

# The state of the state and local government sector: Fiscal issues in the Seventh District

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## Introduction and summary

The National Governors' Association has projected that state budgets will face an \$80 billion deficit in fiscal year (FY) 2004. This would represent almost 18 percent of total state spending. This comes on the heels of a nearly \$30 billion spending gap in FY2003. This degree of budget insolvency in the state sector is unique for two reasons. First, it follows a relatively mild national recession that, by historical standards, would not have been expected to send the states into such budget turmoil. Second, it has affected virtually every state, regardless of the type of revenue system they use to support state government functions. The persistent nature of these budget shortfalls has exhausted the usual budget adjustments that states make to pull themselves through tough times. Fund transfers, drawing down reserves, and one-shot revenue infusions were all used to balance state budgets in FY2002 in the hopes that stronger economic growth would restore fiscal health going forward.

In addition, states have been operating in a distinctly "anti-tax" environment, in which proposals to increase taxes to balance budgets have been met with public and political opposition. Given this bleak situation, it is an appropriate time to examine the prospects for a return to fiscal good health in the state and local government sector, as well as the background to the current instability. Some analysts have suggested that beginning in the late 1990s, states began running structural rather than cyclical deficits.<sup>1</sup> In a structural deficit, available revenues are simply inadequate to maintain existing government services. Many of these same analysts also suggest that states' and localities' existing revenue systems no longer support government commitments. Gradual exemptions and distortions in major tax bases have increased the volatility of tax sources, while reducing the tax base. If this is the case,

managing state government through a boom and bust cycle will require new models for state budgeting. Policymakers need to restructure budget models to reflect the service commitments of state government and the productivity of the revenue structure.

In this article, I review the state and local budget situation. In particular, I look at conditions in the states that comprise the Seventh Federal Reserve District (Illinois, Indiana, Iowa, Michigan, and Wisconsin). These states have pursued different fiscal policies over the last decade and have relied on different tax structures to pay for government, yet all are facing significant budget shortfalls.

This article suggests that budget problems during the most recent period are indeed different from past experience. Structural factors seem to be playing a larger role in fiscal stress. As illustrated by the behavior of the five Seventh District states, the roots of fiscal stress vary based on policy actions taken over the course of the last decade. Putting state budgets on a sound footing will require different strategies, depending on each state's choice of tax structure and expenditure commitments.

## Long-run trends in state and local budgets

In this section, I examine broad trends in state and local revenues and expenditures over a number of economic cycles from 1960 to 2002.<sup>2</sup> This period includes recessions in 1975, 1980–81 and 1981–82, 1990–91, and 2001. The most current data for the combined state and local sector is provided by the U.S. Bureau of Economic Analysis in its *National Income and Product Accounts* (NIPA). However, the NIPA data aggregates the sector into broad categories and cannot

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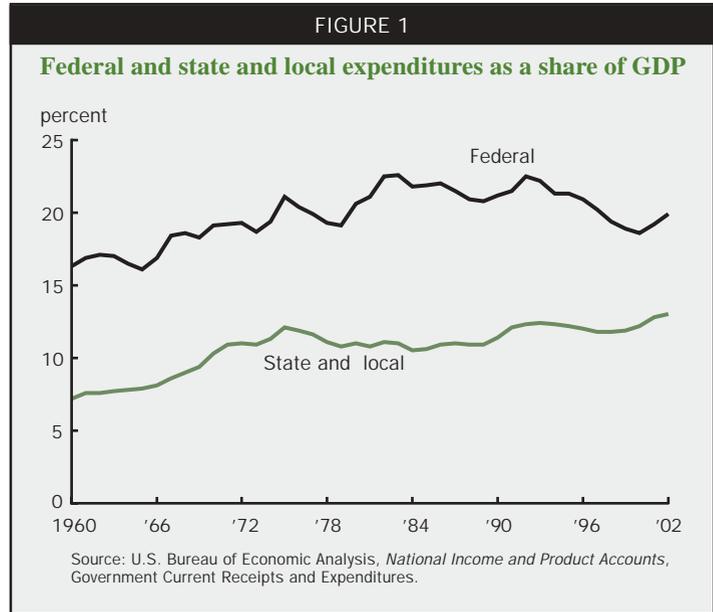
be used to understand spending and revenue trends in specific state and local activities and programs, such as education and welfare. In order to perform this analysis, I use the U.S. Bureau of the Census' *Government Finance Series*; however, this series is produced with a two- to three-year lag, making it difficult to analyze the most recent trends.

As figure 1 shows, the state and local government sector has been growing, measured as current expenditures relative to gross domestic product (GDP). In 1960 state and local expenditures totaled \$38.1 billion or roughly 7 percent of U.S. GDP of \$527 billion. By 2001, state and local expenditures had risen to almost \$1.2 trillion or just under 12 percent of U.S. GDP of \$10 trillion. The sector's expenditures grew fastest during the 1960s.

Over the decade of the 1990s, the state and local share of GDP drifted upward, starting at 11.4 percent in 1990 and ending at 11.8 percent in 2001.

Some of the recent growth of the state and local sector may be explained by trends in fiscal federalism. The federal government share of expenditures measured as a share of GDP fell for much of the 1990s (see figure 1). Much of this can be attributed to declining defense spending. In addition, the federal government continued to transfer program responsibilities to the states as part of a program of fiscal devolution. States complained that this was the era of the unfunded federal mandate, as federal laws required states to pay for more education, regulation, and health care services.<sup>3</sup> While this is partially true, most of the increase in state expenditures appears to be the result of state participation in federal matching programs such as Medicaid and other transfer programs.<sup>4</sup> Programs like welfare and food stamps were added to state budgets and, while these are primarily financed by federal dollars, total state expenditures from all welfare programs grew from 22.9 percent of state expenditures in 1978 to over 30 percent by the late 1990s.<sup>5</sup> In addition, states have taken greater responsibility in funding education. After World War II, states were responsible for financing one-third of K-12 education. By 2000, the state share had risen to about one-half.<sup>6</sup>

According to recent NIPA data, on a current dollar basis, the sector wracked up



a record deficit of more than \$50 billion in 2002 (see figure 2). Adjusted to reflect constant dollars, the deficit would still be five times the size of the 1991 deficit of roughly \$10 billion. Measured as a percentage of expenditures, at nearly 4 percent the 2002 deficit ranks as the largest over the period 1960 to 2002 (see figure 3).

