with North Dakota the lowest at 16.4 percent. Three states – Massachusetts, New York and Virginia – exceed the 10-percent limit in both these major taxes, with all three having general sales taxes more than 10 percent below the U.S. average and personal-income taxes more than 10 percent above the national average.

Two states – Alaska and New Hampshire – have neither a broad based income tax nor a general sales tax. In addition to these two states, several states do not have one or the other of these major popular taxes. Delaware, Montana and Oregon have no general sales tax; while Florida, Nevada, South Dakota, Texas, Washington and Wyoming have no personal-income tax.

The states that depart from the norm of general sales and personal-income taxes sometimes rely on an unusual tax to provide a major boost to the state's tax revenue. Delaware is an interesting example. It has no general sales tax, but receives about one-third of its tax revenue from license taxes. The average amount of revenue derived from license taxes for all states is 6 percent, and the closest to Delaware is Oklahoma with 14 percent. The bulk of the Delaware amount is from corporate-license taxes, a circumstance made possible by the fact that so many businesses incorporate in Delaware. This provides the state with a readily available "resource" and steady revenue stream. What makes this situation so interesting is that this is not a natural resource, but a historical resource that Delaware has been able to translate into a significant tax-revenue source for the present time. The first "Frequently Asked Question" in the business section of Delaware's state Website is: "Why do so many companies incorporate in Delaware?" The response lists several reasons, among them that the state has a court system with, "over 200 years of legal precedent as a maker of corporate law."

Alaska is another good example of how a state copes without having either of the usual major taxes. Without a general sales tax or a personal-income tax, Alaska relies on severance taxes – taxes levied on non-renewable resources such as oil and gas – for almost one-half of its tax revenues. In economic terms, virtually all of these taxes are exported to non-Alaskan consumers. Recognizing that these non-renewable resources will be exhausted someday, Alaska took an additional step and established a permanent fund, setting aside some of these monies so that they will continue to produce investment revenue after the resources are exhausted.

Vermont provides an example of two different

facets of state tax systems: 1) a tax "substituting" for either a general sales or personal-income tax; and 2) the redistributive aspects of some state tax systems. Vermont levies both personal-income and general sales taxes, though, as noted above, out of all the states that use general sales taxes, Vermont derives the lowest percent of its taxes from this levy. In 1998, Vermont started imposing a statewide education property tax. The purpose of this new levy is to redistribute property-tax monies among the state's school districts. The state collects this property tax and redistributes the funds based upon a formula designed to equalize financial resources. This is how Vermont chose to deal with this issue. Other states often use general sales taxes or personal-income taxes in the same way, because they produce a large volume of revenue. Regardless of the tax used, the general effect is the same.

Thus it can be seen that each state's tax system has unique aspects. States can rely on natural resources, like Alaska does; on historical resources, like Delaware does; on the wealth produced by their citizens directly, through personal-income taxes; or on wealth as measured indirectly through purchases and general sales taxes. There is no magic tax formula for a state, only the cumulative effect of history, geography and politics.

The category of revenue from the federal government – the second largest source of state money – is dominated by a single functional activity. Intergovernmental revenue for public welfare comprises 57 percent of all federal intergovernmental revenue. The next largest intergovernmental-revenue category, education, is a distant second, making up 16 percent of federal intergovernmental revenue. Demonstrating just how significant this public-welfare amount is for states, it makes up a little less than one dollar in every eight (12 percent) of all state revenues. To provide some relative sense of proportion, individual-income taxes represent 15 percent of all state government revenues and general sales taxes represent 14 percent.

The federal revenue for public welfare illustrates an important aspect of our federal governmental system: one level of government with superior revenue-raising ability provides money to another level of government with the ability to administer an activity. Just as the federal government does with public welfare, the states repeat the pattern by providing local governments with funds for education, highways and other activities.

The trends in federal intergovernmental revenue over the past few decades show that the relative importance of federal funds is near levels it hasn't been at since the days of the federal general revenue sharing program.[8] In 1980, for example, federal intergovernmental revenue accounted for 22 percent of state revenues. By 1990, it had dipped to less than 19 percent, but it rose to almost 21 percent in 2000.

Current charges – direct fees for service – constituted 7.5 percent of state revenues in 2000. Looking back to 1990, the comparable figure was 6.8 percent. The two primary components of this funding continue to be education (primarily tuition from public postsecondary institutions) and state hospitals, which together constitute 66 percent of all current charges. Though this growth is steady, but not exceptional, it demonstrates the continuing push in state governments for recouping costs from the populations using specific services.

