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State Sovereignty and Fiscal Policy

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<u>State Sovereignty and Fiscal Policy</u>

The economic impact of changes in the Federal Government's taxing and spending has been continuously in the foreground of political-economic debate for nearly two years. It took that long to convince a majority of the public and the Congress that the axiom "taxation for revenue only" had at least one corollary--namely, that taxation which produces revenue also produces an influence, at times critical, on the rate of economic expansion.

It now appears that the tax reduction enacted last spring has been a significant factor in stimulating the national economy to somewhat higher levels of economic activity and one consequence of such greater activity is that State and local governments--without any changes in their present tax laws--will have larger revenues.

That rising national income means increased revenue from general and selective sales taxes, pay roll, personal income and corporate profits taxes is widely recognized; the response of these yields to rising economic activity is usually obvious. But in addition and in the longer run, rising GNP can also be expected to affect taxes whose yields have usually been assumed to have little or no income elasticity, such as property taxes, and even estate and gift taxes. Realization of the increased yield potential from these taxes may depend on the awareness which tax administrators have of current economic developments. For example, by how well assessment ratio levels for the property tax are maintained. One of the earmarks of good tax administration and alert fiscal planning is the keeping of tax yields in step with changes in the economy.

In spite of the higher yields at existing tax rates that will be forthcoming from a growing economy, many States and localities will need still more revenue. Some projections for the coming year suggest that State and local expenditures may rise by 5 billion (GNP basis) and a significant part of this amount will be financed by taxation. The recent Federal tax reduction opens up some possibility of increasing State and local yields by substituting State and local taxation for Federal taxation.[1/] The extent to which sources can be transferred in this manner is limited by the narrower range of revenue resources available to the States and localities and by the competition among the States for business investment and residents. Moreover, it may be contrary to the current public policy to dilute significantly the stimulative effects of a Federal tax cut.

The problem of financial planning that States and localities, and more particularly their fiscal authorities, face, is one of charting an expenditure--taxing course that recognizes the characteristics of our economic society. Implicit in these characteristics are practical limitations on the range of fiscal sovereignty but there are opportunities, too, for broadening the choice of alternatives, particularly as a consequence of Federal taxing--spending policies.

The States are nominally sovereign within the confines of their existing constitutions or their constitutions as they may choose to amend them. But the notion that constitutional restraints are the

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1/ This possibility is in addition to the increase in the tax base in income tax States which permit Federal taxes as a deduction in computing taxable income.

only limits on the exercise of a State's fiscal sovereignty shows little awareness of several life-sized facts. Facts that, on the one hand, raise expenditure levels and modify their patterns and on the other hold down levels of taxation and exercise a conforming influence on the type of taxes used.

These modifying and shaping influences on fiscal decisions arise from the nature of the U. S. economy where freedom to move productive resources of capital or labor is unrestricted and where individuals, within their capabilities, are virtually unlimited in their choice of a place to work or a place to live.

In my remarks today I am going to discuss the nature and extent of these influences on the fiscal policies of our State and local government. First, however, I want to relate the volume of State and local fiscal operations to national aggregates of economic activity in order to evaluate the changing importance of these activities on the economy.

Increasing Importance of State and Local Expenditures and Receipts.

Since the end of World War II, the total expenditures of government on a national income basis--Federal, State, and local--has nearly quadrupled. As a per cent of gross national product, total expenditures have risen from 19.5 per cent in 1947 to over 30 per cent in 1963. There was, of course, the burst in Federal expenditures in the early 1950's to cope with Cold War developments and the Korean conflict. However, with the end of the Korean War, State and local expenditures began to move up more rapidly and by 1963 accounted for more than one-third of total government outlays. Thus, more than 10 per cent of gross national product is channeled through State and local fiscal operations.

Assuming that national defense needs will not be of Korean or World War II proportions, the recent trend in Federal expenditures, to level off or even decline and for State and local expenditures to rise, both as a proportion of GNP, can be expected to continue. Such a trend has some major economic implications. It implies a shift in the allocation of resources away from heavy-goods, defense-type industries and towards services, such as education or medical care, and toward highway construction and urban redevelopment. It also implies a shift in revenue source utilization from the Federal Government to State and local units. Such a shift in utilization may be accomplished either by increasing the volume of Federal aid to State and local governments or by reducing Federal tax rates to make more head room for increased State and local taxation.

Measures of State and Local Finance.

Turning now to the evaluation and comparison of State and local fiscal operations, we should be aware of how complicated this task is because of the multitude of taxing and spending jurisdictions in the United States; for with the multitude of jurisdictions goes a near multitude of tax laws, of spending habits, and service needs. It becomes necessary, therefore, to use some technique for summarizing the extent and character of State and local expenditures and the burden of their taxation.