Examining the receipt and expenditure trends in the state and local sector might shed some light on how this deficit occurred. As figure 4 illustrates, the annual percentage change in state and local receipts

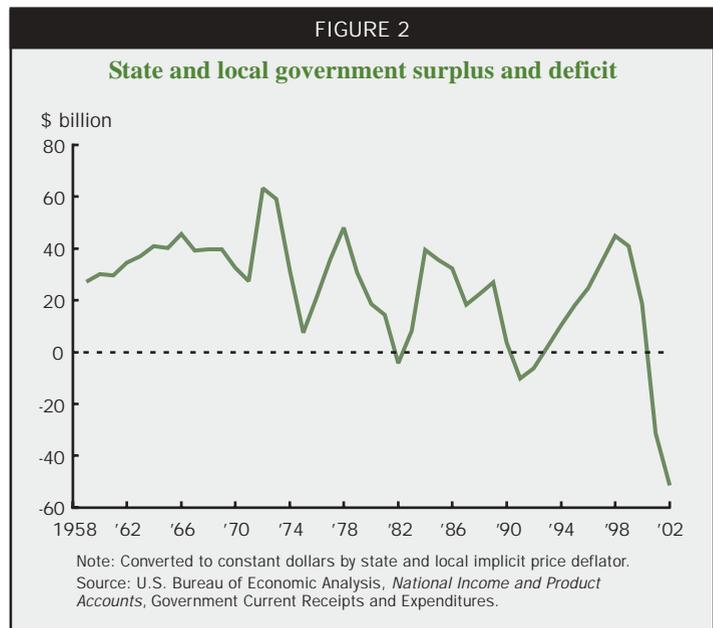


FIGURE 3

State and local surplus and deficit, percent of expenditures, NIPA basis



Source: U.S. Bureau of Economic Analysis, *National Income and Product Accounts*.

and expenditures has some notable highs and lows. During the 1975 recession, state and local receipts fell by 3.5 percent, while expenditures grew by only 1 percent. From 1979 to 1983, real receipts fell for four consecutive years, with expenditures falling for three of those years. In the latest cycle, growth in receipts peaked in 1998 and had fallen to 1 percent in 2002 while expenditure growth accelerated. The bulk of the recent decline in receipts has been in the state sector—state tax receipts fell more than 10 percent in the third quarter of 2002.<sup>7</sup>

The current fiscal imbalance in the sector begs the question whether the state and local sector went on a spending binge in the 1990s? As figure 4 demonstrates, constant state and local expenditures grew from 1993 to 2000 in a range of 1.4 percent to 4.0 percent per year, which is not extraordinary by historical standards. However, it is clear that expenditure increases began to grow fastest just as receipts began to fall.

Real receipts in the sector demonstrated a somewhat u-shaped pattern over the decade of the 1990s. Receipt growth was strong from 1990 to 1995, which partially reflected the tax hikes put into effect following the 1990–91 recession and then fell off and stabilized in the 2 percent to 3 percent range for the middle of the decade. Receipts growth peaked in 1998 at 4.4 percent and then declined to 3.5 percent in 1999, 1.7

percent in 2000, and 1.1 percent in 2001. In 2002, receipts grew by a sluggish 2.3 percent (figure 4).

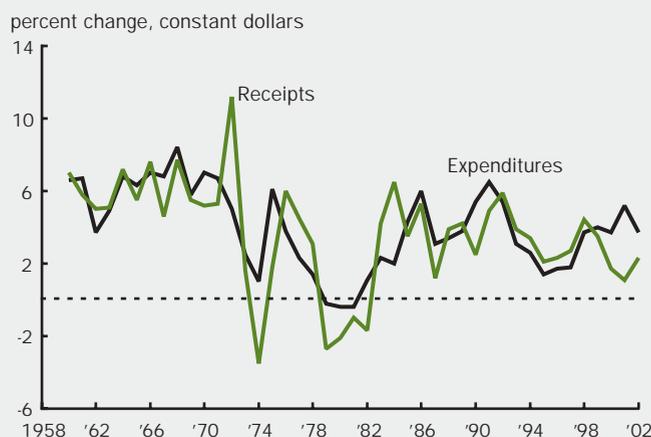
State and local budgets in the 1990s

These broad trends in the state and local sector tend to mask the structural changes that were occurring. On the expenditure side, states increased their spending on education, health care, and public safety functions, and all of these functions grew to take a somewhat larger share of the state and local budget pie. On the revenue side, the personal income tax grew in its importance. In many states the personal income tax supplanted the general sales tax as the largest single tax source. Several states also undertook tax reforms that increased their reliance on state tax sources while lessening the local property tax burden. The decade saw a great deal of reshuffling of state and local responsibility and an increased expenditure emphasis on specific programs.

Using the Bureau of the Census, *State and Local Government Finance* series, it is possible to examine the change in revenues for the sector by revenue source. Revenues grew at significantly different rates over this period. Comparing two years, state and local revenues in 1990–91 versus 1999–2000,<sup>8</sup> general own source revenues for state and local governments grew at a real rate of 25.9 percent. However, among

FIGURE 4

State and local receipts and expenditures



Note: Converted to constant dollar by state and local implicit price deflator. Source: U.S. Bureau of Economic Analysis, *National Income and Product Accounts*.

TABLE 1		
State and local real revenue growth by source, 1990–91 versus 1999–2000		
	Percent	Average annual
General own sources	25.9	2.59
Personal income tax	47.6	4.76
Sales tax	31.4	3.14
Corporate income tax	21.7	2.17
Property tax	11.4	1.14
Gross state product	34.0	3.40
Population growth	11.4	1.14

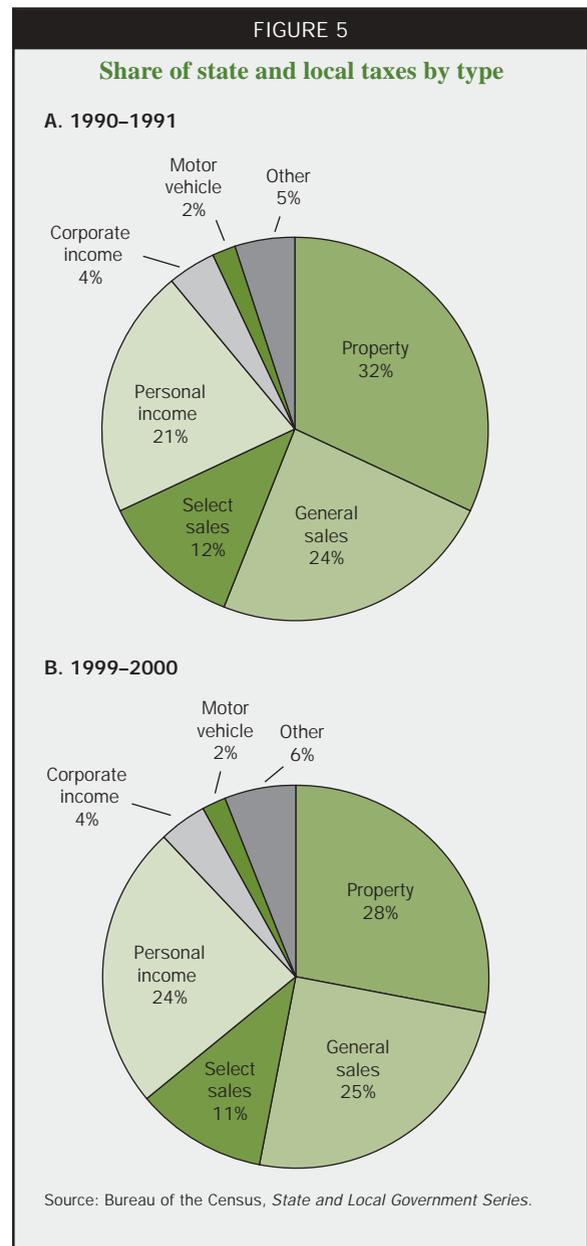
Sources: U.S. Bureau of the Census, various years, *State and Local Government Finance Series*, and author's calculations.

the major tax bases, growth rates ranged from 47.6 percent for the personal income tax, to 31.4 percent for the sales tax, 21.7 percent for the corporation income tax, and 11.4 percent for the property tax. To place these growth rates in perspective, real gross state product grew by 34 percent over the same period (see table 1). These different growth rates led to a slight shift in the importance of each tax base, most notably an increase in the share of tax revenue raised through the personal income tax (from 21 percent to 24 percent) and a decline in the property tax from 32 percent to 28 percent (figure 5).