State Government Expenditure

State government total expenditures rose at an average annual rate of 6.6 percent from 1990 to 2000. Most major expenditure categories were fairly close to this overall average, except for salaries and wages, which had a much lower average annual rise of 4.4 percent. The change in salary and wages reflected the very limited rise in employment over this entire period of 5 percent, which computes to an average annual increase of only 0.5 percent.[9] The explanations for this phenomenon are unclear. We can see that postsecondary education, which accounts for slightly more than one-third of state employment, had an average annual increase in employment of 0.9 percent, marginally above the overall average. There is no statistic that stands out as being a major contributor to this trend. There are, however, two reasonable conjectures, which might be related. The first explanation may be that the state governments are contracting more activities to the private sector. Contracting maintains delivery of services, but limits the impact on payrolls. The second possibility is that state governments are paying for services by funding them in local governments. The fact that state intergovernmental expenditures to local governments increased at an average annual rate of 6.4 percent – compared with the salary and wages average rise of 4.4 percent – lends some credence to this thought.[10] But additional research is required to verify this idea.

Functionally, education and public-welfare expenditures continue to overshadow all other areas of state spending. Education accounted for 32.1 percent and welfare 22 percent of the total in 2000. Adding in the next two largest functional activities – insurance-trust expenditures (9.7 percent) and highways (6.8 percent) – shows that seven out of every 10 state dollars are for one of these four activities.

Looking more closely at education activities, it is apparent that state spending in this area goes in two

divergent directions. Most of state education spending – more than 60 percent of the total – is given intergovernmentally to local governments, almost all of it to support elementary and secondary education programs run by local school systems.[11] About one-third of the education outlays provides funding for state-run postsecondary education programs. The balance is used for a variety of other education programs, subsidies and state administration of education activities. Though there has been a great deal of discussion about state-government support for education over the past few decades, the statistics do not show any major change. The proportion of education expenditures in the overall state-spending pattern has remained within one or two percentage points of the current level. Additionally, the split within education spending between the intergovernmental support for elementary and secondary education and direct support for postsecondary education has also remained fairly constant over this same period.

On the other hand, the share of state expenditures spent on public welfare has increased by a noticeable percentage in the past decade. In the 1970s and 1980s, the percentage was in the range of 17 to 18 percent. The percentage rose to 18.3 percent in 1990. In the next few years, it rose steadily – to 19.8 percent in 1991, 22.2 percent in 1992 and crested at 23.5 percent in 1994. It has stayed about this new level since then; in 2000, it stood at 22 percent. We need to be careful about using this comparison over time without additional explanation. This shift is the result of many factors: changing laws, increased Medicaid costs, different eligibility rules and economic conditions. Though the explanation certainly isn't simple, the result is – increased pressure on state spending.

The "disproportionate share" issue in Medicaid financing is a good example of the problems associated with understanding changing levels in state public-welfare outlays. In the early 1990s, some states took advantage of a Medicaid rule that allowed states to increase federal matching funds. They did this by "taxing" hospitals for Medicaid expenditures, thereby invoking a federal rule that returned funds to the states at a better than 1:1 ratio. The states repaid the hospitals for the "tax" and retained the balance. The federal government phased out this rule, but it had an enormous impact in several states. For example, in New Hampshire, for a time, the disproportionate-share tax was the single largest tax source.

Other functional activities show some changes in patterns relative to all expenditures in recent years. Spending on corrections, for example, has cooled off after some rapid rises over the past 15 years. Hospitals continue to require a smaller percentage of resources, while spending on health requires a somewhat higher percentage. However, from the perspective of total state spending, changes in these activities are, by and large, relatively small.

State Government Indebtedness

Indebtedness is not a major feature of the state-government fiscal landscape. In 2000, state-government debt totaled $548 billion. This is about three-fifths the level of the local-government debt burden. Both pale in comparison to the federal government's total debt of $5.6 trillion.[12]

The single largest portion of state-government debt – $227 billion, or 41 percent – is in the category of public debt for private purposes. This is so-called industrial-development or industrial-revenue debt (IDBs or IRBs). In the last few decades, this type of debt has risen substantially, to become a significant portion of state- and local-government debt. The issuance of this debt has been more a tool of state governments than of local governments. Not only is the percentage of total debt much greater than for local governments (41 percent for states and 16 percent for local governments), but the absolute amount is considerably more ($227 billion for states and $137 billion for local governments).[13]

The remainder of state debt goes to support activities that are generally considered significant state-government responsibilities. This includes education, highways and utilities. The education debt is mostly for postsecondary education, but in some instances – Delaware and California, for example – the state-debt issues include a significant amount of elementary and secondary education debt for constructing local school facilities.