For this purpose, it is necessary to draw on a different set of bookkeeping records than the national income accounts to which I have heretofore referred. State-by-State data on State and local revenues, expenditures and debt are available from the compilations of Governments Division of the U. S. Census.

In 1962, the latest year for which such detailed Census data are available, State and local governments spent nearly $60 billion and received in revenue slightly more than $58 billion. Approximately 87 per cent of the revenue received by State and local governments was derived from their own revenue sources and 13 per cent received as grants-in-aid of various kinds from the Federal Government.

These aggregates have a meaning of their own but they have to be transformed into some relative terms in order to bring to light similarities or differences in fiscal policies among the States. The usual practice with respect to expenditures is to express them on a per capita basis. The practice is not wholly satisfactory because of differences in price and wage levels in various parts of the country. Ideally, per capita expenditures should be adjusted for these differences, but we do not yet have detailed enough price-wage indices to make such adjustments. However, the price-wage differentials are probably not of such magnitude to seriously and frequently impair inter-State comparisons of the levels of public services.

When it comes to comparing tax payments, it is customary to convert these into per capita terms also. It is clear, however, that the real burden of providing public goods and services depends not only on the tax rates and the number of people paying taxes but also on the levels of income. A $300 per capita tax revenue is a greater burden in a State where per capita personal income averages $1,500 than in areas where per capita personal income averages $3,000. The burden of taxation would, with the same level of per capita revenue be equal to 20 per cent in the first case ($1,500) and only 10 per cent in the second ($3,000). Thus, it is the proportion of personal income which is taken in tax revenue by the State and local governments which gives the most useful estimate of the range in the burden or cost of providing public goods and services.1/

Dispersion in State and Local Finance

Using these two measures--per capita expenditures and revenue as a percentage of personal income--it becomes apparent that there are significant differences, not only to the levels of State and local expenditures and revenues, but also to the type of expenditures and taxes.

The differences in levels of expenditure and revenue would be even greater if it were possible to obtain data for various locations within States. Large intra-State disparities can arise because local finance is at least as costly as State finance; they do arise because local needs vary widely and local property tax resources often show even greater variability both in potential and in use. It follows, therefore, that what can be said about the disparities in State-wide averages could be said with even greater force and effect if intra-State data were available.

In 1962, State and local expenditures for the United States as a whole averaged $321 per person, of which $118 on the average was spent for education, $56 for highways, $27 for welfare, and the remainder $117 for other State and local functions. Aggregate expenditures range

1/ Revenue as a per cent of income is arithmetically the same, of course, whether it is computed on a per capita basis or using the totals.

from a high of $551 per person in one State to the low of $221 in another--the difference between the two being greater than the national average.

A less dramatic but more scientific way of summarizing the extent of differences in total expenditure patterns would be to compute a measure of relative dispersion which would tell us how closely clustered the various States were to the U. S. average. And a less elegant but possibly more revealing technique would be to show the number of States (or the proportion of the U. S. population living in States) that deviate by given percentages from the average.

I have chosen this last technique to try to bring into the focus of judgment the degree to which the States' fiscal policies can be said to be diverging or conforming. And to give all of these statistics a kind of "back home" feeling, I have appended to the circulated copies of my remarks, a table and maps which show the relative fiscal position of each State with respect to its (1) expenditure, (2) revenue, (3) debt, and (4) personal income.

Income Brackets for States.

Nearly 16 per cent of the U. S. population live in States where the average per capita personal income is more than 25 per cent below the average for the entire country. In contrast, nearly a third of the population live in States where the average per capita income is more than 20 per cent above the U. S. average.

As is apparent from both the maps and the tables, these deviations have a discernible regional pattern. Incomes in the North-East areas of the country and in the Mid and Far West will sustain, at a given tax rate, higher levels of public expenditures than will those in the South and Southwest. Or to be more specific, just to maintain a comparable level of public expenditures, those States in the lower income brackets would have to use tax rates roughly double those in the high income bracket States.

Tax Revenues

In actual practice we do not find any such disparity in tax rates between the low and high income bracket States. On the contrary, the striking fact is the narrowness in the dispersion from the U. S. average. While effective rates of tax show a tendency to vary inversely to levels of income, over 80 per cent of the total population live in States where the effective rate of total State and local taxation falls within 15 per cent of the U. S. average. In contrast, our measure of taxable capacity-personal income shows that less than 50 per cent live in States within 15 per cent of that U. S. average.

No doubt it is the mobility of persons, businesses and investment that maintains pressure on policy makers to keep the effective rate of total State and local taxation rather closely aligned, not only with adjacent States within an economically defined region, but also between regions.