The differences in tax growth rates can be explained by several factors.<sup>9</sup> Fox (2003) suggests three structural issues have affected recent state tax performance. The first issue is the relative inelasticity of most tax sources. Tax elasticity and tax buoyancy measure the response of a particular tax to growth or decline in economic activity. Elastic or buoyant taxes tend to grow faster during high growth periods than less elastic taxes. Conversely, elastic or buoyant taxes tend to decline more sharply during recessions. Estimates of tax buoyancy<sup>10</sup> by Bruce, Fox, and Tuttle (2002) show that, on average, only the personal income tax (with an estimated elasticity of 1.76) is an elastic tax base. This elasticity contributed to the growth in personal income tax receipts during the 1990s, particularly in states with strong personal income gains. In contrast, all other major tax bases are relatively inelastic. The authors find that the elasticity of the sales tax is only 0.81. The corporate income tax elasticity was even lower. Interstate corporate tax competition has made it difficult for states to raise corporate taxes.

A second factor has been the narrowing of the tax base. In the case of the sales tax, the base has been eroded through mail order and e-commerce shopping, technology changes, legislated exemptions, and changing

purchasing patterns. Technology changes that have affected the tax base include the digitization of goods such as books, software, and music. These are taxable products when purchased in their physical format, but they often go untaxed when downloaded by computer. In terms of exemptions, the most popular is food (30 states). Drugs are also frequently exempted, and states also have special exemptions designed to spur economic activity. Finally, consumption patterns continue to shift to favor services. In 1979 services represented 47.4 percent of consumption. By 2002, this figure had risen to 58.8 percent.<sup>11</sup> Given that no state has yet implemented broad-based service taxation,



this shift in consumption patterns is eroding the states' tax base.

The corporate income tax has been eroding through legislated exemptions, federal tax base shrinkage, and tax planning and reduction strategies by businesses and corporations. Fox and Luna (2002) find that the effective corporate tax rate has fallen by about one-third since the late 1980s even as the simple nominal rate has edged up slightly. Some of this is due to the states' own actions. One of the more common devices has been to adopt single (sales only) factor apportionment formulas or other favorable (double-weighted sales) apportionment factors for determining tax liability. These devices are usually proposed to support economic development by lowering the tax burden for firms located in the state with significant out-of-state sales. This is in contrast to the former three-factor formula that based tax liability on property, payroll, and sales. The net effect is that single sales factor and double-weighted sales formulas narrow the tax base. Changes in the federal corporate tax base have also been important. Virtually all states use the federal definition for profits as a starting point for calculating tax liability. Federal tax changes regarding depreciation and tax sheltering have reduced taxable profits and, thus, the state corporate tax base.

Property tax growth was constrained during the 1990s for several reasons. First, many states and localities adopted property tax limitation requirements that limited the rate of tax increase. Second, several states (Michigan and Wisconsin, for example) introduced measures to reduce property tax burdens through tax swaps, whereby certain state tax bases were raised in conjunction with local property tax cuts and increased state aid to localities, particularly in the form of paying for K–12 education.

On the expenditure side, education and social service and income maintenance programs dominate. Combined, these two areas consume 51 percent of all direct state and local expenditures. As was the case with revenues, some program areas (when measured at 1990–91 levels versus 1999–2000 levels) grew at faster rates during the 1990s, but the overall emphasis on education and social services remained relatively constant (see table 2). Using the Bureau of the Census, *State and Local Government Series*, real direct expenditure growth was roughly 22 percent. The fastest growing major program category was public safety,<sup>12</sup> growing at 30.3 percent. Education<sup>13</sup> grew at 29.5 percent. Growth rates in the social service category varied. While the public welfare component of this category grew at 21.3 percent, the health component grew at 40.7 percent. The difference reflects policy changes

over the decade. Welfare reform reduced the welfare rolls and helped contain costs. In the health sector, Medicaid program expansions and health care inflation led states to devote a greater share of their budget to health programs (see table 2). In addition, the 1990–91 recession increased expenditures for health and welfare programs in that year, while strong economic growth in 1999–2000 reduced expenditure pressures. One area that did not grow particularly fast over this period was state and local government salaries. Real growth in salary expenditures was 15.4 percent.

### Related literature

Several studies have examined whether the current fiscal problems facing the states differ significantly from the experience in previous economic cycles. Knight, Kusko, and Rubin (2003)<sup>14</sup> examined this question using NIPA data by disaggregating the possible causes of the deficit. The paper examines the relative contributions of macroeconomic factors (the slowdown in the economy), changes in capital gains realizations, and changes in state policy, such as tax actions and spending increases, to help explain what is driving the deficit. The authors consider the slowdown in the economy and capital gains realizations to be largely outside the state and local sector's control, while policy changes are within the sector's control. A significant contribution of the study is that it contrasts the effect of these factors with prior periods of fiscal stress (1978 to 1982, 1989 to 1991). To perform the analysis, the authors use a high-employment budget framework to isolate the effects of the business cycle on state and local budgets.<sup>15</sup> This framework calculates the budget surplus or deficit by adjusting tax receipts and outlays to the levels they would attain if the economy were operating at its potential (with potential defined as the highest level of economic output that can persist without raising inflation).

"The bottom line of this analysis," say Knight, Kusko, and Rubin, "is that neither the cyclical

TABLE 2

#### State and local real revenue growth by major program, 1990–91 versus 1999–2000

	Percent	Average annual
Total direct expenditures	22.0	2.20
Public safety	30.3	3.03
Education	29.5	2.95
Public welfare	21.3	2.13
Health	40.7	4.07

Sources: U.S. Bureau of the Census, various years, *State and Local Government Finance Series*, and author's calculations.

weakness in the economy, when measured relative to its potential level, nor the direct effects of capital gains realizations, when measured relative to their long-run trend, account for very much of the deficit in 2002. *The implication is that the current deficit is largely structural and thus unlikely to be eliminated in the absence of significant budgetary actions by these governments (italics added).*”<sup>16</sup> The authors find that economic weakness was the primary contributor to budgetary difficulties in the periods from 1978 to 1982 and 1989 to 1991. They suggest that the primary policy contributors to the 2002 deficit were state tax cuts enacted during the 1990s and increases in Medicaid expenditures.

Other analysts have pointed to a difference in tax policy responses as aggravating state fiscal conditions most recently. Maag and Merriman (2003)<sup>17</sup> compare state tax policy changes in response to the 1990 and 2001 recessions. The authors find that in the most recent episode, major state tax revenues (income, general sales) have performed quite sluggishly compared with the 1990–91 recession. In the case of the income tax, in 1990 revenues began to increase only one calendar quarter later than GDP recovered and rose to pre-recession level within five quarters. In 2001, state revenues continued to fall even after GDP recovery had been underway for four consecutive quarters.<sup>18</sup> The authors suggest that it is this change in revenue pattern that has been different in the most recent recession. Possible reasons for this revenue decline include state income taxes becoming more volatile and relying more on income from equity investments and declines in the sales tax base associated with the growth in Internet sales.