State Government Cash and Assets

State-government cash and investments totaled more than $2.5 trillion in 2000. Although this is a considerable cache of assets, equivalent to about two years' worth of total revenues for states, most of this is obligated for state pensions and bond redemption. State public-employee retirement systems controlled $1.8 billion of the total (70 percent).[14] States put aside another $415 billion (16 percent) in debt offset, bond funds and other insurance-trust systems.

Even the remaining balance of state cash and investments, totaling $349 billion, is not entirely unencumbered for state governments to use. The reason is that state constitutions and laws have set aside certain monies that come from a specific revenue source to fund certain activities. Texas, for example, reserves

$24 billion out of $49 billion in non-pension, non-bond redemption assets in the permanent school fund. This fund, established in the 19th century, has a portfolio consisting of stocks, bonds, several million acres of land, and oil and mineral royalties. Under the state constitution and state law, the principal is untouchable; only the interest and dividends can be spent, and that money must go for educational purposes. So even though Texas theoretically has a considerable source of funds available in its cash and investments, it has, in effect, made these funds off limits by design. In a short-term fiscal emergency, Texas could not gain access to this money.

State portfolios in nearly all funds benefited from the considerable rise in market valuation that occurred under the extremely favorable economic conditions that prevailed from the late 1990s through 2000. Dollars earned through investments during this period lessened the need to raise funds through other sources. For public-employee retirement systems, for example, this meant government contributions could be reduced, and the reduced government contribution meant that the government needed fewer taxes, charges or other revenues. Now that more normal conditions, from a historical perspective, have returned, the states will have to readjust their thinking about the use of their cash and investments.

Emerging Issues in State Finances

The most significant issue facing the states in 2002 is an old one: how will the states cope in recessionary times? Economic downturns put state governments in a dual bind, one economic and the other political. The economic bind is that many important revenue sources – sales taxes, for example – begin to drop almost immediately when the economy makes a downturn. When the economy sneezes, the states catch cold. At the same time as revenues constrict, the pressure for additional social services, especially public welfare, increases. With only one exception, the states must balance their budgets, so they cannot borrow their way out of the issue, even if they were willing to. Rainy-day funds, specifically designed to be tapped in bad times, are a popular concept among state officials, but they are almost never funded to the recommended levels and therefore have a limited ability to mitigate problems.

The economic-political aspect for states is the difficulty in raising additional revenues to cover shortfalls. From an economic point of view, that action might not be wise because it could deepen a recession. But even if they were so inclined politically, raising taxes is an extraordinarily difficult thing for states to do.

Along with the recession, there is the threat of reduced federal funding. The federal government expects to run a deficit for the next several years – a result of the recession, increased defense and security spending following the September 11, 2001 terrorist attacks and a restricted flow of personal-income taxes as a result of a rate reduction. In the competition for federal funds, the programs that directly benefit state and local governments are likely to be constricted, putting even more pressure on state funds and programs.

The states will also feel stress from their own subordinate governments, especially in the area of elementary and secondary education. The needs of local school systems are increasing for several reasons. First, school-age populations are rising.[15] Second, school populations require more resources because of special needs.[16] And third, there is a national push to improve the accountability and quality of elementary and secondary education through the use of standardized testing. Local governments, with their heavy reliance on inelastic property taxes, have a difficult time developing sufficient financial resources and look to the states to finance these new and increased requirements.

Another issue that is starting to surface relates to the subject of portraying a government's financial status accurately through accounting methods. Some of the impetus for this goes back to two heavily publicized financial events: the collapse of the Enron Corporation into bankruptcy, with several accounts placed off-the-books; and the loss of significant funds in Orange County, California through a risky investment strategy. The confluence of these two events has public-sector observers asking if there are more "Orange Counties" out there. The Government Accounting Standards Board, the national organization charged with establishing accounting guidelines for state and local governments, has been in the forefront of the movement seeking better accounting information that clearly shows all of a government's assets and liabilities. But establishing guidelines and getting compliance from the dispersed power centers in the world of state and local government are two different things.

Notes

Data Sources: The U.S. Census Bureau produces a wide variety of data on state government organization, finances and employment, available at *http://www.census.gov/govs/www/index.html*. The information covers local governments for comparative purposes. The Census Bureau also maintains a historical database with information on finances and employment since 1972. Readers can contact the Governments Division, U.S. Census Bureau, Washington, D.C. 20233-6800 or send an e-mail to *govs.cms.inquiry@census.gov*.

[1] *Survey of Current Business*, (Washington, D.C.: Bureau of Economic Analysis, Dec. 2001 and Sept. 1988).