Although the rate of total taxation is not widely divergent, the type of taxation does vary and often with significant incidence implications. In general, most States tend to rely primarily on one of three major revenue forms, property taxes, sales taxes, or income taxes. In addition, most States utilize one of the other two as a secondary source of revenue. The choice of the primary source shows definite regional patterns but there is no obvious explanation for the choice of the secondary source.

The property tax is the primary revenue for most States, except in the South. For those States which rely primarily on the property tax, which, of course, is usually the main source of local revenue, income taxes or sales taxes are apparently interchangeable as the main source of State revenue. In the South, where sales taxes are the major source of revenue, property or income taxes are apparently interchangeable. However, there is no State which has low rates of taxation for all three major revenue sources and there is no State which levies high rates of taxation on all three.

With the regional variation in the primary source of revenue, and the wide dispersion as to the secondary source of revenue, it is remarkable that the various combinations result in levels of effective rates of total taxation which are so similar. Such geographic patterns as exist reveals that with some exceptions, those States in the North-East tend to have average to below-average tax rates; those in the South are rather widely dispersed; and those in the West tend to have average to above-average rates.

Expenditures.

The distribution of per capita expenditures by States about the average for the United States more nearly resembles the distribution of per capita income than that of State and local taxation. There is a tendency for expenditures to be somewhat higher than would be expected strictly on the basis of per capita income, probably reflecting the influence of Federal aid. But taxable resources and Federal aid are not the only determinants of the level of expenditures. State and local governments are constantly subject to pressures to achieve standards of public services available elsewhere.

On the demand side, State and local expenditures appear to respond to three major factors: (1) the size and composition of the school population; (2) the degree of urbanization; and (3) the rate of change or growth in the resident population.

Per capita expenditures for education with only minor exceptions are the largest single type of expenditures for State and local governments. Per capita expenditures for education depend primarily on the proportion of the population which are of school age. However, other factors, such as the number of children in private schools have a significant cost influence. Nearly 20 per cent of the elementary and secondary school age population in the North-East attend private (including parochial) schools, compared to only 10 per cent in the Mid and Far West. If to this the proportion of the college age population attending State supported colleges and universities is added, the reasons for the relatively high levels of per capita education expenditures in the West become more clear.

In the South, the level of per capita expenditures for education is low, probably a dual reflection of the impact of low incomes. Not only do low levels of personal income restrict the size of State and local revenues but low levels of average income also create the necessity for young people to leave school earlier and probably reflect family conditions which reduce the incentives for educational achievement.

The impact of the degree of urbanization on costs has been pointed out many times. The greater the density of population, the greater the need for additional services and the greater the cost of providing, under congested conditions, the conventional services of police protection, water supply, sanitation and transportation facilities in some form, whether highways or other forms of transit.

Parenthetically, per capita highway expenditures at the present time are highly influenced by the Federal Inter-State program and as a result, tend to be more nearly uniform throughout the country then any other major category of State and local spending.[1/]

The third major determinant of levels of public expenditures is the rate of growth in the population. Relatively static populations with a usable stock of community facilities do not require anything like the capital investment in schools, streets, roads, water, and sanitation plants that are indispensable in areas with rapidly growing populations.

Among the major categories of State-local expenditures, the pattern of health, recreation, and welfare spending is most difficult to account for. Not only does the greatest disparity between States occur in spending for these functions, but there is also a lack of any apparent regional or other geographic pattern. Even States with roughly equal income levels may show widely divergent levels of health and welfare spending.

1/ Abstracting from levels reached in certain sparsely populated States with large areas in the public domain.

As I suggested earlier, it may be that if we look within the broad geographic areas delineated by State boundaries, we would find some explanation of the expenditure patterns which give the State averages their inexplicable variance. I strongly suspect that in major metropolitan areas where average income levels tend to be more uniform, there are markedly different levels of health-welfare need and community reaction to that need. After all, metropolitan areas are not as homogeneous as the average suggests and the intraregional disparities often spill into adjacent States.

The metropolitan resident has to work where a job can be found but the automobile and the freeway give him quite a range of choice for his residence. And it is at the place where he lives that health, welfare, and educational costs must be financed. Some States and local units have chosen to minimize tax rates rather than to provide expanded public services hoping to attract business and new residents with preferences that fit these policies. Other States and local units have chosen to expand the quantity and quality of public services, even though it requires higher tax rates to do so. This policy attracts people who can afford and are prepared to pay for a higher level of community services. Thus, the disparity in public fiscal policy tends to be self-reinforcing.