More importantly, the authors suggest that it has been the states’ tax policy response that has delayed revenue recovery. In the late 1980s and early 1990s, states enacted significant tax increases. According to National Association of State Budget Officers data, states made modest net increases to taxes even prior to the 1991 recession. FY1988 through FY1990 saw net tax increases of slightly less than \$1 billion (in FY1989) to \$4 billion (in FY1990). However, it was the sharp tax increases in 1991 and 1992 that were notable. Net tax increases were \$10.3 billion in 1991 and \$14.2 billion in 1992. In addition, the largest increases were across the major tax bases—personal income and sales. In all, 16 states enacted personal income tax increases in 1991 and 20 followed suit in 1992.

In contrast, the authors suggest that the tax policy reactions to the 2000 recession were smaller in magnitude and different in character. Figure 6 illustrates the net revenue raised by each tax base (as a

percent of the previous year’s tax revenue) that could be attributed to tax policy changes, such as increases in the rate or broadening of the base. Not only were total net tax changes smaller in FY2002 and FY2003 than in FY1991 and FY1992, but the increases were relatively restrained in the large tax bases of personal income and sales. Tax increases were largest in tobacco and business income. This slow revenue response has been a feature of the most recent state fiscal problems and may be contributing to the prolonged slump in the sector after a relatively mild national recession.

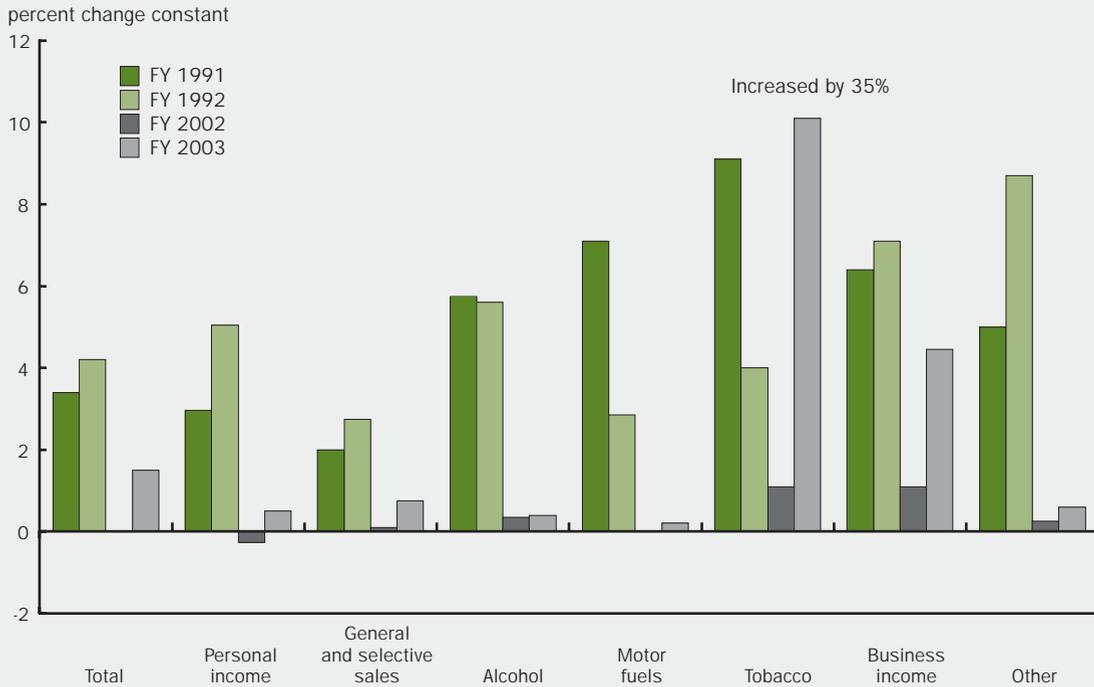
Both of these studies lead to a similar conclusion that much of the problems facing the sector this time around are related to state policy actions. Both expenditure and revenue policies have created problems. On the expenditure side, states (often prodded by federal matching grants) have expanded Medicaid services and eligibility. Similarly, they have increased school spending in response to demands for higher performance standards at both the state and federal level. States have adopted stricter sentencing laws that have increased prison costs. Recently, increased security costs in response to the September 11th, 2001, terrorist attacks have pressured state spending. On the revenue side, shifts in economic activity have narrowed tax bases (shift from goods to service consumption), but states have failed to take corrective action. This suggests that the sector is facing a structural rather than cyclical problem.

### Economic determinants of state and local budget cyclicity

To understand what policy prescriptions might work best to balance the states’ books, we must first understand the interplay between the factors that affect how any state will respond to a slowdown in the economy. These include the industrial structure of the state’s economy, its mix of taxes and their relative volatility, the breadth of the state’s tax base, and demographics in the state that might influence what services are required. For example, consider a hypothetical state that has a relatively balanced tax structure (similar reliance on income and sales taxes), broad tax bases, and a heavy reliance on manufacturing firms. Given that the recent recession was led by the manufacturing sector, the resulting declines in the taxable manufacturing wage base and manufacturing corporate income may explain a significant portion of the state’s budget deficit. If state policymakers believe that the manufacturing downturn is cyclical, their policy response might be to use one-shot budget measures to hold the state together while waiting for a recovery in the manufacturing sector. On the other hand, if policymakers believe

FIGURE 6

Fiscal year net tax policy change as a share of prior calendar year revenue in two recessions



Source: Maag and Merriman (2003).

that the downturn in manufacturing is a structural phenomenon, they may choose to alter the state's tax and expenditure policies to reflect a change in the level of state economic activity.

Tax structure plays a significant role in the cyclical response of a state to a downturn. On average, 34.5 percent of state taxes came from sales taxes and 37.4 percent from individual income in 2001.<sup>19</sup> However, this varies significantly from state to state. For example five states (Alaska, Delaware, Montana, New Hampshire, and Oregon) have no general state sales tax. Seven states (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming) have no personal income tax. This reliance on a single major tax base can create fiscal pressures if economic conditions reduce either taxable consumption patterns or personal income. In the case of two neighboring states—Washington and Oregon—Washington raised nearly 64 percent of its state tax revenue through the sales tax, while Oregon raised nearly 75 percent of its tax revenue through the income tax. While both states have faced deficits during the recent recession, Oregon's has been far worse as high unemployment has reduced personal income, significantly reducing income tax receipts. Washington has faced similar economic

conditions, but has seen the less elastic sales tax hold up better over the cycle.<sup>20</sup> Even states with both major tax sources may rely more heavily on one base than another. California receives almost 50 percent of its revenue from income tax; the sales tax accounts for 27 percent. In Mississippi, sales taxes raise 49 percent of tax revenue, while income tax accounts for 22 percent.

Demographics are also important. States with relatively larger populations of young and old face special expenditure problems, related to K–12 education and Medicaid, respectively.