[2] Robert D. Behn, *The Fortune 500 and the 50 States: A Combined Ranking*, (Durham, NC: Institute of Policy Sciences and Public

Affairs, Duke University, Feb. 1990).

[3] Year of data refers to the year the state governments ended their fiscal year. Most state governments end in June, so 2000 data represents the amount for the fiscal year ending June 2000. Four states have fiscal years that end in months other than June: New York (March), Texas (August) and Alabama and Michigan (September), but the same principle applies.

[4] Insurance trusts are activities of government where the government acts as an insurer. These activities include public-employee retirement systems, workers-compensation systems, unemployment-insurance systems and a few others.

[5] The fact that there is a difference between revenues and expenditures in these numbers must not be equated with the concepts of a budgetary "surplus" or "deficit." The reason is that the Census Bureau data represents a statistical compilation, not an accounting balance sheet. Total revenues almost always exceed total expenditures in the Census Bureau data. There are several reasons why this occurs, key among them the treatment of indebtedness financing, capital expenditures, accruals and insurance-trust system transactions. One example illustrates the practical application for a single government, but also has direct applicability for larger totals. A government might choose to finance a capital project through bonds. To avoid double counting, the Census Bureau data would not recognize the borrowing from the bond issue as revenue, but would recognize the capital outlay made from that bond money as expenditure. The revenue that balances the capital expenditure in the long run is the increased revenue stream over the period of the bond from taxes or charges that goes to paying off the bond's principal and interest. Thus, if the government spent the bond money in year one, there would be more expenditure than revenue in that year, but there would be more revenue than expenditure in every other year until the debt matured.

[6] Decreasing taxes can have its own set of political difficulties. In Virginia, for example, in the late 1990s, the state government sought to eliminate in phases a local personal-property tax on motor vehicles. The state agreed to make up the difference to local governments with state funds. The first phases, done in good economic times, presented few problems. But when an economic downturn reduced available state funds to continue the phase-out, a political schism developed. Some leaders tried to continue with the program, insisting that there was a commitment to complete the phase-out; others opposed this action on the grounds that there was insufficient state revenue and that the state had other priorities to meet before continuing to reduce this tax.

[7] Two states, New Hampshire and Tennessee, have personal-income taxes that are limited to a base of interest and dividends. Although still technically defined as such, these taxes are unlike the more broadly based income taxes employed in other states, and therefore have been excluded from the count of states that use personal-income taxes.

[8] In 1983, state participation in the federal general revenue sharing program ceased. Local governments continued receiving funds through this program until 1986.

[9] The employment data refers to full-time equivalent employment, which converts part-time employees to the corresponding number of full-time employees based on hours worked.

[10] Because of compounding, the difference between an average annual increase of 6.4 and 4.4 percent after ten years is almost 60 percent.

[11] Only in Hawaii is the elementary and secondary education system wholly administered directly by the state government. In other states, there have been small segments of elementary and secondary education run directly by the state. In some cases there are historical precedents, such as in Maine. More recently, state control of local schools is the result of state takeovers of systems with significant financial or educational problems. For the most part, the latter cases reflect a temporary change of control.

[12] *Historical Tables, Budget of the United States, Fiscal Year 2003*, Table 7.1 (Washington D.C.: U. S. Government Printing Office, 2002.)

[13] The local government data is for fiscal 1999. The state and local numbers are not an exact comparison in time, but the relative proportions hold true. Although public debt for private purposes is legally a government credit obligation, the structuring of the debt financing means that the interest and principal derive from private funding sources; that is, the private facilities that are the beneficiaries of the funds. The governments act in somewhat of an agency capacity in these cases. For this reason, governments often treat public debt for private purposes separately from other debt. For an excellent discussion of this type of public debt see Dennis Zimmerman, *The Private Use of Tax-Exempt Bonds*, (Washington, D.C.: Urban Institute, 1991).

[14] For a more detailed discussion of state public-employee retirement-system assets, see the article by Benjamin Shelak in this volume.

[15] See Paul R. Campbell, *Population Projections for States by Age, Sex, Race, and Hispanic Origin: 1995 to 2025* (Washington D.C.: U.S. Bureau of the Census, Population Division, PPL-47, 1996).

[16] An Urban Institute report showed that children of immigrants – either foreign born or having a foreign-born parent – more than tripled from 1970 to 1997, going from 6.3 percent of all K-12 students to almost 20 percent. One-quarter of these students are not fluent in English, and the poverty rate among them was 44 percent in 1995. See Jorge Ruiz-de-Velasco and Michael Fix, *Overlooked and Underserved: Immigrant Children in U.S. Secondary Schools*, (Washington D.C.: Urban Institute, 2000).

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