Basically, State and local governments like everyone else, have to trade off a number of conflicting objectives. Within the general framework determined by their levels of average income, they are expected to provide at least a minimum level of essential public services. This must be done without pushing effective total tax rates too far out of line, especially with those of immediate neighbors. Low income bracket States frequently find that higher-than-average rates of total taxation are required to even approach a competitive level of basic public services. On the other hand, high income bracket States find that they can provide desirable levels of basic public services with relatively low tax rates. These are the States with the real alternative of lower tax rates or expanded public services.

Need and Ability.

To roughly differentiate the limitations on the levels of public expenditures which arise from lack of taxable resources from those which reflect a conscious decision to minimize tax rates or to maximize public expenditures, an expenditures-to-revenue ratio can be used. To obtain such an index, per capita expenditures were divided by revenue as a per cent of personal income. The ratio was then standardized to the average for the United States which was defined as being equal to 100.

Using this device, those States having relatively high expenditures and tax levels show an expenditure-to-revenue ratio of close to 100; likewise, for those States with relatively low expenditure and tax levels. A high value of the revenue-to-expenditures ratio indicates that fairly high levels of public services are being provided with relatively low tax rates. A low values of the ratio indicate that high tax rates are required to maintain expenditures.

It is not surprising that when this ratio is computed using the revenue from the State's own resources, its distribution is similar to that of the index of personal income.[1/] However, when the ratio includes Federal grants in aid, significantly different results are obtained. The principal difference is that Federal aid tends to even out the discrepancies resulting from variations in levels of State income. In a few States, usually the wealthier ones, the addition of Federal aid cause the index to decline.

A quick look at the types of Federal aid programs available reveals that most such programs require that some proportion of the total cost be met by the State and local governments and frequently there is some limitation as to the maximum amount of funds available.[2/] Therefore, to qualify for Federal aid, State expenditure programs must be planned so as to take advantage of the various forms of aid and some States obviously are more successful at doing this than others. Some of the wealthier States, even though their programs may be geared to Federal aid, are undoubtedly bumping against program maximums.

Borrowing.

The use of credit as a source of funds for State and local governments is frequently overlooked in discussions of fiscal alternatives. State and local governments can and do borrow money. However, the peculiarities and specific restriction which surround State and

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1/ The index of personal income also defined the average for the United States as being equal to 100. Standardizing the average per capita income in each State to that of the U. S. simply expresses average per capita income in each State as a per cent of the U. S. average.

2/ U. S. Senate, Committee on Government Operations, "Catalogue of Federal Aid to State and Local Governments," 88th Congress, 2nd Session. Prepared by Legislative Reference Service, Library of Congress, April 15, 1964.

local borrowing are even more diverse than those associated with their tax laws. It is very difficult to separate out specific circumstances, such as the public power debt in the Northwest and Nebraska, from debt which has arisen because expenditures have expanded faster than revenue or from debt which reflects a preference for borrowing rather than increased rates of taxation. From the standpoint of showing the extent of differences among the States, very different results are obtained if the change in total debt outstanding is used or debt relative to income is relied on. I have used total debt outstanding on a per capita basis in both the charts and the tables mainly to complete the picture of State and local fiscal operations. The rather wide dispersion of total debt outstanding does suggest that in some States a pay-as-you-go or a pay-before-you-go policy has a firm hold on policy makers, whereas in other cases there is a predelection, if not a "weakness," for using time to stagger the impact of the huge public investment in community facilities in urban areas.

Outlook for the Future

We have seen that the levels of State and local expenditure and revenue are initially defined by the economic resources of the States and modified by the distribution of Federal aid. However, States are not totally confined by their levels of income nor by competition, either as to the types of taxes levied or the level of services provided. In a few cases there is a surprising range of choice exercised as to the level of taxation and the level of expenditure.

The trend of the post-War years has been toward greater uniformity among States in the levels of per capita expenditures. Despite the competitive pressure for higher levels of public services, very few States so far have found it necessary to exploit all three of the major forms of State and local revenue. But, if rising levels of general economic activity do not provide revenue adequate to meet the continuing demands for increased expenditures, it seems quite likely that more States will find that they must either increase their reliance on the two forms of taxation which they are currently using or begin to utilize the remaining one.