Finally, states can try to cushion themselves against cyclical pressures by instituting rainy day funds. These are state savings programs designed to accumulate balances during good times with reserves being spent when recessions occur. During the most recent recession, rainy day balances peaked at 5.85 percent of expenditures in 2000.<sup>21</sup> When these funds were combined with other state balances, states had reserves of slightly more than 10 percent (\$48.8 billion) of expenditures in 2000. The funding of state rainy day programs tends to be uneven, however, with the bulk of the balances being carried in only four states. Further, if states are facing structural deficits, rainy day funds are not designed to address this type of fiscal pressure.

## Dealing with the problem

In FY2003 states tried to address the expenditure side of the equation primarily by “spreading the pain.” According to a survey by the National Conference of State Legislatures,<sup>22</sup> 29 states opted for across the board spending cuts by all agencies. Other significant targets included higher education and Medicaid, with 13 states opting to trim these budgets. In FY2004 it appears that in addition to these areas, local revenue sharing and K–12 education will be added to the list.

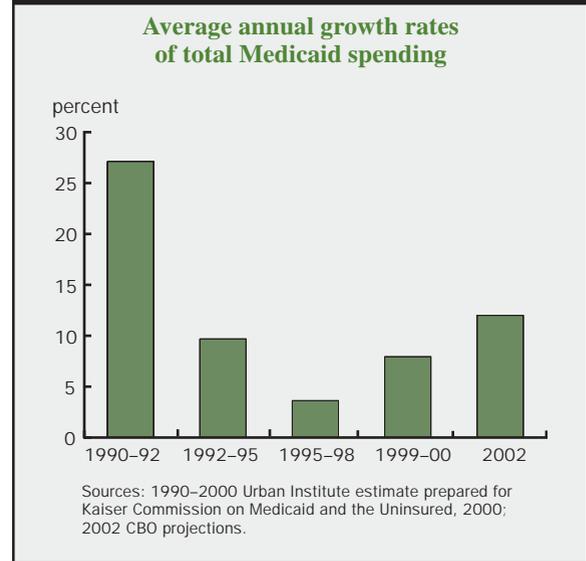
A particularly popular emerging strategy is to focus on Medicaid and health care costs. A report from the Kaiser Commission on Medicaid and the Uninsured<sup>23</sup> makes it clear why Medicaid will receive special attention in state budgets. To begin with, it is important to understand the scope of Medicaid’s role in the health care system. Medicaid provides health insurance coverage for 44 million Americans and one in five children. It is the single largest source of federal grants to states and pays for half of all nursing home care. Roughly 15 percent of state general fund expenditures are devoted to Medicaid.

Recently the rate of spending growth in Medicaid expenditures (and in health care in general) has accelerated. First, Medicaid spending responds to recession. However as figure 7 demonstrates, average annual spending growth rates began to accelerate after a period of very slow growth in the middle of the 1990s. This has paralleled the experience with general health insurance premiums, which have also seen a rapid run-up in costs in 2000 (8.3 percent) and 2001 (11 percent).<sup>24</sup> Medicaid expenditure growth has been driven by increasing drug costs, higher provider rates, expanded enrollment, and increases in the number of long-term care patients. Prescription drug costs have received particular attention, as annual costs from 1998 to 2000 rose by 19.7 percent.<sup>25</sup> Another key contributing factor has been the demographics of the Medicaid population. While the growing elderly and disabled population make up only 27 percent of Medicaid enrollees, they account for 67 percent of total expenditures and accounted for 57 percent of the growth in federal Medicaid expenditures in 2001–02 (figure 8).

In an effort to reign in spending increases, four general strategies were applied by most states in FY2003. These were:

- Controlling pharmacy costs, including requiring prior authorization before a prescription can be written and filled, instituting preferred drug lists, lowering payments for drug products, and instituting or increasing patient co-pays;
- Instituting payment cuts, freezes, or limited increases for health care providers;

FIGURE 7



- Restricting or cutting Medicaid program eligibility and benefits; and
- Cutting and freezing administrative budgets related to Medicaid.

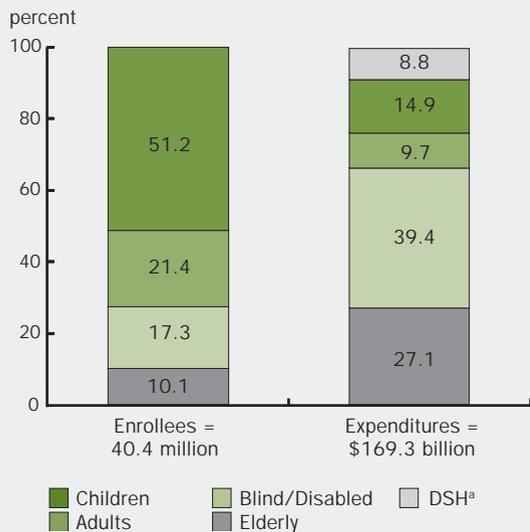
Many states are also seeking waivers for federal rules for pharmacy and other programs in the hopes that greater flexibility will make it easier to meet budget challenges.

Ironically, one of the problems with cutting Medicaid budgets is that it reduces the size of federal Medicaid grants. This is particularly hard for states whose federal Medicaid assistance percentage (FMAP) is above the minimum level of 50 percent. Essentially these states lose more than \$1 in federal revenue for every \$1 reduction in state spending. In all, 25 states had FMAPs of greater than 60 percent in FY2002 (including the Seventh District states of Indiana and Iowa). Ten states and the District of Columbia had FMAPs of 70 percent or more. Of the other Seventh district states, Illinois had the minimum FMAP of 50 percent and Michigan and Wisconsin had FMAPs of between 51 percent and 60 percent.

States are clearly reluctant to make changes in the major tax bases such as sales or income. This is in clear contrast to tax increases passed in response to the 1990–91 recession.<sup>26</sup> Instead “revenue enhancements” have been concentrated in selective sales taxes, sin taxes, or increases in licenses and fees. These have been seen as more politically palatable. However, many of these narrow taxes and fees lack the broad revenue raising capacity to close the shortfalls facing the states.

FIGURE 8

**Medicaid enrollees and expenditures by enrollment group, 1998**



<sup>a</sup>Disproportionate share hospital payments.  
Source: Urban Institute estimates, based on HCFA-2082 & HCFA-64 reports.

Broad-based revenue strategies that appear popular include increased use of bonds to pay for projects that previously may have been funded out of operating expenses and securitizing proceeds from the tobacco settlement awarded in 1999. The use of debt to carry the states through the current doldrums has been popular because low interest rates have made refinancing government debt and new debt issuance attractive. However, states are reaching their debt limits and the deteriorating fiscal conditions have landed 17 states on the credit rating agency Moody’s “negative outlook” list for a possible credit rating cut. Five states, California, Illinois, Kentucky, Oregon, and North Carolina have seen reductions in their credit rating since the fall of 2002 and all of these states will face higher borrowing costs as a result.<sup>27</sup> Still, in the absence of more sustained economic growth, it is unlikely that these revenue remedies will be sufficient.