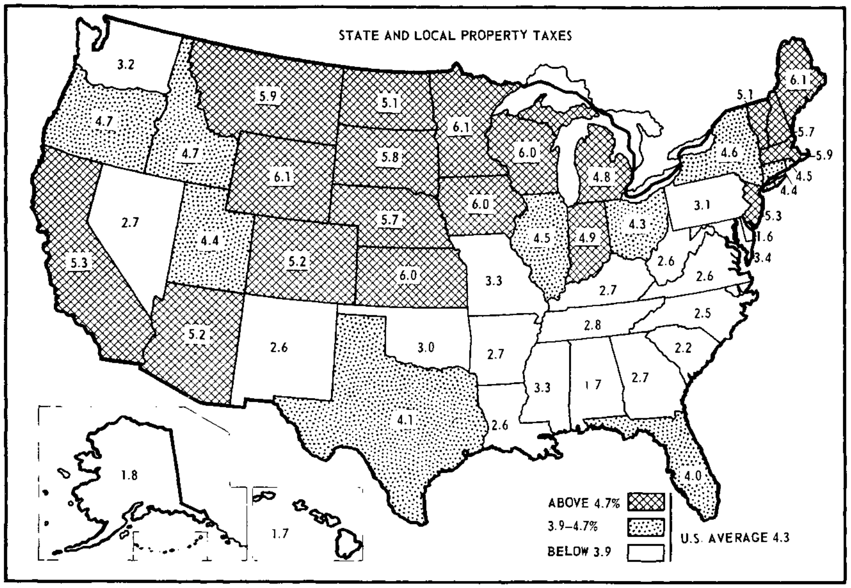
I do not foresee the time when the States and localities will lose their fiscal identities or idiosyncracies. Some will always be richer and others will be poorer. They will shed their fiscal inheritances reluctantly, probably imperceptibly. But the nation's economy is becoming more and more sensitive to differentials in costs. And our citizens are more and more aware of differentials in public services as well as taxes. Unquestionably the mobility of our businesses and people is such as to enable both to take advantage of substantial location bargains. As budget officers and the principal fiscal architects in your States, you will in the future have increasingly to face the competitive fiscal ingenuity of your counterparts. As a citizen and taxpayer, I can only say, keep the competition clean but make it vigorous.

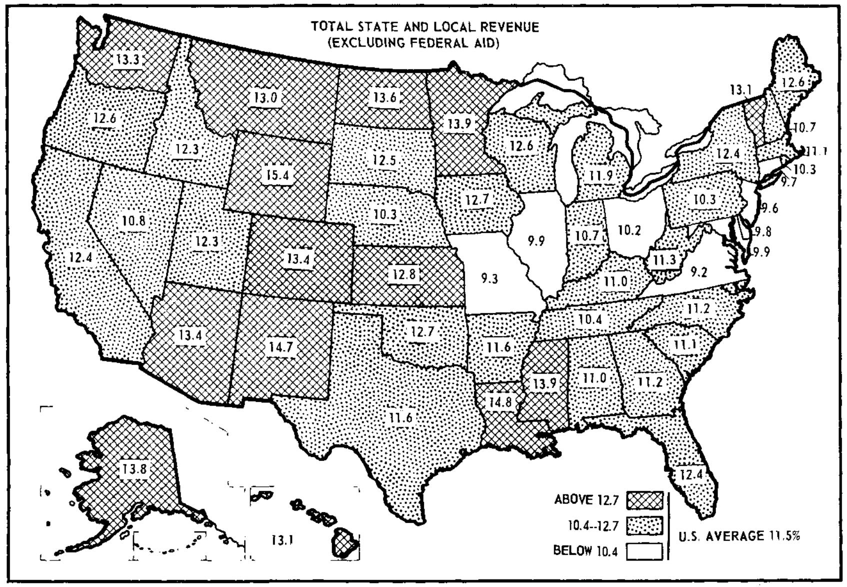
Proportion of Total Population Living in States
Where the Deviation from the U. S. Average is:

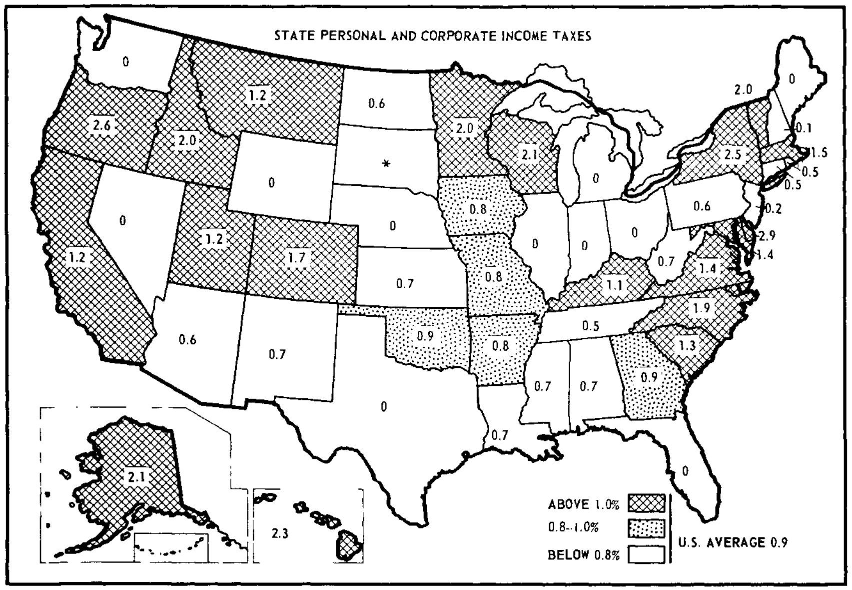
	More than 25% Below	15–25% Below	5–15% Below	5% Below to 5% Above	5–15% Above	15–25% Above	More than 25% Above	Total
Per Capita Personal Income								
North-East	—	.5	.5	19.0	1.8	21.2	1.7	44.6
South-Southwest	15.5	2.9	11.5	2.3	—	—	—	32.3
Mid and Far West	—	0.4	6.0	5.6	1.7	9.2	0.2	23.2
U. S. Total	15.5	3.8	18.1	26.9	3.5	30.4	1.9	100.0
Revenue as a Percent of Income								
Total Revenue								
North-East		4.9	22.4	7.1	10.2	—	—	44.6
South-Southwest		4.6	2.0	17.0	4.3	2.0	2.4	32.3
Mid and Far West		—	1.0	—	17.1	5.0	0.2	23.2
U. S. Total		9.5	25.4	24.1	31.5	7.0	2.5	100.1
Property Taxes								
North-East	6.4	1.8	—	12.8	16.3	3.6	3.7	
South-Southwest	19.4	3.6	2.9	5.5	—	.8	—	
Mid and Far West	.7	1.6	—	.5	1.4	10.6	8.5	
U. S. Total	26.5	6.9	2.9	18.8	17.7	15.0	12.1	100.0
Sales Taxes								
North-East	16.3	—	3.2	11.1	6.6	3.0	4.3	
South-Southwest	—	2.3	5.5	2.3	1.8	8.9	11.3	
Mid and Far West	2.0	4.3	0.4	1.4	9.8	3.2	2.2	
U. S. Total	18.3	6.6	9.0	14.8	18.2	15.2	17.8	100.0
Income Taxes								
North-East	30.1	—	—	—	—	—	14.5	
South-Southwest	11.2	6.3	3.3	3.5	—	1.7	6.2	
Mid and Far West	3.5	1.2	1.5	—	—	—	17.0	
U. S. Total	44.8	7.5	4.8	3.5	—	1.7	37.6	100.0
Per Capita Expenditures								
Total								
North-East	—	6.1	12.8	7.5	8.6	9.7	—	
South-Southwest	6.8	16.3	5.9	2.4	.8	—	—	
Mid and Far West	—	—	.8	4.0	5.4	3.0	10.1	
U. S. Total	6.8	22.4	19.5	13.8	14.8	12.6	10.1	100.0
Education								
North-East	—	.8	18.4	16.7	1.6	7.1	—	
South-Southwest	7.7	14.5	8.6	—	—	—	1.3	
Mid and Far West	—	—	1.2	.4	5.6	2.2	13.8	
U. S. Total	7.7	15.4	28.2	17.1	7.2	9.3	15.2	100.0
Highway								
North-East	—	10.1	22.0	5.5	6.0	—	1.1	
South-Southwest	3.9	2.9	7.3	11.5	4.1	2.5	—	
Mid and Far West	.4	—	1.0	9.2	2.1	—	10.5	
U. S. Total	4.2	13.0	30.3	26.2	12.3	2.5	11.6	100.0
Welfare								
North-East	8.0	.3	17.4	.7	9.9	5.5	2.8	
South-Southwest	16.5	.8	3.9	2.7	1.8	2.3	4.1	
Mid and Far West	1.5	1.5	4.1	2.5	—	1.9	11.8	
U. S. Total	26.0	2.6	25.3	6.0	11.7	9.7	18.8	100.0
Index of Expend. to Revenue								
Excluding Federal Aid								
North-East	—	.7	—	15.0	7.1	20.1	1.7	
South-Southwest	9.4	15.7	2.5	4.6	—	—	—	
Mid and Far West	—	.8	6.7	5.9	.5	9.2	.2	
U. S. Total	9.4	17.2	9.1	25.5	7.6	29.3	1.9	
Including Federal Aid								
North-East	—	.5	6.2	13.4	21.2	2.0	1.4	
South-Southwest	6.1	19.0	.8	6.3	—	—	—	
Mid and Far West	—	—	5.3	6.8	1.2	9.6	.3	
U. S. Total	6.1	19.6	12.3	26.5	22.3	11.6	1.7	
Per Capita Debt								
North-East	3.6	5.5	4.8	15.1	—	—	15.7	
South-Southwest	14.0	3.5	7.4	7.3	—	—	—	
Mid and Far West	5.9	1.2	3.1	1.8	—	9.7	1.6	
U. S. Total	23.5	10.2	15.3	24.1	—	9.7	17.3	100.0