**The state and local government sector in the Seventh District**

What has been the experience of the Seventh District states in the most recent economic cycle? Each of the five states in the District has unique spending and revenue patterns, which have influenced their responses to budget difficulties. One way to measure this diversity relative to the national average is to examine

taxes and expenditures relative to personal income in each state (see tables 3 and 4). As a percentage of income, the combined state and local tax burden is the lowest in Illinois (10.8 percent of personal income, state rank of 33) and Indiana (10.6 percent of personal income, state rank of 40), with both taxing at levels below the U.S. average. In Iowa and Michigan, the tax burden is roughly equal to the U.S. average at a little over 11 percent of personal income. Only Wisconsin can be characterized as being a high tax state relative to the U.S. using this measure, with state and local taxes equal to nearly 13 percent of personal income and a state rank of 5. However, what is notable in the Seventh District is the variance in the distribution between state and local tax sources. While Illinois has the lowest state tax burden of the five states, its reliance on the local property tax means that it has the highest local tax burden of the group. Conversely, Michigan has a high state tax burden that is balanced by a very low local tax burden. In general, the table shows that Seventh District states rely more on state tax sources to raise revenue than on local sources.

On the expenditure side, both Iowa and Wisconsin have relatively high combined state and local spending levels, measured as a percentage of personal income (table 4). While the U.S. average for state and local combined general expenditures is 19.4 percent of personal income, Wisconsin’s expenditures ran at 21.5 percent of personal income and Iowa’s at 21.4 percent. Illinois ranked 46th in the nation in this category with expenditures at 17.2 percent of income. When it comes to the distribution of spending between the state and local governments, Iowa, Michigan, and Wisconsin have state expenditure levels as a percentage of income above 14 percent (versus the U.S. average of 12.4), Indiana is close to the national average, and Illinois is significantly below that average at 9.9 percent. For local expenditures, the range is tighter but Wisconsin and Michigan earn a higher-than-average ranking for local expenditures relative to personal income. Of course, part of the explanation for this is that the use of a personal income measure benefits a relatively higher income state like Illinois. As I discuss below, the states’ individual revenue and expenditure policies, combined with economic trends, underlie the fiscal problems in each state.

**Illinois**

Illinois’s fiscal problems are influenced by its tax structure. The state raises similar shares of taxes from both major bases, personal income and sales (although it is slightly more dependent on the income tax). From a structural tax base perspective, Illinois would appear to be proportionately more reliant on

TABLE 3

**State and local taxes as percentage of personal income, FY2000**

	State/local taxes	State rank	State taxes	State rank	Local taxes	State rank	Per capita personal income (U.S. = 100)
Illinois	10.8	33	6.1	43	4.7	10	108.4
Indiana	10.6	40	6.5	36	4.0	23	91.9
Iowa	11.1	23	7.1	25	3.9	27	89.6
Michigan	11.4	19	8.2	13	3.2	40	100.2
Wisconsin	12.9	5	8.7	7	4.2	20	96.8
U.S.	11.2		6.9		4.3		

Source: Rockefeller Institute, "State & local government gateway," available at [http://stateandlocalgateway.rockinst.org/fiscal\\_trends/state\\_rankings/tables/ranktot39slg](http://stateandlocalgateway.rockinst.org/fiscal_trends/state_rankings/tables/ranktot39slg).

the local property tax than is the case for most states. For the nation as a whole, property taxes account for roughly 28 percent of the total taxes raised by state and local governments. In Illinois, property taxes in 2000 accounted for 36 percent of total state and local taxes. Other states in the region have historically had relatively high property taxes as well. However, Michigan and Wisconsin made a policy choice in the 1990s to reduce the local property tax burden and to provide better equalization of local school funding by increasing state taxes and lowering the property tax. Many states throughout the nation took similar actions in response to lawsuits aimed at reducing disparities in local school funding.

Several commissions examining Illinois's tax structure have suggested a similar approach to improving the state's finances. In 2002, the Education Funding Advisory Board recommended raising state income and sales taxes by \$5.3 billion to provide \$3.5 billion in property tax relief and \$1.8 billion in additional school funding. Implementing such a restructuring in Illinois requires changes to the income tax. The state constitution mandates that the state should have a flat

rate income tax. Given the low nominal rate (3 percent), the income tax allows few exemptions for low-income households and requires that a typical family of four starts paying the tax at around \$8,000 in income. This makes Illinois's income tax regressive relative to states with graduated income tax structures. Without a constitutional amendment to change the flat-tax requirement, increasing the flat rate would only aggravate this situation. In addition, the constitution mandates that the corporate income tax cannot have a rate greater than eight-fifths of the individual income tax rate. This effectively means that the corporate income tax rate of 4.8 percent cannot be increased independently. Corporate income tax collections are also affected by the use of a single factor (sales-only) apportionment formula for calculating state tax liability. This means that the 4.8 percent tax rate is applied only to corporate income in proportion to in-state sales; multistate corporations operating in the state but selling outside the state pay no tax. Other factors, such as payroll and property, are not considered.

Illinois's system has another couple of notable features. Most prominent is that all retirees' pension

TABLE 4

**State and local expenditures as percentage of personal income, FY2000**

	State/local expenditures	State rank	State expenditures	State rank	Local expenditures	Local rank	Per capita personal income (U.S. = 100)
Illinois	17.2	46	9.9	47	10.6	25	108.4
Indiana	18.6	35	12.4	30	10.5	26	91.9
Iowa	21.4	19	14.4	18	11.4	16	89.6
Michigan	19.8	26	14.1	22	12.0	12	100.2
Wisconsin	21.5	18	14.2	21	12.9	5	96.4
U.S.	19.4		12.4		11.3		

Source: Rockefeller Institute, "State & local government gateway," available at [http://stateandlocalgateway.rockinst.org/fiscal\\_trends/state\\_rankings/tables/ranktot39slg](http://stateandlocalgateway.rockinst.org/fiscal_trends/state_rankings/tables/ranktot39slg).

income is exempt from taxation regardless of the size of the pension. In 2000 it was estimated that this cost the state \$500 million in income tax revenue.<sup>28</sup> Furthermore, like Wisconsin and Michigan, Illinois receives a low return from the federal government for its tax dollars. Because of demographics, a lack of military bases, and the state's relatively high personal income, Illinois received only 78 cents for every dollar that it sent to Washington in FY2002.<sup>29</sup> In terms of the sales tax, the basic state rate is comparable to that of most states but local rate add-ons can significantly boost tax levels. Like most states, Illinois offers significant exemptions in its sales tax and, so far, has failed to capture the growing volume of sales in service-related transactions.<sup>30</sup>

Illinois's FY2004 budget deficit is estimated at roughly \$5 billion. Illinois's recent revenue problems have been blamed on a decline in personal income tax revenues triggered by a sluggish economy. The Illinois Office of Management and Budget has indicated that although sales tax revenues remained relatively flat from FY2001 to FY2003, personal income tax revenues declined by \$525 million in FY2001 (6.6 percent) and \$74 million in FY2002 (1 percent).<sup>31</sup> Governor Blagojevich maintained his pledge to avoid major tax increases to bridge the gap; however, he raised selected fees and business taxes. The state also floated debt to meet its existing pension obligations. In addition, the state implemented widespread expenditure cuts, as well as a number of one-shot revenue enhancements. Illinois did not make any structural changes in its major tax bases. A final policy element that has hurt Illinois recently has been the inability to build a significant rainy day fund balance. By FY2002, the state was carrying less than \$230 million in its budget stabilization fund, representing only 2 percent of state expenditures.