STATE AND LOCAL TAXES AS PER CENT OF PERSONAL INCOME: 1962

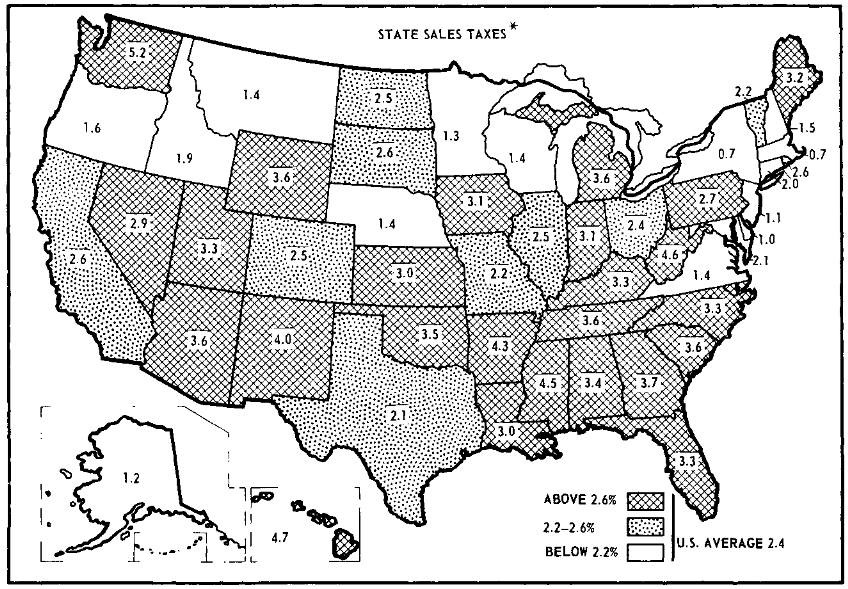
ABOVE 110% OF U S AVERAGE. WITHIN 90 110% OF U S AVERAGE BELOW 90% OF U S AVERAGE







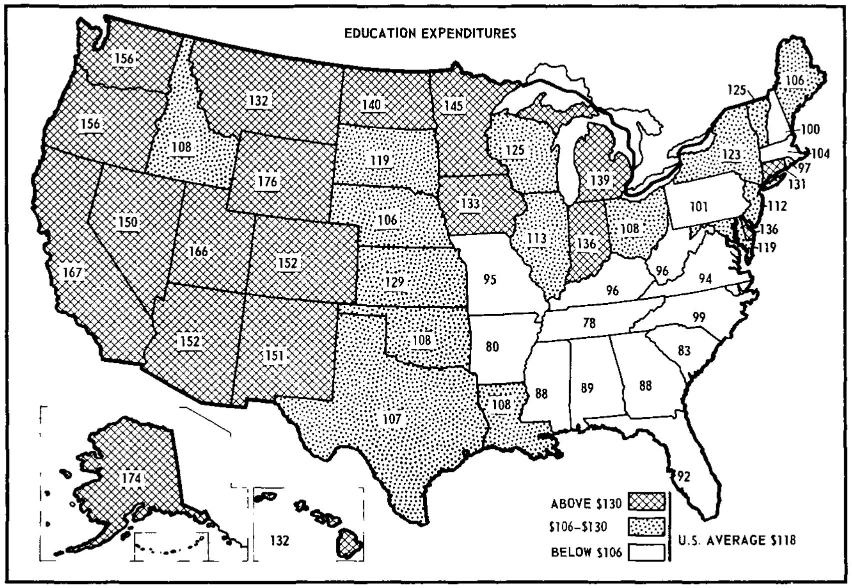
* LESS THAN 0.1

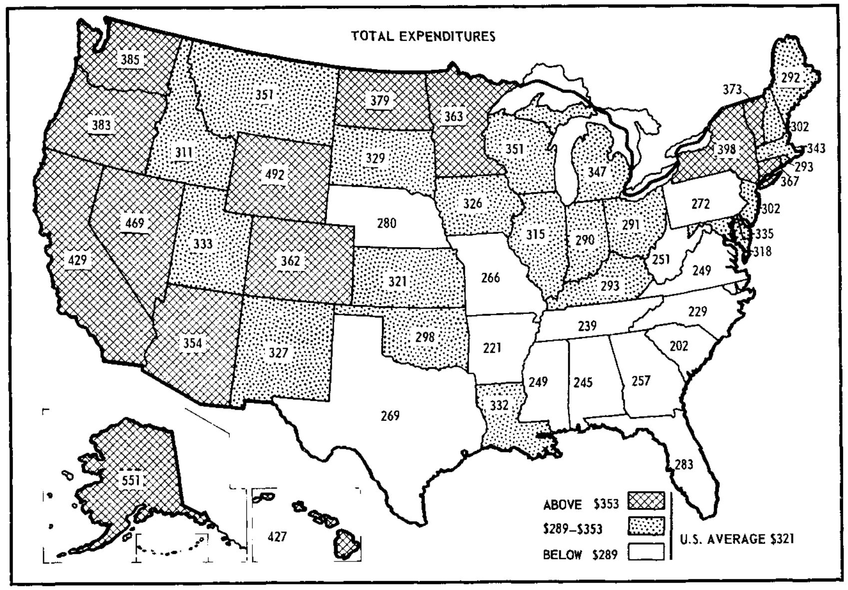


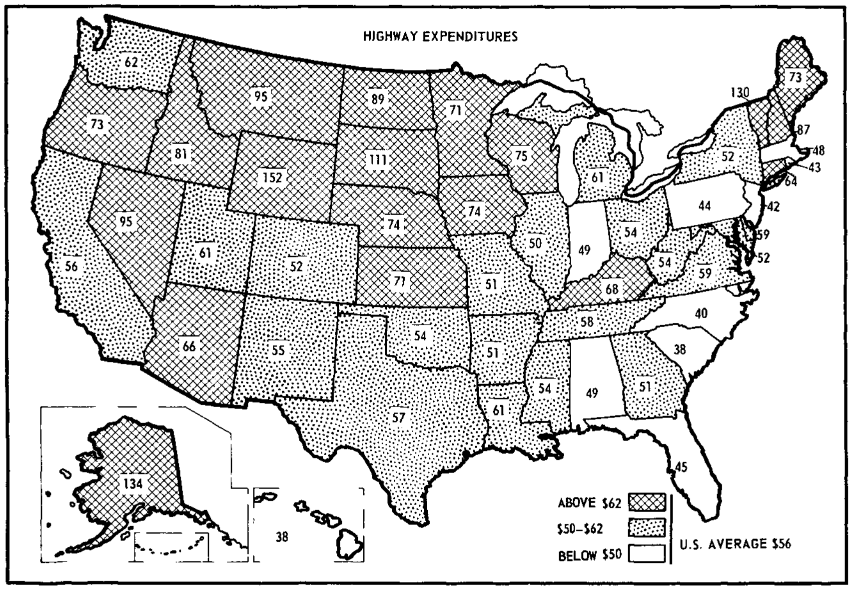
* GENERAL AND MOTOR FUELS AND LICENSES ONLY

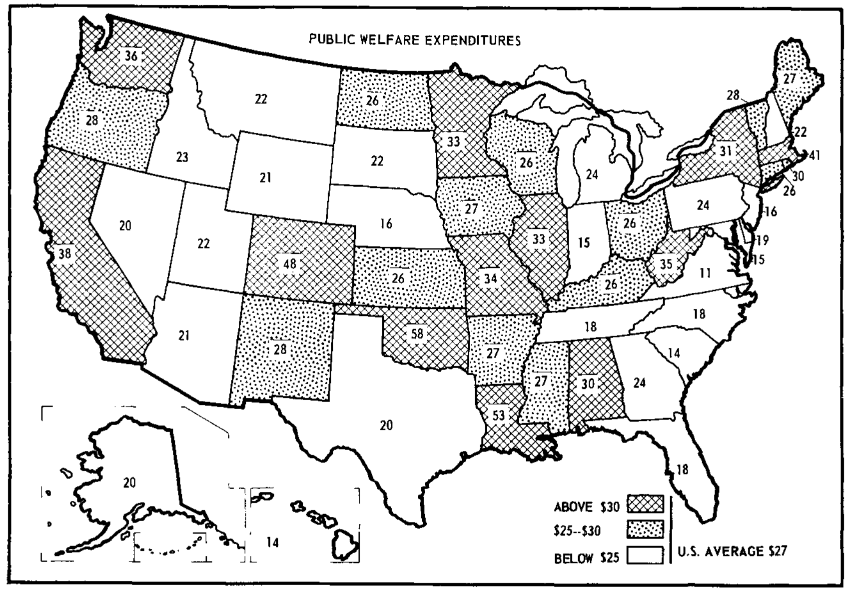
STATE AND LOCAL PER CAPITA EXPENDITURES 1962

ABOVE 110% OF U S AVERAGE — WITHIN 90 110% OF U S AVERAGE — BELOW 90% OF U S AVERAGE









INDICES OF EXPENDITURES-REVENUES, INCOME, AND DEBT PER CAPITA:1962

ABOVE 120. 110 120. 90 110. 80 90. BELOW 80