### **Indiana**

Indiana has enacted sweeping tax reform on the heels of an Indiana Supreme Court decision in 1998 that struck down the state's previous property assessment system.<sup>32</sup> Essentially, the court found that over time property assessments bore little relationship to actual property values. To adjust for this would require statewide reassessments based on market values that were expected to increase property tax levies by 33 percent but, more importantly, would result in a sharp reshuffling in tax burdens. Business property taxes would also increase, raising concern about the state's economic development prospects. This response was seen as politically unpalatable.

Instead, a tax study committee headed by the lieutenant governor recommended that the state shift school

funding from local to state sources, eliminate the inventory and gross receipts tax, increase the sales tax rate, and move to a graduated personal income tax. This would permit the state to offer significant property tax relief, while maintaining government programs. The plan that passed the legislature has the state assuming 60 percent of the current property tax burden (primarily by paying a larger share of K-12 education), allowing for a 12.8 percent decrease in property tax payments and doubling the value of the homestead exemption on residential property (from 10 percent to 20 percent) to establish a more progressive property tax structure. The plan is designed to raise \$1.5 billion in state revenues, with \$1 billion earmarked for property tax relief.<sup>33</sup>

Indiana also altered its business tax structure. The state eliminated the gross receipts tax and will phase out the inventory tax by 2007. To compensate for the lost revenue, Indiana raised the corporate income tax rate from 7.75 percent to 8.5 percent. In addition, it doubled the research and development tax credit to 10 percent.

Other changes to replace revenue lost from property tax reductions and business cuts included raising the cigarette tax from 40 cents to 55 cents, raising the sales tax from 5 percent to 6 percent, and some adjustments to gambling taxes. The state legislature rejected a recommendation to introduce a graduated personal income tax. However, it did make the personal income tax more progressive by adopting the earned income tax credit. In all, the tax restructuring increased available state revenues by about \$500 million.

Despite these reforms, Indiana's fiscal situation remains strained. Revenue growth continues to disappoint as the state's economy has been disproportionately affected by the recent recession. As the most manufacturing-dependent state in the nation, Indiana has been particularly slow to recover. Indiana has benefited from the large fund balances it built up during the late 1990s and early 2000. The state's rainy day fund plus its general fund balances exceeded 20 percent of state expenditures in 1997 through 1999. It has needed to draw on these balances in recent years and, by 2002, they were under 4 percent of expenditures.

### **Iowa**

Iowa has one of the more balanced tax structures in the District, with roughly equal shares of revenue being raised from sales, income, and property levies. Like most states, Iowa offers an array of sales and business tax exemptions, and it is estimated this costs the state \$1.2 million in lost revenue.<sup>34</sup> Popular exemptions include farm machinery and agricultural feed.

While some have suggested that reducing the number of sales tax exemptions might help solve some of the state's budget problems, the state has found it difficult to identify any obvious exemptions to target. In addition, Iowa has developed two rainy day funds (the cash reserve fund and the economic emergency fund) to help smooth its performance during economic downturns. The state has carried significant general fund balances, reaching 20 percent of expenditures in 1997 and 1998 and exceeding 10 percent in 2000. By 2002, fund balances had fallen to 5 percent of expenditures.

One obvious target for reform is the state's personal income tax. The source of greatest fiscal pressure has been an unanticipated decline in capital gains tax revenues. Iowa became more reliant on capital gains revenues after 1998, when a tax reform package cut the personal income tax by 10 percent and reduced inheritance taxes. This is estimated to have cost the state \$450 million in revenues.<sup>35</sup> Iowa's personal income tax is relatively complicated, with a significant number of deductions, credits, and exemptions. And at 75 lines, even the tax form in Iowa is significantly longer than in most states. Iowa has also reduced the yield from its income tax by an estimated \$600 million by allowing taxpayers to deduct taxes paid to the federal government. While lawmakers have proposed eliminating or reducing this deduction, it is unclear whether this will meet with much support.

### **Michigan**

Michigan dramatically overhauled its tax structure during the 1990s, largely to meet K–12 education financing needs. The 1994 tax reform raised the state's sales tax (from 4 percent to 6 percent) while lowering property taxes and established a guaranteed minimum per-pupil funding level for all school districts. The shift meant the state was now responsible for roughly 78 percent of school funding compared with just 29 percent prior to the change.

Michigan's state budget is primarily composed of two major funds—the general fund and the school aid fund. The general fund supports most state operations other than K–12 education and is supported by the state business tax and the personal income tax (revenues from both of these sources have declined in recent years). In FY2004, general fund revenues fell to \$7.78 billion, equaling the available revenues in FY1993. In contrast, the school aid fund is supported by a mix of revenue sources, including property and sales taxes and gaming revenues. This revenue mix has proven more stable and has allowed for steady or slightly improving performance in the school aid fund.

Michigan aggressively cut taxes during the 1990s. The state made an estimated \$32 billion in cumulative tax cuts during the decade, including repeal of the intangibles tax on dividends and interest, increased personal income tax exemptions, increased deductions for children, new tax breaks for seniors, phase-out of the inheritance tax, and a five-year decline in income tax rates.<sup>36</sup> The state also added adjustments and exemptions, which had the effect of narrowing the sales tax base.

Michigan has a unique tax feature, the single business tax. Designed to behave much like a value-added tax, this business tax was popular with government finance experts. The tax was also a significant revenue raiser, accounting for 9.4 percent of total state tax collections in 2001 and providing nearly one-quarter (\$2.2 billion) of the revenue in the general fund budget. However, the tax was very unpopular with the state's business community, particularly small businesses. In response, in 1998 the legislature enacted a phase-out of the tax over a 20-year period. The legislature stipulated that the phase-out would be suspended if the state's rainy day fund fell below \$250 million, and, indeed, it was suspended in 2002. In exchange for the suspension, legislators agreed to accelerate the timetable; the tax is now due to be phased out by 2010.

Michigan had built up its budget stabilization fund to 16 percent of expenditures by 2000, but subsequently drew down these balances to 4 percent (as of 2002).<sup>37</sup>

The state's aggressive tax cutting in the 1990s has affected its ability to maintain its commitment to paying for local government. The state has agreed to take on a larger role in funding local government and education, but has whittled down its tax base to a point where revenue sharing is in jeopardy. Yet, local government has only limited ability to raise revenue. The state has placed limits on local property taxes and prohibits cities and counties from levying an income tax. Even local option sales and hotel occupancy taxes are highly restricted in Michigan, and all local tax changes must be approved by the state legislature.

Michigan's revenues have clearly been hurt by the economic slowdown, but estimates suggest that 70 percent of the estimated \$1.8 billion decline in general fund revenues can be attributed to policy actions that reduced the single business tax and the personal income tax.<sup>38</sup> On the expenditure side, the FY2004 budget cut spending for higher education by 10 percent and reduced aid to local governments by 3 percent. The state managed to maintain K–12 education spending at the existing level.<sup>39</sup>

## Wisconsin

Wisconsin has created a different kind of fiscal pressure on its government. On the spending side, it followed a similar path as Michigan by shifting greater responsibility for funding K–12 education to the state. In 1993, the legislature imposed revenue caps on school districts. Much of this was in response to Wisconsin's having the second fastest property tax growth in the nation in the 1980s. To balance the local caps, the legislature also mandated that the state would pay two-thirds of the cost of K–12 education. It was anticipated that the larger state role and the revenue caps would decrease local property taxes by nearly 40 percent.<sup>40</sup>

From all appearances, Wisconsin's problems derive from a tax system that simply fails to produce enough revenue to fund the level of services the state has chosen to provide. The tax structure is remarkably balanced and does not suffer from obvious structural failings. The state has created a joint legislative committee on tax exemptions that has limited the proliferation of tax exemptions found in most states. Even in the case of the income tax, Wisconsin has been less affected than other states by the recent decline in personal income tax receipts, because it had already exempted 60 percent of volatile capital gains income from its tax base.

Wisconsin would also seem to have fewer available revenue options for solving its fiscal problems. For 30 years the state has been in the top ten for most measures of tax burden. Higher taxes would be hard for lawmakers to support and possibly detrimental to economic activity. The state failed to build a rainy day fund in the 1990s, and its budget practice of carrying forward budget balances from the first to the second year of the biennium has helped mask the actual condition of its budget. Wisconsin was among the first states to securitize its tobacco settlement fund revenues in order to have immediate access to those revenues. The state received a payment of \$1.3 billion for a settlement that was valued at \$5.9 billion over 25 years.

A special commission in 2001 examined the state's budget situation and concluded that while the state needed to trim its taste for spending, solving the state's budget problems on the expenditure side only would hurt its economic growth.<sup>41</sup> The panel suggested increasing the state sales tax rate from 5 percent to 6 percent and adding professional and business services to the sales tax base.

In designing the FY2004 budget, Wisconsin cut local revenue sharing by \$50 million, as well as cutting funding to state agencies by 10 percent or \$400 million. In all, 2,300 state jobs will be eliminated. Despite these cuts, the state will fall short of its commitment to pay for two-thirds of K–12 education spending.<sup>42</sup>

## Conclusion

States have always faced periodic budget crises and yet have managed to muddle through. However, the current financial decline appears to be driven by structural factors in both revenues and expenditures. Short-term fixes and incremental changes to make ends meet have failed to return states to fiscal solvency. When choosing a strategy for correcting an imbalance in state and local finances, it is important to examine the structural and cyclical differences that exist between states. Structural issues such as choice and breadth of tax base, structure of the local economy, and demographics all affect state budgets differently. Cyclical issues, such as where a recession's impact is concentrated, must also be considered. While broad trends in funding programs such as Medicaid, education, and prisons have been affecting all states, each state's fiscal response needs to take into account the tax policy and expenditure choices that the state has embraced. For some states, expenditure reductions will be more appropriate and, for others, changes to the basic tax structure may work best.

## NOTES

<sup>1</sup>See Tannenwald (2001) and Orszag (2003).

<sup>2</sup>Because of the heterogeneity in spending between state and local governments across the 50 states, using combined state and local revenue and expenditure data is appropriate. In some states such as Hawaii, the state government is responsible for almost 80 percent of the expenditures for the state and local government sector. In contrast, Florida favors a more decentralized approach with the state and local sectors being responsible for roughly equal shares of total expenditures. The determining factor is usually how K–12 education is paid for.

<sup>3</sup>In a study conducted under the Unfunded Mandates Reform Act, the Congressional Budget Office (CBO) found that over the period 1996–2000, only 9 percent (32) of the bills with intergovernmental mandates imposed annual costs on state or local government of \$50 million or more. See U.S. CBO (2001). State organizations have countered that in 2003, federal unfunded mandates for special education, the No Child Left Behind Act, election reform, and homeland security ranged from \$23.5 billion to \$82.5 billion. See National Conference of State Legislatures (2003a).

<sup>4</sup>Fox (2001).

<sup>5</sup>*Ibid.*, p. 13.

<sup>6</sup>*Ibid.*, p. 14.

<sup>7</sup>Rockefeller Institute (2002).

<sup>8</sup>The use of two data points has some weaknesses. First, 1990–91 was a recession year. Clearly, personal income tax receipts would have been affected by the downturn and this may overstate the degree of change compared with 1999–2000 when the economy was in expansion. The sales and property taxes tend to be less responsive to the business cycle and, therefore, would be less affected by the choice of 1990–91 as the base for comparison.

<sup>9</sup>Fox (2003).

<sup>10</sup>Tax buoyancy measures the percent change in revenue divided by the percent change in the base. Unlike tax elasticity estimates, these measures don't exclude changes in tax rates and bases over time. These estimates were constructed over the most recent business cycle from peak to peak using 1998 to 2000 and from trough to trough using 1991 to 2002.

<sup>11</sup>Fox (2003), p. 12.

<sup>12</sup>Public safety includes police, fire, and corrections. Of these three components, corrections grew the fastest at 36.5 percent.

<sup>13</sup>Education includes higher education, K–12 education, and capital outlays.

<sup>14</sup>Knight, Kusko, and Rubin (2003).

<sup>15</sup>See Kusko and Rubin (1993), pp. 411–423.

<sup>16</sup>Knight et al. (2003), p. 8.

<sup>17</sup>Maag and Merriman (2003).

<sup>18</sup>*Ibid.*, p. 4.

<sup>19</sup>U.S. Census Bureau (2002b).

<sup>20</sup>For example, on a year-over-year basis in 2002, sales tax receipts fell 1 percent in the first quarter, and grew by 1.5 percent, 3.8 percent, and .7 percent, respectively, in quarters two through four. In contrast, personal income tax revenues fell by 14.3 percent in the first quarter and continued to fall by 22.3 percent, 1.6 percent, and .7 percent, respectively, in quarters two through four. See Rockefeller Institute (2002), revenue report database.

<sup>21</sup>National Governors Association and the National Association of State Budget Officers (2002), p. 15.

<sup>22</sup>National Conference of State Legislatures (2003b).

<sup>23</sup>Holahan, Weiner, Bovbjerg, Ormond, and Zuckerman (2003).

<sup>24</sup>Kaiser Family Foundation analysis of state data from HIAA, KFF/HRET, and BLS in 2001.

<sup>25</sup>Growth rate represents changes in total fee-for-service expenditures for the types of service. Kaiser Commission on Medicaid and the Uninsured/Urban Institute Analysis of HCFA-64 data.

<sup>26</sup>See Magg and Merriman (2003).

<sup>27</sup>Wiggins (2003), p. 15.

<sup>28</sup>Institute on Taxation and Economic Policy (2001).

<sup>29</sup>See Northeast Midwest Institute (2003).

<sup>30</sup>Barrett et al. (2003), p. 52.

<sup>31</sup>Illinois Office of Management and Budget (2003), p. 26.

<sup>32</sup>Town of St. Johns vs. Indiana Board of Tax Commissioners, Indiana Supreme Court, December 4, 1998.

<sup>33</sup>Barrett et al. (2003), p. 54.

<sup>34</sup>*Ibid.*

<sup>35</sup>Council of State Governments (2003), p. 9.

<sup>36</sup>Barrett et al. (2003), p. 62.

<sup>37</sup>Council of State Governments (2003), p. 13.

<sup>38</sup>*Ibid.*

<sup>39</sup>Anderson (2003), p. 4.

<sup>40</sup>Sheffrin (1998), p. 133–134.

<sup>41</sup>State of Wisconsin (2001).

<sup>42</sup>Anderson (2003), p. 4.

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